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2021 Economic Reform Programmes of Albania, Montenegro, North Macedonia, Serbia, Turkey, Bosnia and Herzegovina and Kosovo*

The Commission's Overview & Country Assessments

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

2021 Economic Reform Programmes of Albania, Montenegro, North Macedonia, Serbia, Turkey, Bosnia and Herzegovina and Kosovo*:

The Commission's Overview and Country Assessments

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

EUROPEAN ECONOMY

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INTRODUCTION

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

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

In 2021, the Republic of Albania, Bosnia and Herzegovina, Kosovo, Montenegro, the Republic of North Macedonia, the Republic of Serbia and Turkey submitted their seventh annual Economic Reform Programmes covering the period 2021-2023 ([1]). The programmes 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 on 12 July 2021 in the margins of the Economic and Financial Affairs Council meeting.

This paper contains the Commission staff's assessments of the ERPs 2021-2023, preceded by a horizontal overview summarising the key findings from a cross-country perspective, and taking stock of the implementation of the country-specific policy guidance adopted in 2020. The cut-off date for the assessments was 16 April 2021.

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

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([1]) The Economic Reform Programmes can be found at https://ec.europa.eu/neighbourhood-enlargement/policy/policy-highlights/economic-governance_en
([2]) This paper includes at the end of each country assessment the country-specific policy guidance adopted in July 2021.

Part I

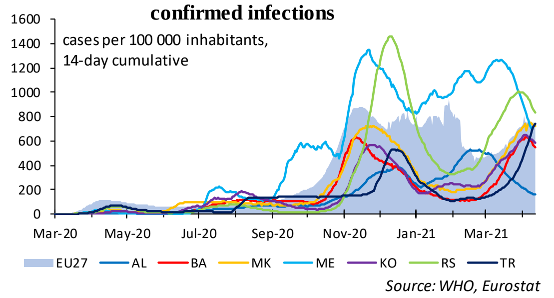
Horizontal Overview of the 2021 Programmes

1. HORIZONTAL OVERVIEW OF THE 2021 PROGRAMMES

1.1. ECONOMIC DEVELOPMENTS IN 2020: IMPACT OF THE COVID-19 CRISIS AND THE POLICY RESPONSE

The COVID-19 pandemic took a heavy toll in the Western Balkans and Turkey. Since the end of the first quarter of 2020, the pandemic has hit the Western Balkans and Turkey in several waves. While the first wave from March to May 2020 led to a limited number of COVID-19-related deaths thanks to the stringent containment measures that were taken from the beginning, the somewhat stronger second wave in the third quarter of 2020 largely subsided before the end of the quarter. The third wave developing in the fourth quarter however took the heaviest toll in terms of infections, hospitalisations and fatalities as a strong seasonal acceleration of the pandemic was accompanied by containment measures of a relatively stable level of stringency. After relatively low levels at the very beginning of 2021, infections and hospitalisations again accelerated in February and March, influenced in particular by the spread of more contagious variants.

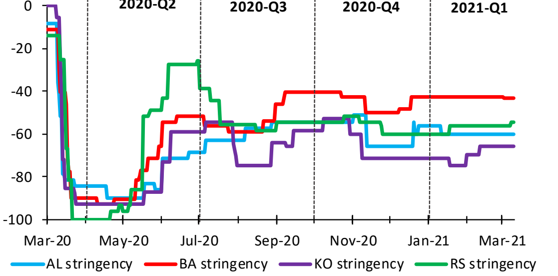
Graph I.1.1: **Evolution of the number of confirmed infections**



Source: WHO, Eurostat

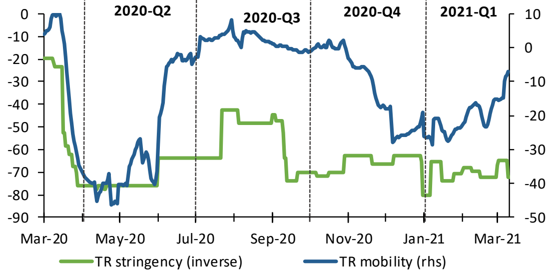
The pandemic had a significant negative impact on economic growth in the Western Balkans and Turkey in 2020. As a result, after a relatively strong pre-crisis growth momentum, all Western Balkan economies suffered a contraction in 2020 while only Turkey, after sluggish growth in 2019, is estimated to have recorded some expansion in 2020. Across the Western Balkans, the depth of the downturn varied widely, ranging from a relatively mild 1% fall in GDP in Serbia to a very sharp output loss of 15% in Montenegro, with Bosnia and Herzegovina (3%), Albania (3.3%), North Macedonia (4%) and Kosovo (7%) recording intermediate levels of contraction. The sectoral structure of the economies, in particular the share of tourism, played a central role in the severity of the economic fallout, accounting in particular for the very sharp contraction in Montenegro. Strong agricultural seasons had a mitigating impact in Serbia and Albania in particular. Differences in the policy response to the crisis, partly due to varying degrees of available policy space, also had an impact on economic outcomes.

Graph I.1.2a: **Western Balkans - stringency of restrictions**



Source: Oxford University

Graph I.1.2b: **Turkey - stringency of restrictions and mobility**



Source: Oxford University, Google COVID-19 Community Mobility Reports

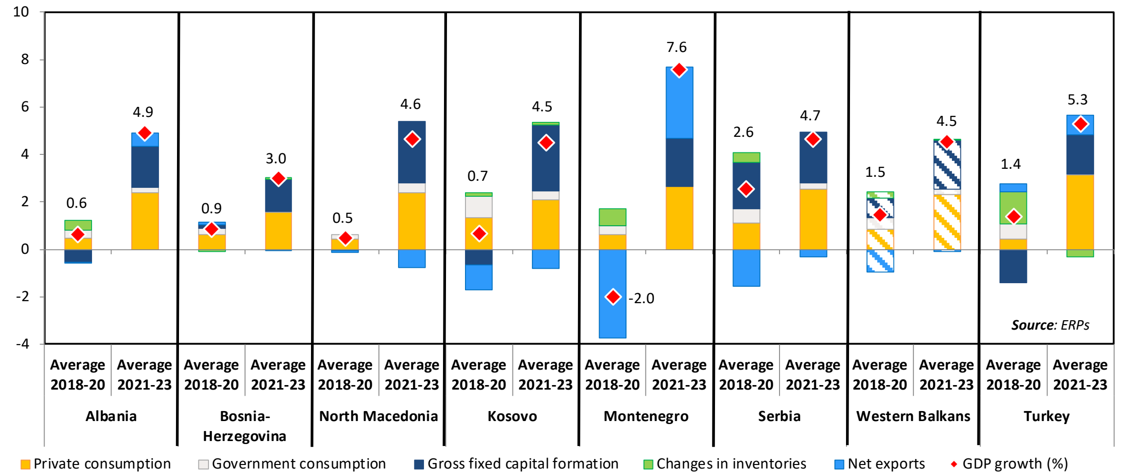
The overall contraction was significantly mitigated by a series of fiscal, monetary and financial support measures in both the Western Balkans and Turkey. Depending on the available fiscal space, the volume of the direct discretionary fiscal support measures varied considerably from around 1% of GDP in Albania and Montenegro, 2% in Turkey, 2.5% in Bosnia and Herzegovina, 3% in North Macedonia, up to 5% in Kosovo and 8% in Serbia. In countries with lower overall volumes of support, the measures were typically more targeted towards enterprises and individuals active in sectors most hit by the crisis. In countries with larger overall packages, such as in Serbia, this tended to be accompanied by broader lump sum support to a large part of enterprises across all sectors as well as cash payments to all households. In both the Western Balkans and Turkey, the direct fiscal support measures were accompanied by liquidity-enhancing state guarantee schemes for loans to enterprises, which reached a volume of up to 4% of GDP in the case of Serbia. A range of liquidity-enhancing measures were also taken by the central banks of the Western Balkans and Turkey, in particular via loan moratoria, as well as market operations and interest rate cuts in the case of Albania, North Macedonia, Serbia and Turkey. In Turkey, the financial sector, led by state-owned banks, provided subsidised credit lines at favourable conditions to households and businesses. To cover the increased budget financing needs triggered by the economic contraction and the discretionary fiscal mitigation measures, the Western Balkans and Turkey resorted to increased market financing but also, with the exception of Serbia and Turkey, to borrowing from international financial institutions. Complementing financing from the IMF and other international financial institutions (IFIs), the EU granted a total of EUR 750 million in macro-financial assistance (MFA) to five Western Balkan partners (in Serbia, however, the increased financing needs were fully covered by tapping domestic and international capital markets). The EUR 750 million MFA was part of the larger EUR 3.3 billion support package for the Western Balkans in response to the COVID-19 pandemic announced by the EU in April 2020 ([3]). By the end of March 2021, the first MFA instalments totalling EUR 250 million had been disbursed to North Macedonia, Kosovo, Montenegro and Albania. Moreover, to spur the long-term economic recovery of the Western Balkans, the EU presented an economic and investment plan that sets out a substantial investment package mobilising up to EUR 9 billion of funding for the region.

1.2. MACROECONOMIC AND FISCAL OUTLOOK

Most of the Economic Reform Programmes (ERPs) project economic growth to rebound strongly in 2021 and to recover or exceed pre-pandemic rates of expansion after that. For most Western Balkan economies, except for Serbia and Albania, the strength of the 2021 rebound is however expected to remain below the 2020 contraction. Thus, only Serbia expects to return to its 2019 level of real GDP already in 2021. Helped by carry-over effects from strong growth momentum in the second half of 2020, the ERP for Turkey projects output to increase by around 6% in 2021, largely exceeding pre-crisis growth rates. Apart from Serbia and Kosovo, most Western Balkan economies are expected to expand faster in 2022-2023 than in 2018-2019, while Turkey projects to maintain a rate of expansion of 5%, substantially above the pre-crisis track record. Both in the 2021 rebound and the 2022-2023 expansion, the key driver of economic growth in both the Western Balkans and Turkey is projected to be domestic demand, primarily private consumption and gross fixed capital formation. While net exports are set to have a slightly negative or neutral contribution to growth in most of the Western Balkans in the rebound and after that, they are expected to contribute positively to growth in countries with a strong tourism sector, i.e. Montenegro and Albania, as well as in Turkey.

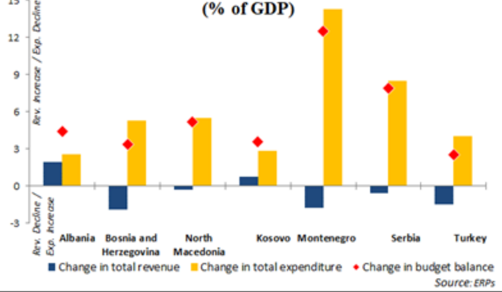
([3]) The other large components of the overall EU support package were loans by the EIB (EUR 1.7 billion) and grant money, mostly from a reallocation of funds of over EUR 800 million under the Instrument for Pre-Accession Assistance (IPA), to be disbursed under various modalities, including budget support. By the end of March 2021, a total of nearly EUR 400 million in grants had been disbursed under the IPA components of the support package.

Graph I.1.3: **Contributions to real GDP growth, percentage points**

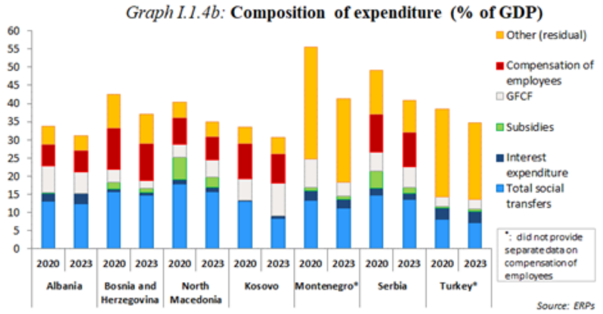


The ERPs' baseline growth projections are subject to a high degree of uncertainty given the protracted impact of the pandemic. Renewed waves of the pandemic both in the Western Balkans and their main trading partners have led to continued or more stringent containment measures in the first quarter of 2021, which risks delaying the recovery as compared to the ERP baseline scenarios. With the exception of the moderate rebound projected for Bosnia and Herzegovina, the risks to the ERP's baseline growth projections are therefore clearly tilted to the downside. In particular, a slower recovery in the EU, the main trade and investment partner of the Western Balkans, may lead to lower demand for their exports (also of tourism services) as well as lower inflows of remittances and foreign direct investment. Furthermore, in most of the Western Balkans' baseline growth projections (in particular for Albania, North Macedonia and Kosovo) the rebound of overall gross fixed capital formation relies heavily on substantial increases in public investment. However, this may be challenging to achieve given persistent weaknesses in public investment management and a track record of low rates of implementation of the capital budget. In Turkey, the recent dismissal of the central bank governor has led to increased uncertainty, and given the country's vulnerability to changes in investor sentiment, this could constrain the strength and durability of the recovery. All ERPs acknowledge the high level of uncertainty surrounding their baseline scenario and include at least one lower growth scenario; however, these lower growth scenarios are not always well-elaborated and remain in general relatively benign.

Graph I.1.4a: **Fiscal adjustment 2020-23 (% of GDP)**

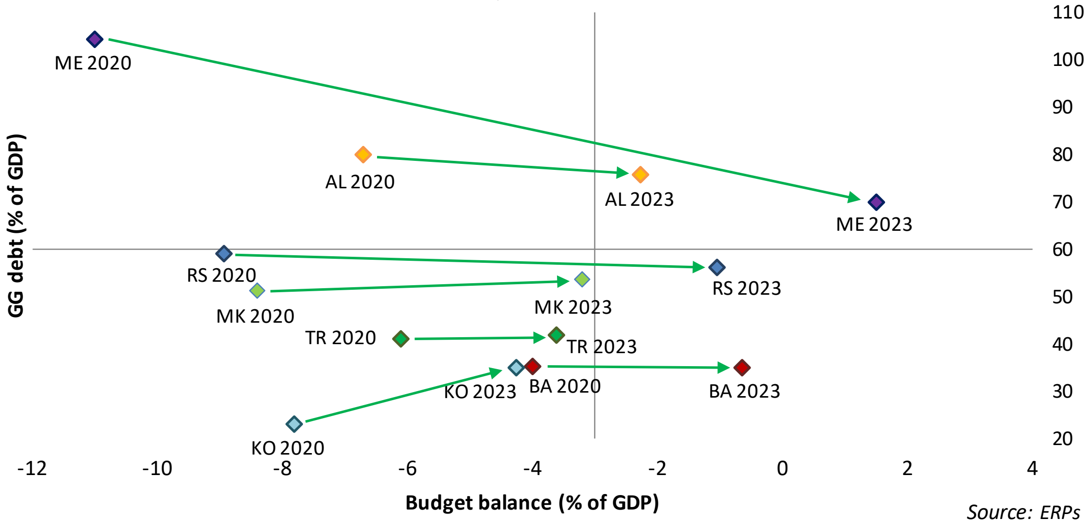


Graph I.1.4b: **Composition of expenditure (% of GDP)**



Following crisis-related high fiscal deficits and substantial increases in the debt-to-GDP ratio in 2020, gradual fiscal consolidation is planned to start in 2021 or 2022. The combination of discretionary fiscal support measures, automatic stabilisers, large revenue shortfalls and nominal GDP contraction (except for Serbia) led to high fiscal deficits in the Western Balkans in 2020, ranging from an estimated 4% of GDP in Bosnia and Herzegovina, 7% in Albania, 8% in Kosovo, Serbia and North Macedonia, and up to 11% of GDP in Montenegro.

Graph I.1.5: **Projected changes in budget balance and GG debt, 2020-23**

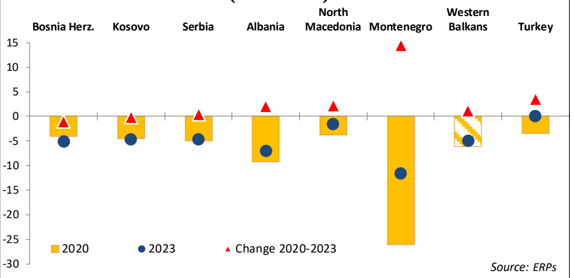


Source: ERPs

In Turkey, thanks to buoyant tax revenue and limited discretionary fiscal support measures, the general government deficit is expected to have been kept significantly below the ERP target of 6.1% of GDP, implying a significant fiscal tightening in 2020. For the Western Balkans, the ERPs project a gradual improvement of the budget balance over the programme horizon, starting already in 2021 for Montenegro, Serbia, North Macedonia and Bosnia and Herzegovina, and in 2022 for Albania and Kosovo. The improvement is mostly projected to be achieved via a decrease in spending, reflecting in particular the phasing out of crisis-mitigation measures. Only Albania and Kosovo also project increases in their revenue-to-GDP ratios. However, the protracted impact of the pandemic and the ensuing renewed or additional fiscal support measures are already set to delay or decelerate fiscal consolidation. After surging across the Western Balkans in 2020, the public debt-to-GDP ratio is projected to record some further increase in 2021 in Kosovo, North Macedonia, Bosnia and Herzegovina, and, taking into account the recently renewed crisis support, also in Serbia, while Montenegro and Albania project the debt burden to start falling already this year. In 2022 and 2023, only Kosovo projects further increases of its (relatively low) debt ratio. North Macedonia expects broad stabilisation while highly indebted Montenegro optimistically forecasts a particularly large decrease in the public debt ratio. The remaining Western Balkan ERPs project a gradual decline of their debt ratios. The main driver of the expected debt decrease is the favourable snow-ball effect, as the rate of nominal growth is projected to again exceed the effective interest rate for all Western Balkan economies as of 2021. Turkey's ERP projects a slight decrease of the deficit level to below 4% of GDP (close to the 2020 outturn) and stabilisation of the debt ratio at around 41% throughout the programme period.

Current accounts deficits are mostly forecast to narrow over 2021-2023. In most of the Western Balkans and in Turkey, the crisis triggered a substantial deterioration of the current account balance. This was mostly driven by lower exports of services by countries with large tourism sectors such as Montenegro, Turkey and Albania, and by significantly lower inflows of remittances in most of the Western Balkans except for Kosovo and Montenegro. A lower goods trade deficit and lower reinvested earnings provided some offset across the countries, which even led to a marked improvement in the overall current account balance in Serbia. The 2021 rebound is projected to lead to a widening current account deficit in Serbia, Kosovo and Bosnia and Herzegovina, while the external balance is projected to improve in Montenegro and Turkey (in particular due to the gradual recovery of inbound tourism) and in Albania and North Macedonia (in particular due to the recovery of workers' remittances). For 2022 and 2023 all Western Balkan ERPs except Bosnia and Herzegovina's project a decline of their current account deficits while Turkey even expects to reach a balanced current account by 2023. These projections are subject to large uncertainties, in particular related to the recovery of tourism. In terms of securing the necessary external financing, the Western Balkans expect to continue to rely mainly on foreign direct investment inflows. As for external borrowing, several Western Balkan countries (Serbia, North Macedonia, Montenegro and Albania) managed to tap international markets and issued sizeable Eurobonds at favourable terms in 2020-2021. However, a potential tightening of global financial conditions might have negative repercussions on capital flows into both the Western Balkans and Turkey.

Graph I.1.6: **Evolution of current account balances (% of GDP)**



Source: ERPs

Note: Western Balkan countries are presented in increasing order of the change between 2020-2023

Inflation is projected to remain at moderate levels in the Western Balkans while Turkey faces continuing large price pressures and significantly above-target inflation. After a crisis-induced trough in 2020, inflation is projected to rebound in the Western Balkans in 2021 and to remain at moderate levels after that, supported by gradually recovering domestic demand and low imported inflation. For Turkey, despite a decrease in average annual inflation in 2020 and substantial monetary tightening since November 2020, consumer price inflation accelerated to 15% y-o-y at the end of 2020, far above the central bank's 5% target. The ERP's envisaged disinflation path, which expected inflation to reach 5% by 2023, was too ambitious and has since been revised. The authorities' intention, outlined in the ERP, is to maintain a tight monetary policy stance until 2023, which is necessary to anchor inflation expectations, stabilise the exchange rate, reduce dollarisation, and rebuild foreign exchange reserves. The course of inflation will depend on the future orientation of monetary policy, which is subject to particularly large uncertainty given the abrupt and unexpected dismissal in March 2021 of the central bank governor after only 4 months in office.

1.3. MAIN CHALLENGES

While further support to households and businesses most affected by the crisis appears necessary until the economic recovery has been firmly established, structural reform implementation needs to accelerate to foster a sustainable recovery in the medium-term. The pandemic had a deep recessionary impact in the enlargement region that was partially cushioned by fiscal, monetary and financial support measures. The protracted impact of the pandemic and continued high uncertainty calls for maintaining support to businesses and households until the economic recovery is firmly entrenched. At the same time, structural reform implementation should regain momentum to achieve a sustainable recovery, boost potential growth and strengthen resilience in the medium-term. Overall, the main challenges that will need to be tackled in the upcoming period concern the following areas:

First, fiscal policy will need to provide further crisis-mitigation support for as long as is necessary. After that, provided the recovery becomes well entrenched, deficit and debt levels will gradually

need to be consolidated, while ensuring a high level of efficient growth-enhancing spending. Given the protracted impact of the pandemic and continued uncertainty, fiscal policy will continue to operate in an exceptional situation in 2021 and will need to maintain support for businesses, jobs and households where necessary. At the same time, support measures should be well targeted, temporary and transparent to maximise their cost efficiency and avoid creating lasting market distortions or permanent entitlements. Conditional on a well-entrenched economic recovery, a well-calibrated return to a more prudent fiscal position appears feasible and desirable in the 2022 budget and in the updated medium-term financial frameworks to ensure gradual debt reduction and rebuild fiscal buffers. In this context, more should also be done to shift budgets towards a more growth-oriented composition to accelerate the recovery, in particular by fostering the digital and green transitions. While governments considerably expanded capital spending in percentage of GDP in Albania, Serbia and Bosnia and Herzegovina in 2020, only Serbia plans to maintain and further increase this share over the programme horizon. For all partners, to durably maximise the growth-enhancing effect, increased capital expenditure needs to be accompanied by higher expenditure efficiency and a proper cost-benefit analysis of investment projects. This includes better investment management (including project planning and selection), avoiding supply-side shortages resulting from a sudden increase and fall in public investment focused on specific areas, and potentially reprioritising spending after pandemic-induced structural changes and in view of green and digital adaptation needs, also ensuring full benefit from EU funding. Appropriate resources also need to be allocated to develop human capital and mitigate the scarring effects of COVID-19 by investing in education, training and health.

Second, given the considerable crisis-induced deterioration of fiscal positions, fiscal-structural reforms to strengthen medium-term debt sustainability should advance already in the short term. This should include raising the capacity to mobilise public revenue by improving tax administrations and reviewing distortive, inefficient and costly tax exemptions. Failure to contain current spending, especially on public wages and pensions, has been a recurrent problem across the Western Balkans, and could hamper fiscal adjustment efforts. This calls for putting in place or reinforcing fair, transparent and sustainable public wage and pension systems and better targeting social transfers. Efforts should also continue to monitor and address fiscal risks stemming from public guarantees, inefficient state-owned enterprises and often non-transparent public-private partnerships, which may have increased as a result of the crisis. Finally, fiscal governance needs to be improved by strengthening or introducing fiscal rules (with the necessary escape clauses to allow for exceptional crisis circumstances) and setting up independent fiscal councils. This would send a strong signal about the authorities' commitment to return to prudent fiscal policies as soon as the economic recovery has been firmly established.

Third, the Western Balkans and Turkey need to closely monitor and address the impact of the crisis on the financial sector. Macro-prudential indicators have overall remained sound and capital adequacy ratios are well above minimum requirements in the Western Balkans, but the crisis may have a considerable lagged impact that will only become apparent once the mitigation measures end. While the ratio of non-performing loans (NPLs) has remained stable and in some cases even decreased in 2020, the protracted impact of the pandemic and the end of forbearance measures may lead to a substantial deterioration of the quality of banks' assets that need to be closely monitored and addressed via stronger legal and regulatory frameworks for NPL resolution. Despite financial sector support measures, credit growth decelerated in Kosovo, Montenegro, North Macedonia and almost came to a halt in Bosnia and Herzegovina, while Albania and Serbia recorded some acceleration supported in particular by large state guarantee schemes. In Turkey, annual credit growth accelerated to 35%, supported by subsidised loans provided in particular by state-owned banks. The NPL ratio remained low and the banking sector is well capitalised, but high dollarisation poses a particular challenge.

Fourth, all seven economies face challenges with their business environments. For most, the regulatory and institutional environment remains a key challenge hampering private sector development and competition. Several also face problems with still sizeable and unprofitable state-owned enterprises, which leads to a misallocation of resources and creates unfair competition for private companies. All seven economies struggle with corruption, legal unpredictability and slow legal procedures, making the economies less attractive to foreign and domestic investments. In order to overcome these challenges, there is a need for effective and well-coordinated structural reforms to improve the business environment and the investment climate, including significant efforts to strengthen the rule of law and institutions to fight corruption.

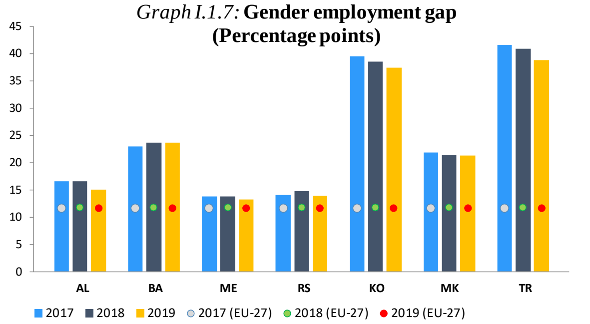
Fifth, informality is very high in all seven economies. While there is a lack of reliable data, the size of the informal economy is estimated at 25-35% of GDP in all seven economies. Widespread informality undermines competition, hinders the efficient allocation of state and private resources, and reduces tax revenues and funding of social security systems. For most economies, informality is driven by the overall weak institutional and regulatory environment, insufficient enforcement capacity of the public authorities, corruption and low awareness of the negative social implications. The low level of trust in government and the perceived low quality of public services discourage tax compliance. Undeclared work leads to less job security and safety at work. In order to overcome these challenges, governments need to incentivise tax compliance by taking public awareness measures, simplifying administrative procedures and lowering ceilings for cash transactions, for example, and they need to ensure stricter law enforcement in this area.

Sixth, inefficient energy use and insecurity of energy supply are among the main obstacles to competitiveness and leave ample scope for more environment- and climate-friendly policies. The underdeveloped energy market is one of the key challenges in Kosovo and Serbia, although the region's other economies face similar issues. The energy market's liberalisation in Serbia, despite being an obligation under the Energy Community, is lagging behind. Electricity tariffs still do not reflect actual costs in most economies. Progress in establishing the regional electricity market is slow and still hampered by bilateral disputes. High energy imports are one of the sources of the large trade deficits in the region. The economies have great potential for developing renewable energy sources and reducing their dependence on coal, which would allow them to further diversify the energy mix and reduce pollution. While construction and maintenance of infrastructure is important, the focus should be on tapping into the potential of renewable energy and energy savings, which includes improving energy efficiency and fully opening electricity markets to competition. Governments should give priority to discontinuing subsidised energy tariffs while providing incentives for energy efficiency and social protection schemes to prevent energy poverty.

Seventh, the lack of regional economic integration in the Western Balkans prevents the region from realising its full growth potential. All Western Balkan partners have committed to boosting regional cooperation and creating a common regional market based on the four freedoms (free movement of goods, services, capital and people) while also covering aspects of digital, investment, innovation and industrial policy. This would bring more competition and allow economies of scale and productivity gains. Such a regional market, based on EU rules and standards, would provide a stimulus for intra-regional trade and investment, increase the benefits of big infrastructure projects and make the Western Balkans a more attractive investment destination. Finally, the common regional market represents a stepping stone for the region to become more closely integrated with the EU single market already before EU accession, thus further contributing to the region's economic growth.

Eighth, low activity, including women's lower integration in the labour market, and poorly targeted active labour market policies remain key challenges. Labour markets in the region continue to be characterised by overall low activity and employment as well as high unemployment. With the exception of Serbia, the COVID-19 pandemic has brought to a halt and slightly reversed the improvements in labour market outcomes. Structural challenges remain, including under-utilisation of labour resources and lower integration of women, young people and less represented ethnic groups in the labour market. The gender employment gap in 2019 ranged from around 13 to 15 pps. in Albania, Montenegro and Serbia to around 37 to 39 pps in Kosovo and Turkey, well above the EU-27 average of 11.7 pps. (see Chart 9 and Annex table III). The outreach and coverage of support services for jobseekers are limited. Active labour market policies are not sufficiently targeted at categories most in need, such as the long-term unemployed, and only a small range of measures is on offer. Undeclared work constitutes from around 20% to more than 30% of the workforce. No comprehensive strategies have been implemented so far to address the issue. Social partners are not regularly consulted on the design and implementation of economic, employment and social policies, and social dialogue between employers and workers, including collective bargaining, is underdeveloped.

Graph I.1.7: **Gender employment gap (Percentage points)**



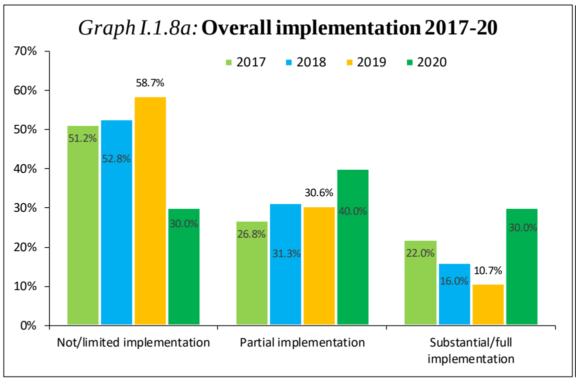
Source: Eurostat and national sources

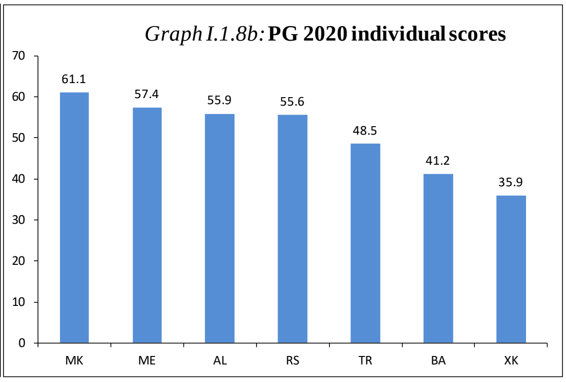
Ninth, the level and structure of social spending is not addressing the needs of the poorest segments of the population. Despite continuing positive economic trends in the pre-crisis years, high levels of poverty remain a problem in all partners. Social assistance schemes are under-funded and do not cover those most in need; the low support levels are ineffective in reducing poverty, thus further increasing income inequality, which is still high in most cases. On the other hand, relatively generous non-means tested social benefits, for instance to war veteran categories, might create disincentives to work. Social care services are not yet provided everywhere, especially in rural areas, thus hindering the social inclusion of vulnerable people.

Tenth, structural skills mismatches persist, due to under-investment in human capital and weak education systems. The education systems in the Western Balkans and Turkey face challenges from early childhood education and care (ECEC) up until the transition to the labour market and adult education. Enrolment in ECEC is particularly low compared to the EU, potentially affecting long-term education outcomes, especially of children with a less favourable economic background. Efforts to increase pre-school education are a first step in the right direction. New curricula are being introduced in basic education, but the mismatch between the provision of secondary and higher education and the needs of the labour market often impede a smooth transition from school to work. Furthermore, the low participation in adult learning and lack of awareness in the population of the need to acquire qualifications in lifelong learning remain an issue. Training teachers for all levels of the education system remains a challenge for most economies.

1.4. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED IN 2020

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey has adopted targeted policy guidance (PG) for all partners in the enlargement region.





The guidance represents the participants' shared view on the short-term policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the PG is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. The Commission evaluates implementation of the PG in the following year's ERP assessments ([4]).

The assessment of the implementation of last year's policy guidance points to an across-the-board improvement in implementing the jointly agreed recommendations mostly linked to the particular short-term character of many recommended crisis-mitigating measures. The average score across the Western Balkans and Turkey has strongly increased, from 35.5 out of 100 for the implementation of the policy guidance adopted in 2019 to 50.8 in 2020 ([5]). Less than one third (30%) of the policy guidance saw no or only limited implementation, which is the lowest share so far. An equal percentage (30%) has been substantially or fully implemented; the highest share since 2017 (see Chart 10). In terms of individual performances, the scores display some variation, but four out of seven exceed 50 (see Chart 11). Overall, the implementation of the policy guidance adopted in 2020 is assessed as 'partial' ([6]) for most partners, with North Macedonia achieving the highest score (61.1).

([4]) The detailed evaluation of individual PG items can be found in Section 5 of the Commission's ERP assessments.
([5]) For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes available at https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en
([6]) The assessment categories are as follows: limited (0<37.5), partial (37.5-62.5), substantial (62.5-87.5), full (87.5-100) implementation.

Table I.1.1 :

Economic Reform Programmes 2021 - Key indicators

	2017	2018	2019	2020e	2021	2022	2023
Real GDP growth (% change)							
Albania	3.8	4.1	2.2	-4.4	5.5	4.8	4.5
North Macedonia	1.1	2.7	3.2	-4.4	4.1	4.6	5.2
Montenegro	4.7	5.1	4.1	-15.2	10.5	6.5	5.8
Serbia	2.1	4.5	4.2	-1.0	6.0	4.0	4.0
Turkey	7.5	3.0	0.9	0.3	5.8	5.0	5.0
Bosnia and Herzegovina	3.0	3.1	2.4	-3.0	2.5	3.1	3.4
Kosovo	4.2	3.8	4.9	-6.7	5.2	4.1	4.2
Unemployment rate (%, LFS)							
Albania	14.1	12.8	12.0	12.0	11.1	10.3	9.4
North Macedonia	22.4	20.7	17.3	16.6	15.8	15.0	14.1
Montenegro	16.4	15.5	15.1	17.2	15.6	14.3	13.8
Serbia	13.5	12.7	10.9	10.2	10.1	9.2	8.5
Turkey	11.1	11.2	13.7	13.8	12.9	11.8	10.9
Bosnia and Herzegovina	20.5	18.4	15.7	16.3	15.7	15.1	14.2
Kosovo	30.5	29.6	25.6	25.5	:	:	:
Current account balance (% of GDP)							
Albania	-7.5	-6.8	-8.0	-9.2	-7.1	-7.2	-7.1
North Macedonia	-1.1	-0.1	-3.3	-3.7	-2.6	-1.6	-1.5
Montenegro	-16.1	-17.0	-15.0	-26.0	-18.7	-15.1	-11.6
Serbia	-5.2	-4.8	-6.9	-5.0	-5.5	-5.1	-4.6
Turkey	-4.8	-2.8	0.9	-3.5	-1.9	-0.7	0.1
Bosnia and Herzegovina	-4.7	-3.3	-3.0	-4.0	-4.6	-4.7	-5.1
Kosovo	-5.4	-7.6	-5.6	-4.5	-6.3	-6.1	-4.7
Inflation (CPI, annual % change)							
Albania	2.0	2.0	1.4	1.7	2.4	2.8	3.0
North Macedonia	1.4	1.5	0.8	1.1	1.5	2.0	2.0
Montenegro	2.8	2.9	0.4	-0.3	1.2	1.4	1.2
Serbia	3.1	2.0	1.9	1.6	1.9	2.3	2.5
Turkey	11.1	16.3	15.2	11.6	9.9	6.2	5.4
Bosnia and Herzegovina	1.3	1.4	0.6	-0.8	1.2	1.3	1.4
Kosovo	1.5	1.1	2.7	0.2	1.8	1.0	1.0

Sources: Economic Reform Programme (ERP) 2021 for 2019-2023, CCEQ for 2017 and 2018.

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

Table I.1.2 :

Economic Reform Programmes 2021 - Fiscal indicators

	2017	2018	2019	2020e	2021	2022	2023
Total revenue* (% of GDP)							
Albania	27.8	27.5	27.4	27.0	28.8	28.7	28.9
North Macedonia	31.0	30.4	31.5	32.1	32.6	32.0	31.8
Montenegro	41.5	42.2	44.7	44.6	45.8	43.5	42.8
Serbia	41.5	41.5	42.1	40.3	40.4	40.5	39.7
Turkey	31.2	31.9	33.1	32.5	31.7	31.2	31.0
Bosnia and Herzegovina	43.0	43.0	40.1	38.5	37.2	36.9	36.5
Kosovo	26.3	26.3	26.5	25.7	26.5	26.7	26.5
Total expenditure* (% of GDP)							
Albania	29.8	29.1	29.3	33.7	35.2	31.6	31.1
North Macedonia	33.8	31.5	33.7	40.5	37.6	35.8	35.0
Montenegro	46.8	46.2	46.7	55.6	48.7	43.7	41.3
Serbia	40.4	40.9	42.3	49.2	43.4	42.1	40.7
Turkey	34.0	34.7	36.1	38.6	36.3	35.2	34.6
Bosnia and Herzegovina	40.4	40.8	37.9	42.5	39.8	38.3	37.2
Kosovo	27.5	29.1	29.5	33.5	34.4	31.7	30.7
General government balance (% of GDP)							
Albania	-2.0	-1.6	-1.9	-6.7	-6.5	-2.9	-2.3
North Macedonia	-2.7	-1.1	-2.2	-8.4	-4.9	-3.8	-3.2
Montenegro	-5.3	-3.9	-2.0	-11.0	-2.9	-0.2	1.5
Serbia	1.1	0.6	-0.2	-8.9	-3.0	-1.6	-1.0
Turkey	-2.8	-2.8	-3.0	-6.1	-4.5	-4.0	-3.6
Bosnia and Herzegovina	2.5	2.1	2.2	-4.0	-2.5	-1.4	-0.6
Kosovo	-1.3	-2.9	-2.9	-7.8	-7.9	-5.0	-4.2
General government debt (% of GDP)							
Albania	70.2	67.7	66.3	79.9	78.6	77.7	75.6
North Macedonia	39.4	40.6	40.6	51.2	53.2	53.3	53.7
Montenegro	63.3	70.1	75.6	104.3	88.4	77.4	69.9
Serbia	57.9	53.7	52.9	59.0	58.7	57.9	56.0
Turkey	28.0	30.2	32.5	41.1	40.8	41.6	41.8
Bosnia and Herzegovina	34.7	33.3	31.1	35.2	37.1	36.1	34.9
Kosovo	16.6	16.9	17.5	23.1	28.6	32.1	34.8

Sources: Economic Reform Programmes (ERP) 2021 for 2019-2023, CCEQ for 2017 and 2018.

**2017 and 2018 data from Ministry of Finance.*

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

Table I.1.3:

Gender employment gap (percentage points)

	2017	2018	2019
EU-27	11.7	11.8	11.7
Albania	16.5	16.5	15
North Macedonia	21.9	21.4	21.3
Montenegro	13.8	13.8	13.3
Serbia	14	14.7	13.9
Turkey	41.6	40.8	38.8
Bosnia and Herzegovina	23	23.7	23.6
Kosovo	39.4	38.5	37.4

Sources: Eurostat for Montenegro, North Macedonia, Serbia and Turkey; for Albania, Bosnia and Herzegovina and Kosovo national Labour Force Surveys.

The gender employment gap is defined as the difference between the employment rates of men and women aged 20-64. The employment rate is calculated by dividing the number of persons aged 20 to 64 in employment by the total population of the same age group. The indicator is based on the EU Labour Force Survey.

Part II

Country analysis

1. ALBANIA

1.1. EXECUTIVE SUMMARY

The economic reform programme (ERP) estimates that in 2020, the economy contracted by less than initially projected. Hit by the double shock from the earthquake of November 2019 and the COVID-19 pandemic, real GDP decreased 3.3% in 2020. Pandemic-related domestic and international restrictions caused substantial losses in tourism and manufacturing, but economic conditions started to improve in the second half of the year. Within the limited fiscal and monetary policy space, the government and the central bank took swift and appropriate action to support businesses, households and the healthcare sector; this cushioned the impact on the labour market and preserved macroeconomic and financial-sector stability.

The ERP projects the economy to rebound to an average of 5% growth in 2021-2023, driven by strong recovery in private consumption, exports and investment. In 2021, the ERP expects growth to increase to 5.5% due to moderate recovery in private consumption and investment, a strong resurgence of services exports (including tourism) and an exceptionally high level of public investment. Real growth is expected to moderate to 4.5% by 2023 and be driven increasingly by private consumption and investment. This should help to create conditions for a gradual fall in the unemployment rate to 9.4%.

Ambitious capital spending plans are expected to keep the fiscal deficit above 6% of GDP in 2021, followed in 2022 by expenditure cuts to halve the deficit and a gradual reduction of the public debt ratio. In 2020, the fiscal deficit reached 6.9% of GDP owing to a stark drop in tax revenues coupled with unforeseen expenditure needs and post-earthquake reconstruction. In 2021, the deficit is set to remain above 6% of GDP despite an expected rebound in revenue. This is because public investment will increase significantly to complete post-earthquake reconstruction and stimulate economic recovery, while pandemic-related expenditure needs will remain high. In 2022 and 2023, lower capital expenditure is expected to bring the fiscal deficit below 3% and move the primary balance into positive territory by 2023 in line with the new fiscal rule. The ERP expects the public-debt ratio to decrease gradually, by some 4.3 pps. over three years. It is projected to reach 75.6% of GDP in 2023, when the pace of debt reduction is set to accelerate.

The main challenges Albania faces are as follows:

- **The commitment to fiscal consolidation needs to be supported by increased revenue mobilisation and improved management of liabilities**. Spending on earthquake-related reconstruction and recovery support must be accommodated in the short term, but will keep the budget deficit high. Medium-term fiscal plans are rightly geared towards fiscal consolidation in view of the elevated level of debt, but are contingent on economic recovery becoming well entrenched. The new positive primary balance rule, applicable from 2023, will help anchor stability-oriented fiscal policy. Completing and implementing the medium-term revenue strategy should be a priority with a view to meeting the ambitious revenue targets on which the fiscal plans largely depend. Improving and expanding the monitoring of fiscal risks, including those stemming from public-private partnerships, concessions and state-owned enterprises, by developing additional capacity would contribute further to debt sustainability.

- **There is considerable scope to make public expenditure more growth-friendly and efficient.** The implementation rate of capital expenditure has improved since 2019, but some investment projects are still not subject to stringent public financial management practices. High-budgeted public investment must be managed more efficiently. The transparency and control of payment arrears improved, but efforts to eliminate arrears need to be stepped up, especially at a time when stressed businesses need liquidity. Increased public investment in infrastructure is not matched by a similar increase in investment in human capital, which is a crucial factor for future growth. Spending on health, social protection, education, and research and development remains significantly below needs and below the levels of EU and regional peers; a continuous gradual increase in public spending on these areas would make the composition of public expenditure more growth-friendly.

- **Albania's business environment remains hampered by structural weaknesses**. Private sector development remains below its potential, as action to improve the business environment lacks effective policy instruments and a more strategic approach. The lack of business know-how, low financial literacy and the high degree of informality are obstacles to access to finance for the private sector, which consists mainly of micro and small businesses. Business support services remain inadequate, notably as regards export facilitation, and assistance with access to finance and entrepreneurial know-how. Transparency in the adoption and implementation of legislation is still insufficient, particularly regarding the effective and timely consultation of businesses and social partners on new legislation affecting their operations.

  The high level of informality is a key challenge for the economy. Informal economic activity and employment are cross-cutting challenges that distorts competition and constitutes a serious barrier to the development of the private sector, and also on the quality of jobs and on the sustainability of social protection. Informality also has an impact on fiscal revenues, affecting the capacity of the state to provide high-quality public services. Albania lacks a comprehensive strategy for the tackling and monitoring of all aspects of the informal economy. Such a strategy would need to be accompanied by an action plan with baselines, including clear and measurable targets and establish the regular a performance-based monitoring of the plan's implementation and results.

- **Although the number of university graduates is increasing, the share of the adult population with low skills and the percentage of young people not in employment, education or training remain high**. The impact of the crisis on the labour market was partially mitigated by labour preservation measures. Employment rebounded seasonally in the third quarter, but it contracted again in the fourth quarter of 2020. Vocational education and training attracts few young people and the operationalisation of its new legal framework has been delayed. Albania lacks tools for regular monitoring and forecasting of skills needs in the labour market. Also, while a measure is foreseen on innovation, the link between innovative businesses and academia is weak, with insufficient science and research funding and unfavourable conditions for the development of business incubators.

- **Poverty and social exclusion are widespread and spending on social protection and healthcare is insufficient to decrease poverty and increase healthcare coverage**. The government adopted income support measures during COVID-19 pandemic, but more structural measures to increase benefit adequacy are still pending. Moreover, the availability of social services is insufficient to support the active inclusion of people in vulnerable situations. The government took steps to increase healthcare coverage for Albania's significant number of uninsured people, but access to healthcare is still limited due to high out-of-pocket payments, the remoteness of healthcare facilities and a critical shortage of doctors.

The policy guidance set out in the conclusions of the economic and financial dialogue held with Albania in May 2020 has been partially implemented. The medium-term fiscal framework plans for gradual fiscal consolidation, and the fiscal rule was strengthened. The government provided financial support to affected households and businesses in a generally transparent and cost-effective manner (though this cannot be confirmed for the implementation of post-earthquake reconstruction). Tax relief measures were temporary, substantial progress was made on VAT refunds and reporting on arrears, and work on tax expenditure continued. The adoption of the medium-term revenue strategy was postponed and limited progress was made on increasing capacity for monitoring fiscal risks and improving management of public investments. Effective measures and close supervision preserved the stability of the financial sector, and the development of hedging instruments advanced.

While Albania approved a COVID-19 package to support businesses, SMEs and self-employed people, there was not an adequate stakeholder consultation of its preparation, adoption and implementation. There was progress on energy efficiency legislation and bylaws, but insufficient progress on implementation. Little of the current National Energy Efficiency Action Plan (NEEPA) plan was implemented, and the energy efficiency agency is still not yet fully staffed and operational. The creation of the energy efficiency fund has been abandoned, but it seems that no alternative mechanisms seem defined to provide the required incentives for energy efficiency measures targeting the private sector, households, and local authorities. The draft amended Energy Efficiency Law has been prepared but parliament has not been adopted it. Albania adopted swift measures to preserve employment and implement new active labour market measures to help some laid-off workers, including workers formerly employed in the informal economy, back into employment. Temporary increases in social assistance benefits improved their adequacy, but an adequacy assessment and a subsequent systemic adjustment of benefits are still pending. Municipalities' capacity to identify needs and prepare social plans improved somewhat, but more work must be done in this area. Further structural action is needed to reduce out-of-pocket payments and decrease the unmet need for medical care. Albania took positive steps to increase access to healthcare during the COVID-19 pandemic. The Government is trying to strengthen the so far weak response to the health emergency in regional hospitals.

The analysis of key challenges in the ERP is incomplete. Although some reform measures are in line with the priorities identified by the Commission, some challenges are not adequately addressed. The programme's macro-fiscal framework is optimistic, in particular the revenue forecast. The fiscal deficit is reasonable in view of the pandemic and the delayed reconstruction needs. The commitment to continue reducing public debt is better anchored with the new primary balance rule applicable as of 2023. The analysis of structural obstacles fails to examine key sectors of the economy, notably agriculture, industry and services (except tourism). The budget of education measures does not allocate sufficient resources for teacher and assistant teacher training and fails addressing inclusiveness in kindergartens. The measures on employment, vocational education, social protection and healthcare propose relevant activities. However, the measure on social protection measure does not address the sustainability of social services after support from the Social Fund is phased out, and the healthcare measure does not do enough to tackle high out-of-pocket expenditure, low public spending on healthcare or the emigration of healthcare professionals. A new measure has been introduced to address informality, complementing the ongoing fiscalisation efforts, but these are mainly focused on taxation, and more comprehensive steps need to be taken to fully address this challenge.

1.2. ECONOMIC OUTLOOK AND RISKS

Albania's economic reform programme (ERP) estimates economic contraction in 2020 at 4.4%, only half as much as previously forecast, while recent data confirmed an even lower contraction of 3.3%. Economic momentum was weak at the start of the year following the earthquake of November 2019. When the first COVID-19 infections were identified in early March 2020, the authorities immediately responded with a temporary strict lockdown and adopted the first set of support measures in April 2020. In the second quarter of 2020, the pandemic-induced sharp drop in private consumption and investment caused a deep recession, while in the third quarter, the easing of restrictions and the resumption of regional and domestic tourism limited the year-on-year contraction. Increasing exports and retail activity indicate further recovery in the last quarter of the year. Overall, pandemic-related domestic and international restrictions caused substantial losses in tourism and manufacturing, while good performance by Albania's large agricultural sector and the electricity generation and construction industries buffered the downturn. The economic improvement in the second half of 2020, combined with wage subsidies and an employment promotion programme, limited the increase of the unemployment rate (7), which stood at 12.3% at the end of 2020. The labour market participation rate decreased to 68.7% in 2020, with women more negatively affected than men.

The ERP projects the economy to rebound to an average of 5% growth between 2021 and 2023, driven by a broad-based recovery of private consumption, exports and investment. In 2021, the ERP expects growth to increase to 5.5% due to moderate recovery in private consumption and investment, a strong resurgence of services exports (including tourism) and an exceptionally high level of public investment. The ERP assumes that net external demand will contribute 1.1 pps. to growth in 2021, though this is set to moderate in subsequent years because of rising imports. Private consumption and investment are expected to be the main drivers of growth once more; their contribution will increase significantly to reach 3.1 pps. in 2022, when the contributions made by public consumption and investment are projected to flatten. Agriculture, manufacturing, construction and services are expected to make the biggest contributions to the growth of production value between 2021 and 2023, supported by strongly rebounding growth rates in trade, transport and hospitality services. The labour market participation rate is expected to recover to 69.9% in 2021, above the pre-crisis level. While the employment growth rate is expected to be moderate, progressively decreasing from 1.7% to 1.3% between 2021 and 2023, the unemployment rate is forecast to fall gradually to 9.4% in 2023.

The economic outlook, which relies on optimistic projections for public investment, is subject to downward risks stemming from the COVID-19 pandemic and the political cycle. In early 2021, the restrictions introduced in response to surging infection rates had only a limited impact on economic activity in Albania. However, the manufacturing and business service sectors continue to feel negative effects from the continuing pandemic in Europe. In addition, disruptions resulting from the national elections, which are scheduled for 25 April 2021, could delay the implementation of the ambitious public investment plans on which the recovery of growth partly relies. The ERP revises upwards last year's projections (which were made before the COVID-19 pandemic began) not only for 2021, but also for 2022; expected real GDP growth for 2022 was upgraded from 4.0% to 4.8%. The ERP provides an optimistic and a pessimistic scenario for real GDP growth rates. These deviate from the baseline growth scenario by +0.5 pps. and -1.5 pps., respectively. However, the assumption of a revenue-to-GDP ratio 1 pp. higher than the 2020 pre-crisis estimate is not supported by any explanation in the ERP and seems unrealistic.

Table II.1.1:

Albania - Comparison of macroeconomic developments and forecasts

	2019		2020		2021		2022		2023	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	2.2	**2.2**	-6.8	**-4.4**	3.7	**5.5**	4.6	**4.8**	n.a.	**4.5**
Contributions:										
- Final domestic demand	2.3	**2.3**	-4.9	**-4.6**	3.9	**4.3**	4.1	**4.6**	n.a.	**4.1**
- Change in inventories	-0.6	**-0.6**	-0.7	**:**	0.0	**:**	0.0	**:**	n.a.	**:**
- External balance of goods and services	0.6	**0.5**	-1.2	**0.2**	-0.2	**1.1**	0.5	**0.2**	n.a.	**0.3**
Employment (% change)	0.8	**2.4**	-2.7	**-0.6**	1.0	**1.7**	2.0	**1.4**	n.a.	**1.3**
Unemployment rate (%)	12.2	**12.0**	14.5	**12.0**	13.9	**11.1**	12.8	**10.3**	n.a.	**9.4**
GDP deflator (% change)	0.7	**0.5**	0.9	**-2.1**	1.1	**1.5**	1.6	**2.2**	n.a.	**2.4**
CPI inflation (%)	1.4	**1.4**	1.9	**1.7**	2.1	**2.4**	2.3	**2.8**	n.a.	**3.0**
Current account balance (% of GDP)	-7.6	**-8.0**	-10.9	**-9.2**	-9.0	**-7.1**	-7.3	**-7.2**	n.a.	**-7.1**
General government balance (% of GDP)	-1.8	**-1.9**	-6.3	**-6.7**	-5.3	**-6.5**	-3.2	**-2.9**	n.a.	**-2.3**
Government gross debt (% of GDP)	66.3	**66.3**	78.8	**79.9**	77.4	**78.6**	75.4	**77.7**	n.a.	**75.6**

Sources: Economic Reform Programme (ERP) 2021, Commission Autumn 2020 forecast (COM).

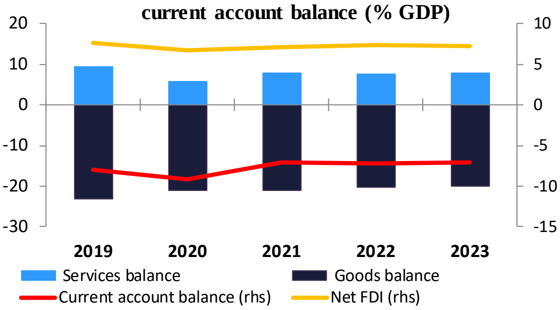
(7) Data and ratios on the labour market refer to the age group of the15-65 year old.

Inflation is expected to rise to 2.4% in 2021 before converging to the 3% target in 2023 in line with the assumed closing of the output gap. In response to the economic downturn that is expected to result from the pandemic, the Bank of Albania (BoA) lowered the policy rate to 0.5% in March and does not expect to change its loose monetary stance given the expected recovery. However, the very low policy rate limits the monetary policy space for responding to future shocks. The ERP assumes that the output gap will gradually narrow from 2021 and turn positive in 2023. Accordingly, the BoA expects the inflation rate to converge to its 3% inflation target in 2023. The macro scenario does not include assumptions for the exchange rate of the Albanian lek and the inflation rate in the EU. The expected strong increase in domestic consumption and the expected recovery of commodity prices could generate push up prices in 2022 and 2023, but the ERP does not provide any additional explanation or project wage growth.

After temporarily widening to 9.2% in 2020, the current account deficit is expected to stabilise at 7.1% of GDP from 2021 on, financed almost entirely by foreign direct investment (FDI) inflows. In 2020, the sharp decrease in tourism exports and the fall in remittance inflows drove the cyclical widening of the current account deficit. Following the recovery of the host countries of Albanians working abroad, remittances are expected to rebound to their pre-crisis level in 2021. For 2021-2023, the ERP expects improving services and goods balances to stabilise the current account deficit. A lasting lower level of imports and a higher export ratio than before the crisis are projected to drive the reduction of the goods trade deficit to below 20% of GDP. Services exports are expected to recover more gradually and the surplus of the services balance, in terms of GDP, is forecast to stabilise slightly below pre-crisis levels in the medium term. The more cautious projection for services is supported by the muted recovery observed in manufacturing services in the clothing industry and the expected lasting structural changes in tourism. The composition of goods exports is projected to shift towards agricultural and metal exports, while imports are set to remain low because of the lower level of FDI inflows, continuing a trend that began in 2019 with the completion of some exceptionally large energy projects. FDI inflows are expected to catch up in 2021 and 2022 before stabilising at about 7% of GDP. In 2020, the temporary drop of FDI inflows increased the share of debt-creating inflows in the financing of the current account deficit to about 20%, mainly in form of a large Eurobond issued by the government. In 2021-2023, the sustained inflow of FDI is expected to fully finance the decreasing current account deficit again.

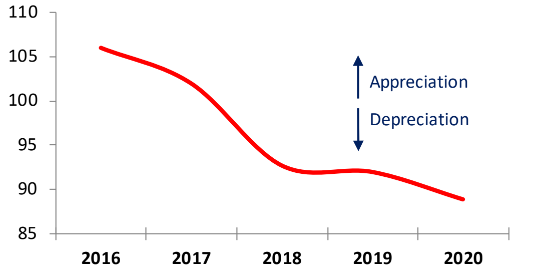
External competitiveness and current account

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



Source: Economic Reform Programme (ERP) 2021.

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



Source: Economic Reform Programme (ERP) 2021.

Albania's vulnerability from its increasing external debt ratio is mitigated by solid foreign exchange (forex) reserves and the dominance of concessional debt. Gross external debt is estimated to have reached 70% of GDP in 2020, up from 60.4% at the end of 2019. About 90% of the external debt stock is long-term and more than half of that is owed by the government, mostly on concessional terms. Although the ratio of the government's external debt stock over fiscal revenue deteriorated in 2020, this is expected to be temporary, due to the exceptional revenue loss in 2020. The BoA's risk analysis shows that the external debt ratio is more sensitive to currency depreciation than to increasing interest rates.

Considering the very moderate reaction of the lek’s exchange rate during the crisis, a depreciation shock does not seem likely and is adequately cushioned by forex reserves. Forex reserves have consistently increased in recent years and totalled EUR 3.9 billion at the end of 2020, corresponding to about 30.6% of GDP and covering over eight months of imports of goods and services (reflecting the temporary import drop) and around 46% of external debt.

Timely and effective regulatory interventions contributed to the stability of the financial sector, under the close supervision of the Bank of Albania. As well as lowering the policy rate to 0.5% in March 2020, the BoA provided liquidity to the market and suspended banks’ dividend payments until the end of 2021. Between March and August 2020, the BoA temporarily facilitated the deferral of loan instalments to help crisis-hit borrowers and allowed banks to restructure loans without additional provisioning. There were concerns that financial soundness indicators would deteriorate once these temporary regulatory measures were lifted, but these fears have proved unfounded so far. Even after the moratorium on loan repayments ended in August (at which point it covered 38.5% of the loan portfolio), the ratio of non-performing loans continued to decrease, reaching 8.1% by the end of 2020. Banks can still make use of relaxed loan provisioning rules until the end of 2021, but many foreign-owned banks are applying the rules of their foreign (mostly EU) parent companies. Despite the pressure on profits – return on equity fell to 10.7% in 2020 – banks remained profitable and well capitalised. Credit growth slowed from 7.1% to 6.7% in 2020. However, deposit growth accelerated to 8.3%. This resulted in a slight reduction of the loan-to-deposit ratio, which was already very low. Although exposure to unhedged foreign exchange risks decreased and the BoA is developing more hedging instruments, some vulnerability remains; this is also connected to banks’ exposure to sovereign risks and the dominance of variable-rate loans in the overall loan portfolio. The BoA’s stress test confirmed that banks were solvent without requiring capital injections in 2021.

Table II.1.2:
Albania - Financial sector indicators

	2016	2017	2018	2019	2020
Total assets of the banking system (EUR million)	10248	10768	11 398	12 380	13 156
Foreign ownership of banking system (%)*	82.6	81.4	80.8	78.4	69.4
Credit growth (%)	0.1	0.6	-3.2	7.1	6.6
Deposit growth	2.9	-1.2	-1.3	3.9	8.3
Loan-to-deposit ratio	54.0	54.9	53.9	55.6	54.7
Financial soundness indicators (end of period)					
- non-performing loans	18.3	13.2	11.1	8.4	8.1
- net capital to risk-weighted assets	15.7	16.6	18.2	18.3	18.3
- liquid assets to total assets	12.8	13.0	14.8	15.1	13.6
- return on equity	7.1	15.7	13.0	13.5	10.7
- forex loans to total loans (%)	57.8	55.7	55.1	50.1	48.5

* of total sector assets
Sources: Economic Reform Programme (ERP) 2021, IMF, Bank of Albania.

An impressive number of financial reforms inspired by EU law will contribute to the stability and development of the sector beyond 2021. The BoA has begun to update resolution plans for systemic banks and intends to have a complete regulatory framework for banking sector resolution in place by 2023. Work continues on alignment with EU directives on financial instruments, payment systems and money laundering. The new capital market law will contribute to the development and integrity of the capital market. Financial inclusion has improved, due in part to the modernisation of payment systems and the promotion of electronic financial transactions and banking services in view of reduced mobility during the pandemic. This trend is expected to continue as banks are beginning to offer accounts to the unbanked, while a modernised credit registry will increase the transparency of credit data and help to improve access to finance in future.

1.3. PUBLIC FINANCE

The government revised the 2020 budget four times to accommodate the revenue losses and expenditure needs resulting from the pandemic. As the development of the pandemic was unforeseeable and growth projections changed, the government adjusted revenue and expenditure plans several times, most recently in December 2020, to accommodate support for the economy and the healthcare sector. Earthquake-related reconstruction projects stalled in the second quarter before their implementation could actually get up to speed. The revenue ratio decreased from 27.4% of GDP in 2019 to 27.1%, mainly due to an 8.5% year-on-year drop in tax revenue. Expenditure increased 9.1% y-o-y, which, coupled with the lower GDP denominator, pushed the expenditure ratio from 29.3% of GDP in 2019 to 34.1%. Capital expenditure increased most strongly, including spending on reconstruction (which amounted to 5.4% of GDP). Expenditure on social assistance and healthcare was also higher.

Within the limited fiscal space, households and businesses received effective and targeted support through established channels. To address the impact of COVID-19, the government disbursed 1% of GDP on two support packages for businesses and households and on measures for the healthcare sector. Direct support subsidised wages at minimum-wage level, especially in the sectors most affected by the mobility restrictions applying from March to May. Direct support was also used to pay grants directly to self-employed people and micro businesses. Informally employed people were encouraged to register to receive support under the Economic Aid scheme (*"Ndihma Ekonomike")* and for those registered unemployed before the start of the lockdown the usually very low unemployment benefits were doubled. In addition, the government provided liquidity to businesses in the form of sovereign guarantees equivalent to 1.65% of GDP (two schemes totalling ALL 11 billion with interest subsidy and ALL 15 billion without subsidy). About 40% of these guarantees were used by the end of 2020. Additionally, the government allowed profit and corporate income tax payments for 2019 and 2020 to be postponed and waived the related penalties and interest. SMEs and businesses directly affected by the drop in external demand (tourism, textile processing and business services/call centres) were relieved from profit tax and income tax for April to December 2020 and payments of small business tax (levied by local governments) were suspended.

While the fiscal stance is still expansionary in the short term to accommodate spending on post-earthquake reconstruction, in the medium term the ERP aims to consolidate public finances and comply with the fiscal rules. Ambitious expenditure plans are expected to keep the fiscal deficit above 6% of GDP in 2021, slightly below the actual deficit of 6.9% in 2020 ([8]). The first budget amendment of 5 February 2021 increased expenditure by 1.5% to provide additional funding for contingencies, social assistance, health insurance and capital expenditure, but does not foresee an increase of the deficit. Overall, expenditure is to increase by 12% to 35.7% of GDP in 2021 (compared with 29.3% in 2019), temporarily boosted by capital spending on earthquake-related reconstruction. From 2022, though, a sharp reduction in capital expenditure is set to bring the fiscal deficit to below 3% of GDP. The expenditure ratio is expected to decrease from its peak of 35.2% of GDP in 2021 to 31.1% in 2023. Capital expenditure is expected to fall by 2.5 pps. in 2022 to slightly above its pre-crisis level, while current expenditure is set to remain about 1.5 to 2 pps. above its earlier level to accommodate increased interest costs and slightly higher allocations for spending on healthcare and social security. The primary balance

([8]) There are differences between the data presented in the text of the ERP and the programme's data annex. The latter does not reflect the actual outturn of 2020. In addition, the macro-fiscal framework, on which the ERP and the budgets 2021-2023 are based, does not distinguish between the current and capital expenditure of local governments. Consequently, the ERP table shows higher overall gross fixed investment by the public sector than the budget plan.

is expected to improve from -3.9% of GDP in 2021 to -0.1% in 2022 and turn positive in 2023, in line with the new fiscal rule.

The fiscal consolidation strategy is not supported by concrete proposals to increase revenue mobilisation. The revenue ratio is projected to rebound strongly to 28.9% in 2023 and exceed its pre-crisis level by 1.5 pps. This is partly because higher grants are expected from budget support programmes and for earthquake reconstruction, but it is mainly due to the assumed strong growth in tax revenue, such as the additional 6% increase in budgeted VAT revenue, which is to finance additional expenditure included in the first budget amendment. Overall, revenue is expected to grow by 15% and reach 29% of GDP in 2021, but the ERP does not present concrete policy proposals for revenue mobilisation. The tax revenue forecast seems overly optimistic given the performance in pre-crisis years, the narrowing of the tax base and the postponement of the medium-term revenue strategy.

Table II.1.3:

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

	2019	2020	2021	2022	2023	Change: 2020-23
Revenues	27.4	27.0	28.8	28.7	28.9	1.9
- Taxes and social security contributions	22.1	21.6	22.8	23.1	23.3	1.7
- Other (residual)	5.3	5.3	6.0	5.6	5.5	0.2
Expenditure	29.3	33.7	35.2	31.6	31.1	-2.6
- Primary expenditure*	27.2	31.5	32.6	28.8	28.2	-3.2
of which:						
Gross fixed capital formation	5.5	7.3	8.3	5.8	5.8	-1.5
Consumption	9.6	10.9	10.6	10.0	9.8	-1.1
Transfers & subsidies	12.0	13.2	13.4	12.8	12.4	-0.8
Other (residual)	0.1	0.1	0.3	0.2	0.3	0.2
- Interest payments	2.1	2.2	2.6	2.7	2.9	0.7
Budget balance	-1.9	-6.7	-6.5	-2.9	-2.3	4.4
- Cyclically adjusted	-1.8	-4.5	-7.3	-3.4	-2.6	1.9
Primary balance	0.2	-4.5	-3.9	-0.1	0.6	5.1
- Cyclically adjusted	0.3	-2.3	-4.7	-0.6	0.3	2.6
Gross debt level	66.3	79.9	78.6	77.7	75.6	-4.3

* Excluding arrears clearance
Sources: Economic Reform Programme (ERP) 2021 and preliminary fiscal results 2020.

The ERP focuses on stimulating economic recovery by increasing capital expenditure and includes only limited support for households and businesses affected by the pandemic. The 2021 budget includes ALL 11.6 billion (0.7% of GDP) to fund COVID-19-related measures including the vaccination campaign, additional social assistance, the digitalisation of schools, business support and labour market measures. However, the ERP provides only some details of the employment promotion programme. The budgeted salary increase for teachers and healthcare workers does not address the problems caused by the pandemic but will help to keep staff in these critical sectors. The additional budgets for social assistance, labour market policies and business support are dwarfed by the very ambitious investment and reconstruction plans, which are supposed to stimulate economic recovery. The investment priorities have not been reviewed in the light of the pandemic and are set to continue projects initiated under the 2017-2021 government programme, which focus on road construction. The public investment drive will certainly stimulate construction activity, as it did in 2020, but might have limited effects on other sectors, like manufacturing and tourism. More targeted support for recovery, tailored to the needs of sectors including services, would require a more in-depth analysis of the pandemic’s effect on business and employment than is presented in the ERP. The allocation for human development is increasing in nominal terms but not as strongly as capital investment, while spending on education is set to decrease both in GDP terms and as a share of total expenditure.

Box II.1.1: **Recovery measures in the 2021 budget**

The ERP describes few discretionary and targeted fiscal measures to support the recovery and strengthen resilience. Overall, expenditure on health care services and social protections are planned to remain elevated, but the specific COVID-19-related support measures of 2020 are not planned to continue. A number of ongoing initiatives are very pertinent in the new context, like the expansion of digitalisation, promoting e-commerce, legislative framework for start-ups, and some of these may have been front-loaded. On the other hand, the ERP does not describe any specific support to the tourism sector in view of the pandemic, which leaves a heavily affected major growth-relevant sector at risk of a delayed recovery and of a diminished service structure.

a. Incentives to increase employment

Overall, the budget for additional labour market support is ALL 150 million (0.01% of GDP). The COVID-19-related employment promotion programme is costed with about ALL 30 million for 2021 and 2022. The employment promotion programme, targeting persons who lost their employment due to the pandemic, includes 3 targeted schemes to subsidise wages (at minimum wage level) and/or compulsory social insurance to variable degrees depending on the length of employment and the type of jobseekers (formal or informal).

b. Support public and private investment, and the green and digital transition

Investment priorities have not been reoriented in view of the pandemic, except of an allocation of ALL 1.1 billion (0.06% of GDP) for digital competencies and the school's digital infrastructure, but public investment is planned to increase to 7.3% of GDP including 1.7% of GDP for reconstruction. The reconstruction projects mainly consist in construction of housing and schools, while the regular capital expenditure budget will continue to finance ongoing investment projects, mainly roads.

d.) *Support solvent businesses*

The budget includes additional business support of ALL 250 million (0.02% of GDP) in the context of the pandemic, but the ERP does not provide details on this support. The ERP mentions the budget provision of ALL 1 billion (0.06% of GDP) to subsidise farmers' use of diesel, which is neither targeted to solvent farmers nor limited in time, and subsidises use of fossil fuel instead of its reduction. Considering that the agricultural sector recorded exceptional growth in 2020, this initiative cannot be seen in relation with the pandemic. However, it is positive that this support takes the form of a subsidy instead of a tax exemption that would add to complicating the tax system.

e.) *Liquidity measures*

In the 2021 budget about ALL 100 million (0.01% of GDP) have been included for the expenditure of interest subsidies offered in the first sovereign guarantee scheme. Possible payments of principal in case guarantees are called, have been provisioned with ALL 2 billion in 2021 (0.13% of GDP, below the line). In January, the government extended the application time for its 2nd sovereign guarantee scheme, of which ALL 10 billion (0.6% of GDP) have not been used, to June 2021. It guarantees 60% of the loan principal, but doesn't provide for interest rate subsidies.

The key fiscal policies in 2021 will further narrow the tax base and do not support the expected revenue mobilisation, even though the introduction of automated electronic VAT invoicing will help to narrow the VAT gap. From 2021, businesses with a turnover below ALL 14 million (about EUR 120 000) will be exempt from paying profit tax and those with a turnover below ALL 10 million (about EUR 80 000; a higher threshold than common in the EU) will be exempt from registering for VAT. These tax measures for 2021, which were announced in the second quarter of 2020, were not intended as support for SMEs in the context of the COVID-19 crisis but as a means of relieving small businesses from the burden of tax administration. The ERP does not assess the possible impact of these exemptions on business development, investment and tax compliance. At the same time, the government postponed the adoption of the medium-term revenue strategy, which is crucial for a realistic and reliable increase of public revenue and for financing a growth-friendly fiscal policy, even though its supporting international partners (EU, IMF) asked it to reconsider or present a preliminary draft. The roll-out of the "fiscalisation" scheme, consisting of obligatory, electronic VAT invoicing, is an important step towards increased VAT-efficiency and will help to reduce informal sales. The ERP assumes that this will lead to an increase in VAT revenue, but does not provide concrete estimates.

Box II.1.2: **The budget for 2021**

* The draft budget for 2021 was presented to parliament on 16 November 2020 and adopted on 6 December 2020 targeting a 6.5% of GDP deficit. Parliament adopted its first amendment on 5 February 2021, which increased expenditure from 34.9% to 35.4% of GDP and revenue from 28.5% to 29% of GDP.
* Key fiscal policies are the permanent exemptions of small business from profit tax and VAT and the increase of wages in the health and education sector and of the minimum wage. The increase of the social contributions due to the higher minimum wage compensated some of the tax expenditure due to the new tax exemptions and result in an overall decrease of revenue by 0.1% of GDP, while expenditure increased by 2.9% of GDP.

Table: Main discretionary measures in the budget for 2021

Permanent revenue measures*	**Temporary/permanent Expenditure measures****
• ALL 3-4 billion raising VAT registration threshold to turnover of ALL 10 million, about EUR 80 000 (-0.2% of GDP)	• ALL 28 billion post-earthquake reconstruction (1.7% of GDP)
• ALL 0.7 billion exemption of businesses with turnover below ALL 14 million (EUR 120 000) from profit tax (-0.05% of GDP)	• ALL 8 billion to increase salaries of health workers by 40% and of teachers by 15% (0.5% of GDP)
• ALL 3 billion increase to social contributions due to increase of minimum wage (0.15% of GDP)	• ALL 7.5 billion directly related to needs from the COVID-19 pandemic including vaccines (0.4% of GDP)
	• ALL 5 billion reserve fund for elections, project studies, contingency (0.2% of GDP)
	• ALL 1 billion diesel subsidy to agricultural business (0.06% of GDP)

* Estimated impact on general government revenues.

** Estimated impact on general government expenditure.

Source: ERP

The public debt ratio peaked at 76.1% of GDP in 2020, lower than expected, because contracted public guarantees undershot initial projections ([9]). Despite the deficit outcome of 6.9% of GDP turning out 0.4 pps. higher than expected, public debt turned out lower than initially forecast both in nominal terms (-ALL 30 billion) and, due to the higher than expected GDP, as a share of GDP (-3.7 pps.). This is partly because the amount of public guarantees included in the debt stock was adjusted after the year ended on the basis of the guarantees actually contracted ([10]). In addition, the energy sector needed a lower amount of guarantees than expected. Public guaranteed debt is expected to decrease gradually to its average pre-crisis level by 2023.

Box II.1.3: Debt dynamics

Albania

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

	2019	2020	2021	2022	2023
Gross debt ratio [1]	**66.3**	**79.9**	**78.6**	**77.7**	**75.6**
Change in the ratio	-1.4	13.6	-1.3	-0.9	-2.1
Contributions [2]:					
1. Primary balance	**-0.2**	**4.5**	**3.9**	**0.1**	**-0.6**
2. "Snowball" effect	**0.3**	**6.7**	**-2.7**	**-2.6**	**-2.3**
Of which:					
Interest expenditure	2.1	2.2	2.6	2.7	2.9
Growth effect	-1.4	3.1	-4.1	-3.6	-3.3
Inflation effect	-0.3	1.4	-1.2	-1.7	-1.8
3. Stock-flow adjustment	**-1.6**	**2.4**	**-2.5**	**1.6**	**0.8**

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

Source: Economic Reform Programme (ERP) 2021, ECFIN calculations.

The debt dynamics are based on rather optimistic growth expectations and assume a stable exchange rate. Debt reduction is expected to be driven by the favourable snowball effect despite a projected increase in interest expenditure. The improving primary balance, based on a planned decrease in capital expenditure coupled with strong revenue growth, is set to contribute to debt reduction from 2023. Achieving the projected high growth rates and the planned fiscal consolidation are key for debt reduction. The level of public debt is likely to be lower than shown in the table, as the actual outcome was lower in 2020 (estimated at 77.9% of GDP) and public guarantees continue to be overestimated in 2021.The projected debt reduction in 2021, despite the still high primary deficit, relies on a significant favourable impact from stock-flow adjustments. Fluctuations in stock flow adjustments in the table above reflect the issuance and use of Eurobonds. In addition, the projected recovery could well lead to a strengthening of the Albanian currency, which would have debt-reducing valuation effects.

The ERP plans to gradually reduce the public-debt ratio starting in 2021, even though the deficit remains high. The medium-term fiscal plan sets out a 1 pp. reduction of the debt ratio in 2021 and 2022, accelerating to 2 pps. per year from 2023. At the end of the period covered by the ERP, the debt ratio could drop below 73% based on the revised debt figures. This is expected to be supported by strong improvement in the primary balance, which is required to be zero or positive from 2023 according to a recent amendment to the organic budget law. The proposed halving of the fiscal deficit from 6.5% in 2021 to 2.9% in 2022 appears drastic, but the transition will likely be smoother if the very ambitious capital expenditure plans for 2021 prove difficult to implement fully. The share of foreign-financed debt increased from 45.6% in 2019 to 46.5% in 2020 and is set to continue increasing to 48.5% in 2024. It will nevertheless remain below 55%, in line with the debt management strategy to limit exchange rate risks.

([9]) The data in the tables refer to the ERP submission, which did not reflect the latest updates on debt and fiscal outturns.
([10]) Public guarantees were expected to increase from 2.5% of GDP in 2019 to 4.7% of GDP in 2020, partly because of the crisis-related guarantee schemes worth 1.6% of GDP, which the government set up to provide liquidity to business. The organic budget law requires 100% of public guarantees to be accounted to the public debt. In this respect, it is stricter than the EDP calculation method, which requires guarantees to be included in public debt based on the risk that the guarantee will be drawn.

Albania's debt management strategy aims to continue extending the maturity of domestic debt and limit the share of securities with variable interest rates in order to lower roll-over and interest rate risks. **Contingent liabilities from public-private-partnerships (PPPs) and state-owned enterprises (SOEs) remain high with rising out-of-budget payments, while efforts to improve their monitoring need to continue.** The results of the improved monitoring and assessment of PPPs and concessions are reported in annual PPP monitoring reports and are integrated into the fiscal risk statements, which regularly accompany the budgets. In 2020, the fiscal risk analysis started to include the water utility sector, whereas enhanced monitoring of SOEs like Albpetrol and Albgas is planned for 2021. Plans have been made to monitor the natural-disaster risks to which Albania is prone. However, institutional capacity for meeting risk-assessment needs is still limited, with a heavy reliance on external help from International Financing Institutions (IFIs). Payments to 13 PPPs and concessions are expected to reach ALL 14.46 billion in 2021, equivalent to 3.6% of the 2020 tax revenue ([11]); this is a sharp increase from the ALL 9.6 billion in 2020 (2.5% of 2019 tax revenue) and is due to increased payments on maturing PPPs. If new PPPs ([12]) are concluded and tax revenue does not perform as well as expected, the related payments could approach the 5% limit set by the fiscal rule. In addition, the contingent risks stemming from PPPs without budgetary payment obligations, which are not reported in the ERP, remain unevaluated and the state budget remains exposed to liabilities in the energy sector, which receives 70-80% of state guarantees.

Box II.1.4: **Sensitivity analysis**

The sensitivity analysis of this year's ERP extends to 2025 and provides more detail on the expenditure and financing categories to reflect the impact of the scenarios on the financing composition. The ERP provides both an optimistic and pessimistic scenario for real GDP growth rates, which deviate from the 5.5% baseline growth scenario, which assumes no shock in 2021, by +0.5 pps. and -1.5 pps. respectively. In the pessimistic scenario, the revenue ratio is set 0.5 pps. lower than in the baseline, however, assuming that it will exceed all revenue ratios realised since 2015 does not seem adequate for a pessimistic scenario.

Adjustment under the pessimistic scenario is set to avoid increasing the debt ratio, mainly by reducing domestically financed investment and lowering operational & maintenance expenditure without adjusting reconstruction-related and foreign financed investments. In 2021, cutting domestically financed capital expenditure would carry the adjustment alone with a very limited increase in the fiscal deficit. From 2022 on, annual issuances of EUR 500 million Eurobonds will complement domestic borrowing, which will be about 0.5 pps. of GDP higher than under the baseline scenario from 2023 on. Compared with the optimistic scenario, the reduction public debt to GDP ratio would be only incremental in the pessimistic scenario and about 5 pps. higher by 2023, while interest expenditures would only differ slightly between 2.8% and 3% of GDP. In all scenarios, the primary balance would turn positive in 2023, as legally required.

Implementation of the comprehensive public finance management (PFM) reform strategy progressed but the reform pace slowed, hampered by the pandemic and a lack of capacity. The updated PFM reform strategy for 2019-2022 addresses key weaknesses and includes targets to improve public investment management, budget comprehensiveness, expenditure and arrears control, fiscal risk monitoring and revenue mobilisation. However, speedier implementation is prevented by continuing capacity limitations across the administration. The reporting and publication of arrears have substantially improved. VAT refunds reached most small businesses promptly but new agreements had to be arranged for delayed VAT refunds to some large firms and local government arrears increased. Budget execution

([11]) Under the organic budget law, payments to PPPs and concessions from the budget are not to exceed 5% of the actual tax revenue of the preceding year.
([12]) The list presented in the ERP only reflects those PPPs and concessions that are explicitly intended to receive payments from the budget during their implementation; they mainly relate to road construction and hospital services.

improved and capital expenditure increased by 13.7% in 2020, although only 50% of planned reconstruction expenditure was implemented. Public reconstruction funds and concessions and PPPs remain outside the established processes for approving, managing and reporting on public investment; this reduces their transparency and efficiency. The postponement of previously agreed reforms like the medium-term revenue strategy could indicate reform obstacles beyond technical capacity limitations, which also lead to overestimated tax revenue targets and ad hoc changes of taxation policy. Potential election-related disruptions and reorganisations could further delay reform implementation.

The expenditure composition could more clearly prioritise education and innovation and accelerate the increase of spending on social security and healthcare. Higher public investment in infrastructure projects is not matched by a similar increase in investment in human capital, which is a crucial factor for future growth, foreign direct investments and technology transfer. Allocations for healthcare and social protection have increased gradually since 2015, particularly in response to the crisis. However, they remain significantly below EU and regional averages and contribute too little to poverty reduction. The allocation for education is declining and public expenditure on research and development (R&D) remains negligible. In 2021, the government does not plan to further increase the ratio of expenditure allocated to healthcare and social security. Moreover, expenditure on education has been scaled back (both in GDP terms and as a share of total expenditure) and the ERP does mention when public research funding (0.06% of GDP in 2019) will reach the government's 0.1% target.

Albania activated the escape clause of its fiscal framework in 2020, but plans to comply with a strengthened set of fiscal rules from 2021. Albania's organic budget law allows for an exemption from fiscal rules in the event of a natural disaster. The government used this exemption in 2020 when the state of emergency was announced following the November 2019 earthquake and when it was extended due to the COVID-19 pandemic. The exemption clause for states of emergency therefore covered both the increase in the public-debt ratio ([13]) in 2020 and the fact that net borrowing was higher than the planned capital expenditure. At the same time, budget payments to PPPs remained below 5% of 2019 tax revenue. In July 2020, the Albanian parliament adopted a proposal to introduce into the organic budget law a requirement that the primary balance must be neutral or positive from 2023. In 2021, the government does not plan to apply the exemption clause and the budget includes a reduction of the public-debt ratio. Capital expenditure is planned to be higher than net borrowing ('golden rule'). The PFM strategy aims to gradually align fiscal data with ESA 2010 requirements.

1.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Albania's private sector development remains below its potential, as efforts to improve the business environment lack sufficient policy instruments and a more strategic approach. Exports are concentrated in few low-value added products, due to the narrow industrial base. There is widespread informality, businesses have difficulties to employ skilled staff, and support to innovation remains limited.

The Commission has conducted an independent analysis of the Albanian economy to identify the key structural challenges to mitigate the impact of the pandemic, to boost competitiveness and inclusive growth, drawing from Albania's ERP itself but also using other sources. This analysis of the economy shows that Albania experiences several structural weaknesses across many sectors. However, the main challenges to mitigate the impact of the COVID-19 pandemic and to support the recovery in terms of boosting competitiveness and long-term and of sustained and inclusive growth are: (i) increasing innovation and skills of young people and adults to enhance employment; (ii) increasing coverage and

([13]) The fiscal rules in Albania set a debt-to-GDP ceiling of 45%, with the obligation to decrease the ratio each year until the target is reached. In addition, targeted net borrowing should be lower than planned capital expenditure plans and payments to PPPs limited to 5% of the previous year's' tax revenue.

adequacy of social protection and health insurance to reduce the share of population at risk of poverty and (iii) improving the business environment and investment climate by increasing government support and tackling informality.

Albania also needs to tackle corruption, improve the rule of law and strengthen institutions in order to promote competitiveness. Addressing these fundamental challenges is a prerequisite for a successful transformation of the economy. The Commission is closely following the issues of strengthening the rule of law, including the ongoing justice reform as well as those related to corruption in the annual Albania report.

Key challenge #1: Increasing innovation and skills of young people and adults to enhance employment

Albania's labour market contracted slightly due to the COVID-19 pandemic with informal workers hit harder. The employment rate (20-64) improved by 10.5 pps. between 2014 and 2019 to reach a record high of 67.1%. Despite lagging behind the EU-27 average by 6 pps., this was the highest level among the Western Balkan countries. Although female employment has increased at a swifter pace than male employment in recent years, the gender employment gap still stood at 15 pps. Following a decrease to 65.3% in the second quarter of 2020 due to lockdown measures and an increase to 67.1% in the third quarter, the employment rate fell back to 65.8% in the fourth quarter, i.e. a decrease by 1.2 pps. y-o-y. Data from the tax authority show that by December 2020, the number of formally employed people exceeded the 2019 level. Unemployment (15-64) grew slightly and reached 12.3% in the fourth quarter of 2020, i.e. an increase by 0.7 pps. y-o-y. Even as formal employment rebounded, between January and December 2020 the number of registered unemployed increased by 25 955 (or 39%) to 92 326 between January and December 2020, the highest level since 2017. Only 16% of those newly registered as unemployed between the first and the third quarter were eligible for unemployment benefits. This suggests that informal workers and people in non-standard forms of employment represented a significant share of the newly registered unemployed and that these groups were left on the fringes of government support, thus increasing their risk of poverty and social exclusion.

Ever more young people are graduating from higher education, but the share of young people not in employment, education or training (NEET) is high. Albania saw a remarkable shift in higher education levels between 2010 and 2019 as the share of university graduates in the age group 30-34 rose from 11.4% to 31.3% and reached 40.8% for the age group 25-29. In 2019, one in four young people aged 15-29 were NEETs (26.6%); this is more than double the EU-27 average (12.6%). Within this age group, the share of NEETs was highest among upper secondary graduates (28.9%), followed by university graduates (26.5%), while young people with no more than lower secondary education fared the best (24.4%). This indicates a very challenging labour market transition for young people and problems with the quality of education. This is linked to the structure of enterprises that are not yet able to absorb the increased number of graduates with higher education coupled with currently low attraction of foreign direct investment into the country and limited or inexistent career guidance, whereby students make choices that may not always correspond to the demand in the labour market. The situation also highlights a potential need for additional actions to channel the increasingly skilled young workforce into entrepreneurship and social economy.

The government increased its support for active labour market policies (ALMPs) to tackle the crisis. In 2020, the ALMP budget was increased by 50% and two new employment promotion programmes (EPPs) were approved for people who lost their jobs due to the crisis, one of which specifically targets people who were informally employed. However, due to the difficult situation in 2020, the budget allocation was not used in full and the increase was carried over to 2021. Implementation of the new EPPs is prioritised in 2021 under the *reform measure 16 ("Improving the employability of the most vulnerable unemployed")* to help those who lost their jobs due to the crisis to get back to work. Albania intends to finalise the public employment service's information system, implement jobseeker profiling and develop individual employment plans in 2021; these measures are necessary to boost the effectiveness and efficiency of active employment policies. The reform measure provides for the creation of a Youth Guarantee programme. Given the high number of NEETs and an increased risk of school drop outs due to the pandemic, these plans are very relevant to increase the labour market integration of young people. However, the proposed approach, which makes reference to a pilot with 200 young people in 2022 and a deployment countrywide in 2023, is not sufficiently close to the principles of the EU Youth Guarantee, such as universality, close coordination among multiple ministries and agencies, the establishment of an adequate legal framework, and covers not only employment and internships, but also apprenticeships and further education opportunities.

The share of the active population with low educational attainment remains high and progress is limited by insufficient provision of and participation in learning. In 2019, almost half of the population aged 25 to 64 had low educational attainment (44.7%), meaning primary education or less. This is double the EU-27 average (21.6%). Among registered unemployed, the share exceeds 55%. However, the system lacks any form of remedial education for the young and middle-aged workforce. Participation of adults (people aged 25 to 64) in formal or non-formal education and training is extremely low (0.8%) compared to the EU-27 average (10.8%). Vocational training courses are mainly provided by public vocational training centres (VTCs) but are insufficient in scale, with only 15 154 participants in 2019. Only 12.4% of registered jobseekers (8 818) were upskilled or reskilled in VTCs in 2019. The geographical coverage by ten VTCs is limited, with one of them being mobile and covering the north-east of the country. The courses on offer cater for low-skilled people. Albania is developing a bylaw on outsourcing training to private providers to increase the offer for mid- and high-skilled people. Another 6 814 adults were certified after attending vocational training delivered by 136 private training providers. The system of recognition of prior learning is underdeveloped, thereby limiting access to formal qualifications for those who may have earned relevant competences in informal settings.

Albania lacks tools for regular monitoring and forecasting of skills needs in the labour market. This makes it difficult to set the right priorities for secondary vocational education and tertiary education and provide relevant career guidance and upskilling and reskilling programmes for unemployed and low-skilled people. An inadequately educated workforce is the third of the top three business obstacles for medium and large enterprises in Albania (World Bank 2019). The challenge is recognised in the ERP and *reform measure 16* plans to conduct a skills needs analysis in 2021. The Ministry of Education, Youth and Sports has started using administrative data to assess the labour market transitions of university graduates and collect information on their sector of employment and earnings. This exercise can provide first insights into the quality and relevance of curricula and lead to the prioritisation of programmes whose graduates are in demand on the labour market.

Vocational education and training (VET) attracts only a low number of young people, is under-financed, lacks stronger involvement of the private sector and its modernised legal framework still lacks full operationalisation. Only 17% of upper-secondary students attend VET, far below the regional average of 62%. VET is a second-choice form of secondary education attracting mainly boys (who account for 83.6% of all VET students) from vulnerable socio-economic backgrounds, which raises questions regarding equal opportunities in student sorting. The system is dependent on donors' funds, which exceed state allocations. State funding does not take into account the real costs of different VET providers. The National VET Council is not yet operational and sectoral skills committees are not established yet, resulting in limited opportunities for the private sector to shape the VET policy design (SDC and UNDP 2020). A comprehensive set of laws has been adopted since 2014 to modernise VET provision, but there are still difficulties with making the legal framework operational through secondary legislation. A bylaw on work-based learning was adopted in 2020, but other important bylaws are still pending (on financial autonomy, opening/closing of VET providers and on inspection). The Ministry of Finance and Economy has very limited human resources to advance with the reform while both agencies, the National Agency for Employment and Skills (NAES) and the National Agency for VET and Qualifications, are not fully staffed yet. NAES has to handle new responsibilities and is in an early stage of operationalisation of its new functions.

Reform measure 15 ("Increasing the quality and access to VET") aims to address some of the existing challenges. It plans the completion of the legal framework as regards financial autonomy and income generation by VET providers. The planned establishment of two sectoral skills committees is a positive step towards increasing business involvement, but the number of committees could be higher and the schedule for their establishment could be linked with the implementation of the optimisation plan for VET providers, which is expected to be completed by September 2022. The plan on which businesses were not consulted rearranges 46 existing VET providers into 27 institutions, most (22) of which will perform both initial and continuous VET, thus increasing the financial efficiency of the system and expanding the offer of continuous training. The optimisation plan provides for capacity building for VET providers to prepare them for new responsibilities entrusted to them by the VET law.

Albania also ranked particularly low in the 2019 Global Competitiveness Index (World Economic Forum, 2019) for innovation capability (110th of 141) and R&D (126th) and spends less than 0.5% of GDP on the latter. It has few innovation support or development policies in place, even though these could stimulate private investments, increase competiveness and help to diversify the economy. A clear methodology to establish research or science funding is also missing. There are no operational science or technology parks and no funds to support the establishment of new business incubators (SME Policy Index, 2019). At the same time, university graduates face higher unemployment than in the EU (12.3% compared to 5.3% for the age group 15-64). Moreover, the collection of statistics about research and innovation is insufficiently developed to support the policies.

Despite some progress on the digital agenda strategy and e-government, fixed broadband penetration is still low, notably in rural areas (40% of the population) where only 5% of people are connected to the internet. The limited digital infrastructure and the lack of digital skills negatively impact the supply and demand for digital products and the limit the digital sector's potential to create employment and positive effects, especially in services. E-commerce remains underdeveloped, though the COVID-19 crisis requires from enterprises and consumers to adjust themselves to distance marketing and trade.

Reform measure 10 ("Improving institutional, financial and human capacities for research and innovation") is very relevant and if implemented, it has the potential to foster Albania's innovation and research capacities. The measure is ambitious, providing for R&D to be doubled as a percentage of GDP in three years. It also includes the completion and implementation of the Smart Specialisation Strategy (S3). However, efforts for the implementation of these measures will need to be clearly steered and strongly supported, for their timely adoption.

The recent establishment of the Council for Higher Education and Research should foster the implementation of measures to strengthen research and innovation capabilities at the national level. However, efforts need to be stepped up for the introduction of indicators in the statistical programme for the production of statistics and reliable data on science and technology as well as of a methodology to assess expenses / funding on R&D in both public and private sector.

Key challenge 2: Increasing the coverage and adequacy of social protection and health insurance to reduce the share of the population at risk of poverty

Spending on social protection is low. Between 2015 and 2019, Albania spent 9.3% of its GDP on social protection, excluding healthcare; this was half the EU-27 average of 18.6%. Most social protection spending was on pensions (82.4%), followed by non-contributory cash assistance programmes to people with disabilities and people at risk of poverty (13.7%, equivalent to 1.27% of GDP) and by the baby bonus scheme (accounting for 1.5% of social protection spending). In 2019, only 1.1% (0.1% of GDP) of the social protection budget was spent on passive and active employment policies and around 1.3% (0.12% of GDP) on social services and administration costs for social protection at central and municipal level.

Poverty and social exclusion are widespread and the capacity of social transfers to decrease poverty is very low. Almost half of Albania's population (49%) was at risk of poverty or social exclusion in 2018, more than double the EU-27 average (21.6%). In 2020, 63 510 families (around 9% of Albanian population) received means-tested income support through the Economic Aid scheme (*Ndihma Ekonomike*). The adjusted means-test was deployed countrywide in 2019, but no assessment is available to show whether targeting of poor households has improved. People with disabilities (147 102 in December 2020) receive monthly benefits to cover their medical and care costs and compensate them for their inability to work. Despite this, 56.1% of them live at risk of poverty or social exclusion ([14]). Before the crisis (fourth quarter of 2019), only 3.8% of people registered as unemployed received unemployment benefits while another 31.2% received support through the Economic Aid, leaving 65% without material support. Unemployment benefit coverage and the level of social benefits are structurally too low to maintain private consumption and support the economic recovery. The capacity of social transfers (excluding old age and family pensions) to reduce the at-risk-of-poverty rate stands at only 11.3%, below regional peers and significantly below the EU-27 average reduction of 32.38%.

The allowances paid under the Economic Aid scheme are too low to combat poverty. Based on Statistics on Income and Living Conditions (EU-SILC) 2018 data, the annual allowances for a four-member household of two parents and two children under 14, including monthly energy compensation and an allowance for both children attending school (ALL 80 976), stand at 14.4% of the median equivalised annual income for a household of this composition (ALL 562 668), far below the poverty threshold.

The government took temporary measures to increase the adequacy of social assistance benefits and extend income support during the pandemic. From April to June, people working in businesses that had limited annual turnover and closed due to the lockdown received monthly payments equal to the minimum wage. Importantly, this measure included self-employed people and unpaid family members. A one-off lump-sum payment of ALL 40 000 was made to employees in most of other businesses that closed or were impacted by the economic slowdown, thus boosting their income. Unemployment benefits were doubled, but only for people who were registered as unemployed before the lockdown, while eligibility criteria for unemployment benefits were not eased. Of the 21 273 people newly registered as unemployed between the first and the third quarter of 2020, only 3 330 (15.7%) were granted unemployment insurance, while 5 850 received assistance under the Economic Aid scheme (27.5%). Ineligible formal workers who were laid off due to the lockdown or the economic slowdown benefitted from a lump-sum of ALL 40 000, while informal workers who were laid off did not receive any material support. Economic Aid benefits were doubled for three months (April to June 2020) and the budget of the scheme for 2021 was increased from ALL 4.6 billion to 7.1 billion. As a result, benefits doubled in the first six months of 2021; however no assessment was performed to gauge benefit adequacy. In an effort to address the policy guidance of May 2020 and the relevant conditionality attached in the European Commission's Macro-Financial Assistance (MFA) to Albania, *reform measure 17 ("Strengthen and expand health and social protection coverage")* foresees to assess the adequacy of Economic Aid benefits in 2021. This assessment will take into account the data from the EU-SILC and establish a transparent mechanism for their annual review. A subsequent adjustment of benefits is planned for 2022. During the lockdown of 2020, a lump-sum of ALL 16 000 (EUR 130) was paid to 4 524 families that had unsuccessfully applied for Economic Aid benefits between July 2019 and April 2020. In addition, a total of 88 671 families received food packages, hygiene kits and emergency support services. The recipients included 18 144 Roma/Egyptian families and 54 980 elderly people.

The scarcity of social care services is a major obstacle to the active inclusion of vulnerable people. Only 10 065 people, or 0.35% of the population, received social care services in 2019 (State Social Services data). Social care services are distributed unevenly across the country and are completely lacking in one third of municipalities (21 out of 61). Albania only provides five of the seven types of services

([14]) As measured for people aged 16 and above strongly limited or limited in activities due to health problems.

defined by law. Para-social services and specialised services are not available yet. *Reform measure 17* only sets the very modest goal of employing 150 socially vulnerable people and people with disabilities in social enterprises by 2023.

Although the number of local social plans is increasing, very limited resources are available to establish new social services and the capacities of local governments are insufficient. In 2020, the number of municipalities with an approved social plan increased substantially from 24 to 50 (of 61) with the help of donors and NGOs. Efforts to build capacity in 2020 focused on 21 municipalities that did not provide any social services. Despite this, local governments' capacity to assess needs, apply for government funds and manage social services remains weak. Municipalities must have a social plan to apply to the Social Fund, which was put in place in 2019 to help roll out new social care services. The mid-term budget for 2021 to 2023 foresees that annual allocation will stagnate at ALL 200 million (approx. EUR 1.61 million), despite an increase in the number of eligible municipalities and thus in the resources required. The target under *reform measure 17* of developing 45 new services with support from the Social Fund is realistic given the limited funding provided. However, it is insufficient to markedly improve the availability of social services in the country. The question of whether the newly established social services will be sustainable once support from the Social Fund is phased out, has not been addressed yet.

The Albanian healthcare system is underfinanced and the share of uninsured people is significant. The budget allocation to healthcare has been steadily increasing as a share of GDP, from a low of 2.5% of GDP in 2008 to 3% in 2018, 3.05% in 2019, 3.36% in 2020 and 3.41% in 2021, the latest marked increases being linked to the COVID-19 pandemic. This is still below the allocation levels of regional peers (with the exception of Kosovo) and significantly below the EU-27 average of 7.0% (2019 data). Public spending on healthcare as a share of total government spending has also been consistently low at 10% or below, thus not reaching the 12% share recommended by the World Health Organisation (WHO). This signals that healthcare has low priority in the allocation of the government budget. Health services within primary and hospital care are financed through the Compulsory Health Care Insurance Fund (CHCIF). Insurance contributions for formally employed people only covered about a third of CHCIF expenditure in 2019 (32.7%), with the state budget financing the remaining 67.3%. The state budget covers investments, other capital expenditure, as well as health insurance for economically inactive people ([15]). Other economically active people (self-employed, small family businesses, farmers) can enrol voluntarily in the health insurance scheme. There are around 600 000 uninsured citizens (21% of the population); they are principally informal workers ([16]), low-income groups, minorities (Roma/Egyptians), and people living in rural and peri-urban deprived areas (WHO 2020a). The 2020–2025 Strategy on the development of primary health care services calls for the status and funding of primary healthcare to be strengthened and increased.

The government took steps to increase the healthcare coverage for uninsured people. Uninsured people are entitled to free emergency care and the government put in place additional free entitlements irrespective of insurance status under the 2016-2020 Albanian National Health Strategy (ANHS). These entitlements are annual health check-ups for people aged 35 to 70 years (2016) ([17]) to detect non-communicable diseases, visits to general practitioners (2017) and national breast and cervical cancer screening programmes (2018). As a result, annual check-up visits and the use of primary healthcare increased in recent years. However, the coverage of annual check-up visits falls short of objectives announced in ANHS. If admitted to hospital, the care and medications for uninsured patients are covered and, similar to insured patients, they only have to pay entry fees (ALL 2 000 to 4 000). However, further outpatient care and medicines are not covered for uninsured people. The chronically-ill benefit from

([15]) Children, students under 25 years, pensioners, beneficiaries of Ndihma Ekonomike and disability benefits, registered unemployed, asylum seekers and other categories.
([16]) 30% of all employment in non-agricultural sector in 2019 was informal.
([17]) The programme was introduced already in 2015 for a more restrained age group of 40-65.

reimbursement of drugs on the government list. Additional 12 health care packages cover specific intensive therapies in private facilities, but uninsured people face fixed tariffs. Children below 18, students under 24 and recipients of Economic Aid benefits are entitled to free, mainly preventive, dental care in public facilities. In practice, most dental treatment is provided in private facilities and people, even if insured, must pay the full cost of care (WHO 2020b). Although the number of medicines on the government list has grown and state financing has increased, co-payments for outpatient medicines continue to drive financial hardship (WHO 2020a). As a result of legal changes introduced in November 2020 (Decision of the Council of Ministers No 908), all people infected with COVID-19 are considered to have health insurance.

