EUROPEAN
COMMISSION

Brussels, 22.4.2021
SWD(2021) 93 final

COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

KOSOVO*
(2021-2023)

COMMISSION ASSESSMENT

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** 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.*

1. Executive summary

Amid high levels of uncertainty, the Economic Reform Programme (ERP) expects an economic recovery from the COVID-19 induced recession in 2020. The ERP forecasts real GDP growth to rebound to 5.2% in 2021 and continue in line with the historical trend in subsequent years. The key growth drivers are expected to be the recovery of services export and a large surge in public investment, following sharp contractions in 2020. The key downside risks to this outlook stem from continued pandemic-related restrictions and persistent under-execution of public capital spending.

At 7.9% of GDP, the headline budget deficit is set to remain as high in 2021 as in 2020 due to economic recovery measures and a surge in public investment. As per the fiscal rule definition, which excludes some capital spending, the deficit is set at 4.7% of GDP in 2021, while a gradual return to the deficit ceiling of 2% of GDP is projected for 2023. Large financing needs are expected to be met by using government deposits and issuing new debt. Ensuring budget financing for 2021 while preserving adequate fiscal buffers will be a key challenge. Public debt increased rapidly from 17.5% of GDP in 2019 to 23.1% in 2020 and is set to reach 34.8% by 2023. Immediate fiscal risks, some of them thoroughly assessed in the programme, stem from slower-than-expected economic recovery and political uncertainty, a likely under-execution of capital spending and an underestimation of current spending, mainly on social benefits.

The main challenges facing Kosovo include the following:

- **Supporting the recovery with appropriate measures remains key in 2021, while there is a need to plan gradual fiscal consolidation and compliance with the deficit rule in the medium term.** The envisaged return to the 2% deficit ceiling by 2023 would benefit from structural reforms on the budget revenue and expenditure sides, which should improve the quality of public finance. Kosovo's revenue base is narrow and has been weakened by tax exemptions and preferential tax rates. Advancing tax debt collection once the recovery is entrenched could also contribute to revenue mobilisation. Current spending would benefit from the review and streamlining of social security payments, including war veteran pensions, and a coherent public sector remuneration system. The costing of fiscal initiatives before adoption is indispensable in this regard. To preserve the sustainability of public finance in the medium-term, there is a need to respect the 40% cap on public debt, and to diversify the investor base which is currently skewed towards debt purchases by the pension fund and the central bank.

- **Given multiple development challenges, which have been accentuated by the crisis, Kosovo needs a more coherent and better executed multiannual investment strategy.** While limited progress has been made in the implementation of capital projects, further efforts are needed to improve the planning, selection and control of capital projects with a view to enhancing medium-term growth potential. Fiscal risks related to publicly owned enterprises (POEs) and related investment decisions should be properly assessed, incorporated into budgetary planning and contribute to the overall investment strategy.

- **Persistent, widespread informality continues to represent a key structural challenge for Kosovo's economy.** It limits the fiscal space for public spending in priority areas, it deters the development of the private sector and it prevents a significant section of the workforce from accessing adequate levels of social protection and training. Kosovo has a strategy and a corresponding action plan that are designed to address the key underlying causes of informality. However, there are delays in implementing them and reporting on this. Strong political support, effective implementation and close monitoring are required to achieve the desired outcomes, while measures to address the underlying causes of informality related to the business environment should complement the strategy.

- **The inadequate and unreliable supply of electricity is one of the main constraints on Kosovo's competiveness and acts as a break on productivity.** The lack of energy security gives rise to significant costs for business and represents the biggest obstacle to attracting high-quality foreign direct investment (FDI). 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. Progress in achieving of regional integration could support the financial stability of the Kosovo transmission system operator (KOSTT).

- **The education system in Kosovo does not provide students with the necessary skills and knowledge currently required by the labour market**. The results of the 2018 PISA survey reveal a very poor performance by the education system. Effective quality assurance is one of the weakest points of pre-university education in Kosovo. A series of reforms were launched to improve the capacity of the employment service, which is currently insufficiently developed to ensure matching between workers and vacant jobs and the implementation of relevant active labour market policies, including upskilling and on-the-job training.

The policy guidance set out in the conclusions of the Economic and Financial Dialogue of May 2020 has been implemented to a limited extent. The government has suspended the fiscal rule and turned to the EU and the IMF for financial assistance, allowing to undertake a timely response to the crisis. The emergency measures were well-targeted but this was less the case for the economic recovery package. There has been no progress on reclassifying the war veteran pension beneficiaries, while the law on salaries for public employees was repealed by the Constitutional Court. Tax revenue fell due to the crisis, while there was little progress in reducing informality. There has been partial progress with improving financial oversight of POEs and the options paper on establishing a fiscal oversight body. Limited progress was made on improving project investment management. Financial support to the private sector via the economic recovery package was largely insufficient. Efforts to reduce the administrative burden on citizens, businesses and the public administration were limited. The government adopted a number of health strategies but their implementation was limited. There are no unemployment benefits to date and assistance for the groups most affected by the COVID-19 crisis was limited. The capacity of the public employment service has not been increased to address the increased number of registered unemployed.

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 intention to support economic recovery in 2021 and strengthen the sustainability of public finance in the medium term. It also refers to the need to review tax policies and tackle informality. However, weaknesses in fiscal governance could delay achievement of these goals. It includes measures to improve the business environment and reduce the informal economy. The ERP also partially addresses energy access challenges and 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

Sluggish growth in early 2020 evolved into a full-fledged recession following the outbreak of COVID-19. In the first quarter, real GDP increased by a modest 1.3% y-o-y due to the political stalemate and related delays in capital investment. The pandemic-related restrictions led GDP to contract by 9.3% and 7.3% y-o-y in the following two quarters, mainly on the back of falling exports of services and decreasing investment. Government spending and declining imports provided a positive contribution to GDP growth. The increase in private consumption, especially in the third quarter, seems counter-intuitive and might point to data quality issues[1].

The ERP's baseline scenario assumes that the economy will recover in 2021, but stresses a high degree of uncertainty. On the back of rebounding services exports and investment, real GDP is forecast to increase by 5.2% in 2021 and recover its 2019 level. The projected rebound is above the forecasts of the World Bank and IMF, which are set at 4% and 4.5%, respectively. In both 2022 and 2023, economic growth is projected to continue in line with the historical trend of 4.1%, but the negative output gap is not expected to close over the ERP's horizon. The projected rebound of services exports in 2021 (+22%) relies on the assumption of an improving health situation and relaxing international travel restrictions. In 2022-2023, the growth of services exports should follow the historical tend. Exports of goods are set to increase gradually in line with improving external conditions and assumed gains in competitiveness. Imports of goods are projected to increase on the back of the assumed growth in investment and consumption, while imports of services are set to recover from a low base in 2021 and follow the historical trend thereafter. The rebound in investment (16%) in 2021 is expected to be mainly driven by a large surge in public capital spending. Private investment is set to be supported by favourable credit and improving business conditions, but it is not expected to reach its pre-pandemic level until 2023. Private consumption is set to grow only modestly in 2021, due to uncertainty surrounding the economic recovery and lower inflow of remittances resulting from the lagged impact of the economic slowdown in Germany and Switzerland, and accelerate to some 3% in 2022-2023. A similar profile is assumed for public consumption, which seems at odds with the already elevated level of government spending in 2020-2021. The ERP rightly acknowledges that the macroeconomic and fiscal outlook continues to be affected by high levels of uncertainty due to the COVID-19 pandemic.

[1] This might be linked to the discrepancy between quarterly 2020 and annual 2019 GDP data as published by the Kosovo Agency of Statistics.

Table 1:

Kosovo - Macroeconomic developments

	2019	2020	2021	2022	2023
Real GDP (% change)	4.9	-6.7	5.2	4.1	4.2
Contributions:					
- Final domestic demand	3.5	-5.6	5.3	5.6	4.7
- Change in inventories	0.0	-0.3	0.2	0.1	0.1
- External balance of goods and services	1.4	-0.9	-0.3	-1.6	-0.6
Employment (% change)	5.2	-6.5	:	:	:
Unemployment rate (%)	25.6	25.5	:	:	:
GDP deflator (% change)	0.6	0.5	1.8	1.1	1.3
CPI inflation (%)	2.7	0.2	1.8	1.0	1.0
Current account balance (% of GDP)	-5.6	-4.5	-6.3	-6.1	-4.7
General government balance (% of GDP)	-2.9	-7.8	-7.9	-5.0	-4.2
Government gross debt (% of GDP)	17.5	23.1	28.6	32.1	34.8

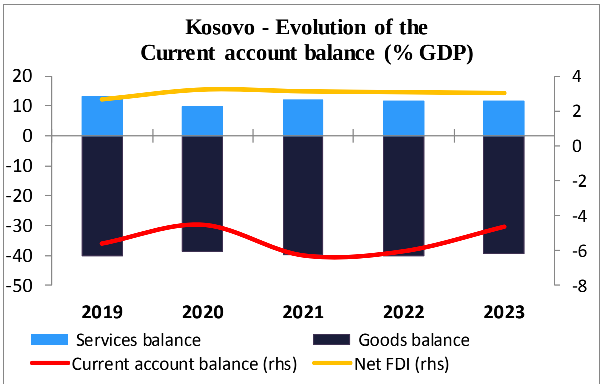
Sources: Economic Reform Programme (ERP) 2021.

Downside risks to growth predominate. In addition to uncertainty related to the evolution of COVID-19, including stricter pandemic containment measures and a slower rollout of vaccines, the programme's assessment on downside risks refers to a possibly less benign external environment and lower remittances, and potential delays in implementing recovery stimulus and capital projects. Aggregating all downside risks, the ERP's 'low growth' scenario results in 2.7% average annual growth in 2021-2023. Weak administrative capacities are very likely to intensify the risk of delays in executing capital projects. Therefore the 'low growth' scenario's assumed execution rates, which are closer to historical rates, seem more plausible in the short term. The ERP's upside risks relate to improved execution of investment projects and the positive effects of implementing planned structural reforms such as fighting the informal economy, cutting energy losses, reducing capital risk premia and increasing employment. This 'high growth' scenario is assumed to result in 5.3% average growth over the period.

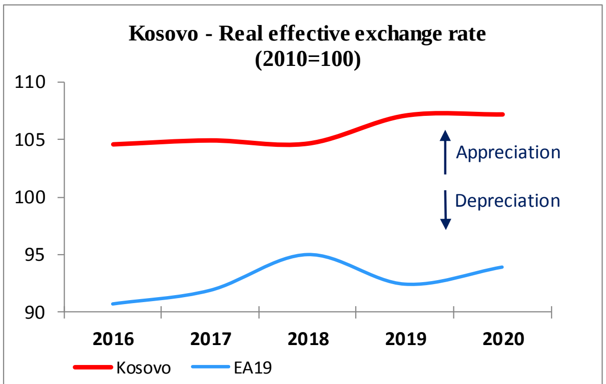
Inflation is expected to accelerate in 2021 due to higher energy prices and recovering GDP growth. Reflecting contracting economic activity, average inflation dropped to 0.2% in 2020 from 2.7% in the previous year. Other drivers of declining prices were lower energy prices and the elimination of import tariffs from Serbia and Bosnia and Herzegovina in April 2020, while a positive contribution came from food prices. Due to the projected recovery, inflation is set to rise in 2021, but remain subdued in the following years in line with the projections for the euro area.

The current account deficit narrowed in 2020 due to the compression of imports and strong inflow of remittances. Exports of services (mainly diaspora tourism from Western Europe) were the most affected by travel restrictions and dropped by 25.7% in 2020 compared to a year earlier. Exports of goods, which are much smaller and rely on a narrow sectoral base, increased by 12.6%, mainly driven by the solid performance of base metals. The sizeable contraction of imports (by 9.4%) led to a small improvement in the merchandise deficit, which narrowed to 38.8% of GDP from 40.2% in 2019, while the surplus of services trade is estimated to have declined to 9.8% of GDP from 13.1% over the same period. The overall trade deficit increased to 29% of GDP from 27% in 2019, and is projected to improve slightly to 28% during 2021-2023. The key factor partly offsetting the trade deficit is remittances, which, despite the crisis, increased by 13.1% in 2020 and amounted to 14% of GDP. Because of travel restrictions in 2020, the amount of remittances sent via official channels was higher than usual. Remittances are projected to decline by 6.1% in 2021, due to the lagged impact of the economic slowdown in Germany and Switzerland, and recover in the following years. Overall, the current account deficit is projected to deteriorate from 4.5% of GDP in 2020 to over 6% in 2021-2022 as the economy picks up pace, and moderate to 4.7% in 2023, due to decelerating growth of investment and imports in that year.

