



Council of the  
European Union

Brussels, 23 April 2020  
(OR. en)

7471/20

ECOFIN 245  
UEM 97  
COWEB 46

#### COVER NOTE

---

From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	21 April 2020
To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union

---

No. Cion doc.:	SWD(2020) 65 final
Subject:	COMMISSION STAFF WORKING DOCUMENT ECONOMIC REFORM PROGRAMME OF KOSOVO* (2020-2022) COMMISSION ASSESSMENT

---

Delegations will find attached document SWD(2020) 65 final.

---

Encl.: SWD(2020) 65 final

---

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



Brussels, 21.4.2020  
SWD(2020) 65 final

**COMMISSION STAFF WORKING DOCUMENT**

**ECONOMIC REFORM PROGRAMME**

**OF**

**KOSOVO\***  
**(2020-2022)**

**COMMISSION ASSESSMENT**

The Economic Reform Programmes (ERP) were submitted around end-January 2020 and the present Commission assessment was finalised shortly thereafter in February 2020, supported by a fact-finding mission in mid-February.

The Covid-19-related economic crisis has in the meantime rendered the macro-fiscal scenarios presented in the ERP and in the Commission assessment largely obsolete. The Commission will publish its updated macroeconomic and fiscal projections for candidate countries, reflecting the expected impact of the Covid-19 crisis, in its spring economic forecast in early May 2020.

While the short-term macro-fiscal outlook has profoundly changed, the present Commission assessment also identifies structural reform challenges and priorities, including in the area of fiscal governance, which remain largely valid. Addressing these structural issues will be essential to ensure a sustained economic recovery after the crisis. The Joint Conclusions to be adopted at the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey will accordingly focus this year on the short-term priorities to mitigate the socio-economic consequences of the Covid-19 crisis and on the medium-term priorities to strengthen the foundations of a sustained recovery thereafter. While the Commission assessment does not address weaknesses in the public health system and issues in the social protection system are assessed only as far as they are linked to the key structural challenges, these two areas will feature more prominently among the issues identified in the policy guidance.

## Contents

<b>1. Executive summary</b> .....	<b>2</b>
<b>2. Economic outlook and Risks</b> .....	<b>4</b>
<b>3. Public finance</b> .....	<b>6</b>
<b>4. Key Structural challenges and reform priorities</b> .....	<b>11</b>
<b>5. Overview of the Implementation of the policy guidance adopted at the Economic and Financial Dialogue in 2019</b> .....	<b>21</b>
<b>6. Assessment of other areas and structural reform measures included in the ERP 2020-2022</b> .....	<b>24</b>
<b>ANNEX A: Overview of the main indicators per area/sector of the economy</b> .....	<b>32</b>
<b>ANNEX B: Progress with structural reform measures from ERP 2019-2021</b> .....	<b>34</b>
<b>ANNEX C: Compliance with Programme Requirements</b> .....	<b>35</b>
<b>References</b> .....	<b>36</b>

## 1. EXECUTIVE SUMMARY

**The Economic Reform Programme (ERP) expects a robust increase in investment and private consumption to support an acceleration in GDP growth.** The ERP forecasts average annual GDP growth of 4.5% in 2020-2022, above the historical trend. Private consumption should remain the key growth driver, supported by strong remittances, increasing wages and growing credit. A large surge in overall investment is projected to be initially driven by ambitious plans for public investment, with private investment also rising steadily. The key downside risks to this outlook stem from a less benign external environment and the persistent under-execution of public capital spending. Further risks relate to rising public spending for social transfers and wages, which undermines private-sector development.

**The budget deficit is projected to widen due to heavily frontloaded public investment, including several infrastructure projects financed by privatisation revenues and international financial institutions.** As per the fiscal rule definition, the deficit is set to stay slightly below the rule's ceiling of 2% of GDP in 2020-2022. Despite large overall deficits, 5.1% of GDP on average in 2020-2022, the ERP expects the public debt increase to be rather limited, from 17.5% of GDP in 2019 to 20.7% in 2022. Immediate fiscal risks, some of them well assessed in the programme, stem from a likely underestimation of current spending due to the war veteran pension scheme, additional social transfers currently being considered by the new government, and a possible large increase in public wages when the Law on public salaries comes into force. The expected revenue increase relies mainly on higher GDP growth and improved tax debt collection.

The main challenges facing Kosovo include the following:

- **Given numerous development challenges, Kosovo needs to better align budgetary planning with the actual payments while respecting the limits prescribed by the fiscal rule.** 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 ensure that each category of current spending does not exceed the initial allocation. Social spending is systematically underestimated in the budget, leading to regular fund reallocations. The composition of public spending should focus more on supporting medium-term growth potential. In the case of capital spending, it is important to plan new investment taking into account the outturn of the previous year and the backlog of project implementation. Over 30% of the capital budget remained unused in 2019.
- **Improved revenue collection and better supervision of publicly owned enterprises (POEs) would mitigate fiscal risks and provide additional funds for priority reform areas.** Some progress has been made in reducing tax debt in 2019. However, further efforts are needed to raise tax revenue by reducing the informal economy and improving the efficiency of tax revenue collection, which could secure more funding for priority areas, including education and health. Fiscal risks should be contained by improving the financial oversight of POEs, and by strengthening fiscal governance, including fiscal impact assessments of new initiatives.
- **Kosovo needs to accelerate its fight against its large informal economy,** which constitutes a serious barrier to the development of its private sector and increased competitiveness. It also affects the capacity of the state to provide good quality public services and prevents a relevant part of its workforce from having access to adequate levels of job security and protection. Kosovo has a new strategy and action plan to combat informality that is designed to address key underlying causes of informality. Strong political support, effective implementation and close monitoring are required to achieve the desired outcomes.

- **The inadequate and unreliable supply of electricity is one of the main constraints on Kosovo's competitiveness and acts as a break on productivity.** Access to electricity remains a key challenge, 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, Kosovo needs to step-up efforts to make use of the potential for energy efficiency. To develop a sustainable energy supply, Kosovo needs to find attractive alternatives to polluting sources of energy. The planned investment in the new coal power plan (*Kosova e Re*) is expected to put upward pressure on prices and will require appropriate planning and policy response.
- **Kosovo suffers from very low activity and employment levels, especially for women and young people.** The severe youth unemployment and a high share of young people not in employment, education or training reveals the difficulty of the education system to cope with the labour market needs. The gender gap is particularly significant. Unemployment considerably affects women even those with tertiary education. The results of the 2018 PISA survey are alarming, revealing an outdated education system, which also suffers from a lack of funding. It unveiled that every second student in Kosovo is functionally illiterate. The capacity of the employment service is not sufficiently developed to ensure matching between workers and vacant jobs and the implementation of active labour market policies, including upskilling and on-the-job training, to increase employment of vulnerable groups and improve the transition from informal to formal work.

**The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2019 has been implemented to a limited extent.** Tax revenues collection has improved, the wage bill rule has been respected, but the risk related to the implementation of the Law on salaries for public employees remains high. There has been limited progress with regard to improving financial oversight of POEs and 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 veteran pension beneficiaries. Energy efficiency support schemes in the private sector and households have increased, but remain limited. A study to support the development of a programme aimed to protect vulnerable consumers was finalised, but there was no progress in the adoption of a plan for the gradual adjustment of tariffs to reflect an expected increase in costs. Nor was competitive bidding in support schemes for renewable energies introduced. The government adopted a new strategy to fight informal economy. Some positive achievements have been noted. Responses in the areas of employment, social and education policies were limited (although some progress was made in early childhood education), reflecting budgetary and administrative capacity constraints and a complex political environment.

**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 to support economic growth through ambitious capital investments. It also refers to the need to support private sector and promote inclusive growth. However, weaknesses in fiscal planning and governance could jeopardise achievement of these goals. It includes measures to improve the business environment and reduce the informal economy. The ERP also partially addresses challenges regarding access to energy, in the judiciary system and in the capacity of the education system to respond to labour market needs. Although the proposed measures in the ERP are aligned with the main structural challenges, their implementation is lagging and the expected improvements have not been achieved as planned.

## 2. ECONOMIC OUTLOOK AND RISKS

A robust pace of economic expansion continued in 2019, with real GDP increasing by 4.3% year-on-year in the first 9 months and the ERP estimating it to have reached 4.0% for the year as a whole. Growth was mainly driven by private investment and private consumption, the latter supported by social transfers, large inflows of remittances, and robust wage and credit growth. The contribution of net exports to growth was slightly positive.

The ERP's baseline projection assumes a more moderate and flatter GDP growth profile than the previous programme, but the envisaged growth path above historical trends is still on the optimistic side. GDP growth is set to accelerate to 4.4% in 2020 (the rate is slightly higher than the 4.2% projection of the previous ERP because of a lower base in 2019). In both 2021 and 2022, economic growth is projected to strengthen to 4.5% (down from the previous forecast of 4.8% for 2021), despite the projected slowdown in Kosovo's main trading partners. As in previous programmes, the growth acceleration is expected to be driven by a large surge in public investment (in particular increase of 11.5% year-on-year in 2020), and strong growth in public consumption, which is set to peak at 10.5% year-on-year in 2020 and practically stagnate afterwards. Favourable credit and improving business conditions are seen to support private investment, which is expected to increase by more than 5% each year. Private consumption growth is set to accelerate over the forecast period, to more than 4%, amid rising household credit, wages and social transfers, and despite an expected slightly decelerating trend in remittances. Export growth is projected to average 8.3% in 2020-2022 due to the expected robust expansion of services exports, a favourable outlook for nickel exports in 2020 resulting from increasing demand for electric vehicles, and government incentive schemes for the manufacturing industry. Import growth is projected in line with the assumed growth in investment and consumption, resulting in a negative contribution of net exports to growth over the programme's horizon. The ERP assumes a slightly negative output gap in 2020, which turns nearly neutral in 2021 and positive in 2022.

Table:

### Kosovo - Macroeconomic developments

	2018	2019	2020	2021	2022
<b>Real GDP (% change)</b>	<b>3.8</b>	<b>4.0</b>	<b>4.4</b>	<b>4.5</b>	<b>4.5</b>
<i>Contributions:</i>					
- Final domestic demand	6.9	3.0	6.4	5.1	5.0
- Change in inventories	0.6	0.1	0.0	0.1	0.0
- External balance of goods and services	-3.7	0.9	-2.0	-0.7	-0.5
<b>Employment (% change)</b>	:	:	:	:	:
<b>Unemployment rate (%)</b>	:	:	:	:	:
<b>GDP deflator (% change)</b>	<b>1.0</b>	<b>1.7</b>	<b>1.4</b>	<b>1.0</b>	<b>0.9</b>
<b>CPI inflation (%)</b>	<b>1.1</b>	<b>2.7</b>	<b>1.8</b>	<b>1.3</b>	<b>1.2</b>
<b>Current account balance (% of GDP)</b>	<b>-7.6</b>	<b>-5.6</b>	<b>-7.5</b>	<b>-6.9</b>	<b>-6.6</b>
<b>General government balance (% of GDP)</b>	<b>-3.0</b>	<b>-2.9</b>	<b>-5.6</b>	<b>-5.3</b>	<b>-4.5</b>
<b>Government gross debt (% of GDP)</b>	<b>16.9</b>	<b>17.5</b>	<b>18.7</b>	<b>19.9</b>	<b>20.7</b>

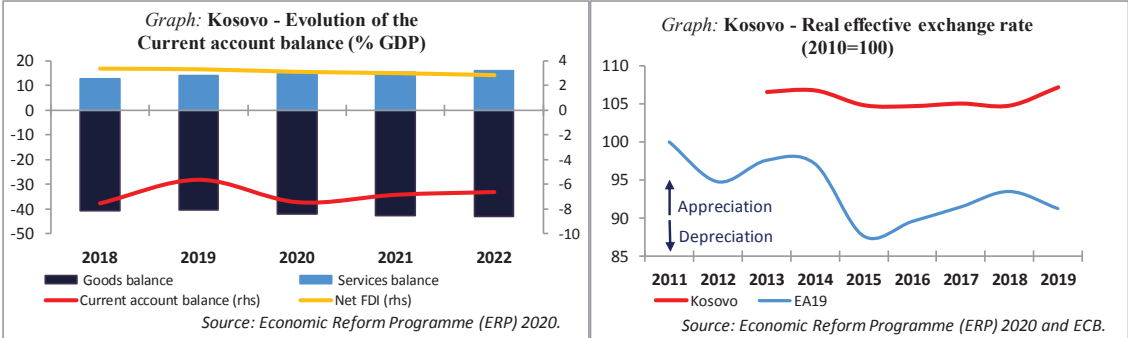
Sources: Economic Reform Programme (ERP) 2020.

