EUROPEAN
COMMISSION

Brussels, 18.4.2016
SWD(2016) 134 final

COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

KOSOVO*
(2016-2018)

COMMISSION ASSESSMENT

* 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

COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

KOSOVO[*] (2016-2018)

COMMISSION ASSESSMENT

[*] 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

Table of contents

1. EXECUTIVE SUMMARY

Kosovo's economic growth strengthened in 2015 driven by private demand, following its weakest growth since independence in 2014. The baseline scenario of the Economic Reform Programme (ERP) forecasts an average 4.2% GDP growth between 2016 and 2018. Due to low employment and a narrow production base, stronger private consumption growth will continue to be underpinned by a stable inflow of diaspora remittances. Ambitious investment growth will depend on the relatively volatile inflow of foreign direct investment (FDI), which is sensitive to political stability. The public sector's contribution will remain subdued due to its limited fiscal capacity following recent increase in wages, pensions and other transfers. The main downside risks will arise from possible political and fiscal shocks.

The 2016 budget projections, made in cooperation with the IMF, are broadly realistic and in line with the baseline ERP scenario. No new tax changes are envisaged during the forecasting period. Current expenditure is projected to increase due to the introduction of the new benefits for war veterans, the rise in social transfers and the adjustments to the old age pension system. However its proportion of overall spending should decrease due to an ambitious rise in capital spending, caused by increased expenditure for the construction of the Route 6 highway. The budget deficit is expected to be 2% of GDP which is in line with the fiscal rule. Identified fiscal risks arise from persistent pressure from large interest groups for increases in entitlements and transfers.

Removing obstacles to private sector development is the main challenge facing Kosovo. So far, Kosovo's growth model depended on transfers-driven consumption and large public investments in infrastructure. Changing the pattern towards private-sector-driven growth will require a comprehensive reform agenda and its thorough implementation. Limited fiscal capacity should to be used prudently and efficiently, without endangering the stability of public finances. The main challenges here include the following:

- **Budget execution monitoring and fiscal rule enforcing mechanisms are weak, and the macro-fiscal framework preparation process is exposed to political influences.** With the addition of a new exception to the fiscal rule, setting up related monitoring and enforcement mechanisms becomes even more important. Attempts to limit the rise in current expenditure have been limited to the adoption of the wage rule, limiting the rise of public wage bill to nominal GDP growth, as of 2018, and a temporary discretionary freeze on spending for goods and services. With limited room for further increases, rising pressures from social groups for new transfers, and rising maintenance costs of newly built infrastructure, Kosovo needs to contain the rise in current expenditure and preserve the share of capital spending.

- **Capital investment budget has been constantly under-utilised (on average by 15%) both on the central and the local government level.** When not accounting for the large road building projects capital budget spending is even lower. This shows difficulty in coping with more than one smaller project at the same time, indicating low institutional capacity for project preparation and management.

- **Poor infrastructure, in particular in the energy sector, is a bottleneck to further private sector development and the general competitiveness of the economy.** Unreliable energy supply, distribution losses in the electricity network and low energy efficiency are the main weaknesses. More work should be directed at improving energy efficiency in both the public and private sector. The transport sector is plagued by the weak administrative capacity of the regulatory institutions and the poor state of the railway system. The ERP acknowledges these weaknesses and presents an appropriate mix of measures, albeit insufficiently focused on soft measures in the transport sector.

- **Private sector development continues to be hindered by a complex business environment with a large informal sector.** The significant informal economy creates unfair competition, makes access to finance more difficult and hampers SMEs' ability to grow and innovate. Undeclared turnover and work also have negative implications for public revenue collection and the labour market. A changing regulatory environment and weak protection of property rights and contract enforcement are additional obstacles to doing business. The ERP includes several measures to address them, though these are not sufficiently explained

- **Kosovo's labour market performance is not improving, with most of the working age population inactive and a strong unemployment increase in 2014 and 2015.** Labour participation and human capital accumulation are also weak due to distorting effects of large remittances. Social challenges are only partially identified, notably weaknesses in the health care system. The proposed measures are directed towards improving education and training and their alignment with labour market needs, and the functioning of the Employment Agency. Though relevant, they lack definition and a clear sequence of specific steps.

The macroeconomic and fiscal framework of the ERP is coherent, consistent and provides an adequate basis for policy discussions. The structural reform section of the ERP is a considerable improvement compared to last year. The ERP presents a good analysis of the structural obstacles and includes measures that are generally relevant to address them, even though in some cases the description of the measures is not adequately detailed.

Last year's policy guidance jointly adopted in the Ministerial Economic Dialogue of 12 May 2015 has been partially implemented. Public finances have been brought under control under the aegis of the ongoing IMF programme. Revenue and expenditure consolidation measures were taken with positive results, bringing the deficit under the fiscal rule threshold. However, ad-hoc increases in current expenditure in pre-election times are still a possibility. Furthermore, the fiscal framework still needs to be strengthened with sound monitoring and enforcement mechanisms. Although the board of the Privatisation Agency was appointed at the end of 2015, the privatisation agenda was put on hold, and there have been no improvements in the publicly-owned enterprises (POEs) corporate governance. Positive steps include the setting up of the National Investment Committee (NIC), the completion of the energy interconnection with Albania, steps taken to improve judicial efficiency and reduce court backlogs, and the implementation of central procurement. However, there was no significant progress in reducing undeclared work, there is not yet a comprehensive framework for FDI and no measures to increase investor protection have been introduced.

2. ECONOMIC OUTLOOK AND RISKS

Economic growth has strengthened recently on the back of investment and construction, while exports remained weak. Available data broadly confirm that the economic recovery took hold in 2015 and the consensus forecast puts real growth at 3.7%. This compares to a growth rate of 1.2% in the previous year. Stronger growth was supported by a recovery of investments mainly resulting from the ongoing construction of the Route 6 highway to Skopje and more than doubled FDI inflows. On the other hand, following strong goods export performance in the first seven months, overall exports finished the year with only marginal 0.7% growth. The substantial decrease in goods exports in the second half of the year is the result of lower crude metals exports. Furthermore, as was evident in 2014, investments in Kosovo react to political turmoil and the ongoing renewed political crisis could therefore have impacted growth towards the end of the year.