Graphs: external competitiveness and current accout



Source: Economic Reform Programme (ERP) 2021.



Source: Economic Reform Programme (ERP) 2021 and ECB.

Despite the crisis, net foreign direct investment (FDI) held up well in 2020 and covered nearly two thirds of the current account deficit. Net FDI is estimated to have increased by 13.6% in 2020, on the back of lower profit-related outflows in the financial sector and a drop in outward FDI. FDI inflows into real estate have declined, as travel restrictions reduced the number of diaspora members arriving and investing in Kosovo. Gross FDI inflows decreased by some 10% in 2020. The bulk of FDI is concentrated in non-tradeable activities, with real estate and financial services accounting for 54.8% and 27.3% of the total FDI stock, respectively, contributing little to enhancing export capacity and mitigating balance-of-payment vulnerabilities. Kosovo's net international investment position has deteriorated to -10.7% of GDP from -5.8% in 2019, mainly driven by an increase in public debt and a decrease of external assets held by the Central Bank and the Kosovo Pension Fund. More than 70.7% of gross liabilities consists of FDI, which is considered to be beneficial for macroeconomic stability, while the remaining 29.3% consists of government debt and other sector liabilities. The reserve assets covered 3.1 months of imports in the third quarter of 2020, up from 2.8 in 2019.

Table 2:

Kosovo - Financial sector indicators

	2016	2017	2018	2019	2020
Total assets of the banking system (EUR million)	3 637	3 870	4 186	4 761	5 353
Foreign ownership of banking system (%)	88.9	88.1	86.8	86.7	86.5
Credit growth	10.4	11.5	10.9	10.0	7.1
Deposit growth	7.2	6.8	8.7	16.2	11.5
Loan-to-deposit ratio	77.0	80.3	81.9	77.6	74.5
Financial soundness indicators (end of period)					
- non-performing loans	4.9	3.1	2.7	2.0	2.7
- net capital to risk-weighted assets	17.8	18.1	17.0	15.9	16.5
- liquid assets to total assets	41.5	37.9	38.5	38.7	39.8
- return on equity	19.7	21.3	20.4	18.9	14.0
- forex loans to total loans (%)	0.2	0.2	0.1	0.1	0.1

Sources: National Central Bank, Macrobond.

Despite contracting economic activity, the mainly foreign-owned banking sector has remained stable in 2020. In response to the crisis the Central Bank of Kosovo (CBK) allowed for a 3-month loan repayment moratorium, which applied to 50% of bank loans, as well as loan extensions and restructuring. These measures helped banks to avoid increasing provisions and supported credit growth, which has decelerated modestly to 7.1% in 2020 from 10% in the previous year. The growth of deposits declined to 11.5% from 16.2% over the same period. Higher growth of deposits towards the end of 2020 was partially supported by the stimulus measure that allowed the withdrawal of 10% of pension savings from the Kosovo Pension Saving Trust (KPST). Financial soundness indicators have remained satisfactory, e.g. the loan-to-deposit ratio and non-performing loans (NPLs) stood in December at 74.5% and 2.7%, respectively. While bank profitability has declined with the average return-on-equity ratio contracting to 14% in 2020 from 18.9% in 2019, the risks in the banking sector seem contained. However, the ERP and official statistics do not report the impact of CBK measures on the NPLs. The ERP does not provide quantified forecasts for the financial sector, but the underlying assumption is of an increase in NPLs during 2021, while the largely foreign-owned banking sector is not expected to face liquidity problems.

3. PUBLIC FINANCE

The 2020 budgetary outcome significantly deteriorated due to shrinking revenues and higher pandemic-related spending. The ERP estimates the 2020 headline budget deficit to be 7.8% of GDP, which corresponds to a deficit of 6% of GDP under the fiscal rule definition[2]. The fiscal rule was suspended due to the crisis, allowing for the deficit to exceed the prescribed ceiling of 2% and the government cash balance to decrease to 3.2% of GDP from 5.1% in 2019. In response to the crisis the caretaker government adopted the emergency

[2] 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.

package (EUR 180 million) in March, supporting affected businesses, formal and informal employment, the health sector, social protection of the most vulnerable households, and providing financial liquidity. As the situation continued to deteriorate, Kosovo adopted a budget revision in end-July, including an additional provision of EUR 185 million for the economic recovery programme, bringing the budgeted 2020 crisis-related stimulus to a grand total of EUR 365 million or about 5.2% of 2020 GDP. A large part of this additional support (4.3% of GDP) was spent in 2020. The economic recovery programme targeted broadly the same categories as the emergency package, with additional allocations for medical and security workers, vulnerable households, support for firms and capital spending. Further measures to support the economy included tax deferrals for firms, most of which had to be paid by end-2020, and the postponed payment of the concessionary fee for Pristina airport (-0.15% GDP). In 2020, government revenue is estimated to have contracted by 9.6% compared to the 2019 outcome. Tax and non-tax budget revenue also fell short of projections of the revised 2020 budget, with the collection rates from direct and indirect taxation standing at 94% and 96%, respectively. Non-tax revenue was supported by an additional EU grant through the resilience contract (+0.3% of GDP). Public spending increased by 6.7% or 4 pps. of GDP compared to the previous year, mainly due to the implementation of the economic recovery programme. The implementation of the revised 2020 budget was uneven among different categories, with wages and particularly subsidies and transfers significantly overshooting the revised budget allocation. Due to the political stalemate in the first half of 2020 and the low implementation rate of projects financed by international financial institutions (IFIs), capital spending contracted by 28% as compared to 2019, with only half of the planned investment expenditure actually realised while capital spending from the investment clause (i.e. financed by donors) reached only 29% of the 2020 revised budget allocation.

The declared ERP objective in 2021-2023 is to support economic recovery and strengthen Kosovo's fiscal position while improving tax policies and administration. As in the previous years, the fiscal strategy is frontloaded, assuming major increases on the revenue and expenditure sides in 2021, due to the base effect of 2020, the impact of the economic recovery programme and recovering GDP growth in 2021. The ERP provides for several tax initiatives, including taxpayer service automation, less contact between taxpayers and tax officials and the simplification of declaration procedures, in order to reduce informality. In nominal terms, direct and indirect tax revenue in 2021 is projected to increase by 12.3% compared to 2020, exceeding its 2019 level, and by 5.3% in 2022 and 4.7% in 2023. As a share of GDP, tax revenue is set at around 24% for the whole period. Despite the high base in 2020, total expenditure is set to increase further by 0.9 pps. to 34.4% of GDP in 2021 and decrease gradually to 31.7% in 2022 and 30.7% in 2023. Supported by public investment and the economic recovery package (3.1% of GDP), primary expenditure in 2021 is projected to reach 33.9% of GDP in 2021 and moderate gradually to 29.9% in 2023. The ERP assumes an extraordinary increase in capital spending in 2021 (65%), with spending from the investment clause more than doubling from the year before. In the subsequent 2 years, the nominal growth of capital spending is set to moderate to 8.7% and 5.6%, respectively. Under the fiscal rule definition, the budget deficit is expected to reach 4.7% of GDP in 2021 and adjust towards the 2% ceiling in 2022-2023. The headline deficit is projected to widen to 7.9% of GDP in 2021 and decrease to 5% and 4.2% in the subsequent 2 years.

Table 3:

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

	2019	2020	2021	2022	2023	Change: 2020-23
Revenues	26.5	25.7	26.5	26.7	26.5	0.7
- Taxes and social security contributions	24.0	23.0	24.2	24.2	24.0	0.9
- Other (residual)	2.5	2.7	2.3	2.5	2.5	-0.2
Expenditure	29.5	33.5	34.4	31.7	30.7	-2.8
- Primary expenditure	29.1	33.1	33.9	31.0	29.9	-3.2
of which:						
Gross fixed capital formation	7.5	5.7	8.8	9.1	9.1	3.4
Consumption	12.8	14.4	14.1	13.2	12.5	-1.8
Transfers & subsidies	8.8	13.1	10.6	8.7	8.3	-4.8
Other (residual)	:	0.0	0.5	0.1	0.1	0.1
- Interest payments	0.3	0.4	0.5	0.7	0.8	0.4
Budget balance	-2.9	-7.8	-7.9	-5.0	-4.2	3.6
- Cyclically adjusted	-2.9	-5.4	-6.5	-3.9	-3.3	2.1
Primary balance	-2.6	-7.4	-7.4	-4.3	-3.5	3.9
- Cyclically adjusted	-2.6	-5.0	-6.0	-3.2	-2.6	2.4
Gross debt level	17.5	23.1	28.6	32.1	34.8	11.7

Sources: Economic Reform Programme (ERP) 2021.

The 2021 budget was approved in late 2020, but it is likely to be revised during the year. The 2021 draft budget was prepared in October before the adoption of the Law on Economic Recovery (in December), which envisages an additional stimulus package of EUR 200 million and some tax exemptions. Fiscal implications of the Law on Economic Recovery are not fully covered by the adopted 2021 budget (end-December), thus it is likely that the new government will need to revise the budget. The 2021 budget projects public revenue at 26.5% of GDP which is the same as in 2019. Compared to the outturn of 2020, tax revenue is set to rise by 12.3% in 2021 with a similar increase of indirect tax revenue (11.9%) and a stronger growth of direct tax income (14%). As a share of total revenues, the contribution of direct taxes is projected to increase slightly to 16.1% from 15.5% in 2019. The share of indirect taxes remains roughly at the pre-crisis level while non-tax revenue will decline due to temporary exemption of paying mining royalty. Due to the implementation of the economic recovery programme and an extraordinary hike in capital spending, budgetary expenditure is projected increase to 34.4% of GDP, which is way above the 29.5% recorded in 2019, and even exceeds the level reached in 2020. The shares of main spending aggregates are roughly the same as in 2019. The key items of the economic recovery programme are transfers to households and firms and allocations for goods and services in health sector, including for COVID-19 vaccination. While still at low level, debt interest payments are set increase to 0.5% of GDP from 0.3% in 2019. Due to large financing needs resulting from a high headline deficit at 7.9% of GDP in 2021, government cash deposits are set to drop further to 2% of GDP.

While economic recovery support measures are set to continue in 2021, their targeting is not clearly defined. As in 2020, the 2021 economic recovery programme (EUR 222.4 million or 3.1% of GDP) is a temporary measure, expected to support health spending and address the social and economic consequences of the crisis. Transfers to households and firms (1.6% of GDP) account for more than half of the programme, followed by the allocation for goods and services in health sector (0.7% of GDP), including the procurement of COVID-19 vaccines. Further items are additional allowance for public wages (0.2% of GDP) and capital spending in health and education through the investment clause (0.6% of GDP). While the overall goal is to support demand and investment, the ERP doesn't provide enough information to assess whether the measures are well-targeted. In 2020 some transfers to private firms (EUR 60 million or 1% of GDP) were done universally without analysing whether beneficiaries were hit by the pandemic. Delayed approval of the Law on Economic Recovery was hindering the implementation of recovery package in the second half of 2020 and, once adopted, it added a new ad hoc spending item to support operational expenses of private firms (EUR 200 million) without any transparent allocation criteria. Some tax exemptions, e.g. carbonated drinks from the excise duty in 2020, do not seem to be well-targeted. An exemption from paying mining royalties in 2021 is helping a sector which has been performing well despite the crisis. The ERP doesn't discuss the measures related to the implementation of the Law on Economic Recovery which are coming on top of the economic recovery programme. Since these measures are not fully included in the 2021 budget and ERP 2021 budgetary projections, it is unclear whether all of them will be implemented.

Box: The fiscal implications of the Law on Economic Recovery

* The 2021 budget was adopted on 30 December 2020 without fully taking into account the impact of the Law on Economic Recovery. Among others, the law includes an additional stimulus of EUR 200 million, aiming to support the businesses affected by the crisis, proposals to subsidise wages to employees that lost their jobs and the removal of VAT on all raw materials. It is still unclear how the law will be implemented. The 2021 ERP projections are based on the 2021 budget and allow for some minor measures resulting from the Law.

* Revenue: VAT exemption for raw materials, 5-month exemption for payments of mining royalties, reduction in VAT rate from 18% to 8% for hotels, restaurants and catering services.

* Expenditure: support for private enterprises in the amount of EUR 200 million, covering the tariffs for Kosovo Credit Guarantee Fund services to financial institutions, 5 months' of subsidies for renewable energy tariffs.