**Downside risks to growth predominate.** The programme's improved assessment on downside risks rightly refers to a possibly less benign external environment, a potential delay in public capital spending, especially as regards donor-financed projects, possible energy outages in the context of outdated power generation capacities, and a number of fiscal risks. Aggregating all downside risks, the ERP's 'low growth' scenario results in 2.4% average

annual growth in 2020-2022. This is partly based on lower execution rates for the regular and donor-financed investments, which are actually closer to historical rates than the baseline scenario’s more optimistic assumptions. The political impasse from October to February and the delayed adoption of the 2020 budget are very likely to intensify the risk of delays in executing capital projects, hence the ‘low growth’ scenario’s assumed execution rates seem even more plausible in the short term. Upside risks relate to an improved execution of investment projects and positive effects from implementing planned structural reforms such as fighting the informal economy, cutting energy losses and reducing capital risk premia, and increasing employment. This ‘high growth’ scenario, which is rather unlikely, results in 5.4% average growth over the period. The impact of the potential construction of the new Kosova e Re power plant is not included in the growth scenarios or the fiscal projections.

**Price developments are expected to decelerate as the inflationary impact of import tariffs has mostly petered out during 2019.** In Kosovo’s small euroised economy, prices are determined largely by global commodity prices, with food and transport accounting for 40% and 15% of headline inflation, respectively. Following the introduction of a 100% import tariffs on goods imported from Serbia and Bosnia and Herzegovina in late 2018, annual inflation peaked at 3.4% in May and continued to ease towards the end of 2019. The key driver was food prices. The average annual rate stood at 2.7%, which is projected to decline to 1.8% in 2020 and 1.3% and 1.2% in the following 2 years, which appears broadly plausible.

**While the current account deficit narrowed in 2019, a very large merchandise trade deficit is set to persist.** Due to robust growth in services exports, recovering exports of base metals and moderate growth of imports, the deficit in trade in goods and services is estimated to have narrowed to 26.6% of GDP in 2019 from 27.9% a year earlier, while the merchandise deficit stood practically unchanged at above 40% of GDP. The overall trade deficit is projected to widen to 27.3% of GDP on average over 2020-2022, in line with expectations of higher investment and domestic consumption growth widening the merchandise trade deficit, which is expected to be partly offset by the improvement in the services trade balance. While the real effective exchange rate has undergone some appreciation in 2019, the key bottleneck for stronger export growth stems from limited diversification. Kosovo’s exports of goods remain dominated by metals and minerals (41.8% of the total), although the improving Herfindahl-Hirschman index points to increasing shares of other products, in particular food and plastic articles. Services exports are dominated by tourism services to the diaspora, but information and communication technology services have recently increased rapidly from a low base. Remittances remain the key factor offsetting the trade deficit, reported at 16% of GDP in 2019. Remittances are projected to remain practically stable at 15.4% of GDP during 2020-2022. The current account deficit is set to deteriorate from 5.6% of GDP in 2019 to 7.5% in 2020 and moderate to an average of 6.8% in 2021-2022, which appears in line with the projected increase in investment and higher growth of imports in 2020.



**Net foreign direct investment (FDI) remains a major financing source, but it predominantly targets non-tradable sectors.** The net FDI inflows stood at 3.3% of GDP in 2019, covering more than a half of the current account deficit. The ERP rightly refers to the high share of FDI inflows into non-tradable sectors (with more than 78% of incoming FDI directed to real estate and renting activities in January-October 2019) as not conducive to enhancing export capacity and thus not lowering balance-of-payment vulnerabilities. Kosovo's net international investment position is estimated at -5.1% GDP in 2019, which shows a deterioration compared to 2018 (-1.7%). More than 71% of liabilities consisted of FDI, which is beneficial for macroeconomic stability. Due to improved export performance, the reserve assets covered 4.9 months of imports in 2019, up from 4.4 in 2018.

*Table:*

**Kosovo - Financial sector indicators**

	2015	2016	2017	2018	2019
<b>Total assets of the banking system (EUR million)</b>	3 385	3 637	3 870	4 186	4 756
<b>Foreign ownership of banking system (%)</b>	90.1	88.9	88.1	86.8	86.7
<b>Credit growth</b>	7.3	10.4	11.5	10.9	10.0
<b>Deposit growth</b>	6.5	7.2	6.8	8.7	16.2
<b>Loan-to-deposit ratio</b>	74.7	77.0	80.3	81.9	77.6
<b>Financial soundness indicators</b>					
- non-performing loans	6.2	4.9	3.1	2.7	2.0
- net capital to risk-weighted assets	19.0	17.8	18.1	17.0	15.9
- liquid assets to total assets	44.9	41.5	37.9	38.5	38.7
- return on equity	29.1	19.7	21.3	20.4	18.9
- forex loans to total loans (%)	0.3	0.2	0.2	0.1	0.1

*Sources: National Central Bank, Macrobond.*

**Accounting for 65.3% of financial sector assets, the banking sector is considered sound, profitable and stable.** Credit growth showed some sign of deceleration to 10% in 2019 from nearly 11% a year before, with most loans flowing to non-tradable sectors such as real estate and consumer loans. The expansion of new mortgage lending in January-October has moderated to 8.5% from 11.6% in the previous year, the growth rate of consumer loans was negative (-3.3%). While Kosovo's depth of financial intermediation is relatively low (41.3% of GDP) and further financial deepening could support economic activity, the ERP rightly refers to the need to carefully monitor lending in some riskier segments. Banks have continued to be financed by a robust increase in deposits (16.2% annual increase); the loan-to-deposit ratio was 77.6% in 2019. The proportion of non-performing loans (NPLs) reached a record low of 2.3% 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 18.9% in 2019. The ERP does not provide quantified forecasts for the financial sector, but the underlying assumption is of continuing credit growth, in line with the projected increase in private consumption and investment.

### 3. PUBLIC FINANCE

**The 2019 budget deficit remained comfortably below the ceiling prescribed by the fiscal rule, due to a significant under-execution of capital spending.** The ERP estimates the 2019 headline budget deficit at 2.9% of GDP, which corresponds to a 0.6% of GDP deficit under



the fiscal rule definition and is far below the prescribed ceiling of 2%<sup>1</sup>. Total revenues fell slightly short of plan (96% collection rate), mainly due to robust but still weaker than expected growth in VAT and excise collection, the latter related to a new law banning gambling adopted in March 2019. The 1% of GDP shortfall in indirect taxes was only partially offset by an improvement in collecting tax debt (0.3% GDP). In contrast, the expenditure side recorded significant deviations, which are partly related to the over-optimistic assumptions of the 2019 budget. The recurring failure to contain the costs of the war veterans pension scheme within the legal ceiling and increasing social transfers resulted in overspending on subsidies and transfers by 0.4% of GDP. Due to unrealistic planning and the inability to disburse funds from the investment clause, capital spending stagnated, with only around two-thirds of the planned investment expenditure actually realised. Given the delay in capital spending, the government cash balance rose to 5.1% of GDP, which is well above the fiscal rules' required minimum of 4.5%.

**The declared ERP objective in 2020-2022 is to maintain macro-fiscal stability and comply with the fiscal rules, while sustaining robust capital investment and funding for priority areas.** Similarly to the previous programme, the fiscal strategy is frontloaded, assuming major increases on the revenue and expenditure sides in 2020 and remaining rather stable afterwards. The projections are done on the basis of the 2019 budget without taking account of the actual outturn. Public revenue is set to rise by 0.7 pp. to 27.2% of GDP in 2020 and remain stable at 26.7% in the two subsequent years. Driven by stepped-up capital spending, public expenditure is expected to surge by 3.3 pps to 32.7% of GDP in 2020 and grow below the pace of nominal GDP thereafter. Under the fiscal rule definition, the budget deficit is expected to be 2.0% of GDP in 2020 and slightly below it in 2021-2022. The headline deficit is projected to widen to 5.6% of GDP in 2020 and adjust gradually downward to 5.3% and 4.5% in the subsequent 2 years.

---

<sup>1</sup> 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.

Table:

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

	2018	2019	2020	2021	2022	Change: 2019-22
<b>Revenues</b>	26.1	26.5	27.2	26.7	26.7	0.2
- Taxes and social security contributions	23.2	24.0	24.0	23.7	23.8	-0.2
- Other (residual)	2.9	2.5	3.1	3.0	2.9	0.4
<b>Expenditure</b>	29.1	29.4	32.7	32.0	31.2	1.8
- Primary expenditure	28.8	29.1	32.4	31.6	30.8	1.7
<i>of which:</i>						
Gross fixed capital formation	7.9	7.5	10.5	10.4	10.1	2.6
Consumption	12.6	12.8	13.4	13.2	13.0	0.2
Transfers & subsidies	8.3	8.8	8.4	7.9	7.6	-1.2
Other (residual)	0.0	0.0	0.1	0.1	0.1	0.1
- Interest payments	0.3	0.3	0.4	0.5	0.5	0.2
<b>Budget balance</b>	-3.0	-2.9	-5.6	-5.3	-4.5	-1.6
- Cyclically adjusted	-0.3	0.1	0.3	0.4	0.6	0.5
<b>Primary balance</b>	-2.7	-2.6	-5.2	-4.8	-4.0	-1.4
- Cyclically adjusted	0.0	0.4	0.7	0.9	1.1	-1.1
<b>Gross debt level</b>	16.9	17.5	18.7	19.9	20.7	3.2

Sources: Economic Reform Programme (ERP) 2020.

**Following the snap elections in October 2019, Kosovo had not yet approved the 2020 budget by the time of ERP submission.** The ERP projections for 2020 are taken from the draft budget produced by the outgoing government, based on the medium-term expenditure framework. Compared to the outcome of 2019, total revenues are set to increase by 7.2% year-on-year, backed by a strong increase in revenue from VAT (10.4% year-on-year) and further improved tax debt collection. Total spending is projected to grow by 16.7% year-on-year, driven by an extraordinary increase in capital spending (45% increase as compared to the 2019 outcome) and moderate growth of wages (6.7%) and social transfers (0.7%). The overall growth of wage bill is kept roughly in line with the wage bill rule<sup>2</sup>, but the wage bill projections at central and local levels treat the impact of the Law on salaries differently. While at central level public wages are set without taking into account the law's impact on salaries, the wage bill at local level is projected to grow by 13% as compared to the 2019 budget, due to the assumed implementation of this law. This difference is due to the early planning of municipal budgets, which had been finalised before the law was suspended by the Constitutional court pending its review. In terms of sectors, higher allocations are foreseen for road infrastructure, health and judiciary, but the ERP fails to provide aggregate data of general government spending by function for 2020.

<sup>2</sup> Nominal GDP growth is estimated at 5.9% in 2019.

**Box: The 2020 (draft) budget**

- \* The 2020 budget was not approved at the time of the ERP submission.
- \* The draft projection for 2020 budget targets a total deficit of 5.6% of GDP.
- \* Revenue: improved collection of tax debt, increase in tax base due to economic growth and increased revenue collection efficiency, and higher excise revenue due to higher assumed car imports.
- \* Expenditure: large surge in capital spending financed by IFIs and privatisation proceeds, increase in maintenance expenditure, due to the reclassification of existing spending, increase in subsidies and transfers due to higher number of beneficiaries, e.g. the pension scheme for teachers working in the parallel education system in the 1990s.

