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2022 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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European Commission

Directorate-General for Economic and Financial Affairs

Directorate-General for Neighbourhood and Enlargement Negotiations

Directorate-General for Employment, Social Affairs and Inclusion

2022 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.

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INTRODUCTION

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

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

In early 2022, Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, Serbia and Turkey submitted their eighth annual Economic Reform Programmes covering the period 2022-2024 ⁽¹⁾. The programmes were 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, held on 24 May 2022.

This paper contains the Commission staff's assessments of the ERPs for 2022-2024, 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 2021. The cut-off date for the assessments was 8 April 2022.

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

Comments would be gratefully received and should be sent to:

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

⁽¹⁾ The Economic Reform Programmes can be found at https://ec.europa.eu/neighbourhood-enlargement/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 May 2022.

Part I

Horizontal Overview of the 2022 Programmes

1. HORIZONTAL OVERVIEW OF THE 2022 PROGRAMMES

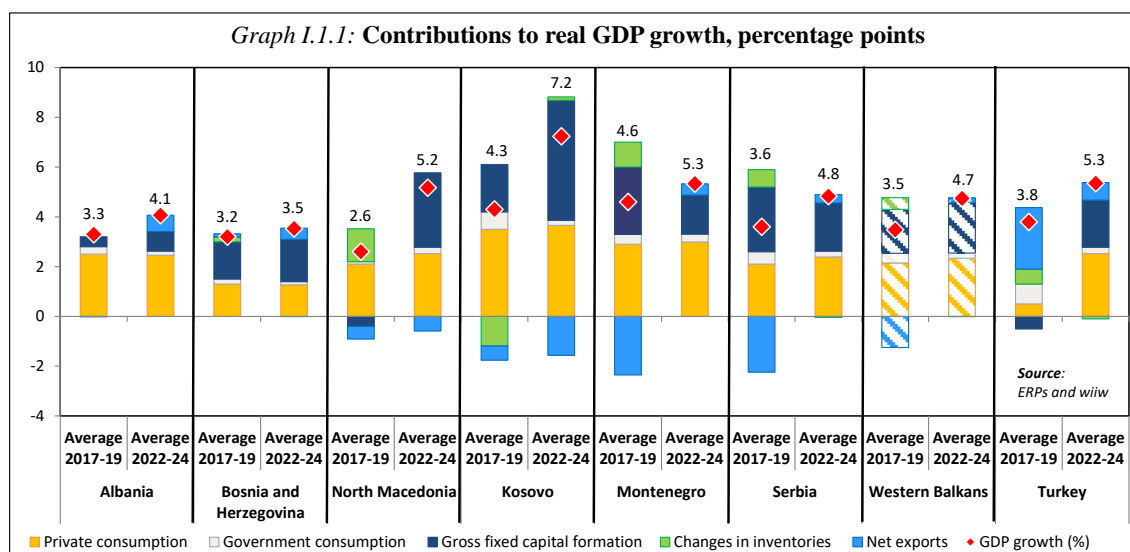
1.1. INTRODUCTION

The macro-fiscal projections of Economic Reform Programmes (ERPs) were all superseded by the economic fallout of Russia's war of aggression against Ukraine. Because the ERPs had been prepared and submitted before the war started and its consequences became apparent, they could not take into account the resulting shocks to the economies of the Western Balkans and Turkey (even if the increase in commodity prices had started before the war). The channels through which the countries are affected by the war are largely similar but the impact is set to differ, reflecting differences in: (i) each country's direct and indirect trade links; (ii) each country's energy intensity; (iii) the significance of food price inflation; and (iv) the role of tourism. Nevertheless, the ERPs' baseline projections are a useful yardstick against which the economic impact of the unfolding events can be measured. Moreover, the programmes' structural reform priorities remain highly relevant. In some cases, such as the energy transition-related challenges, these structural reform priorities have even gained in importance. The Commission published its updated macroeconomic projections for candidate countries as part of its spring forecast in May 2022.

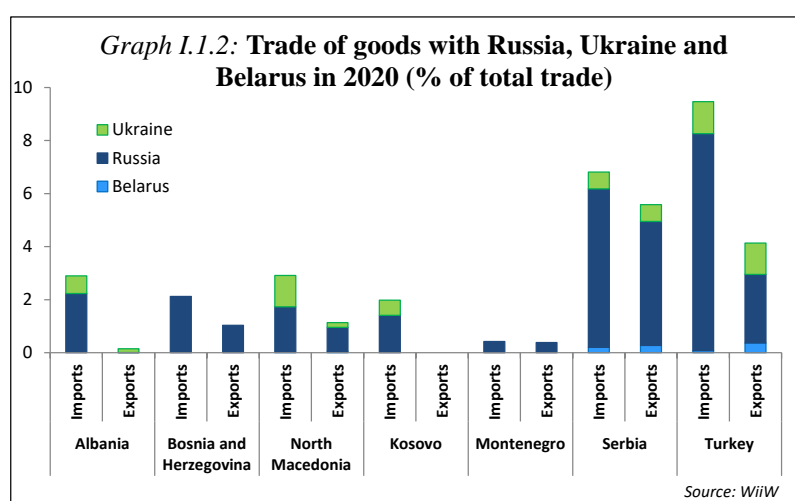
1.2. MACROECONOMIC AND FISCAL DEVELOPMENTS AND OUTLOOK

Economic growth rebounded strongly in the Western Balkans and Turkey in 2021. Following the strong negative impact of the COVID-19 pandemic in 2020, the economies of the Western Balkans and Turkey recovered quickly in 2021. The strength of the upturn varied widely across the economies. There was double-digit growth in 2021 in Montenegro (after a contraction of a similar size in 2020), Turkey and Kosovo. A somewhat slower but still strong pace of expansion was recorded in Albania (8.6%), Serbia (7.4%) and Bosnia and Herzegovina (5.8%). And there was a more moderate output gain of 4% in 2021 in North Macedonia. The lifting of pandemic-related restrictions and the base effect from strong downturns in 2020 (in particular due to the sectoral share of tourism) played a significant role in the rebound in some countries, accounting in particular for the very strong expansion in Montenegro. The main drivers of the solid rebound across the region were: (i) buoyant private consumption, fuelled by pent-up demand and continued crisis-mitigation support measures in some countries; (ii) increased investment, in particular public capital spending in Serbia and North Macedonia; and (iii) strong growth in exports, especially in the case of Turkey.

All ERPs project economic growth rates to exceed pre-2020 rates of expansion in 2022-2024. In particular, Kosovo and North Macedonia project that their average annual economic growth rates in 2022-2024 will outpace their average pace of expansion in 2017-2019 by around 3 pps., and Turkey projects that its growth rates in this period will be around 1.5 pps. greater than in 2017-2019. The ERPs of Serbia and Albania expect average annual growth to be around 1 pp. higher than in the pre-COVID-19 years, while for Montenegro and Bosnia and Herzegovina annual growth is projected to be around half a percentage point higher than in the 3 years before the crisis. 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. Although net exports are projected to make a slightly negative or neutral contribution to growth in Kosovo and North Macedonia in 2022-2024, they are expected to contribute positively to growth in Albania, Bosnia and Herzegovina, Montenegro, Serbia and Turkey.



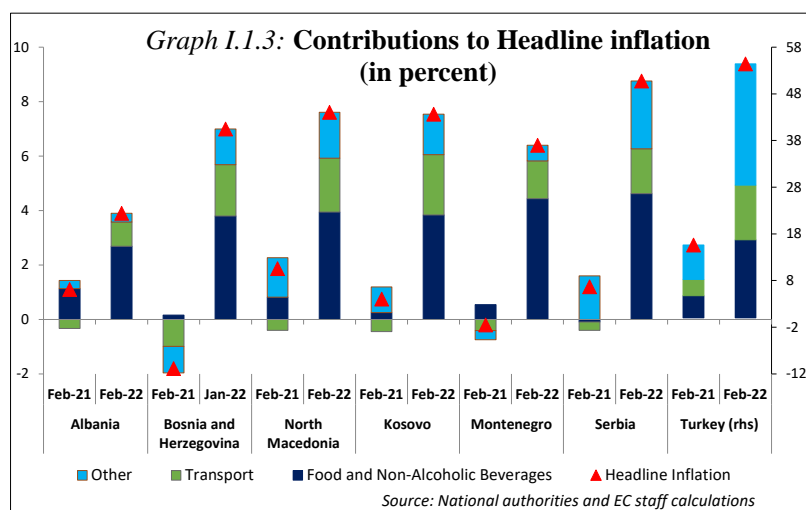
The ERPs' baseline growth projections will have to be revised downwards in a context of sizeable adverse shocks and continued high uncertainty. As is the case in other countries, the growth outlook for the Western Balkans and Turkey in an uncertain economic environment is heavily impacted by: (i) the economic fallout of Russia's war against Ukraine; (ii) the future course of the COVID-19 pandemic; (iii) supply-chain disruptions as a result of both the war and the pandemic; (iv) global inflationary pressures; and (v) likely tightening financial conditions. Russia's invasion of Ukraine has led to rising energy and food prices and a deteriorated growth outlook in the Western Balkans' and Turkey's main trading partners in the EU. At the same time, the direct impact of the war through reduced goods trade with Russia and Ukraine is overall expected to be more limited, albeit somewhat greater in Serbia and Turkey (see Graph 2). In the case of Montenegro and Turkey, fewer tourists from Russia and Ukraine may also significantly affect their tourism sectors, given that tourists from these countries usually make up a sizeable percentage of total arrivals.



The ERPs' growth projections were already subject to downside risks before Russia's invasion of Ukraine. Baseline growth projections, in particular for Montenegro, North Macedonia and Kosovo, rely heavily on substantial increases in public investment. However, these increases may be challenging to achieve given persistent weaknesses in public-investment management and a track record of low

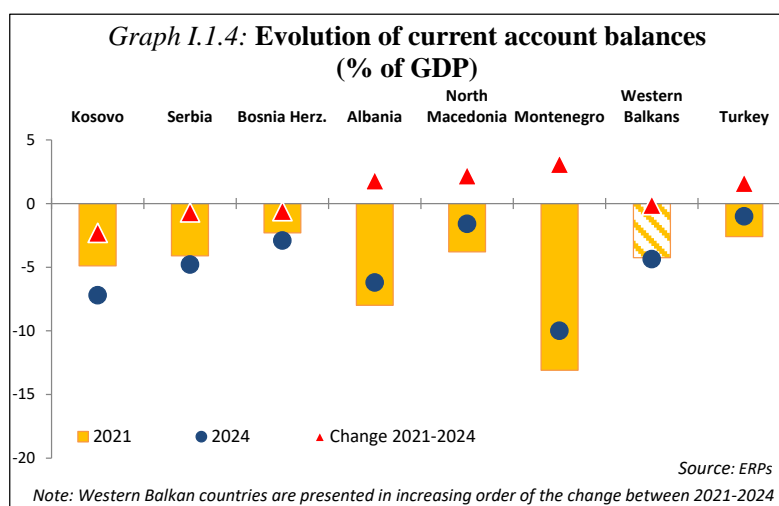
implementation rates of the capital budget. In Turkey, the risks related to the country's continued overly loose monetary policy contribute to additional uncertainty. In combination with the country's vulnerability to changes in investor sentiment, this additional uncertainty might further weigh on the economic outlook for Turkey. Most ERPs (with the exception of Kosovo and Turkey) include at least one scenario of lower growth. However, these low-growth scenarios are not always well elaborated and remain in general too benign in the current situation.

Inflation has accelerated substantially in the Western Balkans, while Turkey faces strong continuing price pressures and the risk of out-of-control inflation. After a crisis-induced trough in 2020 and early 2021, inflation started to increase substantially in the Western Balkans in mid-2021, driven by food and energy prices. The impact was increased by the relatively high weight of food and energy in the consumer price baskets in the Western Balkans, while core inflation rose more moderately. The Western Balkan ERPs expect the surge in inflation to be temporary, with the projected stabilisation of energy and food prices helping inflation to gradually decelerate in mid-2022 and to return to moderate levels in 2023-2024, although there is clearly a risk that inflation could remain elevated for longer. In Turkey, after some stabilisation in 2020 and early 2021, the effect of global price pressures was aggravated by unorthodox monetary policy decisions, which drove inflation up to a two-decade high of more than 60% in April 2022, denting disposable incomes and eroding consumer confidence. The unorthodox monetary-policy stance led to a deeply negative real policy rate and triggered a large depreciation of the lira. This has led to a series of unconventional measures, such as a scheme protecting the foreign-exchange value of lira time deposits, in an effort to reverse dollarisation and ease the pressure on the lira. However, this has come at the cost of increased uncertainty and potentially large contingent liabilities for public finances. The Turkish ERP has not taken the latest major policy and market developments into account, and it projects an inflation path that is notably lower than market expectations were at the time of drafting, while risks of rampant inflation have already materialised.

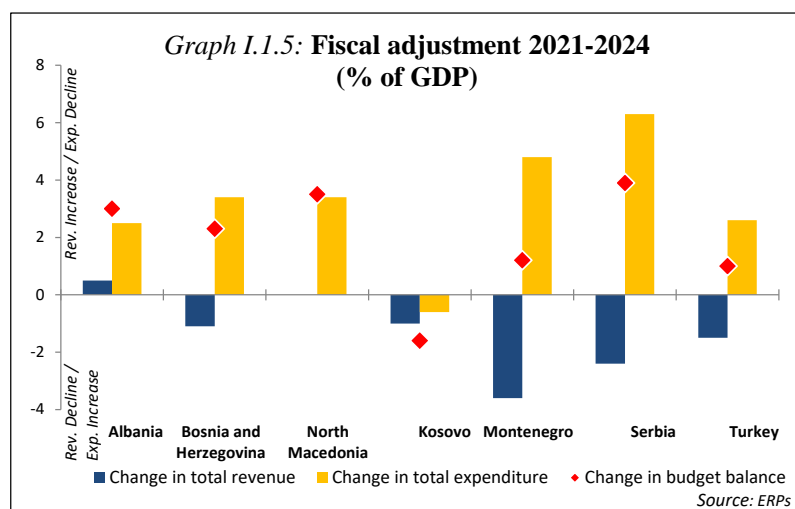


The ERPs mostly forecast current account deficits to narrow over 2022-2024. After a substantial deterioration in 2020 in most of the Western Balkans and Turkey (except for Serbia), the current account broadly stabilised in 2021 in most of the Western Balkans. This was because higher merchandise deficits tended to be broadly offset by larger services surpluses and higher remittances. The current account balance improved markedly in Montenegro, Turkey and Kosovo, mostly driven by particularly high increases in exports of services, especially tourism. Serbia and Bosnia and Herzegovina project a moderate increase in the current account deficit in 2021-2024, while Kosovo forecasts a more substantial

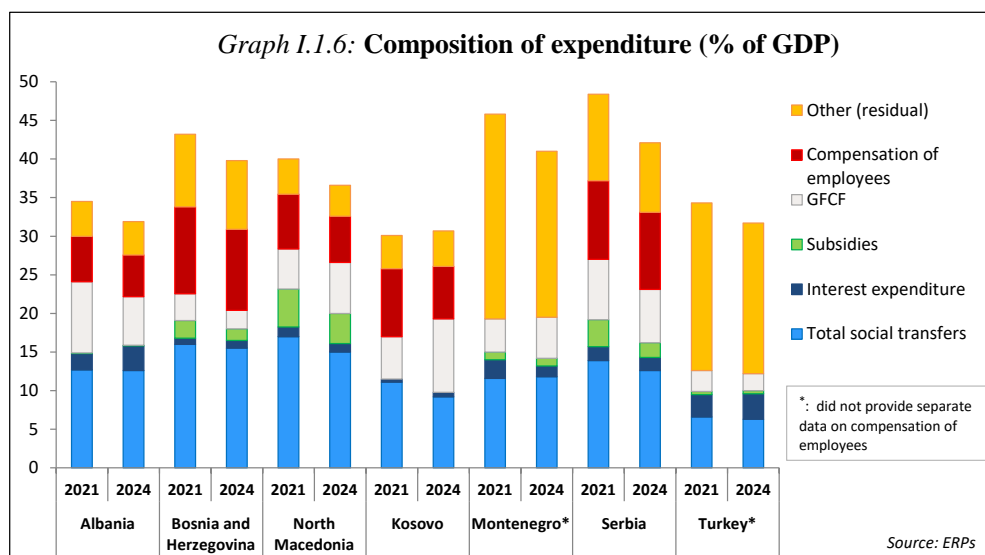
deterioration due to the robust growth of imports driven by high expected capital spending. The ERPs of the other three Western Balkan countries and Turkey project a gradual decline of their current account deficits. These projections are subject to large uncertainties, in particular related to the development of energy and food prices in the context of the economic fallout of Russia's war against Ukraine. On the issue of securing the necessary external financing, the Western Balkans expect to continue to rely mainly on inflows of foreign direct investment, although these inflows are subject to increased uncertainties and the prospects of lower growth. On external borrowing, several Western Balkan countries (Serbia, North Macedonia and Albania) managed to tap international markets and issue sizeable Eurobonds on favourable terms in 2021, and all Western Balkan countries and Turkey benefited from the allocation of special drawing rights by the IMF. However, the tightening of global financial conditions that began in early 2022 – and potential further tightening in the future – may have negative repercussions on capital flows into both the Western Balkans and Turkey. Foreign reserves at the end of 2021 were able to cover 6 or more months of imports in Serbia, Montenegro, Albania and Bosnia and Herzegovina, and more than 4 months in North Macedonia.



The economic recovery helped improve public finances in 2021, and the ERPs plan further gradual fiscal consolidation in 2022-2024. There were substantial decreases in fiscal deficits across the Western Balkans in 2021. This was due to a combination of strong revenue performance, driven by the economic rebound and rising inflation; and contained expenditure growth due to lower crisis-mitigation costs and under-execution of capital expenditure. The results of this can be seen in the budget balance improving in 2021 by an estimated 9 pps. in Montenegro, 6 pps. in Kosovo, 4 pps. in Serbia, 3 pps. in North Macedonia, 2 pps. in Albania and around 1 pp. in Bosnia and Herzegovina. Following their high peaks in 2020 due to COVID-19, general government deficits then fell to more moderate levels in 2021 of around 5% in North Macedonia and Albania, around 4% in Serbia, 2% in Montenegro and as low as around 1% in Kosovo and Bosnia and Herzegovina. In Turkey, the general government deficit is estimated to have only slightly declined to around 3% of GDP in 2021, as buoyant tax revenue from strong domestic demand and rampant inflation, reduced pandemic-related budget support, as well as inflation-induced suppression of real personnel expenditures and current transfers have been partially offset by budget lending to state-owned enterprises to cover some of the surging energy costs.

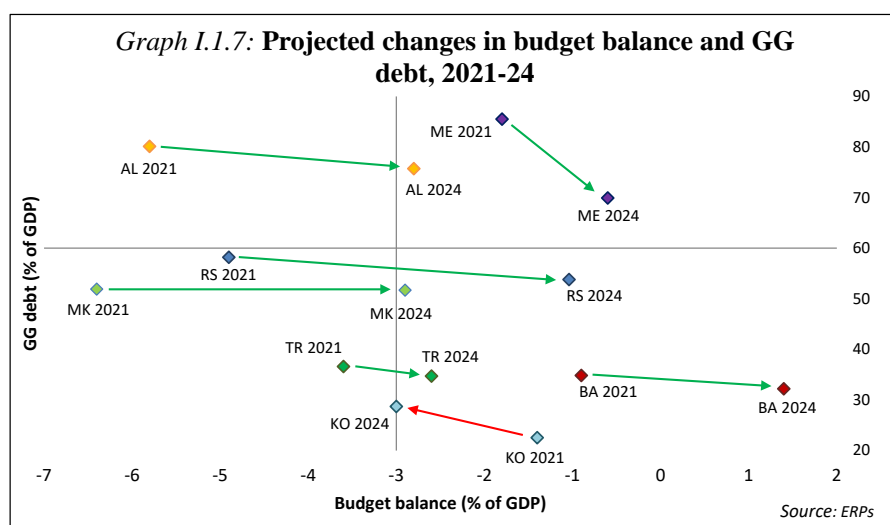


The ERPs project a further gradual improvement in the budget balance over the programme horizon. This further improvement is already forecast for 2022 in North Macedonia, Serbia and Bosnia and Herzegovina. However, the ERPs for Montenegro, Kosovo and Albania plan some back-loaded improvement starting in 2023 after a deficit increase in 2022 in these three countries compared to the better-than-expected 2021 outturn. The budget-balance improvements are mostly projected to be achieved via a reduction in spending as a share of GDP, with only Albania projecting increases in its relatively low revenue-to-GDP ratio). In all countries, the fiscal measures that have already been adopted to mitigate the impact of rising energy and food prices, combined with the contractionary economic fallout from Russia's war against Ukraine, could possibly derail or decelerate the fiscal consolidation planned in the ERPs.



Most ERPs project the debt-to-GDP ratio to broadly stabilise or decrease between 2021 and 2024, with only Kosovo expecting its relatively low debt-to-GDP ratio to increase in this period. After surging across the Western Balkans in 2020, public debt-to-GDP ratios broadly stabilised in 2021. The debt-to-GDP ratio decreased by almost 20 pps. for Montenegro, mostly due to a large growth effect and the reduction of the government's large cash buffer by around 7 pps. of GDP, which was used to pay back maturing debt. Over the course of the future ERP period, the main driver of the expected debt decrease is

in most cases the favourable ‘snow-ball’ effect, as the rate of nominal growth is projected to exceed the effective interest rates for all Western Balkan economies. In Bosnia and Herzegovina, the primary surplus is expected to contribute most to the decrease of the debt-to-GDP ratio. Turkey’s ERP projects a slight decrease of the deficit level to around 3% of GDP (close to the 2021 outturn) and a stabilisation of the debt ratio at around 35% of GDP throughout the programme period. However, this projection does not reflect the strong debt-increasing effect of the lira depreciation in 2021, which resulted in an outturn above 40% of GDP in 2021 (around 3.5 pps. higher than estimated by the ERP).



1.3. MAIN CHALLENGES

Although further support to households and businesses most affected by adverse shocks appears necessary, the implementation of structural reforms also needs to accelerate to foster a sustainable recovery in the medium term. Although the enlargement region has experienced a strong rebound from the COVID-19 crisis in 2021, the economic fallout of the war against Ukraine risks inducing a considerable slowdown. Among other channels, this slowdown risks occurring through higher energy and food prices and decelerating trade and investment. This calls for measures that use the available fiscal space to mitigate the impact of these adverse shocks on businesses and households – if necessary until the economic recovery is firmly entrenched. At the same time, the implementation of structural reforms 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 11 main areas. The paragraphs below contain a discussion of each of these 11 challenges.

First, fiscal policy should stand ready to mitigate adverse impacts from the pandemic and Russia’s war against Ukraine by well-targeted and temporary fiscal measures. Thereafter, conditional on the recovery becoming well entrenched, a gradual consolidation of deficit and debt levels is needed to rebuild largely depleted fiscal buffers. There is a great deal of uncertainty about the potential further effects of the COVID-19 pandemic and the economic fallout of Russia’s war against Ukraine. Given this uncertainty, it appears appropriate for fiscal policy to stand ready to mitigate, if needed, adverse impacts on growth, employment and social cohesion via appropriate fiscal measures until a self-sustained recovery is firmly established. 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 warranted in the medium-term fiscal frameworks presented together with the 2023 budgets. This will help to ensure gradual debt reduction and rebuild fiscal buffers.

Second, continued efforts should also be made to shift budgets towards a more growth-oriented composition to better support the recovery, in particular by fostering the digital and green transitions. All Western Balkan partners, except for Serbia, plan to increase public capital spending as a share of GDP in 2022, while Kosovo and North Macedonia project to further increase this share over the remaining programme horizon. To durably maximise the growth-enhancing effect of increased capital allocations, all partners need to ensure that these are accompanied by higher efficiency and a proper cost-benefit analysis of investment projects. This includes: (i) improvements in investment management (such as project planning and selection); (ii) avoiding supply-side shortages stemming from a sudden increase in public investment focused on specific areas; (iii) potential reprioritisation given crisis-induced structural changes and the needs of the green and digital transitions; and (iv) fully benefiting from EU funding. Appropriate resources also need to be allocated to increase human capital and mitigate the risk of ‘scarring’ effects of recent adverse shocks through investments in education, training and health.

Third, given the considerable crisis-induced deterioration of fiscal positions, fiscal-structural reforms to strengthen medium-term debt sustainability should be prioritised. 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 strengthening fair, transparent and sustainable public wage and pension systems as well as better targeting of social transfers. The partner countries should also continue to monitor and address fiscal risks stemming from public guarantees, inefficient state-owned enterprises, and often non-transparent public-private partnerships. Fiscal risks stemming from these areas may have become more acute following recent crises and the policy response to them. 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 become firmly established.

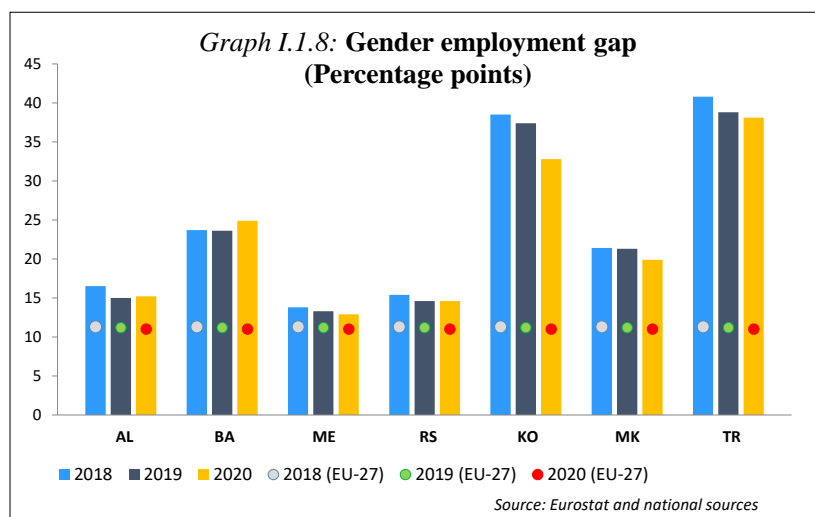
Fourth, the Western Balkans and Turkey need to closely monitor and address inflation developments and the impact of adverse shocks on the financial sector. Given persistent price pressures, price developments need to be carefully monitored and monetary policy may need to be tightened (where monetary policy tools are available) to ensure price stability in the medium term. Macro-prudential indicators have overall remained sound, and capital-adequacy ratios in the region’s banking sectors are well above minimum requirements in the Western Balkans. Nevertheless, there may be pockets of vulnerability and some lagged impact from both the pandemic-induced crisis and the recent price shocks. The ratio of non-performing loans (NPLs) has remained stable and in some cases even decreased in 2021. However, the end of forbearance measures and the economic fallout from the war in Ukraine may lead to some deterioration in banks’ asset quality that need to be closely monitored and addressed via strengthened legal and regulatory frameworks for NPL resolution. In line with the economic rebound, credit growth picked up in 2021 in Albania, Kosovo, Montenegro and Bosnia and Herzegovina, while Serbia and North Macedonia recorded some deceleration in the rate of credit growth, reflecting mainly the phasing-out of crisis-support schemes. Annual credit growth also slowed down to 23% in Turkey, while the country’s NPL ratio remained low. Turkey’s banking sector is adequately capitalised, but high dollarisation in the country poses a particular challenge.

Fifth, all seven economies face challenges with their business environments and a high degree of informality. For most of them, the regulatory and institutional environment remains a key challenge hampering private-sector development and competition. Several economies also face problems with still-sizeable and still-unprofitable state-owned enterprises. This leads to a misallocation of resources and creates unfair competition that holds back private companies. All seven enlargement partners struggle with corruption, legal unpredictability and slow legal procedures, making their economies less attractive to foreign and domestic investment. To overcome these challenges, there is a need for effective and well-coordinated structural reforms to improve the business environment and the investment climate. These reforms should include significant efforts to strengthen the rule of law and institutions to fight corruption. Although 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: (i) the weak overall institutional and regulatory environment; (ii) insufficient enforcement capacity of the public authorities; (iii) corruption; and (iv) a 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 reduced job security and safety at work. To overcome these challenges, there is a need to incentivise tax compliance in a variety of ways, such as public-awareness measures, a simplification of administrative procedures, lower ceilings for cash transactions, and strengthened law enforcement in this area.

Sixth, Russia's war in Ukraine is already having significant spill-over effects, changing the risk profile of the economies on several fronts. In the energy sector, the market is suffering from reduced gas supply from Russia. This has led to upward pressure on energy prices and to reduced security of supply. These problems are affecting Serbia, North Macedonia and Bosnia and Herzegovina in particular, each of which import between 85% and 100% of their gas supply from Russia. The disruption in supply chains is also driving upwards pressure on food prices, through reduced supply of wheat and necessary fertilisers. Finally, perceived and real risks for investors are higher – in turn making it more difficult to mobilise private-sector finance. Reducing vulnerability to external shocks and increasing food and energy security has become crucial. It is essential to accelerate the clean-energy transition by promoting energy-efficiency measures, accelerating the deployment of renewable energy, and diversifying the energy and electricity mix.

Seventh, the lack of regional economic integration in the Western Balkans prevents the region from achieving its full growth potential. All Western Balkan partners have committed to boosting regional cooperation and to creating a common regional market, based on the four freedoms (free movement of goods, services, capital and people) that also covers cooperation in 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 stimulate 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 to already integrate the region more closely with the EU single market before EU accession, which will further contribute to the region's economic growth.

Eighth, there are key challenges in the labour market. Two of the most serious of these challenges are the low rates of labour-market activity, especially among women and young people and poorly targeted active labour market policies to help people find work or training.



Despite positive labour-market developments in most economies before the onset of the COVID-19 pandemic, the enlargement partners continue to be characterised by overall low activity and employment as well as by high unemployment. Although the latest figures show some signs of recovery in the labour market, structural challenges remain. Two of these structural challenges are the under-employment of workers and the lower integration of women, young people, and less represented ethnic groups in the labour market. The gender employment gap in 2020 in the partner economies ranged from around 13-15 pps. in Montenegro, Serbia and Albania to around 33 pps. in Kosovo and 38 pps. in Turkey. These gender gaps are all well above the EU-27 average of 11 pps. (see Graph 8 and Annex table III). The outreach and coverage of support services for jobseekers are limited. Active labour market policies to help people find work or training are not sufficiently targeted at people most in need, such as the long-term unemployed, and only a small range of measures is on offer. The Western Balkan partners committed in July 2021 to gradually set up and implement ‘Youth Guarantee’ schemes (modelled on the Youth Guarantee schemes in the EU, which guarantee jobs or training for people under the age of 30), and most of them set up inter-ministerial expert groups to develop Youth Guarantee implementation plans. North Macedonia is a front-runner in this area, implementing a Youth Guarantee scheme countrywide since 2019. Roughly 20-30% of the workforce are estimated to be engaged in undeclared work in the partner economies. 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, remains weak.

Ninth, social spending is not well targeted towards 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 partner economies and are set to be exacerbated by recent strong increases in food prices. Means-tested social assistance schemes are under-funded, and there are gaps in coverage of those most in need. The low support levels are ineffective in reducing poverty. On the other hand, relatively generous non-means-tested social benefits, for instance to war-veterans, might create disincentives to work. Income inequality is higher than the EU-27 average, but has been falling in most cases. People in vulnerable situations also

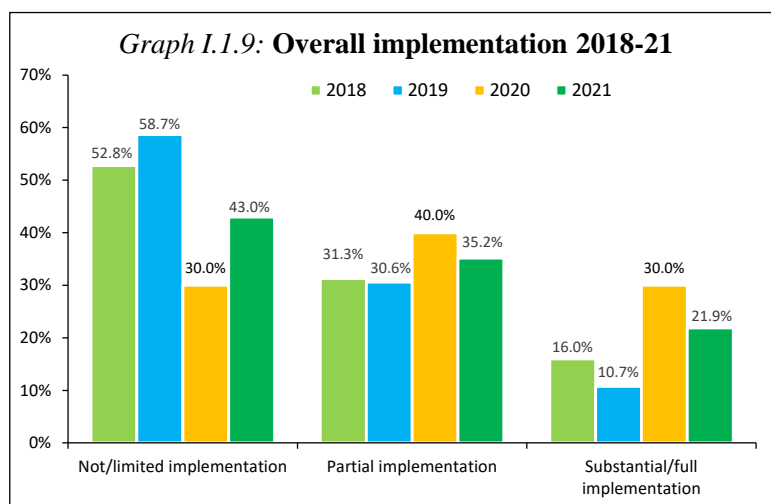
have difficulties in accessing social-care services, the coverage of which is weak and at times non-existent in remote and rural areas.

Tenth, structural mismatches in skills persist, due to under-investment in human capital and weak education systems, including vocational education and training (VET) that is poorly adapted to the needs of the labour market. The education systems in the Western Balkans and Turkey face challenges – starting in early childhood education and care (ECEC) and running all the way up until the transition to the labour market and adult education. Enrolment in ECEC is particularly low in the region compared to the EU, and potentially affects 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 on the one hand and the needs of the labour market on the other often impedes a smooth transition from school to work. VET schools do not provide appropriate skills that match employers' needs, and work-based learning is rather limited. Furthermore, the low rates of participation in adult learning and the lack of awareness in the population of the need to acquire qualifications in lifelong learning remain an issue. The training of teachers for all levels of the education system remains a challenge for most economies.

Eleventh, universal coverage and equal access to essential healthcare services for all remain challenging. Public expenditure on healthcare as a percentage of GDP in the Western Balkans and Turkey is well below the EU-27 average. In addition, health insurance coverage is in general lower than in the EU, with the exception of Serbia. Those not covered by health insurance include: (i) unregistered workers; (ii) young people not in education, employment or training; (iii) people without ID documents; (iv) many farmers; (v) Roma; and (vi) people living in remote and rural areas. Unmet needs for medical care are higher than the EU-27 average (which was 1.8% in 2020) in all enlargement economies and significantly higher in Albania and Kosovo. The main reported reason for unmet medical needs was financial barriers, and women and people aged over 65 were more affected than other groups. In 2020, the numbers improved for all economies for which data are available, and almost equalled the EU-27 average of 1.8% for Turkey (1.9%) and Montenegro (2.1%). Out-of-pocket expenditure as a share of current health expenditure is also high in the partner economies and is more than double the EU-27 average (except for Turkey where it is close to the EU-27 average), resulting in an increased financial burden for households. There is a need to strengthen the financing of the healthcare sector in the Western Balkans and Turkey, as well as to improve access to – and the affordability of – high-quality healthcare.

1.4. IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED IN 2021

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.



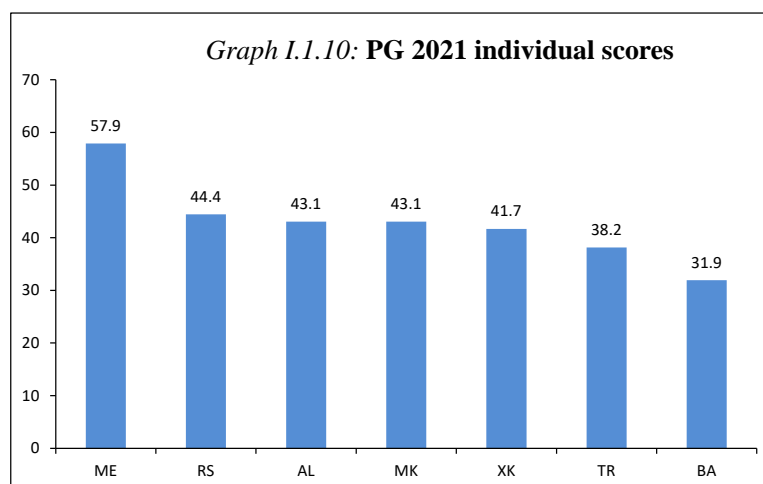
The guidance represents the participants' shared view of the short-term policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the PG is similar to that of the country-specific recommendations usually adopted under the European Semester process for EU Member States. Implementation of the PG is evaluated by the Commission in the following year's ERP assessments ⁽³⁾.

The level of implementation of last year's policy guidance worsened across the board. This is partly linked to the return in 2021 to policy guidance on more challenging reforms after the focus on short-term COVID-19 crisis-related measures in 2020. The average score in implementing the policy guidance across the Western Balkans and Turkey has substantially decreased, falling from 50.8 out of 100 for the implementation of the policy guidance adopted in 2020 to 42.9 in 2021 ⁽⁴⁾. More than two fifths (43%) of the 2021 policy recommendations saw no or only limited implementation, which is a deterioration compared to last year, but nevertheless the second lowest overall percentage so far. Less than a quarter of the PG (21.9%) has been substantially or fully implemented. Still, this is the second best performance since 2017 after the exceptionally high score of implementation of the COVID-19-focused PG from 2020 (see Graph 9). When performance is broken down by individual partners, the scores display some variation, but 4 out of 7 managed a score greater than 40 (see Graph 10). Overall, the implementation of the policy guidance adopted in 2021 is assessed as 'partial' ⁽⁵⁾ for most partners, with Montenegro achieving the highest score (57.9) while Turkey and Bosnia and Herzegovina are trailing behind (with scores below 40).

⁽³⁾ The detailed evaluation of individual PG items can be found in Section 5 of the Commission's ERP assessments.

⁽⁴⁾ 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.

⁽⁵⁾ The assessment categories are as follows: limited implementation (0<37.5), partial implementation (37.5-62.5), substantial (62.5-87.5), and full implementation (87.5-100).



1.5. CONCLUSIONS

As presented above and in the individual Commission staff working documents, there are many macro-fiscal and structural challenges in the Western Balkans and Turkey. These challenges are to some extent similar to challenges that EU Member States are facing. These are compounded by the current high degree of uncertainty about the potential further effects of the COVID-19 pandemic and the economic fallout of Russia's war against Ukraine. This requires governments to stand ready to take appropriate policy responses to mitigate adverse shocks. Against this background, the ERP-based economic and financial dialogue has become even more important as a forum to share experiences, discuss policy strategies, and jointly agree on priority reforms to foster sustainable public finance and resilient growth. Confronted with growing instability, strategic competition and security threats, the EU has decided to take more responsibility for its security and take further decisive steps towards: (i) building European resilience; (ii) reducing dependencies; and (iii) designing a new growth and investment model for 2030, a model which includes building a more robust economic base. This also implies the need for greater energy diversification and for accelerating the twin green and digital transitions. These objectives of good governance and economic prosperity are also relevant for the Western Balkans and Turkey, and can best be achieved by addressing the challenges outlined above.

Table I.1.1:

Economic Reform Programmes 2022 - Key indicators

	2018	2019	2020	2021e	2022	2023	2024
Real GDP growth (% change)							
Albania	4.0	2.1	-4.0	8.7	4.1	4.2	3.9
North Macedonia	2.8	3.2	-6.1	4.1	4.6	5.2	5.7
Montenegro	5.1	4.1	-15.3	13.4	6.4	5.1	4.5
Serbia	4.5	4.3	-0.9	7.0	4.5	5.0	5.0
Turkey	3.0	0.9	1.8	9.0	5.0	5.5	5.5
Bosnia and Herzegovina	3.3	2.8	-3.2	3.1	3.4	3.5	3.7
Kosovo	3.4	4.8	-5.3	9.7	7.8	7.1	6.8
Unemployment rate (% , LFS)							
Albania	12.8	12.0	12.2	11.4	10.3	9.4	8.9
North Macedonia	20.7	17.3	16.4	15.8	14.4	12.9	11.4
Montenegro	15.5	15.4	17.9	16.7	15.8	14.6	13.6
Serbia	13.7	11.2	10.1	11.0	10.2	9.1	8.0
Turkey	10.9	13.7	13.2	12.6	12.0	11.4	10.9
Bosnia and Herzegovina	18.4	15.7	15.9	17.8	16.9	15.9	15.1
Kosovo	29.6	25.7	25.9	25.8	:	:	:
Current account balance (% of GDP)							
Albania	-6.8	-7.9	-8.8	-8.0	-7.3	-6.9	-6.2
North Macedonia	-0.1	-3.3	-3.4	-3.8	-3.8	-2.4	-1.6
Montenegro	-17.0	-14.3	-26.1	-13.1	-10.5	-10.2	-10.0
Serbia	-4.8	-6.9	-4.1	-4.1	-4.4	-4.4	-4.8
Turkey	-2.8	0.7	-5.0	-2.6	-2.2	-1.5	-1.0
Bosnia and Herzegovina	-3.1	-3.0	-2.6	-2.3	-2.5	-2.6	-2.9
Kosovo	-7.6	-5.7	-7.0	-4.9	-5.5	-6.5	-7.2
Inflation (CPI, annual % change)							
Albania	2.0	1.4	1.6	2.0	2.8	3.0	3.0
North Macedonia	1.5	0.8	1.2	3.2	2.4	2.0	2.0
Montenegro	2.9	0.5	-0.3	2.1	2.3	1.8	1.5
Serbia	2.0	1.8	1.6	4.0	4.9	3.0	3.0
Turkey	16.3	15.2	12.3	19.6	12.2	8.4	7.6
Bosnia and Herzegovina	1.4	0.6	-1.0	1.1	0.9	0.8	1.0
Kosovo	1.1	2.7	0.2	3.3	2.5	2.2	2.0

Sources: Economic Reform Programme (ERP) 2022 for 2020-2024, CCEQ for 2018 and 2019.

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

Table I.1.2:

Economic Reform Programmes 2022 - Fiscal indicators

	2018	2019	2020	2021e	2022	2023	2024
Total revenue* (% of GDP)							
Albania	27.5	27.4	26.3	28.6	28.7	29.0	29.1
North Macedonia	30.4	31.5	30.5	33.7	33.6	33.3	33.7
Montenegro	42.2	43.4	44.6	44.0	41.0	40.9	40.4
Serbia	41.5	42.1	41.0	43.5	42.2	41.4	41.1
Turkey	31.9	33.1	32.4	30.7	29.8	29.7	29.2
Bosnia and Herzegovina	43.0	42.5	39.9	42.3	41.7	41.4	41.2
Kosovo	26.3	26.8	25.4	28.7	28.1	27.9	27.7
Total expenditure* (% of GDP)							
Albania	29.1	29.3	33.2	34.5	34.1	31.9	31.9
North Macedonia	31.5	33.7	38.9	40.0	37.9	36.7	36.6
Montenegro	46.2	45.4	55.7	45.8	46.0	42.7	41.0
Serbia	40.9	42.3	49.0	48.4	45.3	42.9	42.1
Turkey	34.7	36.1	36.4	34.3	33.3	33.1	31.7
Bosnia and Herzegovina	40.8	40.6	42.3	43.2	42.0	40.4	39.8
Kosovo	29.1	29.7	33.0	30.1	32.7	31.6	30.7
General government balance (% of GDP)							
Albania	-1.6	-1.9	-6.8	-5.8	-5.4	-2.9	-2.8
North Macedonia	-1.1	-2.2	-8.3	-6.4	-4.3	-3.4	-2.9
Montenegro	-3.9	-2.0	-11.1	-1.8	-5.0	-1.8	-0.6
Serbia	0.6	-0.2	-8.0	-4.9	-3.0	-1.5	-1.0
Turkey	-2.8	-3.0	-3.9	-3.6	-3.5	-3.4	-2.6
Bosnia and Herzegovina	2.2	1.9	-2.3	-0.9	-0.2	1.1	1.4
Kosovo	-2.9	-2.9	-7.6	-1.4	-4.6	-3.7	-3.0
General government debt (% of GDP)							
Albania	67.7	66.3	75.7	80.1	78.8	77.6	75.7
North Macedonia	40.4	40.7	51.9	51.9	53.3	53.0	51.7
Montenegro	70.1	76.5	105.2	85.5	76.6	73.2	69.9
Serbia	53.7	52.0	57.8	58.2	56.5	55.3	53.8
Turkey	30.2	32.5	39.7	36.6	35.8	35.4	34.7
Bosnia and Herzegovina	32.7	31.7	34.0	34.8	35.2	33.9	32.2
Kosovo	16.9	17.5	22.4	22.5	25.5	27.2	28.7

Sources: Economic Reform Programmes (ERP) 2022 for 2020-2024, CCEQ for 2018 and 2019.

*2018 and 2019 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)

	2018	2019	2020
EU-27	11.3	11.2	11.0
Albania	16.5	15	15.2
North Macedonia	21.4	21.3	19.9
Montenegro	13.8	13.3	12.9
Serbia	15.4	14.6	14.6
Turkey	40.8	38.8	38.1
Bosnia and Herzegovina	23.7	23.6	24.9
Kosovo	38.5	37.4	32.8

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

The economic reform programme (ERP) was submitted on 31 January 2022.

The economic consequences of Russia's war against Ukraine may render the macro-fiscal scenarios presented in the ERP partially obsolete. The Commission will publish its updated macroeconomic and fiscal projections for candidate countries, reflecting the expected impact of the war against Ukraine and related sanctions, in its spring economic forecast in mid-May 2022.

The short-term macro-fiscal outlook may change considerably. However, the major medium-term fiscal and structural reform challenges and priorities identified in this assessment remain valid irrespective of the short-term outlook. Appropriate policy responses are essential to ensure a sustained economic recovery, greater resilience and fiscal sustainability.

1.1. EXECUTIVE SUMMARY

In 2021, the economic rebound is estimated to have been stronger than expected. The economic reform programme (ERP) estimates that the economy grew by 8.7% in 2021, and recovered above pre-crisis levels in most segments. A strong rebound of exports including tourism, high public investment including in post-earthquake reconstruction and the continuing accommodative policy all supported the recovery. This helped the labour market to recover almost all the ground lost during the COVID-19 crisis. The fiscal deficit, at 4.5% of GDP, was 2.3 percentage points (pps.) lower than planned because of strong revenue growth, underspending of the capital budget and the much stronger than expected growth in nominal GDP ⁽⁶⁾. Notwithstanding a debt-increasing Eurobond issuance to pre-finance the 2022 balance, as well as concessional lending and public guarantees for the state-owned electricity distributor, this led to a decrease in the debt-to-GDP ratio to 73.2%, much below the earlier estimate of 80.1% which the ERP fiscal scenario is based on.

The ERP projects steady economic growth and a gradual fiscal consolidation relying mainly on lower capital expenditure in 2023. The ERP projects economic growth to stabilise at an average of 4% in 2022-2024, but this projection could not take into account downside risks from a potentially protracted impact resulting from Russia's war against Ukraine, in particular from higher energy and food prices and less dynamic external trade with main trading partners in the EU. Investment and private consumption are expected to remain the main growth drivers, supported by net exports. Solid employment growth is estimated to lower the unemployment rate below 10%. The implementation of the medium-term revenue strategy (MTRS) is projected to gradually increase the revenue ratio from 2023. Together with lower investment expenditure (after post-earthquake reconstruction ends) it is expected to bring the deficit below 3% and the primary balance into surplus in 2024. This is projected to help lower the debt ratio by 4.4 pps. between 2021 and 2024.

The main challenges Albania faces are as follows:

- **While further policy support may be necessary in the short term, continuing fiscal consolidation would help the recovering economy to safeguard sustainability and build fiscal buffers for future unexpected shocks.** Because of high uncertainty about possible further pandemic effects and the impact of Russia's war against Ukraine, it seems appropriate to stand ready to provide crisis mitigation if needed. Contingent on the economic outlook, a gradual reduction of the public debt ratio and a return to a positive primary balance in the medium term would be key to rebuilding fiscal space. Stable fiscal planning without frequent budget amendments and a speedy clearance of contract-based arrears would increase the reliability of fiscal policy and the quality of public finance.

⁽⁶⁾ The assessment and the tables in this document are based on the ERP as submitted and could not be revised to fully reflect the 2021 fiscal outcome and the latest GDP publication of 31 March 2022.

Improving and expanding the assessment of fiscal risks, including those stemming from public-private partnerships, concessions and state-owned enterprises, would further contribute to debt sustainability.

- **Increased revenue mobilisation is crucial to lower the debt ratio and to honour the new positive primary balance rule, and relies on the MTRS being successfully implemented.** The MTRS can only be successful if it undergoes intensive public consultation and its role to effectively guide tax policy in the medium term is ensured by a budgeted, operational implementation plan. All of the plans for high public infrastructure investment should be subject to harmonised, effective planning, appraisal and procurement procedures and be balanced with investment in human capital, which is a crucial factor for future growth. A continuous gradual increase in public spending on health, social protection, education, and research and development would make the composition of expenditure more growth-friendly.
- **Structural weaknesses continue to hamper the business environment.** Private sector development remains below potential, actions to improve the business environment were only partly effective, and high levels of informal economic activity and employment distort competition. A lack of business support services and help with access to finance remains an obstacle, though the adoption of the Strategy on Business and Investment Development for 2021-2027 (BIDs) in mid-2021 should start some necessary steps. Transparency in adopting and implementing legislation remains insufficient—Albania did not draft a comprehensive strategy to tackle the informal economy.
- **Although the number of university graduates is increasing, there is still a high share of adults with low skills and of young people not in employment, education or training.** The labour market has shown resilience throughout the pandemic. However, the coverage and funding of active labour market policies are too low to make a substantive dent in the increased number of registered jobseekers. Vocational education and training still lack stronger involvement of businesses. Teachers in pre-university have received only limited training to implement the new competency-based curriculum. University education is of low quality and largely disconnected from the labour market. While a new measure is expected on innovation, the link between innovative businesses and academia is weak, with insufficient funding for science and research and unfavourable conditions for developing business incubators.
- **Poverty and social exclusion remain high and spending on social protection and healthcare is insufficient to decrease poverty and increase healthcare coverage.** The benefits under the Economic Aid scheme are too low, but the government took temporary measures to increase them and began a process to review their adequacy. A recent initiative aims to foster social inclusion and labour market integration of the scheme's beneficiaries. Social services are scarce. The Social Fund provides financial support to municipalities to establish new ones, but there are concerns about their sustainability. The government took steps to increase healthcare coverage for the sizeable number of uninsured people in the country, but access to healthcare is still limited due to high out-of-pocket payments and a shortage of doctors, especially in rural and remote areas.

The policy guidance jointly adopted at the Economic and Financial Dialogue of 12 July 2021 has been partially implemented. Fiscal consolidation was postponed, and its pace decelerated. Development of the MTRS progressed but it was not adopted. Reporting and clearance of VAT refunds and other arrears progressed. Capacity building was limited for monitoring fiscal risks and improving public investment management. Effective measures and close supervision preserved financial sector stability, but while the NPL-ratio decreased substantially, there has been no progress on resolving the bailiff impasse to further improve NPL resolution. The high level of currency substitution has slightly increased and, while some progress was made in developing the market for hedging instruments, there are no plans for the introduction of measures to promote the national currency in the realm of the government. No cross-

cutting strategy to tackle informality was drafted or adopted, and the relevant measures are the same as in ERP 2021-2023. Plans to enhance the business support services have limited funds and few results were achieved in 2021. Adequate stakeholder consultation remains an issue. Albania established an inter-ministerial task force to develop a Youth Guarantee implementation plan and started developing tools to regularly monitor the labour market and skills needs. Albania has begun to assess the adequacy of social assistance benefits with a view to adjusting them. There was only limited progress made on increasing the capacities of municipalities for social services or on redesigning coverage policy to reduce unmet needs for medical care.

The key challenges identified in the ERP correspond to those identified by the Commission, but their analysis is incomplete. The programme's macro-fiscal framework relies on optimistic projections for net exports and private investment above historical averages, and the planned pace of fiscal consolidation is slower than in previous ERPs. The commitment to continue reducing public debt is better anchored with the new primary balance rule. The analysis of structural obstacles fails to examine key sectors of the economy, notably industry and services (except tourism). The analysis of the green transition does not examine Albania's challenges in depth. The shared European growth model regarding green and digital transition will also have to be reinforced in the ERP process for Albania, even more so in the current geopolitical context. In line with the EU strategy for the Digital Agenda in the Western Balkans, the reform of the development of the broadband infrastructure is expected to positively affect the economy. The reform measures largely address the identified key challenges. However, no measure to improve the quality of higher education has been included in the ERP.

1.2. ECONOMIC OUTLOOK AND RISKS

Albania's ERP revised its growth estimate for 2021 upwards to 8.7%. Following a lower than feared recession of 3.5% ⁽⁷⁾ in 2020, the economy rebounded faster than expected in 2021. Tourism recovered to about 90% of 2019 levels, helped by an early lifting of travel restrictions and by increasing regional tourist flows. This added to a solid recovery of household consumption, while an exceptionally large increase of public investment (driven partly by reconstruction needs following the earthquake of November 2019) and exports of goods also contributed strongly to Albania's growth performance. Private investment also grew strongly and is estimated to have exceeded 2018 levels after 2 years of contraction, supported by an accommodative monetary policy. Abundant rainfall allowed hydro-electricity production to double in the first 3 quarters of 2021, and resulted in net electricity exports in 2021 despite very dry conditions in the last quarter. The recovery is having a positive impact on the labour market and the unemployment rate has decreased to 11.9% from 12.2% in 2020, although employment has not yet returned to its pre-crisis level, especially in services.

The ERP projects economic growth to average 4% between 2022 and 2024, driven by a broad-based recovery of household consumption, exports and private investment. For 2022 and 2023, the ERP expects private consumption and net exports to contribute most to growth, while the contribution of investment is expected to pick up only in 2024. The positive contribution of net exports is expected to continue throughout the ERP horizon, supported by a lower growth of service imports than before the pandemic while export growth is projected to continue at a higher level than the pre-pandemic average. This projection could not take into account downside risks from Russia's war against Ukraine, in particular from higher energy and food prices and less dynamic external trade. Although the projection of the overall investment contribution is broadly in line with the pre-pandemic averages for 2022-2023, this masks an assumed high growth of private investment in 2022 and 2023, and a strongly negative contribution of public investment following a high base in 2021. Services, agriculture, and manufacturing are expected to contribute most to the growth of production value in 2022-2024, with growth expectations slightly above historical averages for all segments except agriculture, which is double its historical rate.

⁽⁷⁾ According to the latest revision by INSTAT of 31 March 2022.

The labour participation rate is expected to rise to 71% by 2024 from 69% in 2020. Despite moderate and gradually decelerating growth in employment of about 1.2% a year on average, the unemployment rate is forecast to fall by 2.5 pps. compared to 2021, to 8.9% in 2024. The ERP estimates the output gap to have remained slightly negative in 2021 and projects it to close in 2023.

The main downside risks are related to optimistic projections for net exports, while the assumed high growth of private investment calls for structural reforms. The growth projection for 2022 and 2023 was lowered by 0.7 pps. and 0.3 pps. respectively compared with last year's ERP, which partly reflects base effects from the upward revision of the expected 2021 growth rate of 3.3 pps., but also some correction of the former overly optimistic expectations. Nevertheless, the favourable economic outlook remains slightly above international and ECFIN forecasts. In particular the projected growth of goods exports exceeds historical averages, and the projection of relatively subdued import growth does not tally with the optimistic investment expectations, as investment is an important import driver. The expected high growth of private investment depends on the political will to accelerate structural reforms, e.g. the postponed adoption of the modernised investment legislation and the announced investment strategy. In addition, Russia's invasion of Ukraine is likely to affect import prices and supply of certain staple foods, which depend heavily on Russian and Ukrainian sources, while in other respects Albania's economic relations with that region are very limited.

Table II.1.1:

Albania - Comparison of macroeconomic developments and forecasts

	2020		2021		2022		2023		2024	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	-4.0	-4.0	6.9	8.7	3.7	4.1	3.6	4.2	n.a.	3.9
<i>Contributions:</i>										
- Final domestic demand	-2.2	-2.2	6.5	8.5	3.8	3.4	3.4	3.4	n.a.	3.4
- Change in inventories	-2.5	-1.5	0.0	:	0.0	:	0.0	:	n.a.	:
- External balance of goods and services	0.7	-0.2	0.4	0.3	0.0	0.7	0.1	0.8	n.a.	0.5
Employment (% change)	-1.9	-1.9	1.7	0.8	1.7	1.7	1.6	1.3	n.a.	0.8
Unemployment rate (%)	12.2	12.2	11.8	11.4	11.0	10.3	10.3	9.4	n.a.	8.9
GDP deflator (% change)	-0.4	-0.4	1.3	0.6	1.5	1.4	1.2	1.0	n.a.	1.4
CPI inflation (%)	1.6	1.6	2.2	2.0	2.8	2.8	2.7	3.0	n.a.	3.0
Current account balance (% of GDP)	-8.7	-8.8	-7.7	-8.0	-7.3	-7.3	-7.1	-6.9	n.a.	-6.2
General government balance (% of GDP)	-6.8	-6.8	-5.9	-5.8	-4.0	-5.4	-3.5	-2.9	n.a.	-2.8
Government gross debt (% of GDP)	75.7	75.7	77.6	80.1	74.9	78.8	73.9	77.6	n.a.	75.7

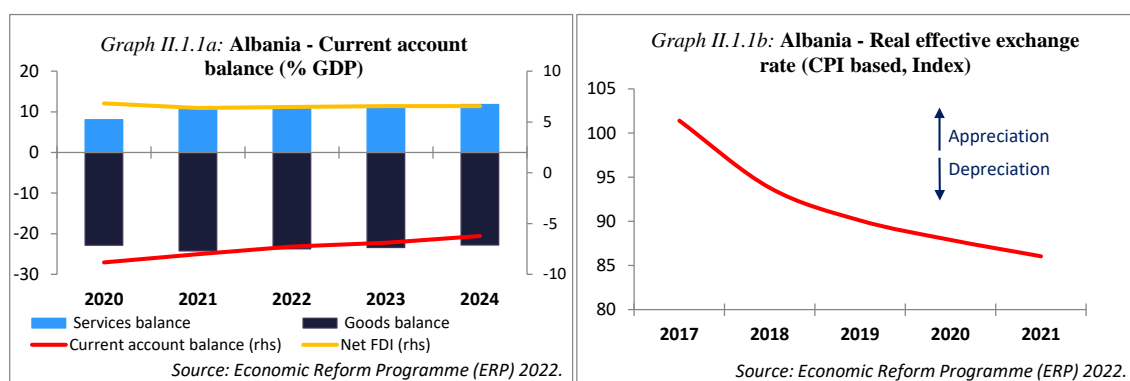
Sources: Economic Reform Programme (ERP) 2022, Commission Autumn 2021 forecast (COM).

Inflation has been on an upward trend but is not expected to exceed its target in the medium term. The inflation rate averaged 2.1% in 2021 but monthly readings showed a continuous increase since mid-2021 due to high increases in food and energy prices. The ERP expects average inflation to rise to 2.8% in 2022 before converging at the 3% target in 2023 in line with the closing output gap. Considering the international price developments in early 2022, the Bank of Albania (BoA) revised its earlier forecast and expects the inflation rate to overshoot its 3% target in 2022, and to remain around or above the target in 2023. In March 2022, the BoA began the announced gradual normalisation of its very loose monetary policy, and raised the policy rate by 0.5 pps. to 1.0%. This was the first rate change since March 2020, when BoA lowered the policy rate to 0.5% in response to the pandemic-induced economic downturn. The ERP does not include assumptions on the exchange rate of the lek and the inflation rate in the EU.

The ERP expects the decreasing trend of the current account deficit, which was interrupted by the COVID-19 crisis, to continue. Despite exports rebounding in 2021, which underpinned the overall improvement of the external balance, the merchandise trade deficit was higher than expected because the strong economic recovery and the high public investment expenditure generated higher import growth, in particular in imports of construction material, textiles and electricity, which accelerated in the last quarter of the year. At an estimated 8% of GDP, the 2021 current account deficit was 0.9 pps. higher than

expected in the previous ERP (despite the higher GDP denominator), partly reflecting the impact of increasing energy prices (Albania imports about 30% of its energy). The ERP forecasts that the external balance will gradually improve to -6.2% of GDP in 2024, based on a decreasing trade deficit, a strongly increasing services surplus and stabilisation of the primary and secondary income accounts (all in terms of GDP). Higher imports than projected and surging import prices might limit the expected improvement of the external balance. Inflows of foreign direct investment (FDI) amounted to 6.7% of GDP in 2021, 0.3 pps. lower than projected in the previous year's ERP. Furthermore, they are expected to stabilise at around 6.5% of GDP in the medium term and would still cover the bulk of the expected current account deficit in 2022-2024. The projection that the FDI to GDP ratio will be about 2 pps. lower than that prior to 2019 seems a realistic assumption, which takes into account the extraordinary effect that occurred between 2016 and 2019 thanks to the recent completion of two very large energy projects is unlikely to be repeated.

External competitiveness and current account



Albania's vulnerability to an increasing external debt ratio is mitigated by solid foreign exchange (forex) reserves and a high share of long-term and concessional debt. Gross external debt has increased by 5 pps. to 65.4% of GDP in 2020, driven by a EUR 650 million Eurobond issuance (of which EUR 250 million was used to repay a maturing Eurobond) and concessional loans to support the economy during the peak of the COVID-19 pandemic. Supported by the strong rebound in GDP, this ratio is expected to have stabilised at an estimated 66% at end-2021, even as new liabilities were incurred including another EUR 650 million Eurobond and EU macro-financial assistance of EUR 180 million. About 94% of the external debt stock is long-term with more than half of that owed by the government, mostly on concessional terms. However, the share of funding raised on the international capital market is expected to increase as the government plans a more frequent issuance of Eurobonds. The BoA's risk analysis shows that the external debt ratio is more sensitive to currency depreciation than to an increase of interest rates. Although the return of the lek to its appreciation trend in 2021 indicates that such a risk is limited, the volatility of international prices due to the Russian invasion of Ukraine might add pressure on the currency value. However, this risk is adequately safeguarded against by forex reserves, which have consistently increased over recent years and totalled EUR 4.9 billion at the end of 2021, covering almost 9 months of imports of goods and services and around 47% of external debt.

The financial sector continued to recover and portfolio quality improved but the high use of foreign currencies remains a risk. The BoA continued to provide liquidity to the market and kept the suspension of banks' dividend payments and relaxed rules on loan provisioning in place until end-2021. Bank profitability (return on equity) improved strongly in 2021 reaching 12.9% from 10.7% at end-2020 but it has not returned to 2019 levels. Capitalisation remained adequate, well above the regulatory minimum and the core liquidity ratio gradually increased in 2021, but remained in average below pre-crisis levels. The growth of credit to the private sector⁽⁸⁾ picked up to 9.1% y-o-y from 6.6% in 2020 and the

⁽⁸⁾ Adjusted for written-off loans and exchange rate impacts.

outstanding loan stock returned to its pre-pandemic level of 39.6% of GDP, which is still low when compared regionally, pointing to ample scope for deeper financial intermediation. The ratio of non-performing loans to total loans dropped to 5.7%, its lowest level since 2009, reflecting not only an increase in outstanding credit but also a declining flow of new problem loans and a 15% fall in the stock of non-performing loans compared with the previous year. However, as the full impact of the crisis on bank balance sheets might become apparent after some delay, the BoA is committed to remaining vigilant and has extended the suspension of the banks' dividend distribution until the end of 2022 to safeguard capital buffers. The share of foreign currency loans in total bank loans slightly decreased to 48.8%, while the high growth of foreign currency deposits led to their share in total deposits increasing to 55.2% and accelerated overall deposit growth to 8.5%. The BoA is developing more hedging instruments which should help decrease foreign exchange risks. Another remaining source of vulnerability is banks' exposure to sovereign risk from an expanding stock of government securities on their balance sheets.

Table II.1.2:

Albania - Financial sector indicators

	2017	2018	2019	2020	2021
Total assets of the banking system (EUR million)	10768	11 398	12 380	13 156	14 980
Foreign ownership of banking system (%)*	81.4	80.8	78.4	69.4	:
Credit growth (% aop)	-0.1	-1.7	3.0	6.1	6.9
Deposit growth (% aop)	1.0	-1.2	2.5	5.8	8.5
Loan-to-deposit ratio (eop)	54.9	53.9	55.6	54.7	54.8
Financial soundness indicators (eop)					
- non-performing loans	13.2	11.1	8.4	8.1	5.7
- net capital to risk-weighted assets	16.6	18.2	18.3	18.3	18.0
- liquid assets to total assets	13.0	14.8	15.1	13.6	13.3
- return on equity	15.7	13.0	13.5	10.7	12.9
- forex loans to total loans (%)	55.7	55.1	50.1	48.5	48.8

* of total sector assets

Sources: Economic Reform Programme (ERP) 2022, IMF, Bank of Albania.

1.3. PUBLIC FINANCE

In 2021, strongly rebounding revenue and an under execution of capital spending helped improve the budget balance, and the deficit turned out 2.3 pps. lower than planned. The initial budget plan aimed for a deficit of 6.9% of GDP, slightly higher than the 2020 outcome. After several upward revisions during the year, the ERP estimates the budget shortfall at 5.8% of GDP, while the actual outturn was even lower at 4.5% of GDP. Tax revenue surged by 19.3% y-o-y, slightly exceeding the 2021 plan as well as 2019 values in all categories except for profit and personal income taxes, while at the same time most VAT refund arrears were cleared. Current expenditure grew 9.4% y-o-y, driven by higher spending on social security, maintenance and wages. However, overall spending was 33.7% of GDP, lower than budgeted, driven in particular by underspending of the capital expenditure budget, which was increased by a total of 20% in the five budget revisions during 2021. In contrast to the ambitious increase, 31% of the capital budget was not spent and actual investment spending fell by 3% from the high level in 2020. At the same time, arrears on investment-related contracts of the central government, almost tripled in the year to September 2021, reaching around 1.1% of GDP and were only cleared by means of reallocating unused funds with the last budget revision.

The ERP presents a back-loaded fiscal consolidation and a moderate pace of debt reduction. It is targeting a fiscal deficit below 3% of GDP from 2023 and a return to a non-negative primary balance in

the same year, as originally laid down by the fiscal rule ⁽⁹⁾. The expected gradual fiscal improvement is based on a further small increase in the revenue ratio by 0.4 pps. to 29.1% of GDP between 2021 and 2024, driven by the implementation of the medium-term revenue strategy and the assumed economic growth. The main contribution to halving the deficit in 2023 is expected to come from a larger retrenchment of capital expenditure compared with the planned high base in 2021, while in 2024 expenditure is planned to increase again by 5.5%. Overall, the expenditure-ratio is planned to drop by more than 2 pps. between 2022 and 2024 to below 32% of GDP, while the average capital expenditure will be kept at 6.7% of GDP. The expected sizeable rise in interest expenditure implies an assumed increase of the implicit interest rate from 2.6% in 2021 to 4.2% in 2024. The ERP's estimate of the cyclically adjusted primary balance shows that counter-cyclical fiscal support in 2020 and 2021 will give way to a sizeable tightening in 2023, when the output gap is expected to close.

(¹⁰)

Table II.1.3:

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

	2020	2021	2022	2023	2024	Change: 2021-24
Revenues	26.3	28.6	28.7	29.0	29.1	0.4
- Taxes and social security contributions	21.3	23.0	22.9	23.2	23.4	0.4
- Other (residual)	5.0	5.6	5.8	5.8	5.6	0.0
Expenditure	33.2	34.5	34.1	31.9	31.9	-2.6
- Primary expenditure*	31.0	32.5	31.4	29.0	28.8	-3.7
of which:						
Gross fixed capital formation	7.1	9.2	7.5	6.2	6.3	-2.9
Consumption	10.9	9.5	9.6	9.1	8.9	-0.6
Transfers & subsidies	13.0	12.8	12.9	12.7	12.7	-0.2
Other (residual)	0.1	1.0	1.4	0.9	0.9	-0.1
- Interest payments	2.1	2.1	2.7	2.9	3.2	1.1
Budget balance	-6.8	-5.8	-5.4	-2.9	-2.8	3.0
- Cyclically adjusted	-5.0	-5.6	-5.3	-3.0	-2.9	2.8
Primary balance	-4.7	-3.8	-2.7	0.0	0.3	4.1
- Cyclically adjusted	-2.9	-3.6	-2.6	0.0	0.3	3.9
Gross debt level	75.7	80.1	78.8	77.6	75.7	-4.3

* Excluding arrears clearance

Sources: Economic Reform Programme (ERP) 2022, Commission calculations.

(⁹) The fiscal rule to keep the primary balance zero or above was introduced in 2020 to take effect in 2023. In 2021, this rule was amended by normative act to enter into force in 2024.

(¹⁰) 2020 and 2021 figures based on GDP estimates used in the ERP.

In contrast to the previous ERP's projections, the loose fiscal stance is set to continue in 2022 with still high capital expenditure. The 2022 budget projects a fiscal deficit of 5.4% of GDP. Total revenue is projected at 28.7% of GDP, while the tax-to-GDP ratio is expected to slightly decrease from the high level reached in 2021. Total expenditure is set to increase by 4.5% y-o-y compared to the 2021 plan, driven by interest expenditure, social insurance outlays and wages. While capital expenditure was set to fall by 14.4% from the very high budgeted level of 2021, based on the actual outturn a 20% increase would be necessary to reach the planned historically high level of 7.5% of GDP ⁽¹¹⁾. Last year's ERP envisaged a stronger onset of fiscal consolidation in 2022 with a significantly lower fiscal deficit of 2.9% based on cutting capital expenditure to 5.8% of GDP. Given the 2021 performance, ambitious capital expenditure plans as stimulus for the economic recovery do not seem necessary in 2022, while the recommended shift in expenditure composition towards human development and innovation is not reflected in the medium-term budget plans.

Key fiscal policies will be the medium-term revenue strategy (MTRS) and the use of sovereign guarantees to stimulate private investment. The main contribution to the medium-term increase in the revenue ratio is expected to come from VAT collection because the MTRS contains plans to abolish most tax exemptions and improve collection efficiency. Reducing informal employment and a redesign of the tax policies concerned, also part of the MTRS, should help to increase social contributions and income tax revenue in addition to rising employment and minimum wages. Based on the experience gained from sovereign guarantees in 2020 for COVID-related support, the government plans to use them as instruments to facilitate access to finance for the agricultural sector, for investments into manufacturing and in innovation. However, the ERP does not provide details on these plans. A number of the ERP reform measures have not been costed and budgeted, signalling a lack of cross-government coordination on the ERP and details are missing for the largest part of the discretionary and the capital expenditure.

⁽¹¹⁾ Including local government and reconstruction expenditure and transfers to the state-owned electricity distributor to shield households and SMEs from the impact of the spike in international electricity prices, although strictly speaking the latter might not count as capital investment.

Box II.1.1: Assessment of measures supporting the recovery

The ERP presents only a few policies that directly support the economic recovery or the address the identified key challenges and does not link these policies to growth expectations. It does not provide the requested data on discretionary and COVID-related measures, contingent liabilities and long-term sustainability. Recent policies to mitigate the impact of rising prices due to the war in Ukraine could not yet been presented and assessed.

a. Incentives to increase employment

The government plans to spend about 0.12% of GDP on continuing temporary employment support programmes and on some new and revised programmes to improve the employability of the most vulnerable jobseekers. Former employees of the Balsh oil refinery, which ceased operations at the end of 2019 without settling its wage bill, will continue to receive minimum wages in 2022 accounting for 0.02% of GDP. Very little funding (less than 0.06%) is allocated to the few programmes mentioned under the 2019-2022 national employment and skills strategy, which aim to increase the quality of and access to VET and increase digital competence.

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

The financing of the COVID-19 vaccines in 2022 is budgeted with ALL 2.7 billion and the post-earthquake reconstruction should be completed in 2022 using ALL 20 billion. The ERP describes railway investments as a measure used to reduce energy intensity of the transport sector and in addition, 0.02% of GDP is budgeted for each of the following: i) increasing energy efficiency, ii) supporting MSMEs and iii) modernising retail payment systems. Broadband development is supported by external funding with very limited financing from the budget while the measure “Improving institutional, financial and human capacities for research and innovation” is not budgeted for at all, despite the announced policy aim to increase funding for research.

The government announced three new sovereign guarantees (below the line items), which are intended to mobilise private investment into manufacturing (ALL 1 billion), innovation (ALL 250 million) and agriculture (ALL 4 billion over 4 years). In addition, a sovereign guarantee for the tourism sector (ALL 1 billion) should support this sector’s recovery, which was hit especially hard by the COVID-19 pandemic. An increased use of sovereign guarantees would also increase the contingent liabilities for public finance and the need for institutional capacity to manage the increasing fiscal risks.

c. Support to demand

The 2022 fiscal package introduces stronger progressivity in income tax leaving a larger part of the lower income bracket non-taxable. Some VAT tax exemptions are to be abolished, and excises harmonised, which will simplify the tax system overall. The indexation of pensions is a permanent measure, which will keep the real income level of pensioners stable. The pensioner year-end bonus seems temporary, but could become permanent similar to the birth bonus introduced in 2019. Both are unrelated to the COVID-19 pandemic and constitute untargeted transfers with relatively high expenditure.

d. Liquidity measures

The budget includes an extraordinary provision of an ALL 8 billion loan to the state-owned electricity supplier OSHEE in 2022. This is to cover the high electricity import costs, for which OSHEE already received a state guarantee of a similar size in 2021 for commercial and concessional loans. The loan is not linked to incentives for energy saving or investments into energy efficiency. It is to provide untargeted support in the form of stable electricity prices for all households and MSMEs.

Box II.1.2: The budget for year 2022

On 25 November 2021, the Parliament approved the 2022 budget, which targets a fiscal deficit of 5.4% and a public debt of 78.8% of GDP. Parliament reconfirmed its approval in its last session of 22 December, overriding the president's decree, which returned the budget to the Parliament for review because the planned debt reduction was deemed insufficient.

Main measures in the budget for year 2022:

Temporary/permanent revenue measures* : +0.39% of GDP (out of 1.6% of GDP projected revenue increase)	Temporary/permanent expenditure measures** +0.85% of GDP (out of 1.47% of GDP projected expenditure increase)
------------------------------------------------------------------------------------------------------------------------	----------------------------------------------------------------------------------------------------------------------

- | | |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> • VAT revenue from elimination of farmers' compensation scheme; reduction of VAT exemption for agricultural inputs and imported machinery; a new tax on imported milk powder (fiscal package 2022) (+0.1% of GDP) • Revenue from harmonisation, indexation and abolition of refunds of excises and a new tax on fuelling in custom-free zones (fiscal package 2022) (+0.17% of GDP) • Additional grants for projects (0.16% of GDP) • Increase of non-taxable income (-0.04% of GDP) | <ul style="list-style-type: none"> • Reserve Fund (0.13% of GDP) • 6% salary increase in health, education and defence sectors (0.15% of GDP) • COVID-19 vaccines (0.15% of GDP) • Pension indexation and pensioners' year-end bonus (0.33% of GDP) • Reduced social assistance and transfers for civil emergencies (-0.14% of GDP) • Transfer to public electricity distributor for price stabilisation (0.43% GDP) • Abolition of expropriation funds (-0.16% of GDP) • Reduction of capital expenditure (-1.3% of GDP) |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

* Estimated impact of specific measures on general government revenues excl. impact of economic growth.

** Estimated impact of reported changes of general government expenditure.

Source: ERP, MFF

In 2021, the public debt ratio turned out much lower than projected, 73.1% of preliminary GDP, but the envisaged debt reduction path will not result in a return to the pre-crisis debt-level in the medium-term. The debt ratio was expected to increase by some 5 pps. compared to 2020 but turned out to be 2 pps. lower, mainly due to a lower-than-planned deficit and the larger than expected nominal GDP. The lower debt level in 2021 will make it necessary to revise downwards the ERP debt projections for 2022 and beyond if the fiscal rule requiring a falling debt ratio is to be complied with. In the medium-term, the ERP expects the public debt ratio to fall by an average of 1.4 pps. per annum. but the pace of the planned reduction is not sufficient to undo the cumulative 8 pps. increase of the debt ratio in 2020 and 2021 in the medium-term and would require about 6 years of fiscal consolidation to return to the pre-crisis debt level.

Box II.1.3: Debt dynamics

Albania

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

	2020	2021	2022	2023	2024
Gross debt ratio [1]	75.7	80.1	78.8	77.6	75.7
Change in the ratio	9.9	4.4	-1.3	-1.2	-1.9
Contributions [2]:					
1. Primary balance	4.7	3.8	2.7	0.0	-0.3
2. "Snowball" effect	5.2	-4.4	-1.4	-1.0	-0.8
Of which:					
Interest expenditure	2.1	2.1	2.7	2.9	3.2
Growth effect	2.7	-6.0	-3.1	-3.2	-2.9
Inflation effect	0.3	-0.4	-1.1	-0.7	-1.1
3. Stock-flow adjustment	0.1	5.0	-2.5	-0.3	-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) 2022, ECFIN calculations.

reduction was driven by a higher snowball effect based on more optimistic growth expectations and on a stronger contribution of inflation. As in 2020, the starting level of public debt is lower than shown in the table, which does not reflect the actual 2021 outcome.

The debt dynamics are based on slightly optimistic growth expectations, assuming a stable exchange and inflation rate and an increasing implicit real interest rate. Debt reduction is expected to be driven by a back-loaded improvement in the primary balance and a favourable but decreasing snowball effect mainly based on real growth effects. Following the large debt-increasing impact of the stock-flow adjustment in 2021, which was driven by a Eurobond issuance exceeding rollover needs and energy sector-guarantees, stock-flow adjustment is projected to help reduce debt in 2022. The projected debt dynamics differs significantly from those in previous ERPs, where debt

External public debt increased in 2020 and 2021, but a stronger reduction than previously planned is projected. In 2021, Albania received an EU loan of EUR 180 million at very favourable terms in the form of macro-financial assistance and issued a EUR 650 million Eurobond with 10 years maturity ⁽¹²⁾. The continuing strong growth of public debt denominated in foreign currency in 2021 pushed its share in the total public debt stock from 47.4% to an estimated 51%, just above the targeted maximum of 50% set out in the debt management strategy. The revised Medium-Term-Fiscal-Framework (MFF) plans to reduce this share to 44.5% by 2024, considerably lower than the share the previous ERP aimed for. Foreign debt consists only of long-term instruments, largely at concessional terms, while the average maturity of domestic debt, which is dominated by shorter maturities, has slightly increased and the shares of short-term and variable rate instruments have slightly decreased between 2020 and 2021. Despite the increased financing demand by the government, interest rates for government securities decreased and S&P Global Ratings affirmed the "B+" Local Currency long-term credit rating of Albania on 28 January 2022, with a stable outlook.

⁽¹²⁾ This is the longest maturity bond Albania has so far issued, with an initial yield of 3.75%, just 0.1pp. higher than for the 7-year maturity Eurobond issued in June 2020.

Box II.1.4: Sensitivity analysis

The sensitivity analysis of this year's ERP extends to 2026 and provides more detail on the expenditure and financing categories to reflect the impact of the optimistic and pessimistic growth scenarios on the financing composition. The real GDP growth rates deviate by +0.5 pps. and -1.5 pps., respectively, from the 4.1% baseline average growth scenario. The fiscal adjustment that is assumed under the pessimistic scenario is set to avoid increasing the debt ratio, mainly by reducing domestically financed investment and lowering operational & maintenance expenditure. The public debt to GDP ratio would decrease by less than 1 pp., considerably lower than the baseline and the optimistic scenario. The assumed lower financing need in the pessimistic scenario as opposed to the other scenarios combined with the same interest payments (all in nominal terms) leads to a higher primary surplus between 2023 and 2025 than in the baseline scenario, in which the primary balance only turns positive in 2024. While the increase of the baseline projection for the revenue ratio from 28.6% to 29.3% is in line with the historical trend, the assumption under the pessimistic scenario appears generous as it would still be the highest revenue ratio since 2015.

Contingent liabilities from public-private-partnerships (PPPs), state-owned enterprises (SOEs) and public guarantees are likely to increase while plans to improve their monitoring lag behind. In 2021, the planned budgetary payments for the 13 ongoing concession/PPP contracts were 25.7% higher than in 2020, when some payments were postponed to 2021, and equivalent to 3.5% ⁽¹³⁾ of the exceptionally low tax revenue of 2020, therefor still below the 5% ceiling set out in the fiscal rules. The fiscal risk from the increasing portfolio of public guarantees is mitigated by accounting them fully as public debt, but there is a lack of transparency over the cost of the guarantees and the probabilities of default. The regular reliance of the state-owned energy utilities on public guarantees and loans constitutes another source of fiscal risk, which is aggravated by the exposure of the hydroelectric power sector to climate change risks and for which mitigation measures still need to be developed. Until now, there was no payment effectuated under the guarantees for the private sector in the COVID-19 context, which amount to 0.6% of GDP. The results of the improved monitoring and assessment of PPPs and concessions are reported annually and are integrated into the fiscal risk statements, which regularly accompany the budgets. However, the reports only cover pre-determined budgetary payments for PPPs and SOEs in a backward-looking manner and do not assess or forecast contingent liabilities stemming from PPPs.

Revenue administration is improving, but public investment management is still to be reformed and spending on human development remains below what is needed. The ongoing 2019-2022 Public Finance Management (PFM) Reform Strategy aims to address key weaknesses and includes targets to improve public investment management, budget comprehensiveness, expenditure and arrears control, fiscal risk monitoring and revenue mobilisation. The reform of the revenue administration clearly progressed, among others demonstrated by, among other things, the clearance of VAT refund arrears and speedier refunds. The renewed commitment to the MTRS should lead to a simpler tax system and a more predictable tax policy, while at the same time reduce the informal economy and tax efficiency gaps. The reporting clearance of arrears have improved, but heavily backloaded underspending of the capital budget in parallel to contract arrears increasing over the year indicate persisting problems with investment planning, contract management and commitment control. Public reconstruction funds, concessions and PPPs remain outside of the established processes for approving, managing and reporting on public investment; this reduces their transparency and efficiency. The structural reform programme in the ERP includes a measure to reform public strategic investment, explicitly including PPP projects and concessions, but the implementation might be hampered by institutional restructuring. Spending on health, social protection, education, and research and development remains significantly below what is needed and a continuous gradual increase in public spending on these areas guided by an updated national development strategy would make the composition of public expenditure more growth-friendly.

⁽¹³⁾ 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.

Frequent budget revisions highlight weaknesses in planning capacity and undermine the transparency and credibility of the budget process. The planning of the medium-term fiscal framework is not based on updated, actual fiscal data but on the previous year's budget plan, and carries over the overestimations of deficit and debt (caused by underspending) from one budget cycle to the next. This is one reason why the budgets are regularly revised just after parliamentary approval, very early in the fiscal year. In 2021, the budget was revised five times without an updated macro-fiscal framework being published. These frequent revisions of the budget by normative acts instead of going through the regular process set out in the organic budget law have become the norm, which undermine the credibility of budget preparation. The use of normative acts in 2021 to postpone the entry into force of the primary balance rule and to suspend the debt reduction rule weakens the binding character of the organic budget law.

1.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

The Commission has conducted an independent analysis of the Albanian economy to identify the key structural challenges to mitigating the impact of the ongoing COVID-19 pandemic, in order to boost competitiveness and inclusive growth, drawing from Albania's ERP itself but also using other sources. This analysis shows that Albania continues to experience several structural weaknesses across many sectors. However, the main challenges for mitigating the impact of the pandemic and supporting the recovery in terms of boosting competitiveness and long-term sustained and inclusive growth are:

- (i) increasing innovation and skills of young people and adults to enhance employment;
- (ii) increasing coverage and 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 the pace of reforms and government support, and by tackling informality.

The three key challenges identified by Albania correspond to those identified by the Commission. For key challenge 1, the focus slightly differs as Albania included only vocational education and training and omitted general pre-university education as well as higher education, which the Commission deems to be essential parts of the key challenge.

To promote competitiveness Albania also needs to tackle corruption, improve the rule of law, and strengthen institutions. Addressing these fundamental challenges is a prerequisite for a successful transformation of the economy. The Commission is closely following the issues related to 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 has showed relative resilience during the COVID-19 induced economic slowdown, with employment slowly recovering to pre-pandemic levels. The employment rate (20-64) of 67.3% in the fourth quarter of 2021 remains only slightly below the fourth quarter of 2019 (67.7%). The job deficit has been narrowing with only 6 069 jobs less in the third quarter of 2021 compared to the respective quarter of 2019. The number of registered jobseekers, which peaked at 98 295 in the second quarter of 2021, fell significantly to 74 833 during the third quarter of 2021, therefore only higher by 4 367 compared to the third quarter of 2019 (pre-pandemic).

The share of the active population with low educational attainment remains high and participation in lifelong learning is low. In 2020, a high share (44.3%) of the active population (25-64) and the majority (56%) of registered jobseekers had at most primary education indicating a need to invest in

reskilling and upskilling. However, the system lacks any form of remedial education for the young and middle-aged workforce and prior learning recognition system. Participation in adult learning in 2020 according to the Labour Force Survey was insufficient (0.6%) and significantly below the EU-27 average (9.2%).

Albania has strengthened its labour market institutions, but the coverage and expenditure on active labour market policies (ALMPs) are too low to reduce the number of registered jobseekers and there have been difficulties in implementing them. In 2021, the National Agency for Employment and Skills (NAES) was finalising the institutional and legal reform, putting in place a new information system, training its staff and developing individual employment plans for jobseekers. Despite steady increases since 2014, the budget of ALL 846.6 million for ALMPs (training and employment promotion programmes (EPPs)) in 2021 equalled only about 0.05% of GDP, significantly below the EU-27 average (0.39% of GDP, 2019 figures). Before the pandemic, the ALMPs covered around 14 000 jobseekers annually (14 725 in 2017, 13 578 in 2018 and 14 052 in 2019) and were reaching an increasing share of them (from 16.4% in 2017 to 19.8% in 2019). Yet, given the high share of registered jobseekers with at most primary education (55% and over since 2017), this coverage is insufficient to offer enough up- and re-skilling opportunities or a more intensive support through EPPs to enable this vulnerable category to join the labour market.

In 2020, due to COVID-19 lockdown and related restrictions, the number of jobseekers who benefitted from ALMPs declined to 8 532, while their share dropped to 10.3% due to an increased number of registered jobseekers. The situation improved slightly in 2021, but remained worse than that of the pre-pandemic period, with the number of jobseekers benefitting from ALMPs totalling 11 166 (14.9% of all jobseekers in the third quarter of 2021). In more detail, the number of participants in EPPs (4 835) almost recovered to pre-pandemic figures, while the number of trainees (6 331) has yet to recover. The implementation of the EPPs suffered from additional contextual factors: (i) a lower number of companies meeting the criteria due to economic slowdown; (ii) a reform of the EPPs at the start of 2020 which, despite being a positive step forward, introduced stricter eligibility criteria for companies requiring an adjustment of practices and training in employment offices and an increased outreach to businesses; and (iii) low staff allocation in public employment service.

As regards the latter point, the Directorate-General of the National Agency for Employment and Skills (NAES), established in 2019, was only 70% staffed at the start of 2022. The employment offices lack human resources, with each frontline officer serving on average 360 jobseekers⁽¹⁴⁾, therefore limiting the number of jobseekers that can be actively assisted. The capacities of frontline officers need to be increased to enhance skills needed for comprehensive guidance and follow-up of harder to employ jobseekers, for conducting skills assessment (which is for now largely based on occupational categories) and for providing employer related services (OECD 2021b). The allocated budget for the EEPs was underused, with ALL 70.4 million out of ALL 590 million disbursed in 2020, and ALL 393 million out of ALL 521.7 million disbursed in 2021. On a positive note, NAES has succeeded in diversifying the businesses that participate in implementing the EPPs and it plans a further communication campaign to support this trend.

Reform measure 2 ('Improving the employability of the most vulnerable unemployed jobseekers'), rolled over from the previous ERP, puts a necessary emphasis on improving the quality and effectiveness of NAES, but it does not address the lack of human resources in employment offices. NAES wants the targeting of the EPPs to be based more on jobseekers' profiles. However, the measure does not aim to increase participation in the EPPs or in vocational training, without which there will only be a marginal impact on the labour market.

There has been progressive but slow operationalisation of the legal basis for vocational education and training (VET), but limited involvement from businesses remains a challenge. The 2017 VET

⁽¹⁴⁾ This figure takes into account 74 833 registered jobseekers in quarter three of 2021 and 208 frontline officers. Of note is that 40 of these frontline officers are heads of sector who devote themselves only partially to clients.

law is almost fully operational, with two new by-laws adopted in 2021, including one on the recognition system of previous non-formal and informal learning. The by-law on financial autonomy and generation of income is still pending. The optimisation plan for VET providers, which was developed in autumn 2020, was not implemented in 2021. There have been improvements in quality assurance by means of introducing self-assessments in all public VET providers and an accreditation model that was developed in 2020 but which still needs to be implemented. Short-term vocational courses are not yet aligned with the national qualification framework. A part of these courses were redesigned with support from Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) to respond to the needs of the regional labour market and to include more practical training in businesses. Donor-supported VET providers developed work-based learning opportunities, especially in the areas of hotels/tourism, ICT and vehicle services. The 2019 regulation on work-based learning (WBL) provides a further opportunity to increase private sector participation in VET and to streamline WBL practices among VET providers. The National VET Council is not yet operational and the establishment of sectoral skills committees has been delayed, resulting in limited opportunities for the private sector to shape the design of VET policy. The skills' anticipation study (methodology) in the agricultural sector (dairy and wine value chains) developed with the support of the International Labour Organization will assist the sectoral skills committees once established by the NAVETQ.

Reform measure 1 ('Increasing the quality and access to VET'), rolled over from the previous ERP, aims to address most of the existing challenges, such as: (i) adoption of the by-law on financial autonomy and income generation; (ii) institutionalisation of the National VET Council; (iii) establishment of sectoral skills committees (firstly in the ICT sector and secondly in the hotels/tourism sector); (iv) referencing the Albanian Qualifications Framework to the European Qualifications Framework; (v) revising assessment standards for occupational competences; and (vi) consolidating the implementation of the accreditation system. While the measure sets implementing the optimisation plan for VET providers as an immediate priority, it does not include concrete activities to carry this out.

Albania has started developing tools to regularly monitor the labour market and skills needs. In 2021, NAES, with help from the RisiAlbania project, piloted a regional labour market analysis in Elbasan to improve the planning of short-term training. This analysis helps to highlight the most prevalent characteristics of jobseekers as well as regional job offers. As such, this analysis can be used to better target the EPPs and vocational training. There are plans to progressively deploy it countrywide, starting with Durrës. In 2017, the United Nations Development Programme (UNDP) carried out an analysis on national skills needs in Albania. NAES has been cooperating with the UNDP on repeating this analysis in 2022 with a transfer of know-how on methodology. The subsequent analysis in 2025 is planned to be carried out fully by NAES. NAES has also started work on developing a labour market observatory which will build on existing administrative and survey data and on scraping of big data to capture macro-level developments in the labour market and various sectors of the economy.

Despite increasing educational attainment, young people face a difficult transition to the labour market pointing to issues with the education system's relevance and quality. Between 2010 and 2020, Albania saw a remarkable shift in higher education levels between 2010 and 2020 as the share of university graduates aged 30-34 rose from 11.4% to 33.2%, while this share reached 40.3% for the age group 25-29. However, there is a very high share of young Albanians not in employment, education or training (NEETs), which reached 27.9% for those aged 15-29, double the EU-27 average of 13.7% (2020 data). The incidence is highest among upper secondary graduates (31.1%), followed by tertiary graduates (27.5%) compared to those with at most primary education (24.9%). This points to issues with the quality of education and its relevance to the labour market. It is also linked to the structure of businesses which are not yet able to absorb the increased number of tertiary graduates coupled with a current low foreign direct investment. The impact of the COVID-19 pandemic on learning outcomes and on businesses, and the lack of measures to help students catch up on their learning could result in longer school-to-work transitions from in the short to medium term.

Albania has taken steps towards establishing a Youth Guarantee scheme based on the EU model to help young people integrate into the labour market. With EU-funded technical assistance, Albania has carried out a mapping of NEETs and a review of the legal framework. A multi-stakeholder group and a technical expert group were set up to prepare the Youth Guarantee implementation plan. Just over 10% of young NEETs aged 15-29 (18 142 out of 175 209) were registered as jobseekers in the third quarter of 2021. The number of staff in employment offices (see above) is currently insufficient to meet inflows of young jobseekers that are expected to increase as the Youth Guarantee scheme is progressively implemented. This could hinder the scheme's effectiveness. Staff also requires training.

The competency-based curricula have now been put in place in all grades – 1 through 12 – in the pre-university education system, but teachers have only received limited training. Three days of training per year from authorised providers is not enough to ensure continuous learning and development. For example, pupils are still not assessed based on competences. With low funding for in-service teacher training, the Agency for Quality Assurance in Pre-university Education (AQAPE) resorts to financially efficient training via professional networks of teachers. This however cannot replace obligatory training. The AQAPE does not yet give due attention to the preparation of the students in the general pre-university education for the labour market both by introducing relevant curriculum and extra-curriculum subject matters and accompanying teachers' trainings. An example would be the optional subject on 'preparing future employers and employees for the world of work' prepared with the support of the ILO. It was introduced for the first time in the current academic year 2021 – 2022 and was picked by over 2000 students in general high schools.

The reform measure 17 (*'Support the implementation of pre-university curricular reform and teacher training'*) was not included under key challenge 1. It partially addresses the issues mentioned above through activities to (i) develop training modules based on professional teaching standards and which are in line with the new curriculum, and (ii) strengthen human resources of local education offices in the curriculum sectors at the level. It also includes the much needed and long overdue activity to align the curricula in university programmes to prepare future teachers to teach subjects based on competency-based curricula.

University education in Albania is of low quality and is largely disconnected from the labour market. In a list of 400 higher education institutions (HEIs) in the QS World University Ranking 2021, the University of Tirana is ranked 351-400, behind its regional peers ⁽¹⁵⁾. There are 40 HEIs in Albania with more than 1 300 study programmes, often multiplied across different HEIs. This clearly highlights the lack of structural planning and education development strategies and results in poor content and lack of alignment with labour market needs. There is a theory-practice gap, with a low number of internships that are limited to the public administration. Even then, level 5 professional programmes are mostly theoretical and lack practical content. Interdisciplinary study programmes are not promoted. The National Strategy of Education 2021-2026 aim to partly remedy this, in particular through increasing the offer of professional programmes, and promoting career-advice services and interdisciplinary and STEM programmes. However, it does not put enough emphasis on cooperation with businesses and on opening programmes based on labour market needs. Furthermore, it also does not plan to change the criteria for financing universities to take more into account how many graduates get jobs after university. Moreover, the ERP does not include any reform measure to address issues in higher education.

