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COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA
(2016-2018)

COMMISSION ASSESSMENT

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1. EXECUTIVE SUMMARY

The economic recovery continues, but fiscal discipline disappoints again. A surge in household and public spending, and robust export growth underpinned the economic expansion in the Former Yugoslav Republic of Macedonia in 2015. Real GDP increased by 3.7%, slightly accelerating from its performance in the preceding year. After repeated slippages in the past years, the government was again required to resort to a supplementary budget in mid-year and to raise the deficit target, even though it had benefitted from revenue overperformance. The revised target was met at year-end, but spending remained tilted towards social transfers, and capital expenditure was again markedly under-implemented compared to the budget.

The government expects an important acceleration of GDP growth until 2018. Economic activity is projected to strengthen gradually to 4.5% in 2018, on the back of accelerating growth in private consumption and a renewed pick-up in investment. Net exports are expected to weigh on growth throughout the programme's horizon. This growth scenario seems overly optimistic, as the expected surge in domestic demand depends critically on further employment growth and increases in disposable income, as well as on the implementation of the government's planned public works. These are subject to important downside risks. Moreover, the country is undergoing a severe political crisis which can deter foreign investors and impact negatively on the government's ability to implement investments and reforms. While there is little immediate concern about external sustainability, the level of external debt remains elevated. It is not likely to diminish in the medium term, as public sector financing needs remain sizeable and will be met in large part by loans from abroad.

The government remains committed to fiscal consolidation, but misses to point out concrete supporting measures. The government intends to reduce the fiscal deficit to 2.6% by 2018, while at the same time maintaining a low tax environment. It has not specified any revenue or expenditure measures supporting these targets and is planning further substantial expenditure increases in 2016. General government debt, as well as public debt, which includes the guaranteed liabilities of state-owned enterprises, are expected to increase further, and to stabilise post-2018.

The main challenges that the country faces in order to improve economic governance, stimulate growth and translate it into employment are the following:

- In the absence of identified revenue and expenditure measures or policy changes, the success of the envisaged path of fiscal consolidation hinges critically on the programme's optimistic growth assumptions.
- Debt stabilisation is subject to risks from potential slippages in the government's fiscal consolidation path. Additional vulnerabilities are created by the high financing needs of the government and state-owned enterprises. Fiscal risks emanating from the operations of the wider public sector are increasing.
- The efficiency of public spending is impeded by weaknesses in budget planning and in the management of capital investment. Shortcomings remain in particular as regards a conclusive medium-term budget framework, and the need for stronger linkages between annual budgets and the medium-term fiscal strategy.
- Progress in making fiscal documentation more comprehensive and more transparent would improve the efficiency and the credibility of public finances.

- Public finance management (PFM) is affected by insufficient prioritisation of public investments and by a weak procurement framework. The National Investment Committee and the single project pipelines are important first steps towards increasing transparency and comparability of projects. A comprehensive PFM reform programme has been in preparation for some time, but has not yet been adopted.
- The unpredictable regulatory environment and difficult access to finance remain major obstacles for small businesses. Shortcomings in access to finance exist both on the supply and demand side. Commercial banks are risk averse in the face of high non-performing loans and SMEs have an insufficient capacity or willingness to access external finance.
- Key challenges in the labour market include high unemployment (in particular long-term), high youth unemployment and the difficult transition from school to work, stagnating labour productivity, and low employment rates among women and people with low qualifications. Skills mismatches are one of the main concerns in the areas of employment and education. While the labour supply measures included in the ERP appear relevant and proportionate, the demand side policies to create jobs are largely absent. The unfavourable employment and social situation is due in some measure to the lack of an integrated approach including both active labour market policies and social assistance measures.

The macroeconomic and fiscal framework of the ERP is coherent, consistent and provides an adequate basis for policy discussions, while the structural reform section remains analytically weak. The measures included are unbalanced in favour of large-scale public investments in infrastructure. Some regulatory reforms have been included, in particular in agriculture and the business environment, albeit with limited expected impact on the competitiveness of the overall economy.

Implementation of last year's policy guidance has started, but remains partial and fragmented. While the government has initiated a number of measures in transport and energy infrastructures; business environment; access to finance; and, regarding the labour market, these reforms, in many cases, lack an overall strategy and are only insufficiently targeting the key challenges. Notwithstanding the adoption of single project pipelines by the National Investment Council, it is not obvious on which basis priority infrastructure investments are selected.

2. ECONOMIC OUTLOOK AND RISKS

Robust growth in 2015 was driven by household consumption, government spending, and exports. In 2015, annual real GDP increased by an estimated 3.7%. The economic expansion was underpinned by accelerating private consumption spending, an important public stimulus, and robust export activity. The latter, driven by the increased production of foreign direct investors, weathered a challenging external environment. Given the flat import demand in the first three quarters, net exports contributed to economic growth. Industrial production, including manufacturing, was disappointing, while construction remained strong, in particular in the second half, supported by demand for public road works.

The authorities expect the economic expansion to gather pace on the back of domestic demand. The government forecasts that GDP growth will accelerate to 4% in 2016, to 4.3% in 2017, and to 4.5% in 2018. Domestic demand would be the sole growth driver. Supported by rising employment and disposable incomes, and by further increases in household credit, annual growth in private consumption spending would accelerate in each of the three years, averaging 3.2%. Investment, after a lacklustre performance in 2015, is set to post gradually higher annual increases each year, averaging 7.8%. The latter would be underpinned by public, and by, mainly FDI-related private investment, driving the economy's investment ratio from 31.4% in 2015 to 34.6% of GDP in 2018. The foreign balance is projected to constitute an increasingly heavy drag on GDP growth in 2016 and 2017, with only slight improvements anticipated in 2018. An extension of production capacities by both foreign and domestic companies underpins the expected gains in exports. These would, however, be outweighed by domestic demand-related import increases. A reduction in current transfer inflows, and a bigger primary income deficit are set to widen the current account deficit in 2017. The economy is forecast to operate at potential as of 2017, but domestic price pressures are expected to remain low.

Domestic demand may prove less buoyant than projected. The authorities may be overestimating the projected expansion of domestic demand. Investment, on the one hand, hinges critically on the implementation of the government's public investment programme. However, the track record of previous years demonstrates that projects financed through the government's capital expenditure budget are prone to fall prey to mid-year budget adjustments, undertaken to meet previously underestimated current expenditure obligations and deficit targets. Also, budgeted capital expenditure has been consistently subject to marked under-realisation in the past. Private corporate investment is inhibited by liquidity strains and difficulties in accessing financing. Household spending, on the other hand, is susceptible to a potential slowdown in the growth of disposable incomes and employment. Overall growth in compensation is sluggish. Renewed, though moderate, price pressures are weighing on real net wages, which, in 2014 and 2015 had been increasing mainly due to deflationary pressures. These gains would stop, if inflation were to become positive. Private transfers from abroad, a stable source of household income, which averaged 19% of GDP over the past five years, are projected by the government to return to their long-term average of 16% by 2017. And, the growth of consumer loans may loose speed, in response to recent measures by the central bank aiming at slowing down their expansion. Moreover, the domestic private economy would have to account for a larger share of job creation for it to have the expected impact on economic growth, whereas job creation has been restricted to established foreign companies and the government sector in recent years. More jobs would also have to be created in higher-productivity sectors with above-average gross compensation. Overall, economic growth may hence be lower than the programme assumes, and may continue to depend importantly on export growth, rather than domestic demand.