**Main measures in the 2020 budget**

**Revenue measures\***

- Tax debt collection: not specified
- Tax compliance: not specified
- Higher excise collection due to car imports: €24 million (0.3 % GDP)
- Higher VAT revenues: €88 million (1.3% GDP)

**Expenditure measures\*\***

- Maintenance expenditure increase: €59 million (0.8% of GDP)
- Increase in subsidies and transfers: €5 million (0.1% of GDP)
- Higher capital spending: €240 million (3.2% of GDP)

\* Estimated impact on general government revenues.

\*\* Estimated impact on general government expenditure.

Source: ERP

**Despite higher budget deficits than assumed in the previous ERP, the projected increase in public debt is more moderate.** Taking into account the projections for GDP growth, inflation and interest payments, public debt is expected to increase to 19.9% of GDP in 2021 instead of 22.5% as projected in the previous ERP. While the much lower than expected deficit in 2019 explains a lower initial debt level (17.5% of GDP in 2019 instead of projected 19.4%), further increases look moderate given the expanding deficit, the reason for which is not explained in the programme. In 2019, the share of domestically held debt increased to nearly 66% of the total, from 62% a year before. Domestic debt is held by a narrow investor base, with the Kosovo Pension Security Trust and the Central Bank accounting for around 38% and 23% respectively of the total. A further 35% of domestic debt is held by commercial banks. The public debt also includes state guarantees, with their share assumed to remain very small at 0.5-0.6% of GDP. The IMF and IBRD hold nearly one third of Kosovo's international debt each, while the remaining part is mainly with foreign banks. The share of short-term domestic debt (maturing within 1 year) is expected to decline from 39.7% in 2019 to 27.6% in 2022, leading to rising average maturity of domestic debt from 2.3 years in 2019 to 2.6 in 2022. Kosovo still does not have access to international debt markets due to the lack of an international credit rating. While the outgoing government was reviewing debt law, which would include provisions regulating the access to international markets, the ERP does not report on any progress in this regard. The ERP foresees that government deposits will reach the legally required level of 4.5% of GDP in 2020, but assumes that they will decline to

3.1% and 2.2% in 2021 and 2022 respectively, which technically complies with the rule but still implies a reduction of fiscal buffers<sup>3</sup>.

### **Debt dynamics**

Despite sizeable budget deficits in 2020-2022, public debt is forecast to rise very gradually to 20.7 % of GDP in 2022. Robust economic growth and inflation are expected to mitigate the increase in the debt-to-GDP ratio, which is driven by an expanding primary deficit. A large downward contribution to the debt ratio is expected to come from stock-flow adjustments in each year, which is not explained in the ERP.

Table:

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

	2018	2019	2020	2021	2022
<b>Gross debt ratio [1]</b>	<b>16.9</b>	<b>17.5</b>	<b>18.7</b>	<b>19.9</b>	<b>20.7</b>
Change in the ratio	0.7	0.6	1.3	1.1	0.8
<i>Contributions [2]:</i>					
<b>1. Primary balance</b>	<b>2.7</b>	<b>2.6</b>	<b>5.2</b>	<b>4.8</b>	<b>4.0</b>
<b>2. "Snowball" effect</b>	<b>-0.5</b>	<b>-0.6</b>	<b>-0.6</b>	<b>-0.5</b>	<b>-0.5</b>
<i>Of which:</i>					
Interest expenditure	0.3	0.3	0.4	0.5	0.5
Growth effect	-0.6	-0.7	-0.7	-0.8	-0.9
Inflation effect	-0.2	-0.3	-0.3	-0.2	-0.2
<b>3. Stock-flow adjustment</b>	<b>-1.5</b>	<b>-1.4</b>	<b>-3.3</b>	<b>-3.2</b>	<b>-2.7</b>

[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) 2020, ECFIN calculations.

**The fiscal scenario is subject to significant fiscal risks and uncertainties that are mostly acknowledged by the programme.** As in the previous programme, fiscal projections are very likely to underestimate current spending while the assumption of a very large surge in capital spending in 2020 appears unrealistic. On the expenditure side, the increase in allocation for social transfers seems rather moderate. However, given the recurring spending overrun on war veteran pensions in the absence of a reclassification of beneficiaries, and new transfers for Albanian teachers who worked in the parallel system in the 1990s, the envisaged growth of 0.7% as compared to the 2019 outcome is likely to be exceeded. Further fiscal risks relate to the cost of the Law on public salaries<sup>4</sup>, which is currently suspended pending review by the constitutional court, and to potential new social spending initiatives, such as a universal child benefit scheme currently being considered by the new government. The projected 45% increase in capital spending seems overly ambitious given the track record of the previous years, limited progress in improving project implementation capacities, and the political impasse at the beginning of 2020. Additional fiscal risks stem from the poor management and financial performance of publicly owned enterprises, which could require further subsidies from the budget. On the revenue side, the projected rise in tax revenue (7.2%) also looks ambitious in the absence of policy measures, with revenue gains expected to come from higher GDP growth and improved collection of tax debt. Moreover, revenues could underperform since projections are based on the 2019 budget instead of the (lower) outcome, which results in rather high assumed annual growth rates for certain taxes. There is ample room for further improving revenue collection efficiency, which, together with reviewing tax expenditures, would help meet the revenue targets.

<sup>3</sup> The underlying assumption for 2021 and beyond is that the liquidation funds of the privatisation agency (PAK) will have been spent by then, which would lead to non-applicability of the deposit rule.

<sup>4</sup> A full year implementation of the Law on salaries could raise the wage bill from the envisaged allocation of €650 to €730 million, bringing wage growth rate to 19%, in breach of the wage bill rule.

**Box: Sensitivity analysis**

The ERP analyses the sensitivity of the debt-to-GDP ratio to three specific shocks. (1) A slowdown in GDP growth by 2 pps. While adhering to the fiscal rule in 2023-2030 would bring the debt-to-GDP ratio to 32.5% instead of 30% in the baseline scenario. (2) If, due to higher spending, the primary balance deteriorates by 1pp of GDP in 2023-2030 and the fiscal rule is not adhered to, the debt would increase to 41% of GDP by the end of 2030, i.e. 12 pps. higher than in the baseline scenario. (3) A 1 pp increase in interest rates on loans, combined with compliance with the fiscal rule, would have a negligible effect on public debt, as 84% of total debt has a fixed rate. The sensitivity analysis underscores the importance of respecting the fiscal rule, especially the 2% deficit rule, which acts as a debt stabiliser.

**Weaknesses in public finance quality are insufficiently addressed and remain a concern.**

The budget composition does not adequately support growth, due to continuously expanding current spending and delayed implementation of capital projects. The relatively benign budgetary outcome is repeatedly achieved on the back of a significant under-execution of capital projects. Rising and non-targeted social transfers not only undermine fiscal stability, but also hinder private-sector development by increasing reservation wages and incentivising informal employment. Public-sector salaries already significantly exceed private-sector wages, which negatively affects the attractiveness of private sector employment. Continuous delays in capital project implementation result in poor quality of transport, energy, education and health infrastructure, which impedes Kosovo's competitiveness and economic development, as demonstrated by a stubbornly high merchandise trade deficit.

**Kosovo's fiscal rules provide the main anchor for macroeconomic and fiscal stability while safeguarding high out-of-budget capital spending.** However, the enforcement of the fiscal framework suffers from the unfinished reclassification of war veteran beneficiaries and constantly expanding social commitments. The exemption from the 2% deficit ceiling of capital projects financed by privatisation proceeds and donors 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. While the authorities show willingness to adhere to the wage bill rule, this could be challenging if the new Law on salaries enters into force without mitigating measures. The proper functioning of Kosovo's rules-based framework is also conditional on the quality of fiscal statistics, which require substantial further improvement.

**4. KEY STRUCTURAL CHALLENGES AND REFORM PRIORITIES**

The Commission has conducted an independent analysis of Kosovo's economy and identified the main structural challenges to competitiveness and inclusive growth, drawing on Kosovo's own ERP and other sources. The analysis highlights a number of structural challenges across many sectors. The four most important ones are: (i) increasing activity and employment levels; (ii) aligning education outcomes to labour market needs; (iii) tapping renewable and energy saving potentials and fully opening the energy market and (iv) formalisation of the economy. While the economy is experiencing several obstacles to inclusive growth and competitiveness, the identified key structural challenges have the biggest potential for enhancing inclusive growth and competitiveness and possess real reform leverage.

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

***Key challenge #1: Increasing activity and employment levels, especially of women and young people***

**No progress was made in expanding the labour market.** Almost two thirds of Kosovo's population is of working age. The working age population will increase over the next decade, as Kosovo has one of the youngest populations in Europe. The lack of attractive employment opportunities and the skills mismatch are the causes for high inactivity and very low employment levels, which are currently showing no signs of improvement. According to official statistics approximately 60% of the working age population, or 719 000 out of 1.19 million Kosovars of working age, were economically inactive in 2019 Q4. Furthermore, of the 41.4% of the population that is economically active, 25.3% are unemployed. The employment rates remain very low by EU and international comparison, at merely 30.7% in 2019 Q4 (men: 47%, women: 14.2%). Besides the low level of employment, 19.5% of employed persons are working in unstable jobs, either as self-employed without employees or people working without pay in a family business. Males are more likely to hold such unstable jobs according to the Kosovo Agency of Statistics (KAS).

**The labour market indicators reveal the huge challenges ahead, especially for Kosovo's youth.** Young Kosovars are facing a particularly difficult situation. One young person (15-24) in two is unemployed (49.1%, 2019 Q4) and one out of three (34.1%) is not in education, employment or training. Labour market functioning is problematic: 27.8% of young adults are working without a work contract. Among the working age population who have an employment contract only 9.7% are benefiting from social security scheme. Civil Society Organizations point out discrimination in vacancy announcement, non-payment of salary contributions and pension contributions, unjustified dismissal from work, use of public vacancies for party-based employment etc. Among the unemployed a large proportion is unemployed for more than 12 months. Around 10% of all registered unemployed people (over 10 000) are higher education graduates in the social sciences with poor job opportunities. Skills gaps persist and are widening due to emigration, especially in the IT sector and medicine. Lack of career guidance and labour market transition support are noted as factors impeding individuals' labour market opportunities. In order to significantly improve young people's labour market performance, Kosovo could study the feasibility of developing a scheme inspired by the EU Youth Guarantee initiative.

**People are leaving the labour market and businesses find it hard to hire workers with the right skills.** The inactivity rate (15-64) peaking at 58.6% (39.8% for males compared to 77.6% for females (2019 Q4), suggests that people are not joining the labour market. At the same time, according to the World Bank most businesses face challenges when hiring workers. About 59% of the businesses which tried to fill a low-skill position and 77% which tried to fill a higher-skill position faced difficulties, because candidates did not have the required skills and job experience. Larger and more innovative companies are more affected by the skills gap. Other factors such as high level of informality and corruption are also major obstacles to job creation. Another bottleneck to job creation is the size of firms: 95% of firms in the private sector, mainly operating in the retail sector, have fewer than 10 employees and hence have limited growth capacity. Outflow of workforce is also a serious business impediment and poses a substantial brain-drain risk for Kosovo. The lack of an economic perspective is considered a key factor that is fuelling emigration of youth and skilled workers.

**Labour market outcomes suffer from the gender gap.** Kosovo has the lowest level of female employment in Europe (13.3% in 2019 Q2 for the 15-64 years group). Similarly, gender differences also persist in employment and unemployment dynamics. Among those in the labour force, unemployment is higher for women than for men (36.6% compared to 22.0% - Q4 2019). Women were employed in the education, trade and health sectors (53.5% of

women employed). Men were mainly employed in the trade, construction and manufacturing sectors (43.8% of employed men (Q4 2019)). Nevertheless, while men on average have higher educational attainment than women, among the employed population the percentage of individuals with university education is twice as high for women. Inactivity has a strong gender dimension: men are more likely to be inactive for market-related reasons (education or training), while over half of females who are inactive reported family responsibility as being the reason.

**The low level of labour market participation of women is caused by multiple factors, among which a limited availability of early childhood education and care.** Childcare is provided by family members in over 95% of households with children under 6 years of age, while care is provided through institutional childcare (2017) for only 2% of households. The share of children aged less than 6 years attending formal childcare was 18%. Recent research by the World Bank, D4D, and Riinvest suggests that there are multiple barriers to women's participation in the labour market, including: family responsibilities in combination with limited access to quality and affordable child and elderly care; conservative social norms and discrimination; lower levels of education and work experience among women; barriers in the labour law (e.g. high cost of maternity leave for employers); and women's limited access to assets and productive inputs (World Bank, 2018).