Despite adopting new initiatives, e.g. the strategy on business and investment development 2021-2027 (BIDs) in the second half of 2021, and the law on innovative start-ups in February 2022, private sector development in Albania is yet to reach its full potential. It is too early to see if the ongoing efforts to improve the business environment and increase support for innovation will have a significant impact. Exports remain concentrated in few low-value added products, due to the narrow industrial base. Although there is an ongoing reform on fiscalisation (the obligatory electronic recording of sales subject to VAT), the widespread informal economy remains an issue. Businesses still find it difficult to employ skilled staff.

⁽¹⁵⁾ Belgrade – 60, Saint Cyril and Methodius in Skopje – 134, Sarajevo – 144, Pristina – 301-350.

Albania continues to rank low in the OECD's 2021 Competitiveness Index Albania - below the Western Balkans 6 average on science, technology and innovation. Scientific research is still systemically underfunded from public sources - general government expenditure on R&D was only 0.08% of GDP in 2019. It is not clear at this stage if the planned measures will achieve the objective of 0.2% of GDP in research and innovation by 2024, as stated in the ERP for 2022-2024. The proportion of companies investing in R&D (about 18%) was the second lowest in the region and public spending on research has been insufficient to strengthen the link between business and academia. At the same time, Albania's investment into tertiary education is losing its effectiveness due to the continuing brain drain of university graduates.

In terms of digital competitiveness, Albania appears to have a good e-commerce policy framework in its national strategy for scientific research, technology and innovation (2017-2022). However, the current level of e-commerce is limited, due in part to the limited capacity of telecommunication operators and internet providers. The BIDs for 2021-2027 aims to address some of these issues, supporting SMEs in taking up e-commerce and on access to finance and business support. Demand for access to finance remains significant - most of the SME activity remains self-financed and credit demand recovered during 2021, helped by support measures and economic recovery and approval rates have also increased. A new law on payment services, was recently adopted that includes dedicated regulations on facilitating e-commerce for SMEs. The law on innovative start-ups, adopted in February 2022, can potentially have a positive impact. However, both of these initiatives are very recent, so it remains to be seen what impact they will have on competitiveness.

Reform measure 03 ("Improving institutional, financial and human capacities for research and innovation") is carried forward from the 2021 ERP. It remains very relevant and could help Albania strengthen its' innovation and research capacities. The measure is ambitious, providing for R&D to be doubled as a percentage of GDP in 3 years (from 0.1% in 2022 to 0.2% in 2024), and doubling the number of funded research and innovation projects. It also provides for the completion and implementation of the Smart Specialisation Strategy (S3), and legal and support initiatives to be put in place over 2022-2024, including the law on innovative start-ups and business and investment development, as mentioned above. However, as mentioned above, these initiatives are very recent, so their full impact remains to be seen.

The activities planned include the improving research infrastructure, carrying out promotional activities for EU scientific programmes, providing investments to support research closely linked to the country's economic development, and promoting activities on skills development. Albania also identifies this as a measure designed to meet the EU Economic criteria regarding completeness. Action to the implementation of these measures will need to be clearly steered and strongly supported, to ensure their timely adoption. For a Key Challenge Reform, the analysis of main obstacles could have been more in-depth, but the current main challenges have been well summarised: 1) inter-institutional coordination and 2) budget constraints.

On inter-institutional coordination, so far, despite repeated reassurances of an order to clarify responsibilities to be signed soon, this continues to be an obstacle for the implementation of the important ongoing exercise Smart Specialisation Strategy (S3) that accumulated delays and need to speedily move into the EDP phase to have some chances to be adopted in 2023 as planned. In regard to budget constraints, despite appreciated budget increases, the target of 1% of GDP remains a challenge. In addition, in part due to lack university research facilities for business and a lack of investment by business in this, trust needs to be built up between universities and business.

The 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 to produce 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, half the EU-27 average of 19.3% in 2019. 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. With social support packages adopted to counter the negative impact of COVID-19, the expenditure increased to 11.0% of GDP in 2020 (EU-27 average increased to 22.0% of GDP) and was at 10.1% of GDP in 2021, but is set to fall below 10% of GDP in 2022 and beyond.

Poverty and social exclusion are high and the capacity of social transfers to reduce poverty is very low. In 2020, a large part of Albania's population (46.2%) was at risk of poverty or social exclusion, double the EU-27 average (21.9%). In 2021, the number of beneficiary households of means-tested income support from the Economic Aid scheme (*Ndihma Ekonomike*) peaked at 69 700 (about 10% of Albanian population). People with disabilities receive monthly benefits to cover their medical and care costs and compensate them for low labour market outcomes. A good step forward has been the removal of cessation of the disability benefit due to employment, agreed in 2019, which creates an incentive for labour market integration of beneficiaries. The operationalisation of the Employment Social Fund provided for in the Employment Promotion Law (2019) would provide an opportunity to support the employment of people with disabilities, but the ERP does not mention it. In the third quarter of 2021, only 6.5% of registered jobseekers received unemployment benefits while another 27.6% received support through the Economic Aid, leaving 65.9% without material support. Unemployment benefit is a lump sum at 50% of the minimum wage, therefore disconnected from previous earnings and presenting a low replacement rate for higher salaries. The capacity of social transfers (excluding pensions) to reduce the at-risk-of-poverty rate stands at only 12.1%, below regional peers and far below the EU-27 average reduction of 32.68%.

The allowances paid under the Economic Aid scheme are too low to combat poverty, but the government took temporary measures to increase them and began a process to review their adequacy. Based on Statistics on Income and Living Conditions (EU-SILC) 2020 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), stood at 12.4% of the median was equivalent to the annual income for such a household (ALL 651 847), far below the poverty threshold of 60% (ALL 391 108). Since their revision in 2018, the allowances were not updated until 2022 and their adequacy reduced compared to the poverty threshold, average wage, and to the Consumer Price Index. Nevertheless, the government doubled the benefits in April-June 2020 and again in January-June 2021 to support households during the economic slowdown. Since 2022, all allowances were increased by 10% and for households with three children they were doubled. Special categories receive lump sum amount, which was tripled in 2022. In compliance with the EU's Macro-financial Assistance conditionality, the government also prepared a roadmap one revising the adequacy of benefits in 2023 and on establishing a mechanism for their annual indexation. Also the effectiveness of how social assistance is targeted will be assessed using EU-SILC and Household Budget Survey microdata. These activities are part of the *reform measure 4* ('*Increasing the coverage and adequacy of integrated social care system to reduce the share of the population at risk of poverty*'), which is rolled over from the previous year.

With a goal to foster social inclusion and labour market integration, in 2019, the Government put in place an exit strategy from the Economic Aid, which has recently received a first impetus for its implementation. The Exit strategy puts in place a maximum 5-year duration of the benefit to limit dependency on social benefits. On 26 January 2022, Ministers of Health and Social Protection and the Minister of Finance and Economy signed a Joint Ministerial Order on the referral of working-age

beneficiaries. Individual action plans will be developed by multi-sectoral working teams involving State Social Services, local government units and employment offices. These plans will examine social situation, social service needs, training needs and employment opportunities. The initial goal is to provide active support to 5 000 beneficiaries. This is a good first step in fostering active inclusion, but it remains to be seen whether enough social services will be available and whether there will be enough capacity to offer active measures (vocational training or EPPs) – *see above under key challenge 1*. Support provided to social enterprises to help create jobs, as planned under *reform measure 4*, will also contribute to this goal, despite its modest target of employing 150 people by 2024.

The scarcity of social care services is a major obstacle to the active inclusion of vulnerable people. Out of 430 584 beneficiaries of social protection in 2021, 56% received social assistance payments, 34% disability allowances and only 10% (42 553) or 1.5% of the population benefited from social services (53% public, 27% non-public and 20% mixed). This shows that social services are scarce even for people with disabilities or socially vulnerable people let alone for the general population. In total, 493 social services are distributed unevenly across the country and are completely lacking in five municipalities (out of 61). Services for excluded young people, victims of trafficking and young people in conflict with law are lacking in 53 municipalities, services for adults with disabilities in 47, services for older people in 36, services for children without parental care in 32 and services for children with disabilities, victims of violence or families in need lack in 18 municipalities (SDC, MHSP, UNDP 2021).

All municipalities, except for one, developed local social plans by the end of 2021 but their implementation capacities remain weak. Donors and NGOs helped develop most of the plans and also delivered up to three days of training to municipality staff. However, periodic training and provision of technical support to local staff is lacking, resulting in weak capacities to assess needs, plan and deliver services. The State Social Services, which could deliver training and capacity building, lack resources to do so. *Reform measure 4* aims to increase the capacity of municipalities without, however, elaborating on the details.

The state budget resources for developing new social services are only being increased very slowly and the mode of their disbursement highlights challenges posed to the sustainability of these new services. Municipalities must have a social plan in order to apply to the Social Fund, which was put in place in 2019 to help roll out new social care services. Despite virtually all municipalities becoming eligible in 2021, the budget for 2022 provides for the same allocation to the Social Fund as in previous years (ALL 200 million; approx. EUR 1.61 million) and the mid-term budget plans for only mild increases (ALL 216 million in 2023 and ALL 232 million in 2024). Moreover, it is unclear if support from the Social Fund at the level of 30% of the cost of new services will continue beyond the third year of the existence of newly established services, therefore posing a challenge to the sustainability of these services. Another weak point is the low capacity of most local governments to assess needs, apply for government funds and manage social services. *Reform measure 4* plans to develop 45 new services by 2024 with support from the Social Fund. However, the issue of their sustainability has not been addressed.

The Albanian healthcare system is underfinanced and there is a significant share of uninsured people. The budget allocation to healthcare as a share of GDP has been steadily increasing, from a low of 2.5% of GDP in 2008 to 3% in 2018, 3.23% in 2020 and 3.35% in 2021, with the latest increases being linked to the COVID-19 pandemic. This is below the allocation levels of regional peers (except for Kosovo) and significantly below the EU-27 average of 8.0%. Healthcare has been consistently receiving 10% or less of government spending, therefore not reaching the 12% share that the World Health Organisation recommends. There are around 600 000 uninsured people (21% of the population); they are principally informal workers, low-income groups, minorities (Roma/Egyptians), and people living in rural and peri-urban deprived areas (WHO 2020a). Albania faces chronic under-funding of primary healthcare, especially maternal and child health (UN 2020). The budgetary programme launched in 2018 has led to the reconstruction and equipping of 300 primary health care centres and has improved service provision in urban and rural areas. It is set to continue until 2025.

The government took progressive steps towards universal healthcare coverage. 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: (i) annual health check-ups for people aged 35 to 70 to detect non-communicable diseases, which is a rather entitlement in the world, (ii) visits to general practitioners and (iii) access to national breast and cervical cancer screening programmes. 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 (between ALL 2 000 and 4 000). An additional 12 healthcare packages cover specific intensive therapies in private facilities, but uninsured people face fixed tariffs. Children under 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). In the coming years, the government aims to improve access to dental care and ophthalmologic care and devices for children.

High out-of-pocket (OOP) payments limit access to healthcare. The limited public spending has resulted in Albanian households relying on OOP spending, which represented 44.58% of current health expenditure in 2018, significantly above the EU-27 average of 15.57% and above regional peers. Heavy reliance on OOP payments, part of which is informal, results in significant financial hardship for households and may exacerbate inequalities and barriers to accessing healthcare (Tomini et al. 2015). For 16.7% of Albanians, more than 10% of their household expenditure goes on healthcare and for 5% of Albanians it exceeds 25%, shares that are considerably higher than for regional peers (WHO 2021). In 2015, 12.4% of Albanian households experienced catastrophic health spending (WHO 2020b). Albania faces an issue with financial protection for people on low incomes and other vulnerable categories. Outpatient medicines and care are not covered for uninsured people. Although the number of medicines on the government list has grown and state financing has increased, co-payments for outpatient medicines continue to exacerbate financial hardship (WHO 2020a). The chronically-ill benefit from the reimbursement of costs for drugs on the government list. The UN concludes that despite low public spending on healthcare, there is a potential to reduce the burden of OOP spending of poor people and people in vulnerable situations through coverage policy (UN 2020). In 2020, 9.1% of the population reported an unmet need for medical care due to its high cost. This is far above the EU-27 average of 1.1% and 3.3 pps. above the second worst performer (Greece). The main groups affected include persons with disabilities and chronic diseases, poor households, people aged 65 and over, and minorities (WHO 2018).

Albania is facing a shortage of doctors that could jeopardise access to medical care in the coming years. In 2020, the per capita ratio of medical doctors was 18.75/10 000, the lowest among candidate countries and potential candidates and significantly below the levels recorded in EU Member States (WHO data). The geographical coverage is skewed towards central and larger urban areas where medical specialists are concentrated, as opposed to remote and small districts. This results in difficult access to healthcare for people living in rural and remote areas who have to travel to Tirana and other bigger cities. These people also face extra spending for travel and accommodation, with extra hardship experienced by people with disabilities. 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 opportunities for professional development (SDC 2020). 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 health professionals out of the country. Another potentially positive step is an increase in the quota of medical students from 300 to 450 as of 2022.

Reform measure 5 ('Increasing access to health care') is rolled over from the previous year. It has been partially implemented, despite the distortions due to the COVID-19 pandemic. It tackles some challenges described above through expanding the coverage of free healthcare packages and preventive programmes, revising legislation on drugs, enabling dual practice for doctors to increase their motivation to remain in Albania and transforming hospital financing. The measure does not do enough to tackle high OOP expenditure, lack of access for vulnerable people to healthcare and outpatient medicine, and low public spending on healthcare in terms of GDP. More attention should be given to integrating primary,

secondary and tertiary healthcare, and to the online training of healthcare staff. The measure does not include a breakdown of activities by year.

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

Albania's assessment in the ERP for 2022-2024 includes measures to tackle the informal economy, notably fiscalisation, but it does not assess either the scale of the informal economy or its impact upon the economy, even on government revenue. Similarly, while it does examine how both the earthquake in 2019 and COVID-19 affected the economy, it does not analyse the underlying business issues apart from the need for companies to focus more on innovation, particularly in the agricultural sector. In section 5.2.4 of the ERP on the business environment and the informal economy the analysis of obstacles under this section is limited to the informal economy, exposure of businesses to different aspects of informal economy and some corrupt practices that enable the 'formalising' of informal actions (this section seems to be the same with the one under Key Challenge 3, as part of the analysis is repeated there). This section is not comprehensive, as it does not analyse the numerous other issues that affect the business environment. These include frequent changes of relevant legislation, weak consultation of legal texts at the draft stage, weak contract enforcement, and issues related to the legal system and to property.

While the ERP for 2022-2024 describes issues caused by the informal economy and the Albanian government's commitment to the "good governance of business" and to the reduction of corruption, it does not define what "good governance of business" is or describe other challenges to the business environment. Nevertheless, it describes how the government intends to tackle the informal economy, which it has identified as impeding fair competition and lowering revenue for the state budget. However, the sector analysis has not been updated – it still refers to the 2020 COVID-19 year and the negative impact of this on specific sectors as regards GDP. The analysis should have been for 2021, when Albania experienced positive growth. Furthermore, a sector performance analysis could have been included, though reference made to the Investment Council Secretariat survey on the impact of COVID-19 on businesses is welcome. However, a better and more complete assessment of the business climate would have better informed the analysis and, potentially, the means to tackle the informal economy, which is pertinent to the next point.

Albania's business environment remains prone to structural weaknesses, with many companies having only limited capacities for production or innovation, and investment in skills development is low. Diversification of production and exports remains low. Frequent changes to the regulatory framework, low productivity as well as competition from a large informal sector remain major issues. Micro and small businesses, which account for a far higher level of employment and added-value than the EU average, struggle to access finance due to a lack of business know-how and skills, low financial literacy, and a high level of undeclared work. Around 20% of SMEs do not have bank accounts and cannot produce financial reports to obtain funding. In 2021, the government adopted its Business Investment Development strategy (BIDs), designed to stimulate innovation-driven and knowledge-based economy, create new, higher-quality jobs via the potential of the digital transition and the transformation of international value chains. It also emphasises sustainable development, including tapping into the green/circular economy, EU and regional integration. The government programme also anticipates two sovereign guarantees of EUR 50 million for businesses investing in digitalisation and innovation. However, the unified investment law is not yet in place, despite being drafted for several years.

The informal economy continues to constrain Albania's economic development - according to the Business Environment and Enterprise Performance (BEEPS) survey, almost one-third of transactions have an informal aspect. 44.7% of companies reported competing against informal competitors, with 37.2% citing this as a major business obstacle, and it extends into many sectors. The share of informal employment was 36.2% in 2020, equal to 2017 levels, and in the agriculture sector it was 48.7%, though both were around 1% lower than 2019. Informal employment remains common among young people (15-24 years old) with one in every two young people being in informal employment, especially for those with lower levels of education. However, the share of young people

with higher education has increased by around 3 pps. compared to 2018, while the share of those with low levels of education has decreased by 2.3 pps.

While the measures, introduced in 2020 and continued 2021, set out to tackle the – informal economy may be useful, they are largely restricted to “fiscalisation”. This helps to address some aspects the informal economy by obliging many cash transactions to be turned into digital transactions. The informal economy in the labour market, mainly in the form of lack of a regular work contract accompanied by a lack of social and health insurance or contracts with under-declared salaries (and thus insurance contributions). While it is clear that commercial transactions via banks should be encouraged, if the necessary security is in place, the ERP does not examine the wider causes for the existence of the informal economy. Albania’s policies to tackle the informal economy are not comprehensive. They are focused more on the above measures rather than on structural or sector-specific issues. This is despite the Joint Conclusion from the 2021 ERP for Albania on adopting a strategy to address the informal economy, which was also a recommendation of the 2021 OECD competitiveness index (OECD 2021a).

The Economic and Investment Plan (EIP) 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 EIP, will direct most of the support towards key productive investments and infrastructure. This will support the twin green and digital transition and the development of an economy that is connected, competitive knowledge-based, sustainable, innovation oriented and thriving, with an increasingly dynamic private sector. Circular-economy principles form the 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 from further access to innovative technologies.

Building a common regional market has the potential to further increase competitiveness and growth. The common regional market is based on EU standards and will help the country integrate into 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 Albania’s young people. This is especially important given the high rates of youth unemployment.

Reform Measure 06 “Strengthening the fight against informality”

This measure is carried forward from the 2021 ERP. It is well-designed, which can help to reduce of the informal economy. However, while it mainly focuses on aspects of fiscalisation, it does not form part a wider comprehensive strategy to tackle all aspects of informal economic activity and informal employment, though this was set out as a joint conclusion in the 2021 ERP exercise. Implementation started in 2021. The actions planned in 2022 are expected to focus on wealthier individuals, using information held in public registers and received through inter-institutional cooperation. The proposed indicators are relevant. However, compliance for wealthier individuals is currently low and insufficiently enforced, and quite a portion of revenues is probably undeclared. In order to tackle informality more broadly it would also be necessary to ensure progress on property tax reform and initiatives to decrease tax loopholes. Furthermore, the breakdown for the expected costs is not provided, there is no indication as to what the source of funding is, and the risk analysis does not take into account the impact of the COVID-19 pandemic.

The ERP reports extensively on the ongoing fiscalisation process, providing concrete data for specific categories of businesses, though there is no explanation for why the rate of small businesses that have issued fiscalisation receipts remains below 50%. Feedback to the Commission from Albanian businesses

and business organisations signalled that they generally consider fiscalisation a good initiative. Nevertheless, it may be premature for businesses that have challenges related to infrastructure or internet access, as for the latter in particular it is necessary to implement fiscalisation. However, according to the findings of the Ministry of Finance and Economy report on “*Support for digitalisation of SMEs in Albania to mitigate the COVID 19 pandemic impact to businesses*” around 98% of Albanian SMEs have an internet connection or have at least one employee who uses the internet for business purposes.

This measure ensures continuation of the actions to tackle the informal economy and informal employment, and the government is also working on finalising a draft medium-term revenue strategy (MTRS) that is expected to include the measures mentioned to tackle the informal economy in the ERP. Albania is planning to roll-out activities under this measure that target global income from taxpayers and individuals as well as a compliance programme for wealthier individuals. However, this may only target wealthier and more mobile workers. It is not clear how these actions will target workers without a contract, or without social and health insurance, or contracts with under-declared salaries, despite there being incremental increase targets on reducing undeclared jobs and lowering the level of undeclared wages (none of the targets address the lack of social and health insurance, although the state labour and social services inspectorate is developing risk assessment tools with ILO to tackle informality in the labour market, and on undeclared and under declared work, which is expected to be launched in 2022).

To build on this, strong inter-sectoral coordination is needed to analyse the underlying causes of the informal economy and informal employment, and then to design coordinated measures to address both the revenue and employment issues; This coordination is needed to address both informal economy and informal employment and monitor the results of the ensuing anti-informality measures in a comprehensive and integrated way. To this end, protocols and consultation mechanisms should be established to strengthen these dynamics, including the promotion of tripartite dialogue with both business and employees on issues of the informal economy and informal employment, as well as stronger means to ensure inspection.

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

This measure is carried forward from the 2020 and 2021 ERPs. However, its roll-out being planned for 2021 (as well as several follow-up activities), the law on innovative start-ups was only adopted in February 2022. This means that the of streamlining the institutional framework responsible for fostering research and innovation while also monitoring its impact has not yet taken place. Although several activities planned for 2021 were not implemented, substantial progress was made on some fundamentals in late 2021. For example, the Ministry for Protection of Entrepreneurship, although understaffed, was formally given a mandate to provide support to start-ups. This led to EUR 10 million of funding being allocated for grants under start-up support programmes over 4 years. There was also some progress on the developing an action plan for the “Support for the development of innovative policies” - though this needs to be completed and implemented.

The government is showing momentum and commitment to nurturing the nascent innovation ecosystem. The activities planned for 2022/2023 under reform measure 03 should create better conditions for Albania to benefit from its commitments under the innovation agenda for the Western Balkans and Horizon Europe.

After the law on innovative start-ups the activities was adopted, the activities planned for 2022 include drafting the necessary secondary legislation, establishing the start-up agency, and continuing to implement of the (EU-funded) project on innovation. However, the start-up agency that should provide the support measures to innovative start-ups is only expected to be fully up and running in 2024. Furthermore, there are no baselines for several indicators for this measure, and none of the intermediate targets or the 2024 targets will be easily measurable so as to provide concrete indications of their real impact, as they are mostly process indicators. Furthermore, the risks identified include measures such as adopting legal acts. This is largely within the control of the national authorities, so it is unclear why they are cited as risks. Furthermore, responsibilities have yet to be allocated for implementing the Smart

Specialisation Strategy (S3) (reform measure 10). This needs to be resolved, especially in light of Albania's commitments under the innovation agenda for the Western Balkans and Horizon Europe.

Reform measure 08: "Support measures to MSMEs"

This reform measure in ERP 2022 seems very closely linked to the measure "Improving access to finance for SMEs" contained in the ERPs for 2020 and 2021. The activities under this measure planned for the coming period are mostly focused on providing support for digitalisation, notably support to SMEs, including training, developing a portal on digital marketing, capacity building, helping SMEs to digitalise, and providing instruments to improve their access to finance. These activities are welcome, and could increase competitiveness, if they are also matched with a substantial increase in the institutional capacity of business support services.

However, the description of the measure could have been clearer. Several ongoing initiatives are mentioned, including ongoing programmes, e.g. advisory instruments for MSMEs. Legal initiatives for MSMEs are also mentioned, such as the adoption of BIDs (see above), which is the basis for many of the activities. The references to the 2021 OECD Competitiveness report are welcome. However, the text only mentions statistics provided up to 2019. Statistics could have been included from Albania's Institute of Statistics' (INSTAT) report issued in November 2021. According to INSTAT's 2020 survey, businesses with 50 or more employees provide 40.8% of total employees and 46.2% of turnover, although they account for only 1.3% of active businesses, therefore providing the main contribution to the economy.

The activities expected for 2022 under this measure are very ambitious; it will be a challenge to implement them all as planned. In general, it is difficult to match what is mentioned description of the measure's in the ERP 2022-2024 with the activities planned. Nevertheless, Albania Union of Chambers' establishment of the digital market matching portal is mentioned; to date the inclusion of a private sector activity under the ERP activities has been rare. However, the intermediate indicator targets do not comply with the timeframe for this exercise, which is June 2022 rather than end 2022, and the final targets are foreseen in 2023 -although activities are planned to go on into 2024. In addition, the indicators for results do not reflect the description of the measure or the activities. They are also not ambitious; e.g. the number of users of centralised information platform, which is reported as being operational since May 2020, only anticipates 1 000 users in the baseline year, expected to increase to 2 000 in 2023. This seems more appropriate for a pilot activity. It seems rather low compared to the potential need. According to the INSTAT data, Albania has 101 000 SMEs (with less than 50 employees) and around 88 000 MSMEs with 1-4 employees.

The potential risks identified under this topic are identified as being high, yet the measures include legal adoption, which is largely within the control of the national authorities (so it is unclear why they are cited as high risk). If the risks are high, further risk mitigation measures are needed in addition to awareness raising efforts.

Reform measure 09 "Modernisation of retail payment instruments"

This measure was also carried over from both the 2021 and the 2020 ERPs. It aims to create the conditions needed to improve the range of available banking services. This measure has several potential objectives. It should help to improve access to finance, therefore increasing the level of entrepreneurship, and also help to combat the informal economy, money-laundering ⁽¹⁶⁾ and tax evasion. Furthermore, it should help Albania to align to the EU *acquis* (on payment accounts). The measure is well designed, and the activities are outlined clearly, with a specific timeframe and funding, as are the risks and mitigating measures.

⁽¹⁶⁾ Albania was "listed" by the Financial Action Task Force (FATF) as a "jurisdiction under increased monitoring", due to strategic deficiencies in its Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) regimes. After being "listed", Albania made a high-level political commitment to work with FATF and agreed a specific action plan to be implemented to ensure effective AML/CFT regimes compliant with FATF Recommendations.

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. As signalled in the Commission's report on the 2021 ERP, the description of this measure does not explore potential synergies with other government measures such as the payment of social benefits, despite these being mentioned in the ERP (in the part entitled "*Main recommendation on the analyses Government Payment Digitization*"). Several of the measure's indicator targets are unlikely to give any concrete indication of the measure's impact, as they are statements as opposed to being quantifiably measurable.

Box II.1.5: Monitoring performance in light of the European Pillar of Social Rights ⁽¹⁷⁾

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

ALBANIA		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Worse than EU avg., improving
	Individuals' level of digital skills (basic or above basic)	Worse than EU avg., trend N/A
	Youth NEET (% of total population aged 15-29)	Worse than EU avg., improving
	Gender employment gap	Worse than EU avg., improving
	Income quintile ratio (S80/S20)	Worse than EU avg., improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU avg., improving
	Unemployment rate (% of population 15-74)	Worse than EU avg., improving
	Long term unemployment rate (% of population 15-74)	Worse than EU avg., improving
	GDHI per capita growth	N/A
Social protection and inclusion	At risk of poverty or social exclusion (in %)	Worse than EU avg., improving
	At risk of poverty or social exclusion rate for children (in %)	Worse than EU avg., improving
	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU avg., improving
	Disability employment gap	Better than EU avg., improving
	Housing cost overburden	Better than EU avg., improving
	Children aged less than 3 years in formal childcare	Worse than EU avg., trend N/A
	Self-reported unmet need for medical care	Worse than EU avg., improving

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

Albania has steadily improved employment and unemployment rates, being one of the best performers among candidate countries and potential candidates, and showed relative resilience during the COVID-19 slowdown in 2020. Further improvement in employment results has been hindered by the high NEET rate, which increased slightly in 2020 (1.1 pps.), placing Albania among the worst performers among candidate countries and potential candidates. Another hindrance is the gender employment gap, which was wider than that in the EU-27 in 2020 (15.2 pps. vs 11.0 pps.), but a slight improvement can be noted in recent years. This gap is in part driven by the low provision of early childhood education and care, especially for children under 3. Unemployment, especially long-term, is still far higher than the EU average, which is partly due to low provision of active labour market policies. Albania is a medium performer in the region as regards the income quintile ratio.

Albania has a very high share of low-skilled adults and high but decreasing rates of early school leaving. There are significant rural-urban and socio-economic differences in access to education. Albania's early school leaving rate decreased from 21.3% in 2015 to 15.6% in 2020, but it remains among the highest in candidate countries and

potential candidates. Annual participation in adult learning is very low (9.2% in 2017) compared to the EU (37.4% in 2016). The overall level of digital skills is far below the average of candidate countries and potential candidates.

Risks of poverty and social exclusion are very high and the capacity of the social protection system to reduce them is low. This is documented by the limited impact social transfers (excluding pensions) have on poverty reduction which was only 12.10% in 2020 compared to 32.68% in the EU. Albania is among worst performers in terms of rate of poverty and social exclusion (46.2%). Although there is a social assistance scheme, the allowances are not adequate. However, the government temporarily increased their adequacy in 2020 and 2021 and embarked on a process leading to a systemic increase in the benefits. The capacity of local governments to provide social care is very low, but the central government is paying more attention to this situation and supports financially the establishment of new services. The pension system has almost universal coverage, albeit with low pensions. About 600 000 adults, mainly informal workers, do not have health insurance, but access to universal healthcare has been improving over recent years. In 2020, 10.6% of people reported an unmet need for medical care. While this value has improved over the last four years, it is still almost six times higher than in the EU (1.8%).

⁽¹⁷⁾ The table includes 16 headline indicators of the Social Scoreboard, used to compare performance of EU Member States (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2020 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). For data see Annex B. NEET: neither in employment nor in education and training; GDHI: gross disposable household income.

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. Employment data are regularly measured by both the Labour Force Survey (LFS) and the National Agency for Employment and Skill. LFS data are not yet available in Eurostat, but INSTAT has been sending LFS microdata to Eurostat since 2017 and has been working on its quality, timeliness and validation.

1.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2021

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 region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the PG is similar to that of the country-specific recommendations usually adopted under the European Semester for the EU Member States. The Commission evaluates the work carried out to implement the policy guidance in the following year's ERP assessments. The table below presents the Commission's assessment of implementation of the 2021 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at Ministerial level on 12 July 2021.

Overall: Partial implementation (43.1%)	
2021 policy guidance	Summary assessment
<p>PG 1:</p> <p>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.</p> <p>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.</p> <p>Increase the institutional capacities of the fiscal risk unit to continue and expand its work without reliance on external assistance</p>	<p>There was partial implementation of PG 1:</p> <p>1) Substantial implementation: The 2022 Budget and MFF include an extended planning horizon, which outlines a gradual reduction of the public debt ratio, albeit at a slower pace than planned in last year's ERP (these projections could not yet take into account the expected significant fallout of Russia's invasion of Ukraine). The primary balance is projected to be neutral in 2023 and positive in 2024 in line with the original fiscal rule, which was postponed to 2024 by normative act in 2021. The revenue forecast is slightly optimistic considering historical averages but could be realised by means of the implementing the MTRS.</p> <p>2) Partial implementation: The commitment to the MTRS has strengthened since October 2021 and its development has accelerated but it is not yet completed. The inter-ministerial committee envisaged the implementation of the MTRS in 2022. However, in order to allow for a serious public consultation its implementation could not begin before the ERP's submission. However, the fiscal package for 2022 already includes some of the measures planned under the MTRS (without consultation).</p> <p>3) Limited implementation: The fiscal risk unit continued to expand their scope of work with the support of the World Bank, but its staffing did not increase.</p>

<p>PG 2:</p> <p>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.</p> <p>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.</p> <p>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.</p>	<p>There was partial implementation of PG 2:</p> <p>1) Substantial implementation: VAT refund arrears were almost at zero by the end of 2021, the stock of contract-based arrears decreased, and the reasons for the increasing local governments' arrears were reportedly analysed along with a draft plan to reduce them.</p> <p>2) Limited implementation: There was no progress made on the approval process, but basic treasury reporting of reconstruction expenditure continued during the implementation of the consolidated budget implementation report. Implementation of reported plans to improve public investment management including PPPs is likely to be hampered by institutional restructuring of the management of external assistance.</p> <p>3) Limited implementation: The ERP plans a gradual, minimal increase of expenditure on education (10.5 to 11.5%) and health (9.9% to 10.5%), but from a very low 2021 level. However, the programmed increase will allow expenditure shares to recover only to 2019 levels by 2023 and 2024 respectively. In terms of GDP no change is projected. For social protection expenditure, which increased in 2020 to 33% only to drop sharply to 28% in 2021, a slightly increase is planned to 30.1% in 2024, still 2 pps. below 2019 expenditure share levels and just 0.2pp above them in terms of GDP. All three expenditure categories are somewhat ring-fenced from cuts for fiscal consolidation but no significant change in expenditure composition planned until 2024 despite a drop in capital expenditure from 2023. Regarding R&D, the ERP claims that the Ministry of Finance and Economy is not able to calculate such spending, but the IMF does calculate it based on GFS data: in 2020, the general government's R&D expenditure stood at EUR 25 million, equal to 0.58% of total expenditure and 0.19% of GDP, after a 17% increase in 2019. In order to maintain these shares the expenditure would need to grow by about 6% each year. To reach 1% of total planned expenditure an annual increase by at least 20% would be necessary, which would be equal to 0.3% of GDP.</p>
<p>PG 3:</p> <p>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.</p>	<p>There was partial implementation of PG 3:</p> <p>1) Substantial implementation: The central bank has conducted a compliance self-assessment with PWC Spain (with support from the European Bank for Reconstruction and Development) regarding the equivalence of Albania's supervisory and regulatory framework with that of the EU. Financial stability challenges were monitored closely, and prudential measures related to the pandemic were phased out in time. The central bank is now conducting an asset quality review of the five major systemic banks, while</p>

<p>Further reduce remaining institutional and legal obstacles to swift and effective NPL resolution, including by resolving the bailiff deadlock and strengthening bankruptcy proceedings.</p> <p>Continue with the implementation of measures aimed at promoting the use of the national currency, including by developing the market for forex hedging instruments.</p>	<p>maintaining restrictions on dividend distribution, which is conditional on increased macroprudential requirements. Provisioning increased through 2021 and seems adequate.</p> <p>2) Partial implementation: Albania made progress in completing the bankruptcy legislation by adopting the remaining by-laws. No progress has been made in resolving the bailiff impasse which continues to delay collateral execution.</p> <p>3) Limited implementation: Some progress was made in developing the market for hedging instruments, as the Bank of Albania started publishing bids and asking for prices for quotations collected from banks and introduced 3-month outright forwards as an instrument for changing its reserves. There was no progress and there are no plans to introduce measures to increase the use of the national currency in the realm of the government</p>
<p>PG 4:</p> <p>Provide enhanced business support services to improve access to finance and entrepreneurial know-how.</p> <p>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.</p> <p>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.</p>	<p>There was limited implementation of PG 4:</p> <p>1) Limited implementation: there are plans to improve business support services, notably under the BIDs for 2021-2027, adopted in August 2021. However, the national authorities admit that the funds in question are rather limited and there is a lengthy application process. Few results were achieved in 2021.</p> <p>2) Limited implementation: Consultation with private sector remains weak, and not effective particularly on issues such as the fiscal policy package.</p> <p>3) No implementation: this did not happen. Discussions are ongoing to see if something similar can be provided for under the MTRS</p>
<p>PG 5:</p> <p>Establish an inter-ministerial task force involving relevant ministries, their agencies, and stakeholders to develop a Youth Guarantee implementation plan.</p>	<p>There was substantial implementation of PG 5:</p> <p>1) Full implementation: The Ministry of Finance and Economy, with the help of EU-financed technical assistance project, has been working on analyses on the development of the Youth Guarantee Implementation plan, such as the mapping of young people not in employment, education or training, and on analysing the legal framework. On 24 February 2022, Order of Prime Minister No. 28 'For the establishment of the inter institutional working group and technical group for the establishment, implementation and monitoring of the national plan for the Youth Guarantee scheme and for assignment of the national coordinator' was approved, implementing the</p>

<p>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.</p> <p>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.</p>	<p>policy guidance. In the next phase it will be essential to fully involve relevant ministries, their agencies and stakeholders (social partners, NGOs, in particular youth organisations) to develop the plan.</p> <p>2) Partial implementation: With the help from donors, the National Agency for Employment and Skills has piloted a regional labour market analysis in Elbasan. NAES plans to deploy it in other regions. NAES has also started work on developing a labour market observatory which will add to existing administrative and survey data and conduct the scraping of big data. For 2022, the repetition of skills needs analysis (last conducted in 2017 by UNDP) is planned with UNDP's help. This will involve the transfer of know-how to NAES, which aims to conduct this analysis autonomously in 2025. The skills' anticipation study (methodology) in the agricultural sector (dairy and wine value chains) developed with the ILO support, will assist the sectoral skills committees to be established by the NAVETQ.</p> <p>3) Partial implementation: The measures indicated are promising, but are yet to be implemented as they are planned for 2022 and beyond. Some progress has been made on research and innovation, as mentioned under reform 03 and 07, regarding a) the increase of funding (although still far from 1% of GDP as targeted in the National Strategy for Science, Technology and Innovation) and b) the allocation of EUR 10 million of public funding to start-ups support programmes for 4 years. These are now beginning (the first calls were expected in Q2 2022).</p>
<p>PG 6:</p> <p>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.</p> <p>Build capacities in local governments to apply for support from the Social Fund and to plan, manage and deliver social care services.</p> <p>Redesign coverage policy, including for outpatient medicine, to reduce unmet need for medical care and</p>	<p>There was limited implementation of PG 6:</p> <p>1) Partial implementation: Albania has adopted a roadmap with relevant activities to assess the adequacy of benefits. It aims to adjust their adequacy as of 2023 and to establish a mechanism for their annual indexation. The assessment is being carried out with help from the World Bank and is expected to be finalised in of the first quarter of 2022. Furthermore, proposals for draft by-laws are expected by June 2022, with their adoption and the allocation of an appropriate budget expected for 2023.</p> <p>2) Limited implementation: Despite developments in the drafting and approval of social plans in 60 out of 61 municipalities, implementation remains limited. The social plans were developed with help from donors and NGOs, which provided up to 3 days of training to municipality staff. Nevertheless, the capacities at local level to plan, manage and deliver social services remain weak. The State Social Services agency lacks internal capacity to put in place a capacity-building system for municipalities.</p> <p>3) Limited implementation: The government has yet to</p>

financial hardship, particularly among persons with disabilities and chronic disease, poor households, people aged 65 and over, and minorities	take any comprehensive measures to address this policy guidance. Some targeted measures are planned, such as increasing reimbursement for laboratory analyses, or improving access to dental care and ophthalmologic care and devices for children. Other priorities include increasing the budget for drugs provided for outpatient and hospital care and to developing a new methodology for drafting the list of drugs subject to reimbursement, which could lead to lower co-payments. It is unclear whether annual caps on co-payments will be introduced, which could decrease financial hardship for vulnerable households or increase access to medicines. Adequate measures are needed to ensure full access to medical care, especially for patients with chronic diseases or with disabilities, in particular for patients living outside Tirana (i.e., at local level). The financial resources allocated so far are not sufficient to ensure that these people's specific needs are met.
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1.6. THE 2022 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, 24 May 2022

[...]

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

1. If needed, use the available fiscal space in the 2022 budget to cushion the potential impact of adverse shocks through targeted support to vulnerable households and firms; provided the economic recovery is well entrenched, plan in the medium-term budgetary framework a gradual reduction of the public debt ratio and a return to a positive primary balance by 2024, while lowering the general government arrears below 2.5% of total expenditures in 2022. Restrict budget revisions to the regular revision process set out in the Budget Law and use the regular legislative process should an amendment of the Budget Law become necessary. Assess the fiscal risks from state-owned enterprises and develop proposals for their mitigation.
2. Implement the activities outlined in reform measure 10 of the ERP on Public Strategic Investments and in the PFM strategy to improve the management of public investments including PPPs. Adopt the medium-term revenue strategy following an intensive public consultation, and complement it with a budgeted, operational implementation plan to guide tax policies in the coming years. Continue to increase the shares of spending on education, health, social protection, and R&D in total public expenditure.
3. Carefully assess and analyse price developments and stand ready to tighten monetary policy, if needed, to preserve price stability in the medium term. Ensure a transparent and accurate reporting of asset quality and adequate provisioning, further reduce remaining obstacles to NPL resolution, particularly by resolving the bailiff deadlock, and reduce data gaps in particular as regards the real estate sector. Foster the implementation of measures aimed at promoting saving and borrowing in national currency and at limiting the use of foreign currency in the real economy, including through measures in the remit of the government in line with the Memorandum of Cooperation.
4. Provide enhanced business support services to improve access to finance and entrepreneurial know-how. Assess the effectiveness of the consultation mechanism and then revise it with input from businesses and social partners in order to make the process more comprehensive, practical and transparent. Design a strategic and coordinated action plan for implementing anti-informality policies, based on, but not limited to, the medium-term revenue strategy.
5. Finalise, in co-operation with all relevant ministries, their agencies and stakeholders, a Youth Guarantee Implementation Plan, adopt it and initiate its implementation. Conduct the regional labour market analysis in all regions, institutionalise the national skills needs analysis and utilise these tools together with the Labour Market Observatory to improve the labour market relevance of initial and continuous vocational education and training for young people and adults and to target the use of active labour market measures. Encourage cooperation between innovative businesses and academia as foreseen in the Strategy on Business and Investment Development 2021-2027, by continuing to increase science and research funding, and by creating the conditions for the development of business incubation programmes.

6. Finalise the assessment of adequacy of 'Economic Aid' benefits, increase their adequacy as of 2023, and establish a mechanism for their annual indexation. Increase allocation to the National Social Fund to ensure coverage, provide additional support to municipalities with limited resources, and improve the sustainability of newly established social services through continued contribution beyond the third year under a condition that municipalities establish a Local Social Fund with sufficient budget. Redesign reimbursement policy for outpatient medicine to reduce financial hardship, particularly among persons with disabilities and chronic disease, poor households, people aged 65 and over, and minorities.

ANNEX A: ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2022-2024 ERP

The 2022-2024 ERP identifies the areas where - the most significant key obstacles exist, such as the business environment, education and skills, labour and employment, the informal economy, and research and development. It also continues to address the negative impact the COVID-19 pandemic and the 2019 November earthquake had on the economy due, identifying tourism and services as being among the hardest hit sectors. It provides a general assessment of the current reforms towards formalisation of the economy, while acknowledging that informal economic activity remains a significant concern, as illustrated by the high number of cash transactions and non-declared workers. However, there is limited analysis of the sectors where the informal activity is most prevalent, and the challenges encountered when trying to tackle it. The text describes the challenges in the education system and the need to better match the skills offered through the education system and vocational education and training (VET) with market demand. The text also addressed 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 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 foreign direct investment (FDIs), product diversification, and exports all affect the country's competitiveness and growth and its ability to create jobs, but these are also not analysed. Furthermore, issues with the rule of law, corruption, unclear property titles and the proper functioning of the judiciary system still hinder businesses and reduce Albania's attractiveness for foreign investments.

Public financial management

The analysis of this area is extremely short. It is also incomplete, as it only mentions issues on public strategic investment, notably obstacles mentioned in Albania's public investment management assessment (PIMA) conducted by the IMF in 2016. However, public financial management is far wider than this, notably including the delegation of decision making, managerial accountability, and internal and external auditing. The analysis should have covered the obstacles in this whole area. This could have been done, as many such obstacles are being addressed under Albania's 2019-2022 PFM Action Plan (2019-2022 PFM strategy). The risk analysis is also incomplete - most of the mitigating measures are missing, and the "high" risk item ("risk of law changes") seems to be entirely within the control of the authorities.

Reform measure 10 "Public Strategic Investments"

The actions planned for 2022 seem to be relevant - and include developing a public investment strategy to guide public investment and preparing and maintaining the single project pipeline, which are useful and necessary. The assessment of obstacles and challenges in public investment management is realistic and is based on the IMF PIMA findings from 2016, which still seem to be realistic. The proposed measure - drafting the Public Investment Management strategy - will also address one of the unmet PG recommendations on assessing and approving all investments, which involve public funds and PPPs, through the same approval process.

However, the description of the main obstacles in the area and of measure are extremely short, so it is barely possible to get a complete understanding of the obstacles and the response. In addition, the final targets are missing altogether, so it will be very difficult to evaluate their success.

Green transition

The 2022-2024 ERP is very weak on the green transition. It contains an analysis that starts with a description of the European Commission's plans in the area rather than those of Albania. The analysis of

the main obstacles in the text is short, stressing its alignment with that of the Green Agenda for the Western Balkans, shaped around 5 areas of intervention: i) decarbonisation, ii) circular economy, iii) pollution reduction, iv) sustainable farming and v) biodiversity. The analysis recognises that this is new for Albania and that awareness of the green economy is generally weak.

Though brief, the analysis of the obstacles appears to be realistic. It admits that there is currently a low level of political interest and a lack of knowledge in the country about the opportunities presented by the green economy, as well as a lack of skills. These are challenges to both the development of national policy on this and on cross-sectorial uptake of the concept. In its analysis Albania acknowledges that, in order to ensure proper implementation of green economy programmes, it is crucial that public institutions need to be strengthened to remove institutional barriers, protect the environment and reconcile socio-economic objectives.

However, though Albania has endorsed the Green Agenda for the Western Balkans, the ERP 2022-24 should does not include measures which address these issues or that increase the capacities in the environment sector. It is hoped that the next ERP will do so - key issues in this regard that could be addressed in the next ERP include pollution reduction and waste, which is a priority of the current government in the environment sector. Uncontrolled and untreated pollution bears long-term environmental and financial cost for the economy, especially for the sustainability of tourism, agriculture, and fisheries sectors, as well as generating negative public health impacts that also have negative impact on productivity. Furthermore, as mentioned above, although it is a reform priority for Albania (and was included in ERP 2021-2023) in order to ensure water supply, improve water quality, proper wastewater treatment, ensure access to water in tourist areas, improve good governance and reduce non-revenue water use stemming from informal connections, wastewater is no longer included in ERP 2022-2024 as a reform measure.

Energy 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. Electricity prices for households and SMEs are highly subsidised, which disincentivises the energy efficiency measures in addition to weighing on fiscal accounts. Diversifying energy sources, incentivising energy saving or investments into energy efficiency as well as potentially adjusting currently untargeted support in form of stable electricity prices for all households and MSMEs are important areas for discussion in the context of fiscal sustainability. However, as Albania is a member of the Energy Community the text should also have foreseen the timely alignment to and implementation of the EU Energy Efficiency Directive (2018/2002/EU), following the adoption of the Clean Energy package in November 2021. As part of the efforts to improve connectivity and security of supply, the power line interconnecting Albania and Kosovo has become operational.

Reform Measure 13: “Liberalisation of the energy market”

The measure to liberalise the energy market was rolled over from the two previous ERPs, where it was entitled “Further liberalisation of the energy market”. The measure is important for raising the competitiveness of the sector and of the economy through efficient production and distribution and competitive electricity prices. The activities planned are likely to help achieve this aim, except the Skavica HPP project, which seems to be unrelated to the measure. The indicators selected are not well aligned with the measure’s objectives and should be reviewed. A good indicator would be the number of customers supplied through the free market, as well as the number of independent producers of renewable energy (or total renewable power installed) selling electricity through the free market.

Reform measure 14: “Diversifying energy sources through the promotion of renewable energy sources and energy efficiency improvements”

This measure on diversifying energy sources was also rolled over from the two previous ERPs. It includes promoting the use of renewable energy sources other than hydropower. The activities promoting other renewable energy electricity generation are important for reducing the country's dependency on energy imports, and ultimately aim to reduce the cost of energy for the economy. Energy efficiency activities, although likely to produce results further into the future rather than in the short term. However, energy audits and feasibility/design studies should be in higher focus in the measure and should be boosted in the period 2022-24, in order to advance the technical maturity of energy efficiency projects and accelerate their financing and implementation programming. The number of studies that have already been completed and the number of projects financed would have been useful indicators for this measure.

Transport market reforms

The analysis is well developed in terms of identifying the main obstacles in the transport sector. It states that further reforms are necessary in this area; Albanian companies in the World Bank 2019 Enterprise survey identified transport as one of the main obstacles to improving the business environment. There is now a new National Transport strategy for 2021-2025, which notably involves the building of the intermodal railway connection linking the new Port of Durrës in Porto Romano with the energy park, in line with the National Transport plan. In addition, on 1 July 2021, Albania adopted a legal package that entered into force on 20 August 2021. This comprised four laws with regard to the institutional framework, establishing an independent railway regulatory authority, a railway safety authority, and a national investigation authority on rail and maritime safety.

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

This measure has been rolled over from previous ERPs. Upgrading and extending the Durrës-Airport-Tirana railway will increase intermodal transport, and should double the speed of passenger and freight transport between Tirana and Durrës, boosting traffic and reducing road congestion. A contract for upgrading the Tirana-Durrës railway was signed in early February 2021. This strategic investment also benefits from EU funding under the European economic and investment plan. It forms part of Rail Route 2, linking the capital of Albania, Tirana with the capital of Montenegro, Podgorica, and is extended to the port of Durrës. This is a key project for the region. Project-level indicators are used and need to be further developed to reflect the sector reform, which includes information on electrifying the railway line, although there is little indication on when this will take place. New information has been added about the link between investment and the revised National Transport plan.

There has been no progress on this measure and the proposed activities were all postponed by one year. Most of the comments in the previous ERP assessment are still valid. Progress has been slower than expected. The document does not explain the reasons behind these substantial delays. The risks and mitigating measures are well presented, as is the impact on job creation (including the impact on the gender balance principle) and the environmental and energy efficiency considerations.

The ERP also flags that this measure should enable Albania's rail system to move toward alignment with the EU rail system and that it will be relevant to the green agenda. Contrary to the previous ERP, the 2022 ERP mentions urban planning and land acquisition and the potential risk from land expropriation. This issue was introduced in this ERP, and it is elaborated upon. However, the ERP does not include the reasons preventing this process from being completed. The issue has resulted in all dependent activities being delayed. Furthermore, the measure should reflect in its indicators that cargo activities from the Port of Durrës will be relocated to a new port which is to be constructed near Porto Romano. The timeline of the activities for 2022 and 2023 need to be revised taking into consideration delays in the project so far.

Agriculture, industry and services

The analysis of the main obstacles in the ERP for 2022-2024 is concentrated on the agriculture and tourism sectors. However, it fails to address obstacles in industry or other service sectors. This limits the ERP's usefulness as a document for economic policy coordination and prioritisation, meaning that the coherence of economic policies is not ensured. The analysis of the agricultural sector is quite long but it is incomplete, not least as it fails to mention the impact of EU IPARD support. The agricultural sector managed to survive the COVID-19 pandemic crisis in 2020. It even achieved positive growth in the first three quarters of 2020 and its positive contribution to growth continued during 2021. However, it remains prone to structural problems such as land consolidation, land fragmentation, and property ownership issues. These are obstacles which are well addressed in this ERP, as opposed to the previous ERP.

Obstacles regarding maritime tourism are well defined, highlighting the impact of the pandemic on the tourism sector as whole. However, structural problems such as land consolidation, land fragmentation, and property ownership issues are not addressed.

As regards industry, the ERP for 2022-2024 does not provide any analysis for this important sector, as was the case in the ERP for 2021-2023. This is a significant shortcoming. It even does not mention, at least in this regard, the recent Business and Investment Development strategy that Albania adopted in 2021, even though the sector-specific analysis and recommendations normally contained in such a document would logically have been relevant to several sectors in the economy, including industry.

As regards services, the analysis examines the impact of the COVID-19 pandemic on this sector, notably the significant consequences for the tourism sector. The impact on tourism in 2021, as in 2020, may be even more pronounced than in other countries in the region apart from Montenegro, due to the size of the Albanian sector. However, the analysis of areas in the service sector, aside from tourism, is very weak

Reform measure 16: “Better marine and maritime governance and services”

This was a new measure in the 2021 ERP, focused on maritime tourism. The same comments apply as in 2021 – the reform is small in scale and seems to be an isolated initiative, based on some legal reforms. Within these limits the analysis identifies the main obstacles in the sector, which will require an in-depth and comprehensive reform to address them properly. However, the proposed measure is very limited. It should ideally have been treated as part of a larger picture, where relevant policies/plans regarding marinas/ports should be also considered. On the other hand, taking into consideration the impact of the COVID-19 pandemic on tourism, the diversification of tourism products is welcome.

The description of the measure has improved compared to the last ERP, with clear references to the strategic policy documents, and other sector reforms, such as those related to the blue economy and the financial approach to incentivise maritime tourism. The legislation was due to be finalised in 2021, but was not completed and has been partially postponed. The description of the measure focuses on the legal framework and is insufficient to give a clear picture of the current conditions in the sector, whereas a clear overview is needed to understand the impact of the proposed measure. Despite this, within these constraints the activities are well planned and detailed. They are feasible and are relevant to the proposed measure.

However, apart from one exception, baselines are not included, and neither are final targets in any meaningful way. While the reforms in the tourism sector are welcome, as it is an untapped sector with high potential for economic development, this measure still needs to be integrated better into the overall sector development policies and plans. The risks have been clearly identified, including the impact of the pandemic.

Digital transformation

The analysis of the main obstacles in the areas of digital transformation and digital economy comprises a list of current and ongoing initiatives rather than a presentation of the overall picture or an analysis of the current challenges, objectives and issues. However, it does mention the objective to increase broadband penetration, and that a new national broadband plan is being rolled out. This plan aims to: 1) build up broadband infrastructure; 2) strengthening financing and broadening the criteria for receiving funding; 3) step up spectrum management; and 4) ensure sustainable competition. The analysis also mentions that a key new element in the plan is providing public funding through a universal service obligation and through State aid to increase the build-up of infrastructure to cover rural and remote areas. It also mentions the legal basis. However, there is no overall analysis of the current obstacles in this area.

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

This measure was carried over from the 2020 and 2021 ERPs. The information on the reform has been updated, supplemented with new developments in the sector, and highlights the European Green Deal. In addition, the measure is analysed in light of the ongoing COVID-19 pandemic and its impact in the sector. The reform was well-prepared, it will have a clear impact on the economy, and it is in line with the EU strategy for the digital agenda in the Western Balkans. Albania has low broadband penetration, particularly in rural areas, and the proposed measure clearly addresses this obstacle. The measure also takes into account the ongoing crisis due to the COVID-19 pandemic and its impact on the sector.

The measure states that it will build upon two major 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 explanation seems focused on EU initiatives and the planned time-frame is rather vague, with broad aims such as “investments in white areas” without any further details provided for 2023 or 2024. In fact, there is no information about whether all activities planned for the year 2021 have been completed. The adoption of the new law on electronic communications, in line with the new European Electronic Communication Code was not finalised in 2021 despite this being planned initially, yet this was not in the activities for 2022. The same is true for capacity-building activities. It is unclear why activities for 2022 do not include the activities not carried out in 2021.

Economic integration reforms

Unfortunately, the data provided in the section containing the analysis of the main obstacles does not include 2020 statistics. The analysis would have benefited from updated statistics in terms of exports of goods and services in 2020, despite the impact of the COVID-19. Statistics for the trade of goods for the first three quarters of 2021 were already available in INSTAT, but the analysis only refers to 2019 trade statistics. This analysis would also have benefited if it covered the key sectors which drive exports, and the diversification in the exports portfolio and the reasons for such diversification. However, these elements are lacking, although the efforts the government has taken under CEFTA and the Regional Cooperation Council to implement the 2021-2024 Common Regional Market action plan are described in detail (Albania has notably fulfilled its commitments under CEFTA). However, the analysis fails to address the obstacles that challenge the sector

Reform Measure 12: Deepening economic integration

This measure is relevant to of Albania’s active involvement in the regional trade integration through CEFTA and it mentions most of the relevant information. Overall Albania has undertaken several steps to open the market and deepen its economic integration with the region. The follow-up to CEFTA undertakings such as the process of mutual recognition of the authorised economic operators are actions that will support Albania’s EU integration process.

However, the activities described under the measure are not well defined. They seem to be repeated for the following 3 years, which could make the monitoring of their implementation a significant challenge. Furthermore, the regional action plan for establishing the common regional market has already been adopted and is in force. However, it is expected to be an activity that is repeated over the next three years; repetition of activities seems redundant. The expected follow-up activities related to the implementation of the action plan of the National Committee for Trade Policy and Facilitation are useful. However, more details are needed in terms of concrete actions, as it is not clear what part of the action plan will be implemented in 2022 and what components will be introduced during the following 2 years. There is also an element of duplication, as the drafting of the export strategy also appears under measure 8: 'Support for MSMEs'. Furthermore, on the results indicators, two out of the three intermediate and final targets are the same. It is unclear why this would be the case. There is also no time frame for achieving the intermediate and final targets, which could make them very difficult if not impossible to measure in a coherent way.

Education and skills

Skills, vocational education and training, higher education and reform measure 17 are analysed above in Section 4, under key challenge #1.

Albania's budget allocation to education is relatively low at 3.6% of GDP in 2022, which is an increase compared to 2020 (2.4% of GDP) and 2019 (3.3% of GDP), but it remains 1.4 pps. below the EU-27 average for 2020. 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 out of 77 countries. Girls and socio-economically advantaged students perform better than boys and disadvantaged students pointing to equity issues (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 the 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 (15.6% in 2020), but remains the second highest among candidate countries and potential candidates.

Reform measure 18: "Inclusiveness and equality in education"

This measure is rolled over from the previous ERP. It 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. The number of children benefitting from free textbooks has increased in recent years. Currently all children in grades 1-9 as well as children of special categories in grades 10-12 benefit from free textbooks. The measure continues with the replacement of collective classes in rural areas with regular higher quality education in nearby schools and a 50% increase in reimbursement of transport costs for students. Nevertheless, careful choices need to be made as school is sometimes the only centre of community life in remote localities and increased quality could also be achieved through more use of digital education and online tools. Other positive activities include the standardisation of work of psycho-social services and training of their employees.

As regards inclusiveness, focus has been put on assistant teachers, and the number of children with special needs who attend regular schools has increased. Attention is being given to the training of assistant teachers. However, a more comprehensive approach combining physical environment, curriculum and assistive devices as well as further training for teachers (beyond assistant teachers) are required. The transformation of special schools/institutes into resource centres supporting the education of children with disabilities and their social integration is still ongoing, but not at an adequate pace as regards the needs concerned. More human and financial resources are needed to transform these special schools / institutes into resource centres. While the share of children aged 3-6 attending kindergartens increased significantly until the school year 2017-2018, it has been stagnated since. Enrolment of children

from vulnerable families also lags behind. The partnership between central and local governments is essential to ensure adequate early childhood education and care and the provision of services to the families that cannot afford the kindergarten costs. Increased attention also needs to be given to the early childhood care for children aged 0-2, which is a very underdeveloped sector in Albania. It is important that kindergarten teachers are fully trained and that school readiness for the grade 1 of compulsory education is ensured. This can only be achieved with stronger partnerships with municipalities and by increasing financial resources for the sector.

Reform Measure 19: “Development and empowerment of digital competency of teachers”

This measure involves integrating ICT into the digitalisation of education, a priority that is set out in the National Strategy on Education for 2021-2026. ICT will be introduced into the curricula of grade 1 in 2022, grade 2 in 2023 and grade 3 in 2024. The measure also includes introducing coding skills in grade 4 in 2022, grade 5 in 2023 and grade 6 in 2024. This comes after two years of the COVID-19 pandemic and there is an urge to ensure continuity in education but also to digitalise educational curricula overall. ICT has greatly influenced the way educational services are provided, as it has the potential to provide students with lifelong learning skills, ensure they fully participate in society and enable them to have success in their professional life. However, more research is needed to ensure its practical application in Albania.

The EU4School programme, implemented by UNDP, will assess the IT skills of teachers in 63 educational facilities, as a first step in assessing the needs gap. It is important to ensure an adequate assessment not only of competences but also of the infrastructure and services available in municipalities, such as electricity supply and internet connection. A stronger partnership is needed with families to ensure blended education is rolled out. The biggest challenge is for teachers. The measure includes specific teacher training, as they will deliver the ICT and coding classes. In addition, it includes the training of leaders of professional networks to promote the use of ICT in the teaching process. More emphasis and resources should be allocated to ICT training in a broader sense, and with a long-term approach.

Employment and the labour market

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

Social dialogue

Bipartite social dialogue remains very weak in both the public and private sectors. The limited effectiveness of social dialogue mechanisms undermines the value of collective action and erodes public trust in the ability of social partners to influence policy and law making. As regards the national tripartite body (National Labour Council, NLC), a by-law was adopted in January 2020 clarifying the representativeness criteria for social partners. In 2021, the NLC secretariat was staffed with three members, one for each constituent party. However, the last meeting of the NLC was convened in February 2021. The mandate of the NLC expired in April 2021 and its renewal is planned only for April 2022, resulting in a long absence of consultation. Tripartite consultations are being treated as a formality and documents are shared with social partners only shortly before the meetings. Moreover, the NLC's six technical sub-committees are not functional and so do not contribute to prepare the NLC's discussions and decisions. There is no earmarked budget line to support the proper functioning of NLC and its sub-committees. The Ministry of Finance and Economy and other relevant Ministries need to establish a practise of discussing and consulting with the NCL draft laws, by-laws or decisions directly or indirectly affecting employment and the world of work. Albania still plans to set up regional tripartite councils. In addition, the system for the amicable resolution of labour disputes needs further consolidation to enhance access to justice for the workers especially the vulnerable ones. On a positive note, the Albanian social partners advocated for the ratification by the Albanian Parliament (3 February 2022) of the ILO

Convention 190 and committed to promoting safe and healthy working environments that are free from violence and harassment.

Social protection and inclusion

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

Healthcare

This area and the reform measure 5 are analysed above in Section 4, under key challenge #2.

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

Area/Sector	2016	2017	2018	2019	2020	EU-27 Average (2020 or most recent year)
Energy						
Energy imports dependency (%)	20.2%	38.2%	21.1%	31.5	30.7%	57.5%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand euro	227.07 ^w	228.07 ^w	217.10 ^w	N/A	N/A	110.18 ^w
Share of renewable energy sources (RES) in final energy consumption (%)	36.94%	35.90%	36.84%	38.04%	45.02%	22.09%
Transport						
Railway Network Density (metres of line per km ² of land area)	11.06 ^w	11.62 ^w	11.62 ^w	5.88 ^w	7.79 ^w	49.0 ⁽²⁰¹⁸⁾
Motorisation rate (Passenger cars per 1000 inhabitants)	151.1 ^w	146.8 ^w	159.9 ^w	174.1 ^w	191.3 ^w	519 ⁽²⁰¹⁸⁾
Agriculture						
Share of gross value added (agriculture, forestry and fishing)	22.6%	21.8%	21.1%	21.0%	21.8%	1.8%
Share of employment (agriculture, forestry and fishing)	40.2% ^w	38.2% ^w	37.4% ^w	36.4% ^w	N/A	4.3%
Utilised agricultural area (% of total land area)	41.1 ^w	40.8 ^w	40.8 ^w	N/A		40.6%
Industry (except construction)						
Share of gross value added	14.0%	12.8%	14.1%	13.8%	12.5%	19.5%
Contribution to employment (% of total employment)	12.8% ^w	12.5% ^w	12.7% ^w	13.1% ^w	N/A	18.2%
Services						
Share of gross value added	53.2%	54.9%	54.5%	55.4%	55.3%	73.1%
Contribution to employment (% of total employment)	40.5% ^w	42.4% ^w	42.9% ^w	43.5% ^w	N/A	71.0%
Business environment						
Rank in Global Competitiveness Index (Source: World Economic Forum)	93	80	76	81	N/A	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	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	N/A	2,32%
R&D expenditure – EUR per inhabitant	N/A	N/A	N/A	N/A	N/A	EUR 694.60
Digital economy						
Percentage of households who have internet access at home	N/A	N/A	84%	85%	N/A	91%
Share of total population using internet in the 3 months prior to the survey [NB: population 16-74]	N/A	N/A	62.6% ^w	68.6% ^w	N/A	88%
Trade						
Export of goods and services (as % of GDP)	29.0%	31.6%	31.6%	31.3%	23.1%	46.7%
Import of goods and services (as % of GDP)	45.8%	46.6%	45.3%	45.0%	37.9%	42.9%
Trade balance (as % of GDP)	22.4%-	-22.7%	-20.2%	-20.7%	-20.4%	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	15.6% ^w	9.9%
Young people not in employment, in education and training (NEET) (% of population aged 15-29)	30.0% ^w	29.7% ^w	28.6% ^w	26.6% ^w	27.9% ^w	13.7%
Children aged less than 3 years in formal child care (% of under 3-years-olds)	N/A	N/A	N/A	N/A	N/A	35.3% ⁽²⁰¹⁹⁾
Individuals who have basic or above basic overall digital skills (% of population 16-74)	N/A	N/A	N/A	21%	xx	56% ⁽²⁰¹⁹⁾

Employment and labour market						
Employment rate (% of population aged 20-64)	62.1% ^w	63.9% ^w	65.6% ^w	67.1% ^w	66.3% ^w	71.7%
Unemployment rate (% of labour force aged 15-74)	15.2% ^w	13.7% ^w	12.3% ^w	11.5% ^w	11.8% ^w	7.2%
Long term unemployment rate (% of labour force aged 15-74)	10.1% ^w	8.9% ^w	8.3% ^w	7.3% ^w	7.0% ^w	2.5%
Gender employment gap (Percentage point 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	15.2 pps. ^w	11.0 pps.
Disability employment gap (Percentage points difference in employment rates between people with and without a disability)	N/A	18.1 pps.	16.9 pps.	18.7 pps.	13.3 pps.	24.5 pps.
Real gross disposable income of households (Per capita increase, Index = 2008)	N/A	N/A	N/A	N/A	N/A	107.23
Social protection system						
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	N/A	58.5%	53.9%	50.8%	46.2%	21.9%
At-risk-of-poverty or social exclusion rate of children (% of population 0-17)	N/A	62.0%	57.7%	53.9%	51.0%	24.2%
Impact of social transfers (other than pensions) on poverty reduction	N/A	12.55%	11.03%	11.88%	12.10% ^w	32.68%
Income inequality - quintile share ratio (S80/S20) (Comparison ratio of total income received by the 20% of the population with the highest income to that received by the 20%						

with the lowest income)	N/A	7.47	6.98	6.38	5.86	5.24
Housing cost overburden (% of population)	N/A	9.2%	6.0%	5.5%	3.8%	9.9%
Healthcare						
Self-reported unmet need for medical care (of people over 16)	N/A	13.1%	14.8%	14.6%	10.6%	1.8%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	41.77% ^z	44.45% ^z	44.58% ^z	N/A	N/A	15.57% ⁽²⁰¹⁸⁾

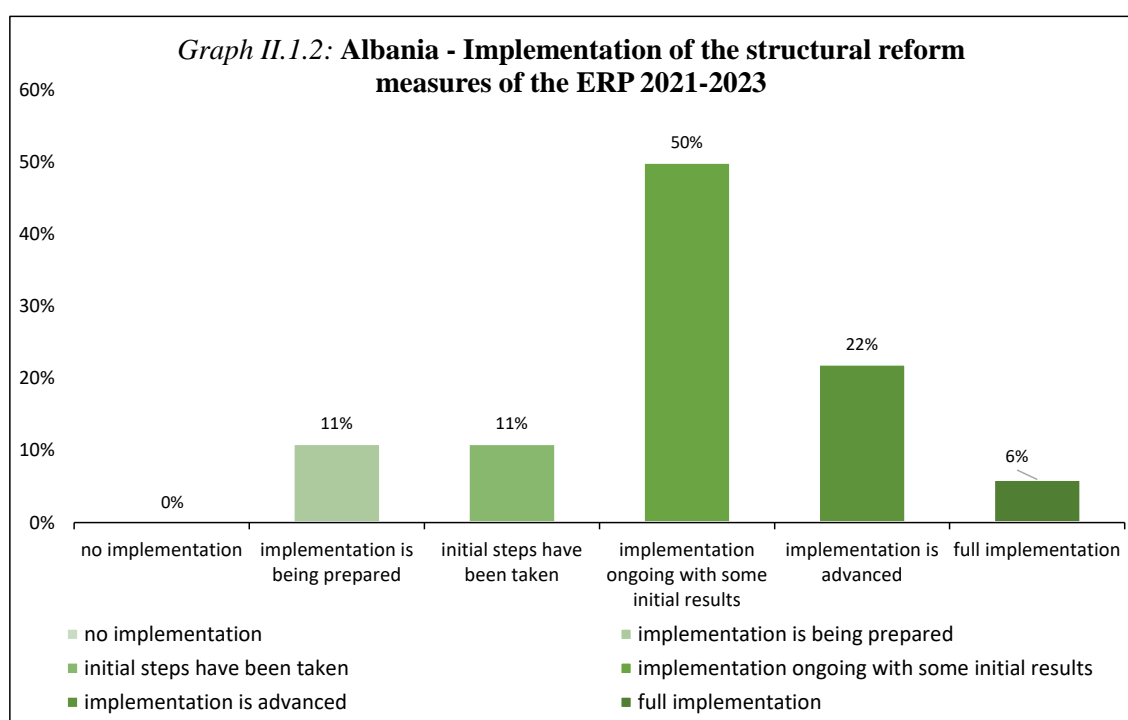
w: data supplied by and under the responsibility of the national statistical authority and published on an "as is" basis and without any assurance as regards their quality and adherence to EU statistical methodology'

z: data from the World Health Organization

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

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM THE ERP FOR 2021-2023

While tackling the immediate impact of COVID-19 pandemic remained a clear priority in 2021, progress was made in implementing the measures from last year's ERP (average score: 3.4 out of 5). Activity reports provide a fairly accurate description of the level of implementation of the measures that were reported on. However, five measures were not reported on. These were measures on i) areas of wastewater, ii) retail payments, iii) the quality and coverage of VET, iv) on cross border movement, and v) on access to healthcare respectively. In addition, a 2022 measure on economic integration was reported on, which cannot be taken into account. The Commission therefore had to independently evaluate the extent to which these five measures were implemented in the reporting period. . The scoring was slightly imprecise for the measures related to addressing the informal economy, diversifying energy resources, and the employability of the most vulnerable unemployed jobseekers. Some of the activities related to broadband and inclusive education were not reported on, so also had to be estimated.



ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The ERP process is coordinated by the Ministry of Finance and Economy. The Minister is the national coordinator, as defined by order no.107 of the Prime Minister of Albania, dated 6 August 2019. This order sets out the ERP's coordination structure as well as the establishment of the inter-ministerial group and the inter-ministerial technical secretariat. 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.

Consultation with the parliament or regional and local authorities did not happen, and there were no proactive outreach actions to seek the opinions and feedback from different stakeholders. According to the ERP technical secretariat at the Ministry of Finance and Economy, the ERP document was uploaded onto the government's platform for consultation on 22 December 2021, but no comments were provided. This means that no pro-active public consultation took place. In previous years, e-mail notifications were sent to different stakeholders to get their opinion and written comments on the document. However, for the 2022-2024 ERP, the authorities failed to complete a successful consultation process. The ERP coordination structure should examine what happened and revise the mechanism for consulting with stakeholders to avoid a passive consultation process.

Macroeconomic framework

The programme is in line with the medium-term budgetary framework and the Budget Law of Albania. It was submitted in time on 1 February 2022. It describes the past economic developments based on the available data and was published on the Ministry of Finance and Economy's website. Projections for 2022 and beyond are only provided in the form of data without explanation. The basis for the projections on export developments and foreign direct investment are not mentioned. The framework's horizon extends to 2026 but data on long-term sustainability (demographic developments, pensions, health expenditure) and on contingent liabilities/use of sovereign guarantees and discretionary measures were not provided. Information on the level of implementation the policy guidance 2 and 3 was implemented is incomplete. The ERP does not provide an analysis of labour productivity, skills shortages, migration, brain drain or the investment environment.

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, in particular on capital expenditure. 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 or to make comparisons in time, 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 2021, once the outturn data was available, the fiscal deficit of 2021 changed significantly within a few weeks after the submission of the ERP. One month after the submission of the ERP 2022, the 2021 outturn data changed the public debt ratio (similar to last year) so much (2 pps. of GDP) that the ERP plan for 2022 would actually result in an increasing instead of a decreasing public debt ratio. 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 yet 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 functional government expenditure (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 2021-2023 ERP sufficient and up-to-date*, this is mostly accurate, with some exceptions. There are 19 reforms in the ERP 2022-2024, i.e. within the limit of max 20 reforms. The page limit is not respected - the structural reform measures contain more than 68 pages (i.e. 28 pages more than max 40 pages), without taking the annexes into consideration. As is described in each measure, in majority of cases the activities are clearly defined along the three-year period of implementation.

With regards to tables 9-12: Table 10.a (costing of structural reform measures) 50% were not completed. In some cases, clearly high-cost measures are 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 32% of the structural reform measures of ERP 2020-2022 are not reported upon. These 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

The economic reform programme (ERP) was submitted on 31 January 2022.

The economic consequences of Russia's war against Ukraine may render the macro-fiscal scenarios presented in the ERP partially obsolete. The Commission will publish its updated macroeconomic and fiscal projections for candidate countries, reflecting the expected impact of the war against Ukraine and related sanctions, in its spring economic forecast in mid-May 2022.

The short-term macro-fiscal outlook may change considerably. However, the major medium-term fiscal and structural reform challenges and priorities identified in this assessment remain valid irrespective of the short-term outlook. Appropriate policy responses are essential to ensure a sustained economic recovery, greater resilience and fiscal sustainability.

2.1. EXECUTIVE SUMMARY

The baseline scenario set out in Montenegro's economic reform programme (ERP) foresees real GDP to fully recover to its pre-COVID-19 crisis level in 2022 and to maintain robust growth afterwards, but uncertainty is exceptionally high. The reopening of borders contributed to a strong rebound of the economy in 2021, thanks to a revival of tourism and related services. Over the programme period, the economy is set to benefit from a strong fiscal stimulus in 2022, supporting households' income and lowering the tax wedge, as well as from an ambitious multiannual capital investment programme. However, there are downside risks. A new wave of the virus and the fallout from Russia's aggression against Ukraine could hold back tourism, slowing down the economic recovery. War-related risks could also lead to further rises in energy and food prices. Import may increase by more than expected if investment plans are realised.

The ERP's fiscal strategy relies on a strong stimulus in 2022 and back-loaded consolidation based on expenditure retrenchment. The strong rebound of the economy in 2021 boosted revenue and, together with capital budget under-execution and lower spending on goods and services, enabled a very sizeable improvement of the budget balance which came in lower than planned. However, the 2022 budget targets a sharp increase in the deficit driven by revenue measures to abolish health contributions designed to lower the tax wedge, as well as new social spending initiatives. Over the medium term, the fall in the revenue ratio is expected to be outweighed by planned expenditure restraint relying on some reduction in current spending, which did not yet receive support in parliament. The public debt ratio fell by some 20 percentage points to 85.5% in 2021 thanks to the economic rebound and the use of accumulated deposits to pay back maturing debt. Under the ERP, Montenegro plans to bring debt below 70% in 2024.

The main challenges facing Montenegro include the following:

- **While lingering downside risks to the economic recovery call for a cautious phasing out of fiscal support, the public debt burden, albeit declining, remains a challenge.** Non-discretionary spending remains high, exacerbated by electoral competition and a marked pro-cyclical fiscal stance in 2022. At the same time, given the high uncertainty about the pandemic and the impact of Russia's war against Ukraine, standing ready to provide crisis mitigation if needed seems appropriate. Overall, fiscal sustainability needs to be enhanced by a medium-term plan to reduce debt contingent on the economic outlook and based on specific measures. Broadening the tax base, streamlining tax exemptions and incorporating new budget revenue initiatives to offset recent revenue-decreasing measures would contribute to rebuild fiscal space and reduce public debt.

- **Strengthening the long-term sustainability of public finances requires improvements in fiscal governance and public investment management.** New expenditure initiatives are often adopted without properly taking into account their fiscal implications. Large infrastructure projects should be better managed and prioritised in light of the fiscal space available. Following up on plans to set up an independent fiscal institution would contribute to improving fiscal policymaking.
- **Making the regulatory environment business-friendly.** Public authorities have committed to digitalisation, with several reforms under way, and in 2021 the country fully implemented the electronic procurement system. New reform initiatives on access to finance, support for innovation and on the management of state-owned enterprises are both relevant and needed. Steadfast implementation of business-centric reforms should remain the authorities' focus over the coming years.
- **Reducing the size and scope of informal economy.** The 'Europe Now' reforms of 2021 reduced the tax wedge on labour and could have a significant impact on the informal economy. If successful, these reforms and changes in the regulatory environment, in particular on digitalisation, may well shrink the informal economy over the coming years. Nonetheless, it is necessary to keep a clear vision of desired changes, to follow with further reforms, to ensure full cooperation between businesses, state and local authorities, and to make a plan for monitoring and follow-up actions to achieve a pronounced impact on the informal economy.
- **Persistently unfavourable labour market outcomes undermine potential growth and improvements in living standards.** The COVID-19 pandemic continued to exacerbate the structural deficiencies in the labour market, including persistently low rates of labour market activity and high unemployment, especially among women, young people and the low-skilled. Montenegro has taken some initial steps to tackle these problems. Further efforts are needed to tackle high youth unemployment and to reform the social protection system. The provision of active labour market policies is not effective in activating people on the labour market. While some studies over the past year on active labour market measures were conducted, the country lacks a continuous monitoring mechanism of active labour market measures.

Montenegro partially implemented the policy guidance, jointly adopted at the Economic and Financial Dialogue meeting of 12 July 2021. The government provided well-targeted support to vulnerable sectors during the pandemic, preserving jobs, and provided liquidity to companies and citizens, supporting the strong rebound of the economy in 2021. It adopted a new fiscal strategy at the end of 2021 to boost economic recovery over the medium-term. However, some of the budget consolidation measures failed to be adopted, and the budget deficit for 2022 risks exceeding the level originally planned. Some initial progress was made with the public investment management assessment (PIMA) and establishment of a fiscal council. However, progress stalled after some initial work. Montenegro advanced on the preparation of the draft Youth Guarantee implementation plan, on the roadmap for reforming the social protection system, and made some progress on reforming the vocational education and training system.

The ERP 2022 provides an ambitious and comprehensive programme integrating economic, fiscal and structural reform plans that are partly in line with the key challenges and priorities that the Commission identified. The core of the programme is structured around the 'Europe Now' programme. Some measures accompanying this initiative were rejected and some unplanned measures incorporated, requiring adjustment later on to rebalance the programme. On structural reforms, the ERP incorporated many new, well-designed and relevant reforms, focused primarily on the identified key challenges to Montenegro's economy. Digitalisation, reforms of the labour market and of state owned enterprises are particularly relevant. A new measure related to the green transition is another welcome addition. The shared European growth model linked to the twin green and digital transition will have to be consolidated

in the ERP process for Montenegro, even more so in the current geopolitical context. There was moderate progress on implementing the reform measures in 2021.

2.2. ECONOMIC OUTLOOK AND RISKS

Montenegro's economy recorded very strong growth in 2021, though it did not fully recover its pre-pandemic level. The double-digit rebound in GDP was driven by a robust revival of tourism, helped by the reopening of borders and its positive spillover effects on related services. The increase in the number of visitors boosted private consumption, but it also resulted in a surge in imports due to the strong dependency of the economy on foreign goods. However, thanks to increased surpluses in the services and income balances, the current account deficit narrowed. Labour market conditions suffered particularly from the negative effects of the pandemic despite several state-support packages to preserve jobs. Employment kept contracting year-on-year, from the outbreak of the pandemic in March 2020 until June 2021.

The ERP projects GDP growth to average above 5% over 2022-2024, supported by an ambitious infrastructure investment and fiscal stimulus programme. According to the ERP, traditional sectors of the economy like tourism, energy and agriculture are expected to recover or exceed their pre-pandemic levels in 2022. The programme sets out an ambitious new multiannual investment cycle. After completion of the first section of the Bar-Boljare highway in 2022, work is planned to start in other sections by the end of 2022, together with the construction of new power plants, development of airports and other public infrastructures.

Another intention is to develop digitalisation and the IT sector in an effort to diversify the economy. Economic development would be further supported by fiscal stimulus provided by the government's 'Europe Now' programme⁽¹⁸⁾. This programme, accompanying the 2022 budget, aims to boost employment, investment and domestic demand by increasing net wages significantly as a result of lowering the tax wedge, hiking up the minimum wage and increasing public sector wages. Overall, these measures are expected to boost households' disposable income while reducing labour costs for businesses. As a result, the ERP expects real private consumption to rise by more than 4% on average over 2022-2024. Investment would return to growth in 2022 and it is expected to surge by some 9% in both 2023 and 2024. Meanwhile, public consumption growth would moderate from 2% in 2022 to 1.5% in 2024. After the recovery of the economy to its pre-crisis level in 2022, both imports and exports are expected to decelerate markedly afterwards. The ERP projects the output gap to close in 2022 and turn strongly positive by 2024, which raises questions about the sustainability of the forecast buoyant GDP growth.

The baseline GDP growth scenario is on the optimistic side and subject to significant risks. The macroeconomic outlook continues to be subject to a relatively high degree of uncertainty in the recovery phase from the COVID-19 pandemic as well as new risks stemming from Russia's war against Ukraine in particular given the exposure of Montenegro's tourism sector to the region (over 20 percent of Montenegro's foreign tourists come from these two countries). However, the ERP's projection that it will recover the pre-pandemic GDP level in 2022 seems attainable considering the strong rebound registered in 2021, and further fiscal support from the 'Europe Now' measures, even as the government withdraws most pandemic-related support measures.

Overall, the baseline scenario appears broadly in line with the Commission's forecast for 2022, but diverges noticeably for 2023 and 2024. In particular, the programme's ambitious public investment plan raises some doubts, considering the technical, financial and administrative hurdles experienced with major infrastructure projects in the past. The 'Europe Now' programme aims to quickly improve the

⁽¹⁸⁾ See more details in Chapter 3, Public finance.

living standards of the population by reducing the tax wedge and raising wages. However, it could result in higher domestically driven inflation, which is only factored into an alternative scenario (see below). Another risk only considered under the alternative scenario is the unstable political situation as some ERP reforms could be discarded or reversed in the event of a change of administration. The strong deceleration of imports foreseen in the baseline scenario is not consistent with past investment dynamics, as these usually require significant imports of construction machinery and equipment.

Table II.2.1:

Montenegro - Comparison of macroeconomic developments and forecasts

	2020		2021		2022		2023		2024	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	-15.3	-15.3	10.7	13.4	6.4	6.4	3.2	5.1	n.a.	4.5
<i>Contributions:</i>										
- Final domestic demand	-6.4	-6.4	4.3	3.5	2.6	3.8	3.5	5.5	n.a.	5.3
- Change in inventories	-1.0	-1.0	0.0	0.0	0.0	0.0	0.0	0.0	n.a.	0.0
- External balance of goods and services	-7.2	-7.8	6.3	9.9	3.8	2.6	-0.6	-0.5	n.a.	-0.8
Employment (% change)	-10.1	-10.0	3.5	4.8	2.3	3.5	2.5	3.4	n.a.	3.0
Unemployment rate (%)	18.3	17.9	19.3	16.7	18.5	15.8	17.2	14.6	n.a.	13.6
GDP deflator (% change)	-0.2	-0.2	2.3	2.8	2.3	2.2	1.4	1.7	n.a.	1.4
CPI inflation (%)	-0.8	-0.3	3.3	2.1	2.5	2.3	1.5	1.8	n.a.	1.5
Current account balance (% of GDP)	-26.0	-26.1	-17.8	-13.1	-15.8	-10.5	-16.8	-10.2	n.a.	-10.0
General government balance (% of GDP)	-11.1	-11.1	-3.4	-1.8	-0.5	-5.0	0.2	-1.8	n.a.	-0.6
Government gross debt (% of GDP)	103.5	105.2	87.3	85.5	77.8	76.6	71.7	73.2	n.a.	69.9

Sources: Economic Reform Programme (ERP) 2022, Commission Autumn 2021 forecast (COM).

The programme presents an alternative low-growth scenario focused on a series of events, some of which would merit being considered as part of the baseline. The alternative scenario assumes higher inflation and a worsening of the epidemiological situation reducing tourism flows. This would result in a significant fall in private consumption until 2024, accompanied by a contraction of exports, falling by half in 2022 compared to the baseline. In addition, it assumes a slower increase in public investment which would also cause a sharp fall in GDP growth, notably in 2023 and 2024. Net foreign direct investment (FDI) inflows are forecast to remain much more resilient, declining only moderately (by an average of 1.3 percentage points of GDP) in the same two years. But this might not fully reflect the potential fallout of increased political uncertainty on investor confidence.

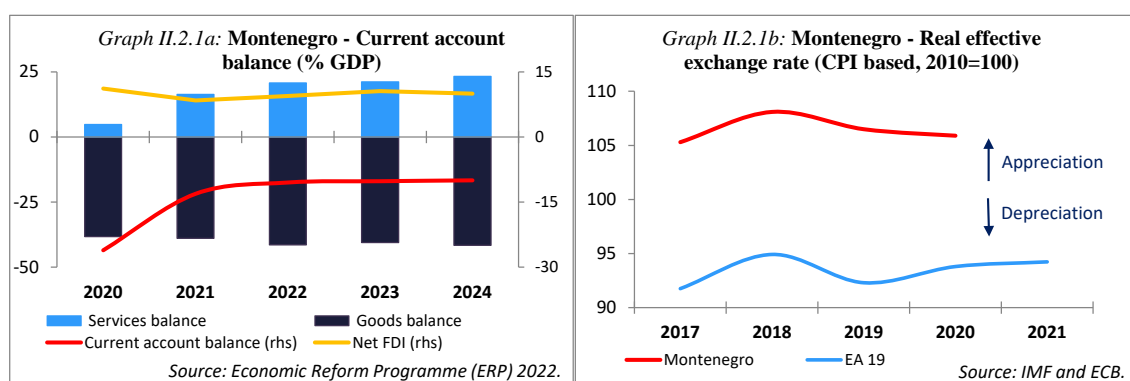
Inflationary pressure – driven in 2021 by import prices – is likely to mount following strong wage increases in 2022. So far, inflation has been led by the rebound in global oil and food prices through imports. The ERP baseline scenario foresees stable and moderate consumer prices over the medium term, with inflation averaging 2.3% in 2022 and easing gradually afterwards to 1.4% in 2024. This scenario appears benign in view of recent geopolitical tensions, which would lead to further rises in energy prices and to environmental charges on CO2 emissions, making electricity prices structurally higher. The ERP also assumes a strong and generalised increase of wages in 2022 (by some 17% in nominal terms), which is at odds with the scenario of low inflation. Second-round effects and the indexation of pensions and public sector wages to the minimum wage (which surged by 80% in net terms at the beginning of 2022) are likely to further increase inflationary pressures while worsening the sustainability of the pension system.

The ERP's projection of a decreasing current account deficit appears inconsistent with the ambitious investment programme. Montenegro's large external imbalances reflect the weak competitiveness of its economy (mainly due to non-cost factors) and high investment needs. Montenegro's current account is characterised by surpluses in the services and income balances driven by tourism and remittances, which only partially offset the chronic and large merchandise trade deficit.

Following a large improvement in 2021 when the current account deficit halved thanks to the revival of tourism and remittances, the ERP baseline assumes a further sizeable reduction in 2022, and then small decreases (to around 10% of GDP) over the next two years. However, this scenario seems unlikely given the likely underperformance of tourism in 2022, and the robust investment growth projected for 2023 and 2024, which – taking into account historical evidence – is likely to result in high import needs for construction material and equipment. Furthermore, large wage increases exceeding productivity gains might impair cost competitiveness, although the reduction of the tax wedge through the abolition of health contributions provides some cushion.

Investments are set to remain stable, after recording double-digit levels during the pandemic. Net FDI inflows totalled 11.6% of GDP in 2020 and 11.7% in 2021. The ERP projects FDI to remain broadly stable, averaging some 10% of GDP in 2022-2024, and fully covering the projected current account deficit. Downside risks to this outlook stem from political risks coupled with a tightening of global financing conditions, which could hinder access to, or increase the cost of finance. Furthermore, the intention announced in the ERP to engage into construction of several sections of the Bar-Boljare and Adriatic highways simultaneously, could lead to higher than expected current account and budget deficits. The external debt surged to 224% of GDP in 2020⁽¹⁹⁾ (driven by the denominator effect, as GDP contracted by 15.5% in nominal terms in 2020), after having remained stable at around 160% of GDP over the previous 10 years. The main reason for this massive increase was the emission of government debt to finance COVID-19 socio-economic support measures and to build up fiscal reserves.

External competitiveness and current account



The banking system remained stable with some key metrics improving, but the quality of loan portfolios needs close monitoring. From March 2020 to September 2021, the Central Bank of Montenegro carried out an asset quality review (AQR) of all domestic banks according to ECB methodology based on pre-pandemic assumptions. Results confirmed the stability of the domestic banking system, and rated as satisfactory the level of asset quality and capital adequacy. The aggregated solvency ratio⁽²⁰⁾ was 16.2% (2019 reference data), above the statutory minimum of 10%. Only one bank was required to strengthen its position, after which its solvency ratio increased to 12%.

During the COVID-19 pandemic, the central bank adopted ten packages of temporary measures aimed at preserving the liquidity and solvency of domestic banks. As a result, the balance sheets of domestic banks recorded significant growth. Thus, at the end of 2021, banks' lending and deposits were 9.8% and 20.9% higher respectively compared to December 2019, while profitability (return on equity) returned to its pre-pandemic level.

⁽¹⁹⁾ Data provided by the Central Bank of Montenegro. Figures not available yet for 2021.

⁽²⁰⁾ i.e. regulatory capital to risk-weighted assets ratio.

Banks continued to fund themselves mainly through domestic deposits. However, there are risks due to a potential increase in non-performing loans (NPLs) as the loan moratorium expired in December 2021. So far, the NPL ratio has increased only moderately, to 6.2% of total loans at the end of 2021, compared to 5.5% in 2020 and 4.7% in 2019. To tackle this risk, the Central Bank of Montenegro will reinforce the supervision of credit institutions, insurance companies and financial investment conglomerates in 2022.

Table II.2.2:

Montenegro - Financial sector indicators

	2017	2018	2019	2020	2021
Total assets of the banking system (EUR million)	4,182	4,407	4,604	4,586	5,328
Foreign ownership of banking system (%)	73.0	74.3	67.9	80.3	85.0
Credit growth (aop)	11.8	8.5	4.5	3.2	6.4
Deposit growth (aop)	13.8	5.9	0.5	-3.0	24.6
Loan-to-deposit ratio (eop)	0.8	0.8	0.9	0.9	0.8
Financial soundness indicators (eop)					
- non-performing loans	7.3	6.7	4.7	5.5	6.2
- net capital to risk-weighted assets	16.4	15.6	17.7	18.5	18.5
- liquid assets to total assets	25.3	22.6	20.8	22.2	26.4
- return on equity	7.6	8.5	10.0	3.6	5.9
- forex loans to total loans (%)	0.7	0.5	0.4	0.2	0.2

Sources: National Central Bank, IHS Markit.

2.3. PUBLIC FINANCE

The 2021 budget was much delayed but recorded a lower-than-planned deficit. The preparation of the budget was marked by tensions within the ruling coalition, delaying its adoption until June. Public institutions relied on temporary financing in the meantime. The adopted budget targeted a deficit of 2.8% of GDP, but the final outcome was lower, at 1.8% of GDP according to the ERP ⁽²¹⁾, thanks to both higher revenue and lower expenditure. This represents a very sizeable improvement compared to the deficit of 11.1% of GDP recorded in 2020. Budget revenue was boosted by the strong economic recovery as well as the introduction of higher excise rates, electronic fiscalisation of businesses' cash registers, increased tax discipline and the transfer of public companies' profits to the central budget. However, plans to tax illegally acquired property or undeclared revenue, and to introduce labelling of fuel products to reduce fraud, failed to be adopted. Overall, total central government revenue surged by 16.6% y-o-y and exceeded initial plans by 1.6%. Public expenditure declined by 2.6% y-o-y, coming 2.1% lower than planned, notwithstanding the high expenditure base set in 2020 to finance COVID-19 support measures and lower social security transfers in 2021. Significant savings were achieved in discretionary spending too. Moreover, further expenditure reduction came as a result of delayed public works worth some 1.4% of GDP.

The fiscal strategy combines tax reductions with spending retrenchment to achieve fiscal consolidation. The medium-term key objectives of Montenegro's fiscal policy consist in reinforcing macroeconomic stability and the long-term sustainability of public finances while supporting the recovery from the pandemic and economic growth. To this end, the government adopted in 2021 three plans: a medium-term fiscal strategy, an economic strategy (or 'Economic Recovery Platform for 2022-2026'), and an ambitious socio-economic programme called 'Europe Now'.

Although the medium-term objectives remain similar to the past, the new plans constitute a major policy change by introducing a progressive personal and corporate income tax system in Montenegro and

⁽²¹⁾ 2.1% of GDP according to central government preliminary budget execution data.

abolish health contributions. As a result, tax revenue is projected to fall from an already moderate level by 2 pps. of GDP as of 2022. Non-tax revenue is also set to decrease as a percent of GDP as a result of abolishing health contributions. The decrease in the revenue ratio is forecast to be outweighed by a 4.8 pps. decline in the spending ratio between 2021 and 2024, by making savings in government consumption and interest payments. The primary balance, which turned positive in 2021 as the budget outcome was better than expected, is set to deteriorate sharply in 2022 as revenue measures kick in, and is forecast to turn positive again only in 2024 thanks to the back-loaded retrenchment of expenditure.

The sharp increase in the 2022 budget deficit implies a strong pro-cyclical fiscal stance in a context of robust economic growth. The initial government proposal targeted a noticeable increase in the 2022 budget deficit to 3.8% of GDP, based on robust real growth of 6.4% and moderate inflation of 2.3%. Capital expenditure was planned to rise significantly to 5.6% of GDP, up from 4.3% a year before, in order to finance an ambitious plan of infrastructure investments. However, the budget adopted by Parliament on 29 December 2021 further increased the deficit target to 5.1% of GDP, after adding a number of unplanned social benefits amounting to more than 1.3% of GDP, while rejecting some of the government's proposed compensatory initiatives to balance the impact of revenue-decreasing measures ⁽²²⁾. The adopted budget thus assumes a sharp reduction in budget revenue in 2022 (by some 3 pps. of GDP compared to 2021) due to the abolition of health contributions and the introduction of a EUR 700 threshold as the non-taxable part of wages. Budget expenditure is set to increase by 0.5 pps. of GDP compared to 2021.