Main measures in the 2020 budget

Revenue measures*

- VAT exemption for raw materials produced in Kosovo: not specified
- Exemption for 5 months from payment of mining royalties: EUR 14.5 million (-0.2% of GDP in non-tax revenue, included in the ERP 2021 projections)
- Reduction in VAT rate from 18% to 8% for hotels, restaurants and catering services: EUR 3.4 million (less than 0.1% GDP loss in tax revenue, included in the ERP 2021 projections)

Expenditure measures**

- Support for private enterprises: EUR 200 million (2.8% of GDP): implementation not specified)
- Subsidise wages of 2 months of the employees in private sector who have lost their jobs for more than three months, by EUR 300 per month (implementation not specified, not costed yet)
- Covering the tariffs for Kosovo Credit Guarantee Fund services to financial institutions: EUR 4.5 million (less than 0.1% GDP increase in spending, not included in the ERP 2021 projections)
- Five months' of subsidies for renewable energy tariffs: EUR 15.7 million (0.2% GDP expenditure, not included in the ERP 2021 projections)

* Estimated impact on general government revenues.

** Estimated impact on general government expenditure.

Source: MoF estimates

Public debt is increasing rapidly, while the ability to meet financing needs will partly rely on the depletion of fiscal buffers. In 2020 the debt-to-GDP ratio is estimated to have increased to 22.3% from 17.5% in 2019. Domestic debt, which is held by a narrow investor base, rose by 21% in 2020 with a large share of new issuances absorbed by the Kosovo Pension Saving Trust (KPST). The share of domestic debt held by the KPST increased to 47% from 38% in 2019, while a further 21% and 28% of domestic debt are with the CBK and commercial banks, respectively. Foreign debt increased by 34% in 2020 on the back of financing provided by international donors, including EU macro-financial assistance (the first tranche of EUR 50 million has been disbursed out of a total of EUR 100 million), World Bank loans (EUR 76 million) and the IMF Rapid Financing Instrument (EUR 52 million). Significant financing needs in 2021 imply a further increase in public debt, which is expected to rise to 28.7% of GDP in 2021 and to continue to drift upwards gradually, towards 35% by 2023. The ERP expects government deposits to decline to 2% of GDP in 2021 from 3.2% in 2020, since tapping into fiscal buffers will help to meet financing needs. Government deposits are projected to stay at this level until 2023, which implies a reduced capacity to face potential new shocks. The KPST still has room to buy new bond issuances in 2021, but its legal limit[3] might be exhausted by 2022. As Kosovo cannot access international debt markets due to the lack of an international credit rating, there is a need to diversify its investor base in order to ensure adequate financing while safeguarding government deposits. This should include insurance companies, non-financial private firms and possibly diaspora investors, which together currently hold about 4% of domestic debt. The dynamics of foreign debt will depend on the political situation in Kosovo and relations with IFIs.

Box: Debt dynamics

Sizeable budget deficits in 2020-2023 will result in rapidly increasing public debt. From 2021 some offsetting impact on the debt-to-GDP ratio is expected to come from economic growth and inflation. Interest expenditure is still low but steadily increasing, to 0.8% of GDP in 2023. Downward contributions to the debt ratio are expected to come from stock-flow adjustments in 2021-2022, which might be related to the use of government deposits to meet financing needs.

Kosovo

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

	2019	2020	2021	2022	2023
Gross debt ratio [1]	**17.5**	**23.1**	**28.7**	**32.1**	**34.8**
Change in the ratio	1.3	5.6	5.5	3.5	2.7
Contributions [2]:					
1. Primary balance	**2.6**	**7.4**	**7.4**	**4.3**	**3.5**
2. "Snowball" effect	**-0.5**	**1.6**	**-1.0**	**-0.8**	**-0.9**
Of which:					
Interest expenditure	0.3	0.4	0.5	0.7	0.8
Growth effect	-0.8	1.3	-1.1	-1.1	-1.3
Inflation effect	-0.1	-0.1	-0.4	-0.3	-0.4
3. Stock-flow adjustment	**-0.8**	**-3.4**	**-0.9**	**-0.1**	**0.2**

[1] End of period.

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

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

Source: Economic Reform Programme (ERP) 2021, ECFIN calculations.

[3] Government securities should not exceed 30% of KPST assets.

The fiscal scenario is affected by high levels of uncertainty related to the macroeconomic and political situation in Kosovo. The ERP rightly acknowledges the risks related to continued COVID-19 related restrictions, which could weigh on economic recovery and the projected increase in budgetary revenue. Risks related to possible delays in capital spending, initiatives for new social transfers, poor performance by publicly owned enterprises and the accumulation of arrears are also duly acknowledged. According to the ERP, the government did not issue any new state guarantees in 2020. However, the Law on Economic Recovery allowed early, tax-free withdrawals of 10% of pension savings from the KPST (EUR 200 million or 3% of 2020 GDP) which the government promised to reimburse from 2023 onwards. This amount has not yet been included in any state guarantee or debt accounting, as the government did not issue an explicit state guarantee to underpin the promise. Further risk relates to a substantial share of uncommitted foreign debt[4] (EUR 160 million or 2.2% of GDP) which could weigh on the implementation of the recovery package and capital projects. As usual, budgetary planning for 2021 projects a conservative path for social transfers and an overly ambitious surge in capital spending. Compared to the outturn of 2020, regular social transfers and subsidies are projected to decline by 13.4% while capital spending is set to rise by 65%. The allocation for social transfers assumes that war veteran pensions will stay within the legal cap of 0.7% of GDP which, in the absence of a reclassification of beneficiaries, will not be feasible (the corresponding spending in 2020 reached 1.1% of GDP).

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. would bring the debt-to-GDP ratio to 33.7% instead of 30.4% in the baseline scenario, if the deficit rule is adhered to in 2024-2034. (2) If, due to higher spending, the primary balance deteriorates by 2 pps. of GDP in 2024-2034 and the deficit rule is not adhered to, debt would increase to 40.3% of GDP by the end of 2034, i.e. 9.9 pps. higher than in the baseline scenario. (3) A 1 pp. increase in interest rates on loans, combined with compliance with the deficit rule, would have a negligible effect on public debt, as more than 60% of total debt has a fixed rate and higher interest spending should be compensated by lower primary deficits. The sensitivity analysis underscores the importance of compliance with the 2% deficit rule, which acts as a debt stabiliser. Moreover, anticipating that financing from privatisation funds will end over the medium term, it is important to keep current expenditure under control.

A narrow tax base, inappropriate targeting and transparency of social transfers and weaknesses in investment management continue to impair the quality of public finance. A substantial share of war-related and specific category-based social transfers, so called Pillar 0 pensions, which are non-contributory and financed from the budget, do not target poverty and result in duplicate budgetary payments. In contrast, allowing the withdrawal of 10% of pension savings from KPST (mandatory defined-contribution scheme or Pillar 2) under the stimulus measures undermines the credibility of the contributory system and reduces future pensions. The lack of a focused investment strategy and continuous delays in capital project implementation have led to poor quality transport, energy, education and health infrastructure, which was exacerbated by the crisis. The planning, execution and ex-post evaluation of the public investment programme could be improved by implementing the recommendations

[4] The IMF Article IV consultation (2021)

made by the IMF under its Public Investment Management Assessment. In mid-2020 the Constitutional Court repealed the Law on Salaries for Public Employees, which helped to contain the wage bill, but left Kosovo without a transparent and fair system for the remuneration of public employees. A revised law is needed for establishing a uniform wage grid and improving compensation fairness, but any new initiative should be based on fiscal impact assessments and respect the wage bill ceiling rule. Wage increases should also better take into account productivity developments in industry. In addition to streamlining expenditure, Kosovo's public finance would benefit from strengthening the revenue base. Currently, the revenue base is weak as a result of exemptions, preferential tax rates and special regimes. It would be useful to start producing a regular review of tax expenditure, in order to assess the revenue foregone and shape future policies. The collection of tax debt, on which good progress was made in 2019, was interrupted by the crisis, but needs to be addressed in medium-term fiscal strategies.

To ensure the medium-term sustainability of public finance, a gradual return to the deficit rule is essential. The return to the 2% deficit ceiling is planned by 2023. Government deposits are not expected to revert to their pre-crisis level (4.5%), as a substantial share will be spent to finance the budget deficit in 2021. The rapidly rising debt-to-GDP ratio is likely to impact on the use of the investment clause. According to the fiscal rule definition, the exemption from the 2% deficit ceiling for capital projects financed by privatisation proceeds and donors can be invoked until 2025, provided that public debt remains below the prescribed ceiling of 30% of GDP. The debt-to-GDP ratio is projected to exceed the 30% ceiling in 2022, implying that the investment clause could not be invoked thereafter. Given the pressing need for infrastructure investment in Kosovo, a possible solution could be to align the investment clause to the general debt ceiling of 40% of GDP. Increasing the debt ceiling up to 50%, as suggested previously by the government, does not seem warranted and could weaken consolidation efforts. The proper functioning of Kosovo's fiscal framework is also conditional on the quality of macro-financial 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 three most significant ones are: (i) improving the quality and relevance of the education system to increase employment and mitigate skills mismatches; (ii) continuing to formalise the economy and to address the low competitiveness of the private sector; and (iii) tapping into the potential of renewable energy and energy savings and fully opening the energy market. While there are several obstacles to inclusive economic growth and competitiveness, the identified key structural challenges have the biggest potential for enhancing inclusive growth and competitiveness and possess real reform leverage.

Kosovo also needs to continue to tackle corruption, improve the rule of law and strengthen institutions and improve the administration's capacity in order to promote competitiveness. Addressing these fundamental concerns is a prerequisite for the successful transformation of the economy. The Commission has been closely monitoring the issues of strengthening the rule of law and fighting corruption in the annual enlargement package report on Kosovo.

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

A very large percentage of the population continues to be inactive and face considerable difficulties. Two thirds of the population in Kosovo are working age population (15-64 years) but 61.2% of the working age population is inactive. The employment rate (15-64 years) in the third quarter of 2020 is 30.1% with a wide gender gap (46.2% male compared to 14.4% female). By reducing employers' costs, the recent publication of a draft law on labour and maternity leave aims to encourage employment. Other ongoing initiatives regarding the improvement of child and elderly care services and the project to decrease the duration of short-term employment contracts from the existing 10 years to 3 years pursue the same goal. Kosovo has the youngest population in Europe but access to preschool is hampered by the limited number of programmes and an unequal distribution of facilities. Ministry of Education, Science and Technology reports only 4.9% attendance in public pre-school education (0-4 years). UNICEF emphasises that social norms also prevent the establishment of inclusive education which translates into poor health, cognitive, social and development outcomes with lifelong impact. Almost half of the young people aged 15-24 (46.9% in the third quarter of 2020) are unemployed of whom almost half are long-term unemployed. In early 2020, 98 542 young people (29% of the population aged 15-24) were not in employment, education or training (NEET). A fifth of the population lives below the poverty line. Due to the COVID-19 outbreak, Kosovo's economy is forecast to contract by 7.5% in 2020 increasing the numbers of those the at-risk of poverty.

Emergency COVID-19 measures targeted formal and informal sector workers but regular social assistance remains inadequate. The government adopted a set of measures to mitigate the economic and social consequences of the COVID-19 crisis and stimulate the economic recovery in timely manner. Nevertheless, simulations of income shocks suggest that 70 000 to 170 000 people could fall into poverty, while the middle class could shrink by many as 100 000 people. The current Social Assistance Scheme (SAS) is inadequate due to its restrictive eligibility criteria. Unemployed peoples in Kosovo have no insurance contrary to the recommendations of the International Labour Organization Convention on minimum standards of social security. More than half of the people falling into poverty do not benefit from any social assistance programme. Although the government is now drafting reforms of the Law on Social Assistance, the adoption of the new law and the secondary legislation will take several more months and the new scheme will not be ready before mid-2021 at the earliest.