**Implementing and monitoring the implementation of the sector strategy 2018-2022 and the youth employment plan 2018-2022 will be key to increasing employability.** As in some other Western Balkan countries, Kosovo has a multiplication of strategies and action plans, while facing difficulties in implementing them, mainly due to the lack of capacity, ownership, coordination and budget. The recently adopted sector strategy anticipates five pillars of intervention, one of them aimed at increasing employment, developing market relevant skills and improving labour market administration. The youth employment plan will serve as a basis for guiding the government's annual work programme in relation to youth employment and education policies, the development of the mid-term expenditure framework, Kosovo's annual budget and partners' funding strategies. The effective implementation and monitoring of the action plan will need strong political support as well enhanced coordination and cooperation between ministries, donors and other bodies involved.

**The capacity of the Employment Agency should be significantly increased to deal efficiently with the high level of unemployment and inactivity.** It is hard for the unemployed to find jobs, mainly due to the mismatch between skills and the needs of the labour market. In addition to the necessary alignment of the education system with the labour market, the role of the Employment Agency is essential to providing high quality services to jobseekers and to the business community to improve the match between supply and demand. It is obvious that its scarce resources are not in line with the level of the services expected (1 advisor per 1,400 unemployed). Public investment in effective labour market policies, including upskilling, is too small to bring about significant improvement. The monitoring/evaluation of the impact of the implemented measures is still at an early stage.

*ERP reform measure 19 (Improving and expanding public employment services and increasing the employability of long-term unemployed, young people, women and other vulnerable groups)* is similar to the measure included in the previous ERP. The number of beneficiaries of active labour market measures (ALMMs) should be more ambitious in order to bring improvements in the labour market. Increased partnerships with business organisations should also be considered. The Employment Agency should also develop its monitoring capacities and expand the reach of its services to rural areas. The draft Labour Law should include maternity and paternity rights, and be adopted as soon as possible.

## ***Key challenge #2: Aligning education outcomes to labour market needs***

**The poor performance of Kosovo's education system calls for urgent action.** Even though Kosovo's young population (50% under the age of 30) represents a major potential for Kosovo's development, tapping this potential requires a major shift in government's education policy. In terms of overall outcomes of general education, Kosovo scored amongst the worst performers in the 2018 PISA assessment, with more than 70% of underperformers in mathematics, reading and sciences (the target for EU MS is below 10 % of underperformers). Even the highest-performing students scored only around the OECD average. Kosovo ranked the worst of the Western Balkans and Turkey. The OECD signals as a specific problem for Kosovo named the suppression of the growth mind set. More than 60% students agreed with the statement that 'intelligence is something about them that they can't change very much', which consequently means that those students are unlikely to make the investments in themselves that are necessary to succeed in school and in life. There is a need for the authorities to reflect on results and to improve their education policies and outcomes.

**Public spending in the education sector in Kosovo is insufficient.** In spite of the steady growth of public spending in recent years (from 3.3% of GDP in 2007 to 4.7% of GDP in 2019), making Kosovo comparable to other countries in the region, the country lags behind other countries in terms of student per capita spending due to its low GDP level and a large number of students.

**Availability of early childhood education and care is very limited.** As reported by UNICEF based on the recent Multiple Indicator Cluster Surveys data, only about 14% of children between 3 and 5 years attend early childhood education and only 6% of children had fathers engaged in activities to promote their learning and school readiness. Kosovo is far from the European benchmark of 95% of children in early childhood education. Only 83% of children are developmentally on track in at least three of the following four domains: literacy-numeracy, physical, social-emotional, and learning. UNICEF also reports that child health indicators in Kosovo are among the poorest in the region, pointing to gaps in both access to and quality of healthcare. Child labour resulting from poverty is an important issue which need an appropriate response from the Labour Inspectorate and Centres for Social Welfare.

*Reform measure 16 (Developing early childhood education)* proposes to increase by 2,100 the number of children enrolled in preschool education until 2022. The measure should be more ambitious in order to have a significant impact. Kosovo needs also to progress according to the 11<sup>th</sup> principle of the European Pillar of Social Rights on affordable and good quality early childhood education. The stakeholders need urgently to agree on adopting the new curriculum for pre-school.

**Quality of teaching is a serious obstacle in most VET schools.** Approximately 57% of upper secondary students in Kosovo follow a vocational education and training (VET) pathway but the sector remains dogged by its lack of attractiveness to students, with general secondary and higher education enjoying greater prestige. Teaching and learning methods in VET schools are largely theoretical and offer limited practical training and suffer from a lack of teaching and learning materials. The VET sector could benefit from the dual model, as suggested by recent studies. The private sector should be more involved in defining labour skills that are needed in the market. Furthermore, a full lifelong learning perspective for skills development is still to be developed. The ERP's *reform measure 17 (Implementation of the new curriculum framework in the VET system)* proposes the adoption and piloting of a new curriculum for VET adapted to labour market needs, and revision of its funding formula. The measure is relevant, but, the proposed new curriculum is still focused more on academic content rather than on the development of competences and skills.



**A high proportion of young people is leaving higher education with limited skills and employment perspectives.** The completion rate is low and there is a high unemployment rate among university degree holders (10% of registered unemployed are young graduates), suggesting a mismatch between higher education programmes and labour market needs. Furthermore, the capacity of universities to undertake research work is limited, which impacts negatively on the quality of post-graduate programmes and hampers innovation and economic development in Kosovo. The procedures to recruit and promote university professors as well as the regulation which lays down the minimum accepted standards for research criteria need to be revised.

*ERP Reform measure 18 (Enhancement and quality assurance in higher education)* in the ERP is very much focused on institutional aspects, and does not contain elements that would concretely improve the link to the labour market, such as career guidance, traineeships in study programmes, or evaluation of labour market outcomes of graduates.

### **Key challenge #3: Formalisation of the economy**

**Widespread informality continues to represent a key structural challenge for Kosovo's economy.** An assessment conducted in 2017<sup>5</sup> points to an estimated figure of the informal economy amounting to €1.845 billion, around 31.7% of GDP, with 23.57% for the grey economy (legal but undeclared activities) and 8% coming from the black economy (illegal activities) as well as a tax gap for income and VAT taxes of around €106.8 million. A recent assessment from the IMF<sup>6</sup> estimates that the shadow economy in Kosovo stood at 38.8% of GDP in 2016. The most affected sectors are construction, retail trade, accommodation and transport. From an employment perspective, more than 45,000 full time equivalent employees were estimated to be working in the informal sector, with agriculture at the top followed by real estate and trading activities. In spite of some positive developments resulting from measures taken by the government, such as increased cooperation on joint investigations and inspections and the drafting of tax compliance plans, informality still remains a key challenge.

**Informality has significant negative consequences.** First, it reduces the tax base, limiting the fiscal space for more productive spending in priority areas, such as education and infrastructure. Second, it creates an uneven playing field amongst businesses and is a deterrent for private sector investment, including foreign direct investment. According to the latest business environment and enterprise performance survey (BEEPS V), competition from 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 a major issue, the highest among all 30 countries covered in BEEPS V (the average was 39%). In addition, firms operating in the informal sector have more difficulties in accessing finance and tend to engage less in research and development and innovation and hire fewer workers. Moreover, workers in the informal sector have limited access to social protection and additional benefits, and are more vulnerable when they lose their job or retire. Their access to training is also negatively affected, which further exacerbates the inadequate skills of the workforce.

**The high level of informality in Kosovo is linked to the low trust in government, the perception of poor quality public services, the prevalent corruption levels and related challenges in law enforcement.** Taxation issues, normally presented as a cause for informality, are not considered a major contributor to the phenomenon (tax levels are

---

<sup>5</sup> 2017 estimations based on 2015 statistical data. EU-funded project Further support to Kosovo institutions in fight against organised crime, corruption and violent extremism (2017), *Assessment on the extent of the informal economy in Kosovo*.

<sup>6</sup> IMF (2019), Working Paper: Explaining the Shadow Economy in Europe: size, causes and policy options.

relatively low and ease of paying taxes is relatively good – Kosovo ranked 57<sup>th</sup> in the World Bank Doing Business Report).

**Formalising the economy brings benefits from an economic and social perspective.** Higher collection of tax revenues provides additional resources to improve public services, particularly to invest in key infrastructures (e.g. energy) and in social sectors. It also creates a more favourable environment for investment, access to finance, higher productivity and competitiveness levels. Finally, formalisation brings higher levels of job security and protection, particularly for those groups of the population most affected by informal employment, namely women and youth.

**To address the adverse effects of the informal economy, Kosovo adopted two strategies to prevent and fight it, the first in 2014 and the second in 2019.** Appraisal of the impact of the first strategy against its targets was jeopardised by the lack of regular assessments of the tax gap and other key indicators on informality. Available data suggest only a slight reduction of the share of the informal economy in GDP between 2013 (32.7 %) and 2015 (31.7 %). This progress resulted mainly from a reduction of the grey economy, reflecting an improvement in the effectiveness of the tax and customs administrations practices. On the other hand, during that period, the size of the black economy increased, which calls for a more robust criminal justice response in the fight against high-level corruption and organised crime.

**The new strategy adopted in May 2019 includes relevant measures to address informality and provides for improved monitoring mechanisms. Among the target set by this new strategy for 2023 are the reduction of the share of the informal economy in GDP to 26%, a reduction of the informal employment rate to 10% (down from the official baseline value of 14% in 2019) and an increase in final confiscation of criminal assets, particularly in sectors with high risk activities.** Its action plan (2019-2021) anticipates action in key areas such as statistics and risk and impact assessments, registry of businesses, reduced use of cash as means of payment, cooperation between the tax administration and law enforcement authorities, and labour inspections. In comparison to the previous strategy, it benefits from the inclusion of qualitative and quantitative indicators that will enhance the monitoring process.

**Measures to address the underlying causes of informality related to the business environment and incentives to formal work should complement the strategy.** While the strategy comprises relevant measures to fight informality, it would benefit from measures aimed at improving the business environment, in particular the simplification, merger and abolishing of licences and permits and the reduction in the duration of commercial dispute settlements. Both measures would largely help reduce incentives for businesses to engage in informal activities. Improvement of the employability of groups most affected by informality and the elimination of disincentives to formal work, such as the inadequate structure of social benefits, with a prevalence of categorical benefits, would also help reduce informal employment levels.

**The implementation of the ongoing strategy, which is still in its early stages and has been negatively affected by the 2019 political context, has led already to some improvements.** During 2019, combined activities deployed by the Tax Administration, including audits, investigations, inspections and visits, changes in the electronic tax system, etc., generated an increase of 10.4% in tax revenues when compared to 2018<sup>7</sup>. The Kosovo Customs, law enforcement agencies and other relevant institutions stepped up their coordination, particularly in high-risk tax evasion areas and entities. In addition, the Kosovo Customs' Law

---

<sup>7</sup> Source: Economic Reform Programme (ERP) 2020.

Enforcement Directorate carried almost 200 joint activities with the Kosovo Police, the Tax Administration and Kosovo Force in the field of combating the informal economy, smuggling, trans-border illegal activities and premise searches, etc.

**Other relevant measures were implemented in 2019, although some are at an early stage of preparation or implementation.** The Law on Tax Administration and Procedures and the Labour Law, both pending approval by the Assembly, include provisions to lower the threshold for cash transactions between businesses from €500 to €300 and for mandatory payment of salaries through bank transfer. The implementation of a tax compliance plan for the construction sector, one of the sectors most affected by informality in Kosovo, was initiated and the number of visits and controls based on risk assessments increased. On informal employment, 20 new officers were recruited for the reinforcement of the Labour Inspectorates' teams, and the Tax Administration and the Ministry of Labour and Social Welfare are developing a joint plan to assess and tackle informality in the labour market. The first implementation report of the strategy is foreseen to be concluded during the first quarter of 2020.