The 2022 budget is articulated around the 'Europe Now' programme, a major fiscal reform initiative to support the post-pandemic recovery. As of January 2022, the programme introduced a progressive income taxation system. This constitutes a major change in fiscal policy, putting an end to the 9% flat tax rate for corporate (CIT) as well as the personal income tax (PIT) of the past. The new regime brings in three CIT rates (9%, 12% or 15%), depending on the company's profit, and two rates (9% and 15%) for gross personal income between 700 and 1000 euros, or above, respectively. It also applies a new 0% tax rate for personal income up to 700 euros.

In addition, mandatory health insurance fees are also abolished, cutting the tax wedge on labour to 20.4% of the gross wage and up to 31.1% for net wages of 2 000 euros and higher, compared to the previous 39% flat rate for all. The aim of this reduction of labour costs is to support the formalisation of employment and promote job creation and investment. The budget also brought in a sharp (80%) increase in the minimum wage to EUR 450. The abolition of health contributions together with the minimum wage hike are expected to considerably boost the net average wage in Montenegro to EUR 700, up from EUR 537 at the end of 2021.

The budget incorporated additional wage increases for public health and education workers. Overall, full implementation of the 'Europe Now' programme, as adopted in December 2021, would require the adoption of corrective measures (as initially foreseen) to ensure its sound financing and avoid the projected sharp increase in the budget deficit.

⁽²²⁾ Additional expenditure compared to the government proposal related to reintroducing benefits for mothers of three or more children, make a third additional annual pension indexation (besides the two regular ones in January and July), a further increase in the minimum pension, and a new benefit for all children under the age of 18. Conversely, the Parliament rejected the proposed increases in excise rates and in the VAT rate for restaurants and catering services, and the amendments to the law on public-sector wages to lower wage coefficients to contain public wage growth resulting from the much higher minimum wage.

Box II.2.1: The budget for 2022

- * On 29 December, the Parliament of Montenegro adopted the 2022 budget law. It projects a deficit of 5.1% of projected GDP.
- * The 2022 budget put into effect the ‘Europe Now’ programme. However, Parliament rejected some of the measures to strengthen the revenue side of the budget, and incorporated a series of unplanned social benefits into the budget, without offsetting measures.
- * Structurally, the introduction of progressive taxation in January 2022 represents a major change to the fiscal framework, putting an end to years of low flat tax rates.

Table: Main measures in the budget for 2022

Revenue measures*	Expenditure measures**
<ul style="list-style-type: none"> • Increasing the minimum wage and reducing the tax wedge on labour (<i>Estimated impact: -2.4% of GDP</i>) • Rescheduling tax receivables (<i>Estimated impact: 0.3% of GDP</i>) • Introduction of CIT and PIT progressive taxation (<i>Estimated impact: 0% of GDP in 2022 and EUR 0.5% of GDP afterwards</i>). • Reducing informal economy (<i>Estimated impact: 0.2% of GDP</i>) 	<ul style="list-style-type: none"> • Increasing the minimum wage and reducing the tax wedge on labour (<i>Estimated impact: -0.01% of GDP</i>) • Aligning other expenditure categories (<i>Estimated impact: 0.2% of GDP</i>) • Benefit for mothers of 3 or more children (<i>Estimated impact: 0.5% of GDP</i>) • Benefit for all children under 18 (<i>Estimated impact: 0.5% of GDP</i>) • Increasing the minimum pension (<i>Estimated impact: 0.3% of GDP</i>) • Introducing a third annual pension indexation (instead of two) (<i>Estimated impact: n/a</i>)
<p>Measures rejected in Parliament or withdrawn by the government:</p> <ul style="list-style-type: none"> • Change of excise tax policy (<i>Estimated impact: 0.4% of GDP</i>) • Fiscal labelling of fuels (<i>Estimated impact: 0.3% of GDP</i>) • Taxation of undeclared revenue (<i>Estimated impact: 0.4% of GDP</i>) • New legislation on games of chance (<i>Estimated impact: 0.3% of GDP</i>) • Increase in the VAT rate (from 6% to 21%) for restaurants and catering services (<i>Estimated impact: n/a</i>) • Tax on cash withdrawal for businesses (<i>Estimated impact: 0.09% of GDP</i>) • Amendments to the law on public sector wages in order to readjust wage coefficients to the new minimum wage (<i>Estimated impact: 0.06% of GDP</i>) 	
<p>* Estimated impact on general government revenues. ** Estimated impact on general government expenditure.</p>	
<p>Source: ERP</p>	

In the medium term, the ERP projects an expenditure-based consolidation path. Tax revenue is projected to recover somewhat in 2023, as the ERP expects some of the measures rejected by Parliament to be presented again and finally adopted, such as the taxation of undeclared assets and further increases in excise rates. Budget revenue is also set to increase further as a result of reducing informality and the impulse from robust economic growth expected in 2023 and 2024. The ERP expects the introduction of progressive taxation to remain neutral for personal income tax revenue. Corporate income tax revenue projections (assuming a 0.5% of GDP increase from 2023) seem optimistic as more than 90% of domestic companies are micro or small firms benefitting from the lower 9% tax rate.

On the expenditure side, capital spending and social security transfers are planned to remain broadly stable over the medium term at around 5% and 12% of GDP respectively. However, current expenditure is set to decline significantly from 40.4% of GDP in 2022 to 35.8% in 2024 as the level of current spending remains stable in nominal terms over this period in a context of rapid GDP growth. As a result, the budget deficit will gradually decline, to reach 0.6% of GDP in 2024 with a primary surplus of 0.8% of GDP.

Overall, the ERP expects the 2022 tax reform to have a positive multiplying effect on the economy over the medium term, broadening the tax base thanks to the creation of new jobs, higher consumption and investment and the reduction of informality. The long-term sustainability of public finances would be reinforced as a result. However, this back-loaded fiscal consolidation scenario appears vulnerable to expenditure slippage risks. As witnessed with occasion of the adoption of the last budget, the unstable political situation generates a pre-electoral context prone to increasing social spending.

Table II.2.3:

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

	2020	2021	2022	2023	2024	Change: 2021-24
Revenues	44.6	44.0	41.0	40.9	40.4	-3.6
- Taxes and social security contributions	36.2	36.5	33.8	34.6	34.5	-2.0
- Other (residual)	8.4	7.6	7.2	6.2	5.9	-1.7
Expenditure	55.7	45.8	46.0	42.7	41.0	-4.8
- Primary expenditure	53.0	43.4	44.2	41.1	39.6	-3.8
<i>of which:</i>						
Gross fixed capital formation	6.3	4.3	5.6	4.9	5.3	0.9
Consumption	13.1	12.0	11.3	10.6	10.1	-1.9
Transfers & subsidies	14.3	12.7	13.5	13.5	12.8	0.2
Other (residual)	19.4	14.4	13.8	12.2	11.4	-3.0
- Interest payments	2.7	2.4	1.8	1.6	1.4	-1.0
Budget balance	-11.1	-1.8	-5.0	-1.8	-0.6	1.1
- Cyclically adjusted	-5.8	-0.9	-5.5	-2.2	-1.5	-0.6
Primary balance	-8.4	0.6	-3.2	-0.3	0.8	0.2
- Cyclically adjusted	-2.6	1.7	-3.3	-0.6	0.0	-1.7
Gross debt level	105.2	85.5	76.6	73.2	69.9	-15.6

Sources: Economic Reform Programme (ERP) 2022, Commission calculations.

The ERP projects public debt to decline rapidly to around 70% of GDP by 2024. The debt stock reached a record high of 105% of GDP at the end of 2020, driven by high budget deficits and a large Eurobond issued that year to pre-finance debt maturing later under favourable conditions. This boosted government reserves to 19% of GDP at the end of 2020. In 2021, part of these reserves were used to pay back maturing debt worth some 5.7% of GDP, which, combined with the strong economic rebound and the primary surplus, resulted in an almost 20 pps. fall in the debt ratio.

Despite the planned significant increase in the budget deficit, the ERP expects the public debt ratio to continue falling markedly in 2022, due to growth effects and further debt repayments from cash reserves, which still amounted to 10.9% of GDP in September 2021. In 2023-2024, growth and inflation effects will become the main factors driving down the public debt ratio.

Overall, the decrease in the debt ratio and debt management efforts have lowered vulnerabilities linked to the high debt burden and its composition. In 2021, the government concluded a hedging arrangement with a consortium of private banks to shelter public finances from currency risk on an USD 944 million loan from China to build a major highway section. The swap deal also reduced the interest rate on this debt from 2% in US dollars to 0.88% in euro. Currently, around 97% of the public debt is held in euro and only 2.3% in USD. In addition, 74.3% of all debt carries fixed interest rates.

Box II.2.2: Debt dynamics					
Montenegro					
Composition of changes in the debt ratio (% of GDP)					
	2020	2021	2022	2023	2024
Gross debt ratio [1]	105.3	85.5	76.6	73.2	69.9
Change in the ratio	28.8	-19.8	-8.9	-3.4	-3.4
Contributions [2]:					
1. Primary balance	8.4	-0.6	3.2	0.3	-0.8
2. "Snowball" effect	16.7	-12.3	-4.9	-3.3	-2.7
Of which:					
Interest expenditure	2.7	2.4	1.8	1.6	1.4
Growth effect	13.9	-12.1	-5.0	-3.7	-3.1
Inflation effect	0.2	-2.6	-1.7	-1.2	-1.0
3. Stock-flow adjustment	3.7	-6.9	-7.1	-0.4	0.1
[1] End of period.					
[2] The snowball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).					
The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other effects.					
Source: Economic Reform Programme (ERP) 2022, ECFIN calculations.					

Active debt management operations in 2021 and 2022, using government cash deposits to repay public debt instead of borrowing to roll it over, are set to generate large stock-flow adjustments, which combined with a gradual improvement in the primary balance in the outer years, are expected to drive a fast reduction in the public debt ratio by some 35 pps. of GDP in 2020-2024. A favourable scenario of strong GDP growth, moderate inflation and falling interest costs would continue supporting the reduction in the debt ratio, thanks to the snowball effect.

The ERP identifies numerous risks to the achievement of planned fiscal targets. Apart from the risks related to the 'Europe Now' programme mentioned above, the weak financial situation of some public companies as well as some guarantees represent additional hazards for the stability of public finances. Overall, these risks could be managed by using the government's cash deposits or a well calibrated budget rebalance. There is also a specific (and unavoidable) issue concerning future statistical data revision. Concretely, the future introduction of the European System of Accounts (ESA 2010) methodology would require reclassifying some operations of public companies into the general government sector, increasing deficit and debt levels.

More optimistically, the ERP expects that some reforms, such as improving the corporate governance of state-owned enterprises (SOEs), streamlining the public administration, or the concession of Montenegro airports, could result in a better fiscal performance than planned. However, many of these reforms are not new and have either failed in the past or have been postponed several times, which raises doubts about their implementation. Another major risk – not reflected in the ERP –, concerns the political situation following the no-confidence vote and the fall of the government in February. This may result in structural reform delays, policy reversals or budgetary slippages but also in underperformance of planned capital investments as construction plans may be further delayed.

Box II.2.3: Sensitivity analysis

The programme makes a detailed analysis of the deficit, with a comparison between scenarios as well as with the previous ERP. The comparison of scenarios includes a detailed risk matrix identifying potential positive and negative events (see above). However, a detailed impact of each single risk is not quantified; only their total effect on the budget balance, as reflected in the alternative scenario.

Last year's programme projected an almost balanced budget for 2022 and a surplus for 2023. By contrast, this year's ERP baseline scenario projects no surpluses and a particularly high deficit for 2022. This sudden change, in a context of strong recovery of the economy and budget revenue above pre-pandemic levels (in nominal terms), is the consequence of the government's intention to frontload the 'Europe Now' programme and thereby provide a rapid boost to the economy.

Introduction of a progressive taxation system represents a major systemic change. As of 2022, the system should help reduce inequalities. Higher revenues and profits would contribute more to sustaining public finances, while the introduction of a non-taxable part of the wage (with a threshold above the average salary) would benefit workers on a lower income. Overall, the new structure of spending devised in the Europe Now programme is conducive to growth and social inclusion by supporting capital spending, lowering labour costs and increasing significantly households' disposal income.

Gaps in the budgetary framework remain to be addressed. Amendments are still pending to the Law on Budget and Fiscal Responsibility with a view to establishing an independent fiscal council to strengthen the oversight of fiscal policy, although some preparatory work has already been done. Activities are being carried out to implement projects to enhance the budgetary system, establish a proper medium-term budgetary framework and improve internal financial control. Programme budgeting was introduced with the 2021 budget. However, it will take a few years to achieve full implementation, with the introduction of performance indicators to monitor progress.

The Revenue and Customs Administration is implementing a project to set up an integrated revenue management system (IRMS) and an online fiscalisation system in real time, to increase transparency of the tax payment process and reduce informality. This would contribute not only to improving the efficiency of the system, but also to implementing the 'Europe Now' programme. The government has been working on the development of a public asset management company (called 'Montenegro Works'), inspired by the model of the Hellenic Corporation of Assets and Participations (HCAP), to achieve a more efficient and integrated operation of public companies. There is a considerable delay in rolling out accrual accounting and production of government finance statistics based on ESA2010 standards.

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

The Commission has conducted an independent analysis of Montenegro's economy to identify the key structural challenges to competitiveness and inclusive growth, drawing on Montenegro's ERP and other sources. This concise analysis shows that, despite progress made, the country suffers from several structural and crosscutting weaknesses across many sectors of the economy. The key challenges in terms

of boosting competitiveness and securing long-term inclusive growth remain the same as identified in the last years. They are:

- (i) increasing employment, particularly of women and young people, and tackling long-term unemployment;
- (ii) strengthening the regulatory environment and
- (iii) reducing informality in the economy.

This assessment therefore focuses on those three key challenges.

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

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

Despite the economic growth in 2021, labour market indicators only improved marginally. The unemployment rate in the third quarter of 2021 fell by 4.2 pps. to 14.8%, compared to the same period in 2020. The employment rate increased from 43.0% to 46.5% and the activity rate from 53.1% to 54.6%, though it has still not reached the pre-crisis level of 60% in the third quarter of 2019, according to Monstat. By way of comparison, in the EU, the unemployment rate (15-74) was 6.9%, the activity rate (20-64) was 78.9% and the employment rate (20-64) was 73.6% in the third quarter of 2021. There are significant disparities between the country's three regions. The unemployment rate in the Northern region (33%) was more than eight times that in the Coastal region (4%) in the third quarter of 2021. A number of vulnerable groups, including Roma and persons with disabilities face additional challenges in accessing the labour market, despite the support available for these groups under employment and education programmes. Montenegro adopted two further economic support packages in 2021 aimed at job retention by providing support to businesses, workers affected and 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', Montenegro proposed to roll over Measure 16 from the 2021 ERP, and proposed Reform Measure 2 – 'Introducing new work schemes and work-life balance'. The aims of the measure remain appropriate and in line with EU-Montenegro priorities.

The most vulnerable groups on the labour market are still women, young people and the low skilled, and long-term unemployment remains a structural challenge. The pandemic had a significant negative impact on youth employment (15-24), with employment rate for the age group falling to 18.4% in the fourth quarter of 2020 from 26.9% in the fourth quarter of 2019. The rate of unemployment (15-24) also rose to 42.0% in the fourth quarter of 2020 from 27.8% in the fourth quarter of 2019. In 2019, the rate of young people (15-29) not in employment nor in education or training (NEET) stood at 21.3%. This reflects significant difficulties in transitioning from education to employment, and a mismatch between the skills acquired through formal education and the skills in demand on the labour market. It could also indicate few job opportunities available for young people. The NEET rate increased significantly in 2020 to 26.6%. The NEET profile analysis conducted by the International Labour Organization (ILO) points to a high and increasing number of unemployed graduates from secondary and higher education who are out of employment. The highest share of unemployed people continue to be those with a lower level of education. High long-term unemployment persists; 75.5% of the unemployed people were unemployed for more than a year in the fourth quarter of 2020. Montenegro adopted the National Employment

Strategy for 2021-2025 together with the Action Plan for 2022 on 29 December 2021 after a significant delay. The ambitious Strategy contains measures to support a sustainable rise in employment, including through strengthening skills development. Montenegro's local employment strategies are important in guiding efforts to address regional differences by taking tailored measures.

The country has active labour market measures to help young people join the work force, though the effectiveness of these measures remains to be seen. The government took steps to put in place a Youth Guarantee in Montenegro. In 2019, it put in place a specific measure designed to encourage young people to join the labour market through employment or self-employment, however its effectiveness is yet unknown. The professional training programme for graduates in place for over a decade has been recently evaluated by the ILO, finding that the programme has been ineffective and recommending that (ILO, 2022). In line with the Western Balkans Declaration adopted in July 2021 on ensuring sustainable labour market integration of young people and with the 2021 policy guidance, Montenegro acted quickly to create a multi-stakeholder group in charge of drafting the Youth Guarantee implementation plan. Reform Measure 3 on 'Introducing the Youth Guarantee Programme in Montenegro' is expected to support this work and provide a cross-sectoral policy overview combining multiple measures to activate young people. In 2021, Montenegro launched an employment programme for young people in preparation for the Youth Guarantee.

The pandemic widened the already wide gender gap in the labour market. The employment gap (20-64) between women and men continued to widen, standing at a 15.6 pps. difference in the fourth quarter of 2020 (compared to 11.2 pps. difference in the fourth quarter of 2019). In 2020, the rate of women inactive on the labour market (20-64) remained far above the rate for men at 40.1% compared to 25.4%. Employment gains continue to be larger for men than for women. Gender-sensitive career counselling, programmes aimed at encouraging young women's enrolment in non-traditional vocational programmes and studies, or programmes aimed at helping women come back to the labour market after a prolonged absence, for example as a result of childcare, are lacking (OECD, 2021). In July 2021, the government adopted a new National Strategy for Gender Equality for 2021-2025 and an Action Plan for 2021-2022, identifying clear operational objectives and measures to improve gender equality. The pandemic also had a negative impact on the previously improving enrolment rate in early childhood education and care, which should help improve the employment and training prospects for women. Previous improvements made in the enrolment rate of children in pre-primary education worsened by 7.6 pps. in the 2020/2021 academic year compared to 2019/2020, which is an expected effect of the pandemic. Regional disparities remain with low take-up in the north. The government adopted the Strategy and Action Plan for Early and Preschool Education for 2021-2025 in 2021. Implementing these measures should help restore the previous gains made.

Active labour market policies (ALMPs) are not sufficient to help jobseekers find sustainable, long-term employment and they still focus insufficiently on re- and up-skilling. The country lacks a comprehensive monitoring and impact assessment of the effectiveness of ALMPs, including following up on the number of beneficiaries who remain employed in the long term following their participation in activation programmes. This means that continuous policy adjustments are not made to render the policies fit for purpose. Efforts are ongoing to improve the currently ineffective institutional set-up and functioning of Montenegro's public employment service, the Employment Agency of Montenegro (EAM). This is reflected in *Reform Measure 1 – 'Strengthening operational capacities of the Employment Office for the performance of services and measures via digitalisation'* which follows through on Reform Measure 17 in the 2021-2023 ERP. The process to digitalise EAM based on the results of the procedures identified and revised is expected to facilitate its work. It is also expected to improve the provision of tailor-made and targeted services for young people and adults, and to contribute to the effective monitoring and evaluation of ALMPs.

Informality remains an obstacle to improving labour market outcomes. Although it is assumed that the wage-subsidy measures in response to the pandemic have prompted employers to formalise some of

their employees, disincentives to declare work remain, and this requires a comprehensive set of measures. The Labour Law adopted in December 2019 and the tax reform measures in the Europe Now programme adopted at the end of 2021 aim at increasing labour market flexibility and remove the incentives for undeclared work. The capacity of the Administration for Inspection Affairs, under which the Labour Inspectorate operates, remains limited.

A mismatch of skills remains a significant challenge, particularly for young people. According to the 2020 Human Capital Index issued by the World Bank, ‘a child born in Montenegro today will be 63% as productive when they grow up as they could be if they enjoyed complete education and full health’. The quality and relevance of the entire education system and the lack of practical experience of graduates from vocational and higher education have been long-term challenges. This has been aggravated by the COVID-19 pandemic and continues to be a reform priority under the Osnabrück and Bologna Declarations (ETF, 2022). There is a high rate of people transitioning from vocational education and training programmes to higher education and other programmes that are less suited to market needs. Occupational mismatch (i.e. over-qualification) is highest for people with a tertiary education (around 14%). Although tertiary educational attainment is still lower than the EU average, the labour market cannot absorb the numbers of tertiary graduates in certain areas, such as business and humanities, and yet there is still a shortage of medical and STEM graduates (ETF, 2019). This is detrimental notably in view of their significance for the occupational domains targeted by the smart specialisation strategy. Montenegro’s Entrepreneurial Lifelong Learning Strategy for 2020-2024, the National Partnership and the Innovation Fund are expected to help address these skills shortages. Furthermore, the Strategy for the Development of Vocational Education in Montenegro (2020-2024), along with its action plans, outlines measures for overcoming workforce skills shortages and to improve the efficiency and the effectiveness of the VET system and lifelong learning. Montenegro has committed to the Western Balkans agenda on innovation, research, education, culture, youth and sport, which is expected to guide its reform efforts.

Lifelong learning and adult education with up- and re-skilling has not yet played a sufficiently prominent role, including in facilitating the green and digital transitions. Given the very high share of long-term unemployment, developing and implementing these measures remains essential. In 2022, drawing up a digital education action plan and the Digital Skills Strategy should identify further measures to address these shortcomings.

These shortcomings were clearly identified in the 2022-2024 ERP. It proposes two new reform measures to target the persistent skills mismatches in the labour market and improve the relevance of the education system, *Reform Measure 4 – ‘Increasing employability of adults by improving their skills and competences needed at the labour market’* and *Reform Measure 5 – ‘Digitalisation of the education and development of digital skills’*. These are in line with the European Commission’s policy recommendations.

Montenegro adopted several reform measures in 2021 and 2020 that aim to improve the protection of the most vulnerable segments of the population, improve general living conditions and bring more people onto the job market. In line with the Social and Child Protection Strategy, the government with the help of UNICEF has commissioned a study to review the social protection system. Following up on the 2021 policy guidance, it has drafted a comprehensive roadmap of reforms. Following amendments to the Law on Pensions and Disability Insurance and the Law on the Labour Fund in July 2020, in May 2021 it brought in other changes. It adopted amendments to the Labour Law raising the minimum wage from EUR 222 to EUR 250 as of 1 October 2021, and to the Law on Social and Child Protection granting universal benefits to all households with children under the age of six. The measures adopted under the Europe Now programme in December 2021 also include increasing the net minimum wage from EUR 250 to EUR 450 and raising the non-taxable personal income to EUR 700, thereby decreasing the tax wedge on low-wage earners.

Reform Measure 6 on ‘Reform of the national system for disability assessment’ and 7 on ‘Define financial preconditions for reforms proposed under the Roadmap’ respond to the need to complete the social care system and to reform the social protection system in line with needs.

Key challenge #2: Strengthening the regulatory environment

The institutional and regulatory environment in Montenegro calls for further reforms in the coming years. The regulatory environment is not sufficiently business-oriented and hinders the dynamic development of local companies and foreign investors’ activities, as underlined in detail in the Commission’s ERP assessments in 2020 and 2021. Substantial improvements are needed to remedy the inefficiencies and delays when dealing with the administration, excessive complexity and the administrative burden from local taxation and para-fiscal charges, and the effectiveness of consultation mechanisms between authorities and the business community, which should be continuous and structural. Also on the list of issues for improvement are transparency in decision-making, inconsistencies and arbitrary interpretation and law enforcement by public authorities, and access to finance for SMEs, both in general and in specific contexts (COVID-19, innovation policies).

Companies stress that these deficiencies weaken the regulatory environment at central and local levels and hold back Montenegro’s economy. This translates into lost opportunities in terms of jobs (with an impact on Key Challenge 1) and provides incentives, specifically to micro and small enterprises, to carry out undeclared work and transactions (thus fuelling the issues described under Key Challenge 3).

Montenegro made tangible progress in 2021 to improve the business and regulatory environment, despite the COVID-19 impact. It met a major milestone on public procurement, migrating from a paper-based system to the fully electronic system by the end of 2021. Electronic procurement is expected to bring significant improvements to public procurement over the coming years. A centralised e-procurement system via a single, dedicated portal, enabled by making comprehensive changes to procurement legislation (aligned with EU law) paves the way for significantly easier access to information on tenders from all contracting authorities, speeding up procedures and improving their transparency. Implementing e-procurement has the potential to significantly reduce the scope for corruption, breaches of competition rules and the potential for lengthy and costly appeals.

Involving businesses and social partners in dialogue with the government and regulatory processes saw some promising developments. Businesses found it easier to have their voice heard in the design of structural reforms planned under the current ERP and in the adopting COVID-19 mitigation measures. The development and expansion of the role of the Competitiveness Council in 2021 could spur a more systematic involvement of business partners in designing, drafting and implementing measures that affect businesses. Supported by a permanent secretariat and ad hoc technical working groups and bodies, the Council has the potential to become an important forum of consultation with the government.

The first result of this closer cooperation is the Register of (fiscal and para-fiscal) Charges, reporting information on levies and charges affecting businesses at national and local levels. The Register provides a basis for further simplification and harmonisation in the domain of local taxation. It remains to be seen whether the authorities will use the Competitiveness Council in the future to strengthen major government reforms and programmes. This would be in line with the policy guidance (PG 4) of the 2021 Joint Conclusions of the Economic and Financial Dialogue between the EU and Montenegro.

The government has embraced digitalisation as a way to strengthen Montenegro’s regulatory environment. The process to digitalise the public sector and develop transactional e-government services features prominently in the policy guidance of the Joint Conclusions (PG 5). In its latest ERP 2022-2024, Montenegro committed to developing transactional electronic government services that, when implemented, may greatly improve the institutional and regulatory environment and bring clear gains in terms of efficiency and transparency of relations between businesses and public authorities. Though most

of these reforms were planned or initiated earlier, the outbreak of the COVID-19 pandemic provided an additional stimulus to these e-government projects. Implementing the discussed e-government services could achieve a significant reduction in the scope for corruption and unequal treatment between businesses. Accelerating the digitalisation of the economy and public administration may also facilitate progress in addressing key challenges 1 and 3, as it reduces the time and cost of administrative procedures for employers and businesses.

The proposed *Reform Measure 9 – ‘Establishing a full electronic registration of enterprises’* is credible and well developed. It should streamline the procedure of setting up and registering a company.

Another of the proposed reforms – *Measure 11 – ‘Strengthening competitive position of MSMEs by establishing a single access point’* aims to create a web portal containing all information relevant to micro, small and medium enterprises that should also enable digital application for MSMEs support. It is relevant and could contribute to creating a business-friendly regulatory environment.

Reform Measure 13 – ‘Improving digitalisation of the e-government by developing a platform for complex e-services’ focuses on developing transactional level e-services of key interest to the Montenegrin society. While its scope and significance go beyond the institutional and regulatory environment, business (in particular micro and small businesses) would be among the beneficiaries of the reform. The measure is relevant for increasing the competitiveness of and innovation in the Montenegrin economy. The government could focus on simplifying administrative procedures, both paper-based and digital, to achieve better results. It is not clear how the local authorities are involved in providing the envisaged e-government services.

Reform Measure 14 – ‘Improving legislative and regulatory framework for further development of broadband internet connection infrastructure’ could be considered a flanking measure for the development of digital services at the national and local level. It concentrates on the adoption and implementation of the Law on Electronic Communications (in line with Directive (EU) 2018/1972), the national plan for broadband development and the strategy of development of 5G networks. The reform is relevant and will undoubtedly contribute to developing a competitive and modern economy. A more detailed description of expected impacts on competitiveness, society and labour is advised.

Access to finance, support for innovation and reform of state-owned enterprises complement the list of regulatory environment reforms over the coming years. Montenegro’s current ERP adds new areas of focus for the structural reforms under the regulatory environment challenge. Better access to finance for micro, small and medium enterprises is, in a way, a classic area of business, institutional and regulatory environment reforms in many EU and Western Balkan countries. In Montenegro, it regained prominence due to the pandemic, with SMEs in the tourism and related sectors hit very hard in 2020 and only partially recovering in 2021.

Reform Measure 10 – ‘Improving access to financing for MSMEs by creating a Credit-Guarantee Fund’ is relevant and credible, but it depends on swift adoption of the legislative framework by the Montenegrin Parliament.

Access to funding also features prominently in developing innovation and providing support for research and development. *Reform Measure 12 – ‘Strengthening the national innovation and research ecosystem’* focuses on effectively implementing the Innovation Fund to support innovative enterprises and on building the institutional capacity of the Council for Innovation and Smart Specialisation, in line with the country’s smart specialisation strategy. It is relevant and aligned with the EU strategies. Successful monitoring and implementation of the measure depends on the Ministry of Economic Development and the Innovation Fund having sufficient administrative capacity.

A prospective public financial management reform, *Measure 15 – ‘Improving management of business undertakings in majority state ownership’* fits in well with other reforms of the regulatory environment. As reported by the latest OECD Competitiveness Outlook 2021, Montenegrin state-owned enterprises are managed and perform worse than other state-owned enterprises in the region. The ultimate aim of the reform, according to the Ministry of Finance and Social Welfare, is to define an optimal portfolio of state ownership, transform the management structures and practices of selected enterprises and ultimately improve their financial performance by setting up a holding company for these enterprises. If successfully implemented, this would have a major impact on the performance of Montenegro’s economy, given that state-owned enterprises are some of the largest companies and the largest employers. Nonetheless, the scope of the reform presented in 2022-2024 ERP is much narrower and focuses only on the setup and initial operations of Montenegro Works company, the body that should spearhead these reforms. A comprehensive approach in the next edition of the ERP is desirable.

In summary, Montenegro’s efforts to improve its regulatory and institutional environment started showing some results in 2021. This also prompted the government to table new priority reforms in this field. Public authorities committed to action to digitalise the economy and roll out new e-government services. If fully implemented, these reforms have the potential to improve the efficiency and transparency of the regulatory environment, reduce costs and limit the scope for corruption. New reform initiatives on access to finance, support for innovation and management of state-owned enterprises appear very relevant. Working towards an inclusive, business-oriented regulatory environment and implementation of a business-centric culture by the central and local public administrations should remain the authorities’ focus in the coming years.

Key challenge #3: Formalisation of the economy

The informal economy constitutes a major obstacle to the inclusive, sustainable growth and the competitiveness of Montenegro. According to different studies and estimates, the informal economy represents between 25 and 33% of the country’s GDP and employs around 30% of the workforce (UNDP). The informal sector is fuelled by deficiencies in the institutional and regulatory environment, weaknesses on the labour market, insufficient enforcement capacity of the public authorities, corruption and tax non-compliance. The most common practices of the informal economy in Montenegro are reportedly informal employment and other forms of informal contracts (particularly for works in the services sector), unregistered sales of goods and services; tax avoidance on sales of excisable goods; pursuing economic activity without registration or the required license.

The impact of the informal economy is particularly harmful for the SMEs operating legally and microenterprises in the services sector, which dominate the economy. These smallest companies perceive informal competition as the most costly obstacle to doing business. The costs of the informal economy and corruption are also higher for innovative companies, which particularly hinders the development of sectors of the economy that are based on knowledge and skills. On the side of the public authorities, the lack of proper monitoring tools is an obstacle to preparing, implementing and assessing the results of targeted reform measures that attempt to address the informal economy.

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

Previous attempts to reduce the informal economy were undermined by the lack of continuity and political support and by delays caused by the COVID-19 crisis. Reducing the scale of the informal economy became a formal priority for the government in 2017. An action plan adopted at that time had a rather limited scope, focusing on a 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 provide a quick increase in revenue to the state budget. A more comprehensive approach to informal economy and a more ambitious, if undefined programme of reforms was outlined in the 2019-2021 ERP. The authorities acknowledged, at the time, the need for a multi-faceted, multisector approach to the challenge and the importance of involving legitimate businesses and social partners in action to reduce the informal economy.

However, since the time, the activities reported under successive ERPs focused mostly on internal reorganisations, reshuffling responsibilities between different administrative bodies and working groups and repackaging previous plans. They did not result in a convincing new approach to the informal economy and failed to overcome most of the previously identified deficiencies. Progress was delayed again by the outbreak of the pandemic, which put on hold virtually all informal economy – related activities scheduled under the structural reforms part of the ERP, and personnel changes. As a result, despite the EU recommendations and Policy Guidance provided through the Joint Conclusions in recent years, Montenegro did not produce a new action plan that would go beyond suppressive and control measures or provide incentives to bring companies and work into the formal economy.

The 2022-2024 ERP relies heavily on measures in the ‘Europe Now’ programme to tackle the challenge of the informal economy. Reducing the size of the informal economy, with an emphasis on the labour market, is one of the stated goals of the ‘Europe Now’ programme, a fiscal and tax reform adopted by the parliament at the end of 2021. The key reform under this programme combines the reduction of the tax wedge on labour, thanks to the abolition of health insurance contribution paid by employers, and the introduction of non-taxable income for gross salaries up to EUR 700. This is accompanied by a higher (than before) personal income tax on salaries above EUR 1000. These measures are expected to lower the labour costs for employers and lead to the creation of new (legal) jobs, thus directly reducing the level of undeclared work in the economy.

Reform Measure 17 – ‘Improving the business environment by reducing the labour tax wedge’ – is a direct reflection of this key reform in the 2022-2024 ERP. The measures are relevant, ambitious and comprehensive. They seek to address all three key challenges for Montenegro’s economy – the first reform of such cross-cutting nature in the ERP. The reform certainly has the potential to make a significant impact on the size of informal economy in Montenegro, but potential risks (which are not described well in the text) are high. Careful monitoring of the impact and getting an up-to-date picture of the informal economy sector in Montenegro (see below) are needed to assess the short and mid-term results of the reform and to make any adjustments, if necessary.

The key labour tax reform is accompanied by two, relatively low-key measures. *Reform Measure 16 – ‘Suppressing informal economy through the tax administration reform’* is a continuation of the measure from previous years. It aims to improve the efficiency of the Revenues Administration and reduce costs for taxpayers, providing the capacity to uncover and act on the informal economy. As such, the measure is relevant and clearly developed. However, and as indicated in the past, the risks of further delays in implementation due to restructuring, limited capacities and turnover of staff remain high.

A new reform, *Measure 18 – ‘Information system and mobile application for monitoring the tourism parameters’* aims to link some of the IT systems of the public administration and roll out a new mobile application to register guests to curb unregistered (and thus non-taxed) stays in holiday accommodation. The reform is embedded in the economic priorities of the government, but appears narrow in scope for a strategic-level priority reform addressing a key challenge. It would become more effective if linked with

other measures designed to curb the informal economy and boost the competitiveness of legally operating companies in the tourism or services sector.

The ERP lacks a cross-sectoral, overarching measure that underpins action to reduce the informal economy. According to government officials, the long-delayed work to draft Montenegro's new action plan on the informal economy, mentioned in the last three ERPs, is expected to continue in 2022, but no longer in the scope of this strategic document. As a first step, a survey on the informal economy is to be carried out among companies and households. A consultancy was reportedly chosen to carry out this task and assist the working group, comprised of officials from different ministries, in selecting and designing the activities to be included in the action plan. The survey should also be instrumental in the context of the tax wedge reform (Measure 17).

Montenegro implemented two related initiatives not included in the ERP structural reforms during the pandemic. The first resulted in new excise duty stamps, backed up by a smartphone application that enables users to check the authenticity and legality of excise goods. The second, the e-fiscalisation initiative, aimed at registering and supporting proper taxation on all cash transactions at the point of sale. It was partially implemented in 2021 and work will continue in 2022. These are rare examples of actions aimed at reducing the informal economy that were achieved in the last years.

Follow-up action, better coordination and steadfast implementation are required to achieve tangible results. The yet-to-be drafted government plan to reduce the size of the informal economy would benefit from an approach combining targeted, suppressive and control measures with further incentives to legalise informal businesses and informal employment, beyond the measures taken under the 'Europe Now' programme. Another, so far disregarded aspect of the informal economy that requires government attention is the need to address the most obvious gaps and inconsistencies in legislation that facilitate the operation of informal businesses (for example, concerning the powers of labour inspectorate that operates under the Administration of Inspections Affairs). A deep reform of inspection bodies and their digitalisation is necessary, together with action to develop capacities of inspections and tax authorities. Continuous coordination of action by different public institutions, businesses and other social actors and a structured dialogue involving both central and local authorities is key for the successful and timely implementation of any measures. The process of the digitalisation of the public administration and services provides ample opportunity to reduce the scope and size of the informal economy. The determination of the public authorities to enforce rules through administrative and judicial means will play an equally important role in the process.

In summary, the government has recognised the magnitude of the challenge posed by the informal economy for the long-term, sustainable development of Montenegro and it took some decisive actions at the end of 2021. It remains to be seen whether the reforms and legal changes initiated under the 'Europe Now' programme will result in a significant reduction of the informal economy. Successful implementation of key tax reforms in the labour market and changes ongoing in the regulatory environment, in particular digitalisation, may indeed address some of causes of the informal economy over the coming years. Nonetheless, a clear vision, further reforms and a plan for follow-up actions is needed to produce a cumulative and pronounced impact on the informal economy.

Box II.2.4: Monitoring performance in light of the European Pillar of Social Rights ⁽²³⁾

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

MONTENEGRO		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU avg., improving
	Individuals' level of digital skills (basic or above basic)	Worse than EU avg., trend N/A
	Youth NEET (% of total population aged 15-29)	Worse than EU avg., deteriorating
	Gender employment gap	Worse than EU avg., improving
	Income quintile ratio (S80/S20)	Worse than EU avg., improving
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU avg., deteriorating
	Unemployment rate (% of population aged 15-74)	Worse than EU avg., deteriorating
	Long term unemployment rate (% of population 15-74)	Worse than EU avg., deteriorating
	GDHI per capita growth	N/A
Social protection and inclusion	At risk of poverty or social exclusion (in %)	Worse than EU avg., improving
	At risk of poverty or social exclusion rate for children (in %)	Worse than EU avg., improving
	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU avg., deteriorating
	Disability employment gap	Worse than EU avg., deteriorating
	Housing cost overburden	Better than EU avg., improving
	Children aged less than 3 years in formal childcare	N/A
	Self-reported unmet need for medical care	Worse than EU avg., improving

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

The COVID-19 pandemic reversed years of positive labour market trends. Although employment and unemployment rates, as well as the share of young people (15-29) not in employment, education or training (NEETs) had begun to improve, the pandemic undermined this progress. Structural challenges in the labour market persist, including high and increasing long-term unemployment and continued regional disparities. The gender employment gap continued to narrow steadily, although figures remain below the EU-27 average.

Skills mismatches and the weak provision of adult learning affect school-to-work transitions and result in workers being insufficiently prepared to find suitable and sustainable employment. The quality and relevance of the entire education system and the lack of practical experience of graduates from VET and higher education are long-term challenges, which have been exacerbated by the pandemic. Montenegrins' level of digital skills was slightly below the EU-27 average in 2017, but there is insufficient data to identify a trend. Montenegro continues to outperform the EU-27 average on the rate of early leavers from education and training.

Employment remains the best route out of poverty. 37.8% of the population and 45.8% of children were at risk of

poverty or social exclusion in 2020. After falling continuously, the rates increased again following the outbreak of the pandemic. Though the social protection system has not so far been well equipped to target and assist those in need or to bring people onto the labour market, the Roadmap of Reforms of the social and child protection system is expected to address the systemic shortcomings. In 2020, Montenegro outperformed the EU-27 average in terms of the housing cost overburden, and significantly improved its performance as regards self-reported unmet medical needs, remaining only slightly under the EU-27 average.

The collection of timely and reliable data needs to be sustained and strengthened. Efforts should continue to bring the employment and social statistics more into line with EU standards and to send statistics to Eurostat systematically and on time.

⁽²³⁾ The table includes 16 headline indicators of the Social Scoreboard, used to compare performance of EU Member States (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2020 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). For data see Annex B. NEET: not in employment nor in education and training; GDHI: gross disposable household income.

2.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2021

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 region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the PG is similar to that of the country-specific recommendations usually adopted under the European Semester for the EU Member States. The Commission evaluates the work carried out to implement the policy guidance in the following year's ERP assessments. The table below presents the Commission's assessment of implementation of the 2021 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at Ministerial level on 12 July 2021.

Overall: Partial implementation (57.9%) ⁽²⁴⁾	
2021 policy guidance	Summary assessment
<p>PG 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.</p> <p>Prepare a new public administration optimisation plan with a view to contain the share of the public sector wage bill in GDP.</p> <p>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.</p>	<p>There was partial implementation of PG 1:</p> <p>1) Partial implementation: During the COVID-19 pandemic, the government adopted five packages of socio-economic measures, including wage subsidies to preserve jobs and support vulnerable sectors, including pensioners and unemployed workers. It provided new credit lines under favourable conditions as well as loan moratoria and tax deferrals, for companies and citizens. Overall, support measures are being gradually phased out and no new socio-economic packages were set up since April 2021, as the economy started recovering strongly.</p> <p>Montenegro adopted a new fiscal strategy and budgetary medium-term framework in December 2021. However, the 2022 budget targets a higher deficit of 5% of GDP for this year (above the fiscal rules' ceiling of 3% of GDP), declining gradually afterwards to 0.6% of GDP in 2024. Public debt is planned to fall markedly from 84.5% of GDP in 2021 to 67.6% in 2024. However, consolidation targets seem difficult to attain without additional measures to strengthen budget revenue and contain or reduce spending.</p> <p>2) Limited implementation: Montenegro adopted a new public administration reform strategy (2022-2026). The strategy sets out a plan to optimise human resources in line with the digitisation of the public administration. However, it does not set targets for this adjustment, pending on performing a series of functional sectoral analyses first.</p> <p>3) Full implementation: Implementation of the new system for electronic management of excise stamps started in 2021. The system includes QR codes and new digital security elements to prevent the illegal trade of excise products.</p>

⁽²⁴⁾ 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.

Advance the implementation of a public investment management assessment (PIMA) programme, to improve the quality of public investments.	4) Limited implementation: A PIMA assessment report was released in July 2021, followed in August by an IMF report with recommendations, and an action plan (to be adopted in Q1 2022).
<p>PG 2:</p> <p>Adopt amendments to the Law on Budget and Fiscal Responsibility with the aim of setting up an independent body in charge of fiscal oversight.</p> <p>Develop a comprehensive overview of all tax exemptions, including an analysis of their economic and social impact.</p> <p>Support the economy and business liquidity by reducing public sector arrears and deadlines for VAT return.</p>	<p>There was partial implementation of PG 2:</p> <p>1) Limited implementation: Amendments to the Law on Budget and Fiscal Responsibility are being prepared in order to create the formal preconditions for the establishment of a fiscal council. Adoption of the amendments is planned in the first half of 2022.</p> <p>2) Partial implementation: The Ministry of Finance and Social Welfare drew up a list of tax exemptions with the technical support of the IMF. However, the analysis of the economic and social impact is still pending.</p> <p>3) Substantial implementation: The time limit for VAT refund was reduced from 60 to 30 days. Measures were part of the socio-economic measures to support the economy during the pandemic. Further progress was made in reducing public sector arrears (i.e. liabilities for current expenditure), recording a 8.4% y-o-y contraction at the end of 2021.</p>
<p>PG 3:</p> <p>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.</p> <p>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.</p> <p>Complete the ongoing Asset Quality Review, transparently publish its general findings and timely take remedial action where needed.</p>	<p>There was substantial implementation of PG 3:</p> <p>1) Substantial implementation: Good progress was made in key pieces of legislation to further align Montenegro's regulation and supervision with the current EU framework. This included the Law on Credit Institutions and the Law on the Resolution of Credit Institutions that became effective in January 2022. Most support measures have been phased out, except some for households. Regarding provisioning, the coverage ratio has decreased slightly, but remains high in a regional comparison.</p> <p>2) Partial implementation: The CBCG has completed a survey that identified slow collateral resolution procedures. It also created an inter-ministry working group to resolve the issues. Overall, however, progress in legislation and in implementing actions to strengthen the broad institutional framework for efficient insolvency has been slow.</p> <p>3) Substantial implementation: The AQR was completed, and its main headline results published. Follow-ups are currently being implemented by banks.</p>
<p>PG 4:</p> <p>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.</p>	<p>There was substantial implementation of PG 4:</p> <p>1) Partial implementation: The Competitiveness Council, which brings together representatives of the government, business associations and municipalities, developed an action plan to remove by mid-2022 some of the less complex barriers to business that were identified by the Council.</p>

<p>Establish technical-level mechanisms and administrative best practices allowing for a continuous structural dialogue between authorities and the business community.</p> <p>Focus on further simplifying business taxation, reducing number and diversity of para-fiscal charges and facilitating payment of tax commitments.</p>	<p>2) Substantial implementation: In February 2021, the government adopted a new decision on the membership and functions of the Competitiveness Council, with the aim of increasing its role and efficiency. There was improvement in communication, consultation and involvement of the private sector on draft legislative acts and on the directions of the country's economic policy development (ERP).</p> <p>3) Substantial implementation: The registry of fiscal and para-fiscal charges was set up in March 2021 and is regularly updated. There are plans to create a similar registry for business licences. All municipalities implemented laws on administrative fees and on local communal fees, adopted in March 2019. Work is progressing on electronic registration for companies and it should lead to a further reduction or abolishment of the fees and charges applied when registering a business.</p>
<p>PG 5:</p> <p>Prioritise digitalisation of the public sector and development of transactional electronic government services to speed up and enhance the economic recovery.</p> <p>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.</p> <p>Ensure structural cooperation between central and local authorities in the development and implementation of measures aimed to reduce the informal economy.</p>	<p>There was partial implementation of PG 5:</p> <p>1) Substantial implementation: Digitalisation of the public sector became a priority for the government and is supported by two strategies, the Digital Transformation Strategy 2022-2026 and the Public Administration Reform Strategy 2022-2026. The project to set up a national platform for the provision of complex e-services started in 2021. Further reforms focus on the digitalisation of crucial public services like education, healthcare and employment.</p> <p>2) No implementation: Work on the comprehensive action plan on the informal economy is postponed to the second half of 2022.</p> <p>3) Partial implementation: Central and local authorities (represented by the Union of Municipalities) worked together with business associations on structural reform issues, including on the informal economy, in the framework of the Competitiveness Council. The action plan to remove some of the less-complex barriers to business, developed by the Competitiveness Council, includes actions to combat the informal economy.</p>
<p>PG 6:</p> <p>Establish an inter-ministerial task force involving relevant ministries, their agencies and stakeholders to develop a Youth Guarantee implementation plan.</p> <p>Based on the review of the social protection system, finalise the roadmap and start implementing social protection reforms.</p>	<p>There was substantial implementation of PG 6:</p> <p>1) Full implementation: The inter-ministerial task force was set up, involving relevant ministries, their agencies and stakeholders with the task of drawing up a Youth Guarantee implementation plan.</p> <p>2) Substantial implementation: The review of the social protection system was finalised and the Roadmap of Reforms was drafted, although it has not yet been officially adopted nor does it contain a clear timeline and financial planning. Reform efforts have continued, notably by amending the Law on Social and Child</p>

<p>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.</p>	<p>Protection granting universal benefits to all households with children under the age of six.</p> <p>3) Partial implementation: The Action Plan for 2022-2023 for the Implementation of the Strategy for Vocational Education (2020-2024) sets out various measures and activities reforming the practical and dual VET education system to improve their impact on labour market outcomes.</p>
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2.6. THE 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, 24 May 2022

[...]

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

1. Strengthen fiscal sustainability by reintroducing the initially planned revenue measures of the 2022 budget while providing additional targeted support to vulnerable households and firms if needed to cushion the impact of adverse shocks. Use any excess revenues to contain the 2022 deficit. Adopt a new medium-term fiscal strategy with the 2023 budget, including concrete consolidation measures and targeting a primary surplus as of 2024 and continued public debt reduction over the medium-term, should the recovery be firmly entrenched.
2. Implement the public investment management assessment (PIMA) recommendations, prioritising key public infrastructure works within the available fiscal space while avoiding exceptions regarding project selection. Adopt amendments to the Law on Budget and Fiscal Responsibility and take concrete steps towards setting up a fiscal council. Based on an analysis of the economic and fiscal impact of all tax expenditures, prepare concrete budgetary recommendations to reduce tax expenditure (like exemptions, deductions, credits, deferrals, etc.) and share this analysis with the Commission.
3. Carefully assess and analyse price developments, and stand ready to use the limited tools available under the chosen monetary framework to ensure price stability. Ensure a transparent and accurate reporting of asset quality and adequate provisioning as well as a timely follow up on findings from the Asset Quality Review, and continue to reduce data gaps in particular as regards the real estate sector. Continue to improve and implement legislations to further align with the EU framework on regulation and supervision, including on deposit insurance, and accelerate efforts to provide viable and timely solutions for swift and effective NPL resolution.
4. Finalise an analysis of barriers to businesses at the local administration, propose improvements to the institutional and regulatory environment on this basis and start to implement them. Continue implementing digital services for micro, small and medium enterprises and prioritise the development and implementation of interactive e-government platform for transactional electronic services. Adopt a strategic plan for “Montenegro works” and perform an analysis of Montenegrin state-owned enterprises to prepare a proposal for the optimal portfolio of state ownership.
5. Complete the survey on informality and assess the short-term effects of the “Europe Now” programme. Analyse the results and feed them into a comprehensive action plan to tackle informality and start its implementation. Ensure structural cooperation between central and local authorities in the development and implementation of the plan, including on preventing measures and incentives to legalise informal businesses and employees.
6. Finalise, in co-operation with all relevant ministries, their agencies and stakeholders, a Youth Guarantee Implementation Plan, adopt it and initiate its implementation. Based on the Roadmap of Reforms on Social assistance and social and child protection services in Montenegro, establish a clear timeline and financial planning for its implementation and continue implementing the reforms. Continue efforts to reform the provision of active labour market policy measures with an emphasis on their labour market relevance, including work-based learning, and establish a continuous monitoring mechanism.

ANNEX A: ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2022-2024 ERP

Public financial management

The reforms of Public Financial Management (PFM) over the last two years led to the introduction of programme-based budgeting, including the first elements of performance budgeting. Additional legislative changes are needed to complete these reforms, such as the establishment of a fiscal council and the adoption of accrual accounting. A new PFM strategy for 2022-2026 has yet to be finalised. Capital budgeting, debt management, and asset management require further reforms. The interoperability of the different IT systems remains an obstacle to some reforms. Some progress was made in 2021 on budget transparency. However, the monitoring and reporting framework is still lacking, due to IT issues. The civil society is not systematically involved in monitoring the implementation of the PFM reforms. Implementation of the public sector accounting law in 2022 remains uncertain.

Reform Measure 15 ‘Improving management of business undertakings in majority state ownership’ is analysed under the key challenge on strengthening the regulatory environment.

Green transition

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

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

Reform Measure 21 ‘Reducing release into circulation of lightweight carrier plastic bags and single-use plastic products’ is a new reform, relevant given Montenegro’s environmental concerns. It may also result in increased cooperation between the NGO sector, scientific community, businesses and local administration. The analysis lacks real data on recycling and on the volume of plastic waste. The impacts of the reform may be difficult to measure, as statistical data on plastic waste and recycling is not available.

Digital transformation

The digitalisation of the public sector and development of transactional e-government services for the population and businesses has featured prominently among the priority reforms of the Montenegrin government over the past years. The process gained additional momentum during the COVID-19 pandemic. Access to broadband networks is key to the digitalisation of the economy, public services and to implementing Montenegro’s Smart Specialisation Strategy in the ICT industry. By the end of 2020, some 93% of Montenegrin households were in the area with a high-speed broadband connection (defined as 30 Mbit/s). However, the actual take-up of high-speed broadband or better among households is much lower, only reaching some 29% in 2020. Meanwhile 20% of households still had no internet access in 2019, despite it being technically available, with the figure increasing to 37% in rural areas.

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

Business environment and reduction of the informal economy

The analysis of these areas and of their relevant reform measures (10 in total) is provided in the section on the key challenge to strengthen the regulatory environment and the key challenge on formalisation of the economy.

Research, development and innovation

Public and private investments in research, development and innovation are low. Montenegro is nonetheless considered an emerging innovator in the European Innovation Scoreboard for 2021, with a summary innovation index of 47.8% relative to EU 100%. The links between academia, research institutes and business are still weak. Only 2.2% of Montenegrin micro, small and medium enterprises invest in R&D, compared to 22% at regional level. Research staff are employed almost exclusively by the government or in the higher education sector. With a rate of 0.50% of GDP invested in R&D (2018), Montenegro's spending is just over one fifth of the EU-28 average (2.18% of GDP in 2018). The adoption of a Smart Specialisation Strategy (S3) in June 2019 allows Montenegro to concentrate its scarce resources on thematic sectors for research and development as a basis to strengthen sectoral policies based on innovation. Its areas of specialisation are agriculture and food processing, energy and sustainable environment, sustainable health tourism and ICT.

Reform Measure 12, 'Strengthening the national innovation and research ecosystem', is analysed under the key challenge on strengthening the regulatory environment.

Economic integration reforms

The low level of processing local products and the small size of businesses hinder the country's competitiveness for exports. Montenegro's largest exports are low value-added bulk products - aluminium, bauxite and electricity. These three items alone made up 42% of all merchandise exports in 2020. Manufactured goods, construction materials, machinery, transport equipment and food are the main imports. There is significant potential to increase intra-regional trade within the Central European Free Trade Agreement (CEFTA) framework and with the EU, as trade preferences granting access to the EU market without customs duties apply to 98.6% of Montenegrin products.

In 2020, during the pandemic, Montenegro's foreign trade contracted by 18.1% compared to the previous year. Bilateral trade with the EU contracted similarly, by around 16% year-on-year. The EU remains Montenegro's main foreign trade partner, accounting for 44% of all trade (i.e. 38.5% of exports and 45.1% of imports of goods). This compares to 31.2% of trade with CEFTA countries. The total trade in goods and services plunged from 108.5% of GDP in 2019 to 86.3% in 2020. The EU also remains the main source of foreign direct investment inflows for Montenegro.

The 2022-2024 ERP does not include reforms that cover this area.

Energy market reforms

The energy market is in need of improvement to its infrastructure and efficiency. Energy transmission losses amounted to over 17% of electricity consumption in 2017, five times the EU average. The reliability of the electric power supply in rural areas also needs to improve. The use of renewable energy sources is high. In 2018, some 39% of the country's electricity production came from renewable sources, mostly hydropower and biomass. Energy production from renewable sources and cross-border trade in energy should increase significantly over the coming years thanks to new investments. The wholesale and retail electricity markets in Montenegro are open for competition, but new providers are yet to come.

Reform Measure 20, 'Financial support to households aimed at applying energy efficiency measures' is rolled over from the last ERP. The reform remains relevant and credible. Geopolitical developments are likely to accelerate implementation of this measure.

Transport market reforms

Montenegro would benefit greatly from developing and improving transport infrastructure and from ensuring a good connection with European transport corridors. The country's geographical situation makes it particularly important to improve transport links with the wider region and the rest of Europe. Montenegro scores very low on road, airport and shipping connectivity. There is continuous if slow progress on improving and modernising sections of the road and rail networks, mainly thanks to EU funding. Sufficient funding for the current maintenance of rail and road network remains an issue. Further action is needed to open up the rail market to competition. The suspended 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.

The 2022-2024 ERP does not include reforms that cover the transport market.

Agriculture, industry and services

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

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

Services, particularly tourism services, are the country's main export. They accounted for around 80% of total exports in 2019 before the pandemic. The sector provided over 72% of gross value added in 2019 and employed close to three quarters of the workforce. The country's Smart Specialisation Strategy of 2019 identifies health tourism as a direction to develop, which would partially offset the high seasonality in tourism. Further diversifying the services sector away from tourism would reduce the economy's vulnerability to external factors, such as the pandemic, geopolitical risks, and climate change.

Reform Measure 22 'Support to investments in the food manufacturing sector aimed at strengthening the competitiveness' is a continuation of the reforms tabled in previous ERP editions. The reform is linked to IPARD implementation and dependent on IPARD funding. The measure is relevant and of a good quality, well developed and explained. It provides links to the Smart Specialisation Strategy and creating green jobs for young people.

Reform Measure 19 'Sustainable green tourism' is a revised version of a reform tabled in the previous ERPs to support tourism. It proposes to include green growth ('greening' of tourism establishments) and digitalisation as important components in tourism. The measure is relevant and justified. It appears well designed and realistic, though implementation will depend on further developments in the health and economic context. The funding appears rather limited given the ambitious scope of this reform.

Reform Measure 10 ‘Improving access to financing for MSMEs by creating a Credit-Guarantee Fund’ is analysed under the key challenge on strengthening the regulatory environment.

Education and skills

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

Employment and the labour market

This area and Reform Measures 1, 2 and 3 are analysed above in Section 4, under Key Challenge 1.

Social dialogue

Montenegro made a marked improvement in the consultation of social partners in 2021. The tripartite Social Council resumed its meetings and was regularly consulted on relevant decisions, including on the Europe Now programme. The effectiveness of social dialogue and the mainstreaming of the consultation of social partners across all relevant ministries and departments however remains limited. The update of the general collective bargaining agreement following the adoption of the new Labour Law in 2019 has still not been finalised.

Social protection and inclusion

Reform Measures 6 and 7 and, partially, this area are analysed above in Section 4, under Key Challenge 1.

The social situation in Montenegro has stagnated after the improvements made in previous years. 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 people not employed is 39.9%. Activation measures coupled with targeted social assistance therefore remain key. Children of all ages are at the highest risk of poverty. 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.

Healthcare

Although the availability of healthcare services is adequate, primary healthcare provision is insufficient. Under the Law on Compulsory Health Insurance, all citizens are entitled to access to healthcare. However data on real coverage is scarce, with estimates ranging from 99.3% (age 65 or over) to 81.3% (18 to 24) (CeMI, 2017). Financing the healthcare system has improved, reaching 8.42% of GDP in 2018, but out-of-pocket payments remained staggeringly high at 39.6% in 2018, compared to the EU average of 15.6%.

Although the availability of healthcare services (number of hospital beds and medical staff) is comparable to the EU averages, primary healthcare provision and prevention measures remain underdeveloped. The rate of self-reported unmet medical needs rose sharply to 3.1% in 2019, having previously fallen significantly to 2.1% in 2020, close to the EU average of 1.8% in 2020. 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 healthcare.

Reform Measure 8 on ‘Improving access to and quality in delivery of healthcare services and the digitalisation of the healthcare system’ rolls over Measure 20 from the previous year. Implementation of this measure did not progress due to the pandemic, and neither did the aim to bring in telemedicine services. Telemedicine has the potential to remedy certain shortcomings in the provision of primary healthcare services, such as accessibility, but it remains to be seen whether it will address the overall structural shortcomings of the healthcare system.

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

Area/Sector	2016	2017	2018	2019	2020	EU-27 Average (2020 or most recent year)
Energy						
Energy imports dependency (%)	34.6%	40.5%	31.1%	32.9%	27.4%	57.50%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	263.06	263.25	259.50	258.14	280.25	110.18
Share of renewable energy sources (RES) in final energy consumption (%)	41.53%	39.69%	38.80%	37.72%	43.77%	22.09%
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	N/A	49.0 ⁽²⁰¹⁸⁾
Motorisation rate (Passenger cars per 1000 inhabitants)	297 ^w	310.6 ^w	331.7 ^w	350.3 ^w	N/A	519 ⁽²⁰¹⁸⁾
Agriculture						
Share of gross value added (Agriculture, Forestry and Fishing)	9.0%	8.4%	8.2%	7.9%	9.1%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	7.8%	7.9%	8.0%	7.1%	7.5%	4.3%
Utilised agricultural area (% of total land area)	18.4% ^w	18.6% ^w	18.6% ^w	18.6% ^w	18.7% ^w	40.6%
Industry						
Share of gross value added (except construction)	12.2%	11.3%	12.5%	11.9%	13.5%	19.5%
Contribution to employment (% of total employment)	9.9%	9.5%	9.9%	9.5%	10.1%	18.2%
Services						
Share of gross value added	72.1%	73.4%	72.3%	72.3%	70.1%	73.1%
Contribution to employment (% of total employment)	74.7%	75.0%	73.1%	73.4%	74.1%	71.0%

Business Environment						
Rank in Global Competitiveness Index (Source: World Economic Forum)	70	77	71	73	N/A	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	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	N/A	2.32%
R&D expenditure – EUR per inhabitant	20.60€	24.10€	37.7€	N/A	N/A	694.60€
Digital Economy						
Percentage of households who have internet access at home	69.8% w	71%	72%	74%	80% w	91%
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	78% w	88%
Trade						
Export of goods and services (as % of GDP)	40.6%	41.1%	42.9%	43.8%	26.0%	46.7%
Import of goods and services (as % of GDP)	63.1%	64.5%	66.7%	65.0%	61.0%	42.9%
Trade balance (as % of GDP)	-43.9%	-44.9%	-46.2%	-44.1%	-41.5%	N/A

Education and Skills						
Early leavers from education and training (% of population aged 18-24)	5.5%	5.4%	4.6%	5.0%	3.6%	9.9%
Young people neither in employment nor in education and training (NEET) (% of population aged 15-29)	22.3%	21.4%	21.0%	21.3%	26.6%	13.7%
Children aged less than 3 years in formal child care (% of under 3-years-olds)	28.9% ^w	32.89% ^w	34.13% ^w	37.21% ^w	N/A	35.3% ⁽²⁰¹⁹⁾
Individuals who have basic or above basic overall digital skills (% of population 16-74)	N/A	50%	N/A	N/A	U	56% ⁽²⁰¹⁹⁾
Employment and Labour Market						
Employment Rate (% of population aged 20-64)	57.1%	58.2%	59.8%	60.8%	55.2%	71.7%
Unemployment rate (% of labour force aged 15-74)	17.8%	16.1%	15.2%	15.2%	17.9%	7.1%
Long term unemployment rate (% of labour force aged 15-74)	13.4%	12.5%	11.4%	12.0%	13.4%	2.5%
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.	12.9 pps.	11.0 pps.
Disability employment gap (Percentage points difference in employment rates between people with and without a disability)	16.6 pps.	25.8 pps.	21.2 pps.	18.7 pps.	28.0 pps.	24.5 pps.
Real gross disposable income of households (Per capita increase, Index = 2008)	N/A	N/A	N/A	N/A	N/A	107.23

Social Protection System						
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	43.1%	42.2%	41.2%	36.6%	37.8%	21.9%
At-risk-of-poverty or social exclusion rate of children (% of population 0-17)	48.9%	49.0%	48.5%	43.9%	45.8%	24.2%
Impact of social transfers (Other than pensions) on poverty reduction	17.24%	24.84%	23.72%	16.95%	18.71%	32.68%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	7.38	7.57	7.37	6.72	5.96	5.24
Housing cost overburden (% of population)	16.5%	15.1%	14.7%	11.7%	9.4%	9.9%
Healthcare						
Self-reported unmet need for medical care (of people over 16)	2.7%	2.7%	2.3%	3.1%	2.1%	1.8%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	38.23%	42.17%	39.61%	38.56%	N/A	15.57% ⁽²⁰¹⁸⁾

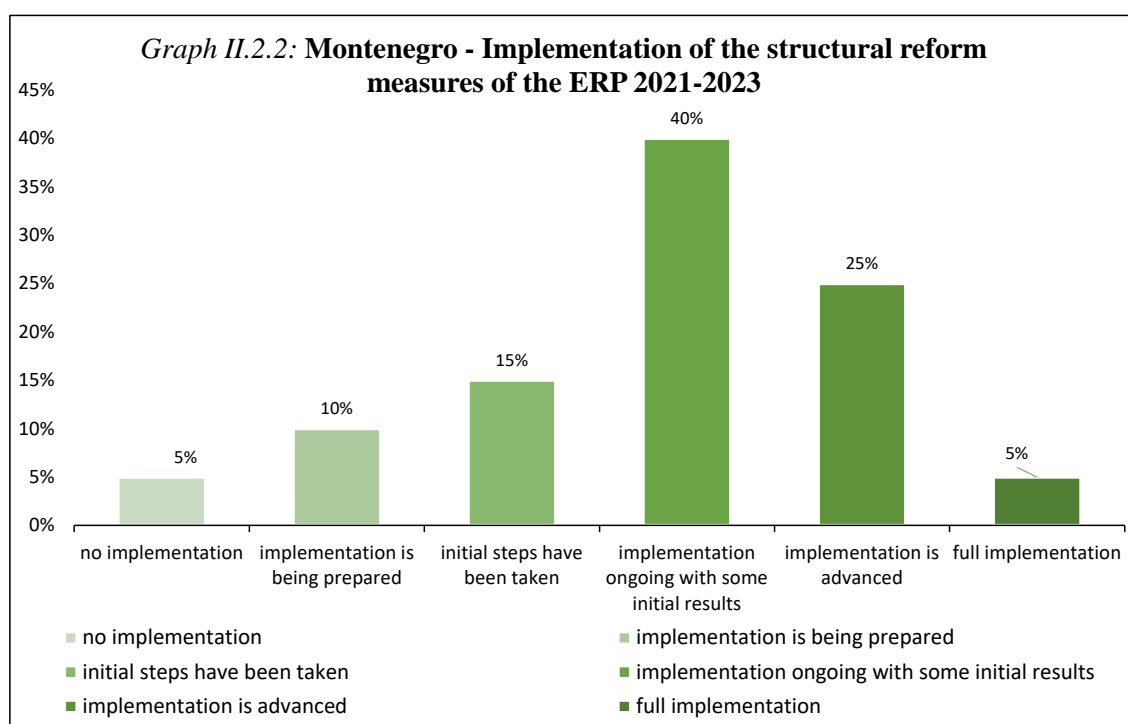
w: data supplied by and under the responsibility of the national statistical authority and published on an "as is" basis and without any assurance as regards their quality and adherence to EU statistical methodology'.

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

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM 2021-2023 ERP

Montenegro made moderate progress in implementing the measures in 2021, with an average score of **3.16** out of 5. Reporting on the structural reform measures from 2021 is sometimes vague and often does not tally with the set indicators, with some few reforms missing the scoring completely. Information provided on some reforms was based on administrative outputs only.

Implementation was strong for some measures, such as Measure 5 on boosting the competitiveness of MSMEs and their access to the new markets and Measure 14 on setting up the system for continuous monitoring of the quality of apprenticeship at the employer's. Implementation was weaker for many other measures, such as Measure 2 on supporting investments in the food-manufacturing sector with the aim of boosting competitiveness and Measure 7 on suppressing the informal economy by reforming the Tax Administration. Implementation was particularly weak for Measures 6 and 20 – on improving and implementing the measures for suppression of informal economy and on the use of telemedicine services in Montenegro. Work on the latter measure and several other reforms that had weak levels of implementation was undermined by the COVID-19 pandemic.



ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government of Montenegro submitted the 2022-2024 Economic Reform Programme to the Commission on 31 January 2022.

Inter-ministerial coordination

The Ministry of Finance and Social Welfare coordinated the work to prepare the 2022 ERP. An inter-ministerial working group involved all relevant ministries. State Secretaries from the Ministry of Finance and Social Welfare and the Ministry of Economic Development ensured support and visibility for the ERP process at the decision-making level.

Stakeholder consultation

The national ERP coordinator organised an initial consultation on the design of the ERP measures in September 2020. Another public consultation on the draft of the document took place in December 2021, including a round table public discussion.

Macro framework

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

Fiscal framework

The fiscal framework is well detailed, in line with stated policy objectives and consistent with the ERP macroeconomic framework. However, the programme is less exhaustive on medium-term developments, in particular the fiscal consolidation path. Overall, the factors behind the ERP's projected revenues and expenditures mirror the 'Europe Now' initiative, and they are presented clearly. However, some revenue measures assumed in the ERP's macro and fiscal scenarios were rejected or pending (uncertain) adoption by the new government, whose plans are still unknown, weakening ERP's medium-term projections. Montenegro's fiscal reporting does not follow ESA2010 standards, and therefore does not meet the Commission's fiscal notification requirements.

Structural reforms

The structural reform parts follow the guidance note. A dedicated section in the ERP provides information on the implementation of the policy guidance for 2021. Reporting on the structural reform measures from 2021 is in some cases too vague and does not use the set of indicators adopted for the reform. There are 22 reform measures in the 2022-2024 ERP and this exceeds the page limit, partly due to the European Commission requests for improvements. The structure of the 2022-2024 reform measures is, in almost all cases, well prepared in terms of scope, timeline and the budget for activities planned.

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3. NORTH MACEDONIA

The economic reform programme (ERP) was submitted on 31 January 2022.

The economic consequences of Russia's war against Ukraine may render the macro-fiscal scenarios presented in the ERP partially obsolete. The Commission will publish its updated macroeconomic and fiscal projections for candidate countries, reflecting the expected impact of the war against Ukraine and related sanctions, in its spring economic forecast in mid-May 2022.

The short-term macro-fiscal outlook may change considerably. However, the major medium-term fiscal and structural reform challenges and priorities identified in this assessment remain valid irrespective of the short-term outlook. Appropriate policy responses are essential to ensure a sustained economic recovery, greater resilience and fiscal sustainability.

3.1. EXECUTIVE SUMMARY

The economy rebounded in 2021 and growth is expected to gradually accelerate in the mid-term.

2021 saw a solid recovery from the COVID-19-induced recession, supported by external demand and private consumption, while inflationary pressures increased during the year. The programme's baseline scenario is optimistic, with growth expected to average 5.2% between 2022 and 2024, benefiting from a global recovery from the pandemic and a planned increase in public investment to historically high levels. In a context of high uncertainty, the growth outlook for 2022 is, as elsewhere, subject to a series of downside risks due to the impact of Russia's war against Ukraine, the future course of the COVID-19 pandemic, global and domestic inflationary pressures, e.g. from strong wage growth, and potentially tightening financial conditions. Large implementation risks connected to private and public investment could also weigh on the growth outlook. War-related risks could in particular translate into further rises in energy and food prices and less favourable external trade developments due to a deteriorated growth outlook in the main EU trading partners.

Public finances improved in 2021, and the ERP aims to stabilise debt in the medium term, by curbing current expenditure. Tax revenue recovered in 2021, and the fiscal deficit narrowed significantly, to 5.4% of projected GDP, also on account of under-implementation of the very ambitious capital expenditure budget. This came in spite of a rise in subsidies, transfers, and government consumption, mainly resulting from crisis needs. Between 2022 and 2024, the ERP expects fiscal consolidation to continue, and the general government deficit to drop to 2.9% of GDP by 2024, mainly due to savings in current expenditure, as crisis-related support measures are slowly phased out. The deficit is expected to decrease, while remaining above its pre-crisis level. Public debt, which rose sharply in 2020 due to pandemic-related financing needs, is projected to rise further in 2022, and to decline thereafter, but to stay above 60% of GDP during the programme's horizon. The declared objective is to restructure the budget, i.e. improve the composition of public finances, by significantly raising the share of capital expenditure. These plans largely depend on the unwinding of pandemic-related fiscal support, and on strong GDP growth. However, they are not sufficiently underpinned by concrete consolidation measures on the revenue or expenditure side. Hence, the envisaged consolidation path seems unrealistic, despite a likely overestimation of capital expenditure, considering that government activity in addressing shortcomings in the management of public investment is protracted.

The main challenges facing North Macedonia are the following:

- **Downside risks to the economic recovery call for a cautious phasing out of fiscal support while rebuilding fiscal space in the medium term.** The economy started to recover in 2021 from the downturn induced by the COVID-19 crisis. Due to high uncertainty about potential further pandemic effects and the impact of Russia's war against Ukraine, standing ready to provide crisis mitigation if needed seems appropriate. At the same time, once the recovery is on solid grounds, the country needs to return to more prudent fiscal positions and to stabilise debt levels in the medium term. This should be supported by strengthening fiscal governance. Once adopted by the parliament, the provisions of the new Organic Budget Law (OBL) should be swiftly implemented, particularly its fiscal rules, and an independent fiscal council be set up.
- **The implementation of budgeted capital expenditure remains weak largely because of shortcomings in the management of public investment.** It is important to address these shortcomings to ensure a rigorous and transparent project selection and efficient preparation and implementation, given the government's plans to significantly raise capital investment. Measures should be based on the approved action plan. Adopting the new legal framework for public-private partnerships could provide additional financing sources for public infrastructure projects. The country's revenue-to-GDP ratio is, by comparison, very low. Revenue collection suffers from substantial - primarily structural - weaknesses, including a comparatively narrow tax base, and shortcomings in technical and human capacities. These need to be addressed, so as to facilitate the move towards a reduction in the primary balance.
- **Competitiveness of domestic companies, investment and global value chain integration is undermined by a challenging business environment.** This includes a large informal economy, a lack of skills, innovation and technology adoption, low productivity and the need to modernise and digitalise public administration. COVID-19 had significant negative effects on the economy of North Macedonia and exacerbated these structural challenges, causing companies 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 the companies of North Macedonia. Improving the competitiveness of local companies and benefiting from the post-COVID-19 restructuring of global value chains will require improvements in human and physical capital and the business environment, including better enforcement of business regulation and corporate governance, a more focused investment attraction strategy, less complex state-aid rules, 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 Russian aggression against Ukraine clearly demonstrates the urgent need to accelerate the clean energy transition as a way to reduce vulnerability to external shocks and increase energy security.** At this stage, the economy of North Macedonia is characterised by high energy intensity, inefficiencies in the ageing energy production system, persistently high dependency on highly polluting lignite coal, and inefficient energy consumption. A sustainable post-COVID recovery will have to address longer-term transition to green growth, particularly in the context of geo-political shocks and bearing in mind the upcoming carbon border adjustment mechanism. Energy supply is unreliable and efforts on energy diversification need to be improved. The government has annual targets on raising the share of renewables in energy consumption, but, at this stage, renewable energy still only accounts for a relatively small share of power generation and hydropower is the most exploited renewable source of energy. Energy efficiency has the potential to significantly reduce the impact of energy costs on the competitiveness of the economy by reducing the need for energy overall, but measures to improve energy efficiency are hardly progressing. While energy transition and the sustainability of the energy system are priorities in the recently adopted government program,

demonstrating the government's commitment to the green transition, implementation will be a challenge and needs to be accompanied by enhanced institutional capacity.

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

The policy guidance jointly adopted at the Economic and Financial Dialogue of 12 July 2021 has been partially implemented. Notably, on formalising the informal economy, the government adopted a new 2021-2022 Action Plan along with a report on the implementation of the previous Action Plan (2018-2020). By preparing a decision to appoint the Deputy Prime Minister, steps were taken to coordinate the 2018-2022 strategy for formalising the informal economy. Efforts were made to improve the national e-services portal (www.uslugi.gov.mk) which provides electronic services to citizens. The country shows a continued commitment to streamlining para-fiscal charges. North Macedonia focused the development of a new financing formula on primary and secondary education and is planning to review the financing of the vocational education and training (VET) system. A national council was established to develop a new financial model for higher education. Staff received training in an effort to improve the Centres of Social Work. On active labour market policies, North Macedonia provides more targeted solutions to low-skilled and vulnerable unemployed individuals. Structural reform measures planned in last year's ERP (2021-2023) were only partially implemented.

The key challenges identified in the ERP match those identified by the European Commission. The planned structural reform measures nearly entirely focus on addressing the identified key challenges, following a fairly coherent but not always strategic vision for the country's economic development, consistent with other national plans and strategies. The impact assessment of the structural reform measures could be further improved to allow prioritisation based on measures' economic, social and environmental impact. The shared European growth model based on the green and digital transition will also have to be strengthened in the ERP process for North Macedonia, even more so in the current geopolitical context. While North Macedonia continued to successfully implement the Digital Agenda for the Western Balkans and the Regional Roaming Agreement, further efforts are needed, particularly to increase access to broadband, e-government and digital skills.

3.2. ECONOMIC OUTLOOK AND RISKS

In 2021, the economy started to recover from the pandemic-induced downturn. After a major economic recession in 2020, real output increased in 2021 by an estimated 4% y-o-y, mainly driven by exports and private consumption. Strong real wage growth, stable inflows from remittances as well as substantial government support measures, with a budget totalling about 5.4% of cumulative GDP in 2020 and 2021, bolstered household's disposable incomes and thus supported the economic recovery. Investment was markedly above the level of the previous year. Both, exports, benefiting from the recovery of foreign demand, and imports, driven by firming domestic demand, surged. Mainly on account of wage subsidies and liquidity support, the labour market proved resilient, with employment increasing further.

The programme expects increased growth dynamics largely driven by domestic demand. A large rise in public investment, further increases in disposable incomes stemming from solid employment growth and further strengthening transfer inflows from abroad, flanked by continued government support measures are projected to be the key determinants for investment and household consumption. On the external environment, a gradual stabilisation of global supply chains is expected, which should have boost exports. However, due to strong domestic demand and a high import content of exports, import growth is also projected to be rather high, leading to an overall small negative contribution of net exports to economic growth. Overall, the ERP expects real GDP growth to accelerate from 4.6% in 2022 to 5.7% in 2024, resulting in average real growth of 5.2% over these 3 years. This is about one percentage point higher than in the previous programme and much above the historical pace of expansion in the pre-COVID-19 years, mainly reflecting stronger projected investment and private consumption. On average, investment is expected to increase by 8.9% a year during the programme period, while private consumption is expected to increase by 3.9% on average. As a result of strong growth, the ERP forecasts that the pre-crisis level of production will be reached during 2022, while the projected output gap remains very negative, but would close in 2023. The labour market is set to benefit from the strong economic recovery, as well as from additional policies to boost job creation through active labour market measures and business support. The high investment spending is projected to have a positive effect on capital formation and thus also on labour productivity.

The programme's projections are rather optimistic. The macro-scenario significantly exceeds the forecasts of the Commission and international financial institutions. The macroeconomic outlook continues to be affected by relatively high uncertainty in the recovery phase from the COVID-19 pandemic and new risks stemming from Russia's invasion of Ukraine. In particular, the recent strong increase in energy prices and persistent supply bottlenecks in the labour market might have more permanent effects on the country's general price dynamics. This could impede disposable income and the expected acceleration in private consumption. Propelled by government subsidies and rises in both the minimum wage and public sector pay, real wage increases have recently far exceeded productivity developments, harming external competitiveness of North Macedonia. ⁽²⁵⁾ The GDP projection relies significantly on the large projected scaling up of public investment, which is very optimistic, also in view of added fiscal pressures arising from the energy crisis. On the upside, the global recovery as well as a more vigorous return of investors to the country, could benefit the country's manufacturing industry given its proximity to the EU market. In particular, progress on the country's EU accession could represent a major boost to consumer and investment confidence and thus support the country's economic catch-up.

The programme presents two alternative macroeconomic scenarios based on identified risks to the baseline projection. The programme contains two lower growth scenarios, looking at external and domestic risks, respectively. The materialisation of unfavourable external risks would result in a lower average annual output growth of 4%, while domestic risks scenario would lead to output growth of 4.6%. Both of these scenarios still seem rather benign.

⁽²⁵⁾ As of the last quarter of 2020, there has been a renewed, slight increase in overall productivity and the rise in unit labour cost has slowed down somewhat.

Table II.3.1:

North Macedonia - Comparison of macroeconomic developments and forecasts

	2020		2021		2022		2023		2024	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	-4.5	-6.1	4.0	4.1	3.9	4.6	3.7	5.2	n.a.	5.7
<i>Contributions:</i>										
- Final domestic demand	-3.5	-7.6	5.0	5.8	4.7	5.3	4.1	5.8	n.a.	6.2
- Change in inventories	-2.3	n.a.	0.0	n.a.	0.0	n.a.	0.0	n.a.	n.a.	n.a.
- External balance of goods and services	1.3	1.5	-1.0	-1.7	-0.8	-0.7	-0.3	-0.6	n.a.	-0.5
Employment (% change)	-0.3	-0.3	1.1	0.8	2.6	3.1	2.5	3.5	n.a.	3.8
Unemployment rate (%)	16.4	16.4	15.7	15.8	15.1	14.4	14.6	12.9	n.a.	11.4
GDP deflator (% change)	0.9	0.9	1.9	5.7	1.4	2.4	1.0	2.0	n.a.	2.0
CPI inflation (%)	1.2	1.2	3.3	3.2	2.1	2.4	1.8	2.0	n.a.	2.0
Current account balance (% of GDP)	-3.4	-3.4	-3.6	-3.8	-2.6	-3.8	-2.2	-2.4	n.a.	-1.6
General government balance (% of GDP)	-8.2	-8.3	-6.1	-6.4	-4.9	-4.3	-4.3	-3.4	n.a.	-2.9
Government gross debt (% of GDP)	51.2	51.9	54.5	51.9	56.3	53.3	58.1	53.0	n.a.	51.7

Sources: Economic Reform Programme (ERP) 2022, Commission Autumn 2021 forecast (COM).

The ERP expects import-driven inflationary pressures to subside in the coming years. Inflation picked up in 2021, driven by higher prices for food, energy and transport, mainly due to increasing global prices, and reaching 4.9% y-o-y in December 2021. As a result, annual average inflation rose to 3.2% in 2021, compared to 1.2% the year before. Core inflation was less buoyant, but nevertheless rose to 4.2% in November. The programme projects annual average consumer price inflation to level out from 3.2% in 2021 to its long-term average of about 2% in 2024. This is based on a projected slowdown in the growth of energy prices and decreasing price pressures for primary goods as a result of the gradual unblocking of supply chain bottlenecks. The programme acknowledges significant risks related to the currently high volatility of energy prices and the possibility of renewed supply chain disruptions in case of a COVID-19 resurgence. The programme's baseline inflation forecast is on the optimistic side. As a small, open economy with a de-facto currency peg, the country's price level is largely determined by international price developments. But higher than assumed inflationary pressures could also result from domestic demand, given the expectation that the output gap will close in 2023 and turn significantly positive in 2024, and given the continued upward trend in nominal wages in 2021. The latter was boosted by the government's decision to hike the minimum wage by 18.5% beginning in March 2022, while public sector wages and pensions will also be increased markedly this year. ⁽²⁶⁾ The Central Bank maintained its accommodative monetary stance by lowering the policy rate to 1.25%, in March 2021.

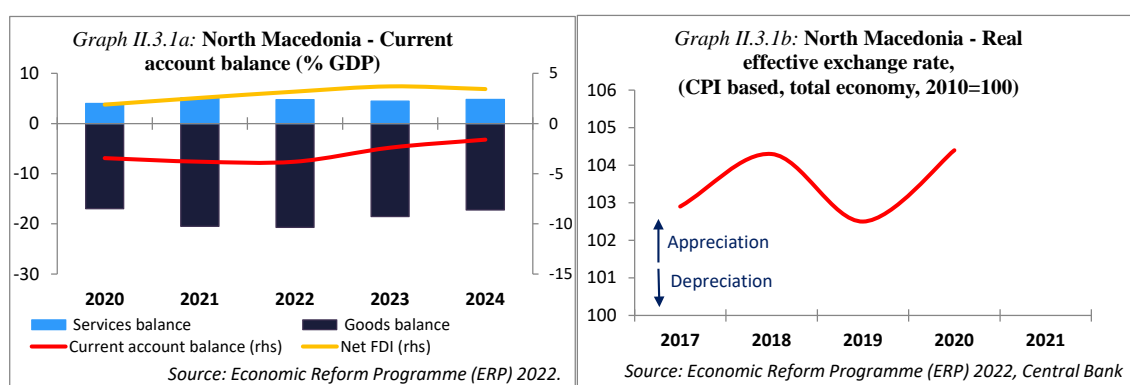
The projected fall in the current account deficit is optimistic and partly relies on expected improvements in the country's trade structure. The merchandise trade deficit widened in 2021 (-3.3 pps. to 20.3% of projected GDP), as imports surged, driven by higher prices for energy. At the same time, private transfers increased by 3.9 pps. y-o-y to 17.3% of projected GDP. Overall, the current account deficit widened from 3.4% of GDP in 2020 to an estimated 3.5% of GDP in 2021. The programme expects it to narrow as of 2023, to reach 1.4% of GDP in 2024. The merchandise trade deficit is expected to rise slightly in 2022 (+0.5 pps. to 20.8% of projected GDP), given sustained high imports of energy, and then to gradually decrease to 17.2% of GDP in 2024, thanks to stronger external demand and the expected further transformation of the country's trade structure towards higher value-added products. According to the programme, private transfers, as a share of GDP, would gradually decline to 15.2% in 2024, i.e. below the average of the 5 years pre-COVID (16.7%). This projection might have benefited from some more information regarding its assumptions. The diversification of exports towards higher value-added products has not progressed much in the past few years and remains a challenge in the

⁽²⁶⁾ The government recently changed the methodology for the indexation of pensions to a 50% CPI- and 50% wage-based formula, which is likely to push up the pensions bill. It also granted a temporary supplement for pensioners for April, May and June 2022 in the amount of 1000 MKD.

short term. The primary income deficit is expected to deteriorate slightly, towards 4.4% of GDP by 2024, reflecting foreign investors' earnings projections. Given the planned sizeable increase in investment as a share of GDP, from 33.8% in 2021 to 35.9% in 2024, the projected improvement in the current account balance would necessitate a significant rise in domestic savings, which is however not further discussed in the programme.

Inflows from foreign direct investment are projected to more than cover the current account deficit and bolster foreign reserves. In 2021, foreign direct investment (FDI) inflows rose to around 3.7% of projected GDP, up from 1.5% of GDP in 2020, fully covering the current account deficit. The programme expects a further increase in the role of FDI for financing the current account, reflecting a recovery of the global economy from the COVID-19 pandemic but also taking into account planned government measures to increase the country's attractiveness to FDI. FDI inflows are expected to increase from 2.6% of GDP in 2021 to some 3.5% on average during the programme period, which is in line with the -year average before the pandemic. External vulnerabilities remain contained. Gross external debt is projected to have inched up somewhat in 2021 (+3 pps. y-o-y to 81.3% of estimated GDP). Taking into account mid-term public debt refinancing needs, it is projected to rise somewhat higher in 2022 and then to decline. A high share, about 70%, of external debt continues to be long-term. Additionally, at some 37% of total external debt, intercompany loans and trade credit represent a less risky and more flexible category of debt, as the programme notes. The country's net international investment position had deteriorated in the third quarter, compared to one year earlier, mainly on account of increased public borrowing abroad. Foreign reserves increased markedly in 2021, covering about 4.8 months of prospective imports at end-December, as funds from the second tranche of the EU's macro financial assistance (MFA) as well as IMF Special Drawing Rights flowed in, and the central bank intervened in the markets, resulting in net purchases. The programme expects foreign reserves to rise further. It presents stress-test results on shocks to GDP (stronger sensitivity of debt dynamics), the primary deficit and interest rates (less sensitive).

External competitiveness and current account



The financial sector remained stable during 2021. The sector's key indicators, such as capital adequacy ratios, liquidity, and profitability recovered from the COVID-19 shock. Borrower relief measures, in the form of loan moratoria for households, ended in 2020, for corporates in 2021. So far, while the number of restructured loans increased in the first half of 2021, there has been no marked impact on the non-performing loan (NPL) ratio. This may, however, remain a risk for the future, when government support to households and corporates is phased out. Private sector credit rose by some 5-6% in 2021, supported by credit lines from the European Investment Bank, as well as the temporary relief for banks on reserve requirements for loans to vulnerable companies. The currency denomination of domestic credit moved further towards denar-denominated loans, partly thanks to government measures to bolster the use of the country's domestic currency. Banks continue to dominate the financial sector of North Macedonia, 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 2021. Ten out of the sector's 13 banks are predominantly under foreign ownership, accounting for some 75% of the sector's assets. 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 Financial Stability Law, attributing the key macroprudential role to the central bank, is currently awaiting adoption in the parliament. Important legislation on financial stability, such as the Bank Resolution Law and the Law on Deposit Insurance, is still in the drafting phase.

Table II.3.2:

North Macedonia - Financial sector indicators

	2017	2018	2019	2020	2021
Total assets of the banking system (EUR million)	7 513	8 187	8 945	9 490	9 779***
Foreign ownership of banking system (%)	70.1	71.4	72.8	75.0	
Credit growth (aop)*	2.4	6.6	7.2	6.4	5.8
Deposit growth (aop)	5.7	8.6	9.6	7.8	8.3
Loan-to-deposit ratio (eop)	93.4	91.5	88.4	87.1	86.9
Financial soundness indicators (eop)					
- non-performing loans**	6.3	5.2	4.8	3.4	3.2
- net capital to risk-weighted assets	14.2	15.0	14.8	15.3	15.8
- liquid assets to total assets	29.8	30.6	31.9	32.5	32.4
- return on equity	13.5	16.0	11.7	11.3	12.9
- forex loans to total loans (%)	42.5	41.4	42.3	42.3	41.2

* corrected for the write-offs

** including the impact of write-offs.

*** Q3

Sources: National Central Bank, IMF, Macrobond.

3.3. PUBLIC FINANCE

Public finances improved in 2021 on the back of stronger than expected revenue, and in spite of large expenditure increases. On 28 July, the parliament endorsed a budget revision for 2021. It raised the planned central government fiscal deficit from initially 4.9% to 6.5% of GDP, since higher total spending (by 8.6%) was only partly offset by stronger revenue (by 4.7%), compared to the original budget. The increase in expenditure mainly reflected the continuation of anti-crisis support⁽²⁷⁾ and a 24% increase in public investment, compared to the initial plan. Allocations for subsidies and transfers rose by almost 65%. According to preliminary data on actual budget execution, central government revenue increased by 15.3% compared to the 2020 outcome. Tax income rose by 17.6%, with the biggest increase accounted for by VAT receipts (+24.1%). Income from social contributions, which benefited from government measures subsidising employer contributions, rose by 6.1%. Total expenditure was higher by 5.7% y-o-y, with the rise in current expenditure of 2.9%. The fiscal deficit eventually turned out lower than budgeted in the revised plan, at 5.4% of projected GDP. This was partly due to under-execution of capital expenditure, which reached only 79% of the revised budget, or 3.2% of projected GDP. Still, compared to the 2020 outcome, capex implementation was higher by 45.2%.⁽²⁸⁾ The budget deficit was financed by domestic and foreign borrowing and grants, including a EUR 700 million Eurobond placed in March 2021, and the second tranche of macro financial assistance from the EU, worth EUR 80 million.

⁽²⁷⁾ This includes implementation of parts of the four sets of anti-crisis measures providing fiscal and liquidity support to households and companies adopted in 2020, totalling EUR 1.1 bn in allocations, with an implementation rate of some 82% (end-February 2021), and the budget for two further sets adopted in 2021.

⁽²⁸⁾ However, payment arrears increased in 2021 by 0.6 pps. to 3.3% of GDP on account of overdue payments in the health sector, state enterprises, and local governments.

Government anti-crisis measures supported households and companies. According to the government, the fiscal impact of discretionary measures in 2021 amounted to 2.5% of projected GDP (the projection in the previous ERP was 2.9% of GDP in 2021, probably assuming higher implementation rates of the first four packages of measures). Wage subsidies continued to be the fiscally most important measure also in 2021. The eligibility criteria for wage subsidies, as well as for deferral for personal income and profit tax payments focus on firms that were generally solvent before the crisis and that suffered a revenue drop of at least 30% compared to the previous year. Special assistance was granted to economic sectors that were hit especially hard by the crisis, such as hospitality and tourism, athletes and artists. 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).

Table II.3.3:

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

	2020	2021	2022	2023	2024	Change: 2021-24
Revenues	30.5	33.7	33.6	33.3	33.7	0.0
- Taxes and social security contributions	27.6	28.4	28.9	29.0	29.7	1.2
- Other (residual)	2.9	5.3	4.7	4.3	4.0	-1.2
Expenditure	38.9	40.0	37.9	36.7	36.6	-3.5
- Primary expenditure	37.6	38.7	36.6	35.5	35.5	-3.3
<i>of which:</i>						
Gross fixed capital formation	3.2	5.2	6.1	6.1	6.6	1.4
Consumption	10.7	11.6	10.8	10.3	9.9	-1.7
Transfers & subsidies	23.7	21.9	19.7	19.1	18.9	-3.0
Other (residual)	0.0	0.0	0.0	0.0	0.0	0.0
- Interest payments	1.2	1.3	1.3	1.3	1.1	-0.2
Budget balance	-8.3	-6.4	-4.3	-3.4	-2.9	3.5
- Cyclically adjusted	-6.2	-4.8	-3.6	-3.5	-3.7	1.1
Primary balance	-7.1	-5.0	-3.0	-2.2	-1.7	3.3
- Cyclically adjusted	-5.0	-3.5	-2.3	-2.2	-2.6	0.9
Gross debt level	51.9	51.9	53.3	53.0	51.7	-0.2

Sources: Economic Reform Programme (ERP) 2022, Commission calculations.

The programme's fiscal scenario projects gradual consolidation based on lowering current spending. Over the ERP period, the general government deficit is projected to narrow to 2.9% of GDP in 2024, which constitutes an effective adjustment of 2.5 pps. compared to the estimated 2021 deficit outcome (or 3.5 pps. compared to the 2021 deficit target). The 2024 deficit would still remain larger than the pre-crisis 2019 deficit of 2.2%. Consolidation in 2022 and 2023 will be entirely based on a reduction in the expenditure ratio (-3.4 pps. between 2021 and 2024 to 36.6% of GDP), which is set to be slightly frontloaded in 2022. Notably, current expenditure would be reined in through a drop in social transfers (-2 pps. of GDP between 2021 and 2024) and in subsidies (primarily frontloaded consolidation by -1.3 pps. y-o-y in 2022). Government consumption would decline by 1.7 pps. of GDP between 2021 and 2024. In contrast, capital expenditure is projected to rise further, by 1.4 pps. in 2024, from the historically high level achieved in 2021. The revenue ratio, which is estimated to have risen, in 2021, to above its pre-crisis 2019 level, would remain broadly stable over the programme's horizon. Yet, its relatively low level, by regional comparison, reflects the country's narrow tax base and 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 budget deficit points to a significant tightening in 2022, a neutral stance in 2023 (when the output gap is expected to close), and some fiscal impulse from discretionary measures in 2024 (0.4 pps. of potential GDP). Given the

programme's assumption that the economy operates above potential in 2024, the renewed deterioration in the cyclically-adjusted primary balance, indicating discretionary support to demand, seems incongruous. The fiscal targets for 2022 and 2023 are similar to the previous ERP, but the fiscal tightening in 2022 is projected to be significantly larger, given that the previous programme assumed a smaller deterioration in the cyclically-adjusted primary balance in 2021 than projected by the current ERP.