Access to health care is limited mainly due to high out-of-pocket payments and remoteness of healthcare facilities. The limited public spending has resulted in an increased reliance on out-of-pocket spending of Albanian households that represented 45% of current health expenditure in 2018, significantly above the EU-27 average of 22% and above regional peers. However, it has been decreasing since 2014, when it was 52% (WHO Global Health Expenditure Database). Heavy reliance on out-of-pocket payments, a part of which is informal, results in significant financial hardship for households and may contribute to increased inequalities and also to barriers in access to healthcare (Tomini et al 2015). In Albania in 2015, 12.4% of households experienced catastrophic health spending (WHO 2020b). In 2018, 21.5% of the population reported an unmet need for medical care (EU-SILC); this was 12 times higher than the EU-27 average (1.7%) and significantly above regional peers for which data are available. Almost two thirds (63.9%) of respondents reported the cost as the reason. The main groups affected include persons with disabilities and chronic diseases, poor households, people aged 65 and over, and minorities. Additional reasons for low access are long waiting times due to the limited number of medical professionals and large distances to primary health care centres in rural areas and low density municipalities (WHO 2018), posing a particular accessibility challenge to persons in need of long-term care and elderly people. While not resolving the issue of distance to care facilities, the budgetary programme launched in 2018 for the reconstruction of 300 primary health care centres has improved service provision in urban and rural areas.

Albania is facing a critical shortage of doctors that could jeopardise access to medical care in the coming years. In 2016, the per capita ratio of medical doctors was 1.216 per 1 000 inhabitants, significantly below the averages for the EU, regional peers and upper-middle-income countries (Eurostat, World Bank DataBank). In the beginning of 2020, there were 330 vacancies for general practitioners and 250 for specialists, representing about 21% and 12% respectively of those currently employed. The current number of physicians being trained in the country (around 300 per year) is lower than the number of vacancies and retirements. The geographical coverage of healthcare personnel is skewed towards central and larger urban areas, as opposed to remote and small districts. The emigration of doctors is increasing due to low salaries, unfavourable working conditions, job and social insecurity (including a high number of lawsuits) and a lack of professional development opportunities (SDC 2020). A survey from 2018 contains alarming figures showing that 24% of doctors are prepared to leave Albania immediately and another 54% would do so if given a chance (FES and TFL 2018). The 40% salary increase given to medical workers in 2021 is a step in the right direction, but it does not address the other factors driving doctors out of the country.

Reform measure 18 ("Increasing access to health care"), envisages to tackle some of the challenges described above, especially in terms of expanding the coverage of free healthcare packages and screening and prevention programmes as well as increasing the list of reimbursed medicines. However, it does not do enough to tackle high out-of-pocket expenditure, low public spending on healthcare or the emigration of healthcare professionals.

Key challenge #3: Improve the business environment and investment climate by increasing government support and tackling informality.

Albania's business environment remains prone to structural weaknesses. Albania's private-sector development remains below its potential, and efforts to improve the business environment need more effective policy instruments. The COVID-19 pandemic has exacerbated certain weaknesses, notably the low level of product diversification: tourism, for instance, accounts for over 20% of GDP (EBRD Regional Economic Prospects, April 2020). The private sector mainly consists of micro and small businesses, which face obstacles to access financing due to their lack of business know-how, low financial literacy and high degree of informality. The reforms to improve the economy's competitiveness have stagnated, and Albania has dropped further in the ranking of the Global Competitiveness Report, sliding from 76th to 81st (World Economic Forum, 2019).

The main business environment obstacles identified by Albanian firms were multiple and complex tax rates, competitors' practices in the informal economy, an inadequately educated work force, transportation and corruption (Enterprise survey, Albania, 2019). Albania's Small Business Act Profile confirms that in order to increase the number of jobs in the private sector, it is essential to scale up the institutional capacity of business support services that aim to improve access to finance and offer support for scaling-up, and to facilitate the internationalisation of firms. Furthermore, the unclear land ownership represents an additional burden for companies, notably in agriculture, tourism as well as contributing to informality. The continued lack of diversification, including in terms of export destination, contributes to Albania's economic vulnerability. Despite the significance of the agriculture (which generated 21.2% of gross value added in 2019 according to EuroStat, the largest in the region), agricultural incomes and investment are low, and the food trade balance is in deficit. Albania is in the process of developing a new Business and Investment Development Strategy (BIDS) for the period 2021-27. However, its content and potential benefits are not presented in the ERP. Given Albania's small domestic economy, integration into the global economy could be a crucial growth path, in this respect Albania could have foreseen efforts to strengthen the Quality Infrastructure necessary for the free movement of good, enabling Albanian firms to place goods on the market in line with rules that are in compliance with the EU single market.

Weak contract enforcement and a high regulatory burden on businesses continue to hamper private-sector development. Albania still needs to streamline its business regulations, ensure better impact assessments of legislative proposals, wider and more complete and regular stakeholder consultations and put in place strong monitoring mechanisms. The lack of a regular work contract, social and health insurance and under-declared salaries represent the main forms of informality.

The rule of law must be strengthened to improve the business environment and to fight corruption in Albania. The ambitious reform of the justice system, which continues to implemented, should promote an effective and independent judicial system. Such measures are crucial to combat corruption and the informal economy and is a pre-requisite for creating a business environment conducive to investment growth.

The ERP's analysis of businesses obstacles leaves out key aspects affecting the investment climate. While it covers issues linked to the low skills, the need for better access to finance, and highlights government measures to support micro and small businesses during the COVID-19 pandemic in 2020 through different support schemes, it does not refer to the low level of digitalisation and innovation as well as the limited capacities for research and innovation (although some reform measures to address these obstacles are included in the ERP). The same applies to the low level of FDI and product diversification and exports. Furthermore, issues related to the implementation of the rule of law reforms, corruption, unclear property titles and proper functioning of judiciary system, which remain serious impediments to businesses and attractiveness of foreign investments, are also not included in the ERP diagnostics.

The informal economy continues to constrain Albania's economic development. The informal economy is estimated to account for at least one third of GDP ([18]), despite some efforts to tackle it, and 30% of the workforce employed in the non-agricultural sector is estimated to be in undeclared work (Labour force survey, 2019). The number of employees without a written contract is among the highest in southeast Europe (SME Policy Index, OECD, 2019). Moreover, between 2016 and 2019 the number of workers who reported that they are receiving lower remuneration than in their written contracts, increased by 23%, reaching 34% (SELDI, 2016). The State Labour and Social Services Inspectorate, the law enforcement institution entrusted with ensuring decent working conditions in the workplace and tackling informality in the labour market, is not empowered with adequate human and financial resources.

The informal economy has a large negative impact on the business environment: it keeps tax revenues low and reduces the fiscal space for investments. In addition, the lower payment of social contributions undermines the funding of the social security system. The poor quality of social services and security are among the reasons cited by Albanians as a reason to migrate. Informal economic activity also implies a lower use of banking intermediation, which is particularly an issue in Albania and leads to reduced access to finance. Informal businesses also under-cut? declared businesses, thus leading to unfair competition.

The high regulatory burden contributes to informal economic activity, as it adds further costs to doing business. The tax burden and the complexity of the tax administration can encourage tax evasion, and in recent years Albania's taxation system has become more complex, with many exemptions and a variety of thresholds for tax registration. The introduction of fiscalisation is therefore welcomed, as it strengths financial inclusion of individuals and SMEs. The Bank of Albania is also working on countering the informal economy by encouraging the transition from cash transactions into recordable digital transactions.

Informal employment is often linked to poverty and social exclusion. It tends to affect workers with fewer skills and less education, in less productive sectors, notably in agriculture and in some service sectors where enforcement of regulations is weaker. To foster the formalisation of the labour market, and as part of the response to the COVID-19 pandemic, Albania adopted the Skema2 employment programme to subsidise formal employment of unemployed people who had lost their jobs in the informal sector. However, this programme is insufficient in scale, with only 1 500 potential beneficiaries, and its scope (as it does not foster skills).

The ERP analysis of the informal economy and informal employment is not comprehensive, as it focuses largely on measures within the competences of the Bank of Albania and the tax authorities. The analysis does not make it clear what the estimated level of informality is and which are the most affected sectors of economic activity. Albania still lacks a comprehensive strategy to tackle and monitor all aspects of informality, and would benefit from a clear action plan with baselines, including clear and measurable targets to establish the regular performance-based monitoring of its implementation and results.

The Economic and Investment Plan for the Western Balkans will help increase the competitiveness of Albania's economy backed by a green and digital transition. A substantial investment package, which is at the heart of the Economic and Investment plan, will direct a large majority of support towards key productive investments and infrastructure. This will support the twin green and digital transition and the development of connected, competitive knowledge-based, sustainable, innovation oriented and thriving economy, with an increasingly dynamic private sector. Circular-economy principles, as a basis for the Economic and Investment Plan and defined in the green agenda for the Western Balkans. The principles could significantly foster sustainable production and consumption. Increasing resources

([18]) Informal Economy in Albania, Academic Journal of Interdisciplinary Studies, MCSER Publishing, Rome-Italy, Vol 2 No 8, 2013.

productivity within the economy would allow local SMEs to benefit from the business opportunities of increased resource efficiency and by further access to innovative technologies.

Building a common regional market has the potential to further enable competitiveness and growth. The common regional market is based on EU standards and will help the country integrate in regional and European value chains. It will also help make the economy more attractive for FDI in tradable sectors, notably by increasing the size of its market. Further connectivity with neighbouring countries in transport and energy will strengthen access to, and integration into, the regional market. The new Additional Protocol 6 of the Central European Free Trade Agreement (CEFTA) to liberalise trade in services also opens new opportunities in the dynamic service sectors, and therefore should be implemented swiftly. Regulatory and investment moves to create a regional digital space and more integrated labour markets with neighbouring economies will offer new possibilities for the country's young people. This is especially important given the high rates of youth unemployment.

Reform Measure 6: "Strengthening the fight against informality"

This measure is a well-designed measure which can have an impact in the reduction of informality, but it mainly focuses on the fiscalisation aspects and it is not inscribed in a wider comprehensive strategy to tackle all aspects of informal economic activity and informal employment. Implementation has just started and it foresees that all the businesses subject to the law on fiscalisation should be using electronic invoices by the end of 2021. The proposed indicators are relevant but there is no indicator to measure the tax gap, the expected increase in revenues, nor on the informality in the labour market. The breakdown for the expected costs is not provided and there is no indication of the source of funding. Furthermore the risk analysis does also not take into account the effects of the delays that may result from the COVID-19 pandemic, or the election process.

Reform measure 7: "Developing a legal framework to support innovative start-ups"

This measure was carried over from the previous ERP. It seems to have good momentum and strong commitment from the government to nurturing the nascent innovation ecosystem. However, efforts need to be stepped up to ensure the adoption of the law on start-ups and streamline the institutional framework responsible for fostering research and innovation while also monitoring its impact.

The activities expected in 2021 have been described in some detail but the ones planned for 2022 and 2023 are not clear, rendering the monitoring of its implementation difficult. While one of the main actions planned is the implementation of the innovation and entrepreneurship pillar of BIDS 2021-2027, there is no explanation of what is to be addressed under the BIDS. The measure could have been more ambitious, for instance it could have taken the form of a fully-fledged innovation programme encompassing activities to stimulate smart specialisation, business angels, and the creation of innovation hubs that would build on centres of research, (such as universities), and linked to a range of measures to boost digital skills. Furthermore, responsibilities should have been identified for the implementation of the major ongoing exercise of Smart Specialisation Strategy (S3) (reform measure 10), notably in light of the Albanian commitments under the Innovation Agenda for the Western Balkans and Horizon Europe.

Reform measure 8: "Improving access to finance for SMEs"

This measure was also carried over from the previous ERP, but most of the comments made in the Commission's 2020 assessment have not been incorporated. The digitalisation of SMEs and the streamlining of funding instruments to improve SMEs' access to finance are welcome activities, and could have an impact on competitiveness, if matched with a substantial increase in the institutional capacity of business support services.

The first activity aims to establish z the unit to promote SMEs within the Ministry of Finance and Economy in 2021. This was expected to be carried out in 2020 but no explanation for its postponement has been provided. An EU-funded assessment of the grant scheme offered by AIDA was conducted during 2020, and the activities were expected to be built upon the findings. However, this is not mentioned in the description part of the reform measure. It is also not clear whether the redesigned grant schemes will already start in 2021, and how much additional funding is expected to be provided.

The measure also envisages that SMEs will use of an online centralised information platform to find financial support. However, there is a risk that it may not reach those SMEs which are not online, or entrepreneurs with limited digital skills. As Albania remains a small market for investors, the activity on e-commerce could have a meaningful impact if it is developed in a context of the Common Regional Market, as highlighted in the Economic and Investment Plan for the Western Balkans. The expected indicators and targets are nevertheless very modest and no information is provided on the costing and budgeting of this reform, thus calling into question its potential impact.

Reform measure 9: "Modernisation of retail payment instruments"

This measure was also carried over from the previous ERP. It aims to create the conditions needed to improve the range of available banking services. This could contribute to improving access to finance, enhancing the level of entrepreneurship, and to combating the informal economy, money-laundering and tax evasion. The measure is well designed and the activities are outlined clearly, with a specific timeframe and funding, as are the risks and mitigating measures. This measure is also pertinent as the number of electronic transactions have increased considerably during the COVID-19 pandemic, and the banking system was able to provide for this service, having been required to do so by the unprecedented conditions. However, the measure does not explore potential synergies with other government measures such as the payment of social benefits.

Box II.1.5: Monitoring performance in light of the European Pillar of Social Rights

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

Relative to the EU-27 average, there is scope for improvement in all available indicators of the Social Scoreboard supporting the European Pillar of Social Rights ([19]). Albania has steadily improved employment and unemployment rates. The share of young people not in employment, education or training (NEETs) decreased only very slightly between 2017 and 2019 (0.4 pps.), meaning Albania remains among the worst performers in the region. The gender employment gap (20-64) was wider than the EU-27 average in 2019 (15 pps. vs 11.7 pps.), but had improved on previous years. The share of people at risk of poverty or social exclusion was very high (49%) in 2018. This is the second highest level in the Western Balkans and Turkey, among countries where these data are available. Albania is a medium performer in the region as regards the income quintile ratio.

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

Albania's education outcomes remain very low, partly due to low levels of funding. There are significant rural-urban and socioeconomic differences in access to education and the early school leaving rate remains the highest after Turkey.

The social protection system does not adequately target those in need. Although there is a social assistance scheme, the allowances paid are too low to prevent poverty. This is documented by the low impact of social transfers (excluding pensions) on poverty reduction which was only 11.03% in 2018 compared to 32.38% in EU-27. The effects of the social assistance reform on better targeting still need to be assessed by tracking the share of households in the poorest decile/quintile that are covered by the scheme. The capacity of local governments, which are responsible for providing social care, is too low. The pension system has almost universal coverage, albeit with low pensions. About 600 000 adults do not have health insurance, primarily informal workers, low-income groups, minorities (Roma people), and people living in rural and

([19]) The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The indicators are also compared for the Western Balkans and Turkey, with one small adjustment in the age bracket for the unemployment rate (reducing the upper age limit to 64 instead of 74) for Albania and Kosovo due to data availability. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2019 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). Data from 2017-2019 are used and can be found in Annex A.

peri-urban deprived areas. 21.5% of people aged 16 and over reported an unmet need for medical care in 2018; this was 12 times higher than the EU-27 average (1.7%).

Data availability improved in 2019 with the first publication of the Survey on Income and Living Conditions (EU-SILC), but some headline indicators of the Social Scoreboard are still not measured (GDHI) or are not publicly available. Despite an announced publication in December 2020 of EU-SILC data for 2019, the publication was postponed and the data were not available by mid-April 2021. Although the delay is being attributed to COVID-19 pandemic, the data were collected before its outset. Micro data from SILC have not yet been made available to researchers to carry out up-to-date analyses of social protection and inclusion policies. Employment data are regularly measured both in the Labour Force Survey and by National Employment Services.

1.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2020

Overall: Partial implementation (55.9%) ([20])	
2020 policy guidance	**Summary assessment**
PG 1:	There was **partial implementation** of PG 1
Keep the increase of fiscal deficit and public debt temporary while accommodating the fiscal costs of post-earthquake reconstruction and addressing the pandemic impact in a transparent and cost-effective manner	1) **Substantial implementation**: The medium-term fiscal framework plans for a reduction of fiscal deficit and public debt from 2021, while the 2021 budget accommodates significant reconstruction-related spending. The COVID-19-related financial support to households and business was transparent, legitimate, targeted and cost-effective (distributed via existing channels).
Set time-limits for tax-relief measures, while paying all VAT refunds in time	2) **Partial implementation:** The deferral of tax payment medium and large companies and teh provision of tax relief for small businesses were limited to 2020 and partly extended to 2021. For 2021, the tax exemptions were announced for small businesses without time limit (below ALL 10 and ALL 14 million turnover exempted from VAT and profit tax respectively). New regular VAT refund claims were paid on -time in 2020 but the tax authorities have sought new agreements with some companies to delay payment of VAT refund arrears.
Adopt the medium-term revenue strategy, with a particular focus on reviewing tax expenditures	3) **Limited implementation:** the government postponed the development and adoption of the medium-term revenue strategy was to 2022. The Ministry of Finance and Economy is working on a tax expenditure review, supported by the World Bank.

([20]) For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2020 Economic Reform Programmes available at https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en.

PG 2: Publish on a regular basis a breakdown of all arrears of public expenditure and prevent any increase of their stock above the level of end-2019. Assess and approve all investments, which involve public funds, through the same approval process, based on the same minimum quality and fiscal affordability criteria. Increase the institutional capacities for monitoring and containing fiscal risks stemming from public-private partnerships, concessions and state-owned enterprises.	There was **partial implementation** of PG 2. 1) **Full implementation:** A breakdown of all arrears was published regularly and their stock did not increase above the 2019 level. 2) **Limited implementation:** Albania postponed the unification of the approval process due to the COVID-19 pandemic and capacity problems; capacity building efforts continued. 3) **Partial implementation:** The Financial Risk Unit has continued to monitor and report on fiscal risks related to PPPs, concessions and SOEs without additional staff. It improved its capacity with the support of technical assistance from the World Bank, funded through regional EU programmes.
PG 3: Closely monitor financial stability challenges arising as a result of the coronavirus pandemic and take appropriate action if needed Resolve remaining legal impediments to NPL resolution in the realm of the government, especially the bailiff deadlock that lingers on collateral execution, also in order to mitigate a potential renewed build-up of NPLs as a consequence of the coronavirus pandemic. Develop the market for forex hedging instruments, taking into account international expert advice, in the context of strengthening the use of the national currency.	There was **partial implementation** of PG 3. 1) **Substantial implementation.** The authorities have taken several measures to provide borrower relief and help smoothing the adjustment of the banking system to the major economic shock experienced, thereby ensuring that banks continue supporting the economy. They issued guidance and kept close communication with banks to ensure efficiency and transparency in the restructuring process and mitigate operational risks. In addition to prudential measures, banks were also required to efficiently administer expenses, including bonuses and the distribution of dividends. The full impact of the crisis in particular on asset quality is yet to become visible, likely requiring further adjustments. 2) **Limited implementation:** There has been no progress in resolving the bailiff deadlock that continues to linger on collateral execution. Credit registry has been enforced with additional information that captures the performance of the portfolio during the pandemic. 3) **Partial implementation:** Based on the IMF's recommendations, an action plan has been drafted, including a set of measures to be taken in order to develop hedging instruments. Its implementation has been delayed during the pandemic, but the BoA has taken first steps by introducing forward instruments into its forex interventions as an alternative to spot instruments.
PG 4: With a view to mitigating the economic consequences of COVID-19 pandemic and stimulating economic recovery, establish an effective and transparent mechanism to support the businesses affected by the crisis, in particular small and	There was **partial implementation** of PG 4. 1) **Substantial implementation**. The government has reported on the support packages implemented for businesses, SMEs and the self-employed and has specified the number of beneficiaries. It has also presented a brief assessment on the impact of COVID-19 to the sectors of economy. Businesses

medium-sized enterprises and self-employed.	have applied for support packages through the General Directorate of Taxation (GDT) by submitting the list of employees, who were entitled to benefit from the salary support schemes. Information was public on how they should submit electronically through the website of GDT and periodical information was shared also in media as regards the number of businesses and employees benefiting from the schemes.
Extend social protection coverage and provide incentives for businesses and employees in the informal economy sector to register and to facilitate their transfer to the formal economy.	2) **Partial implementation.** There have been positive practices, which need to be extended further, considering the high presence of informality in the labour market in Albania. Through the COVID-19 support packages the authorities have tackled the unemployed category, by doubling the unemployment benefit. About 2 923 unemployed job seekers have benefited from this measure. A programme launched in September 2020 targeted job seekers who lost their jobs due to COVID-19, irrespective of whether they were formally or informally employed by subsidising wages and compulsory insurance to businesses that would employ them. Between September and December 2020 the programme benefited 1 650 individuals, of which 560 were previously informal workers.
Ensure transparency and predictability of measures, by consulting new legislation with businesses and social partners.	3) **Partial implementation.** Albania has adopted a law on public consultation and the dedicated website where draft laws are published for consultation is online at www.konsultimipublik.gov.al COVID-19 support measures were mainly announced in media by the government, as taken under urgent circumstances with not proper consultation with all the relevant actors. This has generated critics by some of private stakeholders, and as a response, the category of businesses/sectors of economy entitled to support measures was amended accordingly. Overall, further efforts are needed to ensure full implementation of the Law on Public Consultation in practice, to ensure proper timing for comments by the stakeholders, and proper reflections in the draft law.
PG 5: Considering the big investments to be made for the post-earthquake reconstruction speed up the adoption the secondary legislation for the laws on energy efficiency and energy performance of buildings and provide incentives for energy efficiency measures in the private sector and households.	There was **partial implementation** of PG 5 1) **Partial Implementation.** There has been good progress on the adoption of relevant legislation/secondary legislation on the energy efficiency including in buildings, and of regulations related to minimum criteria for energy performance in buildings, and the methodology for calculating the optimal cost levels in energy performance requirements in buildings;. However there is no information about the incentives for energy efficiency measures in the private sector and in households. The draft amended Energy Efficiency Law was adopted by Parliament on 8 March 2021. The government removed from the law on energy efficiency the creation of an energy efficiency fund, instead proposing an energy efficiency obligation scheme for utilities in the sector, as set down in the

	amended law on energy efficiency.
Increase access to healthcare and public health insurance coverage while reducing the share of out-of-pocket payments on total health expenditure.	2) **Partial implementation:** Although good efforts were made to increase access to healthcare services and cope with COVID-19 pandemic, it is still very much needed to reduce the share of out-of-pocket payments in total health expenditure, reduce the unmet need for medical care (including dental care) and increase the number of medical staff, especially doctors. The refund scheme for COVID-19 treatment for ambulatory patients cared for at home is improving, but much should be done to cover real expenditure, including spending on testing kits. Albania has made some capital investments in healthcare infrastructure and services, especially primary care, and more healthcare services are now provided by public hospitals, but structural problems remain in access to quality services, especially in rural areas and for the most vulnerable groups.
PG 6: Take short-term measures to preserve employment including through short-time work schemes, and once the COVID-19 pandemic subsides, ensure an increased provision of active labour market policies, especially training, upskilling and reskilling.	There was **substantial implementation** of PG6: 1) **Full implementation:** Albania responded swiftly to the lockdown. Since Albania has no short-time work schemes, the government deployed other types of support to preserve employment. During the second quarter of 2020, the government made minimum salary payments for three months to support 65 574 self-employed people and employees in small businesses with an annual turnover below ALL 14 million and granted lump-sum payments of ALL 40 000 to 9 435 employees and laid-off employees in larger businesses closed down by government restrictions, to 68 391 employees of small businesses impacted by a reduction of economic activity, and to 4 927 employees of all types of accommodation structures. Additional lump-sum payments of ALL 26 000 were provided in August to 4 553 employees in public transport. Companies also received liquidity support in form of zero-interest loans to cover employee salaries for three months. The government increased the budget for ALMPs by about 50% (from ALL 390 million to ALL 590 million). Confronted with a small demand for revised ALMPs, the government acted swiftly to introduce two new employment promotion programmes (through a bylaw) through which it supports the reemployment of people who lost their jobs due to the crisis. This support is also offered to people formerly employed in informal economy, which is a very positive step. In 2021, more support will be necessary in form of training, upskilling and reskilling.
Improve the adequacy of social assistance benefits and set up an objective mechanism for their regular update, taking into account the data from the Survey of Income and Living Conditions.	2) **Partial implementation**: The government took a timely emergency measure to double the benefits paid under the Economic Aid scheme during the three-month lockdown (April to June 2020). The budget for the scheme was also increased for 2021, from ALL 4.6 billion to 7.1 billion. As a result, benefits were again doubled during the first half of

	2021. This has improved the adequacy of benefits temporarily, but cannot be considered to be a structural revision of benefits. Albania has not assessed benefit adequacy taking into account EU-SILC and other data (e.g. minimum wage). There is no roadmap towards a structural revision (increase) of benefits and towards establishing a transparent mechanism for their annual review. However, the ERP announces that an assessment will take place and a mechanism will be established in 2021, and the benefits are to be revised in 2022.
Take more effective steps to increase availability of social care services through enhancing ability of municipalities to identify needs for social services and to prepare social care plans.	3) **Partial implementation:** The number of approved social care plans increased considerably in 2021, from 24 to 50. Given that the plans were developed with the help of donors and NGOs, it is unclear to what extent municipalities' ability to identify needs for social services and prepare social care plans was enhanced. Government action concentrated on 21 municipalities, in which social services staff received training. Other capacity issues relating to social services in municipalities (ability to prepare applications for the Social Fund and plan, manage and deliver social services) remain a challenge.

1.6. ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2021-2023

The ERP identifies the areas where there are the most significant key obstacles, such as the business environment, education and skills, labour and employment, the informal economy, and research and development. It also addresses the negative impact on the economy due to the COVID-19 pandemic and the 2019 November earthquake, identifying tourism and services as being among the hardest hit sectors. It provides is a general assessment of the current reforms towards formalisation of the economy, while acknowledging that informal economic activity remains a significant concern, as illustrated by the volume of cash transactions and non-declared workers. However, there is limited analysis of the sectors where the informal activity is most prevalent, and the challenges in tackling it. The text describes the challenges in the education system and the need to better match the skills offered through the education system and VET with market demand, also addressing aspects of closer cooperation between the private sector and universities/schools.

Infrastructure challenges related to energy, water and the transport sector should have been included in this part of the text. The low level of digitalisation, innovation, and research and innovation capacities - which generate the increased demand for both new services and for improved infrastructure and knowhow - were also not analysed in the text, even though the ERP includes reform measures to address these obstacles. The level of FDIs, product diversification, and exports all affect the country’s competitiveness and growth and the generation of jobs, but these are also not analysed. Furthermore, issues related to the rule of law, corruption, unclear property titles and the proper functioning of judiciary system remain serious impediments to businesses and reduce Albania’s attractiveness for foreign investments.

Energy and transport market reform

This part of the analysis is well developed in terms of identifying the main obstacles in the energy sector. Power generation in Albania remains vulnerable to the hydrological situation; this influences the need for electricity imports to secure an uninterrupted power supply in the country, and increases the financial burden for the state-owned power generation company. As part of the efforts to improve connectivity and security of supply, the power line interconnecting Albania and Kosovo has become operational. The share of on-technical losses in electricity consumption was maintained at a low level (6%) during the three first quarters of 2020.

The analysis is also well developed in terms of identifying the main obstacles in the transport sector. Further reforms are necessary in this area; transport was one of the main business environment obstacles identified by Albanian companies in the World Bank 2019Enterprise survey. However, there is no reference to framework policy documents for the transport sector. A new National Transport Strategy must be prepared and adopted.

Reform Measure 1: “Further liberalisation of the energy market”

The measure to further liberalise the energy market was rolled over from the previous ERP. Its activity aiming to unbundle energy distribution and supply is in line with the obligations under the EU Third Energy Package and Albania's own strategies and must be fulfilled in 2021. The Albanian Power Exchange is foreseen to be made operational in 2021-2022 but it is not clear which activities will take place in which year. More details are need on which activities on security of supply are taking place in which year specifically. If this were clarified it would ensure more transparency and make it easier to monitor implementation. The effective liberalisation of the energy market is still not effective, and there are no mitigating measures in this respect.

Annex 1, Table 11 mentions that in the fourth quarter of 2020, customers connected to 20 kV grids will be supplied through the liberalised market. However, there is no information confirming whether this has already been implemented. The number of customers supplied through the liberalised market would be a good indicator under measure 1, as would the number of independent renewable energy producers (or the total renewable energy power capacity installed) selling electricity through the free market.

Reform measure 2: "Diversifying energy sources through the promotion of renewable energy sources and energy efficiency improvements"

The measure on the diversification of energy sources was rolled over, and it includes the promotion of the use of renewable energy sources other than hydropower. The regulatory framework already includes some measures to encourage the use of renewable energy sources; these are expected to stimulate energy efficiency in buildings, households and industry. The activities planned for 2021-2023 are quite ambitious and aim to integrate wind, solar, and biomass energy projects into the power generation capacities. Not that the trans-Adriatic pipeline, an international strategic investment, is complete, it is important to include gas capacities as energy sources in the analysis.

There has been progress in the implementation of the National Renewable Energy Action Plan (NREAP 2019-2020), which aim to expand renewable installed electricity and generators to 738 MW to achieve the national target on renewable energy consumption (38%) in 2020. Of this 738 MW, 490 MW is from photovoltaics (PV), 150 MW from wind, 57 MW from hydropower and 41 MW from waste. So far, six PV plants are operating, providing about 12 MW capacity, and another twelve plants are in the process of obtaining authorisation. Although the project for a 100 MV power plant failed and the applicant's permit was not extended, the construction of a 140 MW PV plant in Karavasta (Lushnjë - Fier) was signed in May 2020 and construction is expected to start in 2021. A tender for a 100 MW PV plant in Spitala was announced on 2 December 2020, and call for tender for wind farms will be launched in 2021.

The net metering scheme is operational and attracts interest of small producers for photovoltaic up to 2 MW. The Ministry of Infrastructure and Energy (MoIE) is putting pressure on OSHEE to improve its procedures for issuing connection permits for photovoltaics, and MoIE and OSHEE are still negotiating about the methodology for calculating the electricity price from self-producers. These aspects need to be addressed in the measure for 2021.

Secondary legislation on energy efficiency and on energy performance in buildings has been prepared and is awaiting adoption by the parliament, while the Council of Ministers adopted several decisions on energy efficiency in 2020. However, energy audits, measures and projects on energy efficiency and energy savings need to be accelerated. The indicators in measure 2 do not seem relevant and should be improved. Suitable indicators for measuring Solar, wind power capacity contracted (and installed), % of losses (and energy saved) in transmission and distribution networks, Number of performance audits produced, number of large consumers having implemented, or secured finance for, EE measures (and energy saved), could be suitable indicators to measure progress of measure 2.

The measure presents a good assessment of the impact on competitiveness.

The costing tables do not show TA and investment figures, although there are several ongoing and planned projects financed by donors through grants and loans. In addition, there is no budget for the establishment of the new National energy agency and its operation, which ca jeopardise the efficient implementation of the actions foreseen by the measure.

Reform measure 3: "Rehabilitation and construction of the railway segment Durres-TIA-Tirana"

Rehabilitating and extending the Durres-Airport-Tirana railway will allow the development of intermodal transport, and should double the speed of travel of passenger and freight transport between Tirana and

Durres, which should boost traffic and reduce road congestion. This measure was rolled over from the previous ERPs. There was no progress on the measure and the proposed activities were all postponed by one year. The risks and mitigating measures are well presented, as are the impact on job creation (including gender balance principle) as well as environmental and energy efficiency considerations. However, there is no mention of the land acquisition and the potential risk from land expropriation. Furthermore, the ERP should reflect that cargo activities from the Port of Durres to a new port to be constructed near Porto Romano. The timeline of the activities for year 2022 and 2023 need to be revised taking into consideration new contractual timelines for design preparation (revision) and construction. A contract for the rehabilitation of the Tirana-Durres railway was signed in early February 2021. This strategic investment is also benefiting from EU funding under the European Economic and Investment Plan (as part of Rail Route 2 linking the capitals of Tirana and Podgorica, and extends to the port of Durres, and is a key project for the region). The indicators used are at project level and need to be further developed to reflect the sector reform, which includes information on the electrification of the railway line, although there is little indication on when this is planned to take place. New information has been added regarding the link between investment and the revised National Transport Plan.

Agriculture, industry and services

The analysis of the main obstacles is concentrated in the tourism sector, while failing to address the water sector, agriculture and other services. This limits the usefulness of the ERP as document for economic policy coordination and prioritisation, and his means that the coherence of economic policies is not ensured. The agricultural sector managed to survive the COVID-19 pandemic crisis in 2020, even achieving positive growth in the first three quarters of the year. Nevertheless, it remained prone to structural problems such as land consolidation, land fragmentation, and property ownership issues. However, the ERP text does not analyse the agricultural sector at all.

As regards industry the ERP does not provide any analysis of this significant sector. It does not mention the new Business and Investment Development Strategy that Albania is currently developing, even though the sector specific analysis and recommendations normally contained in such a document might be relevant to different sectors of the economy. The exception is the reform of the water sector: this is a reform priority for Albania in order to ensure water supply, improve water quality, proper waste water treatment, insure access to water in tourist areas, improve good governance and reduce non-revenue water use stemming from informal connections.

As regards services the analysis examines the impact of the COVID-19 pandemic, notably its considerable consequences for the tourism sector. The impact on tourism may be even more pronounced than in other countries of the region apart from Montenegro, due to the size of the sector in Albania. However, the analysis of areas of the service sector aside from tourism is very weak.

Reform measure 4: “Reform on the Water and Waste Water Sector”

The reform targeting water and wastewater still appears ambitious, in terms of both the service targets and the budget foreseen (unchanged since ERP 2019-2021). Investments require time to mature and be implemented, and low capacity for implementing the reform at utilities or central level remains a key challenge.

There is little information on the projects being implemented or in the pipeline. This includes measures for reducing losses, which is described as a major national objective, together with increasing service hours of water supply on the coastline. An indicator on loss reduction should be considered to measure progress on this key national objective. The indicator on the number of hours supply seems to be the countrywide. If this is the case, a sub indicator covering the coast should be considered in order to measure the second national objective.

Implementation of the reform has brought results in terms of regularising illegal or informal connections to the networks. This has led to lower administrative losses and improved revenues for utilities. This should improve cost coverage and boost utilities' financial sustainability s. However, an indicator to measure the cost recovery ratio achieved (operation costs, total costs) should be considered in order to measure performance.

It would be advisable for the sector to design an energy efficiency programme, as electricity accounts for the bulk of utilities' expenses. Other than steps to reduce technical water losses, which generate energy savings in pumping costs, but frequently higher require investment costs and longer implementation time, low- to medium-cost measures (such as changing old pumps or the impeller of non-performing pumps) are not considered. These would bring short term benefits and savings with a fast return period on investment, as shown in a 2015 study by GiZ and demonstrated in practice in a few projects.

Reform measure 5: "Better marine and maritime governance and services"

This is a new measure focused on maritime tourism. The reform is small in scale and seems to be an isolated initiative. The description of the measure is insufficient to give a clear picture of current conditions in the sector, whereas a clear overview is needed to understand the impact of the proposed measure. Baselines are not included and neither are final targets. While the reforms in the tourism sector are welcome, as it is an untapped sector with high potential for economic development, the measure needs to be better integrated in the overall sector development policies and plans. The risks are well identified including the impact of the pandemic.

Research, development and innovation and the digital economy

The analysis of the main obstacles in the area of research, development and innovation and the digital economy gives a realistic picture of the state of play and the current challenges. It acknowledges that the current funding level of 0.06% of GDP is still far from the national target of 1%. It also recognises that there is still a need to increase investment in research and take other measures to strengthen research and innovation capabilities at national level. In addition, it also acknowledges that cooperation between universities and - industries/business remains weak and that both sides need to broaden and deepen their cooperation. However, it does not explore why this is or how it can be addressed.

The state of play on innovation is mentioned, but the analysis does not go further. It does not cover needs and potential solutions, though it does include some reform measures to address these obstacles. There is a short analysis of why broadband important, followed by a long description of ongoing and planned measures. However, some aspects, such as poor broadband coverage in some rural areas, are not mentioned.

Reform measure 11: "Development of the broadband infrastructure for digital economy"

This measure was carried over from the 2020 ERP. The overall reform is in line with the EU strategy for the Digital Agenda for the Western Balkans and aims to address Albania's low broadband penetration, particularly in rural areas. The information on the reform has been updated and supplemented by references to new developments in the sector. The measure also takes into account the ongoing crisis due to the COVID-19 pandemic and its impact on the sector.

The measure builds on two important activities that were completed in 2020: the adoption of the national broadband plan, and the completion of the feasibility study and cost-benefit analysis for the broadband infrastructure. However, the planned time-frame for the completion of the activities in 2021 might be overly optimistic.

Economic integration reforms

Unfortunately, the data provided under the section on analysis of main obstacles does not include 2020 statistics, even those of the first three quarters of 2020. The analysis relies only on 2019 trade statistics. This is problematic, as the COVID-19 pandemic in 2020, especially the lockdown the March to June 2020, impacted on businesses, including exports and imports, and had a wider impact across the region and the world. All of these issues will have affected trade statistics. Albania has fulfilled its commitments under CEFTA: in April 2020 it ratified the Additional Protocol 6. However, the reporting of the activities under the National Trade Facilitation Committee is not up to date, as it still mentions an expected meeting in November 2020.

Reform Measure 12: "Facilitating cross-border movement of goods"

This is a relevant measure undertaken in the framework of Albania's active involvement in the regional trade integration through CEFTA, MAP REA and the Regional Cooperation Council. The measure was carried over from the previous ERP. The activities foreseen for 2020 will be undertaken during 2021-2023. These include enhancing the cross border trade at the border crossing point with North Macedonia by opening the single operational one-stop shop. Furthermore, the new computerised transit system is intended to be fully operational by 2023.

However, apart a reference to the COVID-19 pandemic, there are few explanations of the reasons for the delays in the measure's implementation.

Education and skills

Skills, VET and higher education and reform measure 15 are analysed in section 4, under key challenge #1.

Albania's budget allocation to education is very low at 2.7% of GDP in 2021, 0.6 pps. lower than in 2019 and 1.9 pps. below the EU-27 average (2018 figures). After continuous improvements in previous PISA rounds, the results for 2018 are mixed: results improved for mathematics, plateaued for reading and deteriorated for sciences. Overall, Albania ranked 55th of 77 countries. Education performance in Albania is inequitable, and girls and socio-economically advantaged students perform better than boys and disadvantaged students (PISA 2018). The enrolment rate of children from more vulnerable families in early childhood education is significantly lower (by more than 20 pps.) than the enrolment rate of children whose families are wealthier or whose parents hold a university degree (INSTAT 2018). Drop-out rates tend to be higher among pupils from Roma/Egyptian communities, and several measures are in place to promote education. These include financial support, exemption from or reduction of tuition fees, and special quotas for admission to higher education. The share of early school leavers continues to fall (16.3% in 2019), but remains the second highest in the region. In addition, assessment practices are still based on the old model and do not evaluate pupils based on competences.

Reform measure 13: "Finalise and support the implementation of pre-university curricular reform, teacher training and employment"

Albania introduced new competency-based curricula in pre-university education. However, teachers received only a very basic three-day theoretical training course on the new curricula, and deployment of more in-depth training and other support is slow. In fact, the allocation to teacher training remains very low, forcing the ministry to focus mainly on cost-effective professional networks of teachers, with a budget of EUR 40 000 per year. The measure also plans to train pre-school teachers and head teachers, with a small annual allocation of EUR 60 000. The plan to establish lifelong learning training centres in universities to organise teacher training in pre-university education is a positive step. Nevertheless, the measure does not tackle the issue of non-alignment of initial teacher training programmes with the new curricula in pre-university education. Furthermore, the measure does not propose activities to prevent a rise in the school drop-out rates and address the increase in learning poverty stemming from the COVID-19 crisis.

Reform measure 14: "Inclusiveness and equality in education"

The measure aims to strengthen inclusiveness and equality in education, with special emphasis on the participation of children from vulnerable groups, including children from the Roma and Egyptian minorities and children with disabilities. It aims to extend the provision of free textbooks to children in grades 8 and 9. The policy of replacing collective classes in rural areas with regular education and providing transport for students should increase systematically in the coming years to ensure a lasting impact, along with new initiatives to enlarge capacity in dormitories. Other positive activities include the increase in staff numbers in school psycho-social services and the increase in the number of assistant teachers; this latter measure aims to integrate students from ethnic minorities and students with special needs into mainstream schools. However, more efforts are needed to establish dedicated schools for children with special needs (e.g. deaf students) and provide complementary equipment and ad hoc training. There are no activities to assist the most vulnerable groups with online learning (such as the provision of special IT tools) or prevent students from dropping out of school. The budget does not appear realistic to take stock of all the challenges in inclusiveness and all the concerned categories. The budget for training the heads of professional networks of assistant teachers and training assistant teachers themselves is too low (EUR 27 000 per year). Unfortunately, the measure does not aim to increase inclusiveness in kindergartens except in the last year of pre-school, for which it provides assistant teachers.

Employment and the labour market

This area and reform measure 16 are analysed in section 4 above, under key challenge #1.

Social dialogue

Bipartite social dialogue remains very weak in both the public and private sectors. As regards the national tripartite body (National Labour Council, NLC), a bylaw was adopted in January 2020 clarifying the representation criteria for social partners. Moreover, the secretariat was fully staffed with three members, one for each constituent party. However, consultations are being treated as a formality and documents are shared with social partners only shortly ahead of the meetings. Moreover, the NLC's six committees are not functional and so cannot prepare the NLC's plenary meetings. Albania still plans to set up regional tripartite councils. Lastly, the system for the amicable resolution of labour disputes needs further consolidation.

Social protection and inclusion

This area and the relevant reform measures (reform measures 17 and 18) are analysed in section 4 above, under key challenge #2.

1.7. THE 2021 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, 12 July 2021

[…]

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

1. Conditional on the economic recovery becoming well entrenched, foresee in the 2022 budget and medium-term fiscal plan a gradual reduction of the public debt ratio and, based on a realistic revenue forecast, a return to a positive primary balance as of 2023 in compliance with the corresponding fiscal rule. Complete the Medium-Term Revenue Strategy and begin its implementation in line with the inter-ministerial committee agreement but at the latest before the next ERP submission. Increase the institutional capacities of the fiscal risk unit to continue and expand its work without reliance on external assistance.
2. Continue to reduce the stock of contract-based arrears; reduce VAT arrears to zero in 2022 and analyse the reasons for the increasing arrears of local governments. Assess and approve all investments, which involve public funds including PPPs, through the same approval process and continue to report actual earthquake reconstruction expenditure in the consolidated budget implementation. Re-orient public expenditure composition towards development of human capital and innovation by foreseeing a continuous gradual increase of expenditure on education, health, social security and R&D in terms of shares in total expenditure.
3. Maintain a strong financial sector regulatory framework in line with international and EU best practices, ensure sound credit risk management, a transparent display of asset quality and adequate provisioning. Further reduce remaining institutional and legal obstacles to swift and effective NPL resolution, including by resolving the bailiff deadlock and strengthening bankruptcy proceedings. Continue with the implementation of measures aimed at promoting the use of the national currency, including by developing the market for forex hedging instruments.
4. Provide enhanced business support services to improve access to finance and entrepreneurial know-how. Improve transparency in the adoption and implementation of legislation particularly by ensuring an effective timely consultation of businesses and social partners on the new legislation affecting their operations. Draft and consult a comprehensive strategy to tackle and monitor all aspects of informality, with an action plan with baselines, including clear and measurable targets and establish the regular a performance-based monitoring of its implementation and results.
5. Establish an inter-ministerial task force involving relevant ministries, their agencies and stakeholders to develop a Youth Guarantee Implementation Plan. Develop institutionalised tools to monitor skills needs in the labour market with an aim to provide relevant career guidance and to improve the offer of short-term vocational courses accordingly. Incentivise the link between innovative businesses and academia in the upcoming draft Strategy on Business and Investment Development 2021-2027 by including clear targets to increase science and research funding and by creating the conditions for the development of business incubators.

6. Perform an assessment of the adequacy of benefits under the ‘Economic Aid’ scheme, taking into account the data from the ‘Statistics of Income and Living Conditions’ survey, in view of their systemic adjustment. Build capacities in local governments to apply for support from the Social Fund and to plan, manage and deliver social care services. Redesign coverage policy, including for outpatient medicine, to reduce unmet need for medical care and financial hardship, particularly among persons with disabilities and chronic disease, poor households, people aged 65 and over, and minorities.

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

Area/Sector	2016	2017	2018	2019	EU-27 Average (2019 or most recent year)
Energy					
Energy imports dependency (%)	20.2%	38.2%	21.1%	N/A	60.62%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	227.07 w	228.07 w	217.10 w	N/A	112.92
Share of renewable energy sources (RES) in final energy consumption (%)	36.94%	35.90%	36.84%	36.67%	19.73%
Transport					
Railway Network Density (meters of line per km^2 of land area)	11.06 w	11.62 w	11.62 w	5.88 w	49.0 (2018)
Motorisation rate (Passenger cars per 1000 inhabitants)	151.1 w	146.8 w	159.9 w	174.1 w	519 (2018)
Agriculture					
Share of gross value added (Agriculture, Forestry and Fishing)	22.6%	21.8%	21.1%	21.2%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	40.2% w	38.2% w	37.4% w	36.4% w	4.36%
Utilised agricultural area (% of total land area)	41.1 w	40.8 w	40.8 w	N/A	40.0% (2017, EU-28)
Industry (except construction)					
Share of gross value added	14.0%	12.8%	14.1%	13.3%	19.7%
Contribution to employment (% of total employment)	12.8% w	12.5% w	12.7% w	13.1% w	18.1%
Services					
Share of gross value added	53.2%	54.9%	54.5%	55.6%	73.0%
Contribution to employment (% of total employment)	40.5% w	42.4% w	42.9% w	43.5% w	70.8%

Business Environment					
Rank in WB Doing Business (Source: World Bank)	90	58	65	82	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	93	80	76	81	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	Up to 28.3%	N/A	N/A	N/A	N/A
Research, Development and Innovation					
R&D intensity of GDP (R&D expenditure as % of GDP)	N/A	N/A	N/A	N/A	2,2%
R&D expenditure – EUR per inhabitant	N/A	N/A	N/A	N/A	EUR 688.6
Digital Economy					
Percentage of households who have internet access at home	N/A	N/A	84%	85%	86% (2018)
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	N/A	N/A	62.6% w	68.6% w	85% (2018)
Trade					
Export of goods and services (as % of GDP)	29.0%	31.6%	31.6%	31.6%	49.4%
Import of goods and services (as % of GDP)	45.8%	46.6%	45.3%	45.3%	45.7%
Trade balance (as % of GDP)	22.4%-	-22.7%	-20.2%	-20.8%	N/A
Education and Skills					
Early leavers from education and training (% of population aged 18-24)	19.6% w	19.6% w	17.4% w	16.3% w	10.2%
Youth NEET (% of population aged 15-24)	27.0% w	25.9% w	26.5% w	25.5% w	10.1%
Formal child care - children aged less than 3 years (% of total)	N/A	N/A	N/A	N/A	35.3%
Individuals’ level of digital skills (% of individuals aged 16-74 who have basic or above basic overall digital skills by sex)	N/A	N/A	N/A	21%	56%

Employment					
Employment Rate (% of population aged 20-64)	62.1% [w]	63.9% [w]	65.6% [w]	67.1% [w]	73.1%
Unemployment rate (% of labour force aged 15-64)	15.6% [w]	14.1% [w]	12.8% [w]	12.0% [w]	6.8%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	14.4 pps. [w]	16.5 pps. [w]	16.5 pps. [w]	15.0 pps. [w]	11.7 pps.
Social Protection System					
% of population at risk of poverty or social exclusion	N/A	51.8%	49.0%	N/A	20.9%
Impact of social transfers (Other than pensions) on poverty reduction	N/A	12.55%	11.03%	N/A	32.38%
Self-reported unmet need for medical care (of people over 16)	N/A	19.0%	21.5%	N/A	1.7%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	N/A	7.47 [w]	6.98 [w]	N/A	4.99

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

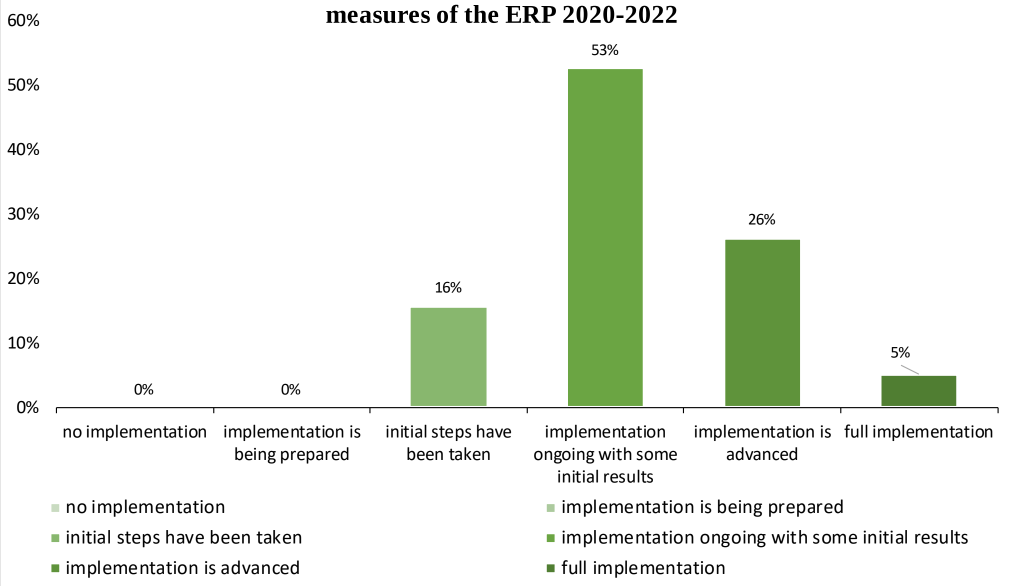
Source of data in Annex A: EUROSTAT, unless otherwise indicated

ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2020-2022

Table 11: Reporting on the implementation of the structural reform measures of the ERP 2020-2022

While tackling immediate impact of COVID-19 pandemic has been a clear priority in 2020, progress was made in implementing the measures from last year's ERP (average score: 3.3 out of 5). Activity reports provide a fairly accurate description of the level of implementation. The scoring is slightly imprecise for the measures related to access to finance, and to tourism services. Implementation is stronger for some measures, such as measure 3 on the railways, measure 8 on the legal framework for innovative start-ups, or 12 on broadband infrastructure. In contrast, implementation is weaker for other measures, such as measure 5 related to energy, measure 10 on retail payment modernisation, or 17 on VET access where the implementation is varied, with some sub-elements progressing while others not at all or even, in one case, having been cancelled. Implementation of the measure 7 on property tax reform has also been limited.

Graph II.1.2: **Albania - Implementation of the structural reform measures of the ERP 2020-2022**



ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The ERP exercise was coordinated by the Ministry of Finance and Economy upon an order or Prime Minister's Office. The Minister herself is the national coordinator. An inter-ministerial working group for the preparation of the ERP is in charge and the ERP focal points are appointed in each line ministry.

The authorities have reported about the consultation process which took place during 14 December-9 January. It is understood that the stakeholders are contacted via e-mail although there is no information on the number of agencies/stakeholders that were contacted, nor the list of those agencies which were invited to provide for information. From the material included in the report there has been good feedback with inputs provided by donor institutions, international organisations, (UN WOMEN; UNDP; IOM; WHO) and some embassies (Germany, Slovenia, Switzerland and Austrian Development Agency) as well as the European Investment Bank and EBRD and one business association. Written comments of those who responded to the invitation for consultation were included as annex to the document.

The consultation with parliament or regional and local authorities is missing and there is need for more proactive outreach actions to attract as much as possible the opinion and feedback of different stakeholders. Face to face meetings/virtual meetings with different stakeholders could be one of the methods to be followed. Once the document was adopted by the Council of Ministers it was published in the website of Ministry of Finance and Economy at: https://financa.gov.al/wp-content/uploads/2021/02/Economic-Reform-Programme-2021-2023.pdf

Macroeconomic framework

The programme is in line with the medium-term budgetary framework and the Budget Law of Albania and was submitted in time on 1 February 2021. It describes the past economic developments based on the available data and it was published on the website of the Ministry of Finance and Economy. Projections for 2022 and beyond are only provided in form of data without explanation. The basis of projections of export developments and FDI are not mentioned. The horizon of the framework extends to 2025 but data on long-term sustainability (demographic developments, pensions, health expenditure) is not provided at all. Information on the level of implementation of the policy guidance 2 and 3 is incomplete. The ERP does not provide an analysis of labour productivity, skills shortages, migration, brain drain the investment environment. The impact of the pandemic on business sectors and the economic structure is missing, concrete measures for business support in 2021 in the context of the pandemic are not presented.

Fiscal framework

The ERP does not make clear a link between the analysis of the challenges the economy faces, the proposed reforms, and the corresponding budget allocations and lacks details on the expenditure plans. It remains unclear if policies are sufficiently financed, because budget priorities in the ERP are not accompanied by the corresponding budget allocation and they are also not linked to the structural reform part. It is difficult to link policies mentioned in the ERP with the macro-fiscal or budget tables, because the budget headings are aggregating many expenditure types while at the same time new headings for small expenditure items are introduced, which change every year. The ERP document could not take into account the full year's budget outturn for 2020 for which data was made available a few days after the submission deadline, data on public debt changed significantly within a few weeks after the submission and one week after the submission a budget amendment was adopted with changes on revenue without substantial explanation. One month after the submission of the ERP 2021, the public debt ratio of the year 2020 has again changed (similar last year) so much (2 pps. of GDP) that the plan for public debt reduction from 2021 is not consistent with the actual outturn. (increasing public debt ratio instead of decrease). There is only limited information on the contributions to and spending by the social insurance schemes. Information on arrears, local-government revenues and expenditure is missing. Fiscal data do not meet ESA 2010 requirements, in particular not on: the valuation of foreign debt, the consolidation of financial and non-financial transactions, the recording of arrears, of PPPs and of capital transfers and loans within the public sector and on COFOG. With the support of Eurostat, the statistical office is striving to align its fiscal statistics with EU requirements. Albania regularly sends EDP notifications to Eurostat on a best-effort basis and strives to improve them. It has not yet completed the move from cash-based to accrual accounting, and government finance statistics are not yet aligned with international standards.

The structural reform priorities section mostly follows the guidance note. In terms of the *reporting of the implementation of the policy guidance and the structural reform measures from the 2020-2022 ERP sufficient and up-to-date*, this is mostly accurate with some exceptions. There are 18 reforms in the ERP 2021-2023, i.e. within the limit of max 20 reforms. The page limit is not respected. The structural reform measures contain 60 pages (i.e. 20 pages more than max 40 pages) without taking into consideration the annexes. As is described in each measure, in majority of cases the activities are clearly defined along the three year period of implementation. However, there are cases when the activities are repeated for the next coming years, making it impossible the monitoring of implementation of the measure over the three year period.

With regards to tables 9-12: Table 10.a - costing of structural reform measures - 50% not completed; in some cases it is paradoxically indicated a cost zero- such as for the reform 18- increasing access to healthcare services. On Table 10.b – Financing of structural reform measures - 55% not completed. On Table 11 – It is not reported about structural reform measures in 32% of reform measures of the ERP 2020-2022. The reform measures are related to: i) *Defragmentation and consolidation of agricultural land; ii) Reform on the Water and Waste Water Sector, iii) Improve institutional capacity of the research and innovation system; iv) Finalisation of the pre-university curricular reform, training and hiring of teachers; v)Inclusive education; vi)Modernisation of the early childhood education system financing.*

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2. MONTENEGRO

Montenegro failed to submit the 2021-2023 Economic Reform Programme (ERP) to the Commission by the deadline of end January. Instead, the authorities made an effort to provide informally parts of a draft ERP in February, in particular on the structural reform agenda, and supplementary elements, including some macroeconomic and fiscal projections, in March. The ERP was formally adopted by the government on 1 April 2021 and transmitted to the Commission on the same date. Preliminary macroeconomic and fiscal figures were amended in the final version, and these last minute changes and the absence of statistical tables in the annex did not allow for a full-fledged and detailed Commission assessment, in particular of the macroeconomic and fiscal programmes and outlook. This applies to a somewhat lesser degree to the key structural challenges and reform priorities part, on which the Commission received more comprehensive programme details.

2.1. EXECUTIVE SUMMARY

The official version of the ERP was submitted late, on 1 April 2021. In spite of some earlier but partial draft contributions from the authorities, last minute changes in the macroeconomic scenario and the absence of a fully-fledged medium-term fiscal strategy and statistical tables, means that the Commission could only prepare a less detailed assessment of the macro-fiscal outlook and programme.

The central scenario foresees an overly optimistic recovery of the economy. The restrictions imposed in the context of COVID-19 brought the tourism-dependent economy to a standstill. Due to the significant deterioration in external and domestic demand, real GDP dropped by an estimated 15.2% in 2020. The ERP baseline scenario expects the economy to rebound in 2021, supported by improvement in the health situation in the second half of the year. The economy is expected to return to its pre-crisis level already in 2022. The completion of the first section of the Bar-Boljare highway in 2021 together with an expected recovery of tourism would lead to a narrowing of the current account deficit, making net exports the key driver of growth. However, as elsewhere, risks are to the downside, and delays in the launch of COVID-19 vaccination could challenge this recovery scenario. Moreover, credit activity is expected to remain subdued as crisis-related support to lending activity is withdrawn.

The fiscal strategy projects a significant improvement of the fiscal position over the medium term. The impact of the pandemic widened the budget deficit, which rose to 11% of GDP in 2020, while public debt surpassed 100% of GDP. From 2021 onwards, the programme foresees a sizeable improvement in the budget balance, which is set to reach a surplus in 2023. The rebound of GDP growth, the reimbursement of maturing debt using accumulated government deposits, together with a tight control of expenditure would significantly reduce the public debt-to-GDP ratio (by some 34 pps.). However, a high degree of uncertainty surrounds that favourable scenario. Although the programme provides some budgetary savings, these are offset by concurrent expenditure increases. Over the medium term, fiscal consolidation appears to rely on a rebound of the economy to improve tax revenue, a large reduction in capital spending once the first section of the highway is completed, and the withdrawal of crisis-related fiscal support. Current spending would be contained by, among others, optimising the number of public administration jobs. Given the prevalence of ad hoc decisions and a track record of fiscal slippages, there is a need to continue strengthening fiscal frameworks and governance.

The main challenges facing Montenegro include the following:

- **Stabilising public finances requires a stronger commitment to a credible consolidation path once the economic recovery takes hold.** The public debt burden remains the highest in the region, rendering its sustainability a key challenge. Non-discretionary spending is also a significant burden on public finances, calling for a rebalance of current spending, particularly on the wage bill in order to release fiscal space for health and growth-enhancing expenditure. The resilience of budget revenue needs to be enhanced by broadening the tax base with measures to boost the fight against informality and tax evasion, and streamlining tax exemptions.

- **Fiscal governance needs to be reinforced in order to prevent budget slippages and unburden the private sector.** Strengthening fiscal governance would require reinforcing fiscal oversight in line with plans to set up an independent fiscal institution. Fiscal policy could assist the recovery and resilience of the economy by reducing public sector arrears and accelerating VAT refunds.

- **Making the regulatory environment friendly for businesses requires constant commitment on the part of the state and local authorities.** Delays, discretionary behaviour and inconsistencies in interpreting and implementing laws are yet to be addressed. Mechanisms for continuous dialogue with businesses and social partners need to be developed, as demonstrated during the COVID-19 crisis. E-procurement rollout and simplification of taxation should be prioritised.

- **Tackling the large informal economy is still an important structural challenge.** The government is yet to rethink its approach and adopt a more comprehensive action plan to reduce informality in the economy. Preventive and educational actions, as well as incentives for the formalisation of businesses and labour are needed, along with controlling and suppressing actions. Ensuring full cooperation between central and local-level authorities is paramount.

- **The persistence of unfavourable labour market outcomes undermines potential growth and the improvement of living standards.** Although the labour market continued to improve prior to the COVID-19 pandemic, the persistently low activity and high unemployment rates, especially among women, young people and the low-skilled, reflect structural issues. Measures were taken to address youth unemployment, albeit they do not tackle the challenge comprehensively. Addressing skills mismatches is key to improving labour market performance. The social protection system is neither effective in protecting the most vulnerable segments of the population nor in activating those willing to work.

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2020 has been partially implemented. Both the previous and the current governments made use of consistent fiscal policy responses to mitigate the consequences of the pandemic and support the recovery. Good progress was recorded on public finance management with the establishment of a centralised public sector employment payroll system and the implementation of an electronic fiscal invoice system. The Central Bank of Montenegro took financial sector support measures to cushion the impact of the crisis while continuing to implement an asset quality review of domestic banks. However, the public administration optimisation plan did not yet achieve a meaningful permanent reduction of staff.

The government adopted four packages of economic measures, aimed at supporting businesses and employees during the COVID-19 pandemic. However, they were only partially implemented. The dialogue with the business associations, social partners and civil society appeared to be continuous throughout the crisis, but cooperation on crisis mitigation between central and local authorities was sporadic. The support measures endeavoured to preserve employment, but no new active labour market policies have been introduced or existing ones strengthened to facilitate transition to work. Coordination measures and e-healthcare provision have improved the healthcare system’s ability to manage the COVID-19 crisis; however, the structural weaknesses of the healthcare system have not been addressed.

The ERP is broadly aligned with the reform priorities identified by the Commission, but the reform process lost momentum. The analysis of the main challenges facing the macroeconomic and fiscal frameworks is broadly consistent with the Commission’s views. However, some parts suffer from a lack of detail, particularly beyond 2021. This is the consequence of the absence of a budget by the official deadline for submission of the ERP. The authorities are in the process of drawing up a new multi-annual fiscal strategy, which should provide a more solid basis for next years' programme. On structural reforms, the ERP reiterates the huge majority of the 2020 measures, with some recalibration and few new reforms. This is, in part, because many activities foreseen for 2020 were delayed or completely stalled by the COVID-19 pandemic.

2.2. ECONOMIC OUTLOOK AND RISKS

The COVID-19 pandemic and the subsequent introduction of lockdowns and travel restrictions took a very heavy toll on Montenegro's tourism-dependent economy. The shock had widespread effects, depressing not only tourism and retail services, but also trade, investment, and employment. The significant deterioration in external and domestic demand resulted in a very deep 15.2% contraction of GDP in 2020 according to preliminary estimates, in contrast to a 4.1% expansion of the economy recorded a year before. The labour market particularly suffered in 2020, with employment declining by an estimated 7.3% y-o-y while the unemployment rate climbed by 2 pps. over the year to 17.2%, in spite of several state-support packages to preserve employment.

The ERP projects a fast recovery of the economy. A comparison with the previous programme is not meaningful due to the massive shock in 2020 and the ensuing base-effect distortion. In the ERP's baseline scenario, GDP growth is expected to expand by 10.5% ([21]) in 2021, supported by a partial rebound of investment and private consumption. Growth is projected to ease to 6.5% in 2022 and to 5.8% in 2023 when tourism would recover – or even exceed – its pre-crisis level. Export growth is seen outpacing imports, making net export a key driver of growth as of 2022. Investment in digitalisation and the green transition is expected to sustain a high level of gross fixed capital formation over the medium term (at around 27.6% of GDP), even after the completion of the highway works in 2021. Having supported the economy in 2020 and 2021, government consumption is seen to remain flat in 2022 and record some marginal increase in 2023. The sharp decline in economic activity in 2020 plunged the output gap into negative double-digits. However, authorities expect a very fast recovery of employment to pre-crisis level already in 2021. Overall, the economy is expected to recover its pre-crisis level, and close the negative output gap, already in 2022.

The projected recovery path seems overly optimistic. The macroeconomic outlook continues to be affected by high uncertainty due to the COVID-19 pandemic. Overall, the projected evolution of GDP components is broadly compatible with the assumptions on the development of the pandemic and pressing fiscal consolidation efforts. However, GDP growth projections for 2021 and 2022 appear to be 3.3 pps. higher on average than estimated in the Commission Autumn Forecast. ERP expectations seem optimistic given the very high incidence of the virus in Montenegro, the late start of vaccination, and the strong reliance on other countries for the recovery of its tourism industry. Moreover, the low diversification of Montenegrin exports remains a constraining factor. The expected recovery of the pre-pandemic unemployment rate already in 2021 seems at odds with a partial recovery of tourism activity in the second half of the year. The ERP includes an estimate of the impact of some reforms on the macroeconomic scenario. Accordingly, five projects related to public works in 2015-2022 would increase GDP growth and employment by an additional 7.1 and 2.4 pps. respectively by the end of the seven-year period. While being of interest, this analysis could be brought up to date by including, rather than infrastructure projects dating from 2015, some more recent key structural reforms from this year's ERP exercise.

([21]) The final ERP submitted to the Commission in April 2021 presents a more optimistic macroeconomic scenario than previous ERP draft contributions, which foresaw a more gradual growth path of 7.3% in 2021, 5.9% in 2022 and 6.3% in 2023. This late revision makes even more pertinent the Commission staff's assessment that the projected recovery path seems overly optimistic.

Table II.2.1:
Montenegro - Comparison of macroeconomic developments and forecasts

	2019		2020		2021		2022		2023	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	4.1	**4.1**	-14.3	**-15.2**	6.8	**10.5**	3.7	**6.5**	n.a.	**5.8**
Contributions:										
- Final domestic demand	1.9	**1.9**	-13.4	**-6.4**	5.4	**5.8**	3.0	**4.5**	n.a.	**3.5**
- Change in inventories	1.4	**1.4**	0.0	**1.0**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	0.7	**0.7**	-0.9	**-8.8**	1.5	**4.7**	0.7	**2.0**	n.a.	**2.3**
Employment (% change)	2.2	**2.7**	-2.6	**-7.3**	2.3	**6.2**	1.9	**2.3**	n.a.	**1.6**
Unemployment rate (%)	15.3	**15.1**	18.1	**17.2**	16.6	**15.6**	15.9	**14.3**	n.a.	**13.8**
GDP deflator (% change)	n.a.	**2.0**	n.a.	**-0.2**	n.a.	**0.0**	n.a.	**1.0**	n.a.	**0.7**
CPI inflation (%)	0.5	**0.4**	-0.5	**-0.3**	1.0	**1.2**	1.4	**1.4**	n.a.	**1.2**
Current account balance (% of GDP)	-15.0	**-15.0**	-15.8	**-26.0**	-14.3	**-18.7**	-13.9	**-15.1**	n.a.	**-11.6**
General government balance (% of GDP)	-2.0	**-2.0**	-8.8	**-11.1**	-4.7	**-2.9**	-3.6	**-0.2**	n.a.	**1.5**
Government gross debt (% of GDP)	76.5	**75.6**	87.3	**104.3**	85.6	**88.4**	83.0	**77.4**	n.a.	**69.9**

Sources: Economic Reform Programme (ERP) 2021, Commission Autumn 2020 forecast (COM).

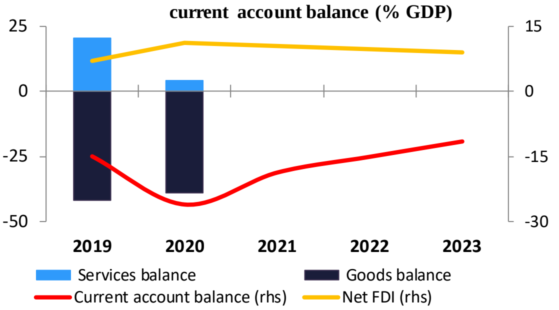
The ERP presents a clear view of economic risks and uncertainties, developing two alternative macroeconomic scenarios based on some of their implications. Apart from the pandemic-related risks, given the extraordinary importance of tourism for the domestic economy, any factor hindering tourism, such as structural changes to travel behaviour, unfavourable weather conditions or delays setting up a new national airline following the bankruptcy of the previous one, would hinder the recovery. The programme also acknowledges risks in the event of lower than expected investment. The alternative macroeconomic scenario gauges the effects of external shocks affecting investment and tourism. The ‘low-growth scenario’ assumes a slower recovery of tourism revenues in 2021 (to 55% of its 2019 level, compared to 65% in the baseline), resulting in lower GDP growth by 3.2 pps. in 2021 compared to the baseline. The shock would largely affect exports, which would be lower by 10.5 pps., while imports would increase marginally, by 0.8 pps., in 2021. The impact would also be asymmetric on labour, with employment declining by 1 pp. and the unemployment rate remaining (abnormally) flat at 15.6%. Overall, the low-growth macroeconomic scenario does not seem plausible given some inconsistencies in some of the underlying assumptions, and therefore it appears inadequate for sustaining a solid fiscal strategy. Authorities also consider a ‘high-growth scenario’, based on a much higher recovery of tourism revenue (i.e. to 75% of its 2019 level already this year), resulting in a 12% growth of the economy in 2021. However, the underlying prerequisites for this scenario (e.g. mass vaccination providing collective immunity of the population already in the first half of 2021) seem unlikely.

Inflation is expected to remain low in spite of the foreseen acceleration of economic activity. Montenegro witnessed a prolonged period of negative inflation in 2020. Inflation remained in negative territory in the last ten months of 2020, lowering consumer prices by 0.8% on average over the year. The ERP envisages a rebound of inflation in 2021 to 1.2%, easing afterwards to 1.4% in 2022 and 1.2% in 2023. On the assumption of a rapid improvement of labour market performance and subsequent strengthening of aggregated demand, notwithstanding the expectation of stable food and oil prices, the inflation rates for the two outer years seem underestimated. The fact that the ERP’s inflation projections for 2022-23 remain very similar or the same in the low-growth scenario seems to support this view.

The current account deficit is one of Montenegro’s key structural challenges. A narrow production base and large consumption and investment needs result in large and persistent trade deficits. The merchandise trade gap improved in 2020, as goods imports fell by 19% y-o-y. However, tourism was heavily affected by travel restrictions and Montenegro’s traditional surplus on the services account therefore plunged from 20% of GDP in 2019 to just 4% in 2020. The primary account posted a small surplus of 1.4% of GDP thanks to the reduction in compensation to non-resident employees. Remittances held up relatively well and the secondary account surplus increased by 2 pps., to 7.2% of GDP. Overall, the current account deficit worsened markedly in 2020, expanding to 25.5% of GDP, compared to a 15.0% deficit a year earlier. The ERP foresees a substantial decrease in the current account deficit by 6.1 pps. between 2021 and 2023, thanks to the services account being supported by the recovery of travel activity. Moreover, the completion of the first section of the Bar-Boljare highway in 2021 would also contribute by reducing import needs for construction material and services. Overall, despite the expected improvement, the current account deficit is set to remain very high, at 11.6% of GDP in 2023. The ERP provides an analysis of external sector competitiveness, projecting some improvement thanks to a gradual decline in unit labour costs.

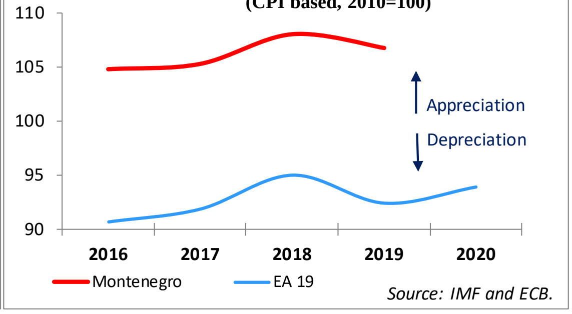
External competitiveness and current account

Graph II.2.1a: **Montenegro - Evolution of the current account balance (% GDP)**



Source: Economic Reform Programme (ERP) 2021

Graph II.2.1b: **Montenegro - Real effective exchange rate (CPI based, 2010=100)**



Source: IMF and ECB.

Foreign direct investment resisted the pandemic shock so far. In spite of the deep recession, net FDI inflows surged by 53.2% y-o-y to 10.9% of GDP in 2020 compared to 6.2% the year before, covering 42.9% of the current account deficit, the rest being financed by net inflows from portfolio investment and loans. The increase in net FDI was driven by a marked decline in investment outflows compared to 2019, when the government bought back the state utility EPCG shares from foreign investors. The composition of FDI inflows changed in 2020, with investments in equity (namely in firms, banks and property), declining on annual basis. Conversely, intercompany debt increased (by 21.1% y-o-y), and accounted for 58.8% of FDI inflows as parent companies supported local subsidiaries during the pandemic. The ERP's assumption of continuing strong FDI inflows over the next few years seems plausible if supported by macroeconomic stability and economic reforms. At the end of 2019 (latest available data), Montenegro's net international investment position (NIIP) represented -168.6% of GDP, the same level as a year before. However, the negative net position is expected to have deteriorated driven by the high external financing needs in 2020. The redemption of old debt in early 2021 should slightly reduce the negative investment position. However, given Montenegro's strong reliance on foreign sources of finance, the external investment position is expected to remain in highly negative territory in the medium term. According to 2019 data, the share of FDI in Montenegro's net international investment position accounted for 43.0% of which 60% relates to equity investments, while other investments (mostly loans) account for around 40%. Overall, the strong reliance on foreign loans increases Montenegro's vulnerabilities to external shocks.

The financial sector proved resilient in spite of the COVID-19 crisis, but credit activity is expected to remain subdued as crisis-related support for lending activity is withdrawn. Banks' capital adequacy ratio remained comfortably above the regulatory threshold. The aggregated capital adequacy ratio reached 18.5% in 2020, well above the statutory minimum of 10%. Payment deferrals and loan restructuring helped contain the share of non-performing loans (NPLs), which increased to 5.5% nonetheless, up from 4.7% a year before. NPL coverage with loan-loss provisions (at 88.3%) remains substantial, and banks with high NPLs are subject to special supervisory scrutiny. Profitability indicators remained positive in 2020, but profit fell 53% over the year. In 2020, return on assets and on equity reached 0.5 and 3.6%, respectively. In the context of the COVID-19 pandemic, the Central Bank of

Montenegro has so far implemented six packages of temporary measures aimed at preserving the liquidity and credit-worthiness of clients, while boosting the banks' lending potential. These measures, such as cutting the reserve requirement ratio by 2 pps. had an asymmetric impact. Thus, while new loans to legal persons grew by 15.2% y-o-y in 2020, natural persons borrowed 42.5% less due to increased COVID-19 related uncertainties and rising unemployment. In addition to a loan moratorium and debt restructuring, both legal and natural persons also resorted to withdrawing their bank deposits, which declined by an average of 4% y-o-y.

Table II.2.2:
Montenegro - Financial sector indicators

	2016	2017	2018	2019	2020
Total assets of the banking system (EUR million)	3 790	4 182	4 407	4 604	4 586
Foreign ownership of banking system (%)	75.5	73.0	74.3	67.9	81.3
Credit growth	1.3	11.8	8.5	4.5	3.2
Deposit growth	9.4	13.8	5.9	0.5	-3.0
Loan-to-deposit ratio	0.8	0.8	0.8	0.9	0.9
Financial soundness indicators (end of period)					
- non-performing loans	10.3	7.3	6.7	4.7	5.5
- net capital to risk-weighted assets	16.0	16.4	15.6	17.7	18.5
- liquid assets to total assets	24.5	25.3	22.6	20.8	22.2
- return on equity	1.5	7.6	8.5	10.0	3.6
- forex loans to total loans (%)	1.1	0.7	0.5	0.4	0.2

Sources: National Central Bank, Macrobond.

The programme foresees credit growth to the private sector to recover strongly in 2021, and ease gradually in the outer years broadly in parallel but at a faster pace than economic recovery. It also identifies credit risk as key, and refers to the Central Bank of Montenegro's completion (expected for April 2021) of an asset quality review of all domestic banks, which is crucial to further reinforcing the financial soundness of the banking sector and addressing any potential capital shortfall. However, the supervision of the non-banking sector also needs to be reinforced, as it may hold a large part of the NPLs shifted off-balance sheet by the banks. Overall, the full impact of the crisis on banks asset quality will only show once the loan moratorium expires and potential corporate bankruptcies rise once the government crisis response programmes are phased out.

2.3. PUBLIC FINANCE

The economic recession had a much greater negative impact on the revenue side of the budget than on spending. The general government registered a high deficit of 11.0% of GDP in 2020 compared to the revised budget plan's target of 7.2% of GDP. In 2020, the government adopted three packages of support measures in the context of the COVID-19, worth some 6.1% of GDP. Measures included tax deferrals, wage subsidies, one-off payments to pensioners and welfare recipients as well as targeted support for key sectors of the economy such as tourism and agriculture. The sharp contraction of the economy, combined with discretionary support measures on the revenue side, had a very strong impact on tax revenue. Thus, budget revenue fell by 13.1% over the year, with nearly all revenue categories underperforming compared to 2019. Meanwhile, in order to restrain overall spending, the government reallocated certain expenditure to healthcare services and supplies, while reducing capital spending by one third. Nonetheless, total expenditure grew by 4.8% y-o-y. Overall, the programme estimates the direct fiscal impact of the COVID-19 pandemic in 2020 resulted in a tax shortfall equivalent to 6.2% of GDP, while discretionary measures in support of the economy and citizens increased expenditure by 1% of GDP.

Table II.2.3:
Montenegro - Composition of the budgetary adjustment (% of GDP)

	2019	2020	2021	2022	2023	Change: 2020-23
Revenues	44.7	44.6	45.8	43.5	42.8	-1.8
- Taxes and social security contributions	39.3	39.6	39.8	39.4	38.7	-0.9
- Other (residual)	5.4	5.0	5.2	4.1	4.1	-0.9
Expenditure	46.7	55.6	48.7	43.7	41.3	-14.3
- Primary expenditure	44.4	52.9	44.5	40.4	39.0	-13.9
of which:						
Gross fixed capital formation	7.0	6.3	5.6	3.0	2.8	-3.5
Consumption	16.3	19.0	16.4	16.6	15.6	-3.4
Transfers & subsidies	18.0	22.2	20.2	19.2	18.3	-3.9
Other (residual)	3.1	5.4	9.4	7.9	7.7	2.3
- Interest payments	2.3	2.7	2.5	2.3	2.2	-0.5
Budget balance	-2.0	-11.0	-2.9	-0.2	1.5	12.5
- Cyclically adjusted	-4.4	-7.0	-0.8	0.7	0.1	7.1
Primary balance	0.3	-8.4	-0.3	2.2	3.7	12.1
- Cyclically adjusted	-1.3	-3.2	2.5	3.6	1.9	5.2
Gross debt level	75.6	104.3	88.4	77.4	69.9	-34.4

Sources: Economic Reform Programme (ERP) 2021

The main objective of Montenegro's medium-term fiscal strategy is to consolidate public finances in order to achieve an almost balanced budget in 2022 and a budget surplus in 2023 by strengthening budget revenue and phasing out crisis- and highway-related spending. Fiscal consolidation relies on three pillars. First, recovery to the pre-pandemic public revenue level would depend on the recovery of economic growth and further broadening of the tax base thanks to the introduction of fiscal cash registers, more efficient tax inspections, and certain ad-hoc measures (such as a new legislation on games of chance). The second pillar focuses on the optimisation of current spending by introducing some discretionary expenditure cuts and containing overall spending in nominal terms (i.e. a faster growth of nominal GDP compared to current spending). Moreover, the extraordinary pressure on health and social spending during the pandemic is not expected to last beyond 2021, and its withdrawal should help to reduce budget expenditure. In addition, the ERP announces a revision of the public administration optimisation plan in order to reduce the number of staff. Thirdly, capital spending is expected to decline significantly following the completion of works on the first section of the Bar-Boljare highway. Overall, the budget balance would improve rapidly, reaching a close-to-balanced position in 2022 and a surplus in 2023 of 1.5% of GDP. The fiscal objectives seem ambitious and would require budget spending to be kept in check.

The government formed in December 2020 decided to postpone the approval of the 2021 state budget until the end of March. According to the law on budget and fiscal responsibility, the Ministry of Finance approved temporary financing for the first months of 2021. Spending units are therefore receiving monthly funding worth 1/12 of the actual expenditures realised in 2020. Although economic output will begin to recover in 2021, overall activity is expected to remain below 2019 levels, hindering the full recovery of budget revenue to its pre-pandemic level. Moreover, continued demands on the budget from intensified social welfare payments and medical spending, as well as additional expenditure under the recovery packages would still encumber 2021 budget expenditure. According to preliminary budget plans, the central government deficit would reach 3.0% of GDP, assuming real GDP growth of 10.5% and an inflation rate of 1.2%. The local government budget is planned to register an aggregated surplus of 0.15% of GDP in 2021, resulting in a marginally lower deficit in the general government budget of 2.9% of GDP (just below the fiscal rules' threshold of 3% of GDP). Compared to 2020, the preliminary 2021 budget plans for an increase in revenue of some 0.8% of GDP and a sharp decline in expenditure of around 6.9% of GDP, reflecting the withdrawal of crisis-related spending starting in 2021 and a reduction in some non-discretionary spending.

Most of the budgetary measures in 2021 focus on the revenue side, and particularly on broadening the tax base. The implementation of the electronic monitoring of fiscal cash registers (e-fiscalisation) already started in January 2021. This, in combination with more efficient work by inspection services, should contribute to reducing informality and increasing tax proceeds. Amendments to the legal framework for games of chance should create conditions for some new budget revenue streams at the end of the year. The ERP also announces a further increase in excise rates as well as the introduction of new excises duties. The Law on Restructuring Tax Liabilities would continue to facilitate the reimbursement of taxpayers' arrears in monthly instalments. There are no new measures on the expenditure side apart from a new public administration optimisation plan aimed at reducing the wage bill. The programme presents some budgetary savings of discretionary nature; however, these are offset by concurrent expenditure increases. Overall, the effects of the proposed consolidation efforts have proved rather modest in the past and may therefore not yield significant budget savings in the future.

Box II.2.1: The budget for 2021

* The government adopted the draft central government budget for 2021 on 30 March 2021, and presented for adoption to the parliament in April.
* The ERP's target for this year's general government deficit is 2.9% of GDP.
* The draft budget law includes some novelties; for instance, the abolition of the upper threshold for the payment of social security contributions. Moreover, other measures like the financial support required for the establishment of a new national airline were not covered.
* The reduction in the number of ministries (from 16 to 12) adopted by the new government had no immediate impact on budgetary outcome. A revision of the structure and composition of several public administration areas has been announced. However, the scope and budgetary impact of that reform remains unclear.

Table: Main measures in the budget for 2021

Permanent Revenue measures*	**Permanent Expenditure measures****
• Electronic monitoring of fiscal cash registers (e-fiscalisation)	• Public administration optimisation plan
• Intensified work of inspection services	• Reduction of VAT on eggs (from 21% to 7%) *(estimated impact: EUR 2.3 million)*
• New law on games of chance *(to be adopted in the fourth quarter)*	
• Further increase in tobacco, carbonated drinks, alcohol, sweets and ice cream excises *(estimated impact: EUR 29 million)*	
• So called 'fuel marking' (to fight illegal trade in petroleum products) *(estimated impact: EUR 12 million)*	
• Abolition of upper threshold for the payment of social security contributions *(estimated impact EUR 3.5 million)*	
• Distribution of income from dividend and profit tax from state owned companies *(estimated impact: EUR 43.5 million)*	
• Increased revenue from increase of minimal salary (i.e. labour taxes and contributions) *(estimated impact: EUR 11.4 million)*	
• Fee from property acquisition not justified *(estimated impact: EUR 20 million)*	
Temporary Revenue measures	
• Tax deferrals *(negative impact on 2021, neutral after 24 months)*	

* Estimated impact on general government revenues.

** Estimated impact on general government expenditure.

Source: ERP

Box II.2.2: Measures taken for 2021 to support the recovery and increase the resilience of the economy

a. Incentives to increase employment

Incentives introduced with the second package of support measures aim to support the retention of workers by reducing the labour tax wedge. Namely, subsidies for new staff recruited before 31 December 2021 will exempt the employer from paying income tax and contributions for pension and disability insurance (up to the amount of the gross average wage for the previous year). The exemptions will cover 90% of taxes and contributions paid in 2021, 60% in 2022, and 30% in 2023. In contrast, programmes for skills upgrading or short-time working schemes to support job transition, remain less developed.

b. Support public and private investment, and the green and digital transition

The third package of government measures included a very ambitious reform agenda until 2024, linked to the strategic policy objectives of the green and digital transition with the aim of diversifying the economy. The green transition plans investments on clean energy projects amounting to one billion euros. A substantial part relates to investments by the state-owned electric power company in new production plants. The digital transition will require EUR 28.9 million in public and private investments. It will include establishing an IT cluster, a centre for e-commerce support, a virtual and augmented reality innovation centre, and the establishment of Montenegro’s Innovation Fund.

c. *Support demand by providing temporary tax cuts and promoting a growth-friendly tax system*

Support for households through temporary tax cuts may help sustain the recovery as it takes hold in 2021, especially to support aggregate demand. All tax deferrals are temporary in order to avoid a deterioration in the underlying fiscal positon. Measures concern one-off financial assistance for vulnerable categories of citizens, with an estimated total cost of EUR 7 million. An additional EUR 5.5 million was allocated to support local tourism by means of EUR 200 tourism-vouchers (valid until July 2021) for all workers in the education and healthcare sectors.

d. *Support solvent businesses*

Efforts are made to provide taxpayer support to economic sectors impacted by the crisis. However, the general support approach does not distinguish solvent firms from those in difficulties before the crisis, and could result in rising delinquency rates once the support is over. Measures concern the postponement and rescheduling (in 24 monthly instalments) of income taxes and social security contributions incurred in the period from 1 July to 31 December 2020. The state-owned Investment and Development Fund set up specific credit lines to bolster the liquidity of micro, SME and large companies operating in the sectors of tourism and hospitality, transport, medicine and food production.

e. *Liquidity measures*

Measures such as tax deferrals are justified in providing further liquidity while reducing accumulated tax refunds in order to avoid or alleviate solvency problems for firms. Key measures involve increasing of the turnover limit for mandatory VAT registration (to EUR 30 000 from EUR 18 000), shortening the VAT refund period (from 60 to 30 days), reducing (until July 2021) the VAT for catering services (to 7% from 21%) and reducing the rental costs for state-owned property by 50% (only in 2021). In addition, government interventions on the market are foreseen as well as support for purchasing domestic agricultural products, fisheries and aquaculture products.

The government adopted four packages of measures to support the economy in the context of the COVID-19 pandemic. Overall, most of the measures are temporary. However, many of them have had their timeline and coverage extended in subsequent packages. The government's policy response was timely. The first package was rapidly adopted on 19 March 2020, focusing on rapid support for the most vulnerable categories of the population and supporting real sector liquidity. The second package (in April 2020) placed more emphasis on supporting employment. The third one (in July 2020) was very ambitious, providing short-term measures in support of the economy, but also a recovery plan worth more than one billion euros, involving public and private investments until 2024, in order to increase the resilience and diversification of the economy. The new government (formed on 4 December 2020) adopted a new package in January 2021, broadly in line with the previous ones.

There are no new features on the revenue or expenditure side for 2022 and 2023. Some measures present in 2021 are to be maintained over the following years too, in particular the regular increase of the tobacco excise rate and the further reduction of tax arrears in the context of the Law on rescheduling tax receivables. However, other measures presented in the previous ERP are not mentioned, particularly the economic citizenship programme or the concession of Montenegro's airports. On the expenditure side, capital spending would fall to 3.5% of GDP per year after the conclusion of the first section of the highway in 2021. Overall, public spending is set to decline significantly by 14.3 pps., from 55.6% of GDP in 2021 to 41.3% of GDP in 2023 (or by 6% in nominal euro terms).

The stock of public debt soared at the end of 2020. Last year's ERP expected the public debt to fall to 72.3% of GDP in 2020, down from 78.7% a year earlier. Instead, there has been the unplanned surge in the budget deficit due to the COVID-19 crisis, but also massive borrowing at the end of 2020 in order to secure financing at favourable terms to meet debt-rollover needs in 2021 pushed public debt above 100% of GDP in 2020. The ERP expects the debt ratio to decline rapidly, by more than 34 pps. in 2020-2023, driven by the improving primary balance, the rebound in GDP growth and the use of large government deposits to repay maturing debt (see box below). In spite of the high stock of public debt, annual gross financing needs are set to fall rapidly (from 12.7% of GDP in 2021, down to 6.2% in 2022 and 3.4% in 2023) due to both lower debt rollover and deficit financing needs. A highway-related credit line with China would cover 85% of the road's financing needs. Moreover, the amount of accumulated government deposits is substantial, totalling some 20% of GDP at the end of 2020. Of this, some 4.9% of GDP was used in March 2021 to reimburse maturing debt. Some 80% of the public debt is in euros, and 18% in USD. To reduce the related currency risk related to USD borrowing, authorities are negotiating a hedging arrangement with a group of banks. Interest rate risk is also low, as 73.2% of the total debt has been issued at a fixed rate. The ERP announces the preparation of a new public debt management strategy until 2023, to be endorsed after the adoption of the 2021 budget.

Box II.2.3: Debt dynamics

The rebound in GDP growth, the significant improvement in the primary balance, which is projected to turn into a surplus as from 2022, and favourable large stock-flow adjustments are expected to drive the very sizeable reduction in the public debt ratio, which is projected to fall by some 334 pps. in 2021-23. Stock-flow adjustments remain largely dominated by liability management operations. In particular, the sizeable issuing of Eurobonds in 2019 and 2020 boosted the gross public debt stock with the purpose of building government deposits to repay maturing debt and to cover financing needs in 2020 and 2021. The use of these deposits will reverse the sign of stock-flow adjustment in the period 2021-2023. Decreasing investment related to the highway will result in primary surpluses in the two outer years, further contributing (together with a favourable snowball effect) to quick debt reduction.

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

	2019	2020	2021	2022	2023
Gross debt ratio [1]	**75.6**	**104.3**	**88.5**	**77.4**	**69.9**
Change in the ratio	5.5	28.7	-15.8	-11.0	-7.5
Contributions [2]:					
1. Primary balance	**-0.2**	**8.4**	**0.3**	**-2.2**	**-3.7**
2. "Snowball" effect	**-1.9**	**16.3**	**-7.5**	**-3.9**	**-2.6**
Of which:					
Interest expenditure	2.2	2.7	2.5	2.3	2.2
Growth effect	-2.8	13.5	-9.9	-5.4	-4.2
Inflation effect	-1.4	0.1	-0.1	-0.8	-0.5
3. Stock-flow adjustment	**7.6**	**4.0**	**-8.7**	**-5.0**	**-1.2**

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

Source: Economic Reform Programme (ERP) 2021, ECFIN calculations.

Fiscal plans are subject to significant risks and uncertainties. The ERP presents a matrix of economic and fiscal risks emphasising that the recovery of the economy, and therefore of public finances, relies primarily on the return of tourism. However, this factor does not only depend on Montenegro, but also on the countries of origin. The rate of vaccination, both in origin and destination countries, will be key to this recovery. The poor performance and governance of some state-owned enterprises (particularly in the transport sector) is identified as a key fiscal risk, given their dependence on state subsidies and tax arrears for their survival. Authorities also recognise the possibility of higher (and unplanned) costs when concluding the works on the first section of the highway. However, continuing the remaining sections of the highway (including through PPP arrangements) also represent a risk to public finances, not included in the ERP. The introduction of the new child benefit would require careful planning of its fiscal impact as well as the sources of financing in order to avoid fiscal risks, as witnessed in the past in the case of the poorly planned benefits for mothers of three or more children. There is also a risk of early elections given the heterogeneous government coalition's narrow parliamentary majority, which could see an increase in fiscal pressures in the context of a new electoral cycle. Containing current spending, particularly on the wage bill, might prove challenging as previous plans for reducing current spending have repeatedly been derailed in the pre-pandemic years.

Box II.2.4: **Sensitivity analysis**

The programme offers a detailed analysis of the deficit, with a comparison between scenarios as well as with the previous ERP. The comparison among scenarios offer a detailed risk matrix including potential positive and negative events. However, the impact of such risks are not quantified. While the previous programme predicted a balanced budget for 2020, followed by surpluses in the two outer years, this year's ERP confirms a very large deficit in 2020, and estimates a fast recovery path towards budget surplus, expecting budget revenue not to recover to pre-pandemic levels until 2022. The analysis highlights the asymmetric nature of the pandemic shock on budget performance, resulting in a much sharper deterioration of the revenue side than of expenditure.

The quality of public finances is hindered by the rigid structure of the budget. Non-discretionary items such as spending on wages and benefits dominate the expenditure side of the budget. Public finances were further strained by the COVID-19 pandemic due to increases in health-related spending. Thus, after increasing public spending on the health sector, no measures are proposed to reinforce the health fund to reduce its persistent deficit. In addition, the introduction of amendments to the pension law further deteriorated the chronic deficit of the pension fund. To support the stability of the pension system, the ERP includes the postponement of the early retirement age by one year (to 63) and the abolition of the special retirement conditions at the end of 2021. These measures seem insufficient to compensate for the reduction of the retirement age (by one year for men and by three years for women) introduced in 2020. To reduce the wage bill, the ERP announces a review of the public administration optimisation plan, including maintaining the restriction for new recruitments. However, these schemes have produced poor results in the past. Unfavourable demographic trends increase the pressure on the long-term sustainability of public finances. Overall, although the ERP diagnostic is accurate, the policy response lacks ambition.

Several projects are being implemented to strengthen Montenegro's budgetary framework. The Law on Budget and Fiscal Responsibility provides the formal framework for Montenegro's fiscal policy. Amendments to this law were prepared and adopted by the government along with the 2021 budget on 30 March 2021. These amendments aim to establish an independent fiscal council to strengthen the oversight of fiscal policy. Programme budgeting and medium-term planning were also included with the 2021 budget. These amendments also introduced the development of performance indicators with the aim of fully implementing programme budgeting with the 2022 budget. Internal control mechanisms need to be reinforced, including making the budgetary inspectorate department fully operational. There is a considerable delay in the introduction of accrual accounting and the production of government finance statistics based on ESA2010 standards. The problem is primarily due to the lack of human resources at the Ministry of Finance, but also at the statistical office (MONSTAT).

2.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Montenegro's comparative advantage is built on its geographical location, climate and landscape. Its small and open economy is service-oriented and largely focused on tourism as the principal source of income. Services account for nearly 80% of total exports, while foreign tourists alone generate over 20% of the country's GDP. It's tourism potential is still far from being fully exploited, with the mountainous northern region offering significant opportunities for further growth, including outside the summer holiday season. At the same time, given the country's reliance on one sector and its small size, the economy remains vulnerable to external shocks and the challenges of climate change.

Montenegro is one of the countries most exposed to pandemic-induced distortions, given tourism's large share of GDP and employment. This calls for renewed efforts to promote diversification and increase the value added in economic activities, as well as prioritisation of skills development programmes, in response to smart specialisation priority areas with high potential in the post-COVID-19 period, and in light of the digital and green transitions.

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

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

Key challenge #1: Increasing employment, particularly of women and young people, and tackling long-term unemployment

Positive labour market trends that could be observed before March 2020, were negatively impacted by the COVID-19 pandemic and the ensuing halt of economic activity. In the third quarter of 2020, the unemployment rate (15-74) rose to 19.4%, compared to 16.6% in the first quarter and 15.6% in the third quarter of 2019. The activity rate (20-64) in the third quarter of 2020 stood at 66.2%, 6.1 pps. lower than in the third quarter of 2019. The employment rate (20-64) continued to decline throughout 2020 to 53.5% in the third quarter of 2020, compared to 60.1% in the first quarter of 2020 and 61% in the third quarter of 2019. By way of comparison, in the EU the unemployment rate was 7.4% in the third quarter of 2020 (6.5% in the third quarter of 2019), the activity rate was 78% in the third quarter of 2020 (78.1% in the third quarter of 2019) and the employment rate was 72.4% in the third quarter of 2020 (73.1% in the third quarter of 2019). Despite a slight improvement, there are still great geographical disparities. The unemployment rate in the Northern region (36.3%) was more than six times than that in the Coastal region (5.5%). Roma and persons with disabilities face additional challenges in accessing the labour market, despite the continued support from employment and education programmes targeting those groups. Montenegro reacted quickly and adopted unprecedented measures aimed at mitigating the socio-economic impact of the pandemic. Three packages of measures were adopted in 2020 and a fourth one in 2021, which was aimed at job retention through support for businesses, workers affected and certain vulnerable groups.

As a direct response to the 2020 policy guidance to "take measures to preserve employment including by ensuring short-time work schemes and flexible working arrangements", *Reform Measure 16 – "Improvement of labour legislation by introducing new work schemes"* was proposed. While the aim of the measure is appropriate, it lacks clarity on the specificities of the schemes and arrangements intended to be implemented. It is unsure whether the new work schemes will be introduced in time to curb the impact of the COVID-19 pandemic on the labour market.

The most vulnerable groups on the labour market remain women, young people and the low skilled while long-term unemployment continues to be a structural challenge. While the unemployment rate for women is only slightly higher than that of men, the gender employment gap remains high with a 13.1 pps. difference. The pandemic had a significant, negative impact on youth employment (15-24) (17.6% in the third quarter of 2020 compared to 29.5% in the third quarter of 2019) and unemployment (15-24) (38.1% in the third quarter of 2020 compared to 23.9% in the third quarter of 2019) rates as well. Even before the outbreak of the pandemic, the rate of youth (15-24) neither in employment, nor in education and training (NEET) increased from 2018 (16.2%) to 2019 (17.3%), reflecting significant difficulties in transitioning from education to employment, paired with a mismatch between skills provided through formal education and those required on the labour market. It could also indicate weak job creation. The highest share of unemployed persons continue to be those with lower educational attainment. High long-term unemployment persists (65.5% in the third quarter of 2020). The decrease in the share of long-term unemployed compared to 2019 can be attributed to the increasing number of unemployed persons overall, rather than any improvement in the situation. The National Employment Strategy 2021-2024 was not adopted as planned in 2020.

While female inactivity remains high, an increased participation in early childhood education and care is expected to support their access to employment. In the third quarter of 2020, women's inactivity rate (20-64) remained far above men's at 41.8% compared to 24.2%. Employment gains continue to be larger for men than for women. This is partly due to traditionally lower engagement of women on the labour market, a significantly higher share of unpaid work done by women (ILO, 2019), as well as the structure of the social benefits system which can discourage women from entering the labour market. Women have also been more affected by the increasing unemployment due to the COVID-19 crisis. The enrolment rate of children up to 3 years old in child care rose to 37.21% in 2019 (Monstat) and reached 72.62% for those aged 3 to 6 (Monstat), indicating a clear positive trend. However, regional disparities remain with low take up in the North. The forthcoming adoption of the Strategy and Action Plan for Early and Preschool Education 2021-2025 should reinforce this positive trend.

Despite the numerous, long-term activation programmes in place, these continue to be ineffective in activating the working-age population. Active labour market policies (ALMPs) are not adequate to assist jobseekers in finding sustainable, long-term employment and still focus insufficiently on re- and up-skilling. Although an evaluation of ALMPs is expected to be finalised in 2021, the lack of a comprehensive monitoring and impact assessment of the effectiveness of ALMPs, including following-up on the number of beneficiaries that remain employed in the long term, prevents continuous policy adjustments from being made to render the ALMPs fit for purpose. Efforts to improve the currently ineffective institutional set-up and functioning of Montenegro's public employment service, the Employment Agency of Montenegro (EAM), are on-going. These considerations are reflected in *Reform Measure 17 – "Operational capacity building at the Employment Office for the performance of services and measures through digitalisation"*. The digitalisation of EAM based on the results of the identification and revision of the procedures should facilitate its work and improve the provision of tailor-made and targeted services.

Informality remains an obstacle to improving labour market outcomes. While it is assumed that the wage-subsidy measures in response to the pandemic have prompted employers to formalise some of their employees, disincentives to formalisation remain, requiring comprehensive measures to fight undeclared work. The Labour Law adopted in December 2019 aims to increase the flexibility of the labour market, but the effects of its implementation remain to be seen. The capacity of the Labour Inspectorate remains limited. A specific ALMP has been established since 2019, targeting young people and incentivising their participation in the labour market through employment or self-employment, however its effectiveness is yet unknown. A horizontal policy overview combining various measures to activate youth, such as the EU Youth Guarantee, is lacking.