*Reform Measure 11 (Reducing the informal economy)* aims to implement selected priorities of the new strategy, many of them already initiated in 2019. While the measure is relevant and reflects the Commission's assessment, some of the activities proposed are not ambitious enough, especially the ones planned for 2020. As for the activities envisaged for 2021 and 2022, they seem credible and significant enough to boost productivity and growth, while reducing both the grey and black economy.

***Key challenge #4: Tapping renewable and energy-saving potentials and fully opening the energy market***

**The inadequate and unreliable supply of electricity is one of the main constraints on Kosovo's competitiveness and acts as a brake on productivity.** The outdated power system essentially relies on old, inefficient and highly polluting lignite thermal power plants (TPP) with a total installed capacity of 1,560 MW, only operating at 880 MW, and covering around 92% of electricity production. There are two lignite-fired generation TPP (Kosovo A and Kosovo B). Currently, most power plant units in Kosovo are at the end of their technical lifetime. This situation is exacerbating critical air pollution. The technical upgrade to reduce the environmental impact of Kosovo B, supported by the EU, is expected to start in 2020. The rest of the electricity is generated by small hydropower, wind and solar power plants. Electricity demand and consumption continues to grow steadily. This, together with the ageing of the power plants and the insufficient flexibility to adapt to consumption in peak periods, means that electricity has to be imported and exported to balance the system. Net imports were at 366 GWh in 2019 (imports of 1,242.2 GWh and exports of 876.2 GWh).

**The reliability of the electricity supply is still below the average for Europe and Central Asia.** Despite some improvements in the reliability of supply, Kosovo ranks 90th in the world for ease of getting electricity (World Bank, 2020). The lack of energy security gives rise to significant costs for business and represents the one of the main obstacles 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.

**Kosovo has been making some efforts to diversify its energy production mix, with new wind farm and solar projects, but the main planned new generation capacities continue to rely on coal.** As regards the planned *Kosova e Re* power plant (450 MW) at a total estimated cost of over €1 billion, the contractor for the works has been selected but this costly project could have macro-fiscal implications due to state guarantees, could raise electricity prices for consumers and will contribute to deteriorating air quality. 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: according to the Kosovo Agency of Statistics the RES share was 22.9% in 2019. 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 use of fuelwood is the most used commodity for house heating, complemented by a mix of coal and wood, with a very negative impact on the air quality, making Kosovo one of the most polluted areas in Europe. *Reform measure 2 (Increasing diversity of energy sources)* was rolled over from last year's ERP, but with substantial changes: the activities related to the construction of the Kosovo e Re power plant were dropped and there are new activities aimed at the introduction of a market-based mechanism for the development of renewable energy sources, which is in line with Kosovo's decarbonisation targets. On the other hand, the power generation from small hydropower plants is planned to increase, raising concerns over their environmental impact.

Furthermore, **limited efforts were made to improve the efficiency of support schemes for renewable energy projects.** The use of feed-in tariffs hampers the opening of the auction market and damages consumers' interests by imposing high prices outside market trends. The declining costs of renewable energy and the interest of financial actors in investing in Kosovo is offering new possibilities of diversifying its energy mix. There is an increase in RES investments and several projects are already planned to develop important wind, hydro and solar energy sources. However, the development of hydro sources needs to be carefully assessed, and consequent environmental impact must be considered. Kosovo could advance much further in its targets by adopting a national energy efficiency action plan. The Energy Community is expected to adopt new energy and climate targets for 2030, aiming at the same level of ambition as the EU's targets and this will require substantial additional efforts from Kosovo.

**Kosovo needs to promote energy efficiency, as the potential for energy savings is significant, and it is key to overcome the challenges relating to the energy supply.** Some efforts were made to increase energy efficiency incentives for the rehabilitation of public buildings and households. Distribution losses remain high if compared with regional standards (technical losses of 13.17% and commercial losses of 14.75% produced total losses of 27.92% in 2018). Moreover, investment in and maintenance of the distribution network remain low. The Law on energy efficiency facilitated the establishment of an Energy Efficiency Fund that needs to start its operation in 2020. Energy efficiency measures mainly target the public sector, however, and there is a need to increase energy efficiency incentives to households and the private sector, which account for 39% of the final electricity consumption. Kosovo would also need 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. *Reform measure 1 (Reducing energy consumption through energy efficiency measures)* anticipates the deployment of further energy efficiency measures, particularly through the Energy Efficiency Fund, but the actions remain overly focused on public sector infrastructure investments, with no policies or incentives to save energy in the residential and private sectors. Kosovo would also need 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 and in implementing the third energy package, 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 would purchase the electricity produced by the plant, could be detrimental to market opening and therefore not respecting Energy Community and EU law. Kosovo has the lowest electricity prices for households in the Western Balkans: €0.06 per kWh in the first half of 2019, as compared with a regional average of €0.08 and an EU average of €0.2 per kWh (Eurostat) and do not fully reflect the real costs. As agreed in the 2019 ERP policy guidance, Kosovo should prepare a plan for the gradual adjustment of energy tariffs that reflects the expected upward pressure on prices from the significant investments required in the sector costs, while developing a programme for protecting vulnerable customers, in line with Energy Community requirements.

**Despite progress, regional integration is still 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. Additional steps were made towards further integration of energy markets with Albania by the signature of a bilateral agreement between transmission system operators in December 2019 to establish a joint control block. This, however, can only be implemented once the energy dispute with Serbia is solved. The current situation imposes significant losses on the Kosovo operator (KOSTT) and threatens the security of the European power system.

**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 for the benefit of citizens in the EU. Since the 20 principles are essential for countries if they are to achieve fair and well-functioning labour markets and welfare systems, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar to guide the aligning of their labour markets and welfare systems with those of the EU.

**On most of the principles of Pillar, Kosovo performs considerably below the EU average according to the indicators of the Social Scoreboard<sup>8</sup>.** 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.

Kosovo		
<b>Equal opportunities and access to the labour market</b>	Early leavers from education and training (% of population aged 18-24)	Better than EU average, improving
	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, no change
<b>Dynamic labour markets and fair working conditions</b>	Employment rate (% of population aged 20-64)	Worse than EU average, no change
	Unemployment rate (% of population aged 15-74)	Worse than EU average, deteriorating
	GDHI per capita growth	N/A
<b>Social protection and inclusion</b>	Impact of social transfers (other than pensions) on poverty reduction	N/A
	Children aged less than 3 years in formal childcare	Worse than EU average, trend N/A
	Self-reported unmet need for medical care	N/A
	Individuals' level of digital skills	Worse than EU average, trend N/A

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

**Investments in the education system, in particular the early stages, is very limited.** The vast majority of children under 5 receive no formal early childhood education. In school year 2018/2019, the number of children in public pre-school education (from 0 to below 5) has slightly increased and in public pre-primary education (5-6) has decreased when compared to year 2017/2018. The only indicator, in which Kosovo saw improvement between 2016 and 2018, is the share of early school leavers, which decreased from 12.7% to 9.6%, i.e. below the EU-28 average (10.5%).

**Kosovo's performance on social inclusion, social protection and poverty alleviation is mixed.** Social expenditure is largely 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. Low-income households have less access to essential services and for many of them services are not affordable, because they are left unassisted by government subsidy programmes (Social Assistance Scheme). A planned reform of the SAS is expected to broaden the coverage of vulnerable categories.

**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 Income and Living Conditions are not yet conducted. Specific challenges exist with regard to establishing indicators based on population data, e.g. in the area of education.

<sup>8</sup> The Social Scoreboard includes 14 headline indicators, of which 12 are currently used to compare Member States performance (<https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/social-scoreboard-indicators>). The 12 indicators are also compared for the Western Balkans and Turkey, with one small adjustment for the age bracket for the unemployment rate (reducing the upper age bracket to 64 instead of 74 years) due to data availability. The assessment includes the country's performance in relation to the EU-28 average (performing worse/better/around the EU-28 average, generally 2018 data are used for this comparison) and a review of the trend for the indicator based on the latest available three-year period for the country (improving/deteriorating/no change). Data from 2016-2018 are used and can be found in Annex A.

## 5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2019

<b>Overall: Limited implementation (27.9%)<sup>9</sup></b>	
<b>2019 policy guidance</b>	<b>Summary assessment</b>
<p><b>PG 1:</b></p> <p>Complete the war veteran certification and reclassification processes in order to decrease the costs of the war veteran pension scheme in line with the current legislation.</p> <p>Ensure, if necessary through secondary legislation to the Law on Public Salaries, that the 2020 budget complies with the existing fiscal rules, in particular with the wage bill rule.</p> <p>Improve the collection of tax revenues so that the ambitious revenue projections for 2019 are fully met.</p>	<p>There was <b>limited implementation</b> of PG1:</p> <p>1) <b>Not implemented:</b> The reclassification has not been done, despite being long overdue. Consequently, the actual expenditure for this scheme has exceeded the initial annual budget allocations by €20 million by the end of 2019, overrunning the rule of the ceiling of cost by 0.7% of GDP as indicated in the amended Law on war veterans.</p> <p>2) <b>Limited implementation:</b> Due to resignation of the Government, no secondary legislation was adopted to enable the full implementation of the new Law on Public Salaries that entered into force on 1 December 2019. Once in force, the Ombudsperson challenged the new law at the Constitutional Court, and the latter took the decision to suspend it with an interim measure of 3 months, with the recommendations that the current system of salaries be applied until then. If the Constitutional Court has not delivered a verdict before then, a further extension of the suspension is possible.</p> <p>3) <b>Partial implementation:</b> in 2019 Kosovo has increased tax revenue collection as compared to the previous year, due to robust GDP growth and the reduction of tax debt. Nevertheless, the overall tax revenue fell short of the envisaged target in the 2019 budget.</p>
<p><b>PG 2:</b></p> <p>Improve financial oversight and accountability of publicly owned enterprises (POEs).</p> <p>Strengthen institutional capacities at central and local government levels for multiannual investment planning and investment project management in order to improve the execution of capital spending.</p>	<p>There was <b>limited implementation</b> of PG2:</p> <p>1) <b>Limited implementation:</b> The new Law on POEs, including regulation of financial support, was sent to the government. Financial oversight, accountability and efficiency of the POEs remain weak and require that the Kosovo authorities take concrete actions. No progress was made in conducting regular fiscal risk assessment and strengthening institutional management of POEs. Currently, the legal authority for central oversight of POEs remains unclear.</p> <p>2) <b>Limited implementation:</b> the approved administrative instructions prepared by the Ministry of Finance on improving planning, selection, execution and monitoring of capital projects entered into force on 1 January 2020, including steps taken for multiannual commitments in the financial statements. Prior to this, the Ministry organised training sessions for the Budgetary Organisations, with further sessions planned during 2020. However, due to low administrative capacity and the lack of political decisions, execution of capital spending continued to be slow during</p>

<sup>9</sup> 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](https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en).