Table 1:

Macroeconomic developments and forecasts

	2014	2015	2016	2017	2018
Real GDP (% change)	1.2	3.8	4.0	4.3	4.3
Contributions:					
- Final domestic demand	3.0	5.0	6.1	5.8	5.6
- Change in inventories	-0.5	0.1	0.1	0.0	0.0
- External balance of goods and services	-1.2	-1.3	-2.2	-1.6	-1.3
Employment (% change)	-4.4	2.6	3.0	2.6	2.6
Unemployment rate (%) LFS	35.3	:	:	:	:
GDP deflator (% change)	3.3	0.3	0.5	0.7	0.9
CPI inflation (%)	0.4	-0.2	0.4	0.4	0.6
Current account balance (% of GDP)	-7.9	-9.6	-8.6	-9.1	-9.3

Sources: Economic Reform Programme (ERP) 2016

For the 2015-2018 period, the ERP baseline scenario projects slightly lower economic growth than the previous programme did. Following the weakest growth in ten years in 2014 (1.2%), GDP growth is estimated to have rebounded by 3.8% in 2015 and is expected to remain stable around its long term average of 4.3% by 2018. Private consumption will continue to provide the biggest contribution to GDP, growing by close to 4% on average over 2016-2018, and underpinned by an increasing inflow of remittances and stronger consumer lending. Public consumption is expected to remain subdued under the ongoing IMF standby arrangement. After having rebounded by 9.2% in the first three quarters of 2015 investments are set to continue to grow strongly, by an average of 9.7% per year. Recent changes in the tax system introduced to support domestic production, and announced improvements to doing business, are expected to contribute to a sharp rise in private investments. Budget space for public investment will likely remain limited, and will focus on road infrastructure. However, the newly adopted 'investment clause' of the fiscal rule is meant to allow for additional IFI financed investment spending not to be counted in the fiscal rule adjusted deficit. Owning to the narrow export base, export growth (expected to be 4.9% in 2016-2018) will likely be determined by the external demand for metals, but there are some signs of gradual export diversification in the agriculture, textile production and tourism sectors. Import growth is expected to be 5.2% during this period, and will be underpinned by a strong rise in investments, which usually have a substantial import component. Import substitution, namely of agricultural products, is expected to gradually be strengthened, following rising private investment in domestic production.

On the production side the services sector is projected to grow by 3.9% over 2016-2018, driven by trade, transportation and IT. Both the manufacturing and IT sectors are expected to benefit from the adopted tax and customs exemptions for production line products and IT equipment. However a shortage of high-quality labour force will remain a constricting factor. Expected growth in the agriculture sector (2.6% on average) is not seen as particularly significant, especially following the increases in agricultural subsidies in 2015 and several announced initiatives for improving the sector's competitiveness.

The current IMF programme and the Stabilisation and Association Agreement (SAA) with the EU are important stability anchors. The first review of the standby arrangement was adopted and the government was commended for its work on meeting the programme requirements. Under the ongoing IMF programme, fiscal policy should stay stable at least until the budgetary midterm review in 2017. Furthermore, the recent conclusion of the SAA with the EU will increase Kosovo's profile among investors and facilitate trade and investment.

While broadly plausible, the ERP's growth scenario is subject to a number of risks related to the investment climate, financing conditions and political instability. Throughout the forecast period, domestic risks to growth will arise from an investment climate undermined by an inefficient judiciary, weaknesses in electricity supply, contract enforcement, and an inefficient and unaccountable public administration. The continued restructuring of publicly owned enterprises (POEs), and the privatisation of non-essential ones, is necessary to capture total factor productivity gains and free up resources for new investments. Risk of political instability, reform delay, and backtracking remain prominent.

The low growth scenario foresees a plausible shock to electricity supply and underlines the fragility of the fiscal situation. As growth is slowed to 2% of GDP on account of lower investments, and budget expenditure for energy subsidies increases, the fiscal rule would be breached in the first year without returning to normal throughout the forecasting period. This scenario serves as a warning against further imprudent increases in current expenditure, in particular larger than expected increases in war-related benefits.

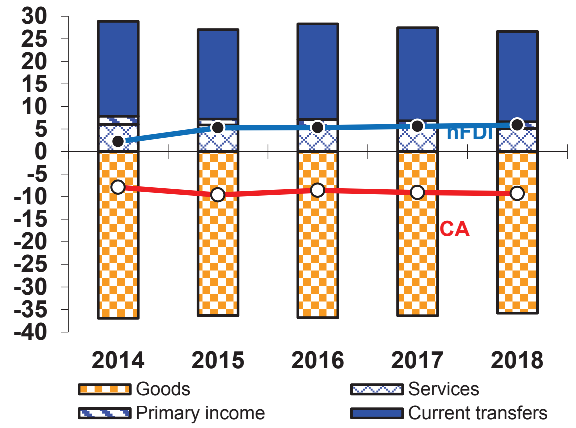
Price developments are outside of Kosovo's control. As a euro-ised economy heavily dependent on external supply, Kosovo price developments are heavily influenced by import prices, especially world food and energy prices. In 2015, Kosovo's CPI inflation was on average -0.5%, due to falling import prices, stagnating food prices, and falling energy prices in the latter part of the year. Core inflation (non-food, non-energy) was negative throughout the year.

Structural external imbalances are a perpetual vulnerability of the economy. A weak and unproductive economic base leaves Kosovo dependent on exporting crude materials and low-value-added products and importing a wide range of consumer and capital goods. The official data for 2015 shows a widening of the current account for the whole year to 9.6% of GDP. Fast growing remittances and a stagnating trade deficit were not enough to either offset or mitigate the large outflow of FDI-related profits and a continuation of the decline in transfers to the government. The ERP predicts that the current account deficit will stabilise at around

9% of GDP over the forecasting period, as a result of growth in FDI-driven investment (8.9% on average). Exports and imports are expected to grow by 6.6% and 5.6%, respectively with gradual export diversification towards higher-value-added products and import substitution in agricultural products and construction material.

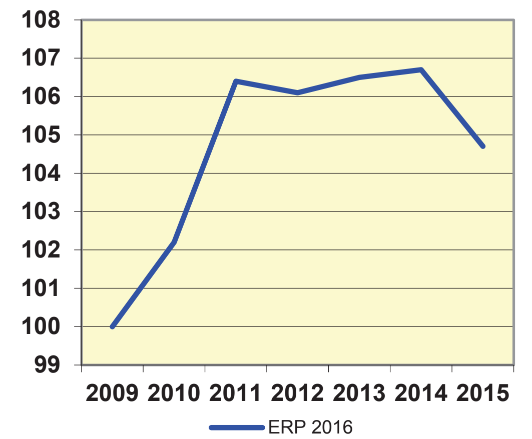
Graph 1: **External competitiveness and the current account**

Evolution of the current account balance (% of GDP)



Source: Economic Reform Programme (ERP) 2016, ECFIN

Real Effective Exchange Rate (CPI based, total economy, 2009=100)



The financing side of the balance of payments, with a high proportion of unrecorded flows, remains heavily dependent on volatile FDI inflows. In 2015 net FDI inflow increased to 5.4% of GDP, due to recovery in construction and real estate investments. Since 2009, most FDI has gone to the real estate, construction, and banking sectors. Changing this pattern towards green field investments in tradable production sectors will require broad-based reforms, some of which are outlined in the ERP, aimed at attracting FDI, strengthening property rights protection, improving access to finance, and targeted investment in human capital.

