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COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

KOSOVO*
(2019-2021)

COMMISSION ASSESSMENT

* This designation is without prejudice to positions on status, and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo Declaration of Independence

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1. EXECUTIVE SUMMARY

Kosovo's economic reform programme (ERP) expects economic growth to remain robust, supported by public spending initiatives and private consumption. The ERP baseline scenario is on the optimistic side, forecasting average annual GDP growth of 4.5 % in 2019-2021, which is above the historical trend. Private consumption should remain the main growth driver, supported by growing remittances, higher social transfers and easier access to credit. A very ambitious public investment plan is set to drive overall investment growth. Public consumption is set to increase sharply in 2019, due to higher allocations for infrastructure maintenance and priority areas, but to stagnate afterwards. Shortcomings in the execution of public investment and higher import growth than assumed in the ERP remain the main downside risks to the economy. Moreover, political decisions such as the 100 % tariffs on imports from Serbia and Bosnia and Herzegovina have a negative impact on trade and undermine regional economic integration. The possible construction of a major new power plant (Kosova e Re) constitutes an upside risk for growth, but could have significant repercussions for public debt.

The budget deficit is set to widen, while recurrent pressure for higher wages and social transfers create fiscal risks. The 2019 budget deficit is projected to reach the upper limit of 2 % of GDP fixed by the fiscal rule. The expected high revenue growth relies on ambitious gains from tax compliance. The projected rise in expenditure is driven by a steep rise in current and capital spending, the latter due to the expected start of several infrastructure projects financed by privatisation revenues and international financial institutions (IFIs). The overall deficit is projected at 5.2 % of GDP on average in 2019-2021 (1.8 % when adjusted for capital spending excluded under the fiscal rule), and public debt is set to rise to 25.1 % of GDP by 2021. Immediate fiscal risks stem from the recently adopted Law on salaries for public employees (which risks breaching the wage bill rule), overspending on the war veterans pension scheme and persistent pressure from large interest groups for increases in entitlements and transfers, as shown by the recent adoption of the Law on teachers' pensions.

The main challenges facing Kosovo include the following:

- **Given numerous development challenges, Kosovo needs to prioritise public expenditure within the limited fiscal space and in compliance with the fiscal rule.** Preserving high rates of capital spending, as envisaged in the budget, and ensuring funding for priority areas such as health, education and the judiciary remain key. Prioritisation, planning and coordination between policies are essential, while new initiatives should be properly evaluated and costed before adoption. While Kosovo has taken some steps to improve capacities for policy evaluation, macro-fiscal forecasting, budget planning and fiscal oversight, further efforts are needed to improve fiscal governance and efficiency of public spending while reducing fiscal risks. Improved revenue administration should create more space for priority spending.
- **Capital projects are regularly delayed due to weak capacities for project implementation.** Around 25 % of the capital budget remained unused in 2018. The costs of social spending are systematically underestimated in the budget, leading to regular fund reallocations at the expense of capital spending. Further improvement of multiannual investment planning and administrative capacities for project management is important if Kosovo is to achieve the ambitious public investment growth envisaged in the ERP.
- **The informal economy represents around a third of GDP, leads to unfair competition and reduces job security and safety at work.** Institutional weaknesses in

the updating and exchange of business information and weak inspections and tax audits contribute to the level of informality. The perception of poor quality in public services such as healthcare and education may also create a disincentive to pay taxes. The government has developed a revised Strategy and Action Plan for combatting informality, which is expected to be adopted in April 2019.

- **Kosovo's competitiveness continues to be hampered by an unreliable and undiversified energy supply.** Access to electricity remains one of the main problems, creating large costs for businesses. The problem is exacerbated by the unresolved dispute between the transmission system operators of Kosovo and Serbia. Kosovo is investing in renewables, but the current system of feed-in tariffs needs to be reviewed. Despite positive developments, energy inefficiency continues to pose a major problem that warrants close attention. The investment in the Kosova e Re is expected to put upward pressure on prices and this will require appropriate planning and policy response.
- **Very low activity and employment levels and the marginal presence of women in the labour market are the most striking challenges in Kosovo.** No improvement has been achieved in recent years, despite steady economic growth. Very high numbers of young people are out of education or employment, which is not conducive to developing the future workforce. Private-sector employment is of poor quality, with high levels of informality. A comprehensive approach to economic development creating new jobs is not yet in place, and strong skills mismatches persist. Measures for alleviating widespread poverty are very limited, and social expenditure is largely concentrated on categorical benefits and pensions.

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2018 has been partially implemented. Capacities for macroeconomic forecasting and budget planning have increased, but there has been little progress with regard to the options paper on establishing a fiscal oversight body. Investment project management at local level has improved slightly. There has been no progress on reclassifying the war veterans pension beneficiaries. The Law on energy efficiency was adopted in November 2018 and the Energy Efficiency (EE) Fund was established in January 2019. There has been steady progress in the deregulation of energy prices. However, no study was conducted on the gradual adjustment of tariffs to reflect future costs. The new strategy and action plan on combatting the informal economy has been drafted and is undergoing consultation but is not yet adopted. Response to the 2018 policy guidance has been mixed in the areas of employment, social and education policies, reflecting budgetary and administrative capacity constraints on the one hand, but also a complex political environment. Positive developments can be noted in the work of the Employment Agency, but reforms in the education and social sphere are lagging behind.

The ERP sets out reform plans that are broadly in line with the key challenges and priorities identified by the Commission. It reflects the government's commitment to stable public finances and supporting economic growth through ambitious capital investment. It also refers to the need to support private sector and promote inclusive growth. However, recently adopted fiscal policy measures could jeopardise achievement of these goals. Weaknesses in electricity supply, access to finance and contract enforcement as well as the large informal economy are also recognised as major impediments. The proposed education, employment and social policy measures are mostly rolled over from previous ERPs. While this is justified to the extent that the measures are still ongoing, there is a lack of structural reforms fostering job creation and addressing structural bottlenecks.

2. ECONOMIC OUTLOOK AND RISKS

Robust economic growth continued in 2018, with real GDP increasing by 3.9 % year on year (y-o-y) in the first 9 months and the ERP estimating it to have reached 4.3 % for the year as a whole. Growth was mainly driven by strong expansion of investment and private consumption, supported by public infrastructure projects, large inflows of remittances, and robust wage and credit growth. The net contribution of trade was negative.

The ERP assumes a more realistic pace and profile of GDP growth than the linear acceleration envisaged in 2018. GDP growth is set to accelerate to 4.7 % in 2019 (rather than 4.9 %, as projected in the previous ERP) and slow to 4.2 % in 2020 (previously 5.1 %), before picking up again, to 4.8 %, in 2021. It is expected to be driven by a double-digit average annual surge in public investment, in particular in 2019, financed by the liquidation proceeds of the Privatisation Agency, IFI lending and, strong growth in private consumption amid rising remittances, household credit, higher social transfers and assumed rise in employment. Public consumption is expected to increase by 6.5 % in real terms in 2019 due to higher spending on infrastructure maintenance and in priority sectors such as healthcare and the judiciary, but to adjust downwards in 2020 and grow moderately thereafter. Export growth is set to average 5.5 % in 2019-2021 due to the expected robust expansion of services exports and diversification of merchandise exports. Import growth is projected to average 4.3 % over that period, resulting in a negative contribution of net exports to growth. The ERP assumes that economic output will remain broadly at its potential level.

Table 1:
Kosovo - Macroeconomic developments

	2017	2018	2019	2020	2021
Real GDP (% change)	4.2	4.3	4.7	4.2	4.8
<i>Contributions:</i>					
- Final domestic demand	3.0	7.7	6.1	4.9	5.3
- Change in inventories	0.1	0.1	0.1	0.1	0.1
- External balance of goods and services	1.2	-3.5	-1.4	-0.8	-0.6
Employment (% change)	7.6	:	:	:	:
Unemployment rate (%)	30.5	:	:	:	:
GDP deflator (% change)	1.4	1.1	0.6	1.4	0.8
CPI inflation (%)	1.5	1.1	1.3	1.3	1.3
Current account balance (% of GDP)	-6.8	-8.1	-9.6	-9.0	-9.1
General government balance (% of GDP)	-1.3	-2.8	-6.0	-5.3	-4.4
Government gross debt (% of GDP)	15.5	16.2	19.4	22.9	25.1

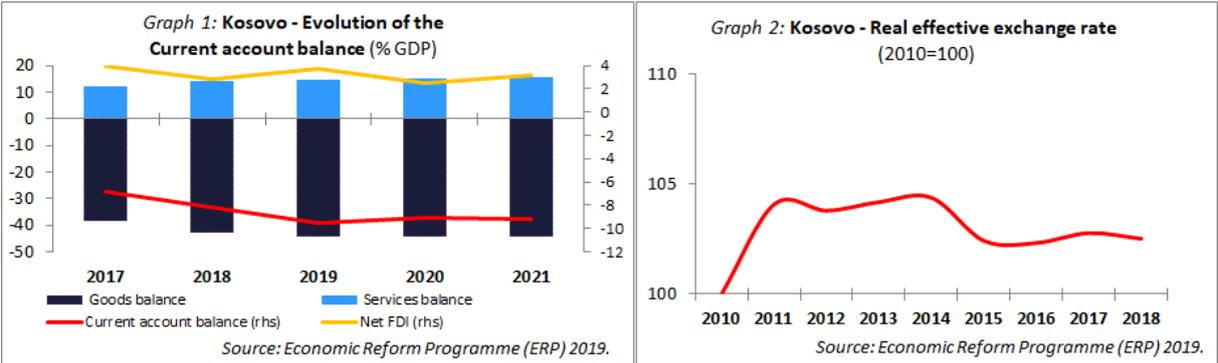
Sources: Economic Reform Programme (ERP) 2019.

The baseline scenario of average growth of 4.5 % in 2019-2021 looks optimistic. Despite the downward revision from the ERP of 2018, it is still above the 4 % average annual expansion projected by the IMF. One domestic risk is the under-execution of public investment, which is a recurrent issue due to overoptimistic planning and weak capacity for implementation. Moreover, import growth could turn out to be higher than expected given the historical trend and the substantial import component of investment. Political instability, new untargeted social transfers and minimum wage increases could further undermine the business environment, which is already struggling with widespread informality and high reservation

wages. Another downside risk to GDP growth stems from lower-than-projected growth in the EU and its spillovers through slower growth in remittances and moderating demand for Kosovo’s goods and services exports. The ERP’s ‘low growth’ scenario takes account of some of these potential downside risks, resulting in 3.5 % average annual growth in 2019-2021. The ‘high growth’ scenario assumes that the construction of Kosova e Re will start in 2019 and that public investment will be higher than in the baseline, resulting in average growth rate of 5.7 % over the period.