The 2022 budget continues to back the economic recovery, while shifting expenditure from crisis support to public investment. The 2022 budget marks a balanced approach between the withdrawal of temporary, pandemic-related payments to companies and households; cuts in current spending; and a rise in capital expenditure. The general government fiscal deficit is projected to drop to 4.3% of GDP, down from an estimated deficit of 5.4% of GDP in 2021. It is based on a (rather too optimistic) projection of 4.6% real GDP growth and 2.4% inflation. The programme expects total revenue for the general government to amount to some 33.6% of projected GDP, marginally below last year's level. Tax income is projected to be higher by 10% compared to the 2021 outcome. Total expenditure would amount to 37.9%, which is 2.1 pps. below the estimated level of 2021, mainly due to a projected drop in subsidies and transfers (for which the programme does not provide an explanation other than the overall phasing out of crisis-related support), and in government consumption. The general government's capital expenditure would rise by 24.5% y-o-y (+0.9 pps. in terms of GDP) – a steep jump from 2021 and prone to serious implementation risks. Social transfers would increase by some 2% y-o-y (-2.2 pps. of GDP), compared to the 2021 outcome. The budget appropriately includes an envelope of non-earmarked funding, amounting to 0.6% of projected GDP, which could be used for stepping-up emergency support, allowing the government to respond swiftly in case of need.

Capital expenditure is projected to rise markedly in the medium-term. The government aims to successively raise the share of capital expenditure in total expenditure from 8% in 2020 to 18% in 2024. In terms of GDP, capital expenditure is expected to rise from 3.2% in 2021 to 6.6% in 2024. This seems overly ambitious, given the government's track record of under-implementing the capital expenditure budget, but also given the deficient framework governing the management of public investment, and the possibilities of private sector cofunding, which the government explicitly targets through its recently adopted Growth Acceleration Plan. The Plan aims for EUR 4 bn of public investment to leverage private financing for an additional EUR 8 bn (equivalent to 68% of estimated 2021 GDP) from a variety of sources, including the budget, IPA funds, and commercial loans in the 2022-2026 period. To help attract private financing, the government plans to issue new, innovative types of bonds targeted at infrastructure and green projects (development bonds, green bonds, and project-specific bonds). While the government declares its intention to redesign the structure of public expenditure in favour of capital investments, the structure of current expenditure would remain focused on social transfers over the programme's horizon (some 52% of total current expenditure), including pension payments. The share of subsidies (the bulk of it being agricultural subsidies followed by subsidies to public and private enterprises) is projected to drop from 15.4% in 2020 to 12.1% in 2024; the share of spending on goods and services would rise from 6.8% to 9%; and the share of wages and allowances would increase slightly from 13% in 2020 to 13.2% in 2024 – while the programme expects significant savings in current expenditure from lower government consumption.

The programme does not plan for specific budgetary measures that would underpin the expected consolidation, making the outlook overly ambitious. While the medium-term fiscal plans appropriately balance the needs to phase out crisis-related emergency support and to advance structural reforms and fiscal consolidation, information on concrete measures and their implementation is scarce. In support of the fiscal projections, the programme lists a number of policies aimed at reining in current expenditure; improving the implementation of capital expenditure; and enhancing revenue collection, without elaborating on or quantifying concrete measures. Overall, the ERP would have benefited from more detail on the operationalisation of these objectives, such as presented in the recent Fiscal Sustainability and Economic Growth Support Plan. In particular, the intended measures to achieve the envisaged savings in public consumption and in subsidies to the corporate and to the agricultural sector could have been

outlined. On the revenue side, more precise, and quantified, roadmaps for the streamlining of tax relief and deductions in income taxation as well as of VAT preferential rates would have informed the assessment of the government's fiscal projections. Moreover, in addition to ongoing expenditures to uphold the energy sector and maintain subsidised electricity prices for households, authorities adopted a package of measures to protect households from rising food and energy prices and to help firms maintain liquidity in the amount of EUR 400 mn in March 2022, which is likely to require an adjustment of the fiscal consolidation path.

Raising capital spending remains a challenge given protracted shortcomings in public investment management. Apart from permanent savings in current expenditure, redesigning public expenditure in favour of growth-enhancing investment requires significant improvements in the management of public investment. The implementation of wider-ranging measures to improve the planning, allocation and execution of investment projects, based on the 2020 Public Investment Management Assessment (PIMA) by the IMF has seen limited progress so far. The government is in the process of setting up a dedicated unit in the Ministry of Finance, so as to ensure centralised oversight of public sector investment. Measures to ensure the productivity-enhancing character of projects, so as to support the sustainability of the economic recovery, are lagging. This concerns, among other things, the planned adoption of a new methodology for the appraisal, selection and prioritisation of projects, which, in turn, partly hinges on the adoption of the new Organic Budget Law.

The projected improvement in the primary balance is not sufficient to lower debt from its 2021 level. In 2021, general government debt remained at the same level as one year earlier, at 51.9% of estimated GDP, after having jumped by 11.4 pps. in 2020, reflecting financing needs arising from the COVID-19 crisis and the fall in GDP. The ERP forecasts that the general government debt ratio will be at the same level in 2024 as 3 years earlier, close to 52% of GDP. After rising further in 2022, the debt-reducing impact of economic growth and inflation would prevail over the debt-enhancing impact of the primary deficit, leading to a decline in the ratio. The public debt level, which includes the debt of public enterprises, stood at 60.9% of government-estimated GDP at the end of 2021, almost the same level as one year earlier. The government expects the public debt level to rise further in 2022 and 2023, reaching 63.3% of GDP (*different figure for 2023 in the Fiscal Sustainability and Growth Support Plan: 65.2%*), before stabilising in 2024, and then starting to drop due to declining fiscal deficits and accelerated economic growth. The debt level is projected to exceed the 60% threshold provided for in the draft fiscal rules (that are currently up for adoption by the parliament in the context of the draft Organic Budget Law) until the end of 2024. Although the dynamics of general government debt are driving the overall rise in public debt, the government expects guaranteed public debt (accounting for 9% at end-2021) to peak in 2023, as loans are released to finance public-investment works carried out by state-owned enterprises. It would then stabilise and drop to 6.3% of GDP in 2026, consistent with last year's expectation.

Box II.3.1: Debt dynamics

North Macedonia

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

	2020	2021	2022	2023	2024
Gross debt ratio [1]	51.9	51.9	53.3	53.0	51.7
Change in the ratio	11.4	0.0	1.4	-0.3	-1.3
<i>Contributions [2]:</i>					
1. Primary balance	7.1	5.0	3.0	2.2	1.7
2. "Snowball" effect	3.5	-3.3	-2.1	-2.3	-2.7
Of which:					
Interest expenditure	1.2	1.3	1.3	1.3	1.1
Growth effect	2.6	-1.9	-2.2	-2.6	-2.8
Inflation effect	-0.4	-2.7	-1.2	-1.0	-1.0
3. Stock-flow adjustment	0.9	-1.7	0.5	-0.2	-0.4

[1] End of period.

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

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

Source: Economic Reform Programme (ERP) 2022, ECFIN calculations.

projects that the debt-reducing snowball effect will supersede the debt-driving impact of the primary deficit, which is expected to gradually decline further.

General government gross debt is projected at close to 52% of GDP by 2024, the same level as in 2020 and 2021. Overall, economic growth and inflation will not lead to a reduction in the debt ratio over the programme's horizon due to a continued negative primary balance. After rising by 1.4 pps. y-o-y in 2022, mainly due to a still sizeable, albeit declining primary deficit; interest payments; and a positive stock-flow adjustment (replenishing government deposits at central bank with excess inflows), the debt ratio is projected to decline as of 2023, when the programme

The structure of government debt carries moderate risks. Largely on account of continued heavy borrowing abroad in 2021, to meet pandemic-related financing needs, the share of foreign currency debt increased in this period (to 76% at the end of Q3-2021). More than 90% of this debt is denominated in euro, which is significantly above the minimum threshold established by the government (85%). Risks stemming from exchange rate depreciation are mitigated by the de facto currency peg to the euro. The risk to the debt portfolio from interest rate developments has declined somewhat, as the share of fixed rate debt in total debt has risen by 2.4 pps. from end-2020 to 79.5% at the end of the third quarter of 2021. The programme considers these risks by testing the sensitivity of public debt to interest and exchange rate risk. In the medium-term, the government should be in a position to refinance more of the maturing external debt via new domestic issuance, given the recent extension of the maturities of domestic issues, mitigating potential pressure on the exchange rate.

The financing of fiscal deficits and debt repayments is projected to average some 8% of GDP per year between 2022 and 2024. Apart from financing the still elevated budget deficit in 2021, the government needed to roll over a Eurobond worth EUR 500 million, which it had refinanced through new debt issued in March (EUR 700 million). The government estimates that financing requirements in 2022 will be significantly lower than in 2021 (by 11%), amounting to some 5.8% of projected GDP, and including the expected fiscal deficit (4.3% of GDP), foreign debt repayments totalling 0.8%, and domestic debt repayments of 0.7%. They would be funded through domestic (3.3% of projected GDP) and foreign borrowing, including a Eurobond. Financing needs would peak in 2023, mainly on account of a maturing Eurobond, at 9.3%, and drop again in 2024, to 6.3%. Overall, around EUR 1 490 million in foreign and domestic government debt is due for repayment in this period. ⁽²⁹⁾ However, these figures do not include potential calls on contingent liabilities the government has assumed by guaranteeing the debt of public enterprises.

⁽²⁹⁾ In 2023, the 2016 Eurobond (EUR 450 million) matures, followed by the 2018 Eurobond (EUR 500 million) in 2025.

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 1.4 pps. in 2022-2026, the budget deficit would increase by an average of 0.8 pps. per year. The second parameter is capital expenditure. Lower capital expenditure (about 70% realisation) would imply a reduction in GDP growth by 0.8 pps. per year and an increase in the deficit by 0.4 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% on average in 2022-2026 (compared to 3.1% in the baseline scenario, and to 4.2% in the same risk scenario in last year's programme for 2021-2023). 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 and other currencies.

The government's fiscal consolidation plan is subject to significant implementation risks. On the revenue side, progress in increasing public revenue by streamlining tax deductions is weak. 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. Revenue projections might also prove optimistic if economic growth turns out lower than forecast. Some recently adopted or announced policy initiatives aimed at supporting the recovery and employment, and involving further fiscal expansion, do not comply with the requirements of being targeted and/or temporary, such as government subsidies covering the rise in employers' social contributions resulting from the 18% increase in the minimum wage effective as of April 2022; an additional, ad hoc rise in pensions, on top of the two statutory increases, in 2022; and the planned increase in public sector wages. The government intends to reduce expenditure for goods and services, in line with the planned phasing out of pandemic-related support measures, as well as expenditure for wages and allowances. It plans to generate savings from better targeting of subsidies and transfers. However, it does not specify the source of the savings, which seem to rely mainly on the unwinding of temporary support measures rather than on systemic reforms. The allocation of subsidies at company level generally remains generally opaque in terms of the sums received by beneficiaries and the criteria for allocating support. Introducing a state aid registry would make this process more transparent, and contribute to a more targeted, efficient, and growth-enhancing use of funds. Moreover, potential savings in the biggest category of subsidies, in agriculture, accounting on average for 1.1% of GDP in the period 2015 to 2020, have not been considered in the consolidation plans. Also, the pension system may require more resources than anticipated - the statutory indexation of pensions is high (+2.9% y-o-y in January, with an additional increase planned for July). Pension expenditure as a share of total current expenditure already accounts for 27% of the 2022 budget. Between 2015 and 2021, budget transfers to the Pension and Disability Fund have increased by 35%, while the Fund's pension expenditure rose by 37.4%. The government is also discussing to raise public sector wages in some key segments in 2022.

The energy crisis requires the government to find additional financing. More recently, uncertainties about the fiscal and economic cost of high energy prices have heightened risks for the fiscal scenario. For 2022, the government projects some EUR 800 million in additional costs, of which some EUR 230 million (some 2% of estimated 2021 GDP) would be direct fiscal cost, resulting mainly from subsidies to electricity producers, revenue shortfalls (estimated at some EUR 32 million) from the temporary reduction of VAT on electricity, and transfers to households to cover the rise in energy prices. The government hopes to raise some of the needed funding from unspent budget allocations for pandemic-related measures. To cover the remaining financing needs, it is pondering a supplementary budget for early summer.

Plans to leverage private capital through public-private partnerships would require a strong legal framework. The drafting of a new law on improving the implementation of public-private partnerships, including better management of fiscal risks has been finalised, but not yet been submitted to parliament. The draft law is envisaged to address a number of shortcomings in the current legal framework governing

PPPs and concessions, such as a lack of detailed administrative guidelines on selecting, implementing and managing PPP projects; and limited central oversight, as each contracting authority sets its own contract formats and terms and conditions. Currently, fiscal risks, such as contingent liabilities arising from PPPs financed by municipalities, are not systematically reported to the central government.

There was little progress in further improving the fiscal framework. The new draft Organic Budget Law (OBL), which introduces fiscal (deficit and debt) rules and provides for an independent fiscal council, and for a proper medium-term budget framework was submitted to the parliament in December 2021 and is awaiting adoption. The government started drafting secondary legislation, but implementation of the rules might take time. Clauses allowing deviations from the fiscal rules have been widely discussed, and need to be carefully drawn up so as not to endanger debt sustainability. 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.

3.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

This chapter sets out the Commission's independent analysis of the economy of North Macedonia and identifies the main structural challenges the country faces. Addressing the immediate impact of the COVID-19 pandemic as well as new risks stemming from Russia's invasion of Ukraine has been a priority for the government. However, medium- to longer-term prospects for both economic growth and resilience to external shocks will depend on the ability of North Macedonia 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 - and essentially shared by North Macedonia - are:

- (i) improving the quality and relevance of the education system to increase employment and mitigate skills mismatch levels,
- (ii) improving the competitiveness of domestic companies, including integration into global value chains (GVCs) and reducing informal economy
- (iii) energy sector modernisation and transition to clean energy.

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. Key factors that undermine the country's competitiveness, investment and GVC integration include a challenging business environment, a lack of skills, innovation and technology adoption, low productivity, a distortive effect of subsidies on competition and the need to modernise and digitalise public administration. 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. A sustainable post COVID recovery suggests to address longer term transition to green growth, in particular in the context of geo-political shocks exacerbating the energy crisis. Such a green transition entails significantly improving energy efficiency in buildings; promoting the distribution of less polluting energy production sources, including, as an intermediate step in the decarbonisation process, the diversification of gas supply sources and routes; and investing in renewable energy sources.

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 issues to do with the

strengthening the rule of law and the fighting of corruption in its enlargement package, including the Report on North Macedonia.

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

The labour market of North Macedonia has shown a relatively high resilience to the COVID-19 pandemic, albeit progress in the employment rate has been put to a halt. Improvements in the labour market of the past two decades were halted by the pandemic, but the latest figures show some recovery. In the third quarter of 2021, the employment rate (20-64) increased slightly by 1.4 pps. to 59.8% and the activity rate by 1 pp. to 70.8%, compared to the third quarter of 2020. This is corroborated by the slightly shrinking unemployment rate (15-74), which in the same period fell from 16.5% to 15.5%, but is still well above the EU-27 average (6.9%). The impact of the COVID-19 pandemic, as demonstrated by the main socio-economic indicators, has so far been partially mitigated by the package of measures adopted by the government. However, long-lasting negative effects of the pandemic are still possible due to limited fiscal space. Data show that the pandemic primarily hit low-skilled workers, especially people working in agriculture, transport and manufacturing, while employment continued to increase among those with tertiary education. The ERP acknowledges the deficiencies of the labour market under the key challenge 'Strengthen human capital for inclusive development'. However, the proposed measures only address some aspects.

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. Many of the unemployed in North Macedonia, 75.4% in 2020, are long-term unemployed. This is more than double than the share in the EU-27 (35.8%) and higher than in the other countries in the region. The quality of available jobs remains an important issue fuelling the emigration of higher educated people ('brain-drain'): 27.6% of 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 high. With the support of the ILO, the Government developed a national employment strategy to promote more and better jobs for all. The strategy was adopted in November 2021 and aims to address the structural challenges affecting employment growth but also to mitigate the consequences of the COVID-19 pandemic.

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 employment rate of recent graduates (20-34) is only 54%, which is one of the lowest compared to the EU and other countries in the region. The countrywide implementation of the Youth Guarantee in all 30 employment centres in 2019 led to a significant reduction in youth unemployment (aged 15-24) from 45.4% in 2018 to 35.6% in 2019 and in the share of young people not in employment, education or training (NEET) aged 15-29 from 29.8% to 24.5% between 2018 and 2019. However, the rates remain high in 2020: unemployment has stagnated at 35.7% and the NEET rate has increased to 26.2% - both substantially above the EU-27 averages of 16.8% and 13.7%, respectively. The COVID-19 pandemic has interrupted a five-year declining trend of NEETs. 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 (27.6% of male NEETs compared to 37.1% of women) indicates the social conventions or pressures which place higher importance on women's roles within the family (OECD, 2020). Further success of the Youth Guarantee scheme significantly hinges on the improvement of the employment service capacity as well as that of other providers of key services such as social protection and education.

Spending on active labour market policies is relatively high, compared to the region, but lower than the EU average. In 2020, spending reached 0.27% of GDP (EU-27 average: 0.39% of GDP in 2019). Despite the countrywide implementation of the Youth Guarantee, there has been no comprehensive impact assessment of the effectiveness of active labour market policies for many years. Active labour market policies have a limited scope and cover less than 25% of the poor. However, in 2020, 66.8% of young unemployed aged 15-29 were involved in some type of active labour market programme. Better targeting the most vulnerable categories could include a combination of additional benefits and specific activation and skills development or the establishment of mobile units to reach and work with vulnerable groups, considering also the experience gained from previous outreach support. Despite recent progress the capacity of the public employment service is hindered by: limited human resources; insufficient staff training; limited funding allocation for active labour market policies with increased dependence on EU funding allocation; and limited investment in infrastructure.

Reform measure 2 of the ERP (“Increasing the flexibility of the labour market”) aims to extend the labour legislation, including active employment programmes, to non-standard form of work. As part of a new law on labour relations, planned to be adopted in 2022, the measure is deemed necessary due to an existing lack of legislation on remote working and working from home. Furthermore, specific active labour market measures will be directed at people in an unfavourable social position, primarily the beneficiaries of guaranteed minimum assistance. The measure aims to help increase the employment rate, decrease unemployment and reduce poverty and social exclusion. However, the measure does not focus on the right things and addresses the key challenges only partly.

The insufficient relevance and quality of education continues to contribute to skills mismatches, leading to persistent unemployment and underuse of young people’s potential. The education system contributes to the lengthy school-to-work transition by failing to identify and meet the needs of the labour market. Some of the issues related to the quality of education in North Macedonia already identified in the past are still evident. The skills mismatch continues to be a major impediment to people finding work. In 2019, job mismatches in terms of young tertiary graduates aged 15-34 working in jobs below their education level stood at 35% (ETF, 2019). However, new school and VET curricula focus more on the demands of the labour market. In addition, North Macedonia has put 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, which was referenced to the European Qualifications Framework in 2016, was designed to support the modernisation of education and training, with a view to improving the quality of education and its adaptability to labour market needs, and promoting lifelong learning and mobility.

The education system of North Macedonia does not give young people sufficient key competences and skills they need to actively participate in the labour market. International student assessments show substantial weaknesses for students in North Macedonia and reveal disparities in learning outcomes based on the place of living, ethnicity, socio-economic status and gender. This continues to hinder companies’ competitiveness and their deeper integration into the global economy. Despite substantial improvements in the Programme for International Student Assessment (PISA) results in 2018, compared to 2015, North Macedonia still ranks low among the other participating countries (68th place out of 78) and compared to its regional peers. TIMSS 2019 survey results show a similar trend, with the country’s students ranking in the 45th place in mathematics and 51st place in science among the 58 assessed countries. 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’ socio-economic status, educational track, and language of instruction. The OECD has signalled that there is a specific problem in fostering the ‘growth mind-set’. 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 the age of 15.

A reform of the education system was planned in the 2018-2025 education strategy, but it requires greater funding. The education strategy and the related action plan both prioritise providing quality skills to young people to prepare them for the labour market. However, these two documents also state that financial support is insufficient and that inter-sector coordination is lacking. Public spending on education is clearly insufficient. North Macedonia has steadily reduced its spending on education from 4.62% of GDP in 2011 to 3.9% in 2020. This level is currently below the EU-27 average of 5.0% in 2020 and also below peer-country averages. The education system is also undermined by the inefficiency of public spending (World Bank 2019). In addition, discrepancies in student-teacher ratios in schools are significant, impacting the overall quality of education. North Macedonia is planning to draw up a new financing model to redistribute public education funding and to make it more transparent. The new financing model aims to make the funding of primary and secondary education more transparent and to regulate how the funds from the Ministry of Education and Science are redistributed by the municipalities. The current formulas have not changed for many years and do not properly account for school equipment and teacher training needs. The new system will be based on standardised input parameters, including a basic amount per student, a variable component providing funding for costs for some students in primary education, such as those from socially disadvantaged families, and a development component to be introduced in 2023 to provide additional funds depending on the schools' achievements.

Major reforms are being made in VET, but the quality of teaching is still an obstacle to participate in the labour market. 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-27 average (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 have not acquired a specialisation to participate in the labour market. The three-year and four-year VET curricula were revised in 2019. The development of the three regional VET centres (Tetovo, Kumanovo, Ohrid) is hampered by slow parliamentary adoption of the necessary legislation. 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, 2019).

Reform Measure 1 of the ERP ("*Further development of the qualification system*"), rolled over from the last year, addresses the key bottleneck of the education system and builds on the activities implemented in 2021, such as the adoption of the new curricula or establishment of a National Council for Higher Education and Scientific Research. The measure reflects the key policy reforms presented in the Employment and Social Reform Programme (ESRP) adopted by the government. To implement this measure, the modernisation of three regional VET centres is key, and such centres of excellence need to be further developed throughout the country. The modernisation of the reform of VET led to an increased share of students enrolled in VET and participating in work-based learning. 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 government's top priorities, the measure's expected impact on competitiveness could be further strengthened.

Adults' participation in learning is low. The percentage of adults participating in learning was 2.6% in 2020, significantly below the EU-27 average of 9.2%. Further development of qualifications, arrangements for validation of non-formal and informal learning and up-skilling/re-skilling programmes throughout the country are key to integrate medium-skilled and low-skilled people into the labour market. Promoting lifelong learning and the strengthening of non-formal education should help to improve workers' technical and managerial skills. This can support fast productivity growth in companies and industry.

The continuing gender gap undermines the overall economic potential of North Macedonia. The gender employment gap (the percentage-point difference in the employment rate of men and women aged 20-64) stood at 19.9 pps. in 2020, relative to the gender gap in EU-27 of 11.3 pp. The low activity of females (20-64) is characterised by a high inactivity among low-educated women (79% in 2020). This is partly due to women's traditionally lower presence in the labour market, disincentives for women to work, caring and household duties and women's lack of confidence in their skills and labour market prospects (OECD 2021) and 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 10.6 years shorter than that of men (2020).

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

Key challenge #2: Improving the competitiveness of domestic companies, including integration in global value chains and reducing informal economy

The COVID-19 pandemic exacerbated structural challenges, leading to significant negative effects on the country's economy with the war in Ukraine increasing economic uncertainty and slowing down the recovery from the pandemic. As regards the COVID-19 crisis, domestic economic activity plunged in the wake of containment measures, and external trade suffered from lockdowns and recessions in trading-partner economies, and through the temporary breakdown of automotive supply chains. The COVID-19 pandemic has put a significant additional burden on companies, causing them to cut their investment in human and physical capital. It has negatively affected profitability and turnover in 90% of companies and caused a drop in their productivity (International Labour Organisation, 2020). According to the COVID-19 follow-up Enterprise Survey, 70% of firms experienced decrease in liquidity, while around 40% of them needed to close down temporarily their businesses. Although tackling the immediate challenges of the COVID-19 crisis has been an urgent priority since 2020, reform measures to foster the competitiveness of domestic companies need to be strengthened further. More recently and following the Russian aggression against Ukraine, rising geopolitical tensions, pressure on energy, commodity and food prices, combined with supply-chain disruptions (including in the automotive sector) negatively affect sustainable growth and competitiveness. Adverse effects of the rising energy prices on the private sector include loss of contracts with electricity providers and an unpredictable rise in electricity and gas costs.

Key factors that undermine the country's competitiveness, investment and GVC integration include a challenging business environment, a lack of skills, innovation and technology adoption and low productivity. The country's businesses suffer from unsophisticated technology, limited capacities of production and innovation, inconsistent quality of goods and services, low investment in human and physical capital, frequent changes to the regulatory framework, low productivity and competition from a large informal sector. While since the last OECD Competitiveness Outlook, North Macedonia progressed in various policy areas, its policies to increase competitiveness need to be effectively and continuously implemented as well as stepped up to have a more sustainable impact. The future success of the economy mainly hinges on the success of a broad range of structural economic reforms, especially ones aiming to

further improve the business environment (e.g. measures to combat the informal economy, simplification of the legal framework for doing business and the establishment of a fully functional state registry), enhanced support to innovation and technological development and promotion of human capital (i.e. skills development). Such reform efforts could also help attract foreign investment to sectors with high value added.

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.

Moreover, implementation remains a challenge, also due to frequent election cycles. Contract enforcement is lengthier and costlier than in peer countries (OECD, 2021). A new bankruptcy law, intended to facilitate market exit by reducing the cost and time⁽³⁰⁾ of procedures, is still awaiting adoption. To effectively support a sustainable economic recovery and faster growth, the government also needs to improve the management of public investment. Decisive steps are needed to rationalise parafiscal charges at central and local levels. *Measure 12 of the ERP, "Streamline the use of parafiscal charges", rolled over from 2021 and linked to the policy guidance.* The measure envisages the assessment of 377 previously identified parafiscal charges, aiming at further elimination, remodelling or optimisation and digitalisation. The methodology for further rationalisation of para-fiscal charges for SMEs will be established only after the 377 charges are screened and optimised. The measure should also seek to clarify the rationale for these charges and their impact on competitiveness.

To enhance the business environment will require further efforts on increasing the efficiency and transparency of public administration, in particular its modernisation and digitalisation. Especially in this challenging period, businesses need a fair, predictable and functional regulatory framework, with an effective and increasingly digital public administration (ILO, 2020). Public administration reform is an important precursor of growth and 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. While the national e-portal for services is being upgraded with more than 130 services, uptake is still low (*see also measure 11 in Section 6*).

The business environment also continues to be impeded by the substantial informal economy whose challenges have not been addressed decisively. Unfair competition, especially from the informal sector, is cited as a major challenge for businesses in North Macedonia (OECD, 2021). In the latest Enterprise Survey⁽³¹⁾, more than 50% of surveyed firms noted that they competed against informal or unregistered firms, and 40% of all firms identified this as a major constraint. According to IMF estimates, the informal sector of North Macedonia could account for as much as 37.6% of GDP. It takes various forms, notably 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. Undeclared work exacerbates the negative impact of the COVID-19 crisis on the economy. Backed up by high-level political commitment of all relevant institutions, the strategy and the action plan formalising the informal economy will have to be more vigorously implemented, assessed and reviewed, with specific attention paid to the business environment component. Measure 16, rolled over from the previous year and linked to the policy guidance, aims at *introducing mechanisms for formalising informal work in sectors with high incidents of undeclared activities*. However, there is scope for more effectively addressing the motives for engaging in informal business activities identified in the country's 2018-2022 strategy. The measure focuses on employment policies and does not address other important aspects, such as taxation, including social security contributions sufficiently. Awareness raising activities are missing. Activities are delayed and the adoption of a new strategy is expected only in 2023. The proposed activities could be presented more clearly. The impact of COVID-19 on the labour market and undeclared work is not taken into account. The impact of the

⁽³⁰⁾ An e-auction system applied for the liquidation process has already helped to reduce the time

⁽³¹⁾ As agreed between the participating institutions World Bank, the EBRD and the EIB

measure on competitiveness is not quantified and the impact on employment and gender is not sufficiently considered.

As the lack of skills undermines economic growth and the development of a knowledge society, increasing investment in human resources is vital. Reform of the education system is sluggish and the large skills mismatch persists. While North Macedonia has made substantial progress on the number of people with higher educational attainment, curricula do not equip graduates with the necessary skills to match labour demand. Therefore, structural deficiencies of the labour market persist, restraining potential growth. Among the most important ones are low participation rates, especially for women and weak human capital development, leading to underutilised labour resources amid demographic decline. Many young people are not active in the labour market. Around 80% of unemployed are long-term unemployed, largely reflecting the skills mismatch. Both domestic and FDI companies face rising emigration and (qualified) labour force shortages.

Domestic companies' low and slow-growing productivity continues to hinder their competitiveness. The deterioration in labour productivity and price competitiveness in 2020 largely reflects the economic impact of the pandemic and the government's job-retention measures. The continued rise in wages, bolstered by crisis-induced government wage subsidies, remain a challenge for external competitiveness, given the adverse developments in labour productivity over recent years. A large share of the workforce is still employed in low-productivity and low-wage sectors (OECD, 2021). The recent increase in the minimum wage (not linked with increased productivity) entails risks of not being sustainable over time.

Productivity could be further improved by more investment in research and innovation. At 0.4% of GDP, the economy's expenditure on research and innovation has not increased over recent years, and remains significantly below the EU average. The country is an emerging innovator, according to the EU innovation scoreboard. An increased budget (but also non-financial incentives and measures for collaboration between researchers and businesses) in this area would support the country's economic recovery, also given the relevance of innovation to the Economic and Investment Plan for the Western Balkans. Even though government funding for innovation increased in 2020, private firms are reserved about adopting new technologies. The Fund for Innovation and Technological Development invests in small and medium sized enterprises (SMEs) to improve the innovative capabilities of companies and to support the adoption of new technologies that boost private sector competitiveness. Finalisation of the smart specialisation strategy delayed by the COVID-19 crisis, should 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. Measures for closer cooperation between academia and the private sector are being implemented (*see also measure 17* in Section 6) and subsidies are being provided to companies to intensify their research and innovation capacities. The Economic and Investment plan aims to boost competitiveness of SMEs through investments in start-ups and the scaling up of innovative companies. The combination of grants and guarantees should reinforce open, innovative, business friendly ecosystems in the region based on a "triple helix" approach.

Instead of tackling the country's underlying structural challenges and business environment issues, the government's flagship policy to attract foreign direct investment (FDI) and improve domestic firms' competitiveness relies on providing various forms of state aid to businesses. In the 2019 Global Competitiveness Index, the country ranks 112 (out of 141 countries) in 'Distortive effect of taxes and subsidies on competition'. In a post pandemic environment, the extended use of State-aid schemes to support domestic companies must be based on close, continuous assessment of the business environment issues and clear policy objectives. The current model of state-aid is highly complex, untargeted and involves too many providers. The system is characterised by a short-term perspective and would benefit from more outcome focused approach. In spite of some progress, a fully operational State aid registry and a more effective State aid notification system are yet to be developed. Measure 15 of the ERP aims at the *establishment of Management Information System on State aid* and is linked to the 2021 policy guidance.

The measure will build a network of institutions dealing with State aid. It has the potential to enhance transparency for the general public and to create a level playing field for companies. The envisaged State aid registry will have to contain the legal basis (i.e. which State aid rules) based on which the respective aid is approved by the Commission for Protection of Competition. The expected impact on competitiveness is not explained in quantitative terms.

The COVID-19 crisis has shown the vulnerability of global value chains (GVCs) which represented 80% of global trade before the crisis (IMF, 2019). The dependency of the automotive sector on GVCs and the ongoing supply issues have the potential to create bottlenecks in the automotive production and to hold back GDP growth. 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 COVID-19, 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).

Prioritising and strengthening of targeted public policies to address the underlying structural obstacles to domestic companies' competitiveness could help to attract FDI and integrate more enterprises into global value chains. Despite positive developments in diversification (FDI is concentrated in a few sectors benefiting from economies of scale on a global level), supplier linkages between domestic enterprises (SMEs) and the FDI sector remain relatively weak as foreign investors rely on imports for most of their inputs other than low-cost local labour. Such weak linkages between the FDI sector and the rest of the economy mitigate the structural transformation of the economy, economic growth and job creation (OECD 2021). The limited growth impact reflects the largely low value added activities in the country's manufacturing plants, including labour-intensive assembly and cabling. The focus should be on attracting FDI that can source more content locally. The modest growth and weak integration of enterprises into GVCs also reflect enterprises' limited capacity to innovate and adopt new technology.

Although the high-end segments of regional and global supply chains hold potential for North Macedonia, firms do not invest sufficiently in innovation or meet quality standards necessary for attracting FDI and enhanced GVC integration. This is a critical barrier to GVC integration for many industries, including the automotive sector (OECD 2021). Most domestic companies lack the capacities and skilled workforce to innovate and adopt technologies and they cannot meet the quality standards required by the automotive or other relevant industries and value chains. This stems from difficulties in accessing finance as well as human capital and skills given the shortcomings in the quality and relevance of the education system (OECD 2021).

Further developing certain service sectors such as logistics, transportation, and information and communication technologies could be an opportunity for domestic companies. Because of their size, MSMEs could become ideal providers of the types of services GVCs are increasingly asking for. According to multinationals operating in the country, 30% of the companies surveyed held the view that services needed by these multinationals do not meet the required quality standards (Finance Think, 2019). This forces foreign companies to use alternatives outside the country. Most of these services are highly human-capital intense and require the mastery of digital tools.

While there is little evidence so far of much FDI nearshoring taking place, North Macedonia could still benefit from a realignment of global production networks in the post-pandemic phase. In that sense, the COVID-19 crisis may also offer opportunities for domestic companies to integrate sustainably into global value chains to further diversify their export structure and mitigate future shocks. Following the war in Ukraine, supply chain reshuffling may take place, especially in the automotive sector. To benefit from potential nearshoring opportunities, the country can embrace proactive policies to enhance its investment competitiveness and promote itself to potential investors based on currently successful sectors and those with identified potential. The global shift toward electrical vehicles and digitalisation

holds potential to integrate into automotive, electronics and IT–Business Process Outsourcing value chains by targeting FDI in these emerging sectors (World Bank, WIIW, 2021).

The Economic and Investment Plan for the Western Balkans will help increase the competitiveness of the economy of North Macedonia 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. A crucial element of the EIP - building a common regional market - has the potential to further enable competitiveness and growth. Implementing the plan will help the country integrate into regional and European value chains and attract FDI in tradable sectors, notably by increasing the size of its market.

Overall, North Macedonia presents 10 measures related to this key challenge in its ERP. The ones that are more closely linked to the European Commission’s assessment of this key challenge, are analysed in this section, the rest in Section 6.

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

The economy of North Macedonia is highly dependent on energy imports and characterised by high energy intensity, inefficiencies in the ageing energy production system, persistent high dependency on highly-polluting lignite coal, as well as inefficient energy consumption. The country has no gas or oil and has limited quantities of coal. Approximately ~68.7% of electricity is domestically produced and 31.3% is imported. Domestic electricity production relies heavily on lignite (41.95%) followed by hydro (16.86%) gas (10.81%), wind (1.48%), biogas (0.78%) and solar (0.33%). The country’s 2040 energy development strategy provides guidance on the direction of the energy sector up to 2040, but an action plan for its implementation is still pending. The government formally initiated an energy transition process and the country was the first Contracting Party to commit to a coal phase-out (by 2027) as a member of the Powering Past Coal Alliance. Still, the transition to low-carbon growth has been slow (OECD 2021). Challenges have been exacerbated by the Russian invasion into Ukraine. Energy prices have significantly gone up, risking higher inflation for a longer period and impacting on demand and competitiveness. The adoption of a 5-year programme for implementing the energy development strategy and an integrated national energy and climate plan will be a positive step for the Green Agenda for the Western Balkans, notably its aim to remove bottlenecks in key network infrastructures, accelerate the shift to a low-carbon economy and promote the clean energy transition and a European integrated energy market.

Energy supply is unreliable in North Macedonia and efforts on energy diversification needs to be improved. The country still faces challenges related to electricity supply. In spite of some improvements, the economy relies heavily on highly polluting coal for electricity generation and electricity and distribution networks are outdated and inefficient. Domestic lignite has a low caloric value and estimated reserves are limited to 15-20 years. Hydro capacities (particularly valuable in ensuring the fast supply of energy to compensate for surges in demand) depend on hydrological conditions, which have not been favourable in the past several years. Taken together, these factors have led to an increase in the import of electricity in recent years to 37% of the gross domestic consumption in January-September 2021, up from 32% in 2020. When considering security of supply on the basis of a diversified energy mix and sources of supply, the country’s natural gas supply framework has some way to go (OECD, 2021). Distribution of natural gas, as an intermediate step in the decarbonisation process, is advancing, with efforts made to increase the transmission network. However, the country relies exclusively on Russian gas through a single connection, exacerbating the energy crisis in the current geo-political context. The diversification of gas supply sources and routes is progressing slowly. The government is taking measures to ensure the necessary funding for the construction of an interconnection line e.g. with Greece (a second interconnector towards Greece is currently in an advanced stage of planning), thereby supporting

diversification of natural gas sources and facilitating access to transit pipelines ⁽³²⁾. The construction of a new 400kV electricity transmission interconnector line with Albania is under way. Despite recent efforts, the production of renewable energy lacks diversification. No new wind capacities have been built since 2014 (ECS, 2021). Implementing the Economic and Investment Plan for the Western Balkans, strengthening connectivity and going towards greener and more digital economies, will assist in diversifying energy supply and in reducing dependencies from Russian oil and gas imports. This includes developing gas interconnector to Serbia, Kosovo and Greece. End March 2021, in an effort to push down prices for consumers, EU leaders agreed that member states will work together on voluntary common purchase of gas, LNG and hydrogen. The common purchases platform will also be open to Western Balkan countries.

Concerns related to energy supplies and the risk of significant price hikes prompted the government to declare a 30-day energy crisis in November 2021 which was subsequently extended to June 2022. Rising energy import costs continue to have an impact on North Macedonia, its policies, competitiveness and public finances. Russia and Ukraine are major commodities producers, and disruptions have caused global prices to surge, especially for oil and natural gas. The Energy Regulatory Commission increased the regulated electricity price for households and small consumers by 9.48% starting from 1 January 2022. At the same time, the country's own energy reserves, hydro and lignite are at a worrying low level due to unfavourable hydrology but also poor resource planning in the State owned enterprise ESM. To mitigate the energy crisis, exacerbated by the Russian aggression against Ukraine, the government undertook various measures, starting with a range of initiatives in the energy sector designed to secure supplies, shield consumers from significant price hikes (e.g. subsidising heating prices and temporary taking over of the private heating company (BEG) in January 2022 until the end of the heating season) and ensure confidence in the state-owned electricity generation entity ESM. More recently, Parliament had agreed a package of 26 measures ⁽³³⁾ worth EUR 400 million, of which EUR 90 million in tax holidays and EUR 310 million for direct payments from the State budget. If the efforts to increase domestic production fail to materialise, ESM (production) will have to reduce delivery volume and buy the remaining demand at market prices. This would lead to an extraordinary high price for the end consumer, while the need for additional electricity import volumes using current international transmission lines may cause capacity problems for existing infrastructure. Inflation expectations ⁽³⁴⁾ have already increased significantly and could feed into wage- and price-setting processes. As requested by IFIs, a more targeted approach to vulnerable household to offset the impact price increases is needed in the short term.

While planned investments in new coalmines and extension of the work of the thermal power plant (TPP) Bitola can provide some short-term mitigation, they may jeopardise the strategic goals of decarbonisation and decommissioning the two TPP's by the end of 2028. The energy crisis will therefore likely have additional negative environmental effects both due to the direct effects of increased burning of lignite and oil. The government has yet to propose medium to long-term sustainable solutions. 'Just transition' activities have yet to be pursued in a determined manner while progress in activating the development of renewable energy in an efficient and transparent manner – in particular solar – is still lagging behind. To mitigate the negative social and economic impacts of the closure of coal-fired power plants and related coal mines in the affected regions, it is important to urgently work out a plan to address associated labour and regional development issues (EBRD, 2021).

North Macedonia aims to increase the share of renewable energy sources (RES) to 35-45% of gross final energy consumption by 2040. The amended national renewable energy action plan is in line with

⁽³²⁾ The project will Provide a diversified gas supply in North Macedonia from TAP pipeline and LNG terminals in Greece, aiming to improve competitiveness and reduce gas prices (currently only Russian gas from TBP), and to increase possibility of supply by 2.8 bcm (existing 0.8 bcm).

⁽³³⁾ For instance, a reduced VAT rate for electricity that was supposed to gradually return to 18% (planned increase from 5 to 10% in July 2022) is now postponed until December 2022.

⁽³⁴⁾ Inflation already accelerated to 4.9% in December 2021.

the revised binding target of 23% of energy coming from RES by 2020 and 24% by 2025. The Energy Law is fully aligned with the Renewables Energy Directive. The government pursues annual targets to raise the share of renewables in energy consumption. While at this stage, renewable energy still only accounts for a small share of power generation, important wind park and solar power plant investments are foreseen in the framework of the Economic and Investment Plan, including installation of solar power plants on the site of the exhausted coalmine in Oslomej and adjacent to the coal-fired thermal power plant in Bitola. Hydropower is the most RES in the country and several of the already-built and planned plants are in protected areas. The overall target of 23% of renewable energy in gross final energy consumption by 2020 is far from being achieved (19.22% in 2020) because of the insignificant share of renewable energy in the transport sector, not reaching even 0,5% in 2020 (ECS, 2021). Feed-in-tariffs and premiums are used to support the deployment of renewables. In 2020, contracts were signed for installing capacity 62 MW-capacity solar power plants, using premiums granted via auctions. The government should reconsider the decision to keep the feed-in-tariffs for small hydro power plants, which either do not require support or have a negative environmental impact. Thresholds for administratively set feed-in tariffs are not aligned with the Guidelines on State Aid for Environmental Protection and Energy (ECS, 2021). The capacity cap per type of renewable energy technology has to be removed to achieve the 2025 renewable energy target. Provisions on sustainability of biofuels are still not aligned. Electricity prosumers can refer to the rulebook on renewables but its implementation is lacking due to administrative obstacles. *Measure 5, rolled over from last year, aims to promote renewable energy sources.* It is very relevant as it will help diversify energy generation and contribute to energy supply security, with expected positive effects for the economy, by lowering the electricity costs and creating green jobs. However, the activity looks narrow in its scope as it focuses primarily on biofuels. Some activities foreseen in the previous ERP and the follow-up of the assessments performed in 2021 are no longer included, i.e. measures to improve the heating and cooling sector or on the electrification of the public transport. Schemes supporting the deployment of renewables may have to be reconsidered, in particular schemes on small hydropower. They should ensure that the incentives do not favour RES that do not require support or have a negative environmental impact. The proposed result indicators do not reflect the specific activities, i.e. use of biofuels. The impact assessment needs improvement.

Energy efficiency can boost the competitiveness of the economy through cost savings, but measures in this area are stalled. The economy is characterised by high-energy intensity with low efficiency in energy production and consumption. A Law on energy efficiency transposes the energy efficiency and the energy performance directives. Despite these improvements, implementation is lacking. Energy intensity in North Macedonia needs to be reduced and legislation on energy efficiency must be enforced. The adoption of implementing legislation remains a challenge, due to limited human and technical capacity at the Energy Department of the Ministry of Economy and the Energy Agency. Financing to promote energy efficiency is limited, and the envisaged Energy Efficiency Fund remains to be set up (activities for its establishment and operationalisation have started). There is a particular need to improve energy efficiency in buildings. To that end, a buildings renovation (and street lighting) programme with a budget of EUR 25 million is currently under way. As a member of the Energy Community and following the adoption of the Clean Energy package by the Energy Community Ministerial Council in November 2021, there is a need for timely alignment with and implementation of the Energy Efficiency Directive (2018/2002/EU). *Measure 6, rolled over from last year, aims to improve energy efficiency.* A refurbished and improved building stock will help pave the way for a decarbonised and clean energy system, as the building sector is one of the biggest energy consumers and is responsible for a high proportion of greenhouse gas emissions and air pollution. However, the lack of capacity within the public institution (Ministry of Economy and Energy Agency) for collecting and sharing information, monitoring progress and promoting energy efficiency, remains an obstacle. Insufficient information on the current energy and resource profile of buildings and the potential benefits of renovation, are among the biggest barriers to taking decisions on energy efficiency measures. The impact assessment part needs improvement.

The country's long term energy strategy, extending to 2040, considers the need for expansion in infrastructure. There also appears to be extensive international donor community involvement in

investment projects (OECD, 2021). The Growth Acceleration Plan envisages offsetting up an Energy Efficiency Fund within the Development Bank of Northern Macedonia, to invest in energy efficiency and renewable energy in public buildings. Financing is also planned under the Hybrid Green and Digital Economy MSME Fund and as the Hybrid Strategic Green Investment Fund for projects undertaken by large companies. The new government has pledged medium-term investment in RES, a gas interconnection with Greece, the completion of the gasification of the country and energy efficiency. However, the same government program foresees the opening of the Zhivojno coalmine to provide domestic quantities of coal to enable stable production of electricity in the TPP Bitola for an additional 10 years. The Transposition and swift implementation of the acquis on guidelines for trans-European energy infrastructure (through a revised law on strategic investments) should facilitate the realisation of PECEI (projects of energy community interest) and PMI (projects of mutual interest) infrastructure projects.

Energy transition and the sustainability of the energy system are priorities in the recently-adopted government programme. A sustainable post-COVID recovery, combined with the ongoing geo-political shock exacerbating the energy crisis, should involve a longer term transition to green growth in a determined manner. This includes: improving energy efficiency in buildings; promoting the distribution of less polluting energy production sources, such as natural gas, as an intermediate step in the decarbonisation process; investing in RES; and advancing on regional interconnectivity. Pursuing a business-as-usual growth model post-COVID-19 carries the risk of locking in growth on an unsustainable (brown as opposed to green) trajectory (World Bank, 2021). The process of gradually phasing out coal has to be strategic as well as carefully planned and has to be accompanied by heavy investment, including in human capital and in the restructuring of the work force. So far, the share of carbon-intensive exports in total exports in 2019 is still over 40 % (World Bank, 2021). Appropriate pricing for carbon would not only provide incentives to focus on green recovery but would also offset the adverse effect of the EU Carbon Border Adjustment Mechanism on the competitiveness of Western Balkan exports (World Bank, 2021). In line with the EIP, the Commission will support the development of renewable and less-polluting energy sources.

Digital technologies can boost the effectiveness of green transition policies. This includes innovative production and manufacturing processes and their digitisation, new business models, sustainable-by-design advanced materials and technologies enabling the switch to decarbonisation, including green digital technologies.

Overall, the country needs to continue its effort to improve the competitiveness of the energy industry. In addition to short-term measures aimed at mitigating the economic impact of the war in Ukraine, efforts are required to diversify energy supply, increase the share of renewable energy resources and to swiftly proceed with measures to improve energy efficiency. Specific attention should be given to sustainable growth given the country's potential for sustainable energy and efficient energy use. Affordable energy security can be achieved through a combination of imported natural gas, affordable local renewable energy, and energy storage technologies. In line with the Green Agenda and through the Economic and Investment Plan, the support in the field of energy will be reinforced. Strong emphasis will be put on energy market integration, decarbonisation and clean energy, just transition, increased digitalisation of the system and smart grids, energy efficiency, including modernisation of district heating, and energy security. Greening growth drivers can be an important incentive for much-needed innovation and productivity-driven growth. Despite challenges, for example in applying the EU Carbon Border Adjustment Mechanism, the green transition is also an opportunity to discover new products and new markets (World Bank, 2021).

North Macedonia presents five measures related to this key challenge in its ERP. Some of them, more closely linked to the European Commission's assessment of this key challenge, are analysed in this section, the rest in section 6.

Box II.3.3: Monitoring performance in light of the European Pillar of Social Rights ⁽³⁵⁾

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

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

Relative to the EU-27 average, North Macedonia faces challenges for a number of indicators of the Social Scoreboard supporting the European Pillar of Social Rights.

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

The education system of North Macedonia does not equip young people with the necessary key skills and knowledge. The low quality of the education system contributes to the lengthy school-to-work transition and the skills mismatch continues to be a major impediment to people finding work. In 2019, 35% of people with tertiary education worked below their level of qualification. However, new school and VET curricula focus more on the demands of the labour market.

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

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

⁽³⁵⁾ The table includes 16 headline indicators of the Social Scoreboard, used to compare performance of EU Member States (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The indicators are also compared for

3.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2021

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 region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the PG is similar to that of the country-specific recommendations usually adopted under the European Semester for the EU Member States. The Commission evaluates the work carried out to implement the policy guidance in the following year's ERP assessments. The table below presents the Commission's assessment of implementation of the 2021 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at Ministerial level on 12 July 2021.

Overall: Partial implementation (43.1%) ⁽³⁶⁾	
2021 policy guidance	Summary assessment
<p>PG 1:</p> <p>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.</p> <p>Also with a view to improving the realisation of capital expenditure, reinforce the management of</p>	<p>There was partial implementation of PG 1:</p> <p>1) Substantial implementation. In order to mitigate the economic shock triggered by COVID-19 pandemic, the Government responded by adopting six sets of temporary economic measures aimed at protecting the liquidity of companies, preserving jobs and ensuring social protection for the unemployed and the vulnerable households. The international community agrees that the overall measures were successful in mitigating the major negative effects on the population and businesses. The State Budget for 2022 includes a programme of above EUR 88 million to cover the measures to deal with the consequences of the health pandemic and to overcome the economic consequences of the coronavirus. Ex-post assessment is needed to better appreciate the overall impact of the measures. In 2021, despite the protracted pandemic effects, the domestic economy started recovering, but in the fourth quarter slowed down somewhat, due to the impact of the omicron variant, the supply side restrictions and the energy crisis. For these reasons, the budget of 2022 needs to still focus on economic resilience. However, fiscal consolidation still remains an important policy objective of the government; the medium-term fiscal policy aims to gradually reduce the budget deficit as percentage share of GDP. Yet, the consolidation path relies on overoptimistic economic and revenue growth and it is not underpinned by concrete measures apart from the phasing out of temporary crisis support.)</p> <p>2) Limited implementation. The Government approved the Public Investment Management (PIM) action plan in 2020,</p>

the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2020 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). For data see Annex B. NEET: neither in employment nor in education and training; GDHI: gross disposable household income.

⁽³⁶⁾ For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes available at https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en.

<p>public investment, in line with measures outlined in the related Action Plan.</p>	<p>covering the period 2021-2024. The capacity of the Ministry of Finance is limited and roles and responsibilities in the PIM cycle have to be further clarified. The plan envisages the establishment of a PIM department in MoF. Nevertheless, this department has not been created yet and implementation of the PIM action plan is behind schedule. The new methodology for capital spending which rewards good spenders on a quarterly basis, taking away planned capex from underperformers is operational. Persistent challenges in the capital investment policy are as follows:</p> <ul style="list-style-type: none"> - A number of policy documents not consistent with each other; no umbrella document to frame the national public investment priorities; multiple pipelines of projects, depending on the donor funding and the responsible institutions; -selection, planning, preparation, implementation and monitoring methodology for capital investments is not transparent, inclusive or based on solid criteria. - The EU proposed methodology that is implemented by the National Investment Committee was not mainstreamed to all investments. - A number of contracts were signed last year without a link to the adopted infrastructure pipelines and in a way that questions the current dominant methodology. - Very few of the co-existing pipelines include the maintenance of the existing and the new infrastructure, putting at stake the sustainability of the EU financing, (particularly of those under IPA I) - There is overlapping responsibilities and no real centre of weight at the Government to ensure monitoring over the implementation even in the case of major projects (Corridor 8 railway). - There is no central oversight.
<p>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.</p>	<p>3) Limited implementation. In order to improve revenue collection and optimise the tax base for most taxes, the MoF prepared a tax base analysis. There are certain deviations compared to the EU directives, which would be targeted and followed by future legal changes. MoF prepared a report on tax deductions, which are calculated as a percentage of GDP. Annual action plans to streamline tax exemptions would help to tackle the issue. Furthermore, an analysis with comparison of the list of goods and services subject to reduced VAT rate in line with the national legislation was conducted; minor deviations were noted, related to the goods and services for strategic products (e.g. agricultural mechanisation) and other products (e.g. medical services, computers). Activities to create a business intelligence unit continue as part of the twinning project "Improving Revenue Collection" and are planned in the draft PFM Reform Programme 2022-2025.</p>

<p>PG 2:</p> <p>Adopt the new PPP law and ensure its efficient implementation, including the development and functioning of the PPP registry.</p> <p>Take the necessary legislative steps for the establishment of the Fiscal Council.</p> <p>Improve transparency and evaluation of firm-level subsidies by setting up a state aid registry.</p>	<p>There was limited implementation of PG 2:</p> <p>1) Limited implementation. The Government has developed a draft PPP law, but it has not been submitted to the Parliament for final adoption.</p> <p>2) Limited implementation. The establishment of the Fiscal Council is foreseen in the draft Organic Budget Law that was submitted to the Parliament for final adoption in December 2021. The second reading of the OBL took place in December 2021 but it has not been adopted yet by the Parliament.</p> <p>3) Limited implementation. The State aid registry is still not set up. The draft law on state aid is still in the parliament and has gone through a process of consultations with relevant institutions.</p>
<p>PG 3:</p> <p>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.</p> <p>Further reduce institutional and legal obstacles to swift and effective NPL resolution, including by facilitating out-of-court settlement and modernising the insolvency regime.[Ruzica]</p> <p>Safeguard the National Bank's independence in its key statutory tasks, including in staffing issues, in line with the law on the national bank, and to this end exclude the National Bank from the scope of the new law on administrative servants.</p>	<p>There was partial implementation of PG 3:</p> <p>1) Substantial implementation. The European Commission decided to consider the supervisory and regulatory framework applicable to credit institutions in North Macedonia as equivalent to that applied in the EU. Key legislations and regulations improved, and progress was made in bringing the financial stability law to parliament. Nevertheless, the law on the national bank still needs to be amended to clearly establish the National Bank as the competent resolution authority. There are also some delays in aligning the banking law with the EU law on deposit insurance. Provisioning seems broadly adequate, despite a slight decrease in the coverage ratio.</p> <p>2) Partial implementation. The quality of financial reporting and corporate governance was further improved through a new Code of Corporate Governance of companies. A draft Law on Insolvency was provided for public consultation in 2021 and another on valuation was drafted. But the progress could be accelerated.</p> <p>3) No implementation. The National Bank has not been excluded from the scope of the new draft law on administrative servants, therefore, despite some efforts, there are still concerns about adequately safeguarding the National Bank's independence, including in staffing issues</p>
<p>PG 4:</p> <p>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.</p>	<p>There was partial implementation of PG 4:</p> <p>1) Partial implementation. Public consultations through the dedicated national electronic consultation system allow for inclusive participation of all stakeholders, however the electronic system is not used to its full potential. The main tool for consultation remains the online platform ENER (National Electronic Register of Regulations). However, the practice for the adoption of laws under a short legislative procedure and the use of the "EU flag" procedure (a fast track</p>

<p>Use the list of mapped parafiscal charges to clarify the public services provided through the proceeds of individual charges and identify those that need to be eliminated, remodelled or streamlined.</p> <p>Continue the digitalisation of public services for businesses and citizens.</p>	<p>procedure aimed at aligning legislation with the EU acquis) continued. Great care should be taken in the use of fast track procedures, which need to be limited to ensure effective scrutiny and consultation of legislation. The quality control and the follow-up to the public consultation process needs to improve.</p> <p>2) Limited implementation. Consistent with reform measure 12, the country shows commitment to streamlining parafiscal charges. However, activities have only just started to reducing the number of parafiscal fees. To streamline the wide range of parafiscal charges imposed on businesses, the government published, on a designated web page, a list of 377 parafiscal charges at central and local level along with their value. Technical assistance is being put in place with the aim of evaluating, annulling, optimising and rationalising these charges. First results are expected by end of 2022 (with support of IPA).</p> <p>3) Partial implementation. Consistent with reform measure 11, the national e-services portal www.uslugi.gov.mk provides electronic services to citizens. The government instructed line ministries to digitalise the internal processes and the services they provide to business and companies. However, insufficient resources (human and technical) are allocated for this purpose and the adoption of the National ICT strategy is delayed. An EU funded e-governance project, should contribute to digitalisation of more than 135 services.</p>
<p>PG 5:</p> <p>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.</p> <p>Assess the implementation of the 2018-2020 Action Plan and identify gaps, in particular related to tax policy and administration.</p> <p>Develop and implement the new 2021-2022 Action Plan.</p>	<p>There was partial implementation of PG 5:</p> <p>1) Limited implementation. The decision to appoint the Deputy Prime Minister office to coordinate the implementation of the strategy was prepared, but not yet adopted by the government.</p> <p>2) Full implementation. The government adopted the report in October 2021. Some progress was made on the action plan, but the COVID-19 pandemic impeded its implementation, including the formalisation of undeclared workers as supported by an EU funded project. When reviewing implementation, additional activities were added to all four strategic goals of the action plan. The report was also reviewed by the Economic and Social Council.</p> <p>3) Partial implementation. The new 2021-2022 action plan was adopted in October 2021, but implementation in 2021 was limited. Several activities from the previous action plan are continuing under the new action plan, in particular those which were added as part of the above-mentioned review process</p>
<p>PG 6:</p> <p>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.</p>	<p>There was partial implementation of PG 6:</p> <p>1) Partial implementation. North Macedonia developed a new formula for financing primary and secondary education. The formula establishes clear standards on the basis of which funds are distributed from the Ministry of Education and</p>

<p>Strengthen access to active labour market policies, particularly for low-skilled unemployed and people in vulnerable situations.</p> <p>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.</p>	<p>Science to the municipalities, and from the municipalities to the schools. Its gradual implementation is envisaged to start as of 2022. The measure also comprises a review on the financing of regional VET centres that is done through the central government budget and seeks to review practical education in VET schools in order to reduce costs for schools due to increasing co-financing by companies. The National council for higher education and scientific research was set up. It adopted guidelines for methodology, standards and accreditation procedure in the higher educational institutions and will develop the new financial model.</p> <p>2) Partial implementation. The Operational Plan for Active Labour Market Employment and Services Programs and Measures provided low-skilled and vulnerable unemployed people with more targeted solutions and contributed to a general improvement in active labour market policies. In July 2021, additional funds were ensured for salary subsidies for low-qualified people; and in November for self-employment, salary subsidies and general employment. The Employment Service Agency launched psychosocial support and mentoring services to Guaranteed Minimum Assistance (GMA) users. More attention is also being paid to sustainable employment. However, COVID-19 has hindered further steps and the overall financing is still below the needs.</p> <p>3) Partial implementation. Efforts were made to improve case management in the Centres of Social Work, including by training staff. As of June 2021, the electronic exchange of information between employment agencies and centres for social work was set up. Individual activation plans were prepared for GMA users. However, capacity is still insufficient and the pandemic has slowed the cooperation between the Centres of Social Work and Employment Centres.</p>
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3.6. THE 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, 24 May 2022

[...]

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

1. If needed, use the available fiscal space in the 2022 budget to cushion the potential impact of adverse shocks through targeted support to vulnerable households and firms; foresee in the medium-term fiscal plan accompanying the 2023 budget a gradual reduction of the primary deficit-to-GDP ratio to its pre-crisis (2019) level. Set up a central public investment management unit in the Ministry of Finance and ensure its proper functioning. In line with the Tax System Reform Strategy, design comprehensive tax reforms and draft legislative changes that contribute to enhancing revenue by broadening the tax base, and accelerate the digital transformation of the Public Revenue Office.
2. Submit the new public-private partnership (PPP) law to the Parliament for adoption and ensure its implementation, including by setting up a fully functioning PPP registry. Ensure central monitoring of all fiscal risks related to state-owned enterprises, PPPs, and Local Government Units by the Ministry of Finance. Implement the new organic Budget law as soon as it is passed by the Parliament and take the necessary legislative and organisational steps to enable the new Fiscal Council to take up operations.
3. Carefully assess and analyse price developments and stand ready to tighten monetary policy, if needed, to preserve price stability in the medium term. Maintain a transparent and accurate reporting of asset quality and adequate provisioning, further reduce institutional and legal obstacles to swift and effective NPL resolution, all relevant institutions to continue to reduce data gaps in particular as regards the real estate sector and further implement measures to promote the role of the local currency. Safeguard the national bank's independence in its key statutory tasks, including in staffing issues, in line with the law on the national bank, and to this end exclude the national bank from the scope of the new law on administrative servants and the law on public sector employees.
4. Use the list of mapped para-fiscal charges to evaluate, optimise and rationalise para-fiscal charges at central and local levels. Continue the digitalisation of public services for businesses and citizens by upgrading and enhancing the use of e-portals for services. Adopt a comprehensive new strategy and Action Plan for formalisation of the informal economy 2023-2025 and ensure high level political commitment by all institutions relevant for the coordination and implementation.
5. Increase the number of staff and the technical/engineering capacity of the Energy Department in the Ministry of Economy and the Energy Agency. In line with the commitments of the Green Agenda for the Western Balkans: Adopt and implement energy efficiency legislation, including bylaws to the energy efficiency law. Following development and adoption of the legal and regulatory framework, establish the envisaged Energy Efficiency Fund.
6. Develop new vocational education and training (VET) legislation with a focus on inclusion, labour market needs and a new methodology of financing VET as well as provide a yearly report for improving higher education, including recommendations for a new formula for the financing of

higher education. Continue efforts to strengthen access to active labour market policies, particularly for low-skilled unemployed and people in vulnerable situations. Further increase the capacity of and cooperation between the employment agencies and centres for social work as well as education and training institutions to provide integrated services and measures for improvement of inclusion in the labour market.

ANNEX A: Assessment of the other area/sector and structural reform measures included in the 2020-2022 ERP

Public financial management (PFM)

North Macedonia, like most WB6 countries has considerable room for PFM improvement. The Organic Budget Law introduces fiscal rules, a Fiscal Council, multiannual expenditure framework and programme-based budgeting and its adoption is a pre-conditions for many PFM reforms going forward. Moreover, the public internal financial control law establishing strengthened managerial accountability and internal audit functions, is still awaiting adoption. An action plan for the implementation of the Public Investment Management Assessment (PIMA) recommendations is in place, but to overcome fragmentation in public investment, a co-ordination structure has to be set up involving all key institutions in order to ensure efficient implementation. New draft legislation on PPPs also provides for new tools and processes to ensure better management of fiscal risks arising from PPP. However, considerable delays are expected on the development and establishment of the PPP and concessions registers which would facilitate the implementation of the laws. It will be important to ensure consistency of the ERP with other plans, including the 2021-2027 intervention investment plan and the 2022-2026 growth acceleration plan. North Macedonia is moderately prepared in the area of financial control. The implementation of the public internal financial control (PIFC) policy paper and action plan has been delayed due to the COVID-19 crisis and limited capacities of key stakeholders. The functioning of the financial inspection is not sufficient. The independence of the State Audit Office is not yet guaranteed by the Constitution. The parliamentary oversight of public funds management is not efficient yet. The analysis could have mentioned the role PFM plays – e.g. through spending reviews – in creating fiscal space for new policy priorities and in informing the medium-term fiscal consolidation plan.

Measure 20: PRO digital transformation by setting up ITIS

This new measure is very relevant as it addresses the long-standing issue of the Public Revenue Office's (PRO) obsolete and fragmented IT system, which impedes its administrative and operational capacities. The measure has the potential to address EU and IMF (e.g. Tax Administration Diagnostic Assessment Tool assessment) recommendations to improve the PRO's business processes, implement a new integrated IT tax system, develop compliance risk management and further extend e-services. To this end, the measure is relevant and well explained, including a description of the key functionalities of the system. The potential risks are well identified and will need to be addressed in order to minimise their impact when implementing the measure (i.e. insufficient institutional ownership and very weak human resource capacities, especially in the IT sector). There are some concerns that the reversal of an earlier decision to procure a COTS tax administration software in favour of a modular system may lead to suboptimal results (IMF, 2021). The IT system is one of the key pre-conditions for improving revenue collection and it features in the 2020-2023 Tax System Reform Strategy and the newly drafted 2022-2025 public financial management strategy. The measure's expected impact on competitiveness could be further improved.

Green transition

This reform area is very closely linked to key challenge 3 and is analysed above in Section 4. Complementary to this analysis and as part of a sustainable post-COVID-19 recovery, the country also needs to unlock the potential of the circular economy, with recycling and reuse as the rule and a significant reduction in the use of natural resources.

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

Measure 7 is new and although it is relevant, it focuses almost exclusively on (donor-funded) capital investments and does not address the necessary structural reforms, including implementation of the full cost recovery and polluter-pays principles enshrined in the Water Law of 2008. Moreover, there is little reference to the required strengthening of administrative capacity and interinstitutional coordination. The activities planned for 2022, 2023, 2024 are not realistic. The measure related to EU funding needs to respect the procurement and disbursement plans for the respective projects. The impact analysis is poor. Circular economy is mentioned as a project objective, but the text does not mention any benefits for the country's competitiveness.

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

The measure, supported by EU funding, is new and relevant. Waste management regions were identified in the country's 2021-2031 Waste management plan and the planned steps to set up a regional waste management system are consistent with Commission recommendations. However, important elements of the implementation and sustainability of the investment are missing. For instance, a reference to a cost covering waste tariff policy, which is considered key to ensuring proper quality services and a sustainable waste treatment system, is missing. Another key milestone is to set up the Regional Waste Management Company, but regrettably this is not explicitly in the list of planned activities. The impact analysis is very poor. Circular economy is mentioned as a project objective, but no mention is made of the benefits for the country's competitiveness.

Business environment and reduction of the informal economy

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

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

This new measure is very relevant. So far, commercial loans from local commercial banks are the predominant source of funding. This measure has the potential to effectively address the lack of diversification of sources of funding, especially the micro and small businesses, which is a major constraint of the business environment. The idea of a hybrid fund is included in the GAP. Contrary to general State aid applied so far, such a public-private venture capital fund can be seen a more progressive market-oriented step forward towards sustainable access to finance for SMEs. Still, the description of the measure should further explain the synergies with other funding options mentioned in the GAP, such as the hybrid green strategic investment fund. The government could further explain the measure's impact has on competitiveness.

Measure 14: Financial support for Roma entrepreneurs

This new measure is very relevant, also from a social point of view, as it targets a very disadvantaged group of the country's society. The measure is supported through EU funds. One challenge is that the

implementing agency - the Roma Entrepreneurship Development Initiative - still needs to be registered in the Central Donor Assistance Database before work can begin. The impact analysis of the social outcome includes some quantification, while the impact on competitiveness should be further explained.

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

The strategic vision for support of innovation is unclear, as the strategy for research and innovation ended on 31 December 2020. While implementation was monitored on an annual basis, no assessment of the impact of the 7-year strategy was undertaken. Gross domestic expenditure on R&D relative to GDP remains low at 0.37% of GDP, significantly below the EU average. An increased budget in this area would support the country's economic recovery, also given the relevance of innovation to the Economic and Investment Plan for the Western Balkans. Measures for closer cooperation between academia and the private sector are being implemented and subsidies are being provided to companies to intensify their research and innovation capacities. Participation by the private sector in overall research spending remains low at 0.1% of GDP. The government's support for R&D&I is being provided mainly through State-aid schemes implemented by the Fund for Innovation and Technology Development (FITD). The FITD's investments in SMEs aim to improve their innovative capabilities, and to support the adoption of new technologies that contribute to private sector competitiveness. The impact of this funding should be further assessed. The country's performance in the Horizon 2020 framework programme has improved compared to the previous year but it still remains slightly low at 11.7%, compared to an average success rate of 12.1%. The finalisation of the smart-specialisation strategy, supported by the Joint Research Centre, is delayed by the COVID-19 crisis.

Measure 17: Enhancing cooperation between the academy and the industry

This measure is rolled over from last year as there were no significant developments. The comments from last year's assessment are still valid. 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 set up at the State university in Skopje, and some funding was secured for its initial operation. However, the government has not yet explained the STP's specific fields of operation and specialisation. A balanced public-private structure for ownership and management, with initial public funding, is a preferred model for operating a life-science park. However, it is not clear whether potential private investors have been found. This measure could benefit from activities going beyond the setting up 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. There are no detailed plans for the activities 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.

Digital transformation

While North Macedonia continued to successfully implement the Digital Agenda for the Western Balkans and the Regional Roaming Agreement, further efforts are needed to unlock the potential of the country's digital transformation. The digitalisation of the economy has proven to be particularly relevant during the COVID-19 pandemic. A strategy for development of digital skills was prepared, as part of the broader ICT strategy and action plan. As the strategy is still under preparation, it is not yet certain that it will address the digitalisation of SMEs effectively (OECD, 2021). The national e-portal for services is being upgraded with more than 130 services. This is in principle an encouraging development given the importance of digitalising the public administration and increasing online services for citizens and businesses due to COVID-19. However, a large number of these services are not directly available through the portal, which only publishes information and links to the relevant portals. For the e-services

that are available, usage and satisfaction levels remain low (OECD, 2021). Greater efforts by and improved coordination between institutions are still needed to modernise and digitalise the public administration, including the planned establishment of an Agency for Digitalisation and Registers. Successful e-services include the e-Tax System that has simplified tax reporting, and mobile applications like e-VAT that enables VAT returns for individual taxpayers. On e-commerce, the National Bank reported a five-fold increase in internet transactions by citizens in 2020 compared to 2019. Yet, e-commerce in the country is progressing at a slow pace. 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 use of electronic signatures for services to citizens and companies modestly increased. Overall, there is a particular need to increase access to broadband, expand available e-government services and develop digital skills.

Building on the 2018 Digital Agenda for the Western Balkans, the economic and investment plan offers an opportunity to accelerate the digitalisation of governments, public services and businesses, in a manner consistent with the EU's values and legal framework.

Measure 11: Broadening the scope of digital services provided on the national e-service portal

This measure is also rolled over from 2021 and the portal has been in place for several years. As it increases the efficiency of the administration and improves service delivery to citizens and businesses, it is important for improving the overall business environment and the ease of doing business. A large-scale, EU-funded project to upgrade the e-services portal with 139 new services for companies and businesses started in August 2020. The project identified most of the services that are to be included in this project, as well as the registers that need to be digitalised to allow for e-service delivery. Most of the new services should be functional in 2022. Currently 127 services are provided by administrative bodies that are accessible in the online portal, but only 50 provide for fully electronic interactions. The ERP explains the measure's purpose, timeline, impacts, and potential implementation risks clearly. These risks stem from the inefficient coordination and communication between State institutions, lack of IT human resources and lack of commitment at operational level. These risks should be clearly monitored and actions taken to mitigate them. The indicators used to measure implementation are appropriate, but the measure national strategic investments and country's policy guidance of the country on digital transformation could be better explained. A strategic approach on digital skills and access to broadband is lacking.

Economic integration performance

2020 was a very challenging year due to the COVID pandemic. North Macedonia had one of the highest trade levels in the region in 2019, but in 2020, pandemic-related export bans, restrictions on the movement of people, and closures of shops and services, led to a significant decline in imports and exports. Trade, tourism and transport, which are substantial drivers of growth in the economy, were the most affected, contracting by almost 12.3% (OECD, 2021). As one of the economies in the region with a greater level of integration into GVCs, it felt the immediate effects more severely (OECD, 2020). In particular, it suffered from the disruption to supply chains from the manufacturing slowdown in the People's Republic of China and reduced demand in the United States and especially the EU. Producers of machinery and equipment, and mechanical appliances were most affected (OECD, 2021). Although the EU remains the country's main trading partner, total bilateral trade declined by 12.9% in 2020, due to the COVID-19 pandemic, which was slightly worse than trade patterns elsewhere in the region. Total volume of trade in goods in 2020 was worth EUR 8.7 billion (2021: EUR 10.8 billion). In 2020, the EU accounted for 58% (2021: 61%) of North Macedonia's total trade in goods (74% of total exports (2021: 79%) and 46% (2021: also 46%) of total imports). After the EU, the UK and Serbia are the most significant trade partners of North Macedonia (representing 13% and 5% of total trade respectively in 2021). The main traded products are machinery and appliances, chemicals, and mineral products. In terms of foreign direct investment (FDI), the EU is also the country's main economic partner: EU companies

are by far the leading investors, accounting for about 64 % of FDI stock in North Macedonia in 2020, against 2.2% for Chinese companies and 0.5% for Russian companies. North Macedonia has an open economy and is highly integrated into international trade. The economy posts a high degree of trade openness with a trade to GDP ratio of 124% of GDP in 2020. This is slightly lower than in the preceding year, as trade volumes declined by significantly more than GDP. Exporting companies, notably SMEs, still face key obstacles to trade. These impediments are due to non-tariff barriers, including technical standards, but also administrative obstacles for trade in services (OECD, 2021). The insufficient quality of logistics is an impediment to further increases in exports. 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 18: Strengthening the market rules in North Macedonia

The measure is rolled over from 2021. Strengthened market surveillance began in January 2021 supported by EU funding. The measure continues to be relevant for country's planned internal market reforms and its further inclusion in the European single market, as indicated by the economic and investment plan. It is expected to improve the country's position by harmonising legislation with that of the EU in the area of free movement of goods, free movement of services, and market surveillance. 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 better explained.

Energy market reforms

An analysis of this area is partly included in the analysis of key challenge 3 in Section 5.1, namely energy sector modernisation and transition to clean energy. The electricity and gas markets are open for competition. The electricity transmission and distribution network operators are unbundled in accordance with the EU *acquis*. However, the gas transmission system operator is not yet unbundled in line with the Third Energy Package. Legislation is not yet aligned with the EU Regulation on wholesale energy market integrity and transparency. Regional market integration of North Macedonia requires significant improvement as the country has not implemented any market coupling with any of its neighbours, largely reflecting the lack of a day-ahead market. The market coupling project with Bulgaria hinges on the creation of a day-ahead market in North Macedonia (ECS, 2021).

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

Measure 9: Increasing the competitiveness of the electricity market

This measure is rolled over from the previous year. Given the energy crisis, it is very relevant. It aims to set up a more liquid and organised electricity market to allow more competition in energy supply for the benefit of customers. Additional efforts are needed to finally set up the day ahead market and couple with Bulgaria after years of delay. The activity looks ambitious as it plans to finish the process in 2022, though the roadmap is not yet finalised. The impact assessment part is not quantified

Transport market reforms

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, 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 of around 5%. The country's integrated road transport system reduces travel time by 17% and road fatalities by 16.6%, benefiting trade flows and the economy (ERP, 2022). The World Economic Forum's 2019 *Global*

Competitiveness Report ranks the country 84th out of 138 economies for transport infrastructure. Relatively low-quality transport infrastructure, as well as weak trade and transport logistics still present barriers for foreign companies aiming to invest in the country. These issues 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 ⁽³⁷⁾. This corridor will give the country's companies an alternative export option via Albanian and Bulgarian ports. North Macedonia would also benefit from opening up of its rail-transport market – at least for domestic and regional firms. At 32%, the fatality rate in traffic accidents is high and above the EU average. However, the national system for continuous road crash data collection is still to be set up and the action plans on road safety inspection and audit need to be followed up and implemented.

Measure 10: Implementation of an Intelligent Transport System (ITS) along Corridor X

This measure, linked also to the digital economy policy, is rolled over from the previous year. The ITS should be put in place along Road Corridor X from Tabanovce to Gevgelija, which is a strategic objective of the 2018-2030 national transport strategy. In parallel, a National ITS strategy should be finalised by mid-2022 which may be overoptimistic. The measure aims to improve the safety of road transport and ease traffic flow along Corridor X. Nevertheless, it remains 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's full potential impact on competitiveness and growth cannot be fully determined, given the insufficient analysis in the ERP and the lack of any estimate for savings (in cost and time).

Agriculture, industry and services

Agriculture, forestry, and fisheries accounts for 10.3% ⁽³⁸⁾ of gross value added and 12% of the country's employment (2020 data) making it the third largest sector in terms of employment. The agricultural sector is characterised by an unfavourable farming structure (large number of very small semi-subsistence farms) with mixed agricultural production on small and scattered land plots. Efficiency and productivity of the sector is low and, following the war in Ukraine, the lack of fertilizers has the potential to further significantly agricultural productivity. Data released by the State Statistical Office show an increase in food prices by 9.6% compared to February 2021 and the government has introduced various forms of mitigating measures, including subsidies. One of the major problems in the country's agricultural sector is the ageing of the labour force. About 15% of agricultural workers are young (15-24 years-old). Low incomes and unfavourable working conditions, as well as deteriorating living conditions in rural areas, discourage young people from starting a career in agriculture (FAO, 2021). The sector receives the largest portion of state aid, and subsidies to the sector have been increasing while production has been going down. To reform the agricultural sector to align it the EU common agricultural policy (CAP), involves the "decoupling" of farm subsidies, i.e. a shift to payments that are not linked to area and production levels of specific commodities, livestock numbers, and input use (FAO, 2020). There needs to be a stronger link between agricultural policies and other sectoral policies such as those on trade, education and SMEs. On the positive side, there is a good level of preparation in the area of food safety, veterinary and phytosanitary policy and absorption of EU funds under the Instrument for Pre-accession Assistance for rural development (IPARD II) has been improving. Opportunities of the sector include good access and distribution links to European markets and potential for structural improvement (land consolidation, producer groups, cooperatives). Several actions could be taken to increase productivity through innovation and the application of modern technologies. These actions include: (i) investing in the skills

⁽³⁷⁾ On 23 February, the WBIF endorsed a related flagship project: Construction of the final stretch of the rail corridor between Kumanovo in North Macedonia and Bulgaria will get underway with a €412 million investment. Electrification systems will also be installed on the entire railway line. This project will create over 200 new jobs, slash travel time, decrease pollution, and facilitate trade across the region and with the EU.

⁽³⁸⁾ Eurostat estimate.

and know-how of agricultural workers; (ii) strengthening the agriculture advisory services; and (iii) connecting agriculture with research, education, and tourism.

Measure 19: Modernisation of the post-harvest management of agricultural products from North Macedonia

This is a new measure. It is relevant as it is in line with the national priorities set out in the 2021-2028 national strategy for agriculture and rural development. The measure is ambitious enough to impact on the income of the involved farmers, agriculture co-operatives and producer organisations. The activities planned under this measure are based on the analysis and recommendations provided earlier by an EU-funded project that helped establish of the Common Market Organisation in North Macedonia. The description of the measure is adequate and its implementation is ensured through a World Bank loan (World Bank Agriculture Modernisation Project). Still, the lack of favourable legal framework for the setting up and operation of agricultural co-operatives might have a serious negative impact on the project. To mitigate the identified risks, swift clarification is needed on whether the locations for the purchase centres in Resen and Strumica and for the trading platform in Skopje have been identified and whether construction licences have been issued. Activities should include comprehensive details on the preparations for the construction. It should also be clarified whether construction activities will be continue in 2024. Complementary costs and related activities funded by IPA in 2023 and 2024 should be clarified in the activity table. The impact assessment is incomplete, as there is no quantification. The impact of the war in Ukraine on this new measure will have to be assessed.

The main obstacles to competitiveness in the country'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 (excl. construction) contributed 19% of the economy's gross value added and 23.9% of jobs in 2020. The structure of the industry is continuously improving with the industry's share of higher-value-added manufactured goods (machinery and equipment, chemical products) rising at the expense of basic goods (iron, steel and clothing). 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). No measure has been included for this area in the ERP.

North Macedonia has a sizeable and diverse service sector. The services sector accounts for 64.2% of gross value added and 57.1% of employment in 2020. 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 25% 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 (close to 40% of services exports). Close to 36% 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. Services provided by manufacturing companies (23% of services exports) have significant potential for growth because their development is closely related to the inflow of export-oriented FDI. No measure has been included for this area in the ERP.

Education and skills

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

Employment and the labour market

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

Social dialogue

Bipartite social dialogue in the private sector and the commitment of social partners to reinforce collective agreements remain weak. Only few enterprises have collective agreements at company or branch level. The tripartite Economic and Social Council (ESC) is actively involved in the elaboration of relevant legislation before its adoption, but participation is limited to proposal that fall under the competence of the Ministry of Labour and Social Policy. The visibility and impact of the ESC are low. On funding, the ESC depends on the budget of the Ministry of Labour and Social Policy for financing its activities and the secretariat. At the local level, despite some progress in raising awareness on the benefits of social dialogue, the utilisation of the Local Economic and Social Councils as an effective tool for formulation and implementation of local employment policies is still very limited. The 2021-2027 National Employment Strategy aims to strengthen the role of central and local-level social dialogue institutions, including by collective bargaining - the primary instrument for the setting of wages and other conditions of work by 2027.

Social protection and inclusion

The number of people at risk of poverty after social transfer rate slightly decreased by 0.3 pps to 21.9% in 2020. However, research estimations show that child poverty has increased during the pandemic. Social transfers, particularly pensions, are key for keeping individuals above the poverty line. Since 2020, the pension contribution rate has slightly increased from 18% to 18.8%. In the same period, the maximum allowed fee from pension contributions collected by private pension companies decreased from 2.25% to 2%. The government adopted the 2021-2027 national strategy for social entrepreneurship that aims to set up a favourable legal framework for social enterprises. However, the pandemic has hampered the update of other national social protection strategies. Although the Law on Social Protection strengthens their competencies, municipalities still do not sufficiently recognise their role in designing and adopting their own programmes in the field of social protection. Improving coordination between Public Employment Service (PES) and other services like social work centres, associations, social service providers, health sector, municipalities which have legal obligations to provide additional forms of social protection support, is another prerequisite for the success of the social reforms package. The social impact of the COVID-19 pandemic has been mitigated by enabling the access to Guaranteed Minimum Assistance (GMA) for individuals who lost their jobs during the pandemic.

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

Reform measure 3 aims to better targets cash transfers and increase their effectiveness by connecting them to labour market activation and social inclusion. This measure is considered crucial for tackling poverty in the country and is rolled over from the previous year with some amendments. 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 capacity of the bodies that are responsible for implementing, monitoring and enforcing the new Law has to be increased. The measure includes developing a new law to provide financial and technical support to social enterprises that focus on improving the employment prospects of vulnerable people, including people with disabilities. The measure also aims for a greater inclusion of people with disabilities in the open labour market and seeks to further deepen the cooperation between PES and Centres for Social Work to provide support and labour activation to employable GMA beneficiaries.

Healthcare

The country's healthcare system covers 90% of the population but its adequacy remains insufficient. The share of public expenditure was 4.2% of GDP in 2017, far below the EU-27 average of 7.8% in the same period. However, according to data of the Ministry of Finance the share reached 8.5% in 2020 due to the COVID-19 pandemic. Social security contributions accounted for 52.4% of total health budget in 2020. The contribution rate for the actively employed is 7.3% of their gross wage. The unemployed and those not covered by insurance from any other source pay 5.40% on 50% of the average national wage. Health insurance for injury at work and occupational diseases is paid by the employer (0.5% of the gross salary). The health insurance system provides a broad network of primary healthcare at the municipal level and an extensive network of secondary healthcare institutions. Categories lacking coverage include in particular farmers, people without identification documents and people in irregular jobs and with irregular incomes, most of which are Roma (UNICEF, 2016). Healthcare causes a significant financial burden on households: Up to 20% of the average total costs of medical treatment is paid out-of-pocket by the patient. However, robust statistical data on what out-of-pocket payments are used for is missing. In addition, distance or transportation problems and long waiting lists are among the most relevant unmet needs. EU Statistics on Income and Living Conditions (EU-SILC) data show that 20.5% of people in the country have difficulty using the healthcare service. This figure is close to the official number of people at risk of poverty suggesting that most who have difficulty in accessing healthcare may also be at risk of poverty. The Moj Termin eHealth system that was introduced in 2013 helped to significantly reduce waiting times and should be extended to primary care doctors. The National Health Strategy 2020 identifies strategic goals and is complemented by a strategy and action plan (2019-2023) to improve primary healthcare. However, low public expenditure on health and the major shortage of health professionals remain among the biggest challenges.

Measure 4: Strengthening the quality of the Primary Healthcare

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

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

Area/Sector	2016	2017	2018	2019	2020	EU-27 Average (2020 or most recent year)
Energy						
Energy imports dependency (%)	58.8%	56.2%	58.4%	58.1%	63.3%	57.5%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand euro	289.97	292.98	267.13	285.87	271.97	110.18
Share of renewable energy sources in final energy consumption (%)	18.04%	19.64%	18.18%	17.49%	19.22%	22.09%
Transport						
Railway Network Density (metres of line per km ² of land area)	26.85%	26.85 ^w	26.85 ^w	26.9 ^w	26.9 ^w	49.0 ⁽²⁰¹⁸⁾
Motorisation rate (Passenger cars per 1000 inhabitants)	190	194	200	205	206.7	519 ⁽²⁰¹⁸⁾
Agriculture						
Share of gross value added (agriculture, forestry and fishing)	10.6%	9.1%	9.8%	9.3% (p)	10.3 (e)	1.8%
Share of employment (Agriculture, Forestry and Fishing)	16.6%	16.2%	15.7%	13.9%	12.0	4.3%
Utilised agricultural area (% of total land area)	49.8%	49.8%	49.7%	49.7%	50.0	40.6%
Industry						
Share of gross value added (except construction)	19.7%	20.5%	21.5%	20.7%	19%	19.5%
Contribution to employment (% of total employment)	23.1%	23.3%	23.9%	24.1%	23.9%	18.2%
Services						
Share of gross value added	61.7%	62.9%	62.5%	63.6%	64.2%	73.1%
Contribution to employment (% of total employment)	53.1%	53.2%	52.9%	55.0%	57.1	71,0%

Business environment						
Rank in Global Competitiveness Index (Source: World Economic Forum)	63	60	84	82	N/A	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	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%	N/A	2,32%
R&D expenditure – EUR per inhabitant	20.30€	17.20€	18.8€	19.9€	N/A	694.6€
Digital economy						
Percentage of households who have internet access at home	75%	74%	79%	82%	79%	91%
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	72%	75%	79%	81%	81%	88%
Trade						
Export of goods and services (as % of GDP)	50.7%	55.1%	60.4%	62.3% (p)	58.1% (e)	46.7%
Import of goods and services (as % of GDP)	65.5%	69.0%	72.8%	76.5% (p)	70.9 (e)	42.9%
Trade balance (as % of GDP)	-18.5%	-18.1%	-16.8%	-18.2%	- 16.9%	N/A
Education and skills						
Early leavers from education and training (% of population aged 18-24)	9.9%	8.5%	7.1%	7.1%	5,7%	9,9%
Young people neither in employment nor in education and training (NEET) (% of population aged 15-29)	31.3%	31.1%	29.8%	24.5%	26.2%	13.7%
Children aged less than 3 years in formal child care (% of under 3-years-olds)	9.1%	10.3%	8.8%	13.0%	N/A	32.3
Individuals who have basic or above basic overall digital skills (% of population 16-74)	34%	32%	N/A	32%	N/A	N/A

Employment and labour market						
Employment Rate (% of population aged 20-64)	53.3%	54.8%	56.1%	59.2%	59.1%	71.7%
Unemployment rate (% of labour force aged 15-74)	23.7%	22.4%	20.8%	17.3%	16.4%	7.2%
Long term unemployment rate (% of labour force aged 15-74)	19.1%	17.4%	15.5%	12.4%	12.4%	2.5%
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.	19.9 pps.	11.0 pps.
Disability employment gap (Percentage points difference in employment rates between people with and without a disability)	28.4 pps.	29.4 pps.	27.1 pps.	28.6 pps.	N/A	24.5 pps.
Real gross disposable income of households (Per capita increase, Index = 2008)	N/A	N/A	N/A	N/A	N/A	N/A
Social protection system						
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	39.2%	37.0%	35.3%	34.2%	N/A	21.9%
Impact of social transfers (other than pensions) on poverty reduction	14.80%	14.29%	14.79%	15.00%	N/A	32.68%
Income inequality - quintile share ratio (S80/S20) (Comparison ratio of total income received by the 20% of the population with the highest income to that received by the 20% with the lowest income)	6.63	6.38	6.16	5.56	N/A	5.24
Housing cost overburden (% of population)	12.5%	11.7%	10.2%	9.9%	N/A	10.0%

Healthcare						
Self-reported unmet need for medical care (of people over 16)	2.9%	2.5%	2.3%	2.5%	N/A	1.8%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	35.32% ^z	42.43% ^z	42.11% ^z	40.38% ^z	N/A	15.57% ⁽²⁰¹⁸⁾

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

e: estimate (Eurostat).

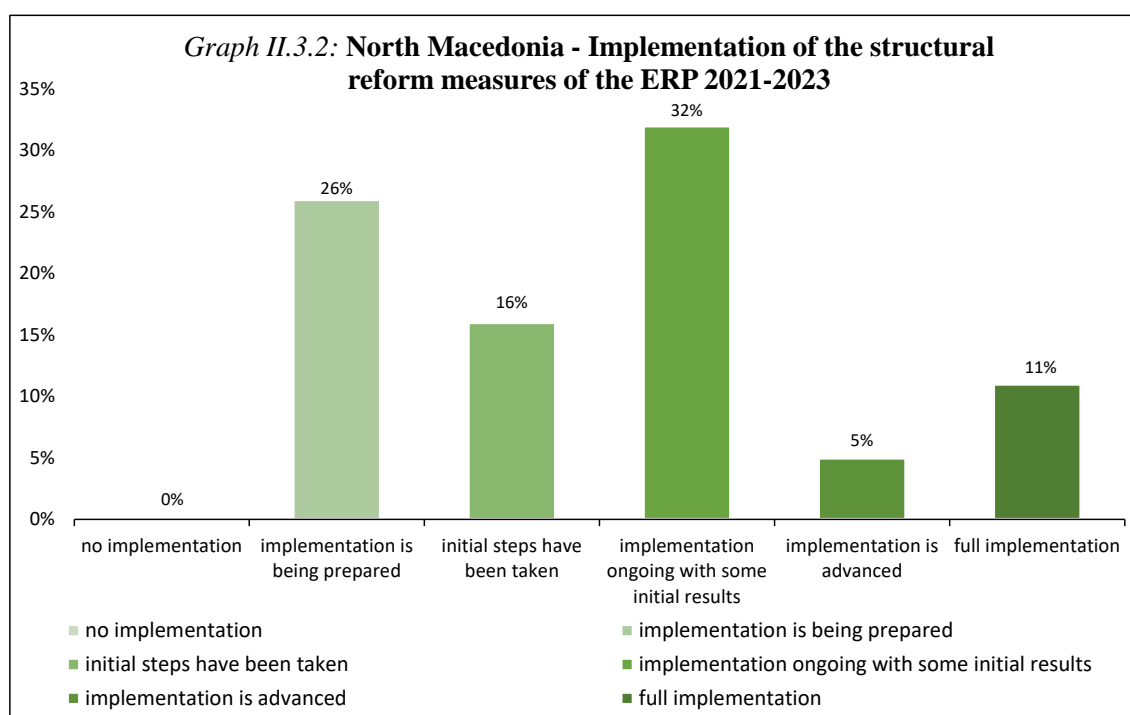
p: provisional (Eurostat).

z: data from World Health Organization.

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

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM 2021-2023 ERP

While continuing to tackle the impact of COVID-19 pandemic, in 2021, a robust economic recovery set in and the structural reform momentum has been broadly maintained. Progress was made in implementing the measures from last year's ERP (average score: 2.6 out of 5). Activity reports provide a mostly accurate description of the level of implementation. The scoring is somewhat imprecise for the measures related to agricultural development and social sector. Implementation is stronger for some measures, such as measures 2 on promotion of renewable energy sources 9 on e-market place for low-value procurement and 15 on trade facilitation. In contrast, implementation is weaker for other measures, such as measure 4 related to the implementation of an intelligent transport system along corridor X and measure 20 on strengthening primary healthcare where implementation is very limited.



ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government of North Macedonia submitted the 2022-2024 ERP on 31 January 2022. 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 28 January. The coordination process worked well and the attendance to technical meetings was good.

Stakeholder consultation

The draft of the 2022-2024 ERP's structural reforms was posted on the Ministry of Finance's website from 10 to 24 December. Interested parties were also invited to send written contributions. Comments and suggestions received in writing are attached as an annex to the ERP.

Macroeconomic framework

The macroeconomic framework is coherent and consistent, while somewhat optimistic. The ERP presents two alternative scenarios compared to the baseline: (i) assuming lower 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 2021. In line with the revised economic growth assumptions, the ERP has raised the deficit projections for 2022 and 2023, 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. Reform areas which have not or only partly been included as key challenges in Section 5.1. should have been analysed more in depth in Section 5.2. 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 consistent with other national plans and strategies. The description of the implementation risks and mitigation measures continues to improve. The ERP includes 20 measures and exceeds the page limit. Prioritisation of reform measures has focused on addressing the key structural challenges identified. The measure on strengthening the quality of primary healthcare is also prioritised reflecting the needs of COVID-19 pandemic. Tables 9-11 in the annex are properly completed. The implementation reports of the 2021-2023 ERP's policy guidance and Table 11 in annex

are well prepared. The scores attributed largely reflect the implementation level. Though not explicitly requested by the guidance note, additional useful information was provided in Annex 2a (links between reform measures and ongoing or planned investments) or summarised in Annex 4 (result indicators of structural reform measures). Contributions received by external stakeholders during the consultation process were annexed to the document.

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4. SERBIA

The economic reform programme (ERP) was submitted on 31 January 2022.