Table 2:

Financial sector indicators

	2011	2012	2013	2014	2015
Total assets of the banking system, mEUR	2,650	2,830	3,059	3,187	3,387
Credit growth	16.4	3.8	2.4	4.2	7.3
Bank loans to the private sector %	52.6	50.5	44.9	41.5	40.0
Deposit growth	8.6	8.3	7.5	3.6	6.5
Loan to deposit ratio	80.0	80.7	78.0	74.9	75.3
Financial soundness indicators					
- non-performing loans	5.7	7.5	8.7	8.3	6.2
- net capital to risk weighted assets	17.6	14.2	16.8	17.8	19.0
- liquid assets to short-term liabilities	40.8	39.1	48	43.6	44.9
- return on equity	14.9	7.1	9.4	20.2	26.4
- forex loans to total loans	0.0	0.0	0.0	0.0	0.0

Sources: National Central Bank, DataInsight

The net international investment position has been positive but has been consistently decreasing since 2013. By the end of 2015, it fell by almost 70% compared to the end of

2014, to 1.7% of GDP. Recovered FDI and new government external debt related to the IMF programme, increased international liabilities, and the asset side, dominated by the central bank, pension and investment funds, kept at a slower pace. Gross external debt remains at a relatively low level of 33% of GDP, with 9.7% of GDP in short-term debt held entirely by the private sector.

Despite optimistic growth forecasts, the effect on depressed labour market conditions remains negligible. Employment is expected to increase on average by 3.1% in the forecasting period, insufficient to absorb the large inflow to the labour force (1.4% annually) and reduce already high unemployment. There are no estimates of unemployment and activity rates in the ERP but there is little chance of a drastic lowering of the two given the structure of the unemployed and inactive population. The proportion of long term and unemployed youth is likely to remain high, as long as the skills mismatch between the available labour force and market needs persists. Furthermore, the 'Dutch disease' effect of the large inflow of remittances increases the wage reservation level, and discourages labour force participation and accumulation of human capital. Labour productivity is projected to grow by a modest 1.1% on average, significantly lower than the 2.5% growth in wages, which raises the possibility of a further loss in competitiveness.

The banking sector remains stable, liquid and profitable, but also heavily under-utilised. Credit growth in 2015 (6.3%) was driven by the supply side as banks lowered lending standards, decreased interest rates and offered products with longer maturities. Despite falling revenue (-2.5%), the banking sector strengthened its profitability due to lower provisioning and safety buffers. The loans- to-deposit ratio and the bank-loan-to-GDP ratio stood at 74.8% and 35.7%, respectively, indicating ample potential space for further financial intermediation. Unfortunately the ERP scenario does not provide specific numbers regarding developments in the financial sector in the forecasting period. It can be assumed that stronger credit growth would resume if banks continued to reduce their lending requirements.

3. PUBLIC FINANCE

In 2015, public finances benefited from stronger growth and the ongoing IMF programme. Having inherited the 2015 budget proposal and without enough time to revise it, the new government initially adopted an unrealistic budget. However the budget revision in July 2015 reduced both revenue and expenditure by around 1% of GDP, and brought budget planning to a more realistic level. Nevertheless, budget execution underperformed, both on the revenue and expenditure side, and the deficit remained within the 2% fiscal rule limit. Compared to 2014, budget revenue grew by 8.9%, driven by strong growth in tax revenues. Both VAT and corporate income tax increased significantly (10.3% and 23.1%, respectively) as a result of the increased turnover and profitability in Kosovo's ten largest companies (banks, telecoms and energy production companies). Kosovo customs raised its revenue by 9.1%, through increases in import excise duties, strengthened controls, the introduction of new valuation practices, and improved information sharing. Overall expenditure was 6.1% higher than in 2014. The proportion of spending under current expenditures increased to 74% (71.8 in 2014) due to a full year's effect of public wage and pension increases enacted in April 2014, the implementation of the provisions from the collective agreement which regulates experience premiums for public employees, and increases in agriculture subsidies. Capital expenditure was utilised at 95% of the planned amount, but only thanks to the EUR 25 million advanced payment for construction of the Route 6 highway. Constant underutilisation of the capital investment budget raises questions about institutional capacity for project implementation. The total budget deficit amounted to EUR 117.1 million or 2.0% of GDP. The deficit calculated according to the fiscal rule stood at 1.5% of GDP. Financing of the budget was covered by the issuance of domestic debt with extended maturities. In 2015 Kosovo for the first time issued a domestic bond with a five year maturity. Government bank balances, an additional insurance against fiscal shocks, were increased to EUR 208 million or 3.7% of GDP, through the issuance of domestic treasury bills, financing from the IMF programme and withdrawal of available funding from the privatisation fund.

Maintaining a sustainable fiscal position and improving public financial management are Kosovo's main public finance objectives in 2016-2018. The fiscal rule implemented in 2014 limits the deficit to 2% of GDP and the law on public debt sets the long-term public debt level ceiling to 40% of GDP. To expand the fiscal space in the short run the parliament has adopted an amendment to the fiscal rule which makes it possible to exclude new donor-financed capital projects from the headline deficit. This is in addition to capital investment financed by privatisation proceeds, which is already exempt. To limit the rise in current expenditure as of 2018, a rule governing rises in the budget wage bill has been adopted, limiting its annual growth to nominal GDP growth. Measures to strengthen public finance have also been put in place on the revenue side by changes to the VAT: an increase of the standard rate to 18%, and an introduction of the lower rate of 8% for essential goods and services. To incentivise domestic production and support the nascent IT industry VAT exemptions were introduced for imported production capital goods and IT equipment. To discourage tax evasion the VAT registration threshold was reduced to EUR 30 000 making and additional 1800 enterprises liable to VAT. The direct full year effect of these measures is estimated at EUR 19-35 million. However even more is expected from the secondary effects of increased consumption and domestic production. The ERP fiscal scenario does not foresee any additional tax rate changes. The announced merger of the tax administration and customs is expected to increase productivity and improve service, but the specific mechanisms to achieve thiso remain vague. The merger should be carried out in a transparent way, with a clear action plan, to avoid any political interference.

Table 3:

Composition of the budgetary adjustment (% of GDP)

	2014	2015	2016	2017	2018	Change: 2015-18
Revenues	23.9	25.0	26.2	25.2	24.5	-0.5
- Taxes and social security contributions	22.1	22.0	22.6	22.0	21.5	-0.5
- Other (residual)	1.8	3.0	3.6	3.2	3.0	0.0
Expenditure	26.5	27.1	28.1	27.2	26.6	-0.5
- Primary expenditure	26.3	26.8	27.7	26.7	26.1	-0.7
of which:						
Gross fixed capital formation	7.4	7.0	7.6	7.4	7.6	0.6
Consumption	12.4	12.6	12.5	12.1	11.6	-1.0
Transfers & subsidies	6.5	7.2	7.4	7.1	6.8	-0.4
Other (residual)	0.0	0.0	0.2	0.1	0.1	0.1
- Interest payments	0.2	0.3	0.4	0.5	0.5	0.2
Budget balance	-2.6	-2.0	-1.8	-1.9	-1.9	0.1
Budget balance as per fiscal rule	-2.2	-1.5	-1.6	-1.7	-1.7	-0.2
Primary balance	-2.4	-1.7	-1.4	-1.4	-1.4	0.3
Gross debt level	10.4	13.5	17.3	20.0	22.0	8.5