Price developments are expected to remain benign. In Kosovo’s small euro-ised economy, prices are determined largely by global commodity prices and inflation in the main trading partners. Average annual inflation reached 1.1 % in 2018, as prices rose throughout the year in line with recovering commodity prices, from -0.2 % year on year in January to 2.9 % year on year in December. The key driver, however, was food prices, which rose steadily from July and hit 5.5 % year on year in December following the introduction of 100 % import tariffs on goods imported from Serbia, and Bosnia and Herzegovina (BiH). The ERP expects inflation to remain at 1.3 % on average in 2019-2021, but does not provide further details, e.g. on the expected impact of the import tariffs. The ERP projection is rather benign while the CBK forecasts an annual inflation rate of 2.0 % in 2019. Monthly inflation rates observed in January and February were over 3 % y-o-y, mainly driven by food prices which rose over 6 % y-o-y in each month.

High trade and current account deficits reflect Kosovo’s low production and export base. Despite robust growth in services exports, the trade deficit is estimated to have deteriorated to 28.5 % of GDP in 2018, from 25.9 % a year earlier. It is projected to widen further, to 29.3 % of GDP on average over 2019-2021, in line with expectations of higher investment and domestic consumption growth. Kosovo’s exports of goods still consist mostly of metals, minerals and low added value products, although the improving Herfindahl-Hirschman index points to some export diversification. Service exports are dominated by tourism services to the diaspora. Net transfers (mainly remittances) are the main offsetting factor, at 12 % of GDP in 2018. Remittances are projected to grow by an average of 5 % a year in 2019-2021, which is in line with the historical trend. The current account deficit is expected to deteriorate from 8.1 % of GDP in 2018 to an average of 9.3 % in 2019-2021, which appears broadly plausible.



While expected to pick up, net foreign direct investment (FDI) continues to cover only a third of the current account deficit. It fell substantially, to 2.7 % of GDP in 2018, from 3.9 % the previous year. The drop was due to weaker performance by foreign firms and higher repatriation of profits for debt repayments, which reduced the scope for reinvesting earnings. The sectoral FDI structure is still dominated by real estate and renting, which made up 86 % of the total in January-October 2018. FDI inflows are projected to recover to 3.7 % of GDP in 2019, followed by another dip to 2.5 % in 2020, falling below one third of the current account deficit. In the third quarter of 2018, Kosovo’s net international investment position stood at -

1.7 % of GDP, practically unchanged from 2017. Reserve assets are on a declining trend, from 3.8 months of imports in 2017 to 3.5 in 2018, and are expected to fall further, to around 3 months, in 2019-2021.

Table 2:
Kosovo - Financial sector indicators

	2014	2015	2016	2017	2018
Total assets of the banking system (EUR million)	3 187	3 385	3 637	3 870	4 184
Foreign ownership of banking system (%)	90.4	90.1	88.9	88.1	86.8
Credit growth	4.2	7.3	10.4	11.5	10.9
Deposit growth	3.6	6.5	7.2	6.8	8.7
Loan-to-deposit ratio	74.2	74.7	77.0	80.3	81.9
Financial soundness indicators					
- non-performing loans	8.3	6.2	4.9	3.1	2.7
- net capital to risk-weighted assets	17.8	19.0	17.8	18.1	17.0
- liquid assets to total assets	43.6	44.9	41.5	37.9	39.1
- return on equity	22.5	29.1	19.7	21.3	20.2
- forex loans to total loans (%)	0.3	0.3	0.2	0.2	0.1

Sources: National Central Bank, Macrobond.

The banking sector accounts for the bulk of financial assets and remains stable, liquid and profitable, but fast-rising consumer and real estate loans require close monitoring. In January-October 2018, bank lending expanded by 11.6 % from a year before, supported by low interest rates, guarantees extended by the Credit Guarantee Fund for lending to SMEs, and strengthened contract enforcement. Lending to firms and households registered similar rates of growth (11.8 % and 11.4 % respectively). While the level of financial intermediation remains low and there is ample scope for credit deepening, the ERP rightly highlights the need to monitor high loan growth in certain segments, e.g. consumer loans, which strongly outpaced growth in nominal GDP and wages. While its policy toolkit remains limited mainly to minimum reserve requirements, the central bank (CBK) regularly monitors systemic risks and implements macro-prudential policy under a recently adopted framework. Banks have continued to be financed predominantly by deposits; the loan-to-deposit ratio was 83.9 % in October 2018. The proportion of non-performing loans (NPLs) reached a record low of 2.8 %² and the NPLs are fully provisioned. Risks in the banking sector remain contained and profitability is high, with an average return-on-equity ratio of 18.8 % in October. While insurance and micro-finance companies have become more active, they still account for only 7 % of total financial system assets.³ The ERP does not provide quantified forecasts for the financial sector, but the underlying assumption is of continuing credit growth, with private consumption and investment expected to remain the main drivers of growth.

¹ IMF 2018 Article IV Consultation.

² Improved asset quality, favourable economic conditions and accelerated lending activity partially drove the NPL reduction. However, the bulk of the decline appears to stem from accelerated write-offs, following amendments to the Regulation on credit risk management, which reduced the overall stock of NPLs.

³ The remaining 23 % of financial assets are held by the pension funds.

3. PUBLIC FINANCE

Despite the failure to implement the reform of the war veterans pension scheme, the deficit target for 2018 was comfortably met, as capital spending underperformed significantly. The ERP estimates the 2018 budget deficit at 1.1 % of GDP; while the IMF estimate is higher (1.5 %), both are still comfortably within the fiscal rule ceiling of 2 %⁴. The ERP and the IMF estimated the overall headline budget deficit at 2.8 % and 3 % of GDP, respectively. Revenues performed largely as expected, although growth in indirect tax revenues slowed to 2.1 % (from 7.2 % in 2017), due to weaker excise and VAT collection, and shortfalls in collection at municipal level. There were more significant deviations on the expenditure side. The failure to reclassify beneficiaries of the war veterans pension scheme in line with earlier plans resulted in spending in that category exceeding projections by some 0.3 % of GDP. Due to weak administrative capacities in capital project planning and management, the capital budget was significantly underspent (by 2.4 % of GDP), even though capital expenditure increased 14 % year on year.

The 2019 budget targets a fiscal deficit of 2 % of GDP, which is the upper limit allowed by the fiscal rule. It complies with the fiscal rules by keeping the wage bill constant as a share of GDP and the government's bank balance at 4.5 % of GDP. At the same time, the fiscal stance is expansionary, as the budget envisages a significant increase in both the headline deficit, which is projected to rise by around 3 percentage points (pps), to 6 % of GDP, and as measured according to the fiscal rule definition. The budget provides for a considerable increase in total spending (by around 4.5 % of GDP), driven by an acceleration in infrastructure investment financed by IFIs and privatisation receipts under the 'investment clause', which should raise capital spending by some 3 % of GDP. It also accommodates higher government consumption, social spending and public transfers, in particular higher (permanent) spending on pensions following sizeable increases in basic (20 %) and contributory (15 %) pensions. There are increased allocations to priority sectors such as healthcare, education and the judiciary. The budget relies on savings equivalent to 0.25 % of GDP from the reform of the war veterans pension scheme, for which it allocates EUR 57.9 million, or 0.8 % of GDP (i.e. slightly above the 0.7 % cap) on the basis of a reclassification of recipients. A projected significant increase in total revenues (1.2 % of GDP) is to be driven by indirect taxes, VAT and excise, which account for 76.5 % of total public revenues, reflecting higher total consumption. Substantial revenue gains of around 1 % of GDP should come from initiatives to improve tax debt collection and tax compliance, and from excise rises. Total public revenue and expenditure are set to grow by 7.2 % and 13 % respectively as compared with the 2018 budget, but by 10.2 % and 21.5 % as compared with the estimated 2018 outcome.

⁴ The fiscal rule places a cap on the fiscal deficit of 2 % of forecast GDP, excluding capital projects financed by privatisation proceeds and donors ('investment clause'). This exemption for donor-financed investments can be invoked until 2025, provided the public debt ratio remains below 30 % of GDP. As a part of the fiscal rule, the wage bill rule provides that the increase in the public wage bill cannot exceed nominal GDP growth. The government deposits used as fiscal buffers are legally required to stay at 4.5 % of GDP as long as the government is using privatisation proceeds. The debt rule provides that public and publicly guaranteed debt cannot exceed 40 % of GDP.

Box: The 2019 budget

- * The 2019 budget was presented in October 2018 and adopted in early February 2019.
- * It targets a deficit of 2 % of GDP in line with the fiscal rule definition.
- * Revenue: increase of excise on tobacco, improved collection of tax debt, increase in tax base due to economic growth and large imports of diesel cars.
- * Expenditure: increase in maintenance expenditure, primarily driven by the reclassification of existing spending, increase in subsidies and transfers due to higher pensions and higher number of beneficiaries in other schemes, higher capital spending financed by IFIs and privatisation proceeds.

Main measures in the 2019 budget

Revenue measures*

- Excise tax revenue: increase of EUR 19 million (0.3 % of GDP)
- Tax debt collection: increase of EUR 27 million (0.4 % of GDP)
- Tax compliance: gains of EUR 14 million (0.2 % of GDP)

Expenditure measures**

- Maintenance expenditure: increase of EUR 71 million (1 % of GDP)
- Subsidies and transfers: increase of EUR 74 million (1 % of GDP)
- Capital spending: increase of EUR 255 million (3.2 % of GDP)

* Estimated impact on general government revenues.

** Estimated impact on general government expenditure.

Source: ERP

The main objective in 2019-2021 is to maintain fiscal sustainability and compliance with the fiscal rule while addressing significant public infrastructure gaps. The fiscal strategy is frontloaded. Public revenue should rise by 1.2 pps to 27.4 % of GDP in 2019 and stay stable at 26.9 % in the 2 subsequent years. Non-tax revenue is projected to stay at roughly the same level (around 3 % of GDP). Like revenue, public expenditure is expected to surge in 2019 and grow moderately (by 2 %) in nominal terms on average thereafter. As a ratio to GDP, public spending is projected to increase by 4.5 pps to 33.4 % of GDP in 2019 and decline gradually to 32.2 % and 31.3 % in the 2 subsequent years. The resulting budget deficit, using the methodology of the fiscal rule, will be 2.0 % of GDP in 2019, 1.4 % in 2020 and 1.9 % in 2021, while the overall deficit is projected at 6 %, 5.3 % and 4.4 % respectively.