The Kosovo education system was ranked among the lowest quality among OECD countries by the 2018 Programme for International Student Assessment (PISA)**.** Access to early education programmes for children aged 36-59 months is very low (13.9%) compared to the EU average of over 80%. Evidence from the PISA survey shows that pre-school education - the basis on which the success of students in further education is determined - has not been yet sufficiently prioritised in Kosovo (Majlinda Gjelaj 2019). Kosovo students' scores are the equivalent to 5 years of schooling behind the OECD average in reading, and a little over 4 years behind in math. The performance gap is particularly clear among individuals belonging to ethnic minorities and among people in vulnerable situations. Students in urban areas tend to outperform students in rural areas. Nevertheless, students show an extremely positive spirit despite the limited prospects upon graduation: the average of life satisfaction among students is one of the highest of the countries and economies participating in PISA - ranking 3 out of 70 (OECD 2018b). They also firmly believe in their own ability to perform, especially when faced with adversity (ranking 9 out of 77). They also perceive their teacher as being very enthusiastic and supportive compared to other PISA participating countries and economies. One in two upper secondary student is registered in vocational programmes and in 2018, for the first time, Kosovo recorded a lower proportion of people (18-24) leaving early from education and training compared to the EU-28. Keeping young people in education while upskilling them through vocational qualifications has proved to be a successful policy option. However, the time spent in school may translate unevenly into learning (ETF 2020b).

Effective quality assurance is one of the weakest points of the pre-university education in Kosovo, as recognised by the Kosovo Education Strategic Plan 2017-2021. With government expenditure on education amounting to 4.6% of GDP in 2019, Kosovo is comparable to the EU-27 average of 4.7%, but the proportion of children in the country is higher and goals and priorities far exceed available finance. A lack of educational material has been reported by school principals and students. The new Law on Textbooks and Teaching Materials is expected to be adopted in 2021. There are also low levels of private sector involvement in education and training and a lack of information on skills and vocations (World Bank, 2019b). The recruitment of teachers also suffers from political influence in the absence of administrative instructions seeking to address this issue. Existing quality mechanisms at all levels of education are not consistently applied.

Many firms in Kosovo encounter problems due to applicants' lack of skills while low-skilled people lack formal employment opportunities. Finding the right employees with the required skills and competencies is one of the most important factors to develop a vibrant private sector (Krasniqi 2019). According to the World Bank, insufficient levels of labour market skills are potentially caused by insufficient skill formation opportunities in early childhood, the low quality and lack of relevance of school-based education and vocational training as well as of training programs delivered through active labour market programs. Domestic companies and foreign direct investment are suffering from the skills shortage of new entrants to the labour market. Socioemotional skills, foreign language skills, and computer skills are the most in demand (World Bank, 2020c). But aligning policies, training programs and curricula to the current and future needs of the labour market is challenging in the absence of relevant and real-time data on job creation and skills needs and forecasts of future skills needs. Job matching platforms in Kosovo represent a specific segment of the labour market. They are used almost exclusively for highly-skilled occupations whereas low and medium skilled jobs are more likely to be filled through informal channels. The lack of economic opportunities is considered to be a key factor fuelling emigration of young people and skilled workers.

Reforming the education system by giving people the relevant skills and competences needed to face the challenges ahead is an absolute necessity. More than half of upper secondary students enrol in vocational education, but they often remain unemployed as their training does not provide them with the necessary skills. Numerous strategies are not always followed up by real implementation plans and monitoring mechanisms. They show a need for digitalisation and revision of the teaching methods in the education system in general. In particular, vocational education and training (VET) does not yet have the capacity to provide students with digital skills and competences in line with European and international education standards. The funding of the VET system is insufficiently coordinated to meet the specific needs of local and international business and to facilitate the transition to the labour market. Over 90% of the total school budget is spent on wages and salaries. Cooperation with the private sector remains underdeveloped mainly due to the small size of companies, which have difficulties identifying their needs. Policy makers are not really focused on changing this situation. Information on matters like skills supply and demand is lacking. All of these elements mean that VET is not highly responsive to labour market needs.

The Employment Agency of Kosovo has been making efforts to increase the scope and quality of services provided to jobseekers and the unemployed. Recently, the Ministry of Labour and Social Welfare launched a series of reforms to modernise Public Employment

Services (PES) in Kosovo[5]. It aims to provide a service tailored to the needs of the client including profiling, counselling, career guidance, training or mediation services as well as online publication of vacancies for employers. But the number of case managers remains insufficient compared to the number of jobseekers. Additionally, a specific division responsible for work and education migration provides information on circular migration for those interested in moving to Germany. The highly centralised organisational structure of the PES makes management, coordination, monitoring and control processes (including funding from donors) demanding (EuropeAid 2019). The capacity to evaluate active labour market measures, in order to determine their effectiveness and measure the impact on participants' employability, is very low and, in addition, it has insufficient financial and qualified human resources.

Reform measure 15: "Increasing inclusiveness and quality of education in early childhood". The measure - rolled-over from the previous ERP - aims to increase children's participation in Early Childhood Education. The drafting and adoption of the law on early childhood education is again postponed as has the drafting of bylaws and administrative instructions to allow the implementation thereof. It remains unclear whether the Law will facilitate access for the people in vulnerable situations especially Roma, Ashkali and Egyptians. The training of educators and the licensing of pre-schools should not be delayed any longer..

Reform measure 16: "Implementation of the new curricular framework" in the vocational education and training system. The measure aims to increase the compatibility of VET with labour market needs and has been rolled-over from the previous ERP. The implementation of the measure is based on the adoption of the core curriculum in the VET area, the revision of the VET funding formula and the launch of the new curriculum pilot by VET institutions. The quality of placements/internships in businesses is not addressed. The VET Council has been made functional and there is a satisfactory level of involvement on the part of businesses. The model for private businesses' cooperation with schools appears to target a modest number of schools per year (only 10). The main sources of VET finance are the Ministry of Finance and international donors. The link between finances and goals is not always clear.

Reform measure 17: "Increase Quality Assurance in higher education by strengthening the Kosovo Accreditation Agency (KAA)" and profiling higher education institutions. The measure aims to increase the quality of higher education by improving legislation and the capacity building of mechanisms assuring the quality provided by higher education institutions. The draft Law on Higher Education has not been approved. The draft Law on the KAA has not yet been approved and, as a result, there has been no recruitment to the Agency either. ENQA recommendations should urgently be addressed for readmission. The measure also includes actions relating to public higher education institutions to strengthen their autonomy and transparency as well as to improve research infrastructure.

Reform measure 18: "Improving and enhancing public employment and vocational training services, increasing the employability of the long-term unemployed, young people, women and other vulnerable groups." The measure consists mainly of improving public employment and vocational training services by reviewing employment policies with the aim of increasing the effectiveness of active labour market measures and piloting the subcontracting of vocational training programs through private providers and opening new profiles in line with labour market demands. This measure has largely been rolled over previous past years. Its scope and actions are properly sequenced and could provide the described outcomes. The target of 3 000 long-term unemployed with a focus on people in vulnerable situations such as young people, women,

[5] *Offers and services for job-seekers* on https://aprk.rks-gov.net/en-US/JobSeeker/Index/52

and people with disabilities is not sufficiently ambitious but takes into account the available resources which do not correspond to the challenges of the labour market.

Key challenge #2: Formalisation of the economy and low competitiveness of the private sector

Persistent widespread informality continues to represent a key structural challenge for Kosovo's economy. Different assessments produced over the past decade point towards an estimated figure of informality ranging between 30 to 39% of GDP, and an EU-funded project estimated the preliminary cost of informality to be around EUR 106.8 million as a result of the tax gap for income tax revenue and VAT alone (IMF, 2019). Informality is deeply rooted in crucial sectors such as construction, retail trade, accommodation and transport. More than 45,000 full-time equivalent employees were estimated to be working in the informal sector, most of them in the agricultural, construction and retail sectors. Due to the highly seasonal nature of these three sectors, they were hit harder by the COVID-19 crisis, especially during the first lockdown in 2020 and the almost complete shutdown of the economy in the first and second quarter of 2020. 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, the reporting, monitoring and evaluation of implemented measures and strategies has not been consistent, which undermines overall efforts to tackle informality in Kosovo.

Kosovo's formal entrepreneurial landscape is dominated by low-value added, non-specialised, family-owned micro-companies engaged in non-tradeable activities, which lowers the economy's export competitiveness. This is directly reflected in the persistently high current account deficit figures (8% of GDP in 2018, 5.5% in 2019, projected to deteriorate further to projected 7.2% in 2020 in the context of the COVID-19 crisis) and more so in the highly imbalanced trade of goods, with imports being almost eight times larger than exports (World Bank, 2020a). The structure of Kosovo's goods export basket structure is currently heavily skewed towards the export of a single product category: base metals and mineral products (58.6 and 48% of total exports in 2017 and 2018, respectively). Whilst year-on-year exports of goods increased by 13.4% in the first half of 2020, further analysis has shown that this is largely due to the exceptional performance of Kosovo's largest exporter (ERP 2021-2023). Exports of services, currently showing a large surplus, have been growing at a slower pace than imports of services (10.3% compared to 11% respectively), over the past four years. If this trend is not reversed, it will likely deepen the trade deficit even further, thus raising Kosovo's external vulnerabilities. It is particularly significant given that current account deficit figures are high, at -5.5% of GDP in 2019, a situation that should not be prolonged indefinitely (World Bank, 2020a). A clear strategy and measures to improve the trade deficit, especially on exportable goods, is lacking.

Foreign direct investment (FDI) and remittances, which could help to counterweight the current account's deficit, are unable to fill that gap. FDI inflows to Kosovo have fluctuated, with an overall descending trend during the period 2010-2018. Kosovo has primarily attracted investment in real estate and related business activities (34% of FDI stock), financial intermediation (17%) and manufacturing (12%), with some smaller investments in the agriculture, mining and energy sectors[6]. Additionally, FDI is limited to a handful of countries, namely states where a sizeable, well-established Kosovo diaspora exists. Export-oriented FDI has been very scarce, and overall figures are relatively low, passing the EUR 300 million figure only once in the past 7 years. Remittances are used almost

[6] *Foreign investment in Kosovo,* on www.santandertrade.com/en/portal/establish-overseas/kosovo/investing

exclusively for consumption purposes: on two-digit numbers for most of the decade (12% of GDP on 2019), they are four times higher than overall FDI (World Bank, 2020a). While the *proposed reforms 3, 4, 5 and 6* in this year's ERP include useful activities and actions that may help foster export dynamics in Kosovo and strengthen the competitiveness of the agricultural, manufacturing and services sectors, no significant change to the observed situation could effectively be made without a comprehensive, long-term trade and competitiveness strategy for the coming years and decade. A more detailed analysis of these measures is provided in section 6 of the document.

Informality has significant and multiple negative consequences for the economy. First, it reduces the tax base, limiting the fiscal space for more productive spending in priority areas, such as education, health and infrastructure. Second, it creates an uneven playing field amongst businesses and is a deterrent for additional private sector investment, including foreign direct investment. Informal activity has consistently been identified as the major obstacle to doing business in Kosovo (World Bank et al, 2019a; EBRD, 2016)[7]. Informality also affects the competitiveness and export potential of Kosovo's private sector: firms operating in the informal sector have more difficulty accessing finance and tend to engage less in research and development and innovation and to hire fewer workers. Finally, workers in informal sectors have more limited (or no) access to social protection and additional benefits, and are more vulnerable when they lose their job or leave the labour market. Their access to training is also negatively affected, which further exacerbates the inadequacy of the skills of the workforce and contributes to the migration of specialised and skilled workers to markets where better labour and wage conditions can be found. Conversely, the lack of social and other benefits in formal employment – given the lack of existing structures to provide them – discourages many informal employers and employees from formalising.

The high level of informality in Kosovo is mainly linked to a generally low level of trust in government and institutions. High tax rates, nominally a major cause of informality, are not considered to be a major contributor to the phenomenon in Kosovo (income, individual and VAT tax levels are relatively low when compared to regional and other European economies). Among global indicators, Kosovo was placed in a mid-ranking 48th place in the 'paying taxes' subcategory of the 2020 World Bank *Doing Business* Report. This could point towards an overall low level of law enforcement and tax control on the part of local authorities as a potential underlying cause of high levels of informality. Formalisation would contribute to higher tax revenues, which could - in turn - provide additional resources to improve public services. It would also help create a more favourable, level playing field environment for investment, increasing access to finance, 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. Further digitisation of public services available to citizens and businesses offers the potential to facilitate the ease of doing business and to reduce incentives for businesses and citizens to participate in the informal sector.

[7] The *2019 Enterprise Survey* put informality as the single most pressing hindrance perceived by business in Kosovo, with 26% surveyed companies listing it first, well above the 19% of surveyed firms in the region selecting this option (WB et al., 2019). Similarly, according to the 2016 business environment and enterprise performance survey (BEEPS V), competition from informal competitors was signalled as the single most important issue in Kosovo. In all, 66% of firms reported that having to compete against firms in the informal sector was a major issue, the highest among all 30 countries covered in BEEPS V (the average was 39%). (EBRD, 2016)

To address the adverse effects of the informal economy, Kosovo adopted two strategies on preventing and fighting informality, the first in 2014 and the second in 2019. The available data suggest only a slight reduction in the size of the informal economy as a percentage of GDP throughout the decade – however, no consistent figures have been published since 2015. This relative progress resulted mainly from a reduction in the grey economy, reflecting an improvement in the effectiveness of tax and customs administrations practices. However, the impact appraisal of the two strategies against their targets was jeopardised by the lack of regular assessments of the tax gap and other key indicators on informality.