Table 1:

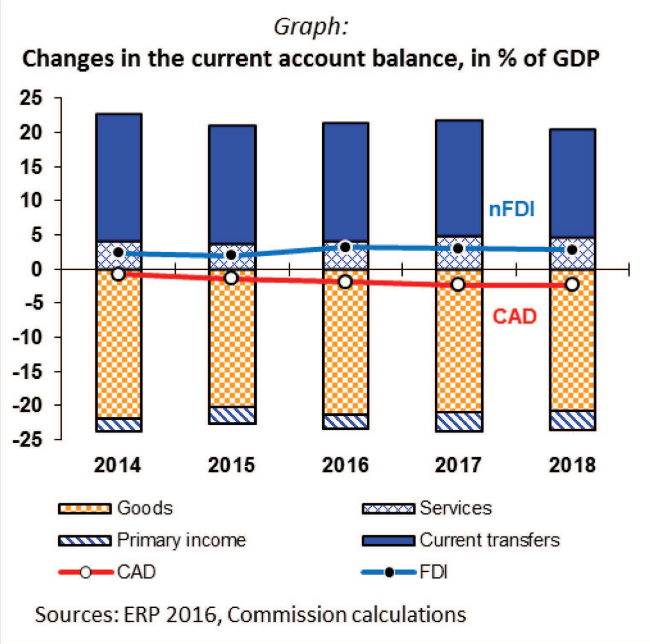
Macroeconomic developments and forecasts

	2014		2015		2016		2017		2018	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	3,5	**3,5**	3,3	**3,5**	3,3	**4,0**	3,5	**4,3**	na	**4,5**
Contributions:										
- Final domestic demand	4,8	**5,5**	3,1	**3,7**	3,3	**4,5**	3,8	**5,1**	na	**5,2**
- Change in inventories	0,7	**na**	-1,3	**na**	-1,0	**na**	0,0	**na**	na	**na**
- External balance of goods and services	-1,9	**-1,9**	1,4	**-0,2**	1,0	**-0,5**	-0,2	**-0,8**	na	**-0,7**
Employment (% change)	1,7	**1,7**	2,1	**2,1**	2,1	**2,4**	2,3	**3,2**	na	**3,5**
Unemployment rate (%)	28,0	**28,0**	27,0	**26,9**	25,8	**25,7**	24,6	**24,3**	na	**22,8**
GDP deflator (% change)	1,1	**1,1**	-0,5	**1,5**	0,4	**1,7**	1,2	**1,7**	na	**1,7**
CPI inflation (%)	-0,3	**-0,3**	-0,3	**-0,3**	0,7	**2,0**	1,5	**2,0**	na	**2,0**
Current account balance (% of GDP)	-0,8	**-0,8**	0,2	**-0,5**	0,2	**-1,9**	0,1	**-2,4**	na	**-2,4**
General government balance (% of GDP)	-4,2	**-4,2**	-3,8	**-3,6**	-3,5	**-3,2**	-3,1	**-2,9**	na	**-2,6**
Government gross debt (% of GDP)	38,2	**38,2**	39,6	**38,6**	40,8	**39,4**	41,6	**40,7**	na	**41,5**

Sources: Economic Reform Programme (ERP) 2016, Commission 2016 Winter Forecast (COM)

Export dynamics benefit from positive fundamentals. The external balance may weigh less on growth than assumed in the programme. Supported by an increasingly dynamic external environment, exports are likely to increase at solid rates. A number of recently established foreign companies are expected to start production in 2016, and the ongoing change in the export structure towards higher value-added products is having a first positive impact on export values. Import demand may remain more subdued than the programme assumes, given that both drivers, public and foreign direct investment, and household spending may turn out less buoyant than projected. However, export activity is likely to remain driven by a limited number of foreign companies established in the tax-advantageous industrial zones, which source almost all their inputs from abroad.

Short-term external vulnerabilities are still contained. The financing of external deficits relies heavily on remittances from abroad and on foreign direct investment inflows. The trade deficit for goods and services, while remaining sizeable, fell somewhat in 2015, to some 16.5% of estimated GDP which was more than covered by private transfers. Yet, the current account deficit increased slightly, to 1.4% of GDP, as a result of the widening primary income deficit. It was overcompensated for by net inflows of FDI. The authorities expect the current account deficit to widen further and stabilise at 2.4% in 2017 and 2018. A further deterioration of the primary income deficit and a decline in private transfer inflows would offset further improvement in the trade balance. Yet, the impact of enhanced production capacity by exporting foreign investors, and a reduction in the import-intensity of exports may only be noticeable in the medium-term, while the expected reduction in private transfers may be more immediate and put additional pressure on the current account in the short-term. Also, FDI inflows remain low and volatile, and the authorities have revised downwards their projections for 2016-2018.



Public sector financing requirements create risks for external sustainability. While key indicators of indebtedness, such as the coverage of short-term external debt by foreign reserves, suggest that the country has a low external debt, the actual level remains high. At the end of 2015, the share of gross external debt in estimated GDP stood at 69.9%, having risen by about 14 pps since 2009. This rise was mainly accounted for by increased government borrowing abroad, with the share of external private debt in GDP remaining largely constant. At the end of 2015, the external debt of the public sector came to about 31% of GDP, having risen by 12 pp since end-2010, and markedly exceeding central bank reserves. The maturity structure is favourable, limiting refinancing risks, as short-term debt accounts for only 15% of total. Yet, sizeable foreign trade credits to the private sector and short-term intercompany lending contain rollover risk. The programme does not inform about the currency breakdown of foreign debt or, on upcoming repayment obligations. The authorities expect the share of external debt in GDP to stabilise at the 2015 level. Yet, given the government's reliance on foreign funding for financing its public investment agenda and the budget deficit, external debt is set to rise further. Meeting the authorities' medium-term targets for the stabilisation of external debt thus hinges critically on strong growth performance. The sustainability analysis in the programme would have benefitted from a clearer identification of debt-creating flows, and from an assessment of vulnerabilities arising from potential shocks to interest rates or to the primary current account.

The alternative scenario fails to take into account downside risks to domestic demand. The authorities have presented an alternative macroeconomic scenario based on weaker external demand from the main trade partners. The resultant fall in the growth rates of exports and investment would lower real GDP growth by an average of 1pp in 2016, 2017, and 2018, compared to the baseline scenario. This scenario would have benefitted from an analysis of the impact of domestic risk factors, such as delayed implementation of critical structural reforms, under-implementation of public investment, renewed political uncertainties curbing confidence, or, adverse developments in households' disposable income on domestic demand.