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

	2017	2018	2019	2020	2021	Change: 2018-21
Revenues	26.3	26.2	27.4	26.9	26.9	0.7
- Taxes and social security contributions	23.3	23.2	24.3	23.9	24.0	0.8
- Other (residual)	2.9	3.0	3.1	3.0	2.9	-0.1
Expenditure	27.5	28.9	33.4	32.2	31.3	2.3
- Primary expenditure	27.3	28.7	33.0	31.8	30.9	2.2
<i>of which:</i>						
Gross fixed capital formation	7.3	7.9	11.1	10.8	10.6	2.7
Consumption	12.1	12.5	13.4	12.8	12.5	0.0
Transfers & subsidies	7.9	8.3	8.4	8.1	7.7	-0.5
Other (residual)	0.0	0.0	0.1	0.1	0.1	0.1
- Interest payments	0.3	0.3	0.4	0.4	0.4	0.1
Budget balance	-1.3	-2.8	-6.0	-5.3	-4.4	-1.6
- Cyclically adjusted	-1.2	-2.5	n.a.	n.a.	n.a.	n.a.
Primary balance	-1.0	-2.5	-5.6	-4.9	-4.0	-1.5
- Cyclically adjusted	-0.9	-2.2	n.a.	n.a.	n.a.	n.a.
Gross debt level	15.5	16.2	19.4	22.9	25.1	8.9

Sources: Economic Reform Programme (ERP) 2019.

Public debt is increasing gradually and is mainly held by domestic public institutions.

While at end 2018 Kosovo's public debt stood at 16.2 % of GDP, which is moderate by regional comparison, high primary deficits are expected to drive a rise in the debt ratio to 25.1 % of GDP by 2021. The 2020 debt-to-GDP ratio will probably be 2.9 pps higher than projected in the 2018 ERP. Around 62 % of the debt is issued domestically and held by a narrow investor base consisting of Kosovo public institutions and banks, with the Kosovo Pension Security Trust and the CBK holding around 29 % and 30 % of domestic debt stock respectively. The international debt is held mainly by IFIs. The share of international debt is expected to increase, to 46 % of the total by 2021. The average weighted interest rate is set to decline gradually, from 2.4 % in 2019 to 1.7 % in 2021. The average maturity of domestic debt rose to 27 months at the end of 2018, from 20 months in 2017, as Kosovo has issued debt with longer maturities more regularly, including bonds with 7 and 10 years' maturity in 2018. Kosovo still does not have access to international debt markets due to the lack of an international credit rating, but the government is reviewing the debt law, which would include provisions regulating the access to international markets. Government deposits should remain at the legally required level of 4.5 % of GDP in 2019-2020 and decline to 3.4 % in 2021, which is technically in compliance with the rule but still implies a reduction of fiscal buffers⁵.

⁵ The underlying assumption for 2021 is that the liquidation funds of the privatisation agency (PAK) will have been spent by then.

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

	2017	2018	2019	2020	2021
Gross debt ratio [1]	15.5	16.2	19.4	22.9	25.1
Change in the ratio	1.5	0.6	3.2	3.6	2.2
<i>Contributions [2]:</i>					
1. Primary balance	1.0	2.5	5.6	4.9	4.0
2. "Snowball" effect	-0.5	-0.5	-0.4	-0.7	-0.9
<i>Of which:</i>					
Interest expenditure	0.3	0.3	0.4	0.4	0.4
Growth effect	-0.6	-0.6	-0.7	-0.8	-1.0
Inflation effect	-0.2	-0.2	-0.1	-0.3	-0.2
3. Stock-flow adjustment	1.0	-1.3	-2.0	-0.6	-0.9

[1] End of period.

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

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

Source: Economic Reform Programme (ERP) 2019, ECFIN calculations.

Debt dynamics

In line with sizeable budget deficits in 2019-2021, public debt is forecast to rise steadily to 25.1 % in 2021. Robust economic growth is expected to mitigate the increase in the debt-to-GDP ratio. The impact of interest rate payments and inflation are set to be marginal. In contrast, a substantial downward impact on public debt is projected from stock-flow adjustment for 2019 (not explained in the ERP).

Underestimating current expenditure and overestimating capital spending and revenue growth are the main fiscal risks in 2019-2021. The projected rise in the revenue ratio relies mainly on a narrowing of the tax compliance gap and collection of the tax debt. While clear targets have been set and measures have been taken to improve tax administration, the risk of missing the ambitious targets is significant. This risk is mitigated somewhat, as the 2019 budget includes contingency measures to adjust spending in the event of revenue shortfalls. On the expenditure side, the allocation for the war veterans pension scheme assumes that the reclassification of beneficiaries takes place, which is far from certain. If it does not, there will be a repeat of the budget overrun seen in 2018. Various additional social benefits for specific groups, such as the recently adopted pension supplement for Albanian teachers active in the 1990s, generous maternity benefits (currently under debate) and an early retirement scheme for the police add further uncertainty and potentially sizeable fiscal risks. On the other hand, the projected major increase in capital spending in 2019 (48 % more than the 2018 outcome) seems overly ambitious given the track record of implementation in previous years. Overall, the budget composition could turn out much less favourable to growth than envisaged, with higher current spending, including social transfers not targeting poverty reduction, and lower capital expenditure. Additional fiscal risks stem from the poor management and financial performance of publicly owned enterprises.

While the ERP rightly acknowledges fiscal risks relating to new social transfers and revenue underperformance, it is silent on the Law on salaries for public employees (adopted in February 2019). The ERP projects the public wage bill to grow by 4.2 % on average in 2019-2021, which is in line with the rule capping its growth at the rate of nominal GDP growth. As the overly generous new Law on salaries will only take effect towards the end of 2019, the fiscal impact this year will be manageable. However, the full implementation in 2020 could result in the rule being breached unless mitigating measures are taken⁶. To address this risk, the Ministry of Finance is working on secondary legislation to limit allowances and cancel vacant positions in order to comply with the wage bill rule. Containing

⁶ A further repercussion is that a higher basic wage in primary education will also raise teachers' pensions, so that the allocations for 2019-2021 will be exceeded.

public wage growth is all the more important as public-sector salaries already significantly exceed private-sector wages and are detrimental to the competitiveness of the economy.

The arrangements for financing Kosova e Re, the costs of which are estimated at over EUR 1 billion, give rise to further fiscal risk. Kosovo has signed a commercial agreement with a US private investor, which is currently conducting the tendering process for engineering, construction and long-term maintenance works. The World Bank has decided not to go ahead with a planned partial loan guarantee. If the government supports Kosova e Re with financing or a guarantee, including a purchase price guarantee, this would have a significant impact on public debt, which was EUR 1.1 billion in 2018 (16.2 % of GDP). A large increase in public debt would also have repercussions for the ‘investment clause’, which can be invoked only if debt remains below 30 % of GDP. Therefore, public support for Kosova e Re would significantly reduce the fiscal space available for other projects.

The existing system of fiscal rules provides the main anchor for fiscal policy while safeguarding high out-of-budget capital spending. The adjusted deficit rule caps the fiscal deficit at 2 % of forecast GDP, excluding capital projects financed by privatisation proceeds and donors. This exemption for donor-financed investments can be invoked until 2025, provided public debt remains below 30 % of GDP. The overall debt-to-GDP ratio is capped at 40 % of GDP. As part of the fiscal rules, the wage rule limits wage bill growth to the nominal GDP growth rate from 2018. A further constraint on current spending is a limit on war veterans pension expenditure corresponding to 0.7 % of GDP annually; this has yet to be implemented due to the failure to reclassify recipients. While the authorities remain committed to adhering to the fiscal rules, recurrent pressure from various interest groups for more entitlements and transfers, and the tendency to yield to such pressure to win political support create risks and uncertainty on a regular basis.

4. STRUCTURAL CHALLENGES AND REFORM PRIORITIES

Kosovo has been improving its business environment in recent years and slowly diversifying exports. However, its manufacturing base continues to be limited, resulting in a persistent trade deficit. Attracting more investment to reach higher growth rates will be needed to improve living standards towards EU levels. This will require continuous implementation of structural reforms across many sectors. The Commission has conducted an independent analysis of Kosovo’s economy and identified the main structural challenges to competitiveness and inclusive growth, drawing on Kosovo’s own ERP and other sources. The analysis highlights a number of structural challenges across many sectors. The three most important ones are: (i) increasing activity and employment levels; (ii) tapping renewable and energy saving potentials and fully opening the energy market and (iii) formalisation of the economy - the energy sector suffers from outdated production capacity, low energy efficiency and a not fully liberalised energy market and a tariff system that does not yet reflect real costs.

4.1. Key challenges

Key challenge #1: Increasing activity and employment levels

Kosovo's socioeconomic development is not advancing, since the labour market is not expanding. Very low activity and employment levels and the marginal presence of women in the labour market are some of the most striking challenges, next to pervasive informal employment and poor job quality in the private sector. Despite steady economic growth, the situation has not changed in recent years and will not do so unless a more comprehensive approach to economic development with creation of new jobs is considered. Skills mismatch also hinders a more sustained labour market expansion, while at the same time increasing

numbers of young people are trained for taking up employment abroad. Social expenditure is largely concentrated on categorical benefits and pensions, with limited investments in human capital.

Key challenge #2: Formalisation of the economy

The widespread informal economy represents a major structural weakness. The most recent EU-supported assessment (2017) showed that it represents around 31.7 % of Kosovo's GDP with an estimated breakdown of 23.5 % of GDP for the 'grey economy' (legal but undeclared activities) and 8.2 % for the 'black economy' (illegal activities). A 2014 study estimated that the informal economy constituted 32.7 % of GDP, so it shrank only marginally in those three years. The reduction was bigger in the grey economy, which indicates that more progress was made in public financial management than in law enforcement, especially since most informality consists of undeclared revenue and work rather than unregistered businesses. The reduction in the grey economy was a result of more effective tax administration by both tax and customs authorities. In contrast, the black economy grew in absolute terms (by EUR 35 million) thus outweighing the shrinking of the grey economy. Informality is also a significant problem in terms of employment. Estimations on informal employment range between 30 and 40 %. Agriculture is the economic sector that relies most on informal employment, followed by real estate, construction and wholesale trade.

A wide range of factors contribute to informality. The tax burden in Kosovo is low compared with other countries' (in order to attract FDI dividends are tax-exempted), and is not seen as a major contributor to informality. Similarly, Kosovo ranks 44th in the world for ease of paying taxes, better than both BiH (139th) and Albania (122nd), for example. Instead, factors that contribute to informality seem rather to be institutional weaknesses in the updating and exchange of business information, the burden inspections place on formal companies and the large number of licenses and permits that businesses face. Also, the low trust in government and the perception of poor quality in public services such as healthcare and education discourage tax compliance.

Informality has many adverse effects. It creates unfair competition for formal businesses, limiting their opportunities for expansion and further investments in their development, innovation and productivity. It also reduces the opportunities associated with formal employment, including job security and safety at work. According to the latest *Business environment and enterprise performance survey* (BEEPS V) survey, competitors' informal activity is seen as the major obstacle to doing business in Kosovo. In all, 66 % of firms reported that having to compete against firms in the informal sector was as a major issue, the highest among all 30 countries covered in BEEPS V (the average was 39 %).