The most recent strategy, adopted in May 2019, includes relevant measures to address informality and provides for improved monitoring mechanisms. Among the targets set by this new strategy for 2023 are the reduction in the size of the informal economy as a percentage of GDP to 26%, the reduction of the informal employment rate to 10% and an increase in the final confiscation of criminal assets. Its first action plan (2019-2021) provides for actions in key areas such as statistics and risk and impact assessments, registration of businesses and increased cooperation among administrations. In comparison to the previous strategy, it benefits from the inclusion of qualitative and quantitative indicators to improve the monitoring process. Despite the improvements to the strategy, there is still room to improve implementation and reporting on implementation, and the corresponding action plan to tackle the informal economy. Furthermore, implementation efforts have been hampered by both the political context and the ensuing economic and health crises in the context of the COVID-19 pandemic.

Measures to address the underlying causes of informality related to the business environment and incentives to engage in formal work should complement the strategy and be adapted to the fallout from the COVID-19 crisis. While the strategy includes relevant measures to fight informality, it would benefit from measures that aim to improve the business environment, in particular the simplification, merger and abolition of licences and permits and the reduction in the duration of commercial dispute settlements. In addition, further digitisation of public services should be considered. The emergency measures enacted during the early stages of the COVID-19 crisis in the spring and summer of 2020 proved useful in prompting undeclared and informal workers to register at the Employment Agency of Kosovo, and businesses were keener to disclose turnover and profit figures in order to be considered for business and employment support schemes.

The ongoing implementation of the 2019-2023 strategy, which is still in its early stages, has been negatively affected by both the political context, and the COVID-19 situation. Tax revenues are expected to be heavily distorted in 2020 due to the pandemic, with total revenue falling by 14% compared to 2019, but a better understanding of the impact of the implemented actions could be possible in 2021. Many activities planned for 2020 were affected by the COVID-19 crisis, including by-laws and legislative proposals that needed assembly approval.

Reform measure 10 "Reducing the informal economy" aims to implement selected priorities of the new strategy, many of which were initiated in 2019 with the launch of the strategy. While the reform measure is relevant and reflects the Commission's assessment, the activities proposed to take place in 2020 were not ambitious enough and, due to the circumstances, a number of them could not be implemented, resulting in a delay of a year for most future activities. The activities now rolled over to 2022 and 2023 - including the proposed review of the action plan of the strategy, scheduled to take place in 2022 - seem credible and significant enough to boost overall GDP, productivity, growth, revenues and competitiveness while reducing the current size of both the grey and black economies, if they are implemented in full and according to the planned timeline.

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

The inadequate and unreliable supply of energy is one of the main constraints on Kosovo's competiveness and acts as a break on productivity.

The outdated power system essentially relies on old, inefficient and highly polluting lignite thermal power plants with total energy installed capacity of 1 430 MW. Currently, there are two lignite plants in Kosovo operating at 880 MW only, covering around 92% of electricity production: Kosovo A with five units and Kosovo B with two units. Most power plant units in Kosovo are now at the end of their technical lifespan, but the government is contemplating an extension of the lifespan of the Kosovo A working units, which would exacerbate critical levels of air pollution. The technical upgrade of Kosovo B will be supported by the EU and will reduce the environmental impact of the power plant. Remaining energy production is generated by small hydropower plants and wind generation (139 MW out of a total installed capacity of 1 430 MW). Electricity demand and consumption continues to grow steadily. This, together with the ageing of the power plants and insufficient flexibility to adapt to consumption in peak periods, means that electricity has to be imported and exported to balance the system. While net exports were only 186 GWh in 2020, imports (860.8 GWh) and exports (1 043.5 GWh) were both quite sizeable. This scenario is particularly challenging for Kosovo in light of the ambitious Green Agenda for the Western Balkans. The potential disruption derived from the obsolete generating capacity and dependency on energy imports could have a negative effect on Kosovo's growth potential and the competitiveness of its industries.

Reliability of energy 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 biggest obstacle to attracting high-quality FDI. According to the latest Business Environment and Enterprise Performance Survey (BEEPS V), firms perceive the unreliable electricity supply as the second biggest obstacle to doing business in Kosovo.

Kosovo has been making efforts to diversify its energy production mix, with new wind farm and solar projects, but the main generation capacities that are planned will continue to rely on coal. In December 2017, the Kosovo Government signed a EUR 1.3 billion contract with ContourGlobal for the construction of a new 450 MW coal-based power plant ('Kosova e Re'), but the contractor announced that it would not proceed with the project and submitted a Notice of Arbitration against Kosovo in December 2020, citing Kosovo's failure to financially support the project. As a result, Kosovo has decided to explore the possibility of extending the lifetime of the highly polluting Kosovo A power plant and is considering the use of gas power generation. Kosovo is on track to meet the mandatory target set by the Energy Community Treaty of 25% of renewable energy sources (RES) as a share of gross final energy consumption by 2020: the RES share was 24.9% in 2018. However, this was mainly achieved by revising the definition of RES to include biomass for heating, which is widely used by household customers, rather than by making any substantial investment in renewable energy. Fuelwood is the most-used commodity for heating homes, complemented by a mix of coal and wood. This has a very negative impact on air quality, and has made Kosovo one of the most polluted places in Europe. Furthermore, limited efforts have been made to improve support schemes for renewable energy projects. The practice of feed-in tariff impedes the opening of the auction market and damages consumer interests by imposing high prices above the market rate. However, in line with EU recommendations, the State Aid Commission recently decided to declare the incentive scheme for feed-in tariffs for renewable energy non-compatible. The declining cost of renewable energy and interest on the part of financial actors to invest in Kosovo offer new opportunities to diversify its energy mix. There is an increase in RES investments and several projects to develop important wind and solar energy sources are already planned. Kosovo could advance much further in its RES targets by adopting a National Renewable Energy Efficiency Action Plan and competitive selection processes for its renewable energy support. The Energy Community is expected to adopt new renewable energy targets for 2030, in line with the EU's targets, and this will require Kosovo to make substantial additional efforts. These targets could be reflected in the upcoming Kosovo energy strategy.

Kosovo needs to emphasise energy efficiency, as the potential for energy savings is significant. Some efforts were made to increase energy efficiency incentives for the private sector and households. Another key to overcoming the challenges relating to energy supply is further investment in energy efficiency. Distribution losses remain high compared to regional standards (technical losses of 13.32% and commercial losses of 7.33% amounted to total losses of 20.65% in 2020). Moreover, investment in and maintenance of the distribution network remain low. The Law on Energy Efficiency facilitated the establishment of an Energy Efficiency Fund, which is now operational. Kosovo would benefit from further energy efficiency incentives for households and the private sector (which account for 39% of final electricity consumption). It would also benefit from a comprehensive action plan to address inefficient (and highly polluting) heating based on solid fuels (coal and firewood), which significantly harm public health and the economy, and from better energy efficiency statistics. As such, *reform measure 1 "Reducing Energy Consumption through Energy Efficiency Measures"* aims to promote energy efficiency incentives resulting in a reduction in network demand, the promotion of a sustainable energy mix, help to meet emissions and energy efficiency targets and a reduction in energy poverty. Some progress was made with the operationalisation of the Energy Efficiency Fund and the extension of support schemes to private and public buildings. However, the current activities are not sufficient to meet energy efficiency targets and most of the support is provided by international donors. In addition, the distribution network is still characterised by significant losses. Kosovo should target these challenges in its energy strategy with sustainable investments in energy infrastructure and an ambitious and comprehensive approach to the promotion of energy efficiency.

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). Kosovo has the lowest electricity prices for households in the Western Balkans: EUR 0.0605 per kWh in the first half of 2020, compared to a regional average of EUR 0.08 and an EU average of EUR 0.2126 per kWh (Eurostat). The prices do not reflect the real cost. As presented in the 2019 ERP policy guidance, in order to mitigate the expected upward pressure on prices from the significant investments required in the sector, Kosovo needs to develop a programme to protect vulnerable customers in line with Energy Community requirements.

Progress has been made on regional integration. A new connection agreement between KOSTT and the European Network of Transmission System Operators for electricity (ENTSO-E) entered into force, leading to the operationalisation, in December 2020, of the 400 kV interconnection line (with a German investment of EUR 75 million) between Kosovo and Albania, which had remained unused for 3 years. Furthermore, additional steps were taken towards further integration of energy markets with Albania upon the signature of a bilateral agreement between transmission system operators in December 2019. These recent agreements could bolster the financial stability of the Kosovo operator and improve the security of regional transmission networks.

The Economic and Investment Plan for the Western Balkans will contribute to the green and digital transition, in particular the use of renewable energy sources, which will positively reflect on Kosovo's competitiveness. A substantial investment package, which is at the heart of the Economic and Investment Plan, will direct a large majority of support towards key productive investments and infrastructure. This will reflect and support the twin green and digital transition and the development of a connected, competitive, knowledge-based, sustainable, innovation-oriented and thriving economy. Circular economy principles, which form the basis of the Economic and Investment Plan and are defined in the Green Agenda for the Western Balkans, could foster significant levels of sustainable energy production and consumption.

Reform measure 2: "Increasing diversity of energy sources": aims to address obstacles in the sectors of renewables, gas and district heating, in order to balance excess demand, in order to achieve a more sustainable energy mix and to help meet emissions and renewable energy targets. Some progress was made on steps taken to explore the development of other energy sources, such as gas that could be supplied using the EU-funded North Macedonia-Kosovo gas interconnector. However, greater efforts are needed to improve the development of renewable energy sources, such as solar and wind. This ambition should be reflected in the Kosovo energy strategy; further investment to extend coal-based production and the extensive use of subsidies for coal would be detrimental to achieving this objective.

***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 concerning equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion for the benefit of citizens in the EU. 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 the ministers will use the Pillar to guide the alignment of their labour markets and welfare systems with those of the EU.

On most of the principles of the Pillar, Kosovo performs considerably below the EU average according to the indicators of the social scoreboard[8]. To some extent this is inevitable, since Kosovo is poorer than the EU Member States and other countries in the region, however it points to an urgent need for more effective and substantial policy reforms to improve socioeconomic conditions for the population.

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

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) had slightly increased and in public pre-primary education (5-6) has decreased compared to year 2017/2018 The only indicator, in which Kosovo saw improvement between 2016 and 2018, was 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 focused on administering a wide and increasing range of categorical benefits. Financial and other social assistance to the poorest segments of the population is still limited. Low-income households have less access to essential services and for many of them services are not affordable, because they do not receive assistance from government subsidy programmes (Social Assistance Scheme). A planned reform of the SAS is expected to broaden the coverage of people in vulnerable situations.

The statistical system is at an early stage of development. Kosovo Agency of Statistics conducts a quarterly Labour Force Survey based on EU methodology. 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.

[8] 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 indicators are also compared for the Western Balkans and Turkey, with one small adjustment in the age bracket for the unemployment rate (reducing the upper age limit to 64 instead of 74) for Albania and Kosovo* due to data availability. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2019 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 2017-2019 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 2020

Overall: Limited implementation (35.9 %)[9]	
2020 policy guidance	**Summary assessment**
PG 1: Create fiscal space and undertake well-targeted measures to address the socio-economic consequences of the crisis.	There was **limited implementation** of PG1: 1) **Partial implementation:** The government has undertaken timely fiscal response to address the socio-economic shortfalls of the pandemic, and has allocated fiscal support of 5.2% of GDP in the form of emergency support and a medium-term recovery programme. In terms of adequacy and targeted nature of the support measures, while the government rightly targeted and timely responded to the income loss of vulnerable households, concerns about some individual measures remain, especially those related to support to the business sector, were implemented without well- defined criteria for allocation of funds. The medium-term recovery programme, on the other hand, was to a large extent implemented without clearly defined criteria for the allocation of funds, especially those related to support the private sector.
Contain spending on the public wage bill and on war veterans pensions through progress with the reclassification of beneficiaries.	2) **Limited implementation:** The government managed to contain spending on the public wage bill as the Constitutional Court annulled the adopted Law on Public Salaries. The annulled Law would have had a high fiscal cost and therefore have breached the fiscal wage bill rule. Since the Constitutional Court decision, no new initiative has started to draft a new law on Public Salaries that would address the challenges with regard to public salaries, and currently the old salary system is being applied. No progress was recorded with the reclassification of the beneficiaries of the war veterans pension scheme, while the actual expenditure continued to exceed planned budget allocations by EUR 15 million in 2020 (around 20% higher), overrunning the cap of 0.7% of GDP as provisioned in the amended Law on war veterans.
Reinforce the medium-term sustainability of public finances, improve tax revenue collection by reducing informality.	3) **Limited implementation:** As expected, tax revenue collection was hit by the crisis, falling short by 9% compared to 2019. However, considering the significant share of informality in the economy, due to restrictive measures introduced by the government to contain the spread of the pandemic, there was no progress marked nor reports published on achievements of implementation of the Strategy on fighting the informal economy and its action plan. There is no analysis of the possible impact on the informal economy of the measure in the emergency package to support wages for informal labourers, whose employers register them and commit to paying their salaries for at least a year.