External factors are expected to exert moderate pressure on prices. The fall in prices for fuels and, consequently, transport, was the main factor that drove the average annual inflation rate down below zero again in 2015. This was supported by lower prices for food, accounting for over 40% of the CPI structure. The government assumes that the CPI will rise by 2% in each year covered by its forecast. External factors would be the main drivers, as the downward trend in oil prices is expected to come to a halt, while prices for food and some other commodities are expected to rise again. The authorities see few pressures arising from stronger domestic demand.

The banking sector remains resilient, but credit risk lingers on. The sector's performance remained robust in 2015. Banks posted markedly higher profitability in 2015 than in the preceding year. Liquidity indicators remained sound, as did solvency indicators, with the capital adequacy ratio about double the domestic supervisor's required minimum of 8%. Amid some easing of lending conditions, growth in credit to the private sector accelerated further. Credit risk remains high, however, with the average ratio of non-performing loans (NPL) to total loans in the non-financial sector in 2015 only slightly below its level in the preceding year. About 90% of all NPLs consist of mortgages with immovable commercial property as collateral, according to the authorities. While banks have resorted increasingly to restructuring, in response to the central bank's credit risk management regulation of March 2013, they find the sale of foreclosed assets difficult in illiquid property markets. To facilitate sales, the authorities are working on two registers taking stock of property transactions and estimated values. In December 2015, the central bank imposed an obligation on banks to write-off fully-provisioned loans that have been on their books for more than 2 years, with effect in June 2016. Overall, monetary policy kept its neutral stance, to which it reverted in 2014. It kept the key interest rate unchanged at 3.25%, and successfully defended the currency peg, against the background of declining foreign exchange reserves.

Table 2:

Financial sector indicators

	2011	2012	2013	2014	2015
Total assets of the banking system, mEUR, at end-year	5.385	5.738	6.008	6.509	6.889
Foreign ownership of banking system, in % of total equity	73.8	75,1	74,5	75,4	74,8
Credit growth to private sector, annual change in %	8,1	7,3	4,3	8,4	9,1
Deposit growth, annual change in %	4,6	7,2	4,8	8,2	7,9
Loan- to-deposit ratio (Q4)	86,4	88,1	88,8	88,1	90,6
Financial soundness indicators					
- non-performing loans (in % of total loans to the non-financial sector)	9,6	10,4	11,9	11,6	11,4
- regulatory capital to risk weighted assets	16,7	17,3	17,2	16,4	16,0
- liquid to total assets	31,2	31,8	33,0	33,0	32,0
- return on equity	1,4	1,7	3,0	6,1	9,1
- forex loans (in % of total loans)	58,7	56,6	54,0	50,7	47,7

Sources: National Central Bank, DataInsight

3. PUBLIC FINANCE

Fiscal discipline was again disappointing in 2015. The government did not use the revenue overperformance in the first half of the year, caused by a recent broadening of the profit tax base, to create buffers against unforeseen fiscal pressures later in the year, or to frontload consolidation. Rather, in a mid-year supplementary budget, both current and capital spending were increased, and the deficit target was raised by 0.2pps to 3.6% of GDP (and met at year-end). VAT revenues underperformed yet again in 2015, pointing to persistent difficulties in collection. On the expenditure side, the supplementary budget raised salaries and allowances, in particular for the police, and expenditure on goods and services, mainly as a result of the migrant crisis. Pensioners benefited from supplementary ad-hoc indexation, with pensions raised by 10% overall, above the 5% indexation cap in force. Although the budget for public investment projects was also raised in mid-year, capital expenditure was noticeably low yet again, with only 84% of budget implemented. The authorities point out that some of the underperformance relates to non-productive capital spending on the budget users' own accounts, while the remainder is due to delays in the procurement and implementation.

The 2016 budget is again based on over-optimistic assumptions. The macro framework underlying the 2016 budget – assuming 4% real GDP growth - appears overly optimistic, leading to a likely overestimation of public revenues. The authorities expect total general government revenue, on the assumption of no changes in revenue policies, to increase by over 17%, in nominal terms, over the 2015 outcome, with the revenue share in GDP almost unchanged. The expenditure share in GDP is expected to decline by 0.2pps. Yet, meeting this consolidation target depends on the government's growth projections coming true, as it plans further substantial increases in spending: a further 5% indexation increases in pensions planned for September 2016 and 2017; a possible supplementary indexation of pensions; possible increases in public wages still being considered by the government; a 5% increase in social transfers planned for July 2016; and, a 15% increase in budgeted public investment expenditure. The fiscal stance is expected to be more restrictive, with the cyclically-adjusted deficit declining from 3.8% in 2014 to 3.2% in 2018 (closing of the output gap assumed for 2017 by the government). The government's plans for financing the projected 2016 deficit (308m euros) by parts of the proceeds from its November 2015 Eurobond (270m), possibly a further Eurobond in 2016, and, if necessary, recourse to its sizeable deposits at the central bank, seem well-reasoned.

Box: The 2016 budget

* On 24 November 2015, the parliament adopted the 2016 general government budget, based on the assumption of 4% real GDP growth and 2% inflation.
* The budget assumes an almost unchanged revenue ratio of 32.3% of projected GDP, and a decline in the expenditure ratio by 0.2pp to 35.6% compared to the 2015 revised budget.
* The general government deficit target is set at 3.2% of GDP, after an estimated 3.5% deficit in 2015.

Main measures in the 2016 budget

Revenue measures	Expenditure measures
	• 5% increase in social benefits as of July (0.07% of GDP p.a.) • 5% increase in pensions as of September (0.5% of GDP p.a.) • Increase in agricultural subsidies (extent not specified)

Source: ERP 2016

Medium-term fiscal consolidation needs to be underpinned by concrete measures. In line with the 2015 fiscal strategy, the authorities predict that the general government deficit will decline gradually from 3.6% of GDP in 2015 to 2.6% in 2018. This would be managed by a 1pp drop in the revenue ratio, to 31.2% of GDP over this period, and a

2pps decline in the expenditure ratio, to 33.8% of GDP. Total revenues would rise by 27.5% between 2015 (actual outcome) and 2018, while total expenditure would rise by 23%, in nominal terms. While overall net lending would decrease, in terms of GDP, the government is not predicting a decline in the cyclically-adjusted balance (the programme does not contain information on temporary or one-off measures so as to project changes in the overall structural balance). The amounts allocated to the main current expenditure items - social transfers, subsidies, and collective consumption - are expected to decline, as a share of GDP, over 2016-2018. Yet the government's medium-term fiscal strategy does not specify measures to support such ambitious fiscal consolidation. Rather, the intended annual increases in entitlement spending, and the large public investment agenda, raise questions about the credibility of the mid-term scenario. As a result of a flat tax rate, a relatively narrow tax base, and shortcomings in VAT collection, in particular, income from personal and corporate income taxes has been low. The persistent underperformance of tax revenues - by an average of about 8% between 2009 and 2014 - and, in particular, overestimation of VAT revenues, which make up between a third and a quarter of total central government revenue, appears to be a major cause of unheeded financing pressures arising in mid-year. It is also not clear whether the government expects the 2015 surge in profit tax revenue to be sustained in future years. The projected decline in both, revenue and expenditure share in GDP, therefore seems to rely overly on GDP growth assumptions. The authorities point to recent and forthcoming measures to streamline social spending, and measures aimed at improving the efficiency of public financial management, but do not quantify the expected savings. The government may need to identify concrete measures, or at least guidelines such as keeping constant the share in GDP of certain categories of entitlement spending under less optimistic GDP growth assumptions; reflect on revenue-enhancing measures; and consider improvements in the efficiency of tax collection. The government does not inform in the programme about planned policy changes in areas with high reform needs, such as the pension system.

