



Council of the  
European Union

Brussels, 25 April 2022  
(OR. en)

8300/22

ECOFIN 350  
UEM 74  
COWEB 39

**COVER NOTE**

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From:	Secretary-General of the European Commission, signed by Ms Martine DEPREZ, Director
date of receipt:	20 April 2022
To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union

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No. Cion doc.:	SWD(2022) 126 final
Subject:	Commission staff working document - Economic reform programme of Kosovo* (2022-2024) - Commission assessment

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Delegations will find attached document SWD(2022) 126 final.

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Encl.: SWD(2022) 126 final

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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.



Brussels, 20.4.2022  
SWD(2022) 126 final

**COMMISSION STAFF WORKING DOCUMENT**

**ECONOMIC REFORM PROGRAMME**

**OF**

**KOSOVO\***  
**(2022-2024)**

**COMMISSION ASSESSMENT**

The economic reform programme (ERP) was submitted on 31 January 2022.

The economic consequences of Russia’s war against Ukraine may render the macro-fiscal scenarios presented in the ERP partially obsolete. The Commission will publish its updated macroeconomic and fiscal projections for candidate countries, reflecting the expected impact of the war against Ukraine and related sanctions, in its spring economic forecast in mid-May 2022.

The short-term macro-fiscal outlook may change considerably. However, the major medium-term fiscal and structural reform challenges and priorities identified in this assessment remain valid irrespective of the short-term outlook. Appropriate policy responses are essential to ensure a sustained economic recovery, greater resilience and fiscal sustainability.

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## 1. EXECUTIVE SUMMARY

**Following a robust economic recovery in 2021, Kosovo's Economic Reform programme (ERP) projects very high GDP growth to continue.** The economic rebound in 2021 was mainly driven by the resumption of travel by diaspora and related financial inflows. After increasing by 9.7% in 2021, the ERP projects real GDP to rise by 7.8% in 2022 and continue rising by some 7% in 2023-2024, well above historical trends. The programme expects the large surge in private and public-sector investment to be a key driver of this growth. There are major downside risks to this outlook stemming from pandemic-related uncertainty, lower-than-expected financial inflows from the diaspora and persistent under-execution of public capital. Further risks to the outlook, notably via higher energy and food prices, have emerged in the context of Russia's invasion of Ukraine, which could also lead to less dynamic trade developments with the main EU and non-EU trading partners.

**Supported by high revenue growth and cautious public spending, the headline budget deficit narrowed to 1.4% of GDP.** The fiscal stimulus in 2022 is expected to widen the headline budget deficit to 4.6% of GDP, while the deficit, as per the fiscal rule definition, which excludes some capital spending, is set at 2.9% of GDP. Kosovo's programme projects a gradual return in 2023 below the deficit ceiling of 2% of GDP, as set in the fiscal rule. Immediate fiscal risks, some of them included in the programme, stem from lower-than-expected revenue, pressure to roll out new social benefits and an unrealistic planning of capital spending.

The main challenges facing Kosovo include the following.

- **Providing fiscal support to the recovery is still needed in 2022, but the envisaged consolidation and gradual return to the deficit rule is key to maintaining fiscal sustainability in the medium term.** Given the high degree of uncertainty about potential developments of the pandemic and the impact of Russia's war against Ukraine, it seems advisable to provide policy support where needed. The timing of the envisaged return to the 2% deficit ceiling by 2023 may be affected by the economic outlook. Structural reforms on both the budget revenue and expenditure sides should improve the quality of public finances. A review of existing tax exemptions and preferential tax rates would help mobilise revenue. Current spending would benefit from a review and streamlining of social benefits, including war veteran pensions, a proper assessment of the fiscal impact of new social initiatives and a coherent and fiscally affordable public-sector wage system. To ensure public finances are sustainable over the medium-term, there is a need to diversify the investor base for public debt. It currently relies on financing provided by international donors and domestic public institutions.
- **Multiple development challenges and long-standing weaknesses in capital spending call for action to tackle investment bottlenecks.** Though Kosovo has made partial progress in implementing capital projects, further action is needed to strengthen public investment management in line with the recommendations of the IMF's Public Investment Management Assessment. The fiscal risks related to publicly owned enterprises (POEs) and related investment decisions should be properly assessed, incorporated into budgetary planning and fed into the country's 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, deters the development of the private sector and prevents a significant section of the workforce from accessing proper levels of social protection and training. Kosovo has a

strategy designed to address the key underlying causes of informality. However, there are delays in implementing them and reporting on the work, and the corresponding action plan is now outdated. Strong political support, effective implementation and close monitoring are required to achieve the desired outcomes. In addition, the strategy measures are needed to improve the business environment that contributes to informality and impedes private sector development.