Government efforts to combat informality have focused on the revision of the strategy and action plan, expected to be adopted in April 2019. Kosovo adopted its first strategy and action plan for preventing and combating the informal economy in 2014; it focused on the development of a legal framework, in particular in the area of anti-money laundering. The more precise qualitative and quantitative indicators in the revised (2019-2022) strategy action plan should improve the monitoring of progress. In particular, regular assessments of the 'tax gap' should guide efforts to combat the informal economy. The latest (2017) assessment found that the biggest part of the effective tax gap was in personal income tax (56.2 %) followed by corporate income tax (32.2 %) and VAT (11.6 %). The Kosovo Statistics Agency (ASK) is studying informal activities in four sensitive sectors: transport, retail trade, construction and accommodation. This should further help the government formulate the most effective policy response.

Key challenge #3: Tapping renewable and energy saving potentials and fully opening the energy market

Kosovo's competitiveness continues to be hampered by the unreliable and undiversified energy supply. The outdated power system essentially relies on two old, inefficient and highly polluting lignite thermal power plants with total installed capacity of 1 560 MW,⁷ and covering around 92 % of electricity production. Electricity demand and consumption have grown steadily over the years. This, together with the ageing of the power plants and insufficient flexibility to adapt to consumption in peak periods, means that electricity has to be imported and exported to balance the system⁸. While net imports were only 366 GWh in 2018, imports (1 242.2 GWh) and exports (876.2 GWh) were both quite sizeable.

The duration and frequency of power outages have been reduced⁹, but the reliability of the energy supply is still well below average for Europe and Central Asia. Kosovo ranks 113th in the world for ease of getting electricity (World Bank, 2019). The lack of energy security gives rise to significant costs for business and represents the biggest obstacle to attracting high-quality FDI. According to the last BEEPS V, firms perceive the unreliable electricity supply as the second biggest obstacle to doing business in Kosovo. The resultant fiscal burden is higher for micro-enterprises (44.5 % of average annual turnover) and small businesses (21 %) than for medium enterprises (3.9 %) and large businesses (1.8 %).

Kosovo has not diversified its energy production mix and new generation capacities continue to rely on coal. The planned construction of Kosova e Re (450 MW), at a total estimated cost of over EUR 1 billion will mean that the 50-year-old, highly polluting Kosovo A power plant can be closed. Kosovo is on track to meet the mandatory target set by the Energy Community of 25 % of renewable energy sources (RES) in gross final energy consumption by 2020 (ASK): the RES share was 23.59 % in 2017. However, this has been achieved mainly by revising the definition of RES to include biomass for heating, which is widely used by household customers, rather than any substantial investment in renewable energy. The Energy Community is expected to adopt new renewable energy targets for 2030, in line with the EU's targets and this will require substantial additional efforts from Kosovo.

The government is investing in renewables, but its support should be made more cost effective. The revised measure in the ERP involves building 28 new small hydro power plants (with total capacity of 99.6 MW) and implementing five new wind energy projects (137.4 MW) and two solar energy projects (3.4 MW). This is certainly welcome, but considering the declining costs of renewable energy, Kosovo could advance much further in its RES targets by adopting competitive selection processes for its renewable energy support.

Another key to overcoming the challenges relating to the energy supply is further investment in energy efficiency. Distribution losses remain high if compared by regional standards (technical losses of 12.75 % and commercial losses of 8.82 % produced total losses of 21.57 % in 2017). Moreover, investment in and maintenance of the distribution network remain low. The Law on energy efficiency and the EE Fund respond to the policy guidance jointly adopted by Kosovo and the EU in May 2018 and should improve the situation. However, Kosovo would benefit from further energy efficiency incentives to households and private sector (which account for 39 % of the final electricity consumption). It would also

7 The operational capacity is nevertheless only around 1,038 MW (Kosovo Energy Corporation -KEK).

8 Total production of electricity in 2017 was 5,300 GWh, with an electricity balance of around 90.96 %.

9 The system average interruption duration index (SAIDI) was 13.9 in the *World doing business report* (WDB) 2019, as compared with 62.1 in WDB 2018; the system average interruption frequency index (SAIFI) was 8.9, as compared with 34.7 in 2018.

benefit from a comprehensive action plan to address inefficient (and highly polluting) heating based on solid fuels (coal and firewood), which do significant harm to public health and the economy, and would also benefit from better energy efficiency statistics.

There is no open trading in the electricity market and energy tariffs do not yet fully reflect costs. While Kosovo has made some progress in phasing out cross-subsidies between different categories of customers, the retail market is still only partly deregulated (for the supply of high voltage customers). The contractual framework for the construction of Kosova e Re, whereby a single buyer will purchase the electricity produced by the plant, could be detrimental to market opening. Kosovo has the lowest electricity prices for households in the Western Balkans: EUR 5.9 per 100 kWh in the first half of 2018, as compared with a regional average of EUR 8 and an EU average of EUR 20.4 (Eurostat). In order to mitigate the expected upward pressure on prices from the significant investments required in the sector, Kosovo needs to develop a programme for protecting vulnerable customers in line with Energy Community requirements.

Regional integration in the energy sector is prevented by the unresolved dispute between the transmission system operators of Kosovo and Serbia. This is blocking the entry into force of the connection agreement reached in the Dialogue between Pristina and Belgrade and the use of the 400 kV connection between Kosovo and Albania completed in June 2016 (with an investment of EUR 35 million). This imposes significant losses on the Kosovo operator (KOSTT) and threatens the security of regional transmission networks.

4.2. Labour market, education and social policies

Labour market developments

Labour market performance lags considerably behind the region and the EU, with no sign of a positive trend. Economic growth has not contributed to employment; the continued growth of the working age population is putting pressure on the labour market and is only partly absorbed by emigration. In 2018 the labour force participation rate fell to 40.9 % from 42.8 % a year before. Participation by women stood at only 18.4 %, and a third of economically active women are unemployed (33.4 %). The overall employment rate stood at 28.8 %, as compared with 29.8 % in 2017, while the wide gap between male and female employment rates (45.3 % and 12.3 % respectively) persisted. The unemployment rate slightly fell to 29.6 % in 2018, from 30.5 % in 2017. High youth unemployment increased further and reached 55.4 % from 52.7 % in 2017. The ERP does not provide forecasts for employment growth or the unemployment and activity rates; however, with large annual inflow of young people to the labour force and so far modest employment growth, large changes in the labour market outcomes are unlikely.

Further consolidation of Kosovo's labour force survey (LFS) may be necessary. A survey conducted by the Millennium Challenge Corporation (MCC) in 2017 using the same EU labour force survey as Kosovo (but on age group 15-74) resulted in showing a significantly higher labour market performance (which may even be higher if calculated for age group 15-64). MCC calculated the activity rate at 49.6 % (+7 pps vs LFS), the employment rate at 41.1 % (+11 pps.) and overall unemployment at 16.3 % (-13 pps). The difference between MCC and LFS results is particularly marked for youth, at 29.2 % it is calculated over 20 pps lower than LFS.

The labour market is characterised by strong gender segregation. Only a small percentage of women have jobs (2018: 12.3 %), the gender employment gap over 32 pps is among the widest in Europe. Female employment is highest among women aged 35-45 (2018: 16.7 %), while male employment is highest in the age group 45-54 (2018: 65.9 %). Work on a

strategic approach to encouraging the entry of women into the labour market is at an early stage. The proportion of young people not in education, training or employment (NEET) is exceptionally high at 30.1 % (2018), well above the regional (2017: 23.5 %) and nearly three times higher than the EU average. There is a strong correlation between employment and education level. Around 66 % of tertiary graduates are employed and they account for 60 % of public sector employees. Secondary graduates are the largest group (43.7 %) in private sector employment.

The establishment of the Employment Agency (EARK) has been an important step in rebuilding the public employment service. Counselling services for jobseekers have been in place since 2017 and have reached around 100,000 a year. The provision of training measures is limited due to budget constraints, but around 6,000 mostly medium qualified jobseekers received training at vocational training centers. The EARK budget for active labour market policies will amount to EUR 6.6 million in 2019, including the reintegration fund for citizens returning to Kosovo. No consolidated information is available on the overall amount of active labour market measures provided in Kosovo in multiple donors' projects, few of which are coordinated with EARK. First steps have been taken to develop a specific support for young people with the youth employment action plan.

Low economic development and a lack of growing firms impede the creation of quality jobs. Most formal employment is based on temporary contracts (2018: 74.5 %), only 25.5 % of all workers in the labour market have a permanent contract, primarily in the public sector. Informality is a defining labour market feature; estimates of its scale range between 30 % and 40 %, depending on the definition used. The problem is complex and includes work without a contract and/or without social security coverage, but also a substantial proportion of underdeclared work.

Social dialogue is poorly developed, in particular in the private sector. Workers' fundamental rights are well established in the public sector only. Private-sector workers are *de facto* not represented by trade unions. A number of business confederations represent mostly the interests of larger (foreign) employers, while over 90 % of registered companies are micro-enterprises with fewer than 10 employees. The general collective agreement negotiated in 2014 is not being implemented, but negotiations for a new agreement have started. A protracted conflict over the composition of the Economic and Social Council (ESC) is to be solved by amending the law governing the ESC, but there have been no concrete developments to date.

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

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

On most of the principles of Pillar, Kosovo performs considerably below the EU average according to the indicators of the Social Scoreboard¹⁰. To some extent this is inevitable, since Kosovo is poorer than the EU Member States and the other countries in the region, but points to an urgent need for more effective and

substantial policy reforms to improve socioeconomic conditions for the population.

Women and young people have a very marginal presence on the labour market. The potential of a large young population to boost growth and employment is not utilised; rather, the high pressure on the labour market is absorbed by emigration.

Investments in the education system, in particular the early stages, is very limited. The vast majority of children under 5 receive no formal early childhood education. However, the situation has improved considerably for 5-6-year-olds, most of whom have access to pre-school education, albeit only a few hours of curricular activities per week.

Kosovo's performance on social inclusion, social protection and poverty alleviation is mixed. Social expenditure is largely concentrated on administering a wide and increasing range of categorical benefits. Financial and other social assistance to the poorest segments of the population is still limited. There is no comprehensive strategy for poverty reduction.

The statistical system is at an early stage of development. KAS conducts a quarterly Labour Force Survey based on EU methodology. The quality of the data needs to be improved. Statistics on the social situation are not yet developed in line with EU surveys. Specific challenges exist with regard to establishing indicators based on population data, e.g. in the area of education.

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

10 The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The 12 indicators are also compared for the Western Balkans and Turkey. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around EU-28 average) and a review of the trend for the indicator based on the latest available 3-year period for the country (improving/deteriorating/no change). Data from 2014-2017 are used.

Social Protection System

Kosovo has very high poverty rates by EU and regional standards. Data based on EU methodology will become available when the results of the EU survey on Income and Living Conditions (EU-SILC) conducted by KAS for the first time in 2018 are released. Poverty levels measured on the basis of income are high and growing, while consumption-based numbers indicate lower and declining poverty thanks in no small parts to remittances. Overall, international surveys show higher poverty rates than domestic figures. The most recent MCC survey (2017) established an at-risk-of-poverty rate of 36.5 % (around 10 pps above the level for the regional as a whole). Kosovo's Household Budget Survey (2015) indicated a rate of 27.9 %. These are rates before social transfers and tend to drop slightly when social transfers are included. Poverty is more widespread among the rural population, families headed by women, individuals with low education levels and smaller ethnic minorities.