<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>2019, with a 60% rate of execution. 3) <b>Limited implementation:</b> the working group set up by the Ministry of Finance has continued working on the options paper, which observes several examples of how such bodies are established in other countries. However, finalisation of the option paper is still pending.</p>
<p><b>PG 3:</b></p> <p>Continue improving the central bank's analytical toolkit, including by establishing an inflation expectations survey.</p> <p>Further identify and address the underlying legal and institutional factors hampering access to finance for SMEs.</p> <p>Closely monitor the emergence of potential financial stability risks related to the consumer loan segment, deploying appropriate micro- and macroprudential policy tools if needed.</p> <p>Continue to base decisions concerning the central bank's holdings of government securities on a transparent investment policy, and gradually reduce their level to avoid crowding out private sector activity on the secondary market.</p>	<p>There was <b>partial implementation</b> of PG3:</p> <p>1) <b>Substantial implementation:</b> An inflation expectations survey has been established and integrated into the lending survey. In the inflation expectations survey commercial banks are asked about their inflation expectations for (i) the whole current year, (ii) the remainder of the current year, (iii) the next year. However, the CBK has not yet published comprehensive results of the inflation expectations survey.</p> <p>2) <b>Limited implementation:</b> No new measures were undertaken in 2019. The World Bank is providing technical assistance looking at supply side-constraints. The KCGF is used extensively by commercial banks, but regulatory and judicial bottlenecks continue to hamper access to finance for SMEs.</p> <p>3) <b>Limited implementation:</b> The ERP states that lending activity to households has been carefully monitored, but no micro- or macroprudential tools have been deployed, and the availability of data on consumer lending for further analysis remains limited. The CBK asked the World Bank FinSac for technical assistance, which is planned for April 2020, to investigate making potentially a better use of the credit registry for analysis.</p> <p>4) <b>Limited implementation:</b> The level of holdings of government securities increased by 5.8% between March 2019 and January 2020. The CBK has shared their internal investment policies with us and plans to publish a framework of investment principles on the webpage.</p>
<p><b>PG 4:</b></p> <p>Increase energy efficiency incentives for the private sector and households;</p> <p>Adopt a plan that includes the gradual adjustment of energy tariffs reflecting expected increases in costs and mitigation measures for vulnerable consumers;</p> <p>Improve the support schemes for renewable energy projects with the introduction of competitive bidding/auctions for renewables support.</p>	<p>There was <b>limited implementation</b> of PG 4:</p> <p>1) <b>Limited implementation:</b> Support schemes for the private sector and households continued to be introduced, mainly driven by international financial institutions and donors. They include preferential credits through commercial banks and micro-lending institutions. However, the scope of these schemes remains limited and incentives in energy efficiency in this segment, accounting for almost 40% of Kosovo energy potential, need to become an investment priority.</p> <p>2) <b>Limited implementation:</b> A study providing recommendations for developing a programme to support vulnerable consumers was delivered to the government working group by the World Bank. Although the work has progressed, the vulnerable consumers programme still needs to be adopted by the authorities and no plan for the adjustment of tariffs has been produced.</p> <p>3) <b>Limited implementation:</b> Some steps have been taken to improve the support schemes for renewable energy projects, but competitive bidding/auctions have not been introduced. The necessary transition to competitive bidding procedures for renewable energy capacities is undermined by the continued use of fixed feed-in tariffs by the energy regulator (feed in-tariffs of 42 MW and 20 MW for solar PV in June and November 2019 have been approved,</p>



	significantly exceeding the target, but were challenged by the Basic Court of Pristina). The increase in new renewables investments in Kosovo in 2019, especially wind and solar, is however noteworthy.
<p><b>PG 5:</b></p> <p>Ensure the implementation of the new Strategy and Action Plan 2019-2023 to fight the informal economy in accordance with the prescribed timetable, integrating appropriate actions to address undeclared work.</p>	<p>There was <b>limited implementation</b> of PG 5:</p> <p>1) <b>Limited implementation:</b> the working group on informal economy has been operationalised and has met regularly. Kosovo institutions have started implementing the strategy and action plan adopted in May 2019. In particular, some steps were taken to increase controls based on risk assessments by Kosovo Tax Administration and to address the phenomenon of informal employment. The action plan now includes appropriate actions to address undeclared work. However, the political instability and delays with establishment of the new government have generated delays.</p>
<p><b>PG 6:</b></p> <p>Develop active measures for increasing female labour market participation and employment;</p> <p>Increase the provision of vocational education and training for professions in demand;</p> <p>Increase investments in education with particular focus on expanding early childhood education.</p>	<p>There was <b>limited implementation</b> of PG 6:</p> <p>1) <b>Limited implementation:</b> The expenditure on ALMMs increased from €1.8 million in 2018 to €6.1 million in 2019. However, these measures are not specifically focused or targeted on women. In fact, the share of registered unemployed women participating in ALMMs is lower than that of male (3.9% vs 9.4% according to 2017 data from the Agency for Employment). Only 6.3% of the registered unemployed are covered by ALMMs provided by the Employment services.</p> <p>2) <b>Limited implementation:</b> The quality of provision of VET for professions in demand has not increased in the reporting period. However, a mapping of skills has been carried out using donor funds that can provide a good basis for reforming the provision of VET.</p> <p>3) <b>Limited implementation:</b> In 2019, public spending on education in terms of percentage of GDP remained at the same level as in 2018 (4.7%). The average public spending per student increased by 12% between 2017/18 and 2018/19 (from €610 to €684) and the number of children aged 0-5 attending preschool education slightly increased from 8,335 in 2018/2019 (representing a participation rate of 6.2%) to 9,393 in 2019/20 (participation rate of 18%). Nonetheless, Kosovo is far below the OECD spending averages of €9,300 on spending per student and 87% share of 0-5 year old children attending preschool education.</p>

## **6. ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2020-2022**

### ***Business environment***

**The improvement of the business environment is key for the effective transformation of Kosovo's economy.** The 2020 World Bank Doing Business Report, which ranked Kosovo 57<sup>th</sup> (dropping 13 places from the previous year), acknowledges progress made in dealing with construction permits, getting electricity, protecting minority investors and enforcing contracts. A general inspection reform, for which a new law is pending approval, is expected to simplify and decrease the number of overlapping and parallel inspections. However, this progress is considered limited and has not translated into Kosovo becoming more attractive to investments. The latest BEEPS found that electricity supply was among the top three obstacles constraining domestic companies and deterring potential investors from locating their businesses in Kosovo, along with corruption and the informal sector. Other important challenges are weak contract enforcement, the mismatch between skills and labour market needs and undiversified and limited access to finance. Higher salaries in the public sector are also seen as a deterrent to attracting workforce to the private sector. The Kosovo Investment and Enterprise Support Agency needs to strengthen its role in promoting investments and exports, through the provision of before and after-care services and programmes in support of investments and the private sector.

### **Measure 7: Adoption of Evidence-Based Policies and Reduction of Administrative Burden**

The reform measure is rolled over from past ERPs. The activities are valid and can help improve public service delivery by ensuring political buy-in from the top. However, the implementation of the strategy needs to go beyond legislative changes. While it is important to look at legal requirements that are currently excessive, it is also necessary to review other aspects of administrative burden. There is a need to expand e-government services that could be accessed through digital identification. Different government IT- databases need to be interconnected, which requires close inter-ministerial cooperation. These aspects are not reflected in the activities. The budget corresponds to the proposed activities. The indicator on reduction of permits and licenses is realistic, but seems to have been achieved already.

### **Measure 8: General Inspection Reform**

This measure remains a slowly developing process. In its third year of preparation, the reform has incurred delays partly due to the political stalemate in 2019. The horizontal nature of this reform may cast doubts whether the proposed timeline of activities during 2020-2022 can still be seen as reasonable and realistic. The reform will continue to require solid administrative capacity especially once the implementation of the Law on Inspections starts. Sizeable coordination efforts will be required in particular during and after rationalising the inspection bodies and amending sectoral legislation. Regarding the latter activity, while it is scheduled to take place in 2020, it is most probable that sectoral review and legal modification will take several years. Whereas the list of central inspectorates and special inspection units are broadly defined in the draft Law on Inspections, it is expected that details of those will be defined through separate laws after the adoption of the Law. The expected impact has measurable indicators and the costing of activities appears realistic with the exception of the amendment of sectoral legislation, which is not reflected in the costs.

### **Measure 9: Establishment and functioning of the Commercial Court**

The measure is new, although related to last year's measure to increase the efficiency of the judiciary in resolving cases. The measure has the potential to increase efficiency in handling

commercial cases and help reduce the duration of dispute settlements, including the backlog, in which case it would clearly improve the business environment. However, the activities need to be more specific and the implementation risks are underestimated. The set targets seem to be overly optimistic. The judicial reform should take into account potential implications on the relevant Belgrade-Pristina dialogue agreements, including the Justice Agreement, and should be aligned and harmonized with other ongoing reform initiatives. Since the establishment of the Commercial Court will have implications for the judicial structure, it should be ensured that the relevant legal framework detailing the judicial system in Kosovo, as well as any procedural issues, is properly analysed and drafted in order to avoid future contradictions within the legal framework. The impact of the measure could also be complemented by a more systematic promotion of alternative dispute resolution mechanisms. The measure has been budgeted; however, the costs need to be more clearly specified.

#### **Measure 10: Reduce informality in the real estate sector**

The proposed measure is linked to last year's ERP (measure 8), but entails substantial changes. The title of the measure can be misleading; the activities are not sufficiently developed to adequately tackle the informalities in the real estate sector and, as a result, may have negative implications for the economy. The proposed measure is limited only to addressing the issue of uncontested informal transactions that occurred prior to 1999, by introducing a new procedure for formalisation of those transactions before the Kosovo Property Comparison and Verification Agency. However, adding the formalisation of transactions that occurred prior to 1999 to the portfolio of the Kosovo Property Comparison and Verification Agency may be seen as contrary to the ongoing administrative reform, whose aim is to reform this Agency in the long run. Furthermore, the measure does not tackle the issues of all contested informal transactions and other informal transactions that occurred after 1999, nor of fraudulent property transactions that ought to be processed by the prosecutors/courts; this significantly limits the potential impact of this measure. In conclusion, the measure lacks a strategic and comprehensive vision for reducing informalities in the real estate sector. There is no correlation between the aim of the measure and the activities listed therein. The planned funding of the measure relies exclusively on donor funding.

#### ***Research, development and innovation (RDI)***

**Kosovo's performance in the research, development and innovation (RDI) sector is still very low** in its various dimensions (governance of RDI policies, public research system, public-private linkages, innovation in firms and human resources for innovation), and record the lowest scores in the Western Balkans region<sup>10</sup>. In 2018, a new Law on Innovation entered into force and an updated national innovation and entrepreneurship strategy was drafted. Nonetheless, the sector suffers from the fragmentation of competencies for implementing the innovation policy and the lack of overall coordination among line ministries and the SME agency KIESA. Overall financial support for research and development is also very limited (less than 0.1% of GDP compared to an average of 2% in the EU), particularly for business innovation. Horizon 2020 performance is steadily increasing, albeit from a very low level. Kosovo took its first steps in the development of a smart specialization strategy, but will be challenged by the unavailability of most statistical data.

#### **Measure 12: Improving the Environment for Innovation and Entrepreneurship**

This measure seems ambitious. The activities proposed are a step in the right direction. However, most of the activities focus on financial support to businesses and innovation

---

<sup>10</sup> OECD (2018), *Competitiveness in South East Asia – a policy outlook 2018*.

centres rather than tackling the underlying structural problems preventing innovation from happening, which are not only financial. The measure lacks a systemic, comprehensive approach towards education, research and development (the whole knowledge triangle), which has to stem from the adopted strategy on innovation. Support to research institutions and cooperation between them, universities and the business sector (the triple helix) is key to starting and developing R&D in Kosovo, but is not provided for in the measure. On the other hand, the activities to be performed by the innovation centres and the sources of funding for their functioning are unclear. There is only one indicator, which is focused on employment growth in micro, small and medium enterprises (MSMEs) and none on the benefits of innovation processes or on key indicators for the R&D sector. The proposed financial sources seem adequate for the implementation of the proposed activities.

### ***Digital economy***

**The digitalisation of the economy is gradually advancing.** Kosovo achieved the midterm targets of its 2013-2020 Digital Agenda, as household penetration of fixed broadband internet reached 93.2% and penetration to mobile telephony stands at 115.68%. With less than 10% of households still unconnected, Kosovo is reducing the infrastructure gap between urban and rural areas and looking to provide high-quality broadband to uncovered areas. Kosovo also engaged constructively in high-level regional dialogue on digital transformation and implementation of a Regional Roaming Agreement as of 1 July 2019, which will gradually remove roaming prices in public mobile communication networks for all end users. However, Kosovo needs to continue to develop the legal framework and necessary infrastructure to stimulate e-commerce and allow for international electronic payments. Additional efforts are also required to finalise the e-governance strategy. On cybersecurity, Kosovo is improving its legislation to ensure the security of network and information systems; however, it should step up the implementation of relevant measures in this field, particularly by allocating the necessary financial and human resources.