The composition of public expenditure could be more growth-friendly. The general government budget continues to be heavily dominated by entitlement spending, reducing the room for manoeuvre as regards fiscal contingency planning in the event of disappointing fiscal outcomes. Social transfers including pensions account for some 45% of total budgeted spending. Pensions alone make up about one quarter of total spending. As a share of GDP they have been rising continuously, widening the pension fund's deficit, which has already undergone several rounds of cuts in contributions, and which is covered by the central government budget. The share of pensions and pensions-related payments in GDP is expected to rise further in 2016 and beyond, from 8.5% in 2011 to 9.6% in 2018. The share of all social transfers has also been rising continuously, to about 15.1% in 2015, according to government estimates, while it is projected to fall by some 0.5pps until 2018, given both diminishing annual nominal increases and the strong growth performance. On the other hand, the share of capital expenditure in total general government expenditure averaged only 11%, amounting to 4.5% of GDP over the last 10 years.[1] The authorities plan to increase public investment spending temporarily to 5.4% of GDP in 2016. The ratio is then projected to fall again reaching 5% of GDP by 2018.

Public investment projects need to be prioritised and management of capital investment improved to contain budget pressures. While budgeted capital expenditure

[1]However, this does not take into account public infrastructure projects financed by the Public Enterprise for State Roads since 2013.

is already relatively modest as a share in GDP and total expenditure, and subject to under-execution, the lack of clear prioritisation among the many donor and budget-financed projects, and of regular and timely information on the state of their implementation, jeopardises the implementation of investment projects which could have a major impact on economic growth. Better prioritisation of infrastructure investment projects with high growth potential is needed to avoid risks to public debt stabilisation. The link between the calculated budgetary impact of the many ongoing projects in the programme, and the annual budget and multi-annual fiscal framework is unclear. Implementing these projects seems to significantly exceed budgeted capital expenditure, thereby calling the envisaged fiscal consolidation path into question. Nor does the programme make it clear whether and, if so, to what extent off-budget capital investment planning and annual and medium-term budget planning are linked.

Table 3:

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

	2014	2015	2016	2017	2018	Change: 2015-18
Revenues	29,8	32,2	32,3	32,0	31,2	-1,0
- Taxes and social security contributions	25,9	27,1	27,1	26,8	26,5	-0,6
- Other (residual)	3,9	5,1	5,2	5,2	4,7	-0,4
Expenditure	34,0	35,8	35,6	34,9	33,8	-2,0
- Primary expenditure	33,0	34,6	34,6	33,7	32,6	-2,0
of which:						
Gross fixed capital formation	4,3	4,9	5,4	5,2	5,0	0,1
Consumption	11,3	11,9	11,5	11,0	10,6	-1,3
Transfers & subsidies	17,5	17,8	17,7	17,5	17,0	-0,8
Other (residual)	-0,1	0,0	0,0	0,0	0,0	0,0
- Interest payments	1,0	1,2	1,0	1,2	1,2	0,0
Budget balance	-4,2	-3,6	-3,2	-2,9	-2,6	1,0
- Cyclically adjusted	-3,8	-3,3	-3,1	-3,1	-3,2	0,1
Primary balance	-3,3	-2,5	-2,2	-1,7	-1,4	1,1
Gross debt level	38,2	38,6	39,4	40,7	41,5	2,9

Source: ERP 2016. Figures for 2015 are based on the Finance Ministry's projections from mid-2015.

Public debt is expected to increase markedly while the rise in government debt is likely to remain more contained. The authorities expect general government debt, driven by sustained primary fiscal deficits, to increase by 2.9pps to 41.5% of GDP between end-2015 and end-2018. The rise in public debt would be more important, by 5.4pps to 52.4%, on account of government-guaranteed borrowing by state-owned enterprises, which carry out an increasingly large share of the public investment agenda. This implies a rise in government guarantees on borrowing by state-owned enterprises of 2.5pps in this period. In 2015, guarantees, which are contingent liabilities of the government, increased by 1.7pps to 9.4% of GDP, and are expected to increase further on account of the government's large agenda of transport and energy infrastructure projects. The government's debt projections diverge considerably on the upside from the previous year's programme. Information on the reasons would have been helpful. Still, if the current Government programme which comprises an ambitious agenda of budget-relevant policy initiatives and investment projects, were to be fully implemented, without any compensatory revenue-raising or expenditure-reducing measures, or cost-reducing policy changes - to contain a widening pension deficit, for example - it is unlikely that the fiscal consolidation path could be implemented or, that the public debt trajectory would be complied with as projected.

Debt stabilisation is subject to significant risks. The authorities predict that general government debt will gradually rise further, reaching 41.5% of GDP by 2018, from 38.6% in 2015. Under this scenario, debt stabilisation remains elusive. The debt path is sensitive to whether or not the government can implement its plans for fiscal consolidation. Deviation from the fiscal consolidation path through further increases in the primary budget deficit balances would thus have a considerable impact on debt levels. If GDP growth remained below expectations in 2016-2018, the impact on the debt burden would be even larger. The government acknowledges the high sensitivity of the budget deficit to lower – hence more realistic – growth assumption. According to its alternative scenario, the target of driving the deficit to below 3% in 2017 would be missed, if annual GDP growth averaged 3.2% between 2016 and 2018. Increased borrowing by state-owned enterprises poses an additional risk for the debt trajectory, through the possible materialisation of contingent liabilities of the government, on account of its rising amount of guarantees for borrowing by public enterprises. This would also increase external vulnerabilities, through its likely impact on foreign reserves, as a large part of these guaranteed loans is extended by creditors abroad in foreign currency.

Table 4:

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

	2014	2015	2016	2017	2018
Gross debt ratio [1]	**38,2**	**38,6**	**39,4**	**40,7**	**41,5**
Change in the ratio	4,2	0,4	0,8	1,3	0,8
Contributions [2]:					
1. Primary balance	**3,3**	**2,5**	**2,2**	**1,7**	**1,4**
2. "Snow-ball" effect	**-0,4**	**-0,7**	**-1,1**	**-1,0**	**-1,2**
Of which:					
Interest expenditure	1,0	1,2	1,0	1,2	1,2
Growth effect	-0,6	-1,3	-1,5	-1,6	-1,7
Inflation effect	-0,8	-0,6	-0,6	-0,6	-0,7
3. Stock-flow	**1.3**	**-1,4**	**-0,3**	**0,6**	**0,6**

Notes:

[1] End of period.