Sources: Economic Reform Programme (ERP) 2016, ECFIN calculations

The 2016 budget plan appears to be more realistic than in 2015 and tries to limit the growth of current spending. The 2016 budget, adopted by the assembly in December 2015,aims at a fiscal deficit of EUR 95 million[1] or 1.6% of GDP, in line with the fiscal rule. The budget is based on nominal GDP growth of 4.5% in 2016, and CPI inflation of 0.4%. Total revenue is expected to be EUR 1.6 billion, 9.5% higher than in 2015. The increase should come from stronger economic growth, the effect of a full year VAT and excise changes, and the repayment of some tax arrears as a result of the new debt amnesty law. Although taxes collected at the border currently account for most of the budget revenue, the implementation of free trade agreements with the EU and Turkey will likely lead to a gradual shift towards domestically collected taxes. Expenditure is forecast at EUR 1.684 billion in 2016, 8.5% higher than in 2015. The budget for wages and salaries will increase by 2.6%, which reflects the implementation of the collective agreement. Subsidies and transfers are planned to increase by 6.3%, reflecting a 25% increase in social assistance, implementation of the law on state-financed pension schemes, provision of pensions to war veterans and other war categories, and maintenance of higher subsidies for agriculture. Increases in transfers have been offset by a rationalisation of expenses in the goods and services category, which will stay at the same level as in 2015. Although the rationalisation of goods and services spending is welcome, further neglect of spending on infrastructure maintenance could yield higher costs in the future. The capital expenditure budget is ambitiously expected to increase by 14.7% compared to 2015. Although 90% of capital spending is allocated to ongoing projects, capacity constraints at the administration level could cause delays and under execution.

The fiscal scenario for 2016-2018 is balanced with few immediate risks. There should not be many fiscal surprises during the IMF programme. However, there could be a period of uncertainty in the second half of 2017. As the IMF programme ends in May 2017 and the newly adopted wage rule does not come into force until 2018, the 2017 budget revision could be under pressure to from groups with a vested interest in increasing wages and entitlements. Government deposits, used as fiscal buffers, are being increased to 4.5% of GDP, a level implied by the fiscal rule; this brings an additional level of insurance against unforeseen financing risks. The incentives of the new privileged pensions for war veterans should be re-examined. Set at the minimum wage level and without any age threshold, they hardly encourage employment; this is evident from the higher than expected number of applications. Political risk remains pronounced. Delay or backtracking in reform implementation due to political instability would affect the compliance with the IMF programme and thus increase the overall instability of the economy. In case of elections, the propensity of political elites to ingratiate themselves with large interest groups (public sector employees, pensioners, war veterans etc.) by means of ad hoc increases of benefits remains a concern. The fiscal impact of the low growth scenario presented in the ERP is substantial. Deteriorating public finances are a result of a 2.4 p.p. drop in average growth, almost unitary budget revenue elasticity to GDP growth,[2] and an increasing proportion of predetermined spending (current expenditures, and contracted Route 6 spending). In this case, the public debt would rise beyond 26% of GDP in 2018, severely limiting fiscal space made available through the investment clause.[3]

[1] Fiscal rule takes somewhat adjusted overall budget deficit.

[2] Estimated total revenue elasticity is 1.05.

[3] The investment clause is valid until the share of debt to GDP reaches 30%

Kosovo's capital investment budget has systematically been underutilised, by an average of 15% of the allocated amount. Underspending seems to be more pronounced at local level. However, central level spending has so far been dominated by large road-building projects which were executed according to plan due to contract obligations with foreign-based contractors. When these projects are excluded, the pattern of underspending is also clearly present at central level. Extremely low levels of utilisation of project financing provided by the international financial institutions (IFI), reflect difficulties in coping with more advanced project preparation and implementation procedures. Furthermore, the local government financing scheme does not incentivise collection of own revenues which could be used for capital investments.

The institutional public finance framework needs further strengthening. A fiscal rule and the Law on Public Finance provide the backbone of public finance management in Kosovo. However, the nascent fiscal regulatory framework lacks enforcement and monitoring mechanisms. Repeated ad-hoc fiscal decision making, with significant fiscal impact, such as commitment to large infrastructure projects and across-the-board increases in wages, pensions and other entitlements, is the main risk to budget credibility and fiscal sustainability. It should be legislatively discouraged, especially in election years. Strengthening the fiscal rule with a mechanism governing the increase in current spending would reduce the risk of ad-hoc decision-making. It is recommended that Kosovo sets up a fiscal council of another fiscal rule monitoring and enforcement mechanism with a mandate to evaluate budget outcomes, and contribute to the debate on fiscal issues. Also, strengthening the independence and improving human capital of existing institutions in charge of developing macro-fiscal scenarios and revenue projections would help increase the credibility of government fiscal documents. To improve public finance management, the Ministry of Finance has announced the introduction of mandatory e-procurement and plans to increase the scope of centralised procurement. However, other public procurement reforms should be continued in parallel, to address insufficient administrative capacity, the very weak remedy system, weak enforcement and monitoring etc.

Table 4:

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

	2014	2015	2016	2017	2018
Gross debt ratio [1]	**10.4**	**13.5**	**17.3**	**20.0**	**22.0**
Change in the ratio	8.7	3.1	3.8	2.6	2.0
Contributions [2]:					
1. Primary balance	**2.3**	**1.7**	**1.5**	**1.6**	**1.6**
2. “Snow-ball” effect	**-0.2**	**-0.1**	**-0.2**	**-0.3**	**-0.5**
Of which:					
Interest expenditure	0.2	0.3	0.4	0.5	0.5
Growth effect	-0.1	-0.4	-0.5	-0.7	-0.8
Inflation effect	-0.3	0.0	-0.1	-0.1	-0.2
3. Stock-flow adjustment	**6.5**	**1.5**	**2.5**	**1.4**	**0.9**

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 accru

Source: Economic Refrom Programme (ERP) 2016; ECFIN calculations

Public debt is low but remains sensitive to refinancing and fiscal shocks. At the end of 2015, it stood at 13.2% of GDP,[4] 2.6 percentage point higher than in 2014. Around 49% of the debt is domestically issued, in the form of short maturity treasury bills and bonds, while the rest is mainly held by the IFIs. The average weighted interest rate (3% in 2015) is projected to decrease by 2018. The situation is somewhat confusing in the short term given that Kosovo is progressively issuing domestic bonds with ever longer maturities, and also in the longer term, as Kosovo gradually shifts from concessional loans to market issued international debt. By 2018, the debt level is expected to reach 22% of GDP, with the budget deficit as the main determining factor of debt evolution[5]. The prevalence of short-term debt in is a potential refinancing risk. The government plans to issue EUR 235 million of foreign debt during the forecasting period, most of which will come from the IMF SBA (EUR 116 million). The issuance of domestic bond and treasury bills is expected to amount to 6.3% of GDP on average over the next three years. After the end of the IMF programme, if there is a substantial fiscal shock the government could face financing constraints, given the narrow domestic market, lack of internationally credit rating and relatively large fixed costs of accessing the international markets. To provide an additional buffer government deposits have been replenished towards the level implied by the fiscal rule (4.5% of GDP) and are expected to reach by the end of 2016. The long-term public debt sustainability analysis presented in the ERP highlights Kosovo's limited room for deviations from the fiscal rule.