### **Measure 13: Extension of relevant ICT networks and services infrastructure for socio-economic development**

The measure is rolled over from past ERPs. It is quite ambitious and covers all the necessary and relevant aspects of development of the sector. Rolling out parts of the measure from one year to the next (extension of broadband, training, implementation of the Electronic Identification, Authentication and Trust Services Regulation (e-IDAS)) is realistic. The results are well defined and realistic, as it is the estimated impact on social outcomes. The activities are well-costed and financing sources well identified, as some of the activities are already ongoing. The measure is expected to also lead to improvements in other sectors such as education, business and rural development.

### ***Investment activity***

**Despite being among the most open economies, foreign direct investment (FDI) in Kosovo remains limited (averaging 4.2 % of GDP in 2013-2018), with a negative long-term trend and mainly originating from the large Kosovar diaspora.** The sectoral distribution of FDI remains dominated by non-productive sectors, namely real estate and construction, which have limited impact on the efficiency of the Kosovar firms. There is potential to attract more FDI: Kosovo has a good strategic location, a young population and relatively low labour costs. However, the imposition of a 100 % tariff on all imports from Serbia and Bosnia and Herzegovina put into question Kosovo's commitments to international agreements and could have had long-term consequences for the investment climate. Other key issues affecting FDI are the lack of basic infrastructure and of stable electricity supply, poor education skills, weak rule of law, corruption and the slowdown in the privatisation process.

### ***Trade performance***

**Kosovo is highly reliant on imports and suffers from a chronic high trade deficit.** The trade deficit in goods in 2018 reached almost €3 billion (representing 27.31% of GDP), with imports reaching €3.3 billion while exports were just over €360 million. If exports of services helped to partly offset the persistent goods trade deficit, they are dominated by the travel account, which registers expenditures by non-residents (mainly diaspora) in Kosovo, explaining during 2018 around 80% of total services exports. Most of Kosovo's goods exports still consist of basic raw materials and mineral products, reflecting a limited diversification of the production sector. Trade with the CEFTA region accounted for 47.2% of total Kosovo exports in 2018 (compared to 30% in 2008) and 25.5% of total imports of goods. Due to higher growth of exports than imports during the last ten years, Kosovo has experienced an improved export coverage ratio with the region, from 9.1% in 2008 to 20.3% in 2018. An opposite trend is observed in trade between Kosovo and the European Union. In this case, exports have been almost stagnant, with an average annual growth rate of only 1.44% between 2008 and 2018, whilst imports from the EU grew at an average annual growth rate of 6.2%. CEFTA remains an important market for Kosovo exporters, but obstacles and barriers to trade persist, ranging from political, such as the above mentioned 100% tariff, to non-tariff barriers.

Kosovo is encouraged to implement all 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 into regional and European value chains and help increase the attractiveness of the economy for FDI in tradable sectors, notably by extending the market size. Further connectivity with neighbouring countries in transport and energy will strengthen access to, and integration into, the regional market. CEFTA's new agreement to liberalise trade in services also opens new opportunities in the dynamic service sectors and therefore should be implemented swiftly. The creation of a regional digital space and more integrated labour markets with neighbouring economies will offer new possibilities for the Kosovo's youth, which is also important in light of the high youth unemployment.

#### **Measure 14: Trade facilitation through reducing the cost of trading transactions**

This measure is rolled over from the previous ERP. It is well designed and quite ambitious. It also seems realistic, given that the implementation of several activities is ongoing through EU-supported processes. However, some activities, such as WTO membership negotiations, entail political risks and depend on external factors. Despite that, the structural measure is relatively narrow in scope, aiming to reduce the cost of trading transactions. As such, it does not address the structural challenges in the area of trade like the high trade deficit and dominance of low base exports products and non-tradable services. The result indicators are clear and relevant; however, the costs seem to be underestimated given the ambition of the measure.

#### **Measure 15: Further development of quality infrastructure and empowerment of the role of market surveillance authorities**

This measure is a continuation of the one identified in the previous ERP. It is ambitious, but contains some inaccuracies. It is well designed, but the implementation risks of some activities are underestimated (e.g. accreditation of product certification bodies and accreditation of calibration laboratories). The quality infrastructure agencies and the Ministry benefit from an ongoing EU funded project, which will be implemented until mid-2021.

Therefore, the activities identified in the ERP are aligned to the ones identified in the EU project and will benefit from the support of EU experts.

### *Transport*

**Transport links are less of a constraint on Kosovo's competitiveness than other sectors, but further connectivity with neighbouring countries would strengthen its integration into the regional market.** Investments have been primarily focused on road infrastructure rather than other modes of transport, without a proper balance of resources devoted to the maintenance of roads and railway networks. On rail, the rehabilitation of Route 10 linking southern and northern Kosovo, the Serbian border and Pristina with the capital of North Macedonia, the biggest investment in Kosovo's railway in four decades (around € 200 million), should improve Kosovo's railway network and its connections with the wider European network. Regarding aviation, status issues including lack of revenue from upper air space management constraint Kosovo's ability to invest in training, infrastructure and safety.

### *Agriculture*

**Low productivity levels and high production costs characterise Kosovo's agriculture.** Although remaining relatively large, the sector's share of gross value added continues to decline (9.7% in 2019 compared to 12.8% a year before). Farmers in Kosovo are faced with several constraints, such as high levels of small farms and land fragmentation<sup>11</sup>, outdated farm technologies, lack of production diversification, limited capacity to grow and limited provision of technical support. Although measures have been developed to address some of these issues (e.g. irrigation systems and organic farming), further investments and efforts are needed to ensure their implementation and to enhance the competitiveness of the agricultural sector in Kosovo. Existing support schemes would benefit from a more holistic approach to developing value chains and integrating them in export markets, instead of direct subsidies for agricultural production and food processing facilities. Other neglected areas are the protection of the agricultural land, environment and the less favoured areas (hillsides, rolling land, etc.) with reduced productivity.

#### **Measure 3: Structural changes in the agriculture sector**

This measure could lead to very important improvement in Kosovo's competitiveness in this sector. The development of a master plan on irrigation and expansion and rehabilitation of the irrigation network are particularly pertinent. The implications for gender equality have been duly considered, as has the potential increase in exports. However, implementation is lagging behind and activities have been carried over from the previous year. The measure also lacks the detail to assess its potential effectiveness. Land consolidation, which had been included in previous ERPs, is not considered at all, despite no considerable developments. Protection against transformation and degradation of agricultural land is not tackled either. The important work on the organisation of the markets, the integrated agriculture information system, on quality policy and forestry, supported by the EU, is not mentioned despite its importance for the sector. The measure also ignores the substantial work that is needed to prepare the new Agriculture and Rural Development Programme 2021-2027. The impact on the environment should be considered given the substantial negative externalities of increased production. Only part of the activities seem to have a secured budget. The link between the activities and the indicators is not evident.

---

<sup>11</sup> Approximately 93.03% of agricultural holdings or 100,576 belong to farm size categories of less than 5 ha (Source: Ministry of Agriculture, Forestry and Rural Development (2019), Green Report 2018).

## *Industry*

**Kosovo's industry is characterised by low added-value and competitiveness.** The sector makes a modest contribution to GDP (at around 22 %) and employment (around 14 %). Manufacturing is dominated by food processing and non-metallic mineral products and contributes to 70.3 % of total exports (with metals and rubber and plastics products accounting for 42 % of the total). While manufacturing has the potential to generate quality jobs and raise incomes, industrial development continues to face structural problems. The sector is dominated by MSMEs with low levels of integration into global value chains, innovation and FDI. There is no comprehensive policy framework, and support services for SMEs are weak. Inter-ministerial coordination in this policy area is very weak and responsible institutions such as the Kosovo Investment and Enterprise Support Agency 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.

### **Measure 4: Increasing competitiveness in the production industry**

The effort to establish a more coordinated industrial policy is a positive sign, as activities lack an overall vision and solid needs assessment. It is unclear if the planned industrial policy strategy will be a separate document from the existing private sector development strategy 2019-2022, which has already been developed and awaits adoption. Some activities, like the organisation of international export and investment fairs and the subsidising of companies are not considered as structural reforms. The only activity that could constitute a reform is the construction of physical infrastructure for economic zones. However, the expected impact on the competitiveness of the manufacturing sector remains only marginally outlined. Further efforts are needed to strengthen the private-public dialogue and to use sector-specific business associations to consult the private sector. The measure should also reflect initiatives to promote higher added-value goods with improved quality standards oriented for exports. The measure does not include activities for 2022, whereas the target of increasing competitiveness in the manufacturing sector is a long standing objective. Although the estimated cost of the mentioned activities appears solid at first glance, a significant share is for the construction of infrastructure of economic zones, and its impact and sustainability are not substantiated. Regarding the indicators, a more illustrative measurement could be the share of companies in the processing industry exporting to regional and EU markets. IPA direct funding for SMEs has not been factored into the budget.

## *Services*

**In spite of being the driving force of the economy, Kosovo's services sector suffers from lack of competitiveness and relies heavily on non-tradable services.** With a share of 58.5% of GDP and 70.3% of total formal employment, this sector constitutes the backbone of the private sector (comprising 86 % of registered firms) and is mainly composed of non-tradable activities (accounting for around 70 % in 2017). Trade in services has shown dynamism in recent years, reflected in a sustained service trade surplus and an important contribution to Kosovo's current account. However, exports of services are strongly dependent on travel services (which represented 80 % of total services exports in 2018), the majority of them comprising visit trips undertaken by Kosovo diaspora (not tourism), which raises concerns over its sustainability in the long run. Similarly to manufacturing, the development of a competitive tradable services sector is being held back by an unfavourable business

environment, a deficit in quality infrastructure, and poor access of firms, especially small and medium enterprises (SMEs), to technology and finance.

#### **Measure 5: Increasing competitiveness in the tourism and hospitality sector**

The measure to develop tourism products in Kosovo's touristic regions is rolled over from the past ERP. However, the measure is not ambitious enough to have a significant impact on the economy. In addition to the need for a strategic vision, reform of the sector would also require a concrete action plan with allocated resources. As such, the proposed measure is rather limited in terms of increasing the attractiveness and recognisability of the country. The allocated resources seem realistic for the activities planned, however, neither the resources nor the activities are sufficient to reach the expected results. The measure considers the impact on the environment and the need for inter-institutional cooperation to alleviate the impact, but it fails to include other relevant actions, such as abolishing illegal landfills and cleaning waste across the territory, which is a precondition for attracting tourists.

#### **Measure 6: Increase the competitiveness in the sector of trade in services**

The measure is over-ambitious and some activities are unrealistic as they would require more time to be implemented, such as the finalisation of negotiations for mutual recognition of professional qualifications. The impact of having mutual recognition of professional qualifications in place is over-stated, as it would first require large-scale reform of the education system to ensure the systems of the region are equivalent to each other. The measure does not include the implementation of the Law on Services adopted in 2017, which largely transposed the EU Services Directive. After successfully screening the compatibility of the sectorial legislation with the EU Services Directive, a 5-year action plan for the implementation of the EU Services Directive was approved by the Government in July 2018. The implementation of this action plan and the Law on Services should be taken into account in any reform of the services sector. In particular the activities planned in 2021 to eliminate barriers to trade in services under the CEFTA Additional Protocol 6 (AP6) would be very much helped by the implementation of the above-mentioned action plan. The activity on analysis of local regulations to be aligned under AP6 is over ambitious as the exercise is very lengthy and requires adequate expertise.

#### ***Education and skills***

This sector and the relevant reform measures 16, 17 and 18 are analysed above in section 4 under the challenge #2.

#### ***Employment and the labour market***

This sector and the relevant reform measure 19 are analysed above in section 4 under key challenge #1. This sector is also assessed under key challenge #2.

#### ***Social dialogue***

**The potential of social dialogue remains untapped.** The reduction in the high level of informality in the labour market may improve access of concerned workers to their rights. It could also have a positive effect on the functioning of the social dialogue. However, the structure of the labour market hampers the establishment of a fair relationship between employers and employees. A number of business confederations represent mostly the interests of larger-employers, while over 90 % of registered companies are micro-enterprises with fewer than 10 employees. Although the legal framework is in place, there is little political will to use social dialogue in the process of drafting policies and legislation. The capacity of social partners, in particular that of trade unions, remains limited. A protracted conflict over the



composition of the Economic and Social Council (ESC) is to be solved by amending the law governing the ESC, but progress is pending on this front.