The economic consequences of Russia's war against Ukraine may render the macro-fiscal scenarios presented in the ERP partially obsolete. The Commission will publish its updated macroeconomic and fiscal projections for candidate countries, reflecting the expected impact of the war against Ukraine and related sanctions, in its spring economic forecast in mid-May 2022.

The short-term macro-fiscal outlook may change considerably. However, the major medium-term fiscal and structural reform challenges and priorities identified in this assessment remain valid irrespective of the short-term outlook. Appropriate policy responses are essential to ensure a sustained economic recovery, greater resilience and fiscal sustainability.

4.1. EXECUTIVE SUMMARY

After a strong rebound in 2021, Serbia's economic reform programme (ERP) forecasts the economy will grow more quickly in 2022-2024 than before the COVID-19 crisis. After a relatively mild contraction in 2020, the economy rebounded strongly in 2021 thanks to higher private consumption, investment and government consumption. The ERP projects further strong GDP growth of close to 5% on average in 2022-2024, i.e. around one percentage point (1 pp.) above the pre-crisis growth rates, driven by private consumption, investment and exports. Mostly due to rising food and energy prices, consumer price inflation surged from 3% to almost 8% in the second half of 2021 but the ERP expects it to slow to more moderate levels as of mid-2022. The current account deficit broadly stabilised in 2021 and is expected to widen only slightly in 2022-2024. The financial sector has recorded further credit growth while macro-prudential risk indicators have remained sound. In a context of high uncertainty, the growth outlook for 2022 is, as elsewhere, subject to a series of downside risks associated with Russia's war against Ukraine, the future course of the COVID-19 pandemic, global inflationary pressures and potentially tightening financial conditions. War-related risks in particular could push energy and food prices even higher and affect external trade by holding back growth in Serbia's main EU trading partners.

The fiscal strategy projects a gradual return to a budget close to balance over the medium term. The strong economic rebound and lower fiscal support measures led to a marked decrease in the general government deficit to 4.1% of GDP in 2021, despite strong increases in capital expenditure. The 2022 budget aims to further lower the deficit, to 3% of GDP, mostly through the non-renewal of COVID-19 crisis support. Further gradual fiscal consolidation is projected to bring the budget close to balance in 2023 and 2024, mainly as a result of expenditure growing more slowly than nominal GDP. The debt-to-GDP ratio slightly decreased to 57.1% in 2021 and is expected to decline further in 2022-2024. Significant gaps in fiscal governance remain unaddressed, mainly concerning 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 backed up by reforms.** Serbia has been able to very substantially mitigate the COVID-19 crisis by using available fiscal buffers and is projected to go on achieving good macro-fiscal results. Given the high degree of uncertainty about potential further pandemic effects and the impact of Russia's war against Ukraine, standing ready to provide crisis mitigation if needed seems appropriate. A gradual return to a budget close to balance, contingent on the economic outlook, is key to rebuilding fiscal space in the medium term. For medium-term expenditure restraint, containing spending on wages continues to be a key

challenge. Overall fiscal performance has been sensitive to the economic and political cycle over the last two decades, so well-designed fiscal rules could provide a more effective framework for public finances and help institutionalise sound fiscal policies.

- **There is further scope for managing fiscal risks and improving revenue administration.** Greater transparency around fiscal risks would make them easier to address. This is particularly true for state-owned enterprises, where there are governance deficiencies and incomplete restructuring and privatisation that still represent a substantial risk to public finances. On the revenue side, there is scope for further improvements in the tax administration.
- **Serbia's business environment is improving, with the regulatory and administrative burdens easing, but significant structural challenges continue to hamper competitiveness and growth potential for the private sector and the economy as a whole.** The role of the state in the economy is decreasing but still remains widespread, with privatisation efforts and efforts to improve the management of state-owned enterprises lagging behind. Structural challenges remain for state aid, competition and public procurement, where existing legislation is good but is not implemented consistently enough and can be circumvented through special procedures. Further efforts are needed to improve the transparency, assessment and prioritisation of public investments. Business is also affected by a lack of transparency and predictability in the way business-related legislation is adopted. The shadow economy remains a major impediment to the development of a strong business sector and the consolidation of a functioning market economy.
- **Serbia remains highly dependent on coal and, though work has begun to address this, there is still no joined-up long-term strategy combining 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 is a big concern in the country. Major investment is needed to modernise the country's energy infrastructure and lower carbon emissions with a view to accelerating the green transition. More must be done to diversify supply and Serbia's overall energy mix and especially to reduce dependency on Russian gas.
- **The share of young people not in employment, education or training remains high.** School-to-work transitions are considerably more difficult than in the EU on average. The introduction of the Youth Guarantee aims to address these challenges, support labour market integration and ensure that no young person is left behind. At the same time, workers from across the occupational spectrum continue to emigrate. The low labour market participation of women remains an issue. In addition, the number of people at risk of poverty remains high, and public expenditure on social protection is not sufficient.

The policy guidance in the conclusions of the economic and financial dialogue of July 2021 has been partially implemented. The authorities provided substantial additional, but mostly untargeted, pandemic-related fiscal support in 2021, while the 2022 budget and medium-term fiscal strategy effectively plan a gradual return to a deficit close to balance. Following a decline in 2021 due to high nominal GDP growth, overall spending on wages as a percentage of GDP is projected to remain stable, but no wage indexation mechanism has been adopted and public-sector wage system reform has been postponed to 2025. The adoption of new fiscal rules has also been postponed by another year due to the COVID-19 crisis. Deadlines for the new model of electronic fiscalisation and transition to electronic invoicing have broadly been met. While the Ministry of Finance appears to have brought in a more robust fiscal risk analysis, the results do not seem to have been made publicly available. The first steps in the action plan for the new state-owned enterprise ownership and management strategy have been partially implemented. Serbia is still not prioritising investments in a harmonised manner based on relevant assessments, and issues remain in the areas of competition and state-aid, as well as in the area of public procurement where the special law on linear infrastructure projects remains in place. The work to develop a long-term energy and

climate strategy is only slowly progressing, and the renewable energy sources auction system has been delayed. There was no measure to increase the adequacy of benefits for individuals and families under the financial social assistance scheme to reduce poverty. Partial progress has been made to facilitate school-to-work transitions by stepping up further vocational education and training and to develop a Youth Guarantee implementation plan.

The economic reform programme is aligned in part with the reform priorities identified by the Commission. The macroeconomic and fiscal frameworks are sufficiently comprehensive and integrated with overall policy objectives, providing a suitable basis for policy discussions. 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 and introduces a new welcome reform measure aimed to improve the management of SoEs. The ERP also lacks ambitious reforms on the green transition including regarding clean energy transition and energy efficiency, which has been identified as one of the key structural challenges. The shared European growth model regarding green and digital transition will also have to be reinforced in the ERP process, even more so in the current geopolitical context. On digital transformation, Serbia should now focus on well-targeted reforms and improving Serbia's communications infrastructure, particularly broadband roll-out. The ERP diagnoses the challenges in the areas of social protection and poverty reduction, education, employment and social policies, but the proposed measures lack clearly defined objectives.

4.2. ECONOMIC OUTLOOK AND RISKS

After a relatively mild contraction in 2020, the Serbian economy recorded a strong rebound in 2021 to well above its pre-COVID-19 crisis level. Real GDP growth in 2021, reaching 7.4%, was mostly driven by increases in private consumption, gross fixed capital formation and public consumption that were only slightly offset by a negative contribution of net exports to growth. The rebound of private consumption was particularly supported by a new fiscal stimulus programme worth around 2% of GDP and additional liquidity support measures of similar size. On the supply side, the recovery was chiefly driven by services, construction and industry. After the record harvest in 2020, which created a high base, the drought-hit agriculture sector had a negative contribution to GDP growth. Following a decrease in the unemployment rate in 2020, driven by falling labour market participation, the annual unemployment rate recorded a slight increase in 2021 as the pace of return of discouraged workers to the labour market initially exceeded the growth of employment.

The ERP baseline scenario forecasts that the pace of output expansion will significantly exceed pre-COVID-19 crisis growth rates in 2022-2024. Following a projected 4.5% expansion in 2022 (half a percentage point (0.5 pps.) above the projection in the previous ERP), annual GDP growth is projected to accelerate further to 5.0% annually in 2023 and 2024, around 1 pp. above the pre-crisis rate (that was also the baseline projection for 2023 in the previous ERP). The strong and accelerating post-crisis expansion is expected to be mostly driven by private consumption and gross fixed capital formation and to be accompanied by better net export figures. Export growth is expected to substantially exceed import growth, by around 2 pps. annually. As a result, the contribution of net exports to GDP growth is expected to turn positive in 2022 and reach 0.4 pps. in both 2023 and 2024, in spite of the structurally higher share of imports in GDP. After closing in 2021 due to the strong rebound, the output gap is projected to remain close to balance in 2022 and thereafter as potential growth and real growth are projected at similar levels, mostly due to a sharp rise in total factor productivity. In line with the steady expansion, the annual unemployment rate is projected to resume its pre-crisis downward trend as of 2022, decreasing by 1 pp. annually to 8% in 2024.

Some aspects of the macroeconomic scenario seem optimistic, particularly in a context of high uncertainty. The growth outlook continues to be affected by a high degree of uncertainty around the recovery from the COVID-19 pandemic and the economic impact of Russia's war against Ukraine. Overall, before the war, the macroeconomic scenario appeared plausible for 2022 and somewhat optimistic thereafter. The projected strong growth in imports appears in line with rising investment and private consumption and the recent track record of import elasticities. However, the expected positive contribution of net exports to growth crucially hinges on a further substantial expansion of new export capacities. Potentially protracted supply chain bottlenecks in main trading partners, particularly the EU, may also weigh on export performance. As regards potential growth, while FDI inflows, domestic innovative activity, digitalisation and structural reforms may indeed increase the contribution of total factor productivity to potential growth rates, the strong projected annual increase in GDP as of 2022 nonetheless appears challenging in view of the substantially lower pre-crisis track record under similar conditions. Real growth might, accordingly, be constrained at some point by limitations in potential growth, which may then also entail additional inflationary pressures.

Table II.4.1:

Serbia - Comparison of macroeconomic developments and forecasts

	2020		2021		2022		2023		2024	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	-0.9	-0.9	6.7	7.0	4.3	4.5	4.3	5.0	n.a.	5.0
<i>Contributions:</i>										
- Final domestic demand	-1.3	-1.3	7.6	8.2	4.6	4.4	4.5	4.6	n.a.	4.6
- Change in inventories	0.3	0.3	0.0	-0.5	-0.1	0.0	-0.1	0.0	n.a.	0.0
- External balance of goods and services	0.1	0.1	-1.0	-0.7	-0.2	0.2	-0.1	0.4	n.a.	0.4
Employment (% change)	-0.2	-0.3	2.0	1.2	1.1	1.1	1.0	1.2	n.a.	1.2
Unemployment rate (%)	9.0	10.1	10.7	11.0	10.0	10.2	9.2	9.1	n.a.	8.0
GDP deflator (% change)	2.4	2.4	4.8	4.7	4.1	3.0	3.0	2.9	n.a.	2.8
CPI inflation (%)	1.6	1.6	3.6	4.0	3.6	4.9	2.6	3.0	n.a.	3.0
Current account balance (% of GDP)	-4.1	-4.1	-4.4	-4.1	-4.3	-4.4	-4.1	-4.4	n.a.	-4.8
General government balance (% of GDP)	-8.0	-8.0	-4.9	-4.9	-2.7	-3.0	-1.6	-1.5	n.a.	-1.0
Government gross debt (% of GDP)	57.8	57.8	58.1	58.2	56.3	56.5	54.1	55.3	n.a.	53.8

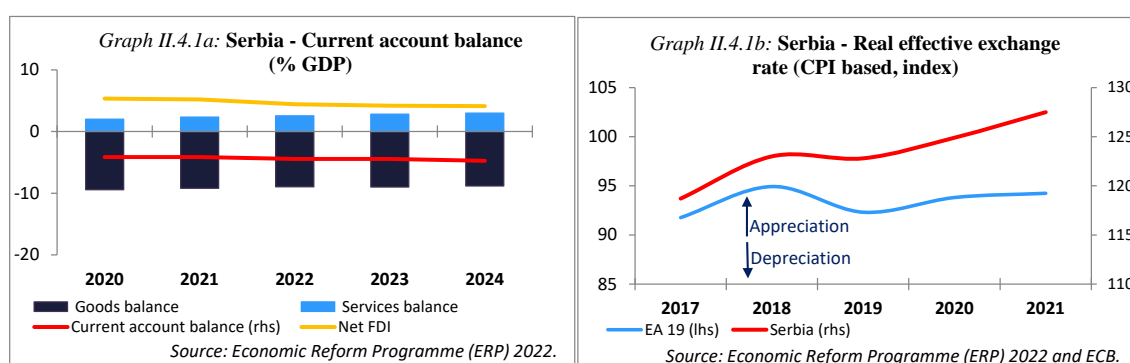
Sources: Economic Reform Programme (ERP) 2022, Commission Autumn 2021 forecast (COM).

The ERP presents a clear and comprehensive view of economic risks prior to the impact of Russia's war against Ukraine and it includes a detailed alternative macroeconomic scenario. The programme identifies numerous risks to the baseline scenario largely related to uncertainty about the future course of the pandemic and the effectiveness of policy responses. The chief outlined risks are: potential new waves of the pandemic, rising energy and commodity prices, persistent supply chain bottlenecks and labour market imbalances that could accelerate global inflation and potentially tighten financial conditions. Thus, risks from the international environment are considered to be tilted to the downside, while domestic risks are considered to be slightly tilted to the upside in the short term due to Serbia's role as a net exporter of basic metals and ores, its increasing export capacities, structural reforms and improving business environment. Russia's war against Ukraine, that started around a month after the submission of the ERP, is set to hit Serbia's economy via various transmission channels, in particular via even higher energy and food prices, thereby fuelling inflation, reducing disposable incomes and private consumption. External trade, foreign direct investment and remittances are also set to be affected due to war-induced lower growth prospects in Serbia's main EU trading partners. The programme presents an alternative macroeconomic and fiscal scenario, projecting substantially lower economic growth (only 2.0% in 2020, 3.0% in 2023 and 3.5% in 2024) and less favourable fiscal performance in the event of pronounced cost pressures on inflation, in particular from higher energy and commodity prices, and a potential tightening of global financial conditions, negatively affecting investment and resulting in lower growth of private consumption due to lower real disposable income. However, though the alternative scenario very usefully

points to the potential magnitude of risks related to global inflationary pressures, the ERP does not specify the scenario's underlying assumptions in sufficient detail to allow for a further assessment.

Consumer price inflation surged in the second half of 2021 but the ERP expects it to ease as of mid-2022 and to remain around the target in 2023 and 2024. Following a track record of low and rather stable inflation for seven consecutive years, consumer price inflation rose strongly in 2021 to an annual average of 4.0%. This was due to a steady surge in the second half of the year, with the inflation rate reaching 7.9% year on year in December, well above the upper end of the central bank's target tolerance band of $3\% \pm 1.5$ pps. The strong increase in headline inflation was mostly driven by food and energy prices while core inflation (excluding energy, food, alcohol and tobacco) rose more moderately to 3.5% in December 2021. The central bank maintained the key policy rate at the record low level of 1.0% throughout 2021 but phased out extraordinary measures providing foreign exchange and dinar liquidity as of March and October, respectively. Moreover, as a further step to reduce monetary accommodation, the National Bank of Serbia also gradually increased the average rate of repurchase agreement (repo) sales of securities by around 70 basis points from 0.11% in October 2021 to 0.79% in mid-February 2022. To stabilise the exchange rate, particularly in view of some dinar appreciation pressures in the summer, the central bank continued to apply its policy of frequent interventions on both sides of the foreign exchange market, buying a net EUR 850 million up to November 2021. The ERP projects inflation will hover above the upper bound of the target tolerance band until mid-2022 and gradually return to the lower half of the band by the end of the year, resulting in an average inflation projection of 4.9% for 2022. The programme anticipates that the effects of energy and food price hikes and supply chain disruptions will wear off by the end of 2022, and does not forecast any major inflationary pressures from aggregate demand. On that basis, inflation is projected to remain around the central point of the target band in 2023 and 2024. Overall, the inflation projections appeared plausible prior to the potential additional inflationary impact of Russia's war against Ukraine. They assumed that the 2021 price surges would be temporary and supply chain disruptions promptly resolved. However, if inflation rates stay significantly above target for a prolonged period, as they may due to the impact of Russia's war against Ukraine, this could induce a series of knock-on effects for core inflation. As stated in the programme, the National Bank of Serbia stands ready to respond promptly, using all available monetary policy instruments if any of the risks materialise that would keep inflation above the upper bound of the target band for a prolonged period.

External competitiveness and current account



The current account deficit has slightly increased in 2021 and the ERP expects it to widen further slightly in 2022-2024. The deficit widened from 4.1% of GDP in 2020 to 4.4% of GDP in 2021. A higher merchandise trade deficit and primary income deficit (reflecting mainly a rebound in reinvested earnings and dividends) were largely offset by a higher surplus on the secondary income (reflecting in particular a rebound in workers' remittances) and the services trade balance. According to the ERP's projections, the current account deficit is set to gradually widen to 4.8% of GDP by 2024. This is based mainly on forecasts of a higher primary income deficit, in particular from higher reinvested earnings in line with

strong inward foreign direct investment and shrinking remittances in percentage of GDP. These balance-deteriorating factors are expected to be partially offset by improving goods and services trade balances (reflecting in particular a foreign-direct-investment-driven increase in export capacities). However, the strong projected growth in domestic demand may lead to a less favourable differential between export and import growth.

Net inflows of foreign direct investment continue to play a central role for external sustainability and competitiveness. In 2020, net inflows had fallen substantially to EUR 2.9 billion or 6.3% of GDP, despite the privatisation of *Komercijalna Banka*, which alone attracted an inflow amounting to 0.8% of GDP. In 2021, however, net inflows rebounded strongly, largely recovering their 2019 record level of EUR 3.6 billion (6.8% of 2021 GDP). They thus continued to fully cover the current account deficit. After the rebound in 2021, the ERP projects that net foreign direct investment will decrease to EUR 2.9 billion in 2022 and increase only moderately to EUR 3.3 billion by 2024. On these projections, despite a gradual decrease in GDP terms, it will still cover the current account deficit in full. Inflows of foreign direct investment are also considered crucial for the ongoing structural transformation of the economy towards tradable sectors. With continued government support for foreign investors, the sustained inflow of foreign direct investment appears plausible, provided macroeconomic stability is maintained and the business environment is further improved. Thanks to the very high net inflow in 2021, the stock of net foreign direct investment in Serbia's net international investment position increased its share to 96% (as of Q3-2021) despite the simultaneous increase in net portfolio debt from high external public debt issuance in the COVID-19 crisis. This reduces Serbia's vulnerability to external shocks, though the net foreign liability position is relatively high at 82% of GDP in Q3-2021 (down by 9 pps from the end of 2020 thanks to very high nominal GDP growth). The relatively high level of foreign exchange reserves, which helped cushion the impact of the crisis in 2020, rose further in 2021. It is expected they will continue to cover at least five months' worth of imports throughout the programme's lifetime.

The financial sector recorded further credit growth while maintaining sound macro-prudential indicators. Lending activity continued to grow in 2021, supported by accommodative monetary policy, the extension of government guarantee schemes and the continuation of COVID-19 crisis-related regulatory forbearance measures. Up to September the pace of credit growth was somewhat slower due to the strong base effect of the 2020 credit moratoria, but it picked up in the fourth quarter to 10.3% year on year for households and 8.3% year on year for business in November. A large share of the growth in business lending was not for investment but for liquidity and working capital, which still suggests some vulnerabilities. After a slight increase to 3.9% in the first quarter, the non-performing loan ratio declined slightly in the second quarter to 3.6% and remained broadly stable in the third quarter of 2021. Though the profitability indicators recorded a fall in 2020 in the crisis, they seem to have broadly stabilised in 2021.

Table II.4.2:

Serbia - Financial sector indicators

	2017	2018	2019	2020	2021
Total assets of the banking system (EUR million)	37 676	41 514	45 838	50 775	56 792
Foreign ownership of banking system (%)	76.9	75.4	75.7	86.0	86.0
Credit growth (aop)	2.4	4.3	9.7	12.3	9.1
Deposit growth (aop)	7.9	7.4	12.9	15.0	14.4
Loan-to-deposit ratio (eop)	1.00	1.00	0.96	0.91	0.88
Financial soundness indicators (eop)					
- non-performing loans	9.8	5.7	4.1	3.7	3.6
- net capital to risk-weighted assets	22.6	22.3	23.4	22.4	20.8
- liquid assets to total assets	35.1	35.7	36.0	37.3	37.7
- return on equity	10.5	11.3	9.8	6.5	7.8
- forex loans to total loans* (%)	67.5	68.5	67.1	64.7	63.2

* Includes both denominated and indexed positions.

Note: Data for December 2021 are preliminary.

Sources: ERP 2022, National Central Bank.

4.3. PUBLIC FINANCE

The economic rebound and the scaling back of fiscal support measures helped to substantially improve the budget balance in 2021, notwithstanding strong increases in capital expenditure. As a result of very good revenue performance from the economic rebound, the general government deficit almost halved from 8.0% of GDP in 2020 to 4.1% of GDP in 2021. It thus approached the original 2021 budget deficit target of 3.0% despite very substantial expenditure increases for a new COVID-19 crisis support package, increased healthcare and capital expenditure, that were included in two amending budgets in April and October, and substantial liquidity support to Srbijagas at the end of the year. At the beginning of the year, in view of the protracted impact of the pandemic, the government announced a new package of fiscal support measures that was included in a first amending budget in April 2021. The package included 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 package was later complemented by a vaccination bonus, further lump-sum payments to all citizens and limited specific support to unemployed people. The planned direct fiscal cost of the additional 2021 support measures amounted to 2.3% of GDP (compared to 8.4% of GDP of discretionary fiscal support in 2020). While continued fiscal support appears adequate 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. The further extension of the existing and the setup of a new guarantee scheme to support the most affected sectors/enterprises have also contributed to ensure continued liquidity for businesses. The additional 2021 measures were 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 beyond. The application of the measures to all companies and adult citizens applying to receive them ensured a high level of transparency and equal treatment in the distribution of the support. On top of the additional support package, the April amending budget also included a substantial increase in capital expenditure, both for infrastructure and new arms purchases, and higher healthcare expenditure, bringing the revised 2021 deficit projection to 6.9% of GDP which was reduced to 4.9% of GDP in a second 2021 amending budget in October. Despite high budget support to Srbijagas of around 0.5% of GDP at the end of the year, the overall 2021 general government budget deficit then turned out at 4.1% of GDP, supported in particular by lower implementation of capital expenditure and a surplus of local administration.

Very strong revenue performance more than offset further expenditure increases in 2021, allowing for a substantial reduction in the general government deficit outturn. Overall revenue increased by 20.3% year on year while overall expenditure increased by 10.1% year on year. Expressed as a share of GDP, total revenue increased by 2.3 pps, while total spending decreased by 1.6 pps due to very high nominal GDP growth. The most significant revenue increases were from social security contributions (+1.6 pps) and VAT (+0.5 pps). On the expenditure side, only capital spending increased faster than nominal GDP (+2.1 pps). As a result of the very high rise in nominal GDP (up 13.9%), the *ex post* share of public wages in GDP fell from 10.5% in 2020 to 10.0% in 2021. In addition to the measures with direct budgetary impact, the 2021 fiscal support packages also included the extension of the 2020 guarantee scheme and the setting up of a new guarantee scheme for loans with a total new volume of 1.9% of GDP in 2021. ⁽³⁹⁾ This brought the total planned size of the package of fiscal and liquidity-support measures in 2021 to 4.2% of GDP (see overview table below).

Box II.4.1: Review of the package of fiscal and liquidity-support measures to support the economy and the population in 2021 (planned amounts)

2021	Planned	
	in bill of RSD	in % of GDP
Direct support to private sector		
Direct support to private sector – 3 months 50% of minimum salary for all entrepreneurs, micro, small and medium enterprises	52	0.8
Direct support to hotels in urban areas	1.2	0.0
Direct support to industries - hospitality, travel agencies, hotels and car agencies	4.1	0.1
Independent artists	0.3	0.0
Direct support to industries – transport of passengers in road traffic and bus operators – EUR 600 per bus	2.7	0.0
Total	60.3	1.0
Measures to preserve private sector liquidity		
Extension of the existing guarantee scheme to support the economy during the	60	1.0
Establishment of a new guarantee scheme to support the most affected sectors /	60	1.0
Total	120.0	1.9
Other measures		
Fiscal incentives – incentives to promote domestic demand	73.1	1.2
Vaccination bonus	7.1	0.1
Total	80.2	1.3
Estimated effects of fiscal measures	140.5	2.3
Total, package of measures	260.5	4.2

Source: ERP 2022-2024

⁽³⁹⁾ The 2022 ERP does not provide any updated estimates on potential guarantee calls from the guarantee schemes. At a maximum call rate at portfolio level of 30%, the guarantee schemes would entail a contingent liability of around 0.6% of GDP. However, the 2021 ERP estimated that calls on the similar-sized 2020 guarantee scheme would not exceed a cumulative total of around 0.3% of GDP over 2022-2023.

Table II.4.3:

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

	2020	2021	2022	2023	2024	Change: 2021-24
Revenues	41.0	43.5	42.2	41.4	41.1	-2.3
- Taxes and social security contributions	36.2	38.9	38.1	37.4	37.3	-1.6
- Other (residual)	4.8	4.6	4.2	4.0	3.8	-0.8
Expenditure	49.0	48.4	45.3	42.9	42.1	-6.3
- Primary expenditure	47.0	46.6	43.5	41.2	40.4	-6.2
<i>of which:</i>						
Gross fixed capital formation	5.3	7.8	7.3	6.9	6.9	-0.8
Consumption	18.5	18.2	17.8	17.5	17.2	-1.1
Transfers & subsidies	19.2	17.4	16.3	15.0	14.6	-2.8
Other (residual)	3.9	3.2	2.0	1.8	1.7	-1.4
- Interest payments	2.0	1.8	1.8	1.8	1.7	-0.1
Budget balance	-8.0	-4.9	-3.0	-1.5	-1.0	4.0
- Cyclically adjusted	-7.1	-5.0	-3.0	-1.6	-1.1	3.9
Primary balance	-6.0	-3.1	-1.2	0.2	0.7	3.8
- Cyclically adjusted	-5.1	-3.1	-1.2	0.1	0.6	3.7
Gross debt level	57.8	58.2	56.5	55.3	53.8	-4.4

Sources: Economic Reform Programme (ERP) 2022, Commission calculations.

A gradual return to a budget close to balance is a welcome objective of the ERP's fiscal strategy over the medium-term. Following the spring 2021 decision to renew substantial COVID-19 crisis support and significantly increase capital spending, the fiscal consolidation path planned by the previous ERP 2021-2023 has broadly been postponed by one year and included accordingly in the ERP 2022-2024. With the projected reduction of the deficit to 3% of GDP in 2022, 1.5% in 2023 and 1.0% in 2024, the debt-to-GDP ratio is expected to continue falling in 2022. The overall planned fiscal stance appears appropriate to ensure medium-term fiscal sustainability. On the revenue side, the ERP expects most categories to keep their share of GDP broadly stable over the programme period. However, some one-off factors that boosted revenue in 2021 are not projected to recur in 2022 and 2023, leading to a declining revenue share in GDP by -1.3 pps. and -0.8 pps. respectively in those two years. Having received a particular boost from deferred corporate income tax payments in 2021, the revenue ratio is forecast to decline by 0.3 pps. in 2022 (compared with the 2021 outturn). Following very favourable collection in 2021, VAT is also projected with a very conservative elasticity in 2022, leading to a 0.2 pps. decline in the revenue ratio in 2022. As in previous years, the programme uses low estimates for non-tax revenue based on the conservative exclusion of extraordinary non-tax revenues⁽⁴⁰⁾ for future budget planning (entailing a -0.5 pps drop in 2022). In 2023, though VAT, business and personal income tax are projected to increase broadly in line with nominal GDP, revenue as a share of GDP is still expected to decrease by 0.8 pps. overall, chiefly due to the phasing-out in 2021 and 2022 of the deferred payment of 2020 social contributions (inducing a 0.3 pps. annual drop in revenue as a share of GDP in 2023) and the conservative assumption of a yearly decrease of tobacco sales (inducing a 0.2 pps. annual drop).

Under ERP plans, the improving fiscal balance will be chiefly driven by a frontloaded decrease in expenditure-to-GDP ratios, largely due to waning COVID-19 crisis support, while the projected containment in later years appears not to be fully backed by concrete measures. The planned fiscal consolidation is entirely concentrated on the expenditure side, to be achieved by not renewing crisis-related one-off emergency expenditure in 2022 and containing expenditure growth below nominal GDP growth for most categories over 2022-2024. The overall share of expenditure in GDP is projected to

⁽⁴⁰⁾ Regular non-tax revenues comprise various fees, charges, revenues of bodies, etc. generated at a steady pace over the year with some seasonal variations, while extraordinary non-tax revenues include profits of public companies and agencies, budget dividends, etc.

decrease by 5.3 pps by 2024 as compared to the 2021 outturn ⁽⁴¹⁾, supported in particular by decreases in subsidies (-1.4 pps.), other current expenditure (-1.1 pps.), social assistance (-1.0 pp.), purchases of goods and services (-0.7 pps.), net budget loans (-0.7 pps.) and capital expenditure (-0.5 pps.). As they mostly reflect the phasing-out of crisis support measures, the decreases in spending ratios are mostly frontloaded. The share of the public wage bill, interest payments and activation of guarantees are expected to broadly stabilise over the programme period. For social transfers, the general downward trend is underpinned by the pension indexation formula, while the particularly sharp fall in 2023 appears to be mostly due to the one-off lump sum pension payments in 2022 (worth 0.5% of GDP). The sharp fall in subsidies-to-GDP ratio does not appear to be backed by concrete reforms that would explain the projected decrease below pre-crisis levels. After reaching a record 7.4% of GDP in 2021, the gradual decrease in capital spending as a share of GDP to 7.3% in 2022 and 6.9% thereafter appears plausible.

The 2022 budget aims to reduce the deficit significantly, mostly by not renewing COVID-19 crisis support. With no provision for renewing the temporary crisis-mitigation measures taken in 2021, the 2022 budget plans strong headline fiscal consolidation by around 2 pps in 2022, to 3% of GDP (a decrease of 1.1 pps even compared to the 2021 deficit outturn of 4.1% of GDP). The 2022 budget's revenue side does not assume major changes to tax legislation. The sole exceptions are: the planned slight further increase in the non-taxable part of gross salaries from RSD 18 300 to RSD 19 300, which will slightly reduce the tax wedge on labour (though only in nominal terms given increased inflation); and a 0.5 pps rate decrease in social security pension contributions for employers. On the expenditure side, the budget contains a pension increase of 5.5% in line with the indexation rule, and a minimum wage increase of 9.4%. Public-sector wages have been increased on an ad hoc basis by 8% for defence, healthcare and social welfare workers, and by 7% for all other public-sector employees, resulting in an overall average increase by 7.3%. Capital expenditure is projected to decrease to 7.3% of GDP (following a 7.4% of GDP record outturn in 2021), which mostly reflects a fall in arms purchases. Shortly after the adoption of the 2022 budget in late November 2021, the government announced some new fiscal measures that may require an amending budget for implementation in due course. This concerns in particular insufficiently targeted lump sum payments to all young people aged between 16 and 30, increased premiums for childbirth and young families, and increased payments to farmers. Following budget support provided to Srbijagas in December 2021, further support to the energy sector for energy price mitigation was provided at the beginning of 2022 even prior to the impact of Russia's war of aggression against Ukraine.

The public debt ratio is set to decline gradually, helped by high nominal GDP growth and an improving primary balance. After a sharp increase by 5.0 pps to 57.8% in 2020, the general government debt-to-GDP ratio has decreased to 57.1% in 2021 (1.1 pps lower than the ERP estimate, reflecting the lower-than-projected deficit outturn and higher-than-expected nominal GDP growth). The debt ratio is projected to fall by 1.5 pps annually on average in 2022-2024, supported by high nominal growth, a further gradual improvement in the primary balance and slightly decreasing interest payments, whose effects are only partly offset by debt-increasing stock-flow adjustments, which are not further specified. Thanks to a favourable fiscal track record and the build-up of fiscal space in the years before the COVID-19 pandemic, Serbia has been able to fully cover its increased financing needs, resulting from the various fiscal support packages in 2020 and 2021, by tapping international and domestic financial markets at favourable conditions and without recourse to financial assistance from the International Monetary Fund or the EU. On 1 July 2021, dinar bonds were included in JP Morgan's GBI-EM index, a benchmark index for local currency bonds in emerging economies, thereby facilitating foreign portfolio investments. However, the still large proportion of foreign currency-denominated debt (70%) 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.

⁽⁴¹⁾ Projected public expenditure as a share of GDP for 2024 is even down by 6.3 pps on the ERP estimate for 2021.

Box II.4.2: Debt dynamics

Serbia					
Composition of changes in the debt ratio (% of GDP)					
	2020	2021	2022	2023	2024
Gross debt ratio [1]	57.8	58.2	56.5	55.3	53.8
Change in the ratio	5.0	0.4	-1.7	-1.2	-1.5
<i>Contributions [2]:</i>					
1. Primary balance	6.0	3.1	1.2	-0.2	-0.7
2. "Snowball" effect	1.2	-4.2	-2.3	-2.4	-2.3
<i>Of which:</i>					
Interest expenditure	2.0	1.8	1.8	1.8	1.7
Growth effect	0.5	-3.6	-2.5	-2.6	-2.6
Inflation effect	-1.3	-2.4	-1.6	-1.5	-1.4
3. Stock-flow adjustment	-2.3	1.5	-0.6	1.4	1.6

[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) 2022, ECFIN calculations.

While the ERP projected a 0.4 pps increase, the government debt-to-GDP ratio decreased by 0.7 pps in 2021. The decline resulted from the effects of strong real growth and higher inflation easily offsetting the debt-increasing impact of the primary deficit, interest expenditure and positive stock-flow adjustments. Looking ahead, in 2022, the primary balance will still have a debt-increasing impact (partially offset by a debt-reducing stock-flow adjustment following higher borrowing in 2021 to cover part of the 2022 liabilities) while in 2023 and 2024 the stock-flow adjustments and interest expenditure are projected to remain the only debt-increasing factors. High real growth, inflation and the return to a primary surplus ensure the clear downward trend of the debt ratio over 2022-2024. 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 4 pps. for the financing of restitutions, while sales or acquisitions of financial assets can have both upward and downward impacts).

Some short-term upside fiscal risks from conservative revenue estimates tend to be offset by ad hoc measures, energy price mitigation and potential further fiscal impact of Russia's war against Ukraine, with the medium-term structural downside fiscal risks set to persist. In the short term, despite high uncertainty surrounding the economic outlook, there are some upside risks to the achievement of 2022 fiscal targets: budget revenues have been forecast using conservative assumptions and are set to rise with inflation higher than projected in the budget and the ERP. However, the impact of non-budgeted ad hoc measures (birth premiums, child benefits, lump sum payments to all young adults, additional payments to farmers) will weigh on the balance. Moreover, the prolonged partial energy price freeze (in particular for gas and electricity) will most likely require higher-than-planned budget transfers to the state-owned electricity company, Elektroprivreda Srbije, and Srbijagas. Further inflationary pressures from the Russian war against Ukraine may give call for further fiscal mitigation measures. Looking ahead, revenue projections appear relatively conservative in terms of elasticities but 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, in particular for expenditure for employees, subsidies and transfers to state-owned enterprises. Given the scale of fiscal risks stemming from inefficient state-owned enterprises, highlighted by the ERP's sensitivity analysis, more transparency and effective implementation of structural reforms in this area seem crucial to achieving the targeted 0.6 pps. of GDP reduction in subsidies from 2022 to 2024. As in previous years, the programme does not mention the restitution-related obligations of EUR 2 billion, or around 4% of GDP, concerning properties confiscated by the communist government after the Second World War. The arrangements for monetary

compensation were confirmed in 2021 and the first government bonds specifically relating to this were issued in January 2022, worth EUR 69 million (0.1% of GDP). The issuing of further specific government bonds over the coming years can be expected to increase the debt-to-GDP ratio accordingly. The guarantee schemes set up during the COVID-19 crisis in 2020 also constitute a contingent liability that may to some extent be called. The schemes had an initial loan volume of EUR 2 billion, around 4.3% of 2020 GDP, with a maximum state guarantee of 30% at portfolio level. In 2021, the original 2020 scheme was topped up with an additional EUR 500 million (1% of GDP) and complemented by a new guarantee scheme worth the same amount to support the most affected sectors and enterprises. However, initial estimates for the first guarantee scheme pointed to relatively low default rates until 2023 ⁽⁴²⁾. 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.

Recent improvements in the quality of public finances are set to be consolidated. Thus, the breakdown of public expenditure is projected to confirm the progress made towards stronger pro-growth orientation, especially as regards the share of capital expenditure. After the record outturn of public capital expenditure at 7.5% of GDP in 2021, the ERP forecasts a slight decrease to 7.3% of GDP in 2022 followed by a stabilisation at 6.9% of GDP in 2023 and 2024. However, it would seem important to ensure that increased infrastructure spending is cost-effective by applying the same selection and management framework to all projects, regardless of the source of financing.

After the COVID-19 crisis-induced peak of 7.1% of GDP in both 2020 and 2021, health expenditure is expected to stay as high as 6.6% of GDP in 2022 and ease off only slightly to 6.4% of GDP in 2023 and 6.3% in 2024 – i.e. still 1% of GDP above the pre-crisis level ⁽⁴³⁾. The share of education spending in GDP is projected to decrease slightly from 3.3% in 2021 to 3.0% of GDP throughout the remaining programme period. Interest expenditure is projected to broadly stabilise at around 1.8 to 1.7% of GDP in 2021-2024, in line with the decreasing debt level and the assumption of still favourable financing conditions. On the revenue side, increasing the tax-free allowance for personal income tax and lowering employers' pension contributions by 0.5 pps. help to gradually reduce the tax wedge on low-income earners. To make informal labour less attractive, there may be grounds for raising the threshold further, above the inflation rate.

While work on some structural fiscal reforms has slowed down or been postponed during the COVID-19 crisis, the budgetary process has improved and efforts are ongoing to mobilise revenue. The 2022 budget was adopted broadly in line with the normal legislative procedure. There was a meaningful parliamentary debate on the 2021 budget, albeit with very few MPs not belonging to the government coalition, and the authorities also submitted the final annual budget execution report for 2020 to Parliament. Work to revise the fiscal rules, which at present do not provide sufficient anchors for fiscal policy, has been put on hold since 2020 as a result of the crisis and is set to resume in the first half of 2022. While wage increases were still implemented through ad hoc adjustments to the budget system law, the new indexation formula for pensions that entered into force in 2020 has now been used to set pension increases in three consecutive years, though occasionally with some lump-sum bonus payments too. Implementation of the planned wage system reform, which had been further delayed by the crisis, has been postponed beyond the end of the programme to 2025. This is so that parameters can be reconsidered on the basis of a more comprehensive new payroll information system. On the revenue side of the budget, the new electronic fiscalisation model is currently being rolled out and is presented, alongside transition to electronic invoicing, in the structural reforms part of the ERP. They are set to make a significant impact in shrinking the grey economy, increasing VAT collection and improving the tax control process,

⁽⁴²⁾ The ERP 2021 expected gross fiscal outflows related to the guarantee scheme to be limited to 0.05% of GDP in 2021, 0.21% in 2022 and 0.06% in 2023.

⁽⁴³⁾ Using the classification of the functions of government (COFOG) classification.

which means they constitute an upside fiscal risk. The well-established Fiscal Council has continued to function appropriately, producing independent fiscal assessments and recommendations. Budgetary statistics have been delivered on time, 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 and further integrating it with the EU. Exports have been a major driver of growth. Manufacturing has modernised and diversified in recent years, but traditional industry, notably the energy sector, has not undergone sufficient restructuring. Its underperformance continues to undermine Serbia's competitiveness and economic growth potential. Moreover, to reach higher growth rates in the longer term, Serbia will need to make better use of the opportunities offered by the single market and the service sector, and to ensure a level playing field for all companies. Further 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 key structural challenges to competitiveness and inclusive growth, drawing on Serbia's own ERP and other sources.

It identified three key challenges:

- (i) increasing employment, in particular of young people, women and vulnerable groups, and social protection to combat poverty;
- (ii) creating a more favourable business environment for investment, and
- (iii) greening Serbia's energy sector and fully opening the energy market.

While the Serbian economy continues to experience several obstacles to inclusive growth and competitiveness especially in the context of the Covid-19 pandemic crisis, tackling the three key structural challenges through properly targeted reforms offers the biggest potential for post-pandemic recovery, economic resilience, and inclusive growth and competitiveness. The Commission welcomes that Serbia identified the same three key structural challenges in Chapter V of its ERP. However, there are some differences in substance, chiefly for key structural Challenge 1 on increasing employment, in particular of young people, women, and social protection against poverty, and in key structural Challenge 3 on greening Serbia's energy sector and fully opening the energy market. For Challenge 1, the aspect of social protection is not analysed. For Challenge 3, the ERP does not sufficiently focus on the greening aspects of this challenge, which the European Commission considers key to reforming the sector. It also does not recognise that the energy market should be *fully* opened. These discrepancies will be further analysed below.

Serbia needs to tackle corruption, improve the rule of law and strengthen institutions in order to promote competitiveness. Addressing these fundamental concerns is a pre-requisite 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 Serbia report.

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

The labour market has shown resilience during the COVID-19 induced crisis. At 76.4%, the activity rate (20-64) was higher in the third quarter of 2021 than in the third quarter of 2019 (73%). The same applies to the employment rate (20-64 age group), which increased by 2.4 pps. in the same period to 68.4%. While both indicators remain below the EU-27 average, Serbia is moving towards it at a steady pace. The first key challenge in Serbia's ERP is similar to the Commission's, mainly addressing the skills mismatch in the labour market: 'Increasing employment, particularly of young people, and alignment the qualification with the labour market needs'. Though Serbia's ERP also recognises the challenges concerning social protection to reduce poverty, it does not address them with suitable measures.

The gender employment gap remains wider than in the EU. The female employment rate (20-64) was 59% in the second quarter of 2021 (67.5% for EU-27) compared to 73% for men (78.4% for EU-27). This produces a gender employment gap of 14% in the second quarter of 2021 (10.9% for the EU-27). The employment rate of women is approaching that of men but the gender gap is still relatively wide. The underlying reasons for the gap include a lack of childcare, a lack of care services for elderly people, and social conventions.

After a temporary drop in 2020, unemployment increased again in 2021 as demand started attracting workers again. The unemployment rate (15-74) rose to 11.1% in the third quarter of 2021, up from 10.4% in the same quarter of 2020; spending on active labour market policies is insufficient. The rise in the unemployment rate comes after a decrease in 2020, when the pandemic-induced economic slowdown discouraged people from looking for a job. The unemployment rate gradually increased as more people entered the labour market in 2021, which can be interpreted as a sign of a recovery. Spending on active labour market policies has increased, following a period of decrease between 2019 and 2020. However, spending remains insufficient at around 0.1% of GDP (EU-27 average in 2019: 0.39%). Active labour market policies have reached only a fraction of the unemployed and their impact on the activation of the labour force remains limited. The ERP acknowledges the shortcomings but does not propose adequate measures to address this situation.

Lower-secondary school education results for 15 year olds lag behind the EU average, although Serbia has the highest PISA rating in the Western Balkans. Serbia's average scores are close to those for some EU Member States (Bulgaria, Greece and Romania). The average score in reading is 439.5 (against the EU average score of 481.7 and the Western Balkans average score of 402), in mathematics 448.3 (EU 488.6 and WB 414) and in science 439.9 (EU 484 and WB 408). The selection procedures for upper secondary programmes are not equitable, with boys twice as likely as girls to attend vocational training programmes.

The school-to-work transition is structurally difficult. The share of young people (15-29) not in employment, education or training (NEETs) was 20.0% in 2020, significantly above the EU-27 average (13.7%), but the lowest among all candidate countries. It takes two years on average for a young person in Serbia to find their first stable employment, against the EU average of 6.5 months. In the third quarter of 2021, the activity rate for the 15-24 age group was just 35.5%, compared to 41.0% in the EU. To ease 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. Since 2020, more than 8 000 young Serbians participated in this programme.

Reform measure 1 in the ERP focuses on the 'Establishment of a Framework for the Introduction of the Youth Guarantee in the Republic of Serbia'. The government will start with preparatory activities, including drafting the implementation plan. Then it will start gradually rolling out the Youth Guarantee in several regions in the fourth quarter of 2024. The measure only partially addresses the key challenge, but will likely contribute to facilitating the integration of young people in the labour market. However, the

Youth Guarantee will be available only for a limited number of young school-leavers; to significantly reduce Serbia's NEET rate, further steps are needed, especially in the field of education.

Vocational education and training (VET) schools do not adequately provide skills to match employers' needs as they have only partially updated curricula and lack appropriate equipment.

Chosen by 73.2% of Serbia's youth, the VET pathway is not sufficiently labour-market-oriented, and does not offer enough re-skilling and upskilling opportunities for adults. These are key obstacles for higher youth and adult employment and activity rates in Serbia. Serbia has made progress in work-based learning with the adoption of the Law on dual education in 2017 and three new by-laws in 2018/19. The Chamber of Commerce and Industry of Serbia has adopted three further legal acts to help implement the Dual Education Law. Two more legal acts are being prepared. The Chamber has a key role in the dual and entrepreneurship education track that started in the 2019/20 academic year. Though the legal framework is now in place, the roll-out of dual VET will take until 2023.

Reform measure 2, 'Qualifications oriented to the needs of the labour market' proposes the roll-out of the dual VET system in line with the Austrian, German and Swiss model. The measure has been rolled over from last year. Unfortunately, dual VET is not scheduled to grow in scale beyond 10.9% of all VET by 2024, with school-based VET still accounting for 89.1% under the plans. This measure does not seem ambitious enough in light of the magnitude of the school-to-work transition challenges and the partially outdated curricula.

In 2020, the employment rate among recent Serbian VET graduates stood at 62.3%, still significantly lower than the employment rate for VET graduates in the EU (78.7%), but higher than for Western Balkan peers. VET education requires further development to ensure that young people are smoothly integrated in the labour market. The draft law on apprenticeships that has been put up for public discussion could help ease young people's transition into the labour market. In addition, Serbia has adopted a strategy for the development of education lasting until 2030, with an accompanying action plan for 2021 to 2023. The goals of the strategy are as follows: improve pre-university and higher education (1), increase the coverage of children's education at all levels (2), prevent dropout of vulnerable groups from education (3), better student achievement (4), quality program - including the response of the educational system to the demands of the labour market (5) - and better support for teachers (6).

In tertiary education, Serbia wants to bring in dual education with close ties to the labour market.

The European Association for Quality Assurance in Higher Education (ENQA) recommended that Serbia improve its governance structures by involving all stakeholders, strengthen the independence of higher education institutions from the government, and improve its internal operational aspects. 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 a profession related to information and communications technology, compared to 8% in the OECD level. This has the potential to provide a boost to the digital transition in the economy. In terms of financing, the budget allocated for 2020 is 3.3%, 1.7 pp. less than the EU-27 average.

Labour migration is continuing across the occupations. The outflow of labour undermines the growth potential of the whole economy and notably the capacity of the public sector to provide health and utilities services. Around 14% of people who were born in Serbia live abroad (ETF 2021). This outward labour migration further exacerbates the rural/urban divide between Belgrade and the rest of the country as the countryside is particularly affected by migration. According to the Serbian Statistical Office, the population rate decreased slightly in 2020 by 0.67%, indicating a continuing depopulation trend. The Serbian ERP acknowledges the need to provide incentives for the return of the Serbian diaspora and to attract foreign experts. The Serbian government has adopted an economic migration strategy for 2021-2027 (Official Gazette of the Republic of Serbia, No 21/20) and an action plan to put it into effect. The strategy covers a range of topics relating to economic migration and its management, the correlation

of migration and development, and the role of the diaspora as a driver of (local) development. In this context, Serbia is proposing *reform measure 3, 'Improvement of the environment for encouraging, supporting and monitoring circular and economic migration'*. The measure is rolled over from the previous year. It 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 chiefly addresses the ICT sector which currently accounts for around 5% of GDP.

In 2020, 29.8% of the Serbian population was at risk of poverty or social exclusion, a high figure compared to the EU-27 average of 21.9%. The most vulnerable were households with three or more dependent children, of which 37.2% were at risk in 2020. The at-risk-of-poverty threshold was on average RSD 22 000 (EUR 191) per month for a single-person household. For a four-person household with two adults and two children below 14, the threshold was RSD 46 200 (EUR 393). The income quintile ratio was 6.1 in 2020 (compared with 5.24 for the EU in 2019). This means that the richest 20% of the population had an income 6.1 times higher than the 20% poorest. The Gini coefficient in Serbia was 33.3 (2020), above the EU-27 average of 30.2 in 2019. According to research carried out for the 2020 youth participation index, 25% of young people in Serbia is at risk of poverty, and a similar percentage use some form of social assistance.

Despite being an upper middle-income country with adequate public revenues, benefits available from the financial social assistance (FSA) scheme are not sufficient to make ends meet. The average cost of a consumer basket is around EUR 323 for a family of three. The poverty threshold for a three-person household is EUR 297. However, FSA support from for a family of three is EUR 132, less than half the cost of the average consumer basket and of the poverty threshold for a household of this size. The impact of social transfers (other than pensions) on poverty reduction has for many years been rather small and in 2020 it stood at 18.73% in comparison to the EU-27 average of 32.68%.

Public expenditure on social protection and budget transfers as a share of GDP has been gradually decreasing in recent years. It amounted to 14.8% of GDP in 2020, down almost 2 pps from 2015. In addition, the pension system is faced with a challenging demographic situation. The ratio of employees per pensioner is stuck at the low level of 1.3. Serbia adopted the Social Card Law aimed at a fairer distribution of social benefits to those below the poverty line. The law will take effect in March 2022. However, expenditure remains insufficient, including spending on social assistance (2.9% of GDP in 2020). No new legislation on social protection has been announced.

In-work-poverty remains high and the untaxable wage base still differs significantly from the minimum salary. In 2021, Serbia raised the minimum wage to EUR 273. The minimum wage is received by 17% of all employees. The poverty threshold for a single-person household is EUR 230. The untaxable wage base has been gradually increased to RSD 19 300 (EUR 164) but this is hardly enough. To make a significant impact on in-work poverty, additional measures are needed, such as further increasing the untaxable wage base until it is close or equal to the minimum salary. This would also contribute to the wage- and consumption-induced growth of the Serbian economy.

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

Serbia's business environment is improving, but significant structural challenges have still to be addressed if Serbia is to achieve its potential for economic growth and competitiveness. Serbia has made notable progress in reducing the regulatory and administrative burden on businesses. The pandemic also accelerated the pace of digitalisation, including the expansion of e-commerce, although the impact on SMEs was limited. However, key structural challenges remain largely unaddressed, relating to the transparency, reliability and predictability of the regulatory framework, and unfair competition from state-owned enterprises.

Addressing the remaining issues would help encourage both domestic and foreign investment, including in industries with a key role in sectors crucial to move forward in digitalising and greening the economy in line with the Green and the Digital Agendas for the Western Balkans. It would also boost competitiveness, medium-term growth potential and job creation. The economic and investment plan for the Western Balkans and the further development of the common regional market will help increase the competitiveness of the economy backed by a digital and green transition, but to achieve the economy's full potential, a conducive business and investment climate is crucial. The government's ERP therefore rightly recognises the importance of improving the business environment and attracting investment to further boost Serbia's economic growth and competitiveness as one of the three structural challenges in this year's ERP.

The role of the state in the economy is shrinking, but remains large, hampering competition. Outside the financial sector, privatisation and restructuring efforts have largely stalled and state-owned enterprises continue to dominate many sectors, including energy, transport, utilities, telecommunications, infrastructure, mining, and natural resource extraction. This outsized presence 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. Most public companies continue to rely on state support, via direct or indirect subsidies. Governance of state-owned enterprises also continues to pose and a large share of the directors are in acting capacity, many having expired mandates as the law on public enterprises limits the tenure of acting directors to 12 months. This stands in the way of a root-and-branch reform of these companies, including more professional management. Improving the efficiency of public enterprises would reduce the strain on public finances and improve the quality of services, level the playing field, and limit the scope for preferential treatment and politically influenced decisions.

The legal framework in competition and State aid is largely in line with the EU *acquis*, but implementation still needs to be improved. The commission for protection of competition and the commission for state aid control have both had their administrative capacity increased and are operating as legally independent bodies. However, the track record of the commission for protection of competition is not sufficiently consistent and transparent. Though it has continued to investigate a significant number of anti-trust cases, it has not issued a single negative opinion on concentration since it began work. In the area of State aid, well defined rules are not always implemented due to strong political pressure for financial assistance, channelled to state-owned enterprises and large foreign investors. These resources are often substantial and may have a significant impact on competition. State support is not sufficiently transparent, which has led to allegations of corruption. The independence of the commission for State aid control has yet to be demonstrated through a consistent and transparent track record.

The legislative framework for public investment management has improved but more needs to be done on transparency, assessment and prioritisation of investment. A strong process for transparent appraisal and selection of public investment projects is a priority, given Serbia's large infrastructure needs and long pipeline of future projects, including projects for the green and digital transition. The new legislative framework for public investment management from 2019 still allows too many exceptions to the rule. In addition, the law on special procedures for linear infrastructure projects adopted in 2020 allows certain linear infrastructure projects 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. As a result of these legal arrangements, and, in some cases, a lack of enforcement of rules, a significant share of public funds for capital investment is still spent without proper checks to ensure compliance with public procurement, State aid and technical standards. This is particularly true for big infrastructure projects financed by loans mostly from non-EU 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.

In recent years, Serbia has reduced the regulatory and administrative burden on businesses, but more efforts are needed. A number of heavy business procedures have been significantly simplified and their cost reduced. However, administrative procedures are still numerous and burdensome especially for small and medium-sized enterprises (SMEs). Local firms have to make 33 tax payments per year, twice as many as in the regional peers. The numerous parafiscal 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 legal framework is prone to unexpected and significant changes, which can be detrimental to business. Business predictability is negatively affected by the lack of full transparency in the adoption of legislation. Government decisions in a number of business-relevant areas are still often taken without proper consultation with businesses and social partners and under too short time constraints.

Further efforts are needed to improve the quality, independence and efficiency of the justice system. An efficient and independent judicial system is a pre-requisite for a predictable investment- and business-friendly environment, and is necessary to encourage innovation, attract foreign direct investment and secure tax revenues. Businesses also raise the issue of the lack of reliability in contract enforcement, as well as lack of expertise among judges, particularly in complex areas of law such as competition, intellectual property, or taxation, which leads to inconsistency in rulings.

Serbia's legal framework for fighting corruption and dealing with economic crime and abuse of office is largely in place. However, its implementation should be strengthened. A particularly critical area is public procurement. The level of competition in the public procurement process remains limited: the average number of bids per tender remains very low (2.6 in 2020). The supervisory institutions (Public Procurement Office, Commission for the Protection of Rights in Public Procurement Procedures, State Audit Institution, Anti-corruption Agency, prosecution, etc.) lack staff and do not always coordinate effectively for fighting corruption in a systematic manner.

The widespread shadow economy remains a major impediment to the development of a strong corporate sector and the consolidation of a functioning market economy. Driving forces behind the shadow economy include high taxes and contributions on salaries, lack of financial resources and favourable loans, parafiscal charges, hidden tax fees and red tape. The consequences are manifested in tax evasion, market distortion, unfair competition and inefficient resource allocation. Notable efforts have been invested in reducing the size of the informal sector, but the pace of reforms is slow.

The ERP reform measures in the area of business environment target the high administrative and regulatory burden, the management of state-owned enterprises and the functioning of the capital markets, but do not sufficiently address the main underlying structural weaknesses. *Reform measure 4, '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 for businesses, reduce opportunities for corruption and in general increase the attractiveness of Serbia as an investment destination. However, the measure has so far yielded rather limited results, with only 13 procedures out of over 2 600 being abolished. Significant efforts are needed to speed up the reform. The new *reform measure 5 ('Sustainable and efficient management of business entities owned by the Republic of Serbia')* aims at setting up a system of corporate governance including a centralised database. As the measure aims to improve the management of state-owned enterprises it is very relevant. The new reform measure 6 ('Development of the domestic capital market through the introduction of new legal mechanisms and provisions of a greater level of investor protection') sets out to increase the competitiveness of the capital market by making it more efficient and transparent, based on the capital market development strategy for 2021-2026. While the measure might have a positive impact on the capital market and help attract further investment, it does not directly aim to address any of the most significant underlying structural challenges.

The ERP once again does not contain any reform measures specifically addressing the issue of the informal economy. However, *Reform measure 9 ('tax administration transformation')* and *measure 10 ('introduction of a new fiscalisation model and transition to electronic invoicing')* have been carried over from last year's ERP but moved from the business environment to public financial management. They may, if properly implemented, lead to improvements in tax inspections, with a positive impact on the informal economy. These reform measures are further analysed in Section 6 under public financial management.

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

Despite recent good progress, particularly on renewables and energy efficiency, a polluting, and inefficient energy sector is not fully compliant with the Energy Community Treaty or with the EU *acquis*, and continues to hamper competitiveness. Energy infrastructure is largely outdated: the energy supply continues to rely mostly on lignite, energy production from coal is still heavily subsidised and a high number of individual heating systems use wood and coal as fuel. The energy sector is the main source of air pollution in Serbia, with health costs for the economy. Licensing rules are rarely applied. In addition, the underperformance of the energy sector and the slow progress on the green energy transition negatively influence Serbia's economic growth potential, especially in the long term. The lack of efficiency in the energy sector also undermines the country's overall economic competitiveness. As EU Member States move towards greener economies, it is important that Serbia moves in the same direction in order to be competitive upon accession.

Addressing remaining issues in this area will stimulate both domestic and foreign investment. This will benefit sectors that are crucial to digitalising and greening the economy in line with the green agenda for the Western Balkans and backed by the economic and investment plan. It would also boost economic competitiveness, the medium-term growth potential and the creation of new jobs. The government's ERP therefore rightly recognises the importance of greening Serbia's energy sector and fully opening the energy market.

Serbia's energy sector, accounting for 4% of GDP, has a high energy and carbon intensity. This is 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 subsidies worth about EUR 41 million to support coal-fired power generation, sustaining unprofitable, inefficient and highly polluting thermal power plants and coal mines. The retail electricity market, though fully liberalised, remains highly concentrated. For example, despite the liberalisation, the state-owned utility Elektroprivreda Srbije (EPS) remains the single most dominant supplier, with around 95% 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. Work on a joined-up long-term strategy that combines energy and climate targets is ongoing but progress is too slow. Serbia relies on domestic coal-fired electricity production provided by outdated power plants. About 69.6% of domestic electricity production comes from coal (lignite), 25.7% from hydropower, 2% from gas, and only 2.6% from wind, and solar together (SORS, 2022). The country continues to invest in new coal power plants. Currently, Serbia is building a new lignite power plant (Kostolac B3) with a capacity of 350 MW. However, in early 2021, Serbia suspended the new Kolubara B 350 MW power plant project. Serbia adopted a new climate law in March 2021, which is a step in the right direction. It is currently drafting its national integrated energy and climate plan with public consultations planned.

Coal power generation adds to already alarming air quality levels in Serbia. According to the European Environment Agency's latest estimates, air pollution from PM2.5 particles in Serbia caused a total of 14 600 deaths in Serbia in 2020 (EEA, 2020). The energy sector is the main source of pollution in Serbia, responsible for 80% of the country's greenhouse gas emissions. Several of the most polluting coal

power plants in Europe are located in Serbia, with Kostolac B being the continent's most notorious sulphur dioxide polluter. In 2020, SO₂ emissions were six times higher than the national ceiling and higher than 2019 levels. Serbia adopted a national emission reduction plan in February 2020, but it is not implemented in practice for sulphur dioxide and dust.

Inefficient energy use in Serbia is a major concern. Lack of efficiency in the energy sector critically undermines the country's overall economic competitiveness. In 2021, Serbia made major progress in aligning with the EU *acquis* on energy efficiency. Serbia created a new Directorate for Energy Efficiency and launched a housing renovation programme. Priorities are to continue improving financial, institutional and human resource capacities and better coordinate energy efficiency actions with all relevant stakeholders, including at local level. Boosting investment in energy efficiency require large-scale consumption-based metering and billing in district heating and the setting up of a sustainable financing mechanism. Serbia should also allocate all income from the new 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 are increasing, but at a slow pace. In 2020, Serbia achieved a 26.3% share of renewables in gross final energy consumption, which is just below the 27% objective and just above the renewable energy share of 21% in the 2009 baseline year. Domestic demand for electric power is expected to outgrow production capacities significantly in the next 5-10 years, necessitating investments in new capacity.

Greening Serbia's energy sector is paramount if Serbia is to meet its obligations under the Energy Community Treaty, its EU membership ambitions, and ensure 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, which is also being incorporated into the Energy Community Treaty. With decreasing global prices for renewable energy and increasing efforts to address carbon leakage in Europe, Serbia needs to avoid locking itself into an increasingly unprofitable carbon-intensive energy system and to tackle this challenge head-on. Recent energy legislation introduced a competitive auction system instead of feed-in tariffs for renewable energy sources. This is an important measure to attract much-needed private investment in the renewables sector and it should be implemented swiftly.

Currently, low electricity prices in Serbia do not provide incentives for investing in energy efficiency and energy savings. 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). Current electricity tariffs do not cover the real cost of the investment needed to guarantee security of supply. Moreover, they do not include the investment needs for Serbia's energy and climate reforms. Increasing electricity prices should be accompanied by appropriate social programmes to mitigate potential adverse effects, bearing in mind that a considerable proportion of the population suffers from 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 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, creating security of supply risks. In January 2022, work started on the Serbia-Bulgaria gas interconnector. 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. Serbia's primary legislation is compliant with the EU's third energy package, but implementation is lagging behind, particularly in the gas sector. The government has mostly completed liberalisation of the electricity market and created an operational electricity wholesale market. However, plans to reform the gas sector are yet to be implemented. There is still no third-party access to the gas network and none of the three transmission system operators has been unbundled. Serbia adopted an action plan on gas unbundling in May 2021 but key elements have been delayed, including the certification of Transportgas Srbija. The unbundling of Yugorosgaz Transport cannot proceed until the Russia-Serbia Intergovernmental Agreement has been ratified. The implementation of Serbia's action plan on gas unbundling also depends on further amendments to the Energy Law. The lack of competition results in high prices for business and households.

Serbia's ERP for 2022-2024 is not sufficiently ambitious regarding the clean energy transition and energy efficiency. The reform measures proposed in the ERP fall short of providing decisive plans for making clean energy transition a core component of economic reform. In addition, major outstanding reforms, such as the unbundling of the gas sector and properly addressing energy poverty, are missing. *Reform Measure 7 ('Energy market development coupled with energy infrastructure construction')* is rolled over from previous ERPs. This represents a continuation of Serbia's efforts to develop its electricity market coupled with new infrastructure investment through the Western Balkans Investment Framework, most notably the completion of all sections of the Trans-Balkan corridor. The reform does not go far enough in the gas sector, where we see positive steps regarding unbundling but regrettably a lack of action on third-party access to existing gas infrastructure. *Reform measure 8 ('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 in line with the EU *acquis*, which includes the newly adopted Energy Efficiency Directive (part of the Clean Energy package) under the Energy Community, and secure sustainable funding for energy efficiency projects. However, the measure falls short of effectively incentivising energy efficiency investments, including in both the manufacturing and housing sectors.

Targets for energy savings could be more ambitious (currently 20%). Concrete policy measures are lacking, such as steps to implement consumption-based metering and billing in district heating or a large-scale renovation wave in Serbia. Setting up a funding mechanism for energy efficiency is a good step, but the model proposed cannot not accommodate the recruitment of the staff needed or the building and management of the pipeline of energy efficiency projects that will be required. Regardless of these shortcomings, the reform measure remains highly relevant for boosting Serbia's competitiveness and long-term growth potential.

Box II.4.3: Monitoring performance in light of the European Pillar of Social Rights ⁽⁴⁴⁾

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

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

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

Serbia has steadily improved employment and has reduced unemployment (best performer), and its labour market has shown relative resilience during the pandemic. The employment rate exceeded pre-pandemic levels, as did the activity rate (76.4% in the third quarter of 2021 compared to 73% in the third quarter of 2019). Women in Serbia have a significantly lower employment rate than men. The gender employment gap is wider than the EU-27 average (14.6 pps. in Serbia, against 11 pps. in the EU in 2020). The gap is attributable to the lower statutory retirement age for women and the low level of part-time work combined with care responsibilities. Spending on active labour market policies has started to increase but remains insufficient at only around 0.1% of GDP (EU-27 average in 2019: 0.39%).

Many young people in Serbia are not in employment, education or training (NEET) and the education system does not always meet the needs of the labour market. The NEET rate was 20.0% in 2020, significantly above the EU-27 average (13.7%), but the lowest among all candidate countries. The activity rate in the third quarter of 2021 in the 15-24 age group was just 35.5%, compared to 41.0% in the EU. Vocational education and training is not sufficiently labour-market oriented, and opportunities for re-skilling and upskilling are lacking, both key obstacles to higher youth and adult employment and activity rates in Serbia.

Serbia's performance on social inclusion, social protection, income equality and poverty alleviation could be significantly improved. The at-risk-of-poverty rate 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 2020 (29.8%) and significantly above the EU-27 average (21.9%). 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 effective in reducing market inequality as other countries in Europe. Furthermore, high government expenditure does not reduce income inequality much.

⁽⁴⁴⁾ The table includes 16 headline indicators of the Social Scoreboard, used to compare performance of EU Member States (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2020 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). For data see Annex B. NEET: neither in employment nor in education and training; GDHI: gross disposable household income.

Serbia has a well-developed statistical system. The Statistical Office of the Republic of Serbia is the main producer of primary data from the labour force survey and the survey on income and living conditions (SILC). The Institute of Public Health produces detailed statistics on public health and demographic trends. The quasi-governmental Social Inclusion and Poverty Reduction Unit processes and interprets data on poverty and inequality and develops indicators to monitor social policy. In academic and civil society circles the monitoring of social policy 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 2021

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 region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the PG is similar to that of the country-specific recommendations usually adopted under the European Semester for the EU Member States. The Commission evaluates the work carried out to implement the policy guidance in the following year's ERP assessments. The table below presents the Commission's assessment of implementation of the 2021 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at Ministerial level on 12 July 2021.

Overall: Partial implementation (44.4%) ⁽⁴⁵⁾	
2020 policy guidance	Summary assessment
<p>PG 1:</p> <p>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.</p> <p>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.</p>	<p>There was partial implementation of PG 1:</p> <p>1) Substantial implementation: The authorities have provided substantial temporary additional pandemic-related fiscal support. However, only around 10% was specifically targeted to vulnerable businesses or to incentivising vaccination while the remainder was offered to all businesses and all adult citizens. In view of the strong economic rebound, the 2022 budget and medium-term fiscal strategy effectively plan a gradual return to a deficit close to balance.</p> <p>2) Limited implementation: Following a 0.45ps decline in 2021 due to very high nominal GDP growth, overall spending on wages as a percentage of GDP is projected to remain stable at 10% in 2022-2024. However, the planned containment continues to rely entirely on ad hoc decisions on wage increases as no wage indexation mechanism has been adopted and the public sector wage system reform has been postponed to 2025. A new central electronic public wage and employment registry (Iskra) has been developed for personnel and wage management with a pilot already effective in the Ministry of Finance. The first phase of the</p>

⁽⁴⁵⁾ 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.

<p>Adopt a credible and binding system of fiscal rules for entry into force as of 2022.</p>	<p>new payroll information system should become operational for some sectors by April 2022 and then be rolled out to most of the public sector (excluding military, security and higher education institutions) by end-2023, which is deemed important for preparing the delayed wage system reform.</p> <p>3) Limited implementation: The adoption of a credible and binding system of fiscal rules has been postponed by another year due to the COVID-19 crisis. Establishing the new fiscal rules framework was included as a commitment in the new policy coordination instrument with the IMF, to be completed by June 2022 deadline allowing for entry into force in 2023.</p>
<p>PG 2:</p> <p>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.</p> <p>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.</p> <p>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.</p>	<p>There was partial implementation of PG 2:</p> <p>1) Full implementation: The new electronic fiscalisation model and the transition to electronic invoicing have been implemented broadly within the set deadlines. The centralised platform for electronic fiscalisation was launched on 1 November 2021. The deadline for taxpayers to switch to the new system is 30 April 2022. As regards electronic invoicing, the launch of e-invoices for public users has been postponed by four months and is now due to start on 1 May 2022 while the remaining phased deadlines have been maintained for 1 July 2022 for storage of e-invoices issued by others and 1 January 2023 for general use in the private sector. Training for users of the new fiscalisation model and electronic invoicing began in July 2021.</p> <p>2) Partial implementation: While the Ministry of Finance appears to have improved fiscal risk analysis by adopting a unified monitoring methodology, filling posts and providing training in the Fiscal Risks Monitoring Department, the results of the department's work on state-owned enterprises do not appear to have been published in quarterly reports.</p> <p>3) Partial implementation: in line with the action plan adopted in June 2021, for the establishment of a centralised database of economic entities in which the Republic of Serbia has ownership, as well as to create criteria for their classification, a questionnaire had to be submitted by economic entities by December 2021. Following receipt of the data their processing is ongoing. No information has been provided on the achievement of the other Q4-2021 target of establishing mechanisms and criteria for reviewing and approving key decisions of SOEs by the Ministry of Economy, to be used as basis for future amendments to the legislative framework.</p>

<p>PG 3:</p> <p>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.</p> <p>Further reduce remaining obstacles to swift and effective NPL resolution.</p> <p>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.</p>	<p>There was partial implementation of PG 3:</p> <ol style="list-style-type: none"> 1) Substantial implementation: the NBS continued to closely monitor the impact of the economic fallout from the pandemic on the financial sector. Forceful measures and policies contributed to supporting the banking system through the pandemic, while most forbearance measures have been withdrawn in the meantime in line with the economic recovery. Provisioning seems broadly adequate, despite a slight decrease in the coverage ratio. 2) Limited implementation: there was no progress on reducing remaining obstacles to NPL resolution, such as enabling the sale of retail NPLs or improving judiciary processes. This requires work by all key stakeholders and improving the legal and judicial framework. At the same time, the NPL ratio remained low and the impact of the COVID-19 crisis on asset quality has remained very contained so far. 3) Substantial implementation: policy has supported the development and use of local government bond and corporate bond markets and has encouraged dinar-denominated deposit and loan growth in the banking sector, which reached an all-time record. A new measure to incentivise dinar lending to corporates will be effective starting from July 2022. However, currency substitution remains high and sustained efforts are needed, e.g. to enhance longer-term funding in dinars for the banking system and to further expand the use of hedging instruments.
<p>PG 4:</p> <p>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.</p> <p>Ensure a harmonised approach for prioritising and monitoring all investments and base investment decisions on feasibility studies, cost-benefit analysis and environmental impact assessments.</p> <p>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</p>	<p>There was limited implementation of PG 4:</p> <ol style="list-style-type: none"> 1) Partial implementation: The legal framework for conducting transparent, inclusive public consultations is in place. However, further improvements are needed to achieve full and consistent implementation, as businesses continue to experience shortcomings in the procedures. These shortcomings make it harder for businesses to obtain information about legislative changes, and to prepare for and provide comprehensive input. 2) Limited implementation: Although a decree on capital project management was adopted in 2019, it is not being applied to all investments. Furthermore, several gaps remain in the decree which are yet to be addressed. 3) Limited implementation: The special law on linear infrastructure projects remains in force and continues to be applied to certain investments, allowing for the circumvention of the domestic law on public procurement. Although a number of by-laws related to the law on State aid have been adopted, others have still

of the Commission for State Aid Control.	to be adopted. In addition, issues persist regarding competition and State aid provided through fiscal State-aid schemes and intergovernmental agreements. The Commission for state aid control still needs to build up a track record of demonstrable operational independence.
<p>PG 5:</p> <p>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.</p> <p>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.</p> <p>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.</p>	<p>There was limited implementation of PG 5:</p> <ol style="list-style-type: none"> 1) Limited implementation: Work on developing a long-term energy and climate strategy started in 2021, but is at very early stage; a first draft is still to be finalised. Investment in modernising energy infrastructure and in lowering carbon emissions is limited, there is still no prioritisation mechanism for investments, and ongoing investments are facing delays in implementation. 2) Limited implementation: There is still no secondary legislation on RESs and energy efficiency related to the set of laws adopted in April 2021. This is holding up the launch of the RES action system. Work is ongoing regarding the establishment of the Energy Efficiency Administration, but is not yet completed. 3) Partial implementation: The electricity sector has been unbundled, and the generation of electricity has been split off from transmission, but the government is still supervising both companies, and third-party access to the Horgos interconnector point is still not granted. The price and tariff reform has not been implemented. Although amendments to the founding acts of Srbijagas and Transportgas Srbija were adopted the gas sector has not yet been fully unbundled. Work is ongoing on the certification of Transportgas Srbija as a transmissions system operator, but has not yet been finalised.
<p>PG 6:</p> <p>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.</p> <p>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.</p>	<p>There was limited implementation of PG 6:</p> <ol style="list-style-type: none"> 1) No implementation: The FSA benefits are very low. As an example: FSA support for a family of three amounts to less than half the cost of the average consumer basket and less than half the poverty threshold. There has been no announcement about the adoption of the new social protection law or amendments to the FSA scheme. The tax-free allowance increased by RSD 1 000 a month in 2022 and is adjusted annually with the consumer price index but remains well below the minimum salary. 2) Partial implementation: The vocational education and training (VET) curriculum in general remains outdated, although more work seems to have been done on dual profiles. Serbia adopted an education strategy that is expected to be fully implemented by 2023. Reform of

<p>Develop in co-operation with all relevant ministries, their agencies and stakeholders a Youth Guarantee Implementation Plan.</p>	<p>the VET schools has started. Attention was focused on setting up the regional vocational training centres, but an evidence-based action plan for locating and rolling out these centres is still lacking. A dual education monitoring framework was piloted and is to be integrated into quality assurance mechanisms. The Qualification Agency adopted a new methodology for developing qualification standards and some 40 new qualification standards were put forward to the Sector Skill Councils. To make a meaningful impact on students' skills development, this needs to be followed with more up-to-date curricula, teacher training and delivery in classrooms.</p> <p>3) Partial implementation: Serbia recently set up an expert group and a coordination body for drafting and monitoring implementation of the Youth Guarantee implementation plan. NEET mapping is ongoing with support from EU-ILO technical Assistance Facility. The Ministry of Labour confirmed its target of delivering a draft Youth Guarantee implementation plan by the end of April 2022.</p>
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4.6. THE 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, 24 May 2022

[...]

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

1. If needed, use the available fiscal space in the 2022 budget to cushion the potential impact of adverse shocks through targeted support to vulnerable households and firms; provided the economic recovery is well entrenched, plan a further gradual return to a deficit close to balance in the 2023 budget and medium-term fiscal framework. Contain overall spending on wages as a percentage of GDP by adopting an adequate wage indexation mechanism and taking preparatory steps towards an appropriately designed public sector wage system reform. Adopt a credible and binding system of fiscal rules for entry into force in 2023 as envisaged in the ERP.
2. To reduce the grey economy, strengthen VAT collection and improve the tax control process, finalise the introduction of the new model of electronic fiscalisation and the transition to electronic invoicing and implement the tax administration reform according to the ERP 2022 timeline. Reinforce fiscal risk analysis capacity, in particular on SOEs, and make resulting reporting publicly available in the fiscal strategy updates in spring and autumn. Implement the time-bound action plan for the deployment of the new SOE ownership and management strategy according to the ERP 2022 timeline to improve the governance of SOEs and reduce related fiscal risks.
3. Carefully assess and analyse price developments and stand ready to tighten monetary policy further, if needed, to preserve price stability in the medium term. Maintain a transparent and accurate reporting of asset quality and adequate provisioning, further upgrade NPL resolution, including by facilitating out-of-court settlement, and continue to reduce data gaps in particular as regards the real estate sector. Continue efforts to promote the use of the national currency, including by enhancing long-term financing in national currency, further encouraging forex hedging and raising awareness of risks related to forex lending.
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. Continue with the process to ensure a harmonised approach for prioritising and monitoring all investments and basing investment decisions on feasibility studies, cost-benefit analysis and environmental impact assessments. Apply the principles of competition, equal treatment, non-discrimination and transparency in public procurement and state aid procedures in line with the EU acquis for all public investment projects regardless of the financing source and ensure a consistent and transparent track record demonstrating the operational independence of the Commission for State Aid Control.
5. Continue to develop and adopt a national long-term energy and climate plan in line with the Green Agenda for the Western Balkans and international commitments, and further increase investments in modernising energy infrastructure and lowering carbon emissions with a view to accelerating the green transition. Implement outstanding financial and institutional measures for higher take-up of renewables and energy efficiency, including launching first auctions for renewable energy sources

(RES) and further develop the newly established administrative entity for energy efficiency and further improve the sustainability of the financing mechanism. With a view to further liberalising the energy market, address outstanding reforms, including price and tariff reform, accelerate the unbundling of all energy utilities in line with the EU acquis, and as regards the gas sector in line with Serbia's Action Plan; as regards Gastrans, Serbia should ensure that its regulatory regime is in full compliance with EU legislation all in line with the Action plan developed following the recently opened Cluster 4 for Energy, Climate and Transport in the EU accession process.

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. Continue facilitating school-to-work transitions by stepping up further VET, including dual VET, through revised curricula and the provision of infrastructure, which enables the acquisition of practical skills. Finalise, in co-operation with all relevant ministries, their agencies and stakeholders, a Youth Guarantee Implementation Plan, adopt it and initiate its implementation.

ANNEX A: ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2022-2024

Public finance management

Despite generally strong diagnostics, more emphasis on the remaining obstacles could help identify well-targeted reform measures and clarify the link to the proposed reform measures that focus exclusively on tax and VAT collection. Although the new 2021-2030 public administration reform strategy and the new 2021-2025 public financial management reform programme have both been adopted, weaknesses in managerial accountability persist. The capacity to monitor the functioning of the internal control systems, including risk management and internal audit, needs to be further expanded and monitoring needs to be better accepted in the administrative culture of the public sector. The Ministry of Finance's centralised budget inspection function, and parliamentary oversight of public finances, both require further strengthening. The State Audit Institution's institutional capacity needs to expand and its continued independence ensured.

Measure 9: 'Transformation of tax administration'

This reform measure has been carried over from previous ERPs, where it was dealt with in the section on improving the business environment. Although the transformation has been ongoing since 2015, and some targets have been met, the overall improvement remains limited. Improvements in terms of predictability and fairness in the implementation of tax rules are yet to fully materialise. The lack of sufficient human resources remains unaddressed by the measure. The description of the measure recognises its link to the business environment and the grey economy in particular.

Measure 10: 'Introducing a new fiscalisation model and switching to electronic invoicing'

This reform measure has been carried over from last year's ERP, and moved from the section on improving the business environment. The measure aims to improve tax control and thus increase VAT collection and reduce the grey economy, and also to modernise invoicing by replacing paper invoices with digital ones. Although ambitious, the activities under the reform measure remain largely unclear, which may hinder its effectiveness. The description of the measure recognises its link to the business environment and the informal economy in particular. Although the measure also recognises its potential impact on the environment through digital procedures, there is no explicit reference to the green and digital transition.

Green transition

With the green agenda endorsed by Serbia in November 2020, the adoption of a climate law in March 2021 and a package of important energy laws in April 2021, Serbia started advancing its green transition, as recognised by the opening of Cluster 4 in the accession negotiations in December 2021. Although the ERP identifies and tackles a number of relevant issues Serbia needs to address, it fails to integrate the green transition throughout the ERP, across the entire economy, beyond transport, energy, waste management and air quality.

Measure 11: 'Introduction of the circular economy concept'

The measure to promote the circular economy has been carried over from last year's ERP. No planned activities took place last year. The measure remains very relevant as it recognises the benefits of the circular economy for the environment, innovation, economic growth and job creation. This is particularly important in view of Serbia's overall need for green transition. Although this year's ERP introduces some additional activities, the measure still lacks ambition. It does not include any immediate practical steps towards a circular economy, which would need to be underpinned by a sufficient budget and robust

performance indicators. The description of activities remains vague. The ERP provides no data on the level of allocations from Serbia's budget for any of the three years

Digital transformation

Serbia has made notable progress on digital transformation across the economy. Digitalisation remains a key priority for the government as clearly demonstrated in the ERP. However, the diagnostics do not sufficiently focus on remaining obstacles to help identify well-targeted reforms. Serbia's communications infrastructure still requires systematic improvement in both regulation and investment. The broadband roll-out is too slow, preventing the uptake of e-government and business services and slowing down the digital transformation of the economy. The 2025 Serbia programme, adopted in December 2019, announced much needed investments in infrastructure in the tune of EUR 14 billion by 2025. However, staff capacity in the ICT sector remains an issue. The challenge remains to ensure links between the ICT sector and traditional industries so as to speed up modernisation in traditional sectors. Unfortunately, the ERP does not include a link to the green transition.

Measure 12: 'Improvement of the national information and communication infrastructure'

The measure is rolled over from previous ERPs. It remains relevant in the context of providing fast broadband connectivity to under-served regions in Serbia - a main obstacle to the digital transition. 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, especially relevant in the context of the COVID-19 pandemic. However, the measure only addresses the infrastructure aspect. It should also contribute to laying the ground for implementing the digital aspects of the common regional market.

Measure 13: 'Setting the infrastructure and environment for the creation and application of innovative and artificial intelligence based solutions'

The measure is new in this years' ERP and is relevant as it provides for further infrastructure to expand the digital transformation. However, the objective of the measure is not sufficiently clear in the ERP and there is a lack of detailed activities. Furthermore, the measure only addresses the infrastructure aspect but neglects other aspects such as digital skills, and support to private sector for digital transformation, etc.

Business environment and reduction of the informal economy

The business environment and the relevant reform measures 4, 5 and 6 are analysed above in Section 4 under key challenge 2.

The informal economy has been slowly shrinking over the years, but remains extensive in terms of both its share of total output and in the number of people employed, as reforms are being implemented at a slow pace. Undeclared labour remains a persistent issue, despite some improvements in the labour market. Agriculture, construction and household services have a particularly high share of undeclared work. The driving forces are corruption, high taxes and contributions on salaries, lack of financial resources and favourable loans, parafiscal charges, hidden tax fees and red tape. The government should develop a mechanism for incentivising companies and workers to move to the formal sector.

The ERP once again does not contain any reform measures specifically addressing the issue of the shadow economy. However, reform measures 9 ('tax administration transformation') and 10 ('introduction of a new fiscalisation model and transition to electronic invoicing') carried over from last year's ERP may, if properly implemented, lead to improvements in tax inspections, with a positive impact

on the informal economy. The reform measures are ambitious in scope but remain unclear in terms of concrete actions and targets.

Research, development and innovation

As recognised in the ERP, although Serbia has a relatively good scientific base, investment in research and development remains low at around 0.9% of GDP, with less than 40% coming from the private sector. The diagnostics also recognise the lack of human resources for research and development and the continued weak cooperation between businesses and academia. However, the underlying reasons for these major structural issues have not been sufficiently identified. Infrastructure for science and technology parks is being expanded, but the need for further support services for these institutions remains. Similarly, the Innovation Fund, which provides grants for industrial research, needs to play a more prominent role in the national funding system. The smart specialisation strategy, the industrial policy strategy, and the strategy for the development of artificial intelligence adopted by Serbia in 2020 are slowly moving towards their implementation phases. The ERP does not include the link to the green and digital transition in this area.

Measure 14: ‘Development of the start-up ecosystem’

The measure is new in this year’s ERP. It aims to stimulate public and private investment and develop an ecosystem for start-up firms. The reform is relevant as it is aimed at addressing one of the main structural issues in the area and could, if successfully implemented, also help stimulate Serbia’s economic growth and competitiveness. However, the measure focuses on smart specialisation and artificial intelligence which significantly narrows its scope. Furthermore, the planned activities are not sufficiently concrete.

Measure 15: ‘Creation of conditions for the development of bio science and bioeconomy through the construction of Bio4 campus’

The measure is new in this year’s ERP. It aims, by developing relevant infrastructure, to attract and experts and businesses in the Bio4 fields (biotechnology, biomedicine, bioinformatics and biodiversity) and to bring them together in Serbia. It further aims to modernise the healthcare system through technological development. Although the measure could contribute to creating an attractive new sector in Serbia, the measure is very narrow considering its pure focus on Bio4. Furthermore, the planned activities are not detailed enough to get a clear picture of the potential of the measure. The measure does not seem to address any of the obstacles set out in the diagnostics.

Economic integration reforms

The ERP rightly analyses ongoing reforms in the area, but does not sufficiently identify underlying issues that remain to be addressed. The structure of the economy has improved further and economic integration with the EU, Serbia’s biggest trade and investment partner, remains high, accounting for 61.4% of its total trade and two-thirds of net foreign direct investment inflows in 2020. Serbia is still to complete accession to the World Trade Organization, which is not moving forward. Trade with the region remains significant and Serbia actively participates in regional cooperation such as the common regional market and the Central European Free Trade Agreement (CEFTA). Further efforts are needed to continue implementing the CEFTA Additional Protocols, as correctly identified in the ERP and reform measure 18. Progress in this context could boost Serbia’s economic growth and competitiveness, and would speed up the recovery from the pandemic and maximise the benefits of the economic and investment plan. In February 2020, Serbia adopted a customs administration development plan for customs e-systems, aiming to ensure integration with the EU system.

Measure 16: ‘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. The activities planned under CEFTA are appropriate and credible. Serbia should continue to play a constructive role within CEFTA. As progress on finalising WTO accession has been minimal in the past years, Serbia needs to take appropriate steps rapidly and resolutely, which has so far not been the case.

Energy market reforms

This sector and reform measures 7 and 8 are analysed above in Section 4 under key challenge 3.

Transport market reforms

The ERP identifies remaining challenges across the transport sector and sets out steps taken, particularly on rail transport, where progress is continuing. An updated transport strategy leading to an EU *acquis*-compliant transport sector still needs to be put in place. Critical improvements are needed on traffic management, maintenance, road safety and the transparency of transport investment. Priorities need to be aligned with the goals of economic development and EU integration, and with the EU’s sustainable and smart mobility strategy. Improvements regarding inland waterways are underway; the potential of river ports as important trade channels needs to be further examined and measures are needed to ensure their full interoperability with roads and railways. The ERP does not sufficiently reflect on the link to the green transition, considering its particular relevance in this area.

Structural Reform 17: ‘Improvement of efficiency and safety in railway traffic’

The reform has largely been carried over from previous ERPs to advance Serbia’s railway reform process. Although the diagnostics set out issues across the transport sector, the reform measure targets only the railway sector. The focus on rail transport safety and access charges is appropriate, but remains too narrow considering other important aspects of the rail reform, such as strengthening institutional capacities, facilitating border crossing procedures, the granting of train driving licences and safety certificates to foreign operators and mutual recognition of rolling stock. Serbia needs to put more focus on railway infrastructure maintenance, in particular given the ongoing cycle of investment in Serbian railway lines. Using rail to export and import goods should be more systematically encouraged to reduce pressure on the environment and on roads and to speed up the green transition.

Agriculture

The ERP rightly recognises the importance of agriculture for the economy which remains significant when coupled with the more dynamic food processing sector. Agriculture employs around one sixth of the labour force. Agriculture and exports of food products accounted for 18.5% of all exports in 2020 and the trade surplus remains significant and stable. The sector nonetheless remains hampered by inefficiency, most notably concerning land (fragmentation, low productivity due to outdated technologies, small economic size and low utilisation of agricultural land per farm), and a lack of investment in new technologies. The strong influence of weather conditions on the sector’s performance remains an unaddressed issue. Moreover, the sector faces the challenge of meeting EU obligations on food safety, veterinary and phytosanitary regulation, strengthening responsible authorities in those areas, and better risk analysis and risk-based performance in relation to border inspections. EU support allocated to Serbia for IPARD is increasing every year and is substantial. Clear bottlenecks in the implementation of IPARD hinder that support to the agriculture and rural development sector is maximised. Successful implementation of IPARD would help increase competitiveness of the sector, increase the attractiveness of rural livelihoods and reduce outmigration from rural areas. It would also contribute to increasing the environmental and climate performance of agricultural producers and primary processors. The scope

remain for further strengthening the capacity of the IPARD Agency as well as to further facilitate access to finance.

Measure 18: ‘Improvements in the competitiveness of agriculture’

The measure is a continuation of activities under reform measure 6 from last year’s ERP, but with more detailed activities planned. The measure remains relevant, but does not aim to address the most significant issues set out in the ERP. The measure also continues to face the risk of further postponements to legislative initiatives, in particular the law on quality schemes for agricultural and food products, and the law on organic production (originally planned for three years ago and repeatedly postponed). The delays in the adoption of legislation is creating a bottleneck both in terms of further legislative alignment and in projects moving forward and developing structures as required by the EU *acquis*.

Industry

Although the competitiveness of industry is key to growing the economy, the ERP does not identify any remaining structural issues in this area, which makes it difficult to assess the relevance of the proposed reform measure. The ERP rightly recognises that the performance of industry is stable despite the continuing pandemic (industry grew by 0.4% year on year and manufacturing industry by 0.1% in 2020). The ERP also recognises that access to finance for SMEs has improved. However, SMEs still face a number of structural challenges and their borrowing costs are still above those of large companies despite several programmes to support SME development, and despite their potential to create new, quality jobs. Support for incoming foreign direct investment is principally geared towards attracting manufacturers. While support for investment is well developed, other services are less so. Clusters, technology parks, internationalisation, and industrial research do exist, and new standards or digitalisation in traditional industries have been introduced but have not yet had a systemic impact. Measures of this kind should be stepped up should be fully compliant with State aid rules. The ERP is regrettably lacking a substantive measure for industrial green growth and does not refer to the green or digital transition in this area.

Measure 19: ‘Safe and quality product – industry Measure 19: “Safe and quality product - industry development factor”

This measure is a carry-over of reform measure 19 from last year’s ERP where it was covered in the area of economic integration. It consists of two components:

- (i) financial support for businesses, primarily SMEs, to increase the use of standards in production and business organisation, product certification, management systems; and
- (ii) 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 has the potential to boost the competitiveness of the economy by facilitating the free movement of goods between the EU and Serbia. The measure is thus relevant, but the link to areas beyond industry is not explained in the ERP.

Services

The ERP recognises the importance of the sector in Serbia's economy, which accounts for over half of the economy and about 30% of total exports, despite the negative impact of the COVID-19 pandemic and related measures taken to limit the spread of the virus. Tourism was particularly affected. About half the value added by services comes from retail, real estate and healthcare. Services have the potential to expand to take an even bigger share of total exports. 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 across the services sector. The CEFTA agreement and the common regional market highlight further sectors in which services could expand regionally, if enough progress were made towards achieving mutual recognition of qualifications and certificates. Although the ERP recognises the need to improve capacities in tourism to become sustainable and meet environmental objectives in line with the green agenda for the Western Balkans, the ERP does not make any clear reference to the green or digital transition and does not include any reform measure directly targeting the services sector.

Education and skills

This sector and the relevant reform measures 1 and 2 are analysed above in Section 4, under key challenge #1.

Employment and the labour market

This sector and the relevant reform measure 3 are analysed above in Section 4, under key challenge #1.

Social dialogue

Social dialogue remains weak and needs further development, in particular in the private sector. Collective agreements are mostly concluded in the public sector. Only few agreements at branch level exist in the private sector. The social partners have limited capacity to address labour and employment challenges. Foreign investors represent a significant share of employers but do not participate in social dialogue. The tripartite Economic and Social Council of Serbia is not consulted in a timely manner on policy initiatives and draft laws prior to their adoption. The Economic and Social Council lacks appropriate resources for its work.

Social protection and inclusion

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

Healthcare

Serbia's healthcare system covers 99% (2021) of the population. The compulsory health insurance scheme is managed by the Health Insurance Fund. The system is partially financed by the contributions of employed and self-employed persons, persons with non-standard work-contracts and pensioners. Unemployed people who are not insured otherwise are insured free of charge. The contribution rate is 10.3%, equally shared between employer and employee. Public expenditure on healthcare accounted for 7.1% of GDP in 2021, up 1 pp. compared to the previous year (EU-27 average in 2021 was 8.0% of GDP). Only 0.13% of the population have private insurance. In 2020, 3.8% of the Serbian population reported unmet needs due to costs, travel distances or waiting lists. This is 2 pps. lower than in 2018 but still above the EU-27 average of 1.8% (2020). According to the World Health Organization, 37.04% of the payments to healthcare providers are out-of-pocket payments made by individuals (2019),

significantly higher than the EU-27 average (15.57% in 2018). There are no official records on over-the-counter payments for pharmaceuticals.

Measure 21: ‘Improvement of the Efficiency of the Healthcare System through the Process of Digitalisation’

This reform has been rolled over from last year. The single electronic health card will create a digital health file with patient information accessible to health sector workers and patients. It 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 sustainable development goal 3: good health and well-being. The reform will make for greater transparency and efficiency in healthcare. However, the measure does not alleviate the shortage of medical staff and their tendency to emigrate.