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

Source: ERP 2016, Commission calculations

Increase in the debt ratio to be mitigated as fiscal consolidation progresses

Gross general government debt is expected to rise by 2.9pps between 2015 and 2018, driven primarily by contributions from primary balances – though these are set to decline - and by fairly steady contributions from interest expenditure. The overall snowball effect is counteracting the rise in the debt ratio, on account of higher inflation expectations and the expected acceleration of GDP growth, while stock-flow adjustment measures weigh on debt levels in 2017 and 2018.

There are still some shortcomings as regards fiscal transparency and in planning and implementing of public finances. Despite measures taken in 2013 and 2014 to improve the planning and implementation of public finances, such as changes in debt management strategy and tightening up commitment controls, and the publication of fiscal data, such as resuming the publication of public debt figures, significant shortcomings remain in fiscal transparency and in the management of public finances. Budget reporting could, for instance, be improved by adding information on public payment arrears, the budgetary impact of policy changes, deficit financing, and, the government's financial assets. There is as yet no definitive and exhaustive medium-term budget framework, although project work started in December 2015. Moreover, there only seems to be a weak linkbetween the macrofiscal framework and the annual budget allocations, and it is unclear how individual budget users' plans are integrated within the overall revenue and expenditure target. The link between the medium-term framework and the annual budget process remains weak.

4. Structural reforms

Structural bottlenecks are preventing economic growth and productivity gains from translating into meaningful job creation. The economy is dominated by the services sector, which accounts for half of GDP, while industry is stable contributing at around 18% (25% including construction) in 2015. The country is trying to ramp up the position of the manufacturing sector in international value chains. To this end, the government is actively pursuing simplification of the business environment and developing investments and it has a proactive strategy for attracting FDI. Although these have produced some results, the effects on employment are unclear, in terms of number and quality of jobs created. Moreover, domestic companies do not yet benefit sufficiently from the presence of foreign investors in terms of technology transfer and access to wider markets, despite the government's initiatives to develop backward linkages. Unemployment is persistently high especially among the young who account for a large proportion of the population.

The economy's private sector suffers from weak access to finance for SMEs, an unpredictable business environment with a frequently changing regulatory framework and insufficient law enforcement. Private investment is low, including in research, development and innovation (RDI), and entrepreneurial skills are weak, including financial literacy. These result in low labour productivity and insufficient competitiveness on international markets and a low technological level.

Economic data are insufficient to conduct evidence-based policies. In the absence of a proper census or civil registry covering the whole population, information on employment/unemployment is insufficiently accurate. Moreover, sectoral data are also insufficient.

The policy guidance jointly adopted in the Economic and Financial Dialogue of 12 May 2015 was only partially addressed. Some ad-hoc programmes and training, as well as a database of potential suppliers, have been developed to create supply linkages between foreign and domestic companies. The National Investment Committee has adopted single project pipelines in four sectors, but the assessment methodology used to rank investments has some shortcomings. Measures to improve and accelerate bankruptcy procedures have been adopted. However, there has been no progress towards creating a predictable legal and regulatory environment or improving the enforcement of contracts or payment discipline. No specific action has been taken to combat corruption and informalities in the economy more robustly.

The measures presented in the Economic Reform Programme broadly contribute to growth but are not sufficiently focused and lack balance between infrastructure projects and sectoral reforms. The ERP has no information on the analytical approach applied to identifying the constraints to growth and competitiveness; the ranking of investment is not transparent and it seems that the investment projects are not assessed against their potential contribution to growth, competitiveness and job creation. Hence, there is no evidence of prioritisation of reform measures. Moreover, many of the measures presented are funded by donors or IFIs and it is unclear how sustainable they would be in the long run if this support ended. Reform measures in the strict sense of the term, such as measures to establish a competitive and transparent regulatory system, privatise land, reform the transport and energy sectors, and reform the labour market are largely absent.

Public finance management

Public finance management (PFM) is weak and the country needs a comprehensive PFM reform programme, which is currently being drafted. The main gaps relating to public finance management are insufficient capacities in medium-term budget planning and in public investment management; an inefficient mechanism to monitor the budgetary impact of government proposals; and, an insufficiently transparent and efficient procurement system. An in-depth review of public finance management is ongoing in the country, and the government is drafting its PFM reform programme.

Infrastructure

Existing transport infrastructure poses less of a binding constraint to growth than assumed in the programme. The road transport network is well-developed by regional standards. While the infrastructure needs upgrading, reforms should also focus on regulatory measures. These include ensuring adequate maintenance, removing obstacles to integration, creating a transparent regulatory environment and fixing fees for the use of roads that are both affordable for users and allow repaying and maintaining the infrastructure. Addressing those weaknesses would contribute to opening up the economy to external markets.

The recommendation to prioritise investments has been partially addressed. The selection of infrastructure investment projects is not based on a transparent impact analysis. A National Investment Council (NIC) has been set up and four single project pipelines put in place. However, the NIC does not seem to consider the fiscal effect of the investments nor, the impact on economic growth and competitiveness in its cost-benefit analyses. It is thus difficult to compare investments and set priorities on the basis of evidence.

The measures presented in the Economic Reform Programme will help link the country better to the region and the EU, but would benefit from a better and clearer prioritisation. As in 2015, the ERP focuses on investments in infrastructure. The investments listed are part of the government's agenda for the South East Europe Transport Observatory (SEETO) corridors. Accordingly, they will help linking the country to the European market, and improve passengers and goods transport. However, it should also be ensured that they correspond to specific needs of businesses. Moreover, only construction costs have been assessed, leaving out budget allocations for maintenance and the returns expected from the investments have not been quantified. Finally, the risks of under-execution of investments are not properly assessed, and regulatory reform measures, such as re-opening the rail market, are not addressed.

The possible effects of public sector access to financial markets to finance these projects should be analysed and considered. Large infrastructure projects carry a higher risk of malpractice and corruption. The future PFM reform programme and a rigorous monitoring of these expenditures provide an opportunity to address possible shortcomings.

The investments in energy foreseen in the ERP are not sufficient to meet the country's needs. Businesses identify insufficient access to diversified and cheap energy as a constraint on competitiveness. The country has an aging energy system About 2/3 of the electricity production based on coal, gas and oil while the rest is from hydropower. The environmental impact of these power plants fails to meet the existing legal standards. The country needs to begin a diversification of its energy sources, for which gas is only an intermediate step, given the heavy dependence on Russian gas. Moreover, utilities markets are not sufficiently competitive or liberalised, which causes distortions and inefficiencies.

The two energy measures will make the system more efficient and reduce technical losses, but they fail to address the over-arching need for market liberalisation. Both the construction of an interconnection with Albania and the rehabilitation and modernisation of the transmission network and power system are well described and their potential benefits detailed. They contain timelines and costs are properly estimated. However, these investments are partial measures. There is no indication of how to manage the aging power generation plants, tackle the dependency on imported gas, or address the high energy intensity of the economy. Moreover, there is no reference to regulatory reforms to link the domestic energy market with those of its neighbours or to liberalise the sector.