Skills mismatch continues to be a significant challenge, particularly for young people. It is a problem for both those with secondary education and those with higher education. There are high levels of transition from VET to higher education and other programmes with lower labour market relevance. Occupational mismatch (i.e. over-qualification) is highest for those with tertiary education (around 14%). While tertiary educational attainment is still lower than the EU average, the labour market cannot absorb tertiary graduates in certain subjects, such as business and humanities, while there is still a shortage of medical and STEM graduates (ETF, 2019), which is detrimental notably in view of their significance for the occupational domains targeted by the smart specialisation strategy. A professional training programme for higher education graduates has been implemented for nearly a decade, however no comprehensive analysis on its impact has been conducted. Up to 2019, around 3 000 unemployed graduates took part, only 50% of whom continued to be employed after participating in the programme. With the help of the ILO, a tracer study has been implemented which should help evaluate the programmes' efficiency.

Reform measure 15 – "Reform of study programmes for bachelor and master studies with strong focus on apprenticeship", is in line with the European Commission's policy recommendations and is expected to improve the overall quality of education, including through the establishment of an adequate monitoring and evaluation mechanism for practical learning in higher education.

Prior to the COVID-19 pandemic, enrolment in dual VET education was rising significantly (834 in 2019/2020 compared to 277 in 2017/2018 and 570 in 2018/2019). However, as in many EU Member States, the pandemic had a negative impact on practical education, as shown by the fall in the enrolment rate for 2020/2021 of 740 students. With the increasing number of students, in 2019, the government commissioned an evaluation in an effort to improve the quality and relevance of the programmes (ETF, ILO 2020). It was followed up via a further internal review in 2020.

Reform measure 14, which follows on from the previous year's measure 15, on the "*establishment of the system for continuous monitoring of the quality of apprenticeship at the employers*", is expected to facilitate fact-based policy making, adapt the apprenticeship programme and improve labour market transitions. The dual education review published in 2020 (ETF, ILO 2020) should serve as a good basis for further analysis.

Participation in lifelong learning has further decreased to 2.5% in 2019 (down from 3.2% in 2018) less than a quarter of the EU-27 average (10.8%), and there are limited opportunities for re- and up-skilling. Lifelong learning and adult education with up- and re-skilling does not play a sufficiently prominent role, including in facilitating the green and digital transitions. Adult education programmes are included in ALMPs. In 2019, 896 unemployed persons took part in adult education programmes, only 13.2% of whom found a job within 6 months of completing the programme. The programmes are not targeted and designed in a manner that would effectively help integrate jobseekers into the labour market. Given the very high share of long-term unemployment, the development of such measures remains essential. No reforms have been announced in the area of adult learning, though a first iteration of the Lifelong Learning Strategy is expected in 2021.

Social support schemes, including unemployment benefits and social assistance schemes, are in place, but are not effective in protecting the most vulnerable segments of the population or in activating the population. The complex web of social benefits and services combined with a lack of systematic follow-up of individual activation plans contributes to the high inactivity rates and discourages formal employment. In line with the Social and Child Protection Strategy, the government has commissioned a study to review the social protection system, the delivery of which has been delayed due to the COVID-19 crisis. However, a preliminary assessment and recommendations are expected to be ready in early 2021 enabling the government to draft an outline of measures to reform the social protection system.

Key challenge #2: Strengthening the regulatory environment

Improving the institutional and regulatory environment in Montenegro requires long-term commitment on the part of the state and local authorities. The regulatory environment is not business-oriented and hinders more dynamic development of local companies and foreign investors' activities. **As the key areas for improvement,** businesses point to inefficiencies and delays when dealing with the administration, excessive complexity and administrative burden from local taxation and para-fiscal charges, and a lack of established mechanisms for continuous structural dialogue between authorities and the business world. Close behind on the list of top concerns are insufficient transparency in decision-making, inconsistencies and arbitrary interpretation and enforcement of the law by public authorities, and shortcomings related to public procurement procedures. Companies stress that these deficiencies lead to unpredictability in the regulatory environment at central and local level and hold back the Montenegrin economy.

Routine administrative relations between the business community and authorities are not focused on the needs of businesses. Conducting business is often hindered by the slow pace of administrative responses or lack of deadlines for some administrative procedures. The authorities seldom provide a rationale or feedback regarding decisions affecting businesses, and when such decisions are questioned the authorities tend to invoke business secrecy rather than allowing the interested party free access to information. On top of this, there are regular reports of conflicting interpretation of laws between different decision-making authorities, between the state and the municipal level, and between local authorities.

Public consultation processes would benefit from a more inclusive and stakeholder-oriented approach. Many legislative proposals require effective and proactive communication strategies targeting stakeholders from the outset. Inclusive public consultations should take place at a sufficiently early stage in a legislative process. Businesses and the organisations representing their views are natural partners of the public authorities; their input is needed at the design stage in order to assess the impact of new laws and regulations on the economy. However, public debate appears only to come very late in the process and is often restricted in scope and time, resulting in very limited feedback from the business world and social partners.

Apart from the high-level Competitiveness Council, there are no established technical mechanisms and practices allowing for continuous structural dialogue between authorities and the business world. There is no overall, central coordination of public consultations by the Secretariat General of the government or any other structure. The practice of consultations seem to differ not only between ministries and administrative bodies but also depending on the topic discussed. Consultations tend also to be formal, one-off affairs, focusing on procedures rather than substance. The authorities' low responsiveness, insufficient transparency and lack of continuous engagement in the public debate processes is another issue to be addressed.

Businesses are also affected by the lengthy processes for adoption of secondary legislation. Frequent delays between the adoption of primary laws and the adoption of their implementing legislation are another source of instability and erratic decision-making by the public administration at the central and local levels.

While the government Montenegro has made some progress in improving the quality of public consultations during 2020 (particularly in the context of the adoption of COVID-19 mitigation measures and the preparation of the ERP structural reforms), the systematic inclusion of business and social partners in designing, drafting and implementing measures affecting the economy has yet to be achieved.

The area of public procurement and concessions is undergoing significant transformation, with the rollout of the electronic procurement system from January 2021. Efficient, competitive, transparent and non-discriminatory public procurement procedures are an integral part of a business-friendly regulatory environment. Public procurement in Montenegro accounts for around 12% of the country's GDP and is generally fulfilling its purpose, although, as noted in the European Commission's country reports, there are some weaknesses in the preliminary selection procedures and particularly at the remedies (appeals) stage.

The launch of the electronic procurement system in 2021 is expected to bring significant improvements to the functioning of public procurement over the coming years. The system is based on the recently-adopted legal framework (the law on public procurement and the law on public-private partnership) providing a good degree of alignment with 2014 EU Procurement Directives on classical procurement, utilities and concessions. The implementation of centralised e-procurement via a single, dedicated portal could make it significantly easier to access information on tenders from all contracting authorities, speeding up procedures and improving their transparency.

The proposed ERP *reform measure 9 – "Implementation of the electronic public procurement system (EPPS)"* is credible and appropriate, as it should help to increase the transparency of public procurement processes, increase the efficiency of procedures and reduce the possibility of corruption and breaches of competition rules. On the technical side, a broader spectrum of risks to the project could be better reflected in the document (expected timeline for adoption of secondary legislation, progress in digitalisation of the state administration, technical preparedness of civil servants and bidders despite trainings provided etc.). Practical implementation by public procurement officers and contracting authorities will be the key to the success of the project and its ultimate impact on the country's competitiveness and long-term growth potential.

Local taxation, transparency and the fairness of the State as a regulator should remain the authorities' focus. While the income tax for companies at state level remains low at a rate of 9%, municipal fees, charges and other financial obligations are seen as a major obstacle for investment in Montenegro. Taxation's legal framework is based on at least 10 different laws, thus increasing its complexity. According to the Montenegrin government, there were 659 different taxes, fees and charges in Montenegro in 2017. Businesses therefore find the tax system arbitrary, unpredictable, confusing and non-transparent. Planning the payment of tax commitments remains notoriously difficult due to the frequency of payments and legislative changes, making this another area for improvement.

Moreover, the business community often questions the general implementation of tax system, denouncing tax discrimination between local and foreign-owned companies, and between small and large companies, citing the government's leniency towards some large local debtors. Preferences, subsidies or aid provided to certain enterprises over recent years increase the perception that politically well-connected businesses enjoy preferential treatment and unfair advantages.

Recognising the challenge of local taxation, the government launched two important actions in this area. Both initiatives are seen as important reforms and encouraging steps in the process of the expected further reforms of the local taxation system. Firstly, the laws on administrative fees and on local communal fees, adopted in March 2019, aim to simplify, restructure and reduce some of the local fees and charges. Some 7% of administrative fees have been abolished, another 11% reduced and 9 out of 12 legal bases for setting local communal fees have been banned, while maximum caps for fees have been introduced for the remaining 3 legal bases. This was the first effort in years to simplify and harmonise business taxation. Secondly, in 2020, in cooperation with business organisations represented in the Competitiveness Council, the government launched the register of fiscal and para-fiscal charges. The register features some 2030 levies and 580 different regulations affecting the financial obligations of businesses.

The proposed ERP *reform measure 8 – "Establishing the register of fiscal and para-fiscal charges"* - relates to the establishment and further development of the register that would consolidate fiscal and para-fiscal charges at the national and local levels. The updating and expansion of the register's functions are among the policy conditions in the Memorandum of Understanding (MoU) in the context of the macro-financial assistance granted to Montenegro during the COVID-19 crisis. The register is expected to become operational by March 2021. Introducing the register of fiscal and para-fiscal charges should address one of the important bottlenecks in the regulatory environment and increase transparency, though it is difficult to assess its impact on the competitiveness of the Montenegrin economy. The measure appears well drafted and clear.

The development of transactional electronic government services is a way to support Montenegro's regulatory environment. The digitalisation of the public sector can greatly enhance the business environment, in addition to the obvious gains in efficiency and transparency of relations between businesses and public authorities. The recent introduction of e-registration for businesses, ongoing efforts to set up the e-cadastre and the launch of e-procurement procedures are prime examples of the strong potential for change. The outbreak of the COVID-19 pandemic sped up some of the e-government projects (e-registration, launch of the online system for payments of administrative fees – NS-NAT). Implementation of e-government services could also lead to a significant reduction in possibilities for corruption and unequal treatment between different businesses.

Overall, the Montenegrin authorities appear committed to a number of actions to improve the efficiency and transparency of the regulatory environment through digitalisation and, despite the COVID-19 pandemic, managed to maintain the momentum of ongoing reforms and launch a new initiative. Development of the administrative processes and practices for an inclusive, business-oriented regulatory environment and the implementation of a business-centric culture among the central and local public administrations should remain the authorities' focus over the coming years. The accelerated digitalisation of the economy and the roll-out of new e-government services, partly due to COVID-19 developments, may contribute to addressing key challenges 2 and 3. An independent, efficient and effective judicial system will be key to creating and maintaining an attractive business environment.

Key challenge #3: Formalisation of the economy

The informal economy is estimated to account for around 30% of GDP. Informality has many different causes and is closely linked to other key challenges discussed in this document. Montenegro's sizeable informal sector is fuelled by deficiencies in the institutional and regulatory environment, weaknesses in the labour market, insufficient enforcement capacity of the public authorities, corruption and high tolerance for tax non-compliance. A further layer of complexity is caused by social and cultural factors, low awareness of the negative societal impacts of the informal economy and the high importance of extended family links and personal connections, as these often tend to increase the acceptance of, and willingness to engage in, informal and undeclared work, the informal economy and informal transactions.

Yet another dimension of informality could be traced to the Montenegrin diaspora and large remittances flowing into the country through formal and informal channels. These payments support family incomes, which could partly explain the very high level of cash transactions in the economy, and fuel a largely informal market in housing construction and renovation.

Policies aimed at reducing informality need to be broad and comprehensive due to the diverse causes of the phenomenon and the complex relationship between labour market structures, the institutional and regulatory environment, taxation, social policies and cultural factors. They need to create incentives and conditions for the formalisation of businesses and labour, apply strong disincentives and sanctions for those economic operators that remain in the informal sector and unfairly compete with legitimate businesses, and act decisively in order to close any gaps in the legal and institutional system that are subject to abuse. The authorities need to employ a wide spectrum of different instruments to combat informality effectively.

The high level of informality in the economy has far-reaching consequences. It hinders the efficient allocation of state and business resources, reduces the revenues of companies and of state and local budgets, slows down economic development, and has negative long-term outcomes for workers. In the Montenegrin context, the impact of unfair competition from the informal sector is particularly heavy on SMEs and microenterprises, which dominate the economy. The smallest companies, which constitute over 90% of Montenegrin businesses and serve the local market, perceive informal competition as the most costly obstacle to doing business. An equally important concern is that the costs of informality and corruption are higher for innovative companies, thus particularly hindering the development of the sectors of the economy based on knowledge and skills.

The presence of informality is also reflected in the labour market. Informal and undeclared work is estimated to represent some 30% of employment (UNDP). Employment is under-reported in the tourism sector and agriculture. The labour taxation system and structural challenges on the labour market may create disincentives for formal employment, with adverse implications for informal workers, the budget and the social security system. The new labour law, adopted at the end of 2019, is also expected to have a positive longer-term impact on informality and undeclared work by improving flexibility on the labour market and improving formal employment.

Reducing the scale of the informal economy has become a priority for the government. An action plan to combat the grey economy was initially adopted in 2017, and a Government Commission for the Suppression of the Grey Economy, chaired by the deputy prime minister for economic policy, was appointed in 2018 to coordinate different actions, encourage cooperation between government bodies and assist local authorities. The Commission included representatives of the Ministry of Finance, the tax administration, customs administration, police administration and the administration for inspection affairs. However, the action plan lacked the necessary scope and a comprehensive approach to informality, focusing instead on the rather narrow range of activities (such as checks and suppressive action on businesses via different inspection services, with the focus on the tourism sector) that could increase the revenues of the state budget.

A new attempt at reducing informality became a more prominent feature among government priorities following the adoption of the Joint Conclusions of the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey in May 2019 and of the ERP 2020-2022 in January 2020. Both documents acknowledged that the absence of a strategy and adequate monitoring tools of informality are key obstacles to preparing, implementing and assessing informality-targeted reform measures. Furthermore, they underlined the crucial importance of close cooperation between central and local authorities, as well as the involvement of legitimate businesses and social partners in efforts to reduce the informal economy.

The outbreak of the COVID-19 crisis in early 2020 stalled progress on reducing informality. The pandemic delayed virtually all activities scheduled under the structural reforms section of the ERP 2020-2022 and effectively put on hold any progress on implementing the informality-related aspects of the 2019 Joint Conclusions. This is particularly visible as regards the design of a strategy and the implementation of preventive actions and incentives to support formalisation. No progress was made in establishing monitoring tools to assess the informal economy and its dynamics. Contrary to expectations, a new law on inspections failed to address the issue of access to the private premises of natural persons suspected of informal activities, thus undermining the enforcement powers of the inspection services.

In addition, the economic measures, adopted by the government in response to the COVID-19 crisis, appear to have missed the opportunity to provide state support as an incentive to legalise informal businesses. On the flipside, they certainly provided valuable support to legally operating businesses and helped some of them to remain in the formal economy. At the same time, incentives provided for new employment may have attracted some of the employees or businesses that operated previously in the informal sector (among some 1000 new jobs that were created).

Due to these developments, the 2021-2023 ERP features a refocused *reform measure 6 – "Improving and implementing the measures for suppression of the informal economy"* - based largely on measure 8 of the ERP 2020-2022. The measure still does not envisage a full strategy on informality, accompanied by benchmarking tools allowing for the continuous assessment and reduction of the informal economy and leading to the design of concrete actions, as agreed in the 2019 Policy Guidance. Instead, it merely brings together previously proposed and unrealised activities, and a few concepts, which should become part of an Action Plan, to be developed in the second half of 2021. At the same time, the measure remains rather vague in terms of the concrete actions to be taken on the suppression of informal economy and on the incentives provided for legal entrepreneurship and employment. Activities are not set to start until 2022, with no concrete actions on informality foreseen for 2021. Further work is needed as regards the impact on social outcomes and the environment. Furthermore, as the only overarching measure on informality, it should be clearly linked to all other currently planned reform measures contributing to the reduction of informality. The Action Plan should give further consideration to preventive and educational action that specifically target micro and small enterprises.

The fight against the informal economy requires sustained efforts and planning in order to achieve tangible results. The government action plan to combat informality still requires updated and more concrete actions to better coordinate the efforts of the different institutions at central and local level and to address additional areas that could contribute to reducing informality, such as actions to incentivise the use of electronic payments. Other important aspects of informality that require the government's attention relate to closing the gaps and inconsistencies in the law that facilitate the development of informal activities. This can often be achieved through the digitalisation of public sector's services, a process that falls under the key challenge on strengthening the regulatory environment.

Specifically in relation to informality, the government launched three important initiatives in 2019. The first of these, carried out in 2020, was the introduction of new excise duty stamps supported by smartphone applications enabling the authenticity of excise goods to be verified online. The other two, which will continue into 2022 and 2023 respectively, were e-fiscalisation (supporting proper taxation of all cash register transactions) and the introduction of an integrated revenue management system in the tax administration (IRMS).

The latter two projects continue under the proposed ERP reform *measure 7 – "Suppression of informal economy by reforming tax administration"* - re-defined from the ERP 2020-2022. The measure is credible, though ambitious and appropriate in terms of promoting competitiveness and long-term growth potential. It is aimed at improving the efficiency of the Tax Administration and reducing costs for taxpayers, which should also help to reduce the informality in the economy. The restructuring of the Tax Administration into a Revenues Administration may cause some delays in the reform. Further work is needed as regards the effects the government expects to see on competitiveness (e.g. curbing of tax evasion, additional revenues to the budget, better planning of tax flows, level playing field for enterprises etc.). The cost of maintenance and necessary staff training for the IRMS, which are both key to successful and timely system roll-out, do not appear to be taken into account. Delays are likely if these factors are not factored in, given the current capacity of the tax administration and the high turnover of qualified staff. The description of the envisaged reform should go into more detail on how the control will be enforced and how various risks (e.g. resistance to endorsing the new system and paying taxes) will be mitigated. In particular, risks related to the cost of moving to the formal economy (which may be too high for some employers in the grey area) should be considered, together with possible incentive schemes to stimulate such a move.

In summary, the Montenegrin government has recognised the need to address the diverse causes of informality by initiating a number of reforms in the institutional and regulatory environment. Nonetheless, the progress achieved in these areas is, with some exceptions, difficult to measure, not least because of the outbreak of the COVID-19 crisis. Many of the actions described are yet to be implemented, some necessary legal changes are still to be adopted and more ambitious reform measures would be welcome. At the same time, reducing unfair competition and informality is heavily dependent on the successful implementation of reforms to the labour market and the regulatory environment, as these address some of the pertinent causes of informality. The impact of the changes that have been made needs to be sustained by proper and steadfast implementation of ongoing reforms over the coming years. The determination of the public authorities to enforce the new rules through administrative and judicial means will play an equally important role in the process.

Box II.2.5: Monitoring performance in light of the European Pillar of Social Rights

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

Montenegro faces challenges with regard to a number of indicators of the Social Scoreboard ([22]) supporting the European Pillar of Social Rights. This is the case for equal opportunities and access to the labour market. While improvements in employment and unemployment rates have been maintained, structural challenges on the labour market persist, such as low activity, high long-term unemployment and the share of young people (15-24) not in employment, education or training (NEETs), as well as regional disparities. Some improvement as regards the gender employment gap has been noted between 2018 and 2019, even though the figure remains above the EU-27average (13.3 pps. in Montenegro v. 11.7 pps. in EU-27).

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

High youth unemployment, a high share of the low-skilled in inactivity, coupled with a high incidence of undeclared work, point to weak transitions within and into employment. The adoption of the new labour law aimed at increasing labour market flexibility and contributing to the reduction of undeclared work, though effects are yet to be seen. Skills mismatches and weak provision of adult learning affect school-to-work transitions and result in insufficient adaptability of workers to find appropriate and sustainable employment.

Employment remains the best way out of poverty. The social protection system is not well equipped to target and assist those in need. In addition, it is insufficiently linked to labour market activation to encourage and facilitate employment. The country's demographic structure puts pressure on both the labour market and the pension system, reformed in 2020, and puts even greater pressure on its sustainability.

Collection of timely and reliable data needs to be sustained and strengthened. The results of the first Statistics on Income and Living Conditions (SILC) survey from 2018 were updated in 2019 and 2020.

([22]) The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The indicators are also compared for the Western Balkans and Turkey, with one small adjustment in the age bracket for the unemployment rate (reducing the upper age limit to 64 instead of 74) for Albania and Kosovo due to data availability. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2019 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). Data from 2017-2019 are used and can be found in Annex A.

Efforts should continue to bring the employment and social statistics even further into line with EU standards and they should be systematically sent to Eurostat.

2.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2020

Overall: Partial implementation (57.4%) ([23])	
2020 policy guidance	**Summary assessment**
PG 1: Use fiscal policy to mitigate the crisis-induced impact on growth and employment.	There was **substantial implementation** of PG 1: 1) **Substantial implementation:** The government adopted four packages of socio-economic measures to support citizens and the economy, including tax deferrals as well as wage and loan subsidies to sustain the economy and employment. To broaden fiscal space further, the government secured sufficient financing to cover 2021 and part of 2022 budgets' needs well in advance, borrowing the equivalent of 17.5% of GDP in December 2020.
While allowing for due reinforcement of healthcare spending during the crisis, reinforce the medium-term sustainability of public finances by limiting overall spending on wages, also by taking concrete steps towards implementing the public administration optimisation plan.	2) **Limited implementation:** Healthcare workers received a 15% pay rise in March and April 2020. Salaries of public administration upper categories (A and B) were decreased by 50% in May and June 2020. So far, the public administration optimisation plan failed to achieve a meaningful permanent reduction of staff. Overall, in 2020, gross wages increased by 4.3% y-o-y. The ERP announces continuing the medium-term optimisation strategy to reduce public spending.
Establish a fully-fledged centralised public sector employment payroll system.	3) **Substantial implementation:** Completion of this project is estimated at 75%. IT equipment was installed in November 2020, and the interface connecting the system with Human Resources Administration data, enabling real-time exchange between the two systems, is in the final stage. The Ministry of Finance and Social Welfare started gradually training and migrating all budget units to the new system.

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

PG 2: To support economic recovery, make sound cost-benefit analysis an integral part of public investment management.	There was **substantial implementation** of PG 2: 1) **Partial implementation:** To advance the public investment management process, a new Decision on Development of the Capital Budget and Setting of and Evaluating Criteria for Selection of Capital Projects was adopted; enabling the preparation of the capital budget for 2020. The government adopted a decision to carry out Public Investment Management Assessment (PIMA). Activities were initiated and meetings held with representatives of the IMF and experts who will conduct the PIMA assessment.
Take steps towards the establishment of a fiscal council, following consultation of the related options paper with stakeholders, including the EU. Introduce the electronic fiscal invoice system (e-fiscalisation).	2) **Substantial implementation:** The options paper for establishment of a fiscal council was adopted and shared with the Commission. Draft amendments to the Law on Budget and Fiscal Responsibility were also prepared in order to create the formal conditions for setting up a fiscal council. 3) **Full implementation:** The system has been fully operational since Jan 2021.
PG 3: Closely monitor financial stability challenges arising as a result of the coronavirus pandemic and take appropriate action if needed, while developing further the supervisory capacity of the central bank.	There was **substantial implementation** of PG 3. 1) **Substantial implementation:** The central bank has taken forceful financial sector support measures to cushion the crisis impact including loan repayment moratoria and loan restructuring, and monitoring activities have been sound, including on the impact of the measures. There was some good progress in strengthening supervision, including the functioning of a professional Supervisory Committee to support central bank decision making and increasing off-site supervision capacity. The full impact of the crisis in particular on asset quality is yet to become visible, likely requiring further adjustments.
Identify and prioritise the removal of obstacles for the swift and successful resolution of non-performing debts, particularly by improving legal, judicial and institutional procedures.	2) **Partial implementation:** The central bank has continued NPL monitoring and gave recommendations to the Government on ways to further improving the NPL resolution framework. Further progress requires inter-ministry work with Ministry of Justice and other key stakeholders on the legal and judicial framework to expedite NPL disposal.
Ensure the participation of all banks in the asset quality review on equal terms, transparently publish its findings and promptly take remedial action where needed.	3) **Substantial implementation:** An AQR has started with all banks participating, but progress was delayed by the pandemic.
PG 4: Ensure smooth and effective support to the private companies and their employees affected by the crisis, in particular micro, small and medium-sized enterprises and self-employed.	There was **partial implementation** of PG 4 1) **Partial implementation:** The government adopted four packages of measures aimed at supporting businesses and employees during the pandemic. The support included loans for SMEs, wage subsidies and job protection measures in the sectors most affected by the pandemic. Overall measures are in line with the guidance provided,

	however many supportive actions targeting companies were implemented only partially.
Extend social protection coverage and provide incentives for businesses and employees in the informal economy sector to register and to facilitate their transfer to the formal economy.	2) **Limited implementation:** No measures specifically targeting the informal economy sector and providing social coverage to its vulnerable employees could be identified among the actions taken by the government. Other support measures, at the very least, provided disincentives for companies to move to the informal sector in the time of crisis. Incentives provided for new employment may have attracted some of the employees or businesses that operated previously in the informal sector (among some 1000 new jobs that were created).
In order to ensure a swift recovery, focus on simplifying tax legislation and reducing the diversity of para-fiscal charges affecting businesses.	3) **Partial implementation:** In relation to simplification of tax legislation, amendments to VAT Law were adopted in July 2020, which introduced minor facilitations for taxpayers. Some progress was achieved in the areas of electronic company registration and electronic payments of administration charges. The laws on administrative fees and local communal fees were implemented by more of the municipalities, while work on the register for fiscal and para-fiscal charges at central and local levels progressed on time.
PG 5: Maintain continuous dialogue with social partners, business organisations and civil society on all decisions taken in response to the COVID-19 pandemic. Provide an active feedback from this dialogue to the public domain.	There was **partial implementation** of PG 5. 1) **Substantial implementation**: Stakeholders were consulted on three out of the four packages adopted in response to the COVID-19 pandemic, with no major objections to the process from stakeholders. The dialogue with the business associations, social partners and civil society seemed to be continuous throughout the crisis. Feedback has been regularly provided to the public.
Ensure close cooperation between central and local authorities on all crisis mitigation and economic recovery measures, including through joint and coordinated actions.	2) **Limited implementation:** Cooperation between central and local authorities was sporadic at best and on a case-by-case basis only. It would be difficult to identify examples of smooth and coordinated actions uniting central and local authorities.
PG 6: Take measures to preserve employment including by ensuring short-time work schemes and flexible working arrangements, as well as through increased provision of active labour market policies to facilitate transition to work and support workers at risk of job loss.	There was **partial implementation** of PG 6. 1) **Partial implementation**: The government has adopted four economic support packages, which, including through wage subsidies and support to businesses, have endeavoured to preserve employment. Short-time work schemes and flexible working arrangements are planned to be introduced during 2021-2022. Active labour market policies have been continuously provided, but their provision has decreased due to the pandemic and no new measures have been introduced to facilitate transition to work.

Ensure adequate income support and social assistance for the unemployed, and for those at risk of poverty and of social exclusion.	2) **Partial implementation**: All four economic support packages included one-off payments to unemployed and/or vulnerable groups, reaching a large majority of the target population. Analysis as regards the adequacy of such income support is not available.
Strengthen the healthcare system's resilience and capacity to improve access and quality provision of health care services.	3) **Partial implementation**: Additional finances allocated, measures improving the administration and coordination of the healthcare system, as well as the provision of e-healthcare services have improved the healthcare system's ability to manage the COVID-19 crisis. At the same time, measures reviewing structural weaknesses in the system and consequent reform measures boosting the system's resilience and capacity to improve access and quality provision of health care services have yet to be adopted.

2.6. ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2021-2023

Research, development and innovation

Public and private investments in research, development and innovation (RDI) are low. Montenegro is a modest innovator (European Innovation Scoreboard 2020). The RDI sector suffers from a low number of researchers and weak links between academia, research institutes and business. Only 2.2% of Montenegrin MSMEs invest in R&D (compared to 22% at regional level) and over 90% of research staff are employed by the government and the higher education sector. With a rate of 0.50% of GDP invested in R&D (2018, last available data), Montenegro's spending represents just above one fifth of the EU-28 average (where spending amounted to 2.18% of GDP in 2018).

On the other hand, the adoption of a Smart Specialisation Strategy (S3) in June 2019, allows Montenegro to concentrate its scarce resources on thematic sectors for R&D as a basis to strengthen sectoral policies based on innovation. The areas of specialisation are agriculture and food processing, energy and sustainable environment, sustainable health tourism and ICT. Other measures supporting an innovative ecosystem include: (i) a programme of support to innovative start-ups and innovation initiatives through smaller-scale support schemes; (ii) support for pre-acceleration of start-ups; (iii) a collaborative grant scheme to engage young researchers and holders of PhDs and (iv) support for intensive education and training programmes for professionals in S3 fields. Two new centres of excellence (covering food science and biomedical science) began operating in January 2020. Overall, statistics gathering in the R&D field remains an important issue to be addressed.

Measure 11: "Improvement of the programme framework for implementation of the Smart Specialisation Strategy of Montenegro"

A new measure that includes elements of R&D-related reforms from previous ERPs, notably of the ERP 2020. It is linked to other measures, targeting the development of MSMEs. Aligned with national strategic documents, the measure aims to optimise the framework of financial instruments and resources in support of S3 and is well justified, though rather ambitious. However, it appears output-based and prescriptive as to what grants it will distribute, providing little detail regarding the innovations, specialisations and field of research on which it will focus. The indicators are designed in a similar manner. Values expressed in the expected impact on competitiveness can well serve as indicators of the measure (spending on research, employment rates, etc). The high risks indicated for the implementation call into question the timeline and feasibility of this reform.

Measure 12: "Improvement of legislative and institutional framework for the development of research, innovation an digital transformation of sectors"

Continuation of measure 12 of the ERP 2020. The improvement of the legislative framework started with the adoption of two laws – the Law on Innovation Activities and the Law on Incentives for Research and Innovation Development - that provide the basic legislative framework for innovation. New activities include the development of five secondary laws, the establishment of an integrated information system and of the Innovation Fund. The measure is based on the national Strategy of the Scientific and Research Activity 2017-2021 and is designed in light of the EU Innovation Agenda for Western Balkans and the EU Communication on European Research Area. It is also aligned with the Smart Specialisation Strategy. The measure is appropriate and credible. However, the activities planned for 2021, 2022 and 2023 may be too ambitious to be implemented. The basis for the calculation of the expected costs is not quite clear.

Digital economy

Access to broadband networks is seen as key to the further digitalisation of the economy. It is also fundamental to the implementation of the smart specialisation strategy in the ICT industry. Montenegro's information society strategy set a number of ambitious goals, to be achieved by 2020. As a result, by September 2020, some 93% of Montenegrin households were in the area of availability of high-speed broadband connection (defined as 30 Mbit/s). However, the actual penetration of high-speed broadband or better among households is much lower, reaching some 29% in 2020. Fixed broadband services, and in particular the optical fibre sector, show strong growth, but mainly in the larger towns. Meanwhile 25% of households still had no internet access in 2019, despite its technical availability, with the figure increasing to 37% in rural areas. The process of mapping existing telecommunication infrastructure has been ongoing since 2018, but it only started in earnest in 2020. The legislative framework for high-speed broadband development is also yet to be adopted. Low population density increases the costs of private broadband deployment and discourages investment by existing private operators in less populated areas, resulting in slow connection speeds.

Measure 10: "Improvement of legislative-regulatory framework and further development of infrastructure for broadband internet connection"

This technical measure is repeated for the third consecutive year. Input indicates that no substantial progress was achieved during 2020. COVID-19 pandemic delayed the National Plan for development of the broadband internet connection and coverage of the population by next-generation access networks, as well as the planned legislative alignment on broadband internet cost reduction. However, the 2021 measure proposes an expanded scope, with the inclusion of the preparatory phase for a new Law on Electronic Communications (to be aligned with Directive (EU) 2018/1972) in the 2021 work plan. While the proposed measure is justified, the indicators need to be reworked (e.g. newly connected households in the isolated areas or outside cities, indicators on skills development and e-government services etc.). After progress is made on "classical" broadband development, including on infrastructure mapping (a prerequisite for installing the 5G network) the measure could possibly be expanded to reflect the planned rollout of the 5G network. Impact on competitiveness, society, labour and environment should be better elaborated.

Investment activity

Public and private investment growth is expected to see a substantial decline in 2020 due to the COVID-19 pandemic and the lack of fiscal space for major public investments. Public investments, which remained at record high levels in 2018-2019, are likely to slow even further with the completion of the first section of Bar-Boljare highway in 2021. Nonetheless, strategic investments in the priority sectors of the economy (transport, energy, agriculture and tourism) will continue at a sustainable pace. Smart specialisation sectors of environment other than energy and ICT do not yet have the rank of strategic priority for investments. Private investments focus mostly on hotel and tourism infrastructure in the coastal area. Efforts are being made to incentivise investment in the north of the country, including through the citizenship scheme, but so far, they have produced very few results.

Foreign direct investment slightly increased in 2019 and remains high in comparison with regional peers. The net inflow of foreign direct investment (FDI) into Montenegro rose to EUR 344.7 million in 2019, from EUR 322.5 million in the previous year. The FDI per capita indicator for the last 10 years averaged around 19% of GDP, while the EU contribution to FDI in Montenegro averaged 43% over the same period. FDI contributes significantly to Montenegro's current account deficit financing.

Trade performance

The trade deficit in goods remains at a record high, reaching 47% of GDP in 2019. The trade deficit in goods widened by 1.6% year on year in 2019. The export of goods remains modest due to low diversification and a predominance of low value added products and raw materials in its structure. Imports, meanwhile, are dominated by manufactured goods, construction materials, machinery, transport equipment and food. On the other side, the trade in services balance recorded another big surplus and a year-on-year increase of 8.5% by the end of 2019, driven mostly by tourism activities.

EU-27 Member States dominate both exports and imports, accounting for 37% and 47% of all trade in 2019. Serbia, Bosnia and Herzegovina and China are the main trade partners outside the EU, accounting for 19.2%, 6.3% and 8.5% of imports respectively and 26%, 7.2% and 4.2% of exports. Trade openness remains relatively high at 108.2%, while tariffs are low and non-tariff barriers relatively low, due to the EU accession process and WTO membership. There is significant potential for greater intra-regional trade within the Central European Free Trade Agreement (CEFTA) framework and with the EU, as trade preferences allowing for access to the EU market without customs duties apply for 98.6% of Montenegrin products. The Economic and Investment Plan for the Western Balkans and the development of a Common Regional Market have the potential to increase trade and enable competitiveness and growth.

Measure 13: “Implementation of measures to facilitate trade in goods and services in accordance with WTO obligations and CEFTA Additional Protocols 5 and 6”

This measure is repeated for the third year in a row, with the same milestones, targets and timelines. The focus is on trade facilitation, i.e. (i) reducing the time and cost of customs clearance procedures; and (ii) better coordination between the different administrative bodies involved, including the connection of information systems (between customs and different inspections). The reform is relevant and relies heavily on the EU funding (implementation of Additional Protocol 5 and Additional Protocol 6). Some activities planned for 2020 were partially implemented due to delays within the SEED+ project (electronic data exchange system between customs administration). This also remains a relevant potential risk to further implementation. Overall progress on this measure will depend on developments and delays of the regional integration. However, risks related to national activities, such as possible delays in the introduction of the New Computerised Transit System, should not be underestimated. The social outcome and environmental impact of this measure could be better developed, as already pointed out last year.

Energy

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

Energy production and cross-border trade in energy should significantly increase in over the coming years. The interconnection of the electricity network with Italy was established in November 2019 and contributed to the completion of the national electricity transmission ring, strengthening the robustness of electricity supply and setting the basis for extending it to neighbouring countries. Several wind, solar and hydropower projects are under way.

Measure 1: "Financial support to the households enabling them to adopt energy efficiency measures and generate electricity for their own needs"

This new measure appears credible and justified. However, there are some doubts regarding its timelines (possibility/reluctance of citizens to invest currently, availability of the loan scheme for less well-off households) and the feasibility of this measure under budget for 2021 and 2022, due to the present economic situation under COVID-19. The risk analysis needs to be reviewed to take account of these factors. The analysis does not consider the clear risk that the delay in approving the state budget will cause delays in public competition procedures for the selection of banks to service the programme. The current description does not establish proper baselines and indicators are unrealistic. Furthermore the description does not provide any links to national Smart Specialisation Strategy, in which 'renewable energy sources and energy efficiency' are a priority area.

Transport

Montenegro's long-term sustainable economic development would benefit greatly from further developing and improving transport infrastructure and from ensuring a good connection with European transport corridors. The country's geographical situation makes better transport links with the wider region and the rest of Europe particularly important. Montenegro scores very low on road, airport and shipping connectivity. The number of road accident fatalities (per 1 million inhabitants) is almost twice the EU average and is increasing.

Following the expected completion of the first section of the Bar-Boljare highway in 2021, major reflection is needed before any further section is attempted. The results of the ongoing cost-benefit analysis, financed by the EU, and the impact on the public debt should be carefully examined. There is slow progress on improving and modernising sections of the road and rail networks, while ensuring sufficient funding for the current maintenance of rail and road network remains an issue. Further steps are also needed to open the rail market up to competition. The ongoing tender for a concession to maintain and upgrade the country's two main airports in Podgorica and Tivat could address the issue of limited accessibility by air transport over the next few years, once the effects of COVID-19 crisis on air transport have been reversed. While Montenegro Airlines went bankrupt in December 2020, a new national airline '2 Montenegro' is expected to start operations in 2022. The efficiency of border-crossing procedures (and customs) is a related area where improvements are needed.

Agriculture

Significant investments are planned to develop the agricultural sector (including forestry and fishery), which currently faces a number of challenges. The government is expecting to invest EUR 75 million to facilitate progressive modernisation over the next 3 years, mainly from EU funds. Agricultural land in use accounts for 18% of the country's territory, although 94% of those areas are pastures and meadows. Agriculture is the main or partial source of income for close to 50 000 households. With the exception of a few larger agricultural enterprises, agricultural production is fragmented and characterised by small, often family-run parcels with high production costs, limited organisation and a lack of adequate equipment. The problem is exacerbated by limited skills and poor access to credit and markets.

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

Measure 2: “Supporting investments in the food manufacturing sector with the aim of boosting competitiveness”

The measure is repeated for a third year in the ERP. As the agriculture and food production are a major sector in the Montenegrin economy, the reform is justified. The measure was also attuned to the Smart Specialisation Strategy. The description should clearly explain that IPARD funding ensures the financial feasibility of this measure. There are no indicators proposed for 2021 for Component I and II. Result indicators should report further on the success achieved by the entities supported (e.g. increase in profit, exports, increase in number of employees) and not on administrative outputs. The text fails to reflect adequately the major risks in the context of COVID-19 pandemic and its economic and social impact (e.g. projected decline in exports of agricultural products in 2020, consumer purchasing power and diminished market demand with the loss of tourism revenue, etc.). The project description, particularly the risk analysis framework, needs to be re-adjusted.

Industry

Montenegro’s industrial base remains modest and hampered by low product diversification and low labour productivity. New investments in energy and aluminium production (the country’s top exports) aim to improve the competitiveness of these sectors, but modernisation efforts in other areas are less pronounced. The production of higher value added products remains limited and local industry is characterised by low participation in European and global supply chains. The government’s efforts focus on SME support and SME policy, a natural choice in a small economy. Industrial policy receives support from the Investment and Development Fund of Montenegro (IDF) among others, but access to finance still remains a significant obstacle for micro and small enterprises.

Measure 3: “Stimulating investments in manufacturing sector with the aim of boosting competitiveness”

The measure has been renamed, yet it is part of the ERP from 2016 and it continues to show the same deficiencies. Drafting quality and clarity has not improved in 5 years and the assessment remarks from previous years still apply; e.g. the measure still lacks details in the description of its scope and analysis, there is no specific outcome tied to the competiveness component, as observed last year, etc. The measure fails to focus on the smart specialisation industries, ICT and food production. Result indicators should be reworked, as they are not capturing changes at the beneficiary level (e.g. no link to employment, or to any increase of the GVA at the beneficiary company). Moreover, the impact of the measure on competitiveness remains overestimated, given the low level of budgetary commitment (EUR 1.3 million per year). Data on allocated grants for 2016-2019 period has been provided, but there is no reference to how the previously received subsidies affect companies’ eligibility for for the programme lines. No evaluation of the measure has been conducted since its inception. The budgetary commitment in the text and table do not match (EUR 1.3 vs. 1.6 million) Risk analysis needs to be better developed.

Measure 5: “Boosting competitiveness of MSMEs and access to the new markets”

The measure is refocused from the ERP 2020 and based on the rolling programme for the Improvement of Competitiveness of the Economy, set in the context of COVID-19, with a more extensive analysis on the major bottlenecks in the MSME sector. The information on the evaluation of past programme lines is welcomed, but the figures do not prove or disprove the effectiveness of the programme, as the indicators used are general rather than beneficiary-oriented. Qualitative information is somewhat more helpful. Indicators are good, though a reference to competitiveness would be welcomed – e.g. the number of MSME employing innovative methods, newly digitalised MSMEs, the number of SMEs adopting international standards, new cooperation links created between SMEs domestically and abroad, etc. The target values for the proposed indicators seem unambitious. There are many risks in this area and the risk analysis needs to be much improved. The COSME guarantee fund programme seems to have been excluded from the measure this year although the agreement should have continued through 2021. Budget allocations seem adequate.

Services

Services were heavily affected by COVID-19 pandemic and are unlikely to recover fully before 2023. Services, particularly tourism services, are the country's main export and accounted for around 80% of total exports in 2019. The sector provided over 72% of GVA in 2019 and employed close to three quarters of the workforce. Retail and wholesale trade and tourism are the main contributors to GVA and employment in the services area; ICT, financial and professional services remain far less developed. Over 90% of the tourist capacity is concentrated in the coastal region. Spa and congress tourism are possible niches that could be exploited, which would also help to offset the high seasonality of the current tourism trends. Further diversification of the services sector beyond the current focus on tourism would reduce the economy's vulnerability to external factors such as the current health crisis, geopolitical risks, intense competition for tourism in the Mediterranean region and climate change.

Measure 4: "Sustainable tourism in the new reality"

The measure concerning the diversification of tourist products from the ERP 2020 became a component of much broader action intended to preserve the tourism industry hit by the COVID-19 crisis. The measure is broad and it contains an ambitious plan to include green growth and digitalisation components in the tourist offer under the new reality. The measure links appropriately with all strategic framework documents, though the reform reads like a compact presentation of a more comprehensive action document. However, after the initial ambitious plan for 2021, the measure has been downsized both in scope and in budget terms (from over EUR 100 million to EUR 0.5 million), focusing on initial activities regarding the development of green accommodation and the rollover of projects for diversified tourism products from previous years. The measure looks realistic, but its implementation will greatly depend on further developments in the health and economic fields. The result indicators would require some work to further develop additional indicators directly related to the expected impact (e.g. the number of businesses introducing digitalisation or green practices, increase of viable alternative businesses in the north, increase/recovery of employment rates in the tourism sector, etc.).

Education and skills

See analysis above in section 4 under key challenge #1.

Despite significant efforts to improve the quality and the labour market relevance of education, the system continues to perform poorly. The tertiary educational attainment rate of 30-34 year olds increased steadily to 36.8%, narrowing the gap with the EU average (40%). Montenegro continues to outperform both the Western Balkan region and the EU average (10.3%) when it comes to the rate of early school leavers, although the rate rose compared to 2018 to 5% in 2019. Access and participation in the formal education system is good, though the insufficient quality of education and training prevents it from being capitalised upon in the labour market. Past years saw a number of reforms aimed at improving the quality of the education system at all levels, but the results remain to be seen.

Employment and the labour market

See analysis above in section 4 under key challenge #1.

Social dialogue

While social partners were consulted on all but the first package of economic support measures adopted in response to the pandemic, the consistent involvement of social partners in decision-

making remains relatively weak. Due to the pandemic, meetings of the Social Council have been interrupted, as has the negotiation of the general collective bargaining agreement following the adoption of the new Labour Law in 2019. Efforts were made to involve social partners in decision-making, but the effectiveness of social dialogue and the mainstreaming of the consultation of social partners across all relevant ministries and departments still needs to be improved.

Social protection and inclusion

See analysis above in section 4 under key challenge #1.

The social situation in Montenegro has been stagnating after previous years of improvement. **Employment remains the best route out of poverty.** The at-risk-of-poverty-or-social-exclusion (AROPE) rate is lowest for employed persons (10.5% in 2019, below the 11.2% EU average) while the AROPE rate for those not employed is 39.9%. Activation measures coupled with targeted social assistance therefore remain key. Children are at the highest risk of poverty of all age groups. Short working lives and an increasing dependency ratio put pressure on the sustainability of the pension system, with additional pressure expected due to the new pension reform.

Reform Measure 18 – "Building and functioning of senior citizens' homes", continuing from previous years, though a welcome effort towards improving the social situation of the elderly, cannot, due to its scope, be considered a structural reform addressing the key social challenges and is too limited to have an impact on employment and competitiveness. The measure has been rolled over from past years.

Reform Measure 19 – "Reform of the national disability determination system" aims to establish a single body for disability determination and to digitalise its system linking it to the e-Social Card and e-Health Card. It should facilitate the evaluation of individual cases and budget forecasting. While the measure is essential for the reform of the social care system, it does not elaborate on the expected impact on beneficiaries, the adequacy and accessibility of their entitlements, or the sustainability of the system.

The healthcare system faces a number of challenges, which have been exacerbated by the COVID-19 pandemic. Few data are available on the healthcare system. While Montenegro ranked 68th out of 195 in the 2019 Global Health Security Index (GHSI), performing well overall, there are significant challenges related to low capacities (NTI and Johns Hopkins, 2019). Financing of the healthcare system is significantly below the EU average resulting in out-of-pocket payments amounting to around 26.7% in Montenegro, compared to an EU average of 16.3% (Master Plan Health 2015-2020). Health insurance coverages ranges from 99.3% (age 65 or over) to 81.3% (18 to 24) (CeMI, 2017). The rate of self-reported unmet medical needs has increased to 3.1% in 2019, above the EU average of 2%. The government adopted a Strategy for Improving the Quality of Health Care and Patient Safety (2019-2023) in 2019, focusing on improving and monitoring the quality of health care.

Reform measure 20 – "Use of telemedicine services in Montenegro through the establishment of the information system for telemedicine and development of Health" is relevant in the context of the COVID-19 pandemic, but it lacks the perspective of a holistic overview of the weaknesses of the healthcare system, including its availability, accessibility and affordability. Furthermore, its feasibility is questionable in terms of the absence of preconditions for its implementation across rural areas.

2.7. THE 2021 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, 12 July 2021

[…]

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

1. Provide well-targeted and temporary pandemic-related fiscal support to vulnerable households and businesses; provided that the economic recovery takes hold by the time of adoption of the 2022 budget, supplement the budget with a medium-term fiscal consolidation plan foreseeing a gradual reduction of the budget deficit and public debt ratio, starting in 2022. Prepare a new public administration optimisation plan with a view to contain the share of the public sector wage bill in GDP. Establish an IT system for electronic management and security printing of excise stamps in order to broaden the tax base by reinforcing the fight against informality and tax avoidance. Advance the implementation of a public investment management assessment (PIMA) programme, to improve the quality of public investments.
2. Adopt amendments to the Law on Budget and Fiscal Responsibility with the aim of setting up an independent body in charge of fiscal oversight. Develop a comprehensive overview of all tax exemptions, including an analysis of their economic and social impact. Support the economy and business liquidity by reducing public sector arrears and deadlines for VAT return.
3. Maintain a strong financial sector regulatory framework in line with international and EU best practices, ensure sound credit risk management, a transparent display of asset quality and adequate provisioning. Further reduce institutional and legal obstacles to swift and effective NPL resolution mainly outside the responsibility of the central bank, including by facilitating out-of-court settlement and modernising the insolvency regime. Complete the ongoing Asset Quality Review, transparently publish its general findings and timely take remedial action where needed.
4. In cooperation with local authorities and representatives of business community, conduct an analysis of businesses-related procedures at the local administration level to identify sources of possible inefficiencies and propose improvements of the institutional and regulatory environment, including for infrastructure developments. Establish technical-level mechanisms and administrative best practices allowing for a continuous structural dialogue between authorities and the business community. Focus on further simplifying business taxation, reducing number and diversity of para-fiscal charges and facilitating payment of tax commitments.
5. Prioritise digitalisation of the public sector and development of transactional electronic government services to speed up and enhance the economic recovery. Finalise work on a new action plan to tackle informality and start implementing it, including targeted preventive measures and incentives to legalise informal businesses and employees. Ensure structural cooperation between central and local authorities in the development and implementation of measures aimed to reduce the informal economy.

6. Establish an inter-ministerial task force involving relevant ministries, their agencies and stakeholders to develop a Youth Guarantee Implementation Plan. Based on the review of the social protection system, finalise the roadmap and start implementing social protection reforms. Prepare, in cooperation with the business sector, a roadmap with concrete measures for reforming the practical and dual VET education system to improve their impact on labour market outcomes.

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

Area/Sector	2016	2017	2018	2019	EU-27 Average (2019 or most recent year)
Energy					
Energy imports dependency (%)	34.9%	40.9%	30.9%	N/A	60.62%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	260.69	260.73	260.44	N/A	112.92
Share of renewable energy sources (RES) in final energy consumption (%)	41.55%	39.71%	38.80%	37.37%	19.73%
Transport					
Railway Network Density (meters of line per km^2 of land area)	18.1 [w]	18.1 [w]	18.1 [w]	18.1 [w]	49.0 (2018)
Motorisation rate (Passenger cars per 1000 inhabitants)	297 [w]	310.6 [w]	331.7 [w]	350 [w]	519 (2018)
Agriculture					
Share of gross value added (Agriculture, Forestry and Fishing)	9.0%	8.4%	8.2%	7.9%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	7.8%	7.9%	8.0%	7.1%	4.3%
Utilised agricultural area (% of total land area)	18.4% [w]	18.6% [w]	18.6% [w]	N/A	40.0% (2017)
Industry					
Share of gross value added (except construction)	12.2%	11.3%	12.5%	11.9%	19.7%
Contribution to employment (% of total employment)	9.9%	9.5%	9.9%	9.5%	18.1%
Services					
Share of gross value added	72.1%	73.4%	72.3%	72.3%	73.0%
Contribution to employment (% of total employment)	74.7%	75.0%	73.1%	73.4%	70.8%

Business Environment					
Rank in WB Doing Business (Source: World Bank)	48	51	42	50	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	70	77	71	73	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	Up to 37.2%	25% to 33%	N/A	N/A	N/A
Research, Development and Innovation					
R&D intensity of GDP (R&D expenditure as % of GDP)	0.32%	0.35%	0.50%	N/A	2.20%
R&D expenditure – EUR per inhabitant	20.60€	24.10€	37.7€	N/A	656.5€
Digital Economy					
Percentage of households who have internet access at home	69.8% [w]	71%	72%	74%	86%
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	69.9% [w]	71.3% [w]	71.5% [w]	73.5% [w]	85%
Trade					
Export of goods and services (as % of GDP)	40.6%	41.1%	42.9%	43.7%	49.4%
Import of goods and services (as % of GDP)	63.1%	64.5%	66.7%	64.8%	45.7%
Trade balance (as % of GDP)	-43.9%	-44.9%	-46.2%	-44.1%	N/A
Education and Skills					
Early leavers from education and training (% of population aged 18-24)	5.5%	5.4%	4.6%	5.0%	10.2%
Youth NEET (% of population aged 15-24)	18.4%	16.7%	16.2%	17.3%	10.1%
Formal child care - children aged less than 3 years (% of total)	28.9% [w]	32.89% [w]	34.13% [w]	37.21% [w]	35.3%
Individuals' level of digital skills (% of individuals aged 16-74 who have basic or above basic overall digital skills by sex)	N/A	50%	N/A	N/A	56%

Employment					
Employment Rate (% of population aged 20-64)	57.1%	58.2%	59.8%	60.8%	73.1%
Unemployment rate (% of labour force aged 15-74)	17.8%	16.1%	15.2%	15.2%	6.7%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	11.7 pps.	13.8 pps.	13.8 pps.	13.3 pps.	11.7 pps.
Social Protection System					
% of population at risk of poverty or social exclusion	34.6%	33.7%	31.4%	30.5%	20.9%
Impact of social transfers (Other than pensions) on poverty reduction	17.24%	24.84%	23.72%	16.95%	32.38%
Self-reported unmet need for medical care (of people over 16)	2.7%	2.7%	2.3%	3.1%	1.7%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	7.38	7.57	7.37	6.72	4.99

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

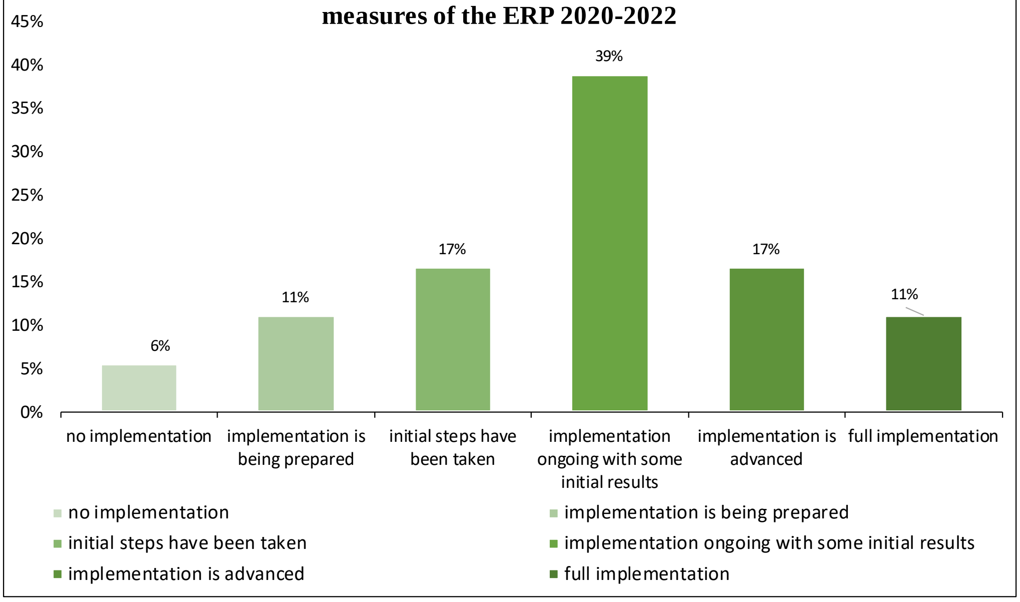
Source of data in Annex A: EUROSTAT, unless otherwise indicated

ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2020-2022

There was very moderate progress on implementing the measures in 2020, with an average score of 2.97 out of 5. Reporting on the structural reform measures from 2020 is often insufficient, missing or not against the set indicators, while the scoring of the implementation stage appears inflated. Information provided on some reforms was scarce to the point that scoring is only tenuous for some of the reforms and should be taken with caution. Downward adjustment to the scoring was made for six of the reforms, based on the description of the implementation and explanations covered by the table, and on the Commission's own research.

Implementation has been stronger for some measures, such as measure 7 on the introduction of electronic public procurement system and measure 10 on support to micro, small and medium-sized enterprises sector. Implementation has been weaker for most other measures, such as measure 3 on support to technological modernisation of the manufacturing industry and measure 12 on enhancement of legislative and institutional framework for innovation. Implementation was particularly weak for measures 1 and 8 – on enhancement of ownership and managerial structure at electric power companies with state dominant ownership and on enhancement and implementation of measures for suppression of informal economy.

Graph II.2.2: **Montenegro - Implementation of the structural reform measures of the ERP 2020-2022**



ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The 2021-2023 Economic Reform Programme (ERP) of Montenegro was submitted with a significant delay. Instead, the authorities made an effort to provide informally parts of a draft ERP in February, and supplementary elements, including some macroeconomic and fiscal projections, in March. The ERP was formally adopted by the government on 1 April 2021, and transmitted to the Commission the same day. However, the latter submission and lack of statistical tables hindered the elaboration of a full, comprehensive and detailed assessment of the Montenegrin macroeconomic and fiscal situation and of its programme of structural reforms.

Inter-ministerial coordination

The preparation of the 2021 ERP was centrally coordinated by the Office of the Prime Minister and the Ministry of Finance. An inter-ministerial working group involved all relevant ministries. The high-level Competitiveness Council, chaired by the Prime Minister, continued to monitor the implementation of the ERP structural reform measures and the jointly agreed policy guidance.

Stakeholder consultation

The national ERP coordinator organised an initial consultation on the design of the ERP measures in September 2020. The European Commission was not informed on any further consultations of the draft ERP before the partial submission of the document on 15 February.

Macro framework

The absence of detailed statistical tables and last minute changes to the macroeconomic scenario were major obstacles for its assessment. The programme presents a clear and concise picture of past developments, albeit not so detailed for those beyond 2020. Similarly, the programme reported on most of the relevant data until 2020. The partial submission received in February did include neither a description of risks to the baseline scenario nor an analysis of the prospects for the country's export performance and the country's price and cost competitiveness position. However, this information was supplemented later in March and completed beginning of April.

Fiscal framework

The absence of a budget was a major obstacle for an early assessment of the fiscal framework, in particular for developments beyond 2021. The programme provided a general description of the new government’s fiscal policy objectives as well as the main fiscal measures for 2021. However, medium-term measures are scarce or vague, hampering any quantitative estimation of the impact of fiscal policy measures. Further efforts are also required to ensure the fiscal data are compatible with ESA 2010 as well as to complete fiscal notification reports.

Structural reforms

The structural reform parts follow the guidance note. A dedicated section of the ERP provides information on the implementation of the policy guidance for 2020. Reporting on the structural reform measures from 2020 is often insufficient, vague and not against the set indicators, while the scoring of the implementation stage appears inflated. The number of reform measures in the 2021-2023 ERP is limited to 20 and the page limit is respected. The structure of the reform measures is mostly good in terms of scope and timeline and in terms of budget for activities planned.

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3. NORTH MACEDONIA

3.1. EXECUTIVE SUMMARY

In 2020, the accelerating economic growth of the Republic of North Macedonia and positive outlook were brought to an abrupt halt by the COVID-19 pandemic. The number of cases increased rapidly. Wide-ranging containment measures, including shop closures and curfews, dampened domestic demand. The external sector was hit by lower foreign demand due to both, the global recession and supply chain disruptions affecting the production of automotive components. As a result, real GDP dropped by 4.5% y-o-y in 2020. Only public consumption contributed positively to growth, fuelled by government purchases to cover the needs of the health sector, and to implement sizeable and well-targeted measures from four successive support packages.

The Economic Reform Programme (ERP) expects a strong rebound in economic activity starting in 2021. The programme anticipates a gradual retreat of the pandemic in 2021 and the lifting of containment measures. Based on these expectations, the programme is rather optimistic: it projects growth to accelerate from 4.1% to 5.2% over 2021-2023, driven by household spending and investment, including a strong contribution from public investment.

The COVID-19 crisis left a deep mark on public finances in 2020. The fiscal deficit almost quadrupled, rising to 8.2% of GDP. This was due to the twin effects of foregone tax revenue from the decline in economic activity, and additional expenditure on anti-crisis measures to support households and companies. The programme expects a gradual recovery of public finances, driven by the projected strong growth in output and the phasing out of current support measures. The fiscal deficit is expected to narrow starting in 2021, but to remain above its pre-crisis level over the programme's horizon. Because of significant external funding to bridge the government's crisis-induced financing gap in 2020, the general-government debt level has increased sharply, rising to over 51% of GDP. It is projected to continue rising until 2023, partly in anticipation of increased lending to public enterprises to implement the government's public-investment agenda.

The main challenges facing North Macedonia are the following:

- **Transparent and targeted fiscal-policy support is still needed amid the current uncertainties.** However, once the recovery takes hold, public finances must recover and return to sustainable levels. This implies moving towards a balanced primary budget, underpinned by: (i) improvements in tax collection; (ii) a broadening of the tax base; and (iii) strengthened fiscal governance bolstered by fiscal rules and an independent fiscal council.

- **North Macedonia's poor implementation record of budgeted capital expenditure and its planned increase in capital spending show the need for significant improvements in the management of public investment**. These improvements should be based on the approved action plan. A new legal framework for public-private partnerships could facilitate public infrastructure projects.

- **The allocation of state support to companies remains opaque, which makes it difficult for aid to be well-targeted and efficient**. The transparency of company-level subsidies could be much improved by setting up a State-aid registry.

- **Domestic companies suffer from low levels of productivity. Productivity growth is also very slow. This hinders companies' competitiveness and integration in the global economy**. The

COVID-19 pandemic has put significant additional burdens on companies, causing them to reduce their investment in development of human and physical capital. At the same time, the crisis has revealed vulnerabilities in global value chains, which also affected North Macedonia's companies. Improving the competitiveness of local companies and benefiting from the post-COVID-19 restructuring of global value chains will require improvements to human and physical capital and the business environment, including better enforcement of business regulation and corporate governance, as well as better services including trade and transport logistics. Greater investment in research and innovation, as well as further regional integration, could further support competitiveness.

- **The size of the informal sector continues to be a challenge for the business environment as it creates unfair competition from unregistered companies**. Undeclared revenues and employment also harm public revenue collection, which will be particularly important for the post COVID-19 recovery. Undeclared revenues and employment also reduce levels of formal employment and its associated benefits, including job security and safety at work. Due to its complex character, reducing the size of the informal sector will require a coordinated approach across the whole of government. This approach will need high-level political steer to include all the stakeholders and measures relevant for reducing informality.

- **The education system does not equip young people with enough of the key competences – skills and knowledge – that they need to actively participate in the labour market**. While North Macedonia has progressed very well in terms of the number of people with higher educational attainment, insufficient quality of education and the structure of enterprises contribute to persistent unemployment and still a high share of young people not in employment, education or training (NEET). The country's education strategy and related action plan prioritise providing skills to young people to prepare them for the labour market. Nevertheless, state financial support for education is insufficient and coordination between different sectors (economic sectors and educational sectors) still needs improvement. Students and families receive limited career guidance information when making important choices and curricula are not in line with labour market needs.

The policy guidance jointly agreed at the Economic and Financial Dialogue of 19 May 2020 has been partially implemented. Notably, the government adopted four sets of fiscal measures to mitigate the crisis impact on the economy; it adopted the Tax System Reform Strategy; it publishes quarterly data on the finances of public enterprises on its website; it adopted an Action Plan for improving public investment management; and it adopted a new draft Organic Budget Law, that provides for fiscal rules and the establishment of a fiscal council. A list containing 377 para-fiscal charges was published. Steps towards their reduction and abolishment remain to take place. To modernise the education system, the government is implementing the 2018-2025 education strategy and action plan, which covers the six pillars of the education system. However, more own budgetary resources and capacities are required to tackle bottlenecks in implementation. The government also implemented special measures to protect jobs during the pandemic. The Law on Social Protection was adopted in May 2019 to strengthen the coverage and rights of people at risk of poverty. The guaranteed minimum assistance (GMA) scheme was implemented. The new Law on Social Protection contained 'activation' measures to encourage recipients of the GMA to enter the labour market. However, these measures are only being partially implemented.

The challenges identified in the ERP largely match those identified by the European Commission. The planned structural reform measures do not all follow a sufficiently coherent and focused vision of the objectives and targets for the country's economic development. The impact assessment of the structural reform measures could be further improved to allow prioritisation based on measures' economic, social and environmental impact. The reform of the social-protection system contributes to the social inclusion of beneficiaries of the system who are at risk of poverty. The key policy reforms and specific programs and measures including indicators and budget in the field of employment, education and social policy are presented in a strategic document called Employment and Social Reform Programme (ESRP). A special

Inter-sectoral Working Group coordinated by the Ministry of Labour and Social Policy has been established in 2016 for the preparation of the ESRP. It is composed of representatives of all relevant institutions participating in the development, implementation and monitoring of the policies in the above mentioned areas. The "Revised Employment and Social Reform Programme ESRP(r) 2020" adopted by the Government in December 2019 sets-out and presents the key policy reforms and specific programs and measures that shall be implemented in a short and medium term (until 2022).

3.2. ECONOMIC OUTLOOK AND RISKS

North Macedonia's economic upswing came to a sudden halt in 2020, as the pandemic hit domestic and foreign demand. Driven by strengthening domestic demand and foreign investment, North Macedonia's economy had been on a path of accelerating growth in the 2 years prior to the crisis. When the pandemic hit the country in March 2020, the government, reacted swiftly to a rapid rise in the number of COVID-19 cases, with wide-ranging containment measures. Domestic economic activity plunged in the wake of these measures, and external trade suffered from lockdowns and recessions in trading-partner economies. In addition, travel bans greatly reduced turnover in the tourism and transport sectors. As a result, real GDP in 2020 dropped by 4.5% on average, with the annual decline narrowing consecutively each quarter since the steep fall in the period between April and June. Investment spending plummeted in the second quarter of 2020, but recovered over the summer. Household disposable income suffered from a stark drop in remittances from abroad, even though the labour market proved resilient throughout the year. In response to the crisis, the government adopted four sets of measures in 2020 to support households and businesses, including subsidies, tax deferrals and interest-free loans. Implementation of these measures so far amounts to some 6.5% of GDP (2020), bolstering employment and wage growth as well as corporate liquidity.

The ERP expects growth to pick up in 2021 and to average 4.6% in 2021-2023. The programme projects real GDP to increase by 4.1% in 2021. This is unchanged from the 2021 forecasts made by the programme last year, except that the programme now expects the negative contribution from the external sector to be bigger, while domestic demand is expected to make a larger positive contribution. Household spending is expected to increase at its pre-COVID-19 rate, with growth accelerating in 2021, 2022 and 2023. Investment spending is also projected to continue growing each year. Due to the high import-dependence of investment and exports, net exports will make a negative contribution to growth in 2021. For 2022, the programme assumes real GDP growth of 4.6% (+0.3 pps. compared to the 2022 forecast in last year's programme). The pre-COVID growth trajectory is forecast to resume in the second half of 2022, and the ERP projects that the negative output gap will close in 2023, when growth is forecast to reach 5.2%. The negative contribution of net exports is expected to gradually diminish each year until 2023. The external assumptions underlying the government's projections are in line with consensus and Commission forecasts, indicating a moderate recovery in foreign demand over the programme's horizon. The programme, for the first time, contains projections beyond the three-year horizon. Hence, the government projects growth to reach 5.9% in 2025, and average year-on-year growth between 2021 and 2025 to reach 5.3%.

In light of lingering uncertainties, the projections seem overly optimistic. The macroeconomic and fiscal outlook continue to be affected by great uncertainty about: (i) the future course of the pandemic; (ii) possible further containment measures; and (iii) the impact of containment measures on the economy, both in North Macedonia and in its major trading partners. Domestically, optimistic assumptions about the disposable income of households and about public and private investment might be disappointed. On the external side, foreign demand might be lower than expected by the ERP. In addition, new FDI and the extension of export-production capacities by established foreign companies might turn out to be lower than projected, given current uncertainties and the ongoing revision of tax benefits for foreign companies. Propelled by government subsidies and rises in both the minimum wage and public sector pay, real wage increases have recently been far in excess of the stagnant growth in productivity. This has eroded North

Macedonia's external competitiveness. However, there is still room to increase fiscal and monetary support if conditions deteriorate. Nevertheless, the programme's baseline scenario seems too optimistic. The implementation of structural reforms may possibly improve growth components, but the programme does not provide any information on this. The expected development of growth components also appears to not be entirely in line with the government's plans for expenditure-based fiscal consolidation.

The programme presents two alternative macroeconomic scenarios based on identified risks to the baseline projection. The first scenario assumes lower export growth due to lower foreign demand, which also leads to lower FDI inflows. As a result, economic growth in 2021 would be lower by 1 pp., and average annual growth in 2021-2025 would be 4%. The second scenario assumes lower-than-anticipated investment, in particular public investment. Growth in 2021 under this second scenario would be 3.7%, and average annual growth would be 4.6% between 2021-2025. Both of these scenarios still seem rather benign.

Consumer prices are expected to rise due to all components. Despite an accommodative monetary-policy stance, and the cut in the policy rate to a record low of 1.5%, average annual inflation remained below official projections at 1.1% in 2020. Moderate inflation pressures arose from food prices and core inflation, while falling energy prices acted in the opposite direction. In line with assumptions about a global economic recovery and a renewed rise in oil prices, the programme expects consumer prices to rise over the programme's horizon, driven by a gradual increase in foreign inflation. Consumer prices are therefore forecast to increase by 1.5% in 2021, (which is 0.5 pps. lower than expected in the previous year's ERP), and further to around 2% in both 2022 and 2023. The programme considers that risks to the inflation forecast arise especially from uncertain dynamics in commodity prices, in particular oil. The programme's inflation forecast is plausible. As a small, open economy with a de-facto currency peg, the country's price level is largely determined by international price developments. However, the ERP's presentation might have benefited from a more thorough analysis of potential pressures from domestic demand, given the expectation that output growth will perform beyond potential in 2023, and also given the further rise in nominal wages in 2020.

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

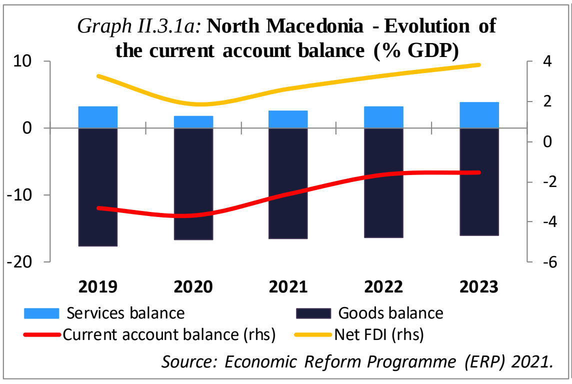
	2019		2020		2021		2022		2023	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	3.6	**3.2**	-4.9	**-4.4**	3.8	**4.1**	3.5	**4.6**	n.a.	**5.2**
Contributions:										
- Final domestic demand	4.3	**5.3**	-4.8	**-5.8**	5.8	**5.4**	6.2	**5.2**	n.a.	**5.6**
- Change in inventories	0.8	**n.a.**	0.0	**n.a.**	0.0	**n.a.**	0.0	**n.a.**	n.a.	**n.a.**
- External balance of goods and services	-1.5	**-2.1**	-0.1	**1.3**	-2.0	**-1.3**	-2.8	**-0.6**	n.a.	**-0.4**
Employment (% change)	5.0	**5.1**	-0.3	**0.4**	0.5	**1.9**	2.4	**2.1**	n.a.	**2.3**
Unemployment rate (%)	17.3	**17.3**	17.3	**16.6**	17.1	**15.8**	16.6	**15.0**	n.a.	**14.1**
GDP deflator (% change)	2.3	**1.1**	-0.7	**1.0**	0.9	**2.0**	2.1	**2.0**	n.a.	**2.0**
CPI inflation (%)	0.8	**0.8**	0.9	**1.1**	1.2	**1.5**	1.5	**2.0**	n.a.	**2.0**
Current account balance (% of GDP)	-3.3	**-3.3**	-4.2	**-3.7**	-3.9	**-2.6**	-3.8	**-1.6**	n.a.	**-1.5**
General government balance (% of GDP)	-2.1	**-2.2**	-8.6	**-8.4**	-4.5	**-4.9**	-3.2	**-3.8**	n.a.	**-3.2**
Government gross debt (% of GDP)	40.2	**40.6**	51.1	**51.2**	53.2	**53.2**	53.6	**53.3**	n.a.	**53.7**

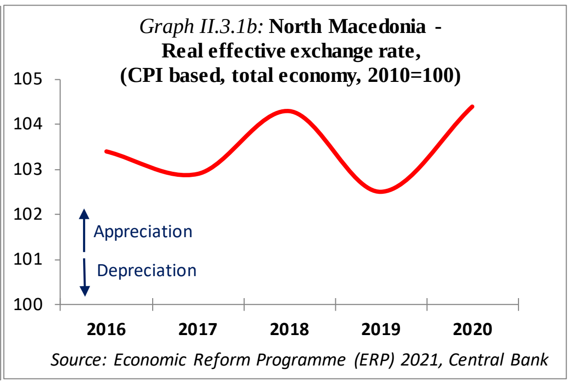
Sources: Economic Reform Programme (ERP) 2021, Commission Autumn 2020 forecast (COM).

External vulnerabilities increased somewhat in 2020, but the outlook is positive. Extended lockdowns and recessions in trading partner economies left a mark on export performance in 2020, in particular of intermediate goods from established foreign companies in automotive supply chains. The merchandise trade deficit in 2020 remained at 16.8% of GDP, as in the preceding year. Inflows of private transfers from abroad declined, by 1.6 pps. y-o-y to 13.2% of GDP. Altogether, the current account deficit widened by 0.2 pps. y-o-y to 3.5% of GDP, slightly below the ERP estimate. The shortfall was not covered by net FDI inflows, which were some 43% lower y-o-y in 2020, on account of significant outflows of intercompany debt, and amounted to only 1.9% of GDP, compared to 3.2% one year earlier. The programme expects the current account deficit to gradually narrow to 1.5% of GDP in 2023 due to a smaller goods trade deficit and a return of current transfers to their long-term average of about 15.3% of GDP in 2023. The primary income balance is expected to worsen, in terms of GDP, by 1 pp., to 3.8% of GDP between 2020 and 2023.

Government financing requirements drove the sizeable rise in external debt. Foreign debt rose by markedly more in 2020 than anticipated in the previous year's programme. This was the result of foreign financing for crisis-induced additional requirements faced by the central government, and was complemented by a small rise in external private sector debt (intercompany loans). External debt (both public and private) amounted to 80.2% of GDP (+7.3 pps. compared to end-2019, and +3.8 pps. compared to projections in last year's ERP). The government also bolstered its foreign exchange reserves, which covered some 4.6 months' worth of prospective imports at end-2020. The share of intercompany debt and trade credits, which constitute less volatile components of foreign debt, remained high and unchanged compared to the previous year, at some 40% of total external debt. In 2021, the programme expects external debt to rise further, mainly due to the public sector (central government borrowing, but also disbursements of foreign loans to public enterprises carrying out public investment). Between 2021 and 2023, on a cumulative basis, gross external debt would rise by 0.4 pps., according to an external debt sustainability analysis presented in the programme. The private sector would contribute 1 pp. to this rise, while the public sector's external debt would drop by 0.6 pps. over this period. Stress-test results presented in this analysis point to limited vulnerability in the event of shocks to GDP, the primary deficit or interest rates.

External competitiveness and current account





The central bank ensured that banks remained resilient during the crisis. Banks continue to dominate North Macedonia's financial sector, accounting for some 82% of sector assets. Banking sector concentration remains moderate and was almost unchanged compared with previous years, with some 57% of assets held by the three biggest banks in 2020. Ten out of the sector's fourteen banks are predominantly in foreign ownership. In August, the central bank revoked the license of one (small) bank, which, however, had a very limited impact on the sector's performance. The banking system remains well-capitalised, but there is a need to preserve capital in view of the likely future rise in NPLs, following regulatory normalisation. The share of own funds allowed to serve as buffers remains high overall in the sector. Capital adequacy (Tier-1 capital to risk weighted assets), rising to some 15.5% at the end of 2020, compared to a year earlier (14.7%). The programme said that capital adequacy remains above regulatory requirements even in extreme stress simulations. Supported by central bank action, banks hold abundant liquid assets (in March, the central bank lowered reserve requirements for loans to the most affected sectors, and in May it expanded the range of securities accepted from banks as collateral in liquidity-increasing operations). The loan-to-deposit ratio increased only marginally in 2020 compared to a year earlier. Despite two temporary periods in which deposits declined, deposit growth remained strong in 2020 overall, with a (crisis-induced) preference among savers for more short-term, liquid, and, to some extent foreign exchange-denominated deposits. Importantly, it is essential that the independence of the central bank is maintained, combined with accountability and transparency, so it can continue to fulfil its mandate of maintaining price stability and the overall stability of the financial system.

Regulatory easing bolstered bank lending, but asset deterioration is expected when measures are phased out. In March, the central bank allowed commercial banks to temporarily ease credit standards, including through two payment moratoria allowing for the temporary deferral of loan repayments. The first moratorium, running from April to September 2020, was taken up by about half of the household loan portfolio, and by about one third of companies. Also, banks could raise the threshold for loans to reach non-performing status (from 90 to 150 days). These measures helped strengthen credit growth and contain the non-performing loan (NPL) ratio: at the end of 2020, the NPL ratio fell to 3.4%. Credit growth to the non-governmental sector amounted to 6.5% in 2020 (2019: 7.3%). After the end of the second moratorium in the spring (for households in March, staggered for companies as of May), and accounting for the 90 days grace period, a rise in the NPL ratio is to be expected. Given the likely increased needs for provisioning after the end of the moratorium, some banks may need to strengthen their capital buffers. The phasing out of regulatory easing also requires a legal framework to be put in place, to deal with a potential deterioration in asset quality. For example, this legal framework could facilitate the transformation and sale of NPLs. In this regard, a swift adoption of the draft Law on bank resolution will be important.

Table II.3.2:
North Macedonia - Financial sector indicators

	2016	2017	2018	2019	2020
Total assets of the banking system (EUR million)	7 233	7 513	8 187	8 945	9 490
Foreign ownership of banking system (%)	69.4	70.1	71.4	72.8	75.0
Credit growth	6.5*	5.9	7.6	6.1	4.1
Deposit growth	5.4	5.1	9.4	9.2	6.2
Loan-to-deposit ratio	87.0	87.7	86.2	83.8	82.0
Financial soundness indicators (end of period)					
- non-performing loans**	6.6	6.3	5.2	4.8	3.4
- net capital to risk-weighted assets	14.0	14.2	15.0	14.8	15.3
- liquid assets to total assets	30.9	29.8	30.6	31.9	32.5
- return on equity	13.6	13.5	16.0	11.7	11.3
- forex loans to total loans (%)	44.9	42.5	41.4	42.3	42.3

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

3.3. PUBLIC FINANCE

In 2020, North Macedonia's public finances deteriorated greatly due to the COVID-19 crisis. The slowdown in economic activity left its mark on public finances, resulting in a 6.9% y-o-y decline in government revenue for the full year, while current expenditure increased by 13.9%. Income from direct and indirect taxes fell, compounded by VAT reductions and deferred tax payments as part of the government's relief measures. The strongest drop in revenue came from VAT income (-26% y-o-y), while revenue from social contributions (+7% y-o-y) was boosted by government subsidies to employers' contributions. On the expenditure side, the government increased spending on the health sector and on statutory transfer payments. In addition, the government needed to budget for four sets of economic measures adopted between March and October, which provide fiscal and liquidity support to households and companies. In order to finance the first set of measures, a budget reallocation in April cut the amount originally planned for capital expenditure in 2020 by 15%. Capital spending therefore dropped by 9.5% y-o-y, to 3.1% of GDP in 2020 (compared to 3.2% in 2019). Following two further budget revisions, in May and in October, allocations for transfer payments increased by 13%, and the fiscal deficit target for 2020 was successively raised, from 2.3% of GDP in the initial, pre-crisis budget plan, to 8.4%. Ultimately, the general government fiscal deficit for the full year 2020 amounted to 8.1% of GDP. The programme estimates that the fiscal impact from automatic stabilisers due to the slowdown in economic activity amounted to some 3.4% of GDP in 2020. The remainder of the estimated increase in the deficit target, compared to the initial plan, is due to discretionary support measures.

Government anti-crisis measures supported households and companies. The programme provides an estimate of the overall total fiscal impact of discretionary measures (2.9% of GDP). Expenditure on wage subsidies, as the fiscally most significant measure, amounted to 1.1% of GDP. The eligibility criteria for wage subsidies include a revenue drop of at least 30% compared to pre-year. Support measures not directly reflected in the budget include liquidity support via interest-free credit lines of the Development Bank of North Macedonia (guarantees constituting contingent liabilities for the government), amounting to 0.6% of GDP.

Table II.3.3:

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

	2019	2020	2021	2022	2023	Change: 2020-23
Revenues	31.5	32.1	32.6	32.0	31.8	-0.3
- Taxes and social security contributions	27.0	27.7	28.1	27.8	27.7	0.1
- Other (residual)	4.5	4.4	4.5	4.2	4.0	-0.4
Expenditure	33.7	40.5	37.6	35.8	35.0	-5.5
- Primary expenditure	32.5	39.2	36.2	34.5	33.7	-5.6
of which:						
Gross fixed capital formation	3.4	3.6	4.3	4.3	4.8	1.2
Consumption	10.0	11.7	11.6	11.0	10.4	-1.2
Transfers & subsidies	18.9	24.0	20.3	19.2	18.4	-5.6
Other (residual)	0.2	0.0	0.0	0.0	0.0	0.0
- Interest payments	1.2	1.3	1.3	1.4	1.3	0.1
Budget balance	-2.2	-8.4	-4.9	-3.8	-3.2	5.2
- Cyclically adjusted	-2.6	-6.5	-3.9	-3.5	-3.6	2.8
Primary balance	-1.0	-7.2	-3.6	-2.5	-1.9	5.3
- Cyclically adjusted	-1.4	-5.2	-2.5	-2.2	-2.3	2.9
Gross debt level	40.6	51.2	53.2	53.3	53.7	2.5

Sources: Economic Reform Programme (ERP) 2021.

The government plans to return to expenditure-based fiscal consolidation starting in 2021. Following a 3.5 pps. improvement in 2021 as crisis support is gradually withdrawn, the general government deficit is expected to decline by a further 1.7 pps. between 2021 and 2023, to -3.2%. However, the government forecasts that it will only reach and fall below its pre-crisis level (2019: -2.2%) in 2025. The primary balance will improve from -3.6% of GDP in 2021 to -1.9% in 2023, and further to -0.9% in 2025. Consolidation will be entirely based on a reduction in the expenditure ratio (-2.6 pps. between 2021 and 2023 to 35%). This relies on containing current expenditure, mainly transfers and subsidies. Capital expenditure, on the other hand, is expected to increase significantly, both in nominal terms and as a share of GDP. After a temporary rise in 2021, the revenue ratio, already low by regional comparison, is projected to decline by 0.8 pps. to 31.8% in 2023. This puts into focus the country's restricted tax base and its persistent problems with revenue collection. These two issues prevent a better balanced fiscal consolidation and a swifter achievement of a balanced primary budget. The ERP's projection for the cyclically-adjusted primary balance points to a significant tightening in 2021 and a broadly neutral stance afterwards. Overall, the projected mid-term return to fiscal consolidation is not underpinned by explicit savings measures. Rather, it relies on projected strong growth; phasing out of anti-crisis support measures; and (not quantified effects from) improvements in public financial management.

In 2021, the government expects the fiscal deficit to narrow as support measures are phased out. The 2021 budget projects a general government deficit of 4.9% and is based on expectations of 4.1% real GDP growth and 1.5% inflation. Under this scenario, revenue would rise by 0.5 pps. y-o-y to 32.6% of GDP, and expenditure would drop by 2.9 pps. to 37.6%, mainly due to a large decline in subsidies and social transfers which had increased greatly in 2020 through government anti-crisis support. Still, capital expenditure is expected to increase by 50% and to amount to 4.3% of GDP. Almost 45% of tax revenue would be generated from VAT, which is about the average of the past 5 years. Financing needs in 2021, including foreign debt repayments totalling 5.3% of projected GDP, and domestic debt repayments in the amount of 0.9% of GDP, are estimated at some 11% of GDP. They would be funded through domestic (3.3% of projected GDP) and foreign borrowing, including a Eurobond ([24]).

Fiscal measures planned by the government for 2021 are tilted towards temporary crisis mitigation through income and liquidity support for households and companies. Government support remains focused on those sector that are particularly hard hit by the crisis. Moreover, most government measures for 2021 are being continued from the previous year without a proper impact assessment having taken place. This is also true of the government's liquidity measures, such as credit guarantees for the private sector, that require a thorough analysis of fiscal risks and options for mitigating these risks. Crisis-mitigating support measures certainly need to be phased out carefully, to avoid a sudden, large-scale failure of companies that are no longer viable without the support. Nevertheless, to bolster the recovery, firm-level support needs to become more targeted towards companies that were financially solvent before the crisis. In this regard, improving the effectiveness of state aid policy through a functioning state aid registry including performance indicators informing the state aid program designs would be useful. Support to private investment should have productivity-enhancing potential, focus on "green" technologies and digitalisation, and export diversification. The government can also bolster the economic recovery through its ambitious public investment agenda. To this end, projects must be more clearly focused on productivity-enhancing investment. They should be prioritised according to transparent criteria and possible obstacles to their timely implementation must be removed. Equally, the possibility of tax deferrals for companies (and households) should be carefully calibrated as the recovery progresses. This will help to avoid the accumulation of tax arrears that might ultimately create sizeable liquidity problems and result in default.

([24]) On 3 March 2021, the government placed a seven-year Eurobond worth EUR 700 million due in March 2028. It is its 8th Eurobond.

Box II.3.1: **Debt dynamics**

North Macedonia

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

	2019	2020	2021	2022	2023
Gross debt ratio [1]	**40.6**	**51.2**	**53.2**	**53.3**	**53.7**
Change in the ratio	0.2	10.6	2.0	0.1	0.5
Contributions [2]:					
1. Primary balance	**1.0**	**7.2**	**3.6**	**2.5**	**1.9**
2. "Snowball" effect	**-0.5**	**2.7**	**-1.7**	**-2.0**	**-2.4**
Of which:					
Interest expenditure	1.2	1.3	1.3	1.4	1.3
Growth effect	-1.2	1.9	-2.0	-2.3	-2.6
Inflation effect	-0.4	-0.4	-1.0	-1.0	-1.0
3. Stock-flow adjustment	**-0.3**	**0.7**	**0.1**	**-0.4**	**0.9**

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

Source: Economic Reform Programme (ERP) 2021, ECFIN calculations.

After a large increase in 2020, general government debt is projected to broadly stabilise by 2023. General government debt rose markedly due to significant external and domestic borrowing in 2020, and amounted to 51.3% of GDP at the end of 2020 (+10.6 pps. compared to end-2019). Apart from the large foreign inflows needed to fill the crisis-related financing gap ([25]), the government also needed to roll over EUR 180 million of the 2015 Eurobond maturing in 2020 ([26]). After rising by 2 pps. y-o-y in 2021, because of the primary balance and interest payments, the debt ratio is projected to remain stable in 2022 and rise further, by 0.5 pps., in 2023. From 2022, the government forecasts that the debt-reducing real-growth effect would supersede the debt-driving impact of the primary deficit, which is expected to decline gradually. In 2023, the increase in the debt ratio would come mainly from increased borrowing for replenishing government deposits (stock-flow adjustment), according to the government.

Debt financing of public investment is expected to peak in 2023. Although the dynamics of general-government debt are driving the overall rise in public debt (overall public debt was 60.2% of GDP in 2020, including the debt of public enterprises), government-guaranteed public debt is also likely to rise further. The government forecasts that government-guaranteed public debt will peak in 2023, as loans are released to finance public-investment works carried out by state-owned enterprises. This is in contrast to the projection of last year's programme, which expected loan disbursements for these purposes to end after 2021, but may be explained by the postponement of a number of public works projects in 2020, as crisis-related needs prevailed.

The structure of government debt contains moderate risks. Maturities of domestic issues (share of 30-yr bonds in the portfolio) have lengthened further in 2020. There was also an increase in the average time to maturity (7.3 years for domestic debt, and 5.5 years for total debt). However, given the large inflows of foreign financing in 2020, the share of foreign currency debt increased in 2020 compared to a year earlier. This highlights vulnerabilities in the event of exchange rate depreciation (mitigated by the de facto currency peg to the euro). The share of euro-denominated in total foreign currency debt declined somewhat in 2020 (-1.8 pps. y-o-y to 91%), yet it is still comfortably above the minimum threshold set by the government (85%). The debt portfolio also remains exposed to risk from interest rate developments, given the considerable (and, in 2020, increasing) share of domestic currency debt at variable rates (yet, at 22% much below the government's maximum threshold of 40%). The programme considers these risks

([25]) The government issued a six-year EUR 700 million Eurobond, and received external loans from the IMF (EUR 176 million), the World Bank (EUR 140 million) as well as a first tranche (EUR 80 million) of Macro-Financial Assistance from the EU (October).
([26]) In 2023, the 2016 Eurobond (EUR 450 million) matures, followed by the 2018 Eurobond (EUR 500 million) in 2025.

by testing the sensitivity of public debt to interest and exchange rate risk. Over the medium-term horizon, the government is likely in a position to refinance more of the maturing external debt by new domestic issuance, given the recent extension of the maturities of domestic issues. The improved structure of public debt is likely to ease financing conditions for the government. This will allow the government to meet its considerable requirements to finance the deficit and roll over maturing domestic and foreign debt in 2021-2023 (the programme calculates that the combined value of deficit finance and rolled-over debt that must be financed is about 10% of GDP on average per year). The government plans to meet these requirements by turning to domestic and foreign sources, including another Eurobond in 2021.

Box II.3.2: **Sensitivity analysis**

The programme includes a sensitivity analysis of the fiscal deficit based on three parameters. The first parameter is GDP growth. If average annual real GDP growth is lower than projected, by 1.3 pps. in 2021-2025, the budget deficit would increase by an average of 0.7 pps. per year. The second parameter is capital expenditure. Lower capital expenditure (about two thirds realisation) would imply a reduction in GDP growth by 0.7 pps. per year and an increase in the deficit by 0.3 pps. on average annually. The third parameter is tax collection. If tax collection drops by 5% per year, this would imply a budget deficit of 4.2% on average in 2021-2025 (compared to 3.3% in the baseline scenario, and to 3% in the same risk scenario in last year's programme for 2020-2022). The programme also assesses the potential impact on debt-servicing costs of external government debt arising from higher interest rates (+1 pp. compared to the baseline) and a 10%-appreciation against the euro of other currencies in the portfolio.

Fiscal consolidation plans are subject to implementation risks, including only timid efforts to increase tax revenue. The government could strengthen its commitment to fiscal consolidation by making fiscal policy initiatives more consistent, and by pursuing its declared intention to improve revenue collection in a more determined manner. Recent policy measures and announcements of new policy initiatives have been ambiguous, as they frequently involve further fiscal expansion (privileged pensions, public sector wage growth, subsidies, capital spending, bailout of local government units) or erosion of revenues (discussion about a zero personal income tax rate for the ICT industry, widened application of a preferential VAT rate in the catering and craft sector and discussion of preferential regime for the agriculture sector and for export-oriented companies, a discussion about tax amnesty, for example). In December, the government adopted the Tax System Reform Strategy which foresees measures to strengthen revenue collection i.e. by broadening the base through the elimination of tax expenditure. However, at the same time, the Reform Strategy foresees further tax incentives for companies and households through the tax base of CIT and PIT. The introduction of new permanent tax incentives goes against the government's declared objective of broadening the tax base and the need to increase the revenue-to-GDP ratio, and also raise concern with regard to fiscal discipline and debt sustainability.

The programme anticipates a medium-term shift towards growth-enhancing public expenditure and measures to address weaknesses in the management of capital spending. Partly because of crisis-related needs, current expenditure was even more tilted towards transfers in 2020, including pensions, and subsidies than in previous years (transfers accounted for 72% of total expenditure). Capital expenditure was again significantly under-executed, also to finance the additional transfer spending. In general, the government is aware of impediments to raising the execution rate of budgeted capital expenditure, and has started to initiate reforms. For example, in the 2021 budget, it introduced a new capital expenditure rule, which provides for reallocation of budgeted funds among budget users if a certain amount of the budget has not been used within a set period of time. In addition, the government adopted an action plan in December, containing measures to improve the management of public investment, based on the 2020 Public Investment Management Assessment (PIMA) by the IMF. However, overall there is limited progress so far in implementing the PIMA recommendations. Looking forward, the government expects capital expenditure to increase from 4.3% of projected GDP in 2021 to 4.8% in 2023. On the other hand, public consumption, as a share of GDP, is projected to decline after 2021, mainly as a result of lower growth in goods and services expenditure post-crisis. It is important that that a drop in current expenditure consists in permanent savings, unlike in previous years, when a decline in collective consumption remained based on temporary cuts. If realised, these dynamics would improve the quality of public spending, but this is subject to the aforementioned risks.

Improving the legal framework for public–private partnerships (PPP) would be a first step towards alternative ways of implementing public investment. Fiscal constraints and marked weaknesses in project implementation by state enterprises increasingly necessitate additional solutions to close the large public infrastructure gap. The current law on PPPs and concessions is marked by a number of weaknesses which often prevent desirable outcomes of projects. Municipalities, which are the most active users of PPPs, lack financial flexibility and technical expertise. Public bodies that wish to use PPPs for major projects complain about a lack of detailed administrative guidelines on selecting, implementing and managing PPP projects. There is often limited central oversight, as each contracting authority sets its own contract formats and terms and conditions. The monitoring of fiscal risks is also not sufficiently ensured: contingent liabilities arising from PPPs and from capital projects financed by the municipalities are not reported to the government. The government has finalised a first draft of the new PPP law, to introduce amendments that would address these shortcomings and ensure that PPPs would become an efficient vehicle for implementing public infrastructure projects, while mitigating potential fiscal risks involved in these contracts. However, severely limited capacities at ministerial level to administer PPPs remain a major bottleneck to their extended use.

The government further improved the fiscal framework and transparency of public finances, but systematic information on enterprise-level support is missing. In December, the government adopted a new draft Organic Budget Law (OBL), which provides for the introduction of fiscal (deficit and debt) rules and an independent fiscal council, as well as for a proper medium-term budget framework. This would bring significant improvements to the way public finances are managed, despite some shortcomings related for instance to the too broadly defined escape clauses of the fiscal rules. However, the law still needs to be passed by parliament and accompanied by secondary legislation, which could lead to protracted implementation. In addition, the government made public finances more transparent by publishing quarterly data on the finances of public enterprises and municipalities. Fiscal documentation does not yet include those public entities that would, under international accounting standards, be classified as belonging to the government sector. However, the fiscal rules in the new draft OBL would apply to the general government whose definition is planned to be based on ESA 2010 requirements. Although the government has a dedicated webpage listing beneficiaries of COVID-19 related support, the allocation of subsidies at company level generally remains opaque with regard to both the sums received by beneficiaries and the criteria for allocating support. Transparency is essential with a view to using funds in a targeted, efficient, and growth-enhancing manner, and could be much increased through the setting up of a proper registry of state aid.

3.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

This chapter sets out the Commission's independent analysis of North Macedonia's economy and identifies the main structural challenges the country faces. Addressing the immediate impact of the COVID-19 pandemic has been a priority for the government. However, medium- to longer-term prospects for both economic growth and resilience to external shocks will depend on North Macedonia's ability to implement structural reforms. Each of the main challenges faced by the country influences overall competitiveness in its own way. However, because these challenges are very often mutually reinforcing, it will be essential to address them to boost productivity and inclusive growth in the medium-to-long term. The three most significant challenges the Commission identified are: (i) improving the quality and relevance of the education system to increase employment and mitigate skills mismatch levels, (ii) increasing the competitiveness of domestic companies and their integration into global value chains (iii) formalisation of the economy.

Education outcomes are not sufficiently linked with the needs of the labour market which prolongs the transition from school-to-work, feeding the informal economy, out-migration and poverty. The informal economy distorts competition, decreases the quality of the business environment, leads to shortfalls in public revenue, and leaves some workers without social protection or with only limited rights. Accompanied by COVID-19 induced disruptions, failure to address the underlying obstacles that drag down the competitiveness of domestic companies will damage the country's growth prospects and trade balance. Disruptions to global value chains caused by the pandemic require actions to retain, strengthen and expand North Macedonia's attractiveness as a participant in these value chains.

North Macedonia also needs to continue to tackle corruption, improve the rule of law and strengthen institutions in order to promote competitiveness. Addressing these fundamental concerns is a prerequisite for successfully transforming the economy. The Commission is closely following the issues concerning the strengthening the rule of law and the fighting of corruption in its *Enlargement Package North Macedonia* report.

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

The persistent structural challenges in the labour market have been further exacerbated by the COVID-19 pandemic. The labour market has improved in the past decade, and this has been reflected by an increase in the average salary. But this improvement was slowed by the unpredictability of the political situation in 2017. Improvements in the labour market were finally halted altogether by the COVID-19 pandemic. The employment rate (20-64) decreased slightly by 0.7 pps. during the year (falling from 59.2% in 2019 to 58.5% in the third quarter of 2020). The labour force participation rate (20-64) decreased even more, falling from 71.5% in 2019 to 69.8% in the third quarter of 2020, showing that people have tended to withdraw from the labour market rather than look for a job. This is corroborated by the slightly shrinking unemployment rate (among 15-74 year olds), which fell from 17.3% in 2019 to 16.5% in the third quarter of 2020 – well above the EU-27 average. The impact of the COVID-19 pandemic, as demonstrated by the main socioeconomic indicators, has so far been partially mitigated by the package of measures adopted by the government and a larger negative impact of the crisis is only expected to become apparent in 2021. North Macedonia's economic reform programme acknowledges the deficiencies of the labour market, but does not propose measures to address them.

Some fundamental structural weaknesses of the labour market remain. Women and young people are particularly exposed to unemployment and inactivity, as are people with disabilities and the low-skilled, particularly Roma. The population is also ageing: the share of the population aged 0-14 decreased from 19.4% in 2005 to 16.4% in 2019), while the share of older people (aged 65 and above) increased from 11.1% to 14.08% during the same period. The long-term unemployment rate stood at 12.4% in 2019 (15-74) and continues to account for most of the overall unemployment rate. The quality of available jobs remains an important issue fuelling the emigration ('brain-drain') of talented people: 1 in every 4 (27.6%) employed young people works in a field that does not correspond to their level of education (World Bank, 2020). The regional disparities are strong, as the employment gap between the southeast (the best-performing region) and the northeast (the worst-performing region) remains around 25 percentage points.

Young people in particular continue to face difficulties in entering the labour market. 45% of young people stay unemployed for 4 years or longer after finishing school, while only 7.3% are unemployed for less than 1 year (Labour Force Survey, 2019). The countrywide implementation of the Youth Guarantee in all 30 employment centres in 2019 led to a reduction in youth unemployment (those aged 15-24) from 45.4% in 2018 to 35.6% in 2019, but youth unemployment still remains high. Similarly, the share of young people not in employment, education or training decreased from 24.1% in 2018 to 18.1% in 2019.

However, this share still remains substantially above the EU average for the same period (10.1% in 2019). The report evaluating the effectiveness of the Youth Guarantee in the country has still not been released. Importantly, looking at the larger group of people aged 20-34, the broad gender gap (25.3% of men not in employment, education or training (compared to 37.4% of women) indicates the social conventions or pressures which place higher importance on women's roles within the family (OECD, 2020).

Active labour market policies are still not sufficient to help jobseekers find sustainable employment, while employment activation remains weak. Despite the countrywide implementation of the Youth Guarantee, there has been no comprehensive monitoring and impact assessment of the effectiveness of active labour market policies for many years. The impact of revised legislation on these policies is also not clear. Active labour market policies have a limited scope, as they cover less than 10% of the unemployed and less than 25% of the poor. The capacity of the public employment service to give job mediation and implement active labour market policies is also weak due to lacking human and financial resources.

The insufficient relevance and quality of education, combined with the structure of the enterprise sector, contributes to skills mismatches. This leads to persistent unemployment and underuse of young people's potential. The education system contributes to the lengthy school-to-work transition by failing to identify and meet the needs of the labour market. The skills mismatch continues to be a major impediment to people finding work. This is because of the discrepancy between the curriculum of secondary schools offering vocational education and training (VET) and the demands of the labour market (ETF, 2020). It is recommended to improve career guidance and establishing a mechanism for monitoring quality and relevance of curricula, including in private universities. North Macedonia is putting in place an institutionalised process and tools for monitoring/forecasting skills needs to adequately align VET, higher education, and up- and re-skilling offers to labour market needs. The national qualification framework, that was referenced to the European Qualifications Framework in 2016, was designed to support modernisation of education and training, with a view to improving quality and adaptability of education to labour market needs, and promoting lifelong learning and mobility.

North Macedonia's education system does not give young people enough of the key skills and knowledge they need to actively participate in the labour market. This continues to hinder companies' competitiveness and their deeper integration into the global economy. Despite substantial improvements in the 2018 Programme for International Student Assessment (PISA) compared to the 2015 study, North Macedonia still ranks low among the other participants (68th place out of 78 participating countries) and compared to its regional peers. Even the highest-performing students scored only around the OECD average. The gender gap is a particular issue, as boys perform worse than girls. This gender gap is far greater than international averages (North Macedonia has the third largest global gender gap in reading performance). Other significant gaps are linked to students' socioeconomic status, educational track, and language of instruction. The OECD has signalled that there is a specific problem in fostering the 'growth mind-set'. For example, more than 60% of the country's students agreed with the statement that 'intelligence is something about them that they can't change very much'. This means that many students are unlikely to make the investments in themselves that are necessary to succeed in school and in life. PISA data also highlight the need for improvements in the quality of teaching, since half of all students have not achieved basic literacy and numeracy skills by age 15.