The level and structure of social spending is not addressing the needs of the poorest. In 2018, spending on social transfers (6.1 % of GDP) was well below regional levels, but the scale was less problematic than its structure. The biggest proportion of domestic social spending (90 %) is on complex categorical pension schemes, while only 10 % is available for social services and social assistance benefits. In 2018, the government started work to reform the system of pensions and benefits, but did not focus on limiting the further expansion of categorical pensions. The impact of cash social assistance on lowering the number of individuals at risk of poverty and social exclusion is marginal (latest available data: 0.9 % in 2015), while the impact of pensions (11.8 % in 2015) and other categorical social benefits (13.6 %) was considerably higher.

The provision of early childhood education and care is scarce. Estimates for all types of public and private pre-school education for children under 5 vary between 1 % and 13 %. Almost no free public childcare is available; this has a significant impact on access for children from vulnerable backgrounds and is also reflected in a clear rural-urban divide.

Work started in 2018 on improving the framework legislation on early childhood education. New legislation is planned to improve the regulatory framework for public and private education providers and the inclusion of vulnerable groups (ethnic minorities, disabled children). However, it is not backed by sufficient investment in infrastructure, which is currently very low. Education and training for specialised pre-primary staff have been introduced slowly since 2017-18.

Education and skills

The links between education and the labour market are weak. Basic education outcomes are low as demonstrated by PISA 2015 results ranking Kosovo in the bottom zone of student performance. Enrolment in basic education has generally improved, but there are still significant gaps in completion rates. Ethnic segregation, disability, economic conditions and traditions constitute barriers to access to education for children. Educational institutions at both secondary and tertiary level are not yet in a position to provide the labour market with a skilled workforce matching labour market needs. Skills needs for fostering private sector development are not yet clearly defined. The fact that young people tend to seek employment abroad hampers Kosovo's long-term development and perpetuates its dependency on remittances.

Insufficient financial and institutional capacities are delaying implementation of Kosovo's strategic plan for education. Kosovo's national qualifications framework was established in 2011 and formally referenced to the European Qualifications Framework (EQF) in 2016. To date, the managing authority has validated 94 medium-level qualifications offered

by 37 accredited providers. However, the practical impact of validations remains limited, as the education and training system is insufficiently prepared to deliver the qualifications.

The quality of teaching is low in most vocational schools. Suitable teaching and learning materials are available for only a fraction of training profiles. Discussions in the past 2 years on developing a new core curriculum have remained inconclusive. Local companies have very limited capacity to offer students placements for practical training. Numerous initiatives have been taken in recent years to modernise vocational education and training (VET), but their scope, results and systemic impact remain unclear. As yet, there is no proper diagnosis of what needs to be done to reform and develop the VET sector. Doing so would ensure that domestic efforts and donor support are strategically geared towards commonly established objectives.

Adult participation in life-long learning is very low and decreasing. In 2017, it amounted to about 4 %. Measures for the upskilling and reskilling of adults are limited to a small number of active labour market measures and donor initiatives. There is a lack of robust initiatives that would contribute to socioeconomic development, given the low level of skills in the adult population.

4.3. Competitiveness and sectoral issues

Business environment

Despite recent improvements in access to finance and the ease of doing business, Kosovo continues to be the least sustainable market economy¹¹ in south east Europe (SEE); in particular it is less competitive than the SEE average (EBRD, 2018). Key weaknesses in the business environment continue to be unfair competition from the informal sector, unreliable access to electricity, weak rule of law and corruption. Firms are particularly concerned about competition from the informal sector and access to electricity (BEEPS V, 2015). The ERP acknowledges these obstacles and in the past few years Kosovo has adopted more best practices in business regulation and recorded good progress in the World Bank *Doing Business Report*, moving from 117th (out of 190) in 2012 to 44th in 2019 (in spite of a small drop from the 40th place in 2018). It ranks particularly high in ‘ease of securing a loan’ (12th) and ‘starting a business’ (13th). However, other aspects of the operational environment for businesses, such as the cumbersome inspections and the high number of licences and permits, remain a challenge.

The effective application of the rule of law is key to improve the business environment. Effective and independent judicial systems are a prerequisite for an investment- and business-friendly environment as they instil confidence throughout the business cycle. Effective measures to strengthen the rule of law, ensure adequate and timely contract enforcement and increase the transparency of legal changes could improve the business environment in Kosovo and thus enhance productivity and competitiveness. Corruption is an issue of concern and should be addressed as a priority to make Kosovo a more attractive place to do business.

Micro, small and medium-sized Enterprises (MSMEs) dominate the real sector and still face some challenges in terms of access to finance despite recent improvements. MSMEs account for 65 % of employment (micro-enterprises alone provide 36 % of total employment), but upscaling of existing firms is needed to create jobs in the private sector. However, upscaling efforts are hampered by the relatively low credit penetration given the income level (with a private-sector credit-to-GDP ratio of 40 % in 2018).

¹¹ Defined by six qualities: competitive, well-governed, green, inclusive, resilient and integrated.

Research, development and innovation (RDI)

Kosovo's capacity in the research, development and innovation (RDI) sector continues to be very limited. This is linked to a weak RDI policy governance, limited involvement of the private sector and poor cooperation between business and academia. In spite of the creation of a Ministry of Innovation and Entrepreneurship in Kosovo in 2017, the limited coordination with other Ministries and the very low level of public expenditure (0.1 % of GDP compared to an average of 2 % in the EU) reflect weak political commitment to RDI. While there are no statistical data on private business spending on R&D, MSMEs' ability to create new competitive products and services is limited. The ERP recognises these weaknesses and proposes improving the legal environment for RDI and providing more funding. This is welcome. Kosovo is not yet participating in Horizon 2020, but in 2018 it committed itself to developing a smart specialisation strategy, which could help to focus RDI efforts on the areas of Kosovo's economy that offer the greatest potential for growth.

Digital economy

The Government is making efforts to move to a digital economy. The 2013-2020 Digital Agenda for Kosovo is being implemented and targets are being met. Mobile telephone penetration has reached over 112 % and fixed broadband penetration increased from 48.5 % in 2012 to 93.90 % in the second quarter of 2018. The challenge is now to extend coverage in rural areas. However, the wider use of e-signatures and the digitalisation of the economy in general require an updated enabling legislation. Cybersecurity remains a problem with the Regulatory Authority of Electronic and Postal Communications (RAEPC) clearly lacking adequate financial and human resources. To meet the Digital Agenda for Europe 2020 targets, Kosovo will receive private investment and a EUR 21.1 million loan from the World Bank to upgrade its digital economy. The recent agreement on the gradual removal of roaming prices in public mobile communication networks for all end users is a positive step towards the creation of a regional digital space in the Western Balkans region. This will offer new possibilities for Kosovo's youth, which is also important in light of the high youth unemployment.

Investment activity

FDI in Kosovo has fluctuated over the past 10 years, but the long-term trend is down. Initially (2007-2011) the privatisation process of socially-owned enterprises attracted significant investment, but since 2012 FDI has shifted to less productive sectors such as real estate and construction (95 % of the total FDI inflows in 2018). This has been driven mainly by the purchase of real estate by Kosovo's diaspora, and by public investments. FDI fell further in 2018, by 16 % as compared with the same period in 2017. The reasons include higher repatriation of profits and debt repayments as well as net FDI outflows in construction and manufacturing. The main sources of FDI in 2018 were Switzerland (33 %), Germany (28 %), Albania (11 %) and the US and the UK (6 % respectively).

Net FDI inflows in Kosovo (estimated at 2.7 % of GDP in 2018) is lower than the regional average (5.5 % of GDP). There is potential to attract more FDI: Kosovo has a good strategic location, a young population and relatively low labour costs. However, the recent imposition of a 100 % tariff on all imports from Serbia and BiH puts in question Kosovo's commitments to international agreements and may have long-term consequences for the investment climate. Among other key issues affecting FDI are a lack of basic infrastructure and of stable electricity supply, poor education skills, a weak rule of law, corruption and the slowdown in the privatisation process.

Trade performance

Kosovo is highly reliant on imports with a persistently high trade deficit (28.5 % of GDP in 2018 when exports accounted for only 26.4 % of GDP). The trade deficit is particularly high in commodities, where it continues to grow, reflecting a weak production base and a lack of international competitiveness. Kosovo exports crude materials and low-added-value products, and imports a wide range of consumer and capital goods. In 2017, its goods exports represented just 5.9 % of GDP, while goods imports amounted to 44.3 %. Its exports face a number of obstacles including non-tariff barriers in the region (some linked to its status), and high administrative costs. It takes a Kosovan exporter over 2 days (59 hours) to comply with border and documentary formalities at a cost of EUR 232, as compared with an average of 10 hours and EUR 127 in the other five Western Balkan economies (World Bank, 2019). Exports are also hindered by an underdeveloped quality infrastructure.

Exports are nevertheless slowly diversifying: in particular, exports of services (which produced a positive balance of EUR 770 million in 2018) helped to partly offset the persistent goods trade deficit. Base metals and mineral products accounted for 48 % of Kosovo's total exports. As in previous years, imports are dominated by mineral products (15 %), processed industrial foodstuffs, beverages and tobacco (12 %), transporting means and vehicles, and equipment. The EU and Central European Free Trade Agreement (CEFTA) parties are Kosovo's main trade partners. The EU accounts for 49 % of imports and 30 % of exports, and 99,6 % of Kosovan products can access the EU market without customs duties. CEFTA parties account for 25 % of imports and 47 % of exports. In 2018, the main export destinations were Albania, North Macedonia and India while the main sources of imports were Serbia, Germany and Turkey.

Kosovo is encouraged to implement all the aspects of the Regional Economic Area Multi-Annual Action Plan (REA MAP). The REA MAP is based on EU standards and will facilitate Kosovo's integration in regional and European value chains and will also help increase the attractiveness of the economy for FDIs in tradable sectors.

Transport

While underdeveloped, the transport links are less of a constraint to Kosovo's competitiveness than other sectors. Although the transport and storage sector makes only a small contribution to employment (2.7 %), it contributes 6 % of gross added value (GVA). Kosovo's 2015-2025 sectoral and multimodal strategy and action plan analyses each mode of transport and proposes investments in roads, railways and multimodal transport. In the past years investment has been primarily focused on road infrastructure rather than other modes of transport, without a proper balance of resources devoted to the maintenance of roads and railway networks.