Sector development

Agricultural sector development

The agricultural sector is facing serious structural challenges which are affecting its competitiveness potential. Agriculture contributes to some 10% of GDP. The share of irrigated land is significantly lower than in neighbouring countries or those at the same latitude with similar physical patterns or production structures. Agricultural land is fragmented, with private farms too small to take advantage of economies of scale or generate enough savings to invest in new technologies and skills acquisition. Certain large state-owned or recently privatised farms are either not operating or are in difficulty and most of the pastureland is still state-owned. Moreover in the absence of a proper legal framework, a large part of the land is abandoned. The sector is weak as regards agri-food processing, which has higher value-added.

The two measures on agriculture are well-conceived. The measure designed to improve irrigation systems is based on a thorough analysis. The measure also assesses future requirements, including those arising from climate change, and the growing need for irrigation. The measure on the consolidation and defragmentation of agricultural land is well-designed with a credible timeframe. Land consolidation is a major reform, which is expected to produce significant positive effects if implemented in full. However, the activities included in the ERP only refer to two pilot projects between 2016 and 2018 whose impact on the sector and on competitiveness has not been quantified. A broad reform of the sector should include developing a proper legislation related to abandoned land, efficient monitoring of the use of state-owned land (database) and the revision on the law on land consolidation, to incorporate state-owned land in the process.

Industry sector development

Despite efforts to attract FDI and establish a competitive manufacturing sector, industry's share in GDP remains below 25 % (2014). The manufacturing sector is the one most affected by shortcomings in the business environment, such as the unpredictable regulatory framework, access to finance and energy, skill gaps, and an insufficient technological level of domestic companies.

Services sector development

Services employ over half of the workforce and provide 65 % of GDP. Tourism seems to have a significant potential and specialised and thematic tourism is being developed. However the legal framework for tourism is insufficiently developed as regards fiscal incentives to private investments, as well as labour market regulations which do not sufficiently support improving professional skills. The government is also supporting ICT services and a reference is made to a short term national ICT strategy.

The measure on increasing market employability lacks a clear over-arching objective. The support for IT companies and development of skills could have a positive effect on this sector. Human capital development responds to the need for a high value added sector and could be relevant. However, the description of the measure is not focused enough and its potential impact on the services sector or on the competitiveness of the economy is not sufficiently developed. Moreover, most of the actions consist of supporting the sub-sectors identified, whose activity is expected to increase and as a consequence, employ more staff, but not to specifically arm job-seekers to respond to the demand for new, diverse skills. The development of ICT services requires that in addition to adequate infrastructure, competition among operators and independence of the regulator are ensured. The ERP makes no reference to these.

Business environment, corporate governance and reduction of the informal economy

Companies identify the large informal sector, poor access to finance for SMEs and shortcomings in electricity supply as the main obstacles to doing business. Another major challenge is the unpredictable legal environment, including frequent changes to the legal framework, insufficiently independent courts, and uneven and unpredictable application of regulations, linked to increasing concerns about judicial independence. According to the 2016 Small Business Act (SBA) assessment, in 2013, 43.4% of those employed worked in SMEs while the value added by SMEs accounted for 42.7% of total value added. SMEs tend to be very small and financial literacy and capacity for innovation need to be improved. The presence of large foreign investors has not raised the technological level of domestic companies or integrated them in international value chains to any significant extent.

Access to finance for SMEs is a major constraint. Collateral coverage rates for loans are among the highest in the region, because of the large proportion of non-performing loans. At the same time, there is no tradition of capital market financing. The insufficient implementation of the otherwise advanced legal framework for corporate accounting, for valuing real estate and the inadequate capacity for drawing up business plans are the main obstacles to closer business relations between SMEs and commercial banks. Finally, the enforcement of credit recovery is slow, increasing the risks to lenders.

The recommendation to improve the business environment has been partially addressed, and a number of relevant measures have been adopted. The ERP presents measures to improve and accelerate bankruptcy procedures. The authorities have taken steps to accelerate digitalisation of procedures (such a registering and valuing property, e-government, enforcement of intellectual property rights etc.), but these do not seem to be part of a comprehensive coherent project. While actions have been taken to improve access to finance, this remains a major constraint and requires further action by all parties including businesses, banks and public authorities. No progress has been made in addressing the recommendations to create a more predictable legal and regulatory environment, enforce contracts, or improve payment discipline and the quality and integrity of inspection services. No specific action has been taken to step up efforts to fight against corruption and informalities in the economy. At the same time, some ad hoc programmes and training, as well as a database of potential suppliers, have been developed to create supply linkages between foreign and domestic companies.

The discussion of the business environment and of the constraints to growth provided in the ERP is not analytical enough and the measures proposed are too narrow. The measure to finance companies through business angels is welcome; it is expected to facilitate access to finance, particularly for start-ups, and support innovation. However, it is a very specific initiative whose impact is likely to be confined to a few of the most innovative companies. The measure to support competitiveness of the enterprise sector is not sufficiently developed and the activities lack adequate information to determine the potential impact on competitiveness. The establishment of one-stop-shops for business licenses and permits is a welcome measure that has been ongoing for some time. It has proved effective so far, together with the initiatives aimed at simplifying requirements for licences and unnecessary regulations (regulatory guillotine).

Technological absorption and innovation

The capacity for technological absorption and research, development and innovation (RDI) is low. Total R&D expenditure as share of GDP is limited (0.44 % of GDP) and consists mostly of public expenditure. Researchers represent 0.21% of the workforce, which is much lower than in advanced economies, but on par with other countries in the region. Support for research and development both for academia and industry is very low although with the recent creation of the Innovation Fund, the government has substantially stepped up efforts for SMEs to engage in innovation.

The recommendation to step up the use of instruments provided by the Innovation Fund has been partially addressed. The implementation of the actions envisaged to stimulate innovation by the Innovation Fund has started and the National Technology Transfer Office is planned to be established in the first semester of 2016. However, the absorption capacity by SMEs is low, due to the lack of sufficiently performing small businesses and the overall level of economic development. Therefore more effort should be made to help SMEs develop the skills and technologies they need to engage in more innovative activities.

The measures presented in the programme correspond well to best practices to stimulate innovation. It will be important, however, that in parallel measures are taken to stimulate SMEs to engage more in research and innovation. The measure designed to establish a triple helix partnership between universities, the government and the private sector could have a significant impact on the economy if it were sufficiently developed and widespread. The envisaged extension of operations of the Innovation Fund to more beneficiaries is welcome. If properly implemented, this would fill a gap that the financial market is currently unable to address. However, both measures tackle the supply-side, which presupposes that a demand for these services already exists. This is questionable, given the already low absorption of the Innovation Fund instruments. Therefore, measures to stimulate the demand are also necessary, such as measures to strengthen the research capacity by increasing the national funding for research on areas of domestic interest and to take measures to increase human capital development.

Trade integration

As a small economy, the country relies on international trade to grow. There is contradictory evidence that technical and regulatory barriers to trade affect businesses, as only 12% of the country's growth can be attributed to trade compared to 40% prior to 2002. The EU is the main trading partner, accounting for about two-thirds of imports and exports, while CEFTA accounts for about 10-15 % of trade.