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

Area/Sector	2016	2017	2018	2019	2020	EU-27 Average (2020 or most recent year)
Energy						
Energy imports dependency (%)	29.7%	33.8%	34.6%	35.6%	29.8%	57.5%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	418.39	418.01	394.50	375.78	391.18	110.18
Share of renewable energy sources (RES) in final energy consumption (%)	21.15%	20.29%	20.32%	21.44%	25.98%	22.09%
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	43.2 ^w	49.0 ⁽²⁰¹⁸⁾
Motorisation rate (Passenger cars per 1000 inhabitants)	266.3	278.2	284.1	297.6	312.5	519 ⁽²⁰¹⁸⁾
Agriculture						
Share of gross value added (Agriculture, Forestry and Fishing)	8.2%	7.2%	7.7%	7.2%	7.6%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	18.6%	17.2%	15.9%	15.6%	14.6%	4.3%
Utilised agricultural area (% of total land area)	39.1% ^w	38.8% ^w	39.4% ^w	39.3% ^w	N/A	40.6
Industry						
Share of gross value added (except construction)	26.4%	26.5%	25.4%	24.0%	23.4%	19.5%
Contribution to employment (% of total employment)	20.2%	21.2%	22.5%	22.6%	22.6%	18.2 %
Services						
Share of gross value added	60.7%	61.3%	61.5%	61.9%	62.5%	73.1%
Contribution to employment (% of total employment)	57.0%	57.5%	57.2%	57.0%	57.5%	71.0%

Business Environment						
Rank in Global Competitiveness Index (Source: World Economic Forum)	94	78	65	72	N/A	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	N/A
Research, Development and Innovation						
R&D intensity of GDP (R&D expenditure as % of GDP)	0.84%	0.87%	0.92%	0.89%	0.9%	2.32%
R&D expenditure – EUR per inhabitant	43.6€	48.6€	56.3€	N/A	61.2€	EUR 694.60€
Digital Economy						
Percentage of households who have internet access at home	64.7% ^w	68%	73%	80%	81%	91%
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	67.1%	70%	73%	77.4%	79%	88%
Trade						
Export of goods and services (as % of GDP)	48.6%	50.5%	50.4%	51.0%	48.2%	46.7%
Import of goods and services (as % of GDP)	53.3%	57.1%	59.1%	61.0%	56.5%	42.9%
Trade balance (as % of GDP)	-6.8%	-8.1%	-10.3%	-11.7%	-10.6%	N/A
Education and Skills						
Early leavers from education and training (% of population aged 18-24)	7.0%	6.2%	6.8%	6.6%	5.6%	9.9%
Young people neither in employment nor in education and training (NEET) (% of population aged 15-29)	22.3%	21.7%	20.1%	19.0%	20.0%	13.7%

Children aged less than 3 years in formal child care (% of under 3-years-olds)	18.1%	14.5%	13.3%	17.2%	18.1%	32.3%
Individuals who have basic or above basic overall digital skills (% of population 16-74)	N/A	39%	N/A	46%	N/A	56% ⁽²⁰¹⁹⁾
Employment						
Employment Rate (% of population aged 20-64)	57.6%	60.0%	61.6%	63.6%	64.3%	71.7%
Unemployment rate (% of labour force aged 15-74)	16.5%	14.6%	13.8%	11.3%	9.8%	6.8%
Long term unemployment rate (% of labour force aged 15-74)	9.5%	7.4%	6.7%	5.5%	4.5%	2.5%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	15.1 pps.	14.7 pps.	15.4 pps.	14.6 pps.	14.6 pps.	11.0 pps.
Disability employment gap (Percentage points difference in employment rates between people with and without a disability)	27.3 pps.	25.4 pps.	27.2 pps.	36.0 pps.	34.8 pps.	24.5 pps.
Real gross disposable income of households (Per capita increase, Index = 2008)	N/A	N/A	N/A	N/A	N/A	107.23

Social Protection System						
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	30.0%	39.5%	34.0%	31.1%	29.8%	21.9%
At-risk-of-poverty or social exclusion rate of children (% of population 0-17)	34.5%	41.7%	36.0%	34.5%	30.6%	24.2%
Impact of social transfers (Other than pensions) on poverty reduction	21.28%	18.67%	17.91%	18.02%	18.73%	32.68%
Income inequality - quintile share ratio (S80/S20) (Comparison ratio of total income received by the 20% of the population with the highest income to that received by the 20% with the lowest income)	11.00	9.40	8.60	6.50	6.06	5.24
Housing cost overburden (% of population)	31.0%	33.6%	31.3%	21.6%	17.8%	32.68%
Healthcare						
Self-reported unmet need for medical care (of people over 16)	4.5%	4.8%	5.8%	4.8%	3.8%	1.8%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	40.45% ^z	40.64% ^z	38.31% ^z	37.04% ^z	N/A	15.57% ⁽²⁰¹⁸⁾

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

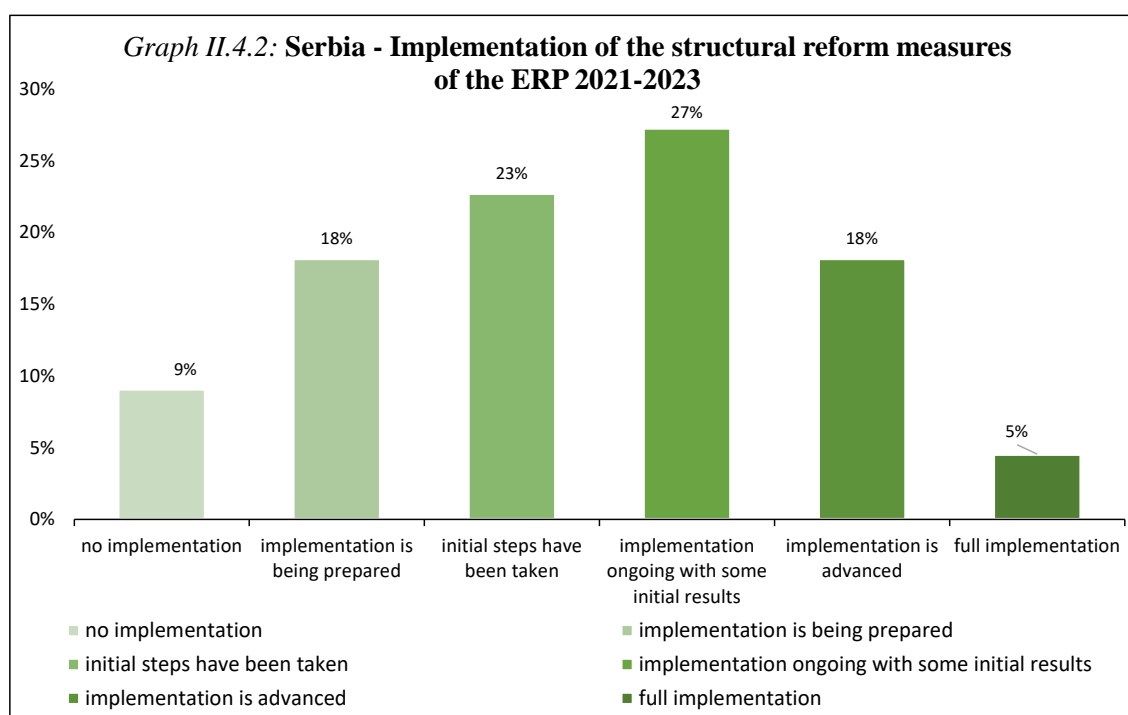
z: Data from World Health Organization.

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

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2021-2023

There was continued progress in implementing the measures in 2021, with an average score of 3.3 out of 5 (up from 2.8 in 2020). Overall, reporting on the implemented activities is fair.

The highest level of implementation involves measures that have been carried over for several years, in particular measures relating to the reduction in administrative and regulatory burden for businesses. By contrast, the pace of implementation is particularly slow for reforms regarding land consolidation, digitalisation of the agricultural sector and railway reform.



ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government adopted and formally submitted the Economic Reform Programme on 31 January 2022. The programme is in line with the medium-term fiscal strategy and the 2022 budget and covers 2022-2024.

Inter-ministerial coordination

Preparation of the 2022-2024 ERP was coordinated by the Ministry of Finance (Minister of Finance was appointed as a national coordinator) and the Secretariat for Public Policies. A number of other institutions also contributed through a working group set up specifically for this task, including the National Bank of Serbia (for the macro-fiscal part) and a number of line ministries (for the structural reform measures part). This ERP, the eighth, benefited from the accumulated 'know-how' and 'lessons learnt' from previous rounds, which further improved the overall process. Several training courses were organised by the Centre of Excellence in Finance, the German [Academy for International Cooperation](#) (GIZ) and others, for those involved in preparing the document.

Stakeholder consultation

The national authorities involved stakeholders in the preparation of the document, and held a consultation on the draft ERP. For the first time, stakeholders were invited to provide comments through the new online e-consultation portal. It is unclear whether all stakeholders were invited to comment, following some complaints from social partners. As a final step in the consultation procedure, a meeting took place with the National Convention, which brings together some 700 social partners, non-governmental organisations, business associations and other stakeholders in Serbia. The National Convention set up an inter-sectoral working group, which examined the proposed reform measures and submitted comments and suggestions. The participants were given sufficient time to comment in writing and the draft was made available online. Comments received from stakeholders were included in the annex to the economic reform programme document.

Macro framework

The programme presents a clear and concise picture of past developments. It also covers all relevant data at the time of drafting. The macroeconomic framework is sufficiently comprehensive and coherent. The baseline macroeconomic scenario is broadly plausible and major uncertainties and risks are clearly outlined and recognised. The programme presents an alternative 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 inflationary pressures and 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 21 reforms, one more than the maximum suggested by the guidance. The quality of measures varies. In some cases, measures are narrow in scope, well-targeted and planned in detail, while in others they are overly ambitious and wide in scope. The annexed tables are filled in correctly.

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5. TURKEY

The economic reform programme (ERP) was submitted on 31 January 2022.

The economic consequences of Russia's war against Ukraine may render the macro-fiscal scenarios presented in the ERP partially obsolete. The Commission will publish its updated macroeconomic and fiscal projections for candidate countries, reflecting the expected impact of the war against Ukraine and related sanctions, in its spring economic forecast in mid-May 2022.

The short-term macro-fiscal outlook may change considerably. However, the major medium-term fiscal and structural reform challenges and priorities identified in this assessment remain valid irrespective of the short-term outlook. Appropriate policy responses are essential to ensure a sustained economic recovery, greater resilience and fiscal sustainability.

5.1. EXECUTIVE SUMMARY

Turkey's economy faces growing challenges and is highly exposed to the fallout of the Russian invasion of Ukraine. In 2021, economic growth surprised on the upside and the economy grew by double-digits. Private consumption, exports and manufacturing performed particularly well. However, economic activity slowed down in the last quarter of the year, as the significant depreciation of the lira, increased market volatility and the steep rise in inflation took a heavy toll on economic sentiment. The economic reform programme's (ERP) macroeconomic scenario is optimistic and does not take into account the adverse effects of recent policy decisions. The overly loose monetary policy and weak central bank independence drove inflation up to a two-decade high, denting disposable incomes and eroding economic confidence. The unorthodox policy stance led to a series of unconventional measures to contain the slide of the lira and reverse dollarisation, but at the cost of increased uncertainty and potentially large contingent liabilities. Reducing external imbalances sustainably remains an elusive policy target, despite notable increases in international trade integration. Although the banking sector went through the crisis relatively unscathed, legacy issues remain, in particular in state-owned banks. Turkey's economy is highly exposed to the fallout of Russia's war against Ukraine, in particular via its energy and wheat imports. Though tourism may also be impacted, Turkey might receive more tourists from Russia as the alternative destinations in Europe have effectively been closed to Russian visitors. Thus, the effect of the crisis on tourism revenues of Turkey might be more limited than initially thought.

The programme targets fiscal consolidation but spending priorities do not adequately address challenges related to higher energy prices and growing poverty. Since the beginning of the pandemic, budget execution has consistently exceeded expectations. Like in previous years, maintaining fiscal prudence is the cornerstone of the authorities' macroeconomic policy. Fiscal consolidation, largely based on an overly strong reduction of current expenditure and transfers, is planned to continue. However, the medium-term budgetary plan is based on overly benign macroeconomic assumptions. It also fails to sufficiently address major structural policy issues, like high energy prices, growing poverty and inequality and does not include the effects of a number of recently-adopted measures. The ERP projects government debt to remain below 40% of GDP, but underestimates the debt-increasing effects of the weaker lira. Despite an overall conservative fiscal policy and debt management efforts, fiscal risks and debt vulnerabilities have increased. The programme outlines further efforts to improve the quality of public finance but, in the absence of strong fiscal anchors, the medium-term budgetary framework is subject to frequent changes and is not sufficiently credible and binding.

The main challenges for future economic policy are the following:

- **The unbalanced policy mix and high policy-induced uncertainty hamper growth and increase vulnerabilities.** The overly loose monetary policy has led to very high inflation and increased risks, not least in the context of tightening global financing conditions and with the impact being particularly harmful to the most vulnerable. Addressing these challenges will require restoring central bank independence and maintaining a tight monetary policy stance in keeping with achieving price stability, under a transparent framework and consistent communication.
- **The spending priorities under the fiscal scenario would need to be revised to sufficiently address the main challenges and risks.** The 2022 budget needs to be revised as it does not take into account the changed macroeconomic environment and a number of recent measures to support the lira. In view of the high uncertainty about potential further pandemic effects and the impact of Russia's war against Ukraine, standing ready to provide crisis mitigation if needed seems appropriate. Contingent on the economic outlook, maintaining a prudent and broadly neutral fiscal stance as communicated by the authorities is an asset. However, increased poverty and inequality call for more and better targeted fiscal support, while a credible medium-term consolidation plan and further improvements in public finance management could help contain growing fiscal risks.
- **The regulatory and institutional environment lacks transparency, independence and predictability necessary to promote competitiveness, which hampers much-needed foreign and domestic investments.** Turkey needs to improve the rule of law and the independence of the judiciary, and to strengthen the independence of regulatory authorities in order to promote the investment climate and competitiveness. A step in the right direction has been in dispute resolution, where Turkey made progress in 2021 by further improving mediation practices in a range of fields. State interventions in price-setting mechanisms in key product areas continue to hamper the free functioning of product markets.
- **Adapting to climate change as a competitive advantage.** Adapting to climate change and moving from a linear to a circular and sustainable use of resources is key for ensuring the competitive advantage for businesses. As proposed in the Turkish "Green Deal Action Plan" establishing an emissions trading scheme aligned with the European system, and fostering a circular economy, can contribute to the decarbonisation of the economy and can prepare for the implementation of the EU Carbon Border Adjustment Mechanism. Resolute action is needed to ensure that businesses can adapt.
- **The labour market shows signs of recovery and efforts were made to tackle skills mismatches and shortages, although the relevance of education and women's and young people's situation on the labour market remain key challenges.** The potential of women in the labour market remains largely untapped. Low participation rates in early childhood education and care have a negative impact both on women's labour market participation and on the educational foundation of children later in life. The share of young people not in education, employment or training (NEET) and the youth unemployment rate remain high. Active labour market policies as well as upskilling and reskilling opportunities do exist, and further efforts were made in 2021, but remain limited in scope.

The policy guidance set out in the conclusions from the Economic and Financial dialogue of July 2021 has been partially implemented, with a lower rate of implementation compared to the previous year. The budget deficit outperformed in 2021, while transfers to the most vulnerable households and allocations for capital expenditure and active labour market policies increased somewhat, although remaining overall rather limited. The lira's share in new borrowing increased and fiscal plans envisage a continuation of fiscal consolidation over the medium term. No progress has been achieved, however, in streamlining tax exemptions, improving control of expenditure arrears, and in the

management and monitoring of PPPs. Monetary policy was overly loose, triggering further rise of the already high inflation. Several members of the monetary policy committee have been dismissed unexpectedly and there are persistent concerns over the central bank's ability to determine independently the policy stance. There is a high uncertainty about the future monetary policy direction. The banking sector has remained largely resilient to market distress. Non-performing loans (NPLs) declined, banks' capital adequacy ratios were on average soundly above the regulatory minimum, and profitability rebounded. Some reform measures have been announced on 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. Some measures have been adopted for young people and NEET, for example to improve access to vocational education and training (VET). Efforts were stepped up on upskilling and reskilling through tailor-made measures at vocational training centres and measures were taken to encourage higher enrolment rates. The rate of participation in early childhood education and care remain low.

Overall, the programme correctly identifies the main structural challenges facing the economy, but policy credibility and reform implementation remain weak. 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 challenge related to raising skills levels to improve job prospects, in particular of women and young people, and has adopted a number of relevant reforms on this dimension, while further efforts remain necessary.

The shared European growth model based on the green and digital transition will also have to be strengthened in the ERP process, even more so in the current geopolitical context reflecting a much more uncertain economic outlook.

5.2. ECONOMIC OUTLOOK AND RISKS

Turkey's economic growth surprised on the upside in 2021. Real GDP grew by 11% and, supported by base effects, both domestic and external demand expanded strongly. The initial growth expectation of 5.8% was, thus, surpassed by a large margin. Private consumption was particularly buoyant, catching up after 3 years of subdued performance. Exports increased by close to 25%, with exports of goods reaching a record high level. Inventories adjusted downwards, following an excessive build-up the year before, while investment growth sputtered in the second half of the year. Manufacturing activity was very strong, boosting the post-COVID-19 recovery. However, the economy slowed down by the end of the last quarter of 2021 as the significant depreciation of the lira, increased market volatility and the steep rise in inflation took a heavy toll on economic sentiment.

The ERP forecasts steady and robust economic growth over the medium term. At around 5-5.5% per year, growth expectations are also largely unchanged from last year's programme. Domestic demand is projected to remain the main driver of growth, with a significant contribution from private consumption. The growth of public consumption is expected to be subdued, in particular in 2022. Investment is forecast to continue to recover, albeit at a more modest pace. The ERP expects the very good export performance to continue in the next years, benefiting from rebounding external demand, especially of international tourism and travel. Outpacing imports growth, it would thus sustain a positive contribution of net exports to growth in each year of the programme. The ERP projects a persistently strong industry performance, growing 5.7% on average, trailed by services (5.4%) and agriculture (3.8%). The output gap is projected to close in 2022 and be slightly positive in the following years. By factors of production, economic growth in 2022-2024 is expected to be driven mainly by the increasing capital stock (growing 6% per year on average), while as pandemic effects dissipate further, employment contribution will also rise

(3.9%). The ERP estimates that total factor productivity will have a marginal effect on growth, continuing its downward trend and averaging just 0.5% during this period.

The macroeconomic scenario is optimistic and does not take into account the effects of recent policy changes on inflation, exchange rate, economic sentiment and risks. Turkey's economy is highly exposed to the fallout of Russia's war against Ukraine, in particular via its energy and wheat imports, and tourism. The macroeconomic and fiscal outlook continue to be affected by the still relatively high uncertainty surrounding the evolution of the COVID-19 pandemic. In addition, the baseline scenario is based on a set of outdated assumptions, in particular about inflation and the lira exchange rate. It also does not take into account adverse effects of the overly loose monetary policy and other more recent major economic policy decisions, like the introduction of FX guaranteed-deposits (which came late in the process of ERP preparation), which make the ERP baseline highly improbable. The ERP sketches a number of risks linked to the length of the pandemic, global supply bottlenecks and the tightening of financial conditions by major central banks, among others. However, new risks have emerged due to the Turkish economy's very high exposure to the fallout of Russia's war against Ukraine. Rising global prices of energy and other key commodities represent a particular challenge for external sustainability and the already very high inflation. On the upside, the ERP also notes Turkey's strong competitive position to benefit from a projected shortening of global supply chains and nearshoring. However, despite some pick-up in foreign direct investment last year, the investment potential remains dampened by policy uncertainty and market volatility. With the balance of risks clearly tilted on the downside, the failure to present an alternative scenario is a major drawback of the programme and a step back from previous years.

Table II.5.1:

Turkey - Comparison of macroeconomic developments and forecasts

	2020		2021		2022		2023		2024	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	1.8	1.8	9.0	9.0	4.0	5.0	4.0	5.5	n.a.	5.5
<i>Contributions:</i>										
- Final domestic demand	4.0	4.0	6.5	7.4	2.9	4.3	2.9	4.7	n.a.	5.0
- Change in inventories	4.9	3.1	-1.9	-1.8	-1.0	-0.4	0.0	0.1	n.a.	0.0
- External balance of goods and services	-7.1	-5.3	4.4	3.4	2.0	1.1	1.1	0.6	n.a.	0.5
Employment (% change)	-4.8	-4.5	6.7	6.8	4.6	4.5	3.1	3.7	n.a.	3.6
Unemployment rate (%)	13.1	13.2	12.7	12.6	12.6	12.0	12.2	11.4	n.a.	10.9
GDP deflator (% change)	14.8	14.8	20.2	20.9	18.3	12.9	17.0	8.8	n.a.	7.9
CPI inflation (%)	12.3	12.3	17.8	19.6	17.7	12.2	15.4	8.4	n.a.	7.6
Current account balance (% of GDP)	-4.9	-5.0	-2.7	-2.6	-2.2	-2.2	-1.6	-1.5	n.a.	-1.0
General government balance (% of GDP)	-4.7	-3.9	-3.6	-3.6	-3.5	-3.5	-3.1	-3.4	n.a.	-2.6
Government gross debt (% of GDP)	39.7	39.7	39.1	36.6	38.9	35.8	38.7	35.4	n.a.	34.7

Sources: Economic Reform Programme (ERP) 2022, Commission Autumn 2021 forecast (COM).

Overly loose monetary policy and weak central bank independence drove inflation up to a two-decade high. Inflation increased to more than 50% year-on-year in February 2022. The inflation targeting regime and the free floating exchange rate nominally pursued by the central bank have effectively stopped being the guiding framework for monetary policy. Under the new governor appointed last year, since last September the bank moved aggressively to cut interest rates by 500 bps. to 14% despite high and growing inflation. Real interest rates turned deeply negative, leading to depreciation pressures on the lira. However, monetary policy became increasingly inefficient as most of the market interest rates have not reacted to the cut in the central bank policy rate and actually increased, as inflation expectations went up significantly.

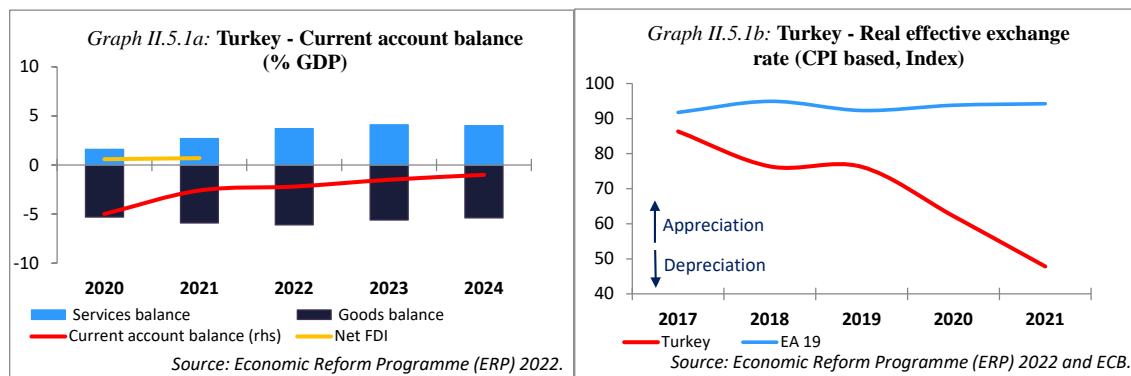
Unorthodoxy breeds unorthodoxy. The increased pressure on the lira led in December 2021 to direct official central bank interventions for the first time since 2014 and the adoption of a number of new initiatives, including sizeable tax reductions and a scheme protecting the FX value of lira time deposits. The new instrument was initially offered to natural persons and was later extended to legal entities; it was further extended to include Turkish citizens residing abroad and then to foreign residents and entities. By mid-February, it attracted more than TRY 300 billion or about a fifth of all time deposits in lira. Another of the announced measures, with potentially significant impact, is a requirement that exporters sell to the central bank 25% of their FX receipts. The central bank interventions and the new measures have stemmed the tide of lira depreciation and, at the margin, even temporarily reversed the deposit dollarisation trend. However, the FX-protected deposits (gold-protected deposits were also offered in February 2022) created unknown but potentially large contingent liabilities. They are also not a long-term solution and cannot replace a stability-oriented monetary policy, as indicated by the high market interest rates and risk premium.

Inflation is likely to remain persistently high. The ERP has not taken the latest major policy and market developments into account and projects an inflation path that is notably lower than market expectations and the central bank's latest forecast from January that by the end of 2022 inflation would approach 30% year-on-year. The steep depreciation of the lira, second round effects, the impact of the war in Ukraine, and higher expectations are likely to sustain very high inflation in 2022. The significant acceleration in producer price inflation, which reached 105% in February, and continued global price increases of energy goods and other commodities, are set to continue exerting inflationary pressure as well. Fundamentally though, it is the central bank policy of deeply negative real interest rates, the lack of an effective policy anchor and undermined institutional independence that are the key factors keeping inflation high over the medium term and providing fertile ground for continued volatility.

Turkey's integration in international trade increased markedly but external vulnerabilities remain significant. Trade openness grew by around 50% in the last 5 years, with both exports and imports reaching record highs in 2021 when Turkey's share in global trade exceeded 1% for the first time. However, exports continue to be dominated by low and medium-low technology industries. The gap between the respective shares of medium-high and high-technology imports and similar exports is high, at above 20 pps. The economy is strongly exposed to international commodity price developments, in particular energy. The current account deficit remained non-negligible, despite coming down from its peak in the crisis to below 2% of GDP. External debt hovers just below 60% of GDP, but the share of short-term debt in total external debt rose to 28% last year, driven by increased borrowing by the non-financial sector. The central bank foreign exchange reserves have recovered somewhat from their lows in 2020, before deteriorating again by the end of 2021 because of interventions to stabilise the lira. Foreign exchange swaps in non-core currencies with other central banks increased further, while net reserves remained deeply negative. The country's risk premium rose from already high levels, reflecting the market's negative assessment of the overly loose monetary policy and elevated policy uncertainty.

Sustainably reducing external imbalances remains a key policy target but it is likely to prove challenging. The ERP reaffirms the 11th Development Plan's strategic goal of moving to a less import-dependent, sustainable, export-oriented and non-inflationary growth structure. The authorities have also highlighted as a top priority the need to move away from short- to long-term external financing. With its vibrant private sector, strategic location and strong industrial base Turkey is well placed to pursue these goals. However, the current macroeconomic policy mix has increased volatility and is not conducive to attracting long-term foreign investors. In addition, the steep fall in the lira, while providing short-term cost competitiveness gains, also breeds higher inflation. The recovery of international travel and tourism is threatened by the fallout of Russia's war against Ukraine in the short term, while a strategic reassessment of the economy's long-term dependence on them is missing. The ERP also fails to provide details on the specific instruments and policies to increase productivity and the technological sophistication of its exports.

External competitiveness and current account



Although the banking sector went through the crisis relatively unscathed, legacy issues remain. Bank lending has been the authorities' preferred demand management tool for many years. As the economy recovered in 2021, some of the prudential measures supporting new credit and shielding the banks from the full impact of the crisis fallout have been lifted and total lending growth decelerated as a result. The banking sector's headline capital adequacy ratio remained soundly above the regulatory minimum and profitability rebounded somewhat, although remaining rather low. In recent years, the use of subordinated debt increased and core capital levels fell below 13% in 2021. In addition, relaxed prudential measures still protect capital adequacy ratios, in particular by using a 252 business day rolling average FX rate and suspending mark-to-market accounting rules, thereby postponing the recognition of related losses. Banking system duality continued, as state-owned banks' expansion during the crisis came at the price of weaker capital and profitability positions. However, their non-performing loans ratio fell to just 2.1% at the end of 2021, 1 pp. below the level of the total banking system, while provisioning increased to 86%. State banks have been recapitalised several times in the last years, mostly through government securities. In the beginning of 2022 they have been recapitalised again (TRY 52 billion) with the view to prepare them to lead again a new cycle of credit expansion. The banking sector's external debt roll-over ratios have remained stable at close to 100%, but at around USD 80 billion or 10% of GDP their obligations remain significant. The non-financial sector's negative net FX position shrank to USD 115 billion, its lowest level in nearly a decade, while its short-term position remained positive and stable at close to USD 60 billion. In view of its importance for attracting investments and supporting economic growth, Turkey is working on the implementation of an action plan to ensure effective anti-money laundering and countering the financing of terrorism regimes, compliant with recommendations by the Financial Action Task Force.

Table II.5.2:

Turkey - Financial sector indicators

	2017	2018	2019	2020	2021
Total assets of the banking system (EUR million)	719	641	676	678	628
Foreign ownership of banking system (%)	28.2	26.8	26.0	25.0	26.0
Credit growth (aop)	21.9	21.3	6.5	29.6	23.3
Deposit growth (aop)	20.3	22.9	18.8	37.0	29.7
Loan-to-deposit ratio (eop)	1.23	1.18	1.03	1.04	0.85
Financial soundness indicators (eop)					
- non-performing loans*	3.0	3.9	5.4	4.1	3.2
- net capital to risk-weighted assets	16.9	17.3	18.4	18.8	18.3
- liquid assets to total assets	8.0	10.7	10.0	9.4	13.3
- return on equity	15.9	14.7	11.5	11.6	15.3
- forex loans to total loans (%)	32.6	39.9	38.0	34.0	42.0

* including the impact of write-offs.

Sources: National Central Bank, IHS Markit.

5.3. PUBLIC FINANCE

Since the beginning of the pandemic, budget execution has consistently over-performed. At around 2.8% of GDP in 2021, the central government deficit was significantly below the revised 2021 target and the 2020 deficit (both at 3.5%). Although data are not yet available, the general government deficit is estimated to have declined as well, to around 3% of GDP. According to the ERP, the fiscal stance remained procyclical; while the output gap is estimated to have remained negative, the -cyclically-adjusted primary balance improved as a result of both strong revenue performance and expenditure restraint. Buoyant domestic demand lifted central budget total revenue to 20.7% of GDP, with tax revenue exceeding by a large margin the revised estimate and previous year's results. On the other hand, the reduced pandemic-related budget support and rampant inflation suppressed real personnel expenditures and current transfers, which came in far below their 2020 levels and pushed total expenditure down to 23.5% of GDP. Nonetheless, in order to cover some of the surging energy costs, budget lending, mainly to the Turkish state energy company BOTAS, shot up at the end of the year, more than doubling this expenditure line. Interest payments remained elevated at 2.7% of GDP, reflecting some of the costs of the weaker lira.

Box II.5.1: The effect of the measures taken to tackle the COVID-19 pandemic on public finance*

A) Support provided from the central government budget	Number of Beneficiary Person/Household/Businesses	2020-2021 Amount Provided (Billion TRY) ⁽¹⁾	2021 Additional Planned	2021 Year-end Forecast	2020-2021 Year-end Realisation Forecast
Medicine, medical equipment, health personnel payments	-	27.3	11.5	24.6	38.8
Additional payments for treasury interest supported	-	1.7	0.6	1.0	2.3

loans given to agricultural producers and tradesmen ⁽²⁾					
Social security premium effect of short-time work, unpaid leave application	-	29.2	0.0	13.0	29.2
Increasing the minimum retirement salary to 1 500 TL	645 823	0.9	0.0	0.0	0.9
Grant payments to tradesmen ⁽³⁾	2 548 968(4)	9.0	0.1	9.2	9.2
SMEDO World Bank and JICA loans	-	0.0	0.8	0.8	0.8
Social support programme ⁽⁵⁾	-	4.4	0.0	0.0	4.4
Others	-	0.3	0.0	0.3	0.3
Subtotal		72.8	13.0	49.0	85.8
Tax deductions (waived income tax) ⁽⁶⁾	-	43.8	0.0	28.8	43.8
Financing cost of tax and	-	4.0			4.0
Total (A)		120.6	13.0	77.8	133.6
B) Unemployment Insurance Fund and Social Assistance and Solidarity Encouragement Fund Payments	Number of Beneficiary Person/Household/ Businesses	2020-2021 Amount Provided (Billion TRY) ⁽¹⁾	2021 Additional Planned	2021 Year-end Forecast	2020-2021 Year-end Realisation Forecast
Cash aid support ⁽⁷⁾	3 095 356	14.0	0.0	6.8	14.0
Short-time work allowance ⁽⁸⁾	3 773 121	36.7	0.1	11.3	36.8
Unemployment benefits ⁽⁹⁾	1 421 144	7.8	1.8	4.8	9.6
Normalisation support ⁽¹⁰⁾	1 997 258	4.8	0.5	1.2	5.3
Social support programme ⁽⁵⁾	-	5.5			5.5
Total (B)		68.8	2.4	24.0	71.1
Total (A+B)		189.3	15.4	101.8	204.6
C) Deferred and granted loans	Number of Beneficiary Person/Household/	2020-2021 Amount	2021 Additional	2021 Year-end	2020-2021 Year-end Realisation

	Businesses	Provided (Billion TRY) ⁽¹⁾	Planned	Forecast	Forecast
Tax, social security premium deferrals	2 300 000	70.2			70.2
Loan deferrals	-	143.2		7.9	143.2
Loans granted	9 503 881	315.1			315.1
Total		528.5		7.9	528.5
GRAND TOTAL (A+B+C)		717.8	15.4	109.7	733.1

Source: Economic Reform Programme (ERP) 2022

*The GDP data of 2020 is used

(1) As of October 2021.

(2) It shows the additional payments arising from the Presidential Decree, which ensured that the interest burden arising from the increase in the demand for treasury interest-supported loans given to agricultural producers and tradesmen due to the changing market conditions during the epidemic period, the loan delays made in this period and the interest increase in the loans extended before 2021, shall be covered by the Treasury.

(3) Includes rental support, cash support and loss of turnover payments granted to tradesman. Rental and cash support grant as of December 14 2021; Turnover support February 6 2021; Cash support to tradesmen was announced to the public on May 17 2021.

(4) Includes information on 'loss of income, rent and turnover support' as of June 2021. The number of approved applications for income loss support is 1 077 506; the number of approved applications for rental support is 171 203; number of application for loss of turnover support is 8 232 ; the number of approved applications for the new tradesmen support is 1 292 027. Loss of income support and loss of turnover support are not paid at the same time, and if any beneficiaries of loss of income support, they are paid by deducting from the loss of turnover support.

(5) Support programme and additional periodic shares transferred within the scope of COVID-19 expenditure has been made. Of this amount, TRY 4.4 billion is treasury support, TRY 2.1 billion is the donations collected within the scope of Donation Campaign, and the remaining TRY 5.5 billion is used from the SASI Fund. As of October 22 2021, the number of single households benefiting from the assistance within the scope of the Pandemic Social Support Programme, Donation Campaign and Full Lockdown Social Support Programme is 7.2 million.

(6) All segments of the society benefited from tax rate reductions.

(7) The termination restriction expired on 30 June 2021. The year-end estimation was made within the framework of this assumption.(8) The short-time working allowance, which was applied due to the pandemic in the current legal framework, expired on 30 June 2021. The year-end estimation was made within the framework of this assumption.

(9) It is assumed that the monthly unemployment allowance amount will return to the usual trend before pandemic, after the termination restriction and short-time working application ends on 30 June 2021.

(10) The total number of people who receive uncombined support on the basis of insured is 6 191 391. The number of people benefiting from combination is 1 997 258. The number of beneficiaries represents the total number that has not been combined on the basis of the insured. An insured person who returns to his normal working order can benefit from this support for 6 months.

The crisis-related economic support declined substantially and many of the measures expired in 2021. Of the estimated TRY 733 billion (around 14% of the 2020 GDP) package of policy support provided since the beginning of the pandemic, most funds (85%) were allocated in 2020 while the remainder was spent in 2021. The relative weight of the assistance, however, shifted towards the government budget, as the exceptional credit support measures have been largely terminated. With the gradual recovery of the labour market, the short-time working allowance scheme and the ban on dismissals were also lifted in mid-2021. Overall, the total economic relief package has reached more than 10 million people. Despite its coverage and the strong economic rebound, however, poverty and inequality increased strongly in the last 2 years because of rising inflation and limited direct transfers to the most vulnerable parts of the population.

The ERP targets continued mild fiscal consolidation. Like in previous years, maintaining fiscal prudence is the cornerstone of the programme and of the authorities' macroeconomic policy. The primary balance is expected to steadily improve, by 1.4 pps. to a surplus of 0.7% of GDP in 2024, and the overall budget deficit to fall to 2.6% of GDP. The ERP envisages a strong reduction of current expenditure and transfers, which would contribute around four fifths of the planned total expenditure adjustment of 2.5 pps. over the programme period. Investment expenditure and transfers are also set to decline, from already low levels. In contrast, interest payments are projected to rise further. Measures on the revenue side are expected to have limited effect, mostly through declining non-tax revenue, while tax revenue is forecast to remain broadly stable in terms of GDP.

Table II.5.3:

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

	2020	2021	2022	2023	2024	Change: 2021-24
Revenues	32.4	30.7	29.8	29.7	29.2	-1.5
- Taxes and social security contributions	25.4	24.5	24.6	24.7	24.7	0.2
- Other (residual)	7.1	6.2	5.2	5.0	4.5	-1.7
Expenditure	36.4	34.3	33.3	33.1	31.7	-2.5
- Primary expenditure	33.6	31.4	30.1	29.7	28.5	-2.9
<i>of which:</i>						
Gross fixed capital formation	2.6	2.7	2.5	2.5	2.2	-0.5
Consumption	16.2	15.0	14.3	14.3	13.7	-1.3
Transfers & subsidies	8.4	7.1	6.9	6.8	6.7	-0.4
Other (residual)	6.4	6.6	6.3	6.1	5.9	-0.8
- Interest payments	2.8	2.9	3.2	3.4	3.3	0.4
Budget balance	-3.9	-3.6	-3.5	-3.4	-2.6	1.0
- Cyclically adjusted	-5.7	-4.0	-3.7	-3.4	-2.4	1.6
Primary balance	-1.1	-0.7	-0.3	0.0	0.7	1.4
- Cyclically adjusted	-2.9	-1.1	-0.5	0.0	0.9	2.0
Gross debt level	39.7	36.6	35.8	35.4	34.7	-1.9

Sources: Economic Reform Programme (ERP) 2022, Commission calculations.

The fiscal scenario does not adequately address challenges from the changed macroeconomic environment. The medium-term budgetary plan is based on benign macroeconomic assumptions, and does not take into consideration the much higher inflation and the strong depreciation of the lira. Maintaining a tight fiscal stance and an overly loose monetary policy is suboptimal and creates fertile ground for increased volatility. The current situation, where the economy is close to its potential and inflation significantly above the central bank target, calls for a bold shift of the macroeconomic policy mix towards a more neutral fiscal stance and a significantly tighter monetary policy. The budgetary scenario also fails to sufficiently address major policy issues, like higher energy prices, and growing poverty and inequality. The envisaged retrenchment in current and capital spending is only partially

justifiable by the lifting of pandemic-related measures. Its magnitude goes beyond the needs of maintaining spending discipline and risks harming the quality of public services.

The 2022 budget was outdated already by the time of its adoption. The Parliament approved the central government budget on 17 December, envisaging a deficit of TRY 278.4 billion (3.5% of GDP). The budget is based on an assumption of a real GDP growth of 5.0%, annual average inflation of 12.2%, and a TRY/EUR exchange rate of 11.0. However, the current much higher inflation and exchange rate projections would inflate tax bases and necessitate a budget revision of most expenditure and revenue lines. The larger nominal GDP in 2022 would also mean that the current nominal deficit target actually corresponds to 2.8% of GDP, remaining broadly unchanged from the better than expected 2021 outcome.

The budget does not include all recently-adopted measures, some of which have a potentially significant impact. Many of the measures, incorporated in the 2022 budget, are a continuation from the previous year. The corporate income tax rate, for example, was temporarily increased from 20% to 25% in 2021, and is set at 23% in 2022. Additional customs duties on thousands of products, levied in previous years, were extended into 2022. The application of the sliding scale system for smoothening the price dynamics of some fuels is also not new and is expected to bring some revenue losses. In an effort to address rising poverty and to foster labour force participation, income taxes and social security contributions on the part equalling the minimum wage will be temporarily covered by the State in 2022. On the other hand, the termination of the temporary reduction, introduced in 2021, of VAT rates on certain products should increase revenue. The budget, however, did not include the effects of a number of recently-adopted measures. The 50% increase in the net minimum wage, as well as higher payments for civil servants and pensions have not been envisaged on the expenditure side, while surging energy prices might lead to higher subsidies and lending to soften their social and business impact. Importantly, the programme and the budget also did not include the effects of the numerous measures adopted to protect and incentivise the holding of lira assets or to lower inflationary pressures. In the first quarter of 2022, the VAT on a number of basic consumer goods was reduced from 18% to 8%. Legal entities choosing to convert part of their deposits into the new financial instruments could benefit from withholding and corporate income tax exemptions, reduced corporate income tax rate, and lower tax on certain dividend payments. In addition, the State contribution to the private pension system was raised from 25% to 30%. There is also an unknown, but potentially significant budgetary impact from guaranteeing the FX value of lira time deposits.

The ERP projects government debt to remain below 40% of GDP but underestimates debt-increasing effects from the weaker lira. The programme estimates government debt to have come down from its peak in 2020 to 36.6% of GDP in 2021, and expects it to continue falling in the next years. It forecasts the snow-ball effect, mainly driven by the high inflation rate, to remain the dominant debt-reducing factor. Real GDP growth would also exert downward pressure on the debt ratio, although covering only half of the debt-increasing effects from higher interest payments. The largely balanced primary deficit would have a broadly neutral debt effect under the envisaged budget scenario. The programme, however, grossly underestimates the negative stock-flow adjustment related to the strong lira depreciation in 2021 that drove debt above 40% of GDP at the end of the year. Net government debt increased as well, rising above 20% of GDP and nearly tripling in the last 4 years.

Government debt vulnerabilities increased, despite debt management efforts to reduce them. There were concerted steps to increase the share of lira-denominated new domestic borrowing, which rose from 63% to 72% in 2021. The weighted average maturity of domestic borrowing increased as well, from 34 to 53.5 months, lifting the average time to maturity of domestic debt and the total debt stock to 3.0 and 5.4 years, respectively. However, some key debt metrics aggravated further due to the sharp lira depreciation, while the flight of some non-resident investors has shrunk the investor base for government debt and affected market liquidity. Non-residents' holding of domestic debt declined to 2.9%, the lowest level on record, while corporate investors' share shrank to 11.9%. Public banks, however, increased their share, and hold nearly 40% of domestic debt. For the first time in decades, in 2021 the share of domestic debt

fell below 50% of total debt. Despite increased borrowing in lira, its strong depreciation pushed the share of foreign exchange-denominated debt up by 10 pps. to a record high of around two thirds of total debt. The average time to maturity of external central government debt fell to 7.8 years. Borrowing costs increased across the board, with lira yields going above 20% by the end of the year and the yields on USD-denominated Eurobonds also moving up, in some segments even above the levels reached during the 2018 currency crisis. The outlook on the country's long-term credit rating worsened and it remained several steps below investment grade, while in February Fitch downgraded Turkey's rating from BB- to B+. The 5-year credit default swap spread increased above 600 bps in December 2021. After subsiding somewhat in the beginning of 2022, it went up again because of the war in Ukraine to 650 bps. in early March.

Box II.5.2: Debt dynamics

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

	2020	2021	2022	2023	2024
Gross debt ratio [1]	39.7	36.6	35.8	35.4	34.7
Change in the ratio	7.1	-3.2	-0.8	-0.4	-0.7
<i>Contributions [2]:</i>					
1. Primary balance	1.1	0.7	0.3	0.0	-0.7
2. "Snowball" effect	-1.8	-6.1	-2.3	-1.1	-0.9
Of which:					
Interest expenditure	2.8	2.9	3.2	3.4	3.3
Growth effect	-0.5	-2.7	-1.5	-1.7	-1.7
Inflation effect	-4.1	-6.3	-4.0	-2.7	-2.4
3. Stock-flow adjustment	7.8	2.2	1.3	0.7	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) 2022, ECFIN calculations.

Despite an overall conservative fiscal policy, fiscal risks have been building up. The volatile macroeconomic performance in recent years has imperceptibly increased fiscal risks. As part of the authorities' reaction to this volatility, there has been a series of tax restructurings and amnesties, and multiple tax exemptions and reductions have been introduced, which has undermined the tax base and complicated fiscal planning. In addition, rising poverty and inequality are likely to put additional pressure on government resources, especially in view of the very high energy prices. Previous large scale projects to improve infrastructure through PPPs continue to weight on the budget. Large contingent liabilities, not sufficiently recognised in the government's policy documents, also arise from the constant need to recapitalise state-owned banks, which are used as strategic levers to boost lending for the economy (often at below-market interest rates), or to bail out structurally important state-owned enterprises, in particular in the energy and transport sectors. The most recent round of measures to support the lira and stimulate the holding of lira time deposits have also brought not only direct costs to the budget (which are still not estimated and formally accounted for), but also unknown and potentially significant contingent liabilities linked to the exchange rate dynamic. The elevated risks and volatility have kept government liquidity preference high, with public sector deposits and other financial assets persistently above 5% of GDP since mid-2020.

The ERP outlines further efforts to improve the quality of public finance. The programme budgeting approach continued to be applied for the 2022 budget cycle. Some expenditure reviews have been initiated to improve efficiency in resource allocation and fairness in income distribution. From the beginning of 2022, the minimum subsistence allowance was abolished and the labour income equalling the minimum wage has been exempted from income and stamp taxes. However, systematic public information on expenditure arrears remained scarce. The envisaged new framework to improve the PPPs management and monitoring, and to consolidate them into a single framework, fully integrated in the budget process, is not yet adopted. 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.

The fiscal framework lacks strong anchors. There are no national fiscal rules and independent fiscal institutions to monitor fiscal performance, review forecasts and advise the government on fiscal policy matters. The medium-term budget framework is subject to frequent changes and is not sufficiently credible and binding. The macroeconomic forecast, underpinning budgetary planning, remains biased, underestimating domestic and external imbalances. Nonetheless, conservative revenue estimates have provided significant budgetary leeway to ensure the achievement and even overachievement of deficit targets. The pandemic-related measures have been overall transparent and properly estimated and accounted for. However, transparency related to quasi-fiscal activities and risks could be further improved.

5.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Turkey benefits from 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 mitigated the COVID-19 crisis in 2021, it continued to expand domestic credit and relax monetary policy. While this policy was effective in providing some short-term relief, it also further exacerbated the imbalances and increased inequalities. The Lira depreciated significantly in the last quarter of 2021, with increased market volatility and, a steep rise in inflation.

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 Commission considers that 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;
- (iii) improving transparency and predictability in the regulatory and institutional environment affecting businesses;
- (iv) implementing ambitious climate and environmental policies.

Turkey's analysis of key challenges focuses on:

- (i) enhancing the quality of the labour force;
- (ii) enhancing the quality of the education system; and
- (iii) raising the share of high value-added production in industry.

Turkey needs to improve the rule of law and the independence of the judiciary, and to strengthen institutions in order to promote competitiveness. On the green transition, Turkey needs to step up implementation of climate and environmental policies. Addressing these fundamental concerns is a prerequisite for successfully transforming the economy.

Key challenge 1: Raising the level of skills in order to increase employment, in particular of women and young people

The strong economic growth since the early 2000s helped moving people out of informal employment in agriculture into formal urban employment in services. However, this trend has come to a halt and rates of declared employment have stagnated. The natural population growth is seeing substantial changes with around 800 000 new jobseekers every year, the influx of 3.6 million Syrian refugees under temporary protection and the labour market impact of the COVID-19 pandemic have left their traces on the labour market.

The ban on layoffs and the job retention schemes aimed at countering the impact of the COVID-19 pandemic expired at the end of June 2021, but the labour market remained stable and is showing recovery. The employment rate (15+) in the third quarter of 2021 grew by 2.8 pps. compared to the third quarter of 2020 to 45.4% (TURKSTAT), surpassing pre-pandemic levels. The activity rate (20-64) reached 52.6% in the third quarter of 2021, an increase of 2.3 pps. compared to the same quarter of the previous year (TURKSTAT). According to TURKSTAT, 2.6 million more people were employed in 2021 than in the previous year, resulting in a net increase of 738 000 people compared to the third quarter of 2019. The unemployment rate (15-74) continued to decrease, reaching 11.7% in the third quarter of the third quarter of 2021 (TURKSTAT) (EU 6.9%), signifying a 1.6 pps. decrease compared to the same period in 2020 and a 2.4 pps. decrease compared to the third quarter of 2019. The massive roll out of short-time 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-time work benefits in 2020 and 2021 proved effective in protecting formal job-holders in the labour market from a more severe impact. At the same time, workers in the informal economy and the self-employed received only ad hoc cash support, while these groups were among the hardest hit by the pandemic ⁽⁴⁶⁾ (OECD 2021).

Women's potential on the labour market continues to be underutilised. Despite women's higher educational attainment, their labour force participation rate (15+) continues to be structurally and significantly below men's. In the third quarter of 2021 it stood at 33% compared to men's which was at 70.3%, showing a vast gap of 37.3 pps. In the third quarter of 2021, the employment rate of women (20-64) was 28.2%, less than half that of men (63%), resulting in a significant 34.8 pps. gender employment gap. 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 a subsidy system to incentivise employers to hire female employees, first introduced following the 2008 global financial crisis. More recently, Turkey introduced a number of Social Security Institution (SSI) pilot projects. In 2019, two further programmes started, which support childcare provision but they only involve 14 000 working mothers. These measures are commendable but remain limited in scope and impact. The lack of childcare facilities (see below), the lack of appropriate work-life balance policies

⁽⁴⁶⁾ <https://www.oecd.org/economy/surveys/TURKEY-2021-OECD-economic-survey-overview.pdf>

which would stimulate working-time flexibility and low potential wages to be earned continue to hinder female labour force participation. In addition, at 10%, part-time work is less developed in Turkey compared with the EU average of 19%. Last but not least, traditional gender stereotypes do not see women as part of the labour force. The low rate of women's labour market participation results not only in their social and economic dependence on men, but also limits Turkey's economic growth outlook. According to a McKinsey study conducted in cooperation with the Turkish Industry and Business Association (TÜSİAD) ⁽⁴⁷⁾, 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.

Early childhood education and care services and elderly care services continue to be very limited in Turkey, which is a significant barrier for women's prospects of entering the labour market their position therein, as well as for children's early educational development. Early childhood education and care is still only available in big urban centres and the enrolment rate for children up to 3 years-old is very low. The number of people above 65 years-old increased from 6.6 million to 8.2 million between 2016 and 2021, while elderly care service provision remains limited. As childcare and elderly care are primarily taken on by women, this has direct, negative implications on female labour market participation. Measures have been put in place, but it is unsure whether they are achieving their desired effect. Kindergarten is attended by 54% of children and 71% of 5 year-olds were enrolled in pre-school education. Full enrolment of 5 year-olds in pre-school education was initially scheduled for 2023, but has now been pushed back.

In an effort to address the 2021 policy guidance to 'continue to roll out mandatory pre-school education and advance further towards a 100% enrolment in primary and secondary education with updated curricula', Turkey included *measure 5 on 'Access to pre-school education will be provided based on equal opportunity principle'*, a measure updating measure 14 from the previous ERP, and *measure 6 on 'Specialised Institutional Guidance and Inspection branches will be established depending on school and programme types'*. Both of these measures are ambitious and are expected to contribute to the implementation of the above-mentioned 2021 policy guidance. Furthermore, *measure 16 on 'Preparing the digital contents of the courses taught in Open Education Schools and presenting them to the students through the Education Information Network (EBA) platform and preparation of digital contents of course-certificate-authorisation programmes organised for individuals within the scope of lifelong learning'* is expected to further increase access to education for all, including during the pandemic, through a digital education platform.

Turkey's young people continue to be disadvantaged on the labour market. The rate of young people (15-29) not in employment, education or training (NEET) increased to 32% in 2020, a 2.5 pps. increase compared to 2019. While the NEET rate improved slightly by the third quarter of 2021 (15-24) to 26% (TURKSTAT) compared to 26.9% in the same quarter in 2020, it remains more than 2.5 times the EU-27 average (10.3%) for the same age range. The NEET rate of young women is around twice as high as that of men. Youth unemployment (15-24) stands at 22.1% in the third quarter of 2021, almost twice the overall unemployment rate. The slight decrease in the labour force participation rate in the age group 15-24 to 41.6% in the third quarter of 2021 compared to 42.1% in the same quarter in 2020, suggests that the labour market situation of young people has not yet started to improve. The natural population growth that results in hundreds of thousands of people joining the labour market every year and the inflow of young Syrian refugees increase the pressure on the labour market since the economy does not generate an equivalent number of jobs. The Eleventh Development Plan and Priorities (2019-2023) sets out to provide decent job opportunities to youth and includes plans to activate NEETs. After nearly a decade, Turkey updated its Youth Strategy and adopted the National Youth Employment Strategy and Action Plan (2021-2023) in October 2021 which was developed with input from relevant public and private stakeholders. It is expected that the adopted Strategy and Action Plan will contribute to systemically addressing the barriers faced by NEETs.

⁽⁴⁷⁾ <https://tusiad.org/en/reports/item/9642-women-matter-turkey-2016-report-turkey-s-potential-for-the-future-women-in-business>

In line with above strategic documents and in response to the 2021 policy guidance on addressing ‘high youth unemployment and NEET rates through better access to education and improved VET’, *measure 3 on ‘Youth employment will be increased by strengthening vocational training centres’* aims to increase employment rates among young people by strengthening vocational training centres, including through cooperation with the private sector. To address skills mismatches on the labour market, specifically targeting young people, Turkey included *measure 2 on ‘Professions of Future’* in its ERP. This measure, rolled over from the previous year (measure 22 in the 2021-2023 ERP), focuses on information and communication technologies and R&D, and via vocational education and on-the-job training is expected to boost skills development in a digital era. The measure identifies a need for qualified workforce in fields such as data analysis, software, cyber security, robotic applications and digital business processes.

Progress has been made on improving the labour-market relevance of education and training policies, while employers still face difficulties in finding employees with the right profiles at the current wage levels. According to a survey ⁽⁴⁸⁾, 51 out of 100 companies in Turkey state that they cannot find the right talent (Manpower 2019). While data is sparsely available on this, the emigration of high-skilled labour force seems to have increased in recent years, which is expected to further exacerbate skilled labour shortage. There is often a mismatch in cross-sectoral 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. A comprehensive strategy on a socially-just transition to a changing world of work, with reskilling and upskilling programmes, is lacking. However, the implementation of the Education Vision for 2023 has progressed, for example with the setting up of VET Centres of Excellence together with the private sector, which aim to: (i) create better practical linkages to businesses as a practical innovative solution to economic issues; (ii) develop VET policies and measures to provide the skills needed for all sectors of industry; and (iii) enhance VET’s responsiveness to support innovation, including at higher VET levels. The latter policy also aims to include learners from the widest range of social backgrounds, including people who have not succeeded in general academic education and migrants. Within the Education Vision 2023 reforms, and with the support of the EU programmes, the work has started to improve and to update the skills of vocational teachers. It also includes an infrastructure reform, with a focus on priority areas (such as educational function, teachers and administrators, school environment and governance).

Measure 1 on ‘Job Clubs’, rolled over from last year (measure 19 in the 2021-2023 ERP), is an overarching measure aiming to provide intensive job and vocational counselling programmes, with special attention to people that are disadvantaged in the labour market, including women, young people, persons with disabilities, long-term unemployed and migrant workers. This remains a relevant measure and is expected to contribute to addressing the key structural challenge in Turkey.

Key challenge #2: Improving transparency and predictability in the regulatory and institutional environment affecting businesses

The institutional and regulatory framework remains fragile, particularly its predictability, transparency and efficiency. The judicial system’s serious backsliding in recent years continues to undermine businesses’ trust in its efficiency and independence. Effective measures to strengthen the rule of law, to ensure adequate and timely contract enforcement and improve the availability and functioning of dispute settlement mechanism remain key factors for improving the business environment. Even though alternative dispute resolution mechanisms have been promoted, commercial judicial processes are slow and there is a substantial backlog of commercial court cases. The increased State interference in the economy and the lack of State aid controls hinder the market-based consolidation of a level playing field for economic actors. Limited access to finance is an obstacle to companies’ investment and growth prospects especially given the need to recover economically from the COVID-19 pandemic, and to the

⁽⁴⁸⁾ Survey by Manpower, an HR solutions provider:
https://go.manpowergroup.com/hubfs/Talent%20Shortage%202019/2019_TSS_Infographic-Turkey.pdf.

realisation of Turkey's industrial policy ambitions. However, the 2022 ERP does not include specific measures on improving the business environment.

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. In November 2021 specialised courts were established for tax offences, IT crimes and financial crimes. 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.

Effective measures to strengthen the rule of law, to ensure appropriate and timely contract enforcement and to improve the availability and functioning of dispute settlement mechanisms remain key factors for improving Turkey's business environment. To improve dispute resolution, mediation practices began in the field of commerce, consumer law, banking and finance, intellectual property, energy and mining, health, sports, insurance and construction. Nonetheless, commercial judicial processes are slow and there is still a substantial backlog of commercial court cases. The bankruptcy system is expected to register a wave of restructuring in the near future. The system has started to be reformed but implementation is delayed and procedures are still costly and slow, with a low recovery rate. In 2020 the average duration of bankruptcy and insolvency proceedings was 1280 days.

The unpredictable regulatory environment is 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 set up 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 (RIA), such studies are rarely carried out. In practice RIA is not being conducted for primary legislation, and is only conducted for subordinate legislation on an ad hoc basis, at the discretion of the Presidency.

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 has been pending for almost a decade. Recent changes to the administrative set-up for State aid have led to an oversight structure that is neither complete, nor independent, nor operational. Turkey continued the implementation of the general incentive package (2012 Incentive Scheme), the Project Basis investment programme and the support programmes provided by TUBITAK (Scientific and Technological Research Council of Turkey) and KOSGEB (SME Development Organisation of Turkey). In 2021, KOSGEB rolled out "fast support" programmes targeting the most impacted sectors by the COVID. This was co-financed by the World Bank and JICA. The objective was to retain and increase the employment level of enterprises in the most impacted sectors.

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 2020, its total assets amounted to TRY 2169 bn. 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 2019 and 2020. The TWF is audited by an independent audit firm and by auditors appointed by the President. The acquisition and management of companies under the trusteeship of the Savings Deposits Insurance Fund (TMSF) remains non-transparent. As of the end of 2020, the management of 796 companies based in 38 provinces across Turkey with a total asset value of TRY 70.3 billion (EUR 7.8 billion) and with a total of 40 061 employees, remained under the trusteeship of the Fund. 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 accounts for a considerable share of economic activity, well above the OECD average. Turkey has been implementing the action plan and strategy for the fight against the informal economy (2019-2021) but the results are difficult to measure, since no concrete performance indicators were identified. There are plans to extend the focus on reducing unregistered employment (ERP 2022, **Measure 4, rolled over from the previous year, “Reducing unregistered employment by focusing on increasing audit capacity in non-agricultural sectors”**), but 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 dis-incentivise 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 (FDI) 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. To attract more investments, Turkey's FDI Strategy (2021-2023) entered into force in June 2021. 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 laws are welcome steps for the further development and deepening of capital markets. They include the easing of loan securitisation, offsetting up a single public insurance company, and 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 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 of the constrained firms are those that were discouraged from applying for a loan. The main source of discouragement being high borrowing costs.

Non-bank financial instruments are available and utilised across the economy, while efforts have been stepped up further to develop venture capital and crowdfunding, with various state-supported and private venture capital funds operational.

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, 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.

Key Challenge #3: Supporting the green transition of the economy

Turkey faces critical environmental and climate challenges, both in terms of mitigation and adaptation. Due to the strong economic and demographic growth and the use of a high-carbon energy mix, greenhouse gas emissions have increased by more than 150% since 1990. Air quality, water pollution and pollution generally are a major concern, especially in large cities and industrialised regions. Global warming combined with Turkey's semi-arid climate causes the depletion of water resources. Therefore, more ambitious climate and environment policies need to be introduced to create the necessary enabling environment. Turkey ratified the Paris Agreement on 6 October 2021 and committed to limiting its net greenhouse gas emissions. Shortly afterwards, the Environment and Urbanisation Ministry was renamed as Environment, Urbanisation and Climate Change Ministry. Turkey also released a "Green Deal action plan" on 16 July 2021. While this roadmap demonstrates the willingness of the Turkish government to deal with green transition, it does not set a time-bound and clear overall objective.

Measure 11 "Technical Assistance for the Green Deal action plan" included in the ERP looks more like an awareness-raising action. A more ambitious set of activities rather than a continuation of a series of meetings and the organisation of surveys could have been planned for the upcoming years. Only the establishment of a clear and legally binding strategy, with cross-cutting and concrete measures, substantial investment and stronger administrative capacity will enable Turkey to start its transition to a modern, resource-efficient and competitive economy.

Following a strategy of maximising the use of domestic and renewable energy sources, the share of the country's renewable energy in the electricity generation reached 44% in 2020. The ratio of renewable energy installations in the total installed power generation capacity increased from 45% in 2019 to 51% in 2020. Encouraging further the development of renewable energy installations (in full respect of Turkey's Customs Union obligations) can break energy dependency and create new opportunities for businesses. Moreover, the National Energy Efficiency action plan (2018) proposes to put in place a national energy efficiency financing mechanism in order to achieve the objectives set out in the country's Energy Efficiency strategy. Nevertheless, this financing mechanism was not implemented.

The ability to adapt to climate change and to move from a linear to a circular and sustainable use of resources is key for ensuring the future competitive advantage of businesses. As proposed in the Turkish

“Green deal action plan”, establishing an ETS system, aligned with the European system and fostering the circular economy can contribute to the decarbonisation of the economy and prepare for the implementation of the EU Carbon Border Adjustment Mechanism. Eco innovation is emerging in Turkey, especially in the automobile and energy sectors. A first Climate Council was held in February 2022 to establish a road map in line with the Paris Agreement to reach net-zero emissions by 2053. **Measure 10: “Support mechanism will be established for the replacement of inefficient electric motors used in industry with more efficient ones” was carried over from the 2021 ERP (Measure 4).** It is commendable, but remains modest to address the challenges mentioned above. It is hardly a structural reform measure.

Further developing green finance, notably by strengthening the legal framework and working on green taxonomy, is crucial to encourage private investments in innovative and green industries. R&D activities also need to be supported to enable the development and the dissemination of green production technologies. According to a recent OECD analysis, SMEs in Turkey have access to a broad range of financial support for their greening efforts, in particular to improve energy efficiency and invest in eco-innovation (in the form of grants, subsidised loans and similar).

Finally, green transition require developing new activities and skills to turn these challenges into economic opportunities. Addressing corresponding employment and professional training needs is key to ensure a smooth transition to a resource efficient and low carbon economy.

Box II.5.3: Monitoring performance in light of the European Pillar of Social Rights ⁽⁴⁹⁾

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions and social protection and inclusion for the benefit of citizens in the EU. The European Pillar of Social Rights Action Plan, adopted on 4 March 2021, aims at rallying all relevant forces to turn the principles into actions. Since the 20 principles provide a compass for upward convergence towards better working and living conditions in the EU, they are equally relevant for candidate countries and potential candidates.

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

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

Turkey's labour market indicators continue to deteriorate, indicating structural deficiencies in the labour market, especially for young people and women. The employment rate has been deteriorating since 2018 reaching 51.0% in 2020, 20.7 pps below the EU average, although by December 2021 employment rate reached 57.2% surpassing pre-2018 levels, according to TURKSTAT. The unemployment rate rose by nearly 3 pps from 2018 to 2019 and slightly improved in 2020 by 0.5 pps to 13.2% which is nearly twice the EU average of 7.2%. While long-term unemployment has slightly deteriorated in the past years to 3.3% in 2020, it is not significantly worse than the EU of 2.5%. The rate of youth NEETs was among the highest in the region with 32% compared to the EU average of 13.7% and the gender employment gap is the highest in the region (10 pps above the second highest rate in the region) at 38.1 pps, compared with the EU average of 11 pps. A significant proportion of the female population never enters the formal labour market.

Skills mismatches and limited reskilling opportunities continue to limit labour market improvements. Overall, education outcomes remain low. Individuals' level of digital skills is improving, but it remains significantly below the EU average at 34% compared to 55%. While

primary education is nearly universal, there are low enrolment and high dropout rates in secondary education. Enrolment figures for pre-primary and primary education slowly improved, but the quality of education remains a challenge, as indicated in the results of PISA testing.

The impact of social transfers on poverty reduction remains very low. It accounts for only 9.45% (EU average 32.68%), although the figures are improving slowly but steadily. The rate of people at risk of poverty or social exclusion (AROPE) continues to deteriorate. 34.1% of the population and 43.4% of children are AROPE, compared to the EU average of 21.9% and 24.2% respectively. Income distribution remains the most uneven in the region with the income quintile ratio at 9.20 compared to the EU average of 5.24.

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) monthly, quarterly and annually and the Survey on Income and Living Conditions (SILC) annually.

⁽⁴⁹⁾ The table includes 16 headline indicators of the Social Scoreboard, used to compare the performance of EU Member States (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2020 data are used for this comparison) and a review of the trend for the indicator based on the latest available 3-year period for the country (improving/deteriorating/no change). For data see Annex B. NEET: not in employment, education or training; GDHI: gross disposable household income.

5.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2021

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 region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the PG is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the PG is evaluated by the Commission in the following year's ERP assessments. The following table accordingly presents the Commission's assessment of the implementation of the 2021 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at Ministerial level on 12 July 2021.

Overall: Partial implementation (38.2%) ⁽⁵⁰⁾	
2021 policy guidance	Summary assessment
<p>PG 1:</p> <p>Maintain the fiscal policy stance consistent with the aim of supporting disinflation and lowering vulnerabilities, while increasing support to the most vulnerable households</p> <p>and providing adequate allocations for capital expenditure and active labour market policies.</p> <p>Adopt a 2022 budget together with a plan for a gradual fiscal consolidation over the medium term.</p> <p>Increase the share of local currency in new borrowing.</p>	<p>There was substantial implementation of PG 1:</p> <p>1) Partial implementation: The government tightened its fiscal policy in 2021 and achieved a better budget performance than expected. A number of fiscal measures have been adopted to reduce the adverse effects of inflation. Turkey had maintained sufficient fiscal room which could have been used in a more effective and targeted manner to increase support to vulnerable households and businesses. Through different channels, the government has increased its support to them (such as temporary tax reductions and deferrals, cash aid support, etc.). Furthermore, the central government budget allocated for the 'protection and strengthening of the family', 'the protection and development of children' and 'fight against poverty and social assistance' has been increased between 2021 and 2022, though their overall share in the budget has increased only marginally.</p> <p>2) Partial implementation: Capital expenditure execution in 2021 was above initial plans. The allocation for capital expenditure has also increased in 2022 as compared to 2021, but its share in overall spending has not changed significantly. The budget allocated for active labour market policies has also increased.</p> <p>3) Substantial implementation: The government adopted the 2022 budget, with a planned budget deficit of 3.5% to the GDP. A gradual fiscal consolidation is expected over the medium term, with a projected budget deficit of 3.2% of GDP in 2023 and 2.9% in 2024.</p> <p>4) Substantial implementation: The Ministry of Treasury and Finance had committed in several policy documents to</p>

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

	<p>reduce the share of foreign currency-denominated debt in total debt stock. Indeed, some efforts have been made and the share of lira-denominated new domestic borrowing increased from 63% to 72% in 2021. However, due to foreign FX borrowing and the weaker lira, the share of foreign currency in the total debt stock increased from 56.2% to 66%, while the share of lira-denominated debt fell from 43.8% to 34% between 2020 and 2021.</p>
<p>PG 2:</p> <p>Expand the tax base by developing a plan to streamline gradually tax exemptions and reductions.</p> <p>Reduce expenditure arrears and improve their monitoring and control.</p> <p>Adopt the new framework legislation on Public Private Partnerships in order to improve their management and monitoring.</p>	<p>There was limited implementation of PG 2:</p> <ol style="list-style-type: none"> 1) No implementation: No such plan was developed and the tax base was weakened further by new measures. 2) No implementation: No steps were taken to address this recommendation. 3) Limited implementation: According to the Economic Reform Package announced in March 2021, the government expected the completion of the proposal on the single public private partnership framework law at the end of 2021. The law has not yet been adopted, but the legislative preparation has advanced.
<p>PG 3:</p> <p>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.</p> <p>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.</p>	<p>There was limited implementation of PG 3:</p> <ol style="list-style-type: none"> 1) No implementation: The monetary policy stance was not sufficiently tight throughout most of the year and was even loosened further as of autumn, triggering high market volatility, currency depreciation and exacerbating inflation amid deeply negative real interest rates. The unexpected dismissal of the central bank governor in March and of three members of the Monetary Policy Committee in October, including two deputy governors, has renewed concerns over the central bank's ability to determine the monetary policy stance at its own discretion. Moreover, the absence of a clear nominal anchor and the increased complexity of the operational framework add to the uncertainty about the future direction of monetary policy and increase the risks to price and financial stability. 2) Partial implementation: Pandemic-related forbearance measures were lifted as of October, although with a transition period and after being extended twice. Restrictions on dividend distributions remain and are only relieved under pre-agreed conditions. Several forbearance measures remain in place, while the frequently changing and complex regulatory framework lacks transparency and allows for unwarranted flexibility, deviating from international standards. The authorities conduct regular stress tests, but do not consider an independent third-party Asset Quality Review. The extension for 2 years of the Financial Restructuring Framework Agreement will further delay NPL recognition, while reporting on restructured loans is not mandatory. The banking system maintains high levels of provisioning and the coverage ratio also increased slightly in 2021.

<p>Continue to improve legal, institutional and regulatory frameworks to foster swift and efficient NPL resolution, including the further development of the NPL market.</p>	<p>3) Partial implementation: The authorities introduced regulatory amendments and guidelines covering loan classification procedures, monitoring practices, distressed asset resolution and the activity of asset management companies. Regarding the latter, banks are now able to sell stage 1 and 2 loans in addition to NPLs, while asset management companies are now allowed to establish funds to issue asset-backed securities (which can only sell asset-backed securities to offshore investors). Further to the recent amendments to the bankruptcy law, strengthening firm insolvency frameworks remains warranted.</p>
<p>PG 4:</p> <p>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.</p> <p>Implement legislation and enhance transparency regarding state aid.</p> <p>Finalise the legislation on easing private investments and prepare its implementation.</p>	<p>There was limited implementation of PG 4:</p> <p>1) Partial implementation: Shortcomings in the independence of regulatory authorities have not been addressed. However, some important steps were taken in the judicial system. The government took actions with the specialisation of civil courts to render decision-making more efficient. The Singapore Convention was ratified providing an international legal framework for the enforcement of the settlement agreements resulting from commercial mediation. Turkey also adopted amendments to the bankruptcy law helping easier liquidation and market exit. To increase transparency, access to court decisions has been provided. However, in terms of consultation with stakeholders, implementation remains limited. Turkey does not have a clearly defined, regular mechanism with guidelines and criteria for such consultations. Regulatory impact assessment tools are not in use. Only two specific examples of consultations have been provided in the ERP document, which remains disproportionately low as compared to the number of adopted legislative acts. Moreover, in the legislative process Turkey does not make sufficient use of existing social dialogue mechanisms, such as the Economic and Social Council which remains inactive.</p> <p>2) No implementation: According to the economic reform package (announced in March 2021), the government envisaged the adoption of a single framework State aid legislation, which ensures an impact assessment. The Ministry of Treasury and Finance (March 2021) committed to collect comprehensive data instantly on all support programmes in a single centre, and provide access to all support schemes more easily, quickly and effectively from a single platform until the end of 2021. The deadline set for this action was not met. Furthermore, <i>“there is a continued lack of State aid implementation rules, enforcement and transparency, while the institutional set up remains incomplete”</i> as also highlighted in the 2021 Country Report.</p> <p>3) Limited implementation: According to the Economic Reform Package (announced in March 2021), the government aimed at finalising and putting into practice a new system for the protection of private sector investment by the end of 2021.</p>

	The draft legislation is being revised in light of the feedback from stakeholders, who voiced concerns offsetting up investment coordination units within the Ministries and the establishment of an investment ombudsman system (with the power of making legally binding decision).
<p>PG 5:</p> <p>Increase the provision of active labour market policy measures for young people.</p> <p>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.</p> <p>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.</p>	<p>There was partial implementation of PG 5:</p> <p>1) Partial implementation: The high unemployment rate for young people and the NEET rate, particularly for women, are still major challenges. Active labour market policy measures have been adopted in line with the National Youth Employment Strategy and Action Plan (2021-2023). However, the Strategy lacks well-developed result indicators for the actions. İŞKUR has continued to provide active labour market measures to young people in 2021, but their scope remained limited.</p> <p>2) Limited implementation: Gender gaps in the labour market continued. Employment subsidies, with a longer eligibility duration for women and young people, have been implemented. No significant progress has been achieved in terms of appropriate and affordable childcare infrastructure in Turkey. Legal limitations over the establishment of municipal day cares remain. Pre-primary classrooms will be established under IPA funded project.</p> <p>3) Partial implementation: To promote formal employment, the government continued to pay social security premiums and taxes over the minimum wage for each worker to be recruited until the end of 2022. As of January 2022, income tax applying up to minimum wage is paid by the State, reducing the relative tax burden on formal employment. Cross-audits have intensified and the audit capacity is increasing. However, these measures alone may not necessarily help the most vulnerable employees or the self-employed engaged in undeclared work.</p>
<p>PG 6:</p> <p>Continue to roll out mandatory pre-school education and advance further towards a 100% enrolment in primary and secondary education with updated curricula.</p> <p>Address high youth unemployment and NEET rates through better access to education and improved VET, as well as outreach to young NEET.</p>	<p>There was a partial implementation of PG 6:</p> <p>1) Limited implementation: The COVID-19 pandemic had a negative impact on school attendance and access to education. Early childhood education at age 5 has not become compulsory so far, although target of a 100% enrolment rate is announced for 2023. A participation fee remains in place limiting access to education, although most public schools continued to reimburse fees for children from disadvantaged families. The Presidency of the Republic announced the construction of 3 000 pre-schools and 40 000 pre-primary classrooms by the end of 2022.</p> <p>2) Partial implementation: The high youth unemployment and NEET rate, particularly for women, remained a major challenge. Some measures have been adopted for young people and NEETs, including improved access to VET in line with the National Youth Employment Strategy and Action Plan (2021-2023).</p>

<p>Increase offers and participation in lifelong learning measures and step up re- and upskilling possibilities for the labour force.</p>	<p>3) Substantial implementation: There are 995 public education centres and 24 maturation institutes in Turkey, providing general and vocational courses in the context of lifelong learning. Vocational Training Centres provide on-the-job training, as well as re- and upskilling through tailor-made trainings. The participation rate in lifelong learning remained low. To encourage enrolment, the Apprenticeship and Vocational Education Law was amended to provide insurance against occupational diseases and a minimum wage guarantee. The adoption of the amendment led to a sharp increase in enrolment at the centres.</p>
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5.6. THE 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, 24 May 2022

[...]

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

1. Rebalance the policy mix and use the available fiscal space in the 2022 budget to cushion the impact of adverse shocks through targeted support to vulnerable households and firms. Increase the share of local currency in new borrowing and reduce the share of public banks holdings in domestic government debt. Expand the tax base by developing a plan to gradually streamline tax exemptions and reductions.
2. Adopt the new framework legislation on Public Private Partnerships in order to improve their management and monitoring. Simplify public procurement procedures and reduce the number of exemptions. Phase out the FX value guarantees on lira time deposits as envisaged by the end of 2022 or earlier.
3. Use all available monetary policy instruments in line with the central bank's mandate of price stability to ensure a permanent fall in inflation towards the target. Enhance the institutional basis for sustainable price stability in line with operational central bank independence and bolster market confidence. Further strengthen the integrity of financial sector regulatory framework in line with international and EU standards, withdraw the regulatory flexibilities provided to the financial sector during the pandemic, particularly with regard to loan restructuring and NPL recognition practices, encourage high quality credit risk management and enhance confidence by conducting more transparent asset quality reviews and publish its methodology and outcomes.
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. Prepare a new Action Plan for the fight against informal economy and set concrete performance indicators.
5. Take steps to set up a domestic carbon pricing. With a view to meeting the national decarbonisation objective, finalise the long term national energy strategy. In order to adapt to climate change, finalise the update of the national adaptation strategy.
6. Improve the transition of young people into the labour market through active labour market measures, better access to education and improvements in the vocational education and training system. Incentivise female labour market participation through legislative and fiscal measures and provision of appropriate and affordable childcare infrastructure beyond the big urban centres of Turkey. Increase offers and participation in lifelong learning measures and step up re- and upskilling possibilities for the labour force.

ANNEX A: ASSESSMENT OF THE AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE 2022-2024 ERP

Energy

As part of the green energy transition, Turkey aims to: (i) increase energy efficiency in industry, buildings and energy production and transmission; (ii) increase the share of renewable energy in its energy mix and support the utilisation of hydrogen; and (iii) integrate and digitalise the energy systems to provide sustainable and uninterrupted energy supply and a resilient energy market.

To strengthen the Turkish electricity sector and to support long-term security of supply, the legislative basis for the electricity futures market (EFM) was enacted. The EFM will enable market participants to preserve their positions and protect themselves from market price fluctuations. The electricity futures market was opened by Energy Exchange Istanbul (EXIST) on 1 June 2021.

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 thermal power is decreasing even while for gas, Turkey has built excess capacity of 360 cubic metres per day with a target of 400 cubic metres per day by 2023. Increasing the share of renewable energy in the energy mix will help achieve carbon neutrality by 2053 target. 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 benefiting from a preferential feed-in-tariff mechanism, that was rolled over in 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.

Agriculture

The ERP identifies the need to change the legislation on agricultural statistics to make data submission mandatory for agriculture rather than voluntary. Under the EU's common agriculture policy, only participation in, and provision of data to the Farm Accountancy Data Network System (FADN) is voluntary, not statistical data collection. The FADN system has been operating in Turkey since 2009 and is currently used in 81 provinces. However, the (confidential) data collected through FADN are used for different purposes, particularly for determining and monitoring the annual agricultural incomes of enterprises and measuring their performances. Although the ERP recommends changing from a voluntary system to a mandatory one, the FADN cannot be mandatory if harmonisation with EU practice is pursued.

Measure 14: "Improvement of data collection processes and increasing the capacity of evaluation in agriculture statistics" (ERP (2021-2023) Measure 3)

The ERP, as in 2021, identifies the need to change the legislation on agricultural statistics to make data submission for agricultural holdings mandatory rather than voluntary. However, as stated in 2020, it lacks information on what (if anything) was done in 2021 to introduce and/or adapt these legislative changes to provide more reliable data.

This measure has been rolled over from the previous three ERPs. The ERP states that one online and three face-to-face trainings took place on different topics and 250 data collection and system entry supervisors were trained. However, it is not clear if the impact of these trainings was measured. It is important to see whether data collection has actually started.

Industry

Turkey's industry, having struggled to maintain its competitiveness in the years before 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, (minus 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 more or less 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. Key structural weaknesses compared with the EU are made apparent 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 was mostly in 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 account for most of the 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 companies and SMEs has accelerated, 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 next industry and technology strategy is expected to have a strong emphasis on green transition. The predominantly low-technology manufacturing in Turkey's less-advanced regions would benefit from services specific to upgrade their products and processes.

Turkey adopted a comprehensive economic reform package in March 2021, which contains measures to further digitalise public and business services for enterprises, enhance digital skills and reform State aid and similar incentives. It also aims to support the internationalisation of SMEs as well as, the green transformation of industry, notably a circular economy plan.

ERP measures 7 and 9 focus on adoption and the growth capacity of SMEs adding impetus to the existing measures. They have the potential to address the most apparent needs, if they specifically target SMEs likely to be threatened by the twin transformation or the low-technology trap. However, more systemic responses are needed if Turkey wants to fulfil its economic ambition.

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.

With the pandemic receding, and strong growth in 2021, the outlook for 2022 is good. Tourism is performing well, with spill-over effects to some services and manufacturing sectors. Exports and tourism revenue is expected to drive the economy in 2022.

Measure 15: "Increasing tourism market share and brand value" (ERP (2021-2023) Measure 6)

This measure has been rolled over from the previous ERP. The tourism sector has been one of the sectors the most affected by the COVID-19 pandemic. Tourism revenues contribute significantly to the development of the economy, the improvement of the trade balance and thus to the reduction of the current account deficit. Therefore, the roll-over of this measure from the previous ERPs is justifiable.

The measure still focuses on marketing and branding actions, but its scope has been broadened. As part of the efforts to diversify Turkey's tourism products and destinations and enhance their competitiveness, tourism training activities are being carried out to keep the tourism service quality and skills at high standards, which is considered as a positive initiative. However, there is a discrepancy between the scope of the measure and the activities planned for 2022, 2023 and 2024, as they focus mostly on the marketing and branding activities and do not refer to these training activities. The same applies for enhancing the tourism infrastructure in particular in the regions that lag behind despite their remarkably important natural, historical and cultural assets (such as the Black Sea, and Eastern and South Eastern Anatolia). There is no clear budget allocation for the activities.

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 dropped a category to 'emerging innovator' in the 2021 European Innovation Scoreboard. Turkey's strengths are in digitalisation, sales impacts and linkages. Its top-3 scores are for job-to-job mobility of human resources in science and technology, Government support for business R&D, and Broadband penetration.

Its strong decline in innovation performance in 2021 is due to reduced performance on the indicators using innovation survey data, namely (i) enterprises providing ICT training; (ii) job-to-job mobility of human resources in science and technology; (iii) patent and design applications, and (iv) environment-related technologies. To raise the export capacity of Turkish SMEs, the country would need to prioritise concepts such as the digital single market and smart specialisation.

Measure 7: "Enhancing the R&D and innovation activities of SMEs" (ERP (2021-2023) Measure 11)

Measure 7a "Prioritising technological product investments to increase the technology level and export capacity of SMEs and supporting the commercialisation of R&D projects – roll-over (ERP (2021) Measure 11a)"

This measure is rolled-over. As it has been in place for some years now, it could include impact-related indicators and not only output-based indicators such as the number of SMEs supported. Instead, indicators with economic data should be included such as increase in value-added, increase in the share of high technology products in SMEs' exports, increase in patent applications and patents etc.

Measure 7b "Enhancing the R&D and innovation activities of SMEs; and the development and implementation of mechanisms to encourage and facilitate technology based and innovative SMEs access to finance, participation in mentoring and cooperation networks –roll-over (ERP(2021) Measure 11b)"

This is a continuation of measure 11b in the previous ERP (2021-2023) and is based on TUBITAK calls/programmes for enhancing research, development and innovation activities of in particular the SMEs. These programmes are comprehensive and reach out almost all the stakeholders in the research and innovation ecosystem. They are positive in terms of supporting the innovation activities of SMEs for accessing to finance, know-how and networks. Some of these calls under this measure will prioritise projects that contribute to EU Green Deal goals, which is considered to be a positive step.

Generally on R&D and innovation, Turkey could conduct an impact assessment of TUBITAK and KOSGEB R&D supports and give more emphasis on enhancing the national and regional smart specialisation policies. Recently, the Ministry of Industry and Technology (DG for Strategic Research and Productivity) carried out impact assessment for some TUBITAK and KOSGEB support measures (such as TUBITAK's 1507 and BIGG programmes). These studies could be extended to cover all R&D supports and could be the basis for measures on future implementation. This study (in Turkish) is available at: <https://www.sanayi.gov.tr/assets/pdf/birimler/SAVGM6550KanunRapor2.pdf>

Measure 8: “Supporting competent research infrastructures on a performance basis within the new legal framework” (ERP (2021-2023) Measure 12)

This measure (i.e. implementation of Law No. 6550 to support research infrastructures) is again rolled over, and is in line with the 11th development plan.

The Ministry of Industry and Technology (DG for Strategic Research and Productivity) conducted an impact assessment for the research institutes supported through Law No. 6550. Its conclusions could provide lessons for future implementation. The study (in Turkish) is available at: <https://www.sanayi.gov.tr/assets/pdf/birimler/SAVGM6550KanunRapor2.pdf>

As Turkey embarks on the green transition, the positive impacts on environment and climate change could have been better explained since the selected research institutions and the potential results are expected to contribute to green and sustainable growth.

Measure 9: “Establishing Model Factories (SME Competency and Digital Transformation Centres) and Innovation Centres to increase the efficiency of SMEs and their digital transformation” (ERP (2021-2023) Measure 5)

This measure is rolled-over from last year as it continues to be relevant. As the measure has been in place for some years now, some impact-related indicators can be added, such as (i) increase in total factor productivity; (ii) increase in value-added in production of the serviced SMEs; and (iii) increase in the share of exports with high technology content. Currently all indicators are about the provided service itself and not about the real objective of the measure. Furthermore, on the expected impact of the measure it is stated: "It is anticipated that companies will make serious improvements in resource use and waste production". This should be based on a measurable and objective target, the word "serious" is subjective.

Measure 12: “Increasing the secure sharing and accessibility of public sector data with new data strategy”

This measure is new and is a positive development given the importance attributed to the digital transformation of the economy. However, the scope of the measure could be further developed. The measure does not provide clear clarification on how public data will be shared with the non-public institutions. The regulatory framework for data sharing with these non-public structures is unclear. Furthermore, no details are provided on the content of the trainings planned for the public and stakeholders (for instance, on issues such as cybersecurity, encryption of data and the sharing of good practices by EU Member States).

Measure 13: “Update of Turkey-EU Customs Union” (ERP (2021-2023) Measure 13)

The ERP once again includes the prospective modernisation of the Customs Union as a ‘reform’ measure under the economic integration heading. It has been repeatedly underlined by the Commission that it could, at best, be a trade policy objective. As in the previous years, the ERP document does not provide an account of the actual structural problems that inhibit Turkey's closer integration into global value chains or that reduce its external competitiveness. Most importantly, it fails to present any autonomous

measures that Turkey could take to address them. Instead, it refers to a few problems that can arguably be due to Turkey's under-utilisation of the benefits of the Customs Union. Due to its improper implementation of this measure, Turkey's backsliding in this area actually damages the level of integration enabled by the existing Customs Union.

Green transformation

This area and reform measures 10 and 11 are analysed above in Section 4, under key challenge #3.

Education and skills

This area and reform measures 5, 6 and 16 are analysed above in Section 4, under key challenge 1.

Employment and the labour market

This area and reform measures 1, 2 and 3 are analysed above in Section 4, under key challenge 1.

The rate of unregistered employment remains high. Apart from economic costs such as lower productivity and tax revenues, there are considerable social costs generated by informality. Workers 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 compared to the EU average of around 40%. Low levels of taxation limit the administration's capacity to provide basic public services, especially for the most vulnerable groups, and thus reduce the intergenerational transmission of poverty. It is difficult to break this vicious circle, which limits Turkey's growth potential. 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 thus a step in the right direction. Additional steps should follow, notably for refugees under temporary protection, who largely work in the informal economy.

Reform measure 4: 'Reducing Unregistered Employment by Focusing on Increasing Audit Capacity in Non-Agricultural Sectors'

This measure has been rolled over from the previous ERP. It aims to increase audit capacity in non-agricultural sectors, which is still relevant considering the rate of unregistered employees and the workload analysis made by the Social Security Institution. The planned activity on recruiting assistant social security controllers is relevant and feasible. The estimated cost from central budget is mentioned and seems realistic. However, measures to perform the audits electronically using technical infrastructure and data sharing are not clear. Furthermore, no indicators are provided or details on the budget allocated for these activities. Since measures on the use of IT in audit systems have been in place for some years now, activities and indicators to follow up the results and measure impact could be developed further.

Social dialogue

The bipartite and tripartite social dialogue is remains weak. 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 is not an enabling factor for fair and inclusive growth.

Social protection and inclusion

The rate of people at risk of poverty or social exclusion (AROPE) was already very high prior to and continued deteriorating as a result of the COVID-19 pandemic. In 2020, 34.1% of the population and 43.4% of children were at risk of poverty or social exclusion, compared with the EU averages of 21.9% and 24.2% respectively. This can be partly explained by the very weak impact of social transfers on poverty reduction which slowly improved in 2020 to reach an estimated 9.45%, which was still far below the EU average of 32.68%. Income distribution remains the most uneven in the region with the income quintile ratio at 9.20 compared to the EU average of 5.24.

Reform measure 18: ‘Dissemination of Family-Oriented Social Services Model’

This measure has been rolled over from the previous ERP and concerns social services for children at risk of falling into institutional care. It envisages the expansion of two government-led schemes: (1) the socio-economic support scheme for families of children at risk (due to economic deprivation); and (2) foster care services.

The measure is likely to reduce child poverty and help children receive care in a community-based setting (instead of institutional care), improving their well-being. However, there is a need to provide associated social services for the children and families benefiting from these schemes. An impact assessment of the SED programme needs to be conducted to determine its effectiveness and efficiency for a set of child-centred indicators. The programme is limited and does not have a transparent selection procedure, so it is unclear whether the current budget levels can cover all families in need. For foster care, families would need to receive necessary guidance and counselling services. Overall, the measure is not very ambitious but realistic in terms of result indicators.

Reform measure 17: ‘Raising Awareness of Hygiene, Healthy Eating, Nature Protection, Food Waste Prevention in Schools and Institutions’

Classroom learning restarted at all levels of education in Turkey on 6 September 2021, with certain COVID-19 precautions in place. Hygiene being a key priority, the Ministry of National Education (MoNE) sent directives to schools on rules and regulations for on-site learning. The MoNE prepared a certification programme called ‘My School is Clean’ in line with the ‘Guidelines on Improving Hygiene Conditions and Infection Prevention Control in Educational Institutions’ in cooperation with the Turkish Standards Institute, and prepared guidelines for inspection. These programmes/guidelines were implemented in all provinces of Turkey, under the coordination of the provincial directorates of the MoNE. Many schools received a ‘My School Clean’ certificate in 2021, and there are plans to audit these schools in 2022. This measure is important for ensuring safe on-site education, especially during the COVID-19 pandemic.

Healthcare

Turkey has a comprehensive health insurance system, aiming for universal coverage, however, about 10% of the population is still not covered, despite the generally affordable premiums. Due to overcrowded university medical programmes, the quality of medical training suffers. And despite the overcrowded programmes, Turkey still faces a shortage of doctors. This factor, combined with a lack of a referral system, results in long waiting times and does not allow doctors to devote sufficient time to patients. The national development plan, published in 2019, focuses on improving the quality and efficiency of primary care and on improving financial sustainability by putting in place incentives to join complementary health insurance schemes. The COVID-19 pandemic has been a serious setback for Turkey's economy and in terms of human casualties. It also impacted the capacity of the healthcare system to continue delivering essential services.

In its 2022-2024 economic reform programme, Turkey introduced three measures to improve the healthcare system, although it remains to be seen whether the below measures can successfully address structural deficiencies in the system.

Reform measure 19: 'Supporting Clinical Trials on Vaccines and Drugs'

This measure is rolled over from measure 25 of ERP (2021-2023). To support the development of vaccines and drugs for COVID-19, the EU granted a total of EUR 8 million to TUBITAK-TUSEB consortium for this measure. Although the measure began on 8 July 2021 no discernible progress has been made.

Reform measure 20: 'Strengthening of the Ministry of Health's COVID-19 Response Capacity'

This measure has been rolled over from the previous ERP. There is a lack of information on what has been achieved so far, and the deficiencies mentioned in last year's assessment persist. The scope of the measure should be revisited/revised with details provided on planned activities and indicators.

The project is considered to be going very well. It has helped enhance the genome sequencing capacity of the National Virology laboratory to process viral disease samples and further data in a shorter period. A strategy for using rapid antigen tests (Ag-RDT) to detect COVID-19 quickly is missing. This element should be included in the national testing strategy to improve the screening, diagnosis and treatment capacity of the health system against potential epidemic threats.

Turkey has successfully implemented this reform measure. Therefore, it no longer needs to be rolled over beyond 2022.

Reform measure 21: 'Increasing the Access of Syrian Nationals under Temporary Protection to Health Services'

This is a new measure. It aims to increase access to healthcare services for Syrians under temporary protection, and is expected to have a significant impact on public health. It envisages the employment of over 4 000 healthcare staff in 190 Migrant Health Centres as well as construction (65) and renovation (52) of Migrant Health Centres to enable sustainable primary healthcare services. For secondary healthcare services, the employment of 800 bilingual patient guides and 50 translators is envisaged. The Migrant Health Centre model is sufficient to provide appropriate quality healthcare services for migrants; however it is mainly financed by the EU. By mid-2021 a total of EUR 842 million (including ECHO-managed projects) had been contracted under the EU-financed Facility for Refugees in Turkey for projects in the health sector, representing approximately 14% of the total amount of EUR 6 billion contracted under the Facility to date. Further integrating Migrant Health Services into the Turkish health system through structural reforms is necessary to ensure the continuation of services. Establishing a Migration Health

Scientific Board may be considered in light of the Ministry of Health's commitment to ensure sustainability and their agreement to develop new policies and regulations.

No measure presented in:

- **Public Finance Management**

No measure was presented in this area in this ERP (2022-2024) and the section dedicated to the public finance management only focuses on the transition made to the performance-based programme budget system. It fails to present the main challenges such as the need to revise the public procurement legislation, the adoption of the new framework legislation on Public Private Partnerships or to strengthen budget transparency and accountability (improving for instance ex-post monitoring and reporting).

- **Business Environment**

No measure was presented in this area in this ERP (2022-2024). The finalisation of the preparation of the legislation on the private sector investment (subsequently its adoption and implementation) (presented in the previous ERP (2021-2023)) is considered essential for the improvement of the business environment. Meanwhile, some measures related to Turkey's FDI Strategy (2021-2023) could have been also included in the ERP document.

- **Energy Market Reforms**

No measure was presented in the energy market area in this ERP cycle. The section on energy market reforms is well developed, addressing the main challenges in the sector. Note that the amendment of the Natural Gas Market Law made at the end of 2021 did not include any revisions on the unbundling of the state petroleum corporation BOTAS. Despite expectations, the adopted amendments did not change the dominant position BOTAS has on the gas market in Turkey, or reduce the State's market share, or lift fossil fuel subsidies.

- **Transport Market Reforms**

No measure was presented on the transport market. The section on transport market reforms failed to take into account energy dependency on fossil fuels as one of the key structural challenges of the Turkish economy. (90% of all transport sector is dependent on fossil fuels and it is a key input for electricity (67%))

Critically, decarbonising the transport sector can:

- alleviate the import dependency on fossil fuels;
- improve the transport sector's carbon footprint contributing to the net zero targets of Turkey;
- ease Turkey's energy bill (hence freeing up valuable financial sources).

The increasing volatility in the prices of natural gas and petroleum can significantly affect Turkey's economy. We would strongly encourage Turkey to include energy dependency among the key structural challenges and to consider decarbonisation among the reform measures to be taken in the transport sector.