However, there are early signs of modal diversification into railway. The maintenance of rail infrastructure has long suffered from low revenues and declining passenger demand (although freight transport by rail has increased in the past 2 years). As a result, only one private operator is licensed in addition to the public one even though a legislative basis has been adopted for opening the railway market. Further connectivity with neighbouring countries in transport and energy would further strengthen the access to, and integration in, the regional market. In February 2019, Kosovo signed a contract for the rehabilitation of Route 10 (a 146 km track linking southern and northern Kosovo), which will be the biggest investment in Kosovo's railway in four decades (around EUR 200 million). When refurbished, Route 10, which is part of the core network, will facilitate internal and regional transport. Aviation is hampered by Kosovo's status and its limited participation in

international civil aviation bodies (International Civil Aviation Organisation, Eurocontrol etc.).

Agriculture

Kosovo's agriculture suffers from low productivity, even by regional standards. The sector's contribution to GVA is shrinking (from 14 % in 2009 to 9 % in 2017). Combined with its increasing share of employment in recent years (from 2.3 % in 2015 to 4.4 % in 2017) this suggests a decrease in productivity, although this could also be linked to reduced informality. The low productivity is related to a lack of investments in modernising production and to continued land fragmentation (almost 95 % of farms are smaller than 5 ha and only 1.6 % exceed 10 ha). Poor irrigation infrastructure is another major issue, as are the dysfunctional links between primary producers, processors and the market. There is also a lack of specialisation, as most farms are engaged in subsistence farming, producing several crops, vegetables and animal products at the same time.

The government seems to lack a clear vision for land consolidation. The underlying problems hampering the proper use and consolidation of agricultural land include its continued use of agricultural land for construction, property issues, and a reluctance to join agricultural cooperatives. However, most government intervention ignores these issues and consists instead of direct subsidies for agricultural production and food processing facilities. The support schemes would benefit from a more holistic approach to developing value chains and integrating them in export markets.

Industry

Kosovo's industry is characterised by low added-value and low diversification. The sector is dominated by MSMEs with low levels of integration in global value chains, innovation and FDI. In 2017, the manufacturing sector represented 10.9 % of Kosovo's GVA (slightly below the regional average of 12 %). Food processing represented the highest share in terms of employment (21.8 %), number of enterprises (26.2 %) and turnover (21.8 %), followed by the production of non-metallic mineral products. However, basic raw materials and mineral products still account for 55 % of Kosovo's exports followed at some distance by prepared foods, beverages, alcoholic beverages and tobacco (9.7 %).

Many structural problems are hindering industrial development. There is no comprehensive policy framework and only weak support services for SMEs. Inter-ministerial coordination in this policy area is very weak and responsible institutions such as Kosovo investment and enterprise support agency (KIESA), lack capacity. The emergence of industrial clusters is hampered by the lack of an overall vision based on a solid needs assessment. A number of business parks and economic zones have been identified and are promoted as industrial clusters, but many suffer from under-use and under-investment. Poor cooperation between companies and educational and research institutions and the generally low level of skills in the labour force lead to low production capacities and a lack of product quality and innovation.

Services

The services sector is the largest in the economy and an even larger contributor to employment; it also accounts for an increasing share of Kosovo's trade. It contributes 71.9 % to GDP, 81.2 % to employment and 39 % to total trade. 86 % of registered firms are active in the services sector and they generate 87.3 % of firms' total turnover in the economy. Employment in services is concentrated in wholesale and retail trade, construction, accommodation and food services, education and health services, and public administration. Services are also the fastest growing export sector, with a trade surplus (14 % of GDP in

2018) which has partly offset the trade in goods deficit. Around 80 % of services exports are ‘travel services’, mostly linked to Kosovo’s diaspora, and 8 % are ‘other business services’. Unfortunately, the ERP fails to provide any proper analysis of the services sector as a whole and merely refers to some general obstacles as regards tourism.

Information and communication technology (ICT) has started to play an increasing role in Kosovo’s economic growth. According to the 2018 Kosovo IT barometer, 74 % of IT companies export their services and products (16 % increase from 2017). However, the ICT sector still ended 2018 with a negative trade balance. However, it is not the growth of exports in the ICT sector itself that will lead to sustainable economic growth, but the application of digital solutions in the wider economy (e.g. energy supply, finance, agriculture). An organic growth of the ICT export sector could also help create an additional edge in the business model of Kosovo’s economy, and contribute to economic growth. The World Bank’s ‘KODE’ (Kosovo digital economy) project is one of the initiatives tackling the issue of how to apply digital solutions in the wider economy, which it is addressing through support for internet connectivity and skills. There is also a shortage of skilled and qualified workers (78 % of IT companies complain about this and 92 % claim that their businesses are affected by brain drain).

A major limitation for the services sector are the inadequate arrangements with neighbouring countries for the mutual recognition of professional qualifications. To make things worse, Kosovo suffers from discriminatory requirements based directly or indirectly on the nationality of providers or their staff or, in the case of companies, the location of the registered office. There are regional efforts to create a regional economic area that could stimulate growth by facilitating further specialisation in each economy and access to economies of scale. However, Kosovo is currently not playing a constructive role in this effort with its imposition of 100 % tariffs on goods from Serbia and BiH.

ANNEX A: IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2018

Overall: Partial implementation (41.7 %) ¹²	
2018 policy guidance	Summary assessment
<p>PG 1:</p> <p>Enhance the institutional capacities and ensure appropriate staffing at the Ministry of Finance in order to improve macro-fiscal planning, forecasting and fiscal impact assessments.</p> <p>Prepare an options paper on the establishment of an independent body for fiscal oversight for further consultations with stakeholders, including the EU.</p>	<p>There was partial implementation of PG1:</p> <p>1) Partial implementation: In 2018, the Ministry of Finance (MoF) recruited three additional staff members, bringing the total to five economists in the macro unit (excluding the director), and it plans to recruit two more in 2019. They have attended a number of training courses.</p> <p>2) Limited implementation: The MoF has set up a working group to work on the options paper. It consists of representatives of various institutions (including ministries, the CBK and the statistics office) and civil society; it has held several meetings to discuss practices in neighbouring and EU countries. However, the paper has yet to be produced.</p>
<p>PG 2:</p> <p>Complete the war veteran certification and reclassification processes with a view of decreasing costs of the war veteran pension scheme in line with the current legislation.</p> <p>Strengthen institutional capacities at central and local government levels for multiannual investment planning, and investment project preparation and management in order to improve the execution of capital spending.</p>	<p>There was limited implementation of PG2:</p> <p>1) Not implemented: The reclassification has not been done and is long overdue. The 2019 budget plans for this scheme to cost around 0.7 % of GDP in 2019, which is the ceiling laid down in the Law on war veterans. However, the ceiling only enters into force after the reclassification is finalised. Without it, the allocated funds will not be sufficient and budget overruns are set to continue.</p> <p>2) Limited implementation: The MoF has prepared two administrative instructions (AIs) that will help authorities improve the planning, selection, execution and monitoring of capital projects; the AIs on ‘the definition of capital projects’ and ‘selection criteria for capital projects’ apply at both central and local government levels. They are currently undergoing public consultation. The 2019-2021 ERP does not report on the implementation of this measure.</p>
<p>PG 3:</p> <p>Continue expanding the central bank’s analytical toolkit by developing an inflation expectations survey.</p> <p>Ensure that central bank purchases of government bonds and bills on the secondary market do not amount to de facto central bank financing of the government.</p> <p>Further address the underlying legal and institutional factors hampering access to finance for SMEs, while monitoring carefully high lending growth to households.</p> <p>Finalise the bank resolution and the crisis management frameworks to strengthen the overall resilience of the banking sector.</p>	<p>There was partial implementation of PG3:</p> <p>1) Limited implementation: A survey has not been established and the CBK is still investigating its design.</p> <p>2) Limited implementation: In the ERP, the CBK states that ‘CBK investment is guided by the Law on the Central Bank and its internal investment policy’. More transparency on any thresholds or directives indicated in the CBK’s investment guidance would help.</p> <p>3) Partial implementation: The Kosovo Credit Guarantee Fund is used extensively by commercial banks, but regulatory and judicial bottlenecks continue to hamper SMEs’ access to finance.</p> <p>4) Partial implementation: The CBK has finalised the bank resolution and liquidation manual, and is currently working on the crisis management framework.</p>

¹² For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission’s Overview and Country Assessments of the 2017 Economic Reform Programmes available at https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en.

<p>PG 4:</p> <p>Adopt the Energy Efficiency Law and establish the Energy Efficiency Fund.</p> <p>Adopt energy efficiency incentives to the private sector and households.</p> <p>Advance in the deregulation of electricity supply prices and</p> <p>Conclude a study with the aim of adopting a plan for the gradual adjustment of energy tariffs to reflect actual costs.</p>	<p>There was partial implementation of PG4:</p> <p>1) Full implementation: The new Law on energy Efficiency (EE) was adopted in November 2018. The EE Fund was established in January 2019 and is expected to become fully operational in June 2019.</p> <p>2) Limited implementation: Some limited support schemes for the private sector and households exist/are planned with support from the European Bank for Reconstruction and Development (EBRD) and the Millennium Challenge Corporation (MCC).</p> <p>3) Full implementation: Power generators have been selling electricity at deregulated prices since April 2017 and sales to industrial (110kV) customers have been deregulated since April 2018. For households and commercial consumers up to voltage levels of 35kV prices are also deregulated since April 2019 and for 10kV they will be deregulated from April 2020.</p> <p>4) Limited implementation: No such study has been conducted, but work has started (with World Bank support) to assess the possible impact on the most vulnerable consumers.</p>
<p>PG 5:</p> <p>Adopt the new Strategy and Action Plan 2019-2022 to fight the informal economy that should include qualitative and quantitative targets.</p>	<p>There was partial implementation of PG5:</p> <p>Partial implementation: the new strategy that includes qualitative and quantitative targets has been drafted, but still needs to be finalised. Currently the new strategy is in the consultation process and it is expected to be adopted in May 2019.</p>
<p>PG 6:</p> <p>Monitor the implementation of the youth employment action plan</p> <p>and increase the scope of active labour market measures in particular for women.</p> <p>Conduct a skills needs analysis for identification of priority sectors to inform the review of occupational profiles and curricula.</p> <p>Complete the necessary steps for the introduction of the general health insurance scheme.</p> <p>Increase enrolment in pre-school education.</p>	<p>There was partial implementation of PG6:</p> <p>1) Substantial implementation: The government adopted the action plan on youth employment on 04 January 2018. Detailed tools were developed to monitor its implementation. The first 6-monthly monitoring report focused on whether activities had started, and what remedial action was needed. The first mid-term assessment will be carried out in mid-2019.</p> <p>2) Limited implementation: Progress has been made as regards the participation of women in active labour market measures (ALMMs), but overall there are significantly fewer female than male participants. The Employment Agency is nearing completion of an in-depth evaluation of all ALMMs, which will also evaluate the gender gap in participation.</p> <p>3) Partial implementation: With support of GIZ, an overview of current vocational education and training (VET) provision in VET schools, the vocational training centers and other private providers has been established, which could support a skills needs analysis that has not yet been conducted.</p> <p>4) No implementation: The start of premium collection has been further postponed.</p> <p>5) Partial implementation: The achievement of 100 % enrolment in pre-school education is hindered by lack of facilities in some areas of the country. Licensing of pre-school education establishments continued.</p>

ANNEX B1: ASSESSMENT OF STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP

Measure 1: Reducing energy consumption through energy efficiency measures

This measure is highly relevant. While carried over from last year, it has been substantially improved and its scope has been extended to activities targeting the residential sector (the largest consumer of energy in Kosovo), in line with the policy guidance recommendation issued in May 2018. It also involves capital investment to reduce technical and commercial losses in the network. The inclusion of activities relating to the EE Fund (another milestone development in addressing last year's policy guidance) shows policy planning consistency.