Measures to facilitate trade integration address some tariff-related, technical and structural barriers, but they remain fragmented and insufficiently selective. The measure involving advancing free trade within CEFTA commits the country to supporting the finalisation of the ongoing negotiations on the regional protocol to liberalise trade in services and the framework agreement on trade facilitation. The application of the Regional Convention on Pan-Euro Mediterranean preferential rules of origin is relevant given the weight of the transformation-based manufacturing sector, and thus the country's need to be able to cumulate preferential origin with its closest partners. However, whether this measure is completed does not only depend on the authorities of the former Yugoslav Republic of Macedonia, but also on ratification procedures in the other signatories. Therefore, the added value and the relevance of this measure in the ERP are unclear. Trade facilitation would benefit from identifying more concrete and selective activities that can be implemented nationally.

The measure to upgrade customs clearance at two important border crossings is consistent with investments in infrastructure. However, the ERP refers to preparatory activities, while actual work is likely to start only after the current programme's timeframe. Although these preparatory measures are necessary, it is not clear why they are a high priority and they do not, in themselves, constitute a reform. At the same time, meaningful activities to do with the functioning of customs are underway, in particular in the area of IT services, and it would have been more appropriate for them to be included in the programme.

Employment and labour markets

Although there were some positive trends in recent years, the economy continues to face persistent labour market challenges. The employment rate (20-64 years) is still quite low - 51.3 % in 2014, 5 pps higher than in 2008. At the same time there is a huge gap between the male (61.6 %) and the female (40.8 %) employment rates. The unemployment rate continued decreasing to 24.6 % in 2015 Q4 – a drop by 3 pps compared to the same quarter of 2014 and 9.2 pps compared to 2008. In particular, conditions for young people remained strained - the unemployment rate in the age group 15-24 stood at 47.3 % in 2015 Q4, marking a drop by 3.1 pps from the same period a year earlier.

The level of basic and transversal/soft skills of the labour force is insufficient, as is the quality of education. This is due to the low efficiency of education spending, limited opportunities for permanent in-service teachers training, oversized classes and a shift system operating in the country. The education system is not equipping students and graduates with skills needed in the modern labour market. Moreover, there is a need for better qualified and trained teachers, in particular given the recent introduction of the Cambridge Curriculum.

Performance evaluations of active labour market policies (ALMP) have been partially strengthened **through a revised strategic and employment framework.** In October 2015, the Government adopted the National Employment Strategy (2016-2020). The country has also started proactively developing an Employment and Social Reform Programme in a wide consultation with all relevant stakeholders. While there is progress in terms of monitoring and evaluation of ALMPs, those activities are mainly on an ad-hoc basis and there is no established regular monitoring system. The spending on these policies still appears comparatively low (0.15 % of GDP in 2015) relative to the magnitude of unemployment in the country. On the other hand, the increased spending would need to go in parallel with the continuous improvement of their efficiency and targeting and the implementation of complementary measures to support labour demand.

The measure on the improvement of the public employment services, in particular by profiling of unemployed persons and designing individual employment plans appears relevant and timely. While a lot has been done recently to modernise the Employment Service Agency (ESA) as a customer-oriented service provider, the insufficient staff and financial resources continue to hamper its effectiveness. In this context, the proposed measure strives to improve the targeting and to ensure that the scarce public resources are spent for the most disadvantaged people. However, the ERP fails to indicate the number of job seekers who will potentially be targeted and no information is provided on the estimated impact on ESA staff. It is reported that the measure has no fiscal implications which is not plausible. There is also no timeframe for the activities.

The envisaged activities of the measure on education and qualifications for all, while relevant and important, risk remaining fragmented if not coordinated with other ongoing efforts to address the skills mismatch. The measure primarily refers to the development of the National Qualifications Framework (NQF), which can play a very important role in better matching the supplied and demanded skills. The challenge is how to bring together the processes/models implemented by the different institutions from both the educational and the employment fields and how to transform the findings into policy actions. In a context of weak institutional capacity to monitor the portfolio of projects, there is a risk that reforms addressing the NQF will be diluted and ineffective. In addition, as the majority of these activities are supported by external assistance on a project basis, it is crucial that the new developed processes are sufficiently internalised and the staff of the government institutions adequately trained to ensure sustainability.

Fostering social inclusion, combatting poverty and promoting equal opportunities

The former Yugoslav Republic of Macedonia faces high levels of poverty (22.1 % in 2014) and material deprivation (35.7 % in 2014). The main sphere where the social inclusion approach is more recognisable is related to investment in early childhood education, particularly aimed at more deprived communities (Roma). This approach has already had positive effects on the reduction of the early school leaving rate in the country.

Overall, the direction of the country's social policy is moving towards more residual social provision, due to limited economic resources and the wide scope of social risks that need to be covered. There is also an evident lack of an integrated and harmonised approach between different areas such as social welfare, social insurance, education, health and housing, which makes social policy measures isolated and partial in their impact. One of the main strengths of social policy governance is the wide network of social service providers and these could be used more efficiently to address the country's social challenges.

The measure aimed at improved inclusion of all children in the education system and equal access to all education levels regardless of their origin and competences is well-articulated but fails to provide concrete targets beyond the already on-going support activities. The focus in the next period will be on children from vulnerable groups to complete primary and secondary education. However, it does not cover pre-school education, which is the key to making headway on these problems as it would enable the marginalised groups to have equal chances of succeeding scholastically, staying in school longer and prospects of a better future.

ANNEX 1: OVERALL ASSESSMENT OF PROGRAMME REQUIREMENTS

The Economic Reform Programme was submitted by the government on 31 January 2016. It was drafted in consultation with the social partners. It covers the period 2016-2018 and is broadly in line with the medium-term fiscal strategy and the 2016 Budget Law. Responding to the requirements to progressively adapt the economic and fiscal surveillance of the enlargement countries to the EU strengthened economic governance, the programme includes sections assessing the sustainability of the external position and the main structural obstacles to growth.

Ownership and internal coordination

The preparation of the ERP was centrally coordinated by the Ministry of Finance. The programme was formally endorsed by the government. An inter-ministerial ERP working group involving seven Ministries and several agencies and other offices worked on its preparation. The ERP did not include a meaningful diagnostic of the main structural obstacles to competitiveness and growth, which affects its relevance and credibility.

Stakeholder consultation

The government made a draft of the Economic Reform Programme available online between 23 and 31 December 2015 in order to consult external stakeholders, including social partners. The government also invited several stakeholders directly to make a contribution. These are included as an annex to the ERP.

Macro framework

The programme presents an accurate review of recent macroeconomic developments largely based on the most timely available data at the time of drafting. As in previous years, it presents a very optimistic medium-term macroeconomic framework, that does not sufficiently consider downside risks to growth emanating from external and domestic uncertainties. The authorities present an alternative scenario based on lower growth in the country's trade partner economies. This scenario could have also taken into account growth risks stemming from domestic factors, such as delays in the implementation of critical structural reforms. The programme complies with the Commission's request to provide an assessment of the medium-term sustainability of the economy's external position. The presentation includes an analysis of the development and breakdown of gross external debt and of the international investment position. It informs about external financing needs and repayment obligations, and refers to the standard indicators of external indebtedness.