[9] 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.

PG 2: Improve the execution of capital spending by strengthening institutional capacities at central and local government levels for multiannual investment planning and investment project management. Improve the financial oversight and accountability of publicly owned enterprises (POEs). Prepare an options paper on the establishment of an independent body for fiscal oversight for further consultations with stakeholders, including the EU.	There was **partial implementation** of PG2: 1) **Limited implementation:** In 2020 budget allocations for capital investments were lower by 20% compared to 2019. Under-execution trend continued with only 56.5% rate of execution, partly due to lack of political decisions, and due to the shutdown of the economy during the pandemic crisis. The three adopted administrative instructions by the Ministry of Finance, which aimed at improving planning, selection, execution and monitoring of capital project and which entered into force in January 2020 are lagging in implementation. Multiannual planning of capital investments remains at initial stages. 2) **Partial implementation:** Regardless of the historic trend of poor financial oversight, accountability and efficiency of the POEs, the pandemic crisis aggravated the liquidity situation for some of the POEs, which required extended government support. Despite being long overdue, the government has not put forward the new Law on POEs for approval and has not taken any concrete step in improving the institutional management of POEs. Nonetheless, significant steps have been taken in the area, such as the publication of quarterly balance sheets, and the preparation of a first-ever risk assessment of POEs. Additionally, it was decided that POEs loans data was to complement current public debt publications. 3) **Partial implementation:** The Ministry of Finance, with the assistance of EU-funded IMF support, has produced the first draft of the paper on establishment of an independent body for fiscal oversight. However, the options paper has yet to be consulted with all other stakeholders and its finalisation is pending.
PG 3: Closely monitor financial stability challenges as a result of the coronavirus pandemic and take appropriate action if needed, while developing a more integrated framework for measuring household indebtedness. Undertake an in-depth analysis of the staffing and competence requirements in the central bank's key policy areas, especially financial stability. Continue with the inflation expectations survey and publish the time series once more data points become available.	There was **partial implementation** of PG3: 1) **Partial implementation**: Financial stability challenges were monitored closely and forceful prudential measures were taken to support borrowers and banks, but the functioning and set-up of the macro-prudential committee could be improved. The framework for measuring household indebtedness is only in draft stage. 2) **No implementation:** While new positions were created, no in-depth analysis of the staffing and competence requirements were undertaken. 3) **Full implementation**: The inflation expectations survey was continued and the time series were published on the webpage of the central bank (https://bqk-kos.org/financial-stability/bank-lending-survey/summary-of-the-results-of-the-bank-lending-survey/?lang=en).
PG 4: Establish an effective and transparent mechanism to support the private sector and employees affected by the crisis, in particular micro, small and medium-	There was **limited implementation** of PG 4: 1) **Limited implementation**: MSMEs were the most affected by the COVID-19 outbreak in Kosovo. As a policy response, the Kosovan authorities have provided financial

sized enterprises and self-employed. Extend social protection coverage and provide incentives for businesses and employees in the informal economy sector to register and to facilitate their transfer to the formal economy. Further implement relevant business environment measures, in particular the simplification, merging and abolishment of licences and permits.	support via the economic recovery package, which is largely insufficient to mitigate the economic fallout and private sector backdrop. The Government distributed EUR 60 million to all active businesses, pursuing an approach that involved no selection criteria for financial allocations. Instead, a flat rate has been used to subsidise salaries regardless of the financial state of the beneficiary economic operator. There has been no impact assessment to assess the economic sectors that have been most affected by the pandemic. Because of the protracted legislative approval, the increased guarantee threshold for loans issued to MSMEs via the Kosovo Credit Guarantee Fund was delayed. 2) **Partial implementation**: Regarding the part on social protection coverage, the Government has proposed new legislation on social and family services (SAS), which will include the broadening of the base of families with children benefiting from SAS; besides that, however, no other progress was recorded. The government took action to create incentives and to formalise employment in the informal sector through the payment of support wages to informal labourers, whose employers register them and commit to paying their salaries for at least a year 3) **Limited implementation**: The programme to reduce the administrative burden for citizens, businesses and the public administration was approved in 2020. The Central Registry provides up-to-date information on all licensing documents that central institutions issue to businesses. Coordination between central institutions responsible for licensing should be strengthened while aiming to merge and reduce permits and licenses. Further efforts to simplify licences and permits through repealing unnecessary procedural, data and other requirements should also be accompanied by measures to make with making fees and procedures transparent and easily accessible to the public and companies. Increasingly digital approaches to service delivery need to be introduced. The Business Inspections Reform draft law experienced little progress and will have its legislative drafting will have to be continued this year for its full adoption and implementation.
PG 5: Strengthen the health sector in order to provide adequate and accessible primary health services for all citizens.	There was **limited implementation** of PG 5: 1) **Limited implementation**: The pandemic has put Kosovo's health system under significant strain and has meant that public health reforms have not been implemented. The Kosovan health authorities, notably the Ministry of Health, has adopted some measures to address the PG subpart, but they appear to insufficient and it is unclear how they will be implemented. The following strategic documents were adopted (the rest remain to be implemented): -Strategic plan for mother, child and reproductive health approved; -Strategic plan for human resources approved; -Strategic plan for fighting hospital infections approved; -Strategic

Ensure increased coverage of unemployment benefits and needs-based social benefits for the groups most affected by the COVID-19 crisis. Review social assistance schemes, in particular the category-based pensions, to ensure that they are targeted at groups most in need and focused on poverty reduction.	2) **Limited implementation:** There are no unemployment benefits in Kosovo, this remains unregulated to date; the Law on Economic Recovery was adopted and a range of the categories affected by COVID 19 benefited from some state assistance. There are only initial efforts – such as suggested legislative initiatives – to ensure that social assistance schemes, in particular the category-based pensions, are targeted at groups most in need and focused on poverty reduction.
PG 6: Take measures to preserve employment including through short-time work schemes and upgrade the capacity of the Employment Agency. Conduct a feasibility study for a Youth Guarantee scheme.	There was **limited implementation** of PG 6: 1) **Limited implementation:** The number of jobseekers has increased almost threefold during the COVID-19, yet the budget for the Agency for Employment and its capacity are lower than in 2020. This means that, although the need for increased active labour market measures to address the number of unemployed has vastly increased, there is no capacity to provide more than the usual offer. It is unclear whether some of the economic recovery funds will be processed through the Agency for Employment. The limited fiscal space - and additional challenges in securing financing throughout 2020 - have also been an obstacle for the implementation of this PG. Short-time work schemes are still very limited in size and number, and largely supported by donor schemes rather than private companies. 2) **Limited implementation:** The Government has identified donor funds to conduct a feasibility study for a Youth Guarantee scheme which is one of the flagship actions under the Economic and Investment Plan. The timelines for such a study are not defined.

6. ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2021-2023

Business environment

The improvement of the business environment is key for the effective transformation of Kosovo's economy. The World Bank's Doing Business 2020 report, ranked Kosovo 57th (down 13 places from the previous year) of 190 economies worldwide, acknowledging progress in dealing with construction permits, getting electricity, protecting minority investors and enforcing contracts. A pending general inspection reform, for which a new law should be approved, 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 investors. Recent business surveys continue to highlight the fact that electricity supply is 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-than-average salaries in the public sector are also seen as a deterrent to attracting the workforce to the private sector. The COVID-19 crisis has also had a noticeable impact on Kosovo's business environment, as the contribution made by contact-intensive sectors such as hospitality and restaurants is particularly high. 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 investment and the private sector.

Measure 7: "Removing legal barriers and the reduction of bureaucracy"

This measure amalgamates two reforms presented in last year's ERP and the first draft of the 2021-2023 ERP. The discarded measure (initially presented as *reform measure 8 "General Inspection Reform"*) was carried over for the past 3 years, and both of them are important and relevant. The horizontal nature of both reforms will require solid administrative capabilities and coordination efforts during the planning and implementation of the activities, and after rationalisation of the inspection bodies. The timeline of activities seems reasonable, however, the reforms will require considerable political commitment to advance at the central state administration and municipal levels. While the text mentioned digitalisation, no concrete activities are provided for in this regard. At the moment there is a lack of clarity as to what ministry or department will effectively be leading the government's IT policy. This prevents the government from advancing with its digital agenda in a coordinated manner. For example, different government IT databases need to be interconnected, which requires close inter-ministerial cooperation. Additionally, costing is appropriate for the activities envisaged.

Measure 8: "Establishment and functioning of the Commercial Court"

This measure was initially introduced in ERP 2020-2022. It aims to increase the effectiveness of trade dispute resolution by establishing the Commercial Court as the sole body competent to resolve trade disputes involving foreign businesses and other investors. Besides the adoption of the concept document on reforming the commercial justice area in March 2020, there was no significant development in the implementation of this measure. The Law on the Commercial Court, which will form the basis for the establishment and functioning of the

Commercial Court, is still being drafted. Because of the recent general elections, delays in the overall implementation of this measure and the planned activities are likely. The measure, however, does not seem to include sufficient budgetary allocations for the establishment of a Commercial Court in the 2021 budget or in the projections for the following 2 years; neither is there an independent opinion on budget impact assessment issued by the Ministry of Finance. The proposed measure also lacks information on the premises of the Court (with the capital costs that this would entail), appropriate activities envisaged for the functionalisation of the Court, or appropriate actions to mitigate the risk of delay in adoption of the Law on the Commercial Court.

Measure 9: "Reduce informality in the real estate sector"

The measure is relevant, but no progress was made on implementation in 2020. The proposed measure is limited to addressing the issue of uncontested informal transactions that occurred before 1999, but it does not cover the issue of all contested informal transactions and other informal transactions that occurred after 1999, or the issue of fraudulent property transactions that ought to be processed by the prosecutors and courts. As it stands, the proposed measure is not sufficiently developed to adequately tackle informality in the real estate sector which, as a result, has a significant impact on the economy. The measure lacks an overall strategic and comprehensive vision on reducing informality in the real estate sector in its entirety. The costing estimations for this and the following years still refer to their plans for 2020.

Research, development and innovation (RDI)

Kosovo's performance is still very poor in the research, development and innovation (RDI) sector (governance of RDI policies, public research system, public-private linkages, innovation in firms and human resources for innovation), and the country has the lowest scores in the Western Balkans region[10]. The Law on Innovation entered into force in 2018, and an updated national innovation and entrepreneurship strategy was drafted the same year. Nonetheless, the sector suffers as a result of the chronic fragmentation in implementing 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 2.2% in the EU), particularly for business innovation. Kosovo's Horizon 2020 performance continues to increase, albeit from a very low starting level. The full development of the smart specialisation strategy is still hampered by the lack of availability of most statistical data.

Measure 11: "Improving the research, innovation and entrepreneurship environment"

The actions are well proposed and streamlined. The measure aims to tackle long overdue issues such as the functionalisation of the National Science Council in a well-structured and planned manner. Substantial progress could be achieved in implementing most of the described actions. The activities to be performed by the innovation centres and the sources of funding for their functioning remain unclear. The measure acknowledges the failure to secure the level of investment stipulated by law (0.7% of GDP) but does not indicate how to increase the amounts. The measure is mostly financed by international donors.

[10] OECD (2018a), *Competitiveness in South East Asia – a policy outlook 2018*.