A reform of the education system was planned in the 2018-2025 education strategy, but this reform requires greater funding. The education strategy and the related action plan both prioritise providing quality skills to young people to prepare them for society and the labour market. However, these two documents also both state that financial support is insufficient and that inter-sector coordination is lacking. If the country's Agency for Quality Assurance could function more satisfactorily, this would also help. Public spending on education is clearly insufficient. North Macedonia has steadily reduced its spending on education from 4.62% of GDP in 2011 to 3.7% in 2019. This level is currently below the

EU-27 average of 4.7% in 2019 and also below peer-country averages. The education system is also undermined by the inefficiency of public spending (World Bank, 2019).

Major reforms are being made in VET, but the quality of teaching is still an obstacle. Approximately 56% of upper secondary students in North Macedonia follow a vocational pathway (42 641 students in 2019/2020) – a proportion comparable to the rest of the Western Balkans and higher than the EU average by 13 pps. (EU average is 43%). In 2019, 79% of the country's VET graduates subsequently enrolled in tertiary education, compared to 53% of students from general schools (World Bank, 2019). The low transition of students from general upper secondary education to higher education means that almost half of those who leave secondary school without further education have not acquired a specialisation to participate in the labour market. The three-year and four-year VET curricula were revised in 2019, and the development of the three regional VET centres (Tetovo, Kumanovo, Ohrid) is under way. The lack of technical skills among vocational-school graduates is considered a major bottleneck by companies in North Macedonia. This is because the teaching and learning methods in VET schools are largely theoretical, offer limited practical training, and suffer from a lack of teaching and learning materials (OECD, 2020). There is a need to further invest in the professional development of VET teachers and introduce a more flexible, modularised VET curriculum with the direct involvement of employers.

Participation in lifelong learning has increased slightly. The percentage of adults participating in learning (2.8%) is significantly lower than the corresponding EU-27 average of 10.8% (2019). Based on the strategy for adult education 2019-2023, a pilot project with the Adult Education Centre saw the introduction of two qualifications, although these were only made available in Skopje. Further development of qualifications and up-skilling/re-skilling programmes throughout the country are key to integrate medium-skilled and low-skilled people into the labour market. Furthermore, promoting lifelong learning and the strengthening of informal education should help to improve workers' technical and managerial skills. This is needed to raise productivity in companies and industry.

The continuing gender gap undermines North Macedonia's overall economic potential. The gender employment gap (the percentage-point difference in the employment rate of men and women aged 20-64) stood at 18.9 pps. in the third quarter of 2020, while 68.6% of the inactive population (20-64) in the same period were women. This is partly due to: (i) women's traditionally lower presence in the labour market; (ii) previous disincentives for women to work; and (iii) the burden of childcare and family care. Women are much more likely to be low paid. Estimates of earnings indicate a significant gender pay gap and the potential for discrimination in the labour market against women. Women in North Macedonia also have a working life that is on average 12 years shorter than that of men (Gender Equality Index, 2019).

The emigration of workers is a serious impediment to business, and poses a substantial risk of brain-drain for North Macedonia. The shortage of jobs – and secure, well-paid jobs in particular – is the biggest challenge. This makes it especially difficult to prevent young people from leaving the country. The inability to predict the country's economic prospects is also considered a key factor that is fuelling the emigration of young and skilled workers. According to projections, the share of the population aged 65 and above will double from 12.5% in 2015 to 25.4% in 2050, placing significant strain on the social-protection system. This trend will gradually reduce the share of the working-age population (those aged 15-64) from 70.6% in 2015 to 60.4% in 2050 (ILO, Decent Work Programme, 2019). About 59% of businesses struggle (OECD, 2020) to find workers with appropriate skills.

Informal employment has decreased, but remains at a high level. The informal employment rate fell to 13.8% in 2019, but remains structurally high (Labour Force Survey, 2019). Most informal work is concentrated in agriculture, where 52.3% of work is informal. However, other sectors such as construction, manufacturing and wholesale trade also have high levels of informal employment. The government's focus on reducing the informal economy is in accordance with its 2018-2022 strategy and its 2018-2020 action plan (EBRD, 2019).

Reform Measure *18* of the ERP "Further development of the qualification system", is rolled over from the last year. The measure reflects the key policy reforms presented in the ESRP adopted by the government. The measure addresses the key bottleneck of the education system and builds on the activities implemented in 2020. To implement this measure, the modernisation of three regional VET centres is key, and further development of such centres of excellence is needed throughout the whole country. The measure presents indicators and a budget in the fields of employment, education and social policy. Although both the ESRP and the inclusion of the measure in the ERP signals that education is among the top priorities of the government, the measure's expected impact on competitiveness could be further strengthened.

Key challenge #2: Improving the competitiveness of domestic companies and integration in global value chains

Domestic companies' low and slow-growing productivity hinders their competitiveness. North Macedonia's businesses suffer from unsophisticated technology, limited capacities of production and innovation, inconsistent quality of goods and services, deficient managerial skills and competition from a large informal sector. Further constraints to modernisation of technologies and business processes as well as to expanding manufacturing and internationalisation capacity result from the skills mismatch in the labour market on both managerial and operational level, caused by weakenessess in the education system and a complex application of business regulations.

The COVID-19 pandemic has put a significant additional burden on companies, causing them to cut their investment in development of human and physical capital. The pandemic is expected to exacerbate the slowdown in regional productivity (World Bank, 2020). It has negatively affected profitability and turnover in 90% of companies and caused a drop in their productivity (International Labour Organisation, 2020). The highest share of enterprises reporting a drop in revenues operate in sectors affected by the government ban on business operations and curfew restrictions, specifically transportation, storage, accommodation and food services, construction, trade, and professional, scientific and technical services (ILO, 2020).

The COVID-19 crisis has also shown the vulnerability in global value chains, which represented 80% of global trade before the crisis (IMF, 2019). North Macedonia's links to global value chains are still predominantly concentrated in services and low- to medium-value manufacturing (IMF, 2019). Following the outbreak of the crisis, 45% of the country's businesses reported a decline in demand for products and services, 38% reported weaker confidence in supply chain partners, and 35% reported disruptions in the sourcing of raw materials (ILO, 2020).

Although tackling the immediate challenges of the COVID-19 crisis has been an immediate priority, reform measures to foster the competitiveness of domestic companies need to be strengthened further. Raising the competitiveness of local companies will require higher investments in human and physical capital and improving the overall business environment, including better enforcement of business regulations and corporate governance, as well as better services including trade and transport logistics. Productivity could be further improved by more investment in research and innovation, further cooperation between SMEs and stimulating their geographic agglomeration and interconnectedness, as well as with further regional integration.

Especially in this challenging period, businesses need a fair, predictable and functional regulatory framework, with an effective and increasingly digital public administration (ILO, 2020). The pandemic has amplified the need for an enabling business environment, with low administrative burden and improved access to public services, allowing businesses to cope with the new challenges of the pandemic. Consequently, full implementation of the 2019 Law on inspection supervision and implementing transparent and consistent procedures for inspections would increase the ease of doing business. The COVID-19 pandemic has also demonstrated an urgent need to further simplify access to public services, in particular by digitalising the public administration. Setting up a fully-operational online ‘one-stop-shop’ system for all business-related permits and licences could have an additional benefit for on the business environment.

In recent years, authorities have been focusing on attracting FDI, which in 2019 amounted to 3.8% of GDP, as a way of increasing competitiveness of domestic companies. However, the COVID-19 pandemic has made it much more difficult to attract or even retain FDI. Initial estimates suggest that the decline in global FDI caused by COVID-19 will range from 30% to 50% in 2020-2021 (World Bank, 2020). Therefore, attracting and retaining FDI will require prioritisation and the strengthening of targeted public policies to address the underlying structural obstacles affecting domestic companies’ competitiveness. In particular, attracting FDI to higher-value segments of international value chains will depend on North Macedonia’s ability to reform its education system and labour market. Attracting FDI could further benefit from opportunities to co-operate with local economy on innovation activities.

As attracting new FDI is becoming more challenging, it is a priority to use multinationals already present in the country as a vehicle for productivity growth. Multinational companies operating in the country perceive insufficient technological development, weak adherence to quality requirements, lack of compliance with international standards and certificates as well as limited production capacity of domestic partners as the main weaknesses constraining their integration with domestic industry (Finance Think, 2019). This requires that the authorities should take measures to facilitate technological upgrading and investment in reliability and quality of production, and help domestic companies to develop their technological capacity. In addition, digitalisation of industry is a major driver of productivity gains and should be further strengthened. North Macedonia is currently preparing its smart specialisation strategy, which will be based on the mapping of economic, innovative and scientific potential in the country. This strategy should therefore consolidate the country’s economic policy priorities and support the further development of sector-level strategies in the relevant fields such as education and skills, industry, research and innovation, as well as attracting FDI.

Instead of tackling the country’s underlying structural challenges and business environment issues, the government’s flagship policy to attract FDI and improve domestic firms’ competitiveness relies on providing various forms of State aid to businesses. The special temporary framework for State-aid measures to support affected businesses and the economy during the COVID-19 crisis was justified. However, further extended use of State-aid schemes as a measure to support domestic companies must be based on close, continuous assessment of the business environment issues and clear policy objectives. The Law on financial support of investment, based on which part of state aid is being distributed, retains certain features that are problematic in view of the EU *acquis* on State aid. The Law on strategic investments adopted in 2020 with the aim of supporting so-called strategic projects, lacks a well-elaborated policy framework and implementing regulations. There is an urgent need to develop a comprehensive and transparent registry of State aid and to create a more effective State aid notification system. More action is needed to monitor the cost-effectiveness of these schemes and their impact on competitiveness, to ensure coordination of different programmes, and to strengthen the capacity of the Competition Agency and of institutions providing State aid.

The regulatory framework’s lack of transparency and predictability continues to negatively affect the business environment and the competitiveness of domestic companies, in particular SMEs. Increasing the efficiency and transparency of public administration, reducing the time and costs of commercial disputes and promoting alternative dispute resolution mechanisms would address some of the factors limiting the competitiveness of domestic companies. In 2020, North Macedonia Andrew up initial list of 370 para-fiscal charges at central and local levels, but further steps are now needed to rationalise them.

Further developing certain service sectors could be an opportunity for domestic companies. Services such as logistics, transportation, and information and communication technologies are fairly unsophisticated at present. This forces foreign companies to use alternatives outside the country. According to multinationals operating in the country, 91% of services they need can be found in North Macedonia. However, 30% of the companies surveyed found these services not to be of the required quality standards (Finance Think, 2019). This assessment is also reflected in the relatively small export share of service industries. A shift in public policies in support of upgrading services closely linked to the creative and production industries could allow the country to increase the role played by services in improving productivity and creating value.

The COVID-19 crisis may also offer opportunities for domestic companies. Further efforts should be made to integrate the country's companies into global value chains in a sustainable way, so that domestic companies can further diversify their export structure and mitigate future shocks. North Macedonia needs to consider how to better position itself on the global market, if the pandemic leads to a further retreat from trade integration, with higher trade barriers and re-shoring of production. The country should act to ensure that it can retain, strengthen, or expand its attractiveness as a participant in the global value chain by ensuring the free flow of manufactured goods across borders to ease the pathway to greater integration and diversification. To benefit from these opportunities, North Macedonia should reduce trade costs by streamlining its non-tariff measures and closing the remaining gaps in the main transport corridors. Reducing entry barriers in network industries such as electricity and telecommunications and undue restrictions on professionals like attorneys, accountants, and engineers would further enhance the trade in services. The gaps in national and international digital infrastructure should be bridged and digital cohesion enhanced.

The Economic and Investment Plan for the Western Balkans will help increase the competitiveness of North Macedonia's economy backed by a green and digital transition. A substantial investment package, which is at the heart of the Economic and Investment plan, will direct a large majority of support towards key productive investments and infrastructure. This will support the twin green and digital transition and the development of connected, competitive knowledge-based, sustainable, innovation oriented and thriving economy, with an increasingly dynamic private sector. Circular-economy principles, as a basis for the Economic and Investment Plan and defined in the green agenda for the Western Balkans. The principles could significantly foster sustainable production and consumption. Increasing resources productivity within the economy would allow local SMEs to benefit from the business opportunities of increased resource efficiency and by further access to innovative technologies.

Building a common regional market has the potential to further enable competitiveness and growth. The common regional market is based on EU standards and will help the country integrate in regional and European value chains. It will also help make the economy more attractive for FDI in tradable sectors, notably by increasing the size of its market. Further connectivity with neighbouring countries in transport and energy will strengthen access to, and integration into, the regional market. The new Additional Protocol 6 of the Central European Free Trade Agreement (CEFTA) to liberalise trade in services also opens new opportunities in the dynamic service sectors, and therefore should be implemented swiftly. Regulatory and investment moves to create a regional digital space and more integrated labour markets with neighbouring economies will offer new possibilities for the country's young people. This is especially important given the high rates of youth unemployment.

Key challenge #3: Formalisation of the economy

The informal economy remains deeply entrenched, accounting for a large share of total output and a large share of total employment. Although the State Statistical Office estimates that the informal economy accounts for 17% of GDP and 18% of total employment, other estimates suggest that I could account for as much as high as 37.6% of GDP (IMF, 2019). The country's informal sector takes various forms, of which the most prominent are unregistered labour, partially undeclared wages and other irregularities in the enforcement of the Labour Relations Act. Other practices common to the informal economy include not issuing tax receipts or invoices, or underreporting turnover. The growing prevalence of freelance work and personal services provided at home or via the internet often go unregistered.

Undeclared employment remains a persistent issue and could be exacerbated by the COVID-19 pandemic. The sectors with particularly high labour informality are agriculture, construction, household services and wholesale and retail trade. A large proportion of the population continues to declare itself inactive while likely earning some income from an undeclared activity. In 2019, 42.8% of the population was classified as inactive, almost 16 percentage points higher than the average EU rate. The COVID-19 pandemic could also have an impact on informal employment. Given that many of the sectors most badly hit have a high share of informal workers there could be a drop in informal employment. On the other hand, workers might have switched from formal to informal labour, partly by falsely declaring fewer working hours.

Partially unregistered employment and undeclared wages are also widespread. Income is estimated to be partially or completely undeclared by almost 44% of employees. According to estimates, 27.6% of employees' social security contributions are paid at a level lower than the actual salary received (Centre for Research and Policy Making, 2019). Almost 74% of individuals engaging in additional work to their primary source of employment do so without a formal contract (CRPM, 2019). These workers' social and health benefits are not paid in full, and their rights as workers are not fully protected.

The widespread acceptance of this phenomenon contributes to the persistence of informality. A recent population survey indicates that only 1.6% of individuals in the country highlighted the informal economy as one of the three basic problems in North Macedonia (CRPM, 2019). Furthermore, 21.1% of individuals are willing to participate in undeclared work to get a higher wage (CRPM, 2016). Both employees and employers see benefits in the arrangement: the employer makes savings by not paying social contributions for the real amount they pay exceeding the fictitious reported wage, and the employee receives a higher net salary, albeit by foregoing rights to pension and social protection. The perception that public services such as healthcare and education are of insufficient quality also discourages voluntary tax compliance. Because the system designed to protect employees' rights is not perceived as efficient and just, many employees are likely to willingly forego institutional protection of their legal labour rights.

The high proportion of cash transactions and the related practice of not issuing tax receipts remain an issue. Based on the 2018 Law on anti-money laundering and preventing financing of terrorism, the maximum amount allowed for cash payments had been gradually reduced to EUR 500. However, the government abruptly changed the law in 2019 and increased the maximum allowable cash payment to EUR 3 000. Promoting electronic payments and limiting the use of cash, in particular for higher-value purchases, would likely help reduce activity in the shadow economy.

The size of the informal economy may exacerbate the negative impact of the COVID-19 crisis on the economy. The large informal sector narrows the tax base in a context of already falling tax revenues due to the pandemic. Production in the informal sector is often inefficient, either because companies remain small enough to avoid being detected or because they use outdated technology, thus contributing to the lower productivity and competitiveness of the economy. Companies operating in the informal sector also have more limited access to finance (which constrains investment) and to qualified workers. Moreover, businesses operating completely in the informal economy have had no access to government support schemes in the context of the COVID-19 crisis.

The COVID-19 pandemic has disproportionally affected informal workers. Global estimates show that informal workers' monthly average labour income could fall by 27% in upper-middle-income countries such as North Macedonia as a result of the pandemic. Relative poverty for informal workers and their families is set to increase by more than 21 pps. (ILO, 2020). Informal workers are deprived of social rights and access to unemployment benefits. Even though they do have some access to social protection, the COVID-19 pandemic has confirmed that informal employees are more vulnerable in the event of work-related injury, when they lose their job, or when they retire. High levels of informality also affect the overall level of skills in the economy, as informal workers have less access to training, exacerbating skills shortages. This ultimately generates greater inequality.

The government support measures at the onset of the COVID-19 may have had an impact on the informal sector. Following the outbreak of the pandemic, the government introduced employment-retention measures for the most affected sectors including restaurants, catering services, tourist agencies and transport. To benefit from the employment retention measure, the companies needed to prove a decrease in revenue of at least 30% compared to the previous year. Although the revenues in various sectors have declined the measure may have motivated some companies to understate their revenues at the onset of the crisis. However, the measure was also accompanied by more stringent tax inspection. The government softened the eligibility requirements for the potential beneficiaries of the measure who were self–employed. A cash allowance of 7 000 dinars per household was provided for the most vulnerable households, including those whose members worked in the informal economy. The impact of these measures on incentives for companies and individuals to formalise their business activities is unclear.

Even though COVID-19 poses many challenges, registered businesses still consider competition from the informal economy to be one of the main obstacles for doing business in North Macedonia. According to the latest available business environment and enterprise performance survey (BEEPS, 2019), the activities of competitors in the informal sector are seen as one of the main obstacles for businesses in the country: 14% of companies say that competing against companies in the informal sector is one of their main challenges.

Reducing the size of the informal economy requires appropriate institutional structures. Strengthening the skills, expertise and powers of tax officials, emphasis on voluntary compliance, improving judicial efficiency and ensuring inspectors have greater independence are key in the fight against the informal economy. Appropriate and timely enforcement of contracts along with more the transparency of legal changes will have two beneficial effects. It will increase predictability in the business environment and reduce incentives to participate in informal activity. Clarifying the mandates of various inspection bodies, increasing their skills, and further digitalising processes (notably on labour law and occupational safety) would also help to reduce informality. The COVID-19 crisis has shown the need for and benefits of further digitalising the public administration, which could also further reduce the size of the informal economy.

The impact of economic policies and COVID-19 support measures on the informal economy should be continuously monitored. Continuous increase in the statutory minimum wage and the introduction of subsidies for employers' social security contributions to mitigate the impact of wage increases as well as subsidising social security contributions in certain sectors, during the pandemic could change the incentives of the in informal economy. Furthermore, frequent and sudden policy changes related to taxation, such as suspending the application of progressive taxation, as well as the high level of tax exemptions, create distrust among taxpayers over whether they will receive equitable treatment, and have an adverse effect on voluntary tax compliance. Further simplifying the tax and social benefits system to reduce the number of exemptions, and not necessarily the tax rate, could reduce tax compliance costs and reduce informality.

In an effort to address the informal economy, North Macedonia developed a 2018-2022 medium-term strategy and an action plan. The strategy was developed using a participatory approach and reflects the latest OECD recommendations. It recognises that deterrent measures alone are not enough to effectively reduce the informal economy, and that the country should address underlying causes such as weaknesses in the labour market and business environment. However, only limited progress was made in 2020 in implementing the measures set out in the action plan. The impact of the measures undertaken needs to be regularly assessed and the measures adjusted accordingly. To ensure that the full set of measures in the strategy are implemented and to address the underlying causes of informality, the measures must be further integrated in other sectors' policies and action plans. The 2018-2023 SME strategy included measures to combat the informal economy. This is a good example, and measures to combat the informal economy should be included in other strategies.

In November 2020, the voluntary disclosure programme was announced, intending to encourage tax payers to register undisclosed cash. Without an efficient auditing programme, or robust sanctions against tax evaders, this programme would do little to tackle informality. It might even increase the risk of eroding tax morale and collection in the future, undermining the effectiveness of revenue administration and tax policy more broadly. Before opting for such a programme, North Macedonia should implement a comprehensive action plan to modernise the country's tax administration and improve tax morale and awareness. The role of the Public Revenue Office should be further strengthened, as it currently has no ability to conduct market inspections or field inspections. There are also no measures to encourage voluntary tax compliance as the cornerstone of modern revenue administration.

A fully coordinated government approach, with high level political steering, is needed to successfully develop and implement the action plan in 2020-2022. The government is yet to prepare a comprehensive evaluation of the implementation of the first action plan for the 2018-2020 period. The subsequent action plan that is yet to be drawn up should contain the lessons learned from the previous plan. The updated action plan should be wider in scope and consider all the relevant areas and stakeholders for tackling the informal economy. This updated action plan should include further measures to address the overall societal acceptance of informality given that 52.4% of the population considers this as an inevitable part of their life. Voluntary tax compliance should also be considered. In addition, all fiscal initiatives relevant for the informal sector, such as changes in minimum wages, social security contributions and taxation should be taken into account. Furthermore, the action plan should consider measures to digitalise processes in public administration and introduce risk-based audits, as both of these initiatives would reduce bureaucracy and the opportunity for corruption. Given that e-commerce is a growing industry with a high potential to facilitate informality, the subsequent action plan could also benefit from actions in this field. The strategy and the action plan should also require an analysis to be made of the impact on the informal economy of the anti-pandemic economic support measures.

Reform Measure 12 in the ERP "Introducing mechanisms for formalising informal work in sectors with high incidents of undeclared activities", is rolled over from the previous year. The measure aims to implement the 2018-2022 strategy for formalising the informal economy. The 2018-2022 strategy identifies three salient motives for engaging in informal business activities, but these motives are not properly addressed by the activities under Reform Measure 12. The measure focuses mainly on employment policies while ignoring other important aspects contributing to the informal economy, such as the overall business environment or taxation, including social security contributions. For the area of taxation, the Ministry of Finance drafted an ad hoc action plan in 2019 to address the fiscal aspects of informality, but this ad hoc action plan should be integrated in the overall revised 2021-2022 action plan. Most of the activities in the ad hoc action plan are based on more stringent monitoring and inspection. The measure also suggests implementing awareness-rising activities on the benefits of the transition to the formal economy, and introducing a voucher-based system to promote better working conditions. However, it remains unclear how these activities of the voucher system will be put in place or implemented. The hoped for positive impact of the measure on competitiveness is not sufficiently quantified and the impact on employment and gender is not sufficiently considered. In addition, the measure does not take into account the impact of COVID-19 on the labour market and undeclared work.

Box II.3.3: **Monitoring performance in light of the European Pillar of Social Rights**

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

North Macedonia faces challenges for a number of indicators of the Social Scoreboard ([27]) **supporting the European Pillar of Social Rights.** Despite favourable trends in employment over recent years, the country's unemployment rate remains high and has several distinctive structural characteristics, including long-term unemployment, inequality, and large regional disparities. Because the impact of the COVID-19 pandemic has been cushioned by the government's support package, the real impact of the crisis will be seen in 2021.

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

Women and young people are particularly exposed to the risk of unemployment and inactivity. Despite significant improvements due to the successful implementation of the Youth Guarantee, youth unemployment (15-29) was 20.3% in 2019, while the rate of young people (15-24) neither employed, nor in education or training (NEET) in 2019 was 18.1%. The rate of inactivity in the labour market is particularly high for women. In Q3 2020, 42% of women aged 20-64 were out of the labour market.

Government measures to help people find work or training are insufficient in scope and volume to substantially improve the situation. A new legislative framework and measures to get more people into the job market is a step in the right direction. However, the resources allocated for this measure remain scarce

([27]) The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States' performance (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The 12 indicators are also compared for the Western Balkans and Turkey, with one small adjustment for the age bracket for the unemployment rate (reducing the upper age bracket to 64 instead of 74 years) for Albania and Kosovo due to data availability. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2019 data are used for this comparison) and a review of the trend for each indicator based on the latest available three-year period for the country (improving/deteriorating/no change). Data from 2017-2019 are used and can be found in Annex A.

(EUR 11 million for 3 years). The public employment service could make better use of its well-developed IT system to track the employment status of participants in programmes to help people find work or training over the short and medium terms.

The reform of the social-protection system aims to better target those in need. Social assistance has a very small effect on the poverty reduction. This is due to both the very small amounts of the benefits that are paid out and insufficient effectiveness in targeting these benefits at the most needy. The new legislative framework includes the Law on Social Protection, Law on Child protection, and Law on Social Security of Elders, as well as related bylaws. The framework served as the impetus for the stronger policy response during COVID-19, since the number of GMA beneficiaries has increased. Those most at risk of poverty continue to be: (i) young people; (ii) the uneducated; and (iii) ethnic communities such as the Roma.

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

3.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2020

Overall: Partial implementation (61.1%) ([28])	
2020 policy guidance	**Summary assessment**
PG 1	There was **partial implementation** of PG 1
Use fiscal policy to mitigate the crisis-induced impact on growth and employment.	1) **Substantial implementation**. The government has used fiscal policy to mitigate the crisis-induced impact on growth and employment. It has adopted four sets of measures addressing households and companies (i.e. subsidies to wages and employers' social contributions), totalling EUR 1billion in 2020, and adopted a fifth set in February. To provide financing for these measures, two Supplementary Budgets were adopted in 2020, as well as two decisions for redistribution of funds between budget users and funds.
Adopt the Tax System Reform Strategy 2020-2023 and improve revenue collection capacities in line with the strategy.	2) **Partial implementation**. On 29 December 2020, following two public consultations, the government adopted the 2021-2025 Tax System Reform Strategy and began with the implementation of measures that address the PG subpart appropriately. The country has adopted measures to improve revenue collection, but only a few of them have been implemented yet as the Strategy was adopted in December 2020 only. The capacities of the two key revenue collection administrations, the Public Revenue Office and the Customs

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

	Administration, have increased consistently, both through national funds and sizeable EU assistance. The biggest challenge ahead is the modernisation of the ICT system of the PRO.
Further improve the transparency of public finances by publishing regular fiscal reports on public enterprises and taking steps towards incorporating them in the general government statistics in line with the excessive deficit procedure methodology.	3) **Partial implementation.** The country has adopted and implemented measures that address the PG subpart appropriately. Public enterprises are now obliged to publish their reports on the website. As from October 2020, the MoF started publishing revenues, expenditures and profit / loss for public enterprises, quarterly at the enterprise level. This PG subpart is also the subject of MFA conditionality. The country has adopted measures to include some public enterprises in the general government fiscal documentation. The SSO is responsible for EDP notifications, which are regularly submitted to Eurostat. The data for some public enterprises are also part of the notifications according to the published list of units of S13 Government sectorised by the Commission for Sectorisation (SSO, MF and NBMK). In the new OBL, the fiscal rules apply to General Government (GG) and the definition for GG refers to the list of units published by the SSO for S13 based on ESA2010.
PG 2 To support the economic recovery, improve public investment management to mitigate technical obstacles to implementation of capital spending.	There was **partial implementation** of PG 2 1) **Partial implementation.** The country has adopted measures to address the PG subpart. The MoF developed a PIMA Action Plan (adopted in December 2020) in order to facilitate the implementation of the recommendations of PIMA conducted by the IMF. In order to improve the realisation of capital expenditures, the 2021 Annual Budget Law introduced a new mechanism. Budget users are now obliged to realise 15% of capital expenditures by the first quarter, 40% of capital expenditures by the second quarter and 65% of capital expenditures as of the third quarter. In case of non-fulfilment of this obligation, the unused funds up to the prescribed limit, are re-distributed by the Ministry of Finance to the reserves for capital expenditures of the same budget user, without the right to spend.
Establish a comprehensive registry of state aid and review firm-level subsidies based on their cost-effectiveness.	2) **Limited implementation.** The country has announced some measures to address the PG subpart, but their implementation is at risk. The country has expressed interest in asking support from the international community with regard to providing assistance in developing the state aid registry, but so far the only progress was initiating a consultation process though the Department for Competitiveness and Innovation. The role and involvement of the Commission for Protection of Competition (CPC) is marginal. A state aid registry already exists within the CPC, but it is outdated. It remains unclear who will be in the leading role with regard to state aid: the Cabinet of the Deputy PM, the CPC, the Department for Competitiveness and Innovation. Under the Stabilisation and Association Agreement SAA, it

	should be CPC in the lead. Issues related to the Law on strategic investments with regard to support to strategic projects remain. There was no implementation regarding the review of firm-level subsidies. The country has neither announced nor adopted any measures to address this PG subpart. The number of state aid providers remains high and without coordination, particularly with regard to the cost effectiveness of the granted aid.
Take initial legal and operational steps to establish fiscal rules and a fiscal council with a view to strengthening fiscal sustainability in the medium term.	3) **Partial implementation.** In December 2020 the Government adopted the Organic Budget Law that includes provisions for fiscal rules and a fiscal council. The OBL was published on ENER and subject to wide consultation, including the EUD, ECFIN and the WB. It is now in the parliamentary procedure. It is not clear yet whether the law will enter into force in 2023 or whether some articles (including those on fiscal rules and fiscal council) will be enforced from 2022 as committed by the Minister of Finance. Secondary legislation on the establishment of the fiscal council is not yet elaborated.
PG 3 Closely monitor financial stability challenges arising as a result of the coronavirus pandemic and take appropriate action if needed.	There was **substantial implementation** of PG 3 1) **Substantial implementation**. Forceful monetary and financial sector measures have been adopted to cushion the short-term impact of the crisis, including inter alia borrower relief measures such as loan repayment moratoria and loan restructuring, while monitoring has remained strong. The full impact of the crisis in particular on asset quality is yet to become visible, likely requiring further adjustments.
Operationalise the reconstituted Financial Stability Committee and ensure the legal clarification of the central bank's macro-prudential mandate.	2) **Substantial implementation:** An MoU has been signed across regulators and enabled the Financial Stability Committee to start operations, while the draft Law on Financial Stability that provides the required legal clarifications is expected to be adopted by the first half of 2021.
Work towards a further implementation of the denarisation and NPL resolution strategies, ensuring the effectiveness of the measures taken and making any adjustments deemed necessary.	3) **Partial implementation:** Further efforts were made to implement the denarisation strategy, but the crisis impact resulted in a partial reversal of the earlier progress. Measures were also taken to implement the NPL strategy, with the new insolvency law in early drafting stage with possible adoption by end-2021**.**
PG 4 Ensure a whole-of-government approach and cross-sectoral coordination across public administration to effectively respond to COVID-19.	There was **substantial implementation** of PG 4 1) **Full implementation:** A crisis coordinative headquarters was formed chaired by the prime-minister. Other coordinative bodies were also established such as: (i) the managerial committee for coordination and management of crises; and (ii) the appraisal group that assesses risks and security threats and proposes measures and actions for their prevention, early detection, and management.. Following the adoption of the decision of 20 November 2020 declaring a pandemic crisis in

	the country (until 30 June 2021), the main headquarters for crisis management was active. Two members of civil society organisations, elected through a public call, participate in the work of this body. A centralised information system was set up to inform the public about COVID-19. The Ministry of Health issues daily updates to the public through regular press conferences or press statements. A centralised web site was set up: www.koronavirus.gov.mk The government also set up two mobile applications and two national call centres to keep the public informed about the pandemic. The government holds its session through the e-government information system.
Maintain continuous dialogue with business organisations, social partners and civil society on all measures in response to the crisis.	2) **Substantial implementation:** Government engaged in a dialogue with business organisations, social partners and civil society when designing measures to respond to the COVID-19 crisis. Additional efforts should be made to extend the number of participants and topics in public consultation and reduce the number of laws adopted in shortened procedure.
Take necessary actions to ensure easy access to digital public services for citizens and businesses.	3) **Partial implementation:** The national e-services portal www.uslugi.gov.mk provides electronic services to the public. In August 2020 a project aimed to develop new e-services and digitalising state registers began with drafting a list of 135 new services for citizens and businesses. In November 2020 certified electronic signature was introduced.
PG 5 With a view to mitigate the economic consequences of COVID-19 pandemic and to stimulate economic recovery, establish an effective and transparent mechanism to support the businesses affected by the crisis, in particular micro, small and medium-sized enterprises and self-employed.	There was **partial implementation** of PG 5 1) **Substantial implementation.** In 2020, the government developed and started implementing four sets of measures to improve the resilience of private companies focusing on SMEs and targeting self-employed. The fifth set of measures was announced in early 2021. The government has provided initial public information about money spent and the effectiveness of measures In addition, the IMF's preliminary assessment concluded that the timely policy actions taken by the government have an essential role in mitigating the economic and social impact of the pandemic.
Extend social protection coverage and provide incentives for businesses and employees in the informal economy sector to register and to facilitate their transfer to the formal economy.	2) **Partial implementation.** Social protection activities focused on countering the impact of COVID-19.. The government implemented the guaranteed minimum assistance (GMA) scheme. The new Law on Social Protection contained 'activation' measures to encourage recipients of the GMA to get jobs. However those activations measures were only partially implemented. The impact of changes in social protection on the formalisation of jobs is not assessed.
Create a register of para-fiscal charges to streamline their use and further decrease the administrative and regulatory burden of companies.	3) **Partial implementation.** The Ministry of Economy published on its website a list of 377 para-fiscal charges for businesses, by competent authority, which were mapped based on the catalogue of public services. Steps to reduce and abolish these charges have yet to take place. The government asked IPA funds to carry out a project in this area.

PG 6	There was **substantial implementation** of PG 6
Continue taking measures to preserve employment including by ensuring short-time work schemes and flexible working arrangements.	1) **Substantial implementation.** According to labour market figures, the economy showed some resilience due to the measures taken to offset the consequences of the crisis including by subsidising wages and/or social contributions. Additional income support was provided to people in vulnerable situations and low-income people. The business organisations are involved in the design of the measures.
Increase the capacity of and cooperation between the Employment Agency and Centres for Social Work to provide integrated services and measures for inclusion in the labour market including training upskilling and reskilling.	2) **Partial implementation**. Cooperation between the Employment Service Agency and the Centres for Social Work has improved, but this cooperation should be further strengthened and implemented in a systematic way. EU financial support to the Employment Service Agency supports measures to encourage unemployed people to find work. However, the mentoring and psychosocial support services of these measures have not yet been set up. Services to provide training to the unemployed are currently being implemented.
Ensure adequate and sustainable funding to strengthen the health care sector with an aim to improve access to quality public health care for all citizens.	3) **Substantial implementation.** The health sector was prioritised by the government in 2020. This is reflected in health expenditure. Health expenditure was 5.0% of GDP in 2019, but is estimated to have increased to 8.5% of GDP in 2020. It is planned to account for 5.8% of GDP in 2021, and set to increase to 8.0% of GDP by 2060. The 2021-2025 public investment plan focuses on capital investments, including in health. The plan also focuses on increasing wages in the health sector to stem the decline in numbers of specialised health workers. According to the World Bank, social and health support was well targeted during the pandemic. In the future, North Macedonia should give higher priority to healthcare by appropriate allocation of staff and money to the preventive policies and primary healthcare. This can be achieved by introducing hospital procedures that require shorter stays in hospitals, and by diminishing/ending unnecessary referrals and hospitalisations.

3.6. ASSESSMENT OF THE OTHER AREA/SECTOR AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2021-2023

Business environment

Structural weaknesses in the business environment continue to be an obstacle for domestic companies even though North Macedonia is ranked 17 out of 190 economies in the latest World Bank *Doing Business 2020* report. Informality and the quality of education of the work force are among the top concerns reported by businesses (BEEPS VI, 2019). The absence of civil servants from their posts, because of the pandemic has made the public administration less responsive to businesses. There is a need to make the regulatory environment more predictable, tackle widespread informality, streamline para-fiscal charges and improve the efficiency of the workplace-inspection system. An effective and independent judicial system is a prerequisite for creating an environment that is investment- and business-friendly. Effective measures to further strengthen the rule of law, ensure adequate and timely contract enforcement and decrease corruption could benefit the business environment and overall competitiveness. There is also a need to further promote the skills needed to develop innovation and entrepreneurship, support women's entrepreneurship, simplify business survival and bankruptcy procedures. It is also necessary to monitor the cost-effectiveness of business-support schemes and ensure the coordination of different programmes. . Further digitalisation in public administration in particular streamlining company registration and the provisions of licenses and permits by consolidating the services under one-stop-shop could help to ease doing business. The Public consultation about complex policies and laws relevant for business operation were reduced due to the pandemic. These consultations will need to be restored and intensified.

Measure 9: "E-marketplace for low-value procurement"

This measure is rolled over from last year. It aims to develop an online market-place for low-value procurement and to professionalise civil servants working with public procurement. This measure follows on from the new public procurement law, which has been in force since April 2019. The law aims to harmonise the legal framework for public procurement with the 2014 EU Procurement Directives. It is expected that the measure will help to increase transparency and predictability on the market by publishing public procurement plans electronically and well in advance. The number of bidders per tender is also expected to rise, in particular bids by SMEs. However, the potential effects of these developments have not been sufficiently elaborated upon nor quantified. The risk identified for implementing the measure is perceived as high, but no mitigating measures have been suggested. The financial sustainability of the measure is not described. No budget is provided for 2022 and 2023.

Measure 10: "Streamline the use of para-fiscal charges"

This is a newly introduced and a very relevant measure, related to the policy guidance 5 of the May 2020 Economic and Financial Dialogue between the EU and the Western Balkans and Turkey. North Macedonia decided to use a phased approach in elimination of para-fiscal charges. The measure envisages the assessment of 377 para-fiscal charges that were identified in 2020, conducting further elimination, remodelling or streamlining, or proposing their optimisation and digitalisation. The methodology for further rationalisation of para-fiscal charges for SME's is not elaborated and will be established after the 377 charges are screened and optimised. The reason for such a reversed order is not elaborated though it could be linked to swift reduction of some para-fiscal charges. North Macedonia's chambers of commerce have indicated that businesses do not necessarily object to para-fiscal charges but would like to know what they are used for. Measure 10 could therefore also seek to clarify the rationale for these charges. The government could further elaborate on the impact these para-fiscal charges have on competitiveness.

Measure 11: "Support start-ups and SMEs in selected less-developed regions of the country to grow, produce added value and create a local living economy"

This is a newly introduced measure. It is very relevant and is linked to the key challenge of competitiveness in domestic companies and the integration of domestic companies into global value chains. The measure does not tackle regulatory issues related to the business environment. Instead the measure is related to the implementation of a project that is funded by the IPA and implemented by an external partner. This means that the implementation of the action is not under the control of the government. To encourage businesses, the measure should have included regulatory changes benefitting purpose-oriented start–ups and SMEs, focusing on green-economy and women entrepreneurship. The part of the impact assessment for this measure that deals with competitiveness is rather generic and should consider adding quantitative information.

Measure 14: "Broadening the scope of digital services provided on National E-service Portal"

This measure is also rolled over from the previous year and has been implemented for several years. It is relevant for reducing costs and time spent in dealing with the administration . It is therefore important for improving the overall business environment and the ease of doing business. Although e-services for individuals have progressed, e-services for businesses have not yet been sufficiently developed. There are currently127 services provided by administrative bodies that are accessible online in the portal. However many business-related services offered by individual institutions (such as the central register, the tax authority, the agency dealing with land and property)are not yet linked to the portal. Of the 127 e-services only 50 provide for fully electronic interactions, while more than 80 services merely redirect to the web-site of the respective institutions, where the level of digitalisation of the service depends on the IT development of the institution. The measure elaborates well on its purpose, timeline, impacts, and on potential risks affecting its implementation. These risks stem from the inefficient coordination and communication between state institutions, lack of IT human resources and lack of commitment at operational level. Those risks could significantly challenge the measure's implementation and should be clearly monitored and counteracted by mitigating actions. The indicators used to measure implementation of measure 14 are those set in the IPA monitoring scheme. A large-scale, EU-funded project to upgrade the e-services portal with 135 new services for companies and businesses started in August 2020.

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

North Macedonia's average innovation performance remains below 50% of the EU average. The European Innovation Scoreboard 2020 also assesses the country as a 'modest innovator'. Investment in research and innovation remains low at 0.36% of GDP. Private sector participation is negligible but slightly improving at 0.1% of GDP. There is a need for closer cooperation between academia and the private sector. The country performs poorly in public-private co-publications, private co-funding of public R&D expenditures, design applications, and sales of new-to-market and new-to-firm product innovations. The government's support for R&D&I in2020 was provided mainly through State-aid schemes implemented by the Fund for Innovation and Technology Development. In particular, increased support was given to research and innovation activities in initiatives linked to the response to COVID-19. The impact of this financial support on private-sector R&D remains to be evaluated. It is also important to ensure that the funding provided is distributed in a more transparent manner and accompanied by proper monitoring and an evaluation of the results. The country's annual participation in the Horizon 2020 framework programme is increasing. However, North Macedonia's performance in the programme remains below its potential and the overall success rate of 11.4% is below the average success rate of 15.8%. In 2012, the government adopted an integrated research and innovation strategy covering the whole innovation value chain from basic research to business innovation. However, this strategy now needs to be updated. The smart-specialisation strategy, which is expected to replace an existing competitiveness strategy, is still being developed.

Measure 13: "Enhancing cooperation between the academy and the industry"

This measure is rolled over from last year. It includes two sub-measures: (i) further development of the science technology park (STP) and (ii) grants to increase cooperation between academia and industry. The STP is planned to be a complex organisation offering professional business support and innovation services to increase both innovation, and networking possibilities at national level. The facility was formally established within the State university in Skopje, and some funding was secured for its initial operation. However, the government has not yet explained what specific fields of operation and specialisation the STP will have. A balanced public-private structure for ownership and management, with initial public funding, is a preferred model for operating a life-science park. However, measure 13 does not mention whether potential private investors have been found. This measure could benefit from activities going beyond the establishment of the STP, for example encouraging industry to provide advice to universities on areas of research that would be beneficial for certain sectors of the economy. Increased possibilities for private-sector funding of research and innovation would also be beneficial.. Overall, there are no detailed plans on activates under this measure.. The government has also not quantified the measure's expected impact on competitiveness, while the measure's impact on employment and gender has been insufficiently considered. Some activities on this measure should have already begun in 2020. However, due to the pandemic, State resources were diverted to COVID-19 assistance measures to private companies and the public. There is therefore a degree of uncertainty whether the State budget will have funds to finance this measure in 2021. The government has also not quantified the measure's expected impact on competitiveness, while the measure's impact on employment and gender has been insufficiently considered. Some activities on this measure should have already begun in 2020. However, due to the pandemic, State resources were diverted to COVID-19 assistance measures to private companies and the public. There is therefore a degree of uncertainty whether the State budget will have funds to finance this measure in 2021.

Digital economy

The digitalisation of the economy has proven to be particularly relevant in the context of the COVID-19 pandemic. The country's Association for e-Commerce reported that the value of online transactions made between the public and domestic online traders in the second quarter of 2020 increased by 177% compared to the same period in the previous year. Further digitalisation is still hampered by the relatively high cost of digital services and by the low level of digital skills in the population. The share of the population with internet access (mobile and fixed) in 2019 reached 83.65%. The National Broadband Competency Office was set up according to the European model of gathering experts in the field tasked with an advisory role to national and regional authorities on broadband investments in the country. The national operational broadband plan aims to provide the measures to: (i) improve national broadband connectivity; (ii) assess future public investments in broadband areas where there is no commercial interest in providing broadband; and (iii) develop 5 G technology. In 2019, the country adopted legislation to facilitate the use of electronic identification at national level and foster the use of e-signatures. E-signature is currently limited to a few institutions that provide services to businesses, even though the equipment and software for e-signature has been widely installed. However, the legal framework in electronic communications still needs to be aligned with the EU *acquis*. The 2018-2022 national cybersecurity strategy addresses the country's challenges in cyberspace and fosters the development of a safe, secure, reliable and resilient digital environment. However, further efforts are needed to address shortcomings such as: (i) fragmented cybersecurity protection among institutions; (ii) inadequate cooperation with the private sector; and (iii) the need to improve the legal framework. Digital literacy is one of the education strategy's priorities, while a specific strategy is being drawn up to address digital skills. The government has organised campaigns to inform the public on how to use e-services. An analysis across all of the country's public institutions demonstrated shortages of qualified ICT staff. This analysis recommended the development of policies to retain existing ICT staff and attract new staff with the necessary ICT skills.

Economic integration performance

Before the negative impact of the COVID-19 crisis, the economy had a high and growing degree of trade openness. The total value of trade in goods and services amounted to 132% of GDP in 2019. In 2019, exports and imports grew by 10.3% and 9.6% respectively. Import coverage by exports stood at 76.9% in 2020, with the merchandise-trade deficit amounting to 17.4% of GDP. Before the detrimental effect of COVID-19 on trade, the trade deficit had been falling for several years, leading to a narrowing in the current account deficit and easing the pressure on the exchange rate. The EU remains the country’s main trading partner. Before the disruption caused by the COVID-19 crisis, total bilateral trade with the EU increased by a further 8.9% between 2018 and 2019. In 2019, total bilateral trade with the EU exceeded EUR 10.5 billion or 70.2% of total trade. In 2019, the country’s second largest partner was the group made up of the CEFTA parties (10.1% of total bilateral trade in 2019). By country, Germany, the United Kingdom, Serbia, Greece and Italy were North Macedonia’s biggest trading partners in 2019. 95.6% of products from North Macedonia can access the EU market without customs duties. The export product mix had been improving in years before the COVID-19 pandemic. The share of iron, steel, and clothing in total exports remained stable (17.4% in 2019, the same percentage as in 2018, although this has dropped from 33.3% in 2013). However, there was a further increase in the exports of chemicals, machinery and transport equipment (this category accounted for 57.2% of exports in 2019 compared with 32.8% in 2013). The key import products are platinum and platinum alloys; petroleum oils; other metals and alloys; and flat-rolled iron products. Exporting companies, notably SMEs, still face key obstacles to trade. These impediments are due to non-tariff barriers, including technical standards and administrative obstacles. The insufficient quality of logistics is an impediment to further increases in exports. In 2018 the World Bank’s logistics performance indicator ranked North Macedonia 81st out of 160 countries (World Bank, 2018). The Economic and Investment Plan and deepening the regional integration of the common regional market both have the potential to further increase trade and enable competitiveness and growth.

Measure 15: “Trade facilitation”

This measure is continued from the previous year. It is relevant as it refers to the implementation of CEFTA Additional Protocol 5 on trade facilitation. This additional protocol includes a number of activities to simplify and speed up procedures conducted by different agencies present at the border, in particular by improving the electronic exchange of information. To this end, the countries of the CEFTA region are expected to continue using the functionalities of the SEED+ system. The possible inclusion of Moldova in the system, administered by CEFTA, will enable all CEFTA parties to be integrated and participate in the exchange of pre-arrival information on shipments. Activities to extend the concept of authorised economic operators are continuing. These activities are also expected to reduce the time spent on customs clearance and speed up the movement of goods across borders. The ERP provides a good quantitative assessment of the expected impact of measure 15 on competitiveness.

Measure 16: “Facilitating North Macedonia-Serbia cross-border crossing”

This measure is related to Measure 15, but it focuses specifically on setting up a joint rail station on the border between North Macedonia and Serbia at the Tabanovce/Presevo crossing. At present, checks by the relevant agencies (police, customs, veterinary agencies and phytosanitary agencies) are carried out twice by the relevant services of the two countries. The construction of the new joint facility will house the services of both countries in a single, energy-efficient building. This will enable faster checks and joint conduct of the necessary procedures, thus speeding up the flow of passengers and goods. It will also provide an opportunity to carry out checks while the train is moving. The proposed timeline of 2021-2023 for the proposed activities seems realistic. Nevertheless, the entire process is clearly delayed, as the agreement to set up a joint border crossing between the two countries was signed in 2015. The description of the measure indicates that it would increase the competitive advantage of rail compared to road transport, although the description does not quantify this increased competitive advantage. Savings created by the measure are expressed only in time saved per train. The measure's possible adverse effects on other means of transport (notably road) are not considered. In addition, the possible benefits on the environment from the reduced carbon footprint of rail transport compared to other means of transport is not considered. The description includes a risk analysis and presents appropriate mitigating actions.

Measure 17: "Strengthening the internal market in the Republic of North Macedonia"

This is a new measure in the ERP. It is relevant for the planned country reforms in the area of internal market and further inclusion of the country in the European single market as indicated by the Economic and Investment plan. The measure is expected to improve the country's position by harmonising its legislation with that of the EU in the area of free movement of goods, free movement of services, and market surveillance. This measure is implemented with the support of the IPA-funded project to strengthen market surveillance in 2021-2023. It marks a significant start of reforms in this area after a long period of inactivity. The measure's expected impact on competitiveness and environment, which is only described in general terms rather than with a clear focus on quantitative targets, could be improved further.

Energy

The economy is characterised by high energy intensity, inefficiencies in the ageing energy production system, persistent high dependency on coal, and inefficient energy consumption. These four characteristics of the economy all exacerbate air pollution. Domestic energy production is dominated by fossil fuels. According to the latest available data, 39.43% of gross energy consumption in 2019 was covered by domestic production, while 60.57% was imported. On energy consumption, oil accounted for the largest share at 51.41%, followed by electricity (27.58%), biomass (10.08%) and coal (5.98%). For final electricity consumption, 72.19% was covered by domestic production, while 27.81% was imported. Domestic electricity production in 2019 relied heavily on lignite (41.95%), followed by hydropower (16.86%), gas (10.81%), wind (1.48%), biogas (0.78%) and solar (0.33%). On infrastructure investment, the country continues to construct several sections of gas pipeline. The 2018-2040 national energy strategy was adopted and it properly reflects the main challenges in the energy sector. However, the national energy strategy should now be harmonised with the national climate strategy by taking into account the commitments under the Paris Agreement on Climate Change. The government should also adopt a programme to implement the energy-development strategy. North Macedonia should benefit from further regional integration in energy and further liberalisation of the energy market. The country's electricity market is now open, and the regulation of wholesale and retail prices has ended. The overall percentage of electricity consumption provided on the open market in 2019 was 49.13%. The country has adopted the new balancing rules. In line with the Economic Investment Plan, the Commission will support the development of renewable energy sources and less-polluting energy sources that will secure energy supply in line with the commitments of the green agenda for the Western Balkans.

Measure 1: "Increasing the competitiveness of the electricity market"

This measure is rolled over from the previous year. It aims to set up a more liquid and better-organised electricity market to allow more competition in energy supply for the benefit of customers. The measure will also stimulate cross-border regional-market integration and connectivity. The measure can also be seen as part of the EU's decarbonisation policies, the Green Deal, and the Economic and Investment Plan. The measure could potentially have a significant impact on the economy, as lower energy prices might make the country more competitive. However, the potential impact – either on vulnerable households or on any economic sectors – has not been quantified. The environmental impact assessment of the measure should be strengthened. Significant potential risks related to the implementation of the measure are sufficiently elaborated upon and should be clearly monitored. Other goals should also be considered, such as the need to revitalise the old, electricity-producing infrastructure.

Measure 2: "Promotion of renewable energy sources"

This measure is rolled over from last year, when it was presented together with a measure to improve energy efficiency. It will help diversify energy generation, and improve the security of energy supply. This is expected to benefit the economy by lowering electricity costs and creating green jobs. The measure includes both regulatory aspects (including the adoption of the law on biofuels) and activities to build power-generation capacity. The introduction of the 'prosumer' concept has not been adequately developed and lacks quantification. Following the comments received from the Energy Community Secretariat on the draft national energy and climate plans, the government should reconsider its schemes to support the deployment of renewables. In particular, it should reconsider its schemes for small hydropower facilities, and ensure that the incentives it provides do not favour specific renewable energy resources that either do not require support or have disproportionate environmental impact. The description of the measure does not discuss or quantify any impacts on competitiveness, social outcomes, employment, or poverty reduction.

Measure 3: "Improvement of energy efficiency"

This measure is also rolled over from last year. However, unlike last year it is now presented separately from the measure on promoting renewable energy sources. A refurbished and improved building stock will help pave the way for a decarbonised and clean energy system. This is because the buildings sector is one of the largest energy consumers, and is responsible for a significant share of greenhouse-gas emissions and air pollution. Renovation of both public and private buildings is an essential measure in this context, and has been singled out in the European Green Deal as a key initiative to drive energy efficiency in the sector. The description of the measure does not capitalise on the importance of the measure. The environmental impact, which could be particularly relevant for this measure, was not sufficiently presented and lacks quantification. Impact assessments on economic and social outcomes were also not sufficiently elaborated.

Transport

The transport market remains concentrated on road transport, with limited investment in other means of transportation and with no consistent, intelligent system to manage and control transport traffic. Road maintenance is handled by state companies that are not fully efficient, operating with old equipment. In 2020, the transport sector's contribution to gross value added was 3.5%, which is lower than the EU average level of around 5%. The country's integrated road transport system is deemed to reduce travel time by 17% and road fatalities by 16.6%, benefiting trade flows and the economy (ERP, 2021). The World Economic Forum's *2019 Global Competitiveness Report* ranks the country 84th out of 138 economies for transport infrastructure. Although better than some other peers, North Macedonia still struggles with relatively low-quality transport infrastructure, as well as weak trade and transport logistics. These problems present barriers for foreign companies wanting to invest in the country. They also cause difficulties for domestic companies. The flagship policy of the Economic and Investment Plan will be to further develop the Trans-European Transport Railway Corridor VIII, directly linking North Macedonia, Albania and Bulgaria. This corridor will give the country's companies an alternative export option via Albanian and Bulgarian ports. North Macedonia would also benefit from the opening up of the rail-transport market – at least for domestic and regional firms. The fatality rate in traffic accidents is high at 32% above the EU average. This is why the government is finalising the process to create a lead road-safety agency to ensure a coordinated and comprehensive approach to road safety.

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

This measure is rolled over from the previous year. The ITS should be put in place along Road Corridor X, which is a strategic objective of the 2018-2030 national transport strategy. The ITS-related measures along Corridor X are currently being carried out without a specific ITS strategy, although there are now plans to draw up an ITS strategy. The measure will help to improve the safety of road transport and ease traffic flow along Corridor X. It is unclear how the measures will influence travel time along the corridor, given that the main bottlenecks are at border crossings and toll stations, the numbers of which have significantly increased in recent years. The measure states that its expected economic impact is a reduction in the time it takes to travel to border crossings, but the description of the measure should further elaborate how ITS will directly influence this indicator. The measure's full potential impact on competitiveness and growth cannot be fully determined, given the description's insufficient analysis and its lack of any estimate for savings (in cost and time). Apart from improving the measurement of greenhouse-gas emissions along the corridor, the possible environmental impact of rolling out the ITS and having an ITS strategy in place has not been analysed.

Agriculture

The agricultural sector is characterised by highly fragmented agricultural holdings that are mostly privately owned (80%). It is also characterised by insufficient use of modern technologies. In 2019, agriculture's share of GDP dropped by 0.5 pps., and it now accounts for nearly 8% of GDP. Employment in agriculture also declined in 2019 to 13.9% of total employment (slightly higher than the EU average of about 10%). According to the latest farm-structure survey (2016), an average agricultural holding in North Macedonia uses 1.8 ha of agricultural area and breeds 2.1 LSUs (livestock units). The average farmer cultivated 1.5 ha of land, which is less than 10% of the size of the average farm in the EU-28 (16.1 ha). The size of property holdings and their highly fragmented nature significantly curbs productivity, as it prevents economies of scale and hampers investments in modernisation. Exports of agri-food and fishery products account for 9.72% of total exports (EUR 624.5 million versus EUR 6.42 billion in 2019). Imports of agri-food products in 2019 accounted for 9.89% of total imports (EUR 837.15 million versus EUR 8.46 billion). Although the trade deficit in the agri-food industry decreased by 13.8% in 2019 compared with 2018, the sector is still considered to have weak competitiveness. Agricultural subsidies per hectare (estimated at between EUR 340 and EUR 380) are above the EU average (estimated at below EUR 300 for the EU-27). Subsidies remain linked to production, and are implemented via a very complex administration scheme.. There needs to be a stronger link between agricultural policies and other sectoral policies such as those on trade, education and SMEs. Several actions could be taken to increase productivity through innovation and the application of modern technologies. These actions include: (i) investing in the skills and know-how of agricultural workers; (ii) strengthening the agriculture advisory services; and (iii) connecting agriculture with research, education, and tourism.

Measure 5: "Improving the irrigation system"

The measure is rolled over from the previous year. It continues to target capital investments in: (i) the construction of multipurpose dams; and (ii) the expansion of regional hydro systems. This measure gives very little attention to investments in small-scale irrigation systems. In addition, the ERP does not address actions addressing the regulatory framework so as to improve the role of water users in managing small-scale irrigation schemes. The measure also does not consider progress in adopting appropriate pricing methodologies, even though this is crucial for the sustainability of investments in irrigation. The description of the measure also fails to include information on: (i) the budget of the public water-management company for maintaining the irrigation systems; and (ii) the revenues collected from irrigation users. There is also a lack of information on the private investments made by farmers to make irrigation technologies more environmentally friendly and reduce water use (e.g. drip-by-drip, water wells, and boreholes). The description of the measure also does not mention synergies with other structural measures such as agricultural cooperatives. The quantitative information in the description referred to the construction of nine irrigation systems but these are not mentioned in the narrative part of the description. The impact assessment is generic and does not include sufficient quantitative information.

Measure 6: "Consolidation and defragmentation of agricultural land"

This measure, rolled over from last year, is still relevant as it aims to reduce the excessive fragmentation of agricultural land by consolidating small parcels in larger units suitable for modern and efficient agriculture. Abandoned and state-owned land should be considered under the measure (it is not considered under the measure at present) and if needed incorporated in the regulatory framework. The ERP contains quite specific information on: (i) the land-consolidation areas which are undergoing land consolidation; and (ii) the planned phases of land consolidation. Actions to incentivise voluntary land consolidation by groups of farmers are still missing from the measure, even though voluntary land consolidation is considered crucial for the sustainability and expansion of land consolidation. The description of the measure contains budgeted estimates of capital investments involved in the process. Risks are well identified in the measure, but no mitigation measures are mentioned. The role of the municipalities has proven crucial to consolidate land. However, land-consolidation processes remain deeply centralised, and some degree of decentralisation should be considered to complement the mandate of municipalities planning the rural and urban spaces in their territories.

Measure 7: "Agricultural cooperatives"

The measure to support associations of farmers in agricultural cooperatives remains relevant, as it addresses a key challenge faced by the agricultural sector due to the small size and fragmentation of farms. This measure is rolled over from previous years but there has still been only limited progress in its implementation despite the support provided through national and IPA funds. The measure now takes into consideration the Commission recommendation to link the measure to the alignment process with EU law on producer groups and common market organisations. The government has now set up constructive cooperation between the activities under this measure and the activities supporting the Common Market Organisation in North Macedonia. Although progress was made in preparing the relevant legal framework, there has been a serious delay in adopting both the Law on Agriculture and Rural Development and the relevant secondary legislation. The reform is consistent with other related measures in the ERP, but expectations are low that young farmers – and young female farmers in particular – will become involved in the coming years. This is mainly due to the lack of motivation among farmers to be part of a cooperative. There should be a more active national campaign to increase farmers' interest in agricultural cooperatives. The expected impact of this measure on competitiveness, employment and gender needs to be considered more, and the impact of the measure could be further quantified.

Measure 8: "**Farm road (re)construction"**

This measure is new. The description of the measure should have explained in more detail the specific impact of rural roads on overall agricultural development. The impacts of road construction in rural areas may be positive in increasing market-prices for farm produce, increasing the size of farms, and encouraging greater adoption of modern farming techniques. Given the lacking impact assessment, it is unclear whether this measure is to be considered as an economic reform for the agriculture sector or if it has social relevance to improve quality of life in rural areas. The description of the measure should elaborate further on the prioritisation of the measure's locations. More clarity is needed on who is responsible for implementation, and further explanation is needed on how the relevant ministries will be involved at the different stages of the works.

Industry

The main obstacles to competitiveness in North Macedonia's industry include: (i) low productivity and the slow growth rate of productivity; (ii) limited modernisation of production processes and obsolete technologies caused by insufficient public and private spending on research and innovation; (iii) insufficient development of clusters of businesses; and (iv) a significant skills gap. The industrial sector contributed 24.6% of the economy's gross value added and 30% of jobs in 2019. In 2019, industry's share of higher-value-added manufactured goods (machinery and equipment, chemical products) rose at the expense of basic goods (iron, steel and clothing). This was mainly due to the activities of foreign companies. Nevertheless, in 2019, domestic companies in these sectors contributed an increasing share to total exports. The level of cooperation between universities and the industrial sector remains very low. Low levels of skill among workers also hinder productivity: the average manufacturing and services worker is on average only 25% as productive as their counterpart elsewhere in Europe and central Asia (World Bank, 2018). Linkages between domestic industry and international production chains remain insufficient. However, like elsewhere in the world, the transition towards a greener economy brings significant potential in the local market for low-emission technologies and sustainable products. This offers great potential for new activities and jobs in North Macedonia. The Economic and Investment Plan has productive investments based on circular-economy principles. This plan could significantly foster sustainable production and consumption in North Macedonia's industry. Given the importance of manufacturing to the composition of GDP and jobs, additional reform measures in this area should be considered.

Services

According to the latest available data, the services sector accounted for 54% of the country's total employment and 54.06% of its GDP in 2019. The further development of companies in the services sector is hampered by weak entrepreneurial skills and a significant skills gap among employees, particularly in soft skills. Despite the increase in exports of services, they represent only around 26% of the value of the country's export basket, indicating the low competitiveness of companies in this sector. Tourism and transport continue to account for the largest chunk of the country's services exports (40% of services exports) followed by services provided by manufacturing companies (25% of services exports). Services provided by manufacturing companies have significant potential for growth because their development is closely related to the inflow of export-oriented FDI. Close to 25% of service exports are made up of exports in: (i) telecommunications services; (ii) computer, and other information services; and (iii) other business services. There is room for these categories of service exports to grow further.

Education and skills

This sector and the relevant reform measure (Measure 18) are analysed above in Section 4 under key challenge #1.

Employment and the labour market

This sector is analysed above in Section 4 under key challenge #1.

Social dialogue

Social dialogue in the private sector between employers and trade unions remains weak. The commitment of trade unions and employers to strengthen collective agreements also remains weak. The absence of trade-union activities means that few businesses have collective agreements at the company or branch level. Most members of trade unions are in the public sector. The Economic and Social Council (ESC) is actively involved in drawing up relevant legislation before its adoption, but this is limited to legislation drawn up by the Ministry of Labour and Social Policy. The tripartite ESC of North Macedonia (which includes representatives of employers, trade unions and the government) needs to increase its visibility and impact. On funding, the ESC depends on the budget of the Ministry of Labour and Social Policy to finance its activities and secretariat. At the local level, despite some progress in raising awareness on the benefits of social dialogue, the use of the local economic and social councils as an effective tool for formulation and implementation of local employment policies is still very limited.

Social protection and inclusion

The at-risk-of-poverty-after-social-transfers rate stood at 21.9% in 2019 and the Gini coefficient (30.8%) fell compared to previous years. Social transfers, particularly pensions, are very important for keeping people out of poverty. The implementation of the Law for Social Protection, the amended Law for Child Protection, and the Law for Social Security for the Elderly have helped increase social-protection coverage among vulnerable people, especially among households with children. The newly introduced social rights (i.e. the educational allowance, the social pension, and the increased GMA) were expected to reduce the at-risk-of-poverty rate in the country but the effects of these newly introduced rights are not yet clearly visible. In addition, the COVID-19 pandemic has further damaged overall employment prospects in the country, and this will undermine attempts to assess the effects of the reform of the social-protection system.

The process of decentralising social services is still in its initial stage. Although the Law on Social Protection strengthens the powers of the social services, municipalities still do not take sufficient responsibility to carry out their social functions by designing and adopting their own social-protection programmes. Municipalities should improve coordination between the public employment service and other services such as social-work centres, social-service providers, and the health sector. This is another prerequisite for the success of the social reforms package. The social impact of the COVID-19 pandemic has been made less severe by enabling access to GMA for people whose employment ended during the pandemic. This covered more than 3 500 households in 2020. Due to universal health coverage, very few people in North Macedonia report an unmet need for medical care (2.5% in 2019).

Measure 19: “Strengthening the system for social inclusion of the vulnerable categories of people”

Measure 19 provides better-targeted cash transfers and increases the effectiveness of these cash transfers. It also improves the connection between: (i) cash transfers; (ii) measures for ‘activation’ on the labour market; and (iii) the social services**.** This measure is considered crucial for tackling poverty in the country, and is rolled over from the previous year with some changes. The new Law on Social Protection was adopted in 2019 with accompanying bylaws providing the comprehensive legislative framework for social protection in North Macedonia. The bodies that are responsible for implementing, monitoring and enforcing the law should increase their staff numbers and the skill levels of their staff. A system for licensing social services is currently under development. This system will ensure that each provider meets the prescribed standards and requirements for the relevant social service. The measure contains a relevant information campaign, including fieldwork targeting potential beneficiaries, particularly the people in vulnerable situations (Roma and women with children). Increased cooperation between the public employment service and the centres for social work is indispensable for fostering the support and labour activation of employable GMA beneficiaries.

Measure 20: “Strengthening the quality of primary healthcare”

The main goal of this measure is to improve the quality of primary healthcare (PHC) by: (i) reforming the PHC payment model to promote sickness prevention; (ii) drawing up standards; and (iii) reducing use of higher levels of healthcare. The measure contains plans to develop a platform to facilitate appointments and ensure the traceability of health data. On the availability of healthcare, North Macedonia has a well-dispersed network of primary healthcare at the municipal level. Despite 90.3% coverage by health insurance in 2016, data from the EU Statistics on Income and Living Conditions (EU-SILC) show that 20.5% of people in the country have difficulty using healthcare services. This figure is close to the official number of people at risk of poverty, suggesting that most of those who have difficulty in accessing healthcare may also be at risk of poverty. As indicated in the report by the European Social Policy Network on inequalities in access to healthcare in North Macedonia (Gerovska Mitev, 2018), the main weaknesses were in the accessibility and affordability of the healthcare system including: (i) a lack of integration of unregistered/undocumented people within health insurance and healthcare (mostly affecting

Roma people); (ii) the difficulty of using healthcare experienced by specific households and income groups (such as households with three or more dependent children, single persons with dependent children, and households with income below 60% of the median equalised income); and (iii) a high share of out-of-pocket payments (mostly private and informal) that increase the overall health expenditure of households.

3.7. THE 2021 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, 12 July 2021

[…]

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

1. Provide well-targeted and temporary pandemic-related fiscal support to vulnerable households and businesses; provided the economic recovery is well entrenched, foresee in the 2022 budget and the medium-term fiscal plan a gradual return to the pre-crisis primary deficit to GDP ratio. Also with a view to improving the realisation of capital expenditure, reinforce the management of public investment, in line with measures outlined in the related Action Plan. Improve revenue collection and broaden the tax base in line with the Tax System Reform Strategy, including by drafting annual action plans to streamline tax exemptions.
2. Adopt the new PPP law and ensure its efficient implementation, including the development and functioning of the PPP registry. Take the necessary legislative steps for the establishment of the Fiscal Council. Improve transparency and evaluation of firm-level subsidies by setting up a state aid registry.
3. Maintain a strong financial sector regulatory framework in line with international and EU best practices, ensure sound credit risk management, a transparent display of asset quality and adequate provisioning. Further reduce institutional and legal obstacles to swift and effective NPL resolution, including by facilitating out-of-court settlement and modernising the insolvency regime. Safeguard the NBRNM's independence in its key statutory tasks, including in staffing issues, in line with the law on the national bank, and to this end exclude the NBRNM from the scope of the new law on administrative servants.
4. Improve transparency in the adoption and implementation of legislation, particularly by ensuring a timely formal consultation of businesses and social partners on new legislation affecting their operations. Use the list of mapped para-fiscal charges to clarify the public services provided through the proceeds of individual charges and identify those that need to be eliminated, remodelled or streamlined. Continue the digitalisation of public services for businesses and citizens.
5. Ensure high-level political commitment by all institutions relevant for the coordination and implementation of the Strategy and the Action Plan for formalisation of the informal economy. Assess the implementation of the 2018-2020 Action Plan and identify gaps, in particular related to tax policy and administration. Develop and implement the new 2021-2022 Action Plan.
6. Develop a new formula for the financing of the VET system and of higher education with a focus on the functioning of the Regional VET Centres. Strengthen access to active labour market policies, particularly for low-skilled unemployed and people in vulnerable situations. Increase the capacity of and cooperation between the employment agencies and centres for social work to provide integrated services and measures for improvement of inclusion in the labour market.

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

Area/Sector	2016	2017	2018	2019	EU-27 Average (2019 or most recent year
Energy					
Energy imports dependency (%)	58.95%	56.45%	56.68%	N/A	60.62%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	N/A	291.58	265.46	288.99	112.92
Share of renewable energy sources (RES) in final energy consumption (%)	18.04%	19.63%	18.18%	16.81%	19.73%
Transport					
Railway Network Density (meters of line per km^2 of land area)	26.85 [w]	26.85 [w]	26.85 [w]	26.85 [w]	49.0 [(2018)]
Motorisation rate (Passenger cars per 1000 inhabitants)	190	194	200	205	519 [(2018)]
Agriculture					
Share of gross value added (Agriculture, Forestry and Fishing)	10.6%	9.1%	9.8%	9.3%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	16.2%	16.2%	15.7%	13.9%	4.3%
Utilised agricultural area (% of total land area)	49.8%	49.7% [w]	49.7% [w]	49.7% [w]	40.0% (2017, EU-28)
Industry					
Share of gross value added (except construction)	19.7%	20.5%	21.5%	20.7%	19.7%
Contribution to employment (% of total employment)	23.1%	23.3%	23.9%	24.1%	18.1%
Services					
Share of gross value added	61.7%	62.9%	62.5%	63.6%	73.0%
Contribution to employment (% of total employment)	53.1%	53.2%	52.9%	55.0%	70.8%

Business Environment					
Rank in WB Doing Business (Source: World Bank)	16	10	11	10	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	63	60	84	82	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	Up to 37.6%	N/A	N/A	N/A	N/A
Research, Development and Innovation					
R&D intensity of GDP (R&D expenditure as % of GDP)	0.44%	0.35%	0.36%	0.37%	2,2%
R&D expenditure – EUR per inhabitant	20.30€	17.20€	18.8€	19.9€	688.6€
Digital Economy					
Percentage of households who have internet access at home	75%	74%	79%	82%	86% (2018)
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	72%	75%	79%	81%	85% (2018)
Trade					
Export of goods and services (as % of GDP)	50.7%	55.1%	60.4%	62.3%	49.4%
Import of goods and services (as % of GDP)	65.5%	69.0%	72.8 %	76.5%	45.7%
Trade balance (as % of GDP)	-18.5 %	-18.1%	-16.8%	-18.2%	N/A
Education and Skills					
Early leavers from education and training (% of population aged 18-24)	9.9%	8.5%	7.1%	7.1%	10.2 %
Youth NEET (% of population aged 15-24)	24.3%	24.9%	24.1%	18.1%	10.1 %
Formal child care - children aged less than 3 years (% of total)	9.1%	10.3%	8.8%	13.0%	35.3 %
Individuals' level of digital skills (% of individuals aged 16-74 who have basic or above basic overall digital skills by sex)	34%	32%	N/A	32%	56%

Employment					
Employment Rate (% of population aged 20-64)	53.3%	54.8%	56.1%	59.2%	73.1%
Unemployment rate (% of labour force aged 15-74)	23.7%	22.4%	20.8%	17.3%	6.7%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	21.2 pps.	21.9 pps.	21.4 pps.	21.3 pps.	11.7 pps.
Social Protection System					
% of population at risk of poverty or social exclusion	41.1%	41.6%	41.1%	39.9%	20.9%
Impact of social transfers (Other than pensions) on poverty reduction	14.79%	14.29%	14.79%	14.96%	32.380%
Self-reported unmet need for medical care (of people over 16)	2.9%	2.5%	2.3%	2.5%	1.7%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	6.63	6.38	6.16	5.56	4.99

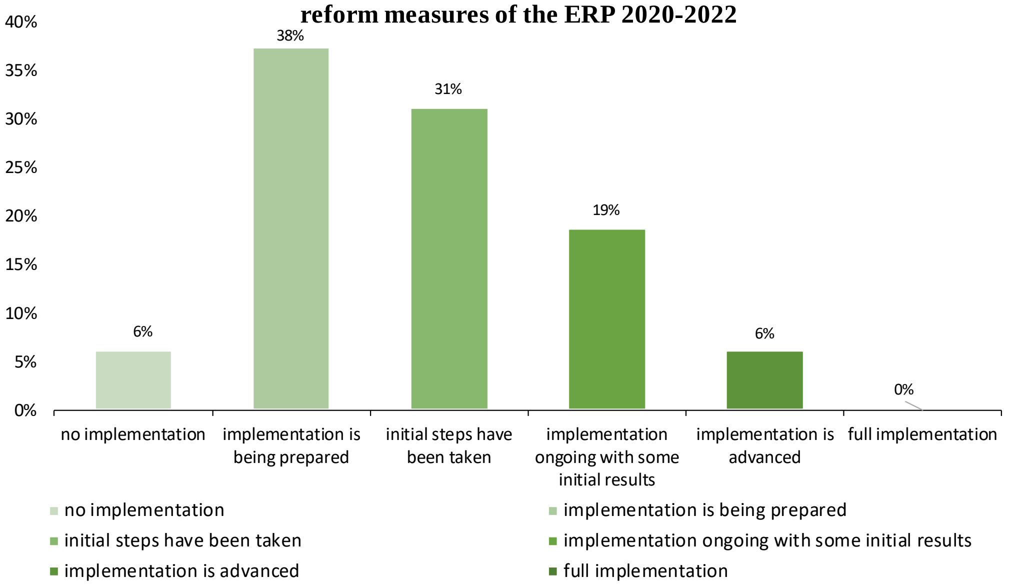
[w]: *data supplied by and under the responsibility of the national statistical authority and published on an "as is" basis and without any assurance as regards their quality and adherence to EU statistical methodology'*

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

ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2020-2022

While tackling immediate impact of COVID-19 pandemic has been a clear priority in 2020, some progress was made in implementing the measures from last year's ERP (average score: 2.21 out of 5). Activity reports provide a mostly accurate description of the level of implementation. The scoring is slightly imprecise for the measures related to agricultural development and social sector. Implementation is stronger for some measures, such as measure 15 on Youth Guarantee and on measure 7 on increasing competitiveness in tourism sector. In contrast, implementation is weaker for other measures, such as measure 12 and 13 related to trade where the implementation is very limited. Implementation of the measure focused at reducing the informal economy has also been limited.

Graph II.3.2: **North Macedonia - Implementation of the structural reform measures of the ERP 2020-2022**



ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government of North Macedonia submitted the 2021-2023 ERP on 29 January 2021. None of its components are missing.

Inter-ministerial coordination

The Ministry of Finance of North Macedonia coordinated the preparation of the ERP and an inter-ministerial working group comprised of several ministries, agencies and other offices were involved in this work. The submitted ERP contains the annex with the list of institutions and individuals involved in the ERP preparation. Upon completion, the government formally endorsed the ERP on 26 January. The coordination process worked well and the attendance to technical meetings was good. On 21 January, Minister of Finance, other relevant ministers and heads on institutions presented the reform measures included in the final version of the 2021- 2023 Economic Reform Programme to the EU Ambassador.

Stakeholder consultation

The draft of the 2021-2023 ERP's structural reforms was posted on the Ministry of Finance's website for 15 days before 21 January. Interested parties were also invited to send written contributions. On 15 January 2021, the draft 2021-2023 ERP was discussed in a session of the Economic and Social Council. Comments and suggestions received in writing are attached as an annex to the ERP.

Macroeconomic framework

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

Fiscal framework

The ERP is based on the latest budget projections following the latest budget revision and on the fiscal data available at the end of the third quarter of 2020. In line with the revised economic growth assumptions, the ERP has raised the deficit projections, compared to previous year's program. It includes: (i) information on the expected budgetary impact of new policy measures; (ii) an analysis of the budget balance's sensitivity to lower GDP, lower revenue, and higher expenditure growth; (iii) an analysis of public debt's sensitivity to changes in interest rates and exchange rates; and (iv) a short assessment of the long-term sustainability of public finances based on a number of assumptions, including population ageing. The external debt analysis refers to stress tests for shocks to the primary current account and to economic growth. These stress tests would have benefited from more detail on the impact of individual debt-creating flows and from alternative scenarios.

Structural reforms

The chapter on structural reforms follows the ERP guidance note. More efforts are needed to quantify the impact for each measure and turn the ERP into a more policy relevant document to guide economic reforms. The description of the implementation risks and mitigation measures has improved. The ERP includes 20 measures and exceeds the page limit. The government has not included any measure on the industry and services sectors though it is a very relevant component in terms of share of GDP and employment, however it has included the analysis of these sectors. The measure on strengthening the quality of primary health care is also prioritised reflecting the emerging needs of COVID-19 pandemic. Tables 9-11 in the annex are properly completed. The implementation reports of the 2020-2022 ERP's policy guidance and Table 11 in annex are well prepared. The scores attributed mostly reflect the implementation level. Contributions received during the consultation process with external stakeholders were annexed to the document.

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4. SERBIA

4.1. EXECUTIVE SUMMARY

After a relatively mild economic contraction in 2020, the economic reform programme projects a strong rebound in 2021 and growth at pre-crisis rates thereafter. The COVID-19 crisis led to only a mild contraction of the Serbian economy in 2020, mostly driven by lower private consumption, net exports and investment that were partially offset by higher government consumption and inventories. Serbia's economic performance turned out to be among the most favourable in Europe, supported, inter alia, by strong pre-crisis momentum; sizeable and timely fiscal and monetary mitigation measures; the sectoral structure of the economy with limited reliance on tourism; and the relatively low average stringency of containment measures. In a rather optimistic scenario, the economic reform programme (ERP) projects a remarkably strong rebound of the economy by 6% in 2021 before returning to the pre-crisis rate of expansion of around 4% in 2022-2023. Growth is expected to be broad-based, driven by private consumption, investment and exports. As elsewhere, the projected strength of the rebound in 2021 is subject to high uncertainty regarding the protracted impact of the pandemic, especially in Serbia's main trading partners. The favourable growth projections for 2021 and the two following years also crucially hinge on the projected evolution of net exports that assume further build-up of export capacity. The financial sector has remained stable and credit growth held up, but the lagged impact of the crisis may still worsen bank balance sheets at a later stage.

The fiscal strategy assumes a strong improvement in the budget balance and falling debt-to-GDP ratios starting already in 2021, which however does not yet take account of the recently announced further support measures. As a result of the economic crisis and very sizeable fiscal mitigation measures, the general government deficit increased very substantially to 8% of GDP in 2020. The original 2021 budget aims to substantially reduce the deficit to 3% of GDP, mostly based on non-renewal of the crisis-mitigation measures. However, a recently announced new support package will add another 2% of GDP in temporary, and mostly non-targeted, crisis-mitigation expenditure in 2021, likely triggering a budget revision. The fiscal scenario projects further gradual fiscal consolidation towards a budget close to balance in 2022 and 2023, mainly driven by expenditure growing more slowly than nominal GDP. The debt-to-GDP ratio, which has risen by some five percentage points to around 58% of GDP in 2020, is projected to gradually decline as of 2021 in the ERP baseline. However, the additional support package in 2021 is expected to delay the declining trend by one year. Significant unaddressed gaps in fiscal governance remain, in particular as regards fiscal rules, public wages and State-owned enterprises (SOEs).

The main challenges in these respects include the following.

- **Fiscal sustainability needs to be anchored by a credible framework and supporting reforms.** Serbia has been able to very substantially mitigate the crisis due to available fiscal buffers and is projected to continue to achieve good macro-fiscal results. In view of the protracted uncertainty about the pandemic impact, providing crisis mitigation until the recovery is entrenched seems appropriate, while the plan to gradually return to a budget close to balance is key to rebuilding fiscal space in the medium term. To underpin medium-term expenditure restraint, containing spending on wages continues to be a key challenge. Since overall fiscal performance has been sensitive to the economic and political cycle over the last two decades, a strengthening of fiscal rules could provide more effective guidance for public finances and help institutionalise sound fiscal policies.

- **There is further scope to control fiscal risks and improve revenue administration.** Increased transparency on fiscal risks could also contribute to better addressing them. This concerns in particular state-owned enterprises, whose governance deficiencies and incomplete restructuring and privatisation still represent a substantial risk to public finances. On the revenue side, there appears to be scope for further improvements in the tax administration, in particular as regards electronic fiscalisation and invoicing.

- **Serbia has made notable progress in reducing the regulatory and administrative burden for businesses, but the business environment should be further strengthened by cutting red tape and improving the predictability of the implementation of legislation.** The widespread shadow economy remains a major impediment to the development of a strong corporate sector and the creation of a functioning market economy. Businesses identify corruption and problems in the exercise of the rule of law as key obstacles to investment climate and economic development. Business predictability is negatively affected by the lack of full transparency in the adoption of legislation on business-related matters. Foreign direct investment (FDI) continue to receive generous public support, while other firms, in particular domestic small and medium-sized enterprises (SMEs), are left in a less favourable position. Further efforts are needed to improve the transparency, assessment and prioritisation of public investments.

- **Serbia remains highly dependent on coal and lacks a coherent long-term strategy that combines energy and climate targets.** Serbia's competitiveness continues to be hampered by a polluting and inefficient energy sector that is not properly regulated. Inefficient energy use represents a major concern in the country. Major investments are needed to modernise the country's energy infrastructure and lower carbon emissions. Increased efforts are necessary to diversify supply and Serbia's overall energy mix. The restructuring of state-owned enterprises in the energy sector is facing delays, posing a risk to public finances.

- **School-to work transitions are considerably more difficult compared to the EU average and structural barriers remain to be addressed.** At the same time, the emigration of workers across the occupational spectrum is continuing. The government has adopted fiscal measures to stimulate circular migration but the impact is still limited. The low labour market participation of women remains an issue. Finally, measures to reduce the tax wedge for workers with a low end income have not been bold enough to support wage-led consumption.

The sizeable fiscal and monetary support measures substantially cushioned the economic effects of the COVID-19 crisis in 2020 while the concrete policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2020 has been partially implemented. The authorities have allowed for crisis mitigation via fiscal stabilisers and by comprehensive fiscal support packages. Following a strong increase in 2020, the share of public wages in GDP is projected to decline in 2021 while steps towards a public sector wage system reform have been delayed. The adoption of new fiscal rules has also been postponed by another year due to the crisis. Capital spending has further increased to a record level of 5.4% of GDP in 2020. While the fiscal risk analysis and the monitoring of SOEs appear to have been reinforced within the Ministry of Finance, the precise implications and timeframe of projected savings from implementation of recommendations remain unclear. A strategic document on SOE ownership including restructuring has been adopted. The government provided effective, transparent and non-discriminatory support to businesses affected by the COVID-19 pandemic and ensured cross-sectoral coordination within the government and across public administration to effectively respond to COVID-19. The public consultation process on new legislation remains to be strengthened. Little progress has been made in reducing the high non-wage labour cost of jobs at the lower part of the wage distribution. There were no measures regarding the formalisation of labour in non-agricultural sectors and the funding for Active Labour Market Policies remains insufficient. Job retention schemes were rolled out effectively but there was no activity on expanding access to unemployed compensation schemes.

The ERP is aligned in part with the reform priorities identified by the Commission. The macroeconomic and fiscal frameworks are sufficiently comprehensive and integrated with the overall policy objectives, providing an adequate basis for policy discussions. However, the alternative scenario may seem somewhat too optimistic. The part covering structural reforms remains largely unchanged from the previous year, reflecting delays in implementation. It repeats important reform measures aiming to reduce the administrative and regulatory burden for businesses, but fails to effectively address underlying structural weaknesses in the investment environment. The ERP also lacks ambitious reforms regarding clean energy transition and energy efficiency. The diagnostic presented in the ERP for education, employment and social policies is correct, while the proposed measures in the areas of employment and social protection based on the diagnostics either lack clearly defined objectives or do not remedy the fundamental challenges.

4.2. ECONOMIC OUTLOOK AND RISKS

After a relatively mild annual contraction induced by the COVID-19 pandemic in 2020, the ERP projects a retrieval of the pre-crisis output level already in 2021. The 2020 contraction was the result of decreases in private consumption, net exports and investment that were only partially offset by higher government consumption and higher inventories. The relatively mild contraction reflects a series of mitigating factors: the strong growth by 5.2% y-o-y in the first quarter of 2020; the relatively short duration of the first and most stringent lockdown; the structure of the economy, in particular the low share of tourism; an exceptionally good agricultural season; a sizeable package of fiscal and monetary support measures and the relatively low stringency of new lockdown measures in the second half of the year. The baseline scenario projects that after a strong rebound by 6% in 2021, the economy will retrieve its pre-crisis pace of expansion by 4% annually in 2022 and 2023. Both the rebound and the further steady expansion are expected to be mostly driven by private consumption and gross fixed capital formation and a relatively favourable evolution of net exports. While net exports are expected to significantly subtract from growth in 2021 as domestic demand rebounds (even with a relatively moderate import growth), their contribution to GDP growth is expected to be close to balance as of 2022 as export growth is expected to substantially exceed import growth. After turning negative in 2020 due to the crisis, the output gap is projected to close in 2021 and to remain close to balance thereafter as potential growth and real growth are projected at similar levels. The scenario thus assumes production capacity to have been safeguarded throughout the crisis. The annual unemployment rate decreased slightly in 2020 due to a strong reduction in the months before the crisis and discouraged workers leaving the labour market during the peak of the crisis. It is projected to broadly stabilise in 2021 (when labour market participation is expected to regain lost ground) and resume its pre-crisis downward trend as of 2022.

In a context of high uncertainty, achieving some aspects of the macro scenario appears particularly challenging. The macroeconomic and fiscal outlook continues to be affected by high uncertainty due to the COVID-19 pandemic. In particular, the projected strong rebound by 6% in 2021 in the baseline scenario appears subject to substantial risks. The projected strong increases in investment and private consumption should typically imply a strong growth in imports, which does not seem to be adequately reflected in the relatively low import elasticity underlying the 2021 projection. At the same time, a potentially protracted impact of the epidemic in main trading partners, in particular in the EU, may weigh on the projected strong export rebound. On the other hand, the baseline scenario did not yet incorporate the impact in 2021 of the additional substantial fiscal support package announced in February 2021, which constitutes an upside risk. While for 2022 and 2023 the import elasticity appears closer to the long-term trend, the expected balanced contribution of net exports to growth hinges on a further substantial expansion of new export capacities. As regards potential growth, while FDI inflows, domestic innovative activity and digitalisation may indeed increase the contribution of total factor productivity to potential growth rates, the strong projected increase as of 2020 nonetheless appears challenging in view of the substantially lower pre-crisis track record under similar conditions. This suggests that there is some risk of an increasingly positive output gap over 2022-2023. Real growth might, accordingly, be constrained at some point by limitations in potential growth.

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

	2019		2020		2021		2022		2023	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	4.2	**4.2**	-1.8	**-1.0**	4.8	**6.0**	3.8	**4.0**	n.a.	**4.0**
Contributions:										
- Final domestic demand	6.2	**6.3**	-2.2	**-1.5**	6.1	**6.7**	3.6	**4.0**	n.a.	**4.1**
- Change in inventories	0.4	**0.5**	-0.1	**0.0**	-0.1	**0.0**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	-2.4	**-2.6**	0.5	**0.5**	-1.2	**-0.8**	0.2	**-0.1**	n.a.	**0.0**
Employment (% change)	2.4	**1.8**	-0.6	**0.5**	1.4	**1.2**	0.8	**1.0**	n.a.	**1.0**
Unemployment rate (%)	10.3	**10.9**	9.3	**10.2**	9.6	**10.1**	9.0	**9.2**	n.a.	**8.5**
GDP deflator (% change)	2.4	**2.4**	2.9	**2.9**	2.7	**2.6**	2.4	**2.7**	n.a.	**3.1**
CPI inflation (%)	1.7	**1.9**	1.5	**1.6**	1.8	**1.9**	1.8	**2.3**	n.a.	**2.5**
Current account balance (% of GDP)	-6.9	**-6.9**	-5.8	**-5.0**	-6.0	**-5.5**	-5.2	**-5.1**	n.a.	**-4.6**
General government balance (% of GDP)	-0.2	**-0.2**	-8.9	**-8.9**	-2.9	**-3.0**	-2.5	**-1.6**	n.a.	**-1.0**
Government gross debt (% of GDP)	52.8	**52.9**	61.5	**59.0**	60.7	**58.7**	59.6	**57.9**	n.a.	**56.0**

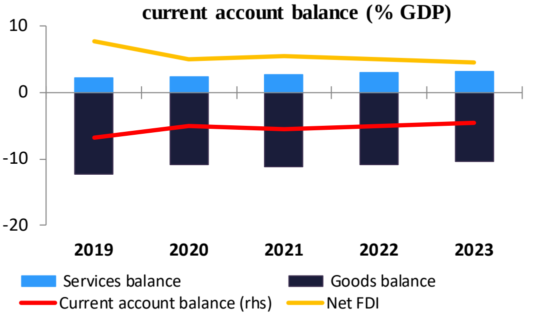
Sources: Economic Reform Programme (ERP) 2021, Commission Autumn 2020 forecast (COM).

The ERP presents a clear and broad view of economic risks and includes a detailed alternative macroeconomic scenario. The programme acknowledges that the risks to the baseline macroeconomic scenario are unusually high, in particular as regards the further evolution of the pandemic and the measures taken to contain it. Risks to the external environment are considered as tilted to the downside in the short term, in particular as to uncertainty impacts on capital flows, lower external demand and higher oil prices, which may however be mitigated by upside risks regarding higher metal export prices, further expansion of export capacities and the effects of the abolition of 100% tariffs on products delivered to Kosovo. Domestic risks are considered to be tilted to the upside on top of the positive baseline of a complete recovery of consumption in 2021, supported by fiscal and monetary support measures that have preserved disposable income and employment. While the further opening up of contact-intensive service sectors will be dependent on the evolution of the pandemic and risks to the agricultural season and investment implementation are seen as balanced, the programme sees some upside risks stemming from reforming public enterprises, in particular in the energy sector. The relatively fast progress of vaccination in Serbia could constitute an upside risk for domestic demand in 2020 that was not yet included in the ERP risk assessment. The programme presents an alternative macroeconomic and fiscal scenario, projecting substantially lower economic growth (only 3.2% in 2021 and 3.0% annually thereafter) and less favourable fiscal performance in the event of prolonged uncertainty regarding the course of the pandemic. This would mainly translate into a slower recovery of exports and investments that would also affect the labour market and private consumption. However, while the alternative scenario very usefully points to the potential magnitude of uncertainty-related risks, the underlying assumptions related to a prolonged pandemic have not been sufficiently specified to allow for a further assessment.

Consumer price inflation has remained low throughout the crisis and is projected to rise only moderately towards 3% in the medium-term. Following a track-record of low and rather stable inflation for seven consecutive years, consumer price inflation averaged 1.6% in 2020, hovering mostly close to the lower end of the central bank's target tolerance band of 3% ± 1.5 pps. As part of a series of monetary measures to mitigate the crisis, the central bank lowered the key policy rate in four steps from March to December by overall 125 bps. to 1.0%. This was accompanied by a series of liquidity-supporting measures to provide dinar and foreign exchange liquidity to the market. These measures also included the purchase on the secondary market of government securities and corporate bonds issued by SOEs To stabilise the exchange rate, particularly in view of some mostly crisis-induced depreciation pressures from February to October, the central bank continued to apply its policy of frequent interventions on both sides of the foreign exchange market, selling a net EUR 1450 million in 2020. The ERP projects inflation to remain in the lower half of the target range, closer to the lower limit, in 2021, assuming relatively low international aggregate demand and inflation combined with the dissipating effect of lower oil prices. Thereafter, inflation is expected to accelerate moderately in 2022 and 2023 in line with the projected domestic and international recovery, while staying below 3%. Overall, the moderate inflation projections appear plausible, in particular as regards domestic drivers, but subject to increased uncertainty as regards imported inflation.

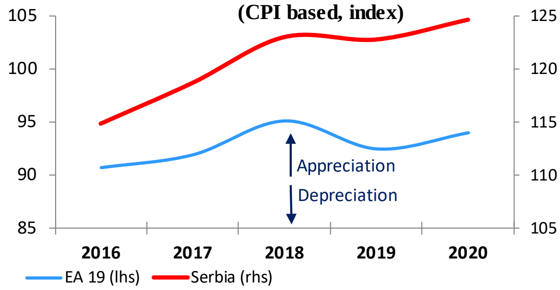
External competitiveness and current account

Graph II.4.1a: **Serbia - Evolution of the current account balance (% GDP)**



Source: Economic Reform Programme (ERP) 2021.

Graph II.4.1b: **Serbia - Real effective exchange rate (CPI based, index)**



Source: Economic Reform Programme (ERP) 2021 and ECB.

Following a substantial decrease in 2020, the current account deficit is expected to widen temporarily in 2021 and gradually narrow thereafter. The current account balance recorded a strong crisis-triggered improvement in 2020, narrowing the deficit to 4.3% of GDP from 6.9% of GDP in 2019. This was mainly the result of a lower primary income deficit (essentially due to lower reinvested earnings) and a lower goods trade deficit (as exports of goods contracted less than imports). These balance-improving factors were partially offset by lower secondary income, mainly corresponding to lower worker remittances. In line with the expected recovery, the ERP projects the current account balance deficit to rise to 5.5% of GDP in 2021 before gradually narrowing to 4.6% of GDP in 2023. This favourable development is expected to be underpinned by an FDI-driven reduction of the merchandise trade deficit, an increasing services surplus, a recovery of workers remittances to pre-crisis levels and a decrease of interest payments due to the lower interest rates. However, growing domestic demand may lead to import growth outpacing at least temporarily export growth, and primary income outflows are set to increase with the rising stock of foreign investment.

Net FDI inflows continue to play a central role for external sustainability and competitiveness. After a record level of EUR 3.6 billion in 2019, net FDI decreased substantially in the crisis context to EUR 2.9 billion or 6.2% of GDP in 2020 (without the EUR 0.4 billion inflow for the privatisation of *Komercijalna Banka* they would have turned out at EUR 2.5 billion or 5.4% of GDP). They thus continued to fully cover the current account deficit. After a rebound in 2021, the ERP projects net FDI to broadly stabilise at EUR 2.7 billion over 2022-2023, thereby assuming a gradual decrease in % of GDP while maintaining full coverage of the current account deficit. FDI inflows are also considered crucial for the continued structural transformation of the economy towards tradable sectors. In view of continued government support to foreign investors, the sustained inflow of FDI appears plausible if macroeconomic stability is preserved and the business environment is further improved. The stock of net FDI has maintained a broadly stable share in Serbia's net international investment position of around 90% despite increased public debt issuance in the crisis. This reduces Serbia's vulnerability to external shocks, notwithstanding the relatively high net foreign liability position which stood at 91% of GDP at the end of 2020 (up by 3 pps. from the end of 2019). The relatively high level of foreign exchange reserve that has allowed for successful cushioning of the crisis impact in 2020 is projected to continue to cover around six months worth of imports throughout the programme lifetime.

The financial sector contributed to cushioning the crisis impact in 2020 while maintaining sound macroprudential indicators. Supported by a series of liquidity-enhancing measures by the central bank and the guarantee schemes set up by the government, the capital adequacy, liquidity and profitability indicators of commercial banks have remained high despite the crisis impact in 2020. Favourable financing conditions and the effect of the three credit moratoria supported credit growth. Lending to households and corporates increased by 11% and 9% respectively which was however largely related to moratorium-related maturity extensions as the volume of newly approved loans decreased at double-digit rates (by around 13% and 20% respectively). A large share of the growth in corporate lending was also not for investment but for liquidity and working capital, which suggests some vulnerabilities. Mainly due to the effect of the first two loan moratoria, the NPL ratio has continued to decline to 3.4% at the end of the third quarter of 2020, before a slight increase to 3.7% at the end of the year following the end of the first two general credit moratoria. There appears to be a risk of some further deterioration of asset quality and other macroprudential indicators due to some lagged effects of the crisis. The state presence in the sector has been considerably further reduced by the completion on 30 December 2020 of the sale of *Komercijalna Banka*, Serbia's third-largest bank by assets.

Table II.4.2:

Serbia - Financial sector indicators

	2016	2017	2018	2019	2020
Total assets of the banking system (EUR million)	36 992	37 676	41 514	46 060	50 820
Foreign ownership of banking system (%)	76.7	76.9	75.4	75.7	86.0
Credit growth	2.5	1.9	9.4	9.1	11.9
Deposit growth	11.4	3.3	15.3	8.5	17.5
Loan-to-deposit ratio	1.00	1.00	1.00	0.96	0.91
Financial soundness indicators (end of period)					
- non-performing loans	17.0	9.8	5.7	4.1	3.7
- net capital to risk-weighted assets	21.8	22.6	22.3	23.4	22.4
- liquid assets to total assets	38.9	35.1	35.7	36.0	37.3
- return on equity	3.3	10.5	11.3	9.8	6.5
- forex loans to total loans* (%)	69.4	67.5	68.5	67.1	64.7

* Includes both denominated and indexed positions.

Note: Data for December 2020 are preliminary.

Sources: ERP 2021, National Central Bank.

4.3. PUBLIC FINANCE

The crisis led to a marked deterioration in the budget balance in 2020 mainly reflecting sizeable fiscal support measures. As a result of the COVID-19 pandemic and the sizeable fiscal support packages to mitigate its epidemiological and economic impact, the general government deficit increased very strongly to 8.1% of GDP in 2020, up from a mere 0.2% of GDP in 2019, and compared to a deficit of 0.5% of GDP in the original 2020 budget. The fiscal support packages with a planned overall fiscal impact of 8.1% of GDP in 2020 (according to the ERP) comprised, inter alia, the deferral of income tax and social security contributions, direct wage subsidy support to SMEs and large companies, limited direct support to the hospitality sector, direct lump sum payments to certain groups and to all adult citizens (see overview table in box below). The approach of offering support to all SMEs seems to have been appropriate and effective for timely implementation of the first package of support, presented in April. A somewhat more targeted approach focussing support on the most affected sectors and companies could have been envisaged for the second package, presented in July. As regards support to citizens, while the undifferentiated equal support to all citizens may have helped timely implementation, also to informally employed people, a stronger focus, e.g. excluding people with the highest formal income, could have more significantly cushioned the crisis impact for the most affected citizens. Compared to the original 2020 budget, total revenues fell short of 1.6% of estimated 2020 GDP, while total spending exceeded the budgeted amounts by 5.9% of GDP. Overall revenue decreased by 1% y-o-y as compared to a planned increase by 2.7% in the original 2020 budget (in relation to 2019 outturn). The most significant revenue shortfalls concerned social security contributions (0.9% of GDP, reflecting deferrals to 2022 and 2023) and VAT (0.6% of GDP, reflecting the contraction of private consumption). As regards the expenditure side, overall spending increased by 17.8% y-o-y, compared to the anticipated 3.5% in the original 2020 budget. The most significant expenditure overruns beyond the original budget concerned subsidies (2.5% of GDP), reflecting crisis-mitigation support to enterprises, other current expenditure (1.4% of GDP), driven by crisis support to citizens, purchases of goods and services (0.8% of GDP), due to higher health spending, capital expenditure (0.6% of GDP), reflecting higher infrastructure investment, and expenditure for employees (0.4% of GDP), including higher wages for healthcare workers. While the increases for the first three expenditure categories are mainly due to the temporary one-off crisis-mitigation measures, the latter category is set to have a more durable character. As a result of the limited estimated increase of nominal GDP by 1.8% of GDP ([29]), the ex-post share of public wages in GDP has risen from 9.5% in 2019 to 10.6% in 2020. The share of capital expenditure in GDP also recorded a further increase from 4.9% in 2019 to 5.4% in 2020. In addition to the measures with direct budgetary impact, the fiscal support packages also included the setting up of a guarantee scheme for loans worth 4.4% of GDP in 2020, bringing the total planned size of the package of fiscal and liquidity-support measures to 12.5% of GDP (see overview table in box below). At a maximum call rate at portfolio level of 30%, the guarantee scheme would entail a contingent liability of around 1.4% of GDP but the ERP estimates related guarantee calls not to exceed a cumulative total of around 0.3% of GDP over 2021-2023.

([29]) Based on the most recent quarterly GDP estimates, the outturn of nominal GDP growth in 2020 may still be somewhat lower at around 0.8%.