### ***Social protection and inclusion***

**Kosovo has very high poverty rates by EU and regional standards.** The most recent MCC survey (2017) established an at-risk-of-poverty rate of 36.5% (around 10 percentage points above the level for the region as a whole). The level and structure of social spending 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. According to the latest Household Budget Survey (2017) more than half of the households in Kosovo are unable to pay utility bills once or twice during the year. For 44% of households, budgets are stressed and any increase in one area of household spending means a family must reduce expenditure on other basic necessities.

#### **Measure 20: Improving social services and empowering excluded groups**

This measure has been rolled over from last year with substantial changes. The activities related to health sector have been dropped without a justification, although they have not been fully implemented. As regards the new measure, the activities are predominantly focused on legislative changes, among which the reform of the Social Assistance Scheme aiming at removing disincentives for employment or to register for employment services provided by the Employment Agency. The costs of the measure need to be more specified.

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

Area/Sector	2018	2017	2016	EU-28 Average
<b>Energy</b>				
Energy imports dependency (%)	N/A	30.0%	23.6%	55.1% (2017)
Energy intensity: Kilogrammes of oil equivalent (KGOE) per thousand euro	445.87	459.95	504.58	117.69
Share of renewable energy sources (RES) in final energy consumption (%)	24.9%	23.1%	24.5%	17.98%
<b>Transport</b>				
Railway Network Density (meters of line per km <sup>2</sup> of land area)	N/A	30.9	N/A	49.9 (2016)
Motorisation rate (Passenger cars per 1 000 inhabitants)	N/A	154	N/A	507 (2017)
<b>Agriculture</b>				
Share of gross value added (Agriculture, Forestry and Fishing)	8.9%	11.4%	13.0%	1.6%
Share of employment (Agriculture, Forestry and Fishing)	3.5%	4.4%	N/A	4.0%
Utilised agricultural area (% of total land area)	N/A	38.2%	N/A	40.0% (2017)
<b>Industry</b>				
Share of gross value added	21.8%	21.8%	21.5%	19.1%
Contribution to employment (% of total employment)	14.3%	17.4%	18.0%	17.3%
<b>Services</b>				
Share of gross value added	58.5%	56.9%	57.4%	73.8%
Contribution to employment (% of total employment)	70.3%	65.3%	66.3%	71.9%
<b>Business Environment</b>				
Rank in WB Doing Business (Source: World Bank)	40	60	64	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	N/A	N/A	N/A	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	N/A	N/A	up to 38.8%	
<b>Research, Development and Innovation</b>				
R&D intensity of GDP (R&D expenditure as % of GDP)	N/A	N/A	N/A	2,12%
R&D expenditure – EUR per inhabitant	N/A	N/A	N/A	656.5€
<b>Digital Economy</b>				
Percentage of broadband penetration (Mobile and fixed) [NB: households]	93%	89%	N/A	86%

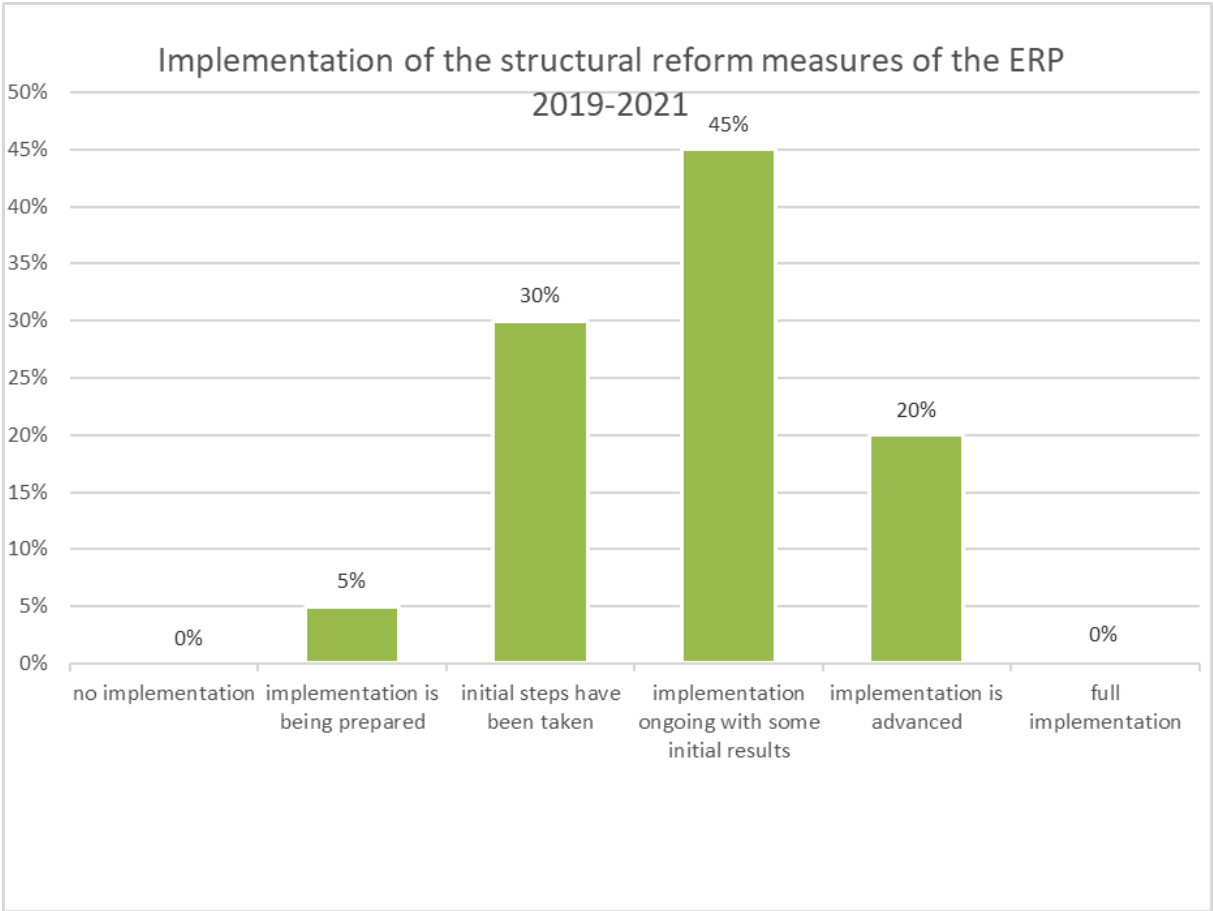
Share of total population using internet [NB: population 16-74]	87%	83%	N/A	85%
<b>Trade</b>				
Export of goods and services (as % of GDP)	26.4%	26.7%	23.7%	46.2%
Import of goods and services (as % of GDP)	55.6%	52.5%	50.9%	43.0%
Trade balance (as % of GDP)	-44.3%	-41.6%	-40.9%	
<b>Education and Skills</b>				
Early leavers from education and training (% of population aged 18-24)	9.6%	12.2%	12.7%	10.5%
Youth NEET (% of population aged 15-24)	30.1%	27.4%	30.1%	10.5%
Formal child care - children aged less than 3 years (% of total)	N/A	N/A	N/A	35.1%
Individuals' level of digital skills (% of individuals aged 16-74 who have basic or above basic overall digital skills by sex)	N/A	21%	N/A	57% <sup>(2017)</sup>
<b>Employment</b>				
Employment Rate (% of population aged 20-64)	33.2%	34.4%	33.1%	73.2%
Unemployment rate (% of labour force aged 15-64)	29.6%	30.5%	27.4%	7.0%
Gender employment gap (Difference between the employment rates of men and women aged 20-64)	38.5%	39.4%	35.4%	11.6%
<b>Social Protection System</b>				
% of population at risk of poverty or social exclusion	N/A	N/A	N/A	21.9%
Impact of social transfers (Other than pensions) on poverty reduction	N/A	N/A	N/A	33.2%
Self-reported unmet need for medical care (of people over 16)	N/A	N/A	N/A	2.0%
Income quintile share ratio (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	N/A	N/A	N/A	5.17

Sources: EUROSTAT and Kosovo Agency of Statistics, unless otherwise indicated.

**ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM THE ERP 2019-2021**

There was a relatively good progress in the implementation of the measures in 2019, with an average score of 3.2 out of 5. The reporting on the planned activities is thorough and provides in general a fair description of the level of implementation.

Implementation is higher in some measures, such as measure 2 on the development of energy generation capacities, measure 5 on increasing competitiveness in the manufacturing industry and measure 9 on increasing the efficiency of the judiciary in resolving cases. At the same time, implementation is weaker in other measures, such as measure 18 on reforming pre-university education and measure 20 on improving social and health services and particularly weak on measure 10 on implementing the General Inspection reform.



## **ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS**

The Economic Reform Programme 2020-2022 was adopted by the government on 22 January 2020 and submitted to the Commission on 30 January 2020 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 ERP was coordinated by the Prime Minister's Office and the Ministry of Finance (MF). The engagement of line ministries and other stakeholders has improved. The ERP attempts to present fiscal impact assessment/budgeting of structural reforms. Coordination between the MF, SPO and Ministry of European Integration as National IPA Coordinator is less visible, partly explaining why the EU-funded IPA activities are not taken into account or are misplaced in the costing part of the structural measures.

### *Stakeholder consultation*

The public consultation process is assessed as satisfactory. Since the parliament was not functional during the consultation process, consultation was not possible at that level. The draft was made available online. In addition, a consultation meeting took place, to which the main stakeholders were invited. IFIs and donors were quite active in providing comments, however the turnout and engagement from CSOs and businesses was relatively low.

### *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 2019 World Economic Outlook. 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 updated tables of macroeconomic data were sent after the ERP submission, hence there are some discrepancies with the ERP assessment figures.

### *Fiscal framework*

The fiscal framework was prepared without the approved budget for 2020. The fiscal projections for 2020 are based on the draft budget prepared by the outgoing government and the medium-term expenditure framework. For 2020 the ERP envisages relatively high revenue and expenditure projections as compared with the 2019 outcome; these are subject to a number of risks that are acknowledged in the ERP. While intended changes in debt management would benefit from better explanation, the ERP provides a useful debt sustainability analysis under three negative shocks. The fiscal tables in the ERP annex are not fully consistent with the main text, the updates have been provided after the ERP submission.

### *Structural reforms*

The structural reform priorities follow the guidance note and largely reflect the challenges in the priority area. Some activities are over-ambitious and too unrealistic to be implemented in the planned timeframe, while others are not ambitious enough to tackle the key challenges. With some exceptions, the reporting on implementation of the policy guidance is sufficient. The reporting on implementation of structural reforms is partially sufficient. The number of reform measures respects the limit of 20. Table 9 is partially complete. Tables 10a and 10b and table 11 are only partially correct. There are some inconsistencies in the rating of the implementation of the reforms. Table 12 is filled in appropriately.

## REFERENCES

- European Training Foundation - *Policies for human capital development: South Eastern Europe and Turkey – An ETF Torino Process Assessment.*
- European Training Foundation – *Country Strategy Paper 2020 Update: Kosovo.*
- European Bank for Reconstruction and Development (2016), *Business Environment and Enterprise Performance Survey (BEEPS V).*
- European Bank for Reconstruction and Development (2019), *Transition Report 2019-2020.*
- IMF (2019), *Explaining the Shadow Economy in Europe: Size, Causes and Policy Options Working Paper.*
- OECD (2018), *Competitiveness in South East Europe: A Policy Outlook.*
- OECD (2018), *Programme for International Student Assessment (PISA), Volume III.*
- OECD (2019), *Assessing the implementation of the Small Business Act for Europe: Kosovo Small Business Act Profile.*
- World Bank (2018a), *Regular Economic Report no.14.*
- World Bank (2018b), *Promoting Women’s Employment in Kosovo*, Brief, 12 September 2018.
- World Bank (2020), *Doing Business 2020: Comparing Business Regulation in 190 economies.*
- World Bank, *Western Balkans Regular Economic Report: Fall 2019.*
- World Bank (2019), *Kosovo Country Report: Findings from the Skills towards Employment and Productivity Survey.*