4. STRUCTURAL REFORMS

Kosovo’s structural reform needs are large and cover most sectors with a particular emphasis on access to energy and reducing the widespread informal economy. Tackling these issues will have a significant impact on the budget, the business environment and employment. Kosovo businesses are not yet integrated in global supply chains or the EU single market in a significant way. Although Kosovo’s young population provides a great potential, its human capital in general needs development. Labour market imbalances persist, with high unemployment rates of above 35 % particularly among young people (61 %), very low employment rates for women (12 %), and a predominance of long-term unemployment. The weak rule of law has a negative impact on the business environment, which is further undermined by a still weak and unaccountable, albeit improving, public administration and a poor track record for implementing legislation.

The policy guidance jointly adopted in the Ministerial Economic Dialogue of 12 May 2015 were only partially addressed. While the ERP does not report on their implementation in a systematic way, some key follow up actions were taken. The establishment of the National Investment Committee (NIC) is a welcome step towards better assessing future major infrastructure projects, including their fiscal impact. The energy interconnection with Albania has been completed on the Kosovo side, which should improve the security of energy

[4] This figure does not include Kosovo's share of the Paris and London club debt of the former Yugoslavia

[5] Overall budget deficit according to the ESA methodology. Fiscal rule adjusted deficit omits certain debt funded expenditure

supply in the long-term. However, no significant action to reduce undeclared work has been reported. Steps were taken towards setting up a centralised public procurement system and the board of the Procurement Review Body was recently approved by the Parliament. Overall, Kosovo needs to step up the implementation of the recommendations in the current year.

The ERP correctly identifies most of Kosovo's competitiveness, employment and social inclusion weaknesses and prioritises the reforms accordingly. However, the level of detail provided for the different reform measures is uneven, and many measures would benefit from a more elaborate description of funding sources, budgetary impact for all three years, expected impact on competitiveness and long-term growth, as well as a better analysis of implementation risks and actions planned to mitigate these. The timetable provided for the implementation is very general and does not include a clear operational plan with specific steps to be taken during each projection year. A better differentiation between ongoing and new reform measures would also have been helpful.

Public finance management

The recent PEFA study and OECD assessment on public finance management (PFM) show a certain improvement in this area, yet a number of significant weaknesses remain. The commitment control and asset management continue to be deficient as payments arrears are increased and public spending is financed through unauthorised use of public financial resources. In the specific area of public procurement the key weaknesses are vulnerability to corruption; weak enforcement and insufficient monitoring; insufficient capacity of public procurement bodies and a non-functional remedy system.

The recommendation to improve public procurement has been partially addressed. The law on public procurement has been amended to allow for the introduction of the mandatory e-procurement for all central level budget organisations but implementation is at a very early stage. Central procurement was approved for a list of six products with further scope for broadening. The board of the Procurement Review Body was approved by the Parliament on 30 March 2016 finally making it operational. A broader reform of public procurement will be necessary to address vulnerabilities referred to above.

The planned measure on the launching and application of electronic procurement is relevant but its link with the wider National Strategy on Public Procurement currently being prepared is not explained. Also, a more realistic assessment of the budgetary needs and of the required steps should be carried out. In this context, it would be very important to accompany the proposed measure with awareness raising and capacity building activities that address the possible constraints of SMEs in Kosovo to fully access and use e-procurement. Kosovo is currently developing its PFM reform programme, which should be adopted by the government at the end of May 2016. It will be essential that the measures set out in this reform programme are implemented in accordance with the adopted timetable.

Infrastructure

The main weakness in the transport area is not a lack of physical infrastructure but the poor maintenance and regulatory environment for its management. Therefore, priority should be given to improving traffic management, road safety, border crossing procedures and maintenance systems, rather than to large-scale public investment projects. There are indications that transport links are not a binding constraint for growth at present, but that they require further development to be able to facilitate cross-border trade. Focusing on border crossings should thus help to enable the opening of the market and facilitate trade. There is also a strong need to strengthen the transport regulatory institutions, ensure their independence and improve administrative capacities.

The recommendation to improve government oversight and the assessment of infrastructure projects has been partially addressed. The National Investment Council (NIC) has been set up to assess all strategic public investments according to their cost-benefit and potential impact on the economy. The single project pipeline that will help to strengthen this approach has been approved. Investments in infrastructure are aligned with the regional agenda on connectivity and the core network. However, the recent progress in establishing the NIC and the single sector pipelines has yet to show tangible results. The measure on the construction of the highway to Skopje and rehabilitation of railway line 10 fails to present any solid case for the expected economic impact or contribution to competitiveness, besides some general statements. Taking into account the very large amounts involved in the implementation of this ongoing infrastructure project (EUR 408 million over the next three years), a much clearer cost-benefit and impact analysis would have been expected. Moreover, the project's timeline, monitoring indicators and overall budget should be specified.

The inclusion of the rehabilitation of railway line 10 is relevant as the line is part of the main Kosovo network and connects Kosovo to an international railway corridor. However, the planned activities - it is not clear if they can start before 2018 - are described in only very general terms. The actual implementation timeline and monitoring indicators are too vague, and the project's budgeting is not complete. The risks associated with the implementation of this reform are not sufficiently considered, e.g. the limited capacity of 'Infrakos' for project implementation; competition from the road sector; political risks associated with the segment passing through North Mitrovica; insufficient liberalisation of the railway market; weak capacities of the railway safety authority, etc.

Unreliable energy supply, distribution losses and low energy efficiency have a severe negative impact on private sector development. Moreover, energy tariffs that do not reflect actual costs and the existence of cross subsidies are not fiscally sustainable. Cross subsidies among energy consumer can also represent a disincentive for investment. According to the World Bank, increasing electricity demand coupled with the planned decommissioning of the Kosovo A power plant will create a substantial electricity gap of 3000 gw/h in ten years' time. According to the latest Business Environment and Enterprise Performance Survey (BEEPS), poor access to electricity is the second most important challenge facing the private sector. Commercial and technical losses are high at 28 % (15 % technical; 13 % commercial). The main reason for significant technical losses is the poor condition of the electricity distribution network. The completion of the electricity interconnector with Albania will contribute to the diversification of electricity sources and increase supply reliability, albeit to a limited degree given that both countries' capacity fall short of peak demand and that their demand patterns are concurrent.

The recommendation to advance towards securing a reliable energy supply has been partially addressed through the completion, on the Kosovo side, of the interconnector with Albania. However, to meet this objective, additional generation capacities, a diversification of energy sources, improved energy efficiency and a gradual adjustment of energy tariffs to reflect actual costs are still essential.

The measures on energy are thus pertinent but are presented without links to the broader reform agenda in the sector. The measure on the further development of energy production capacities is indeed a necessary investment. However, the description in the programme leaves out associated risks, such as the dependency on the development of lignite production (mining). Moreover, the deregulation of prices, the need to plan for a gradual adjustment of tariffs to reflect actual costs and the market opening of the electricity sector are also not taken into account. The measure on energy efficiency is also very relevant given the current and future problems of security of supply. However, it is not sufficiently ambitious as it is focused only on existing commitments (loans) targeting public institutions and does not cover the potential energy savings in the residential sector, which represents around 40 % of final energy consumption and 55 % of total electricity consumption. Much more needs to be done to stimulate investments in energy efficiency.