Box II.4.1: **Review of the package of fiscal and liquidity-support measures to support the economy and the population in 2020 (planned amounts as of 30 September 2020)**

In % GDP

Tax policy measures	
Deferred payment of payroll taxes and contributions for the private sector during the state of emergency and for one additional month; private companies will repay these obligations in instalments, but not before January 2021	3
Deferred advance payment for the second quarter of 2020 corporate income tax	0.4
Exemption from VAT for all donors	-
Total	**3.4**
Direct support to the private sector	
Direct support to entrepreneurs who pay a flat tax and entrepreneurs who pay real income tax, micro, small and medium enterprises in the private sector - three months of payment of the net minimum wage and two additional months of payment of 60% of the net minimum wage	2.3
Direct support to large private companies - support in the amount of 50% of the net minimum wage (during a state of emergency) to employees who have received a decision on termination of employment (based on Articles 116 and 117 of the Labour Law)	0.1
Direct support to the hotel sector – EUR 350 per bed, EUR 150 per room, in dinar equivalent calculated according to the official middle exchange rate of the NBS	0.0
Total	**2.4**
Measures to preserve private sector liquidity	
COVID-19 financial support programme during the crisis through the Development Fund of the Republic of Serbia	0.4
Guarantee schemes to support the economy during the COVID-19 crisis	4.4
Total	**4.8**
Other measures	
Moratorium on dividends until the end of the year, excluding public companies and loss of income arising from dividends	0.3
Wage increase measures and other direct financial assistance (10% increase in salaries of health workers, direct financial assistance of RSD 4 000 to all pensioners, support to agricultural producers)	0.3
Fiscal incentive - payment of EUR 100 to all adult citizens	1.3
Total	**1.9**
Assessment of the total fiscal impact of the measures	**8.1**
Total package of measures	**12.5**
Other costs related to COVID-19 (medical equipment and medicines)	**-**
Total planned costs related to COVID-19 as of 30 September 2020	**12.5**

Source: Economic Reform Programme Serbia 2021-2023

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

	2019	2020	2021	2022	2023	Change: 2020-23
Revenues	42.1	40.3	40.4	40.5	39.7	-0.6
- Taxes and social security contributions	36.8	35.8	36.2	36.3	35.6	-0.3
- Other (residual)	5.3	4.5	4.2	4.2	4.2	-0.3
Expenditure	42.3	49.2	43.4	42.1	40.7	-8.5
- Primary expenditure	40.3	47.2	41.5	40.4	39.1	-8.1
of which:						
Gross fixed capital formation	4.9	5.2	5.5	5.6	5.7	0.5
Consumption	16.5	18.7	17.7	17.2	16.7	-2.0
Transfers & subsidies	16.7	19.4	16.3	15.8	15.3	-4.1
Other (residual)	2.1	3.9	2.0	1.7	1.5	-2.5
- Interest payments	2.0	2.0	1.9	1.7	1.6	-0.4
Budget balance	-0.2	-8.9	-3.0	-1.6	-1.0	7.9
- Cyclically adjusted	-1.0	-8.1	-3.1	-1.7	-1.2	6.9
Primary balance	1.8	-6.9	-1.1	0.1	0.6	7.5
- Cyclically adjusted	1.0	-6.1	-1.2	0.0	0.4	6.5
Gross debt level	52.9	59.0	58.7	57.9	56.0	-3.0

Sources: Economic Reform Programme (ERP) 2021.

A gradual return to a budget close to balance is a key objective of the ERP's fiscal strategy over the medium-term. The projected reduction of the deficit to 3% of GDP in 2021, 1.6% in 2022 and 1.0% in 2023 is expected to ensure a declining path of the debt-to-GDP ratio as of 2021. The overall planned fiscal stance aiming at gradual return towards budget deficits close to balance and gradually declining debt ratios, after completion of one-off crisis mitigation expenditure measures, appears appropriate to ensure medium-term fiscal sustainability. On the revenue side, most categories are expected to evolve in line with nominal GDP, thus keeping their share of GDP broadly stable over the programme period. The most notable exception to this profile is the 0.9 pps. increase of the GDP share of social security contributions in 2021 (as compared to the 2020 outturn) to be followed by broad stabilisation in 2022 and a 0.4 pps. decline in 2023. This projection corresponds to the deferred 2020 payments postponed to the two following years. Higher revenue from contributions is however projected to be almost offset by a lower estimate for non-tax revenue based on the conservative exclusion of extraordinary non-tax revenues ([30]) for future budget planning (-0.7 pps. drop from the 4.6% of GDP outturn in 2020 to 3.9% of GDP throughout the rest of the programme period). The planned fiscal consolidation is accordingly almost entirely concentrated on the expenditure side, based on the non-renewal ([31]) in 2021 of 2020 crisis-related one-off emergency expenditure and the assumption of expenditure increases below nominal GDP growth for most categories over 2021-2023. Thus the overall share of expenditure in GDP is projected to decrease by a particularly strong 5.5 pps. in 2021, supported in particular by lower subsidies (-2.4 pps.), lower other current expenditure (-1.6 pps.) and lower purchases of goods and services (-0.4 pps.). In view of the particularly high uncertainties and the ensuing potential need for further fiscal support, this substantial planned expenditure decrease in 2021 appears rather ambitious. As already confirmed by the new fiscal support package announced in February, the decrease in expenditure is expected to be more limited in 2021. Social assistance and expenditure for employees are also expected to

([30]) Regular non-tax revenues correspond to various fees, charges, revenues of bodies etc. that are generated at a steady pace during the year with some seasonal variations, while extraordinary non-tax revenues include profits of public companies and agencies, budget dividends, etc.
([31]) The announced partial renewal of fiscal support measures in 2021 will accordingly partially delay the expenditure consolidation by one year (see also the paragraph on the 2021 budget below).

decrease as a share of GDP in 2021 despite nominal increases. The further decrease of the expenditure ratio by around 1.5% and 0.5% of GDP in 2022 and 2023 respectively is also mainly based on expenditure increases below relatively high nominal GDP growth of around 7%. While for social transfers this downward trend is underpinned by the pension indexation formula, the strongly declining wages to GDP ratio does not appear to be backed by concrete reforms that would counter the track record of consecutive increases above nominal GDP growth. Capital spending is the only expenditure category that is projected to gradually increase its share in GDP in 2021 and throughout the programme period from a 2020 outturn of 5.4% to 5.7% in 2023.

In response to the protracted impact of the COVID-19 pandemic, the 2021 budget is going to be amended to accommodate sizeable new fiscal support measures. Mainly based on the non-renewal in 2021 of temporary crisis-mitigation measures taken in 2020, the original 2021 budget planned a surprisingly strong headline fiscal consolidation by around 5 pps. in 2021 to 3% of GDP. The revenue side does not assume major changes to the tax legislation apart from a slight further increase of the non-taxable part of gross salaries from RSD 16 300 to RSD 18 300, thereby slightly decreasing the tax wedge on labour. On the expenditure side, the budget contains a pension increase of 5.9% in line with the indexation rule, and a minimum wage increase of 6.6%. Public sector wages were increased on an ad-hoc basis by 5% for health care workers, and by 3.5% for other public employees in January, to be followed by an additional 1.5% rise as of April, while army salaries are to increase by 10% as of April. Capital expenditure is projected to increase to 5.5% of GDP (following a 5.4% of GDP outturn in 2020), whereas close to half of the capital expenditure is earmarked for road and rail transport infrastructure while around one seventh is to be spent on defence. In view of the protracted impact of the epidemic in the winter 2020/2021, the government announced a new package of fiscal support measures in mid-February 2021 and intends to present a revised budget in spring, allowing for the implementation of the new measures as of April. The new package includes wage subsidies for all companies, lump-sum payments to all adult citizens, sectoral support measures to hospitality and transport companies and enhanced liquidity support via the extension of guarantee schemes. The direct fiscal cost of the package is estimated at around 2% of GDP and would thus mechanically bring the 2021 deficit to 5% of GDP instead of the 3% targeted in the original budget. While continued support appears adequate to preserve production capacity and support citizens as long as the recovery is not fully self-sustained, a more targeted approach tailored to the most affected sectors and groups could have improved cost-effectiveness while saving fiscal space to address potential further needs at a later stage. For instance, the employment safeguard conditionality could have been usefully complemented by measures increasing the employment chances of those unemployed ([32]) and inactive workers. The efficiency of the lump sum payments to provide stimulus to the economy may also suffer from a relatively low fiscal multiplier for recipients with a lower propensity to consume. The sectoral support to the hospitality and transport sectors appears the most efficient way of supporting otherwise solvent businesses until the end of the crisis. The further extension of the guarantee scheme in 2021 should also play an important role in ensuring continued liquidity for businesses until recovery is firmly entrenched. The additional 2021 measures are again temporary, like the previous packages adopted in 2020. Assuming no further need for their renewal, they would accordingly not have an impact on the further budgetary trajectory for 2022 and 2023. As regards transparency, the application of the measures to all companies and adult citizens applying to receive them ensures a high level of transparency and equal treatment in the distribution of the support.

After a sharp rise in government debt in 2020, the ERP aims for a gradual reduction of the debt-to-GDP ratio as of 2021. As a result of the crisis and the mitigating fiscal measures, the general government debt-to-GDP ratio increased by 5.3 pps. to 58.2% in 2020 (0.8 pps. lower than the ERP estimate of 59.0%, mostly due to the 0.8 pps. of GDP lower-than-projected deficit outturn). The increase was mostly due to the primary deficit and interest costs that were partially offset by a slightly debt-reducing effect of nominal GDP growth and negative stock-flow adjustments. The ratio is projected to be on a declining path as of 2021, with annual decline gradually accelerating from 0.3 pps. in 2021 to 0.8 pps. in 2022 and

([32]) An additional measure offering a one-off lump-sum payment of EUR 60 to all unemployed was announced in March 2021.

finally 1.9 pps. in 2023. This trend is to be supported by relatively high nominal growth, a gradual improvement in the primary balance and decreasing interest payments, but it is partially slowed down by debt-increasing stock-flow adjustments, which are not further specified. While the end-2020 starting point of the debt trajectory has turned out more favourable than the ERP projection, the additional fiscal support package announced in February 2021 should mechanically, ceteris paribus, add another 2 pps. to the debt-to-GDP ratio in 2021, which would still keep it below 60% in 2021. Thanks to a favourable fiscal track record in recent years and the building up of fiscal space, Serbia has been able to fully cover its increased financing needs, resulting from the various fiscal support packages in 2020 and early 2021, by tapping international and domestic financial markets and without recourse to IMF or EU financial assistance. The large proportion of foreign currency-denominated debt (70%) however continues to expose government debt to the risk of potentially significant exchange rate fluctuations, as demonstrated by the ERP's debt sensitivity analysis. A sufficiently strong rules-based framework capable of effectively anchoring fiscal policy would be important to reinforce medium-term debt sustainability.

Box II.4.2: Debt dynamics

Serbia

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

	2019	2020	2021	2022	2023
Gross debt ratio [1]	**52.9**	**59.0**	**58.7**	**57.9**	**56.0**
Change in the ratio	-1.5	6.1	-0.3	-0.8	-1.9
Contributions [2]:					
1. Primary balance	**-1.8**	**6.9**	**1.1**	**-0.1**	**-0.6**
2. "Snowball" effect	**-1.5**	**1.1**	**-2.9**	**-2.1**	**-2.4**
Of which:					
Interest expenditure	2.0	2.0	1.9	1.7	1.6
Growth effect	-2.2	0.6	-3.3	-2.3	-2.2
Inflation effect	-1.3	-1.5	-1.5	-1.6	-1.7
3. Stock-flow adjustment	**1.8**	**-1.8**	**1.5**	**1.4**	**1.0**

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

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

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

Source: Economic Reform Programme (ERP) 2021, ECFIN calculations.

The government debt to GDP ratio increased by 4.8 pps. in 2020. The rise was due to the primary deficit and the effects of negative real growth and interest expenditure that were only partially offset by inflation and debt-reducing stock-flow adjustments (including the receipts from the privatisation of *Komercijalna Banka*). Looking ahead, while in 2021 the primary balance will also still have a debt-increasing impact, the stock flow adjustment and interest expenditure will remain the only, albeit gradually diminishing, debt increasing factors throughout the entire 2021-2023 period. High real growth, inflation and the return to a primary surplus ensure the accelerating downward trend of the debt ratio over 2021-2023. Issuing restitution-related debt and fluctuations in government financial assets, not included in the baseline scenario, could also have a significant impact on the debt-to-GDP ratio (of around four percentage points for the financing of restitutions, while sales or acquisitions of financial assets can have both upward and downward impacts).

Fiscal risks are non-negligible in a context of continued high uncertainty. In the short term, the main risk to the achievement of the 2021 fiscal targets (apart from the budget revision due to the announced new support package) appears to be linked to the relatively favourable baseline real growth assumption of 6% in 2021. Even assuming a fast recovery, both domestically and in main trading partners, such a strong rebound appears overly optimistic in light of the European Commission autumn 2020 economic forecast as well as more recent forecasts by international financial institutions. A lower growth outturn would normally entail lower revenues and a higher deficit. On the expenditure side, the additional fiscal support measures announced are already set to increase the 2021 deficit outlook accordingly. Looking ahead, while the revenue projections appear to be relatively conservative in terms of elasticities, the containment of expenditure growth below the nominal growth of GDP does not seem sufficiently ensured for some expenditure categories in view of their track record, i.e. in particular for expenditure for employees and subsidies to SOEs. In view of the importance of fiscal risks stemming from inefficient SOEs, as also highlighted by the ERP's sensitivity analysis, increased transparency and effective implementation of structural reforms in this area would seem crucial to achieve the targeted 0.5 pps. of GDP reduction in subsidies within the next two years. As in previous years, the programme does not mention the upcoming restitution-related obligations of EUR 2 billion or around 4% of GDP concerning properties confiscated by the communist government after the Second World War. As the modalities for monetary compensation appear to have been confirmed in early 2021, the issuance of related specific government bonds over the coming years can be expected to increase the debt-to-GDP ratio accordingly. The guarantee schemes of an initial loan volume of EUR 2 billion i.e. around 4.3% of 2020 GDP (with a maximum state guarantee of 30% at portfolio level) set up during the COVID-19 crisis also constitute a contingent liability that may to some extent be called. However, the present estimates point to relatively low amounts estimated to be called over the programme horizon ([33]). Another non-negligible fiscal risk concerns decisions by domestic and foreign courts resulting in fines and damages payable by government bodies. Such potential obligations may in particular arise from the legacy of the Socialist Federal Republic of Yugoslavia, e.g. from ongoing complaints of employees of former socially-owned enterprises.

The breakdown of public expenditure is set to make progress towards stronger pro-growth orientation, especially as regards the growing share of capital expenditure. As regards the quality of public finances, the ERP forecasts a continuous increase in public investment from an already high outturn of 5.4% of GDP in 2020 to 5.7% in GDP in 2023. It however would seem important to ensure that increased infrastructure spending is cost-effective by applying the recently introduced public investment management framework to all projects, regardless of the source of financing. According to the COFOG classification, after the crisis-induced peak at 7.1% of GDP in 2020, expenditure on health will be maintained at around 6.2% of GDP over 2021 to 2023, i.e. around 1% of GDP above the pre-crisis level. Education spending is projected to be maintained at around 3.3% of GDP throughout the programme period. Notwithstanding the increased debt level, interest expenditure is set to decline by around 0.1 pps. annually, in line with favourable financing conditions. On the revenue side, the increase of the personal income tax-exempt monthly threshold contributes to the gradual reduction of the tax wedge on low income labour. To reinforce disincentives to informal labour, further increases of the threshold could be considered.

The budgetary process has been impacted by the crisis and the electoral cycle and the work on revision of fiscal rules has been put on hold during the crisis. The COVID-19 crisis, the general elections and the protracted formation of a new government have delayed the regular budgetary process. Consequently, the Fiscal Strategy was only adopted in November and the discussion and adoption of the 2021 budget was moved to December 2020. There was a meaningful parliamentary debate on the 2021 budget, albeit with a very limited number of MPs not belonging to the government coalition, and the authorities also submitted the final annual budget execution report for 2019 to Parliament. Work on the revision of fiscal rules, which at present do not provide sufficient anchors for fiscal policy, was put on hold in 2020 due to the crisis and is intended to resume in 2021. While wages continued to be increased via ad hoc adjustments to the budget system law, the new indexation formula for pensions entered into force in 2020 and has effectively again been applied for setting the 2021 pension increase. Due to the crisis, the implementation of the planned wage system reform has been postponed by another year, until

([33]) The ERP expects gross fiscal outflows related to the guarantee scheme to be limited to 0.05%, 0.21% and 0.06% of GDP in 2021, 2022 and 2023, respectively.

2022. As regards the revenue side of the budget, the implementation of the new model of electronic fiscalisation and the transition to electronic invoicing, as presented in the structural reforms part of the ERP, could significantly contribute towards reducing the grey economy, increasing VAT collection and improving the tax control process. The well-established Fiscal Council has continued to function appropriately, producing independent fiscal assessments and recommendations. The timeliness of budgetary statistical information has been ensured but budget execution reports still lack information about large one-offs.

4.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Serbia has been gradually restructuring its economy, mainly by investing in the tradable sector. Exports have been a major driver of growth. Manufacturing has modernised and diversified in recent years, but traditional industry, notably the energy sector, has not undergone restructuring. Its underperformance negatively affects economic growth. Moreover, to reach higher growth rates, better use needs to be made of the opportunities offered by the internal market and services, through ensuring a level playing field for all companies. Economic growth and improvements in living standards towards EU levels will thus depend on continuous implementation of structural reforms across many sectors.

The Commission has conducted an independent analysis of Serbia’s economy and identified the main structural challenges to competitiveness and inclusive growth, drawing on Serbia’s own ERP and other sources. The analysis highlights a number of structural challenges across many sectors. The three main ones are: (i) increasing employment, in particular of young people, women and social protection against poverty; (ii) creating a more favourable business environment for investment, and (iii) greening Serbia’s energy sector and fully opening the energy market.

Key challenge #1: Increasing employment, in particular of young people and women, and social protection against poverty

The labour market performance figures are largely unchanged despite the COVID-19 induced crisis. The labour market is largely resilient. The activity rate (20-64) increased slightly from 73.4% in the fourth quarter of 2019 to 74.3% in the fourth quarter of 2020. The employment rate (20-64) increased in the same reference periods from 66.3% to 66.8%. The employment rate in the EU-27 (20-64) was 73.1% in 2019.

The employment rate (20-64) of women was 59.3% in the fourth quarter of 2020 (EU 66.6%) compared with 74.3% for men (EU-27 78.3%). This leads to a gender employment gap of 15% in the fourth quarter of 2020 (EU 11.7%). The underlying reasons for the gap include lack of childcare and lack of services providing care for the elderly, plus social conventions.

The unemployment rate (15-74) increased only slightly to 10% in the third quarter of 2020, **in comparison to 9.8% in the same quarter of 2019.** This is, however, not a sign of high labour market resilience but rather a crisis-induced statistical effect. In fact, during the pandemic a part of the workforce was discouraged from looking actively for a job, which is a condition for being classified as unemployed in the Eurostat Labour Force Survey (LFS). The COVID-19 crisis caused a labour market slack in Serbia, where the labour supply does not meet the labour demand. At the same time jobseekers do not necessarily register as unemployed as they do not expect to receive a job offer. Generally, active labour market policies (ALMPs) address only a fraction the unemployed and fail to reach out to the majority of unemployed and inactive or vulnerably employed. In addition spending is insufficient. In fact, budget spending on ALMPs slightly increased in 2019 but decreased again in 2020. In 2021 Serbia plans to increase allocations again by 40%. Until now, their impact on the activation of the labour force remains limited. Established measures such as job-searching, training and job fairs reached only 27.6% of registered unemployed in 2019. The Serbian Economic Reform programme acknowledges the low adequacy of ALMPs, but does not propose adequate measures to address this situation.

As regards school education the lower secondary school education results of 15 year olds lag behind the EU average, although Serbia is according to the PISA ratings the best faring country of the Western Balkans. In fact, Serbia's average scores are close to those of some of EU Member States such as Bulgaria, Greece and Romania. The average score in reading is 439.5 (EU 481.7-Western Balkans 402), in mathematics 448.3 (EU 488.6-WB 414) and in science 439.9 (EU 484-WB 408).

The selection into upper secondary programmes is not equitable, since boys are twice as much likely than girls to attend vocational training programmes, a share which increases up to five times more amongst students from disadvantaged backgrounds compared to other students.

The school-to-work transition is structurally difficult leading a high rate of young people (15-24) not in employment, education or training (NEETs) of 15.3%. This is structurally higher in comparison to the EU average of 10.1% in 2019. It takes 2 years on average for a young person in Serbia to find a first stable employment against the EU average of 6.5 months. The activity rate in the fourth quarter of 2020 in the age group of 15-24 was only at 31.2%, a decrease of 0.4% compared to the same quarter of the year before. With a view to this youth employment policies need to be stepped up in Serbia.

VET schools do not adequately provide labour market skills matching employers' needs as they have only partially updated curricula and appropriate equipment. The missing labour market orientation of VET training, which is the career path of choice for 73.2% of Serbia's youth, as well as the insufficient offers for re-skilling and upskilling are key obstacles for higher youth employment and activity rates in Serbia.

Serbia has indeed made progress in work based learning with the adoption of the Law on dual education in 2017 and three new bylaws in 2018/19. The Chamber of Commerce and Industry of Serbia (CCIS) has adopted three other legal acts to facilitate implementing the above law. Two more legal acts are being prepared. The CCIS has a key role in the dual and entrepreneurship education track that started in the academic year 2019/20. While the necessary legal framework is now in place but the rollout of dual VET will take until 2023. Serbia proposes in its ERP under Measure 20: "*Qualifications oriented to the needs of the labour market*" the rollout of the dual VET education system according to the Austrian, German and Swiss model. Unfortunately, the development of dual VET education is limited to 8.8% of all VET education by 2023. The share of school based VET education is according to plans still 91.2%. Given the difficult school-to work transitions and the partially outdated curricula this is not ambitious enough.

For now, the employment rate of Serbian VET graduates is at 53.6% still significantly lower than the employment rate of VET graduates in the EU at 76.8%. With a view to this, the further development of VET education is a necessity for the smooth integration of young people in employment. This is also the objective of the political commitments on the Riga Mid-Term deliverables, to which Serbia has committed itself. In international co-operation on VET, Serbia participates as well in the European Alliance for Apprenticeships. These are policy initiatives which aim to make the overall skills development process more relevant to the labour market and societal needs in Serbia. It is critical to re-profile VET as a good-quality option and highlight the possible paths towards personal development, careers, complex jobs, further specialisation, or starting an enterprise.

Concerning secondary education, Serbia postponed the introduction of Matura reform by one year. The reform would have allowed for more feedback on the quality of secondary education as well as for more equitable access to tertiary education.

In tertiary education, Serbia wants to introduce dual education with close ties to the labour market. As regards international frameworks Serbia joined the Bologna Process. However, the European

Association for Quality Assurance in Higher Education (ENQA) concluded in February 2020 that Serbia is not fully compliant with the Standards and Guidelines for Quality Assurance in the European Higher Education Area (ESG). The membership of the Serbian National Entity for Accreditation and Quality Assurance (NEAQA) was consequently suspended, but in April 2020 received the status of an associate member. Serbia may reapply in 2022 if conditions are met. To this end, Serbia was recommended to improve its governance structures by involving all relevant stakeholders, strengthen the independence of higher education institutions from the government, and improve its internal operational aspects. The Ministry of Education, Science and Technological Development is preparing amendments on the Law on Higher Education in order to address the ENQA recommendations and to align with the latest ESG. In addition, Serbia was asked to improve the effectiveness of higher education institutions' internal quality assurance and the processes of accreditation, including the quality of processes, reviewers and outcomes of accreditation.

As regards digitalisation, more than 15% of boys in Serbia expect to work in an ICT-related profession, as compared to 8% on the OECD level. This has a potential to provide a boost to the digital transition of the economy.

In terms of financing the overall budget share for education is 3.6% of GDP which is 1 pp. less than the EU average.

In order to facilitate school to work transitions Serbia has created the "My First Salary" programme. The goal of the programme is to activate young people without prior work experience. For those who finished high school and take up an internship or employment in the public or private sector a monthly benefit of RSD 20 000 (EUR 170) is granted, and for those who graduated from college a monthly benefit of RSD 24 000 (EUR 204) is granted for an internship of nine months. In view of the difficult school to work transitions in Serbia, this is indeed a good initiative. In 2020 some 8 000 young Serbians participated in this programme. It could become even more popular if employers topped up the salaries to the level of the minimum salary (EUR 273) or beyond. The average gross salary in Serbia in 2020 was EUR 706 equivalent to a net salary of around EUR 511.

At the same time labour migration is continuing across the occupations. The outflow of labour negatively affects the growth potential of the whole economy and notably the capacity of the public sector to provide health and utilities services. This outward labour migration exacerbates further the rural/urban divide between Belgrade and the rest of the country as the countryside is particularly affected by this outward labour migration. The Serbian ERP acknowledges the need to provide incentives for the return of the Serbian diaspora and to attract foreign experts. The Government of Serbia has adopted the Strategy on Economic Migration of the Republic of Serbia for the period 2021-2027 ("Official Gazette of the RS", No. 21/20). The strategy covers a range of topics related to the phenomenon of economic migration, their management, the correlation of migration and development, as well as the role of the diaspora as a driver of (local) development. In this context, Serbia is proposing this in the reform Measure 22 "*Improvement of the administrative environment for encouraging, supporting and tracking circular and economic migration*". This is a step into the right direction as it provides incentives for highly qualified individuals in key areas of the economy where there is a shortage in the labour market. The measure addresses predominantly the ICT sector whose current share of the GDP is around 5%. Rather than this structural reform measure, the crisis in Western European labour markets caused by COVID-19 pandemic led to the return of a large number of Serbian citizens to their home country. According to border control statistics, around 400 000 Serbian citizens returned home during the pandemic. Time will tell how many of the returnees will stay for good in Serbia when sanitary conditions improve and the economies in the migration destinations recover.

Informal employment has been steadily decreasing, but remains at a high level. It fell to 16.7% in the fourth quarter of 2020, which is a decrease of 1 pps relative to the same period of 2019. The reduction of informal labour occurred mainly outside agriculture. Domestic service and care jobs in the informal sector were less available during the pandemic. Most informal work is still concentrated in agriculture, where close to two thirds of the workforce work on an informal basis.

31.7% of the Serbian population was at–risk-of–poverty-or-social-exclusion in 2019, which is a high number in comparison to the EU-27 average of 20.9%. The most vulnerable were households with three or more dependent children with the AROPE rate of 53.6% in 2018 and 51.9% in 2019. The at-risk-of-poverty threshold was RSD 19 381 (EUR 164) on average per month for a one-member household, while for a four-member household with two adults and two children up to 14 years of age this threshold was RSD 40 700 (EUR 345). The Income Quintile Ratio was 6.46 in 2019 (EU 4.99). This means that the richest 20% of the population had an income 6.46 times higher than the 20% poorest. The Gini coefficient in Serbia was 33.3 (2019), which is above the EU-27 average (30.2).

Despite being an upper middle-income country with adequate public revenues, benefits available from the FSA (Financial Social Assistance) scheme are not sufficient to make ends meet. The average cost of a consumer basket is around EUR 323 for a family of 3. The poverty threshold for 3 members is EUR 297. However, the support from FSA for a family of 3 is EUR 132 i.e. less than half of the average consumer basket and less than half of the poverty threshold for a household of this size. The impact of social transfers (other than pensions) on poverty reduction has for years been rather small in 2019 stood at 18.02% in comparison to the EU-27 average of 32.38%.

Public expenditure on social protection and budget transfers in the GDP of Serbia has been gradually decreasing in recent years, so that it amounts to 14.5% of GDP in 2019 (a decrease of 2 pps. compared to 2015), and its consequence is a reduction in pensions and unemployment benefits. In order to address the lack of social cohesion Serbia proposes the Structural Reform Measure 23 "*Improvement of the adequacy, quality and targeting of social protection measures".* Serbia will establish an IT based Social Card register, a single administrative network, which will allow for a mapping of beneficiaries and their individual entitlements. It is an act of modernisation through e-government. The Social Card is a vehicle to make public administration more efficient and more resistant to the abuse of benefits. However, efficiency in the delivery of social services is not Serbia's key challenge in the area of social protection. The adequacy of social benefits and the quality of social services are still to be addressed in order to improve the social cohesion of the country.

Serbia has committed itself to the European Pillar of Social Rights and hence to social protection and inclusion and to an adequate minimum income. The gross minimum wage was increased for 2021 to EUR 273, which is still below the cost of the average consumer basket of EUR 323. 17% of all employees receive the minimum wage, i.e. EUR 273 minus taxes and social security contributions. The poverty threshold for a single person household is EUR 230. The untaxable wage base was successively increased to RSD 18 300 (EUR 155). However, this is hardly enough. Additional efforts, such as the further increasing of the untaxable wage base close to or equal to the level of the minimum salary would have a significantly bigger impact on in-work-poverty. In addition, it would contribute to the wage and consumption induced growth of the Serbian economy. The recent decrease in the social security contribution of the workers from 26% to 25.5% was not sufficient to decrease substantially the tax wedge of the low end wage earners.

Key challenge #2: Creating a more favourable business environment for investment

Serbian companies demonstrated their resilience during the COVID-19 pandemic, with more than three-quarters of businesses not changing their number of employees and 12% of companies even hiring more staff (USAID, 2020)**.** The pandemic served to accelerate the expansion of e-commerce and the government's ERP rightly recognises the need to strengthen its economic growth through the digitalisation of the economy, government, and society. However, key structural challenges in the business environment related to the transparency, reliability and predictability of the regulatory framework remain largely unaddressed. If tackled, they have the biggest potential for fostering the post-pandemic recovery, attracting more investments and building up economic resilience as well as boosting inclusive growth and competiveness. The implementation of the Common Regional Market will also offer new opportunities.

The legal framework is prone to unexpected and significant changes, which is detrimental to entrepreneurial calculation. Business predictability is negatively affected by the lack of full transparency in the adoption of legislation. In particular, government decisions in a number of business-relevant areas are still often taken without proper consultation with businesses and social partners and under time constraints that do not allow businesses to organise and adapt their operations to new rules in good time. The methodology on impact assessments, as well as the obligation for line institutions to take into account the Public Policy Secretariat's opinion prior to submitting documents to the government, have yet to be consistently applied in practice. Advice from independent state bodies, such as the Fiscal Council, is often not taken into account. The law on the planning system, adopted in 2018, provides a solid framework for policy coordination, but its partial implementation and the reluctance of decision-makers to follow evidence-based policy-making remain a problem. The lines of accountability between agencies and their parent institutions remain blurred, contributing to overlapping functions, fragmentation, and unclear reporting lines.

Over the past years, Serbia has made notable progress in reducing the regulatory and administrative burden on businesses, but more efforts are needed to reduce bureaucratic red tape and improve consistency in the implementation of legislation. Over the past years, a number of important business procedures such as setting up a new company or obtaining a construction permit, have been significantly simplified and their cost reduced, placing Serbia high at relevant sub-indices of World Bank's Doing Business rankings for 2020 (e.g. 9th place for dealing with construction permits, 73rd place for starting a business). However, business regulations once the company starts working do not seem to always be business friendly. Administrative procedures are numerous and burdensome, often with overlapping authorities. For example, local firms have to make 33 tax payments per year, twice as many as in the regional peers. The numerous para-fiscal charges remain high and non-transparent, lacking rationalisation, thus undermining the predictability and stability of Serbia's tax system and hampering local economic development. The law on foreign exchange transactions is widely considered by the business community to be too restrictive in its design and unpredictable in its application.

The role of the state in the economy is decreasing, but remains large, hampering competition. A number of small-scale privatisations have been completed over the past years, as well as the privatisation of the largest state-owned bank. In addition, the Minister of Economy announced the privatisation of 12 to 20 public enterprises managed by the Ministry in 2021. Nevertheless, state-owned enterprises continue to dominate many sectors of the economy, including energy, transportation, utilities, telecommunications, infrastructure, mining, and natural resource extraction. This outsized presence of state-owned enterprises deters private investment and innovation, impedes overall competitiveness and poses substantial fiscal risks. Many of these companies do not apply corporate governance rules and operate with low efficiency and high costs, also due to elevated wage bills (both through the increased number of employees and higher wages). The majority of public companies continue to rely on some kind of state support, via direct or indirect subsidies (e.g. toleration of arrears, not paying taxes, etc.). Public companies account for 19% of value-added and formal employment, but receive 60% of corporate subsidies. Governance of state-owned enterprises also continues to pose problems: according to Transparency Serbia, only 9 out of 34 public companies have legally elected directors, while 22 are led by acting managers, 19 of which have expired mandates, since the law on public enterprises limits that status to 12 months. This stands in the way of a root-and-branch reform of these companies, including more professional management. The government has, however, committed to adopting an ownership policy and an action plan focusing on improving the corporate governance regulatory framework of public enterprises. Improving the efficiency of public enterprises through restructuring or privatisation would reduce the strain on public finances and improve the quality of services. Moreover, it would create a more level playing field, limiting the preferential treatment accorded to some public companies.

The legal framework in the fields of competition and state aid have been largely brought in line with the EU *acquis*, but the actual implementation remains to be strengthened. Administrative capacity of commissions for protection of competition and state aid control have been increased and are operating as legally independent bodies. The institutional independencies of both bodies should however be strengthened. The commission for protection of competition remains passive, with a low number of cases investigated and without a single negative opinion on concentration since its inception. In the area of state aid, well defined rules are not always implemented due to strong political pressure for financial assistance, which is channelled to state-owned enterprises and large foreign investors. These resources are often substantial and may have a significant impact on the local competition. State support is not sufficiently transparent (legal contracts are not publicly disclosed), which leads to allegations of corruption. The independence of the commission for state aid control is yet to be tested as businesses complain that state aid cases are not followed up.

The legislative framework for public investment management has improved, but the issues of transparency, assessment and prioritisation of investment remain to be fully addressed. Having in place a strong process for the appraisal and selection of public investment projects is a priority, given Serbia's large infrastructure needs and long pipeline of future projects. The new legislative framework for public investment management put in place in 2019 has provided a basis for a sounder project selection process, better prioritisation, stronger impact and more comprehensive planning across different tiers of the government. Yet, the new arrangement allows too many exceptions to the rule, significantly reducing the effectiveness of the legal framework. In addition, the law on special procedures for linear infrastructure projects adopted in 2020 allows linear infrastructure projects of 'special importance for the Republic of Serbia' to be exempted from public procurement rules, without providing clear guidelines for strategic prioritisation. This increases opportunities for extracting benefits by inflating prices in the absence of competition and various subcontracting contracts and creates opportunities for corruption. Due to these legal arrangements, as well as, in some cases, lack of enforcement of rules in place, a significant share of public funds for capital investment continues to be spent without proper checks to ensure compliance with public procurement, state aid and technical standards, particularly when it comes to big infrastructure projects financed by loans, often under undisclosed conditions, provided mostly by third countries. Investment decisions are frequently taken without the appropriate feasibility studies, cost-benefit analysis and environmental impact assessments necessary to ensure the sound use of public funds.

The widespread shadow economy remains a major impediment to the development of a strong corporate sector and the creation of a functioning market economy. Driving forces behind the shadow economy include high taxes and contributions on salaries, lack of financial resources and favourable loans, para-fiscal charges, hidden tax fees as well as red tape. The consequences are manifest in tax evasion, market distortion, unfair competition, and inefficient resource allocation. Notable efforts have been invested in tackling the informal sector, but reforms are being implemented at a slow pace. While the government has been careful in reducing the tax burden in view of fiscal policy needs, it has clamped down against the informal sector by stepping up tax and labour inspections. In 2019, the government adopted an action plan for the implementation of the National Programme for Countering the Shadow Economy for 2019-2021, which aims at further improvement of the work of inspection bodies, a tougher penalty policy and more efficient tax collection. In addition to boosting inspections, the government should develop a mechanism for incentivising companies to move to the formal sector.

Further efforts are needed to improve the quality, independence and efficiency of the justice system. An efficient and independent judicial system is a prerequisite for a predictable investment and business-friendly environment, and is necessary to encourage innovation, attract FDI and secure tax revenues. International sources describe the judiciary as prone to political influence (World Economic Forum ranks Serbia as 101st out of 141 countries in its Global Competitiveness Report 2019, while the World Justice Project ranks it as 75th out of 128 countries for 2020). Courts are slow and inefficient, with an average court case length of 622 days, and litigation incurs very high costs - over 40% of the claim at hand (World Bank, Doing Business 2020). Businesses also raise the issue of the lack of reliability in contract enforcement, as well as lack of expertise among judges, particularly in complex areas of law such as competition, intellectual property, or taxation, which leads to incoherence in rulings.

Businesses identify corruption and problems in the exercise of the rule of law as key obstacles to investment climate and economic development. Serbia's legal framework to fight corruption and in relation to economic crime and abuse of office is largely in place. However, its implementation should be strengthened. Surveys show that corruption is believed to be prevalent in many areas; Serbia is ranked 94th in Transparency International's 2020 Corruption Perceptions Index (down from 91st place the year before), well behind the EU Member States. A particularly critical area of corruption is public procurement. The level of competition in the public procurement process remains limited: the average number of bids per tender fell from 3.0 in 2017 to 2.5 in 2019 (and even 2.1 for bids at the local level). A new procurement law was adopted in 2019 to strengthen the transparency of the public procurement processes and their resilience to corruption. However, the institutions supervising the process (Public Procurement Office, Commission for the Protection of Rights in Public Procurement Procedures, State Audit Institution, Anti-corruption Agency, prosecution, etc.) lack staff capacity and do not always coordinate effectively with the view of fighting corruption in a systematic manner. The adoption of a specific law on special procedures for linear infrastructure projects allowing for their exemption from public procurement rules raised serious concerns regarding its potential for corruption. Companies claim to often refrain from using legal remedies due to lack of trust in the system and fear of being blacklisted by the relevant authorities.

The ERP reform measures in the area of business environment target the high administrative and regulatory burden, but do not sufficiently address the underlying structural weaknesses. *Reform measure 9 ("Improvement of the quality of public services through optimisation and digitalisation of administrative procedures – e-paper")* is repeated from past years' ERPs. It has the potential to significantly reduce administrative costs, reduce opportunities for corruption and in general increase the attractiveness of Serbia as investment destination. However, the measure has so far given rather limited results, with only four procedures out of 2 600 being abolished. Significant efforts are needed to speed up the reform. The new *Reform measure 13 ("Improvement to spatial development management through establishment of e-space digital platform")* aims to improve the efficiency of planning and the quality of planning documents in order to further reduce number of days and costs of obtaining location conditions and construction permits. *Reform measure 12* ("*Improvement of geospatial sector through development of digital platform in support of decision-making for investments"*), rolled over from previous ERPs, should help further clarify ownership, thereby helping to make the investment decision-making process easier. This measure was only partially implemented in the past year as activities slowed down due to the COVID-19 pandemic. Most activities are therefore now concentrated in 2021, which seems unrealistic and may cause additional delays. Risks outlined in previous years, in particular regarding cooperation, communication and overall coordination, remain high among stakeholders.

The ERP presents ambitious tax-related reforms, but the implementation of ongoing reforms remains to be strengthened. *Reform measure 10 ("Transformation of tax administration"*) remains one of the most significant structural reforms in this year's ERP as well. However, the desired changes in terms of predictability and fairness in the implementation of tax rules are yet to fully materialise. The transformation started in 2015 and while some targets were met, such as the separation of core and non-core activities and number of field offices, the overall improvement is limited and the process needs to accelerate. The work on the new programme for 2021-2025 is ongoing. The permanent problem of lack of inadequate human resources is regrettably not addressed by the measure. The ERP has for the first time introduced *Reform measure 11 ("introduction of a new fiscalisation model and transition to electronic invoicing"),* which on the one hand aims to improve tax control and thus increase VAT collection and reduce grey economy, and on the other hand to modernise invoicing by replacing paper invoices by digital ones. Although ambitious, the activities under the reform measure are largely unclear, which may hinder its effectiveness.

Key challenge #3: Greening Serbia's energy sector and fully opening the energy market

Serbia's competitiveness continues to be hampered by a polluting, inefficient and not properly regulated energy sector. The energy sector represents 4% of GDP. It is characterised by high energy/carbon intensity due to losses in distribution, outdated infrastructure, intensive use of coal and low energy efficiency at end-user level. Most energy companies are state-owned and have through the years relied to a varying degree on support from the budget. In 2019, the country paid direct subsides worth about EUR 41 million to support coal-fired power generation, sustaining unprofitable and inefficient thermal power plants and coal mines. The retail electricity market, though fully liberalised, remains highly concentrated. For example, despite the liberalisation, the state-owned utility Elektroprivreda Srbije (EPS) remains the single most dominant supplier, with around 98% of participation in the electricity market. Entry barriers to the sector are high due to direct or indirect regulation of energy prices.

Serbia remains highly dependent on coal and lacks a coherent long-term strategy that combines energy and climate targets. Serbia relies on domestic coal-fired electricity production provided by outdated power plants. About 66.4% of domestic electricity production comes from coal (lignite), 28.4% from hydropower, 1% from gas, and only 4.2% from wind, small hydro, biomass and solar together (AERS, 2019). Despite existing climate and environmental challenges, Serbia continues to prioritise investments in new coal power plants. Currently, Serbia is building a new lignite power plant (Kostolac B3) with a capacity of 350 MW. Serbia adopted a new climate law in March 2021, which is a step in the right direction. However, the country still lacks a coherent long-term strategy which is consistent with the EU 2030 framework for climate and energy policies. Serbia is lagging behind in the region in developing a National Climate and Energy Plan to make its energy sector fit for the future in line with Europe's green energy ambitions.

Coal power generation adds to already alarming air quality levels in Serbia. According to the World Health Organisation, nearly 3 600 premature deaths in Serbia every year are attributed to air pollution (WHO, 2019). The energy sector is the main source of pollution in Serbia, responsible for 80% of the country's greenhouse gas emissions. Thermal power plants and heating account for 57% of total PM10 emissions and for 75% of total PM2.5 emissions. Energy generation and distribution is also the most significant contributor to acidifying gases (49.2% of all nitrogen oxides emissions and 91.4% of all sulphur dioxide emissions) (Health and Environment Alliance, 2017). Several of the most polluting coal power plants in Europe are located in Serbia, with Kostolac B being the continent's most notorious sulphur dioxide polluter. A desulphurisation unit built in 2017 was only put into operation in the fourth quarter of 2020. Serbia adopted a national emission reduction plan in January 2020, but it is not implemented in practice for sulphur dioxide and dust.

Inefficient energy use represents a major concern in the country. Serbia has the second-highest energy intensity in the region, nearly four times higher than the EU average. Lack of efficiency in the energy sector critically impacts the country's overall economic competitiveness. A more strategic approach is urgently needed to address all aspects of energy efficiency. Serbia needs to improve financial, institutional and human resource capacities and better coordinate energy efficiency action with all relevant stakeholders, including at local level. Implementing consumption-based metering and billing in district heating on a large scale and establishing a sustainable financing mechanism is necessary to boost investment in energy efficiency. Serbia should also allocate income from the recently introduced energy efficiency fee in full to finance energy efficiency measures.

Major investments are needed to modernise Serbia's energy infrastructure and lower carbon emissions. Serbian energy infrastructure is generally old and outdated, resulting in high energy losses, particularly in distribution. Given Serbia's reliance on coal-based energy supply, major investments are needed to implement the necessary transition from fossil fuels to renewable sources of energy. Investments in renewable energy have only recently increased. In 2019, Serbia achieved a 21.44% share of renewables in gross final energy consumption, which is below the 25% median trajectory and just above the renewable energy share of 21% in the 2009 baseline year. Domestic demand for electric power is expected to outgrow production capacities significantly in the next 5-10 years, necessitating investments in new capacities. The Fiscal Council estimates that Serbia would need to invest EUR 5.6 billion to meet its future needs for electricity and adhere to environmental legislative requirements (Fiscal Council, 2020).

Greening Serbia's energy sector is paramount in view of Serbia's obligations under the Energy Community Treaty and its EU membership ambitions, but also the sustainability and profitability of the sector. The EU Green Deal and the Green Agenda for the Western Balkans have put in place a new policy framework for the coming period, to be also incorporated in the Energy Community Treaty. With decreasing global prices for renewable energy and increasing efforts to address carbon leakage in Europe, Serbia risks locking itself into an increasingly unprofitable carbon-intensive energy system if it does not tackle this challenge head-on. Recent energy legislation introduced a competitive auction system instead of current feed-in tariffs for renewable energy sources. This is important measure to attract much-needed private investment into the renewables sector and should be implemented swiftly.

The currently low electricity prices do not provide incentives for investing in energy efficiency and energy saving in Serbia. Compared to other economies in the region, electricity prices in Serbia are particularly low (approximately EUR 0.06 per kWh for households without taxes and VAT). They are considered to be among the lowest in Europe (Fiscal Council, 2020). The current electricity tariffs do not reflect real costs covering investments in the network and consequently guaranteeing the security of supply. Moreover, they do not include investment needs for Serbia's energy and climate reforms. Increase in electricity prices should be accompanied by appropriate social programmes to mitigate possible adverse effects, bearing in mind that a considerable proportion of the population falls within the status of absolute poverty and energy poverty.

Increased efforts are necessary to diversify supply and Serbia's overall energy mix. Ensuring security of supply for the domestic natural gas market remains a challenge, despite the recent works on the diversification of gas supply routes. Serbia is dependent on imported natural gas for almost 80% of its total needs, which it receives from a single supplier. Locally produced electricity comes primarily from lignite. Such a supply mix, characterised by high direct and indirect costs, is converted inefficiently and transported to sectors and industry at a price that does not allow for full cost recovery. In this regard, Serbia should make the best use of the Economic and Investment Plan for the Western Balkans (European Commission, 2020) to embark on its coal-phase out and start building a climate neutral economy, by replacing fossil fuels with renewable energy, and gas as a transitional fuel, avoiding stranded assets.

Proper regulation of the electricity and gas markets is key to improving the sector's efficiency and effectiveness. Serbia's primary legislation is compliant with the third energy package, but implementation is lagging behind, particularly in the gas sector. The government mostly completed the liberalisation of the electricity market and established an operational electricity wholesale market. However, the gas sector remains largely unreformed. There is no third-party access to the gas network and none of the three transmission system operators is unbundled. The lack of competition results in high prices for business and citizens.

Serbia's ERP for 2020-2022 does not seem to be sufficiently ambitious regarding the clean energy transition and energy efficiency. The reform measures proposed in the ERP fall short of providing concrete plans for making clean energy transition a core direction of the economic reform path. In addition, important outstanding reform steps, such as the unbundling of the gas sector and properly addressing energy poverty, are missing. *Reform Measure 1* ("*Energy market development coupled with energy infrastructure construction*") is rolled over from four previous ERPs. It represents a continuation of Serbia's efforts in electricity market development coupled with new infrastructure investment through the Western Balkans Investment Framework, most notably the completion of all sections of the Trans-Balkan corridor. The reform lacks ambition, however, particularly in the gas sector, as the required unbundling of gas sector utilities and third party access to existing gas infrastructure are not addressed. *Reform measure 2* ("*Improvement of conditions for enhancing energy efficiency through harmonisation of the legislative framework and establishing a sustainable mechanism for financing energy efficiency project"*) correctly identifies the need to improve the legal framework and secure sustainable funding for energy efficiency projects. However, the measure falls short of effectively incentivising energy efficiency investments. Targets for energy savings could be more ambitious (currently 20%). Concrete policy measures, such as steps to implement consumption-based metering and billing in district heating or a large-scale renovation wave in Serbia are missing. Further alignment with EU legislation on energy efficiency and renewable energy sources represents important progress. Establishing a funding mechanism for energy efficiency is a good step but the model proposed will not allow engaging the necessary staff and building and managing the necessary pipeline of energy efficiency projects. Regardless of these shortcomings, the reform measure remains highly important and relevant for raising the country's competitiveness and long-term growth potential.

The economic recovery from the COVID-19 pandemic should be used as an opportunity to accelerate the transition to a low-carbon economy. Carbon pricing should be at the core of the policy response: it encourages people and firms to reduce energy use and shift to cleaner alternatives. It also generates revenues that can be used as part of a fiscal package that is both efficient and equitable. Other key measures could include reducing subsidies or tax incentives for emission-intensive activities, and investing in clean energy infrastructure, which can create new jobs, and likely crowd in private sector investment. A green recovery approach will allow Serbia to make full use of the Economic and Investment Plan for the Western Balkans (European Commission, 2020) and its three energy flagships on renewable energy, transition from coal and a renovation wave (energy efficiency).

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

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

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

In most of the principles of the European Pillar of Social Rights, Serbia performs weaker relative to the EU average, according to the indicators of the Social Scoreboard ([34]). Improving trends in employment have been observed over recent years. While in some areas lower performance is in a certain way unavoidable, since Serbia is poorer than any one of the EU Member States, more attention needs to be paid to fields that are less dependent on the level of national income, such as gender equality and inequality.

Women in Serbia have a significantly lower employment rate than men. The gender employment gap is wider than the EU-27 average (13.9 pps. vs 11.7 pps. in 2019) with a slight improvement between 2018 and 2019. The wide employment gap is mainly due to the low activity of women in the labour market. The lower statutory retirement age for women and low level of part-time work (10.1% for women) combined with care responsibilities are some of the root factors.

Serbia's performance on social inclusion, social protection, income equality and poverty alleviation could be significantly improved. The at-risk-of-poverty stands around 23.2%, among the highest in Europe. Children and young people below 25 years of age face an at-risk of poverty rate of 27.0%. The at-risk-of-poverty-or-social-exclusion rate was very high in 2019 (31.7%) and significantly above the EU-27 average (20.9%). Disposable income of individuals in the top income quintile is on average almost nine times higher than of those in the lowest quintile. Serbia's tax-benefit system is not as efficient as elsewhere in Europe in reducing market inequality. Furthermore, high government expenditure does not reduce income inequality much.

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

([34]) The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The indicators are also compared for the Western Balkans and Turkey, with one small adjustment in the age bracket for the unemployment rate (reducing the upper age limit to 64 instead of 74) for Albania and Kosovo due to data availability. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2019 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). Data from 2017-2019 are used and can be found in Annex A.

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

4.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2020

Overall: Partial implementation (55.6%) ([35])	
2020 policy guidance	**Summary assessment**
PG 1:	There was **partial implementation** of PG 1
Allow automatic fiscal stabilisers to accommodate crisis-induced economic fall-outs and further mitigate the impact on growth and employment by appropriate discretionary fiscal measures.	1) **Full implementation**: the authorities have allowed for very substantial crisis mitigation on growth and employment via fiscal stabilisers and particularly by comprehensive packages of fiscal (8% of GDP) and liquidity-enhancing (4% of GDP) support to businesses and citizens. The substantial support has significantly contributed to the overall relatively mild contraction of GDP by 1% and the stabilisation of employment in 2020.
To reinforce the medium-term sustainability of public finances, contain overall spending on wages as a percentage of GDP, while allowing for due reinforcement of healthcare spending during the crisis, also by taking concrete steps towards implementing an appropriately designed public sector wage system reform.	2) **Limited implementation**: while the overall spending on wages as percentage of GDP is projected to decline under favourable growth assumptions in 2021, this comes after a very strong ex-post increase in 2020 due to the quasi-stagnation of nominal GDP. While recruitment rules in the public sector have been made somewhat more flexible, no concrete steps towards implementing an appropriately designed public sector wage system reform seem to have been taken. The reform has been postponed by another year.
Adopt a credible and binding system of fiscal rules underpinning fiscal sustainability.	3) **No implementation**: the adoption of a credible and binding system of fiscal rules has been postponed by another year due to the crisis.

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

PG 2: To support economic recovery, further increase growth-enhancing capital spending as a share of GDP in 2020 and over the medium term.	There was **partial implementation** of PG 2. 1) **Full implementation**: notwithstanding the crisis context, capital expenditure implementation was further increased to a record level of 5.4% of GDP in 2020 and is planned to further increase in 2021-2023.
Increase the transparency of the fiscal impact of state-owned enterprises by reinforcing fiscal risk analysis and by publishing quarterly reports on SOEs' financial performance.	2) **Partial implementation**: while the fiscal risk analysis appears to have been reinforced within the Ministry of Finance, the results of the work do not appear to have been made available via quarterly reports.
To reduce fiscal risks, improve the governance of state-owned enterprises including via further restructuring.	3) **Partial implementation**: while the fiscal risk department in the MoF appears to have ensured some monitoring of SOEs, the precise implications and timeframe of savings remain unclear. A strategic document on SOE ownership including restructuring has been adopted recently and a corresponding action plan is planned to be adopted in early 2021.
PG3: Closely monitor financial stability challenges arising as a result of the coronavirus pandemic and take appropriate action if needed.	There was **substantial implementation** of PG3: 1) **Substantial implementation**: The NBS closely monitored the impact of the pandemic on the financial sector. It implemented prompt and forceful policies to support the sector and contain risks, including borrower relief measures such as loan moratoria and facilitating restructuring as well as providing liquidity. The full impact of the crisis in particular on asset quality is yet to become visible, likely requiring further adjustments.
Further implement the measures included in the 2018-2020 NPL strategy and related action plan, including those aimed at preventing the accumulation of new non-performing loans such as reforms of the bankruptcy frameworks.	2) **Partial implementation**: A KMPG/FinSaC report on corporate indebtedness and problem loan prevention has been completed, there was further progress in resolving the Deposit Insurance Agency's NPL portfolio and the bankruptcy framework was also improved. However, progress on reducing structural obstacles to NPL resolution, such as enabling the sale of retail NPLs or improving judiciary processes, remained slow. Further progress requires work by all key stakeholders on improving the legal and judicial framework.
Enhance further the use of the local currency by fostering the development of secondary markets for government and corporate dinar securities, and support the use of hedging instruments.	3) **Substantial implementation:** Policy has supported the development and use of local government bond and corporate bond markets and has encouraged greater dinar-denominated deposit and loan growth in the banking sector, which has

	not seen setbacks related to the pandemic crisis. However, currency substitution remains high and sustained efforts are needed, e.g. to further expand the use of hedging instruments.
PG 4: With a view of mitigating the economic consequences of the COVID-19 pandemic and stimulating economic recovery, ensure effective, transparent and non-discriminatory support to businesses affected by the crisis, in particular micro, small and medium-sized enterprises and self-employed. Extend social protection coverage and provide incentives for businesses and employees in the informal economy sector to register and to facilitate their transfer to the formal economy. Include monitoring and evaluation of measures introduced and further improve the public consultation process by consulting businesses and social partners on the adoption and implementation of all new legislation concerning their operations.	There was a **partial implementation** of PG 4: 1) **Full implementation:** Support of approximately RSD 690 billion (12.5% of GDP) was extended to support economy and population. This included tax policy measures, direct support to the private sector, measures aimed at preserving liquidity of the private sector, and incentives to all adult citizens. 2) **No implementation.** A new strategy for social protection in Serbia for 2019-2025 and amendments to the Law on Social Welfare are still pending. Regulation defining that if employed person automatically loses right to social welfare benefits is still in place. 3) **Partial implementation:** Legal framework for the process of consultation is put in place but the process is still not fully implemented and businesses continue to complain about inappropriate procedures that include no consultation or very limited time given to impact on the final outcome.
PG 5: Ensure cross-sectoral coordination within the government and across public administration to effectively respond to COVID-19. Take measures to preserve employment including through short-time work schemes and ensure increased provision of effective active labour market policies to the unemployed.	There was a **partial implementation** of PG 5: 1) **Substantial implementation:** The Government established a cross-sectoral Crisis Team with the aim of monitoring the situation, managing and coordinating actions and activities and proposing measures to the Government and competent authorities. 2) **Partial implementation:** Serbia rolled out short-term work schemes to preserve employment. In addition, progress was made by the launch of a two-year “My First Salary” youth employment promotion programme in August 2020 and by the 40% increase in the budget for implementation of the planned programmes and measures of active employment policy in 2021 compared to 2020. However, allocations for active employment policy remain insufficient, limited in scope (i.e. mainly one-off actions such as job-search training sessions and job fairs) and reach (i.e. only 27.6% of those registered unemployed benefited from such activities in 2019).

Provide adequate unemployment compensation schemes for laid off workers in order to mitigate the social impact of the economic downturn.	3) **Partial implementation:** Besides significant and mostly effective measures to prevent layoffs in the public and private sector due to the COVID-19 outbreak, no special measures regarding unemployment compensation schemes for laid off workers have been adopted throughout the period.
PG 6: Step up social transfers to ensure adequate income support for people at risk of poverty and social exclusion.	There was a **partial implementation** of PG 6. 1) **Limited implementation: T**he Government adopted a law on social card in January 2021 but did not increase any benefits or the step up income support. Social cards allows only for better mapping and control of beneficiaries of benefits. Social benefits remain insufficient for decent living.
Reduce the tax wedge considerably for low wage earners to ensure living wages and to incentivise the formalisation of employment.	2) **Partial implementation:** Law on Personal Income Tax increased the non-taxable personal income from RSD 16 300 to RSD 18 300 per month, thus decreasing tax wedge, but more needs to be done to avoid in-work poverty.
Ensure adequate and sustainable funding to strengthen the health care sector with an aim to improve access to quality public health care for all citizens	3) **Substantial implementation:** The Government undertook a series of measures and activities that contributed to adequate and sustainable financing of the health sector in the pandemic. Procurement of necessary equipment and medicines was performed and new laboratories and hospitals were built in order to provide quality healthcare services. All resources shifted into the sector are in response to the COVID-19 crisis; while some have a benefit for the system as a whole, they are largely reaction-driven with limited strategic planning towards long-term improved access to quality public healthcare, especially for the vulnerable groups and chronic patients.

4.6. ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2021-2023

Informal economy

The informal economy has been slowly shrinking over the years, but remains extensive, in terms of both its share of total output and in the number of people employed, and thus constitutes a major burden on business. Undeclared labour remains a persistent issue, despite some improvements in the labour market. Agriculture, construction and various types of household services have particularly high labour informality. The driving forces behind the large informal economy are corruption, high taxes and contributions on salaries, lack of financial resources and favourable loans, para-fiscal charges, hidden tax fees and red tape. Notable efforts have been invested in tackling the informal sector, but reforms are being implemented at a slow pace. While the government has been careful in reducing the tax burden in view of fiscal policy needs, it has clamped down against the informal sector by stepping up tax and labour inspections. In 2019, the government adopted an action plan for the implementation of the National Programme for Countering the Shadow Economy for 2019-2021, which aims at further improvement of the work of inspection bodies, a tougher penalty policy and more efficient tax collection. In addition to boosting inspections, the government should develop a mechanism for incentivising companies to move to the formal sector.

The ERP once again does not contain any reform measures specifically addressing the issue of informality. However, the newly introduced **Reform measure 11 ("introduction of a new fiscalisation model and transition to electronic invoicing")**, if properly implemented, may lead to improvement in tax control, with a positive impact on the informal economy. The reform measure is however unclear in terms of concrete actions and targets, although ambitious in scope.

Research, development and innovation

Investment in research, development and innovation is weak. Industrial innovation, in particular, needs more support to increase the added value of exports. Although the country has a relatively good scientific base, investment in research and development remains at 0.89% of GDP (half the EU average of 2.2% of GDP in 2019) and nearly 40% of this amount comes from the private sector. The country lacks human resources for research and development. Only 3 308 (2019) workers per one million inhabitants are employed in this sector, significantly below the EU average of 6 300 recorded in 2019. Cooperation between businesses and academia remains weak and is not systematically supported. The Science Fund, established in 2019, provides support to scientific research activities by announcing public calls and performing the complete procedure and management of competitive project calls. Infrastructure for science and technology parks is being expanded, but support services for these institutions need to be further expanded. Similarly, the Innovation Fund, which provides grants for industrial research, needs to play a more prominent role in the national funding system. In 2020, Serbia adopted its first Smart Specialisation Strategy, an Industrial Policy Strategy, and a Strategy for the Development of Artificial Intelligence. However, only the latter has started being implemented.

Measure 14: "Support for scientific research activity through strengthening scientific research capacities"

The measure, rolled over from the previous ERP, remains very relevant as it addresses crucial questions in the area of research and development, including insufficiently high investments in research and the lack of human resource capacities. The measure however falls short of adequately addressing the necessity to reform the public sector R&D institutes. Some challenges are not identified and addressed, such as the lack of technology transfer facilities. The measure overall lacks clarity and ambition in certain areas.

Measure 15: "Improvement of institutional support for the development of smart specialisation and innovations"

The reform measure is clear and relevant. It however does not outline significant support provided to the innovative companies and start-ups by the Science and Technology Park Belgrade, Novi Sad, Nis and Cacak, and the existing incubators and hubs are also not mentioned as if they are not part of the innovative ecosystem. The measure fails to provide a link between the Smart Specialisation Strategy and the Industrial Policy Strategy. Regrettably, as in the previous years, there are no plans or commitments to increase the percentage of GDP invested in science and research and to catch up with the EU member states average.

Digital economy

Serbia has made notable progress on digital transformation and the Government has kept it as a key priority for the country. Serbia's communications infrastructure requires systematic improvement in both regulation and investment. The broadband roll-out has continued to slightly grow, but remains below the EU average. The lack of broadband prevents uptake of e-government and business services and as a consequence is slowing down the transformation of the economy. Investment by the ICT sector in research is above the national average, but still low compared to EU averages. Exports of ICT services have recorded a continuous growth of over 20% per year in the period from 2015-2019. The 2025 Serbia Programme, adopted in December 2019, announced well-needed investments in infrastructure in the tune of EUR 14 billion by 2025. However, staff capacity remains an issue: employees in the ICT sector represent only 2.6% of total registered employment. There are only about 25 000 of ICT experts in Serbia, with an additional 3 000 professionals added annually. Expert estimate that Serbia needs at least 15 000 additional computer scientists to preserve the currently high annual growth of the sector. The challenge remains to ensure there are links between the ICT sector and traditional industries so as to speed up modernisation in traditional sectors.

Measure 16: "Increasing the availability of e-government by improving infrastructure and introducing new technologies"

The reform measure is very relevant, particularly in view of the current circumstances of the COVID-19 pandemic, which have clearly demonstrated that the investments in e-government made in the past have to a great extent facilitated the response of the Serbian administration to the pandemic. The measure is transferred from the previous ERP. However, the ERP does not provide clear information on what has been achieved so far and the bottlenecks encountered in the previous period. The measure mainly relates to the development of the data centre in Kragujevac and introduction of the concept of a 'smart city', while the connection with other measures of the Programme for the Development of e-Government of the Republic of Serbia necessary for increasing availability of the e-government is not clearly presented. The measure is therefore rather limited in scope.

Measure 17: "Development and improvement of the national information and communication infrastructure"

The measure is rolled from the previous ERP and remains relevant in the context of providing fast broadband connectivity to under-served regions in Serbia. The measure is expected to have a favourable impact on competition, development and better connection of innovation/industry/services (benefit to businesses, online work) as well as providing further education possibilities (access to schools) and better household access to internet in general. Its significance lies in being the first digital connectivity investment implemented by Serbia with the support of the EU after the launch of the Digital Agenda for the Western Balkans and the adoption of the Economic and Investment Plan.

Investment activity

Despite the increase in public investments, particularly in roads and railways, it is still not at a level commensurate with the economy's needs. The institutional framework supporting new investment is weak. Even though a new legislative framework for public investment management was established in July 2019, issues with transparency, assessment and prioritisation of investment remain and need to be seriously addressed. Public procurement practices are not always fully compliant with the legislation, nor are they always fully compatible with EU standards, particularly where large infrastructure projects financed through government-to-government agreements are concerned. Serbia's economy continued to attract significant FDI (EUR 3.6 billion in 2019), well above the region's average. FDI has risen gradually in recent years. Investment is spread across many sectors, with more than a quarter going into manufacturing. The top 15 exporters are mainly foreign-owned, jointly securing about a quarter of total exports. Backward linkages between FDI and domestic firms remain weak. Tailor-made measures are needed to link incoming investors with domestic suppliers, integrating them further in their value chains. Existing programmes for the internationalisation of SMEs need to be stepped up to reach a higher number of beneficiaries.

The reform measure on the establishment of a sustainable system for funding environmental protection, present in previous ERPs, has not been transferred to this year's ERP cycle.

Trade performance

The growth of Serbia's foreign trade is accompanied by an increase in the foreign trade deficit. Exports of EUR 17.5 billion in 2019, recorded a growth of 7.7% year-on-year, while imports grew at a rate of 8.9% (EUR 23.9 billion). The foreign trade deficit (EUR 6.3 billion) increased by 12.5% y-o-y, and exports covered 73.4% of imports in 2019 (74.3% in 2018). The wide dispersion of exports is ensured by the diversification of FDI in a large number of sectors that produce tradable goods. In the first eight months of 2020, the COVID-19 virus pandemic had an adverse effect on trade flows. Serbia's exports amounted to over EUR 10.6 billion (which is a decrease of 7.6% compared to the same period last year), and imports amounted to almost EUR 14.5 billion (decrease of 6.5%). The foreign trade deficit (EUR 3.8 billion) is lower by 3.2% compared to the same period last year, while the coverage of imports by exports remained at 73.4%. Metals, cars, car parts and electric appliances remain the most significant export sectors.

Serbia continued its participation in the Central Europe Free Trade Agreement (CEFTA) and at the Sofia Summit in November 2020 it adopted together with the other Western Balkan partners an action plan to develop a Common Regional Market. The new initiative is structured around the four freedoms (free movement of goods, services, capital and people) and covers aspects of digital, investment, innovation and industry policy. This makes it the most ambitious regional integration effort to date in the Western Balkans. Serbia remains the region's only net exporter and CEFTA remains the country's second-largest trade partner after the EU. Regional cooperation has so far delivered concrete results, including the regional roaming agreement, an agreement on trade facilitation, a regional investment reform agenda, a decision on authorised economic operators, a decision to liberalise trade in services and an agreement to facilitate trade in fruit and vegetables. Further efforts are needed to continue with the ongoing implementation of the CEFTA Additional Protocol (AP) 5 on Trade Facilitation; the implementation of AP 6 on Trade in Services; and playing a constructive role in ensuring the finalisation of negotiations on the CEFTA AP 7 on Dispute Settlement in 2021. These priorities are correctly identified in the ERP, notably in *Reform measure 18 ("Improving conditions for and removing obstacles to trade").* In addition, other aspects of the Common Regional Market Action Plan should be implemented without delay, such as the free movement of people with IDs, the regional development of e-commerce or the mutual recognition of professional qualifications. That would contribute to unleashing the regional potential of trade in services. It is important that regional initiatives include all Western Balkan partners and are in line with EU rules, building on existing commitments.

Measure 18: "Improving conditions for product safety and removing barriers to trade"

This measure has been rolled over from previous ERPs. Reducing barriers to trade is important to strengthen the competitiveness of the economy and boost economic growth, in both the short and the long term. Businesses continue to face systematic inspections at the border because of the non-recognition of EU certificates. Cumbersome inspections hampering trade could be classed as measures having an effect equivalent to quantitative restrictions. The activities planned under CEFTA are appropriate and credible. Serbia should continue to play a constructive role within CEFTA. Regrettably the progress on the finalisation of WTO accession has been minimal in the past years. In this regard, Serbia is committing to making certain amendments to provision in its law on genetically modified organisms that constitute a major stumbling block in the accession process. Serbia's announcements need to be followed up rapidly and resolutely, which has so far not been the case.

Transport

As Serbia keeps expanding its transport infrastructure, compliance with EU standards, interoperability, costing, planning and maintenance become increasingly relevant to ensure that these investments provide maximum benefit to Serbia's economy. An updated transport strategy leading to an EU *acquis*-compliant transport sector still needs to be put in place in Serbia. Critical improvements are needed in traffic management, maintenance, road safety and the transparency of transport investments. The reform of the railway system is ongoing and progress is being maintained. Improvements regarding inland waterways are underway; the potential of river ports as important trade channels needs to be further examined and their full interoperability with roads and railways needs to be secured.

Structural Reform 3: Reform of railways through harmonisation of the regulatory framework and enhancement of rail transport safety

Serbia's railway reforms are steadily progressing. The measures proposed in the ERP are further steps to advance the reform process and align the regulatory framework with EU rules. The focus on rail transport safety (modernisation of level crossings) and access charges is well chosen. The new methodology for track access charges is an important element for the further liberalisation of the rail market in Serbia. However, the measure has a narrow focus. Other important aspects of rail reform that Serbia should advance are the facilitation of border crossing procedures, the granting of train driving licences and safety certificates to foreign operators and mutual recognition of the rolling stock. Serbia needs put more focus on railway infrastructure maintenance, in particular with a view to the upcoming opening of new railway lines. Using rail to export and import goods should be more systematically encouraged to reduce pressure on the environment and on roads.

Agriculture

The importance of agriculture for the economy is slowly diminishing, but remains significant when coupled with the more dynamic food processing sector. Agriculture accounts for slightly more than 6% of gross added value, but employs around one-fifth of the labour force. Together, agriculture and exports of food products contribute significantly to employment and the balance of payments (18.5% of all exports in 2019). Weather conditions continue to have a strong influence on the sector's performance. Other difficulties facing the agricultural sector are (i) land fragmentation, (ii) low productivity due to outdated technologies, (iii) small economic size and (iv) low utilisation of agricultural land per farm. Moreover, the sector faces the challenge of meeting EU obligations in the areas of food safety, veterinary and phytosanitary regulation, strengthening responsible authorities in those areas, and a need to improve border inspections as regards risk analysis and risk-based performance. Finally, the real estate market for agricultural land is hindered by the weak cadastre/property registration, as well as the lengthy procedures for case settlements in courts.

Measure 4: “Improvement of the land consolidation process”

This reform measure is partially deducted from the reform measure 5 of last year’s ERP. Land consolidation is a timely and financially demanding process and the measure is therefore appropriate. However, there was no progress reported in this area for 2020 due to the COVID-19 outbreak and the ERP does not provide concrete information on the current state of play and the baseline scenario. Considering that no progress has been made over the past year, it is unclear whether the timeline for the fulfilment of the given tasks is realistic. Some activities (e.g. land consolidation in Smederevo area) are unclear in terms of achievability due to the lack of legal basis. Delays in the adoption of the legal framework may cause further delays in the whole process. The measure could be more ambitious (e.g. it envisages hiring only one employee in 2021 and an additional four in 2022).

Measure 5: “Improvement of the financial support system for agriculture through digitisation and process automation”

The measure involves optimising and digitalising the procedures for submitting and processing applications for entry in the register of agricultural holdings and national approvals of incentives in agriculture. The reform is closely linked with a pre-condition for EU accession – the existence of a functional Integrated Administration and Control System (IACS). The measure has been rolled over from the previous year, with limited progress reported for 2020. The measure remains relevant and the risks outlined in the last year’s ERP assessment, most notably related to the long procedure for the adoption of the necessary legislation and the lack of human resources, remain valid.

Measure 6: “Improvements in the competitiveness of agriculture”

The measure represents a continuation of activities under reform measure 5 from the last year’s ERP, for which reportedly very limited progress was made in 2020. The measure is relevant, but faces the risk of the further postponement in the necessary legislative process, in particular regarding the adoption of the Law on Quality Schemes for Agricultural and Food Products and the Law on Organic Production (originally planned for two years ago and repeatedly postponed). The Commission’s comments in the last year’s ERP remain valid.

Industry

The competitiveness of industry is key to growing the economy. Support for incoming FDI is principally geared towards attracting manufacturers. After years of declining industry, its share in GDP has now stabilised. Industry accounts for a quarter of value added. Industrial production recorded a growth of 0.3% in 2019 (with manufacturing growth of 0.2% y-o-y). Lack of imported raw materials, disruption of retail chains and reduced demand contributed to the decline in business in the industrial sector during the COVID-19 pandemic. Industrial production in the period January-June 2020 was 1.8% lower compared to the same period in 2019. While manufacturing is stable, the performance of traditional industries such as mining and electricity generation varies considerably. Serbia adopted a new industrial policy strategy in March 2020, but is yet to adopt an action plan for its implementation. While support for investment is well rolled-out, other services are less developed. Clusters, technology parks, internationalisation, and industrial research do exist, and new standards or digitalisation in traditional industries have been introduced; however, these have not yet had a systemic impact. Measures of these kinds should be stepped up and their full compliance with state aid rules should be ensured. The ERP is regrettably lacking a substantive measure for green growth of industry.

Measure 7: “Boosting industrial competitiveness”

The reform aims at improving efficiency of instruments for implementation and better coordination of the industrial policy as defined by the strategy for the period 2021-2030 adopted in 2020. The reform seems to be broad, covering numerous areas (digitalisation, attracting investments and encouragement of export-oriented industries) and therefore not sufficiently focused. The Action Plan for implementation of the Strategy has been drafted and is currently in the process of consultation. The amount planned for the improvement of the technological structure of exports (approx. EUR 80 000 per year) does not look sufficient to carry out the planned activities. Activities under the measure should be further clarified as the ERP does not give details on sequencing or prioritisation. In particular, all activities are planned for all quarters of three years.

Measure 8: "Introduction of the circular economy concept"

The last year's ERP introduced for the first time a measure to promote the circular economy. The reform is very welcome as it recognises the benefits of circular economy for the environment, innovation, economic growth and job creation. This is particularly important in view of Serbia's need to improve in resource savings, energy efficiency and environmental protection. However, though it is a first step in the right direction, the measure lacks ambition. It does not include any immediate practical steps towards a circular economy, which would need to be underpinned by appropriate budgetary allocations and robust performance indicators. The ERP provides no data on the level of allocations from the Serbian budget for any of the three years. The adoption of an action plan has been delayed.

Measure 19: "Safe and quality product - industry development factor"

The measure involves linking together and improving the databases of all quality infrastructure institutions and ministries responsible for adopting technical regulations on industrial products, standards, conformity assessment, accreditation, etc. The measure is rolled over from the last year's ERP and provides roughly an equal timeline for the planned activities. The importance of this measure, designed to reduce technical barriers to trade, lies in its potential for making the economy more competitive and freeing up the free movement of goods flow between the EU and Serbia. It plans financial support to businesses, mainly SMEs, in subsidising products certification, the accreditation process and use of standards, and especially to those that were highly impacted by the COVID-19 crisis.

Services

Services account for over half of the economy and nearly 30% of total exports. About half the value added by services comes from retail, real estate and healthcare. Services have been increasing their share of total exports and have the potential to expand further. Despite the double growth of the surplus (net exports) of services in 2019 compared to 2014, the share of the services surplus of GDP is still at a relatively modest level of 2.3% in 2019 (increase by 1 pp. compared to 2014). Service exports are dominated by tourism, transport and ICT services. To further expand these fast growing and competitive services, investment in infrastructure and skills needs to be tailored to their needs. Targeted efforts are also needed to slow down the ongoing brain drain in most skilled labour. The Stabilisation and Association Agreement with the EU, does not provide for a framework for the liberalisation of services, but this does not significantly affect the above sectors. The CEFTA agreement highlights further sectors in which services could expand regionally, if enough progress were made towards achieving mutual recognitions of qualifications and certificates. Belgrade is well-positioned to function as a hub for the regional provision of many skill-intensive services.

Education and skills

This sector and the relevant reform measures 20 and 21 are analysed above in section 4 under key challenge #1.

Employment and the labour market

This sector and the relevant reform measures 22 are analysed above in section 4 under key challenge #1.

Social dialogue

Social dialogue needs further development, in particular in the private sector. Collective agreements are mostly concluded in the public sector. Only few agreements at branch level exist in the private sector. The social partners need to improve their co-operation in order to accommodate labour and employment challenges as e.g. imposed by the COVID-19 pandemic. Foreign investors should also participate in the social dialogue in Serbia as they represent a significant part of the employers in Serbia. The tripartite Economic and Social Council of Serbia should be consulted in good time on policy initiatives and draft laws. In addition the Economic and Social Council needs appropriate resources for its work.

Social protection and inclusion

This sector and the relevant reform measures 23 are analysed above in section 4 under key challenge #1.

Measure 24: "Digitalisation of the Healthcare system"

The reform is good for more transparency and efficiency in healthcare. The single electronic health card will establish an electronic health file with patient information accessible for health sector workers and patients. It will contribute to better diagnosis and treatment through centralised and instantaneously available patient and treatment information. The initiative is a step forward towards digital transformation of the health sector and contributes to the SDG 3 good health and well-being. However, the measure does not alleviate the shortage and emigration tendencies of medical staff.

4.7. THE 2021 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, 12 July 2021

[…]

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

1. Provide well-targeted and temporary pandemic-related fiscal support to vulnerable households and businesses; provided the economic recovery is well entrenched, plan a gradual return to a deficit close to balance in the 2022 budget and medium-term fiscal framework. Contain overall spending on wages as a percentage of GDP by adopting an adequate wage indexation mechanism and taking steps towards an appropriately designed public sector wage system reform. Adopt a credible and binding system of fiscal rules for entry into force as of 2022.

2. To reduce the grey economy, increase VAT collection and improve the tax control process, implement the new model of electronic fiscalisation and the transition to electronic invoicing according to the ERP 2021 timeline. To increase the transparency of the fiscal impact of state-owned enterprises, reinforce fiscal risk analysis capacity and publish quarterly reports on SOEs' financial performance.

   Implement the first steps of the time-bound action plan for deployment of the new SOE ownership and management strategy to improve the governance of SOEs and reduce related fiscal risks.

3. Maintain a strong financial sector regulatory framework in line with international and EU best practices, maintain sound credit risk management, as well as a transparent display of asset quality and adequate provisioning. Further reduce remaining obstacles to swift and effective NPL resolution. Continue efforts to promote the use of the national currency, including by further encouraging forex hedging and raising awareness of risks related to forex lending.

4. Further improve transparency in the adoption and implementation of legislation, particularly by ensuring a timely consultation of businesses and social partners on new legislation affecting their operations. Ensure a harmonised approach for prioritising and monitoring all investments and base investment decisions on feasibility studies, cost-benefit analysis and environmental impact assessments. Apply the principles of competition, equal treatment, non-discrimination and transparency in public procurement and state aid procedures in line with the EU *acquis* for all public investment projects regardless of the financing source and ensure an operational independence of the Commission for State Aid Control.

5. Develop a long-term energy and climate strategy in line with the Green Agenda for the Western Balkans and international commitments, and step up investments in modernising energy infrastructure and lowering carbon emissions. Implement regulatory, financial and institutional measures for higher take-up of renewables and energy efficiency, including introducing renewable energy sources (RES) auction system and establishing a sustainable financing mechanism for energy efficiency. With a view to further liberalising the energy market, address outstanding reforms, in particular of the energy utility EPS, including price and tariff reform, accelerate the unbundling of Srbijagas in a manner compliant with the EU acquis, and provide third-party access to gas infrastructure.

6. Reduce poverty by increasing the adequacy of benefits of the Financial Social Assistance (FSA) scheme for individuals and families with children and by increasing substantially the untaxable wage base close or equal to the level of the minimum salary for workers. Facilitate school-to-work transitions by stepping up further VET, including dual VET, through revised curricula and the provision of infrastructure which enables the acquisition of practical skills. Develop in co-operation with all relevant ministries, their agencies and stakeholders a Youth Guarantee Implementation Plan.

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

Area/Sector	2016	2017	2018	2019	EU-27 Average (2019 or most recent year)
Energy					
Energy imports dependency (%)	29.7%	33.8%	34.6%	35.6%	60.62%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	418.39	418.01	394.50	375.78	112.92
Share of renewable energy sources (RES) in final energy consumption (%)	21.15%	20.29%	20.32%	21.44%	19.73%
Transport					
Railway Network Density (meters of line per km^2 of land area)	42.55 [w]	42.53 [w]	42.53 [w]	42.52 [w]	49.0 [(2018)]
Motorisation rate (Passenger cars per 1000 inhabitants)	266.3	278.2	284.1	297.6	519 [(2018)]
Agriculture					
Share of gross value added (Agriculture, Forestry and Fishing)	8.2%	7.2%	7.7%	7.2%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	18.6%	17.2%	15.9%	15.6%	4.3%
Utilised agricultural area (% of total land area)	39.1% [w]	38.8% [w]	39.4% [w]	39.3% [w]	40.0% (2017, EU-28)
Industry					
Share of gross value added (except construction)	26.4%	26.5%	25.4%	24.0%	19.7%
Contribution to employment (% of total employment)	20.2%	21.2%	22.5%	22.6%	18.1%
Services					
Share of gross value added	60.7%	61.3%	61.5%	61.9%	73.0%
Contribution to employment (% of total employment)	57.0%	57.5%	57.2%	57.0%	70.8%

Business Environment					
Rank in WB Doing Business (Source: World Bank)	54	47	43	48	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	94	78	65	72	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	Up to 34.5%	N/A	N/A	25-30%	N/A
Research, Development and Innovation					
R&D intensity of GDP (R&D expenditure as % of GDP)	0.84%	0.87%	0.92%	N/A	2,2%
R&D expenditure – EUR per inhabitant	43.6€	48.6€	56.3€	N/A	688.6€
Digital Economy					
Percentage of households who have internet access at home	64.7% [w]	68%	73%	80%	86% (2018)
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	67.1%	70%	73%	77.4%	85% (2018)
Trade					
Export of goods and services (as % of GDP)	48.6%	50.5%	50.4%	51.0%	49.4%
Import of goods and services (as % of GDP)	53.3%	57.1%	59.1%	61.0%	45.7%
Trade balance (as % of GDP)	-6.8%	-8.1%	-10.3%	-11.7%	N/A
Education and Skills					
Early leavers from education and training (% of population aged 18-24)	7.0%	6.2%	6.8%	6.6%	10.2%
Youth NEET (% of population aged 15-24)	17.7%	17.2%	16.5%	15.3%	10.1%
Formal child care - children aged less than 3 years (% of total)	18.1%	14.5%	13.3%	17.2%	35.3%
Individuals' level of digital skills (% of individuals aged 16-74 who have basic or above basic overall digital skills by sex)	N/A	39%	N/A	46%	56%

Employment					
Employment Rate (% of population aged 20-64)	59.1%	61.4%	63.1%	65.2%	73.1%
Unemployment rate (% of labour force aged 15-74)	15.4%	13.6%	12.8%	10.5%	6.7%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	14.4 pps.	14.0 pps.	14.7 pps.	13.9 pps.	11.7 pps.
Social Protection System					
% of population at risk of poverty or social exclusion	38.5%	36.7%	34.3%	31.7%	20.9%
Impact of social transfers (Other than pensions) on poverty reduction	21.28%	18.67%	17.91%	18.02%	32.38%
Self-reported unmet need for medical care (of people over 16)	4.5%	4.8%	5.8%	4.8%	1.7%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	11.02	9.38	8.58	6.46	4.99

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

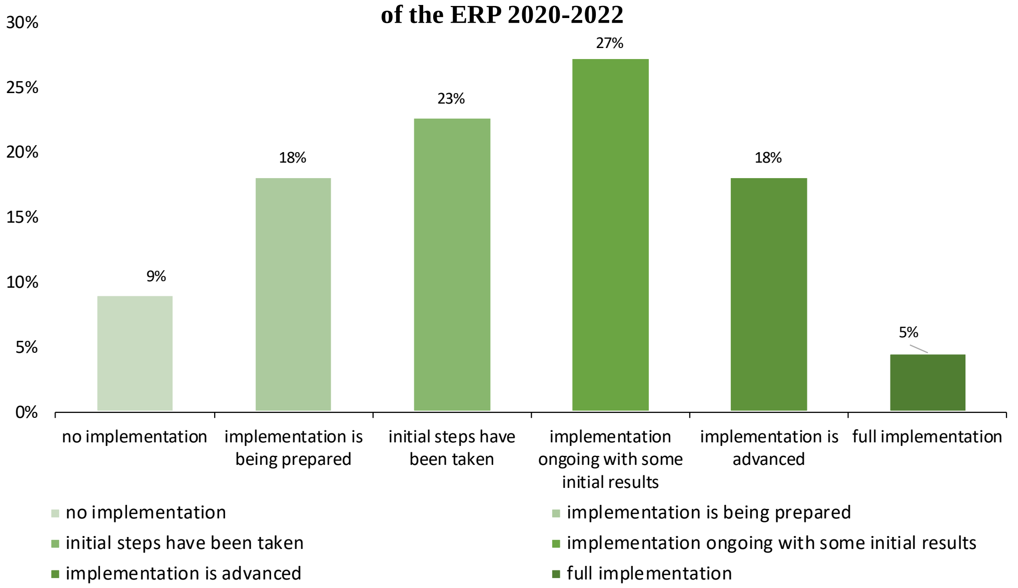
Source of data in Annex A: EUROSTAT unless otherwise indicated

ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2020-2022

There was some progress in implementing the measures in 2020, with an average score of 2.8 out of 5 (down from 3.3 in 2019). The reporting on the planned activities is precise and fair. Some relatively easy reform steps contribute to higher grades, but overall there is a good description of the level of implementation and indication on what remains to be done.

As in the previous years, the highest level of implementation involves the measures on business environment, in particular the improvement of the access to finance and digital transformation of SMEs and further reduction in administrative and regulatory burden. However, for a number of other measures, particularly complex ones, the implementation rate drops significantly, often to below 50%. As in the previous years, the pace of implementation in the area of governance of public enterprise is slow. The slow implementation has also been noted in the areas of environmental protection, financing and competitiveness of agricultural producers and processors, and improving road transport capacity and quality.

Graph II.4.2: **Serbia - Implementation of the structural reform measures of the ERP 2020-2022**



ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government adopted and formally submitted the Economic Reform Programme on 31 January 2021. The programme is in line with the medium-term fiscal strategy and the 2021 budget and covers 2021-2023.

Inter-ministerial coordination

Preparation of the Economic Reform Programme (ERP) 2020-2022 was coordinated by the Ministry of Finance (Minister of Finance was appointed as a national coordinator) and the Secretariat for Public Policies. National Bank of Serbia (for macro-fiscal part) and a number of line ministries (for structural reform measures part), together with some other relevant institutions, were also contributing through a working group established specifically for this exercise. Taking into account that the exercise was repeated for the seventh time, there has been accumulated "know-how" and "lessons learnt" from previous rounds, which further improved the overall process. Several trainings, in particular by the Centre of Excellence in Finance (CEF) and GIZ, were organised for those involved in preparation of the document.

Stakeholder consultation

The national authorities involved stakeholders in the process of the preparation of the document. Several rounds of consultations with a wide range of stakeholders were organised, as well as a meeting with the National Convention, which gathers about 700 social partners, NGOs, business associations and other relevant stakeholders in Serbia. National Convention established an inter-sectorial working group which examined the proposed reform measures and submitted comments and suggestion. The participants were given sufficient time to comment in writing and the draft was made available on-line. Comments received from stakeholders were included in the annex of the Economic Reform Programme document.

Macro framework

The programme presents a clear and concise picture of past developments. It also covers all relevant data at the time of drafting. The macroeconomic framework is sufficiently comprehensive and coherent. The baseline macroeconomic scenario is broadly plausible and major uncertainties and risks are clearly outlined and recognised. The programme presents an alternative macro-fiscal scenario resulting in lower economic growth and higher budget deficit and debt levels. While the alternative scenario appears very relevant in view of the identified risks in a context of high uncertainty, the underlying assumptions do not appear to be sufficiently detailed and quantified to allow for further assessment.

Fiscal framework

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

Structural reforms

Reporting on implementation of the 2020-2022 structural reform measures is detailed and up-to date. The ERP presents 24 reforms, 4 more than the maximum suggested by the guidance. The quality of measures vary. In some cases, measures are narrow in scope, well targeted and planned in good detail, while in others they are overly ambitious and wide in scope. The annexed tables are filled in appropriately.

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5. TURKEY

5.1. EXECUTIVE SUMMARY

Turkey was one of the few countries in the world that experienced positive economic growth in 2020, at the cost of exacerbating long-standing vulnerabilities and inequalities. The growth performance was driven by a low base effect, strong growth momentum before the pandemic, and a sizeable policy stimulus that boosted domestic demand. Crisis-response measures were dominated by a large credit impulse, led by state-owned banks, and underpinned by a rapid relaxation of monetary conditions. As a result, the lira depreciated, external imbalances and dollarisation increased, foreign exchange reserves declined precipitously, and the country risk premium went up markedly. Rising inflation and consumer lending at subsidised rates increased inequalities. In response to worsening vulnerabilities, monetary policy has shifted to a tighter stance since last November, bringing some relief to the lira, but decisively lowering inflation requires consistent policies sustained over a much longer period. Even though it is affected by high uncertainty due to the COVID-19 pandemic, the economic outlook of the Economic Reform Programme (ERP) is positive, with a strong rebound expected in 2021. Correcting external vulnerabilities, however, is likely to take longer than acknowledged in the programme and requires sustained stability-oriented policies. Reducing the high level of dollarisation poses a particular challenge. In view of the severely reduced buffers and renewed policy uncertainty following the dismissal of the central bank governor in March, Turkey also remains very exposed to changes in global financial markets and investors' sentiment in a challenging geopolitical environment. While bank liquidity and capitalisation appear strong, the risk premium remains high and the sector will have to deal with legacy issues and worsening asset quality once crisis related measures are lifted.

The programme targets a frontloaded fiscal consolidation, but misses an opportunity to alleviate a tense labour market situation. The policy response to the crisis involved a rather limited increase in crisis-related expenditure. Together with a strong revenue performance, this led to a significant fiscal tightening in 2020. In line with the previous programme's intentions, the authorities envisage a continued frontloaded fiscal consolidation. The magnitude of the planned consolidation in 2021, however, looks overly ambitious in view of the still fragile recovery and the extremely challenging labour market situation. The programme's medium-term deficit path is entirely based on a continuous decline in primary expenditure, to a level not seen in a decade. In view of the high level of uncertainty, a strong asset of the programme is that it presents rather prudent revenue estimates. Government debt is projected to stabilise in the low 40s as a percentage of GDP, but its maturity and currency structure implies some vulnerabilities. Transparency and public finance reforms advanced. However, fiscal risks, in particular from quasi-fiscal activities, remain elevated.

The main challenges for future economic policy are the following:

- **Renewed policy uncertainty, high inflation and low foreign exchange reserves contribute to elevated external vulnerabilities.** Addressing these challenges would require reinforcing central bank independence and maintaining a tight monetary policy stance over a prolonged period under a transparent framework and consistent communication.

- **The recovery remains fragile, uncertainty is high, and the labour market is still weak.** A more accommodative fiscal policy may be needed to balance the required tight monetary stance, support the recovery, and relieve some of the pressure on the labour market in 2021. Advancing a credible medium-term consolidation plan and further improving public finance quality could lower fiscal risks.

- **The regulatory and institutional environment lacks transparency and predictability which hampers much-needed foreign and domestic investments**. Major shortcomings in terms of independence of regulatory authorities and increased state interference in the economy hinder a market-based consolidation of a level playing field for economic actors. Limited access to finance is an obstacle to investments and growth perspectives for companies, which are particularly needed for the economic recovery from the COVID-19 pandemic and the realisation of Turkey's industrial policy ambitions.

- **The weakness of the labour market remains an issue.** The unemployment rate fell slightly in 2020 but this is not a sign of a structurally better performing labour market. It is rather the result of massive job-retention policies and an indication that workers were discouraged to look actively for a new job during the pandemic. The employment rate fell further with the COVID-19 crisis and may even come under more pressure when the short-term work schemes and the ban on layoffs expire. The potential of women in the labour market remains largely untapped. Active labour market policies as well as reskilling and upskilling offers do exist but are limited in scope. Undeclared work has decreased but remains at a high level. The already high NEET (not in education, employment or training) and youth unemployment rates have increased further.

- **The education system has improved but remains a key challenge.** Unfortunately, some of Education Vision targets such as mandatory schooling for 5 year olds, had already fallen behind. During the pandemic Turkey embarked on a commendable distance learning system, in which the state TV TRT-EBA broadcasts school lessons for the pre-school, primary, secondary and high school students on separate channels. In addition there is an education platform on the internet and tablets were distributed to families in need. Generally, the quality of education has improved as evidenced by the latest Programme for International Student Assessment (PISA).

The policy guidance set out in the conclusions from the Economic and Financial dialogue of May 2020 has been partially implemented, with the rate of implementation improving in comparison to previous years. Budget transfers to households and companies increased and measures were taken to cushion the impact of the crisis on the labour market, although the scope and size of these transfers were rather limited, leaving informal workers particularly exposed. Government investment was greater than initially planned and medium-term plans have been revised slightly upwards. Selective expenditure reviews were conducted in some spending areas and the 2021 budget law was prepared in line with programme budgeting. Monetary policy tightening and simplification since November have addressed a major policy shortcoming, helped stabilise the lira and lowered the country risk premium. However, the dismissal of the central bank governor in March has reversed most of these gains and significantly increased risks. Some reform measures have been announced with regard to the rule of law and the business regulatory environment, but these fall short of addressing core problems in these areas. The number of companies under trusteeship decreased but still remains significant. Turkey rolled out a bold job retention scheme and a ban on layoffs which avoided an employment meltdown. Undeclared work has decreased but there were no specific measures for refugees under temporary protection. Active labour market policies encouraging female labour market participation and youth employment have been continuing but remain limited. Education reforms have continued but the impact remains to be seen.

Overall, the programme correctly identifies the main structural challenges facing the economy, but policy credibility is weak and reform implementation remains uncertain. The Turkish authorities are aware of the numerous structural challenges and vulnerabilities facing the economy. Reform plans have been prepared to address many of them across a wide range of sectors. However, their timely implementation would test the authorities' resolve. Some of the proposed measures in the ERP are also rather small-scale projects that will not result in systemic changes. Despite a strong rebound from the crisis, the recovery remains fragile and major imbalances persist. Turkey has started to address the challenges in the area of education but the impact of the measures will show only in the following years.

Unfortunately, mandatory schooling for all 5 year olds was pushed beyond 2023. Evidence-based active labour market policies need to be stepped up and the fight against informal employment needs to be continued. Structural bottlenecks, like the low labour market participation of notably women and young people in general, remain as relevant as before.

5.2. ECONOMIC OUTLOOK AND RISKS

Turkey was one of the few countries in the world that experienced positive economic growth in 2020. The economy expanded by 1.8%, clearly above the 0.3% expected by the ERP. Several factors made this growth performance possible – the low base effect (2019 growth was just 0.9%), a strong growth momentum before the pandemic (end-2019, early 2020), and a large policy stimulus. Thus, after a slump in the second quarter, the economy rebounded quickly to its pre-crisis level as early as the third quarter of 2020. Growth was driven by domestic demand and remained strong in the last quarter, despite subsiding as a result of a shift towards tighter monetary policy and new restrictions introduced in the wake of a second COVID-19 wave.

The policy reaction to the crisis delivered a quick rebound but exacerbated long-standing vulnerabilities and inequalities. The authorities' crisis-response measures were dominated by a large credit impulse, led by state-owned banks and underpinned by regulatory decisions and rapid relaxation of monetary conditions. Of the estimated 12% of GDP stimulus in 2020, some four fifths came through the credit channel. However, the large-scale monetary stimulus weakened the lira, increased external imbalances and dollarisation, and depleted foreign exchange reserves. Importantly, the policy response also aggravated inequalities by increasing inflation and providing consumer lending at subsidised rates to the relatively well-off segments of society. At the same time, fiscal measures focused on deferring tax and social security obligations, with rather limited transfers to the most vulnerable, like those who lost income and jobs in the crisis.

The ERP expects economic growth to increase further and the negative output gap to close in 2023. The macroeconomic and fiscal outlook continues to be affected by high uncertainty due to the COVID-19 pandemic. Nonetheless, after rebounding to 5.8% in 2021, economic growth is forecast to move to 5% in the medium term. Final domestic demand is projected to remain persistently robust throughout the whole 2021-23 period. Following a strong recovery in 2021, the contribution of net exports to growth is seen as broadly neutral afterwards. A larger-than-expected carry-over effect could potentially boost short-term economic growth even beyond the programme's expectations. At the same time, assuming unchanged growth fundamentals, medium-term growth prospects might prove lower as the output gap might close earlier than forecast. Capital stock and employment are expected to be the main factors of growth, while total factor productivity is projected to remain subdued. The programme acknowledges the high pandemic-related uncertainty and sketches out an alternative low-growth scenario, but fails to present sufficient detail to allow it to be assessed. In addition, the policy uncertainty following the dismissal of the central bank governor in March is likely to affect confidence, thereby constraining growth and undermining growth fundamentals.

Lowering persistently high inflation is a medium-term project, which is undermined by the lack of central bank independence and high policy uncertainty. Inflation increased to 15% y-o-y at the end of 2020, far above the central bank's 5% target. The disinflation path envisaged in the ERP is too ambitious and has since been revised. In an attempt to strengthen confidence, monetary policy reversed course in August last year. It tightened further under a new central bank governor, who took over the reins at the bank in November and in several steps raised the key policy rate by 875 basis points to 19% in March 2021. The monetary framework was simplified and made more transparent. The authorities' intention, outlined in the ERP, to maintain a tight monetary policy stance until 2023 is motivated by the need to anchor inflation expectations, stabilise the exchange rate, reduce dollarisation and rebuild foreign exchange reserves. However, this policy direction was severely undermined by the dismissal of the central bank governor in March, barely four months after he took office. His removal triggered financial market instability, increased uncertainty and called into question the authorities' commitment to reducing inflation and external vulnerabilities. It also showed that maintaining a sufficiently tight monetary policy stance over a prolonged period remains a challenging task, as demonstrated by a long history of missed targets and rapid policy reversals.

Table II.5.1:
Turkey - Comparison of macroeconomic developments and forecasts

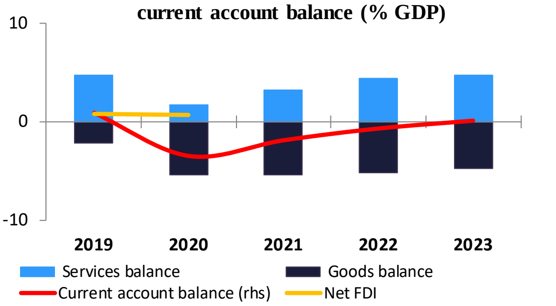
	2019		2020		2021		2022		2023	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	0.9	**0.9**	-2.5	**0.3**	3.9	**5.8**	4.5	**5.0**	n.a.	**5.0**
Contributions:										
- Final domestic demand	-2.2	**-2.0**	-1.8	**0.2**	2.4	**4.8**	4.0	**4.9**	n.a.	**4.7**
- Change in inventories	-0.1	**0.6**	4.0	**5.0**	-1.0	**-1.0**	0.0	**-0.1**	n.a.	**0.1**
- External balance of goods and services	3.2	**2.4**	-4.7	**-5.0**	2.5	**2.0**	0.5	**0.2**	n.a.	**0.2**
Employment (% change)	-2.3	**-2.3**	-4.3	**-4.8**	3.6	**6.0**	4.3	**4.1**	n.a.	**4.2**
Unemployment rate (%)	13.7	**13.7**	13.7	**13.8**	14.1	**12.9**	14.1	**11.8**	n.a.	**10.9**
GDP deflator (% change)	13.9	**13.9**	12.1	**11.9**	11.9	**9.9**	9.4	**6.4**	n.a.	**5.9**
CPI inflation (%)	15.2	**15.2**	11.8	**11.6**	11.7	**9.9**	9.2	**6.2**	n.a.	**5.4**
Current account balance (% of GDP)	1.2	**0.9**	-4.0	**-3.5**	-2.0	**-1.9**	-2.1	**-0.7**	n.a.	**0.1**
General government balance (% of GDP)	-3.0	**-3.0**	-6.2	**-6.1**	-6.0	**-4.5**	-5.3	**-4.0**	n.a.	**-3.6**
Government gross debt (% of GDP)	32.8	**32.5**	41.4	**41.1**	44.5	**40.8**	47.5	**41.6**	n.a.	**41.8**

Sources: Economic Reform Programme (ERP) 2021, Commission Autumn 2020 forecast (COM).

External vulnerabilities increased significantly and correcting them is likely to take longer than acknowledged in the programme. Foreign indebtedness surpassed 60% of GDP. The level and quality of central bank's foreign exchange reserves deteriorated notably as the share of the main global currencies in gross reserves declined. The central bank's net foreign assets (excluding swaps with local banks and foreign central banks) turned negative, falling to around USD 60 billion at the end of 2020. The country risk premium is likely to remain very high, given the increased policy uncertainty following the dismissal of the central bank governor in March. The current account deficit increased to above 5% of GDP last year, markedly above expectations, as a result of a widening trade deficit and losses in tourism revenues. Imports of goods remained relatively strong, in particular in the second half of the year. They were boosted by an outsized credit expansion and higher non-monetary gold imports, reflecting increased domestic financial stress. The ERP's external projections so not fully take into account the latest developments and are rather optimistic. In view of what is likely to be an only partial tourism recovery, higher than forecast import prices, and continued non-monetary gold imports, the current account deficit is set to remain sizeable in 2021 and clearly above programme estimates.