However, the proposed indicators relate to the overall targets and do not reflect the impact of the proposed measures. Two of them (energy intensity of GDP and energy consumption per employee) also lack specific intermediary targets for 2019 and 2020. Moreover, for the measure to have a significant impact on Kosovo's economy, the planned investments should be combined with other policies to incentivise energy saving and 'soft reforms' such as secondary legislation on energy performance and enforcing capacities.

Measure 2: Further development of energy generation capacities

This measure is rolled over from last year's ERP and implementation of some of last year's activities is proving slower than expected (investments in new hydropower and solar projects have been only partly implemented). If fully implemented, its effects on Kosovo's economy would be sizeable. However, the planned activities are over-ambitious. The core project of the measure is the construction of Kosova e Re. While preparations have progressed since last year, procurement and construction tendering are at the stage of technical and financial proposals. The ERP understates the risks associated with this measure. These include political, financial (funding, potential impact on tariffs and the budget, state aid), social and environmental risks. The new investments will also require a plan to adjust energy tariffs gradually to reflect actual costs and to assess potential mitigation mechanisms to minimise the impact on the poor and vulnerable in a fiscally sustainable manner.

Moreover, the measure is overly focused on infrastructure projects and lacks attention to 'soft reforms', such as the introduction of a market-based mechanism for the further development of RES. The costs that are described (EUR 6 million) reflect only the allocations from the budget and not the real cost. The indicator on the share of energy generated from RES is directly linked to the objective of developing new energy generation capacities and improving energy security, but it lacks intermediate targets for 2019 and 2020.

Measure 3: Structural change in the agro-processing sector

This reform measure is very important to improving Kosovo's competitiveness and long-term growth potential. Some of the activities, are quite relevant and suggest a genuine intention to reform, e.g. the development of a master plan on irrigation (examining the possible expansion and rehabilitation of irrigation canals) and the introduction of alternative irrigation measures. This is likely to pave the way for significant donor support in this area. On the other hand, the other activities seem to continue to relate to the Ministry of Agriculture's regular grant and subsidy schemes (over EUR 145 million allocated). No justification is provided for including such schemes in the ERP, which should focus on structural reforms. The ERP does not describe what, if any, impact assessment is to be done to determine the allocation of these subsidies. One of the suggested indicators (increase in added value per year) could be pertinent to assessing improvements in competitiveness, but the link between the proposed activities and the indicator is not evident. A good indicator would have been progress in addressing Kosovo's considerable structural trade deficit in agro-processing products. It is also difficult to determine progress in the previous year's activities, as for most the only

information provided is the number of applications approved, which gives no indication of results achieved. Also, advances in irrigation are not given in terms of percentage of irrigated land, so it is impossible to estimate the real impact.

Measure 4: Consolidation and inventory of agricultural land

The fragmented structure of agricultural land is one of the key issues affecting the productivity of the sector, so this measure is highly relevant. Nevertheless, many of the weaknesses mentioned in last year's assessment remain: there are neither baseline data nor data on the expected results (i.e. increased percentage of consolidated arable land). Moreover, very limited progress was on the implementing activities planned for 2018.

Some activities included this year are welcome and could be the starting point for a proper consolidation of agricultural land. However, considering the importance of this reform, it lacks ambition and is limited to the drafting of concept documents (on the inventory and the regulation of agricultural land) and support for a few municipalities in the preparation of municipal zoning maps. In terms of actual consolidation, the measure aims to consolidate only 75 ha in one municipality in 3 years, which shows the absence of a strategic vision and a real commitment to meaningful reform.

Measure 5: Increase competitiveness in the manufacturing industry

This measure is an adapted version of last year's measure supporting industrial SMEs. Closer cooperation between SMEs, enhanced networking, improved public-private dialogue, and better production quality are central to competitiveness in the industrial manufacturing sector. However, there appears to be no comprehensive strategy or action plan behind the measure. While sectors with greater industrial potential are mentioned, there is a failure to identify the main obstacles to their competitiveness.

The study of the value chain for high-potential sectors is certainly welcome and can help guide investment to areas of greater impact. However, the level of ambition is very low (only one sector to be studied per year) and the sequencing of some of the activities is unclear (e.g. construction of physical infrastructure in three economic zones in 2019 before amending the Law on economic zones in 2020) and their purpose not explained. In order for action in the industrial sectors to create new opportunities, it needs to be backed by proper policy analysis. Key performance indicators are quantified and meaningful, but it is not clear how they relate to the proposed activities. Moreover, they lack targets for 2019 and 2020.

Measure 6: Enhancing competitiveness in the Tourism and Hospitality Sector

This measure is rolled over from the past two ERPs and its main weakness continues to be the lack of vision and political will to implement even the most basic element: developing a policy framework. This was to have been done in 2017. Two years on, the ERP continues to propose the drafting of a strategy and a law on tourism. Although some of the proposed activities seem relevant, in the absence of a policy framework, it is difficult to assess their relative importance and, as a result, they appear rather ad hoc and scattered. The measure is linked to the draft private-sector strategy, but it involves drafting a separate strategy on tourism. The budget for its implementation is rather low, especially as it envisages investments in rural and farm tourism and involves several institutions.

Measure 7: Adoption of evidence-based policies and addressing administrative burdens

This measure, rolled over from previous years, has now become more clearly centred around the simplification, merging and repealing of licenses and permits for businesses. It is realistic given the capacities in the sector and its cross-ministerial nature. It is also among the indicators agreed for the EU's public administration reform (PAR) sector budget support. The

impact on the private sector will probably take time to materialise as the activities are initially focused on setting up the administrative procedures for the actual burden reduction. However, this is being done in a systematic way with the aim of institutionalising the initiative.

Measure 8: Securing property rights by addressing informality in the immovable property sector

This measure is very relevant and could have a significant important impact on the business environment by securing property rights, unlocking access to finance and facilitating dispute settlement, which are all essential to providing legal certainty and attracting local and foreign investment. The measure, rolled over from the past 2 years, is well planned. While its scope is ambitious, there seems to be sufficient political will, donor support and local stakeholder engagement, which have enabled implementation to advance well. Most activities planned for 2018 have been carried out or are in the final stage of implementation. The measure could also have a positive gender dimension in helping women to enjoy equal property rights and facilitating their economic independence. The proposed indicators are relevant, but two of them (increase of requests at the notarial office for settlement of old inheritance; requests for formalisation of informal transactions per year) do not seem ambitious enough to make a significant impact.

Measure 9: Increase the efficiency of the judiciary in resolving cases

This measure aims to improve the efficiency of the judiciary in addressing economic disputes by implementing a case-management information system so as to reduce backlog. The reform, rolled over from the past two ERPs, continues to be highly relevant. Implementation advanced well in 2018, notably with the drafting of legislation and the recruitment of judges and professional associates.

The measure focuses on the case-management information system, a technical tool to allocate and assign cases. However, it would have a greater impact if equal, if not more, attention were given to reducing the length of proceedings, introducing fines for unnecessary adjourned hearings, enhancing judge's performance and supporting the use of alternative dispute resolution mechanisms. The proposed indicators are pertinent, but there is no indication of the current backlog to be able to assess progress.

Measure 10: General inspection reform

This measure was introduced last year and seems pertinent to easing the unnecessary burden for businesses of frequent, uncoordinated and costly inspections. However, the diagnosis of the business environment provides no information as to the magnitude of the problem and its effect on businesses, so the relevance of the measure is difficult to assess. While some steps were taken in 2018, the process has suffered delays and the harmonised law on inspections still awaits finalisation and adoption.

The reform requires solid administrative capacity and an ability to overcome resistance to changes. Both risks are identified in the measure. The proposed timeline and activities for 2019-2020 are in principle reasonable and achievable. The measure has strengthened with the inclusion of the screening of sectoral laws and secondary legislation to align them with the new law on inspection, with implementation of the electronic data management system and with equipment for the market inspectors. However, the expected impact is analysed only very broadly and the proposed indicator (increase in the number of complaints handled) does not really measure the impact of reducing the burden for businesses.

Measure 11: Reduction of informal economy

The introduction of this new measure is very welcome as it addresses one of the key obstacles to doing business in Kosovo. It is also in line with the policy guidance provided in May 2018. The proposed activities are ambitious, but at the same time focused and practicable. The proposed indicators are relevant but they refer to *ex ante* assessments, which should be carried out as a matter of priority in order to be able to monitor progress. Overall, and considering the limited cost and high potential impact, this measure (if fully implemented) could be the most cost-effective in the ERP.

Measure 12: Improvement of innovation and entrepreneurship environment

This measure has continued to suffer from slow implementation, in particular a delay in adopting the new law and strategy. However, progress was made with the functionalisation of the Council for Innovation and Entrepreneurship and the launching of the programme for direct financial support. The measure involves an important focus on financial support for innovative businesses, start-ups and NGOs. As a result, the only proposed indicator is the number of such entities supported which does not give a sense of reform. While the measure could have an immediate impact on the competitiveness of a limited number of companies, it will not lead to overall improvement in the innovation and entrepreneurship environment, which still requires an overarching long-term strategy. The development of a smart specialisation strategy in Kosovo would contribute to the achievement of the objective.

The measure involves support for several innovation and entrepreneurship centres. Considering the obstacles that existing incubators face in Kosovo, these activities would probably have greater impact if accompanied by the improvement and expansion of the services these centres provide, so that they can support businesses at various stages of their development.

Measure 13: Expansion of relevant ICT infrastructure network for socio-economic development

This measure is carried over from past ERPs and remains fully relevant considering the relatively low broadband penetration in Kosovo. Implementation advanced in 2018, notably with 14 pilot projects to extend the ICT network infrastructure in rural areas and agreement on a EUR 20.7 million World Bank loan that will allow investment as from 2019. The measure includes activities aimed at developing infrastructure, supporting the digitalisation of businesses and enhancing e-skills among young people. However, this latter activity appears limited and could be developed further and at different levels, from primary schools to vocational training, to achieve impact.

To increase the potential impact, the measure could also include investment in the infrastructure needed for connection to GEANT (the pan-European data network for the research and education community). Another important aspect, which is not mentioned in the measure, is fostering links between education, research innovation and the economy by establishing national research and education networks. Moreover, in the past 3 years the ERP assessments have highlighted the need to complement infrastructure investments with competition between operators and regulator independence; this has still not been addressed.