Fiscal framework

The programme provides fiscal projections for 2016 to 2018, in line with the presented medium-term macroeconomic scenario, but lacking a clear link to the structural reform agenda. There is limited information on intended revenue and expenditure measures and their likely budgetary impact. In the presentation on the structural balance, information on intended one-off- and temporary measures would have been useful to gauge more accurately the impact of discretionary fiscal measures on the economy. Data reliability is limited and comparison of published data with benchmarks according to EU accounting standards is difficult, as a compilation of EDP and GFS statistics in line with ESA 2010 classification is still missing. The authorities did not submit a fiscal notification to Eurostat in 2015.

Structural reforms

The structural reform priorities section does not follow the guidance note as it does not present an analytical approach overall or per area. As a consequence, the structural reform priorities as included in the 19 measures do not correspond to key obstacles to growth and investment identified. Some notable exceptions were measures 1, 2, 6, 7, 12 and 13 where some analysis was included. Tables 10-12 in the annex have been filled in. Table 11 should have contained more detailed timelines and descriptions of activities at least by year if not by quarter. The summaries in table 12 are very helpful and sufficiently detailed. The policy guidance implementation is only included in the overview table at the beginning of the ERP and is not further discussed in the section on structural reform priorities. The presentation remains general, in large part, and would have benefitted from more concrete description of individual measures. Some measures refer to initiatives taken before the 2015 targeted policy guidance was issued.

The programme contains information on action the authorities have undertaken in response to the Council's 2015 policy guidance. The presentation remains general, in large part, and would have benefitted from more concrete description of individual measures. Also, a number of measures mentioned have not yet been adopted, or remain at the stage of strategy papers, without clear information on intended implementation. Some measures refer to initiatives taken before the 2015 targeted policy guidance was issued.

ANNEX 2: IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2015

2015 country policy guidance for MK	Commission summary assessment
PG 1: Improve the management of public finances by adhering rigorously to the 2015-2017 medium-term fiscal targets outlines in the ERP, and frontload consolidation so as to be on track for the 2017 budget deficit target of 2.9% of GDP. Use any additional fiscal space for further consolidation measures, so as to protect growth-enhancing capital spending in case of unexpected budget pressures. Keep tight control on the development of transfer payments, pensions, and public wages. Introduce a medium-term expenditure framework. Inform in a timely and regular manner on the size of the government workforce and payroll.	PG1 has not been addressed: • Revenue overperformance in 2015 was used to increase spending rather than frontload consolidation. • Public investment expenditure spending reached only 84% of budget. • Entitlement spending and public wages were increased ad hoc in mid-year.
PG 2: Improve the composition of spending, by prioritising investment projects according to their productive potential, and be more transparent on the cost-benefit analysis underlying transfer and investment spending items on the budget. Provide more timely and detailed data on planned and executed capital expenditure.	PG2 has not been addressed: • The government points to the budgeted infrastructure investment spending 2016-2018, and underlines that projects are selected on the basis of feasibility studies, including a cost-benefit-analysis (CBA). However, it is not clear whether CBA is publicly available. There also seem no apparent improvements in the provision of more granular information on project execution and budget impact.
PG 3: Improve the fiscal transparency by including more comprehensive data on the debt of public companies and contingent liabilities in the government's debt management strategy and inform about arrears. Speed up transition to ESA 2010 reporting and resume fiscal notifications. Continue to keep tight control on guaranteed and non-guaranteed borrowing by state-owned enterprises and municipalities.	PG3 has not been addressed: • The government points to strict control procedures regarding public guarantees, as provided for by the Public Debt Law. • A fiscal notification was not provided. • Information on public payments arrears is not available.
PG 4: Improve the employability of workers, by better aligning skills with labour demand needs notably by developing the education system. Strengthen performance evaluations of active labour market policies with a view to better targeting skills development, and inform on their methodology and results in a timely manner.	PG4 has been partially addressed: • An impact assessment of ALMPs revealed limited effectiveness of wage subsidies, self-employment and certain specialised/small scale training schemes. Instead, internships and training schemes for employers proved to be more rewarding in terms of future employment in the primary labour market, and wage gains. However, the ERP provides limited information on how the set of active labour market measures was adjusted to these results, in terms of eligibility criteria or implementation rules. • The country continued efforts on better aligning skills with labour demand needs notably by further reforms of the education system, including a new teaching programme for innovation and entrepreneurship; a skills observatory; and, a board for the National Qualifications Framework.
PG 5: Step up efforts to create supply linkages between foreign and domestic companies with a view to enhancing productivity and employment in the domestic economy.	PG5 has been partially addressed: • The "Supplier Development Pilot Programme", supported by the World Bank, was started in 2015 with an initial 5 domestic companies benefitting from training measures. A database of potential

	suppliers was developed, needs of foreign companies were identified, assessment of capacities of a number of local companies was made. • In order to fulfil the recommendation, the findings will need to be used to design and implement appropriate measures on a wider basis.
PG 6: Increase efforts towards facilitating the disposal of non-performing loans by banks, involving all key stakeholders including the central bank as necessary, with a view to removing potential obstacles to credit extension in the context of a sustained pick-up in credit demand.	PG6 has been partially addressed: • The NBRM obliged commercial banks in December 2015, effective as of June 2016, to write-off non-performing loans that have been fully booked for more than two years. • The NBRM has taken measures to prevent instability arising from the recent increase in non-performing consumer loans.
PG 7: Review the transport strategy in order to align it with the regional agenda on connectivity, with a particular focus on the core investment priorities (core network) and establish a credible planning and funding mechanism. A single sector pipeline would help prioritise investments.	PG7 has been partially addressed: • The investment projects are generally part of the main regional / European corridors. • The National Investment Committee has adopted single project pipelines in four sectors (transport, energy, environment and social sector). So far, there is little information available on issues such as stage of implementation and macrofiscal impact. The methodology for ranking the projects should be clarified, and the analysis of planning, costing and long term sustainability should be developed further.
PG 8: Improve the business environment by designing and implementing the Master plan for Competitiveness and the related Government Action Plan. These should include measures affecting competitiveness, such as a more predictable legal and regulatory environment, enforcement of contracts, respect of IPRs, payment discipline, labour legislation, quality and integrity of inspection services, etc. Ensure regular and structured dialogue with social partners regarding the implementation and review of the Master plan. Step up efforts to fight against corruption and informalities in the economy.	PG8 has been partially addressed: • An ad-hoc working group for the master plan for competitiveness and the corresponding action plan was established. • Most of the deadlines for specific outputs set in the Master plan 2015 have already passed.
PG 9: Improve access to finance for SMEs and speed up bankruptcy procedures. Implement the innovation strategy, and step up the use of instruments foreseen by the Innovation Fund.	PG9 has been partially addressed: • Several measures have been adopted to facilitate access to finance. • Measures to improve and accelerate bankruptcy procedures have been adopted. • Measures under the innovation strategy are designed and progressively implemented. However, demand for these measures remains muted.