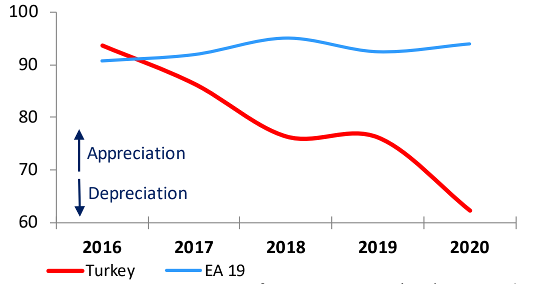
The potential to further expand the tradable sector and to attract more stable and longer-term external financing is still largely untapped. Although goods exports declined during the peak of the lockdown, they have recovered quickly, expanding mainly to non-EU markets. Despite the lira's appreciation since November, the effective exchange rate still gives a competitive edge to local exporters. This, combined with relatively low domestic labour costs and the expected recovery of the global economy, could support robust export growth over the programme horizon. The return to a more orthodox monetary policy was instrumental in bringing back some portfolio investment at the end of 2020. However, the dismissal of the central bank governor has not only renewed depreciation pressures on the lira but also triggered portfolio and other investment outflows. Attracting foreign direct investment (FDI) is recognised by the authorities as important to fostering the technological transformation of the economy. FDI has declined in recent years, hampered by geopolitical uncertainty, macroeconomic instability and concerns over the rule of law. If these are addressed, Turkey's competitive advantages could potentially allow it to attract much bigger FDI inflows.

External competitiveness and current account



Graph II.5.1a: **Turkey - Evolution of the current account balance (% GDP)**

Source: Economic Reform Programme (ERP) 2021.



Graph II.5.1b: **Turkey - Real effective exchange rate (CPI based, Index)**

Source: Economic Reform Programme (ERP) 2021 and ECB.

Boosting bank lending was the preferred policy reaction to recent crises but, although effective in the short-run, it has also built-up financial vulnerabilities. At the outset of the pandemic, the authorities doubled down on policies to support credit, using a wide range of macro-prudential measures. State-owned banks led the way, providing loans at below market rates and expanding their portfolio significantly. The size and scope of the Credit Guarantee Fund increased as well. Many of these measures have been lifted since the policy normalisation started at the end of 2020. As a result, credit growth has declined steeply, while in January 2021 total loans fell by 3% from their peak in October. Bank liquidity and capitalisation remain strong but, as loan deferrals and regulatory forbearance are removed, prudential measures are strengthened and the risk premium remains high, the sector will have to deal with legacy issues and worsening asset quality. This is likely to put additional pressure on commercial banks' equity and on the already low profitability of the sector.

Table II.5.2:
Turkey - Financial sector indicators

	2016	2017	2018	2019	2020
Total assets of the banking system (EUR million)	742	719	641	676	673
Foreign ownership of banking system (%)	30.0	28.2	26.8	26.0	25.0
Credit growth	16.7	20.9	16.0	10.9	34.7
Deposit growth	17.7	17.7	22.1	24.0	35.4
Loan-to-deposit ratio	1.19	1.23	1.18	1.03	1.04
Financial soundness indicators (end of period)					
- non-performing loans*	3.2	3.0	3.9	5.4	4.1
- net capital to risk-weighted assets	15.6	16.9	17.3	18.4	18.8
- liquid assets to total assets	8.1	8.0	10.7	10.0	9.4
- return on equity	12.5	15.9	14.7	11.5	11.6
- forex loans to total loans (%)	34.8	32.6	39.9	38.0	34.0

* including the impact of write-offs.
Sources: National Central Bank, Macrobond.

Increased dollarisation poses a particular challenge. Deposit dollarisation (including gold) reached new highs in 2020 as excess liquidity seeped through to the currency market and confidence in the lira was shaken. From the beginning of the year until early November, the lira lost some 40% of its value against the US dollar. It has since recovered part of these losses, but was again under significant depreciation pressure after the dismissal of the central bank governor in March. In view of the renewed policy uncertainty, dollarisation is likely to increase further from an already high level. Reversing this trend would require a prolonged stabilisation of the lira and reduced inflation expectations, which calls for sustained implementation of an independent and tight monetary policy. In managing their excess foreign exchange liabilities, banks have increased their exposure to the central bank by engaging in significant swaps. Gradually winding down the stock of these swaps, which amounted to around USD 40 billion in March 2021, poses a particular challenge. In view of the severely reduced buffers, Turkey remains particularly exposed to changes in global financial markets and investors' sentiment in a challenging geopolitical environment.

5.3. PUBLIC FINANCE

Budget performance significantly surpassed expectations in 2020. The central government budget deficit was 3.5% of GDP, against a revised target of 4.9%. Nonetheless, the deficit grew compared to the previous year and to the initial, pre-pandemic target of 2.9% of GDP, as interest payments, transfers and capital expenditure increased, while dividends from the central bank declined. Overall, revenue, in particular from indirect taxes, held up strongly. Buoyant domestic demand and targeted tax increases on certain goods, such as motor vehicles, supported revenue growth. Tax collection improved as well, as increased use of digital transactions curtailed the shadow economy. The targeted tax reductions and deferrals, introduced to combat the economic fallout of the crisis, were limited and had only a marginal impact on revenue. The policy response to the crisis involved a rather small increase in social spending and transfers to households, which kept the general government deficit significantly below the ERP target of 6.1% of GDP, implying a fiscal tightening in 2020. Although improving, the underlying budgetary balance, net of one-offs and temporary transactions (including another large super-dividend payment from the central bank), exceeded the headline deficit by some 1.8% of GDP.

Box II.5.1: **The Impact of the Measures Taken Against the COVID-19 Outbreak on Public Finance ***

Estimated fiscal impact of the COVID-19 crisis in 2020	**Due to one-off discretionary measures (in % of GDP)**	**Due to the slowdown of economic activity (in % of GDP)**
Central budget expenditure impact	One-off discretionary expenditure in different measures, 0.8% (TRY 38.5 billion)	Cost of credit subsidy provided for crafts and agricultural producers, 0.02% (TRY 1.1 billion)
Central budget revenue impact	Cost of tax reductions, 0.3% (TRY 15 billion)	Cost of tax and social security insurance premium deferrals 0.07% (TRY 3.6 billion)
Central budget total impact	**1.1% (TRY 53.5 billion)**	**0.1% (TRY 4.7 billion)**
Unemployment Insurance Fund impact	Short-term work allowance, unpaid leave cash support and normalisation support, 0.8% (TRY 36.9 billion)	
Total fiscal impact	**2.0% (TRY 90.4 billion)**	**0.1% (TRY 4.7 billion)**

Source: Economic Reform Programme (ERP) 2021 – Presidency of Strategy and Budget, Ministry of Treasury and Finance

*Only the direct budget effects of measures taken to mitigate the adverse effects of COVID-19 are given. The total economic impact of measures including loan service deferrals and subsided credits amount to TRY 552.7 billion (12.1% of GDP).

The ERP targets further frontloaded fiscal consolidation but misses an opportunity to alleviate a tense labour market situation. In line with the previous programme's policy intentions, the authorities envisage a significant reduction of the budget deficit over the programme period, by 2.5 percentage points (pps.), from 6.1% of GDP in 2020 to 3.6% of GDP in 2023. However, most of the reduction (1.6 pps.) is planned for 2021, with an estimated structural adjustment of 1.2 pps. The magnitude of the planned fiscal tightening in 2021 looks overly ambitious in view of the still fragile recovery and the difficult labour market situation. The programme's medium-term deficit path is entirely based on a continuous decline in primary expenditure, which is set to fall to 31.4% of GDP in 2023 – a level not seen in a decade. This comes at the cost of further supressing current expenditure and leaving capital expenditure at its current level, which is far below historical averages and the economy's needs. Nonetheless, in view of the high level of uncertainty, a strong asset of the programme is that it presents rather prudent revenue estimates. Although gradually declining to 31.0% of GDP, the starting point of total revenue in 2020 is stronger than assumed in the programme, thus leaving a margin for upside surprises.

Table II.5.3:
Turkey - Composition of the budgetary adjustment (% of GDP)

	2019	2020	2021	2022	2023	Change: 2020-23
Revenues	33.1	32.5	31.7	31.2	31.0	-1.5
- Taxes and social security contributions	25.1	25.3	25.6	25.5	25.4	0.1
- Other (residual)	8.0	7.2	6.2	5.8	5.7	-1.5
Expenditure	36.1	38.6	36.3	35.2	34.6	-4.0
- Primary expenditure	33.6	35.5	32.9	31.8	31.4	-4.1
of which:						
Gross fixed capital formation	2.7	2.6	2.6	2.4	2.6	0.0
Consumption	16.5	17.7	16.0	15.3	14.9	-2.8
Transfers & subsidies	7.8	8.8	7.8	7.7	7.6	-1.2
Other (residual)	6.6	6.4	6.5	6.4	6.3	-0.1
- Interest payments	2.5	3.0	3.4	3.4	3.3	0.3
Budget balance	-3.0	-6.1	-4.5	-4.0	-3.6	2.5
- Cyclically adjusted	-2.8	-4.4	-3.7	-3.6	-3.6	0.8
Primary balance	-0.5	-3.0	-1.2	-0.5	-0.3	2.7
- Cyclically adjusted	-0.3	-1.5	-0.4	-0.2	-0.3	1.2
Gross debt level	32.5	41.1	40.8	41.6	41.8	0.7

Sources: Economic Reform Programme (ERP) 2021.

The 2021 budget is conservative and has some space to accommodate additional measures to support economic recovery. The parliament approved the 2021 government budget on 19 December, envisaging a budget deficit of TRY 245 billion (4.3% of GDP), which corresponds to an estimated general government deficit of 4.5% of GDP. The programme expects real GDP to grow by 5.8%, while inflation is projected to be 8.0% at the end of the year. Since the budget's adoption, and taking into account the better than expected outcome in 2020, the authorities have identified additional fiscal space of at least 0.8 pps. in 2021. After the submission of the ERP, they signalled their intention to allocate it entirely to deficit reduction, which would further tighten an already tight fiscal stance. General government revenue is estimated to decrease by 0.8 pps., to 31.7% of GDP, almost entirely because of a drop in non-tax revenue due to lower interest income and receipts from the central bank. Total expenditure is planned to fall significantly more, by 2.3 pps., to 36.3% of GDP. The envisaged savings are planned to come from spending on goods and services (including on defence and security) and social security transfers, as pandemic-related measures are gradually lifted.

The authorities have extended some of the crisis-mitigation measures into 2021 but intend to withdraw them swiftly, despite the still high uncertainty and a weak labour market. With the 2021 budget, the government preserved its approach of providing limited, temporary and targeted support to sectors most affected by the pandemic. It extended the reduced value added tax rate on certain goods and services in the hospitality sector, maintenance and repair, until May 2021. It also extended the reduced withholding tax rate on interest from lira deposits and on rent payments. However, these revenue measures would have a marginal impact on the economy and the budget. Direct payments from the budget to the most vulnerable remained limited and are envisaged to expire as early as the first half of the year. The government has several times prolonged a short-term working allowance and a lay-off ban, currently into the second quarter of 2021 – two measures with significant cushioning impact on the labour market benefiting several million employees. Overall, fiscal support measures remain parsimonious, especially if set against the very challenging labour market situation.

The structural fiscal reforms strategy is evolving. In March, the authorities announced additional measures, including steps to increase budget transparency, promote expenditure efficiency, reduce the informal sector and improve public finance and debt management. If implemented, they would potentially allow for a further reduction in the share of one-off and temporary revenue, improvement of the tax structure, and a reduction in distortions. Permanently strengthening the revenue base could limit the conditions that have favoured ad-hoc decisions and tax amnesties in recent years. Expenditure reviews, on the other hand, could lead to budgetary savings over the medium term. The reform package includes targeted tax exemptions for around 850 thousand small entrepreneurs. There is also a set of largely administrative measures designed to monitor price increases and lower inflation, but they are likely to fall short of expectations, unless monetary policy is used decisively as the main tool for achieving price stability. Some of the steps identified to address another major vulnerability – the high current account deficit – are rather vaguely defined or a continuation of already applied policies, while others openly promote import substitution.

Government debt is projected to stabilise in the low 40s as a share of GDP. In 2020, the government debt ratio increased by 7 pps., to close to 40% of GDP. In addition to the higher primary deficit and interest payments, the depreciation of the lira pushed the government debt-to-GDP ratio up as well. With the forecast stabilisation of the exchange rate, and under the baseline budgetary scenario, the programme expects government debt to remain broadly stable over the medium term. Nevertheless, interest payments are projected to remain relatively elevated, above 3% of GDP, throughout the whole programme period. Part of the increased indebtedness was a result of the government's higher liquidity preference during the crisis and its enlarged holdings of financial assets. Consequently, last year net government debt expanded at a more measured pace, to around 20% of GDP.

Government debt maturity and currency structure imply some vulnerabilities. The significant increase in borrowing last year came at the cost of worsening debt vulnerability indicators. The average time to maturity of central government debt fell from 6.4 years in 2018 to 5.1 years in 2020. The decline was more pronounced for external debt, as the average time to maturity of domestic debt was already quite low at 2.8 years. Long-term borrowing in domestic currency remained relatively costly. Borrowing decisions and the depreciation of the lira drove the share of foreign exchange-denominated debt up to 56.2% of the total at the end of 2020 – a level last seen in the early 2000s. The share of domestic debt in total debt inched up to 58.5%. The flight of foreign investors from the domestic bond market was nearly complete last year – their share tanked to under 4%, before rebounding somewhat at the end of the year. Corporate investors also significantly reduced their exposure. State-owned banks filled the gap, holding close to 35% of all domestic debt by the end of 2020. The country's sovereign rating remains several steps below investment grade. The five-year sovereign risk premium increased considerably in the spring last year, peaking above 640 basis points in early May 2020. The changed monetary policy stance in November brought another rapid turnaround, bringing down the risk premium to 300 bps. It increased again to around 450 bps after the dismissal of the central bank governor at the end of March 2021, remaining significantly above that of peers and historic averages.

Box II.5.2: **Debt dynamics**

Inflation effects are expected to remain the main factor driving down the government debt-to-GDP ratio. Real economic growth is forecast to increasingly contribute to lowering the debt as well, while the debt-increasing contribution from the primary balance is expected to wind down gradually. Higher interest payments are projected to continue to be the main debt-increasing factor. Stock-flow adjustments, mainly driven by shifts in the exchange rate, are also pushing up government debt.

Turkey

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

	2019	2020	2021	2022	2023
Gross debt ratio [1]	**32.5**	**41.1**	**40.8**	**41.6**	**41.8**
Change in the ratio	2.7	8.6	-0.3	0.8	0.2
Contributions [2]:					
1. Primary balance	**0.5**	**3.0**	**1.2**	**0.5**	**0.3**
2. "Snowball" effect	**-1.3**	**-0.5**	**-2.6**	**-1.0**	**-1.1**
Of which:					
Interest expenditure	2.6	3.0	3.4	3.4	3.3
Growth effect	-0.3	-0.1	-2.3	-1.9	-2.0
Inflation effect	-3.6	-3.5	-3.7	-2.5	-2.3
3. Stock-flow adjustment	**3.5**	**6.1**	**1.1**	**1.3**	**1.0**

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

Source: Economic Reform Programme (ERP) 2021, ECFIN calculations.

Continued efforts are needed to counter the elevated fiscal risks. The authorities are cognisant of the still very high macroeconomic uncertainty and domestic vulnerabilities. To counter them, they have opted for a relatively conservative fiscal scenario, leaving some space to accommodate potential pressures on the budget. Motivated by the high level of risk, they have also increased significantly the level of public sector deposits and other financial assets, which stood at 5.4% of GDP for 2020. Efforts are being made to strengthen the monitoring and control of other risks, stemming from state guarantees and deficiencies in the framework for public-private partnerships (PPPs). Within the scope of the risk management framework, the debt assumption limit under PPPs has been kept unchanged at USD 4.5 billion in 2021. Other quasi-fiscal activities, however, like the operation of state-owned banks and enterprises, and of the Turkey Wealth Fund also carry budgetary risks that are not fully acknowledged. Potentially important risks, not sufficiently recognised in the ERP, could arise in particular from the sizeable amount of new credit provided by state-owned banks and public guarantees issued in response to the COVID-19 crisis with a view to supporting the economy. Recapitalisation and restructuring needs of the public sector as a whole, and in particular in sectors such as transportation that have been heavily affected by the crisis, may also put significant pressure on public finance.

Reforms to improve the quality of public finance have advanced. The 2021 central government budget and administration performance programmes were prepared and submitted to the parliament under the programme budget structure. Work on expenditure reviews has progressed as well, which the ERP expects will improve resource allocation and result in budgetary savings over the medium term. Systematic public information on expenditure arrears remained scarce. Important reforms have been announced with a view to strengthening the tax system and reviewing tax expenditure and exemptions. New legislation, which is at an advanced stage of preparation, aims to consolidate the preparation and management of PPPs into a single framework, fully integrating them into the budget process. While reform preparation has advanced, however, there is a need to avoid further delays and move decisively to the implementation phase. The structure of public expenditure is not sufficiently supportive of growth, as the level and share of investment in human and physical capital remains low.

Transparency improved but some weaknesses in the fiscal framework persist. The publication of the 2018 and 2019 audited reports of the Turkey Wealth Fund, in line with the ERP joint policy guidance from last year, is welcome. However, transparency related to quasi-fiscal activities and risks could be further improved. The fiscal framework remains narrowly defined and more efforts are needed to improve the credibility and effectiveness of the medium-term budgetary framework. There are no strong national fiscal rules and independent fiscal institutions to monitor fiscal performance and advise the government on fiscal policy matters. Budgetary preparation and fiscal analysis focuses almost exclusively on the central government level, with little attention being paid to developments at other levels of government.

5.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Turkey is endowed with a strategic geographic position, a strong and entrepreneurial business sector, a large domestic market and a young population. It also has privileged access to the EU market through the Customs Union with the EU. To provide jobs for the many new entrants to the labour market, since the early 2000s, the Turkish economy has relied on credit growth and foreign financing. As a consequence, structural imbalances worsened, amplifying the economy's vulnerability. As Turkey entered the COVID-19 crisis in the spring of 2020, it doubled down on expanding even further domestic credit and relaxing monetary policy. While this policy was effective in providing some short-term relief, it also further exacerbated the imbalances and increased inequalities.

The Commission has conducted an independent analysis of the Turkish economy to identify the key structural challenges to boosting competitiveness and inclusive growth. This analysis drew on the Turkish ERP itself, discussions with the authorities, as well as other sources. It shows that Turkey is experiencing a number of structural weaknesses across many sectors. Besides the need to secure long-lasting macroeconomic stability, which ultimately underpins prospects for inclusive and durable growth, the main challenges in terms of boosting competitiveness and long-term and inclusive growth are (i) increasing employment, in particular of women and young people, and formalising employment, (ii) raising the performance level of education, and (iii) improving transparency and predictability in the regulatory and institutional environment affecting businesses.

Turkey needs to tackle corruption, improve the rule of law and strengthen institutions in order to promote competitiveness. Addressing these fundamental concerns is a prerequisite for successfully transforming the economy. In its annual report on Turkey, the Commission is closely following the issues of strengthening the rule of law and fighting corruption.

Key challenge #1: Increasing employment, in particular of women and young people, and formalising employment

The strong economic growth rates since the turn of the millennium helped moving people out of informal employment in agriculture into formal urban employment in services. However, this development has come to a halt and the new reality is falling employment rates. The natural population growth with 800 000 new jobseekers every year, the influx of 3.6 million refugees under temporary protection and the labour market impact of the COVID-19 pandemic have left their traces on the labour market.

The country faced severe social and economic problems in 2020 but the rollout of short-term work schemes and a ban on layoffs prevented an employment meltdown. The pandemic has worsened the economic situation and Turkey's labour market has come under further pressure. The employment rate

(20-64) was at 53.8% in 2019 (EU 73.1%). In the fourth quarter of 2020 it was further decreasing by 2.4 pps. to 51.3.% in comparison with the fourth quarter of 2019. The activity rate (20-64) dropped from 61.9.% in the fourth quarter of 2019 to 58.7% in the fourth quarter of 2020. According to Turkstat, the number of employed persons decreased by 1 million 268 thousand persons in 2020 compared to the year before. The massive roll out of short- term work schemes, which involved a total of 6.2 million beneficiaries, the ban on layoffs and the obligation to grant unpaid leave for those not entitled to short-term work benefits avoided a worse employment downturn. The short-term work scheme pays benefits up to 60% of gross wages, with a ceiling of 1.5 times the gross minimum wage. The maximum of the short-term work benefit is TRY 4 380. For workers who are not entitled to the short-term work benefits due to insufficient prior contribution to the unemployment insurance scheme, the ban on layoffs applies. 1.4 million workers were granted unpaid leave until January 2021 and the government pays them monthly benefits of around TRY 1 200 (around EUR 135). This is approximately half of the minimum wage and hardly enough to survive. People who are informally employed and lost their jobs do not receive any benefits from the unemployment insurance. They are left to their own means as there is no minimum income scheme in Turkey.

The unemployment rate (15-74) amounted to 12.8% in the fourth quarter of 2020 (EU 7.5%), which is actually a 0.5% decrease from the same period of last year. However, this is mostly a statistical effect resulting from the ban on layoffs and the fact that many workers were discouraged from actively looking for formal employment, which is the prerequisite for being registered as unemployed. After the phasing out of the short-term work schemes and the ban on layoffs the unemployment is expected to increase again unless the economy rebounds very quickly.

One particular challenge is the underused potential of Turkey's young population. The rate of young people (15-24) not in employment, education or training (NEET) has increased to 26.9% in the third quarter of 2020, a rate almost triple the EU-27 average (10.1%) and 0.6 pps. above the same period of last year. Turkstat indicates an annual NEET rate of 28.3% (15-24) for 2020, which is an increase of 2.3 pps. compared to the year before. The biggest share out of this group are women, who do not enter the labour market. Until recently, the growth rates mitigated the situation to some extent, but now youth unemployment (15-24) stands at 25.5% in the third quarter of 2020, almost twice the level of overall unemployment. The fact that the labour force participation rate in the age group 15-24 has decreased in the third quarter of 2020 by 5.3 pps. y-o-y to 42.1%, suggests that an increased number of young people might have given up looking for a job in the current situation. The natural population growth that results in hundreds of thousands people joining the labour market every year aggravates the pressure on the labour market since the economy does not generate an equivalent number of jobs. Labour market participation thus deteriorates. To offer young people and especially those in the low-skilled segment valid prospects is one of the most immediate tasks for Turkish employment policy. The seriousness of the problem is demonstrated by the rate of young people in informal employment, which is 47.7% (i.e. almost half of all employment). In order to reverse the trend, Turkey has rolled out employment incentives for young people (18-29) for whom social security contributions are paid at minimum wage level.

Another big structural deficiency of the Turkish labour market is the underused potential of women in the labour force. The employment rate of women continues to be structurally lower than that for men. In the third quarter of 2020, the employment rate for women (20-64) was 32.7%, less than half of that for men (71.5%), which makes a gender employment gap of 38.8 pps. for the third quarter. The picture is the same for the activity rate. The activity rate of women (20-64) in the third quarter of 2020 was 38.8%, while that for men was 81.0%. Policies aimed at getting women into the labour market have so far had limited results. The most important policy initiative to increase employment and labour force participation among women has been to provide incentives to employers to hire female employees. This measure was introduced in response to the 2008 global economic crisis. More recently, Turkey introduced a number of Social Security Institution (SSI) pilot projects. EU funds financed one, where women are subsidised for third party childcare if they return to work and another involved grandmothers to provide childcare for children aged 0-3 years. Both programmes were discontinued. In 2019, two further programmes started, which support childcare provision but they do not involve more than 14 000 working mothers. The ERP contains now also includes Measure 20: "*Mother at work and child care support*", under which mothers with children can attend vocational training courses. 16 000 women are expected to participate in this qualification measure in 2021 and they can receive a childcare support of TRY 400 per month. These measures are indeed commendable but remain limited in scope and impact. The lack of childcare facilities beyond the big urban centres like Istanbul, Ankara and Izmir and the lack of appropriate work-life balance policies which would stimulate working-time flexibilisation continue to hinder female labour force participation. In addition, part-time work is less developed in Turkey at 10% in comparison with the EU average of 19%. Last but not least, traditional gender stereotypes do not see women as part of the labour force. They rather reduce women to unpaid care and household work in the family. Data compiled by the Turkish Statistical Institute indicate a very clear relationship between women's education and their labour force participation. 15.9% of illiterate women, 27.7% of female lower secondary school graduates, 34.3% of female high school graduates and 72.7% of female university graduates are in the labour force. Besides excluding them from societal life, the partial exclusion of women from participation in economic life is substantially limiting the growth perspectives in Turkey. According to a McKinsey study in co-operation with the Turkish Industry and Business Association (TÜSİAD) ([36]), Turkey's GDP would increase by 20% if it were to reach the OECD activity rate average of women (53.1% in 2019) within 10 years.

The bipartite and tripartite social dialogue is underdeveloped. Few employer organisations in Turkey such as the Turkish Confederation of Employer Associations (TISK) realise this or contribute towards its strengthening. Turkey continues to have a very low private sector trade union affiliation (13.8% of registered workers) and collective bargaining coverage (11% of registered workers). Only the public sector has a high organisation rate with 66.7%. The Economic and Social Council has not convened since 2009 and other social dialogue mechanisms are either not used or lack active involvement. As a result bipartite and tripartite social dialogue is weak and does not play a role as an enabling factor for inclusive growth. This and the limited involvement of social partners in defining an appropriate response to the COVID-19 pandemic are clearly missed opportunities.

Employers sometimes face difficulties in finding employees with the right profile. According to a survey by the HR solutions provider Manpower ([37]) 51 in 100 companies in Turkey state that they cannot find the right talent. Indeed, there is often a mismatch in horizontal skills such as ICT and oral and written expression. The low level of average problem-solving skills in technology-rich environments coincides with lower proficiency in literacy and numeracy among adults and low upper secondary attainment: In addition, jobs in Turkey face a high risk of automation. More than half of all occupations are at risk of redundancy in the near future. Further tailor-made reskilling and upskilling would be of great benefit for the workers affected by the changing world of work. With a view to this, Turkey has included Measure 22: "*Future Professions*" in the ERP programme, under which 18-29 year old workers are trained for the skills of Industry 4.0, namely digital processes and robotics. Unfortunately, the scope of the programme is limited to 1 750 participants. With some exceptions, the offers for lifelong learning are not fit for purpose and limited in coverage. Only 6.2% of the adult population participated in lifelong learning, which is considerably fewer than the EU (11.1%). For the time being there is no alignment with the objectives set by the European Agenda for Adult Learning and the European Skills Agenda. Nonetheless, the public employment service (ISKUR) has made efforts and, with the help of the EU programmes, has invested in capacity building. It has reinforced the career guidance system and increased the number of career counsellors. The ERP includes Measure 19: "*Job Clubs*", under which job-seekers receive job and vocational counselling. This is in itself a good initiative but women, young people and refugees often still get no, or no appropriate, advice and support and are left to their own devices. The coverage of active labour market policies is limited in general.

([36]) https://tusiad.org/en/reports/item/9642-women-matter-turkey-2016-report-turkey-s-potential-for-the-future-women-in-business
([37]) https://go.manpowergroup.com/hubfs/Talent%20Shortage%202019/2019_TSS_Infographic-Turkey.pdf

The rate of unregistered employment remains at a high level. It was at 28.0% in January 2021. The fall of 3.6 pps. in comparison to the same period last year is largely a statistical effect as the informal jobs in tourism, construction and domestic services were not available during the pandemic, whereas the formal registered employment was preserved by job retention schemes. Apart from economic costs such as lower productivity and tax revenues, there are considerable social costs generated by informality. Workers employed in the informal economy are subject to social exclusion and the absence of social security contributions and taxes weakens social security and tax revenues of the state budget. In Turkey tax revenues account for 25% of GDP, while on the average in the EU it is around 40% of GDP. Low levels of taxation can reduce the resources available for public education. This can lead to low levels of schooling, poverty and next generation informality. It is a difficult to break this vicious circle, which is limiting the growth potential of Turkey. In order to bring informality rates down further, the country has submitted a draft law to parliament, which provides for the waiving of fees and penalties if employers formalise workers. In addition, social security contributions for workers will be subsidised. This measure incentivises the creation of formal employment and is a step in the right direction. Additional steps should follow, notably targeting refugees under temporary protection, who largely work in the informal economy.

Key challenge #2: Raising the performance level of the education system

Overall, Turkey has made progress in education, especially in improving access to various levels of education. However, it faces many and various human capital development challenges.

At present, the educational attainment levels are still lagging behind the economic development in Turkey. Only 39% in the 25-64 age group has completed upper secondary education (OECD average 78%). The proportion of low skilled workers, i.e. those who have not completed upper secondary education, is even more striking: 53% of the workers in Turkey belong to this category as opposed to 17% in the EU. Compulsory schooling from 8 to 12 years was only introduced in 2012. In addition, the refugee and migrant influx continues to put substantial pressure on the education system, not only for the displaced people but also for the communities into which they settle.

Historically, Turkey has had the problem of an unskilled labour force, which is still an impediment for further growth. The country is addressing the low human capital development by upscaling its education system and the latest PISA 2018 assessment in Turkey shows that the gap between Turkey and the OECD average has indeed narrowed. The scores in mathematical and science skills went upwards between 2015 (mathematics score 420, science score 425) and 2018 (mathematics score 454, science score 468). Turkey has advanced from the 50th place in 2015 to 40th in 2018, out of 79 participating countries. The remaining challenge is notably reading skills (score 466 in 2018). Only 3% of students were top-performers in reading (OECD average 9%), whereas 26.1% were low performers (OECD average 23%). The ERP also includes Measure 15: "*Increasing the reading culture*", which is intended to boost the reading skills of the Turkey's young people through the rollout of Z-libraries and by providing e-book facilities. The measure is a step in the right direction and will improve reading skills.

Early childhood education and care services continue to be very limited in Turkey. The COVID-19 crisis did not help to improve the situation. Early childhood care is still only available in big urban centres and the enrolment rate for children up to the age of 3 years is very low. This has had consequences that go beyond education. It has hampered women's labour market integration and jobs recovery in the pandemic because women have often been taking care of the kids while schools were closed.

The kindergarten is attended by 54% of children and 71% of children aged 5 years were enrolled in preschool education. Full enrolment of 5 year olds in preschool education was initially scheduled for 2023, but has now been pushed back. The ERP includes Measure 14: "*Dissemination of pre-school education*". It provides for an enrolment rate of 75% by 2023. Turkey should pursue the original Education Vision goal of full enrolment of 5 year olds.

The enrolment rates in primary and secondary education leave room for improvement. The enrolment rate in primary education was 95.9% and the enrolment rate of 14-17 year olds in upper secondary education was 85% in 2020. At 95% lower secondary education is not universal either. In addition, there is a serious problem with early leavers from education and training (18-24 year olds), which at 31% is three times higher than the EU-27 average (10.2% in 2019).

Turkey responded to the COVID-19 crisis in education by launching distance learning through four channels provided by the state-run Turkish Radio and Television Corporation (TRT). The TRT-EBA TV broadcasts school lessons for pre-school, primary, secondary and high school students on separate channels. In addition there is an education platform on the internet. This is a commendable endeavour. However, according to the teachers' union Egitim-Sen some 6 million children are experiencing problems accessing the Education Informatics Network either because they have no computers or because of poor connectivity. This is an additional challenge for the inclusiveness of education as high-income households are more likely to provide the necessary equipment and infrastructure. Efforts targeted at disadvantaged students and refugees, who are less likely to have access to distance education, will be crucial. In this context, it has certainly helped to some extent that Turkey has distributed 500 000 tablets with a data package to children in need.

Turkey's ERP also includes Measure 16: "*Preparing digital skill based programmes*" which aims to enhance digital skills in the ninth grade: Digital literacy is indeed a key competence of the 21 century. In this sense the measure is more than appropriate.

Vocational education and training (VET) in Turkey has a potential for further development as it can mitigate to a certain degree the high NEET and youth unemployment rates. However, VET institutions often fail to provide the right skills set. The regular VET schools, where pupils in the tenth and eleventh grade are in class and in twelfth grade learn through practical work, are often not geared to the labour market. Turkey is aware of this and is broadly updating the curricula of VET education. It has also rolled out dual VET education, where theoretical training in VET school alternates with practical training in companies. The uptake of students in dual VET is better. 82% of the dual VET students get a job after completing dual VET training. Students of regular VET schools have greater difficulties in finding employment when they leave school.

Turkey's 2021-2023 ERP outlines the reform measures needed in technical and vocational education and training (TVET), some of which are related and complementary to the Riga Mid Term Deliverables. These include Measure 17: "*Updating curricula in vocational and technical education*", which aims to fostering labour market skills of presence and future and Measure 2*1: "Establishing a private sector cooperation protocol for vocational training and skills development*" (the MEGEP project – Strengthening the VET system in Turkey). These two measures were rolled over from the last ERP and go in the right direction. They are helping to increase the relevance of VET in Turkey for the labour markets of today and tomorrow. Efforts in this direction should be stepped up.

Turkey participates in the European Alliances for Apprenticeship (EAfA), which promotes the increased involvement of the private sector in skills matching for all levels of VET education. Turkey is also a partner in the EU programme Erasmus+. The country has access to actions in the field of higher education, youth, sport and VET as well as school and adult education projects for cooperation and mobility. It can also cooperate with partners outside Europe under international projects.

Turkey has also always shown a strong commitment to EU policies on education and training. Examples of this include the ET2020 Working Groups and the implementation and monitoring of the EU priorities for VET 2015–2020 (Riga Council Conclusions), in its commitment and pledges to EAfA. As regards skills mismatch in higher education, the business community observes a certain horizontal skills mismatch, as humanities are often preferred to ICT, natural science, business and economic studies, for which is greater demand. More and more university graduates have difficulty in finding a stable formal employment which causes academic informality and labour emigration. Generally, academic proficiency differs widely depending on the school and the students' socioeconomic background. In international co-operation on education Turkey participates in the Bologna process on higher education.

Nationally, Turkey has embarked on the Education Vision 2023 strategy, which is the strategic reform framework for the upscaling of the education system. The commitments are bold. There is a series of evaluation and assessment reports on different targets of the strategy, which is necessary to ensure the outcome. The ministries in charge of the implementation of strategy meet twice a year to take stock.

Key challenge #3: Improving transparency and predictability in the regulatory and institutional environment affecting businesses

Turkey's overall institutional and regulatory environment has been weakening further, despite the government's intention to improve the business climate. In the absence of an effective checks and balances system, the accountability of the executive remains limited. The backsliding in the rule of law continued, and major shortcomings remained in terms of the independence of the regulatory authorities. The increased state interference in the economy hinders the market-based consolidation of a level playing field for economic actors. Limitations in the access to finance are an obstacle to investment and to growth perspectives for companies, which are particularly needed for the economic recovery from the COVID-19 pandemic and the realisation of Turkey's industrial policy ambitions.

The New Economy Programme 2021-2023 recognises the need for reform and puts forward a set of initiatives reflecting the course of the Judicial Reform Strategy. These include the establishment of specialised jurisdictions in various sectors, the specialisation of judges, a reform of the notary system and its expansion to cover non-contentious cases, the promotion of arbitration systems and the increased use of digital technologies for judicial procedures. Such steps may improve procedures technically; however, they do not address overarching concerns, in particular with regard to the independence and professionalism of the judicial system. The Human Rights Action Plan announced in early March also envisages a number of new reforms, including new specialised courts and a revision of the anti-corruption and public procurement legislations. A new economic reform package was presented on 12 March 2021. Its four pillars (investment, production, export and employment) includes a series of measures addressing both macroeconomic imbalances and structural weaknesses. Operational details on the roll-out of these measures have not yet been published.

Effective measures to strengthen the rule of law, to ensure appropriate and timely contract enforcement and improve the availability and functioning of dispute settlement mechanisms remain key factors for improving Turkey's business environment. While Turkey has generally improved its position in the World Bank's Doing Business Index 2020, there has been further backsliding in the areas of contract enforcement and insolvency resolution. Even though alternative dispute resolution mechanisms have been promoted, commercial judicial processes are slow and a large backlog of commercial court cases remains. The implementation of the legislation to improve the insolvency system is behind schedule and the process remains inefficient. In order to mitigate the impact of the COVID-19 pandemic on businesses, all pending and new enforcement and bankruptcy procedures were put on hold until 15 June 2020, and concordat proceedings were suspended as well. However, no further initiatives on bankruptcy procedures were taken after that date, despite an alleged rise in cases.

The unpredictable regulatory environment represents a major obstacle to competitiveness. The regulatory environment ranks among the weakest dimensions in the latest available editions of notably the IMD Competitiveness Index, the INSEAD Global Innovation Index and the IMF country report. The number of regulatory changes in numerous sectors, in particular due to the transition from a parliamentary to a presidential system, has significantly increased in the last 5 years. There are no systematic mechanisms in place for consultations with businesses and social partners on legislative initiatives. Consultations are held through consultative boards, councils, working groups and technical committees established by a few ministries; yet neither a clear calendar for these meetings nor their conclusions are publicly available. Despite a legal framework already being in place for regulatory impact assessments, such studies are rarely carried out.

Market interventions by the state hinder competition and the capacity of economic operators to implement long-term business plans. Strengthening the legal framework for state intervention by making it more transparent, accountable and predictable is a key requirement for a more favourable business environment. Legislation to implement the law on State aid law has been pending for almost a decade. Recent changes in the administrative set-up for state aid have led to an oversight structure that is neither complete, nor independent or operational. Turkey continued the implementation of the general incentive package (2012 Incentive Scheme), the Project Basis Investment Programme and the support programmes provided by TÜBITAK (Scientific and Technological Research Council of Turkey) and KOSGEB (Small and Medium Enterprises Development Organisation of Turkey). These programmes were, however, not adapted to mitigate the impact of the COVID-19 pandemic.

State interventions in price-setting mechanisms in key product areas hamper the free functioning of product markets. The price level of more than a quarter of the goods in the consumer price inflation basket is directly set or strongly influenced by public authorities. In the energy sector, commercial and industrial clients who do not reach a consumption threshold are required to buy electricity from an assigned supplier at a price set by the regulatory authority. The gradual phasing-out of this obligation is still ongoing, but no end-date has been set.

The Turkey Wealth Fund and the Savings Deposits Insurance Fund (TMSF) are largely exempt from transparency requirements and competition. The Turkey Wealth Fund was created under a special law in 2016 and is fully owned by the government. According to its consolidated financial statements at the end of 2019, its total assets at that time were TRY 1 457 billion. The Fund was granted immunity, notably from the Law on the Protection of Competition, the Turkish Commercial Code and the Law on Capital Markets, and it is vested with unlimited borrowing capacity. The Fund is also exempt from certain taxes and charges such as the stamp duty, income and corporate taxes, tax deductions and the Istanbul stock exchange fees. These exemptions are problematic from a competition perspective with regard to the Fund's operations, despite the welcomed publication of its activity reports and financial statements for the years 2018 and 2019. The acquisition and management of companies under the trusteeship of the Savings Deposits Insurance Fund (TMSF) remains non-transparent. As of 30 September 2020, 804 companies with a total asset value of EUR 7.5 billion had been placed under TMSF trusteeship, down from 815 companies in February 2020. Neither a schedule for resolving the release of all companies from trusteeship nor appropriate, effective and timely means of legal redress are in place.

Another factor disrupting the smooth functioning of the market is widespread distortion in the allocation of government contracts and assets. Turkey lacks preventive and anti-corruption bodies while severe flaws in the anti-corruption legal framework allow undue political influence in the allocation of public resources. Public procurement is especially prone to corrupt activities on account of a number of exceptions allowed under public procurement law. Tender procedures covered by exceptions have significantly increased in recent years, while the number of contracts awarded via open auctions has fallen relative to the total number of contracts awarded. The lack of transparency in the selling of public assets by agencies such as the Housing Development Administration and the Saving Deposits Insurance Fund poses serious concerns about the political influence exerted over these bodies.

The informal economy also continues to distort the level-playing field for businesses and thus undermines competitiveness. The informal sector remains large, at close to 30% of GDP, well above the OECD average. The authorities continued to implement the Action Plan and Strategy for the fight against the informal economy (2019-2021). The results of the actions taken so far are, however, difficult to assess, since no concrete performance indicators were set and no data published. There are plans to extend the focus on reducing unregistered employment (ERP 2021, Measure 9, "*Reducing unregistered* *employment by focusing on increasing audit capacity in non-agricultural sectors"*); however, no targets have been set. There is no comprehensive longer-term approach for addressing the informal economy, including aspects of employment and the business environment that disincentivise formalisation, which would allow for sustained progress in addressing these issues.

The government has started to address the very low level of foreign direct investment in Turkey. Potential investors are discouraged by a number of obstacles, such as difficulties in getting approvals, weak enforcement of industrial and property rights and hidden market restrictions. Various measures for improving the investment climate have been initiated under the guidance of the Vice-President's Office. The finalisation of a new Investment Framework Law planned for mid-2020 and foreseen in the ERP 2020 was delayed; the draft is currently under consultation with stakeholders. As part of the ERP measure on investment procedures (ERP 2020, Measure 9, "*Creating guidelines for investment procedures in various sectors*") the additional action of a virtual one-stop-shop portal for information about investment support per sector and province provided by the Ministry of Industry and Technology has been set up and is operational (www.yatirimadestek.gov.tr). The procedural guidelines are still to be initiated (ERP 2021, Measure 8, Preparing new legislation for easing private sector investments).

Recent changes in capital market and banking legislations are welcome steps for the further development and deepening of capital markets. They include the easing of loan securitisation, the establishment of a single public insurance company, the establishment of a board of debt instrument holders, the concept of security trusts, project bonds, and project finance funds, and the expansion of the areas of activity of development and investment banks.

Limited financial resources hamper business development and the growth of companies. While emergency support has been provided to businesses to cushion the impact of the COVID-19 pandemic on economic activity, access to finance remains limited, especially for SMEs. Analysis from the United Nations and the World Bank highlights the fact that the business continuity of micro and small enterprises has been disproportionately put under strain by the COVID-19 pandemic. Such businesses are facing difficulties in maintaining employment and payments with limited operational liquidity, and are thus more likely to close permanently. Despite significant increases in the capacity of Credit Guarantee Fund (since early 2017), the 2019 Enterprise Survey shows that two thirds of Turkish firms are credit-constrained, compared to an average of 52% in higher middle-income countries. Most constrained firms are the discouraged firms, who didn't apply for a loan. The main reason deterring firms from applying loan is by far the high borrowing costs. The government has introduced stimulus packages to support business continuity, protect jobs and keep cash flowing to workers and businesses. The government support measures included a deferral of tax and social security payments, the provision of additional loan guarantees, extended cash transfers to low-income households and extended employment benefits. KOSGEB supported SMEs by extending the maturity date and covering interest costs of loans disbursed under the SME Loan Interest Support Regulation.

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

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

Turkey faces considerable challenges concerning the indicators of the Social Scoreboard ([38]) supporting the European Pillar of Social Rights. This is notably the case for equal opportunities and fair working conditions, especially for those in informal employment. Turkey has a high rate of early school leavers (31%) and young people not in employment, education or training (NEETs, 27.6% for age group 15-24 in the third quarter of 2020). In the third quarter of 2020, the gender employment gap stood at 38.8 pps., the highest among the enlargement countries. Both the at-risk-of-poverty-rate-or-social-inclusion rate (39.8% in 2019) and the income quintile ratio (8.35 in 2019) are higher than EU-27 averages. Social dialogue has been deteriorating in recent years.

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

Low participation in the labour market applies in particular to women. The labour force participation rate of women is 32.7% in the third quarter of 2020. A significant part of the female population never enters the formal labour market. Between 2018 and 2019 unemployment rate was already high but largely stable, in the third quarter of 2020 it fell slightly to 13.2%. This was the positive effect of the short-term work schemes which were rolled out to 6.2 million beneficiaries and no sign of a structural improvement. .Enrolment figures for pre-primary and primary education were low but have improved over the years. However, the quality of education remains an issue, as indicated in the results of PISA testing.

Skills mismatch and limited reskilling opportunities limit labour market integration and mobility. Overall, education outcomes remain low. While primary

([38]) The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The indicators are also compared for the Western Balkans and Turkey, with one small adjustment in the age bracket for the unemployment rate (reducing the upper age limit to 64 instead of 74) for Albania and Kosovo due to data availability. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2019 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). Data from 2017-2019 are used and can be found in Annex A.

education is nearly universal, there are low enrolment and high dropout rates in secondary education. Teacher training and quality is another area which requires investment.

The impact of social transfers on poverty reduction is small. It accounts for only 8.94% (EU-27 average 32.38%).

Turkey has a well-developed system for labour market and social statistics. The Turkish Statistical Institute (TurkStat) is the main producer and coordinator of Turkey's statistical system. TurkStat publishes the Labour Force Survey (LFS) quarterly and annually and the Survey on Income and Living Conditions (SILC) annually.

5.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2020

Overall: Partial implementation (48.5%) ([39])	
2020 policy guidance	**Summary assessment**
PG 1:	There was **partial implementation** of PG 1.
Increase in a transparent manner fiscal transfers to households and companies with the view to limiting the fall-out in employment.	1) **Partial implementation:** Budget transfers to households and companies increased and measures were taken to cushion the impact of the crisis on the labour market. However, the scope and size of these transfers was rather limited.
Increase growth-enhancing capital expenditure above budget plans in 2020 and in the medium term.	2) **Substantial implementation:** Central government investment increased and capital expenditure execution in 2020 was above initial plans. Medium-term government capital expenditure plans have been revised only marginally upwards in comparison to the previous programme.
To reinforce the medium-term sustainability of public finances, prepare an exit strategy to lower the use of one-off and temporary measures over the medium term.	3) **Limited implementation:** Although budgetary performance improved, a medium-term consolidation strategy, focused on the phasing out of one-off and temporary measures is still under preparation.
PG 2:	There was **substantial implementation** of PG 2.
Conduct spending reviews and implement performance budgeting as planned, in order to create space for more productive expenditure and to increase budgetary transparency and accountability.	1) **Substantial implementation:** Selective expenditure reviews were prepared in some spending areas. The 2021 budget law was prepared in line with programme budgeting and submitted to the Parliament.
Publish the regular audited reports of the Sovereign Wealth Fund.	2) **Full implementation:** The 2018 and 2019 audited reports of the Turkey Wealth Fund were

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

Take preparatory steps towards publishing higher-than-annual frequency data by sub-sector on general government budget execution.	published on the Fund's web site. 3) **Substantial implementation:** Quarterly expenditure data are available by general government sub-sectors. Detailed revenue data are also available but in different formats.
PG 3: Implement an appropriate monetary policy stance at the central bank's own discretion to contain inflation broadly in line with the target and anchor inflation expectations, increase trust in the local currency and boost investor confidence, in particular amid the global risk-off environment evoked by the COVID-19 pandemic. Closely monitor financial stability challenges arising as a result of the COVID-19 pandemic and take appropriate action if needed. Ensure the transparency of measures taken to provide liquidity for the banking sector and support the flow of credit to the private sector. Enhance confidence in the banking sector by conducting transparent asset quality reviews, and explore further measures to mitigate the likely build-up of new NPLs.	There was **partial implementation** of PG 3. 1) **Partial implementation:** The monetary policy stance was not sufficiently tight throughout most of the year with highly negative real interest rates and double-digit inflation drifting further away from the target. In November 2020 policy priorities shifted towards price stability and simplifying the monetary policy framework, increasing credibility and temporarily boosting market confidence. These gains were, however, quickly erased after the unexpected dismissal of the central bank governor following the bigger-than-expected rate hike in March 2021. This has renewed concerns over the central bank's ability to determine the monetary policy stance at its own discretion and brought significant uncertainty about the future direction of monetary policy. 2) **Substantial implementation:** The authorities have taken decisive measures to provide borrower relief and help smoothing the adjustment of the banking system to the major economic shock experienced. The measures used to support lending throughout the year are gradually withdrawn and the normalisation process towards more stringent regulation is underway. In addition, banks were also required to maintain a prudent approach in loan restructurings. Regulation is nevertheless still complex, lacks transparency and deviated from international standards, e.g. concerning the NPL definition. 3) **Limited implementation:** There has been no tangible improvement with regard to transparency in asset quality. The authorities are not considering an independent third-party asset quality review, but are conducting regular stress tests. The full impact of the crisis in particular on asset quality is yet to become visible, likely requiring further adjustments.
PG 4: With the aim to improving the business environment, further strengthen the rule of law and the regulatory environment and improve consultation mechanisms with business	There was **limited implementation** of PG 4**.** 1) **Limited implementation**: The absence of an effective checks and balances system, the backsliding in fundamental freedoms, and shortcomings in the independence of regulatory

organisations and social partners on relevant new legislation.	authorities continued.A systematic consultation mechanism does not seem to be in place with the private sector, with the exception of the consultative board meetings of the Ministry of Trade, the Ministry of Culture and Tourism and the Coordination Council for the Improvement of Investment Environment. As regards social partners, tri-partite social dialogue mechanisms that are legally established are not fully functioning in Turkey.
In order to mitigate the impact of the COVID-19 pandemic, target state aid and small and medium-sized enterprises support programmes in a transparent manner to sectors with strong potential for economic recovery.	2) **No implementation:** During the pandemic, Turkey continued with the implementation of the general incentive package (known as the 2012 Incentive Scheme), the Project Basis Investment Programme and KOSGEB and TÜBITAK support programmes. There has been no particular targeting of State aid to mitigate the impact of the COVID-19 pandemic.
Implement additional measures helping viable businesses to avoid insolvency.	3) **Partial implementation:** All pending and new enforcement and bankruptcy procedures (with the exception of execution proceedings related to maintenance payments) were put on hold until 15 June 2020. Concordat proceedings were also suspended. At the beginning of the COVID-19 pandemic, the Government decided that trade registers would note ‘default due to force majeure’ for firms that defaulted in the period covering April to June. These steps were followed on 17 November 2020 by a Law on the Restructuring of Public receivables in order to ease the financial burden on companies. However, there has been no further legislative or administrative development since 15 June 2020 on bankruptcy procedures.
PG 5: Extend social protection coverage and provide incentives for businesses and employees in the informal economy sector to register and to facilitate their transfer to the formal economy.	There was **limited implementation** of PG 5: 1) **Limited implementation:** as part of the measures taken during COVID-19 pandemic, Law No 7256 (Provisional Article 27) enacted in November 2020 introduced an incentive for employers to register their unregistered employees. The incentive which is to be covered from the unemployment insurance fund provides a contribution support of TRY 44.15 for employers for each day they employ unregistered employees. The employer can use this incentive for up to 3 months provided he or she applied to the Social Security Institution by the end of 2020. Furthermore, the employer will not have to pay any penalties for employing unregistered employees. Since this is a recent incentive, no data are available yet.

Revise the Action Plan for reducing the informal economy taking into account the specific situation of migrant workers and those under temporary protection as well as the impact of COVID-19 pandemic.	2) **No implementation:** The action plan for reducing informal economy (2019-2021) has not been revised to include any action directly targeting migrant workers and those under temporary protection.
PG 6: Take measures to preserve jobs including through short-time work schemes and other employment flexibility schemes,	There was **partial implementation** of PG 6: 1) **Substantial implementation:** In 2020, during the COVID-19 pandemic, Turkey took bold measures to preserve jobs. Within this framework, the country eased the application criteria for the short-term work allowance (SWA). Accordingly, workers who have paid social security contributions for the last 60 days, and have paid unemployment insurance contributions for at least 450 days in the last three years can benefit from the SWA. According to statistics released on 31 December 2020, approximately 3.6 million workers received a short-term work allowance. Furthermore, an unpaid leave option for workers was introduced with an income support TRY 39.27 per day an there was a ban on dismissing workers during COVID-19 pandemic except for reasons of malicious intention on the part of the workers. Turkey also introduced flexible and remote working arrangements for civil servants during the COVID-19 pandemic.
step up VET training, re-skilling and up-skilling, and redesign and upscale targeted employment incentives, in particular for recently unemployed workers and young people.	2) **Partial implementation:** The Ministry of National Education has made the necessary legislative changes to open Private Vocational Education Centres for the re-skilling and up-skilling of individuals. These Centres are affiliated to the Ministry of National Education and follow the programmes defined by it. Graduates receive high school diplomas in the same way as those of other Vocational Education Centres. Due to the COVID-19 pandemic, till now only one centre has been opened in Gebze, in the newly established Electric Automobile Factory, but the planning process is ongoing for other centres. Existing employment incentives for women and young workers have been extended until end 2022. A “normalisation support” payment scheme was launched to encourage employers to rehire employees. This involves government clearing of a part of social security contribution debts. Debts of TRY 2.5 billion relating to 3.3 million employees have been cleared. No other measures have been developed for the unemployed, except measures to keep people in employment (see also first point of PG6).

Ensure adequate income support and social assistance for the unemployed and those at risk of poverty and social exclusion.	3) **Partial Implementation**: Due to the ban on dismissing workers, and the strict eligibility criteria of the unemployment insurance fund, the number of unemployment insurance beneficiaries has been decreasing since March 2020. In October 2020, only 255 000 people received unemployment benefits (compared to 594 000 in March 2020), though 4 million people were unemployed. Turkey has run a social support programme to increase the resilience of low income households in the face of the COVID-19 crisis. 6.4 million households each received a one-off payment of TRY 1 000 (around 40% of the net minimum wage). 2 million more households received TRY 1 000 each from a nationwide solidarity fund campaign launched by the Government. In a contradictory move, the Government has also banned solidarity campaigns led by some metropolitan municipalities and blocked the amounts already collected. Due to extensive bans on concerts and entertainment centres, around 24 000 musicians who lost their jobs will receive TRY 1 000 monthly support for three months.

5.6. ASSESSMENT OF THE AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2021-2023

Energy

The ratio of renewable energy installations in the total installed power generation capacity increased from 45% in 2019 to 51% in 2020. The share of the country's renewable energy in electricity generation in 2020 reached 47%, 33.3% of which came from hydropower. The increase in Turkey's installed renewable energy capacity is driven mainly by private investments benefitting from a preferential feed-in-tariff mechanism, which expired at the end of 2020. The continuation of this financial support mechanism was announced on 30 January 2021. As before, the State will provide financial support for the first 10 years of operation to all renewable energy power plants installed by 2025. The major difference is that the new mechanism is based on the local currency (i.e. the Turkish lira). In general, the new feed-in-tariff mechanism offers lower support than the previous support mechanism (e.g. 25% lower for hydropower, 40% lower for wind and 67% lower for solar power). The practice of granting state financial support for the use of domestic equipment in renewable energy installations continues to be of concern to the EU since such a local content requirement is not considered compatible with the EU-Turkey Customs Union.

Measure 1: "Increasing share of renewable energy regarding electricity generation"

This measure has been rolled over from the previous ERP. Its performance is considered to be very good. More details could have been provided as regards the scope of the planned monitoring activities. Turkey has been successful in the implementation of this reform measure, which therefore no longer needs to be rolled over in the upcoming period.

Measure 2: "Development of financial mechanisms regarding energy efficiency"

This measure has been rolled over from the previous ERP. Its performance is considered to be insufficient. Although some progress has been made as regards the implementation of the National Energy Efficiency Action Plan, the national energy efficiency financing mechanism planned is still not in place.

Measure 4: "Support mechanism will be established for the replacement of inefficient electric motors used in industry with more efficient ones"

This measure has been rolled over from the previous ERP. It is in line with Commission Regulation (EC) No 640/2009 with regard to eco-design requirements for electric motors, which Turkey transposed in 2012 (Turkish title: "*Elektrik Motorları ile ilgili Çevreye Duyarli Tasarim Gereklerine dair Tebliğ"*). Indicating the legal basis of the measure may add value to the text as the existing Turkish legislation has required the transition to energy-efficient motors since 2015. The measure can help the implementation of this legislation in an area where EU alignment is also targeted. However, rather than being a structural reform measure, this measure could have been considered as a part of overarching reform to increase the environmental, social and governance standards of industrial enterprises. It is difficult to assess the real impact since the overall number of electric motors to be replaced and the potential for savings is not known. Meanwhile, the risk defined as "Inability of measuring savings resulting from replacement" should have already been mitigated by defining the baseline data, measurement methods and target indicators.

Agriculture

The ERP identifies the need to change the legislation on agricultural statistics in order for agricultural holdings to be required to provide data on a mandatory basis rather than a voluntary basis. In the EU's common agriculture policy, only participation and provision of data for the Farm Accountancy Data Network System (FADN) is voluntary, but not statistical data collection. The FADN system has been established in Turkey since 2009 and is currently used in 81 provinces. However, the data collected through FADN are used for different purposes, particularly for determining and monitoring the annual agricultural incomes of enterprises and measuring their performances, and they are confidential. The ERP refers to the need for a legislative change from a voluntary system to a mandatory one, but the FADN cannot be mandatory if harmonisation with EU practice is to be secured.

Measure 3: "Improvement of data collection processes and increasing the capacity of evaluation in agriculture statistics"

This measure has been rolled over from the previous two ERPs. Insufficient information has been provided on what has been achieved so far within the context of this project. The report states that planned trainings could not be organised in 2020 due to the COVID-19 pandemic and several activities remained limited. The table on result indicators clearly shows that no improvement can have been achieved so

Industry

Turkey's industry, having struggled to maintain its competitiveness in the years prior to COVID-19, faces a severe double challenge of recovery and preparation for the green and digital transformation in a worsening business and investment environment. Industry, without construction, has raised its share of gross value-added in the second half of the last decade by around 10%, keeping its contribution to employment about constant. The domestic producer price index for industry has shot up by 80% during this period. The high dependency on foreign energy sources and raw materials has hardly diminished. Labour productivity has increased to almost 80% of the EU average. Salient structural weaknesses in comparison to the EU are indicated by the low number of top R&D spending enterprises and the employment share of medium to high-technology manufacturing and knowledge-intensive services that can be part of manufacturing value networks. Manufacturing exports are predominantly of low and medium technology intensity, with each accounting for around 40% of manufacturing exports, followed by resource-based goods at almost 17% and the high-technology share having surpassed 3% in 2018. Foreign direct investment (FDI) in manufacturing went dominantly into the chemical and the ICT industries in 2019. The EU is Turkey's largest export destination and FDI source. The automobile and the machinery industries contribute most to manufacturing exports to the EU. Among the manufacturing industries, the machinery industry is particularly characterised by small family-run enterprises. The productivity gap between large and small- to medium-sized enterprises has accelerated to increase, except for start-ups. The commercialisation of R&D remains hindered by the low capacity of Turkish SMEs to adopt process innovations.

Turkey implements policies to increase the proportion of high technology in its industry. The EU's acceleration of the green and digital transformation of its industry has not yet found an appropriate response in the ERP. The predominantly low-technology manufacturing in Turkey's less-advanced regions need access to services specific to upgrading their products and processes. The ERP measures 7 and 10 target the adoption and growth capacity of SMEs and hence add to the existing measures. They address manifest needs, if they target specifically SMEs likely to be threatened by the twin transformation or the low-technology trap. However, more systemic responses are to be conceived, if Turkey wants to fulfil its economic ambition.

Measure 5: "Establishing Model Factories (SME Competency and Digital Transformation Centers) and Innovation Centers to increase the efficiency of SMEs and their digital transformation"

This measure has been rolled over from the previous ERP. Under the measure, 14 Model Factories (SME Competence and Digital Transformation Centres) and Innovation Centres will be established and a Training-Consultancy Support Programme will be initiated in order to increase the productivity of SMEs and contribute to their digital transformation. However, the indicator used for this measure remains unclear and may not be performance-related. More specifically, as regards impact on gender, the measure is said to be gender-neutral. However, digitalisation may have a negative impact on gender balance if women do not have access to education in digital skills on an equal footing with men. It is also a fact that women participate less in digital professions. On the other hand, it may create opportunities for women through a transformation of the work space. Clearly, the issue is not gender-neutral and needs to be considered in connection with gender-based data. In 2018, the Ministry of Industry and Technology published the 'Digital Transformation Road Map for Turkish Industry'. However, there is no reference to this macro level policy document in this measure. Furthermore, there is no information about the Road Map targets and achievements.

Measure 7: "Establishment of SME Guidance and Counseling System"

This measure has been rolled over from the previous ERP. Like last year, it is included under the "Business environment and reduction of the informal economy" heading. It is not clear how business consultancy can improve the business environment. The measure puts the baseline at zero as of October 2020 and seeks to achieve ambitious targets by the end of 2021 in a pandemic-affected economy. The document does not indicate how this will be made possible. Under the measure, the number of authorised technical consultants for SME counselling is to increase to 1 250 from 0 and the number of SMEs serviced to 750 from 0.

Measure 10: "Increasing the number and efficiency of business development, incubation and accelerator centers in order to support innovative entrepreneurship"

This measure has been rolled over from the previous ERP and aims to increase the number and efficiency of business development, incubation and accelerator centres. However, the analysis fails to mention the lack of adequate infrastructure. There are 85 Technology Development Zones, 1 237 R&D centres and 368 design centres in Turkey. The measure could be better focused on increasing the efficiency of the existing centres. The support is provided for furniture, equipment, hardware, human resources and training and marketing costs. Therefore, the link between the main problems (entrepreneurs access to finance for technology transfer and support to networking) and the measure (support for the establishment of new centres) is not clear.

Services

The further expansion and diversification of tourism in Turkey is one of the priorities of Turkey's New Economic Programme 2020-2022 for restoring sustainable growth and increasing employment. In spite of the already strong performance of the tourism sector, the average expenditure per person remains very low, and there is still a largely untapped potential in the tourism sector.

Tourism is one of the sectors most affected by the COVID-19 pandemic, which has brought about new challenges for the approach to developing this sector in the future.

Measure 6: "Increasing tourism market share and brand value"

This measure has been rolled over from the previous ERP. As the tourism sector is one of the sectors which were hit hard by the COVID-19 pandemic, the roll-over of this measure from the previous ERPs is justifiable. The measure therefore remains relevant, as it aims to address Turkey's needs to diversify its tourism products. In the light of the global pandemic developments, the scope of the measure has been also broadened, this time with a special emphasis on the development of tourism-related digital services and platforms as well as on activities focusing on hygiene and health-oriented service understanding. However, the measure only focuses on marketing and branding actions and refers to the Tourism Master Plan as a very limited basis. There are no actions to increase service quality and tourism infrastructure, in particular for rural areas and the regions that are lagging behind. Indeed, there are significant disparities between the different regions of Turkey in terms of quality of services and tourism infrastructure. Therefore, if Turkey intends to diversify its tourism products and destinations; the quality of services, skills and the tourism infrastructure (accommodation, transport, urban and municipal infrastructure) should be upgraded in particular in rural areas and those regions that are lagging behind but have remarkably important natural, historical and cultural assets (such as the Black Sea and eastern and south-eastern Anatolia). Furthermore, if the aim is to diversify the types of tourism, it is essential to develop a strategy which keeps in mind the prospect of promoting sustainable tourism; this means that a better assessment of the expected impacts on the environment is required than the one presented in the ERP.

Business environment

The business environment and the relevant Measure 8 is analysed above in section 4 under key challenge #3.

Informal economy

The informal economy and the relevant Measure 9 is analysed above in section 4 under key challenge #3.

Research, development and innovation

Turkey's new Industry and Technology Strategy has set ambitious targets for increasing expenditure on R&D to 1.8% of GDP and for increasing full-time-equivalent staff in R&D to 300 000 by 2023. Although there has been some progress since 2018, the gap between actual figures and the 2023 targets remains significant, as does the gap with the EU-27 averages.

Turkey remains a 'moderate innovator' according to the European Innovation Scoreboard for 2019. In 2018, there was a significant increase in innovation performance, mainly due to the number of innovators, the amounts invested by firms and an innovation-friendly environment. Structural challenges persist in the low proportion of employment in high-tech manufacturing and knowledge-intense services as well in the limited inflow of foreign direct investment. To raise the export capacity of Turkish SMEs, Turkish priorities would need to be aligned to concepts such as the digital single market and smart specialisation.

Measure 11: "Enhancing the R&D and innovation activities of SMEs"

This measure has been rolled over from the previous ERP. Its targets are rather ambitious. The complementarity between Measure 11a and Measure 11b and the link with Green Growth and environmental impact could be better explained. The measure includes a focus on product development. However, there is no mention of clean or energy-efficient technologies. Furthermore, the impact of Measure 11a on employment is not clear.

Measure 12: "Supporting competent research infrastructures on a performance basis within the new legal framework"

This measure has been rolled over from the previous ERP. The implementation of Law No 6550 to support research infrastructures is in line with the 11th National Development Plan. Positive impacts on the environment have not been elaborated, but the selected institutions and the potential results are expected to contribute to green growth.

Economic integration

EU-Turkey bilateral trade has increased rapidly in recent years. Since the entry into force on 31 December 1995 of the EU-Turkey Customs Union, the value of bilateral trade has increased more than fourfold. From the EU perspective, Turkey is the sixth largest partner for EU exports of goods (3%) and also the sixth largest partner for EU imports of goods (4%).

Measure 13: "Update of the Turkey-EU Customs Union"

This measure has once more been rolled over from the previous ERP. The purpose of the ERP, however to present measures which Turkey can implement on its own.

Education and skills

Education and skills and the relevant reform measures 14, 15, 16, 17 and 21 are analysed above in section 4 under key challenge #2.

Employment and the labour market

Employment and the labour market and the relevant reform measures 19, 20 and 22 are analysed above in section 4 under key challenge #1.

Social protection and inclusion

The situation regarding the risk of poverty and income inequalities was improving in the year before the pandemic (2019). According to the official Statistics on Income and Living Conditions (EU-SILC) for 2019, Gini coefficient was 0.437 with a fall of 1.3 points compared with the previous year. The P80/P20 rate decreased from 8.66 to 8.35. These two figures indicate that income inequality decreased slightly in 2019 but remained structurally higher than the EU average. The at-risk-of-poverty-rate ([40]) was 39.8% in 2019 which is almost double the EU average of 20.9%.

Poverty is expected to have risen with the pandemic in 2020/2021 as more than 6 million people live on frugal short term work benefits -or in the case of unpaid leave- on benefits amounting to half of the minimum wage.

Measure 23: "Increasing the scope of ASDEP and enhancing the accessibility of social assistance beneficiaries to other public services by the transition to the Integrated Social Protection Period"

This measure has been rolled over from the previous ERP and is designed to increase social protection coverage while establishing a link between social assistance and social protection services. It is relevant and important to provide supply-driven and quality social services, but the design of the measure is ambiguous. The measure continues to reflect several deficiencies mentioned in last year's assessment. The steps and activities involved are not clear. The activities are indicators rather than activities. The measure does not include any activity to improve the quality of services delivered by the staff of the Family Social Support Programme (ASDEP). It does not include any gender equality approach. Such a measure should definitely have an impact on poverty, equality and gender but is described as having no impact. No risk is defined, but certain risks, such as coordination among relevant actors, sufficient number of ASDEP staff, etc. should be assessed.

Measure 24: "Dissemination of Family-Oriented Social Services Models"

This measure has been rolled over from the previous ERP and concerns social services for children. The measure seems to have an impact on the well-being of children and poverty. However, the activities are not defined clearly for the measure; they seem to be indicators rather than activities. There is a need to provide social services for the beneficiaries of Social and Economic Support (SED); however, there is no activities are provided for to serve that aim. Providing only financial support is not enough to ensure the social protection of children. There is an urgent need to increase complementarily and cooperation between social assistance and social services for children. There is also a need for an updated impact assessment of the SED programme in terms of aim, selection criteria and results. Even though there is an indicator on foster care, no activity is defined for foster care. The fact that the government is implementing this measure does not necessarily mean that there is no risk. Potential risks should be assessed and mitigating actions should be determined.

Health

As the outbreak of the COVID-19 pandemic has posed a global threat with significant human casualties and severe economic losses, there is a pressing demand to further understand the current situation and develop rational strategies to contain the spread of the virus. To prevent further morbidity and mortality, efforts are being made to develop effective antiviral therapies and an efficacious vaccine at global level.

([40])

Measure 18: “Expanding occupational health and safety activities in schools and institutions”

This is a newly introduced measure in the ERP process. In order to support the development of a health and safety culture among students and employees, it is necessary to improve and maintain health and safety conditions in the educational environment and processes. The purpose of this measure is to expand occupational health and safety activities and to improve hygiene conditions in schools. Certification of 25 schools for the Occupational Health and Safety Management system, 20 for the Quality Management system, and five for the Environmental Management system will be completed in 2021. The first auxiliary training of the 80 000 personnel, and document renewal audits, will be carried out for schools that receive a ‘clean school’ certificate. Especially during the COVID-19 pandemic, hygiene in schools has become very important and therefore it is crucial for this measure to be supported.

Measure 25: “Supporting clinical trials on vaccines and drugs R&D Studies”

The measure will support vaccine and drug development efforts during the COVID-19 pandemic by increasing the number and quality of clinical trials in line with the objectives set out in the 11th Development Plan. Expected impacts on other outcomes are not considered

Measure 26: “Strengthening of the Ministry of Health's COVID-19 Response Capacity”

-The measure aims to develop Turkey’s domestic capacities for responding to health emergencies by adding a molecular surveillance component to its existing national surveillance system. It will include the use of rapid antigen tests (Ag-RDT) for rapid COVID-19 detection and whole-genome sequencing for the timely detection of mutations in pathogens.

The measure is relevant and in line with the body of EU law on communicable diseases and on serious cross-border threats to health as well the WHO’s International Health Regulation (2005), and seeks to coordinate preparedness and response planning and to strengthen capacities for monitoring, early warning and assessment of, and response to, health emergencies. However, no activities are planned for 2021 and the indicators are at output level rather than result-oriented. Expected impacts on other outcomes are not considered.

5.7. THE 2021 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, 12 July 2021

[…]

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

1. Maintain the fiscal policy stance consistent with the aim of supporting disinflation and lowering vulnerabilities, while increasing support to the most vulnerable households and providing adequate allocations for capital expenditure and active labour market policies. Adopt a 2022 budget together with a plan for a gradual fiscal consolidation over the medium term. Increase the share of local currency in new borrowing.
2. Expand the tax base by developing a plan to streamline gradually tax exemptions and reductions. Reduce expenditure arrears and improve their monitoring and control. Adopt the new framework legislation on Public Private Partnerships in order to improve their management and monitoring.
3. Maintain a sufficiently tight monetary policy stance, at the central bank's own discretion in line with instrument independence, as well as a transparent operational framework needed to reduce inflation and bolster market confidence. Maintain a strong financial sector regulatory framework in line with international and EU best practices, ensure sound credit risk management, a transparent display of asset quality and adequate provisioning. Continue to improve legal, institutional and regulatory frameworks to foster swift and efficient NPL resolution, including the further development of the NPL market.
4. With the aim to improving the business environment, further strengthen the rule of law and the regulatory environment and improve consultation mechanisms with business organisations and social partners on relevant new legislation. Implement legislation and enhance transparency regarding state aid. Finalise the legislation on easing private investments and prepare its implementation.
5. Increase the provision of active labour market policy measures for young people. Incentivise further female labour participation through legislative and fiscal measures and provision of appropriate and affordable childcare infrastructure beyond the big urban centres of Turkey. Intensify and diversify policy tools in order to increase the transition to formal employment in the labour market in the aftermath of the pandemic, including for the migrant workers and the workers under temporary protection.
6. Continue to roll out mandatory pre-school education and advance further towards a 100% enrolment in primary and secondary education with updated curricula. Address high youth unemployment and NEET rates through better access to education and improved VET, as well as outreach to young NEET. Increase offers and participation in lifelong learning measures and step up re- and upskilling possibilities for the labour force.

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

Area/Sector	2016	2017	2018	2019	EU-27 Average (2019 or most recent year)
Energy					
Energy imports dependency (%)	75.5%	77.2%	73.8%	N/A	60.62%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	175.03	175.30	167.72	N/A	112.92
Share of renewable energy sources (RES) in final energy consumption (%)	13.7% [w]	12.8% [w]	13.7% [w]	N/A	19.73%
Transport					
Railway Network Density (meters of line per km^2 of land area)	12.920 [w]	13.081 [w]	13.219 [w]	13.305 [w]	49.0 (2018)
Motorisation rate (Passenger cars per 1000 inhabitants)	142	149	151	154.7 [w]	519 (2018)
Agriculture					
Share of gross value added (Agriculture, Forestry and Fishing)	7.0%	6.8%	6.4%	7.1%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	19.5%	19.4%	18.4%	18.1%	4.3%
Utilised agricultural area (% of total land area)	49.1%	48.9%	49.0%	48.4%	40.0% (2017)
Industry					
Share of gross value added (except construction)	22.2%	23.3%	24.9%	24.2%	19.7%
Contribution to employment (% of total employment)	19.5%	19.1%	19.7%	19.8%	18.1%
Services					
Share of gross value added	61.2%	60.3%	60.8%	62.7%	73.0%
Contribution to employment (% of total employment)	53.7%	54.1%	54.9%	56.6%	70.8%

Business Environment					
Rank in WB Doing Business (Source: World Bank)	63	69	60	43	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	51	53	61	61	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	Up to 29.6%	N/A	N/A	N/A	N/A
Research, Development and Innovation					
R&D intensity of GDP (R&D expenditure as % of GDP)	0.94%	0.95%	1.03%	1.06%	2.2%
R&D expenditure – EUR per inhabitant	93.6€	90.8€	83.5€	88.1€	688.6€
Digital Economy					
Percentage of households who have internet access at home	76%	81%	84%	88%	86%
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	58.3% w	64.7% w	71% w	73.98% w	85%
Trade					
Export of goods and services (as % of GDP)	23.1%	26.0%	31.2%	32.7%	49.4%
Import of goods and services (as % of GDP)	25.2%	29.7%	31.3%	29.9%	45.7%
Trade balance (as % of GDP)	-6.5%	-8.9%	-7.0%	-4.1%	N/A
Education and Skills					
Early leavers from education and training (% of population aged 18-24)	34.3%	32.5%	31.0%	28.7%	10.2%
Youth NEET (% of population aged 15-24)	23.9%	24.2%	24.4%	26.0%	10.1%
Formal child care - children aged less than 3 years (% of total)	NA	N/A	N/A	N/A	35.3%
Individuals' level of digital skills (% of individuals aged 16-74 who have basic or above basic overall digital skills by sex)	28%	34%	N/A	36%	56%

Employment					
Employment Rate (% of population aged 20-64)	54.4%	55.3%	55.6%	53.8%	73.1%
Unemployment rate (% of labour force aged 15-74)	10.9%	10.9%	10.9%	13.7%	6.7%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	42.3 pps.	41.6 pps.	40.8 pps.	38.8 pps.	11.7 pps.
Social Protection System					
% of population at risk of poverty or social exclusion	45.1%	41.3%	39.8%	39.8%	20.9%
Impact of social transfers (Other than pensions) on poverty reduction	7.69%	8.64%	7.88%	8.94%	32.38%
Self-reported unmet need for medical care (of people over 16)	3.8%	2.6%	2.9%	3.0%	1.7%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	8.65	8.68	8.66	8.35	4.99

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

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

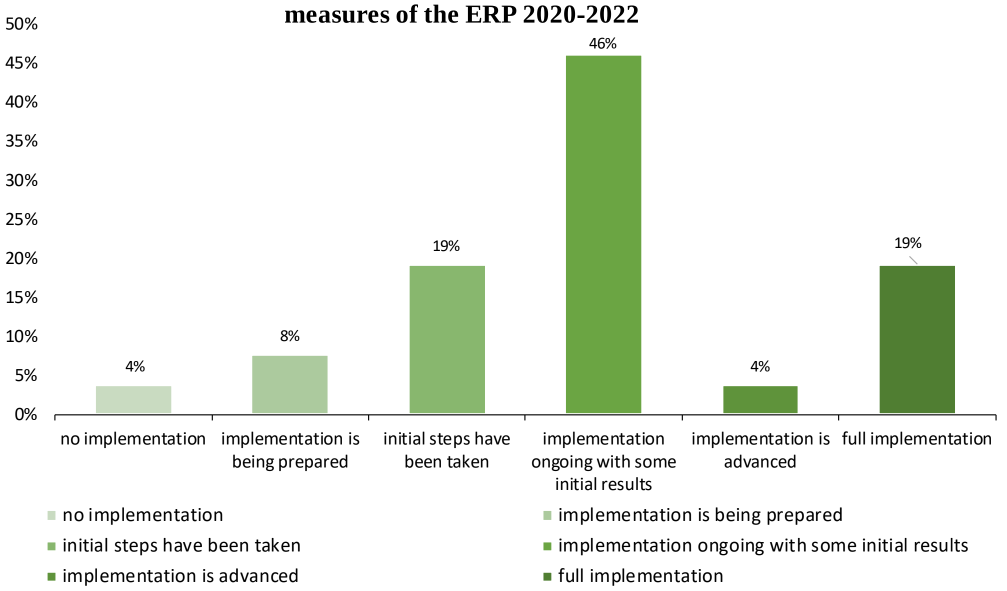
ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM THE ERP 2020-2022

The average score for implementing the measures in 2020 is 2.4 out of 5, which constitutes progress compared to the previous year (2.0), but it needs to be taken into account that last year's score was low due to the abandoning of some measures. The score of 2.4 is impacted by the fact that some measures could not be implemented to the extent planned due to the onset of the COVID-19 pandemic, which induced limitations on measures involving close interpersonal settings (such as on-site training and counselling).

Turkey's reporting on the activities carried out has further improved, but the level of details varies still between measures. A detailed scoring for the planned activities in 2020 has been provided for only two measures. To provide a picture of the level of implementation consistent with the approach for all ERPs, some adjustments to the scoring of activities were made, based on the description of the implementation and explanations presented in the ERP and the Commission's own research.

For six measures, full implementation of the steps foreseen in the measure for 2020 can be noted; these fall in the areas of renewable energy, investment procedures, informal employment, research infrastructure, patents and vocational training. Implementation was particularly weak for the measures on agricultural statistics and skills-based curricula in secondary education. The measure related to the EU-Turkey Customs Union is not considered as a structural reform in the context of the ERP, since its implementation does not depend on Turkey alone.

Graph II.5.2: **Turkey - Implementation of the structural reform measures of the ERP 2020-2022**



ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The 2021-2023 Economic Reform Programme was formally submitted to the Commission on 1 February 2021. Overall, adherence to the Commission Guidance Note has further improved.

Inter-ministerial coordination

The central coordination of the ERP has been under the Presidency of Strategy and Budget since 2019. Each line ministry provided the respective ministry's inputs to the ERP coordinator. The proposed measures for the new ERP were discussed in a workshop held by the Presidency of Strategy and Budget with the ERP coordinators. Afterwards, the ERP coordinator, when deemed necessary, got in touch with the different line ministries and relevant institutions to request additional input. The preparation of the macroeconomic part of the ERP was led by the Presidency of Strategy and Budget on the basis of contributions from relevant institutions.

Stakeholder consultation

The ERP is based on the 11th Development Plan (2019-2023) approved by the Turkish Parliament on 18 July 2019. Furthermore, it was prepared in line with the 2021-2023 New Economy Programme and the 2021 Presidential Annual Programme, which are both implemented upon Presidential Decision. The Development Plan was developed in a broad consultation process with stakeholders and experts, involving working groups and ad hoc committees. However, the reports established by the working groups have not been made public. No specific consultation of external stakeholders on the draft ERP took place and no draft was made available to the public before its adoption.

Macroeconomic framework

The chapter on the macroeconomic framework broadly follows the outline of the guidance note. It succinctly covers nearly all of the required elements with one important exception – it does not present an alternative scenario. This omission is repetitive and is a major drawback, especially in view of the high domestic and global uncertainty. The analysis would have benefited from further improving the links between the macroeconomic and fiscal framework sections and to the macro-relevant structural reforms. The presentation and analysis of risks could also be expanded and deepened.

Fiscal framework

The structure of the chapter on the fiscal framework closely follows the guidance note. It covers all major elements and provides extensive information on the 2021 budget. It is less detailed on the medium-term plans and the underlying measures. The section on contingent liabilities could be expanded to cover all sources of liabilities in a systematic way. The section on public finance risks could be further developed and elaborated as well. The fiscal framework chapter may be usefully expanded to cover elements related to fiscal rules and the medium-term budgetary framework. Providing more data and focusing the analysis at general government level could be welcome as well.

Structural reforms

The structural reform priorities section improved. Reform measures are better specified than last year, although the quality of these measures in terms of description, timeline, estimated impact and risks and key performance indicators could be improved. The maximum number of reforms (20) and the page limit (40) are not respected. Section 6 on budgetary implications of structural reforms is again completely missing. Table 1c in incomplete, tables 1f (external sector developments), 1g (sustainability indicators), 3 (general government expenditure by function), 7 (contingent liabilities) and 9 (selected employment and social indicators), as well as Annex 2 on the external contributions to the ERP were not submitted.

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6. BOSNIA AND HERZEGOVINA

6.1. EXECUTIVE SUMMARY

The global health crisis sharply exacerbated the slowdown that was already in progress, leading to an output contraction of some 4½% in 2020. The areas most affected were private services, such as tourism, export-oriented companies and remittances, which are an important source of disposable income. The labour market benefitted from the government's job support measures. The country's economic reform programme (ERP) projects a subdued, domestic-driven recovery with slightly accelerating annual growth rates averaging at some 3% during 2021-2023. However, this benign scenario rests on the crucial assumptions that the country's persistent political stalemates, which largely paralysed reform implementation during the last years, will come to an end and that public and private investment will increase substantially. Key downside risks are a continuation of the country's political stalemate, which would impede reforms and investments, and a subdued global recovery from the COVID-19 pandemic.

After supporting the economy in 2020, the fiscal framework is maintaining a slightly expansionary fiscal policy throughout the programme period, but clearly without a pro-growth strategy. The pandemic resulted in a sharp drop in revenue and additional spending, transforming the surplus of 2.2% of GDP in 2019 into a deficit of some 4% of GDP in 2020. The programme provides only incomplete information on the actual response to the crisis. Overall, the authorities planned additional spending of about 2½% of GDP for health related spending and general support measures, such as providing support to troubled companies and subsidising wages and social security contributions. Furthermore, up to ½% of GDP was reserved for providing pandemic-related loan guarantees. This relatively limited approach probably reflects financing constraints in some parts of the country, administrative bottlenecks and in particular political stalemates, delaying the decision process and the implementation of spending decisions. The ERP envisages a reduction in the deficit to 0.6% of GDP by 2023, largely achieved through cuts in spending, in particular investment. On the revenue side, another drop in the revenue-to-GDP ratio of 2 pps. is expected for 2021-2023, requiring deep spending cuts in order to achieve the targeted reduction of the deficit. This points to the need to improve the quality of revenue collection, through a more efficient, diverse and growth-friendly revenue collection approach, reducing, in particular, the strong reliance on VAT revenues. The planned reduction in investment is not in line with the country's needs and the jointly adopted 2020 policy guidance. COVID-19 related revenue shortfalls and additional spending are forecast to increase public debt by 6 pps. of GDP, reaching 37.1% in 2021. From 2022 onwards, moderate and declining fiscal deficits and stronger nominal GDP growth are expected to bring the debt ratio down to close to 35% of GDP by 2023.

The main challenges include the following:

- **The quality of public spending and revenue collection remains very low.** The country's main priority appears to be maintaining the current spending structure, clearly neglecting the medium-term investment needs in areas such as education, infrastructure and environment. At the same time, the overall quality of health services remains inadequate, despite significant pandemic-related allocations. The targeting of social spending is very limited and impeded by the country's fragmented administration. The implementation of public investment appears to be mainly driven by the availability of external financing and would need a substantial boost in order to move the country's economy on a higher growth trajectory. The efficiency of tax collection is very uneven, with a strong emphasis on indirect taxes, such as VAT, which is disproportionately burdening lower income groups.

- **The country's medium-term, strategic fiscal planning capacities are very limited.** The high degree of institutional fragmentation, a lack of cooperation among key stakeholders and a highly politicised decision process have resulted in a strong short-term orientation of fiscal policy, primarily trying to maintain the status-quo instead of addressing longer-term issues. As a result, the country's economic reform programme suffers from the lack of a country-wide perspective, an insufficient medium-term orientation and obvious inconsistencies between the various programme elements. Furthermore, the economic analysis is heavily impeded by the lack of empirical data and by the insufficient quality and timeliness of what little empirical data is available.

- **The absence of a common internal market within the country negatively affects the private sector's development.** The COVID-19 pandemic has further increased the importance and urgency for addressing structural weaknesses related to the over-politicised business environment. Partly different legal frameworks and implementation practices, institutional weaknesses, high informality, a weak rule of law, lengthy bureaucratic procedures and low quality public administration are among the main factors for the existing poor business environment. Countrywide strategies and coherent solutions to help businesses are long overdue. Such strategies and solutions include developing the system of quality infrastructure, reforming public financial management, reducing para-fiscal charges, adopting policies for small- and medium-sized enterprises (SMEs) and implementing customs policy legislation and the green and digital transition, which include e-authentication and simplification of business registration, licensing and permit procedures.

- **Oversized, non-transparent and inefficient state-owned enterprises (SOEs) leave an important footprint in the economy, negatively affecting macroeconomic performance, fiscal sustainability, labour market outcomes and competitiveness.** SOEs are a heavy burden on the country's public finances. Many of these companies have low productivity but, at the same time offer significantly higher wages than in comparable private industries. Many public companies rely on state support or they delay due payments to the social security systems or to private suppliers, creating substantial liquidity imbalances in other areas of the economy. The SOE sector causes great distortions and misallocation of production factors and deters the private sector from investing. Reform efforts also need to target the substantial payment arrears of the public sector, in particular the health sector. The COVID-19 pandemic represents a significant additional burden on the health system, characterised by high spending inefficiencies.

- **The authorities by failing to have a unified and coherent approach to the labour market's development, have put people, especially young people, women, Roma and people in vulnerable situations, at particularly high risk of long-term unemployment and inactivity**. Stereotypes about the role of women persist and, together with the low availability of child and elderly care result in a wide gender gap in employment. The education system's lack of alignment with labour market needs creates difficulties for young people exposed to multiple risks of social exclusion while employers are facing difficulties to recruit skilled workers.

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2020 has been partially implemented. Insufficient cooperation among the various stakeholders has been a key obstacle to improving the country's capacities for medium-term fiscal planning and analysis. Some progress has been achieved in improving statistics on the labour market as well as on historic general government data. Local banking supervisory agencies cooperated in order to support the economy in the wake of the pandemic and the requested measure to strengthen the banking sector resolution framework has been adopted. Furthermore, the convertibility of the domestic currency has been maintained. However, the circumstances of the appointment of three Board members in 2020 might raise questions about central bank independence. Limited progress was made in coordinating COVID-19 mitigating measures for businesses, in extending social protection coverage and in facilitating the transfer of economic activity to the formal economy. Efforts continued to simplify business registration procedures through online registration. Some funding was provided to the healthcare sector, but not in a sustainable way, as reforms in this sector are still limited. Centralised procurement of medical products, providing for economies of scale, was limited. In spite of some progress at various levels of government, a common strategy to reform public financial management is yet to be developed and adopted. A series of measures were adopted to preserve employment and support job-seekers, but were insufficient and showcased the unpreparedness of the country's labour market institutions to major shocks. There was an uneven implementation between entities when it came to dispensing public employment services carrying out administrative duties linked to health insurance and mapping social benefits.

The ERP identifies reform challenges that are partly in line with those identified by the Commission. Macroeconomic projections are based on the optimistic assumption that the country will overcome political stalemate. The fiscal framework does not sufficiently present the impact of COVID-19 nor does it provide sufficient information on fiscal plans for 2021. Overall, fiscal policy is set to support the economic recovery until 2023. The measures to promote employment, social policies and education are not credible and lack a fiscal underpinning. Given that the aim is to foster a common internal market in the country, more specific references should have been made to identify and address the structural weaknesses burdening the business environment. Many of the measures in the ERP are not countrywide and therefore lack consistency and coherence. Adopting a whole-of-government approach is a pre-requisite for addressing the challenges. Bosnia and Herzegovina should set up a well-functioning coordination and consultation mechanism for the ERP process.

6.2. ECONOMIC OUTLOOK AND RISKS

Economic activity contracted by about 4½% in 2020. Even before the COVID-19 crisis hit the country, the economic growth had already been on a decelerating path, resulting from a deteriorating international environment and persistent domestic political stalemates. In the second half of the year, economic activity remained subdued, resulting from weak export demand and domestic constraints partly caused by the ongoing COVID-19 pandemic. As a result, the two traditional sources of growth, private consumption and exports, remained weak. Investment dropped by some 13%, further contributing to the overall weak growth performance. The immediate impact on the labour market has remained limited so far, partly thanks to a large share of public sector employment and but also due to governmental employment support measures. Furthermore, the existence of a significant informal economy might lead to an underreporting of the actual economic costs of the pandemic.

The 2021 baseline scenario is more cautious concerning the country's post-crisis recovery. Compared to last year's ERP, the baseline scenario expects clearly weaker growth, in particular in 2020, when estimated growth has been revised downward from +3.5% in the 2020 ERP to -3.0% in the 2021 ERP. Despite the recession in 2020, the 2021 ERP expects a moderate recovery of 2.5% in 2021 and of some 3¼% in 2022 and 2023. As a result, average growth during the programme period is only 3.0%, compared to 3.6% expected in the previous programme. However, even this more moderate growth profile would require a significant increase in public and private consumption. Due to the lower post-crisis dynamics, the programme expects to reach the pre-crisis output level only during 2022, and the negative output gap to close and turn positive only in 2023.

The macroeconomic scenario expects a largely domestic-based recovery, relying in particular on private consumption and investment. The expectation that employment and wages will see strong growth, resulting in a significant increase in disposable income, is an important factor supporting the solid increase in private consumption. Investment is seen to benefit from an improved business environment thanks to structural reforms and increased public investment in transport and energy. The support from the external side is forecast to remain relatively solid, with annual increases of exports by some 6% on average. Unfortunately, the programme does not provide an estimate of the expected growth of the country's export markets. The baseline scenario is largely consistent with the underlying assumptions of a moderate recovery of the international economy, slow progress in fighting the COVID-19 pandemic, but also assumes a significant pick-up in structural reforms and public investment. The main risks to this scenario are related to a weaker than expected employment and investment dynamics, partly resulting from delays in implementing structural reforms. Unfortunately, the ERP does not provide information on the impact of structural reforms of ongoing or of planned recovery measures. Overall, the economic baseline scenario is feasible in the current situation, although some assumptions on the expected political climate as well as on the expected public and private investment appear optimistic. Furthermore, the macroeconomic and fiscal outlook continue to be affected by high uncertainty due to the COVID-19 pandemic.

The alternative macroeconomic scenario assumes a combination of less benign external and domestic factors, which would reduce average yearly GDP growth by about 1 pp. Key assumptions for the alternative scenario are: lower export growth during 2020-2023 (by ¾ pps. on average), lower foreign remittances, lower inflation, delays in structural reforms and further political stalemates. This would lead to an average annual GDP growth of 2.2% in 2021-2023 compared to 3.0% in the baseline scenario. Unfortunately, the programme does not specify its assumptions on the drop in worker remittances nor does it explain the transmission mechanism of delays in structural reforms on economic growth. The alternative scenario briefly discusses the main effects on the labour market, but does not provide any quantifications. Interestingly, the impact of weaker domestic demand on import growth appears to be quite limited. It also would have been helpful to explain how the size of the export growth shock (of 0.7 pps.) was chosen. Given the multitude of potential negative shocks, which are enumerated in the alternative scenario, the expected total impact on overall GDP growth of 0.8 pps. appears rather optimistic.

Table II.6.1:

Bosnia and Herzegovina - Macroeconomic developments

	2019	2020	2021	2022	2023
Real GDP (% change)	2.4	-3.0	2.5	3.1	3.4
Contributions:					
- Final domestic demand	2.9	-3.5	2.4	3.3	3.2
- Change in inventories	0.2	0.1	0.1	0.0	0.1
- External balance of goods and services	-0.7	0.4	0.0	-0.1	0.0
Employment (% change)	-2.3	:	1.7	2.3	2.5
Unemployment rate (%)	15.7	16.3	15.7	15.1	14.2
GDP deflator (% change)	1.9	-0.1	1.1	1.5	1.2
CPI inflation (%)	0.6	-0.8	1.2	1.3	1.4
Current account balance (% of GDP)	-3.0	-4.0	-4.6	-4.7	-5.1
General government balance (% of GDP)	2.2	-4.0	-2.5	-1.4	-0.6
Government gross debt (% of GDP)	31.1	35.2	37.1	36.1	34.9

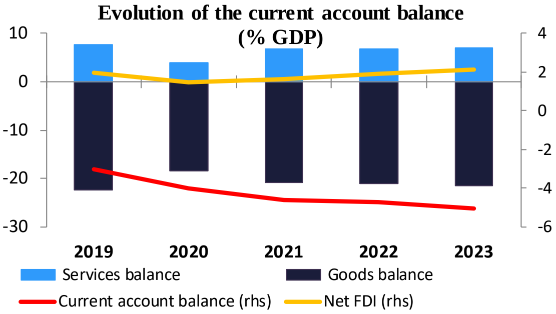
Sources: Economic Reform Programme (ERP) 2021.

Inflation is expected to remain low. In 2020, overall consumer prices were about 1% lower than in 2019, thanks to low prices for imports and weak domestic price pressures. For the programme period, the ERP continues to expect domestic and external price pressures to remain on the low side with annual headline inflation between 1.2% and 1.4%. The country's hard peg to the euro under the currency board arrangement should help to anchor inflation expectations, which then helps to anchor domestic price pressures. Furthermore, expectations of only a subdued domestic recovery are also seen to contain domestic price pressures. However, as the outflow of skilled workers might restart once the economic situation in key destination countries recovers, skills shortages could further deteriorate, creating upward pressure on wages.

The external position is projected to deteriorate slightly. During 2020, the country's current account balance remained largely unchanged as lower export demand for goods and tourism was largely compensated by lower imports, reflecting weaker domestic demand. During the programme period, the current account is expected to deteriorate slightly, resulting from a subdued external demand, in particular in tourism, and a domestic driven recovery, which will increase the current account deficit from 4.0% of GDP in 2020 to 5.1% in 2023. This profile is largely in line with the underlying expected growth profile. As foreign direct investment (FDI) is expected to remain largely stable at some 2% of GDP, a key contribution to the financing of the increasing current account deficits will have to come from foreign loans, in particular from IFIs, given the country's limited access to foreign capital markets. The programme does not specify the sectors of the economy benefitting from foreign investment inflows. The country's stock of foreign exchange reserves has further increased in 2020, partly due to the inflow of foreign assistance, such as the IMF's Rapid Financing Instrument (RFI), amounting to some 2% of GDP. At the same time import spending has declined, leading to a further improvement in the reserve's import coverage. The programme expects a 20% increase in foreign exchange reserves during the programme period, from EUR 7.1 billion in 2020 to EUR 8.6 billion. The programme does not elaborated on the underlying assumptions, but possible explanations could be additional foreign loans, increases in workers' remittances or higher FDI inflows.

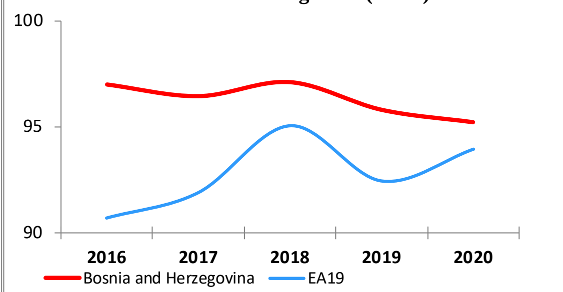
External competitiveness and current account

Graph II.6.1a: **Bosnia and Herzegovina - Evolution of the current account balance (% GDP)**



Source: Economic Reform Programme (ERP) 2021.

Graph II.6.1b: **Bosnia and Herzegovina - Real effective exchange rate (Index)**



Source: Economic Reform Programme (ERP) 2021 and ECB.

The country's financial sector has weathered the COVID-19 crisis relatively well so far. Despite deteriorating profitability and slow loan growth, the banking sector has so far managed to avoid a marked deterioration in financial soundness indicators. The growth of credit to households and enterprises has slowed sharply during 2020, reflecting lower credit demand in view of deteriorated growth prospects. In particular, corporate loan growth has been very weak. Deposit growth has also decelerated substantially throughout the year, probably reflecting the deteriorating liquidity situation of households and corporations as well as a slowdown in workers remittances. The non-performing loans ratio has continued to decline to 6.1% by end-2020, probably reflecting stricter accounting rules due to the application of the new International Financial Reporting Standard 9 and increased loan write-offs in early 2020. The extended loan moratorium as well government measures to support the real economy might also have had a positive effect on the sector's stability. On the other hand, the uptake of the governments' loan guarantees has been muted in some parts of the country, probably reflecting a low guarantee coverage and cumbersome procedures. Nonetheless, despite the sector's overall stability, there are still pockets of vulnerabilities, in particular in the area of smaller, domestically owned banks. In case that the economic rebound remains muted, a withdrawal of the authorities' support measures could lead to a significant deterioration of the financial sector's soundness indicators. In this context, the absence of a single resolution fund and the limited scope of the Deposit Insurance Agency increase the likelihood that the costs of any substantial bank restructuring might have to be financed using tax payers' money.

Table II.6.2:
Bosnia and Herzegovina - Financial sector indicators

	2016	2017	2018	2019	2020
Total assets of the banking system (EUR million)	13 343	14 440	15 829	17 067	17 262
Foreign ownership of banking system (%)	83.5	84.9	84.8	84.1	83.2*
Credit growth	2.1	5.3	6.6	5.7	1.1
Deposit growth	7.8	10.3	11.3	9.3	5.6
Loan-to-deposit ratio	0.97	0.94	0.90	0.89	0.85
Financial soundness indicators (end of period)					
- non-performing loans	11.8	10.0	8.8	7.4	6.1
- net capital to risk-weighted assets	15.8	15.7	17.5	18.0	19.2
- liquid assets to total assets	27.2	28.4	29.7	29.6	29.1
- return on equity	7.3	10.2	9.6	10.4	6.0
- forex loans to total loans (%)	57.4	55.1	53.3	50.7	48.1

* Q3
Sources: Central Bank, Macrobond, IMF.

6.3. PUBLIC FINANCE

Due to the COVID-19 crisis, public finances experienced a marked drop in revenues in 2020, while public spending for health and anti-crisis measures rose sharply. In response to the crisis, the authorities adopted revised budgets, lowering revenue estimates but also increasing spending targets by some 10%. Overall, the authorities planned additional spending of about 2½% of GDP for health-related and general support measures, such as providing support to troubled companies and subsidising wages and social security contributions. Furthermore, up to another ½% of GDP has been reserved for providing pandemic-related loan guarantees.

Compared to last year's estimates, the programme expects that in 2020 tax revenues will have been lower by some 1.2% of GDP, mainly as a result of lower indirect and property taxes. At the same time, expenditure is estimated to have been higher by 3.6% of GDP, mainly due to higher public consumption, transfers and subsidies. As a result, the 2020 deficit is estimated to have been 4% of GDP, compared to an expected surplus of 0.2% in last year's programme. This sharp downward revision is of course the result of the significantly weaker economic situation, lower revenues and the strong increase in discretionary COVID-19-related spending. Key measures have been to support enterprises, subsidise social security contributions and wages, accelerate payments of tax refunds, delay deadlines for the payment of taxes and reduce administrative fees and local excise taxes. Furthermore, guarantee funds have been provided for COVID-19-related support. According to estimates, payments to the health sector to fund medical supplies and facilities, hire professionals, and raise their wages were increased substantially, accounting for some KM 200 million or about 0.6% of GDP. Support measures for households and firms accounted for about KM 600 million, or nearly 2% of GDP. Furthermore, the support through guarantee funds amounted to up to 0.5% of GDP. Thus, overall, the direct anti-crisis support is estimated to have amounted to about 2.5% of GDP, plus another 0.5% in the form of loan guarantees. This would imply that about half of the fiscal deterioration is due to additional spending, while the other half is a result of lower revenues due to the COVID-19 crisis. Even when taking into account the high degree of uncertainty surrounding the actual level of support measures, the overall level of support still appears relatively limited when compared to other countries. One important factor limiting the country's capacity to support the economy is the country's limited access to international capital markets, constraining the country to domestic financial markets and to lending by international financial institutions. Furthermore, persistent political disputes, weak administrative capacities and bureaucratic procedures are also constraining the country's ability to swiftly react to such crises. Furthermore, efforts to target the society's most vulnerable population categories of the society appear to have been very limited. Coordination within the country also seems to have been poor.