Digital economy

The digitalisation of the economy is gradually advancing. 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. The Economic and Investment Plan for the Western Balkans will continue to support investment in digital infrastructure to deploy ultra-fast and secure broadband to ensure universal access. Kosovo also engaged constructively in high-level regional dialogue on digital transformation and the implementation of a Regional Roaming Agreement as of 1 July 2019. In addition, the commitments made during the launch of the Common Regional Market at the Western Balkans Summit in Sofia, will see roaming prices in public mobile communication networks for all end users removed this year. However, Kosovo needs to continue to develop the legal framework and necessary infrastructure to stimulate e-commerce and allow for international electronic payments - a hindrance further exacerbated by the COVID-19 crisis, which meant that physical commercial transactions were largely impossible for several months. 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 12: "Extension of relevant ICT networks and services infrastructure for socio-economic development"

This measure has been implemented according to the plan over recent years. Measures are well planned and sequenced. The inclusion of the development of soft skills to utilise investment in infrastructure is much appreciated. Whilst the introduction of 5G infrastructure is envisaged, a more thorough assessment is needed of absorption capacities and the capacity of the authorities to support the preparation of the private sector. The programming and availability of Instrument for Pre-accession Assistance (IPA) funds, and their interlinking with the measure's costing estimates, are well reflected.

Economic Integration

Kosovo is highly reliant on imports and suffers from a chronically high trade deficit. Despite this trend, the trade deficit decreased by 10% in 2020 compared to the year before, reaching EUR 2.82 billion, with imports accounting for EUR 3.29 billion and exports representing EUR 475 million. The increase in exports in 2020 compared to the year before was significant, representing almost 24%. Although this figure continues to be modest in absolute terms the two-digit increase is unprecedented. Previously exports had 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% during the same period. Whilst the export of services helps offset the persistent goods trade deficit to a certain degree, these are mostly dominated by the travel account, which registers expenditure by non-residents (mainly diaspora members) in Kosovo, accounting for around 80% of total services exports in 2019. This source of income was barely affected by the travel restrictions imposed by Kosovo and EU Member States during the traditional travelling seasons. Most of Kosovo's goods exports still consist of basic raw materials and mineral products, reflecting the limited diversification of the production sector. Trade with the EU and the CEFTA region represents almost the totality of trade exchanges. Due to higher growth of exports than imports over the last 10 years, Kosovo has experienced an improved export coverage ratio with the region, from 9.1% in 2008 to 20.3% in 2019. In December 2020, Kosovo's exports to CEFTA countries reached EUR 23 million, or 49.4% of total exports, with an increase of 89.6%. The opposite trend is observed in trade between Kosovo and the EU. CEFTA remains an important market for Kosovo exporters, but obstacles and barriers to trade persist.

Kosovo is encouraged to implement all aspects of the Common Regional Market as it was outlined in the Economic and Investment Plan for the Western Balkans. The Common Regional Market will facilitate Kosovo's integration into regional and European value chains and help increase the attractiveness of the economy for FDI in tradeable sectors, notably by extending the market size. Further connectivity with neighbouring countries in transport and energy will strengthen access to, and integration into, the regional market. The ratification of CEFTA's additional protocols 5 and 6 will help liberalise trade in goods and services and will also create new export opportunities in the dynamic service sectors; it should therefore be implemented swiftly. The creation of a regional digital space and labour markets that are more integrated with neighbouring economies will offer new possibilities for Kosovo's youth, which is also important in light of the high rate of youth unemployment.

Despite being among the most open economies, foreign direct investment (FDI) in Kosovo remains limited (averaging slightly over 4.0% of GDP in 2013-2020), with a negative long-term trend, and mainly originating from the large Kosovo diaspora. By November 2020, FDI amounted to EUR 295 million, which was 15% higher than for the whole of 2019. The sectoral distribution of FDI remains dominated by non-productive sectors, namely real estate and construction, which have a limited impact on the efficiency of Kosovo firms. There is potential to attract more FDI: Kosovo has a good strategic location, a young population and relatively low labour costs, as well as an ever-growing educated workforce with increasing ICT and foreign language skills. Other key issues affecting FDI are the lack of basic infrastructure and stable electricity supply, poor education skills, weak rule of law, corruption and the slowdown in the privatisation process.

Measure 13: "Trade facilitation through reducing the cost of trading transactions"

The measure and its expected outcome is well justified, and the link to the Common Regional Market and the Green Agenda for the Western Balkans represents an important development integrated into the measure. The Ratification of AP6 on trade in goods remains a long-standing issue. The finalisation of negotiations with CEFTA countries on Additional Protocol 7 on the Trade Dispute Settlement in 2021 may appear overly-ambitious since they only started in October 2020. The adoption of the new Law on Internal Trade and the Law on External Trade is feasible, as both pieces of legislation passed the public consultation stage in 2020. However, some activities, such as WTO membership negotiations, entail additional political risk and are dependent on external factors.

Measure 14: "Further development of quality infrastructure and empowerment of the role of market surveillance authorities"

The activities planned for 2021 are realistic and already under preparation with the support of the IPA-funded project. The mitigating measures of capacity building and staff training are important, particularly since the IPA-funded project is coming to an end, and should be well taken care of. The Activities planned for 2022 and 2023 are reasonable and well sequenced. The budget appears small for the activities envisaged: accreditation in particular can be costly.

Transport

Transport links represent less of a constraint on Kosovo's competitiveness than issues connected to other sectors, but further connectivity with neighbouring countries would strengthen the country's integration into the regional market. Investments have been primarily focused on road infrastructure rather than other modes of transport, without a proper balance of resources devoted to the maintenance of roads and railway networks and with an increasing amount of capital investment being directed towards prestige projects without a clear transportation, environmental or development rationale. On rail, the continuing rehabilitation of Route 10 linking southern and northern Kosovo, the Serbian border and Pristina with the capital of North Macedonia represents the biggest investment in Kosovo's railway in four decades (around EUR 200 million) and is poised to improve Kosovo's railway network and its connections to the wider European network both for passengers and freight. However, a much more ambitious plan, including maintenance and integration with European networks, as well as an upgrade of the legislative framework to align it to the EU acquis, is necessary to upgrade the efficiency of Kosovo's railway networks. Regarding aviation, status issues, including a lack of revenue from upper air space management, continue to constrain Kosovo's ability to invest in training, infrastructure and safety. The flagship policy of the Economic and Investment Plan will be the finalisation of the 'Peace Highway' in Kosovo, directly linking Pristina with Niš in Serbia and thus helping to reduce the transport constraints on Kosovo's economy.

Agriculture

Low productivity levels and high production costs characterise Kosovo's agricultural sector. Although it remains relatively large, the sector's share of gross value added continues to decline (9.7% in 2019 compared to 12.8% in 2018). Farmers in Kosovo are faced with several constraints, such as high numbers of small farms and high levels of land fragmentation, outdated farm technologies, lack of production diversification, limited capacity to grow and limited provision of technical support[11]. Although measures have been developed to address some of these issues (e.g. irrigation systems and organic farming), further investment and efforts are needed to ensure their implementation and to enhance the competitiveness of the agricultural sector in Kosovo. Existing support schemes, currently under review, would benefit from a more holistic approach to developing value chains and integrating them in export markets, instead of direct subsidies for agricultural production and food processing facilities. Other neglected issues are the protection of agricultural land, the environment and less favoured areas (hillsides, rolling land, etc.) with reduced productivity. The sector has only suffered a slight downturn due to the economic fallout from COVID-19: in fact, non-sector-specific business support schemes established as a response to the crisis, coupled with pre-existing agricultural support schemes, have meant that - for some beneficiaries – subsidies have doubled. The Economic and Investment Plan for the Western Balkans has the potential to mobilise further assistance for the sustainable transformation of Kosovo's agri-food system and rural development.

[11] Approximately 93.03% of agricultural holdings, or 100 576, belong to farm size categories of less than 5 ha. (Ministry of Agriculture, Forestry and Rural Development, 2019).

Measure 3: “Structural changes in the agriculture sector”

The activities planned for 2021 are focused mainly on document drafting rather than project or activity implementation. Taking into consideration the fact that agriculture is considered to be a key sector, the measure fails to address a number of structural obstacles that hinder the development of the agricultural sector, such as the small average farm size, low productivity and high production costs, land fragmentation, low diversification of production, poor irrigation infrastructure, outdated technology, limited storage capacities, weak or dis-functional links between primary producer and processor, and between producers and market, and lack of specialisation. Whilst irrigation is rightly chosen as a priority, the measures are introduced at a slow pace, and the quality of water taken from highly polluted rivers is not addressed. The costs estimated for the implementation of this measure for the period 2021-2022 are sufficient.

Industry

Kosovo’s industry is characterised by low added-value and competitiveness. The sector makes a modest contribution to GDP (around 22% over the past decade) and employment (around 14%). Manufacturing is dominated by food processing and non-metallic mineral products and contributes 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, high-level and sustained industrial development continues to face structural problems. The sector is dominated by MSMEs with low levels of integration in global value chains, as well as low shares of innovation and FDI reception. While a comprehensive policy framework is currently being studied, existing support services for MSMEs are weak. Inter-ministerial coordination in this policy area is weak and the responsible institutions (such as the Kosovo Investment and Enterprise Support Agency) lack implementation 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 most are currently under-utilised and under-funded. Poor cooperation between companies and educational and research institutions and the generally low level of skills in the labour force lead to low production capacities and a lack of product quality and innovation. The Economic and Investment Plan, which has at its core productive investments based on circular economy principles, could significantly bolster Kosovan industry’s sustainable production and consumption.

Measure 4: “Increasing competitiveness in the production industry”

The continued effort to establish a coherent industrial policy represents a positive step, however, the implementation of activities under this carried-over measure is slow-paced and remains hampered by the lack of overall vision. Despite claims that the measure is included in the National Plan for Economic Recovery 2020-2021 to mitigate the consequences of the pandemic, it does not address the way in which the production industry was affected, nor does it reflect the support measures of the recovery packages to counter the impact. KIESA support programmes for SMEs should also encourage gender balance and female entrepreneurship. A significant share of the estimated costs are for the construction of infrastructure for economic zones. However, there is still no feasibility study on industrial zones assessing return on investment and their contribution to economic development. Such industrial parks may also privilege companies selected with unclear criteria. Some positive steps were taken to reinforce KIESA’s capacity, including increased staffing and financial resources, but additional efforts are required to allow the agency to fulfil its objectives and to be able to promote linkages between multinational enterprises and SMEs. 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 a lack of competitiveness and relies heavily on non-tradeable 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-tradeable activities (accounting for more than two thirds of all sector turnover). Trade in services has shown dynamism in recent years, reflected in a sustained service trade surplus and its significant contribution to Kosovo’s current account, driven by the travel and hospitality industries, as well as ICT services. Notwithstanding this, exports of services are strongly dependent on travel services (which represented 65% of total services exports in 2020, which is lower than in previous years), the majority of which were comprised of visits undertaken by members of the Kosovo diaspora (rather than tourism), which raises concerns as to its sustainability in the long run. Moreover, the sector has been highly affected by COVID-19 restrictions on international travel and overall mobility in Kosovo. The development of a competitive tradeable services sector is being held back by an unfavourable business environment, a lack of quality infrastructure and poor access on the part 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 has been rolled over from the past ERP. However, the measure is still not sufficiently ambitious to have a significant impact on the economy. The reform of the sector would also require a concrete action plan with allocated resources. As such, the proposed measure is rather limited in terms of making the country more attractive, appealing and recognisable. The measure considers the impact on the environment and the need for inter-institutional cooperation to alleviate that impact but, just as last year, it still fails to include other relevant actions, such as abolishing illegal landfills and cleaning waste across the territory, which is a precondition for attracting tourists.

Measure 6: “Increasing the competitiveness of trade in services”

The measure is well spread over the 3 years; however, the finalisation of negotiations for mutual recognition of professional qualifications in the CEFTA format requires more time and is realistically expected to continue into 2022. The ratification of the CEFTA Additional Protocol AP6 on trade in services is very important and has been delayed for some time, and it should be prioritised in 2021. The Contact Point on Services for trade in services was launched in October 2020. The budget appears too small in relation to the number of activities for the 3-year period envisaged in the proposed reform measure. The amount of support received from IPA funds for the activities listed in this measure is much higher than that stated in the budget table.

Education and skills

This sector and the relevant reform measures 15, 16 and 17 are analysed in Section 4 above, under key challenge #1.

Employment and the labour market

This sector and the relevant reform measure 18 are analysed in Section 4 above, under key challenge #1.