Information provided under 'main obstacles' is on the results of decade's long policies, rather than an actual analysis of the main obstacles. Turkey's national transport master plan, which was also supported by the IPA I EU financing, includes good analysis as well as concrete targets until 2037.

Meanwhile, Turkey committed to the Stockholm Declaration targets to reduce fatalities and serious injuries from road crashes by 50% by 2030. The road safety action plan (the backbone of which was

prepared under the EU funded Road Safety Vision Zero study from IPA I) should be presented in the targets of the reform programme.

The analysis of main obstacles should focus on:

- Why the railways market share is not increasing despite significant investments in the last decade?
- How to establish better market conditions especially in the freight sector?
- Putting the decarbonisation of railways is on the agenda of TCDD.

Railways could become a serious alternative for medium to long-range hauls. Moreover, the new EU smart and sustainable mobility Strategy supports a high share of railways capacity being used for passengers. Turkey's strategic potential as a transit country to the Middle East, Central Asia and China can only be realised on the shoulders of an efficient and effective railways sector. In this respect, inter-modal integration with the key airports, road and ports is needed.

The ERP could also focus more concretely on Turkey's maritime decarbonisation ambitions, given the recent adoption of the Paris Agreement. A recent study revealed that many regulatory reforms are needed to ensure supply of liquefied natural gas and electricity as marine fuels in Turkey. Another key question is whether Turkey is considering to include the maritime sector in the likely establishment of the emission trading scheme.

Low carbon or zero carbon alternative fuels infrastructure at airports (biofuels, hydrogen) could be also considered among the key priorities and challenges. Turkey as a key country in the EU aviation market has a role to play in providing alternative fuels. Moreover, Turkey can also consider including the aviation sector in the emission-trading scheme, if adopted.

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

Area/Sector	2016	2017	2018	2019	2020	EU-27 Average (2020 or most recent year)
Energy						
Energy imports dependency (%)	75.5%	77.2%	73.8%	70%	70.6%	57.5%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	175.03	175.30	167.69	168.42	162.79	110.18
Share of renewable energy sources (RES) in final energy consumption (%)	13.7% ^w	12.8% ^w	13.7% ^w	N/A	N/A	22.09%
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	13.30	49.0 ⁽²⁰¹⁸⁾
Motorisation rate (Passenger cars per 1000 inhabitants)	142	149	151	150	157.5	519 ⁽²⁰¹⁸⁾
Agriculture						
Share of gross value added (Agriculture, Forestry and Fishing)	7.0%	6.8%	6.4%	7.1%	71.5%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	19.5%	19.4%	18.4%	18.1%	17.6%	4.3%
Utilised agricultural area (% of total land area)	4.91%	4.89%	4.90%	4.84%	4.84%	40.6%
Industry						
Share of gross value added (except construction)	22.2%	23.3%	24.9%	24.2%	25.6%	19.5%
Contribution to employment (% of total employment)	19.5%	19.1%	19.7%	19.8%	20.5%	18.2%
Services						
Share of gross value added	61.2%	60.3%	60.8%	62.7%	60.9%	73.1%
Contribution to employment (% of total employment)	53.7%	54.1%	54.9%	56.6%	56.2%	71.0%

Business Environment						
Rank in Global Competitiveness Index (Source: World Economic Forum)	51	53	61	61	N/A	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	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%	1.09%	2.32%
R&D expenditure – EUR per inhabitant	93.6€	90.8€	83.5€	88.1€	N/A	694.60€
Digital Economy						
Percentage of households who have internet access at home	76%	81%	84%	88%	91%	91%
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	78%	88%
Trade						
Export of goods and services (as % of GDP)	23.1%	26.0%	31.2%	32.7%	28.7%	46.7%
Import of goods and services (as % of GDP)	25.2%	29.7%	31.3%	29.9%	32.5%	42.9%
Trade balance (as % of GDP)	-6.5%	-8.9%	-7.0%	-4.1%	-6.7%	N/A
Education and Skills						
Early leavers from education and training (% of population aged 18-24)	34.3%	32.5%	31.0%	28.7%	26.7%	9.9%
Young people neither in employment nor in education and training (NEET) (% of population aged 15-29)	27.8%	27.5%	27.6%	29.5%	32.0%	13.7%

Children aged less than 3 years in formal child care (% of under 3-years-olds)	NA	N/A	N/A	N/A	N/A	35.3% ⁽²⁰¹⁹⁾
Individuals who have basic or above basic overall digital skills (% of population 16-74)	28%	34%	N/A	36%	N/A	56% ⁽²⁰¹⁹⁾
Employment and Labour Market						
Employment Rate (% of population aged 20-64)	54.4%	55.3%	55.6%	53.8%	51.0%	71.7%
Unemployment rate (% of labour force aged 15-74)	10.9%	10.9%	10.9%	13.7%	13.2%	7.1%
Long term unemployment rate (% of labour force aged 15-74)	2.2%	2.4%	2.4%	3.2%	3.3%	2.5%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	42.3 pps.	41.6 pps.	40.8 pps.	38.8 pps.	38.1 pps.	11.0 pps.
Disability employment gap (Percentage points difference in employment rates between people with and without a disability)	18.8 pps.	20.3 pps.	19.4 pps.	19.5 pps.	18.9 pps.	24.5 pps.
Real gross disposable income of households (Per capita increase, Index = 2008)	N/A	N/A	N/A	N/A	N/A	107.23

Social Protection System						
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	26.6%	32.3%	32.4%	33.2%	34.1%	21.9%
At-risk-of-poverty or social exclusion rate of children (% of population 0-17)	35.6%	41.9%	42.5%	43.3%	43.4%	24.2%
Impact of social transfers (Other than pensions) on poverty reduction	7.69%	8.64%	7.88%	8.94%	9.45%	32.68%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	8.65	8.68	8.66	8.35	9.20	5.24
Housing cost overburden (% of population)	10.1%	9.5%	9.7%	10.5%	10.2%	9.9%
Healthcare						
Self-reported unmet need for medical care (of people over 16)	3.8%	2.6%	2.9%	3.0%	1.9%	1.8%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	16.47%	17.38%	17.49%	16.89%	N/A	15.57% ⁽²⁰¹⁸⁾

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

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

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM THE 2021-2023 ERP

Measure 1: Increasing share of renewable energy regarding electricity generation

Turkey's performance in this area is considered very good. Turkey has achieved an impressive share of renewable energy in its overall energy generation and continues to increase that share. Due to the successful implementation of this reform measure, it no longer needed to be rolled over to the next period.

Measure 2: Development of financial mechanisms regarding energy efficiency

Performance is considered insufficient, i.e. no national financing mechanism for energy efficiency has been developed, although drafts have been prepared. Progress has been made on the National energy efficiency action plan. This measure stopped being rolled over, as it has reached its limits.

Measure 3: Improvement of data collection processes and increasing the capacity of evaluation in agriculture statistics

The stage of reform implementation does not seem to fully reflect the actual progress made. The previous ERP indicated that trainings could not be organised in 2020 due to COVID-19 and several activities remained limited. According to the current ERP, only four training courses were organised and 10 more are planned for 2022. This means that capacity building training activities are only at mid-stage of implementation and have not progressed as desired.

The ERP also points to advances in terms of information systems improvement studies and development of business intelligence, decision support and reporting systems, but information on these activities is limited.

Measure 4: Support mechanism will be established for the replacement of inefficient electric motors used in industry with efficient ones

Agreeing with the reporting and scoring.

Measure 5: Establishing Model Factories (Capability and Digital Transformation Centres) to increase the efficiency of SMEs and to enable their digital transformation

This measure was rolled-over from previous years and is already at an advanced stage of implementation. However, reporting on the measure is insufficient and is not based on progress towards indicators, particularly for indicators like the number of businesses served and number of Turkish and Syrian citizens employed under the project. In addition, the employment indicator had been changed to 'the number of companies supported by KOSGEB' in the rolled-over version (measure 9 in the new ERP). This employment target has probably not been met and the indicator has now been changed. Furthermore, according to the 2021-2023 ERP, the target for the number of businesses to be served was 500 for 2021, whereas in the new ERP the actual number for 2021 is 250. The measure's completion score can therefore not be considered a "4".

Measure 6: Increasing tourism market share and brand value

For this measure, information is missing on the progress made on the activities planned for 2021. The scoring could therefore be an overestimate, and could be lowered to "3".

Measure 7: Establishment of SME Guidance and Counselling System

The system seems operational as it can be tested on KOSGEB's website (i.e. it is possible to apply online to become a technical consultant). However, it is unclear whether the ambitious targets of 1250 technical consultants authorised and 750 SMEs serviced have been met. In any case, it is not considered an appropriate measure for business environment. Although the measure can be excluded from the document, there is not enough information to confirm that it has been fully implemented.

Measure 8: Preparing new legislation for easing private sector investments

The Commission agrees with the reporting and scoring.

Measure 9: Reducing Unregistered Employment by Focusing on Increasing Audit Capacity in Non-Agricultural Sectors

The level of reform implementation is low. Only 50 social security controllers were recruited in 2021, which is below the target. The score is overestimated and should be lowered to "3".

Measure 10: Increasing the number and efficiency of business development, incubation and accelerator centres in order to support innovative entrepreneurship

The measure can be excluded from the ERP, in its current shape. This decision is not based on the completion of the measure but on the fact that Turkey considers the measure's actions to be continuous and regular services that do not correspond to a reform measure. The Commission does not agree that the measure, as an objective/target, is completed, i.e. it is not clear if the business development, incubation and accelerator centres are made more efficient.

Measure 11a: Prioritising technological product investments to increase the technology level and export capacity of SMEs and supporting the commercialisation of R&D projects

The information provided on the implementation is insufficient. There is no information on indicators.

Measure 11b: Enhancing the R&D and innovation activities of SMEs; and the development and implementation of mechanisms to encourage and facilitate technology-based and innovative SMEs access to finance, participation in mentoring and cooperation networks

The Commission agrees with the reporting and scoring.

Measure 12: Supporting competent research infrastructures on a performance basis within the new legal framework

This measure was given a score of "4", which means that implementation is advanced. The 2021-2023 ERP envisages that three new research infrastructures will be supported through the implementation of Law No. 6550. However, it seems that this target was not achieved in 2021. The number of supported research institutions remains the same (i.e. 7). Although the progress in the initial years is commendable, a slowdown was observed in 2021. The overall score could be "4" but if the score only relates to 2021, then it should be lowered to "3": implementation ongoing with some initial results.

Measure 13: Update of Turkey-EU Customs Union

"Update of the Turkey-EU Customs Union" is not considered a reform measure.

Measure 14: Dissemination of pre-school education

The Commission agrees with the implementation of the activities planned for 2021. However, pre-school education was not necessarily rolled out in Turkey in 2021. This can only be confirmed by official school attendance figures. The score is overestimated and should be lowered to '4'.

Measure 15a: Increasing the reading culture

The Commission agrees with the scoring.

Measure 15b: Increasing the reading culture (Z-libraries)

The Commission agrees with the scoring.

Measure 17: Updating of curricula in vocational and technical education

The Commission agrees with the scoring. The implementation of this measure is well advanced.

Measure 18: Expansion of occupational health and safety activities in schools and institutions

The Commission agrees with the scoring.

Measure 19: Job clubs

The Commission agrees with the reporting and assessment. Of the nine new job clubs planned, only five were actually opened. Job club leadership training was provided for 50 job and vocational counsellors by the end of October 2021, while the target was 100.

Measure 22: Professions of the future

Agreeing with the reporting, implementation ongoing with some initial results (3). The activities were implemented, but the targets have not been realised.

Measure 24: Dissemination of family-oriented social services models: Foster family service

The score of '3' is appropriate, but the description should include the number of children benefiting from these programmes compared to a year ago as this would show if any real progress has been made. More details are also needed on the quality of the services.

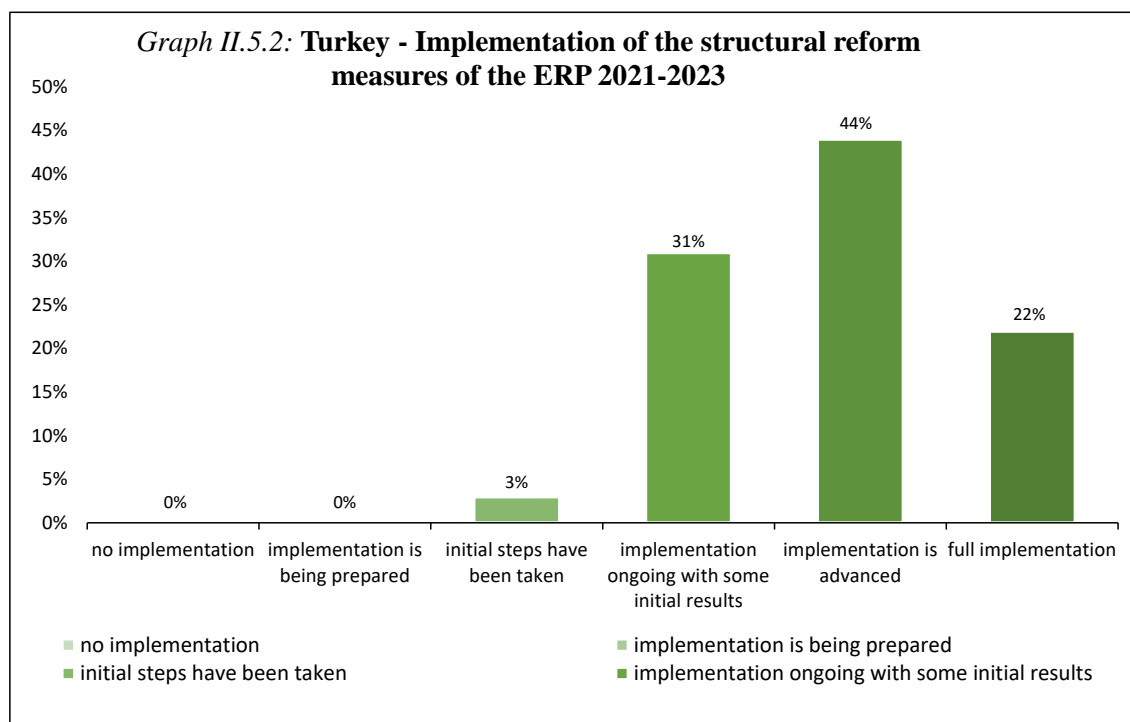
Measure 26: Strengthening the Ministry of Health's COVID-19 response capacity

In general, Turkey has successfully implemented this measure and delivered good results. However, there is a discrepancy between the initially planned activity (where emphasis is placed on the production of the rapid antigen test kits) and the actual reported implementation (rapid antigen kits were purchased and not produced as initially planned). In light of this discrepancy, the score is overestimated and should be lowered to '4'.

The average score for implementing the measures in 2021 is 3.8 out of 5, which is better than the previous year (2.4).

As to Turkey's reporting on the activities carried out, the level of detail varies still between measures. A detailed scoring for the planned activities in 2021 has been provided for only one measure.

For seven measures, full implementation of the steps foreseen in the measure for 2021 can be noted; these fall in the areas of renewable energy, SME guidance, innovative entrepreneurship, pre-school education and vocational training. 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.



ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The 2022-2024 ERP was submitted to the Commission on 31 January 2022. Overall, it has followed the Commission's guidance note.

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 provided in 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 with the macro-relevant structural reforms. The presentation and analysis of risks could also be expanded and deepened.

Fiscal framework

The chapter on the fiscal framework closely follows the outline provided in the guidance note. It covers all major elements and provides extensive information on the 2022 budget. It is less detailed on the medium-term plans and the underlying measures. The section on contingent liabilities could be expanded to systematically cover all sources of liabilities. The section on public finance risks could be further developed. The fiscal framework chapter could be expanded to cover elements related to fiscal rules and the medium-term budgetary framework.

Structural reforms

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 is 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

The economic reform programme (ERP) was submitted with a nearly two-month delay on 24 March 2022. This strongly impeded the Commission's assessment of the authorities' projections and policy plans to address the significant economic challenges the country is facing.

The economic consequences of Russia's war against Ukraine may render the macro-fiscal scenarios presented in the ERP partially obsolete. The Commission will publish its updated macroeconomic and fiscal projections for candidate countries, reflecting the expected impact of the war against Ukraine and related sanctions, in its spring economic forecast in mid-May 2022.

The short-term macro-fiscal outlook may change considerably. However, the major medium-term fiscal and structural reform challenges and priorities identified in this assessment remain valid irrespective of the short-term outlook. Appropriate policy responses are essential to ensure a sustained economic recovery, greater resilience and fiscal sustainability.

6.1. EXECUTIVE SUMMARY

Following a robust economic recovery in 2021, the Economic Reform Programme projects GDP growth to accelerate driven by investment and reforms. The economy registered a solid recovery in 2021, benefiting from strong external demand, pent-up domestic demand and supported by substantial external financing. The Economic Reform Programme (ERP) expects economic growth to accelerate to about 3.5% a year on average, assuming a further moderate international recovery, not yet factoring in recent adverse impacts from Russia's war against Ukraine, and an acceleration of structural reforms. COVID-19-related support measures are expected to be phased out, while the labour market is projected to benefit from the strengthening economic activity. Inflation is expected to remain low. 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, that the international macroeconomic outlook would remain favourable and that public and private investment will increase substantially. In particular the projected inflation profile looks very unlikely in the current global context. Key domestic downside risks are a continuation of the reform stalemate, which would impede investments, while on the external side the COVID-19 pandemic and the fallout from Russia's invasion of Ukraine could seriously undermine growth prospects. Overall, the ERP's outlook appears overly optimistic with respect to output growth, inflation and the expected acceleration of structural reforms.

The fiscal framework envisages a restrictive fiscal stance throughout the programme period. After a better-than-expected revenue performance in 2021, the programme envisages a largely balanced budget in 2022 and significant fiscal surpluses in 2023 and 2024. The main contribution to fiscal consolidation is planned to come from containing spending, in particular on investment and subsidies. The planned reduction in investment spending is in conflict with the macroeconomic assumptions and is not in line with the country's needs and the jointly adopted 2021 policy guidance. COVID-19 related revenue shortfalls and additional spending led to an increase in the public debt to nearly 35% of GDP in 2021 (+4.5 pps. compared to the previous year). From 2023 onwards, significant primary surpluses are expected to reduce the debt ratio, to close to 32% of GDP by 2024. However, there are significant risks to this fiscal scenario, stemming from the exceptional uncertainty on the evolution and economic fallout of the Russia's invasion of Ukraine, the upcoming general elections in autumn 2022, as well as the overall weak fiscal framework and the weak commitment of some stakeholders to the ERP exercise.

The main challenges include the following:

- **The quality of public spending and revenue collection remains very low.** Even before the COVID-19 pandemic, the composition of public spending focussed strongly on public consumption and poorly targeted social transfers, 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, which might have contributed to the high mortality rate during the pandemic. The targeting of social spending has remained inadequate and impeded by the country's fragmented administration. The implementation of public investment appears to be uncoordinated, insufficiently prioritised, slow, mainly driven by the availability of external financing and would need a substantial and sustained boost in order to move the economy to a higher growth trajectory. The efficiency of tax collection is impeded by a significant informal economy and insufficient transparency of taxable income. Furthermore, recent initiatives to disintegrate the BiH Indirect Tax Authority (ITA) could lead to a significant revenue loss. In view of high uncertainty about potential further pandemic effects and the impact of Russia's war against Ukraine, standing ready to provide crisis mitigation if needed seems appropriate.
- **Highly fragmented competences and a lack of cooperation among the country's stakeholders impede medium-term strategic fiscal planning.** The high degree of institutional fragmentation, a lack of cooperation among key stakeholders and excessively politicised decision-making processes are strongly impeding the country's capacity to draw up a consistent medium-term fiscal strategy. As a result, the ERP is lacking a countrywide perspective, and suffers from an insufficient medium-term orientation and obvious inconsistencies between the various programme elements. Furthermore, the economic analysis is negatively affected by the lack or insufficient quality of empirical data.
- **The absence of a common internal market within the country negatively affects the private sector's development.** The current political deadlock and the upcoming general elections risk to further delay the implementation of socioeconomic reforms needed to address the country's development challenges and pave the way for EU accession. The COVID-19 pandemic has already increased the importance and urgency of addressing structural weaknesses related to the over-politicised business environment. It is hampered by institutional weaknesses, high informality (i.e. undeclared work), a weak rule of law, low quality public administration, numerous and lengthy procedures, political interference, corruption and diverging rules in different parts of the country, complicating the operation of companies and creating additional costs. 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 parafiscal charges, adopting policies for small- and medium-sized enterprises (SMEs) and implementing customs policy legislation and supporting 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 on the economy, negatively affecting macroeconomic performance, fiscal sustainability, labour market outcomes and competitiveness.** As the COVID-19 pandemic represents a significant additional burden for the public sector, oversight and governance of public enterprises will need to be strengthened, including with measures to put public companies on equal footing with other industrial enterprises and to reduce substantial payment arrears. 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 in the health sector. Reform efforts are lagging, and the ERP did not contain an analysis of the challenges related to the country's state-owned enterprises, nor did it provide any further reform measures beyond the rolled-over commitment to establish central oversight units.

- **Labour market participation and employment rates continue being structurally low, especially for young people, women, Roma and people with disabilities.** Despite modest but stable improvements of the labour market situation and relative resilience to the COVID-19 pandemic, a large proportion of the population still remains inactive. Stereotypes about the role of women persist and together with the low availability of child and elderly care result in a wide gender employment gap and labour market participation gap. The education system's lack of alignment with labour market needs creates difficulties for young people, exposes them to multiple risks of social exclusion and prompts brain drain, while employers face difficulties in recruiting skilled workers. Social dialogue in the country is particularly weak.

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of July 2021 has been implemented only to a limited extent. The withdrawal of Republika Srpska representatives from country-level institutions has undermined the country's capacity to implement the jointly agreed policy recommendations. Medium-term fiscal planning and analytical capacities of governmental institutions have deteriorated further. The convertibility of the domestic currency has been maintained, although the functioning of the Central Bank's governing board was impeded by delays in the board members' appointment procedure. Limited progress has been made on coordinating COVID-19 mitigation measures for businesses, in extending social protection coverage and in facilitating the transfer of economic activity to the formal economy. Efforts continued on simplifying business registration procedures through online registration, but no progress was made on strengthening the single economic space and the roll-out of customs reforms stalled. State-level entities and the Brčko District adopted public financial management strategies, though there is still no countrywide strategy and the entities' central oversight units for state-owned enterprises are still at the planning stage. No progress has been made in strengthening coordination mechanisms in employment policies at country level, and only one of the entities was able to adopt a new employment strategy, which undermines the development of a countrywide approach. Almost no progress has been made on introducing a Youth Guarantee in the country. Some progress was achieved at entity level to improve access to early childhood education and care for vulnerable groups, even though the closure of many pre-schools resulted in a lower rate of enrolled children.

The ERP identifies reform challenges that are partly in line with those identified by the Commission. Macroeconomic projections are overly optimistic while the fiscal framework is not sufficiently growth-oriented. The measures to promote employment, social policies and education are not sufficiently detailed and lack a fiscal underpinning. Reform measures that would plan the implementation of Youth Guarantee are missing. Given 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 often lack consistency and coherence. Adopting a whole-of-government approach is a pre-requisite for addressing the challenges. The setting up of a well-functioning coordination and consultation mechanism for the ERP process would be key in this respect.

6.2. ECONOMIC OUTLOOK AND RISKS

The economy of Bosnia and Herzegovina recovered strongly in 2021. Economic output increased by 7.7% y-o-y in the first three quarters of 2021, compared to a drop of 3.8% in the same period a year before. The growth supporting factors included strong external demand, benefitting among others from supply chain reshuffling and pent-up domestic consumption, while investment growth remained muted, reflecting COVID-19-related uncertainties as well as persistent political stalemates. The recovery was further supported by substantial external support from the IMF, the World Bank and the EU. Employment recovered from losses during the COVID-19 crisis, backed by government support measures. This helped to bring the unemployment rate down to 16.1% in the fourth quarter of 2021. However, the overall labour force continued to decline, partly as a result of a persistent brain drain. The sizeable informal sector is likely to have been affected by the pandemic to a larger extent than administrative data suggests.

The current account deficit narrowed from 3.8% of GDP in 2020 to 2.8% of GDP in 2021, largely thanks to an improvement in the trade balance of goods and services, as export revenues increased more substantially than the value of imports. Workers' remittances, accounting for up to 12% of GDP, remained stable throughout the crisis. Net foreign direct investments (FDI) inflows increased from 1.7% in 2020 to 2.1% in 2021, still largely consisting of reinvested earnings. With respect to the monetary regime, the country maintained its exchange rate peg to the euro as the anchor currency, adopted in 1997. This approach has served the economy well so far. The country's real effective exchange rate remained rather stable, benefiting from the country's so far low inflation rates.

The ERP projects economic growth to remain robust based on strengthening external demand and accelerated structural reforms. Compared to last year's ERP, the programme's baseline scenario expects moderately stronger growth in 2022 (3.4% instead of 3.1%). For 2023 and 2024, the programme projects a further growth acceleration to 3.5% and 3.7%, respectively. This brings average output growth during the programme period to 3.5%, compared to 3.0% expected in the previous programme. This slightly more optimistic growth profile is based on stronger exports throughout the programme period, averaging 7% a year, and more buoyant private consumption in 2023 and 2024. The ERP expects strong growth in employment and real wages to boost disposable incomes and therefore consumer spending. Investment is expected to benefit from an improved business environment thanks to structural reforms and increased public investment in transport and energy. Thanks to the strong recovery in 2021, the pre-COVID-19 output level appears to have been achieved in 2021 already, while the ERP expects the negative output gap to close in 2022 and to turn positive in 2023 and 2024. The direct impact of the war in the Ukraine is expected to be limited, although the country is likely to be negatively affected by indirect, trade-related effects and sharp increases in energy and food prices, which will erode disposable income. International institutions expect only a moderate GDP recovery in the post-crisis years, of some 2½% to 3% annually, resulting from the negative impact of external uncertainties as well as persistent domestic political tensions.

Table II.6.1:

Bosnia and Herzegovina - Macroeconomic developments

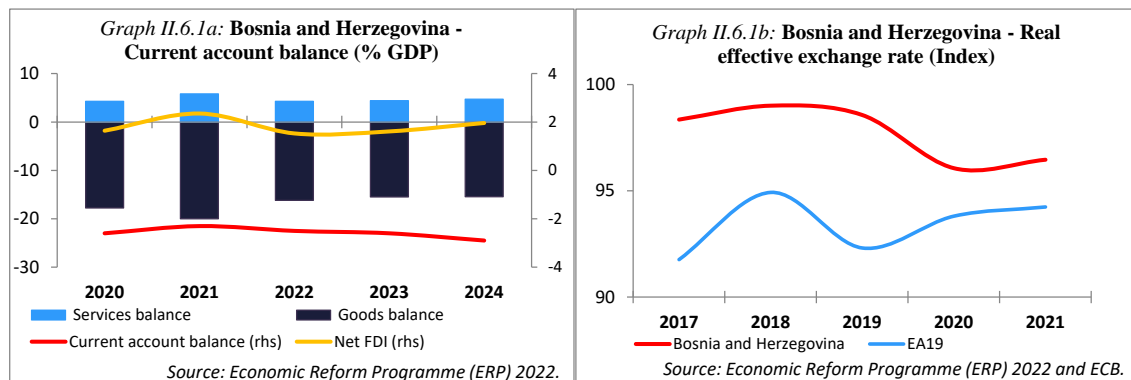
	2020	2021	2022	2023	2024
Real GDP (% change)	-3.2	3.1	3.4	3.5	3.7
<i>Contributions:</i>					
- Final domestic demand	-2.3	2.6	3.1	2.9	3.3
- Change in inventories	-1.9	-0.2	0.1	0.0	-0.1
- External balance of goods and services	0.9	0.6	0.2	0.6	0.5
Employment (% change)	:	-2.7	1.3	1.5	1.6
Unemployment rate (%)	15.9	17.8	16.9	15.9	15.1
GDP deflator (% change)	0.2	0.8	1.0	0.7	0.8
CPI inflation (%)	-1.0	1.1	0.9	0.8	1.0
Current account balance (% of GDP)	-2.6	-2.3	-2.5	-2.6	-2.9
General government balance (% of GDP)	-2.3	-0.9	-0.2	1.1	1.4
Government gross debt (% of GDP)	34.0	34.8	35.2	33.9	32.2

Sources: Economic Reform Programme (ERP) 2022.

The ERP's baseline scenario is optimistic. The main risks are related to a weaker than expected recovery of international demand and a continuation of the country's recent political stalemates, which would lead to further delays in implementing structural reforms, weaker investment and a continued substantial brain drain. Russia's invasion of Ukraine is set to lead to a weaker-than-expected external demand and significantly higher inflationary pressures, negatively affecting exports and household spending, which the ERP sees as key growth drivers. These risks are not acknowledged in the programme, which expects annual inflation to remain subdued and increase to only 1% in 2024. This inflation projection was overly optimistic even before the Russian invasion of Ukraine, given the acceleration of import prices that had started earlier. Also the expected moderate deterioration in the current account deficit, from 2.3% of GDP in 2021 to 2.9% in 2024, would have deserved a further elaboration, given the expected strengthening of domestic demand. Unfortunately, the ERP does not provide information on the impact of structural reforms of ongoing or of planned recovery measures. Overall, the baseline macroeconomic scenario is on the optimistic side especially its assumptions on the international environment, inflationary dynamics and the expected improvement in the political climate which would unlock structural reforms. In the meantime, the macroeconomic outlook has, as elsewhere, been clouded by the fallout of Russia's aggression against Ukraine.

The alternative macroeconomic scenario takes into account less favourable assumptions on external and domestic factors, which would reduce average annual GDP growth by about 1 pp. Key identified risks are a less dynamic international recovery, interrupted supply chains due to continued COVID-19 containment measures, the persistence of higher inflation, continued domestic political tensions and delays in the implementation of structural reforms, due to the upcoming general elections in the autumn. These factors would lead to an average annual GDP growth of 2.5% in 2022-2024 compared to 3.5% in the baseline scenario. The alternative scenario briefly discusses the key risks to the benchmark scenario in a qualitative way, but unfortunately does not quantify the underlying assumptions. Given the multitude of potential negative shocks, the yearly 1.0 pp impact on overall GDP growth still appears to be on the low side.

External competitiveness and current account



6.3. PUBLIC FINANCE

In 2021, the fiscal performance was better than expected, mainly thanks to stronger than anticipated revenue growth. Good revenue performance reflected a solid economic rebound but also accelerating inflation. As a result, total revenues increased by 10.2% y-o-y and were 6.2% higher than projected. The authorities continued to support the economic recovery throughout 2021 by providing subsidies, guarantees, deferred tax payments and wage increases. Total expenditure rose by 6.2% y-o-y, surpassing budget plans by 3.3%, despite less buoyant spending on social security and on wages and compensations. As a result, the preliminary general government deficit stood at 0.9% of GDP, compared to a planned deficit of 1.7% of GDP. The country's fiscal position is estimated to have improved, from a deficit of some 4.7% of GDP in 2020, to largely balanced accounts in 2021, as a result of strong GDP growth in 2021, underperforming public investment due to political stalemates as well as reduced COVID-19-related spending. The public debt ratio rose from 30% of GDP at the beginning of the COVID-19 crisis to some 35% at the end of 2021. There is a significant degree of non-alignment with EU public sector accounting standards, in particular with respect to publicly-owned enterprises, which strongly impedes the assessment of the country's actual fiscal position. As a result, both the deficit and debt ratio could be significantly higher than reported.

The ERP's medium-term fiscal strategy aims to improve the country's fiscal position by enhancing the efficiency of revenue collection and public spending as well as by reducing COVID-19 related support measures. By the end of the programme period, the ERP envisages to turn the 2021 deficit of 0.9% of GDP into a surplus of 1.4%. This should mainly come from a reduction in spending of 3.4 pps. of GDP. Most of this spending reduction should come from lowering public consumption and transfers and subsidies as a share of GDP (by 1.6 pps. and 1.4 pps. respectively), while about one third will be the result of a 1.1 pps. reduction in public investment, from 3.5% of GDP in 2021 to 2.4% in 2024. By that time, public investment is planned to be lower as a percentage of GDP than before the COVID-19 crisis, which is in contrast to the main macroeconomic assumptions on strong public investment. At the same time, the ERP expects a decline in the share of revenues in GDP of 1.1 pps., mainly by projecting that revenue increases will remain below nominal GDP growth. The main contribution (0.6 pps. from an overall reduction of 1.1 pps.) will come from the non-specified 'other' category, while the share of indirect taxes in GDP is projected to fall by 0.5% of GDP. Cyclically adjusted balances point to a neutral fiscal stance in 2022 and a negative fiscal impulse in 2023, which would be appropriate based on the ERP's assumption that the output gap will turn positive that year.

The programme plans a largely balanced general government budget in 2022. The planned deficit of the Republika Srpska entity is largely compensated by a projected surplus in the Federation, leading to a small overall deficit of 0.2% of GDP. Overall, revenues are expected to increase by 2.9%, mainly thanks

to strong growth of indirect tax revenues as well as marked increases in revenues from social contributions and direct taxes, reflecting strong wage and employment growth. On the spending side, the authorities intend to raise spending by 1.5% only. However, this moderate increase is mainly the result of a drop in the unspecified 'other' expenditure and a 0.4% drop in 'material' spending, while the big-spending categories of "wages and compensations" and 'social security transfers' are envisaged to increase by some 3.5%. Notably, the 2022 countrywide budget plans a substantial increase in capital spending, by 23%, although from a rather low level. The ERP presents the countrywide budget as an aggregation of lower-level budgets which had partly still been in the form of drafts. In particular, the 2022 budgets of the larger entity, the Federation, and the state level had not yet been approved.

Table II.6.2:

Bosnia and Herzegovina - Composition of the budgetary adjustment (% of GDP)						
	2020	2021	2022	2023	2024	Change: 2021-24
Revenues	39.9	42.3	41.7	41.4	41.2	-1.1
- Taxes and social security contributions	35.6	37.6	37.5	37.4	37.3	-0.4
- Other (residual)	4.3	4.7	4.2	4.0	3.9	-0.8
Expenditure	42.3	43.2	42.0	40.4	39.8	-3.4
- Primary expenditure	41.6	42.4	41.1	39.4	38.8	-3.6
of which:						
Gross fixed capital formation	3.5	3.5	3.7	2.4	2.4	-1.1
Consumption	17.6	18.6	18.1	17.3	17.0	-1.6
Transfers & subsidies	17.9	18.3	17.4	17.2	17.0	-1.4
Other (residual)	2.6	2.0	1.9	2.6	2.4	0.5
- Interest payments	0.7	0.8	0.9	0.9	1.0	0.2
Budget balance	-2.3	-0.9	-0.2	1.1	1.4	2.3
- Cyclically adjusted	-1.8	-0.4	0.0	1.0	1.1	1.5
Primary balance	-1.7	-0.1	0.6	2.0	2.4	2.5
- Cyclically adjusted	-1.2	0.4	0.9	1.9	2.1	1.7
Gross debt level	34.0	34.8	35.2	33.9	32.2	-2.7

Sources: Economic Reform Programme (ERP) 2022, Commission calculations.

In 2023 and 2024, the programme projects fiscal surpluses of 1.1% and 1.4% of GDP respectively, based on containing capital spending and public consumption. In the last 2 years of the current programme, the ERP expects total revenues to increase nearly as much as nominal GDP - by 3.5% and 4% - respectively. Spending - in particular investment and public consumption - will be contained, in particular in 2023. The programme explains this feature by the need to finance maturing debt. As a result, spending for public investment will be reduced by one third, while public consumption will be largely maintained at its nominal level from the year before. However, upon submission of the ERP, the authorities had not yet agreed on the medium-term fiscal framework, (called the 'Global Fiscal Framework'). Therefore, the presented medium-term outlook may be subject to major revisions.

The relatively low debt level suggests that there is fiscal space to support stronger investment and growth. According to the programme, the country's debt ratio rose by 3.6 pps. and 0.9% pps. of GDP in the COVID-19 years of 2020 and 2021, respectively. For 2022, the programme expects only a moderate increase by 0.4 pps. of GDP, while in the following years, the debt ratio is expected to fall further, declining by 1.3 pps. of GDP in 2023 and by 1.7 pps. of GDP in 2024. Real GDP growth as well as the primary surpluses in 2023 and 2024 are key factors for this decline. However, due to the limited alignment of the country's public account standards with EU requirements there is significant uncertainty about the actual level of public debt. Assuming that the presented data broadly reflects the country's public debt situation, the programme's strong emphasis on achieving fiscal surpluses and reducing the debt burden would have deserved more explanation, in particular given the large investment needs, the

relatively low level of public debt and the currently limited burden of interest payments, accounting for slightly less than 1% of GDP.

Box II.6.1: Dept Dynamics					
Bosnia and Herzegovina					
Composition of changes in the debt ratio (% of GDP)					
	2020	2021	2022	2023	2024
Gross debt ratio [1]	34.0	34.8	35.2	33.9	32.2
Change in the ratio	3.6	0.9	0.4	-1.3	-1.7
Contributions [2]:					
1. Primary balance	1.7	0.1	-0.6	-2.0	-2.4
2. "Snowball" effect	1.6	-0.5	-0.6	-0.5	-0.5
Of which:					
Interest expenditure	0.7	0.8	0.9	0.9	1.0
Growth effect	1.0	-1.0	-1.1	-1.2	-1.2
Inflation effect	-0.1	-0.3	-0.3	-0.2	-0.3
3. Stock-flow adjustment	0.3	1.2	1.6	1.2	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) 2022, ECFIN calculations.					

Risks to the programme's fiscal scenario are substantial, primarily in view of the upcoming general elections, the uncertainties related to the war in the Ukraine, but also due to the low degree of political commitment of some stakeholders, in particular the Republika Srpska, to the ERP process in general. Although the main revenue assumptions are cautious and the country's overall fiscal performance has remained solid in the past, there is a significant risk that in view of the upcoming general elections, the assumed spending restraint will not be realised. In addition, the presented information is strongly impeded by poor transparency and weak reporting standards.

The quality of public finances and budget planning remains low. The country's public finances continue to be plagued by substantial payment arrears, in particular in the health sector, which have likely increased further during the COVID-19 pandemic. In addition, significant budget guarantees have been provided and the fiscal situation of many publicly owned companies is far from being transparent. The programme does not present sufficient plans to improve the spending structure, and like in previous years lacks a sustained pro-growth orientation. This approach is not in line with the policy guidance jointly adopted in the last 5 years, urging for higher investment and a more growth-oriented fiscal policy. Transparency and governance of the public sector are very limited, leading to major governance issues in particular in the health sector and in publicly-owned companies.

The country's fiscal framework continues to be impeded by institutional fragmentation, low-quality fiscal data and a lack of cooperation among the various stakeholders. Alignment with EU reporting standards and budgetary frameworks is still very limited. 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 is a risk of significant 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 and consistently high emigration is a clear consequence of those weaknesses, rather than merely the result of an insufficient functioning of the country's education system. It also points to a poor business environment resulting from the country's institutional and economic fragmentation, a weak rule of law as well as an inadequate and inconsistent legal framework. Furthermore, the economic activities of the public sector negatively affect the economy due to their inefficient management.

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, including independent 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 aspects on strengthening the rule of law and fighting corruption in Bosnia and Herzegovina's annual report.

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

The COVID-19 crisis has interrupted the modest but relatively stable improvement in labour market outcomes of previous years; while recovery is in sight, overall activity and employment rates remain very low. The positive labour market trends of recent years were reversed in 2020, in particular in the Federation of BiH (FBiH) entity, as registered employment decreased and registered unemployment increased. The limited data available suggests that the Republika Srpska (RS) entity managed to maintain the positive labour market trends despite the crisis. To amortise initial labour market disruptions caused by the COVID-19 crisis and reduce job losses, the governments of both entities introduced in 2020 wage subsidies as an employment retention measure.

Labour market participation and employment, which are structurally very low, showed slight signs of recovery in 2021. In 2021, participation in the labour market for the 20-64 age group stood at 63.4%, well below the EU-27 average (77.6%), but showing a slight improvement compared to 2020

(62.3%)(⁵¹). Key reasons for the low activity rates include: discouragement due to prolonged unemployment; disincentives associated with the tax wedge on salaries, which lower take-home earnings and further reduce appeal of low-paid jobs (this is especially significant in the Federation of BiH); poor welfare-to-labour policies; a high number of war veterans; and a high inflow of remittances that substitute job-related income among the low-skilled population. Data (⁵²) on formal (registered) employment suggests that the average number of formal jobs decreased by 1.2% in a year-over-year perspective, from 823 851 jobs in 2019 to 814 046 in 2020. The number of formally employed people started to increase towards the end of 2020 and is getting closer to the pre-pandemic level (Q2 2021 compared to Q2 2019), which suggests a certain recovery in labour market performances. Yet, this development has to be seen against a structurally weak starting point, given that the unemployment rate among the 15-74 age group continued to be very high in 2021 and stood at 17.4% according to the labour force survey, well above the EU-27 average of 7.1%. Vulnerable groups, including the Roma population, are at a particularly high risk of long-term unemployment and inactivity regardless of their education level.

The share of long-term unemployed continues to be very high. In 2021, 78.4% of unemployed people were long-term unemployed, marking a 1.1 percentage point increase compared to pre-COVID-19 figures from 2019. Moreover, of the long-term unemployed, the vast majority (76.2%) has been looking for a job for 24 months or longer. A high share of long-term unemployment can be attributed to structural labour market imbalances – especially those related to skill gaps.

A large proportion of the working-age population is inactive, pointing to an acute need to develop policies to support the transition to the labour market. Those particularly affected are the low-skilled and workers older than 40. According to the national Labour Force Survey, in 2021 people with a low level of education (having completed primary school or lower education only) accounted for 47.7% of the inactive working-age population. In contrast, they account for only 9.3% of employed people. The inactivity rate of older people (50-64) remained high in 2021 at 52.9%, though slightly lower even than pre-pandemic levels (53.3% in 2019).

The business structure in Bosnia and Herzegovina is dominated by micro and small enterprises representing a major source of employment. 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 and administrative burdens - 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 attribute this to a poor alignment between the education system and labour market needs. The employment sector faces skills and qualification mismatches as well as a labour shortage. Apprenticeships and opportunities for adult learning are also under-developed.

The COVID-19 crisis widened existing gender gaps in access to employment, quality and pay, highlighting the need to step up efforts to effectively integrate women into the labour market. While Bosnia and Herzegovina officially complies with international standards, in practice, women face many impediments to equal participation in the labour market and in the public and political sphere. Women are significantly underrepresented in the labour market. They have significantly lower activity and

(⁵¹) Please note however that this trend has to be taken with caution, as due to the transition to the new, redesigned methodology of the Labour Force Survey in 2021, the data series was interrupted. The results of the Labour Force Survey 2021 are not comparable with the results of the continuous Labour Force Survey 2020 and previous years.

(⁵²) Due to a break in time-series in 2020 and limited comparability of data between 2019 and 2020, as well as changes to the labour force survey methodology, it is very difficult to assess employment trends.

employment rates compared with men. According to the national Labour Force Survey, in 2021, the activity rate for women aged 20-64 was only 50% compared to 76.7% for men, and the employment gap stood at 26.1 pps.

The low level of participation of women in the labour market is a multi-layered issue requiring a comprehensive policy response, but caring duties are one of the key drivers of inactivity. Research suggests that some of the key reasons for low coverage rates in childhood care are related to affordability, access (especially in rural areas), and lack of capacities of both public and private pre-school institutions to absorb all children, leaving many unenrolled (Numanović 2021, OECD SEE Competitiveness Outlook 2021). Generally, as access to preschool education depends on the financial capacities of local authorities, less-developed and especially rural areas have less financial means to ensure access, and currently no financial support is available for this from a higher level of government. The proportion of children not enrolled due to lack of places stood at 19.4% in 2020 and has been increasing year on year (Numanović 2021). The number of preschool institutions in BiH also decreased in the 2020/2021 school year (Agency for statistics of BiH 2021). Moreover, despite the rapidly ageing population, the country does not have a system of long-term care that would universally cater to the needs of those with a degree of long-term dependency.

Roma women are particularly disadvantaged and marginalised due to inadequate living conditions, poverty and a disadvantageous position in their family which includes early marriage. They also have more difficulty in accessing healthcare than other citizens. While data on the employment of Roma are scarce, their employment rate is clearly lower than that of other groups, and significantly lower for Roma women. According to the 2017 Regional Roma Survey, the unemployment rate stands at 56%. Only 11% of Roma are employed of whom 63% work in the informal sector. 86% of young Roma (92% for females) are not in employment, education or training (NEET). The share of Roma without any employment experience is also significantly higher than that of other population groups.

For young people, the employment situation remains dire, and the COVID-19 crisis is a threat to the fragile progress achieved in 2016-2019. The COVID-19 crisis has affected 15-24 year-olds more than any other age group. In 2021, youth unemployment (15-24) remained high at 38.3% in 2021. At 11.7 pps., the gender employment gap also persisted in this age group. Unemployment rate for young women stood at 44.5%, much higher than for young men (34.5%). Depending on the source, approximately 33.8-40% of 15-24 year-olds 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 and stigmatisation. The high share of NEETs in the 15-29 age group in 2020 (25.9%) indicates weaknesses in the policy framework and of the responses to the employment and employability/upskilling obstacles faced by young people. There are several inter-linked reasons for this outcome, including poor education-to-employment transitions, limited job and career opportunities in the labour market, under-supplied training options within active labour market measures, lack of accessible and/or affordable retraining and lifelong learning schemes, and low propensity of employers to invest in on-the-job training. However, some positive steps are taken by the entities to address these issues: the Republika Srpska entity adopted a legislation which requires employers to be represented on the management boards of public universities, creating better links and an opportunity to directly influence the priorities in educational fields. Other new initiatives focused on providing vocational counselling to students, developing local councils for education and employment, and developing internships schemes for students. The Federation entity implements several ALMPs that aim to support young people in finding a first employment and ease the school-to-work transition (OECD SEE Competitiveness Outlook 2021).

Regrettably, the ERP contains no reference on progress and no reform measures on establishing and implementing a Youth Guarantee, despite it being a political priority under the jointly agreed policy guidance and a flagship initiative under the European Investment Plan (EIP) for the Western Balkans.

Brain drain remains a challenge for all skills levels. The emigration of the country's workforce puts pressure both on industries relying on the low-skilled workforce (e.g. construction) as well as those relying on medium-to-high skilled professionals (the IT sector, Business Process Outsourcing, etc.). At the same time, it must be noted that BiH has the second highest share of highly educated migrants among the six Western Balkan economies, standing at 19% (OECD Draft Report on Labour Migration in the Western Balkans). In 2020, COVID-19 changed migration patterns in Bosnia and Herzegovina: there are indications that emigration and circular migration have gone down, while returns intensified in the first months of the pandemic. Although the pandemic may have resulted in less emigration in 2020, and consequently kept more people in the country, improvements of human capital through education, training and specialisation gained abroad are also likely to have fallen during this period (ETF 2021).

Informal labour is a persistent challenge in Bosnia and Herzegovina. Recent analyses suggest that informal employment accounts for 30.5% of total employment in the country, with a slightly higher rate for men than for women (30.9% vs. 29.8%). Informal employment in agriculture accounts for around 13.1 pps. of this figure, and other sectors for around 17.4 pps. (ILO 2020). The tax wedge on lower salaries and precarious working conditions remain a disincentive to formal employment. Nevertheless, the entities took some steps to combat informal employment: the Republika Srpska entity has addressed the issue of the tax wedge by increasing the non-taxable salary threshold to 500 BAM per month (2016), and adopting a Law on Incentives which allows employers to increase the non-taxable salary of their employees. The Federation entity has reformed its Law on Labour and adopted a rulebook for its application (2016) that aims to help disincentivise and detect informal work (OECD SEE Competitiveness Outlook 2021).

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. The weaknesses in the tripartite dialogue were also further exposed by the governmental response to the COVID-19 crisis, in particular in the Federation entity, where government's consultations with social partners were limited to the Federation entity's Socio-economic council, attended only by representatives of selected branch trade unions. Neither the Confederation of Independent Trade Unions of BiH (SSSBiH) nor the Federation entity's Employers' Associations have been satisfied with the enacted measures. The SSSBiH complains that the government's formulation of changes to the Labour law has taken place behind closed doors, without social dialogue with unions (SSSBiH, 2020). However, the RS Trade Union (SSRS) claims that the RS Government adopted some measures that they proposed.

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 remains a serious obstacle to private sector competitiveness. Businesses that wish to operate across the entire economy must register separately with both entities and the Brčko District and must frequently obtain the same licenses or permits in each entity or even each local government area and pay a range of different taxes and fees. Each level of government (and within the Federation entity, each of the 10 cantons) has its own business laws, regulations and procedures with which businesses must comply. This increases the costs of establishing a company and protects incumbent companies from competition. Starting a business takes nearly eight times as long in Bosnia and Herzegovina as it does in other economies in Europe and Central Asia and costs three times as much, leading the country to rank a dismal 184 out of 190 countries in the World Bank's latest Doing Business study. The obstacles that this regulatory complexity creates for

businesses is also reflected in the country's low score in the 'Institutions' pillar of the World Economic Forum's Competitiveness Report 2019, leaving it 114th in the world and last in Europe.

The ongoing political crisis has led to a further deterioration in cooperation between the various levels of government and institutions. Institutional paralysis due to the ongoing political blockade has impeded country-wide economic reforms, further slowing down the country's convergence towards fulfilling the EU accession criteria. The authorities have failed to outline a set of countrywide, comprehensive measures that are consistent and properly sequenced, and even technical reforms remain blocked. Just 6% of business respondents in the Balkan Barometer 2021 described coordination among regulatory authorities as 'positive' or 'very positive.' Countrywide strategies and solutions to support business development are long overdue, and the political blockage is impacting business confidence. 40% of the business leaders that participated in the survey believe that economic trends and the business environment will deteriorate over the next year, and another 38% believe it will remain unchanged. Less than 20% see the situation improving in the short run. In order to ensure countrywide ownership and consistent political support to socio-economic reforms, the design and implementation of these reforms will need to be coordinated among between all authorities, including the State-level authorities and will need to involve dialogue with the business community which at present is sporadic. A more business-friendly environment would facilitate the post-pandemic recovery, attracting more investments and building up economic resilience as well as boosting inclusive growth and competitiveness. The implementation of the Common Regional Market is also expected to offer new opportunities.

The COVID-19 pandemic has made it even more important and urgent to address the structural weaknesses in the business environment. The pandemic further highlighted shortages in institutional effectiveness resulting in the slow release of fiscal support to households and businesses (World Bank, 2021). The response to the COVID-19 pandemic was uncoordinated and fragmented in both substance and timing, leading to underutilisation of the full recovery potential across the country and further weakening the single economic space. Supported by the Economic and Investment Plan and in line with the EU digital strategy and the Green Agenda for the Western Balkans and the action plan for its implementation, long-term recovery will need to be backed up by an inclusive green and digital transition as well as regional integration through the Common Regional Market.

The ERP acknowledges problems related to the business environment and regulatory burden. However, it does not include measures adequate to meet the scale of the challenge, nor does it recognise the underlying issues related to lack of coordination among the various levels of government. The measures included relate primarily to changes to the tax regime in each entity, where especially in the Federation the cumulative rate of labour taxes weigh on the private sector. However, it is notable that these changes are not likely to bring any further harmonisation of the regimes for businesses that operate countrywide. The measures related to inspections reform in the Republika Srpska refer to harmonisation between the entity and the municipal levels, but there is no effort to harmonise across entities. Finally, there is reference to online registration, one-stop-shop facilities and the establishment of a single register of permits and license requirements, but again these reforms are likely to be limited in impact and scope do not seem intended to bring about any reduction in the administrative burden for businesses that operate across both entities. None of the reforms comes with a detailed list of actions or a timeline, and none of them have been adequately costed.

In the fight against corruption, the lack of harmonisation of legislation across the country and weak institutional cooperation and coordination continued to hamper results. Transparency International ranks the country 110th out of 180 countries in its 2021 annual Corruption Perception Index, showing no improvement since the previous year and making it the worst performer in the Western Balkans. Closer coordination and cooperation involving all levels of government, legal certainty to business through

harmonised legislation across the country and a consistent application of the rule of law are prerequisites for countering corruption more effectively ⁽⁵³⁾.

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. Contract enforcement, in particular settling commercial disputes, remains problematic though there has been recent progress in this area. There remain problems with establishing property rights in some areas, such as real estate registration. Cooperation and coordination among the various stakeholders has further deteriorated and is a major impediment to the rule of law and a proper functioning of the judiciary, impeding the establishment of a level playing field across the country, with wide-ranging negative effects on the country's business environment.

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, improvements to the administrative environment for firms would include the digital transformation of government services for businesses, including e-signature ⁽⁵⁴⁾, e-registration of businesses and e-construction permits. Economy-wide implementation of service digitalisation is still hampered by the lack of political ownership and co-ordination between different levels of the government, which also leads to the allocation of insufficient budgetary resources for implementation. The lack of interoperable information systems across entities and different levels of government in Bosnia and Herzegovina is a major obstacle to developing economy-wide digital government services (OECD, 2021). Countrywide harmonisation of e-signature and the related coordination, cooperation and data exchange between different administrations is still needed. The adoption 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. This would accelerate the digital transformation and allow for easier integration into regional and international markets. Various important customs reforms such as the new electronic transit procedure (NCTS), the authorised economic operators (AEO) scheme and electronic customs declaration for import and export customs procedures depend on the full implementation of the new Customs Policy Law.

The green transition is also central to this key challenge, especially in light of international energy market developments brought about by Russia's war against Ukraine. The absence of a fully-functional energy market in Bosnia and Herzegovina, with slightly differing legal frameworks and implementation practices, hampers the sector's development as well as investments. Bosnia and Herzegovina still needs to make significant efforts in creating a single regulatory framework and market space that ensures reliable and secure energy supply and attracts investments in a low-carbon energy sector. Adopting laws on renewable energy and energy efficiency, as well as the State Law on Electricity and Natural Gas, with which the entities must comply, should be a priority. Bosnia and Herzegovina should ensure timely transposition and implementation of the Energy Efficiency Directive following its adoption as part of the Clean Energy Package by the Energy Community in November 2021. Delivering on commitments to gradually phase out coal subsidies and to introduce carbon pricing instruments will be particularly challenging. The country remains heavily reliant on lignite coal and still plans to increase its energy generation based on fossil fuels, jeopardising its commitment to decarbonisation and climate neutrality by 2050 and prolonging and increasing the socio-economic risks of an eventual transition from coal. The level of emissions from coal-fired power plants is of concern, as is the plan to build a new plant in defiance of State aid rules.

⁽⁵³⁾ According to the RCC Balkan Barometer 2020, governance, public integrity and corruption continue to be the most negatively perceived aspects of governance performance, with only 2.4% of business leaders claiming that they are 'content' with these aspects in Bosnia and Herzegovina.

⁽⁵⁴⁾ 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.

Key challenge 3: Increasing the efficiency of the public sector, in particular by improving the performance, transparency and accountability of public enterprises

The still-oversized public administration as well as poorly performing state-owned enterprises (SOEs) puts a significant burden on taxpayers and adversely affects the business environment. State influence on the economy is significant, and countrywide public spending remains relatively high, while the overall perception of citizens about public services is very low. Efforts to rebalance the country's current public sector-led growth model and move to a more private sector-led model are not sufficient, given that, according to official statistics, public spending accounts for more than 40% of GDP. Ineffective service delivery, poor human resource management and accountability have major implications on efficiency, quality and access to public services. A functional legislative framework for registries of public sector employees has not been set up, though the ERP refers to plans to establish them in the two entities. Public procurement plays an important role for the private economy, but procedures are complex, prone to corruption and contain a preference for domestic suppliers, which is incompatible with the EU *acquis* and a breach of the Stabilisation and Association Agreement. 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.

All four governments (the State-level, the entities and Brčko District) have adopted individual public financial management (PFM) strategies, but at this stage, there is still no countrywide strategy for the reform of public financial management with a performance-based monitoring⁽⁵⁵⁾. The ERP presents a number of PFM measures such as programme budgeting and public internal financial control, but some of the most crucial challenges remain unaddressed including those described in the section above on public finances and issues related to the proper involvement of the Indirect Taxation Authority in the preparation and costing of proposed changes to the VAT and excise duty regimes. While the ERP does contain a number of relevant measures related to public administration reform such as the establishment of public service registries, these should be prioritised at all levels and not only in one entity. The same countrywide approach on efforts for optimisation of administrative procedures is needed across levels to provide an effective regulatory environment for the private sector and to ensure the equal treatment of businesses across the country.

Oversized, non-transparent and inefficient state owned enterprises (SOE) continue to have economy large economic footprint. As a result of weak ownership arrangements and underperformance, Bosnia and Herzegovina has a relatively low score in terms of governance and efficiency in the OECD's 2021 Competitiveness Outlook. In the Federation entity, an SOE registry is now in place and publicly available, but further steps are needed to oblige SOEs to upload the required information. In the Republika Srpska entity a working group and an action plan on SOE reform are in place. Both entities are planning to set up central oversight units and to develop ownership policy documents. Regular reporting on the performance of SOEs is still 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 people, thus accounting for around 11% of total employment (about a quarter of public sector employment). They control assets worth an equivalent of 100% of GDP. Among all SOEs, entity-owned SOEs (including the 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⁽⁵⁶⁾, the average salaries of SOE employees are 40% higher than in private companies.

⁽⁵⁵⁾ 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).

⁽⁵⁶⁾ Average revenue per worker (measuring productivity) is considered to be around 8% lower than in the private sector.

SOEs are undermining competition, negatively affecting the country's overall competitiveness. 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). In the OECD Competitiveness Outlook 2021, the country has a below average score on ensuring a level playing field with private companies. While most SOEs in both entities are incorporated according to general company law, the presence of a separate legal form ('public enterprises') for some SOEs raises concerns about their operational treatment. The authorities should also consider fully corporatising SOEs that undertake primarily commercial activities but are still organised under the separate legal form of 'public enterprise' (OECD, 2021). Subsidies give SOEs a competitive advantage over the private sector, and in so doing negatively affect the efficiency of resource allocation and the country's fiscal performance. As for the interaction of SOEs with the private sector, the poor quality and fairly high cost provision of inputs to private enterprises negatively impact the private sector's competitiveness. Liabilities to suppliers (4% of GDP according to the IMF) have negative repercussions on the private sector.

SOEs are a significant burden on the country's public finances. Many of the country's SOEs are in poor financial shape and close to half 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. About three quarters of the largest (20) SOEs face considerable financial risks. The cost of supporting public companies and guarantees, which often translate into substantial contingent liabilities, is a heavy burden on public finances and thus the country's taxpayers. Many public companies rely on state support or delay due payments to the social security systems or to private suppliers, in order to remain in operation. This creates substantial liquidity imbalances in other areas of the economy. Potential investors are required to assume these debts and maintain the existing workforce. Some of the SOEs requiring subsidies are no longer operating, but still maintain workers. SOEs' total debts (including approximately 4% of GDP in tax and social contribution arrears) are around 26% of GDP (IMF, 2019). While the precise numbers have not yet been determined, total public sector debt is likely to be approximately 55-60% of GDP.

The planned centralised SOE oversight units (coordinating government efforts to monitor performance in order to strengthen the sustainability of the SOE sector) should separate oversight from policy and the regulatory functions of the line ministries. 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. Major gaps exist, both in the legal framework and in implementation. There are no established criteria to promote independent and professional boards in SOEs (OECD, 2021). SOE performance and board decision making are insufficiently separated from the political cycle. Vested interests are largely responsible for the slow privatisation process and attempts to sell shares in public companies earmarked for sale have been largely unsuccessful.

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

The privatisation process is still not complete and restructuring efforts have made little progress.

Due to the COVID-19 crisis, measures to restructure or to dissolve public enterprises remained very limited. Strategic sectors such as transport and energy are still dominated by poorly-managed and often inefficient state-owned companies. The Federation entity aims to privatise public enterprises in the processing and mining industry and some mining companies undergo bankruptcy procedures. The Republika Srpska entity is 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.

Regrettably, the ERP did not contain an analysis of the challenges related to the country's state-owned enterprises, nor did it provide any further reform measures beyond the rolled-over commitment to establish central oversight units.

Box II.6.2: Monitoring performance in light of the European Pillar of Social Rights ⁽⁵⁷⁾

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

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

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

The employment rate in Bosnia and Herzegovina remains very low, particularly for women and young people, even though it continues to steadily improve. A large proportion of unemployed people are long-term unemployed. Job creation is localised and the low mobility of workers limits the allocation of labour resources to emerging needs. The gender employment gap increased to 24.9 pps. in 2020, being more than twice as high as the gap in the EU-27 (11.0 pps.) and grew further to 26.9 pps. in 2021, the highest level recorded in the last 5 years. This gap is widened 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 4.7% in 2020, much below the EU-27 average (9.9%). However, there is a large share of low-skilled people in the population. Upskilling

strategies to increase the skill levels of the workforce are not sufficiently developed. Participation in early childhood education and care (ECEC) is significantly lower than in the EU and elsewhere in the region. Although it is improving, in 2019 ECEC only covered 7.1% of children under 3, compared to the EU average of around 35%. Most children enrolled in ECEC come from urban families where both parents are employed, while children from rural areas or whose parents are unemployed very rarely attend.

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. The reduction of the at-risk-of-poverty rate by social transfers is estimated at 9.16%, significantly lower than the EU-27 average (32.68% in 2019). Based on 2015 data, self-reported unmet need for medical care was 5.1%, which was higher than the EU-27 average of the same year (3.3%).

⁽⁵⁷⁾ The table includes 16 headline indicators of the Social Scoreboard, used to compare performance of EU Member States (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2020 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). For data see Annex B. NEET: not in employment, education or training; GDHI: gross disposable household income.

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

6.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2021

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 region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the PG is similar to that of the country-specific recommendations usually adopted under the European Semester for EU Member States. Implementation of the PG is evaluated by the Commission in the following year's ERP assessments. The below table presents the Commission's assessment of the implementation of the 2021 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at Ministerial level on 12 July 2021.

Overall: [Limited] implementation (31.9%) ⁽⁵⁸⁾	
2021 policy guidance	Summary assessment
<p>PG 1:</p> <p>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.</p> <p>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.</p> <p>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.</p>	<p>There was limited implementation of PG 1:</p> <p>1) Partial implementation: the authorities supported the health sector, enterprises and households, by financing medical equipment, providing loan guarantees and co-financing social security contributions and wages. However, little effort was made to properly targeting the available funds. According to the adopted budgets of both entities, the fiscal policy envisages a reduction in the fiscal stimulus. However, given that 2022 is an election year, entity budgets expect a significant increase in consumption-related spending, such as raising pensions and wages. Moreover, the recent announcements on future debt acquisition (bonds under unfavourable terms and conditions) by the RS do not inspire confidence on the medium-term debt-stabilising policy.</p> <p>2) Partial implementation: In 2021, spending on public investment appears to have been limited. (country-wide data are not yet available for 2021). However, both entity budgets for 2022 envisage a substantial increase in investment, largely related to infrastructure investment (Corridor Vc).</p> <p>3) No implementation: no progress was made on improving the data exchange between the four tax administrations in BiH during 2021 or on agreeing on the establishment of such a registry.</p>

⁽⁵⁸⁾ 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.

<p>PG 2:</p> <p>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.</p> <p>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.</p> <p>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.</p>	<p>There was limited implementation of PG 2:</p> <p>1) No implementation: no such report was prepared/published. No related strategy was prepared.</p> <p>2) Limited implementation: Some work was carried out with international TA, including through an EU-financed, IMF-implemented project – towards improvement of the countrywide fiscal framework.</p> <p>3) Limited implementation: BiH made little progress in most of these areas, except for the Labour Force Survey and government finance statistics, where it made some progress.</p>
<p>PG 3:</p> <p>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.</p> <p>Further reduce institutional and legal obstacles to swift and effective NPL resolution, and strengthen the bank resolution framework.</p> <p>Safeguard the integrity of the currency board arrangement and the independence of the central bank.</p>	<p>There was partial implementation of PG 3:</p> <p>1) Substantial implementation: The European Commission decided to consider the supervisory and regulatory framework applicable to credit institutions in Bosnia and Herzegovina as equivalent to that applied in the EU. Banking supervisory agencies kept working closely together to coordinate the implementation of support measures for the financial sector. Forbearance measures were withdrawn when economic activity resumed. Provisioning remained adequate, slightly increasing on the back of the extended loan moratorium. However, no progress was made on a unified macroprudential framework.</p> <p>2) Limited implementation: The bank resolution framework is still not fully operational and needs to be strengthened further. The remaining obstacles for an effective NPL resolution framework have also not been addressed, such as facilitating out-of-court restructurings and amending the tax treatment of NPL sales to specialised companies. However, the Federation of Bosnia and Herzegovina adopted a new insolvency framework, similar to the one in the Republic of Srpska.</p> <p>3) Substantial implementation: The full convertibility of the domestic currency was ensured. However, the delays in appointing the governor and board members in the course of 2021 gave rise to concerns. Furthermore, there have been repeated calls to modify the law of the central bank to allow the use of its reserves in the economy.</p>
<p>PG 4:</p> <p>With a view to improve the business environment and strengthen the single economic space, business registration as well as licensing and permitting</p>	<p>There was limited implementation of PG 4:</p> <p>1) Partial implementation: Both entities continued implementing much-needed reforms to improve the business environment. In the Republika Srpska, reforms in recent years</p>

<p>procedures will be simplified and harmonised across the country.</p> <p>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 <i>acquis</i> and ensure that Indirect Tax Authority begins issuing of electronic signatures.</p> <p>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.</p>	<p>have significantly reduced both the cost and the amount of time needed to register a new business, and online registration of businesses was launched in both the RS and in the Brčko District. The Federation also took steps were taken toward online registration of businesses. The Federation adopted a new Law on Crafts and Related Activities in order to simplify administrative procedures for craft-related businesses along with more widely-applicable simplifications to the business registration process. Nevertheless, in neither entity do the measures reported in the ERP match the scale of the challenge, and even within individual entities businesses must still apply for licences and permits at various different agencies. The fragmentation of the market and the absence of a true single economic space remain serious obstacles to growth and competitiveness, and nothing was done to tackle this issue during the previous year – indeed, there have been signs of backsliding in this area.</p> <p>2) No implementation: The law on electronic identity and trust services for electronic transactions was not adopted. The legislation at the level of the entities remains out of step with the EU <i>acquis</i>. The Indirect Tax Authority was accredited for issuing qualified digital signatures for VAT and excise duty, but implementation has not yet begun.</p> <p>3) No implementation: The Customs Policy Law has not entered into force. The computerised transit system and the authorised economic operators scheme have therefore not been implemented.</p>
<p>PG 5:</p> <p>Adopt a comprehensive, country-wide Public Finance Management Strategy with performance-based monitoring and reporting.</p> <p>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.</p> <p>Establish public enterprises central oversight units in both entities and allocate adequate human resources.</p>	<p>There was limited implementation of PG 5:</p> <p>1) Partial implementation: A countrywide strategic framework for public financial management with a performance based monitoring system has not yet been adopted. However, with the technical assistance of the IMF's Fiscal Affairs Department, public finance management reform strategies for 2021-2025 were prepared and adopted at all levels during the reporting period (a precondition for preparing the countrywide strategy), 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.</p> <p>2) Limited implementation: Both entities have registries of public enterprises, but they lack some of the required information on these companies. For the Federation, the registry does not include sufficient information on cantonal public companies.</p> <p>3) Limited implementation: Both entities have announced their intention to establish central oversight units for state-owned enterprises, but so far these have not yet been set up.</p>

<p>PG 6:</p> <p>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.</p> <p>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.</p> <p>Improve access to early childhood education and care services towards children/families with vulnerable backgrounds and in rural areas.</p>	<p>There was limited implementation of PG 6:</p> <p>1) Limited implementation: The Republika Srpska entity's Government adopted an Employment Strategy 2021-2027 in December 2021. However, the Federation entity's Employment Strategy 2021-2027 was voted down in the House of Peoples in November 2021. Considering that entities' strategies should be the basis for the country-wide Employment Strategy, the Federation entity's non-adoption may further hamper the efforts to develop a coordinated country-wide employment policy. No progress has been made on strengthening the coordination mechanisms. Formal coordination bodies on the Youth Guarantee (Expert Group and Multi-Stakeholder Group) at country level are yet to be established. Initial steps have been taken, with the help of the EU-ILO Technical Assistance Facility, on a statistical mapping of the profile of young people not in employment, education or training.</p> <p>2) Partial implementation: A state-wide system to monitor and forecast skills is yet to be established. At entity level, the Republika Srpska entity already has a skills anticipation framework but more efforts are needed on aligning reskilling and upskilling measures to labour market needs. The Federation entity's employment service is also working on aligning skills with labour market needs, but consolidation of the work across all cantons requires more attention. While policy discourse on skills-economy alignment is good in both entities, failure to get a state-wide commitment to common employment priorities will continue to undermine the development of a state-wide skills intelligence framework.</p> <p>3) Limited implementation: In July 2021, the Republika Srpska entity adopted an updated Law on Preschool Upbringing and Education, making preschool education free of charge for children with developmental problems, children without parents' care, children victims of violence and children receiving social assistance. The Law also allows for preschool education in less developed areas to be organised in a wider range of premises, which allows for more flexibility and lower costs. Over the last year, no developments have been recorded in the Federation entity.</p>
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6.6. THE 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, 24 May 2022

[...]

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

1. If needed, use the available fiscal space in the 2022 budget to cushion the potential impact of adverse shocks through targeted support to vulnerable households and firms; provided the economic recovery is well entrenched, return to a debt-stabilising fiscal policy as of 2023 and foresee a gradually improving primary balance in the medium-term fiscal plans. 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 amongst the country's tax authorities, and in particular, clarify the constitutional competence for establishing a central (i.e. country-wide) registry of bank accounts of private individuals, in line with the EU acquis.
2. Prepare a report on contingent liabilities, with a particular emphasis on those related to the COVID crisis response, and prepare a strategy on how to contain the emergence of new contingent liabilities and manage risks related to existing ones. Strengthen the analytical capacities of governmental institutions at all levels of government, in particular the BiH Ministry of Finance and Treasury with a view to improving the preparation and quality of the ERP in line with EU requirements. Invest more significantly in building up the country's statistical capacity for macroeconomic statistics, regional accounts, labour force survey and government finance statistics, and pursue efforts to improve the coverage and timeliness of all statistics.
3. Carefully assess and analyse price developments, supported by the statistical offices through improving price statistics, including a timely update of CPI weights and publishing core inflation series. Ensure a transparent and accurate reporting of asset quality and adequate provisioning, improve the NPL resolution framework for instance by further reducing institutional and legal obstacles, and reduce data gaps in particular as regards the real estate sector. Safeguard the integrity of the currency board arrangement and the independence of the central bank, and appoint the Governing Board members without further delay.
4. With a view to improving the business environment and strengthen the single economic space, simplify business registration as well as licensing and permitting procedures and harmonise them across the country. To foster digitalisation of public services and to complement the development of e-Government 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, whose ability to fulfil its vital country-wide role must be maintained, 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 in BiH with performance-based monitoring and reporting. Create/update in both entities publicly available registers of public enterprises with complete, searchable list of all public enterprises including comprehensive financial statements, audits and organisational information. Establish public enterprises central oversight units in both entities and allocate adequate human resources.
6. Strengthen the coordination mechanisms within the country as regards employment policies and establish an inter-ministerial task force involving relevant ministries, their agencies and stakeholders to develop and finalise a Youth Guarantee Implementation Plan, adopt it, and initiate its implementation. Develop a system to monitor and forecast the skills needs in the labour market to facilitate the alignment of the education and training systems and of reskilling and upskilling provision to labour market needs. Improve access to early childhood education and care services towards children/families with vulnerable backgrounds and in rural areas.

ANNEX A: ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2022-2024

Due to the nearly 2-month delay in submitting the Economic Reform Programme (ERP) and the consequent impossibility to organise the usual fact-finding and assessment missions with the country authorities, it has not been possible to provide the usual sector-by-sector analysis and assessment of reform measures.

Most measures presented in the ERP do not address economy-wide challenges and include, but rather include entity-specific activities only and in a fragmented way. There is often insufficient indication as to which level of government or institution the activities are related. The planned activities and expected outcomes of measures are often not adequately explained, and in some cases the text is simply repeated. In many cases, the activities planned do not appear to be in line with, or address, the main obstacles identified for the various sectors in the preceding analysis. In other cases, a more coherent approach is described in the analysis while the activities themselves are more fragmented.

The results indicators often do not provide enough clarity in the phrasing of what exactly needs to be achieved. Some results indicators that are better-defined, as for instance in the area of healthcare, have not been filled in with any values, which does not allow their monitoring. In the planning of concrete reform measures proposed for the next 3 years, the same measures are sometimes just repeated verbatim for all 3 years, making it impossible to evaluate their implementation adequately.

Despite the availability of technical assistance for the costing of measures, very few of the reform measures reflect costs and even fewer provide an indication of financial assistance from international partners, including from the EU through the Instrument for Pre-Accession Assistance (IPA). Tables 10a and 10b (costing and financing of structural reforms, respectively) and Annex 2 (links between reform areas and relevant policy documents) have not been included in the ERP.

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

Area/Sector	2016	2017	2018	2019	2020	EU-27 Average (2020 or most recent year)
Energy						
Energy imports dependency (%)	31.5%	34.0%	24.3%	27.4%	N/A	57.5%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand euro	448.81	434.20	463.40	435.70	N/A	110.18
Share of renewable energy sources (RES) in final energy consumption (%)	25.36%	23.24%	35.97%	37.58%	N/A	22.09%
Transport						
Railway Network Density (metres of line per km ² of land area)	19.9 ^w	19.9 ^w	19.9 ^w	19.9 ^w	19.9 ^w	49.0 ⁽²⁰¹⁸⁾
Motorisation rate (Passenger cars per 1000 inhabitants)	245.0 ^w	252.0 ^w	263.1 ^w	269.5 ^w	N/A	519 ⁽²⁰¹⁸⁾
Agriculture						
Share of gross value added (agriculture, forestry and fishing)	7.5%	6.6%	6.9%	6.6%	7.1%	1.8%
Share of employment (agriculture, forestry and fishing)	18.0% ^w	18.9% ^w	15.7% ^w	18.0%	12.0% ^w	4.3%
Utilised agricultural area (% of total land area)	34.7% ^w	34.4% ^w	34.8% ^w	35.3% ^w	N/A	40.6%
Industry						
Share of gross value added (except construction)	22.6%	23.3%	23.9%	23.1%	22.9%	19.5%
Contribution to employment (% of total employment)	22.7% ^w	22.2% ^w	23.5% ^w	23.8% ^w	33.4% ^w	18.2%
Services						
Share of gross value added	65.1%	65.3%	64.4%	65.3%	64.5%	73.1%
Contribution to employment (% of total employment)	50.8% ^w	51.6% ^w	52.1% ^w	50.3% ^w	45.3% ^w	71.0%

Digital economy						
Percentage of households who have internet access at home	61.5% ^w	66.0% ^w	69.0%	72.0%	73.0%	91%
Share of total population using internet in the 3 months prior to the survey [NB: population 16-74]	N/A	64.9% ^w	70.1% ^w	69.9% ^w	73.0%	88%
Trade						
Export of goods and services (as % of GDP)	36.3%	40.9%	42.6%	40.6%	34.5%	46.7%
Import of goods and services (as % of GDP)	53.0%	57.1%	57.3%	55.2%	48.5%	42.9%
Trade balance (as % of GDP)	-22.5%	-22.7%	-22.0%	-22.7%	-18.6%	N/A
Business environment						
Rank in WB Doing Business (Source: World Bank)	79	81	86	90	90	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	111	103	91	92	N/A	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	N/A
Research, development and innovation						
R&D intensity of GDP (R&D expenditure as % of GDP)	0.24% ^w	0.20% ^w	0.19% ^w	0.19%	N/A	2.32%
R&D expenditure – EUR per inhabitant	N/A	N/A	N/A	N/A	N/A	€694.60

Education and skills						
Early leavers from education and training (% of population aged 18-24)	4.9% ^w	5.1% ^w	5.4% ^w	3.8% ^w	4.7% ^w	9.9%
Young people not in employment, education or training (NEET) (% of population aged 15-29)	30.8% ^w	28.1% ^w	24.8% ^w	24.4% ^w	25.9% ^w	13.7%
Children aged less than 3 years in formal child care (% of under 3 years-olds)	4.7% ^w	5.2% ^w	6.3% ^w	7.1% ^w	N/A	32.3%
Individuals who have basic or above basic overall digital skills (% of population 16-74)	N/A	N/A	N/A	24%	N/A	56% ⁽²⁰¹⁹⁾
Employment and labour market						
Employment rate (% of population aged 20-64)	44.2% ^w	46.6% ^w	47.7% ^w	49.7% ^w	52.5% ^w	71.1%
Unemployment rate (% of labour force aged 15-74)	25.5% ^w	20.7% ^w	18.5% ^w	15.9% ^w	15.9% ^w	7.2%
Long-term unemployment rate (% of labour force 15-74)	21.6% ^{w,y}	16.8% ^{w,y}	15.2% ^{w,y}	11.9% ^w	11.8% ^w	2.5%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	24.4 pps ^w	23.0 pps ^w	23.7 pps ^w	23.6 pps ^w	24.9 pps ^w	11.0 pps
Disability employment gap (Percentage points difference in employment rates between people with and without a disability)	N/A	N/A	N/A	N/A	N/A	24.5 pps
Real gross disposable income of households (Per capita increase, Index = 2008)	N/A	N/A	N/A	N/A	N/A	107.23

Social protection system						
At-risk-of-poverty or social exclusion rate (AROPE) (% of population)	N/A	N/A	N/A	N/A	N/A	21.9%
At-risk-of-poverty or social exclusion rate of children (% of population 0-17)	N/A	N/A	N/A	N/A	N/A	24.2%
Impact of social transfers (other than pensions) on poverty reduction	N/A	N/A	N/A	N/A	N/A	32.68%
Self-reported unmet need for medical care (of people over 16)	N/A	N/A	N/A	N/A	N/A	1.8%
Income inequality - quintile share ratio (S80/S20) (Comparison ratio of total income received by the 20% of the population with the highest income to that received by the 20% with the lowest income)	N/A	N/A	N/A	N/A	N/A	5.24
Housing cost overburden (% of population)	N/A	N/A	N/A	N/A	N/A	9.9%
Healthcare						
Self-reported unmet need for medical care (of people over 16)	N/A	N/A	N/A	N/A	N/A	1.8%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	28.61% ^z	29.12% ^z	29.31% ^z	29.35% ^z	N/A	15.57% (2018)

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

y: data for people aged over 15

z: data from the World Health Organization

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

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM THE 2021-2023 ERP

Reporting on the implementation of the 2021-2023 ERP's structural reform measures did not follow the guidance note, and the requested reporting table was left out entirely making it difficult to track progress. The reporting included in the ERP is unfortunately inadequate, inconsistent and incomplete. It is frequently difficult to surmise from the ERP to what extent reform measures are still being planned or have actually been implemented, and it is also often unclear which level of government or entity is being described. Given that the ERP was submitted nearly 2 months after the deadline, much of the reporting seems out of date. Even measures taken to implement the policy guidance adopted at the Economic and Financial Dialogue in July 2021 were not adequately reported. Reporting on progress with structural reform measures is important to ensure accountability on commitments to reform and to monitor the effectiveness of measures taken.

ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Council of Ministers adopted the ERP 2022-2024 on 23 March 2022 and submitted it to the Commission on 24 March, nearly 2 months after the deadline. The quality of the programme and the delay in submission 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). The DEP's ability to coordinate the preparation of the ERP was impeded this year by the failure of the Council of Ministers to adopt the usual Action Plan which empowers the DEP to coordinate the drafting process.

Stakeholder consultation

The ERP itself refers only to consultations on part of the document with social partners in Republika Srpska. The full draft ERP was not made available online for public consultation.

Macroeconomic framework

The recent macroeconomic performance is adequately described. The macroeconomic framework's 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 developed.

Fiscal framework

Despite some improvements in the country-wide presentation, the programme continues to lack a consistent, complete and sufficiently detailed presentation of the country's fiscal policy both for 2022 and also of budgetary plans for 2023-2024. This strongly impedes the analysis of country-wide fiscal developments. Public investment projections in the fiscal part are still not consistent with the macroeconomic framework. The requested links to structural reforms are still largely missing. The rationale and underlying measures of the chosen policy approach are not sufficiently developed. The programme provides hardly any quantitative analysis of budgetary measures. The compilation and presentation of fiscal data is not yet in line with 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 results indicators are not always present and potential risks frequently indicate political obstacles. Reporting on the implementation of the policy guidance and structural reform measures from the 2021-2023 ERP is insufficient or in most cases non-existent. In spite of technical assistance ⁽⁵⁹⁾ on fiscal implication of reform measures, Tables 10a, 10b and 11 do not appear at all this year, a step backwards from previous years.

⁽⁵⁹⁾ Provided by the Centre of Excellence in Finance in Ljubljana.

The ERP contains 26 reforms, six more than the 20 prioritised measures described in the guidance note. Most reforms are not sufficiently narrow in scope, and the activities planned in the 3-year period are not clearly defined.

The document is nearly twice as long (168 pages) as the limit provided in the guidance note (90 pages).

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.

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7. KOSOVO

The economic reform programme (ERP) was submitted on 31 January 2022.

The economic consequences of Russia's war against Ukraine may render the macro-fiscal scenarios presented in the ERP partially obsolete. The Commission will publish its updated macroeconomic and fiscal projections for candidate countries, reflecting the expected impact of the war against Ukraine and related sanctions, in its spring economic forecast in mid-May 2022.

The short-term macro-fiscal outlook may change considerably. However, the major medium-term fiscal and structural reform challenges and priorities identified in this assessment remain valid irrespective of the short-term outlook. Appropriate policy responses are essential to ensure a sustained economic recovery, greater resilience and fiscal sustainability.

7.1. EXECUTIVE SUMMARY

Following a robust economic recovery in 2021, Kosovo's Economic Reform programme (ERP) projects very high GDP growth to continue. The economic rebound in 2021 was mainly driven by the resumption of travel by diaspora and related financial inflows. After increasing by 9.7% in 2021, the ERP projects real GDP to rise by 7.8% in 2022 and continue rising by some 7% in 2023-2024, well above historical trends. The programme expects the large surge in private and public-sector investment to be a key driver of this growth. There are major downside risks to this outlook stemming from pandemic-related uncertainty, lower-than-expected financial inflows from the diaspora and persistent under-execution of public capital. Further risks to the outlook, notably via higher energy and food prices, have emerged in the context of Russia's invasion of Ukraine, which could also lead to less dynamic trade developments with the main EU and non-EU trading partners.

Supported by high revenue growth and cautious public spending, the headline budget deficit narrowed to 1.4% of GDP. The fiscal stimulus in 2022 is expected to widen the headline budget deficit to 4.6% of GDP, while the deficit, as per the fiscal rule definition, which excludes some capital spending, is set at 2.9% of GDP. Kosovo's programme projects a gradual return in 2023 below the deficit ceiling of 2% of GDP, as set in the fiscal rule. Immediate fiscal risks, some of them included in the programme, stem from lower-than-expected revenue, pressure to roll out new social benefits and an unrealistic planning of capital spending.

The main challenges facing Kosovo include the following.

- **Providing fiscal support to the recovery is still needed in 2022, but the envisaged consolidation and gradual return to the deficit rule is key to maintaining fiscal sustainability in the medium term.** Given the high degree of uncertainty about potential developments of the pandemic and the impact of Russia's war against Ukraine, it seems advisable to provide policy support where needed. The timing of the envisaged return to the 2% deficit ceiling by 2023 may be affected by the economic outlook. Structural reforms on both the budget revenue and expenditure sides should improve the quality of public finances. A review of existing tax exemptions and preferential tax rates would help mobilise revenue. Current spending would benefit from a review and streamlining of social benefits, including war veteran pensions, a proper assessment of the fiscal impact of new social initiatives and a coherent and fiscally affordable public-sector wage system. To ensure public finances are sustainable over the medium-term, there is a need to diversify the investor base for public debt. It currently relies on financing provided by international donors and domestic public institutions.

- **Multiple development challenges and long-standing weaknesses in capital spending call for action to tackle investment bottlenecks.** Though Kosovo has made partial progress in implementing capital projects, further action is needed to strengthen public investment management in line with the recommendations of the IMF's Public Investment Management Assessment. The fiscal risks related to publicly owned enterprises (POEs) and related investment decisions should be properly assessed, incorporated into budgetary planning and fed into the country's 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, deters the development of the private sector and prevents a significant section of the workforce from accessing proper levels of social protection and training. Kosovo has a strategy designed to address the key underlying causes of informality. However, there are delays in implementing them and reporting on the work, and the corresponding action plan is now outdated. Strong political support, effective implementation and close monitoring are required to achieve the desired outcomes. In addition, the strategy measures are needed to improve the business environment that contributes to informality and impedes private sector development.
- **The unreliable supply of energy is inadequate to meet rapidly growing demand and is one of the main constraints on Kosovo's competitiveness, acting as a break on productivity and exacerbating the recent energy crisis.** The lack of energy security gives rise to significant costs for business and represents a major obstacle to attracting high-quality foreign direct investment (FDI). Kosovo is investing in renewables, but a new, competitive auction-based system is required to unlock the additional investment it needs. Despite positive developments, Kosovo needs to step up efforts to unlock 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 regional integration could support the financial stability of the Kosovo transmission system operator (KOSTT).
- **The education system in Kosovo does not adequately equip students with the skills and competences required by the labour market.** A high share of young people experience a difficult transition from school to work. International ratings reveal a poor performance of the pre-university education in Kosovo. Vocational education still lacks a major curriculum reform, and systematic efforts to train teachers and integrate work-based learning. A series of reforms aim to improve active labour market policies, which are however hampered by low levels of budgetary and human resources in the public employment service.

Kosovo has partially implemented the policy guidance set out in the conclusions of the Economic and Financial Dialogue of July 2021. Although the fiscal rule remained suspended, the robust economic recovery and surging public revenue substantially improved the budget balance. A permanent return to the fiscal rule is planned for 2023. Overall, the measures in the economic recovery package were well-targeted. There has been little progress on reclassifying the war veteran pension beneficiaries and reviewing social security schemes, and the law governing public-sector salaries is still in the process of revision. Tax revenue recovered in line with real GDP expansion and a reduction in the informal economy, but there was no progress on work to review tax exemptions. The financial oversight of POEs has improved somewhat, but work to set up a fiscal oversight body has not advanced. Investment management has improved somewhat but it remains a key weakness. The government has not yet published its climate strategy. Efforts to improve household energy efficiency are still at an early stage. The action plan on combating the informal economy has expired and not yet been updated, though the tax administration has had some recent success in tackling the informal economy. Nevertheless, there was no progress in increasing the transparency of prices for real estate transactions. The government adopted a number of strategies on health but their implementation was limited. There has been some progress on the accreditation and monitoring of higher education, but school inspections still need to resume. Tools to

monitor the labour market and skills needs have been developed and they now need to be used. An inter-ministerial task force was set up and started developing a Youth Guarantee implementation plan.

The ERP sets out reform plans that are partly in line with the key challenges and priorities identified by the Commission. The programme reflects the government's intention to boost economic recovery in 2022 and strengthen the sustainability of public finance for the medium term. It also mentions a number of investment projects that should support infrastructure and competitiveness. However, weaknesses in fiscal governance could delay the achievement of these goals. The programme includes measures to improve the business environment and reduce the informal economy. The ERP also partially addresses issues of access to energy challenges and the capacity of the education system to meet labour market needs. The ERP process for Kosovo should also emphasise the shared European growth model regarding green and digital transition, particularly given the current geopolitical context. The digitalisation of the economy is advancing but efforts are needed to promote e-commerce, enable the use of international electronic payments and finalise the e-governance strategy. Although the proposed measures in the ERP are aligned with the main structural challenges, implementation is delayed and the planned improvements have not yet been materialised.

7.2. ECONOMIC OUTLOOK AND RISKS

Following a deep recession in 2020, Kosovo's economy rebounded sharply in 2021 due to the easing of travel restrictions and to exceptional support from the diaspora. The recovery started in the first quarter with real GDP expanding by 4.2% year on year, which accelerated in the following two quarters to 16.3% and 14.5% year on year, respectively. Growth was driven by a relaxation of travel restrictions and a rebound in financial flows from the diaspora through tourism, remittances and real estate investment. The recovery was boosted by policy support from the government in rolling out COVID-19 related measures, estimated at 3.2% of GDP.

The ERP's baseline scenario assumes a robust recovery with GDP growth much higher than the historical trend. Supported by very strong growth in investment, real GDP is projected to increase by 7.8% in 2022. The projected rebound is much higher than the IMF forecast, which is more in line with the historical trend at 3.8% ⁽⁶⁰⁾. In subsequent years, the ERP expects economic growth to ease off, but remain well above historical trend growth at 7.1% and 6.8% in 2023 and 2024 respectively. The expected strong inflow of investment in 2022 (+21.3%) relies on higher private investment, which is assumed to benefit from reduced uncertainty, government support and improving balance sheets of the private sector. Public investment is also expected to increase strongly due to better execution of capital projects. In 2023-2024 investment growth is set to remain high at around 11%. Due to the base effect, the inflow of remittances, bank lending and social transfers, private consumption is set to increase slightly (1.5%) in 2022 before accelerating to some 6% in 2023-2024, but it is unclear what is behind this expected surge. Public consumption is projected to rise by 4.5% in 2022 due to the rollout of pandemic-related measures, as expected in the 2022 budget, and then to level off afterwards. After a spectacular rebound in 2021, real exports are set to increase by 6.6% in 2022, and continue growing at 7.5% afterwards. Imports are expected to rise by 5% in 2022 (counterintuitive given the projected high increase in investment this year) before accelerating to 6-7% in 2023-2024. The ERP assesses that in 2022, the macro-fiscal risks and uncertainty related to the pandemic are lower than they were in 2021, due to the ongoing vaccination programme and restored business confidence. The main risks are considered to be external, stemming from high energy prices and a potential interest rate hike in the Eurozone. Among the domestic risks the ERP notes pandemic-related restrictions, pressure to roll out new social schemes and fiscal risks related to publicly owned enterprises. In contrast to previous years, the ERP does not provide high and low-growth scenarios, though the latter could have served as a useful reference, given the optimistic baseline GDP projections.

⁽⁶⁰⁾ The IMF Article IV consultation (2022).

The ERP baseline scenario appears overly optimistic and is beset by high uncertainty. Though the recovery was impressive in 2021, it was mainly driven by exceptional financial inflows from the diaspora without pronounced changes in the production structure. Compared to the previous year's ERP projections, the level of estimated GDP at market prices is 6.2% higher than it was in 2021. The upward revisions of 11.9% in 2022 and 15.9% in 2023 seem overly optimistic. Potential GDP growth is estimated at 6.4% in 2021 and set to ease off gradually to 5.4% in 2024, which is at odds with the assumed surge in investment. Moreover, the assumed downside risk of higher energy prices already started to materialise in late 2021. High import costs, increased energy consumption in winter months and insufficient domestic power generation, exacerbated by the partial shutdown of Kosovo B power plant, resulted in temporary power cuts and high energy subsidies (EUR 120 million or 1.5% of 2021 GDP).⁽⁶¹⁾ A substantial new risk stems from the fallout from the Russia's war against Ukraine, in particular via further increases in food and energy prices. These adverse developments are likely to reduce disposable income, merchandise exports and GDP growth.

Table II.7.1:

Kosovo - Macroeconomic developments

	2020	2021	2022	2023	2024
Real GDP (% change)	-5.3	9.7	7.8	7.1	6.8
<i>Contributions:</i>					
- Final domestic demand	-0.1	9.0	8.4	9.2	8.4
- Change in inventories	-0.1	-0.1	0.4	0.0	0.0
- External balance of goods and services	-5.1	0.8	-0.9	-2.1	-1.6
Employment (% change)	-4.4	3.5	:	:	:
Unemployment rate (%)	25.9	25.8	:	:	:
GDP deflator (% change)	1.4	2.4	2.5	2.1	1.9
CPI inflation (%)	0.2	3.3	2.5	2.2	2.0
Current account balance (% of GDP)	-7.0	-4.9	-5.5	-6.5	-7.2
General government balance (% of GDP)	-7.6	-1.4	-4.6	-3.7	-3.0
Government gross debt (% of GDP)	22.4	22.5	25.5	27.2	28.7

Sources: Economic Reform Programme (ERP) 2022.

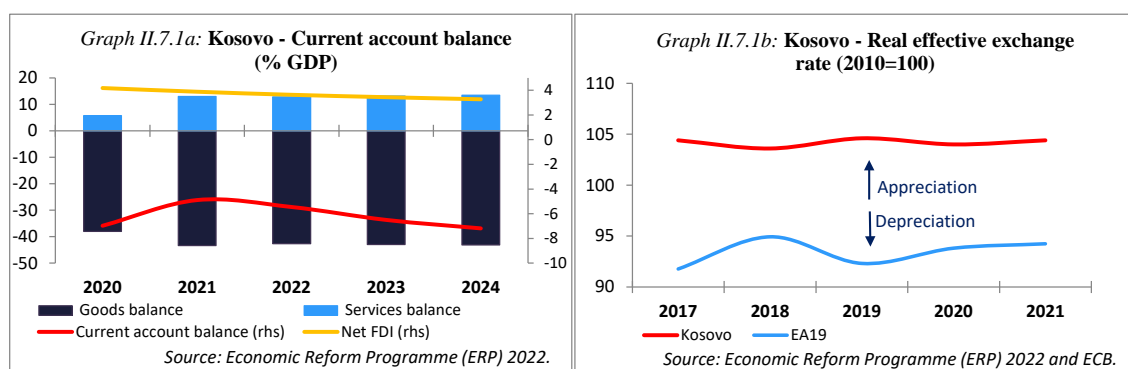
Inflationary pressures are expected to abate, but the 2022 inflation forecast is optimistic. The ERP expects average annual inflation to fall to 2.5% in 2022 from 3.3% in 2021 on the back of a gradual stabilisation of energy prices and fewer supply disruptions caused by the pandemic. This projection is rather benign compared with the IMF forecast of 3.9% for 2022 and given increasing price pressures in late 2021. Inflation rose over the course of 2021 from 0.6% in the first quarter to 6.7% year on year in December. The main drivers were rising food and energy prices and the one-off increase in communication tariffs. Most energy prices are regulated in Kosovo. The decision of the Electricity Regulation Office to bring in a two-tier tariff structure for household consumers, maintaining electricity prices for households consuming less than 800kWh unchanged and doubling them for households consuming more than 800kW, is likely to push up inflation in 2022.