The ambition of the proposed indicators, which involve an increase in the number of cadastral zones and public institutions covered, is also difficult to estimate. A more meaningful indicator would have been the increase in the percentage of the population covered by broadband infrastructure (penetration rate).

Measure 14: Trade facilitation — increasing the cost-effectiveness of international trade transactions

This measure has been rolled over from the previous ERP, but the planned activities have been changed substantially. The measure is now much broader in scope and ambition. Several activities include EU-supported processes, such as the laws on internal and external trade, and the system for exchange of excise data (SEED+). However, some activities (e.g. the draft legislation for digital signature) have been dropped without a justification. The implementation of some activities e.g. WTO membership negotiations, entails political risks and depends on external factors. The proposed indicators are pertinent, but the targets do not seem very ambitious. Some recent measures adopted by Kosovo, such as the 100 % tariffs on imports from Serbia and BiH and the introduction of barriers to ‘protect’ domestic businesses may undermine the efforts and impact of this measure.

Measure 15: Further development of quality infrastructure and empowerment of market surveillance authorities, with focus on construction products

This measure remains highly relevant for competitiveness and central to implementing the Stabilisation and Association Agreement. Overall, there was good progress in implementing the activities planned for 2018, in particular with the adoption of important legislation. Activities for the upcoming period (2019-2021) focus on the construction sector and, while well defined, may prove to be too ambitious. The continued lack of qualified staff and financial resources in the responsible agencies is recognised as a risk, but no mitigating measures have been considered.

Measure 16: Improve the quality of VET on the basis of labour market requirements

The reform, which involves drafting and reviewing occupational standards, is already lagging behind as regards previous ERPs, according to which a good proportion of standards should have been completed in 2017 and 2018. There is no mention of the 25 new standards to be defined and verified. Only three were drafted last year (on interior design, wood workers and wood processors), while another four are being drafted (on technical engineering, plumbing and pipe installers, mechanics, and electrical and heating installers). The budgetary impact of the reform is still unclear, especially as it relies to a great extent on donations from external stakeholders that have not even been identified. There is no clear breakdown of the total cost of the action.

Measure 17: Better and more inclusive pre-university education

The proposed reform concerns only pre-school (not pre-university) education. The reforms are primarily aimed at increasing the enrolment of pre-school children rather than achieving greater inclusion. The ERP target of 100 % by the 2021/2022 academic year seems reasonable. Reaching 44 % for 3-5 year-olds in the same period will be more challenging, as the current rate is just over 33 %. The inclusion aspect of the reform is less developed.

Measure 18: Reform in higher education

The proposed reform is very broad and vague, mixing legislative objectives with infrastructure construction and student assessment. The full implementation of the reform depends on the adoption of the revised draft law on higher education. The government approved the draft law in November 2018. The process of drafting and adopting the Law on the Kosovo Accreditation Agency is advancing and will probably be completed. The new Board of the Agency ensures transparency and is currently working for its readmission to the European Quality Assurance Register (EQAR). The key performance indicators of the measure depend not only on the adoption of legislation in the upcoming period, but also on

the allocation of additional funds. The costs of improving the teacher/student ratio and establishing further quality assurance mechanisms have been underestimated. As a result, the budgetary impact of the reform is still unclear, especially as it relies to a great extent on donations from external stakeholders, which have not even been listed. The 2017-2021 education strategy adopted in 2016 has an accumulated deficit of around EUR 44 million (against the EUR 176 million initially earmarked).

Measure 19: Improving young people's and women's access to the labour market by providing quality employment services, active employment measures and entrepreneurship

The initiatives are appropriate and a continuation of established policy priorities. The focus on training and labour market programmes is valid. The targets relating to women and young people are good, but there is scope to incorporate targets relating to rural areas and perhaps also to the long-term unemployed. Kosovo aims to make greater use of the validation of prior learning and career guidance in the mix of labour market programmes. This could be made more explicit. It intends to include career and validation measures in the learning packages, so these could more accurately be called 'learning and assessment packages'. This will be particularly important for women returning to the labour force and young people who have acquired skills in the informal sector. To maximise the use of existing materials and capacities, the Employment Agency should seek to take advantage of any relevant experience of staff in the Ministry of Education. As with the education measures, there is scope to emphasise cooperation with employers to capture information on vacancies and anticipated skills needs, and to use the experience gained from the use of tracer studies.

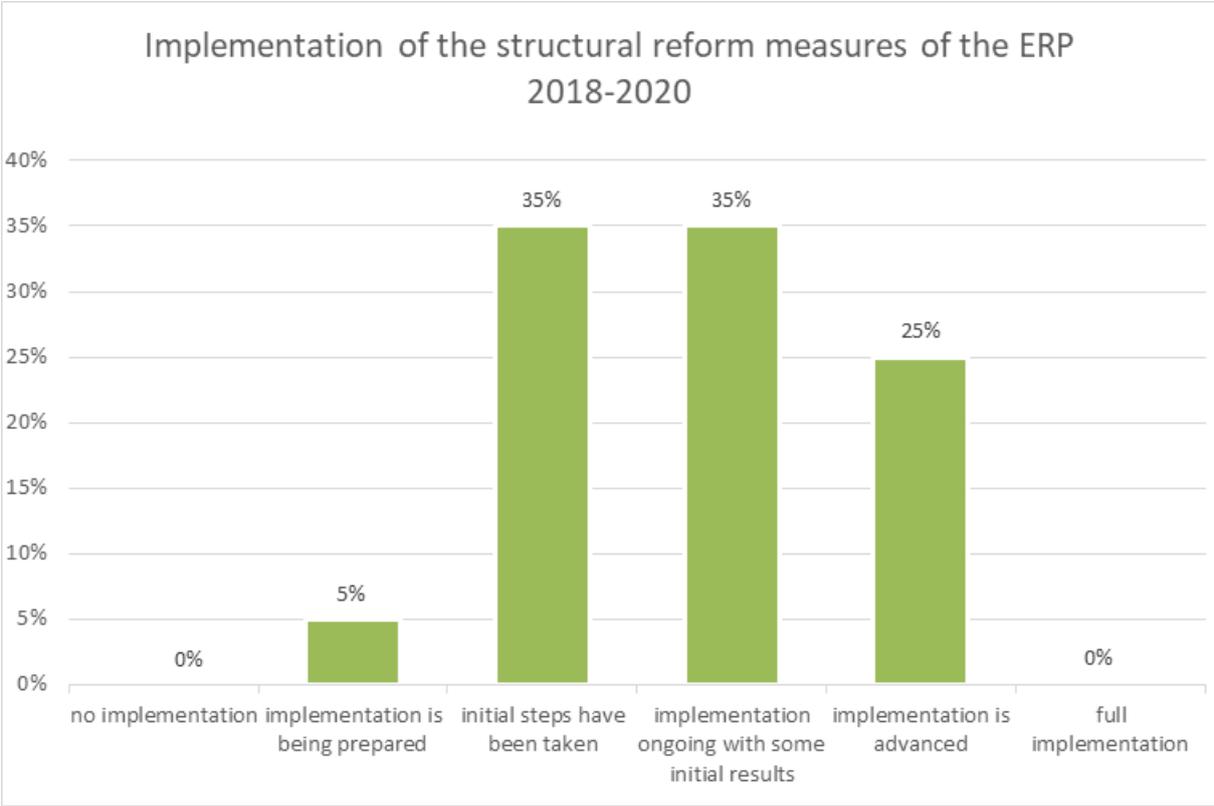
Measure 20: Improvement of social and health services

This measure is again rolled over from the previous ERP and its effective implementation requires a more resolute approach.

ANNEX B2: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM ERP 2018-2020

There was a relatively good progress in the implementation of the measures in 2018, with an average score of 3.2 out of 5. The reporting on the planned activities is thorough and while in some activities the scoring provided is slightly high, overall, it provides a fair description of the level of implementation.

Implementation is higher in some measures, such as measure 8 on the adoption of evidence-based policies and reducing administrative burden, measure 10 on increasing judicial efficiency through reduction of court case backlog and measure 13 on the expansion of ICT infrastructure. At the same time, implementation is weaker in other measures, such as measure 12 on improving entrepreneurship and the innovation environment and measure 17 on reforming pre-university education and particularly weak on measure 5 on expanding farms through consolidation and regulation of agricultural land.



ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme 2019-2021 was adopted by the Government on 29 January 2018 and submitted to the Commission on 30 January 2019 within the deadline. It is in line with the previously approved medium-term fiscal strategy and national development strategy. No components of the ERP are missing.

Inter-ministerial coordination

The preparation of the ERP was centrally coordinated by the Ministry of Finance with the support of the Office for Strategic Planning in the Office of the Prime Minister (OPM). All relevant line ministries contributed to the drafting of the programme and were fully consulted.

Stakeholder consultation

Section 6 of the ERP provides information on the public consultation of the ERP. A draft ERP was made available to the public on the OPM website in December 2018 and January 2019. Written comments from stakeholders were annexed to the ERP with an explanation of which comments have been accepted and integrated. No consultation of the Economic and Social Council took place.

Macroeconomic framework

While somewhat optimistic, the macro-fiscal framework presented in the ERP is broadly plausible and coherent, and provides an adequate basis for assessment. External assumptions have been taken from the IMF's October 2018 *World economic outlook* and the Commission's autumn 2018 forecast. The alternative 'low growth' and 'high growth' scenarios are useful for showcasing the likely impact of some expected and unexpected developments in Kosovo's economy. Forecasts for the labour market and the financial sector are still lacking. The ERP fails to discuss the expected economic impact of the recent decision to impose 100 % tariffs on imports from Serbia and BiH. The cyclical analysis is of limited usefulness, given the short time series available.

Fiscal framework

The fiscal framework was prepared on the basis of the 2019 budget. It envisages relatively high revenue and expenditure projections as compared with the 2018 outcome; these are subject to a number of risks that are partly acknowledged in the ERP. There is no discussion of fiscal risks relating to the new Law on salaries for public employees. Structural measures in the ERP have been included in the 2018 budget. No projection is provided for the cyclically adjusted budget balance. Intended changes in debt management could have been explained better. The fiscal tables in the annex to the ERP are not fully consistent with the main text.

Structural reforms

The structural reforms sections (4, 5 and 6) follow the guidance note. The reporting of the implementation of the policy guidance and the structural reform measures from the 2018-2020 ERP (table 11 in annex) is largely sufficient, but miss some important information (e.g. no reference to adoption of the plan for the gradual adjustment of the tariffs). The number of reform measures is limited to 20 and the page limit (40) for section 4 is respected. The structure of the reform measures is good, in terms of scope and clarity of timeline and budget for activities planned in the three years of the programme. However, activities could be more precise and indicators defined for the estimated impact. Tables 9-11 of the annex are filled in appropriately.

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