Table II.6.3:
Bosnia and Herzegovina - Composition of the budgetary adjustment (% of GDP)

	2019	2020	2021	2022	2023	Change: 2020-23
Revenues	40.1	38.5	37.2	36.9	36.5	-1.9
- Taxes and social security contributions	36.1	34.8	33.9	33.7	33.5	-1.4
- Other (residual)	4.0	3.6	3.3	3.1	3.1	-0.5
Expenditure	37.9	42.5	39.8	38.3	37.2	-5.3
- Primary expenditure	37.2	41.7	39.0	37.4	36.3	-5.4
of which:						
Gross fixed capital formation	2.9	3.5	2.4	2.2	2.0	-1.5
Consumption	17.2	18.4	17.8	17.1	16.4	-2.0
Transfers & subsidies	15.6	17.6	17.3	16.5	16.1	-1.5
Other (residual)	1.4	2.3	1.4	1.6	1.9	-0.4
- Interest payments	0.7	0.7	0.8	0.9	0.8	0.1
Budget balance	2.2	-4.0	-2.5	-1.4	-0.6	3.4
- Cyclically adjusted	1.4	-3.5	-1.9	-1.2	-1.0	2.5
Primary balance	2.9	-3.3	-1.7	-0.5	0.2	3.5
- Cyclically adjusted	2.1	-2.8	-1.1	-0.3	-0.2	2.6
Gross debt level	31.1	35.2	37.1	36.1	34.9	-0.4

Sources: Economic Reform Programme (ERP) 2021.

In the medium term, the country's key fiscal objectives are to reduce the fiscal deficit from 4% in 2020 to -0.6% of GDP by 2023, while at the same time also lowering the tax burden as well as public spending as a share of GDP, by 2 pps. and by 5.3 pps., respectively. The main strategy to achieve this objectives appears to be to assume weak revenue growth and to mainly rely on nominal cuts in investment and subsidies. This will lead to a further reduction in the size of the public sector and will also reduce the deficit down to 0.6% of GDP in 2023. The total fiscal adjustment of 3.4% of GDP during the programme period is slightly frontloaded, with about half of the adjustment (1.4 pps.) planned for 2021, another third (1.2 pps.) for 2022 and the remaining quarter (0.8 pps.) is scheduled for 2023. The adjustment during 2021-2023 largely relies on lowering spending as a percentage of GDP (by 5.4 pps.), while the tax burden is also set to decline further (by 1.3 pps.). Implicit revenue elasticities are relatively low, which might reflect intentions to lower the tax burden on labour and on incomes. However, with this approach, if revenues are higher than planned, those funds risk being used for ad hoc purposes. The programme does not provide sufficient details on intended tax measures, nor does it present complete estimates of the fiscal costs of COVID-19. On the spending side, the already low share of public investment is set to fall further, from 2.9% of GDP in 2019 to 2.0% in 2023. This drop in investment spending might reflect the country's spending strategy, leaving the implementation of investment projects to the availability of external financing, while in the absence of external funds, available resources are primarily used for current spending. In cyclically-adjusted terms, the deficit is estimated to decline from 3.5% of GDP in 2020 to still 1.9% in 2021. According to the programme, the authorities intend to maintain a fiscal stimulus in 2022 and 2023 by targeting cyclically-adjusted deficits of 1.2% of GDP and

1.0%, respectively. There are no explicit links to the reform measures in the structural reform part. Compared to last year's programme, the authorities expect significantly higher deficits throughout the programme period, amounting to some 7% of GDP. Overall, this approach of reducing the deficit in a cautious way appears appropriate given the challenges with COVID-19. However, the composition of the adjustment with a strong reliance on reducing investment spending is not appropriate, as this approach fails to lay the ground for a stronger growth trajectory in the medium term.

Fiscal plans for 2021 envisage a moderate 4% to 2.5% reduction in the deficit, mainly driven by lower investment spending. The programme provides only planned budget data for 2021, which was adopted in September 2020 as the global fiscal framework (GFF). However, the budgets for the entities, accounting for some 95% of fiscal spending, were not included in the document, although they had been adopted on 18 December 2020 for the *Republika Srpska* (RS) and on 11 January for the Federation. According to the September 2020 fiscal plan, the authorities intend to reduce the country's deficit, mainly by cutting expenditure, in particular investment and 'other' non-specified spending items such as inter-governmental transfers. Public consumption and social transfers are set to increase in nominal terms, albeit at rates below nominal GDP growth. Expectations on the revenue side are very cautious for 2021, with a projected increase in total revenues by 0.3% only, compared to nominal GDP growth of 3.6%. Such a low revenue elasticity (of 0.1) is quite unprecedented. The expected output growth in 2021 of 2.5% still will be below the potential (of 2.7%). According to the adopted budgets, the country's fiscal stance in 2021 will most likely be even more cautious in bringing back spending to pre-crisis levels, than envisaged in the global fiscal framework from September, given that the adopted budgets are more optimistic with respect to revenues, and more moderate with respect to spending cuts. For example, the adopted budgets envisage a cut in total nominal spending by some 0.6% compared to 2020, (or 1% of GDP) as reductions in COVID-19-related transfers and subsidies are partly replaced by higher allocations for investment (in the Federation) or higher planned payments for pensions and public sector wages (in the RS).

Public debt rose by 4 pps. of GDP in 2020 and is set to increase by another 2 pps. in 2021, reaching 37% of GDP. After doubling in the wake of the 2008 financial crisis, public debt had declined to some 31% of GDP by 2019, mainly thanks to solid growth in nominal GDP and fiscal surpluses. Difficulties in accessing international financial markets, and the shallowness of the domestic financial market, mean that international financial institutions such as the World Bank, the European Investment Bank and the IMF are still key sources of financing. It is largely thanks to this financing structure that the average implicit interest rate has remained low at some 2¼%. This rate is projected to rise to 2.6% in 2022 before slightly dropping again in 2023. Despite this expected increase, the costs of debt servicing are likely to remain low, at 1% of GDP throughout the programme period. Unless there are significant changes in the international financing conditions, this outlook of slightly increasing financing costs is plausible and consistent with previous programmes. Overall, strengthening growth, inflation and only moderate deficits will help to contain the rise in the debt ratio and will be important factors for the declining ratios in 2022 and 2023.

Box II.6.1: Debt dynamics

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

	2019	2020	2021	2022	2023
Gross debt ratio [1]	**31.1**	**35.2**	**37.1**	**36.1**	**34.9**
Change in the ratio	-1.3	4.2	1.8	-0.9	-1.3
Contributions [2]:					
1. Primary balance	**-2.9**	**3.3**	**1.7**	**0.5**	**-0.2**
2. "Snowball" effect	**-0.6**	**1.7**	**-0.4**	**-0.8**	**-0.8**
Of which:					
Interest expenditure	0.7	0.7	0.8	0.9	0.8
Growth effect	-0.8	0.9	-0.9	-1.1	-1.2
Inflation effect	-0.6	0.0	-0.4	-0.6	-0.4
3. Stock-flow adjustment	**2.2**	**-0.8**	**0.5**	**-0.7**	**-0.3**

[1] End of period.
[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).
The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.
Source: Economic Reform Programme (ERP) 2021, ECFIN calculations.

The programme expects a marked debt increase in 2020 and 2021, largely reflecting the costs of the pandemic. The main factor for the increase in 2020 was the primary deficit of 3.3% of GDP. However, the drop in GDP growth contributed nearly another percentage point to the increase in the debt ratio, while interest expenditures added another 0.7 pps. Going forward, the primary deficit is expected to moderate and turn into a small surplus in 2023, while gradually strengthening real GDP growth and inflationary effects are expected to reduce the debt ratio by some 1.5 pps. annually. Furthermore, stock-flow adjustments in 2022-2023 are also projected to help reduce the debt-GDP ratio. Unfortunately, the programme does not provide details on the factors behind the dynamics in the stock-flow adjustment. The historic data presented on public debt is still slightly different from the data provided by the central bank.

Risks to the fiscal scenario are non-negligible. On the revenue side, the programme assumptions are cautious, which might provide a certain buffer against the failure to reach targets on reducing spending. However, this approach of overly cautious revenue projections also risks creating space during the year for ad-hoc, non-targeted and non-priority spending. Furthermore, there are significant risks of contingent liabilities from public loan guarantees, partly because of the COVID-19 pandemic, but also due to guaranteed energy projects. Budgetary allocations for COVID-19 related loan guarantees amounted to about ½% of GDP in 2020. Overall, largely due to a loan guarantee for the construction of a major coal-power plant, contingent liabilities are expected to increase from some 2½% of GDP in 2020 to some 4% of GDP in 2023. Furthermore, there are substantial payment arrears in particular in the health sector, which before the COVID-19 crisis amounted to up to 7% of GDP and which during the pandemic will probably have increased even further. The need to restructure unviable publicly-owned enterprises could also have significant implications for the country's deficits but also its debt ratio. Poor transparency and weak reporting standards significantly reduce the reliability of risk assessments.

Box II.6.2: Sensitivity analysis

The programme presents a sensitivity analysis of the impact of the alternative, lower-growth scenario on public finances. The alternative scenario analyses the economic effects of export growth being 0.7 pps. lower, which together with other factors would result in average annual GDP growth of about 0.8 pps. lower than in the baseline scenario. According to the sensitivity analysis, the growth of total revenues would be some 0.3-0.6 pps. lower, mainly due to lower VAT revenues. As a result, the deficits would be higher, by about ½ pp. in 2021 and 2022, and by nearly 1 pp. in 2023. Those effects are quite limited, which is not surprising, given the limited direct effects of exports on indirect taxes and the assumed low sensitivity of imports to reduced exports.

The quality of public finances and budget planning remains low. The programme does not contain sufficient plans to improve the spending structure, and lacks a pro-growth orientation. In 2020, COVID-19 related spending led to a shifted towards increased spending for general public services and health, but also direct subsidies and social transfers. In the following years, the programme envisages a certain return to the pre-crisis spending structure. However, in 2023, the share of spending on health and social protection are still significantly elevated, while spending to support the economy is scaled down markedly. Furthermore, there are only marginal nominal increases in spending for education and the environment. Like in the previous ERPs, this approach is not in line with the policy guidance jointly adopted in the last 4 years, urging for a more growth-oriented fiscal policy. For revenues, the programme strongly relies on indirect taxes, which are expected to realise rather low elasticities with respect to nominal GDP growth. Given the regressive nature of indirect taxes and in view of the post-crisis financing needs, the programme fails to discuss measures that could improve the efficiency of tax collection, and in particular improve the contribution from higher income groups. More frequent audits, a better management of large tax payers, the sharing of tax information among entities and the establishment of a central registry of private bank accounts are all important elements that could improve tax compliance. Transparency and governance of the public sector are very limited, leading to major governance issues in particular in the health sector and in publicly owned companies.

The country's fiscal framework continues to be impeded by institutional fragmentation, the low quality of fiscal data and a lack of cooperation among the various stakeholders. Alignment with EU reporting standards and budgetary frameworks is still very limited. So far, only one entity has adopted fiscal rules, and there is no independent fiscal council to monitor countrywide fiscal performance. The effectiveness of the medium-term fiscal framework is also very limited. Finally, the availability and quality of fiscal data suffers from poor reporting standards, a lack of cooperation among the various budget users, and political resistance that impedes alignment with the standards of the European System of National Accounts (ESA). Due to these deficiencies, there could be a significant degree of fiscal underreporting.

6.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

The substantial structural weaknesses of Bosnia and Herzegovina's economy are preventing the country from catching up faster and sustained reform measures are needed to significantly improve the living standards of its people. The Commission has conducted an independent analysis of the economy to identify the key structural challenges to boost competitiveness and inclusive growth, drawing from Bosnia and Herzegovina's own ERP, but also using other sources. Several structural weaknesses lead to an underutilisation of the country's economic potential. High structural unemployment is a clear consequence of those weaknesses, rather than merely the result of an educational system that is not functioning properly. It also points to a poor business environment resulting from the country's institutional and economic fragmentation, a weak rule of law and an inadequate and inconsistent legal framework. Furthermore, the economic activities of the public sector have a detrimental weight on the economy due to their inefficient management. The main challenges of boosting competitiveness and long-term and inclusive growth are therefore to (i) increase employment, particularly of young people, women and people in vulnerable situations (ii) improve the business environment through closer cooperation and coordination at all levels of government and (iii) make the public sector more efficient, in particular improving the performance, transparency and accountability of public enterprises.

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

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

The labour market indicators continued improving until mid 2020, but the activity and employment rates remain very low and differences between entities persist. The activity rate (20-64) increased from 59.0% in 2019 to 61.7% in the second quarter of 2020 while the employment rate increased from 49.7% to 51.9% in the same period. But they continue to be structurally low. The unemployment rate (15-74) was rather stable at 16%. Despite these improvements, national data indicate severe gender gaps in labour market participation and in employment (20-64): 75.2% of men as opposed to 48.1% of women engage in the labour force, 64.7% of men compared to 39.0% of women are employed. The unemployment rate is 17.4 pps. higher for young women (49.0%) than for young men (31.6%). The share of long-term unemployed was very high at 77.3% in 2019 and this is likely to be exacerbated by the COVID-19 crisis. The labour market outcomes differ significantly across entities. In 2019, the activity rate (20-64) and the unemployment rate (15-74) in the *Republika Srpska* entity stood at 67.1% and 12.0% respectively compared to 54.9% and 18.4% in the Federation entity. The female employment rate (20-64) was also higher in the *Republika Srpska* (48.4%) compared to the Federation entity (33.1%). However, as labour market policy falls within the competence of the entities, it is difficult for the administration to come up with a solid and coherent countrywide diagnostic and to agree and implement the necessary reforms.

Due to the COVID-19 crisis, there was a steep decline in working hours and the country has to face a sharp economic contraction that is likely to have a strongly impact on the labour market. GDP plunged 6.3% y-o-y between the third quarter of 2019 and the third quarter of 2020. The previously booming tourism industry which represents more than 1 in 10 jobs, recorded a 70.4% drop in tourist arrivals in the period from January to September 2020 while the overnight stays decreased by 63.5% compared to the same period in 2019. Key research indicators (UNDP 2020) show that the most directly impacted industries have been those related to accommodation, food service, and transport, while the textile industry and fabricated metals sectors experienced a strong disruption in the supply chain. The economy's contraction in these sectors will make it harder, especially for people in vulnerable situations, to access the labour market. The International Labour Organisation (ILO) reports that the labour market disruptions caused by the pandemic have affected women more than men and that young people are now more distanced from the labour market. The decline in working hours in the third quarter of 2020 was equivalent to the loss of 170 000 full-time jobs. 245 000 jobs were at risk (ILO and EBRD 2021).

Despite measures to preserve jobs, the number of newly registered unemployed increased, in particular in the Federation entity. The number of registered unemployed increased from 401 846 in December 2019 to 427 593 in August 2020 and shrank again to 413 627 in December 2020, thus above crisis level. According to the Union of Employers of the *Republika Srpska* entity (2020), the crisis had little effect on the number of employees in that entity while 30 000 to 40 000 employees lost their jobs in the Federation entity. One of the possible explanations is the Federation entity's government belated response to the crisis. Among the registered unemployed, 62.7% are people with secondary school attainment (259 171), 28.3% are people with at most primary education (117 182), while 9% are university graduates (37 274)

A large portion of the population aged 20-64 years is inactive, pointing to an acute need to develop policies fostering transitions into the labour market and employment. Those particularly affected are the low-skilled and workers older than 40. According to the 2019 Labour Force Survey (LFS), people with a low level of education represent 51.4% of the inactive labour force, while their share among the active population is only 15.8%. The inactivity rate of older people (50-64) in 2019 at 53.3% was high, with the employment rate only at 42.2%.

The business structure in Bosnia and Herzegovina is dominated by micro and small enterprises representing a major source of employment. Out of 35 000 enterprises in Bosnia and Herzegovina, 72.8% are micro-enterprises contributing to 40% of GDP while 1.1% are large enterprises (250 and more employees). According to the Centre for Policy and Governance the micro-business sector provides formal and informal employment to more than 400 000 people. Yet they face many challenges - including recruitment difficulties - which means that their potential for development remains largely untapped. This business structure is vulnerable due to the lack of a coordinated extensive public support mechanism.

Employers find it difficult to recruit skilled workers. They underline a poor alignment of the education system with labour market needs. They face skills and qualification mismatches as well as labour shortage. Apprenticeship and opportunities for adult learning are also under-developed. The tax wedge on lower salaries and precarious working conditions remain a disincentive to formal employment.

Significant structural barriers are preventing women and people in vulnerable situations from accessing the labour market. Vulnerable population, including the Roma population, are at a particularly high risk of long-term unemployment and inactivity regardless of their education level. This has been observed in the country also for young people and women as well.

Gender differences continue to exist in access to employment, quality and pay, highlighting the need to step up efforts to support women's effective integration into the labour market. While Bosnia and Herzegovina complies with international standards, the gender gap in political participation and representation remains a challenge according to the Organisation for Security and Co-operation in Europe (OSCE). Women have low participation in the labour market and a wide gender gap exists in employment. Of the total number of registered unemployed, 57% were female in December 2020. Low availability of childcare and elderly care is an additional obstacle to women's participation in the labour market and contributes to low employment levels for women who predominantly assume the role of carer. Given the lack of formal part-time engagement, carers often leave the labour market or work informally (Analitika - Centre for Social Research, 2016). The low enrolment in early childhood education at a mere 15% stands in stark contrast with the EU average of 94.8% (2018) ([41]). Despite the rapidly ageing population, the country does not have a system of long-term care (LTC) that would universally cater to the needs of those with a degree of long-term dependency.

Roma women, in particular, are severely disadvantaged and marginalised due to inadequate living conditions, poverty and disadvantageous position in their family which includes early marriage. They also have a difficult access to healthcare compared to other citizens. Much of the data on the employment of Roma are missing. The Roma employment rate is lower than others, and significantly less for Roma women. According to the 2017 Regional Roma Survey, the unemployment rate is 56%. 11% of Roma are employed but they account for 63% in the informal sector. 86% of young Roma (92% for females) are not in employment, education or training. The share of Roma without any employment experience is also significantly higher than that of other categories of the population.

For young people, the prospect of finding a decently paid job becomes hardly credible. Youth unemployment (15-24) remained high at 38.6% in the second quarter of 2020. Depending on the source, approximately 33.8% to 40% of those aged 15-24 are not able to find any sort of work after completing their education. As a consequence, unemployed young people are exposed to multiple risks in the form of social exclusion, poverty, stigmatisation, and even long-term social isolation. The share of youth not in education, employment or training (NEETs) accounts for 20.7% of the male youth population, and 21.6% of the female youth population. The latter can to some extent be explained by mismatches between the education system and labour market needs and a weak business environment still significantly underdeveloped to generate employment. Employers note that vocational education and training does not provide students with the relevant and up-to-date knowledge and skills (World Bank 2019 report). Facing a lack of job opportunities, poor economic prospects and generally poor working conditions in the private

([41]) For children aged 4 to compulsory education.

sector, young people, including those well-educated, are migrating abroad. This significantly contributes to a fast ageing of the population in the country.

The brain drain is increasingly becoming a challenge. The latest OECD figures show that, in 2018, 44 700 people left the country for Germany (54%), Slovenia (26%), and Austria (9%). The main reasons young people's desire to leave the country is the inability to find work, partly due to the outdated teaching practices, poverty, political and economic instability. Population ageing, high net emigration flows and low participation of women in the workforce pose challenges for the effective functioning of the social protection and healthcare systems. At the same time, shortages of skilled labour require more and better education and training, which is currently underperforming.

Social dialogue in the country is weak. Consultations in the Economic and Social Council are limited to labour law and do not cover larger economic and social reforms. There are no general collective agreements in either entity. Sectoral collective agreements in the *Republika Srpska* entity are limited to the public sector and some state-owned enterprises. In the Federation entity, sectoral collective agreements are also to be found in some branches of the private sector. In either case, the texts of these agreements are not publicly available on the ministries' websites. The overall effectiveness of social dialogue is low and the labour dispute settlement mechanisms are pending reforms.

Reform measure 17: ("Improving labour market efficiency through effective employment policies and strengthening the role of mediation"). The measure to improve labour market efficiency through effective employment policies and strengthening the role of mediation is appropriate but the means for achieving this are not mentioned for the Federation of Bosnia and Herzegovina. Activities in the *Republika Srpska* entity appear very general.

Key challenge #2: Improving the business environment through closer cooperation and coordination at all levels of government

The absence of a common internal market within the country, with partly different legal frameworks and implementation practices, negatively affects the private sector's development. Institutional weaknesses, a weak rule of law, corruption and red tape, lengthy bureaucratic procedures and low quality public administration with the limited capacities are the main elements behind the existing poor business environment. Frequent political stalemates and a lack of cooperation among key stakeholders not assuming their responsibilities lead to overdue reforms being frequenly delayed. The unfavourable business environment, combined with a significant informal sector, results in a high level of structural unemployment, in particular among the young population. The fragmented administrative structure (the poor quality of the institutional set up is reflected in the country's lowest ranking - 114th - in Europe on institutions in the World Economic Forum's Competitiveness Report 2019) puts an added burden on businesses through excessive regulation, taxes and local fees. Starting a business remains cumbersome. According to the Balkan Barometer, corporate leaders from Bosnia and Herzegovina are by far the least confident, as only 28% believe that their economy is a good investment destination, while 38% disagree (RCC, 2020). A more business-friendly environment will facilitate the post-pandemic recovery, attracting more investments and building up economic resilience as well as boosting inclusive growth and competiveness. The implementation of the Common Regional Market will also offer new opportunities.

Due to over-politicisation of the business environment and related socio-economic reforms, including those of a technical nature, the authorities have failed to outline a set of countrywide, comprehensive measures that are consistent and properly sequenced. Countrywide strategies and solutions to support business development are long overdue. This includes the quality infrastructure system, reforming public financial management; using e-signature; reducing para-fiscal fees; reforming insolvency procedures; adopting policies for small and medium sized enterprises (SMEs) and reforming the process for business licenses and permits. In order to ensure countrywide ownership and consistent political support to socio-economic reforms, design and implementation of these reforms will need to be coordinated among all authorities, including the state level.

Such structural weaknesses have been exacerbated by the pandemic as high level of coordination at all levels of government has proved to be challenging in practice. The established crisis management bodies acted in their respective jurisdictions, without a countrywide harmonised approach in place for decisions and actions. The COVID-19 pandemic has made it even more important and urgent to address the structural weaknesses in the business environment. In an attempt to improve the quality of the country's socioeconomic response, the authorities have agreed to establish a Socio-Economic Task Force to provide a countrywide coordination of socio-economic activities. So far, this institution has been not been able to operate properly because of the reluctance of some participants to actively participate in its work. A consistent countrywide approach is largely missing for developing and implementing COVID-19 mitigation measures for SMEs in coordination with the private sector. According to the Balkan Barometer 2020, respondents from Bosnia and Herzegovina are the least satisfied with governmental measures to protect people from the economic consequences of the pandemic.

Measure 9: "Mitigation of the negative consequences caused by the COVID-19 pandemic" is not harmonised across entities. This reflects the fact that a consistent countrywide approach is largely missing and that the country's anti-crisis response has been fragmented until now. Nevertheless, this newly introduced measure elaborates on some aspects of appropriate and timely action for mitigating the effects of the COVID-19 pandemics on SMEs. In the Federation entity, activities involve a short-term relief programme of subsides and guarantees for the economy, while the *Republika Srpska* entity provides for some elements for sustainable recovery through its support for digitalisation, new technologies and social entrepreneurship.

The institutional, legal and regulatory environment continues to be a crucial weakness with adverse effects on the business environment, thus preventing a level playing field among companies. Despite some efforts to simplify legislation and to ensure regulatory impact assessment, the high degree of fragmentation requires companies to comply with different procedures in different parts of the country. Each level of governmental (and within the Federation entity, each of the 10 cantons) has its own business laws, regulations and procedures. Institutional and government barriers remain a significant obstacle to conducting business. The financial and administrative burden on business is characterised by high payroll taxes and an excessive number of administrative procedures at all levels. The very high burden of government regulation is evidenced by the Global Competitiveness Report 2019 where the related ranking is 137th out of 141 countries.

Businesses are subjected to numerous para-fiscal fees and charges due to overlapping administrations and an inefficient delegation of powers to lower levels of government. This facilitates corruption and represents a significant obstacle to businesses and local development. Legislation on developed registers of fees and charges and exchange of information can help eliminate fees deemed harmful for the business environment. End 2020, the *Republika Srpska* entity adopted a set of legislation targeting the reduction of para-fiscal fees. As provided for in the ERP, the adoption of the legal framework for establishing the single register of fees and charges in the Federation entity was adopted in February 2021.

The complex and unpredictable legal and regulatory frameworks foster informality and create room for corruption. The shadow economy accounts for approximately one third of GDP (IMF 2019). It adds to an already significant fiscal burden on formal labour, which in turn impedes formal employment and negatively affects Bosnia and Herzegovina's international competitiveness. Moreover, the large share of the informal sector also likely leads to an underreporting of the economic recession following the COVID-19 crisis, as it largely consists of very small companies in the service sector, which are much more affected by the drop in demand. The reduction of the informal economy by improving inspections was identified as one of the priorities of the socio-economic reforms in 2019-2022.

The legislative framework on preventing and combatting the widespread corruption presents significant gaps due to the non-harmonisation of legislation, strategies and action plans. Transparency International ranks the country 111th out of 180 countries in its newly published annual Corruption Perception Index, making it the worst performer in the Western Balkans alongside North Macedonia. Closer coordination and cooperation involving all levels of government, legal certainty to business through the harmonised legislation across the country and a consistent application of the rule of law are prerequisites for countering corruption more effectively ([42]).

Weaknesses in the rule of law, including in the functioning of the judiciary, negatively affect the country's market economy and its business environment in particular. The constitutional and legal framework governing the judiciary is incomplete and does not provide sufficient guarantees of independence, accountability and efficiency. Important issues include contract enforcement (in particular settling commercial disputes) ([43]), a substantial backlog in court cases, and problems with establishing property rights. Insufficient cooperation and coordination among the various stakeholders is a major impediment to the rule of law and a proper functioning of the judiciary. This prevents the creation of a countrywide level playing field and has wide-ranging negative effects on the country's business environment.

The lack of a unified countrywide approach to the planning and implementation of SME and industrial policies is an obstacle to the development of entrepreneurship and investments and prevents developing and implementing harmonised countrywide COVID-19 mitigation measures for the small and medium-sized enterprises. Reporting on the principles of the Small Business Act is assigned to the state-level Ministry for Foreign Trade and Economic Relations. However, SME policies exist only at the entity level (OECD, 2019). Progress is lagging in the implementation of the Small Business Act. Bosnia and Herzegovina also lacks a countrywide industrial development strategy. Initial steps have been taken to develop a smart specialisation strategy for Bosnia and Herzegovina, but the strategy remains to be developed and adopted.

The ERP rightly describes that due to the allocation of competences and significant differences in the organisation of the business environment, the reforms are the most complex. Still, the document recognises that the economic recovery will also be based on successful implementation of a number of structural reforms. There is a reference to the need to fight corruption to improve the business environment. The Federation entity's 2020-2021 economic stabilisation and recovery program aims to improve the business environment and competitiveness. The ERP hardly makes any reference to the brain drain which is increasingly becoming a challenge ([44]).

A related and partly rolled over ***reform measure 12 ("Enhancing the business environment")*** is very broadly defined. Without giving sufficient details, the Federation entity aims to improving SME access to financing for and remove administrative barriers. The *Republika Srpska* entity broadly includes further optimisation of administrative procedures for business ([45]), SME access to financing, a new anti-corruption strategy, fiscal discipline and efficiency of public administration (e.g. register of employees in the public sector). The envisaged improvement and implementation of the legal framework for the free provision of services refers only to the *Republika Srpska* entity ([46]). However, the country needs to adopt a country-wide approach, i.e. a single comprehensive law aligned with the Services Directive. In general, some efforts were made to include both entities in designing this measure. However, the absence of a

([42]) According to the RCC Balkan Barometer 2020, Governance, public integrity, and corruption continue to be the most negatively perceived aspect of governance performance with only 2.4% of content business leaders in Bosnia and Herzegovina.
([43]) It is expected that COVID-19 will increase the number of commercial cases.
([44]) Those leaving increased from 28 000 in 2013, to 44 700 in 2018 (WFD, 2020). Some 87% of people are either considering or are already planning to emigrate (Eurostat, 2020).
([45]) Portal available on www.pscsrpska.vladars.net
([46]) The Common Regional Action Plan aims at adopting a review of the AP 6 to further liberalise trade in services to, inter alia, enable temporary service supply without establishment and authorisation requirement (in line with the Chapter 3 of the EU acquis).

clear approach to consistent reform priorities and the lack of meaningful countrywide result and risk indicators mean that this measure's expected effectiveness can still not be assessed. Some efforts were made to estimate the cost of activities and sources of financing (including World Bank funding to develop the register of employees and streamline administrative procedures for business in the *Republika Srpska* entity). Nevertheless, the way the measure is structured, still reflects the high degree of fragmentation of the business environment and displays a lack of clarity, coherence and focus.

A harmonised approach to the modernisation, simplification and digitalisation of services is missing as the legal framework for a user-oriented administration varies substantially across the country. Consistent with the Digital Agenda for the Western Balkans and the Economic and Investment Plan, a better administrative environment for firms would benefit from the digital transformation of government services for businesses, including e-signature ([47]), e-registration of businesses, and e-construction permits. Low investment and insufficient competition continue to hinder digital connectivity. As one step towards a comprehensive and effective system of electronic public procurement, this system was enhanced with some additional functionalities. VAT statements and excise duties declarations can now be filed electronically. Given that poor health is a drag on the economy and one of the main reasons for the very low labour market participation rate, both entities have made some progress in establishing electronic patient records to enable healthcare quality agencies to monitor the quality of the services provided (World Bank, 2020). The ERP recognises the importance of e-government and the need to develop e-services.

Simplifying procedures for business registration, licensing and permits countrywide could contribute to a swift recovery from the COVID-19 crisis. The sub-national administration of business registration, licences and permits is complex, partly due to the separate laws and regulations that exist at different levels of government. There is no central registry of business entities and the company registers of the entities and of the Brčko District are not interconnected. Businesses registered in one part of the country are not always automatically and unconditionally recognised in other parts, requiring a costly replication of registration procedures. In areas where the entities have no mutually harmonised legislation (e.g. food supplements and cosmetics), SMEs are asked to formally register in both entities to be able to place their products on the market. The Global Competitiveness Report (2019 edition) gives a particularly low ranking for the time it takes to start a business (137th out of 140). Also the Balkan Barometer surveys (RCC 2020) indicate that Bosnia and Herzegovina is the region's leading critic in terms of obtaining a business license and records lowest scores across nearly all categories surveyed, scoring especially poorly on procedures, requirements, and paperwork. Reforms are continuing for business registration, though in the Federation entity, a set of laws to simplify the registration process of business entities is still pending adoption. The *Republika Srpska* entity recently launched and Brčko District advanced preparations for the electronic registration of business entities. The ERP refers to the need to reform the business registration system. However, the issue is only clearly mentioned in the context of the reform measure on e-government and with a reference to one entity only.

E-authentication is critical for building trust in e-commerce and in government e-signature services. The adoption of a new law on electronic identification and trust services for electronic transactions with a single supervisory body for the whole country in line with the EU *acquis* is still pending. A first qualified trust service Provider for issuing qualified electronic certificates is in place. Preparations are ongoing for other bodies ([48]) to get this status as well. However, countrywide harmonisation of e-signature and the related coordination, cooperation and data exchange between different administrations is still needed. A lack of interoperability and harmonisation of the e-signature system throughout the country limits the capacity to provide electronic services. Implementation of customs policy legislation (including the electronic transit procedure (NCTS), the authorised economic

([47]) New draft legislation aims at transposing the eIDAS regulation and is intended to simplify the services to citizens and the business community in BiH as well as to facilitate the transfer of electronic documents in public administration.
([48]) Agency for Identification Documents, Registers and Data Exchange of BiH (IDDEEA) and the Indirect Taxation Authority.

operators (AEO) scheme and electronic customs declaration for import and export customs procedures) is dependent on the foreseen accreditation of the Indirect Taxation Authority being accredited, as planned, as a qualified trust service provider and subsequently issuing the e-signature. Progress in this area will make it easier for the country to prepare for regional recognition of trust services, including e-signature, as well as recognition of the AEO scheme within the region, both provided for in the Common Regional Market Action Plan. Although the reform measure on 'establishing an electronic signature system' has been discontinued, the ERP (measure 13) has identified the need to adopt the (long delayed) law on electronic identification and trusted services for e-transactions.

Key challenge #3: Increasing the efficiency of the public sector, in particular by improving the performance, transparency and accountability of public enterprises

Bosnia and Herzegovina's public sector is oversized and inefficient, putting a significant burden on taxpayers and adversely affecting the business environment. State influence on the economy is significant, and countrywide public spending remains at a relatively high level, while the quality of the services provided is low ([49]), in particular in the transport and energy sectors as well as in healthcare and education. Efforts to rebalance the country's current public sector-led growth model and move to a more private sector-led model are not sufficient, given that, according to official statistics, public spending accounts for more than 40% of GDP. Bearing in mind the large tax contributions, the public sector provides little in exchange in terms of availability and quality of the country's public services (World Bank, 2019). Ineffective service delivery, poor human resource management and accountability have major implications on efficiency, quality and access to public services. A functional legislative framework for registries of public sector employees has not been established. Public procurement plays an important role for the private economy, but procedures are complex, prone to corruption and still contain a preference for domestic suppliers, which is incompatible with the *EU acquis* and a breach of the Stabilisation and Association Agreement (SAA). Payment arrears of the public sector are substantial, creating a considerable burden for private companies, but also a high degree of uncertainty for other public services because of unpaid contributions to health and pension funds. Some levels of government, namely the state level and the Brčko District, have already adopted individual public finance management strategies 2021-2025. This is a step forward towards the adoption of a comprehensive, countrywide public finance management strategy. Nevertheless, at this stage, there is no direction for countrywide reform on public finance management with performance based monitoring ([50]).

Oversized, non-transparent and inefficient state owned enterprises (SOE) continue to have an important footprint in the economy. In spite of progress in the Federation entity, existing registers of public companies are outdated, not comprehensive and not publicly available. Regular reporting on the performance of SOEs is absent. Legislation defines public enterprises as companies that are either public corporations or companies that would normally be part of the general government (IMF, 2020). According to estimates (IMF 2019), there are over 550 (majority public) SOEs employing around 80 000 persons, thus accounting for around 11% of total employment (about a quarter of public sector employment). They control assets worth an equivalent of 100% of GDP. Among all SOEs, entity-owned SOEs (including the electricity companies of the entities, coal mines in the Federation entity, the *Republika Srpska* entity forest company, highway companies, railways) have the largest operations and account for most of the employment of the SOEs. Despite lower productivity ([51]), the average salaries of SOE employees are 40% higher than in private companies.

SOEs are undermining competition, negatively affecting the country's macroeconomic performance, fiscal sustainability, labour market outcomes and overall competitiveness. The SOE

([49]) According to the Balkan Barometer (RCC, 2020) and in terms of business satisfaction with public services, Bosnia and Herzegovina is the only economy among WB6 where dissatisfied managers outnumbers happy managers (32% vs. 28%).
([50]) Countries with strong public finance management systems were also able to respond more quickly and more effectively to the COVID-19 crisis (as reported in the first Global Public Expenditure and Financial Accountability Report).
([51]) Average revenue per worker (measuring productivity) is considered to be around 8% lower than in the private sector.

sector is characterised by weaknesses in transparency, accountability and performance. Productivity is low in many large SOEs, and many of them are not profitable. SOEs and public enterprises dominate key sectors of the economy, including energy and telecommunications utilities (World Bank, 2018). Many SOEs are statutory corporations that are subject to preferential treatment and deviating from ordinary corporate norms (OECD, 2018). Subsidies give SOEs a competitive advantage over the private sector, and in so doing negatively affect the efficiency of resource allocation and the country's fiscal performance. For instance, coal-fired electricity generation takes place in five thermal power plants, of which four are majority state-owned (ECS, 2019). Moreover, government assistance in all its direct and indirect forms represent also an important disincentive in terms of efficiency and performance of SOEs as it weakens budget constraints. As for the interaction of SOEs with the private sector, the poor quality and fairly high cost provision of inputs to private enterprises negatively impact the private sector's competitiveness. SOE's lobbying governments may prevent private actors from entering markets. Liabilities to suppliers (4% of GDP according to the IMF) have negative repercussions on the private sector. Fiscal sustainability is undermined by arrears on tax and social security contribution (amounting to 4% of GDP).

SOEs are a significant burden on the country's public finances. To a large extent, the country's SOEs are in poor financial shape and close to half of them experience shortfalls in liquidity and require both explicit and implicit budgetary support. Monitoring and managing fiscal risks in ministries of finance is not sufficient. Liquidity problems often result in tax and social security contribution not being paid on time, thus rendering the financial situation of the entity's pension and health funds more difficult. About three quarters of the largest (20) SOEs face considerable financial risks. The cost of supporting public companies and guarantees, which often translate into substantial contingent liabilities, is a heavy burden on public finances and thus the country's taxpayers. Apart from direct subsidies and loan guarantees, government support is granted indirectly through tax and social security contribution arrears. Potential investors are required to assume these debts and maintain the existing workforce. These large payment arrears in SOEs impede the transparency of public sector accounting but are also a burden to private companies in the form of unpaid payment obligations. Some of the SOEs requiring subsidies are no longer operating, but still maintain workers. SOEs' total debts (including approximately 4% of GDP in tax and social contribution arrears) are around 26% of GDP (IMF, 2019). While the precise numbers have not yet been determined, total public sector debt is likely to be approximately 55-60% of GDP.

The COVID-19 pandemic represents a significant additional burden on the public health system, characterised by high spending inefficiencies. The COVID-19 outbreak is severely straining health and public health systems, while measures to contain its spread are resulting in an economic slowdown and threaten the economic security of many of the country's citizens, particularly those with low-incomes. Given the ongoing uncertainty over the next phase(s) of the pandemic, high levels of confidence and trust in the country's health systems are critical if the country is to manage this public health crisis effectively. Bosnia and Herzegovina allocates close to 10% of GDP to the healthcare sector, but the quality of healthcare and the population's satisfaction with it are low. The main reasons for this are fragmentation and the lack of synergies between entities (and cantons), deficient financial control of hospitals and healthcare centres, and the limited accountability of the authorities and hospital management for results (World Bank, 2020). Reforms to strengthen the healthcare sector and achieve a better managed, good quality and accessible public healthcare for all citizens including people in vulnerable situations of the society are at an early stage. Over time, this also includes addressing the substantial payment arrears in the sector. Some public enterprises are significantly behind their payments to health funds, and their employees do not have access to the health services they are entitled to (IMF, 2020). The ERP includes a measure aimed at healthcare reform, but activities are limited to the *Republika Srpska* entity (based on a 2019 action plan to ensure the health system's sustainability) which aims to increase the fiscal discipline of healthcare institutions and its Health Insurance Fund. A particular focus is on halting the increase of arrears and finding a model for their clearance. It is regrettable that the ERP does not present healthcare reform as a countrywide reform measure.

Centralised SOE oversight units (coordinating government efforts to monitor performance in view of strengthening the sustainability of the SOE sector) will need to be established to separate oversight from policy and regulatory functions of the line ministries. The joint socio-economic Program 2019-2022 includes plans to create such units responsible for financial performance monitoring. In addition, responsibilities for monitoring and assessing fiscal implications of SOEs will need to be assigned to ministries of finance. The coverage of SOEs is limited in terms of financial auditing by the Supreme Audit Institutions (SAI), and the implementation of SAI recommendations is low (IMF, 2020).

Whereas legislation partially provides for open and transparent selection procedures, appointments to SOE boards are highly politicised in practice. There are major gaps in terms of legal framework and implementation. Insufficient capacity and the independence of supervisory boards remain an important concern (IMF, 2020). SOE performance and board decision making are insufficiently separated from the political cycle. Vested interests are largely responsible for the slow privatisation process and attempts to sell shares in public companies earmarked for sale have been largely unsuccessful.

There are no ownership policy documents outlining the rationale for government ownership of SOEs. SOE registries and datasets are either not updated or display significant shortcomings. While entity governments have determined ‘strategic companies’, the rationale for public ownership is not based on clearly defined policy objectives. Privatisation (and as appropriate a solid restructuring process as part of this process) may be considered when there is no policy rationale for continued public ownership. Solid registries of SOEs are a precondition for a proper categorisation in terms of policy relevance and economic viability.

The privatisation process is still not complete and restructuring efforts have made little progress. Due diligence procedures for two local telecommunication companies in the Federation entity have been completed, but follow-up remains unclear. Privatisation of utilities is ongoing in the *Republika Srpska* entity and has taken place in some cantons. The *Republika Srpska* entity is also continuing to restructure its railways. Institutionalisation of a central restructuring facility as a central source of standards, analytics, technical assistance, and public financing for SOE restructuring and resolution may be considered, to ensure that the process of company level reform and restructuring - which can also accelerate the green and digital transformation - is transparent, systematic, and predictable.

The ERP does not provide a thorough analysis of this key challenge nor any country wide measure to address it. The existing references are limited to the need to restructure some public companies in the transport and energy sector. A few activities along these lines were included in the energy and transport market reform measures. One measure, focusing on healthcare reform in the *Republika Srpska* entity, also includes defining models to settle arrears. Finally, this entity also refers to reducing the share of public expenditure in public administration by establishing a register of employees ([52]) and increasing efficiency. The *Republika Srpska* entity recognises that the inefficiency of the public sector is reflected primarily in the inefficiency of public companies. The Federation entity has committed to implementing austerity measures in the public sector by restricting growth in the number of employees and the growth of wage expenditures and wage contributions. The Federation entity’s economic stabilisation and recovery program for 2020-2021 envisages reform of SOEs as one key objective ([53]). The government of *Republika Srpska* entity set up a Working Group for Public Enterprise Reform in September 2020 to prepare an action plan for the reform of public enterprises in the *Republika Srpska* entity. The ERP could have referred to relevant activities planned in the adopted socio-economic reform package. These include creating publicly available and harmonised registers of public companies, establishing central oversight

([52]) As indicated as one activity under measure 12 (‘enhancing the business environment’).
([53]) Moreover, the government of the Federation entity Government endorsed the 2021–2027 development strategy (awaiting endorsement by Parliament), which stresses the importance of an efficient, transparent and accountable public sector.

units in both entities, enhancing supervisory, management and appointment procedures and analysing restructuring models for the two telecom companies.

The COVID-19 pandemic could be an opportunity for a more fundamental reform of the SOE sector which has a potential to increase GDP by an annual 3% (IMF, 2019). Significant fiscal shocks and the need for a more responsible fiscal policy in the aftermath of the crisis have the potential to trigger reforms that lead to important efficiency gains in this sector. Opposition to reform can be reduced through careful selection of entrypoints and sequencing (World Bank, 2020). The inclusion of the SOE sector reform in the 2019-2022 socio-economic reform package ('de-politicisation, increased sustainability and efficiency of state owned enterprises'), adopted by entity and state-level governments signals a political willingness to engage in the SOE sector reform and reap the potential benefits.

Box II.6.3: **Monitoring performance in light of the European Pillar of Social Rights**

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

Bosnia and Herzegovina performs weaker relative to the EU-27 average in most of the principles of the European Pillar of Social Rights, according to available indicators of the Social Scoreboard ([54]). The employment rate remains very low, particularly for women and young people. A high 77.3% of unemployed people were long-term unemployed in 2019. The job creation is localised and the low mobility of workers limits the allocation of labour resources to emerging needs. The gender employment gap (people aged 20-64), still at 23.6 pps. in 2019, was twice as high as the gap in the EU-27 (11.7 pps.) and has only showed a slight decrease of 0.8 pps. since 2016. This gap is exacerbated by the low availability of elderly care and early childhood education and care.

Education continues to be of low quality, and the country suffers from a continuing skills mismatch. There has been little change in levels of educational attainment in recent years. This indicates slow structural change in both the labour market and the education system. It is positive that the share of early school leavers is very low at 3.8% in 2019, much below the EU-27 average (10.2%). However, there is a large share of low-skilled people in the population. Upskilling strategies to increase the skill levels of the workforce are not sufficiently developed to accompany a gradual move of the economy towards a structure that requires a more skilled workforce.

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

Social transfers have a limited impact on reducing poverty. Means-tested social assistance does not cover basic living needs. Other non-contributory social benefits insufficiently target low income and vulnerable segments of the population. It is estimated that the reduction of the at-risk-of-poverty rate by social transfers is 9.16%, significantly lower than the EU-27 average (32.38% in 2019). Participation in early childhood education and care is significantly lower than in the EU and elsewhere in the region. It stands at only around 5% for children under 3. Most children enrolled in early childhood education and care come from urban families where both parents are employed, while children from rural areas or whose parents are unemployed almost rarely attend.

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

6.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2020

Overall: Partial implementation (41.2 %) ([55])	
2020 policy guidance	**Summary assessment**
PG 1:	There was **limited implementation** of PG 1:
Take the necessary fiscal measures to alleviate the economic shock of the COVID-19 crisis, in particular protecting the most vulnerable groups.	1) **Partial implementation**: In order to alleviate the economic shock of the COVID-19 crisis, the authorities increased support to the health sector, delayed deadlines for tax payments, subsidised wages and social security contributions and provided financial support to enterprises. Those measures amount to up to 2½% of GDP. Furthermore, loan guarantees have been provided, amounting to another ½% of GDP. However, efforts to protect in particular people in vulnerable situation have remained very limited.
In order to support the recovery, improve analytical, planning and coordination capacities to strengthen country-wide macroeconomic policy formulation and its implementation.	2) **Limited implementation**: The data provision in the macroeconomic part of the ERP has improved. However, coordination and cooperation among the various stakeholders have remained insufficient.
Improve the provision of timely, exhaustive and country-wide statistics and its transmission to Eurostat and the ECB, in particular on national accounts, the labour market and government finance, in line with Eurostat recommendations.	3) **Limited implementation**: Quarterly Labour Force surveys are now produced. Also, the Central Bank has continued to work on the General Government data base. However, very little progress has been achieved with national account statistics and government finance statistics.
PG 2:	There was **limited implementation** of PG 2:
To accelerate the economic recovery, increase growth-enhancing public investment as a share of GDP, based on a comprehensive investment strategy.	1) **Limited implementation:** Some, largely foreign financed investment in infrastructure took place. However, those investments were not necessarily part of a medium-term, growth-enhancing investment strategy.
Improve the targeting of social transfers by increasing the share of means-tested benefits in total social spending.	2) **Limited implementation:** In one part of the country, a comprehensive mapping of all social benefits has started, with a view to establish the base for a better targeting of social transfers.
PG 3:	There was **substantial implementation of** PG 3:
Closely monitor financial stability challenges arising as a result of the coronavirus pandemic and take appropriate action if needed, while addressing the remaining	1) **Partial implementation**: Banking supervisory agencies have worked closely together to coordinate the implementation of support measures for the financial sector such as debt moratoria. But there is no centralised

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

obstacles to NPL resolution and ensuring the proper coordination of supervisory activities.	macro-prudential framework. In addition, the remaining obstacles for an effective NPL resolution framework have not been addressed, such as facilitating out-of-court restructurings and amending the tax treatment of NPL sales to specialised companies.
Strengthen the bank resolution framework by adopting the law on deposit insurance.	2) **Full implementation:** The Law on Deposit Insurance was adopted. At the same time, the bank resolution framework is still not fully operational and needs to be strengthened further, for instance by widening the coverage of the Deposit Insurance Agency and increasing its funding.
Safeguard the integrity of the currency board arrangement and the independence of the central bank, while enhancing its analytical capacity by establishing macroeconomic projections.	3) **Substantial implementation**: The full convertibility of the domestic currency was ensured. The CBBH conducted inflation expectations and bank lending surveys. A macroeconometric model was developed and the CBBH carried out macroeconomic projections. However, the circumstances of the appointment of three Board members in 2020 might raise questions about central bank independence.
PG 4: With a view to mitigating the economic consequences of the COVID-19 pandemic and stimulating economic recovery, establish an effective, coordinated and transparent mechanism to support the businesses affected by the crisis, in particular small and medium-sized enterprises and the self-employed.	There was **limited implementation** of PG 4: 1) **Limited implementation**: In May 2020, a task force was established to coordinate the activities of all levels of the government in Bosnia and Herzegovina concerning socio-economic measures in response to the COVID-19 crisis and to facilitate mobilisation of funding for all levels of government through domestic funds and foreign financial assistance. However, the task force has rarely met and does not appear to be operational. Although substantial resources were allocated to mitigate the economic consequences of COVID-19, a consistent countrywide approach (coordinated with the private sector) is largely missing and the country's anti-crisis response has been fragmented, insufficient and slow so far. Delays in implementation occurred, particularly with the provision of loan guarantees which are characterised by cumbersome procedures. Also, the Economic Stabilisation Fund in the Federation entity, aimed at supporting businesses, was established with significant delay.
Extend social protection coverage and provide incentives for businesses and employees in the informal economy sector to register and to facilitate their transfer to the formal economy.	2) **Limited implementation**: Embarking on a more strategic approach to reduce informal employment has not progressed. Active labour market measures addressed to a limited extent the issue of employees in informal economy and their transfer to formal economy by implementing employment and incentive programmes for employers. COVID-19 mitigating measures include subsidising company's social security contributions and provision of minimum wages to workers in affected sectors. Some steps were taken to map social benefits in

	order to better target them. To improve fiscal harmonisation in the country, the Federation entity has committed to adopting legislation to reduce the tax burden, but has still not done so.
With a view to a swift recovery after the COVID-19 crisis, simplify business registration, licensing and permit procedures country-wide.	3) **Partial implementation**: Efforts were made to facilitate online business registration, but such efforts need to continue and be streamlined. Closer cooperation among different levels of government, allowing in the end for mutual recognition of business registration, is required. All business registries are now accessible online. An integrated electronic system for the registration of business entities and entrepreneurs is successfully launched in the *Republika Srpska* entity. The system simplifies the process and shortens the time required for registration. E-registration is in the testing phase in Brčko District. Moreover, an e-construction permitting system is being piloted in the *Republika Srpska* entity in some cities. The Federation entity is lagging, as the legislative framework for online registration is still not fully in place (awaiting adoption by the Parliament). Once the legislation is fully adopted, the procurement process for the system's implementation can be triggered and the system can be operational in the Federation entity by the end of 2021.
PG 5: Ensure adequate and sustainable funding to strengthen the health care sector with an aim to improve access to quality public health care for all citizens.	There was **limited implementation** of PG 5: 1) **Limited implementation:** The authorities increased health system capacities and re-oriented health providers towards COVID-19 designated facilities. However, the fragmentation of the healthcare system has made coordination that much more difficult. Reform of the health system is one of the priority reforms in terms of ensuring adequate and sustainable financing and efficient service provision to healthcare users.
Identify scope for and implement centralised procurement of pharmaceuticals and medical equipment, especially for high-cost and high-volume medications.	2) **Limited implementation**: Apart from COVID-19 related procurement (where the Ministry of Civil Affairs took a coordinating role, e.g. regarding the COVAX mechanism and the EU advance purchase agreement), there was no centralised procurement of pharmaceuticals or medical equipment. BIH jointed the European Union Joint Procurement Agreement for medical countermeasures (JPA) in April 2020 and is a full member since end February 2021.
Adopt and implement a credible and relevant countrywide Public Finance Management strategic framework with a performance based monitoring and reporting system.	3) **Partial implementation**: No countrywide strategic framework for public financial management with a performance based monitoring system has been adopted. With the technical assistance of the IMF's Fiscal Affairs Department, public finance management reform strategies for 2021-2025 have been developed at all levels (a precondition for preparing the country-wide

	strategy) and adopted at some levels of government, and a countrywide strategy is expected to be drafted in the coming period. Improving public financial management at all levels is also necessary to support fiscal consolidation measures and ongoing structural reforms.
PG 6: Take measures to preserve employment including through short-time work schemes, and strengthen without delay the capacity and human resources of employment offices to ensure registered jobseekers more active support including an increased provision of active labour market policies, especially training, upskilling and reskilling.	There was **partial implementation** of PG 6: 1) **Partial implementation:** The measures and their implementation were addressed by a series of measures at all levels especially those tackling the mitigation of the consequences of the COVID-19 pandemic. However, these seemed to be insufficient. The measures to strengthen the capacity and human resources of employment offices were partially addressed in both entities (under the World Bank loan), but not in the Brcko District. However, these seemed to be insufficient especially due to the unexpected COVID-19 pandemic, highlighting the un preparedness of the labour market institutions for work under such extraordinary circumstances, and the measures, at times, seemed to be inadequately implemented.
Complete in the whole country the discharge of public employment services from administrative duties related to health insurance for registered unemployed.	2) **Partial implementation:** The measures have only been adopted in Nov 2019 and implemented in 2020 in *Republika Srpska*, but discharge of these services still has to be completed in the Federation entity.
Ensure increased coverage of unemployment and needs-based social benefits and in the medium term, map non-contributory social benefits in the whole country and rebalance the social assistance system from status-based to needs-based benefits while increasing their adequacy and coverage.	3) **Limited implementation:** There was no implementation to increase coverage of unemployment benefits. Some measures to address the PG subpart are underway such as comprehensive mapping of all social benefits in the *Republika Srpska* entity, but the measures still have to be implemented in the Federation entity. BiH should continue activities to develop an efficient, sustainable and fair system of social protection and protection of families with children that will guarantee the basic and equal rights of people in vulnerable situations.

6.6. ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2021-2023

Most measures presented in the ERP are not countrywide and only include entity-specific activities in a fragmented way. There is often insufficient indication as to which level of government or institution the activities are related. The planned processes and expected outcomes of measures are often not specific. In many cases, the activities planned do not appear to be in line with, or address, the main obstacles identified for the various sectors. There are only a few reform measures in the ERP that have the potential to cover the country as a whole and primarily those have been assessed in more detail.

Informal economy

The widespread informal economy poses another burden on business in Bosnia and Herzegovina, as the size of the informal economy has remained significant and underminined fair competition. The level of the informal economy appears to be around 30% of GDP and rather persistent over the last years (EFENDIC, PASOVIC, 2018) and the share of informal employment in total employment stands at 30.5% (ILO, based on LFS 2019). The resulting narrow tax base requires rates for taxes and social security contributions to be higher than would otherwise be necessary. This also adds to a significant fiscal burden on labour, which in turn impedes formal employment and negatively affects Bosnia and Herzegovina's international competitiveness. Informal employment is estimated to account for nearly one third of total employment. Apart from low tax morality due to the presence of corruption, inadequate tax policy and a fairly high income inequality in society, the different types of institutional failings appear to be an important factor fostering the informal economy and undeclared work. Policy recommendations to address the informal economy, also broadly relevant for Bosnia and Herzegovina, require a comprehensive package of reforms, including reducing regulatory and administrative burdens, promoting transparency and improving government effectiveness, as well as improving tax compliance, automating procedures, and promoting electronic payments (IMF, 2019). While recognising the informal economy as an obstacle to competitiveness, the ERP diagnostic is weak and limited. The measure to reduce the informal economy has been discontinued without explanation. Nevertheless, the *Republika Srpska* entity mentions (in the context of the on business environment measure) improving the work of inspection bodies and introduction of a revision of the current system of fiscal cash registers as a way to reduce the grey economy. The Federation entity is committed to preventing tax base erosion and profit shifting. The ERP explains that the Federation entity has committed to continuing to implement a tax reform by introducing a cumulative social contribution rate of 32.5% and increase the non-taxable part of income to EUR 409. The aim is to reduce the tax burden that is higher in the Federation entity than in the *Republika Srpska* entity and thereby to contribute to fiscal harmonisation in the country. Under **measure 12 ("Enhancing the business environment")**, reference is made to new **'**fiscalisation systems**'** to reduce tax evasion.

Research, development and innovation

Bosnia and Herzegovina still has limited capacity for technological absorption and for research, development and innovation. The legislative framework regulating science and research development remains fragmented and still needs to be improved throughout the country. There is still no action plan to implement the 2017-2022 revised strategy for scientific development. The institutional set-up for innovation policy is highly decentralised and limited innovation impedes productivity of the private sector. The entity level deals with research and development (R&D) and innovation policy, and coordination is poor. However, a recent decision on appointing the Science Council aims to address this issue. Key obstacles include low investment in R&D; a very low number of researchers per head of population; very few innovation-related policies or strategies and very limited cooperation between academia and the private sector. The Global Competitiveness Report ranks Bosnia's innovation capability (including research and development) 117th out of 141 countries. The country's estimated total allocations for research remain low at 0.3% of GDP. The revised strategy for scientific development sets the goal of having 0.8% of GDP investment in research and development by 2022, which would still be far from the EU´s 2020 average of 2%. The country's research capacities remain very limited, while the trend of a brain drain continues, most notably in the health, medical, and IT sectors, with no systematic measures having been introduced so far to address the issue. Following the COVID-19 outbreak, academia and industry began some activities to alleviate the impact of the pandemic, such as producing medical and personal protective equipmentand sharing expert knowledge and information. However, there needs to be more systemic collaboration and interaction between 'triple helix' actors - academia, industry and governments. According to the 2019 Balkan Barometer, the technological innovation and capabilities score is among the lowest in the region (RCC, 2020). The ERP recognises that the system of managing research, science and innovation is ineffective and identifies the need to strengthen innovation, develop institutional capacities and increase the financing of science, technology and innovation. However, in terms of concrete activities, the ERP only explains that legislation on and the establishment of a Science and Innovation Fund in the *Republika Srpska* entity has been postponed due to the pandemic.

Digital economy

The country is still at a very low level of digitalisation ([56]), performing well below the average of the economies of south east Europe (SEE) when it comes to using and accessing information communication technologies. The Global Competitiveness Report (2019 edition) ranks Bosnia and Herzegovina 80th out of 140 countries for adopting ICT. The information and communication sector accounts for 4.9% of gross value added (2019). While the country ranks worst in terms of perception of digital services provided by the public administration for businesses, reports indicate that the quality of the digital services provided by public administrations has slightly improved (RCC, 2020). Also, the percentage of individuals having basic or above basic digital skills is relatively low (24% in 2019) reflecting deficits in the education system where only 8.4% of the secondary pupils have access to a computer at school while just 6.8% of secondary pupils have school-based access to the internet (ETF, 2019). Legislation to liberalise the telecommunications and electronic media sector is not yet in place. The opening up of mobile virtual network operator (MVNO) licences in mid-2021 might offer opportunities to increase competition in the market. For this to happen, authorities should ensure fairly and transparently priced access to the networks of incumbent operators by new operators applying for MVNO licences. Bosnia and Herzegovina remains the only country in the region that does not have a broadband strategy, even though it introduced the 4G network in 2019. Still, according to the Balkan Barometer, businesses from Bosnia and Herzegovina seem to be among the most digitalised in WB6 (RCC, 2020). There are 67 internet providers and 3 080 859 internet users (87.25% penetration rate), with a penetration rate of 20.05% for broadband internet. The regulatory environment for e-commerce is underdeveloped ([57]). No financial support tools have been developed to accelerate the adoption of ICT and digital services. The availability of a government digital service to complete administrative procedures is among the lowest in the region (RCC, 2019). The use of e-filing for taxes is low. The fragmentation of responsibilities among different levels of authorities has a direct impact on e-government services. Creating a single portal and expanding digital services will allow enterprises to complete processes online (OECD, 2019). This would make it possible to reduce the cost and number of required procedures, while diminishing the opportunities for corruption. The country is continuing to focus on adopting (i) a law on electronic identity and trust services for electronic transactions with a single supervisory body for the whole country; (ii) adopting a broadband access strategy; (iii) a strategy to develop the information society; and (iv) a law on electronic communications and electronic media. The 2021–2027 development strategy of the Federation entity (awaiting endorsement by the Parliament) honours the importance of innovation and digitalisation. The ERP recognises that an efficient and transparent provision of e-services to citizens and businesses (an area where the *Republika Srpska* entity has a particular focus) enables a better business environment. In general, the document does not provide

([56]) 1.6 out of 5 according to the OECD Competitiveness Outlook (2018).
([57]) The Federation entity is still working on an e-commerce law.

for a thorough analysis of this sector and is limited to general statements, including the need to improve the ICT sector by aligning the regulatory framework with EU standards.

Measure 13: "Improving the communication and information society along with the alignment of the regulatory framework with EU standards"

This rolled over measure is in line with the digital agenda, has the potential to support to some extent the Economic and Investment Plan (flagship 8-digital infrastructure) and the Digital Agenda and is very relevant for economic growth and increased productivity. Activities planned under this measure refer mostly to the adoption of legislation and strategies, including the adoption of the broadband internet access strategy and the Law on electronic communications and electronic media. These activities are consistent with the findings and recommendations issued by the European Commission and have the potential to support the Regional Digital Area as envisaged in the Common Regional Market Action Plan. However, no progress in adopting or implementing legislation is noted so far. The adoption of a new Law on electronic communications and electronic media as well as the Law on electronic identity and trust services for electronic transactions with a single supervisory body for the whole country will also reinforce the regulatory framework on e-commerce. The lack of further progress in implementing this measure is compounded by no indications of budgetary appropriations and vague indications of key performance indicators.

Economic integration reforms

Technical barriers to trade are still substantial and both detrimental to trade as well as to a common internal market within the country. The legal basis and administrative structure for technical regulations, standards, conformity assessment, accreditation, metrology and market surveillance are in place, but they are not aligned with the EU *acquis* and remain uneven and fragmented. There is still no countrywide strategy for putting in place the quality infrastructure. The inadequate and uncoordinated level of harmonisation of the legislative and institutional framework with the EU *acquis* on free movement of goods can result in enterprises having difficulties in exporting to the EU single market and in being forced to perform double registrations if placing their products in both entities. The country will need to abolish double registration of companies and any additional registration requirements in the two entities and, where such requirements exists.

The ERP recognises that the lack of a properly developed system of quality infrastructure and the lack of a related strategy stand in the way of a common internal market within the country. *Reform measure 10 (Enhancing the quality infrastructure system according to the EU model/developing a legal and planning framework)* aims to adress this issue. This rolled over and long delayed measure on harmonising quality infrastructure is highly relevant in increasing the country's competitiveness and long-term growth potential. If implemented, the measure would help to create a common internal market within the country and to facilitate trade. The measure is in line with the country's commitments under the Stabilisation and Association Agreement (Article 75). However, the measure also includes implementation of activities related to the implementation of the *Republika Srpska* entity's own quality infrastructure strategy, which is not a countrywide approach. Cross-cutting coordination between the relevant institutions at different levels of government - indispensable for a meaningful implementation of this measure - has not yet been ensured. Apart from establishing a working group for a strategy in November 2020, no progress was made in implementing this measure. Without proper timelines, key result indicators (which are provided only for one entity), more concrete activities, costing or impact on competitiveness, it is difficult to assess to what extent this measure reflects a realistic commitment. The ERP fails to discuss the implications of the *Republika Srpska* entity's own quality infrastructure strategy adopted in October 2019. An Agreement on Conformity Assessment and Acceptance of Industrial Products (ACAA) with the EU - as mentioned as part of the analysis related to this measure - requires Bosnia and Herzegovina as a whole to have a fully EU compliant quality infrastructure. The same applies to a fully operational Common Regional Market to function in line with EU rules. Unless activities are implemented in the country as a whole, Bosnia and

Herzegovina will not be in a position to accelerate EU market integration ahead of accession and fulfil its role within the Common Regional Market.

The Common Regional Market adopted at the Sofia Summit in November 2020 is an important driver of growth and transformation, bringing the region closer to the EU. The action plan is based on EU rules and standards. Deeper economic integration will accelerate compliance with the EU *acquis:* the Common Regional Market is a stepping-stone to integrate the region more closely with the EU Single Market already before accession. Regional cooperation has so far delivered concrete results, including the regional roaming agreement, an agreement on trade facilitation, a regional investment reform agenda, a decision on authorised economic operators, a decision to liberalise trade in services and an agreement to facilitate trade in fruit and vegetables. The country needs to make continued efforts to implement Additional Protocol 5 on Trade Facilitation and Additional Protocol 6 on Trade in Services of the Central European Free Trade Agreement (CEFTA); playing a constructive role in ensuring finalisation of the negotiations of the CEFTA Additional Protocol 7 on Dispute Settlement in 2021. In addition, other aspects of the Common Regional Market action plan should be implemented without delay, such as the free movement of people with IDs, the regional development of e-commerce or the mutual recognition of professional qualifications. This would help to unleash the regional potential of trade in services. It is important that regional initiatives include all Western Balkan partners and are in line with EU rules, building on existing commitments. A full-fledged common internal market across Bosnia and Herzegovina is a basis for regional integration. There is a need to foster mutual recognition of (i) certificates, (ii) testing facilities, (iii) risk management systems and (iv) pre-arrival processing of documents. There is also a need to make progress in implementing the customs policy law, which includes introducing the concept of authorised economic operators. Trade integration with the EU increased markedly, but trade with neighbouring non-EU countries was also up**.** Exports to the EU-27 accounted for 73% of total exports in 2019. Imports from the EU accounted for 62% of total imports. Exports to CEFTA countries rose slightly during 2019, by about 0.5 pps. to 16.6% of total exports, as increases in exports to some of those countries, such as Serbia, largely compensated for the sharp drop in exports to Kosovo resulting from the hike in tariffs. In terms of the effects of the pandemic, in the first 10 months of 2020 ([58]), exports to the countries of the European Union were 11.1% less than during the first 10 months of 2019, while imports were 16.4% lower. Exports to CEFTA countries were 13.4% less than in the same period last year, while imports were 11.7% less. Bosnia and Herzegovina is not yet a member of the World Trade Organisation (WTO), although membership negotiations have been at a very advanced stage already for some time. The ERP fails to provide a proper analysis of this sector.

As the two measures mentioned under this section of the ERP are only referring to the *Republika Srpska* entity, they can not be considered as measures fostering economic integration. **Measure 14 “Improving e-government”** is in principle consistent with the digital agenda, the Declaration on e-Government endorsed in Belgrade in 2019 and has the potential to support to some extent the Economic Investment Plan (flagship 8-digital infrastructure). It focuses on efforts of the *Republika Srpska* entity to progress towards implementation of its e-government development strategy for 2019-2022. Without a countrywide discussion of the measure, it can also hardly contribute to a regional digital area envisaged under the Common Regional Market Action Plan. Measure 15 on real estatate brokerage also covers only one entity (real estate activities account for 5.7% of gross value added in 2019).

Energy

A fragmented, inconsistent, uneven legislative and regulatory framework prevents the country from moving forward and meeting its international obligations. The country remains in a serious and persistent breach of its obligations in a number of fields, particularly natural gas and electricity. The lack of political agreement in natural gas sector is jeopardising security of supply, with effects on the country’s economy and the lives of its citizens. The necessary steps to ensure the adoption of the crucial

([58]) BiH Agency for Statistics

State Electricity and Gas Law in line with Energy Community requirements on the state level are still missing. The lack of a legislative framework significantly impedes the country's effective integration in the regional energy markets. Energy intensity of GDP ([59]) in Bosnia and Herzegovina is about four times higher than in the EU and the country is the most carbon intensive economy in the region. In 2017, coal accounted for 61% of primary energy generation. Important coal subsidies ([60]) per unit of final electricity consumption exceeded the incentives paid to renewable energy producers and are effectively subsidising pollution (World Bank, 2020). Despite the ongoing infringement case initiated by the Energy Community Secretariat, preparations for implementing the Block 7 Tuzla thermal power plant investment project reached its final stage, prolonging dependence on coal ([61]). Several new or expanded lignite-fired power plants are planned or under construction. Nevertheless, plans of the governments to promote the recovery are an opportunity to accelerate the transition to a low-carbon economy and cleaner energy production, in view of long term consistency with the Green Agenda for the Western Balkans. To support a comprehensive energy sector reform, the recently launched initiative for coal regions in transition in the Western Balkans and Ukraine (managed by the European Commission and five collaborating international partners) aims to assist to move away from coal to towards a carbon neutral economy, while ensuring that this transition is just.

The renewable energy and energy efficiency sectors have the potential to contribute to de-carbonisation and alleviate the economic impact of greenhouse gas (GHG) pricing and may over time reduce electricity prices. The country will need to adopt state- and entity-level legislation on renewable energy and energy efficiency in line with the obligations stemming from the Energy Community Treaty. As for *renewable energy*, though moderately advanced in implementation, the country's 2020 target of 40% has not been met ([62]). The regulatory framework continues to be cumbersome for issuing authorisations and licensing. Market-based support schemes are still missing and revised renewable energy laws will need to be adopted, in line with the principle of a cost effective support framework. However, there are plans to adopt a new support package based on auctions, including amendments to the relevant entities' legislation. There is no appropriate system for guarantees of origin and for the use of minimum levels of energy for RES in new buildings in place. On *energy efficiency*, the entity legislation is not fully compliant with the Energy Community acquis ([63]), and the existing laws are not properly implemented. Each entity has established an Energy Efficiency and Environmental Fund. Work on a new national energy efficiency action plan has, for the most part, been completed and the adoption of the plan is awaiting political endorsement. Work on the National Energy and Climate Plan is already at relatively advanced stage, but entity and state level plans need to be streamlined. It is important that investments in energy infrastructure, including thermal and hydro power plants, be made in compliance with Bosnia and Herzegovina's obligations under the Stabilisation and Association Agreement and the Energy Community Treaty. The ERP partly recognises some of these challenges, particularly the requirement to align the legislative framework for gas and electricity with the third energy package, as well as improving energy efficiency ([64]) and RES. The economic recovery from the COVID-19 pandemic should be used as an opportunity to accelerate the transition to a low-carbon economy. A green recovery approach will allow Bosnia and Herzegovina to make full use of the Economic and Investment Plan for the Western Balkans (European Commission, 2020) and its three energy flagships on renewable energy, transition from coal and a renovation wave (energy efficiency).

Measure 1: "Energy and gas market development"

([59]) Kilograms of oil equivalent (KGOE) per thousand Euro
([60]) Coal subsidies per unit of final electricity consumption exceeded the incentives paid to renewable energy producers (ECS, 2021).
([61]) Coal mining provides an estimated 13 000 direct jobs across 14 operating mines, but mine productivity is low (World Bank, 2020).
([62]) The country achieved a 37.6% share of renewable energy sources (RES) in gross final consumption.
([63]) Energy Efficiency Directive and the new Framework Energy Labelling Regulation.
([64]) The Federation entity 2021 – 2027 Development Strategy of the Federation BiH (awaiting endorsement by the Parliament) honours the importance of resource-efficient and sustainable growth.

This rolled over measure rightly recognises the importance of adopting of the state level legislation on electricity and gas in line with the Third Package which would allow for development of the energy and gas market. This is consistent with Bosnia and Herzegovina's commitments under the Energy Community Treaty and the connectivity agenda, both of which aim at gradually integrating Bosnia and Herzegovina into European energy markets. It is also a priority of the country's framework energy strategy. The measure is relevant to the development and functioning of an internal energy market**,** unbundling the transmission system operator and the distribution system operators of the entities as well as setting up organised markets, i.e. power exchange or market coupling. However, bearing in mind in particular the continued politically motivated delays, the measure is inconsistent and uneven. It fails to state that the existing *Republika Srpska* entity Law on Gas will have to be amended and harmonised with the state level law. The planned activities suffer from the sector still being hampered by political interference and from the failure to allocate necessary resources. The activities are not presented per year but grouped for the years 2021-2023, so it is difficult to assess the ambition and credibility, especially considering the limited progress in the implementation of activities in 2020. The measure does not provide clear and consolidated information for the country as a whole in terms of economic indicators, implications and effectiveness for achieving greater competitiveness.

Measure 2: "Improving energy efficiency and the use of renewable energy source"

This largely rolled over measure tackles some priorities to improve reforms in energy efficiency and the use of renewables. Activities such as the adoption of a national energy and climate plan (including an Action Plan for RES) ([65]), a national (or: integrated) Energy Efficiency Action Plan, plans for a market-based renewables support scheme and a building renovation strategy are consistent with the ambitious goals of the Green Agenda for the Western Balkan region ([66]) as well as the Economic and Investment Plan ([67]). Even though work for some activities planned for 2021 already started in 2020, there is still high risk of delays in adoption and implementation of laws/plans. The information given in the ERP is very fragmented and not consolidated, making it difficult to issue a sound assessment on the measure's effectiveness on competitiveness and overall growth, More comprehensive and coordinated action between all levels of the government is required in order to achieve measurable progress. A proper budget allocation to implement the different plans will be crucial for the measure's success.

Measure 6: "Establishment of economic instruments in the field of environment and energy efficiency" is not sufficiently elaborated for any adequate assessment and only concerns the Federation entity. The priorities identified (including adoption of new Law on the Environmental Protection and Energy Efficiency Fund in the Federation of Bosnia and Herzegovina) are therefore likely to be insufficient in meeting the country's needs.

Transport

Transport infrastructure in Bosnia and Herzegovina is insufficiently developed ([68]) and structural adjustment is slow, impeding the country's growth potential and competitiveness. The country's transport strategy needs an update to reflect economic developments. According to the Balkan Barometer (RCC 2020), in terms of availability, quality, and affordability of transportation infrastructure, respondents from the business community are among the most dissatisfied in the region. The necessary investment is delayed by the absence of a single or harmonised legal and regulatory framework, insufficient administrative capacities, poor implementation and coordination, inadequte cooperation between government levels and delays in securing agreed external financing. The highway network is limited (198 km in 2018), rail network utilisation is well below the EU average and the density of the

([65]) An important priority of the Green Agenda for the Western Balkans
([66]) The declaration on the Green Agenda was endorsed by the country
([67]) Flagship number 5 – transition from coal
([68]) The 2019 Global Competitiveness Report ranks Bosnia and Herzegovina's quality of road infrastructure and efficiency of air transport services 121st (out of 141 countries).

railway network is low (20 lines in operations per thousand km^2), making it more difficult for companies to export, and increasing their costs and transport time. The legislative framework on concessions and public-private partnerships remains highly fragmented or is absent in parts of the country. There has been no progress in implementing measures to reform the country's connectivity, which would be a significant driver of economic growth (at a much lower cost). The transport sector is dominated by poorly managed and often inefficient SOEs which exercise monopolies in roads, railways and airports. The entity railway companies are listed as very high risk. The railway company of the *Republika Srpska* entity is undergoing operational and financial restructuring with support from a World Bank programme. The risk score for the railway company of the Federation entity suggests that financial and operational restructuring may also be warranted to reduce financial risks for the Federation entity (IMF, 2019). Bosnia and Herzegovina has to gradually open its railway market, which is hampered by unsafe, outdated and unreliable railway infrastructures on at least half of the core railway network and practically on most railway sections outside this network. Two railway companies of the entities need to complete the process of separating infrastructure management from transport services to ensure their full independence. Competitiveness is affected by overemployment in the main rail transport operators. The economic cost of road crashes ([69]) and the environmental costs of transport activity are very high (OECD, 2018). To some extent, the ERP recognises the main challenges and refers to, among other issues, to underinvestment in railway and road infrastructure and the need to restructure public railway companies.

Measure 3: "Development and improvement of transport infrastructure"

This largely rolled over measure lacks a strategic vision and a structured approach to sector reforms, presenting activities in a fragmented and sometimes repetitive way and sometimes referring to micro-interventions. Various relevant issues related to a more countrywide approach have still not been addressed, such as the need to establish a national system for the continuous collection of road crash data, improved cooperation and coordination between government levels and the related need to overcome delays in securing agreed external financing. In general, activities are presented in an asymmetric manner. For instance, activities related to the financial and operational restructuring of public railway companies (the *Republika Srpska* entity aims to restructure 'Željeznice RS' until the end of 2021) and the need to complete the process of separating infrastructure management from railway undertaking functions are incomplete and incoherent. Equally, investment programmes to address infrastructure deficiencies only indicate activities for one entity without clear costing. Moreover, there are some concerns about the technical maturity of these investments and the indicated timetable. The ERP recognises that considerable financial investment is needed to improve the railway infrastructure, but the activities make no references to revitalising the railway network in line with the Green Agenda for the Western Balkans and promoting a greener and more sustainable transport network. Overall, the measure is not sufficient to have a significant impact on the economy as a whole.

Agriculture

Bosnia and Herzegovina faces many obstacles to increasing agricultural productivity and opportunities for its agriculture. These obstacles include low overall investment and administrative capacities, land fragmentation, low productivity, and outdated facilities for manufacturing and processing. Forests are underexploited: following a ruling by the Constitutional Court annulling the Federation entity's Law on Forestry, the forestry sector in the Federation entity is not duly regulated. Other reasons include low forest roads density and land mines. Small farms and plot fragmentation dominate in Bosnia and Herzegovina. Due to the structure of farms, there is little specialised agricultural production. Agriculture, forestry and fisheries continue to play a significant role in economic growth, job creation and

([69]) The country has managed to reduce road fatalities by 18% over the period 2010-2019, well below the European Commission's goal of reducing fatalities by 50%, as outlined in its 2011-2020 policy orientation on road safety.

social stability. These sectors account for 6.6% of gross value added (2019) and 18% of employment (2019), although an estimated 60% of Bosnia and Herzegovina's population live in rural areas (UNDP), which is very high compared to the OECD average of 20%. As the last agricultural census was conducted in 1960, the absence of up-to-date data on agriculture is a stumbling block to policy making in this sector. The largest share of support for agriculture and rural development (88.7% in 2017) is through direct production support measures. Support measures are not harmonised and in the absence of proper monitoring and evaluation mechanisms, they are not effective enough to increase the sector's productivity and competitiveness. The EU is Bosnia and Herzegovina's key trading partner for agricultural goods. On general food safety, food safety rules and specific rules for feed, Bosnia and Herzegovina increased its export of a number of commodities to the EU by complying with some EU rules and requirements (e.g. industrial eggs as well as poultry meat and poultry meat products). Before it can export other categories of meat, the country first needs to carry out complex preparatory activities to comply with the EU SPS standarsds and import rules. The country has adopted a strategic plan for rural development for 2018–2021 which has the potential to create more synergies between food safety policy, veterinary policy, phytosanitary policy, agricultural policy and rural development policy; this is necessary for the country's overall sustainable economic growth. The ERP recognises the challenge that a lack of harmonised policies and standards in the country poses for this sector, resulting in highly decentralised and fragmented agricultural production, limited economies of scale and therefore limited growth in the sector. The document also rightly stresses that the approach currently applied in the country prevents an internal agreement to comply with the requirements for IPARD assistance and more generally refers to the lack of funding and investment.

Measure 4: "Improve the competitiveness of agriculture, forestry and water management"

The measure has mostly been rolled over. It is largely relevant for the sector's economic performance, growth and export potential as well as job creation and retention. Last year's recommendations better structuring and more harmonisation, consistency and prioritisation of the envisaged activities across the sector have not been followed. On the contrary, the measure appears even more fragmented than in the previous ERP and there are no clear references to the sector's overall priorities, many of which are important for further integration with the EU. Therefore, it remains unclear whether and how to consolidate and harmonise priorities across the sector. The measure is characterised by a high degree of fragmentation and does not demonstrate synergies among entities. The *Republika Srpska* entity includes an activity for the 'protection of domestic production'. In that context, it is of vital importance to our bilateral relationship that Bosnia and Herzegovina respects its international commitments under the SAA. The current strategy for the sector expires in 2021 and there is no reference to a strategy beyond 2021. There is also no reference to COVID-19 mitigating measures or to considerable EU assistance to recovery and resilience of agriculture and rural areas. Among other aspects, the measure includes setting up administrative structures for the common agricultural policy, which include a paying agency, elements of an integrated administration and control system, a land parcel identification system and a farm accountancy data network. There is some reference (in one entity) to starting the alignment of direct payments with EU rules. However, and as largely recognised by the ERP, the measure appears too ambitious and lacks a structured approach to reforms, given the still prevailing issues related to this sector's coordination, the already accumulated long delays, the high number of activities planned and the sometimes unharmonised presentation of activities (e.g. in terms of a new forestry information system or a water information system). There is insufficient information on timelines and budgeting.

Industry

The industrial sector still suffers from the absence of a common internal market within the country. Industry accounted for 23.1% of gross value added and 23.8% of employment in 2019. The sector was the main contributor to the country´s exports over that period. In 2019, the share of value added of mmanufacturing accounts for 15.2%. Bosnia and Herzegovina does not have a unified approach to enterprise and industrial policy, as this is an exclusive competence of the entities, the Brčko District and the cantons in the Federation entity. There is no state-level body promoting consistency between industrial strategies and other policies affecting industrial competitiveness. The fragmented institutional framework is not conducive to business creation, investment, entrepreneurship, innovation and the promotion of SMEs. The ERP fails to provide a specific diagnosis of this sector. Addressing the issues of key challenge #2 is critical and the implementation of the ERP measures on business environment, energy, transport and innovation are crucial for industrial development. Industrial policy will be key in achieving the Green Agenda for the Western Balkans. Integration with the EU internal market means integrating with its industrial ecosystems as they transform in the spirit of the European Green Deal. This implies not only the need for a green modernisation in enterprises, but also investments in the co-operative linkages in the industrial eco-systems such as innovation, inward foreign direct investment, export prerequisites and skills development. The ERP recognises the importance of the manufacturing sector.

Measure 5 "Support to the manufacturing industry" aims to support a medium-term recovery of the manufacturing companies in the *Republika Srpska* entity from the effects of the COVID-19 pandemic. The measure is relevant and appropriate in light of the proposed sectors most heavily affected by the economic downturn. It is also comprehensive and sufficiently ambitious to provide for a gradual transition of the support from a short-term supply of working capital towards increased investments and product development for building the resilience of companies' in the medium term. Nevertheless, the expected effectiveness and significance for growth and jobs retention are limited due to the absence of countrywide efforts to define a long-term recovery plan.

A circular economy, addressing in particular waste, recycling, sustainable production and an efficient use of resources is one of the five broad areas covered by the Green Deal. A circular economy promotes innovative and more efficient ways of producing and consuming. Considerable efforts and investments are needed to build properly functioning waste management centres and recycling facilities, so that the country can use the existing resources currently ending up in landfills (over 90% landfilling rate in the region) or being burned up in incinerators.

Measure 6: "Improving integral waste management and the system of circular economy" is a rolled over measure to establish a legal framework and infrastructure that can support transition to a circular economy and enable adequate management of specific types of wastes. This requires identifying and categorising different types of waste to enable recycling and reuse in support of the circular economy. The measure is in principle relevant, appropriate and consistent with the Green Agenda. Environmental standards are low and often neglected, impeding the health (and thus productivity) of the country's labour force and constitute another factor supporting the brain drain. However, while the analysis and description of the measure mentions only the *Republika Srpska* entity, activities also appear to be carried out in the Federation entity (without elaborating on its rationale in the analysis and description of the measure). In addition, for a number of activities it is not sufficiently clear to which entity they refer to (e.g. drafting new Law on Waste Management). There are also inconsistencies in terms of sources of funding. Without a consistent, countrywide strategy for waste management (the ERP appears to make no reference to the environmental protection strategy which could provide for this), the measure does not cater for the much needed gradual transition to a circular economy in a country-wide harmonised manner. Moreover, given the limited progress in implementing activities in 2020, the proposed activities are overly ambitious.

Services

The service sector, including public administration, health and education, is the largest in terms of employment and value generation, accounting for nearly two thirds of the gross value added (65.3% in 2019). During 2019, most new jobs were created in services and most of the active labour force was employed in this sector (50.3% in 2019). Bosnia and Herzegovina usually achieves a surplus in the service balance, as well as substantial net inflows from tourism. Services exports represent a significant part of the country's international trade. Nevertheless, the country could gain from a liberalisation of the services sector and by addressing the complex regulatory environment for the provision of services even among entities. Tourism has a significant growth potential with high growth in visitor rates. The direct contribution of tourism to employment amounted to 3%, and the total contribution of tourism to employment amounted to10.6% (OECD, 2018). However, the outbreak of the COVID-19 pandemic particularly affected the tourism sector: Only 498 000 visits were recorded in 2020 in the country, a 69.7% decline compared to 2019. Travel restrictions resulted in foreign tourists only comprising 39% of the total and having almost 80% fewer overnight stays than in 2019 ([70]). The ERP fails to provide a specific countrywide diagnostic of this sector.

Measure 8 "Improving the legal framework governing tourism and reducing the impact of theCOVID-19 pandemic on tourism" is a continuation of the 2020 ERP introduced support for an improved legal framework in the Federation entity. Now there is a focus on the mitigating effects of the COVID-19 pandemics on the tourism sector. While individual actions to adopt legislation and strategic documents in both entities are appropriate for a rolling out of the reform process in this sector, the measure has not been re-designed to provide for properly sequenced and countrywide consistent priorities. Under these circumstances, the measure's effectiveness would be limited to providing short-term relief for tourism operators and would not have an impact on a long-term recovery. Bearing in mind the need to mitigate the effects of the COVID-19 pandemic, the development of (mutually consistent with the countries in the region) tourism emergency plans and crisis management strategies should start already in 2021. The measure would in general have benefitted had it taken more into account additional tourism related priorities mentioned in the Common Regional Market Action Plan (item 8.8) and addressed also the lack of a qualified workforce.

Education and skills

Education continues to be of low quality, and the country suffers from a continuing skills mismatch. While part of the problem is poor links between education and the economy, the PISA 2018 finding demonstrate there are clear quality challenges in education in core areas like literacy and numeracy, possibly emanating in primary education and followed through to secondary education, where pupils following vocational education continue to be disenfranchised. The risk is that if systemic quality improvements are not established across all BiH education systems, the economy will be continue to be disadvantaged while employment potential will be undermined. More coordination is needed among the relevant decision makers in the field of education, such as the Conference of Ministries of Education and the Rector's conference. The establishment of the Intersectorial Commission for Qualifications Framework or the correct coordination between Accreditation Agencies at both entity and federal levels is crucial to finalise the accreditation of higher education institutions and study programmes in the country, as well as the development of an action plan to implement the outcome-based common core curriculum prepared by the BiH Agency for Pre-school, Primary and Secondary Education.

Measure 16 "Improving the link between education and the labour market" aims to improving the harmonisation of education with the requirements of the labour market in order to provide economy with educated and professional people and increase the number of employed persons. Improving the education system at all levels is key given the low level of achievement in the PISA survey. The ERP rightfully highlights concerns over enrolment policy which will need to be addressed across all education systems.

Employment and the labour market

This sector is analysed above in Section 4 under key challenge #1.

([70]) Source: European Delegation in Bosnia and Herzegovina

Social protection and inclusion

Bosnia and Herzegovina's fragmented healthcare systems lacked a coordinated and anticipatory approach to COVID-19. However, both entities adopted almost identical epidemiological measures to tackle the pandemic. The systems were unprepared for the number of infected people in autumn surge. The Federation of Bosnia and Herzegovina has a decentralised system of child and family benefits in which implementation of the rights stipulated by the Federation entity general law on social protection is devolved to its cantons. As a result, each canton, depending on its financial possibilities and political priorities, determines which benefit to finance, and at what level. This has strengthened exclusionary policy practices and led to discrimination against children and women (Dobrotić and Obradović, 2020). The government of the *Republika Srpska* entity Government passed the Decree-Law on Changes to the Health Insurance Law, stipulating that financing of COVID-19 treatments will be financed from the entity budget for people without health insurance. In the Federation entity, the Law on alleviation of the negative economic consequences caused by COVID-19 stipulates that during the state of disaster caused by the COVID-19 and for 1 month after, all those residing in the Federation entity are granted universal health insurance coverage – which, in fact, lasted only until the end of June. For the remaining period, this issue was dealt with by the cantons. The country's healthcare system was struggling even before COVID-19, with considerable inequalities in the provision of healthcare between cantons and entities, in terms of coverage of population groups, availability of essential medicines and commodities, out-of-pocket patient spending and health institution debt arrears (World Bank 2020).

Reform measure 18 "Improving the social protection system" aims to develop an efficient, sustainable and fair system of social protection of families with children and to ensure regular payment of social benefits. The activities are mainly focused on adapting the legislative framework. It is therefore unlikely that the effects will be visible in the short or medium term.

6.7. THE 2021 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, 12 July 2021

[…]

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

1. Provide well-targeted and temporary pandemic-related fiscal support to the health sector as well as to vulnerable households and troubled but viable firms; provided the economic recovery is well entrenched, return to a debt-stabilising fiscal policy as of 2022 and foresee a gradually improving primary balance in the budget 2022 and in the medium-term fiscal plans. Increase the share of government capital spending in GDP, by measures to improve public investment management and through an accelerated implementation of those investment projects, that have been subject to a clear positive cost-benefit assessment. In order to improve the efficiency of tax collection, ensure an effective exchange of taxpayer information between the country's tax authorities, and in particular create in line with the EU acquis a central (i.e. country-wide) registry of bank accounts of private individuals.
2. Prepare a report on contingent liabilities, with a particular emphasis on those related to the COVID crisis response, and prepare a strategy on how to manage risks related to contingent liabilities. Strengthen the analytical capacities of governmental institutions, in particular the BiH Ministry of Finance and Treasury with a view to improving the preparation and quality of the ERP in line with EU requirements. Invest more significantly in building up the country's statistical capacity for macroeconomic statistics, particularly the harmonised index of consumer prices, regional accounts, labour force survey and government finance statistics, and pursue efforts to improve the coverage and timeliness of all statistics.
3. Maintain a strong financial sector regulatory framework in line with international and EU best practices, ensure sound credit risk management, a transparent display of asset quality, adequate provisioning and close coordination of supervisory activities. Further reduce institutional and legal obstacles to swift and effective NPL resolution, and strengthen the bank resolution framework. Safeguard the integrity of the currency board arrangement and the independence of the central bank.
4. With a view to improve the business environment and strengthen the single economic space, business registration as well as licensing and permitting procedures will be simplified and harmonised across the country. To foster digitalisation of public services and to complement the development of e-Government infrastructure, adopt the law on electronic identity and trust services for electronic transactions with a single supervisory body in line with the EU acquis and ensure that Indirect Tax Authority begins issuing of electronic signatures. Once the 2015 Customs Policy Law will have entered into force, implement the new computerised transit system (NCTS) at national level, as well as the authorised economic operator (AEO) concept.
5. Adopt a comprehensive, country-wide Public Finance Management Strategy with performance-based monitoring and reporting. Create/update in both entities publicly available registers of public enterprises with complete, searchable list of all public enterprises including comprehensive financial statements, audits and organisational information. Establish public enterprises central oversight units in both entities and allocate adequate human resources.

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

*The representatives of Bosnia and Herzegovina were not able to take a position on two recommendations: i) to “create in line with the EU acquis a central (i.e. country-wide) registry of bank accounts of private individuals” and ii) “to adopt the law on electronic identity and trust services for electronic transactions with a single supervisory body in line with the EU acquis.

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

Area/Sector	2016	2017	2018	2019	EU-27 Average (2019 or most recent year)
Energy					
Energy imports dependency (%)	31.5%	34.0%	24.3%	N/A	60.62%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	448.81	434.20	463.40	N/A	112.92
Share of renewable energy sources (RES) in final energy consumption (%)	25.36%	23.24%	35.97%	37.58%	19.73%
Transport					
Railway Network Density (meters of line per km^2 of land area)	19.9 w	19.9 w	19.9 w	19.9 w	49.0 (2018)
Motorisation rate (Passenger cars per 1000 inhabitants)	225.2 w	251.6 w	262.4 w	268.8 w	519 (2018)
Agriculture					
Share of gross value added (Agriculture, Forestry and Fishing)	7.5%	6.6%	6.9%	6.6%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	N/A	16.2% w	15.7% w	N/A	4.3%
Utilised agricultural area (% of total land area)	34.7% w	34.4% w	34.7% w	35.3% w	40.0% (2017, EU-28)
Industry					
Share of gross value added (except construction)	22.6%	23.3%	23.9%	23.1%	19.7%
Contribution to employment (% of total employment)	22.0% w	22.7% w	23.5% w	N/A	18.1%
Services					
Share of gross value added	65.2%	65.3%	64.4%	65.3%	73.0%
Contribution to employment (% of total employment)	50.8% w	51.6% w	52.1% w	N/A	70.8%

Digital Economy					
Percentage of broadband penetration of households who have internet access at home	61.5% [w]	66.0% [w]	69.0%	72.0%	86% (2018)
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	N/A	64.9% [w]	70.1% [w]	69.9% [w]	85% (2018)
Trade					
Export of goods and services (as % of GDP)	36.3%	40.9%	42.5%	40.5%	49.4%
Import of goods and services (as % of GDP)	53.0%	57.1%	57.3%	55.2%	45.7%
Trade balance (as % of GDP)	-22.5%	-22.7%	-22.0%	-22.7%	N/A
Business Environment					
Rank in WB Doing Business (Source: World Bank)	79	81	86	90	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	111	103	91	92	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	Up to 34.4%	N/A	N/A	N/A	N/A
Research, Development and Innovation					
R&D intensity of GDP (R&D expenditure as % of GDP)	0.24%	0.20%	N/A	N/A	2,2%
R&D expenditure – EUR per inhabitant	N/A	N/A	N/A	N/A	EUR 688.6
Education and Skills					
Early leavers from education and training (% of population aged 18-24)	4.9% [w]	5.1% [w]	5.4% [w]	3.8% [w]	10.2%
Youth NEET (% of population aged 15-24)	26.4% [w]	24.3% [w]	21.6% [w]	21.0% [w]	10.1%
Formal child care - children aged less than 3 years (% of total)	N/A	N/A	N/A	N/A	35.3%
Individuals' level of digital skills (% of individuals aged 16-74 who have basic or above basic overall digital skills by sex)	N/A	N/A	N/A	24%	56%

Employment					
Employment Rate (% of population aged 20-64)	44.2% [w]	46.6% [w]	47.7% [w]	49.7% [w]	73.1%
Unemployment rate (% of labour force aged 15-74)	25.5% [w]	20.7% [w]	18.5% [w]	15.9% [w]	6.7%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	24.4 pps. [w]	23.0 pps. [w]	23.7 pps. [w]	23.6 pps. [w]	11.7 pps.
Social Protection System					
% of population at risk of poverty or social exclusion	N/A	N/A	N/A	N/A	20.9%
Impact of social transfers (Other than pensions) on poverty reduction	N/A	N/A	N/A	N/A	32.38%
Self-reported unmet need for medical care (of people over 16)	N/A	N/A	N/A	N/A	1.7%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	N/A	N/A	N/A	N/A	4.99

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

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

ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM THE ERP 2020-2022

Reporting on the implementation of the structural reform measures of the 2020-2022 ERP did not follow the guidance note: this reporting is inadequate, inconsistent and incomplete, as for instance, there is no information about the *Republika Srpska* entity. In the absence of contribution from state level ministries, it also focuses mostly on non-countrywide measures and only partially reflects the current state of play. When available for one entity, the reporting on the stage of implementation appears often incorrect. There is no reporting at state level. Overall, progress in implementing structural reforms has not advanced much.

ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Council of Ministers adopted the ERP 2021-2023 on 3 February and submitted it to the Commission on 5 February. Preparation and coordination of the ERP was impeded by the consequences of the COVID-19 pandemic. The quality of the programme points to continued significant weaknesses in administrative coordination and policy formulation. The document still falls short of being comprehensive and internally consistent and lacks an overall strategic vision. The readability of the document remains to be further improved. Insufficient time has been left to finalise the ERP as some contributions were submitted very late. Bosnia and Herzegovina needs to strengthen its coordination capacity on economic policy and to ensure consistent political support, high visibility and coherence of the ERP.

Inter-ministerial coordination

The preparation of the ERP was centrally coordinated by the Directorate for Economic Planning (DEP). No single countrywide programme was presented and measures consist often of various pieces of legislation to be adopted at entity level.

Stakeholder consultation

As last contributions from entities to the DEP were only received a few days prior to the adoption of the ERP, no public consultations were held.

Macroeconomic framework

Recent macroeconomic performance is adequately described. The macroeconomic framework is sufficiently comprehensive. Consistency with other parts of the programme, particularly with the fiscal framework, is still limited. The reasoning behind the chosen policy approach and the links to the overarching policy strategy are not sufficiently elaborated.

Fiscal framework

The programme continues to lack a consistent, complete and sufficiently detailed presentation of the country's fiscal policy both for 2020 and also of budgetary plans for 2021. The presentation of fiscal impact of COVID-19 is incomplete. This strongly impedes the analysis of countrywide fiscal developments. Public investment projections in the fiscal part are not consistent with the macroeconomic framework. The requested links to structural reforms are still largely missing. The rationale and underlying measures of the chosen policy approach are not sufficiently elaborated upon. The programme provides hardly any quantitative analysis of budgetary measures. The compilation and presentation of fiscal data is not yet in line with ESA 2010.

Structural reforms

Sections 5, 6 and 7 do not follow the programme requirements, which reflects the absence of proper coordination on country-wide challenges and reform priorities. In many cases, policy goals are vaguely formulated and are not supported by implementable measures and activities. Key result indicators are not always present and potential risks frequently indicate frequently political obstacles. Reporting on the implementation of the policy guidance is insufficient. In spite of technical assistance ([71]) on fiscal implication of reform measures, tables 10a, 10b and 11 do not follow the guidance note, as they are inadequate, inconsistent and incomplete, providing information about one entity only. Significantly more efforts are required to improve the ERP process, which means more senior policy makers also need to participate in its formulation. The identification of key obstacles continues to often lack clarity and consistency with the reform measures and activities.

([71]) Provided by the Centre of Excellence in Finance in Ljubljana.

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7. KOSOVO

7.1. EXECUTIVE SUMMARY

Amid high levels of uncertainty, the Economic Reform Programme (ERP) expects an economic recovery from the COVID-19 induced recession in 2020. The ERP forecasts real GDP growth to rebound to 5.2% in 2021 and continue in line with the historical trend in subsequent years. The key growth drivers are expected to be the recovery of services export and a large surge in public investment, following sharp contractions in 2020. The key downside risks to this outlook stem from continued pandemic-related restrictions and persistent under-execution of public capital spending.

At 7.9% of GDP, the headline budget deficit is set to remain as high in 2021 as in 2020 due to economic recovery measures and a surge in public investment. As per the fiscal rule definition, which excludes some capital spending, the deficit is set at 4.7% of GDP in 2021, while a gradual return to the deficit ceiling of 2% of GDP is projected for 2023. Large financing needs are expected to be met by using government deposits and issuing new debt. Ensuring budget financing for 2021 while preserving adequate fiscal buffers will be a key challenge. Public debt increased rapidly from 17.5% of GDP in 2019 to 23.1% in 2020 and is set to reach 34.8% by 2023. Immediate fiscal risks, some of them thoroughly assessed in the programme, stem from slower-than-expected economic recovery and political uncertainty, a likely under-execution of capital spending and an underestimation of current spending, mainly on social benefits.

The main challenges facing Kosovo include the following:

- **Supporting the recovery with appropriate measures remains key in 2021, while there is a need to plan gradual fiscal consolidation and compliance with the deficit rule in the medium term.** The envisaged return to the 2% deficit ceiling by 2023 would benefit from structural reforms on the budget revenue and expenditure sides, which should improve the quality of public finance. Kosovo’s revenue base is narrow and has been weakened by tax exemptions and preferential tax rates. Advancing tax debt collection once the recovery is entrenched could also contribute to revenue mobilisation. Current spending would benefit from the review and streamlining of social security payments, including war veteran pensions, and a coherent public sector remuneration system. The costing of fiscal initiatives before adoption is indispensable in this regard. To preserve the sustainability of public finance in the medium-term, there is a need to respect the 40% cap on public debt, and to diversify the investor base which is currently skewed towards debt purchases by the pension fund and the central bank.

- **Given multiple development challenges, which have been accentuated by the crisis, Kosovo needs a more coherent and better executed multiannual investment strategy.** While limited progress has been made in the implementation of capital projects, further efforts are needed to improve the planning, selection and control of capital projects with a view to enhancing medium-term growth potential. Fiscal risks related to publicly owned enterprises (POEs) and related investment decisions should be properly assessed, incorporated into budgetary planning and contribute to the overall investment strategy.

- **Persistent, widespread informality continues to represent a key structural challenge for Kosovo's economy.** It limits the fiscal space for public spending in priority areas, it deters the development of the private sector and it prevents a significant section of the workforce from accessing adequate levels of social protection and training. Kosovo has a strategy and a corresponding action plan that are designed to address the key underlying causes of informality. However, there are delays in implementing them and reporting on this. Strong political support, effective implementation and close monitoring are required to achieve the desired outcomes, while measures to address the underlying causes of informality related to the business environment should complement the strategy.

- **The inadequate and unreliable supply of electricity is one of the main constraints on Kosovo's competiveness and acts as a break on productivity.** The lack of energy security gives rise to significant costs for business and represents the biggest obstacle to attracting high-quality foreign direct investment (FDI). Kosovo is investing in renewables, but the current system of feed-in tariffs needs to be reviewed. Despite positive developments, Kosovo needs to step-up efforts to make use of the potential for energy efficiency. To develop a sustainable energy supply, Kosovo needs to find attractive alternatives to polluting sources of energy. Progress in achieving of regional integration could support the financial stability of the Kosovo transmission system operator (KOSTT).