Sector development

Agricultural sector development

Kosovo is one of the biggest importers of agricultural products in Europe on a per capita basis. Many of the imported products could be produced domestically. The agricultural sector is underdeveloped with outdated farming techniques and technologies and fragmented agricultural land plots, illegal changes of agricultural land use and a lack of resources to effectively manage national funds for agriculture and rural development. Improvement of hygiene and food safety standards is also essential to increasing exports of agricultural products.

The two reform measures relating to agriculture are relevant, but the assessment of their impact on competitiveness may not be entirely realistic. The measure on agricultural infrastructure for agro-business plans to establish wholesale markets and expand laboratory capacities, as well as to increase the irrigation system coverage from 15 % to 40 % of arable land by 2020. This would mean an almost tripling of its current coverage in four years, which seems ambitious and unrealistic. Moreover, the budget figures are only presented for 2016. The agricultural sector would benefit from a national strategy for irrigation improvement and expansion, including principles for efficient water use and management. The measure on the consolidation of agricultural land will only be implemented on a voluntary basis. The timeline is not detailed enough and there is a concern that the current process of land consolidation will only cover a number of villages and farms, limiting its impact on competitiveness.

Industry sector development

Kosovo's industry is characterised by a low-value-added and undifferentiated production, as well as weak industry associations and cooperation among companies. The measure to determine the potential for industrial cluster development may be pertinent, but the ERP fails to explain why this is considered the most relevant action in this sector compared to other actions envisaged under Kosovo's industrial policy and the private sector development strategy.

Services sector development

Kosovo's services sector is the largest contributor to employment but it is characterised by small and micro firms that are largely family run, focused on activities with low value-added in non-tradable sectors and by large differentials in earnings across regions. The ERP does not contain a proper analysis of the services sector as a whole but focuses only on the ICT, neglecting other potentially important service areas like retail, wholesale, or those more linked to the diaspora (tourism, real estate, business).

The measure to develop broadband infrastructure in rural areas is relevant for Kosovo's economy. Despite the introduction of VAT exceptions for ICT equipment, a substantial growth in ICT sector will require an adequate supply of educated computer engineers which is lacking. The development of ICT skills for the digital economy is thus especially important, but its potential impact on the economy is limited as activities beyond the pilot phase with the Korean Green Growth Trust Fund are very general and the sources of funding not very clear. Moreover, the development of ICT services requires that in addition to adequate infrastructure, competition among operators and independence of the regulator are ensured.

Business environment, corporate governance and reduction of the informal economy

The large informal sector, together with corruption and poor access to electricity, is one of the top three obstacles to businesses identified by the private sector in the latest BEEPS. In addition, businesses struggle with a complex and changing regulatory framework, notably in customs and trade regulations, multiple state inspections and market surveillance, poor access to finance, weak protection of property rights and contract enforcement, difficult insolvency resolution and the unresolved status of privatisation assets. The informal economy, estimated to constitute around 35 % of GDP, is a key obstacle to competitiveness. A large informal economy damages fiscal revenues and distorts the market by creating unfair competition. Undeclared work also weakens the protection of employees and the systematic evasion of social security contributions hampers building a universal system of social protection.

The recommendation to improve the business environment includes many different elements that have been partially addressed. Kosovo made some partial progress in tackling informalities by easing the process of formalising local businesses. However, no specific incentives were introduced for reducing undeclared work. Progress was much more limited in other areas such as the privatisation of publicly owned enterprises (POEs), although the Privatisation Agency now has a board. No significant progress was recorded in terms of clearing court backlogs, developing cadastre databases or strengthening targeted support for SMEs.

Some of the new measures planned in the ERP 2016-2018 aim to improve the business environment along the lines of the recommendation from 12 May 2015. Streamlining evidence-based policy making through the introduction of regulatory impact assessments, while more linked to public administration reform, can also have a positive impact in the business environment. Strengthening the property rights system and increasing judicial efficiency would address key bottlenecks in the business environment. Strengthening property rights is essential for improving access to finance for SMEs and will help the process of land consolidation. Judicial efficiency reform aims to clear the backlog of court cases that still plague the judicial system in Kosovo. However, neither measure provides enough detail on planned activities, timing or costs, to be able to accurately estimate the quantitative impact on the business environment or the competitiveness of the economy.

The measure on improving the access to finance for Kosovo SMEs is very relevant and addresses one of the key concerns expressed by businesses. If duly implemented and operational, the planned credit guarantee fund has the potential of bringing a tangible benefit to the economy. However, the details provided are very limited and the fund seems to be mostly dependent on not entirely confirmed contributions by external donors.

The measure on improving corporate governance of enterprises with state-owned assets is relevant but does not address the politicisation in the appointments of the management of POEs. POEs do not operate under OECD corporate governance principles nor has the risk they represent for public finances been properly assessed. De-politicisation and professionalisation of the management remain an essential first step in order to enable reforms and modernisation of POEs. The details provided on the reforms related to monitoring, supervision and the centralisation of the Public Enterprise Policy and Monitoring Unit are very limited.

Technological absorption and innovation

Kosovo's capacity for research, development and innovation (RDI) is very low. The public expenditure on R&D is very low (0.10 % of GDP) which shows a low political commitment on the importance of RDI in driving economic competitiveness. Some efforts have been made to update the National Research Programme and to develop an Innovation Strategy but its adoption has been delayed for several years. The main obstacles in the area of RDI include a universities' limited research capacity, a lack of incentives for the private sector and academia, most businesses most businesses very weak financial capacity to invest in RDI, and a lack of infrastructure and networks allowing the integration with regional or global research networks.

The ERP, focussing on the adoption of the innovation strategy as well as implementing measures on fostering business-academia cooperation, is to be welcomed. In particular, the measure on fostering business-academia cooperation through research grants and innovation vouchers is a good initiative that can help address some of the weaknesses in this area. The measure includes important actions to complete the legal and institutional framework for RDI. The envisaged grants and innovation vouchers should include entrepreneurship support for students whose research has clear commercial potential. The Council for Innovation is considering setting up an innovation and entrepreneurship index to benchmark performance in areas such as commercialisation, entrepreneurship and innovation, which would be welcomed. The planned activities on implementing ongoing voucher and grant schemes for SMEs should have been described in more detail in the ERP to make an assessment possible. Awareness raising actions to stimulate participation of SMEs in these schemes and an analysis to understand why SMEs have shown little interest in these schemes so far would be needed. The implementation plans and funding for the Fund for Smart Specialisation are very vague to fully assess its effectiveness, and the fund's link to the obstacles identified and other components of this measure are unclear. Most important, however, is to create the administrative capacity to implement the envisaged actions.

Trade integration

Kosovo faces a number of significant challenges related to its full integration in the global economy. Among the main obstacles in this area are the incomplete regulatory alignment with the EU *acquis*, the poor quality infrastructure, businesses' weak capacity to comply with EU and international standards, and the high costs of, and time needed to, export and import. SMEs in Kosovo face challenges both in developing new products as well as in certifying the products they produce. A lack of experience in marketing and sales also makes it difficult for Kosovo's companies to find contracts in European markets.