Diaspora-related inflows helped reduce the current account deficit in 2021, but high import growth is projected to widen the external gap in the coming years. Following the easing of travel restrictions, exports of services (mainly diaspora tourism from Western Europe, but also transport services) rebounded

⁽⁶¹⁾ A share of EUR 30 million is earmarked for securing imports of electricity, while the bulk of energy subsidies (EUR 90 million) will be used to keep electricity prices unchanged for small consumers, i.e. households using up to 800 kW, and partially compensate price increases for larger consumers (more than 800kW). The latter subsidy, which will be financed from the economic recovery programme for 2022 (EUR 200 million), is not well-targeted as it will be given without adjusting for beneficiaries' income. The tariffs for non-household consumers, including industrial customers, small and medium-sized enterprises, businesses and wholesale customers, remain unchanged. Large companies, e.g. Ferronickel or Trepca, which are not supplied in the regulated energy market, face higher energy prices without any compensation.

by a stunning 89.4% in 2021. Exports of goods, which are much smaller and rely on a narrow product base including base metals, manufactured articles, plastics and prepared foodstuffs, increased by 60% despite the high electricity prices in the second half of 2021 affecting the main export product, base metals. The sizeable increase in imports (by 33.2%) led to a widening merchandise deficit from 38.5% of GDP in 2020 to 44.4% in 2021. The surplus of services trade is estimated to have increased from 5.8% to 13.3% of GDP over the same period. The overall trade deficit fell slightly from 32.6% to 31.1% of GDP in 2021, and the ERP projects it to remain above 30% during 2022-2024. The key factor partly offsetting the trade deficit is remittances, which increased by 20% in 2021 to reach 15.8% of GDP. Further unofficial remittances (2.5% of GDP) are reflected by larger errors and omissions in 2021. Overall, the current account deficit is projected to widen gradually from 4.9% of GDP in 2021 to 7.2% in 2023, due to a robust increase in imports. In terms of the saving-investment balance, the strong increase in both private and public capital spending is seen as the main driver of the forecast widening of the external deficit.

External competitiveness and current account



Due to financial inflows from the diaspora focusing on real estate investment, net foreign direct investment (FDI) increased in 2021 to cover nearly 80% of the current account deficit. Further support for FDI came from reinvested earnings in the financial sector due to the ban on dividend distribution. Net foreign direct investment is estimated at 3.9% of GDP in 2021. The bulk was directed to non-tradeable activities, with real estate and financial services accounting for 68% and 22% of all foreign direct investment inflows respectively, doing little to enhance export capacity. Kosovo's net international investment position improved from -12.3% of GDP in 2020 to -9.5%, mainly driven by rebound in GDP. Around two thirds of gross liabilities consist of foreign direct investment, typically considered a more stable source of financing, conducive to limiting external vulnerabilities. Reserve assets remained rather low, covering three months of imports in the third quarter of 2021, down from 3.2 in 2020.

Table II.7.2:

Kosovo - Financial sector indicators

	2017	2018	2019	2020	2021
Total assets of the banking system (EUR million)	3 870	4 186	4 761	5 365	5 960
Foreign ownership of banking system (%)	88.1	86.8	86.7	86.5	85.5
Credit growth (aop)	11.5	10.9	10.0	7.1	15.5
Deposit growth (aop)	6.8	8.7	16.2	11.6	12.4
Loan-to-deposit ratio (eop)	80.3	81.9	77.6	74.5	76.5
Financial soundness indicators (eop)					
- non-performing loans	3.1	2.7	2.0	2.7	2.1
- net capital to risk-weighted assets	18.1	17.0	15.9	16.5	15.3
- liquid assets to total assets	37.9	38.5	38.7	39.8	37.4
- return on equity	21.3	20.4	18.9	14.0	17.6
- forex loans to total loans (%)	0.2	0.1	0.1	0.1	0.1

Source: National Central Bank.

Helped by the economic rebound, the mainly foreign-owned banking sector remained stable and continued to expand. In February 2021, the Central Bank of Kosovo (CBK) issued a third guide on loan restructuring for a period of nine months, which helped banks avoid increasing provisions. In the second half of 2021, as the economic recovery gained pace, the CBK gradually lifted the pandemic-related support measures⁽⁶²⁾, without a negative impact on bank asset quality so far. Timely regulatory forbearance and large inflows from the diaspora supported rapid credit growth, in particular for households. Bank loans accelerated from 7.1% in 2020 to 15.5% in 2021, while new loans to households, mainly for consumption purposes, rose by 51%, nearly reaching the level of new loans to non-financial corporations in 2021. New mortgage lending to households surged by 75%. Although overall the credit risks remain contained, the ERP mentions challenges in evaluating risks from the rapid credit expansion in the household segment. The growth of deposits increased from 11.6% in 2020 to 12.4%. Financial soundness indicators remained satisfactory, e.g. the loan-to-deposit ratio and non-performing loan (NPL) ratio⁽⁶³⁾ stood at 76.5% and 2.1%, respectively. Bank profitability has surged with the average return-on-equity ratio reaching 17.6% in 2021, up from 14% in 2020. The ERP does not provide quantified forecasts for the financial sector, but the underlying assumption, which appears broadly plausible, is that the largely foreign-owned banking sector will remain stable and profitable.

7.3. PUBLIC FINANCE

The 2021 budgetary outcome has considerably improved due to surging revenue and conservative spending. The ERP estimates the 2021 headline budget deficit to be 1.4% of GDP, which corresponds to a deficit of 0.8% of GDP under the fiscal rule definition⁽⁶⁴⁾. This outcome would comply with the fiscal rule prescribing a deficit ceiling of 2% of GDP, though this rule has been suspended since 2020. The 2021 deficit outturn is much lower than in 2020 (7.6% of GDP) and also undershoots the target of 6.4% set in the revised 2021 budget. Government deposits recovered to 4% of GDP from 3.5% in 2020. The lower deficit resulted primarily from an extraordinary increase in government revenue, which is estimated to have risen by 26.8% from 2020, exceeding the revised 2021 budget projection by 6.8%. Tax revenue increased by 29.8% with healthy growth in direct and indirect tax income, up 25% and 31% respectively

⁽⁶²⁾ The IMF estimates that by October 2021, only 1% of all loans remained under the pandemic-related forbearance.

⁽⁶³⁾ Stable NPL ratio was also supported by the denominator effect, i.e. high credit growth.

⁽⁶⁴⁾ The fiscal rule places a cap on the fiscal deficit of 2% of forecast GDP, excluding capital projects financed by privatisation proceeds and donors ('investment clause'). This exemption for donor-financed investments can be invoked until 2025, provided the public debt ratio remains below 30% of GDP. A further rule provides that the increase in the public wage bill cannot exceed nominal GDP growth. Government deposits used as fiscal buffers are legally required to stay at 4.5% of GDP as long as the government uses privatisation proceeds. The debt rule provides that public and publicly guaranteed debt cannot exceed 40% of GDP.

on 2020. By contrast, public spending increased by only 2.5% and its share in GDP dropped by 2.9 percentage points due to robust GDP growth. Implementation of the revised 2021 budget was uneven among different spending categories. Capital spending reached only 75.8% of the revised budget allocation (although this is still an improvement over previous years), while the execution of current expenditure was roughly in line with the initial plan. The largest increase in spending was in the category of goods and services (9.6%) due in particular to the purchase of vaccines. Spending on social transfers and subsidies fell by 2.9% due to the higher level in 2020, but it was still at 11.1% of GDP in 2021 compared to the pre-crisis level of 8.8%. The ERP estimates the costs of the economic revival programme in 2021 at 3.2% of GDP, which is below the crisis-related stimulus of 4.2% of GDP provided in 2020. The bulk of pandemic-related support in 2021 was spent on transfers to vulnerable households and firms (2.5% of GDP). In addition to direct support measures, the government exempted mining firms from paying royalties for five months and applied a reduced VAT rate for hotels and catering services. Together these measures are estimated to have resulted in a loss of budget revenue of 0.2% of GDP.

The fiscal strategy for 2022-2024 aims to support the economic recovery mainly through capital investments, while maintaining stable public finances and complying with fiscal rules. The fiscal strategy projects tax revenue to fall slightly from the historical high of around 26% of GDP reached in 2021 ⁽⁶⁵⁾, when it was supported by an extraordinary increase in diaspora travel and some formalisation gains, stemming from implementation of pandemic-related measures. Public spending is forecast to be frontloaded, rising to 32.7% of GDP in 2022 before falling to 30.7% in 2024. As in the past, the ERP assumes a very large increase in capital spending in 2022 (by 2.9 percentage points), which should taper off in 2023-2024, bringing investment as a share of GDP to well above 9%. Expressed as a percentage of GDP, government spending and social transfers are projected to ease off steadily in 2022-2024, but to remain above their pre-crisis levels.

The headline deficit is set to widen in 2022 to 4.6% of GDP, and narrow afterwards. The budget deficit, as per the fiscal rule definition, is projected at 1.8% of GDP in 2023, reflecting the authorities' plan to return to compliance with the deficit rule next year, and to fall to 0.8% in 2024. While a more supportive fiscal stance focusing on much-needed investment is justified in 2022, given very cautious spending in 2021 and the still fragile recovery, the assumption that revenue will remain permanently higher is beset with a high degree of uncertainty in terms of the development of the pandemic and financial inflows from the diaspora. The ERP does not refer to any reforms to widen the tax base or review social transfers. The assumption of an extraordinary increase in capital spending is not sufficiently underpinned by concrete measures to improve investment management or disbursement from the investment clause. Though the fiscal projections represent a commendable target, the ERP provides few details on how Kosovo can achieve the target.

⁽⁶⁵⁾ In 2019, the tax revenue to GDP ratio was 24%.

Table II.7.3:

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

	2020	2021	2022	2023	2024	Change: 2021-24
Revenues	25.4	28.7	28.1	27.9	27.7	-1.0
- Taxes and social security contributions	22.4	25.9	25.2	25.1	25.0	-0.9
- Other (residual)	3.0	2.8	2.9	2.8	2.7	-0.1
Expenditure	33.0	30.1	32.7	31.6	30.7	0.6
- Primary expenditure	32.6	29.7	32.2	31.0	30.1	0.4
<i>of which:</i>						
Gross fixed capital formation	5.6	5.5	8.4	9.2	9.5	3.9
Consumption	14.2	13.1	12.8	11.9	11.3	-1.8
Transfers & subsidies	12.8	11.1	10.6	9.8	9.2	-1.9
Other (residual)	0.0	0.0	0.4	0.1	0.2	0.2
- Interest payments	0.4	0.4	0.5	0.5	0.6	0.1
Budget balance	-7.6	-1.4	-4.6	-3.7	-3.0	-1.6
- Cyclically adjusted	-3.6	-2.6	-4.7	-3.4	-2.3	0.3
Primary balance	-7.2	-1.0	-4.1	-3.2	-2.4	-1.4
- Cyclically adjusted	-3.2	-2.2	-4.2	-2.8	-1.7	0.4
Gross debt level	22.4	22.5	25.5	27.2	28.7	6.1

Sources: Economic Reform Programme (ERP) 2022, Commission calculations.

The 2022 budget assumes strong growth in both public revenue and spending. The 2022 budget projects public revenue at 28.1% of GDP, which is 15.7% higher than the revised 2021 budget. Compared to the outturn of 2021, tax revenue is set to rise by 7.9% in 2022 with a smaller increase in indirect tax revenue (5.7%) and higher growth in direct tax income (17%). Total expenditure is projected to reach 32.7% of GDP in 2022, which is 8.7% higher than the spending forecast in the 2021 revised budget. The main reason for this increase is forecast to be capital spending (27%) while current expenditure is set to grow by a modest 3.2% in 2022. Compared to the outturn of 2021, current and capital spending should increase by 3.3% and 67% respectively, with the surge in capital spending not supported by the previous track record of investment expenditure. The 2022 budget includes new child and maternity allowances (0.6% of GDP). The allocation for war veteran pensions is set in line with the legal ceiling of 0.7% of GDP which has been repeatedly exceeded in the past. Debt interest payments are set to remain unchanged at 0.5% of GDP in 2022. The 2022 budget also includes a blanket allocation for the economic revival programme amounting to 2% of GDP. This includes 1.3% of GDP for subsidies and transfers as well as 0.7% of GDP for contingencies for pandemic-related downside risks. The headline deficit is set at 4.6% of GDP which corresponds to a deficit of 2.9% of GDP under the fiscal rule definition. Government cash deposits are planned to decrease slightly to 3.5% of GDP from 4% in 2021.

The priorities set in the government programme are not well reflected in the budget. The ERP doesn't include information on all new initiatives stemming from the government programme. Some, such as child and maternity allowances, are included in the 2022 budget, but it is not clear whether other elements in the programme such as raising the minimum wage or increasing affordable housing will be added in 2022. The ERP does not provide much detail as to the continuation of the economic recovery programme in 2022. It does not mention the latest government initiatives, such as energy subsidies (EUR 120 million) or the increase in basic, disability, invalidity and family pensions up to EUR 100.

The increase in public debt was less pronounced than anticipated in the previous ERP, but the domestic investor base remains shallow. On the back of strong economic recovery and revenue growth in 2021, the debt-to-GDP ratio is estimated to have grown only marginally, to 22.5% from 22.4% in

2020. ⁽⁶⁶⁾ While this outcome is way below the 2021 ERP projection of 28.7%, these figures do not include the liability stemming from tax-free withdrawals of 10% of pension savings from the Kosovo Pension Saving Trust (KPST), which the government promised to reimburse from 2023. ⁽⁶⁷⁾ Domestic debt, which is held by a narrow investor base, increased by 16% in 2021. The KPST's share of domestic debt fell slightly from 47% in 2020 to 45%, while the Central Bank of Kosovo and commercial banks hold a further 20% and 30% of domestic debt respectively. Foreign debt rose by 9.6% in 2021 on the back of financing from international donors. This includes EU macro-financial assistance (the second and final instalment of EUR 50 million was disbursed in June), World Bank loans (EUR 32.2 million) and Council of Europe Bank lending (EUR 17 million). The ERP assumes a 2.9 percentage point increase in the public debt ratio in 2022, to 25.5%, and a continued gradual drift upwards to 28.7% in 2024. The ERP projects government deposits at some 3.5% of GDP in 2022-2024, which would provide sufficient capacity to face potential new shocks. The KPST still has room to buy new bond issuances in the coming years, but it is approaching the legal limit ⁽⁶⁸⁾. Risk management policies also limit the ability of commercial banks to hold more government debt. ⁽⁶⁹⁾ As Kosovo does not have access to international debt markets due to the lack of an international credit rating, it needs to diversify the investor base for government securities in order to secure sufficient financing while safeguarding government deposits. This could include insurance companies, non-financial private firms and possibly retail investors, including from the diaspora. Together, these categories currently hold only about 5% of domestic debt. In 2021, Kosovo issued its first diaspora bonds, albeit in small amounts, in an effort to tap additional sources of financing.

Box II.7.1: Debt dynamics

The sustained though gradually decreasing primary deficit in 2022-2024 is expected to be the main reason behind the steadily increasing public debt. This debt-increasing factor is partly offset by the impact of economic growth and inflation. Interest expenditure is forecast to stay low and roughly stable at 0.5-0.6% of GDP in 2022-2024. Positive but low contributions to the debt-to-GDP ratio are expected to come from stockflow adjustments in 2022-2024.

Kosovo

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

	2020	2021	2022	2023	2024
Gross debt ratio [1]	22.4	22.5	25.5	27.2	28.7
Change in the ratio	4.9	0.1	2.9	1.8	1.4
<i>Contributions [2]:</i>					
1. Primary balance	7.2	1.0	4.1	3.2	2.4
2. "Snowball" effect	1.3	-2.0	-1.6	-1.6	-1.6
<i>Of which:</i>					
Interest expenditure	0.4	0.4	0.5	0.5	0.6
Growth effect	1.0	-1.9	-1.6	-1.7	-1.7
Inflation effect	-0.1	-0.5	-0.5	-0.5	-0.5
3. Stock-flow adjustment	-3.5	1.1	0.5	0.2	0.6

[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) 2022, ECFIN calculations.

The fiscal scenario is a commendable combination of investment-led fiscal support to the recovery and return to compliance with the fiscal rules, but implementation is beset by substantial risks. Highly optimistic GDP and revenue projections are the main downside risk to the budget. On the

⁽⁶⁶⁾ In March Kosovo Agency of Statistics has revised the debt-to-GDP ratio to 23.4% in 2021.

⁽⁶⁷⁾ The IMF estimates the liability to KPST at 1.8% of 2020 GDP.

⁽⁶⁸⁾ Government securities should not exceed 30% of KPST assets.

⁽⁶⁹⁾ The absence of a sovereign risk rating results in a 100 per cent capital risk weight for Kosovo's government securities.

spending side, the fiscal scenario assumes moderate growth of current expenditure and a very ambitious surge in capital investment. There are risks of higher growth in current spending due to new initiatives included in the government programme, such as raising basic pensions or bringing in maternity and child benefits, while existing schemes might prove more costly than expected. In particular, spending on war veteran pensions has repeatedly breached the legal cap of 0.7% of GDP due to a lack of reclassification of beneficiaries and other cost-saving measures. Moreover, the government programme foresees raising the minimum wage, which is currently used as a lower bound for war veteran pensions and thus could lead to further increases in this spending category. The government has been revising the Law on Salaries for Public Employees since mid-2020 and plans to table a new proposal in the spring. The new law should set a uniform wage grid and improve compensation fairness, while the fiscal implications should in principle be contained if the wage bill rule is respected. The under execution of capital investment is a long-standing issue and there is a substantial risk that the much higher allocation for 2022 will not be fully implemented, which therefore is an upside risk to the budget balance. The poor performance by publicly owned enterprises and the accumulation of arrears are further downside fiscal risks.

Box II.7.2: Sensitivity analysis

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

- 1) A slowdown in GDP growth by 2 percentage points would bring the debt-to-GDP ratio to 30.8% instead of 28.7% in the baseline scenario if the deficit rule is followed in 2025-2035
- 2) If, due to higher spending, the primary balance deteriorates by 2 percentage points of GDP in 2024-2034 and the deficit rule is not followed, debt would increase to 53% of GDP by the end of 2035, i.e. 23.8 percentage points higher than in the baseline scenario.
- 3) A 1 percentage point 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 offset by lower primary deficits.

The sensitivity analysis underscores the importance of compliance with the 2% deficit rule, which acts as a debt stabiliser. Moreover, it is important to keep current expenditure under control, in anticipation that financing from privatisation funds will end over the medium term.

The quality of public finance suffers from long-standing issues such as inappropriate targeting and transparency of social transfers, weaknesses in investment management and a limited tax base. Though fiscal support for vulnerable groups was well-targeted under the economic revival programme, a large share of specific category-based social transfers, including war-related pensions financed from the budget, are not focused on alleviating poverty. Decoupling war veteran pensions from potential changes to the minimum wage would help contain overspending risks. Kosovo brought in child benefits and maternity allowances and increased basic, disability, invalidity and family pensions to the minimum benchmark of EUR 100 without making proper assessments of their long-term costs. Further progress is needed to improve the administrative capacity to run capital projects, especially donor-financed projects under the investment clause. As a positive step, Kosovo allocated EUR 50 million for expropriation purposes in the 2022 budget with the aim of unlocking the potential of project implementation. It could improve the planning, execution and *ex post* evaluation of the public investment programme by implementing the recommendations made under the IMF Public Investment Management Assessment and by ensuring the efficient functioning of the Procurement Review Body. On the revenue side, the challenge is to strengthen the tax base, as the implementation of the free trade agreement with Turkey and the Stabilisation and Association Agreement with the EU will result in lower customs revenue. The tax base is weakened by widespread informality and numerous exemptions, preferential tax rates and special regimes. While some tax exemptions, e.g. lower VAT for restaurants and catering, might have been

justified during the pandemic, it would be important to produce a comprehensive review of tax expenditure in order to assess the revenue foregone and shape future policies.

While fiscal stimulus is justified in 2022, the medium-term sustainability and credibility of public finance would clearly benefit from the planned return to the deficit rule. The 2022 budget projects a return to the 2% deficit ceiling by 2023. The development of debt-to-GDP ratio will have major repercussions on the use of the fiscal rule investment clause. According to the fiscal rule definition, the exemption from the 2% deficit ceiling of capital projects financed by privatisation proceeds and donors can be used until 2025, provided that public debt remains below the prescribed ceiling of 30% of GDP. A benign ERP projection of public debt is dependent on high GDP and public revenue growth, which are beset by uncertainty. To avoid the risk of suspending the investment clause while accommodating Kosovo's large investment needs, a possible solution could be to align the investment clause to the general debt ceiling of 40% of GDP. Fiscal governance would also benefit from moving ahead with plans to set up an independent fiscal council, drawing on the options paper prepared recently with the help of the IMF. The proper functioning of Kosovo's fiscal framework is also conditional on the quality of macro-financial statistics, which require substantial further improvement.

7.4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES

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

The government in its ERP also highlighted two of the three areas listed above as key structural challenges, namely (i) improving the quality and relevance of the education system to increase employment and mitigate skills mismatches and (iii) tapping into the potential of renewable energy and energy savings and fully opening the energy market. The government described the reorganisation of the health sector in order to provide adequate and accessible health services for all citizens as a third key structural challenge.

While the ERP continues to acknowledge the importance of efforts to tackle the informal economy and improve the competitiveness of the private sector, it does not place it among the three key structural challenges facing Kosovo. However, given the nature and persistence of the challenges in this area and their immediate impact on competitiveness and inclusive growth, the Commission maintains its assessment that tackling the informal economy and improving the competitiveness of the private sector remains a key structural challenge for Kosovo.

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

Kosovo records very low activity and employment rates in relative terms. In 2020, according to official data, only 42.9% of people aged 20-64 were active in the labour market, far below the levels in its regional peers and very far from the EU-27 average of 77.7%. The employment rate (20-64 years) in 2020 was 32.3%, down 1.9 pps. from 2019 due to the COVID-19 crisis. Data from the first quarter of 2021 show some signs of recovery as the employment rate (15-64) stood at 29.3%, slightly above the same period in 2020 (29.1%) and 1.1 pps. higher than in the first quarter of 2019. A plan to decrease the duration of short-term employment contracts from the current 10 years to 3 years pursues the goal of increasing quality employment.

There is a stark gender divide in the labour market. In 2020, the gender employment gap (for people aged 20-64) was 32.8 pps., among the widest in Europe, though it has been decreasing from 39.4 pps. in 2017. Among the reasons is lower involvement of women in entrepreneurship, which is linked to lower access to finance and real estate property, as well as family responsibilities and lack of affordable early childhood education and care facilities (RCC 2021). High reservation wages supported by remittances and a lack of opportunities and affordable transport options in rural areas are other factors linked with low female labour force participation. In September 2021, as part of the recovery package the government introduced maternity leave for women unemployed longer than 12 months. By excluding women in shorter spells of unemployment, this could act as a disincentive for women planning motherhood to take on (formal) work. The draft Labour Law brings 10 days of paternal leave and the option of parental leave for the mother or the father to take after the end of maternity leave. This provides ways to increase the balance in the distribution of care responsibilities. It also aims to encourage the employment of women by reducing costs for employers by taking over a bigger share of maternity leave benefits.

The provision, accessibility and affordability of early childhood education and care (ECEC) are low. Kosovo's ECEC policy aims are to provide highly targeted public services for more vulnerable social groups, while expecting the rest to rely on the market or the family. Although the availability of ECEC has been increasing, it remains below regional peers, and new services are increasingly provided by the market, which raises affordability issues (Mustafa 2021). Though the level of participation of children aged 0-5 in ECEC was marginal at 6.2% in the school year 2019/2020, there is a high level participation of children aged 5-6 (92.5%) in preparatory classes offered mainly by primary schools (RCC 2021).

Young people in Kosovo face a difficult transition from school to employment. The unemployment rate of young people aged 15-24 was 49.1% in 2020, with more than half unemployed for over 12 months, which puts them in category of long-term unemployed. The share of young people aged 15-29 not in employment, education or training (NEET) was 40.4%. Both figures are very high not only compared to the EU-27 average but also to Kosovo's Western Balkan peers. The lack of jobs is considered to be a key factor fuelling the emigration of young people. To partially address the situation on the supply side, the government has set up a multi-stakeholder group to develop a Youth Guarantee implementation plan.

The Kosovo education system was ranked among the lowest quality by the 2018 Programme for International Student Assessment (PISA). Kosovo students' scores are the equivalent to five years of schooling behind the OECD average in reading, and a little over four years behind in mathematics. The performance gap is particularly clear among students belonging to ethnic minorities and people in vulnerable situations. Students in urban areas tend to outperform students in rural areas. Nevertheless, students firmly believe in their own ability to perform, especially when faced with adversity (ranking 9

out of 77). They also perceive their teachers as being very enthusiastic and supportive compared to other economies participating in PISA. One in two upper secondary students is registered in vocational programmes. The proportion of people (18-24) leaving school early has continued to fall to 7.8% in 2020, which is now lower than the EU-27 average of 9.9%. Keeping young people in education while upskilling them through vocational qualifications has proved to be a successful policy. However, the time spent in school may translate unevenly into learning (ETF 2020).

Effective quality assurance is one of the weakest points across all levels of education. This is recognised in Kosovo's Education Strategic Plan for 2017-2021. With government expenditure on education amounting to 4.6% of GDP in 2020, Kosovo was comparable to the EU-27 average of 4.7%, but Kosovo has a higher proportion of children and reform priorities far exceed the funding available. According to the ERP, in 2021, the budget decreased to only 3.1% of GDP. School principals and teachers reported a lack of teaching and learning materials. A consolidated draft of the new Law on Textbooks and Teaching Materials has been produced in 2021, but the procedure for its adoption and for publishing textbooks remains unclear (KEC, 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, with a lack of administrative instructions seeking to address this issue. Existing quality control mechanisms at all levels of education are not consistently applied.

Reform measure 19 ("Reform in pre-university education and increase of inclusion in early education") sets out ambitious and well-sequenced activities. The work on textbooks, school inspection and teachers' professional development are overdue; hence, this is a welcome addition to the ERP. It is also positive that the government is planning to build new preschool institutions and to adapt existing schools to their use also as kindergartens. The measure includes developing and approving of a core curriculum for ECEC with its subsequent piloting and the training and mentoring for teachers. The reform has the potential to improve quality in basic education and to ensure a broader inclusion of children in ECEC. However the ERP does not include measures to hire teaching assistants for children with special needs (already budgeted for 2022) to address issues of inclusion.

Many firms in Kosovo encounter problems due to applicants' lack of skills and low-skilled people lack formal job prospects opportunities. Finding the right employees with the required skills and competences 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 relevant skills may be the result of insufficient skill formation opportunities in early childhood education, the low quality and lack of work-based learning in initial vocational education and training and in training programmes delivered by the vocational training centres. According to the most recent World Bank's Enterprise Survey on Kosovo from 2019, 44% of the interviewed firms found inadequate education of the workforce as a major constraint, while 36% of them found labour market regulations as a major constraint, both shares being much higher than in its Western Balkans peers. 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 basic skills in the highest demand (World Bank, 2020c). Aligning policies, training programmes and curricula to the current and future needs of the labour market is challenging, although relevant sector studies exist that identify current and future skills needs. Donors financed projects aimed at bridging this gap. The EU ALLED2 project, together with the Kosovo Chamber of Commerce, is developing the Kosovo Skills Barometer. Existing sector studies and occupational standards are not yet used to feed into the development of vocational education and training (VET) planning and curriculum, or active labour market measures. The VET Council has been made functional and it involves businesses to a satisfactory level. However, the Council meets only rarely. The EU ALLED2 helped develop a new VET funding formula, which is awaiting fine-tuning and introduction. On 26 January 2022, the government adopted a decision to establish an Executive Commission for the development of the VET System according to the needs of the labour market. Its

work is planned to address VET governance and financing issues and to discuss setting up a dual training system.

Reforming the education system at upper secondary and tertiary levels by giving graduates the relevant skills and competences needed to face the challenges ahead is a necessity. Many graduates remain unemployed as their training does not provide them with the necessary skills required by the labour market. The labour market does not provide sufficient opportunities to employ the graduates. Numerous strategies exist (or new ones are being drafted), but their implementation and the monitoring of progress hinge too often on donor funding. By and large, education and training do not provide students with the digital skills and other competences in line with European and international education standards. The planning and funding of VET is insufficiently geared towards meeting labour market needs. The lack of cooperation with the private sector is partly due to the small size and informal operations of companies and partly to inflexibilities on the side of schools. There is also an issue of fragmented primary and secondary legislation related to VET (Bajrami 2021). The rapid expansion of higher education institutions, programmes and enrolment led to quality issues. Kosovo's labour market generates little demand for academic qualifications, more so for hands-on vocational skills. A recent skills mismatch measurement indicates that over 40% of young workers with a tertiary education are employed in jobs below their level of education. This calls for an enhancement of quality and relevance in higher education, as well as higher investments in school and post-graduation career guidance and counselling (ETF 2022). The current policy puts focus on transition from VET to university, completion rates and support to students in the first year of tertiary education to increase retention, and monitoring of accreditation criteria by Kosovo Agency for Accreditation. However, a broader policy reform of tertiary education is still lacking.

Reform measure 1 (“Adapting VET to the needs of the labour market”) presents a more holistic approach to addressing long-term issues in the VET sector, compared to the actions proposed in previous years. The latter had been brought forward from year to year without a proper budgeting and mostly relying on donor activities. A large part of the current VET profiles and curricula is still outdated, in fact only 30% of VET profiles are based on occupational standards (Bajrami 2021), except where different donors (using different models) have already changed them. Newly developed or revised VET curricula are planned; some 15-20 may be introduced in schools in 2022. For the rest, an implementation schedule would be needed, which also integrates teacher development, equipment upgrading and the expansion of work-based learning schemes. To inform the planned curriculum activities, existing skill needs analyses and occupational standards can be used and qualifications be developed in line with the Kosovo Qualifications Framework. Following MESTI's administrative instructions on work-based learning adopted in 2020, school-based career centres could take on a greater role in expanding work-based learning schemes.

Reform measure 2 (“Increasing and ensuring quality in higher education by strengthening the Kosovo Agency for Accreditation and profiling higher education institutions”) is well designed and sequenced. After the expected approval of the Law on the Kosovo Agency for Accreditation, the institution is expected to expand its activity in the field of quality assurance, therefore increasing its competences and responsibilities. This has a potential to address the issue of the limited capacity of the agency to monitor that accredited institutions maintain quality standards. Some of the measures proposed in the previous ERP were dropped, although links with businesses might have helped improve the quality of higher education studies.

The Employment Agency of Kosovo is making efforts to increase the scope and quality of services provided to jobseekers but lacks staff and budget. Recently, the Ministry of Finance, Transfers and Labour and Social Welfare launched a series of reforms to modernise the Public Employment Services (PES) in Kosovo. It aims to provide a service tailored to the needs of the client including profiling, counselling, career guidance, training and mediation services as well as online publication of vacancies for employers. However, the 138.5% increase in the number of registered unemployed people in 2020 due

to the pandemic (168 980 in total), which has since fallen but still numbered some 85 000 in January 2022, and the high number of jobseekers per employment officer (on average 1 133 in January 2022) makes personalised services impossible. Despite ever increasing tasks, the PES has insufficient financial and qualified human resources. This will become a pressing challenge when the introduction of the Youth Guarantee is brought in, which requires sufficient human resources in PES for its effective implementation. 49.3% of registered jobseekers in 2020 lacked full school education and there is a lack of formal job offers for this category. Most registered jobseekers (40.1%) belonged to the age group 25-39; 16.6% to the age group 15-24. In 2020, due to the closure of training centres, the number of participants in vocational training fell considerably (from 6 607 in 2019 to 3 436 in 2020). However, despite work-related restrictions, the Employment Agency increased participation in active labour market measures (ALMMs) from 4 611 participants in 2019 to 5 631 participants in 2020, mainly due to the increase in on-the-job training and internship programmes. Due to higher number of registered jobseekers, the share of jobseekers covered by ALMMs and vocational training fell from 15.8% to 5.4% (EARK 2021). Overall, 41% of ALMM beneficiaries continue being employed after participation, showing a need to focus not only on quantity but also on quality (GIZ 2019).

Key challenge #2: Formalisation of the economy and low competitiveness of the private sector

Persistent and widespread informality continues to represent a key structural challenge for Kosovo's economy. Multiple assessments produced over the past decade indicate an estimated figure of informality ranging between 30-39% of GDP. An EU-funded project estimated the preliminary cost of informality to be around EUR 106.8 million as a result of lost income tax revenue and VAT alone (IMF, 2019), representing about 7% of all tax revenue. Over 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, sectors which were hit hard during the COVID-19 pandemic. Indeed, the size of the informal sector limited the ability of the government to target support measures, and informal workers and businesses in some of the hardest hit sectors including tourism and retail were unable to benefit from them.

Informality has significant and multiple negative consequences for the broader economy. Firstly, it reduces the tax base, limiting the fiscal space to invest more in priority areas such as education, health and infrastructure. Secondly, it creates an uneven playing field amongst businesses and is a deterrent for additional, much-needed private-sector investment, including foreign direct investment. Unfair competition from informal businesses has consistently been identified as a major obstacle to doing business in Kosovo (World Bank et al, 2019a; EBRD, 2016) ⁽⁷⁰⁾. Informality also impairs the competitiveness and export potential of Kosovo's private sector: firms operating in the informal sector have more difficulty accessing finance and tend to carry out less in research and development and innovation and to hire fewer workers. Lastly, workers in informal sectors have more limited (or no) access to social protection and additional benefits, and are therefore more vulnerable when they lose their job or leave the labour market. Their access to training is also negatively affected, which exacerbates the inadequacy of 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 – exacerbated by the deficiency 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 the general low level of trust in government and institutions and to weak enforcement. High tax rates are not considered to be a major contributor to the phenomenon in Kosovo (income, individual and VAT tax levels are relatively low

⁽⁷⁰⁾ 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% for the region (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)

compared with 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 indicate an overall low level of law enforcement and tax control by local authorities as a potential underlying cause of high levels of informality, though there has been recent progress on this front.

The government’s strategy to combat the informal economy, adopted in May 2019, includes relevant measures to address the problem and improve monitoring mechanisms but implementation needs to be improved and the action plan extended beyond 2021. Among the targets set 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. The first action plan (2019-2021) set out actions in key areas such as statistics and risk and impact assessments, business registration and greater cooperation among agencies such as the tax administration and the customs authority. Despite recent reporting on implementation of this plan, there is still room to improve implementation, monitoring and reporting. The emergency measures taken during the early stages of the COVID-19 crisis proved useful in incentivising undeclared and informal workers to register at the Employment Agency of Kosovo, and businesses to disclose turnover and profit figures in order to be considered for business and employment support schemes.

Reform measure 10: “Reduction of the informal economy” aims to implement selected priorities of the strategy and has been rolled over from last year’s ERP. While the reform measure is relevant and reflects the Commission’s assessment, many activities remain at an early stage, though recent progress has been demonstrated by the tax administration stepping up enforcement. The activities now rolled over to 2022 and 2023 including a continued risk-based approach to enforcement and increased cooperation among the relevant agencies seem credible and significant to tackle to some degree the size of the informal economy, if they are implemented in full and to the planned timeline. The targeted increases in tax revenue are ambitious, but increases in tax revenue are an imperfect indicator, capturing not only compliance gains but also gains from economic growth. A better indicator would focus on the size of the tax gap, which requires more consistent monitoring. A measure related to tackling tax evasion in the real estate sector was dropped in this year’s ERP, despite it remaining a significant issue. The government has stated its intention to develop the Labour Force Survey to better understand the level of inclusion of women and men in the informal economy and will use this to better inform the next ERP.

Kosovo’s formal entrepreneurial landscape is dominated by non-specialised, family-owned micro-companies characterised by low productivity and export competitiveness. This is directly reflected in the persistently high current account deficit figures (4.9% in 2021) and more so in the highly imbalanced trade of goods, with imports over five times higher than exports. Though year-on-year exports of goods increased by 21% in 2020, further analysis has shown that this was largely driven by higher international demand for nickel and a post-pandemic rebound effect. Exports of services, currently showing a large surplus, grew at a faster pace than imports of services (89.5% compared to 48.8%), in 2021. Unless this trend is reversed, it is likely to deepen the trade deficit even further, thus raising Kosovo’s external vulnerabilities. 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 offset the current account deficit, are unable to fill the gap and have not led to increases in the growth of domestic productivity. Kosovo has primarily attracted investment in areas with limited scope for productivity spillover effects such as real estate and related activities (34% of FDI stock), financial intermediation (17%) and manufacturing (12%), with some smaller investments in the agriculture, mining and energy sectors ⁽⁷¹⁾. In addition, FDI is limited to a handful of countries, namely states with a sizeable, well-established Kosovo diaspora. Export-oriented FDI has been very scarce, and overall figures are relatively

⁽⁷¹⁾ Foreign investment in Kosovo, on www.santandertrade.com/en/portal/establish-overseas/kosovo/investing.

low, passing the EUR 300 million figure only once in the past seven years. Remittances are used almost exclusively for consumption purposes and are four times higher than overall FDI (World Bank, 2020a).

Increasing private sector productivity would improve export competitiveness, increase job opportunities and push up wages. This is particularly the case considering the increase in average wages over the past decade, partly resulting from rising public-sector wages. In order to regain labour cost competitiveness in export markets, productivity will need to increase faster.

Tackling informality would help private sector development in Kosovo, and there are a range of other measures to be taken to improve the business environment. These include simplifying, merging and abolishing licences and permits and cutting the length of commercial dispute settlements. Unfortunately, the ERP has dropped the reform measure from last year that aimed to make the commercial court operational. In addition, efforts must be made to improve trust and confidence in the judicial system to improve certainty in contract enforcement. In a recent survey, 43% of firms identified the court system as a major obstacle to doing business (World Bank, 2020). Lastly, the country should look at measures to further digitise of public services. Some preparation has been made regarding the elimination of unnecessarily permits and reorganisation of licenses on the e-Government platform but progress on implementation is needed (OECD SIGMA, 2021).

Reform measure 9: “Improving the doing business environment by reducing the administrative burden, inspection reform” is rolled over from last year’s ERP. The aim is to reduce the administrative burden by simplifying and digitalising permitting and reforming the inspections system. The horizontal nature of both reforms will require solid administrative capacity and coordination when planning and implementing the activities, and after streamlining the inspection bodies. The targets in the ERP related to the inspection bodies seemly overly ambitious, with a 50% reduction from one year to the next, after several years of no progress. The sharp reduction in the number of permits and licences does not appear justified by capacity building as the sole stated activity in this area for 2023. The reforms will require considerable political commitment to advance at the central state administration and municipal levels. Employment of 20 new labour market inspectors foreseen in last year’s ERP was not achieved and while funding for employment and training of new inspectors is planned, a specific target for the number of new labour market inspectors has been dropped from the ERP.

Key challenge #3: Tapping renewable energy and energy saving potential and fully opening the energy market

The supply of energy is unreliable and insufficient to meet rapidly growing demand and is one of the main constraints on Kosovo’s competitiveness, curbing productivity. The outdated power system relies on two old, inefficient and highly polluting brown coal (lignite) power plants which together generate over 90% of electricity: Kosovo A (five units) and Kosovo B (two units). Renewable energy sources, namely small hydropower plants and wind generation, account for just over 5% of electricity. Energy demand and consumption continues to grow quickly, having doubled since 2000. This, together with the ageing power plants, inefficient consumption and insufficient flexibility to adapt consumption in peak periods, means that electricity has to be imported and exported to balance the system. Since Kosovo tends to import at times of high prices and export at times of low prices, this creates significant costs. This scenario is particularly challenging for Kosovo in light of the ambitious Green Agenda for the Western Balkans. Potential disruption due to obsolete generating capacity and dependency on energy imports could undermine Kosovo’s growth potential and the competitiveness of its industries.

The reliability of energy supply is still below the average for Europe and Central Asia. Despite some improvements on this front, 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 data from the latest EBRD-EIB-WBG Enterprise

Surveys (BEEPS VI, data collected between December 2018 and October 2019), 62% of Kosovan firms experienced on average eight power outages per month.

These structural challenges exacerbated the energy crisis in Kosovo brought on by the unprecedented increase in energy prices in Europe in the second half of 2021. Faced with high prices, higher demand and following the shutdown of one of the units at Kosovo B, the government declared a state of emergency. It imposed rotating power outages and allocated EUR 120 million in subsidies to support consumers.

Kosovo has taken steps to diversify its energy production mix, with new wind farm and solar projects, but the main generation capacities planned will continue to rely on coal. Kosovo is preparing a new energy strategy for the period 2022-2031, focusing first on 2022-2025. This could include the option of extending the lifetime of the highly polluting Kosovo A power plant and using gas power generation. With a 25.7% share of energy from renewable sources in gross final energy consumption in 2019, Kosovo surpassed its 25% target for 2020. However, this was mainly achieved by revising the definition of renewable energy sources to include biomass for heating, which is widely used by household customers, rather than by making any substantial investment in renewable energy. Using a more stringent definition, by one measure renewable energy contributes just 6% to the total energy mix.⁽⁷²⁾ Biomass, primarily fuelwood, remains a significant energy source for heating homes due to cheaper prices, leading to significant air pollution and the attendant negative health effects, particularly during winter months. Kosovo has made limited efforts to improve support schemes for renewable energy projects. The law currently prescribes a support scheme based on administratively set feed-in tariffs; however, since December 2020 it suspended the allocation of feed-in tariffs. Work on designing alternative competitive support schemes remain at an early stage. The falling cost of renewable energy and interest from financial actors in investing in Kosovo offer new opportunities to diversify the energy mix. There is an increase in renewable energy investments and several projects already planned to develop major wind and solar energy sources.

There is significant potential for savings by taking energy efficiency measures. Some efforts were made to increase energy efficiency incentives for the private sector and households. Distribution losses remain high compared to regional standards, with technical losses of about 13% and commercial losses of about 7% leading to total losses of approximately 20% in 2020. Moreover, investing in and maintaining the distribution network at low levels. Kosovo's Energy Efficiency Fund, with a capitalisation of around EUR 20 million largely from international donors, continued issuing public calls to improve energy efficiency in municipalities. There are plans to extend financing to cover the residential sector in 2022. The EBRD, supported by the EU and in partnership with local partner banks and micro-finance institutions, has begun providing credit for households, which account for 39% of final electricity consumption, to make energy efficiency improvements and there is scope for more such investment.

Reform measure 5: "Developing EE [energy efficiency] and RES [renewable energy sources] policies in view of the green transition" is a combination of two reform measures rolled over from last year. It aims to improve energy efficiency, especially in the residential sector, increase the generation of renewable energy and create the conditions needed for investment. In the past year, the Energy Efficiency Fund has financed energy efficiency improvements in municipal buildings, and the reform measure is now well focussed on the residential sector, in line with the findings of this assessment. However, the concrete measures described in the ERP refer primarily to changes to the energy certification of buildings. As of last year, the country lacks the financing and the ambition required to address the challenges, and is only due to issue an action plan to encourage household energy efficiency in 2024. Kosovo should ensure timely transposition and implementation of the Energy Efficiency Directive following its adoption as part of the Clean Energy Package by the Energy Community in November 2021. The reform measure also emphasises increasing renewable energy and unlocking private investment, in line with the challenges

⁽⁷²⁾ (OECD, 2021)

identified in this assessment. Again, however, the measure lacks ambitious targets and an explanation of how investment in renewable energy will be financed or incentivised. 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 take substantial additional steps. These targets could be reflected in the upcoming Kosovo energy strategy.

There is no open trading in the electricity market and energy tariffs do not yet fully reflect costs. Though 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). The Energy Regulatory Office (ERO) initiated an extraordinary tariff review taking into account the significant increase in the wholesale electricity prices in 2021. As most consumers in Kosovo are supplied by the universal supplier, the cost reflectivity in setting universal supply tariffs is an important principle to ensure the financial stability of the electricity sector. Kosovo still needs to develop a programme to protect vulnerable customers in line with the Energy Community requirements, especially in light of rising energy prices and the difficulties experienced in targeting support measures.

Progress has been made on regional integration. A new connection agreement between KOSTT (the transmission system operator) and the European Network of Transmission System Operators for electricity (ENTSO-E) entered into force. This brought into operation the 400 kV interconnection line (with a German investment of EUR 75 million) between Kosovo and Albania, in December 2020 which had remained unused for three years. A further key step was taken in November 2021 with the signing of the memorandum of understanding between Energy Regulators in Kosovo and in Albania to recognise each other's electricity trade and supply licences. By the end of 2022, Kosovo and Albania plan to finalise electricity market integration with the full operationalisation of electricity exchange ALPEX. Market integration will increase the utilisation of cross-border transmission capacities, enabling more efficient utilisation of electricity networks, and increasing competition for the benefit of customers.

Reform measure 6: "Reforming the energy market" is a new measure that encompasses the plans described above for the electricity exchange with Albania (ALPEX) and a platform to enable customers to compare prices. The measure responds to challenge identified both by the ERP and in this assessment, namely the lack of open trading on the electricity market, subsidised and fixed tariffs and the lack of regional integration. However, as with the other reforms in this sector, the plans described in the ERP do not contain enough detail on the intended changes to make them a credible statement of intent. They also seem to require prior significant measures to liberalise the energy market, such as addressing the bulk supply agreement between Kosovo Energy Corporate (KEK) and Kosovo Electricity Supply Company (KESCO), to produce their intended impact on competition, prices and investment.

The Economic and Investment Plan and the Green Agenda for the Western Balkans will contribute to the green and digital transition, in particular the use of renewable energy sources, which should help boost Kosovo's competitiveness. A substantial investment package, which is at the heart of the Economic and Investment Plan, will direct the vast majority of support to key productive investment and infrastructure. This will reflect and support the twin green and digital transition and help develop a connected, competitive, knowledge-based, sustainable, innovation-oriented and thriving economy. Following the 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.

Box II.7.3: Monitoring performance in light of the European Pillar of Social Rights ⁽⁷³⁾

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

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

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

Kosovo presents very low employment levels. Low employment is fuelled by a marked gender employment gap at 32.8% in 2020, though it has been falling since 2017. This gap is in part due to the low provision of early childhood education and care. However, the share of young people not in employment, education or training has been increasing since 2019. The potential of a large young population to boost growth and employment is thus not utilised. Instead, the insufficient labour demand and resulting excess of labour supply prompt emigration.

Investments in the education system, in particular the early stages, is very limited. The vast majority of children under the age of 5 receive no formal early childhood education and care. In the school year 2019/2020, the share of children in pre-school education was only around 8.5% (KEC 2021). However, Kosovo continuously improved its share of early school leavers, which decreased from 12.7% in 2016 to 7.8% in 2020 (below the EU average of 9.9%).

Kosovo's performance on social inclusion, social protection and poverty alleviation is weak. 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 many cannot afford the services, because they do not receive assistance from government subsidy programmes (Social Assistance Scheme). The impact of social transfers (other than pensions) on poverty reduction is among the lowest among candidate countries and potential candidates. A planned reform of the SAS is ongoing and expected to improve the targeting 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. Data is not yet available in Eurostat. The quality of LFS data needs to be improved. Statistics on Income and Living Conditions was conducted once in 2018. Specific challenges exist with regard to establishing indicators based on population data, e.g. in the area of education.

⁽⁷³⁾ The table includes 16 headline indicators of the Social Scoreboard, used to compare performance of EU Member States (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2020 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). For data see Annex B. NEET: neither in employment nor in education and training; GDHI: gross disposable household income.

7.5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2021

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey has adopted targeted policy guidance for all partners in the region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the policy guidance is similar to that of the country-specific recommendations usually adopted under the European Semester of macroeconomic coordination for EU Member States. The Commission evaluates implementation of the policy guidance in the following year's ERP assessments. The table below presents the Commission's assessment of the implementation of the 2021 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at Ministerial level on 12 July 2021.

Overall: Partial implementation (41.7%) ⁽⁷⁴⁾	
2021 policy guidance (PG)	Summary assessment
<p>PG 1:</p> <p>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.</p> <p>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.</p>	<p>There was limited implementation of PG1:</p> <p>1) Substantial implementation: The government implemented around EUR 234 million (3.2% of GDP) pandemic-related fiscal measures out of the EUR 420 million planned in the economic revival package. Fiscal measures mainly took the form of subsidies and transfers to vulnerable families and persons, employment and support to affected businesses. The fiscal support measures were broadly well-targeted, however, the government included and implemented new measures within the revival programme such as child benefit and maternity allowances. These initiatives come at a high fiscal cost and are implemented without a prior in-depth analysis. They risk becoming a permanent feature through new legislation. The government ended 2021 with a low headline budget deficit (1.4% of GDP) on the back of high revenue and under-execution of capital spending. Although it already met the fiscal rule for the budget deficit ceiling of 2% of GDP in 2021, the government envisages a return to the fiscal rule in 2023, as planned under the suspension decision.</p> <p>2) Limited implementation: Following the Constitutional Court decision of July 2020, which declared the <i>Law on Salaries for Public Employees</i> unconstitutional, the government set up a working group tasked with revising the law. A new law governing public-sector salaries could have a significant impact on an efficient functioning of the public administration in Kosovo and stability in this regard. However, preparatory work to standardise positions in the institutions would need to be completed before a new payment system could be put in place. A revised version of the law was planned to be put for public consultation in</p>

⁽⁷⁴⁾ 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.

<p>Undertake a review of tax expenditure quantifying the size of the revenue forgone from exemptions and reduced rates.</p>	<p>February, but it was delayed.</p> <p>In terms of the <i>social security system</i>, the government has not achieved any concrete results so far, although it has planned to reform the Social Assistance Schemes through the World Bank loan and technical assistance. However, Parliament failed to vote for this financial agreement, therefore implementation of the reform and implementation method is uncertain. In relation to war veteran pensions, following the establishment of the working group at the former Ministry of Labour, a condition that was met under the EU MFA loan agreement, no further developments have been made to re-classify the beneficiary list of this pension scheme. Actual expenditure for this scheme continues to exceed the initial annual budget allocations, exceeding by around EUR 20 million in 2021.</p> <p>3) No implementation: The authorities didn't announce or adopt any decision to start reviewing tax expenditure. Following the adoption of the Law on Economic Recovery at the end of 2020, the government extended the list of temporary tax exemptions, while applying temporary reduced tax rates to certain categories, without a proper impact assessment.</p>
<p>PG 2:</p> <p>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.</p> <p>To reduce the risk of contingent liabilities, improve the financial oversight and accountability of publicly owned enterprises, including their regular quarterly reporting.</p>	<p>There was limited implementation of PG2:</p> <p>1) Partial implementation: The execution rate of capital spending rose to 76% in 2021 from 65% in 2020 and 60% in 2019. Nevertheless, implementation of adopted administrative instructions on improving implementation of capital projects remains challenging, particularly given the limited administrative capacities. The government allocated an additional EUR 50 million for expropriation purposes in the 2022 Budget Law, aiming to unlock the potential by running new projects. In addition, the new Article 25 in the 2022 Budget Law aims to facilitate budget allocations for international financial institutions capital projects, depending on their maturity. The government plans to further improve the interoperability between the public procurement system with government financial management information systems.</p> <p>2) Partial implementation: A fiscal risk assessment of publicly owned enterprises is included in the MTEF 2022-2024 and subsequently in the Revised Budget Law of 2021 and 2022 and the ERP. The assessment is limited to high-risk publicly owned enterprises, excluding others. Publication of the quarterly financial statements of publicly owned enterprises has been discontinued, following the publication of Q4 2020 of financial statements. The government has not amended the Law on Publicly Owned Enterprises and does not include this in the legislative agenda for 2022. Changes to the law should aim at improving the rules and procedures on governance and oversight of publicly owned enterprises.</p>

<p>Take next steps towards establishing an independent body for fiscal oversight, based on the recommendations of an options paper.</p>	<p>3) No implementation: The government has not taken any steps to set up the independent body for fiscal oversight, following finalisation of the options paper on the matter.</p>
<p>PG 3:</p> <p>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.</p> <p>Further reduce the remaining institutional and legal obstacles to swift and effective NPL resolution.</p> <p>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.</p>	<p>There was partial implementation of PG3:</p> <p>1) Substantial implementation: Financial stability challenges were monitored closely and prudential measures related to the pandemic were phased out in time. A new framework for measuring household indebtedness has been developed and it is close to completion. Provisioning remained adequate, with the coverage ratio increasing slightly in 2021.</p> <p>2) Limited implementation: The central bank plans to change legislation to enable the development of a secondary market for non-performing loans. Parliament adopted a law to create a new stand-alone commercial court, which might increase the efficiency of the court system.</p> <p>3) Partial implementation: No in-depth analysis of the staffing requirements in key policy areas was carried out, and no new staff has been hired in the financial stability and banking supervision departments. The vacant positions in the Central Bank Board were filled and the quorum was achieved in November 2021.</p>
<p>PG 4:</p> <p>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.</p> <p>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;</p> <p>Adopt an action plan for the gradual adjustment of energy tariffs reflecting actual costs and providing mitigation measures for vulnerable consumers.</p>	<p>There was limited implementation of PG 4:</p> <p>1) Partial implementation: A new 10-year national energy strategy is in the final drafting stages and is due to be published for public consultation in Q2 2022.</p> <p>2) Limited implementation: The Energy Efficiency Fund, with a capitalisation of EUR 20 million, continued to support improvements in energy efficiency of public buildings, but plans to extend financing to the private residential sector are still at an early stage. The renewable energy feed-in tariff regime has been suspended since December 2020. The government is preparing, with support from USAID, a law on renewable energy sources and a new competitive support scheme with the aim of adopting both by the end of 2022.</p> <p>3) Limited implementation: The Energy Regulatory Office announced new electricity tariffs which entered into force in February 2022 following an extraordinary review of tariffs in light of rising energy costs in 2021 and 2022. Prices remained the same for households consuming up to a threshold of 800 kWh (approximately 78% of households) and increased for those consuming exceeding this level, introducing an element of cost-reflective tariffs. There were no changes for business operators. Beyond this extraordinary review, there is currently no action plan for the gradual adjustment of energy tariffs to reflect actual costs. The government committed EUR 90 million to subsidise energy costs for regulated tariff customers.</p>

<p>PG 5:</p> <p>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.</p> <p>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.</p> <p>With an aim to prevent evasion of property income tax, improve transparency by publishing all sales prices of real estate property.</p>	<p>There was limited implementation of PG 5:</p> <p>1) Partial implementation: The government has published a draft updated action plan of the National Strategy for public consultation.</p> <p>2) Partial implementation: Over 4 000 employees formalised their employment status as a result of the requirements of Covid-19 fiscal support measures. A further approximately 2 700 informal employees were newly registered as a result of inspection visits by the tax authority. Together, this represents significant progress in efforts to expand formal employment, though incentives related to temporary fiscal support measures are necessarily time-limited. The tax authority takes a risk-based approach to compliance enforcement and has cooperated with the customs agency in the control of goods categorised as high-risk, in line with the strategy and action plan. Action and outcomes on further measures is not sufficiently reported in the Economic Reform Programme or elsewhere.</p> <p>3) No implementation: Sales prices of real estate property transactions are not systematically published. Property tax collection continues to face challenges related to administrative capacity and inter-institutional coordination and cooperation.</p>
<p>PG 6:</p> <p>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.</p>	<p>There was substantial implementation of PG 6:</p> <p>1) Partial implementation: The Accreditation Agency has successfully completed accreditation cycles in higher education over the last two years. The Agency has also prepared the document on the monitoring methodology and post-accreditation procedures that will serve as a guide for the Agency, higher education institutions, international experts, and the general public to implement fair and transparent post-accreditation and monitoring procedures. The document meets Standard 2.3 of the European Quality Assurance Guidelines for Higher Education (ESG) which requires quality assurance agencies to complete the accreditation cycle with post-accreditation procedures aimed at continuously improving the quality of higher educational institutions. Quality coordinators have been appointed in all schools but the selection of competent quality coordinators remains problematic as does the proper definition of incentives to take up the role of quality assurance coordination (fewer teaching hours of normal duties so that they can focus on their QA coordinator role, QA linked to their professional development and their performance assessment etc.). The situation is concerning when it comes to school inspections. No inspections were carried out in schools over the last two years, which authorities attribute to the pandemic. As of September 2020 only 2% of schools had been inspected.</p>

<p>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.</p> <p>Establish an inter-ministerial task force involving relevant ministries, their agencies and stakeholders to develop a Youth Guarantee Implementation Plan.</p>	<p>2) Partial implementation: With support from donors, the Employment Agency created established the Labour Market Barometer and Skills Barometer in 2021. Though the tool has limited features, the Agency aims to add more features and enhance the skills forecast barometer. What will be crucial is the translation of skills needs into standards, qualifications, curricula, teacher profiles, funding arrangements and equipment specifications. The newly formed Executive Commission on VET intends to revisit reforms to address the skills mismatch.</p> <p>3) Full implementation: An inter-ministerial task force involving relevant ministries, their agencies and stakeholders was set up and a Youth Guarantee coordinator was appointed in October 2021. The task force and the Coordinator are now working, with support from EU-ILO technical assistance facility, to develop a Youth Guarantee implementation plan.</p>
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7.6. THE 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, 24 May 2022

[...]

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

1. If needed, use the available fiscal space in the 2022 budget to cushion the potential impact of adverse shocks through targeted support to vulnerable households and firms; provided the economic recovery is well entrenched, and as envisaged by the ERP, target in the 2023 budget and medium-term expenditure framework a return to the 2% deficit ceiling of the fiscal rule. Ensure proper costing of new pension and social policy initiatives and compliance with the legal ceiling applicable to the public wage bill and spending on war veteran pensions. Undertake and publish a review of tax expenditure quantifying the size of the revenue forgone from all exemptions and reduced rates.
2. Improve the execution of capital spending by implementing the recommendations made under the IMF's Public Investment Management Assessment. Improve the financial oversight and accountability of publicly owned enterprises (POEs) and continue regular quarterly reporting on all POEs. Review the options paper on the establishment of an independent body for fiscal oversight, so that the suggested options ensure operational independence and adequate budgetary safeguards.
3. Carefully assess and analyse price developments, publish time series for core inflation and stand ready to use the limited tools available under the chosen monetary framework to ensure price stability. Ensure that core areas of the central bank, including financial stability and banking supervision, are adequately staffed. Continue to ensure a transparent and accurate reporting of asset quality and adequate provisioning, further reduce remaining obstacles to NPL resolution and continue to reduce data gaps in particular as regards the real estate sector.
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, and implement the plan to liberalise the retail energy market.
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. Improve the business environment through measures to simplify, merge, abolish and digitise licenses and permits with an aim to reduce the barriers to formalisation of employment and businesses and continue to address tax evasion in identified high-risk sectors in line with the strategy and the action plan, which should be updated based on sector risk assessments and tax gap analysis. 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, including training of inspectors, and effectiveness of quality coordinators, as well as monitoring and follow up procedures of higher education institutions and their study programmes by the Accreditation Agency. Narrow the skills mismatch gap by upgrading and using existing skills needs monitoring and forecast mechanisms as well as by increased cooperation with social partners and businesses for an informed planning of initial and continuous vocational education and training, curriculum development and adequate active labour market measures. Finalise, in co-operation with all relevant ministries, their agencies and stakeholders, a Youth Guarantee Implementation Plan, adopt it and initiate its implementation.

ANNEX A: ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2022-2024

Healthcare

The health system in Kosovo guarantees universal access to healthcare in theory, but services are not free. The system is predominantly tax funded with the state acting as both the purchaser and the provider of healthcare services. Public spending on healthcare totalled 4% of GDP in 2020, a sharp increase from 3% of GDP in 2019 which was due to the COVID-19 pandemic. A Health Insurance Fund was set up in 2018, but is not yet operational and no system of health insurance is in place. With only 1.8 doctors and 2.4 hospital beds for 1 000 inhabitants, Kosovo has one of the lowest rates among its Western Balkan peers. The emigration of health professionals is a serious and long-standing issue (FSSHK 2014).

Healthcare services are not free at the point of use; a small user fee (co-payment) is required from all patients, except for vulnerable population groups who are exempt by law, including households that receive social assistance. A large share (40.5% in 2018) of health-related expenditure is paid out-of-pocket (OOP), which raises many concerns about the equality and equity of access to healthcare services, particularly for vulnerable groups. The system does not provide targeted, financial risk protection for the poorest segments of the population. For some treatments that are unavailable, people have to travel abroad and the fund that reimburses this care is only EUR 6.5 million, which does not cover the needs and results in high OOP expenditure.

Financial protection for vulnerable categories of the population to cover costs for prescribed inpatient and outpatient care is low due to a very low budget of EUR 24 million for the reimbursement of medicines. Nearly 10% of the population in Kosovo (self-) reported unmet healthcare needs in 2018, placing Kosovo among the worst performers in the Western Balkans. Based on 2016 data included in the Health Sector Strategy for 2017-2021, 18% of inhabitants cannot afford to access primary healthcare. Since 2017, with the support of donors, the government has set up home visits to counter this issues, but the supply is insufficient to cover the needs.

Measure 4: ‘Improving health services’

The reform measure is centred on mandatory health insurance, offsetting up the Health Information System and universal healthcare. The adoption of the law on health insurance has been postponed to September 2022. The target in 2024 is to collect health insurance premiums from 100% of public-sector employees and from 65% of private-sector employees. The government plans to exempt vulnerable categories of the population, defined via a proxy means test which is to be developed under a project linked to an upcoming World Bank loan (not yet adopted in Parliament), from the payment of premiums.

Apart from a feasibility study planned for 2022, the programme lacks information on the plan to set up the much-needed Health Information System. It is not clear how the government intends to involve the private sector in the universal health coverage scheme, since numerous private hospitals and services already exist in Kosovo and many healthcare workers are leaving the public sector to find jobs in the private sector. The government links the measure and strategic objectives to the Health Sector Strategy for 2017-2021, which has expired. A new strategy is missing.

Public financial management

Public financial management priorities are not yet adequately reflected in the new dedicated section of the ERP. The ERP provides a state of play of international assessments of aspects of public administration reform and public financial management (PFM) and notes that the results of these assessments will feed into the forthcoming public financial management strategy. Unfortunately, however, the ERP does not provide a diagnostic tool to identify the key obstacles facing Kosovo in this

area as assessed by the Public Expenditure and Financial Accountability (PEFA) programme or the OECD SIGMA initiative. Neither does it make a link to how improvements to the public administration and public financial management could help unlock competitiveness and inclusive growth. Specifically, public financial management systems should be strengthened by (1) linking strategic policy and budget planning for sectoral policy priorities and credibly reflecting these in the medium-term expenditure framework; (2) improving the public investment management system in line with the Public Investment Management Assessment (PIMA) recommendations, while making the Public Procurement Review body functional and integrating the module on green investment; (3) improving domestic revenue mobilisation by aligning the current tax policy with international standards to combat the informal economy; (4) developing the country's capacity to conduct spending reviews and ensure that the findings inform the budgeting process to support expenditure prioritisation and create fiscal space for new priorities (i.e. improving social services and green transition). The new PFM strategy 2022-2026 needs to be based on most recent diagnostics and on an inclusive process. The government has stated that it will consider including gender responsive budgeting and fiscal policies in line with UN SDGs and the Law on Gender Equality in the next ERP. Improving capacities in the finance ministry is key for a credible leadership on PFM reforms.

Adding PFM reform measures in the ERP would increase its credibility. The implementation of the key reform measures proposed by the Government requires decisive reforms of PFM structures and institutions.

Green transition

The elements of this area related to energy efficiency and renewable energy and the associated Reform Measure 5 are analysed in Section 4, under key challenge #3.

Kosovo continues to face numerous environmental challenges such as climate change and air, water, waste and soil pollution. The country has some of the worst air pollution in Europe, with an annual mean exposure to particulate matter almost three times the World Health Organization recommended highest levels. The ERP acknowledges this situation and its causes (reliance on coal power plants, emissions from the transport sector, etc.) and describes the current air quality monitoring system. However, it does not propose further significant measures to tackle air pollution. Instead, the analysis focuses primarily on recycling, biodiversity and wastewater treatment. Kosovo also has relatively limited and unevenly distributed freshwater resources. The problem of limited freshwater resources will be exacerbated by the impact of climate change (OECD, 2021).

Measure 7: “Reducing environmental pollution and preserving biodiversity”

The activities proposed under this measure are only partial and insufficient to address existing problems. Most of the activities are legislative or strategic planning measures, while the actual implementation measures are not clearly described. There is little discussion on implementing the Waste Management Strategy, on preparing priority investment projects (for example, wastewater treatment plants), developing capacity at central and local level or on inter-municipal cooperation agreements for joint integrated waste management etc. Furthermore, the planned activities in the ERP include only very partially the work planned under IPA financed projects or by the implementing partners, in particular by KfW. The targets to increase the number of protected nature areas do not address the problem highlighted in the diagnostic part that the management of existing nature areas remains ineffective. However, the new measures to encourage recycling (a deposit refund system for plastics, aluminium and glass) is welcome, credible and comes with a reasonable timeline. These measures would benefit from more outcome-oriented targets, for example recycling levels as opposed to the number of return sites.

Digital transformation

The digitalisation of the economy is gradually advancing. With 99% of households having access to a broadband internet connection, Kosovo has reduced the infrastructure gap between urban and rural areas. The Economic and Investment Plan for the Western Balkans will continue to fund investment in digital infrastructure to roll out 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 Regional Roaming Agreement since 1 July 2021. In addition, two very important commitments were made in Podgorica during the Western Balkans Digital Summit of October 2021: the Memoranda of Understanding on interoperable Western Balkans and Free Flow of Data in the Western Balkans region. However, Kosovo needs to continue to develop the legal framework and infrastructure needed to stimulate e-commerce and enable international electronic payments. Additional work is also needed 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 implementation of relevant measures in this field, particularly by allocating the necessary financial and human resources.

Measure 8: “Extension of ICT infrastructure and services for socio-economic development, advanced public services, as well as digitalisation of the education system”

The measure to extend ICT infrastructure is rolled over from the last ERP and revised to cover multiple policy actions. The measure is comprehensive, well planned and substantial progress could be made if actions described are implemented. The plan correctly identifies the challenges in the sector and highlights opportunities and ways forward. It is encouraging that actions are planned to further develop an e-government portal to better deliver effective electronic services to individuals and businesses. In terms of budgeting, the plan is to implement the measure through combined national and IPA funds. Indicators could be extended to better reflect and measure the proposed activities.

Business environment and reduction of the informal economy

This area and the Reform Measures 9 and 10 are analysed in Section 4, under Key Challenge 2.

Research, development and innovation (RDI)

Kosovo’s performance is still very poor on research, development and innovation (governance of RDI policies, public research system, public-private links, innovation in firms and human resources for innovation), and the country has one of the lowest scores in the Western Balkans region ⁽⁷⁵⁾. The sector suffers as a result of chronic fragmentation and lack of capacity in implementing innovation policy and the lack of overall systematic 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. Over the past year however some positive developments took place that might stimulate a new dynamic in the sector. The authorities appointed a National Scientific Council in 2021, which by law is in charge of drafting the national research programme. Kosovo has successfully completed negotiation with EU and is now a fully associated member of the Horizon Europe programme, though it needs to improve its performance in accessing grants. Action is ongoing to develop and operate the Kosovo Research Information System. In the government programme for 2021 – 2025, Kosovo envisaged setting up an “Innovation and Entrepreneurship Fund”, collecting innovation-related statistical data, and applied to participate in the European Innovation Scoreboard. Work to prepare a smart specialisation strategy started in 2019 using the methodology of the European Commission’s Joint Research Centre. Though it has completed an analysis to identify the scientific priorities and a communication mechanism for stakeholder consultation is in place, progress remains slow.

⁽⁷⁵⁾ OECD (2021), *Competitiveness in South East Asia – a policy outlook 2021*.

Measure 11: “Improving the environment for research, innovation and entrepreneurship”

Since the previous ERP, Kosovo has improved the activities under this measure and taken on board feedback from the previous ERP assessment and other policy dialogue fora. There are a number of positive activities that merit a greater of focus on outcomes, for example the aim to join the European Scoreboard and create a National Innovation Fund. In general, there is a need to explain how certain funding measures are complementary to ongoing support from the EU and other international partners such as the EBRD, for instance support to businesses and incubators. This component should provide resources such as trainings, business consulting services and mentorship that are essential to the success of start-ups and idea generation. There were no activities related to support for or focus on young entrepreneurs or partnerships with stakeholders including industry, the diaspora and the NGO sector. As in previous years, the plan lacks key indicators for the R&D sector and the benefits of innovation processes. The envisaged financial support appears sufficient for the activities targeted and is entirely funded from the national budget, but at 0.1% remains far below the required 0.7% of GDP set by law. There is no mention of how Kosovo will make the most of its new Horizon Europe membership, nor reference to the research data (on researchers, publications, funding per higher education institution spent on R&I, research infrastructure) currently being collected by the ERASMUS+ KRIS project (led by the International Business College Mitrovica) in cooperation with Austrian Development Agency. Lack of data is a challenge in Kosovo, and this is the first such whole-scale initiative to aim to tackle it.

Economic integration reforms

Kosovo is highly reliant on imports and suffers from a chronically high trade deficit. Despite this trend, the trade deficit narrowed by 10% in 2020 on the previous year, to reach EUR 2.82 billion. Though the export of services helps offset the persistent goods trade deficit to a certain degree, these are mostly dominated by expenditure by non-residents (mainly diaspora members) in Kosovo, accounting for around 80% of all services exports in 2019. Most of the goods Kosovo exports are still basic raw materials and mineral products, reflecting a low degree of product diversification. Trade with the EU and the CEFTA region accounts for almost all trade. Due to exports rising higher than imports over the last 10 years, Kosovo has improved the 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, i.e. 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 prospects for young people in Kosovo, which is also important given the high rate of youth unemployment.

Despite being among the most open economies, foreign direct investment (FDI) in Kosovo remains limited (averaging slightly over 4% 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, 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 Kosovar firms. There is potential to attract more FDI: Kosovo has a good strategic location, a young population, relatively low labour costs and a growing educated workforce with increasing ICT and foreign language skills. Other key issues affecting FDI are the lack of basic infrastructure and stable

electricity supply, poor education skills, weak rule of law, corruption and the slowdown in the privatisation process. The measures planned under this area do address this challenge.

Measure 12: “Improving cross-border trade through trade facilitation”

The measure and its expected outcome is well justified, having been rolled over from last year. The link to the common regional market and the Green Agenda for the Western Balkans is an important additional measure. Ratification of Additional Protocol 6 of CEFTA 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 has been delayed to 2022, with ratification in 2023, which is a more realistic timetable. However, some activities, such as WTO membership negotiations, entail additional political risk and depend on external factors.

Measure 13: “Further development of quality infrastructure and empowerment of the role of market surveillance authorities”

The activities planned for 2022 are realistic. Several were planned for 2021 but delayed, and others originally planned for 2022 are on track. The mitigating measures of capacity building and staff training are important and should be followed up properly, particularly since the IPA-funded project has ended. The activities planned for 2022 and 2023 are reasonable and well sequenced, closely reflecting the timetables laid out in the previous ERP. Kosovo has significantly increased the budget since the previous ERP, a welcome change particularly given the end of the IPA-funded project.

Energy market reforms

This area and the Reform Measures 5 and 6 are analysed in Section 4, under key challenge 3.

Transport market reforms

Transport links are less of a constraint on Kosovo’s competitiveness than issues connected to other sectors, but improving connectivity with neighbouring countries would strengthen the country’s integration into the regional market. Investments have been primarily focused on road infrastructure rather than other modes of transport, without a proper balance of resources allocated to of road and railway network maintenance and with an increasing amount of capital investment directed towards prestige projects without a clear transport, environmental or development rationale. On rail, the continuing works on Route 10 linking southern and northern Kosovo, the Serbian border and Pristina with the capital of North Macedonia represents the biggest investment in Kosovo’s railway in four decades (around EUR 200 million). It 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 is needed, including maintenance and integration with European networks, as well as an upgrade of the legislative framework to align it the EU acquis, to improve the efficiency of Kosovo’s railway networks. Regarding aviation, status issues, including a lack of revenue from upper air space management, continue to constrain Kosovo’s ability to invest in training, infrastructure and safety. The flagship policy of the economic and investment plan will be the finalisation of the ‘Peace Highway’ in Kosovo, directly linking Pristina with Niš in Serbia and thus helping overcome transport-related constraints on Kosovo’s economy.

Measure 14: “Further development and modernisation of transport”

This is a new measure in the ERP encompassing some of the main actions to reform the transport sector. The activities are ambitious, comprehensive and include the adoption and implementation of transport-related legislation, drafting and adoption of sectoral strategies and alignment with EU acquis. It is encouraging that the government plans to amend the Law on Railways and the Law on the Establishment

of the Road Traffic Safety Agency. The coordination structures are essential in developing successful road safety policies. The lack of proper maintenance plans is the major reason for slow and unreliable transport services. The measure does not include the development of a multiannual maintenance plan underpinned by sufficient financial resources. It lacks activities to improve road transport climate resilience and the use of alternative fuels. The implementation budget is planned to be covered mainly by national funds and unspecified grants. The indicators for the measure are relatively vague.

Agriculture

Kosovo's agricultural sector is beset by low productivity and high production costs. Although it remains relatively large, the sector's share of gross value added continues to fall, though it accounts for a significant share of informal employment. Farmers in Kosovo are faced with several constraints, such as high numbers of small farms and high levels of land fragmentation, outdated farm technologies, lack of production diversification, limited capacity to grow and limited provision of technical support and access to finance ⁽⁷⁶⁾. Less than a fifth of Kosovo's arable land is irrigated. Although the government has developed some measures to address some of these issues (e.g. irrigation systems and organic farming), further investment and action are needed to ensure the measures are implemented and to boost 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.) that have lower 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 set up 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 more support for the sustainable transformation of Kosovo's agri-food system and rural development.

Measure 15: "Structural changes in the agriculture sector"

As in last year's ERP, the activities listed under this reform measure focus mainly on drafting documents rather than implementing projects or activities. Given that agriculture is considered to be a key sector, the measure fails to address a number of structural obstacles that hinder the development of the sector, such as the small average farm size, land loss to unplanned urban expansion, low productivity and high production costs, low product diversification, inefficient water management, poor irrigation infrastructure and water quality, outdated technology, limited storage capacity, weak or dis-functional links between primary producers and processors, and between producers and market, and the lack of specialisation. Though Kosovo rightly prioritises irrigation, the measures are rolled out at a slow pace, with no concrete actions until 2023, and the plan does not address the quality of water taken from highly polluted rivers. As in other measures, the plan lacks a mention of EU support under IPA (for example, a EUR 10 million project for irrigation under IPA 2020 managed by the World Bank is not referenced).

Industry

Kosovo's industry is characterised by low added-value and competitiveness. The sector makes a modest contribution to GDP (around 22% over the past decade) and employment (around 14%). Manufacturing is dominated by food processing and non-metallic mineral products, accounting for 70.3% of all exports (with metals and rubber and plastics products accounting for 42% of the total). Though, manufacturing has the potential to generate quality jobs and raise incomes, high-level and sustained industrial development continues to face structural problems. The sector is dominated by micro, small and

⁽⁷⁶⁾ 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).

medium sized enterprises with low levels of integration in global value chains, low shares of innovation and attracting low levels of foreign direct investment. While a comprehensive policy framework is currently being studied, existing support services for these companies are weak. Inter-ministerial coordination in this policy area is weak and the responsible institutions lack implementation capacity. In particular, the Kosovo Investment and Enterprise Support Agency (KIESA) appears to lack the resources, technical capacity and experience to fulfil its broad range of objectives in terms of attracting FDI and increasing competitiveness of local firms. 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.

Measure 16: “Increasing competitiveness in the production industry”

Ongoing work to frame a coherent industrial policy is a positive step; however the implementation of activities under this carried-over measure is slow. For example, restructuring KIESA or establishing complaint mechanisms for investors and after-care programmes for investment should already be in place, following Stabilisation and Association Agreement commitments. KIESA support programmes to SMEs should also encourage gender balance and women entrepreneurship. A significant share of the estimated costs are for the construction of infrastructure in economic zones. However, the plan still lacks a feasibility study on industrial zones assessing their return on investment and contribution to economic development. Such industrial parks may also privilege companies selected with unclear criteria. Some positive steps were taken to boost KIESA's capacity, including increased staffing and financial resources, but additional steps are needed to enable the agency to fulfil its objectives and to promote links between multinational enterprises and SMEs. Specifically, further reflection regarding the financial and staff capacities and resourcing needs of KIESA should be undertaken.

Services

Despite being the driving force of the economy, Kosovo's services sector suffers from a lack of competitiveness and relies heavily on non-tradeable services. With a share of 57.7% of GDP and 67.9% of total formal employment, this sector constitutes the backbone of the private sector (comprising 86% of registered firms). It is mainly composed of non-tradeable activities (accounting for more than two thirds of all sector turnover). Trade in services has been dynamic in recent years, reflected in a sustained service trade surplus and it has made a significant contribution to Kosovo's current account, driven by the travel and hospitality industries and ICT services. Notwithstanding this, exports of services are strongly dependent on travel services (which represented 65% of all services exports in 2020, lower than in previous years). However, most of the travel services provided were for visits by members of the Kosovo diaspora (rather than tourism), which raises concerns as to its long-term growth potential. The sector has also 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 for firms, especially small and medium enterprises, to technology and finance.

Measure 17: “Increasing competitiveness in the tourism and hospitality sector”

The measure to develop tourism products in Kosovo's tourist regions has been rolled over from previous ERPs, without much progress in concrete implementation. 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, timeframe and ownership. As such, the proposed measure is

rather limited in terms of making the country more attractive, appealing and recognisable. The measure does not factor in the impact on the environment and the need for inter-institutional cooperation to alleviate that impact. However, as last year, it still fails to include other relevant actions, such as abolishing illegal landfills and cleaning waste across the territory, which is a precondition for attracting tourists. The costing of the measure is not properly assessed and does not factor in donor funding including from IPA, such as a EUR 2 million contribution to enhancing tourism infrastructure in Prizren or a EUR 2 million contribution to a project in Janjevë/Janjevo.

Measure 18: “Increase competitiveness in the sector of trade in services”

The measure is feasible and the finalisation of negotiations for mutual recognition of professional qualifications in the CEFTA format has been extended to 2022. The activities planned annually for 2022, 2023 and 2024 are realistic and the sequencing is sound. Ratification of the CEFTA Additional Protocol 6 on trade in services is still lacking and has been delayed for some time, but does not appear in this measure. The Point of Single Contact, has been set up and is being piloted. The plan does not specify the number of sectors to be digitalised in 2022 or any indicators/targets for 2022. The budget appears too small given the number of activities planned for the three-year period in the proposed reform measure. The twinning project is due to end in November 2022, it is therefore unclear whether IPA funds are expected in 2023.

Education and skills

This area and the relevant reform measures 1, 2 and 19 are analysed above in Section 4, under key challenge #1.

Employment and the labour market

This area and the relevant reform measure 3 are analysed above in Section 4, under key challenge #1.

Social dialogue

Kosovo has yet to tap the potential of social dialogue. Trade unionisation in the private sector is low and affected by the high level of informality in the labour market. However, the structure of the labour market hampers the development of fair relationships between employers and employees. A number of business confederations mostly represent the interests of larger employers, while over 90% of registered companies are micro-enterprises with fewer than 10 employees. Although the legal framework is in place, there is little political will to bring in tripartite social dialogue in the process of drafting policies and legislation. The capacity of social partners, in particular trade unions, to influence policy remains limited. A protracted conflict over the composition of the Economic and Social Council (ESC) is to be solved by amending the Law governing the ESC, which has been postponed and integrated into the revision of the Labour Law.

Social protection and inclusion

Kosovo has very high poverty rates by EU and regional standards. The EU-SILC survey in 2018 revealed that Kosovo had the highest at-risk-of-poverty (27.9%) and at-risk-of-poverty or social exclusion (56.7%) rates were the highest among enlargement countries. The level and structure of social spending does not cover the needs of the poorest. Expenditure on social protection, which increased to 8.1% of GDP in 2020, is very low in normal times (6.9% of GDP in 2019 and 5.5% of GDP in 2021), well below regional levels and almost three times lower than the EU-27 average (19.3% of GDP in 2019, 22.0% of GDP in 2020). The structure of expenditure is also problematic. The highest share of domestic non-contributory social spending (over 90%) was on complex category-specific pension schemes, leaving only 10% available for social services and social assistance benefits. The government plans to reform the

Social Assistance Scheme through a project under a World Bank loan, however this has not yet been approved by the Parliament. The reform aims to improve the focus of the scheme. According to the latest Household Budget Survey (2017), over half of all households in Kosovo were unable to pay utility bills once or twice during the year. For 44% of households, family budgets were under continuous strain and any increase in one area of household spending or utilities meant that a family had to reduce spending on other basic necessities. From September 2021 a new universal cash child benefit was introduced for children aged 0-2 and is expected to be extended to children aged 2-16 by 2023.

Measure 20: “Improving social services and empowering excluded groups”

The reform measure is overall well designed and the new elements such as training for social workers and defining basic social services are welcome. Quite a few measures are rolled over from last year, mainly legislative initiatives that were not adopted given the political instability. The actions should provide a good base for improving social assistance coverage, however it is discouraging to see that this year’s ERP does not include the announced deep sector reforms to ensure that social assistance is means tested and focused on reducing poverty. The integrated case management for social services is not mentioned for 2023 or for 2024.

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

Area/sector	2016	2017	2018	2019	2020	EU-27 Average (2020 or most recent year)
Energy						
Energy imports dependency (%)	23.6%	30.0%	29.3%	30.5%	29.5%	57.5%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	451.30	409.03	398.07	392.34	413.88	110.18
Share of renewable energy sources (RES) in final energy consumption (%)	24.47%	23.08%	24.62%	24.22%	24.40%	22.09%
Transport						
Railway network density (metres of line per km ² of land area)	30.5 ^w	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	164.4 ^w	519 ⁽²⁰¹⁸⁾
Agriculture						
Share of gross value added (agriculture, forestry and fishing)	10.2%	9.2%	8.1%	9.0%	8.9%	1.8%
Share of employment (agriculture, forestry and fishing)	4.2% ^w	4.4% ^w	3.5% ^w	5.2% ^w	4.8% ^w	4.3%
Utilised agricultural area (% of total land area)	38.2% ^w	38.2% ^w	38.5% ^w	38.6% ^w	38.6% ^w	40.6%
Industry						
Share of gross value added	24.3%	24.1%	24.2%	23.4%	24.1	19.5%
Contribution to employment (% of total employment)	18.0% ^w	17.4% ^w	14.3% ^w	15.1% ^w	16.3% ^w	18.2%
Services						
Share of gross value added	56.4%	56.5%	57.2%	57.6%	57.7%	73.1%
Contribution to employment (% of total employment)	66.3% ^w	65.3% ^w	70.3% ^w	67.1% ^w	67.9% ^w	71.0%

Business environment						
Rank in Global Competitiveness Index (Source: World Economic Forum)	N/A	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	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	N/A	2.32%
R&D expenditure – EUR per inhabitant	N/A	N/A	N/A	N/A	N/A	EUR 694.60
Digital economy						
Percentage of households who have internet access at home	N/A	89%	93%	93%	96%	91%
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	N/A	82.9% ^w	87.7% ^w	90.7% ^w	96% ^w	88%
Trade						
Export of goods and services (as % of GDP)	23.8%	27.3%	29.1%	29.3%	21.7%	46.7%
Import of goods and services (as % of GDP)	51.2%	53.1%	57.3%	56.4%	53.9%	42.9%
Trade balance (as % of GDP)	-41.1%	-42.0%	-44.7%	-44.1%	-41.7%	N/A
Early leavers from education and training (% of population aged 18-24)	12.7% ^w	12.2% ^w	9.6% ^w	8.2% ^w	7.8% ^w	9.9%
Young people not in employment nor in education and training (NEET) (% of population aged 15-29)	37.5% ^w	35.1% ^w	37.4% ^w	40.0% ^w	40.4% ^w	13.7%
Children aged less than 3 years in formal child care (% of under 3-years-olds)	N/A	N/A	N/A	N/A	N/A	35.3% ⁽²⁰¹⁹⁾
Individuals who have basic or above basic overall digital skills (% of population 16-74)	N/A	21%	N/A	28%	N/A	56% ⁽²⁰¹⁹⁾

Education and skills						
Early leavers from education and training (% of population aged 18-24)	12.7% w	12.2% w	9.6% w	8.2% w	7.8% w	9.9%
Young people not in employment nor in education and training (NEET) (% of population aged 15-29)	37.5% w	35.1% w	37.4% w	40.0% w	40.4% w	13.7%
Children aged less than 3 years in formal child care (% of under 3-years-olds)	N/A	N/A	N/A	N/A	N/A	35.3% (2019)
Individuals who have basic or above basic overall digital skills (% of population 16-74)	N/A	21%	N/A	28%	N/A	56% (2019)
Employment and labour market						
Employment rate (% of population aged 20-64)	32.3% w	34.4% w	33.2% w	34.2% w	32.3% w	71.7%
Unemployment rate (% of labour force aged 15-74)	N/A	N/A	29.4% w	25.5% w	25.8% w	7.1%
Long term unemployment rate (% of labour force aged 15-74)	N/A	N/A	N/A	N/A	N/A	2.5%
Gender employment gap (percentage points difference between the employment rates of men and women aged 20-64)	35.3 pps.	39.4 pps.	38.5 pps.	37.4 pps.	32.8 pps.	11.0 pps.
Disability employment gap (percentage points difference in employment rates between people with and without a disability)	N/A	N/A	19.7 pps.	N/A	N/A	24.5 pps.
Real gross disposable income of households (per capita increase, Index = 2008)	N/A	N/A	N/A	N/A	N/A	107.23
Social protection system						
At-risk-of-poverty or social exclusion rate (% of population)	N/A	N/A	56.7%	N/A	N/A	21.9%
At-risk-of-poverty or social exclusion rate of children (% of population aged 0-17)	N/A	N/A	N/A	N/A	N/A	24.2%

Impact of social transfers (other than pensions) on poverty reduction	N/A	N/A	5.42%	N/A	N/A	32.68%
Income inequality - quintile share ratio (S80/S20) (Comparison ratio of total income received by the 20% of the population with the highest income to that received by the 20% with the lowest income)	N/A	N/A	15.58	N/A	N/A	5.24
Housing cost overburden (% of population)	N/A	N/A	11.3%	N/A	N/A	9.9%
Healthcare						
Self-reported unmet need for medical care (of people over 16)	N/A	N/A	9.7%	N/A	N/A	1.8%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	N/A	N/A	40.5% ^z	N/A	N/A	15.57% ⁽²⁰¹⁸⁾

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

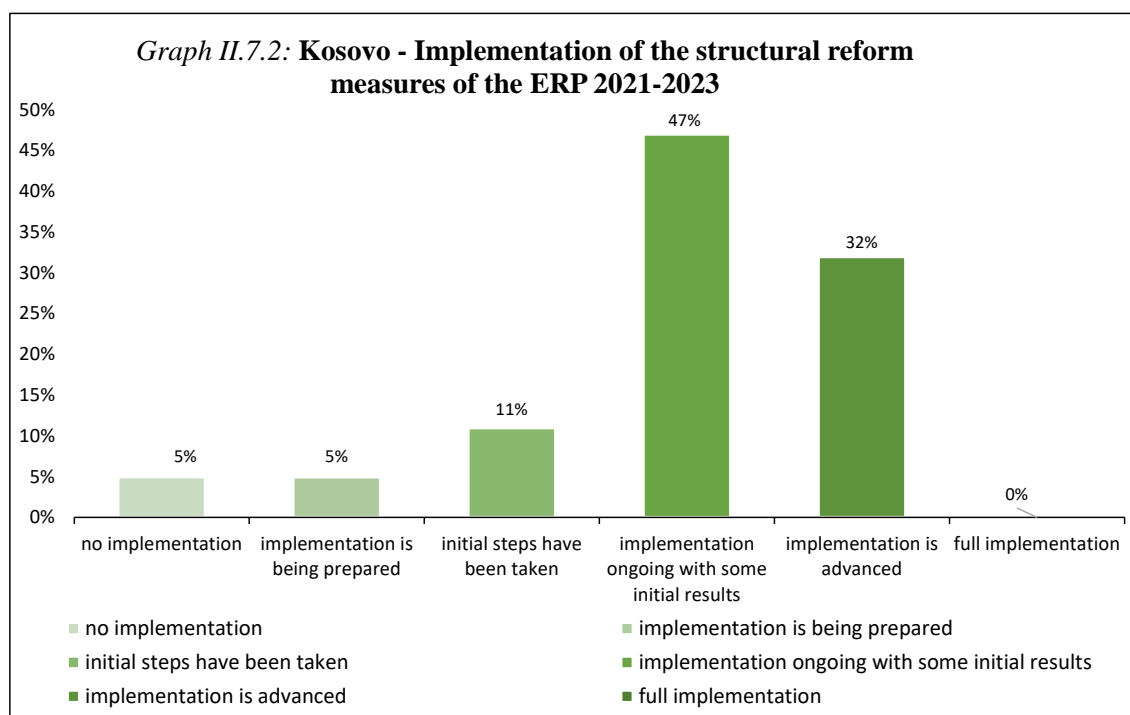
z: Kosovo – Ministry of Health “National Health Accounts 2018” - <https://msh.rks-gov.net/wp-content/uploads/2021/07/ENG-NHA-Report-2018-11-July-2021-Final-with-Annex-1.docx>

Sources: EUROSTAT and Kosovo Agency of Statistics, unless otherwise indicated.

ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM THE ERP 2021-2023

Kosovo made relatively good progress in implementing the measures in 2021, given the many obstacles posed by the ongoing pandemic. It achieved an average score as reported in the ERP of 3.2 out of 5, an improvement over its 2020 score of 2.5. The reporting on the planned activities is generally thorough and provides a fair description of the level of implementation. The implementation indicators for Reform Measure 8 on the establishment and functionalisation of the Commercial Court indicates full implementation, but the Court is not yet operational.

Implementation is higher in some measures, such as Reform Measure 4 (increase of competitiveness in the production industry), 16 (new curricular framework in vocational education and training system) and 18 (improving public employment and vocational training services). It scores lower in other measures, such as Measure 5 (increasing competitiveness in the tourism and hospitality sector) and Measure 7 (improvement of the business environment by reducing the administrative burden and inspections reform). However, this reflects to some extent the difference in level of ambition in the reform measures and the specific breakdown into measurable activities.



ANNEX D: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The government adopted the Economic Reform Programme 2022-2024 and submitted it to the Commission on 31 January 2022, within the set deadline. It is in line with the previously approved medium-term fiscal strategy and national development strategy, and the forecasts and amendments made in response to the COVID-19 crisis. No components of the ERP are lacking.

Inter-ministerial coordination

The ERP was centrally coordinated, with the Ministry of Finance, Labour and Transfers as National Coordinator in close cooperation with the Strategic Planning Office in the Prime Minister's Office. They were supported by area coordinators from the line ministries. The inter-ministerial coordination process worked well, especially given the ongoing constraints posed by the pandemic and related restrictions. However, coordination between the Ministry of Finance, Labour and Transfers, the Strategic Planning Office and the National IPA Coordinator was clearly less strong, since the IPA activities are only minimally or incorrectly reflected in the costing part of the structural measures.

Stakeholder consultation

The draft ERP was made available online with two weeks for stakeholders to provide their feedback, in line with the rules on minimum criteria for public consultation. Due to COVID-19-related restrictions on public gatherings, it was not possible to organise a high-level, in-person consultation meeting with representatives from civil society organisations, business organisations, international financial institutions and donors. Written comments are annexed to the ERP with an indication of whether they have been accepted or rejected, though they include only comments from a small number of international and civil society organisations with no comments from the business community.

Macroeconomic framework

Though the programme acknowledges a number of risks, the baseline scenario assumes that the strong recovery in 2021 will continue over the forecast timeframe, which is highly uncertain, and requires a careful assessment. External assumptions are based on the projections made in the European Commission's autumn forecast and the IMF's October 2021 World Economic Outlook. The ERP doesn't provide alternative 'low growth' and 'high growth' scenarios which would be useful to illustrate the likely impact of some expected developments and risks, such as underspending of capital investment or increase in energy prices, in Kosovo's economy. The forecasts for the labour market and the financial sector are still lacking.

Fiscal framework

The fiscal projections are based on the adopted 2022 budget. The ERP assessment of fiscal projections is based on the ERP annex data, which include some corrections made after the ERP was submitted. For 2022, the ERP envisages a roughly stable ratio of public revenue to GDP while public expenditure is set to increase from the 2021 level, due to a large surge in capital investment. The 2021-2022 fiscal data are not fully consistent with the main text. The revised fiscal tables, including data on cyclical adjustment, were provided after submission. The ERP provides a useful debt sustainability analysis with three negative shock scenarios.

Structural reforms

The structural reform priorities follow the guidance note and cover the new areas such as public financial management, the green transition and digital transformation. With some exceptions, the reporting on implementation of the policy guidance is sufficient, but additional explanatory information could have been included in the actions where there is only initial or limited implementation. The reporting on implementation of structural reforms is generally sufficient, though there are some discrepancies between the stated stage of implementation and the description of progress. The programme meets the limit of a maximum 20 reform measures, though in many cases they are too broadly defined to reflect clear priorities and specific plans. The programme slightly exceeds the page limit set. Table 9 is filled in correctly. Tables 10a and 10b and table 11 are only partially correct; especially concerning is the fact that the IPA funds are not included in the tables. There are some inconsistencies in the way that the implementation of the reforms is rated. Table 12 is filled in correctly.

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