Social dialogue

The potential of social dialogue remains untapped. The reduction in the high level of informality in the labour market may improve the ability of workers to exercise 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 mostly represent the interests of larger employers, while over 90% of registered companies are micro-enterprises with fewer than 10 employees. Although the legal framework is in place, there is little political will to use social dialogue in the process of drafting policies and legislation. The capacity of social partners, in particular that of trade unions, to influence policy remains limited. A protracted conflict over the composition of the Economic and Social Council (ESC) is to be solved by amending the Law governing the ESC, 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 does not address the needs of the poorest. Expenditure on social transfers (6.2% of GDP in 2019) was well below regional levels, but the scale of expenditure was less problematic than the way it was structured. The biggest proportion of domestic social spending (over 90%) was on complex categorical pension schemes, while only 10% was available for social services and social assistance benefits. According to the latest Household Budget Survey (2017), more than half of households in Kosovo were unable to pay utility bills once or twice during the year. For 44% of households, family budgets were under continuous stress and any increase in one area of household spending or utilities meant that a family had to reduce expenditure on other basic necessities.

Measure 19: “Improving social services and empowering excluded groups”

Some actions have been rolled over from last year’s ERP – such as 2021 key actions which had been anticipated for 2020 – but otherwise the proposed measure represents a major improvement compared to last year’s, and the actions and targets for the upcoming years are far more ambitious. If implemented in full, these could have a significant impact on improving the coverage and quality of social and health services.

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

Area/Sector	2016	2017	2018	2019	EU-27 Average (2019 or most recent year)
Energy					
Energy imports dependency (%)	23.6%	30.0%	29.3%	30.1%	60.62%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	447.37	407.79	395.32	385.46	112.92
Share of renewable energy sources (RES) in final energy consumption (%)	24.47%	23.08%	24.62%	25.69%	19.73%
Transport					
Railway Network Density (meters of line per km^2 of land area)	30.5 w	30.5 w	30.5 w	30.5 w	49.0 (2018)
Motorization rate (Passenger cars per 1000 inhabitants)	144.0 w	154.6 w	157.2 w	162.0 w	519 (2018)
Agriculture					
Share of gross value added (Agriculture, Forestry and Fishing)	13.0%	11.4%	8.9%	9.5%	1.8%
Share of employment (Agriculture, Forestry and Fishing)	4.2% w	4.4% w	3.5% w	5.2% w	4.3%
Utilised agricultural area (% of total land area)	38.2% w	38.2% w	38.5% w	38.6% w	40.0% (2017, EU-28)
Industry					
Share of gross value added	21.5%	21.8%	21.8%	22.1%	19.7%
Contribution to employment (% of total employment)	18.0% w	17.4% w	14.3% w	15.1% w	18.1%

Services					
Share of gross value added	57.4%	56.9%	58.5%	57.8%	73.0%
Contribution to employment (% of total employment)	66.3% [w]	65.3% [w]	70.3% [w]	67.1% [w]	70.8%
Business Environment					
Rank in WB Doing Business (Source: World Bank)	64	60	40	60	N/A
Rank in Global Competitiveness Index (Source: World Economic Forum)	N/A	N/A	N/A	N/A	N/A
Estimated share of informal economy in GDP (as % of GDP) (Source: IMF)	(est. up to) 38.8%	N/A	N/A	N/A	N/A
Research, Development and Innovation					
R&D intensity of GDP (R&D expenditure as % of GDP)	N/A	N/A	N/A	N/A	2.20%
R&D expenditure – EUR per inhabitant	N/A	N/A	N/A	N/A	EUR 688.60
Digital Economy					
Percentage of households who have internet access at home	N/A	89%	93%	93%	86% (2018)
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	N/A N/A	82.9% 82.9% [w]	87.7% 87.7% [w]	90.71% 90.7% [w]	85% (2018) 85% (2018)
Trade					
Export of goods and services (as % of GDP)	23.7%	26.7%	26.4%	29.1%	49.4%
Import of goods and services (as % of GDP)	50.9%	52.5%	55.6%	56.1%	45.7%
Trade balance (as % of GDP)	-40.9%	-41.6%	-44.3%	-43.80%	N/A

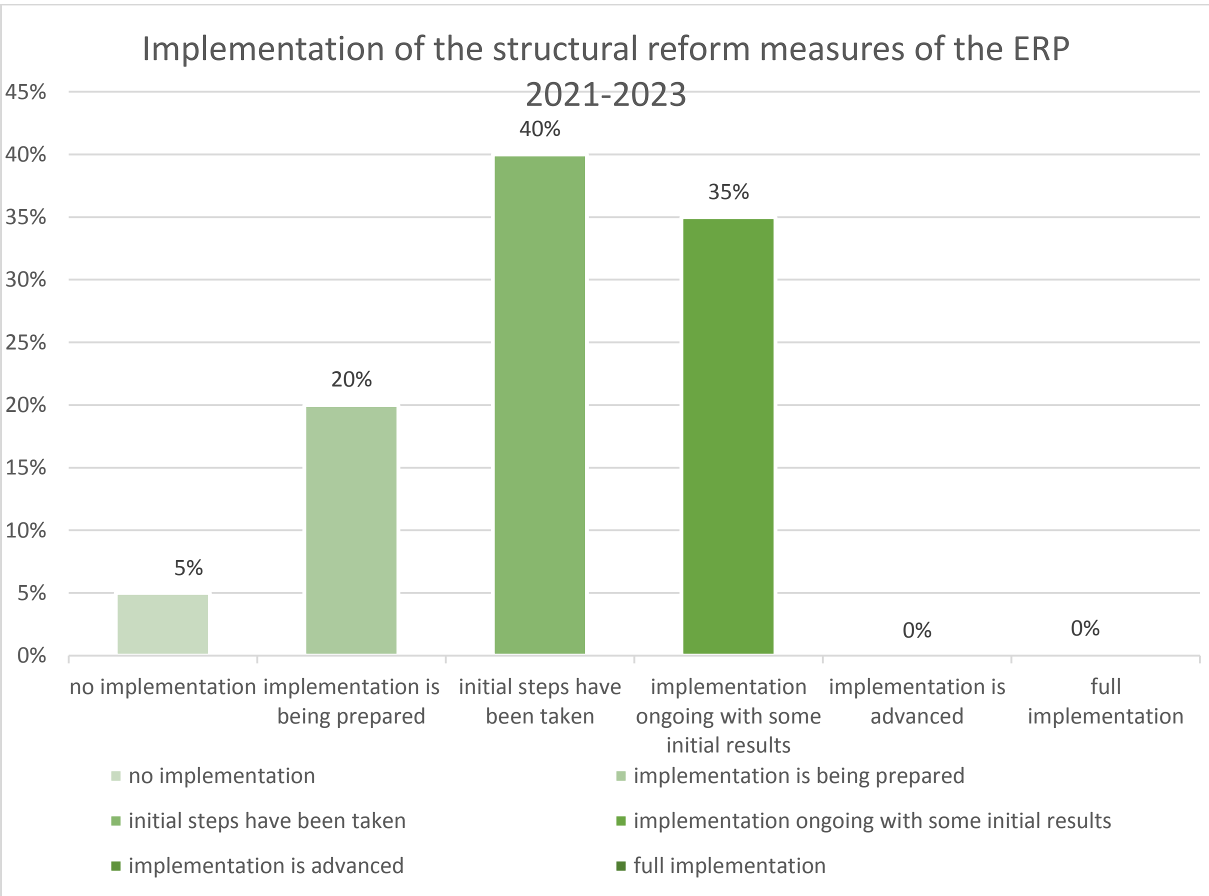
Education and Skills					
Early leavers from education and training (% of population aged 18-24)	12.7% [w]	12.2% [w]	9.6% [w]	8.2% [w]	10.2%
Youth NEET (% of population aged 15-24)	30.1% [w]	27.4% [w]	30.1% [w]	32.7% [w]	10.1%
Formal child care - children aged less than 3 years (% of total)	N/A	N/A	N/A	N/A	35.3%
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	28%	56%
Employment					
Employment Rate (% of population aged 20-64)	32.3% [w]	34.4% [w]	33.2% [w]	34.2% [w]	73.1%
Unemployment rate (% of labour force aged 15-64)	27.5%	30.5%	29.6%	25.7%	6.8%
Gender employment gap (Percentage points difference between the employment rates of men and women aged 20-64)	35.3 pps.	39.4 pps.	38.5 pps.	37.4 pps.	11.7 pps.
Social Protection System					
% of population at risk of poverty or social exclusion	N/A	N/A	56.7%	N/A	20.9%
Impact of social transfers (Other than pensions) on poverty reduction	N/A	N/A	N/A	N/A	32.38%
Self-reported unmet need for medical care (of people over 16)	N/A	N/A	N/A	N/A	1.7%
Income quintile share ratio S80/S20 for disposable income by sex and age group (Comparison ratio of total income received by the 20% with the highest income to that received by the 20% with the lowest income)	N/A	N/A	N/A	N/A	4.99

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

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

ANNEX B: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM THE ERP 2020-2022

There was a relatively good progress in the implementation of the measures in 2020, taking into account the many obstacles posed by the health crisis since March 2020, with an average score of 2.5 out of 5. The reporting on the planned activities is generally thorough and provides in general a fair description of the level of implementation. The implementation indicators for reform measure 7 on the adoption of evidence-based policies and reduction of administrative burdens' were not provided, and our internal assessment of the progress of implementation was used.
Implementation is higher in some measures, such as measure 2 on the development of energy generation capacities, measure 6 on increasing competitiveness in the sector of trade in services, measure 17 on the implementation of the new curriculum framework in the VET system. At the same time, implementation is weaker in other measures, such as measure 9 on the establishment and functioning of the commercial court, measure 16 on developing early childhood education, and particularly weak on measure 8 on the implementation of the General Inspection Reform.



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ANNEX C: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme 2020-2022 was adopted by the government on 27 January 2021 and submitted to the Commission on 29 January 2021, thus within the established deadline. It is in line with the previously approved medium-term fiscal strategy and national development strategy, and the forecasts and modifications made in response to the COVID-19 crisis. No components of the ERP are missing.

Inter-ministerial coordination

The assessment on the inter-Ministerial ERP coordination process is positive, considering the constraints posed by the pandemic crisis and the limited working capacity of the public administration. The ERP was centrally coordinated, with the Ministry of Finance as National Coordinator in close cooperation with the Strategic Planning Office (SPO) within the Prime Minister Office, and 8 area coordinators from the line ministries. This ERP also shows increased cooperation between MF and SPO during the ERP process. However, the coordination between MF, SPO and MIE as National IPA Coordinator is less visible, considering that IPA activities are minimally or incorrectly reflected in the costing part of the structural measures.

Stakeholder consultation

The public consultation process is assessed as satisfactory: considering the COVID-19 restrictions on public gatherings, there was no real possibility for a high level consultation meeting to be organized with different stakeholders such as CSOs, business organisations, IFIs and donors. However, the draft was made available online on 4 December 2020, respecting the rules on minimum criteria for public consultation, allowing two weeks' time for stakeholders to provide their feedback, thus the process could be concluded to meet the minimum criteria. There is no information, however, if the parliament and other regional/local authorities were consulted separately, apart from the opportunity to comment on the draft document through online platform.

Macroeconomic framework

While admitting a number of risks and high uncertainty, the ERP baseline scenario assumes a benign recovery, which is broadly plausible given the base effect of 2020 and provides an adequate basis for assessment. External assumptions are based on the projections of the EC autumn forecast and the IMF's October 2020 World Economic Outlook. The alternative 'low growth' and 'high growth' scenarios are useful for showcasing the likely impact of some expected and unexpected developments and risks in Kosovo's economy. Forecasts for the labour market and the financial sector are still lacking.

Fiscal framework

The fiscal projections are based on the adopted 2021 budget, but include also some elements stemming from the Law on Economic Recovery. The ERP assessment of fiscal projections is based on the ERP annex data, which include some corrections undertaken after the ERP submission. For 2021 the ERP envisages some increase in public revenue and expenditure as compared with the 2020 outcome; these are subject to a number of risks that are acknowledged in the ERP. The 2020 fiscal outturn is not fully consistent with the main text, the updated data were provided after the ERP submission. While the information on the intended debt management was provided upon request after the ERP submission, the ERP provides a useful debt sustainability analysis under three negative shocks.

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 most activities have been affected to some degree by the COVID-19 crisis. With some exceptions, the reporting on the implementation of the policy guidance is sufficient but additional explanatory information could have been included in those actions with only initial or limited implementation. The reporting on implementation of structural reforms is partially sufficient. The number of reform measures respects the limit of 20. However, the page limit is exceeded. Table 9 is appropriately filled. 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.

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