The two recommendations related to trade integration have only been partially addressed. The recommendation to amend the Customs Code and adopt new legislation on customs enforcement of intellectual property rights (IPR) has not been implemented. An action plan on trade facilitation has been developed, but the ERP has no information on clear deliverables including a timeline for the Customs Code amendment and the draft law on IPR adoption. The recommendation to adopt a strategic framework for FDI and increase investor protection has not been addressed.

The ERP focuses on one of the underlying structural challenges of the Kosovo economy in exporting its products, namely poor quality standards. The measure on encouraging businesses to improve the quality of their products aims to improve national quality infrastructure systems. To have a real impact, however, the reform should further enhance the direct support to companies to comply with EU standards (access to expertise/financing) and to address the limitations that SMEs face in order to modify their production methods and facilities.

Employment and labour markets

According to available data for 2014 and first indications for 2015, Kosovo's labour market performance is not improving. The labour market participation rate (41.6 % in 2014) still shows that most of the working age population is inactive. Women are particularly underrepresented in the labour force (21.4 %). The employment rate dropped further to 26.9 % in 2014, while unemployment increased strongly to 35.3 % and the data available for 2015 so far point to a further increase in registered unemployment. Aside from women, young people are also particularly affected; youth unemployment rose strongly in 2014 to 61 %. In fact, one third of all young people are not in employment, education or training (NEET), which is of particular concern given the size of the population and the clear risk of further increasing the proportion of the inactive working age population. Tackling the high unemployment rate is hampered by weak labour demand and a wide skills gap as the overall outcomes of the education system are low. The country has great potential to use its youth dividend to increase the workforce and raise productive employment for economic and social development, as long as young people are equipped with the skills expected by employers and potential investors. However, large remittances discourage labour participation and human capital accumulation.

The recommendation to accelerate the modernisation of vocational education, to continue to improve the quality of higher education and improve alignment of the education system to the labour market has only been partially addressed. A review of some vocational education and training (VET) programmes was carried out and a draft law on higher education prepared but not adopted. Rigorous quality assurance measures are still lacking and the accreditation process is not completed. The recommendation on fighting the informal economy included the provision of incentives to reduce undeclared work; this part of the recommendation has so far not been addressed; the government has only adopted a set of recommendations for structural reforms to formalise employment and overcome exclusion and marginalisation.

The measure on better links between education and the labour market identifies the relevant areas for action, but only in fairly general terms. The four areas of activity are presented as ongoing activities for the whole 2016 to 2018 period. Particular attention should be paid to the planned implementation of a pilot VET system combining learning in schools and learning in the workplace. Such a system is welcome and could help improving links with the labour market, but does not replace a more thorough review of the VET provision in Kosovo considering its limited capacity to prepare young people for the demands of the labour market. The measure on implementing a career system for teachers mainly focusses on formal requirements (volume of training) and salary aspects (raising questions about longer-term sustainability), rather than on aspects such as teachers' competences and further training, which are key to the quality of education.

The measures on the establishment of the Employment Service and the stepping up of active labour market measures are welcome but still underdeveloped. Solid active labour market services and policies are key features needed for a functioning labour market in Kosovo, and the Employment Service's provision of services is not coupled with the new fund's implementation. The fund's strategic objectives and the steps for its implementation are not spelled out sufficiently clearly in the ERP, and information about its budget is unclear.

Action towards making the Employment Service operational lacks elements on planning, efficient design, implementation and monitoring of labour market policy services and measures on one hand, as well as on providing timely support and advice services to jobseekers. The outstanding administrative steps for establishing the Employment Service as a separate entity outside the Ministry of Labour have not been taken, hampering also the increase of inspection capacities for tackling undeclared work.

Fostering social inclusion, combating poverty and promoting equal opportunities

The multiple social challenges of Kosovo are presented in an analysis which primarily focuses on the weaknesses in the health care system, in particular the quality of care and the system's inability to offer universal coverage to any meaningful extent. There is no indication of follow-up to last year's policy plans on introducing a mandatory health insurance contribution.

Other social policies are only addressed in information on social expenditure. There is no data or analysis of the main challenges related to poverty and social exclusion in the country, or the situation of marginalised groups. The social assistance programme has limited coverage due to the small fiscal envelope.

ANNEX 1: OVERALL ASSESSMENT OF PROGRAMME REQUIREMENTS

The Kosovo Economic Reform Programme (ERP) for 2016-2018 was submitted on time. The government approved it following a roundtable discussion with representatives of NGOs and business associations. It is in line with the previously approved medium-term fiscal strategy and national development strategy. This is the second iteration of the programme submitted to the European Commission and there has been some improvement over the first iteration. Overall the document is of good quality in terms of content, structure, and analytical approach. The analysis of the impact of the proposed structural reforms on the macro-fiscal framework has improved compared to last year's document. Estimates have been made for all measures most of which were already planned and budgeted for before the development of the 2016 budget.

Ownership and internal coordination

The ERP was jointly coordinated by the office of the Prime Minister and the Ministry of Finance. It was formally endorsed by the government. An inter-ministerial working group involving 11 ministries worked on its preparation. The coordination of the costing exercise between the office of the Prime Minister and the Ministry of Finance could be improved.

There is a strong correlation between the ERP and the recently adopted National Development Strategy, which is positive. On the other hand, the link to the annual budget and medium-term fiscal framework is still weak. The programme is linked to the European Commission’s annual report in several ways and corresponds well to the requirements of the recently concluded Stabilisation and Association Agreement.

Stakeholder consultation

The government held two public consultations with social partners, business associations, civil society organisations and academia, as well as the Association of Kosovo Municipalities. The draft was also presented to the National Committee on Economic Development. It is unclear whether trade unions were involved in the consultations. It is indicated that the draft will be presented to the Parliament for information. The ERP does not contain any written contributions from stakeholders, no information on the time allowed for comments and no indication of whether feedback was integrated in the final draft. This should be improved next year.

Macro Framework

The presented macro-fiscal framework in the 2016 ERP is broadly plausible. External assumptions have been taken from the IMF October World Economic Outlook and the Commission's autumn forecast. Credibility of the fiscal framework has been greatly improved on the account of more realistic revenue projections. Developed low growth alternative scenario is useful to showcase the fragility of Kosovo public finance and should be used to highlight the importance of prudent fiscal behaviour.

Fiscal Framework

The fiscal framework was prepared in cooperation with the IMF and is in line with the MTEF 2016-2018 and the 2016 budget. It envisages plausible revenue projections due to renewed growth and several policy actions taken in 2015. On the expenditure side the risk remains of capital spending under-execution and the further increase of current spending.

Structural reforms

The sections on structural reform priorities follow the guidance note, present a diagnostic per area, and report on the implementation of the policy guidance from last year. However, the reporting should have been included in the overview on pages 2-5 of the ERP. Moreover, more detailed and up-to-date information on the implementation should have been provided. The structural reform priorities included in the 20 measures correspond well to the key obstacles identified in the diagnostics and in many cases to the policy guidance from 12 May 2015. The number of reforms is limited to 20. However, the page limit of 80 pages has not been respected.