- **The education system in Kosovo does not provide students with the necessary skills and knowledge currently required by the labour market**. The results of the 2018 PISA survey reveal a very poor performance by the education system. Effective quality assurance is one of the weakest points of pre-university education in Kosovo. A series of reforms were launched to improve the capacity of the employment service, which is currently insufficiently developed to ensure matching between workers and vacant jobs and the implementation of relevant active labour market policies, including upskilling and on-the-job training.

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2020 has been implemented to a limited extent. The government has suspended the fiscal rule and turned to the EU and the IMF for financial assistance, allowing to undertake a timely response to the crisis. The emergency measures were well-targeted but this was less the case for the economic recovery package. There has been no progress on reclassifying the war veteran pension beneficiaries, while the law on salaries for public employees was repealed by the Constitutional Court. Tax revenue fell due to the crisis, while there was little progress in reducing informality. There has been partial progress with improving financial oversight of POEs and the options paper on establishing a fiscal oversight body. Limited progress was made on improving project investment management. Financial support to the private sector via the economic recovery package was largely insufficient. Efforts to reduce the administrative burden on citizens, businesses and the public administration were limited. The government adopted a number of health strategies but their implementation was limited. There are no unemployment benefits to date and assistance for the groups most affected by the COVID-19 crisis was limited. The capacity of the public employment service has not been increased to address the increased number of registered unemployed.

The ERP sets out reform plans that are broadly in line with the key challenges and priorities identified by the Commission. It reflects the government's intention to support economic recovery in 2021 and strengthen the sustainability of public finance in the medium term. It also refers to the need to review tax policies and tackle informality. However, weaknesses in fiscal governance could delay achievement of these goals. It includes measures to improve the business environment and reduce the informal economy. The ERP also partially addresses energy access challenges and the capacity of the education system to respond to labour market needs. Although the proposed measures in the ERP are aligned with the main structural challenges, their implementation is lagging and the expected improvements have not been achieved as planned.

7.2. ECONOMIC OUTLOOK AND RISKS

Sluggish growth in early 2020 evolved into a full-fledged recession following the outbreak of COVID-19. In the first quarter, real GDP increased by a modest 1.3% y-o-y due to the political stalemate and related delays in capital investment. The pandemic-related restrictions led GDP to contract by 9.3% and 7.3% y-o-y in the following two quarters, mainly on the back of falling exports of services and decreasing investment. Government spending and declining imports provided a positive contribution to GDP growth. The increase in private consumption, especially in the third quarter, seems counter-intuitive and might point to data quality issues ([72]).

Table II.7.1:
Kosovo - Macroeconomic developments

	2019	2020	2021	2022	2023
Real GDP (% change)	4.9	-6.7	5.2	4.1	4.2
Contributions:					
- Final domestic demand	3.5	-5.6	5.3	5.6	4.7
- Change in inventories	0.0	-0.3	0.2	0.1	0.1
- External balance of goods and services	1.4	-0.9	-0.3	-1.6	-0.6
Employment (% change)	5.2	-6.5	:	:	:
Unemployment rate (%)	25.6	25.5	:	:	:
GDP deflator (% change)	0.6	0.5	1.8	1.1	1.3
CPI inflation (%)	2.7	0.2	1.8	1.0	1.0
Current account balance (% of GDP)	-5.6	-4.5	-6.3	-6.1	-4.7
General government balance (% of GDP)	-2.9	-7.8	-7.9	-5.0	-4.2
Government gross debt (% of GDP)	17.5	23.1	28.6	32.1	34.8

Sources: Economic Reform Programme (ERP) 2021.

The ERP's baseline scenario assumes that the economy will recover in 2021, but stresses a high degree of uncertainty. On the back of rebounding services exports and investment, real GDP is forecast to increase by 5.2% in 2021 and recover its 2019 level. The projected rebound is above the forecasts of the World Bank and IMF, which are set at 4% and 4.5%, respectively. In both 2022 and 2023, economic growth is projected to continue in line with the historical trend of 4.1%, but the negative output gap is not expected to close over the ERP's horizon. The projected rebound of services exports in 2021 (+22%) relies on the assumption of an improving health situation and relaxing international travel restrictions. In 2022-2023, the growth of services exports should follow the historical tend. Exports of goods are set to increase gradually in line with improving external conditions and assumed gains in competitiveness. Imports of goods are projected to increase on the back of the assumed growth in investment and consumption, while imports of services are set to recover from a low base in 2021 and follow the historical trend thereafter. The rebound in investment (16%) in 2021 is expected to be mainly driven by a large surge in public capital spending. Private investment is set to be supported by favourable credit and improving business conditions, but it is not expected to reach its pre-pandemic level until 2023. Private consumption is set to grow only modestly in 2021, due to uncertainty surrounding the economic recovery and lower inflow of remittances resulting from the lagged impact of the economic slowdown in Germany and Switzerland, and accelerate to some 3% in 2022-2023. A similar profile is assumed for public

([72]) This might be linked to the discrepancy between quarterly 2020 and annual 2019 GDP data as published by the Kosovo Agency of Statistics.

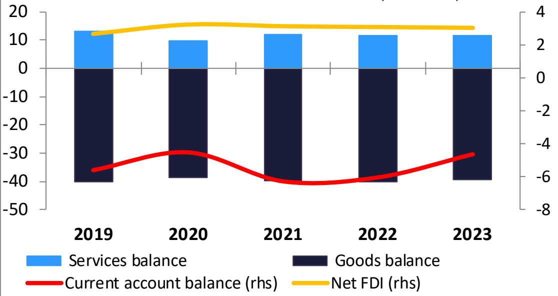
consumption, which seems at odds with the already elevated level of government spending in 2020-2021. The ERP rightly acknowledges that the macroeconomic and fiscal outlook continues to be affected by high levels of uncertainty due to the COVID-19 pandemic.

Downside risks to growth predominate. In addition to uncertainty related to the evolution of COVID-19, including stricter pandemic containment measures and a slower rollout of vaccines, the programme's assessment on downside risks refers to a possibly less benign external environment and lower remittances, and potential delays in implementing recovery stimulus and capital projects. Aggregating all downside risks, the ERP's 'low growth' scenario results in 2.7% average annual growth in 2021-2023. Weak administrative capacities are very likely to intensify the risk of delays in executing capital projects. Therefore the 'low growth' scenario's assumed execution rates, which are closer to historical rates, seem more plausible in the short term. The ERP's upside risks relate to improved execution of investment projects and the positive effects of implementing planned structural reforms such as fighting the informal economy, cutting energy losses, reducing capital risk premia and increasing employment. This 'high growth' scenario is assumed to result in 5.3% average growth over the period.

Inflation is expected to accelerate in 2021 due to higher energy prices and recovering GDP growth. Reflecting contracting economic activity, average inflation dropped to 0.2% in 2020 from 2.7% in the previous year. Other drivers of declining prices were lower energy prices and the elimination of import tariffs from Serbia and Bosnia and Herzegovina in April 2020, while a positive contribution came from food prices. Due to the projected recovery, inflation is set to rise in 2021, but remain subdued in the following years in line with the projections for the euro area.

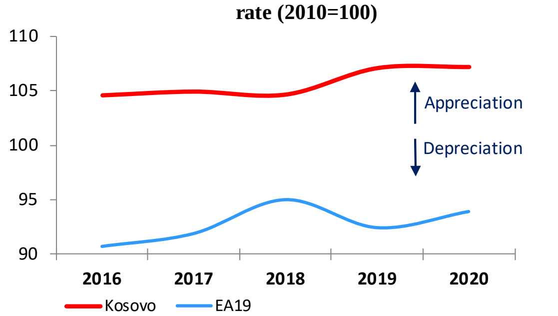
External competitiveness and current account

Graph II.7.1a: **Kosovo - Evolution of the current account balance (% GDP)**



Source: Economic Reform Programme (ERP) 2021.

Graph II.7.1b: **Kosovo - Real effective exchange rate (2010=100)**



Source: Economic Reform Programme (ERP) 2021 and ECB.

The current account deficit narrowed in 2020 due to the compression of imports and strong inflow of remittances. Exports of services (mainly diaspora tourism from Western Europe) were the most affected by travel restrictions and dropped by 25.7% in 2020 compared to a year earlier. Exports of goods, which are much smaller and rely on a narrow sectoral base, increased by 12.6%, mainly driven by the solid performance of base metals. The sizeable contraction of imports (by 9.4%) led to a small improvement in the merchandise deficit, which narrowed to 38.8% of GDP from 40.2% in 2019, while the surplus of services trade is estimated to have declined to 9.8% of GDP from 13.1% over the same period. The overall trade deficit increased to 29% of GDP from 27% in 2019, and is projected to improve slightly to 28% during 2021-2023. The key factor partly offsetting the trade deficit is remittances, which, despite the crisis, increased by 13.1% in 2020 and amounted to 14% of GDP. Because of travel restrictions in 2020, the amount of remittances sent via official channels was higher than usual. Remittances are projected to decline by 6.1% in 2021, due to the lagged impact of the economic slowdown in Germany and Switzerland, and recover in the following years. Overall, the current account deficit is projected to deteriorate from 4.5% of GDP in 2020 to over 6% in 2021-2022 as the economy picks up pace, and moderate to 4.7% in 2023, due to decelerating growth of investment and imports in that year.

Despite the crisis, net foreign direct investment (FDI) held up well in 2020 and covered nearly two thirds of the current account deficit. Net FDI is estimated to have increased by 13.6% in 2020, on the back of lower profit-related outflows in the financial sector and a drop in outward FDI. FDI inflows into real estate have declined, as travel restrictions reduced the number of diaspora members arriving and investing in Kosovo. Gross FDI inflows decreased by some 10% in 2020. The bulk of FDI is concentrated in non-tradeable activities, with real estate and financial services accounting for 54.8% and 27.3% of the total FDI stock, respectively, contributing little to enhancing export capacity and mitigating balance-of-payment vulnerabilities. Kosovo's net international investment position has deteriorated to -10.7% of GDP from -5.8% in 2019, mainly driven by an increase in public debt and a decrease of external assets held by the Central Bank and the Kosovo Pension Fund. More than 70.7% of gross liabilities consists of FDI, which is considered to be beneficial for macroeconomic stability, while the remaining 29.3% consists of government debt and other sector liabilities. The reserve assets covered 3.1 months of imports in the third quarter of 2020, up from 2.8 in 2019.

Table II.7.2:
Kosovo - Financial sector indicators

	2016	2017	2018	2019	2020
Total assets of the banking system (EUR million)	3 637	3 870	4 186	4 761	5 353
Foreign ownership of banking system (%)	88.9	88.1	86.8	86.7	86.5
Credit growth	10.4	11.5	10.9	10.0	7.1
Deposit growth	7.2	6.8	8.7	16.2	11.5
Loan-to-deposit ratio	77.0	80.3	81.9	77.6	74.5
Financial soundness indicators (end of period)					
- non-performing loans	4.9	3.1	2.7	2.0	2.7
- net capital to risk-weighted assets	17.8	18.1	17.0	15.9	16.5
- liquid assets to total assets	41.5	37.9	38.5	38.7	39.8
- return on equity	19.7	21.3	20.4	18.9	14.0
- forex loans to total loans (%)	0.2	0.2	0.1	0.1	0.1

Sources: National Central Bank, Macrobond.

Despite contracting economic activity, the mainly foreign-owned banking sector has remained stable in 2020. In response to the crisis the Central Bank of Kosovo (CBK) allowed for a 3-month loan repayment moratorium, which applied to 50% of bank loans, as well as loan extensions and restructuring. These measures helped banks to avoid increasing provisions and supported credit growth, which has decelerated modestly to 7.1% in 2020 from 10% in the previous year. The growth of deposits declined to 11.5% from 16.2% over the same period. Higher growth of deposits towards the end of 2020 was partially supported by the stimulus measure that allowed the withdrawal of 10% of pension savings from the Kosovo Pension Saving Trust (KPST). Financial soundness indicators have remained satisfactory, e.g. the loan-to-deposit ratio and non-performing loans (NPLs) stood in December at 74.5% and 2.7%, respectively. While bank profitability has declined with the average return-on-equity ratio contracting to 14% in 2020 from 18.9% in 2019, the risks in the banking sector seem contained. However, the ERP and official statistics do not report the impact of CBK measures on the NPLs. The ERP does not provide quantified forecasts for the financial sector, but the underlying assumption is of an increase in NPLs during 2021, while the largely foreign-owned banking sector is not expected to face liquidity problems.

7.3. PUBLIC FINANCE

The 2020 budgetary outcome significantly deteriorated due to shrinking revenues and higher pandemic-related spending. The ERP estimates the 2020 headline budget deficit to be 7.8% of GDP, which corresponds to a deficit of 6% of GDP under the fiscal rule definition ([73]). The fiscal rule was suspended due to the crisis, allowing for the deficit to exceed the prescribed ceiling of 2% and the government cash balance to decrease to 3.2% of GDP from 5.1% in 2019. In response to the crisis the caretaker government adopted the emergency package (EUR 180 million) in March, supporting affected businesses, formal and informal employment, the health sector, social protection of the most vulnerable households, and providing financial liquidity. As the situation continued to deteriorate, Kosovo adopted a budget revision in end-July, including an additional provision of EUR 185 million for the economic recovery programme, bringing the budgeted 2020 crisis-related stimulus to a grand total of EUR 365 million or about 5.2% of 2020 GDP. A large part of this additional support (4.3% of GDP) was spent in 2020. The economic recovery programme targeted broadly the same categories as the emergency package, with additional allocations for medical and security workers, vulnerable households, support for firms and capital spending. Further measures to support the economy included tax deferrals for firms, most of which had to be paid by end-2020, and the postponed payment of the concessionary fee for Pristina airport (-0.15% GDP). In 2020, government revenue is estimated to have contracted by 9.6% compared to the 2019 outcome. Tax and non-tax budget revenue also fell short of projections of the revised 2020 budget, with the collection rates from direct and indirect taxation standing at 94% and 96%, respectively. Non-tax revenue was supported by an additional EU grant through the resilience contract (+0.3% of GDP). Public spending increased by 6.7% or 4 pps. of GDP compared to the previous year, mainly due to the implementation of the economic recovery programme. The implementation of the revised 2020 budget was uneven among different categories, with wages and particularly subsidies and transfers significantly overshooting the revised budget allocation. Due to the political stalemate in the first half of 2020 and the low implementation rate of projects financed by international financial institutions (IFIs), capital spending contracted by 28% as compared to 2019, with only half of the planned investment expenditure actually realised while capital spending from the investment clause (i.e. financed by donors) reached only 29% of the 2020 revised budget allocation.

The declared ERP objective in 2021-2023 is to support economic recovery and strengthen Kosovo's fiscal position while improving tax policies and administration. As in the previous years, the fiscal strategy is frontloaded, assuming major increases on the revenue and expenditure sides in 2021, due to the base effect of 2020, the impact of the economic recovery programme and recovering GDP growth in 2021. The ERP provides for several tax initiatives, including taxpayer service automation, less contact between taxpayers and tax officials and the simplification of declaration procedures, in order to reduce informality. In nominal terms, direct and indirect tax revenue in 2021 is projected to increase by 12.3% compared to 2020, exceeding its 2019 level, and by 5.3% in 2022 and 4.7% in 2023. As a share of GDP, tax revenue is set at around 24% for the whole period. Despite the high base in 2020, total expenditure is set to increase further by 0.9 pps. to 34.4% of GDP in 2021 and decrease gradually to 31.7% in 2022 and 30.7% in 2023. Supported by public investment and the economic recovery package (3.1% of GDP), primary expenditure in 2021 is projected to reach 33.9% of GDP in 2021 and moderate gradually to 29.9% in 2023. The ERP assumes an extraordinary increase in capital spending in 2021 (65%), with spending from the investment clause more than doubling from the year before. In the subsequent 2 years, the nominal growth of capital spending is set to moderate to 8.7% and 5.6%, respectively. Under the fiscal rule definition, the budget deficit is expected to reach 4.7% of GDP in 2021 and adjust towards the

([73]) The fiscal rule places a cap on the fiscal deficit of 2% of forecast GDP, excluding capital projects financed by privatisation proceeds and donors ('investment clause'). This exemption for donor-financed investments can be invoked until 2025, provided the public debt ratio remains below 30% of GDP. As a part of the fiscal rule, the wage bill rule provides that the increase in the public wage bill cannot exceed nominal GDP growth. The government deposits used as fiscal buffers are legally required to stay at 4.5% of GDP as long as the government is using privatisation proceeds. The debt rule provides that public and publicly guaranteed debt cannot exceed 40% of GDP.

2% ceiling in 2022-2023. The headline deficit is projected to widen to 7.9% of GDP in 2021 and decrease to 5% and 4.2% in the subsequent 2 years.

Table II.7.3:
Kosovo - Composition of the budgetary adjustment (% of GDP)

	2019	2020	2021	2022	2023	Change: 2020-23
Revenues	26.5	25.7	26.5	26.7	26.5	0.7
- Taxes and social security contributions	24.0	23.0	24.2	24.2	24.0	0.9
- Other (residual)	2.5	2.7	2.3	2.5	2.5	-0.2
Expenditure	29.5	33.5	34.4	31.7	30.7	-2.8
- Primary expenditure	29.1	33.1	33.9	31.0	29.9	-3.2
of which:						
Gross fixed capital formation	7.5	5.7	8.8	9.1	9.1	3.4
Consumption	12.8	14.4	14.1	13.2	12.5	-1.8
Transfers & subsidies	8.8	13.1	10.6	8.7	8.3	-4.8
Other (residual)	:	0.0	0.5	0.1	0.1	0.1
- Interest payments	0.3	0.4	0.5	0.7	0.8	0.4
Budget balance	-2.9	-7.8	-7.9	-5.0	-4.2	3.6
- Cyclically adjusted	-2.9	-5.4	-6.5	-3.9	-3.3	2.1
Primary balance	-2.6	-7.4	-7.4	-4.3	-3.5	3.9
- Cyclically adjusted	-2.6	-5.0	-6.0	-3.2	-2.6	2.4
Gross debt level	17.5	23.1	28.6	32.1	34.8	11.7

Sources: Economic Reform Programme (ERP) 2021.

The 2021 budget was approved in late 2020, but it is likely to be revised during the year. The 2021 draft budget was prepared in October before the adoption of the Law on Economic Recovery (in December), which envisages an additional stimulus package of EUR 200 million and some tax exemptions. Fiscal implications of the Law on Economic Recovery are not fully covered by the adopted 2021 budget (end-December), thus it is likely that the new government will need to revise the budget. The 2021 budget projects public revenue at 26.5% of GDP which is the same as in 2019. Compared to the outturn of 2020, tax revenue is set to rise by 12.3% in 2021 with a similar increase of indirect tax revenue (11.9%) and a stronger growth of direct tax income (14%). As a share of total revenues, the contribution of direct taxes is projected to increase slightly to 16.1% from 15.5% in 2019. The share of indirect taxes remains roughly at the pre-crisis level while non-tax revenue will decline due to temporary exemption of paying mining royalty. Due to the implementation of the economic recovery programme and an extraordinary hike in capital spending, budgetary expenditure is projected increase to 34.4% of GDP, which is way above the 29.5% recorded in 2019, and even exceeds the level reached in 2020. The shares of main spending aggregates are roughly the same as in 2019. The key items of the economic recovery programme are transfers to households and firms and allocations for goods and services in health sector, including for COVID-19 vaccination. While still at low level, debt interest payments are set increase to 0.5% of GDP from 0.3% in 2019. Due to large financing needs resulting from a high headline deficit at 7.9% of GDP in 2021, government cash deposits are set to drop further to 2% of GDP.

While economic recovery support measures are set to continue in 2021, their targeting is not clearly defined. As in 2020, the 2021 economic recovery programme (EUR 222.4 million or 3.1% of GDP) is a temporary measure, expected to support health spending and address the social and economic consequences of the crisis. Transfers to households and firms (1.6% of GDP) account for more than half of the programme, followed by the allocation for goods and services in health sector (0.7% of GDP), including the procurement of COVID-19 vaccines. Further items are additional allowance for public wages (0.2% of GDP) and capital spending in health and education through the investment clause (0.6% of GDP). While the overall goal is to support demand and investment, the ERP doesn't provide enough information to assess whether the measures are well-targeted. In 2020 some transfers to private firms (EUR 60 million or 1% of GDP) were done universally without analysing whether beneficiaries were hit by the pandemic. Delayed approval of the Law on Economic Recovery was hindering the implementation of recovery package in the second half of 2020 and, once adopted, it added a new ad hoc spending item to support operational expenses of private firms (EUR 200 million) without any transparent allocation criteria. Some tax exemptions, e.g. carbonated drinks from the excise duty in 2020, do not seem to be well-targeted. An exemption from paying mining royalties in 2021 is helping a sector which has been performing well despite the crisis. The ERP doesn't discuss the measures related to the implementation of the Law on Economic Recovery which are coming on top of the economic recovery programme. Since these measures are not fully included in the 2021 budget and ERP 2021 budgetary projections, it is unclear whether all of them will be implemented.

Public debt is increasing rapidly, while the ability to meet financing needs will partly rely on the depletion of fiscal buffers. In 2020 the debt-to-GDP ratio is estimated to have increased to 22.3% from 17.5% in 2019. Domestic debt, which is held by a narrow investor base, rose by 21% in 2020 with a large share of new issuances absorbed by the Kosovo Pension Saving Trust (KPST). The share of domestic debt held by the KPST increased to 47% from 38% in 2019, while a further 21% and 28% of domestic debt are with the CBK and commercial banks, respectively. Foreign debt increased by 34% in 2020 on the back of financing provided by international donors, including EU macro-financial assistance (the first tranche of EUR 50 million has been disbursed out of a total of EUR 100 million), World Bank loans (EUR 76 million) and the IMF Rapid Financing Instrument (EUR 52 million). Significant financing needs in 2021 imply a further increase in public debt, which is expected to rise to 28.7% of GDP in 2021 and to continue to drift upwards gradually, towards 35% by 2023. The ERP expects government deposits to decline to 2% of GDP in 2021 from 3.2% in 2020, since tapping into fiscal buffers will help to meet financing needs. Government deposits are projected to stay at this level until 2023, which implies a reduced capacity to face potential new shocks. The KPST still has room to buy new bond issuances in 2021, but its legal limit ([74]) might be exhausted by 2022. As Kosovo cannot access international debt markets due to the lack of an international credit rating, there is a need to diversify its investor base in order to ensure adequate financing while safeguarding government deposits. This should include insurance companies, non-financial private firms and possibly diaspora investors, which together currently hold about 4% of domestic debt. The dynamics of foreign debt will depend on the political situation in Kosovo and relations with IFIs.

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

Box II.7.1: **The fiscal implications of the Law on Economic Recovery**

* The 2021 budget was adopted on 30 December 2020 without fully taking into account the impact of the Law on Economic Recovery. Among others, the law includes an additional stimulus of EUR 200 million, aiming to support the businesses affected by the crisis, proposals to subsidise wages to employees that lost their jobs and the removal of VAT on all raw materials. It is still unclear how the law will be implemented. The 2021 ERP projections are based on the 2021 budget and allow for some minor measures resulting from the Law.

* Revenue: VAT exemption for raw materials, 5-month exemption for payments of mining royalties, reduction in VAT rate from 18% to 8% for hotels, restaurants and catering services.

* Expenditure: support for private enterprises in the amount of EUR 200 million, covering the tariffs for Kosovo Credit Guarantee Fund services to financial institutions, 5 months' of subsidies for renewable energy tariffs.

Main measures in the 2020 budget

Revenue measures*	Expenditure measures**
• VAT exemption for raw materials produced in Kosovo: not specified • Exemption for 5 months from payment of mining royalties: EUR 14.5 million (-0.2% of GDP in non-tax revenue, included in the ERP 2021 projections) • Reduction in VAT rate from 18% to 8% for hotels, restaurants and catering services: EUR 3.4 million (less than 0.1% GDP loss in tax revenue, included in the ERP 2021 projections)	• Support for private enterprises: EUR 200 million (2.8% of GDP): implementation not specified) • Subsidise wages of 2 months of the employees in private sector who have lost their jobs for more than three months, by EUR 300 per month (implementation not specified, not costed yet) • Covering the tariffs for Kosovo Credit Guarantee Fund services to financial institutions: EUR 4.5 million (less than 0.1% GDP increase in spending, not included in the ERP 2021 projections) • Five months' of subsidies for renewable energy tariffs: EUR 15.7 million (0.2% GDP expenditure, not included in the ERP 2021 projections)

* Estimated impact on general government revenues.

** Estimated impact on general government expenditure.

Source: MoF estimates

Box II.7.2: **Debt dynamics**

Sizeable budget deficits in 2020-2023 will result in rapidly increasing public debt. From 2021 some offsetting impact on the debt-to-GDP ratio is expected to come from economic growth and inflation. Interest expenditure is still low but steadily increasing, to 0.8% of GDP in 2023. Downward contributions to the debt ratio are expected to come from stock-flow adjustments in 2021-2022, which might be related to the use of government deposits to meet financing needs.

Kosovo

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

	2019	2020	2021	2022	2023
Gross debt ratio [1]	**17.5**	**23.1**	**28.7**	**32.1**	**34.8**
Change in the ratio	1.3	5.6	5.5	3.5	2.7
Contributions [2]:					
1. Primary balance	**2.6**	**7.4**	**7.4**	**4.3**	**3.5**
2. "Snowball" effect	**-0.5**	**1.6**	**-1.0**	**-0.8**	**-0.9**
Of which:					
Interest expenditure	0.3	0.4	0.5	0.7	0.8
Growth effect	-0.8	1.3	-1.1	-1.1	-1.3
Inflation effect	-0.1	-0.1	-0.4	-0.3	-0.4
3. Stock-flow adjustment	**-0.8**	**-3.4**	**-0.9**	**-0.1**	**0.2**

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

Source: Economic Reform Programme (ERP) 2021, ECFIN calculations.

The fiscal scenario is affected by high levels of uncertainty related to the macroeconomic and political situation in Kosovo. The ERP rightly acknowledges the risks related to continued COVID-19 related restrictions, which could weigh on economic recovery and the projected increase in budgetary revenue. Risks related to possible delays in capital spending, initiatives for new social transfers, poor performance by publicly owned enterprises and the accumulation of arrears are also duly acknowledged. According to the ERP, the government did not issue any new state guarantees in 2020. However, the Law on Economic Recovery allowed early, tax-free withdrawals of 10% of pension savings from the KPST (EUR 200 million or 3% of 2020 GDP) which the government promised to reimburse from 2023 onwards. This amount has not yet been included in any state guarantee or debt accounting, as the government did not issue an explicit state guarantee to underpin the promise. Further risk relates to a substantial share of uncommitted foreign debt ([75]) (EUR 160 million or 2.2% of GDP) which could weigh on the implementation of the recovery package and capital projects. As usual, budgetary planning for 2021 projects a conservative path for social transfers and an overly ambitious surge in capital spending. Compared to the outturn of 2020, regular social transfers and subsidies are projected to decline by 13.4% while capital spending is set to rise by 65%. The allocation for social transfers assumes that war veteran pensions will stay within the legal cap of 0.7% of GDP which, in the absence of a reclassification of beneficiaries, will not be feasible (the corresponding spending in 2020 reached 1.1% of GDP).

([75]) The IMF Article IV consultation (2021)

Box II.7.3: **Sensitivity analysis**

The ERP analyses the sensitivity of the debt-to-GDP ratio to three specific shocks. (1) A slowdown in GDP growth by 2 pps. would bring the debt-to-GDP ratio to 33.7% instead of 30.4% in the baseline scenario, if the deficit rule is adhered to in 2024-2034. (2) If, due to higher spending, the primary balance deteriorates by 2 pps. of GDP in 2024-2034 and the deficit rule is not adhered to, debt would increase to 40.3% of GDP by the end of 2034, i.e. 9.9 pps. higher than in the baseline scenario. (3) A 1 pp. increase in interest rates on loans, combined with compliance with the deficit rule, would have a negligible effect on public debt, as more than 60% of total debt has a fixed rate and higher interest spending should be compensated by lower primary deficits. The sensitivity analysis underscores the importance of compliance with the 2% deficit rule, which acts as a debt stabiliser. Moreover, anticipating that financing from privatisation funds will end over the medium term, it is important to keep current expenditure under control.

A narrow tax base, inappropriate targeting and transparency of social transfers and weaknesses in investment management continue to impair the quality of public finance. A substantial share of war-related and specific category-based social transfers, so called Pillar 0 pensions, which are non-contributory and financed from the budget, do not target poverty and result in duplicate budgetary payments. In contrast, allowing the withdrawal of 10% of pension savings from KPST (mandatory defined-contribution scheme or Pillar 2) under the stimulus measures undermines the credibility of the contributory system and reduces future pensions. The lack of a focused investment strategy and continuous delays in capital project implementation have led to poor quality transport, energy, education and health infrastructure, which was exacerbated by the crisis. The planning, execution and ex-post evaluation of the public investment programme could be improved by implementing the recommendations made by the IMF under its Public Investment Management Assessment. In mid-2020 the Constitutional Court repealed the Law on Salaries for Public Employees, which helped to contain the wage bill, but left Kosovo without a transparent and fair system for the remuneration of public employees. A revised law is needed for establishing a uniform wage grid and improving compensation fairness, but any new initiative should be based on fiscal impact assessments and respect the wage bill ceiling rule. Wage increases should also better take into account productivity developments in industry. In addition to streamlining expenditure, Kosovo’s public finance would benefit from strengthening the revenue base. Currently, the revenue base is weak as a result of exemptions, preferential tax rates and special regimes. It would be useful to start producing a regular review of tax expenditure, in order to assess the revenue foregone and shape future policies. The collection of tax debt, on which good progress was made in 2019, was interrupted by the crisis, but needs to be addressed in medium-term fiscal strategies.

To ensure the medium-term sustainability of public finance, a gradual return to the deficit rule is essential. The return to the 2% deficit ceiling is planned by 2023. Government deposits are not expected to revert to their pre-crisis level (4.5%), as a substantial share will be spent to finance the budget deficit in 2021. The rapidly rising debt-to-GDP ratio is likely to impact on the use of the investment clause. According to the fiscal rule definition, the exemption from the 2% deficit ceiling for capital projects financed by privatisation proceeds and donors can be invoked until 2025, provided that public debt remains below the prescribed ceiling of 30% of GDP. The debt-to-GDP ratio is projected to exceed the 30% ceiling in 2022, implying that the investment clause could not be invoked thereafter. Given the pressing need for infrastructure investment in Kosovo, a possible solution could be to align the investment clause to the general debt ceiling of 40% of GDP. Increasing the debt ceiling up to 50%, as suggested previously by the government, does not seem warranted and could weaken consolidation efforts. The proper functioning of Kosovo’s fiscal framework is also conditional on the quality of macro-financial statistics, which require substantial further improvement.

7.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

The Commission has conducted an independent analysis of Kosovo's economy and identified the main structural challenges to competitiveness and inclusive growth, drawing on Kosovo's own ERP and other sources. The analysis highlights a number of structural challenges across many sectors. The three most significant ones are: (i) improving the quality and relevance of the education system to increase employment and mitigate skills mismatches; (ii) continuing to formalise the economy and to address the low competitiveness of the private sector; and (iii) tapping into the potential of renewable energy and energy savings and fully opening the energy market. While there are several obstacles to inclusive economic growth and competitiveness, the identified key structural challenges have the biggest potential for enhancing inclusive growth and competitiveness and possess real reform leverage.

Kosovo also needs to continue to tackle corruption, improve the rule of law and strengthen institutions and improve the administration's capacity in order to promote competitiveness. Addressing these fundamental concerns is a prerequisite for the successful transformation of the economy. The Commission has been closely monitoring the issues of strengthening the rule of law and fighting corruption in the annual enlargement package report on Kosovo.

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

A very large percentage of the population continues to be inactive and face considerable difficulties. Two thirds of the population in Kosovo are working age population (15-64 years) but 61.2% of the working age population is inactive. The employment rate (15-64 years) in the third quarter of 2020 is 30.1% with a wide gender gap (46.2% male compared to 14.4% female). By reducing employers' costs, the recent publication of a draft law on labour and maternity leave aims to encourage employment. Other ongoing initiatives regarding the improvement of child and elderly care services and the project to decrease the duration of short-term employment contracts from the existing 10 years to 3 years pursue the same goal. Kosovo has the youngest population in Europe but access to preschool is hampered by the limited number of programmes and an unequal distribution of facilities. Ministry of Education, Science and Technology reports only 4.9% attendance in public pre-school education (0-4 years). UNICEF emphasises that social norms also prevent the establishment of inclusive education which translates into poor health, cognitive, social and development outcomes with lifelong impact. Almost half of the young people aged 15-24 (46.9% in the third quarter of 2020) are unemployed of whom almost half are long-term unemployed. In early 2020, 98 542 young people (29% of the population aged 15-24) were not in employment, education or training (NEET). A fifth of the population lives below the poverty line. Due to the COVID-19 outbreak, Kosovo's economy is forecast to contract by 7.5% in 2020 increasing the numbers of those the at-risk of poverty.

Emergency COVID-19 measures targeted formal and informal sector workers but regular social assistance remains inadequate. The government adopted a set of measures to mitigate the economic and social consequences of the COVID-19 crisis and stimulate the economic recovery in timely manner. Nevertheless, simulations of income shocks suggest that 70 000 to 170 000 people could fall into poverty, while the middle class could shrink by many as 100 000 people. The current Social Assistance Scheme (SAS) is inadequate due to its restrictive eligibility criteria. Unemployed peoples in Kosovo have no insurance contrary to the recommendations of the International Labour Organisation Convention on minimum standards of social security. More than half of the people falling into poverty do not benefit from any social assistance programme. Although the government is now drafting reforms of the Law on Social Assistance, the adoption of the new law and the secondary legislation will take several more months and the new scheme will not be ready before mid-2021 at the earliest.

The Kosovo education system was ranked among the lowest quality among OECD countries by the 2018 Programme for International Student Assessment (PISA)**.** Access to early education programmes for children aged 36-59 months is very low (13.9%) compared to the EU average of over 80%. Evidence from the PISA survey shows that pre-school education - the basis on which the success of students in further education is determined - has not been yet sufficiently prioritised in Kosovo (Majlinda Gjelaj 2019). Kosovo students' scores are the equivalent to 5 years of schooling behind the OECD average in reading, and a little over 4 years behind in math. The performance gap is particularly clear among individuals belonging to ethnic minorities and among people in vulnerable situations. Students in urban areas tend to outperform students in rural areas. Nevertheless, students show an extremely positive spirit despite the limited prospects upon graduation: the average of life satisfaction among students is one of the highest of the countries and economies participating in PISA - ranking 3 out of 70 (OECD 2018b). They also firmly believe in their own ability to perform, especially when faced with adversity (ranking 9 out of 77). They also perceive their teacher as being very enthusiastic and supportive compared to other PISA participating countries and economies. One in two upper secondary student is registered in vocational programmes and in 2018, for the first time, Kosovo recorded a lower proportion of people (18-24) leaving early from education and training compared to the EU-28. Keeping young people in education while upskilling them through vocational qualifications has proved to be a successful policy option. However, the time spent in school may translate unevenly into learning (ETF 2020b).

Effective quality assurance is one of the weakest points of the pre-university education in Kosovo, as recognised by the Kosovo Education Strategic Plan 2017-2021. With government expenditure on education amounting to 4.6% of GDP in 2019, Kosovo is comparable to the EU-27 average of 4.7%, but the proportion of children in the country is higher and goals and priorities far exceed available finance. A lack of educational material has been reported by school principals and students. The new Law on Textbooks and Teaching Materials is expected to be adopted in 2021. There are also low levels of private sector involvement in education and training and a lack of information on skills and vocations (World Bank, 2019b). The recruitment of teachers also suffers from political influence in the absence of administrative instructions seeking to address this issue. Existing quality mechanisms at all levels of education are not consistently applied.

Many firms in Kosovo encounter problems due to applicants' lack of skills while low-skilled people lack formal employment opportunities. Finding the right employees with the required skills and competencies is one of the most important factors to develop a vibrant private sector (Krasniqi 2019). According to the World Bank, insufficient levels of labour market skills are potentially caused by insufficient skill formation opportunities in early childhood, the low quality and lack of relevance of school-based education and vocational training as well as of training programs delivered through active labour market programs. Domestic companies and foreign direct investment are suffering from the skills shortage of new entrants to the labour market. Socioemotional skills, foreign language skills, and computer skills are the most in demand (World Bank, 2020c). But aligning policies, training programs and curricula to the current and future needs of the labour market is challenging in the absence of relevant and real-time data on job creation and skills needs and forecasts of future skills needs. Job matching platforms in Kosovo represent a specific segment of the labour market. They are used almost exclusively for highly-skilled occupations whereas low and medium skilled jobs are more likely to be filled through informal channels. The lack of economic opportunities is considered to be a key factor fuelling emigration of young people and skilled workers.

Reforming the education system by giving people the relevant skills and competences needed to face the challenges ahead is an absolute necessity. More than half of upper secondary students enrol in vocational education, but they often remain unemployed as their training does not provide them with the necessary skills. Numerous strategies are not always followed up by real implementation plans and monitoring mechanisms. They show a need for digitalisation and revision of the teaching methods in the education system in general. In particular, vocational education and training (VET) does not yet have the capacity to provide students with digital skills and competences in line with European and international education standards. The funding of the VET system is insufficiently coordinated to meet the specific needs of local and international business and to facilitate the transition to the labour market. Over 90% of the total school budget is spent on wages and salaries. Cooperation with the private sector remains underdeveloped mainly due to the small size of companies, which have difficulties identifying their needs. Policy makers are not really focused on changing this situation. Information on matters like skills supply and demand is lacking. All of these elements mean that VET is not highly responsive to labour market needs.

The Employment Agency of Kosovo has been making efforts to increase the scope and quality of services provided to jobseekers and the unemployed. Recently, the Ministry of Labour and Social Welfare launched a series of reforms to modernise Public Employment Services (PES) in Kosovo ([76]). It aims to provide a service tailored to the needs of the client including profiling, counselling, career guidance, training or mediation services as well as online publication of vacancies for employers. But the number of case managers remains insufficient compared to the number of jobseekers. Additionally, a specific division responsible for work and education migration provides information on circular migration for those interested in moving to Germany. The highly centralised organisational structure of the PES makes management, coordination, monitoring and control processes (including funding from donors) demanding (EuropeAid 2019). The capacity to evaluate active labour market measures, in order to determine their effectiveness and measure the impact on participants' employability, is very low and, in addition, it has insufficient financial and qualified human resources.

Reform measure 15: "Increasing inclusiveness and quality of education in early childhood". The measure - rolled-over from the previous ERP - aims to increase children's participation in Early Childhood Education. The drafting and adoption of the law on early childhood education is again postponed as has the drafting of bylaws and administrative instructions to allow the implementation thereof. It remains unclear whether the Law will facilitate access for the people in vulnerable situations especially Roma, Ashkali and Egyptians. The training of educators and the licensing of pre-schools should not be delayed any longer..

Reform measure 16: "Implementation of the new curricular framework" in the vocational education and training system. The measure aims to increase the compatibility of VET with labour market needs and has been rolled-over from the previous ERP. The implementation of the measure is based on the adoption of the core curriculum in the VET area, the revision of the VET funding formula and the launch of the new curriculum pilot by VET institutions. The quality of placements/internships in businesses is not addressed. The VET Council has been made functional and there is a satisfactory level of involvement on the part of businesses. The model for private businesses' cooperation with schools appears to target a modest number of schools per year (only 10). The main sources of VET finance are the Ministry of Finance and international donors. The link between finances and goals is not always clear.

Reform measure 17: "Increase Quality Assurance in higher education by strengthening the Kosovo Accreditation Agency (KAA)" and profiling higher education institutions. The measure aims to increase the quality of higher education by improving legislation and the capacity building of mechanisms assuring the quality provided by higher education institutions. The draft Law on Higher Education has not been approved. The draft Law on the KAA has not yet been approved and, as a result, there has been no recruitment to the Agency either. ENQA recommendations should urgently be addressed for readmission. The measure also includes actions relating to public higher education institutions to strengthen their autonomy and transparency as well as to improve research infrastructure.

Reform measure 18: "Improving and enhancing public employment and vocational training services, increasing the employability of the long-term unemployed, young people, women and other vulnerable groups." The measure consists mainly of improving public employment and vocational training services by reviewing employment policies with the aim of increasing the effectiveness of active labour market measures and piloting the subcontracting of vocational training programs through private providers and

([76]) *Offers and services for job-seekers* on https://aprk.rks-gov.net/en-US/JobSeeker/Index/52 opening new profiles in line with labour market demands. This measure has largely been rolled over previous past years. Its scope and actions are properly sequenced and could provide the described outcomes. The target of 3 000 long-term unemployed with a focus on people in vulnerable situations such as young people, women, and people with disabilities is not sufficiently ambitious but takes into account the available resources which do not correspond to the challenges of the labour market.

Key challenge #2: Formalisation of the economy and low competitiveness of the private sector

Persistent widespread informality continues to represent a key structural challenge for Kosovo's economy. Different assessments produced over the past decade point towards an estimated figure of informality ranging between 30 to 39% of GDP, and an EU-funded project estimated the preliminary cost of informality to be around EUR 106.8 million as a result of the tax gap for income tax revenue and VAT alone (IMF, 2019). Informality is deeply rooted in crucial sectors such as construction, retail trade, accommodation and transport. More than 45,000 full-time equivalent employees were estimated to be working in the informal sector, most of them in the agricultural, construction and retail sectors. Due to the highly seasonal nature of these three sectors, they were hit harder by the COVID-19 crisis, especially during the first lockdown in 2020 and the almost complete shutdown of the economy in the first and second quarter of 2020. In spite of some positive developments resulting from measures taken by the government, such as increased cooperation on joint investigations and inspections and the drafting of tax compliance plans, the reporting, monitoring and evaluation of implemented measures and strategies has not been consistent, which undermines overall efforts to tackle informality in Kosovo.

Kosovo's formal entrepreneurial landscape is dominated by low-value added, non-specialised, family-owned micro-companies engaged in non-tradeable activities, which lowers the economy's export competitiveness. This is directly reflected in the persistently high current account deficit figures (8% of GDP in 2018, 5.5% in 2019, projected to deteriorate further to projected 7.2% in 2020 in the context of the COVID-19 crisis) and more so in the highly imbalanced trade of goods, with imports being almost eight times larger than exports (World Bank, 2020a). The structure of Kosovo's goods export basket structure is currently heavily skewed towards the export of a single product category: base metals and mineral products (58.6 and 48% of total exports in 2017 and 2018, respectively). Whilst year-on-year exports of goods increased by 13.4% in the first half of 2020, further analysis has shown that this is largely due to the exceptional performance of Kosovo's largest exporter (ERP 2021-2023). Exports of services, currently showing a large surplus, have been growing at a slower pace than imports of services (10.3% compared to 11% respectively), over the past four years. If this trend is not reversed, it will likely deepen the trade deficit even further, thus raising Kosovo's external vulnerabilities. It is particularly significant given that current account deficit figures are high, at -5.5% of GDP in 2019, a situation that should not be prolonged indefinitely (World Bank, 2020a). A clear strategy and measures to improve the trade deficit, especially on exportable goods, is lacking.

Foreign direct investment (FDI) and remittances, which could help to counterweight the current account's deficit, are unable to fill that gap. FDI inflows to Kosovo have fluctuated, with an overall descending trend during the period 2010-2018. Kosovo has primarily attracted investment in real estate and related business activities (34% of FDI stock), financial intermediation (17%) and manufacturing (12%), with some smaller investments in the agriculture, mining and energy sectors ([77]). Additionally, FDI is limited to a handful of countries, namely states where a sizeable, well-established Kosovo diaspora exists. Export-oriented FDI has been very scarce, and overall figures are relatively low, passing the EUR 300 million figure only once in the past 7 years. Remittances are used almost exclusively for consumption purposes: on two-digit numbers for most of the decade (12% of GDP on 2019), they are four times higher than overall FDI (World Bank, 2020a). While the *proposed reforms 3, 4, 5 and 6* in this year's ERP include useful activities and actions that may help foster export dynamics in Kosovo and strengthen the competitiveness of the agricultural, manufacturing and services sectors, no significant

([77]) *Foreign investment in Kosovo*, on www.santandertrade.com/en/portal/establish-overseas/kosovo/investing change to the observed situation could effectively be made without a comprehensive, long-term trade and competitiveness strategy for the coming years and decade. A more detailed analysis of these measures is provided in section 6 of the document.

Informality has significant and multiple negative consequences for the economy. First, it reduces the tax base, limiting the fiscal space for more productive spending in priority areas, such as education, health and infrastructure. Second, it creates an uneven playing field amongst businesses and is a deterrent for additional private sector investment, including foreign direct investment. Informal activity has consistently been identified as the major obstacle to doing business in Kosovo (World Bank et al, 2019a; EBRD, 2016) ([78]). Informality also affects the competitiveness and export potential of Kosovo's private sector: firms operating in the informal sector have more difficulty accessing finance and tend to engage less in research and development and innovation and to hire fewer workers. Finally, workers in informal sectors have more limited (or no) access to social protection and additional benefits, and are more vulnerable when they lose their job or leave the labour market. Their access to training is also negatively affected, which further exacerbates the inadequacy of the skills of the workforce and contributes to the migration of specialised and skilled workers to markets where better labour and wage conditions can be found. Conversely, the lack of social and other benefits in formal employment – given the lack of existing structures to provide them – discourages many informal employers and employees from formalising.

The high level of informality in Kosovo is mainly linked to a generally low level of trust in government and institutions. High tax rates, nominally a major cause of informality, are not considered to be a major contributor to the phenomenon in Kosovo (income, individual and VAT tax levels are relatively low when compared to regional and other European economies). Among global indicators, Kosovo was placed in a mid-ranking 48th place in the 'paying taxes' subcategory of the 2020 World Bank *Doing Business* Report. This could point towards an overall low level of law enforcement and tax control on the part of local authorities as a potential underlying cause of high levels of informality. Formalisation would contribute to higher tax revenues, which could - in turn - provide additional resources to improve public services. It would also help create a more favourable, level playing field environment for investment, increasing access to finance, productivity and competitiveness levels. Finally, formalisation brings higher levels of job security and protection, particularly for those groups of the population most affected by informal employment, namely women and youth. Further digitisation of public services available to citizens and businesses offers the potential to facilitate the ease of doing business and to reduce incentives for businesses and citizens to participate in the informal sector.

To address the adverse effects of the informal economy, Kosovo adopted two strategies on preventing and fighting informality, the first in 2014 and the second in 2019. The available data suggest only a slight reduction in the size of the informal economy as a percentage of GDP throughout the decade – however, no consistent figures have been published since 2015. This relative progress resulted mainly from a reduction in the grey economy, reflecting an improvement in the effectiveness of tax and customs administrations practices. However, the impact appraisal of the two strategies against their targets was jeopardised by the lack of regular assessments of the tax gap and other key indicators on informality.

The most recent strategy, adopted in May 2019, includes relevant measures to address informality and provides for improved monitoring mechanisms. Among the targets set by this new strategy for 2023 are the reduction in the size of the informal economy as a percentage of GDP to 26%, the reduction of the informal employment rate to 10% and an increase in the final confiscation of criminal assets. Its

([78]) The *2019 Enterprise Survey* put informality as the single most pressing hindrance perceived by business in Kosovo, with 26% surveyed companies listing it first, well above the 19% of surveyed firms in the region selecting this option (WB et al., 2019). Similarly, according to the 2016 business environment and enterprise performance survey (BEEPS V), competition from informal competitors was signalled as the single most important issue in Kosovo. In all, 66% of firms reported that having to compete against firms in the informal sector was a major issue, the highest among all 30 countries covered in BEEPS V (the average was 39%). (EBRD, 2016) first action plan (2019-2021) provides for actions in key areas such as statistics and risk and impact assessments, registration of businesses and increased cooperation among administrations. In comparison to the previous strategy, it benefits from the inclusion of qualitative and quantitative indicators to improve the monitoring process. Despite the improvements to the strategy, there is still room to improve implementation and reporting on implementation, and the corresponding action plan to tackle the informal economy. Furthermore, implementation efforts have been hampered by both the political context and the ensuing economic and health crises in the context of the COVID-19 pandemic.

Measures to address the underlying causes of informality related to the business environment and incentives to engage in formal work should complement the strategy and be adapted to the fallout from the COVID-19 crisis. While the strategy includes relevant measures to fight informality, it would benefit from measures that aim to improve the business environment, in particular the simplification, merger and abolition of licences and permits and the reduction in the duration of commercial dispute settlements. In addition, further digitisation of public services should be considered. The emergency measures enacted during the early stages of the COVID-19 crisis in the spring and summer of 2020 proved useful in prompting undeclared and informal workers to register at the Employment Agency of Kosovo, and businesses were keener to disclose turnover and profit figures in order to be considered for business and employment support schemes.

The ongoing implementation of the 2019-2023 strategy, which is still in its early stages, has been negatively affected by both the political context, and the COVID-19 situation. Tax revenues are expected to be heavily distorted in 2020 due to the pandemic, with total revenue falling by 14% compared to 2019, but a better understanding of the impact of the implemented actions could be possible in 2021. Many activities planned for 2020 were affected by the COVID-19 crisis, including by-laws and legislative proposals that needed assembly approval.

Reform measure 10 "Reducing the informal economy" aims to implement selected priorities of the new strategy, many of which were initiated in 2019 with the launch of the strategy. While the reform measure is relevant and reflects the Commission's assessment, the activities proposed to take place in 2020 were not ambitious enough and, due to the circumstances, a number of them could not be implemented, resulting in a delay of a year for most future activities. The activities now rolled over to 2022 and 2023 - including the proposed review of the action plan of the strategy, scheduled to take place in 2022 - seem credible and significant enough to boost overall GDP, productivity, growth, revenues and competitiveness while reducing the current size of both the grey and black economies, if they are implemented in full and according to the planned timeline.

Key challenge #3: Tapping renewable energy and energy saving potential and fully opening the energy market

The inadequate and unreliable supply of energy is one of the main constraints on Kosovo's competiveness and acts as a break on productivity. The outdated power system essentially relies on old, inefficient and highly polluting lignite thermal power plants with total energy installed capacity of 1 430 MW. Currently, there are two lignite plants in Kosovo operating at 880 MW only, covering around 92% of electricity production: Kosovo A with five units and Kosovo B with two units. Most power plant units in Kosovo are now at the end of their technical lifespan, but the government is contemplating an extension of the lifespan of the Kosovo A working units, which would exacerbate critical levels of air pollution. The technical upgrade of Kosovo B will be supported by the EU and will reduce the environmental impact of the power plant. Remaining energy production is generated by small hydropower plants and wind generation (139 MW out of a total installed capacity of 1 430 MW). Electricity demand and consumption continues to grow steadily. This, together with the ageing of the power plants and insufficient flexibility to adapt to consumption in peak periods, means that electricity has to be imported and exported to balance the system. While net exports were only 186 GWh in 2020, imports (860.8 GWh) and exports (1 043.5 GWh) were both quite sizeable. This scenario is particularly challenging for Kosovo in light of the ambitious Green Agenda for the Western Balkans. The potential disruption derived from the obsolete generating capacity and dependency on energy imports could have a negative effect on Kosovo's growth potential and the competitiveness of its industries.

Reliability of energy supply is still below the average for Europe and Central Asia. Despite some improvements in the reliability of supply, Kosovo ranks 90th in the world for ease of getting electricity (World Bank, 2020). The lack of energy security gives rise to significant costs for business and represents the biggest obstacle to attracting high-quality FDI. According to the latest Business Environment and Enterprise Performance Survey (BEEPS V), firms perceive the unreliable electricity supply as the second biggest obstacle to doing business in Kosovo.

Kosovo has been making efforts to diversify its energy production mix, with new wind farm and solar projects, but the main generation capacities that are planned will continue to rely on coal. In December 2017, the Kosovo Government signed a EUR 1.3 billion contract with ContourGlobal for the construction of a new 450 MW coal-based power plant ('Kosova e Re'), but the contractor announced that it would not proceed with the project and submitted a Notice of Arbitration against Kosovo in December 2020, citing Kosovo's failure to financially support the project. As a result, Kosovo has decided to explore the possibility of extending the lifetime of the highly polluting Kosovo A power plant and is considering the use of gas power generation. Kosovo is on track to meet the mandatory target set by the Energy Community Treaty of 25% of renewable energy sources (RES) as a share of gross final energy consumption by 2020: the RES share was 24.9% in 2018. However, this was mainly achieved by revising the definition of RES to include biomass for heating, which is widely used by household customers, rather than by making any substantial investment in renewable energy. Fuelwood is the most-used commodity for heating homes, complemented by a mix of coal and wood. This has a very negative impact on air quality, and has made Kosovo one of the most polluted places in Europe. Furthermore, limited efforts have been made to improve support schemes for renewable energy projects. The practice of feed-in tariff impedes the opening of the auction market and damages consumer interests by imposing high prices above the market rate. However, in line with EU recommendations, the State Aid Commission recently decided to declare the incentive scheme for feed-in tariffs for renewable energy non-compatible. The declining cost of renewable energy and interest on the part of financial actors to invest in Kosovo offer new opportunities to diversify its energy mix. There is an increase in RES investments and several projects to develop important wind and solar energy sources are already planned. Kosovo could advance much further in its RES targets by adopting a National Renewable Energy Efficiency Action Plan and competitive selection processes for its renewable energy support. The Energy Community is expected to adopt new renewable energy targets for 2030, in line with the EU's targets, and this will require Kosovo to make substantial additional efforts. These targets could be reflected in the upcoming Kosovo energy strategy.

Kosovo needs to emphasise energy efficiency, as the potential for energy savings is significant. Some efforts were made to increase energy efficiency incentives for the private sector and households. Another key to overcoming the challenges relating to energy supply is further investment in energy efficiency. Distribution losses remain high compared to regional standards (technical losses of 13.32% and commercial losses of 7.33% amounted to total losses of 20.65% in 2020). Moreover, investment in and maintenance of the distribution network remain low. The Law on Energy Efficiency facilitated the establishment of an Energy Efficiency Fund, which is now operational. Kosovo would benefit from further energy efficiency incentives for households and the private sector (which account for 39% of final electricity consumption). It would also benefit from a comprehensive action plan to address inefficient (and highly polluting) heating based on solid fuels (coal and firewood), which significantly harm public health and the economy, and from better energy efficiency statistics. As such, *reform measure 1 "Reducing Energy Consumption through Energy Efficiency Measures"* aims to promote energy efficiency incentives resulting in a reduction in network demand, the promotion of a sustainable energy mix, help to meet emissions and energy efficiency targets and a reduction in energy poverty. Some progress was made with the operationalisation of the Energy Efficiency Fund and the extension of support schemes to private and public buildings. However, the current activities are not sufficient to meet energy efficiency targets and most of the support is provided by international donors. In addition, the distribution network is still characterised by significant losses. Kosovo should target these challenges in its energy strategy with sustainable investments in energy infrastructure and an ambitious and comprehensive approach to the promotion of energy efficiency.

There is no open trading in the electricity market and energy tariffs do not yet fully reflect costs. While Kosovo has made some progress in phasing out cross-subsidies between different categories of customers and in implementing the third energy package, the retail market is still only partly deregulated (for the supply of high voltage customers). Kosovo has the lowest electricity prices for households in the Western Balkans: EUR 0.0605 per kWh in the first half of 2020, compared to a regional average of EUR 0.08 and an EU average of EUR 0.2126 per kWh (Eurostat). The prices do not reflect the real cost. As presented in the 2019 ERP policy guidance, in order to mitigate the expected upward pressure on prices from the significant investments required in the sector, Kosovo needs to develop a programme to protect vulnerable customers in line with Energy Community requirements.

Progress has been made on regional integration. A new connection agreement between KOSTT and the European Network of Transmission System Operators for electricity (ENTSO-E) entered into force, leading to the operationalisation, in December 2020, of the 400 kV interconnection line (with a German investment of EUR 75 million) between Kosovo and Albania, which had remained unused for 3 years. Furthermore, additional steps were taken towards further integration of energy markets with Albania upon the signature of a bilateral agreement between transmission system operators in December 2019. These recent agreements could bolster the financial stability of the Kosovo operator and improve the security of regional transmission networks.

The Economic and Investment Plan for the Western Balkans will contribute to the green and digital transition, in particular the use of renewable energy sources, which will positively reflect on Kosovo's competitiveness. A substantial investment package, which is at the heart of the Economic and Investment Plan, will direct a large majority of support towards key productive investments and infrastructure. This will reflect and support the twin green and digital transition and the development of a connected, competitive, knowledge-based, sustainable, innovation-oriented and thriving economy. Circular economy principles, which form the basis of the Economic and Investment Plan and are defined in the Green Agenda for the Western Balkans, could foster significant levels of sustainable energy production and consumption.

Reform measure 2: "Increasing diversity of energy sources": aims to address obstacles in the sectors of renewables, gas and district heating, in order to balance excess demand, in order to achieve a more sustainable energy mix and to help meet emissions and renewable energy targets. Some progress was made on steps taken to explore the development of other energy sources, such as gas that could be supplied using the EU-funded North Macedonia-Kosovo gas interconnector. However, greater efforts are needed to improve the development of renewable energy sources, such as solar and wind. This ambition should be reflected in the Kosovo energy strategy; further investment to extend coal-based production and the extensive use of subsidies for coal would be detrimental to achieving this objective.

Box II.7.4: **Monitoring performance in light of the European Pillar of Social Rights**

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

On most of the principles of the Pillar, Kosovo performs considerably below the EU average according to the indicators of the social scoreboard ([79]). To some extent this is inevitable, since Kosovo is poorer than the EU Member States and other countries in the region, however it points to an urgent need for more effective and substantial policy reforms to improve socioeconomic conditions for the population.

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

Young people have a very marginal presence on the labour market. The potential of a large young population to boost growth and employment is not utilised; rather, the high pressure on the labour market is absorbed by emigration.

Investments in the education system, in particular the early stages, is very limited. The vast majority of children under 5 receive no formal early childhood education. In school year 2018/2019, the number of children in public pre-school education (from 0 to below 5) had slightly increased and in public pre-primary education (5-6) has decreased compared to year 2017/2018 The only indicator, in which Kosovo saw improvement between 2016 and 2018, was the share of early school leavers, which decreased from 12.7% to 9.6%, i.e. below the EU-28 average (10.5%).

Kosovo's performance on social inclusion, social protection and poverty alleviation is mixed. Social expenditure is largely focused on administering a wide and increasing range of categorical benefits. Financial and other social assistance to the poorest segments of the population is still limited. Low-income households have less access to essential services and for

([79]) The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators). The indicators are also compared for the Western Balkans and Turkey, with one small adjustment in the age bracket for the unemployment rate (reducing the upper age limit to 64 instead of 74) for Albania and Kosovo due to data availability. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2019 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). Data from 2017-2019 are used and can be found in Annex A.

many of them services are not affordable, because they do not receive assistance from government subsidy programmes (Social Assistance Scheme). A planned reform of the SAS is expected to broaden the coverage of people in vulnerable situations.

The statistical system is at an early stage of development. Kosovo Agency of Statistics conducts a quarterly Labour Force Survey based on EU methodology. The quality of the data needs to be improved. Statistics on Income and Living Conditions are not yet conducted. Specific challenges exist with regard to establishing indicators based on population data, e.g. in the area of education.

7.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2020

Overall: Limited implementation (35.9 %) ([80])	
2020 policy guidance	**Summary assessment**
PG 1: Create fiscal space and undertake well-targeted measures to address the socio-economic consequences of the crisis.	There was **limited implementation** of PG1: 1) **Partial implementation:** The government has undertaken timely fiscal response to address the socio-economic shortfalls of the pandemic, and has allocated fiscal support of 5.2% of GDP in the form of emergency support and a medium-term recovery programme. In terms of adequacy and targeted nature of the support measures, while the government rightly targeted and timely responded to the income loss of vulnerable households, concerns about some individual measures remain, especially those related to support to the business sector, were implemented without well-defined criteria for allocation of funds. The medium-term recovery programme, on the other hand, was to a large extent implemented without clearly defined criteria for the allocation of funds, especially those related to support the private sector.
Contain spending on the public wage bill and on war veterans pensions through progress with the reclassification of beneficiaries.	2) **Limited implementation:** The government managed to contain spending on the public wage bill as the Constitutional Court annulled the adopted Law on Public Salaries. The annulled Law would have had a high fiscal cost and therefore have breached the fiscal wage bill rule. Since the Constitutional Court decision, no new initiative has started to draft a new law on Public Salaries that would address the challenges with regard to public salaries, and currently the old salary system is being applied. No progress was recorded with the reclassification of the beneficiaries of the war veterans pension scheme, while the actual expenditure continued to exceed planned budget allocations by EUR 15 million in 2020 (around 20% higher), overrunning the cap of 0.7% of GDP as provisioned in the amended Law on war veterans.

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

Reinforce the medium-term sustainability of public finances, improve tax revenue collection by reducing informality.	3) **Limited implementation:** As expected, tax revenue collection was hit by the crisis, falling short by 9% compared to 2019. However, considering the significant share of informality in the economy, due to restrictive measures introduced by the government to contain the spread of the pandemic, there was no progress marked nor reports published on achievements of implementation of the Strategy on fighting the informal economy and its action plan. There is no analysis of the possible impact on the informal economy of the measure in the emergency package to support wages for informal labourers, whose employers register them and commit to paying their salaries for at least a year.
PG 2: Improve the execution of capital spending by strengthening institutional capacities at central and local government levels for multiannual investment planning and investment project management. Improve the financial oversight and accountability of publicly owned enterprises (POEs). Prepare an options paper on the establishment of an independent body for fiscal oversight for further consultations with stakeholders, including the EU.	There was **partial implementation** of PG2: 1) **Limited implementation:** In 2020 budget allocations for capital investments were lower by 20% compared to 2019. Under-execution trend continued with only 56.5% rate of execution, partly due to lack of political decisions, and due to the shutdown of the economy during the pandemic crisis. The three adopted administrative instructions by the Ministry of Finance, which aimed at improving planning, selection, execution and monitoring of capital project and which entered into force in January 2020 are lagging in implementation. Multiannual planning of capital investments remains at initial stages. 2) **Partial implementation:** Regardless of the historic trend of poor financial oversight, accountability and efficiency of the POEs, the pandemic crisis aggravated the liquidity situation for some of the POEs, which required extended government support. Despite being long overdue, the government has not put forward the new Law on POEs for approval and has not taken any concrete step in improving the institutional management of POEs. Nonetheless, significant steps have been taken in the area, such as the publication of quarterly balance sheets, and the preparation of a first-ever risk assessment of POEs. Additionally, it was decided that POEs loans data was to complement current public debt publications. 3) **Partial implementation:** The Ministry of Finance, with the assistance of EU-funded IMF support, has produced the first draft of the paper on establishment of an independent body for fiscal oversight. However, the options paper has yet to be consulted with all other stakeholders and its finalisation is pending.
PG 3: Closely monitor financial stability challenges as a result of the coronavirus pandemic and take appropriate action if needed, while developing a	There was **partial implementation** of PG3: 1) **Partial implementation**: Financial stability challenges were monitored closely and forceful prudential measures were taken to support borrowers

more integrated framework for measuring household indebtedness.	and banks, but the functioning and set-up of the macro-prudential committee could be improved. The framework for measuring household indebtedness is only in draft stage.
Undertake an in-depth analysis of the staffing and competence requirements in the central bank’s key policy areas, especially financial stability.	2) **No implementation:** While new positions were created, no in-depth analysis of the staffing and competence requirements were undertaken.
Continue with the inflation expectations survey and publish the time series once more data points become available.	3) **Full implementation**: The inflation expectations survey was continued and the time series were published on the webpage of the central bank (https://bqk-kos.org/financial-stability/bank-lending-survey/summary-of-the-results-of-the-bank-lending-survey/?lang=en).
PG 4: Establish an effective and transparent mechanism to support the private sector and employees affected by the crisis, in particular micro, small and medium-sized enterprises and self-employed.	There was **limited implementation** of PG 4: 1) **Limited implementation**: MSMEs were the most affected by the COVID-19 outbreak in Kosovo. As a policy response, the Kosovan authorities have provided financial support via the economic recovery package, which is largely insufficient to mitigate the economic fallout and private sector backdrop. The Government distributed EUR 60 million to all active businesses, pursuing an approach that involved no selection criteria for financial allocations. Instead, a flat rate has been used to subsidise salaries regardless of the financial state of the beneficiary economic operator. There has been no impact assessment to assess the economic sectors that have been most affected by the pandemic. Because of the protracted legislative approval, the increased guarantee threshold for loans issued to MSMEs via the Kosovo Credit Guarantee Fund was delayed.
Extend social protection coverage and provide incentives for businesses and employees in the informal economy sector to register and to facilitate their transfer to the formal economy.	2) **Partial implementation**: Regarding the part on social protection coverage, the Government has proposed new legislation on social and family services (SAS), which will include the broadening of the base of families with children benefiting from SAS; besides that, however, no other progress was recorded. The government took action to create incentives and to formalise employment in the informal sector through the payment of support wages to informal labourers, whose employers register them and commit to paying their salaries for at least a year
Further implement relevant business environment measures, in particular the simplification, merging and abolishment of licences and permits.	3) **Limited implementation**: The programme to reduce the administrative burden for citizens, businesses and the public administration was approved in 2020. The Central Registry provides up-to-date information on all licensing documents that central institutions issue to businesses. Coordination between central institutions responsible for licensing should be strengthened while aiming to merge and reduce permits and licenses. Further efforts to simplify licences and

	permits through repealing unnecessary procedural, data and other requirements should also be accompanied by measures to make with making fees and procedures transparent and easily accessible to the public and companies. Increasingly digital approaches to service delivery need to be introduced. The Business Inspections Reform draft law experienced little progress and will have its legislative drafting will have to be continued this year for its full adoption and implementation.
PG 5: Strengthen the health sector in order to provide adequate and accessible primary health services for all citizens.	There was **limited implementation** of PG 5: 1) **Limited implementation**: The pandemic has put Kosovo's health system under significant strain and has meant that public health reforms have not been implemented. The Kosovan health authorities, notably the Ministry of Health, has adopted some measures to address the PG subpart, but they appear to insufficient and it is unclear how they will be implemented. The following strategic documents were adopted (the rest remain to be implemented): -Strategic plan for mother, child and reproductive health approved; -Strategic plan for human resources approved; -Strategic plan for fighting hospital infections approved; -Strategic
Ensure increased coverage of unemployment benefits and needs-based social benefits for the groups most affected by the COVID-19 crisis. Review social assistance schemes, in particular the category-based pensions, to ensure that they are targeted at groups most in need and focused on poverty reduction.	2) **Limited implementation:** There are no unemployment benefits in Kosovo, this remains unregulated to date; the Law on Economic Recovery was adopted and a range of the categories affected by COVID 19 benefited from some state assistance. There are only initial efforts – such as suggested legislative initiatives – to ensure that social assistance schemes, in particular the category-based pensions, are targeted at groups most in need and focused on poverty reduction.
PG 6: Take measures to preserve employment including through short-time work schemes and upgrade the capacity of the Employment Agency.	There was **limited implementation** of PG 6: 1) **Limited implementation:** The number of jobseekers has increased almost threefold during the COVID-19, yet the budget for the Agency for Employment and its capacity are lower than in 2020. This means that, although the need for increased active labour market measures to address the number of unemployed has vastly increased, there is no capacity to provide more than the usual offer. It is unclear whether some of the economic recovery funds will be processed through the Agency for Employment. The limited fiscal space - and additional challenges in securing financing throughout 2020 - have also been an obstacle for the implementation of this PG. Short-time work schemes are still very limited in size and number, and largely supported by donor schemes rather than private companies.

Conduct a feasibility study for a Youth Guarantee scheme.	2) **Limited implementation:** The Government has identified donor funds to conduct a feasibility study for a Youth Guarantee scheme which is one of the flagship actions under the Economic and Investment Plan. The timelines for such a study are not defined.

7.6. ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2021-2023

Business environment

The improvement of the business environment is key for the effective transformation of Kosovo's economy. The World Bank's Doing Business 2020 report, ranked Kosovo 57th (down 13 places from the previous year) of 190 economies worldwide, acknowledging progress in dealing with construction permits, getting electricity, protecting minority investors and enforcing contracts. A pending general inspection reform, for which a new law should be approved, is expected to simplify and decrease the number of overlapping and parallel inspections. However, this progress is considered limited and has not translated into Kosovo becoming more attractive to investors. Recent business surveys continue to highlight the fact that electricity supply is among the top three obstacles constraining domestic companies and deterring potential investors from locating their businesses in Kosovo, along with corruption and the informal sector. Other important challenges are weak contract enforcement, the mismatch between skills and labour market needs and undiversified and limited access to finance. Higher-than-average salaries in the public sector are also seen as a deterrent to attracting the workforce to the private sector. The COVID-19 crisis has also had a noticeable impact on Kosovo's business environment, as the contribution made by contact-intensive sectors such as hospitality and restaurants is particularly high. The Kosovo Investment and Enterprise Support Agency needs to strengthen its role in promoting investments and exports, through the provision of before and after care services and programmes in support of investment and the private sector.

Measure 7: "Removing legal barriers and the reduction of bureaucracy"

This measure amalgamates two reforms presented in last year's ERP and the first draft of the 2021-2023 ERP. The discarded measure (initially presented as *reform measure 8 "General Inspection Reform"*) was carried over for the past 3 years, and both of them are important and relevant. The horizontal nature of both reforms will require solid administrative capabilities and coordination efforts during the planning and implementation of the activities, and after rationalisation of the inspection bodies. The timeline of activities seems reasonable, however, the reforms will require considerable political commitment to advance at the central state administration and municipal levels. While the text mentioned digitalisation, no concrete activities are provided for in this regard. At the moment there is a lack of clarity as to what ministry or department will effectively be leading the government's IT policy. This prevents the government from advancing with its digital agenda in a coordinated manner. For example, different government IT databases need to be interconnected, which requires close inter-ministerial cooperation. Additionally, costing is appropriate for the activities envisaged.

Measure 8: "Establishment and functioning of the Commercial Court"

This measure was initially introduced in ERP 2020-2022. It aims to increase the effectiveness of trade dispute resolution by establishing the Commercial Court as the sole body competent to resolve trade disputes involving foreign businesses and other investors. Besides the adoption of the concept document on reforming the commercial justice area in March 2020, there was no significant development in the implementation of this measure. The Law on the Commercial Court, which will form the basis for the establishment and functioning of the Commercial Court, is still being drafted. Because of the recent general elections, delays in the overall implementation of this measure and the planned activities are likely. The measure, however, does not seem to include sufficient budgetary allocations for the establishment of a Commercial Court in the 2021 budget or in the projections for the following 2 years; neither is there an independent opinion on budget impact assessment issued by the Ministry of Finance. The proposed measure also lacks information on the premises of the Court (with the capital costs that this would entail), appropriate activities envisaged for the functionalisation of the Court, or appropriate actions to mitigate the risk of delay in adoption of the Law on the Commercial Court.

Measure 9: "Reduce informality in the real estate sector"

The measure is relevant, but no progress was made on implementation in 2020. The proposed measure is limited to addressing the issue of uncontested informal transactions that occurred before 1999, but it does not cover the issue of all contested informal transactions and other informal transactions that occurred after 1999, or the issue of fraudulent property transactions that ought to be processed by the prosecutors and courts. As it stands, the proposed measure is not sufficiently developed to adequately tackle informality in the real estate sector which, as a result, has a significant impact on the economy. The measure lacks an overall strategic and comprehensive vision on reducing informality in the real estate sector in its entirety. The costing estimations for this and the following years still refer to their plans for 2020.

Research, development and innovation (RDI)

Kosovo's performance is still very poor in the research, development and innovation (RDI) sector (governance of RDI policies, public research system, public-private linkages, innovation in firms and human resources for innovation), and the country has the lowest scores in the Western Balkans region ([81]). The Law on Innovation entered into force in 2018, and an updated national innovation and entrepreneurship strategy was drafted the same year. Nonetheless, the sector suffers as a result of the chronic fragmentation in implementing innovation policy and the lack of overall coordination among line ministries and the SME agency KIESA. Overall financial support for research and development is also very limited (less than 0.1% of GDP compared to an average of 2.2% in the EU), particularly for business innovation. Kosovo's Horizon 2020 performance continues to increase, albeit from a very low starting level. The full development of the smart specialisation strategy is still hampered by the lack of availability of most statistical data.

Measure 11: "Improving the research, innovation and entrepreneurship environment"

The actions are well proposed and streamlined. The measure aims to tackle long overdue issues such as the functionalisation of the National Science Council in a well-structured and planned manner. Substantial progress could be achieved in implementing most of the described actions. The activities to be performed by the innovation centres and the sources of funding for their functioning remain unclear. The measure acknowledges the failure to secure the level of investment stipulated by law (0.7% of GDP) but does not indicate how to increase the amounts. The measure is mostly financed by international donors.

Digital economy

The digitalisation of the economy is gradually advancing. With less than 10% of households still unconnected, Kosovo is reducing the infrastructure gap between urban and rural areas and looking to provide high quality broadband to uncovered areas. The Economic and Investment Plan for the Western Balkans will continue to support investment in digital infrastructure to deploy ultra-fast and secure broadband to ensure universal access. Kosovo also engaged constructively in high-level regional dialogue on digital transformation and the implementation of a Regional Roaming Agreement as of 1 July 2019. In addition, the commitments made during the launch of the Common Regional Market at the Western Balkans Summit in Sofia, will see roaming prices in public mobile communication networks for all end users removed this year. However, Kosovo needs to continue to develop the legal framework and necessary infrastructure to stimulate e-commerce and allow for international electronic payments - a hindrance further exacerbated by the COVID-19 crisis, which meant that physical commercial

([81]) OECD (2018a), Competitiveness in South East Asia – a policy outlook 2018.

transactions were largely impossible for several months. Additional efforts are also required to finalise the e-governance strategy. On cybersecurity, Kosovo is improving its legislation to ensure the security of network and information systems; however, it should step up the implementation of relevant measures in this field, particularly by allocating the necessary financial and human resources.

Measure 12: "Extension of relevant ICT networks and services infrastructure for socio-economic development"

This measure has been implemented according to the plan over recent years. Measures are well planned and sequenced. The inclusion of the development of soft skills to utilise investment in infrastructure is much appreciated. Whilst the introduction of 5G infrastructure is envisaged, a more thorough assessment is needed of absorption capacities and the capacity of the authorities to support the preparation of the private sector. The programming and availability of Instrument for Pre-accession Assistance (IPA) funds, and their interlinking with the measure's costing estimates, are well reflected.

Economic Integration

Kosovo is highly reliant on imports and suffers from a chronically high trade deficit. Despite this trend, the trade deficit decreased by 10% in 2020 compared to the year before, reaching EUR 2.82 billion, with imports accounting for EUR 3.29 billion and exports representing EUR 475 million. The increase in exports in 2020 compared to the year before was significant, representing almost 24%. Although this figure continues to be modest in absolute terms the two-digit increase is unprecedented. Previously exports had been almost stagnant, with an average annual growth rate of only 1.44% between 2008 and 2018, whilst imports from the EU grew at an average annual growth rate of 6.2% during the same period. Whilst the export of services helps offset the persistent goods trade deficit to a certain degree, these are mostly dominated by the travel account, which registers expenditure by non-residents (mainly diaspora members) in Kosovo, accounting for around 80% of total services exports in 2019. This source of income was barely affected by the travel restrictions imposed by Kosovo and EU Member States during the traditional travelling seasons. Most of Kosovo's goods exports still consist of basic raw materials and mineral products, reflecting the limited diversification of the production sector. Trade with the EU and the CEFTA region represents almost the totality of trade exchanges. Due to higher growth of exports than imports over the last 10 years, Kosovo has experienced an improved export coverage ratio with the region, from 9.1% in 2008 to 20.3% in 2019. In December 2020, Kosovo's exports to CEFTA countries reached EUR 23 million, or 49.4% of total exports, with an increase of 89.6%. The opposite trend is observed in trade between Kosovo and the EU. CEFTA remains an important market for Kosovo exporters, but obstacles and barriers to trade persist.

Kosovo is encouraged to implement all aspects of the Common Regional Market as it was outlined in the Economic and Investment Plan for the Western Balkans. The Common Regional Market will facilitate Kosovo's integration into regional and European value chains and help increase the attractiveness of the economy for FDI in tradeable sectors, notably by extending the market size. Further connectivity with neighbouring countries in transport and energy will strengthen access to, and integration into, the regional market. The ratification of CEFTA's additional protocols 5 and 6 will help liberalise trade in goods and services and will also create new export opportunities in the dynamic service sectors; it should therefore be implemented swiftly. The creation of a regional digital space and labour markets that are more integrated with neighbouring economies will offer new possibilities for Kosovo's youth, which is also important in light of the high rate of youth unemployment.

Despite being among the most open economies, foreign direct investment (FDI) in Kosovo remains limited (averaging slightly over 4.0% of GDP in 2013-2020), with a negative long-term trend, and mainly originating from the large Kosovo diaspora. By November 2020, FDI amounted to EUR 295 million, which was 15% higher than for the whole of 2019. The sectoral distribution of FDI remains dominated by non-productive sectors, namely real estate and construction, which have a limited impact on the efficiency of Kosovo firms. There is potential to attract more FDI: Kosovo has a good strategic location, a young population and relatively low labour costs, as well as an ever-growing educated workforce with increasing ICT and foreign language skills. Other key issues affecting FDI are the lack of basic infrastructure and stable electricity supply, poor education skills, weak rule of law, corruption and the slowdown in the privatisation process.

Measure 13: "Trade facilitation through reducing the cost of trading transactions"

The measure and its expected outcome is well justified, and the link to the Common Regional Market and the Green Agenda for the Western Balkans represents an important development integrated into the measure. The Ratification of AP6 on trade in goods remains a long-standing issue. The finalisation of negotiations with CEFTA countries on Additional Protocol 7 on the Trade Dispute Settlement in 2021 may appear overly-ambitious since they only started in October 2020. The adoption of the new Law on Internal Trade and the Law on External Trade is feasible, as both pieces of legislation passed the public consultation stage in 2020. However, some activities, such as WTO membership negotiations, entail additional political risk and are dependent on external factors.

Measure 14: "Further development of quality infrastructure and empowerment of the role of market surveillance authorities"

The activities planned for 2021 are realistic and already under preparation with the support of the IPA-funded project. The mitigating measures of capacity building and staff training are important, particularly since the IPA-funded project is coming to an end, and should be well taken care of. The Activities planned for 2022 and 2023 are reasonable and well sequenced. The budget appears small for the activities envisaged: accreditation in particular can be costly.

Transport

Transport links represent less of a constraint on Kosovo's competitiveness than issues connected to other sectors, but further connectivity with neighbouring countries would strengthen the country's integration into the regional market. Investments have been primarily focused on road infrastructure rather than other modes of transport, without a proper balance of resources devoted to the maintenance of roads and railway networks and with an increasing amount of capital investment being directed towards prestige projects without a clear transportation, environmental or development rationale. On rail, the continuing rehabilitation of Route 10 linking southern and northern Kosovo, the Serbian border and Pristina with the capital of North Macedonia represents the biggest investment in Kosovo's railway in four decades (around EUR 200 million) and is poised to improve Kosovo's railway network and its connections to the wider European network both for passengers and freight. However, a much more ambitious plan, including maintenance and integration with European networks, as well as an upgrade of the legislative framework to align it to the EU acquis, is necessary to upgrade the efficiency of Kosovo's railway networks. Regarding aviation, status issues, including a lack of revenue from upper air space management, continue to constrain Kosovo's ability to invest in training, infrastructure and safety. The flagship policy of the Economic and Investment Plan will be the finalisation of the 'Peace Highway' in Kosovo, directly linking Pristina with Niš in Serbia and thus helping to reduce the transport constraints on Kosovo's economy.

Agriculture

Low productivity levels and high production costs characterise Kosovo's agricultural sector. Although it remains relatively large, the sector's share of gross value added continues to decline (9.7% in 2019 compared to 12.8% in 2018). Farmers in Kosovo are faced with several constraints, such as high numbers of small farms and high levels of land fragmentation, outdated farm technologies, lack of production diversification, limited capacity to grow and limited provision of technical support ([82]). Although measures have been developed to address some of these issues (e.g. irrigation systems and organic farming), further investment and efforts are needed to ensure their implementation and to enhance the competitiveness of the agricultural sector in Kosovo. Existing support schemes, currently under review, would benefit from a more holistic approach to developing value chains and integrating them in export markets, instead of direct subsidies for agricultural production and food processing facilities. Other neglected issues are the protection of agricultural land, the environment and less favoured areas (hillsides, rolling land, etc.) with reduced productivity. The sector has only suffered a slight downturn due to the economic fallout from COVID-19: in fact, non-sector-specific business support schemes established as a response to the crisis, coupled with pre-existing agricultural support schemes, have meant that - for some beneficiaries – subsidies have doubled. The Economic and Investment Plan for the Western Balkans has the potential to mobilise further assistance for the sustainable transformation of Kosovo’s agri-food system and rural development.

Measure 3: “Structural changes in the agriculture sector”

The activities planned for 2021 are focused mainly on document drafting rather than project or activity implementation. Taking into consideration the fact that agriculture is considered to be a key sector, the measure fails to address a number of structural obstacles that hinder the development of the agricultural sector, such as the small average farm size, low productivity and high production costs, land fragmentation, low diversification of production, poor irrigation infrastructure, outdated technology, limited storage capacities, weak or dis-functional links between primary producer and processor, and between producers and market, and lack of specialisation. Whilst irrigation is rightly chosen as a priority, the measures are introduced at a slow pace, and the quality of water taken from highly polluted rivers is not addressed. The costs estimated for the implementation of this measure for the period 2021-2022 are sufficient.

Industry

Kosovo’s industry is characterised by low added-value and competitiveness. The sector makes a modest contribution to GDP (around 22% over the past decade) and employment (around 14%). Manufacturing is dominated by food processing and non-metallic mineral products and contributes 70.3% of total exports (with metals and rubber and plastics products accounting for 42% of the total). While manufacturing has the potential to generate quality jobs and raise incomes, high-level and sustained industrial development continues to face structural problems. The sector is dominated by MSMEs with low levels of integration in global value chains, as well as low shares of innovation and FDI reception. While a comprehensive policy framework is currently being studied, existing support services for MSMEs are weak. Inter-ministerial coordination in this policy area is weak and the responsible institutions (such as the Kosovo Investment and Enterprise Support Agency) lack implementation capacity. The emergence of industrial clusters is hampered by the lack of an overall vision based on a solid needs assessment. A number of business parks and economic zones have been identified and are promoted as industrial clusters, but most are currently under-utilised and under-funded. Poor cooperation between companies and educational and research institutions and the generally low level of skills in the labour force lead to low production capacities and a lack of product quality and innovation. The Economic and Investment Plan, which has at its core productive investments based on circular economy principles, could significantly bolster Kosovan industry’s sustainable production and consumption.

([82]) Approximately 93.03% of agricultural holdings, or 100 576, belong to farm size categories of less than 5 ha. (Ministry of Agriculture, Forestry and Rural Development, 2019).

Measure 4: "Increasing competitiveness in the production industry"

The continued effort to establish a coherent industrial policy represents a positive step, however, the implementation of activities under this carried-over measure is slow-paced and remains hampered by the lack of overall vision. Despite claims that the measure is included in the National Plan for Economic Recovery 2020-2021 to mitigate the consequences of the pandemic, it does not address the way in which the production industry was affected, nor does it reflect the support measures of the recovery packages to counter the impact. KIESA support programmes for SMEs should also encourage gender balance and female entrepreneurship. A significant share of the estimated costs are for the construction of infrastructure for economic zones. However, there is still no feasibility study on industrial zones assessing return on investment and their contribution to economic development. Such industrial parks may also privilege companies selected with unclear criteria. Some positive steps were taken to reinforce KIESA's capacity, including increased staffing and financial resources, but additional efforts are required to allow the agency to fulfil its objectives and to be able to promote linkages between multinational enterprises and SMEs. IPA direct funding for SMEs has not been factored into the budget.

Services

In spite of being the driving force of the economy, Kosovo's services sector suffers from a lack of competitiveness and relies heavily on non-tradeable services. With a share of 58.5% of GDP and 70.3% of total formal employment, this sector constitutes the backbone of the private sector (comprising 86% of registered firms) and is mainly composed of non-tradeable activities (accounting for more than two thirds of all sector turnover). Trade in services has shown dynamism in recent years, reflected in a sustained service trade surplus and its significant contribution to Kosovo's current account, driven by the travel and hospitality industries, as well as ICT services. Notwithstanding this, exports of services are strongly dependent on travel services (which represented 65% of total services exports in 2020, which is lower than in previous years), the majority of which were comprised of visits undertaken by members of the Kosovo diaspora (rather than tourism), which raises concerns as to its sustainability in the long run. Moreover, the sector has been highly affected by COVID-19 restrictions on international travel and overall mobility in Kosovo. The development of a competitive tradeable services sector is being held back by an unfavourable business environment, a lack of quality infrastructure and poor access on the part of firms, especially small and medium enterprises (SMEs), to technology and finance.

Measure 5: "Increasing competitiveness in the tourism and hospitality sector"

The measure to develop tourism products in Kosovo's touristic regions has been rolled over from the past ERP. However, the measure is still not sufficiently ambitious to have a significant impact on the economy. The reform of the sector would also require a concrete action plan with allocated resources. As such, the proposed measure is rather limited in terms of making the country more attractive, appealing and recognisable. The measure considers the impact on the environment and the need for inter-institutional cooperation to alleviate that impact but, just as last year, it still fails to include other relevant actions, such as abolishing illegal landfills and cleaning waste across the territory, which is a precondition for attracting tourists.

Measure 6: "Increasing the competitiveness of trade in services"

The measure is well spread over the 3 years; however, the finalisation of negotiations for mutual recognition of professional qualifications in the CEFTA format requires more time and is realistically expected to continue into 2022. The ratification of the CEFTA Additional Protocol AP6 on trade in services is very important and has been delayed for some time, and it should be prioritised in 2021. The Contact Point on Services for trade in services was launched in October 2020. The budget appears too small in relation to the number of activities for the 3-year period envisaged in the proposed reform measure. The amount of support received from IPA funds for the activities listed in this measure is much higher than that stated in the budget table.

Education and skills

This sector and the relevant reform measures 15, 16 and 17 are analysed in Section 4 above, under key challenge #1.

Employment and the labour market

This sector and the relevant reform measure 18 are analysed in Section 4 above, under key challenge #1.

Social dialogue

The potential of social dialogue remains untapped. The reduction in the high level of informality in the labour market may improve the ability of workers to exercise their rights. It could also have a positive effect on the functioning of the social dialogue. However, the structure of the labour market hampers the establishment of a fair relationship between employers and employees. A number of business confederations mostly represent the interests of larger employers, while over 90% of registered companies are micro-enterprises with fewer than 10 employees. Although the legal framework is in place, there is little political will to use social dialogue in the process of drafting policies and legislation. The capacity of social partners, in particular that of trade unions, to influence policy remains limited. A protracted conflict over the composition of the Economic and Social Council (ESC) is to be solved by amending the Law governing the ESC, but progress is pending on this front.

Social protection and inclusion

Kosovo has very high poverty rates by EU and regional standards. The most recent MCC survey (2017) established an at-risk-of-poverty rate of 36.5% (around 10 percentage points above the level for the region as a whole). The level and structure of social spending does not address the needs of the poorest. Expenditure on social transfers (6.2% of GDP in 2019) was well below regional levels, but the scale of expenditure was less problematic than the way it was structured. The biggest proportion of domestic social spending (over 90%) was on complex categorical pension schemes, while only 10% was available for social services and social assistance benefits. According to the latest Household Budget Survey (2017), more than half of households in Kosovo were unable to pay utility bills once or twice during the year. For 44% of households, family budgets were under continuous stress and any increase in one area of household spending or utilities meant that a family had to reduce expenditure on other basic necessities.

Measure 19: “Improving social services and empowering excluded groups”

Some actions have been rolled over from last year’s ERP – such as 2021 key actions which had been anticipated for 2020 – but otherwise the proposed measure represents a major improvement compared to last year’s, and the actions and targets for the upcoming years are far more ambitious. If implemented in full, these could have a significant impact on improving the coverage and quality of social and health services.

7.7. THE 2021 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, 12 July 2021

[…]

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

1. Provide well-targeted and temporary pandemic-related fiscal support to vulnerable households and businesses; provided the economic recovery is well entrenched, foresee in the 2022 budget and medium-term expenditure framework a gradual return to the 2% deficit ceiling, according to the fiscal rule definition, by 2023. With a view to ensuring efficient, fair and sustainable public spending, revise the law on public salaries and prepare a review of the social security system, including war veteran pensions. Undertake a review of tax expenditure quantifying the size of the revenue forgone from exemptions and reduced rates.
2. Improve the execution of capital spending by implementing the administrative instructions on the planning, selection, execution and monitoring of capital projects and advancing multi-annual project planning. To reduce the risk of contingent liabilities, improve the financial oversight and accountability of publicly owned enterprises, including their regular quarterly reporting. Take next steps towards establishing an independent body for fiscal oversight, based on the recommendations of an options paper.
3. Maintain a strong financial sector regulatory framework in line with international best and EU practices, ensure sound credit risk management, a transparent display of asset quality, adequate provisioning, and develop a more integrated framework for measuring household indebtedness. Further reduce the remaining institutional and legal obstacles to swift and effective NPL resolution. Ensure the central bank’s effective functioning by undertaking an in-depth analysis of the staffing requirements in its key policy areas, especially financial stability and financial sector supervision and filling the vacant positions in the board needed to restore its quorum.
4. Adopt a coherent long-term energy and climate strategy for lowering carbon emissions, including plans for a phase-out of coal and fossil fuels subsidies as committed under the Sofia Declaration. In line with the commitments of the Green Agenda for the Western Balkans: increase energy efficiency incentives for the private sector and households and improve the support schemes for renewable energy projects with the introduction of competitive bidding/auctions; adopt an action plan for the gradual adjustment of energy tariffs reflecting actual costs and providing mitigation measures for vulnerable consumers.
5. Update the action plan of the 2019–2023 National Strategy for the Prevention and Combating of Informal Economy, Money Laundering, Terrorist Financing and Financial Crimes, and ensure its implementation. Implement incentive measures with an aim to formalise informal employment and businesses, and address tax evasion in identified high-risk sectors in line with the strategy and the action plan. With an aim to prevent evasion of property income tax, improve transparency by publishing all sales prices of real estate property.

6. Thoroughly apply existing quality assurance mechanisms at all levels of education through increased school inspections and effectiveness of quality coordinators, as well as monitoring of study programmes by the Accreditation Agency. Develop a system to monitor and forecast the skills needs in the labour market to facilitate the alignment of the education and training systems and of reskilling and upskilling provision to labour market needs. Establish an inter-ministerial task force involving relevant ministries, their agencies and stakeholders to develop a Youth Guarantee Implementation Plan.

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

Area/Sector	2016	2017	2018	2019	EU-27 Average (2019 or most recent year)
Energy					
Energy imports dependency (%)	23.6%	30.0%	29.3%	30.1%	60.62%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	447.37	407.79	395.32	385.46	112.92
Share of renewable energy sources (RES) in final energy consumption (%)	24.47%	23.08%	24.62%	25.69%	19.73%
Transport					
Railway Network Density (meters of line per km^2 of land area)	30.5 w	30.5 w	30.5 w	30.5 w	49.0 (2018)
Motorisation rate (Passenger cars per 1000 inhabitants)	144.0 w	154.6 w	157.2 w	162.0 w	519 (2018)
Agriculture					
Share of gross value added (Agriculture, Forestry and Fishing)	13.0%	11.4%	8.9%	9.5%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	4.2% w	4.4% w	3.5% w	5.2% w	4.3%
Utilised agricultural area (% of total land area)	38.2% w	38.2% w	38.5% w	38.6% w	40.0% (2017, EU-28)
Industry					
Share of gross value added	21.5%	21.8%	21.8%	22.1%	19.7%
Contribution to employment (% of total employment)	18.0% w	17.4% w	14.3% w	15.1% w	18.1%

Services					
Share of gross value added	57.4%	56.9%	58.5%	57.8%	73.0%
Contribution to employment (% of total employment)	66.3% w	65.3% w	70.3% w	67.1% w	70.8%
Business Environment					
Rank in WB Doing Business (Source: World Bank)	64	60	40	60	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	N/A	N/A	N/A	N/A	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	(est. up to) 38.8%	N/A	N/A	N/A	N/A
Research, Development and Innovation					
R&D intensity of GDP (R&D expenditure as % of GDP)	N/A	N/A	N/A	N/A	2.20%
R&D expenditure – EUR per inhabitant	N/A	N/A	N/A	N/A	EUR 688.60
Digital Economy					
Percentage of households who have internet access at home	N/A	89%	93%	93%	86% (2018)
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	N/A N/A	82.9% 82.9% w	87.7% 87.7% w	90.71% 90.7% w	85% (2018) 85% (2018)
Trade					
Export of goods and services (as % of GDP)	23.7%	26.7%	26.4%	29.1%	49.4%
Import of goods and services (as % of GDP)	50.9%	52.5%	55.6%	56.1%	45.7%
Trade balance (as % of GDP)	-40.9%	-41.6%	-44.3%	-43.80%	N/A

Education and Skills					
Early leavers from education and training (% of population aged 18-24)	12.7% w	12.2% w	9.6% w	8.2% w	10.2%
Youth NEET (% of population aged 15-24)	30.1% w	27.4% w	30.1% w	32.7% w	10.1%
Formal child care - children aged less than 3 years (% of total)	N/A	N/A	N/A	N/A	35.3%
Individuals' level of digital skills (% of individuals aged 16-74 who have basic or above basic overall digital skills by sex)	N/A	21%	N/A	28%	56%
Employment					
Employment Rate (% of population aged 20-64)	32.3% w	34.4% w	33.2% w	34.2% w	73.1%
Unemployment rate (% of labour force aged 15-64)	27.5%	30.5%	29.6%	25.7%	6.8%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	35.3 pps.	39.4 pps.	38.5 pps.	37.4 pps.	11.7 pps.
Social Protection System					
% of population at risk of poverty or social exclusion	N/A	N/A	56.7%	N/A	20.9%
Impact of social transfers (Other than pensions) on poverty reduction	N/A	N/A	N/A	N/A	32.38%
Self-reported unmet need for medical care (of people over 16)	N/A	N/A	N/A	N/A	1.7%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	N/A	N/A	N/A	N/A	4.99

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

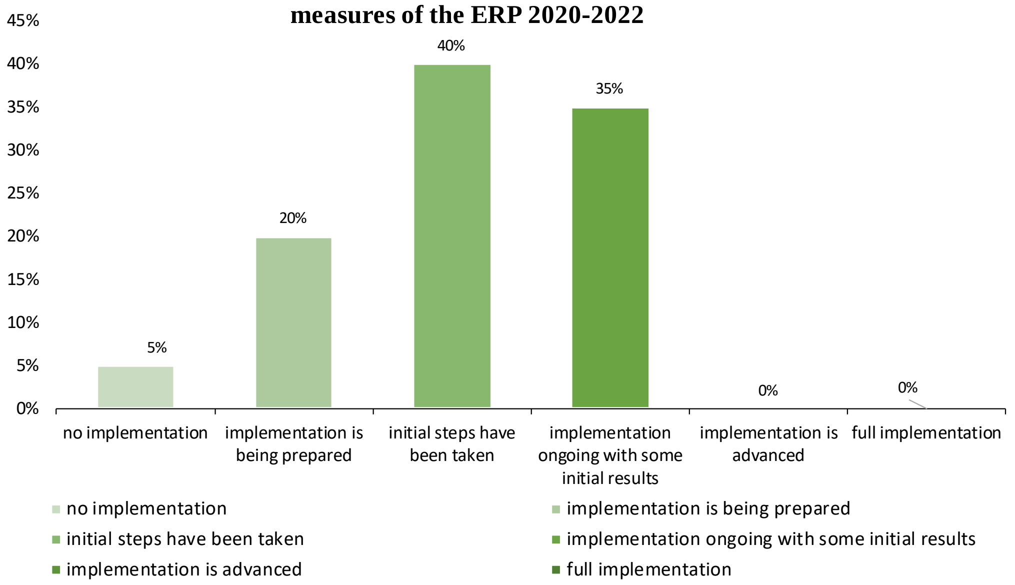
Sources: EUROSTAT and Kosovo Agency of Statistics, unless otherwise indicated.

ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM THE ERP 2020-2022

There was a relatively good progress in the implementation of the measures in 2020, taking into account the many obstacles posed by the health crisis since March 2020, with an average score of 2.5 out of 5. The reporting on the planned activities is generally thorough and provides in general a fair description of the level of implementation. The implementation indicators for reform measure 7 on the adoption of evidence-based policies and reduction of administrative burdens' were not provided, and our internal assessment of the progress of implementation was used.

Implementation is higher in some measures, such as measure 2 on the development of energy generation capacities, measure 6 on increasing competitiveness in the sector of trade in services, measure 17 on the implementation of the new curriculum framework in the VET system. At the same time, implementation is weaker in other measures, such as measure 9 on the establishment and functioning of the commercial court, measure 16 on developing early childhood education, and particularly weak on measure 8 on the implementation of the General Inspection Reform.

Graph II.7.2: **Kosovo - Implementation of the structural reform measures of the ERP 2020-2022**



ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme 2020-2022 was adopted by the government on 27 January 2021 and submitted to the Commission on 29 January 2021, thus within the established deadline. It is in line with the previously approved medium-term fiscal strategy and national development strategy, and the forecasts and modifications made in response to the COVID-19 crisis. No components of the ERP are missing.

Inter-ministerial coordination

The assessment on the inter-Ministerial ERP coordination process is positive, considering the constraints posed by the pandemic crisis and the limited working capacity of the public administration. The ERP was centrally coordinated, with the Ministry of Finance as National Coordinator in close cooperation with the Strategic Planning Office (SPO) within the Prime Minister Office, and 8 area coordinators from the line ministries. This ERP also shows increased cooperation between MF and SPO during the ERP process. However, the coordination between MF, SPO and MIE as National IPA Coordinator is less visible, considering that IPA activities are minimally or incorrectly reflected in the costing part of the structural measures.

Stakeholder consultation

The public consultation process is assessed as satisfactory: considering the COVID-19 restrictions on public gatherings, there was no real possibility for a high level consultation meeting to be organised with different stakeholders such as CSOs, business organisations, IFIs and donors. However, the draft was made available online on 4 December 2020, respecting the rules on minimum criteria for public consultation, allowing two weeks' time for stakeholders to provide their feedback, thus the process could be concluded to meet the minimum criteria. There is no information, however, if the parliament and other regional/local authorities were consulted separately, apart from the opportunity to comment on the draft document through online platform.

Macroeconomic framework

While admitting a number of risks and high uncertainty, the ERP baseline scenario assumes a benign recovery, which is broadly plausible given the base effect of 2020 and provides an adequate basis for assessment. External assumptions are based on the projections of the EC autumn forecast and the IMF's October 2020 World Economic Outlook. The alternative 'low growth' and 'high growth' scenarios are useful for showcasing the likely impact of some expected and unexpected developments and risks in Kosovo's economy. Forecasts for the labour market and the financial sector are still lacking.

Fiscal framework

The fiscal projections are based on the adopted 2021 budget, but include also some elements stemming from the Law on Economic Recovery. The ERP assessment of fiscal projections is based on the ERP annex data, which include some corrections undertaken after the ERP submission. For 2021 the ERP envisages some increase in public revenue and expenditure as compared with the 2020 outcome; these are subject to a number of risks that are acknowledged in the ERP. The 2020 fiscal outturn is not fully consistent with the main text, the updated data were provided after the ERP submission. While the information on the intended debt management was provided upon request after the ERP submission, the ERP provides a useful debt sustainability analysis under three negative shocks.

Structural reforms

The structural reform priorities follow the guidance note and largely reflect the challenges in the priority area. Some activities are over-ambitious and too unrealistic to be implemented in the planned timeframe, while most activities have been affected to some degree by the COVID-19 crisis. With some exceptions, the reporting on the implementation of the policy guidance is sufficient but additional explanatory information could have been included in those actions with only initial or limited implementation. The reporting on implementation of structural reforms is partially sufficient. The number of reform measures respects the limit of 20. However, the page limit is exceeded. Table 9 is appropriately filled. Tables 10a and 10b and table 11 are only partially correct. There are some inconsistencies in the rating of the implementation of the reforms. Table 12 is filled in appropriately.

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