The description of each reform measure in terms of specific actions and timeline should be made in such a way that it can be easily monitored annually in the coming three years. Some of the measures contain such details while others do not. 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.

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

2015 country policy guidance for KOS	Summary assessment
PG1: Sustain the commitment to fiscal discipline and improve transparency of public finances by considering establishing an independent fiscal council, or fiscal agency, with a clear mandate to preserve sustainability of public finances, and reduce deficit bias, and by better coordination between government and parliamentary bodies responsible for budgetary processes. Improve the budget process by legislatively strengthening the role of the Medium Term Expenditure Framework and enshrine principles of cost-benefit analysis as the basis of the policy planning process. Take steps to increase government deposits to the threshold implied by the fiscal rule (4.5% of GDP) to provide additional financing buffer.	Kosovo has partially addressed PG1: • There have been some discussions between stakeholders on possible modalities for the establishment of the fiscal council/ institution but the discussion has not yet moved to the technical level. • All policy initiatives are required by law to be accompanied by a fiscal impact assessment but in practice it is rarely the case. • Government deposits have been increased to 3.6% of GDP and are projected to reach the desired target of 4.5% of GDP by the end of 2016.
PG2: Address immediate fiscal risks with necessary measures aimed at reducing unsustainably high current expenditures while preserving growth enhancing capital spending. Develop a legal framework for maintaining a sustainable public wage bill and strengthen targeting and means testing of transfers. Ensure planned increases in agricultural subsidies are directed exclusively at productivity increasing initiatives. Advance public administration reform with special attention on improving productivity and reducing costs. Take further steps in strengthening public finance management practices.	Kosovo has partially addressed PG2: • With the 2015 budget revision expenditure targets have been reduced. Savings have been found namely among the current expenditure. However issues of capital investment budget under-spending and rising political pressures for new entitlements persist. • Wage bill has been regulated with the new Wage rule, starting in 2018. Annual rise in the wage bill will be limited to the latest available growth rate of the nominal GDP. • Means testing and targeting of transfers have not been strengthened. Furthermore the 2016 budget foresees introduction of the new untargeted war veterans pension. • Agriculture subsidies still show weak link to productivity gains and should be re-examined, supported by other structural policies and phased out with time.
PG3: Modernize revenue collection to reduce reliance on customs receipts by improving property tax collection and strengthening the legal framework for collection of tax and municipal tax arrears. Revisit local government grant financing scheme to incentivise better collection of municipal revenues. Further broaden tax base by introducing the planned mandatory health sector contributions, and reassess planned tax exemptions.	Kosovo has partially addressed PG3: • Reform measure 14# from this year's ERP envisages the establishment of a common revenue agency by merging the Kosovo Tax Administration and Kosovo Customs which will should improve efficiency of tax collection and reduce tax avoidance. • Recommendations from the EU funded project analysing the system of municipal finances have been discussed by the interinstitutional working group on fiscal decentralisation and will be considered for adoption by the ministry of finance in 2016. • Introduction of the mandatory health

	contribution has been postponed.
PG4: Advance restructuring and restart the privatization of non-essential Publicly Owned Enterprises (POEs). Take steps to improve the efficiency and corporate governance of strategic POEs. Address the lack of quorum of the board of Privatization Agency of Kosovo (PAK) and accelerate privatization of Socially Owned Enterprises still in PAK's portfolio.	Kosovo has partially addressed PG4: • Privatization Agency of Kosovo board has been approved in December 2015. • No new privatisations or restructurings have been started. • No improvement in efficiency and corporate governance of POE. Recent management appointments were done along clear political lines and in contrast with OECD corporate governance principles, and are in breach of Kosovo's law on public enterprises, article 17(2).
PG5: Address the underlying causes for high costs of bank-based financing, reduce the duration and cost of insolvency procedures by adopting the new bankruptcy law and further improve contract enforcement with a view to increase overall financial intermediation in the economy.	Kosovo has partially addressed PG5: • Cost of financing in Kosovo has been somewhat reduced as the banks lowered their financing criteria. Contract enforcement is strengthened by the introduction of private enforcement agents.
PG6: Strengthen government oversight and consider setting up an advisory body to contribute to the assessment of future major infrastructure projects, including their fiscal impact and make sure they align with the regional agenda on connectivity (core network). Advance towards securing a reliable energy supply while ensuring the compliance with the EU environmental standards in the production of energy.	Kosovo has partially addressed PG6: • The National Investment Committee (NIC) has been established. • The interconnection with Albania has been completed on the Kosovo side.
PG7: Improve the quality of education by continuing to roll out teacher licencing and training as well as improving quality assurance and strengthening related incentives; improve access to pre-primary and primary school education; accelerate modernization of vocational education, continue improve quality of higher education and improve focus on aligning the education system so as to make it more responsive to the labour market. Assure the timely operationalisation of the recently established Public Employment Service and its effectiveness in lowering the high unemployment rate.	Kosovo has partially addressed PG7: • A review of five VET programmes was undertaken and is about to be finalised. • Preparatory steps were taken for making the Employment Service operational as a separate entity outside the Ministry of Labour, but the process is not yet completed since the Director of the Employment Service still needs to be nominated. • A draft law for reforming Higher Education has been prepared. • The rolling out of the new curricula for primary and secondary education has started.
PG8: Continue to improve the business environment and continue with the clearing of court backlogs, strengthening capacities of judicial system, and developing cadastre databases. Advance measures to tackle informality in line with the strategy for the prevention and fight against informal economy, including incentives to reduce undeclared work. Reduce the administrative burden for business by implementing the Better Regulation Strategy and the Law on Permits and Licences. Develop measures to provide targeted support for SMEs and to widen their access to finance. Step up the fight against corruption and efforts to improve public procurement, by enhancing administrative capacity,	Kosovo has partially addressed PG8: • The strategic plan for Kosovo's judiciary and the national strategy for reducing court backlogs are being implemented. • There was some tax reform easing the tax burden and the process of formalising local businesses. There was liberalisation of the market for fiscal devices. There were some measures for collection of fiscal receipts. No specific incentives were introduced for reducing undeclared work. • The Law on Normative Acts was approved by the government. • The Voucher Counselling Scheme was introduced. No specific measures adopted yet to

increasing efficiency and effectiveness of the Public Review Board, and implementing central procurement.	widen access to finance. • The Public Procurement Law was amended and e-procurement introduced. Central procurement approved for list of 6 products (tenders launched, 1 contract signed). The board of the Procurement Review Body was recently put in place.
PG9: Facilitate trade by amending the Customs Code and adopting new legislation on customs enforcement of IPR.	Kosovo has partially addressed PG9: • Laws on Patents, Trademarks, Industrial Design and GEO Indications and Designation of Origin were adopted.
PG10: Adopt a holistic approach to Foreign Direct Investment that anchors supportive policies in a strategic framework and focus on removing existing obstacles. Increase investor protection by developing an investor after-care program and establish an investor grievance mechanism.	Kosovo has not addressed PG10.