- **The unreliable supply of energy is inadequate to meet rapidly growing demand and is one of the main constraints on Kosovo's competitiveness, acting as a break on productivity and exacerbating the recent energy crisis.** The lack of energy security gives rise to significant costs for business and represents a major obstacle to attracting high-quality foreign direct investment (FDI). Kosovo is investing in renewables, but a new, competitive auction-based system is required to unlock the additional investment it needs. Despite positive developments, Kosovo needs to step up efforts to unlock 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 regional integration could support the financial stability of the Kosovo transmission system operator (KOSTT).
- **The education system in Kosovo does not adequately equip students with the skills and competences required by the labour market.** A high share of young people experience a difficult transition from school to work. International ratings reveal a poor performance of the pre-university education in Kosovo. Vocational education still lacks a major curriculum reform, and systematic efforts to train teachers and integrate work-based learning. A series of reforms aim to improve active labour market policies, which are however hampered by low levels of budgetary and human resources in the public employment service.

**Kosovo has partially implemented the policy guidance set out in the conclusions of the Economic and Financial Dialogue of July 2021.** Although the fiscal rule remained suspended, the robust economic recovery and surging public revenue substantially improved the budget balance. A permanent return to the fiscal rule is planned for 2023. Overall, the measures in the economic recovery package were well-targeted. There has been little progress on reclassifying the war veteran pension beneficiaries and reviewing social security schemes, and the law governing public-sector salaries is still in the process of revision. Tax revenue recovered in line with real GDP expansion and a reduction in the informal economy, but there was no progress on work to review tax exemptions. The financial oversight of POEs has improved somewhat, but work to set up a fiscal oversight body has not advanced. Investment management has improved somewhat but it remains a key weakness. The government has not yet published its climate strategy. Efforts to improve household energy efficiency are still at an early stage. The action plan on combating the informal economy has expired and not yet been updated, though the tax administration has had some recent success in tackling the informal economy. Nevertheless, there was no progress in increasing the transparency of prices for real estate transactions. The government adopted a number of strategies on health but their implementation was limited. There has been some progress on the accreditation and monitoring of higher education, but school inspections still need to resume. Tools to monitor the labour market and skills needs have been developed and they now need to be used. An inter-ministerial task force was set up and started developing a Youth Guarantee implementation plan.

**The ERP sets out reform plans that are partly in line with the key challenges and priorities identified by the Commission.** The programme reflects the government's intention to boost economic recovery in 2022 and strengthen the sustainability of public finance for the

medium term. It also mentions a number of investment projects that should support infrastructure and competitiveness. However, weaknesses in fiscal governance could delay the achievement of these goals. The programme includes measures to improve the business environment and reduce the informal economy. The ERP also partially addresses issues of access to energy challenges and the capacity of the education system to meet labour market needs. The ERP process for Kosovo should also emphasise the shared European growth model regarding green and digital transition, particularly given the current geopolitical context. The digitalisation of the economy is advancing but efforts are needed to promote e-commerce, enable the use of international electronic payments and finalise the e-governance strategy. Although the proposed measures in the ERP are aligned with the main structural challenges, implementation is delayed and the planned improvements have not yet been materialised.

## 2. ECONOMIC OUTLOOK AND RISKS

**Following a deep recession in 2020, Kosovo's economy rebounded sharply in 2021 due to the easing of travel restrictions and to exceptional support from the diaspora.** The recovery started in the first quarter with real GDP expanding by 4.2% year on year, which accelerated in the following two quarters to 16.3% and 14.5% year on year, respectively. Growth was driven by a relaxation of travel restrictions and a rebound in financial flows from the diaspora through tourism, remittances and real estate investment. The recovery was boosted by policy support from the government in rolling out COVID-19 related measures, estimated at 3.2% of GDP.

**The ERP's baseline scenario assumes a robust recovery with GDP growth much higher than the historical trend.** Supported by very strong growth in investment, real GDP is projected to increase by 7.8% in 2022. The projected rebound is much higher than the IMF forecast, which is more in line with the historical trend at 3.8%<sup>1</sup>. In subsequent years, the ERP expects economic growth to ease off, but remain well above historical trend growth at 7.1% and 6.8% in 2023 and 2024 respectively. The expected strong inflow of investment in 2022 (+21.3%) relies on higher private investment, which is assumed to benefit from reduced uncertainty, government support and improving balance sheets of the private sector. Public investment is also expected to increase strongly due to better execution of capital projects. In 2023-2024 investment growth is set to remain high at around 11%. Due to the base effect, the inflow of remittances, bank lending and social transfers, private consumption is set to increase slightly (1.5%) in 2022 before accelerating to some 6% in 2023-2024, but it is unclear what is behind this expected surge. Public consumption is projected to rise by 4.5% in 2022 due to the rollout of pandemic-related measures, as expected in the 2022 budget, and then to level off afterwards. After a spectacular rebound in 2021, real exports are set to increase by 6.6% in 2022, and continue growing at 7.5% afterwards. Imports are expected to rise by 5% in 2022 (counterintuitive given the projected high increase in investment this year) before accelerating to 6-7% in 2023-2024. The ERP assesses that in 2022, the macro-fiscal risks and uncertainty related to the pandemic are lower than they were in 2021, due to the ongoing vaccination programme and restored business confidence. The main risks are considered to be external, stemming from high energy prices and a potential interest rate hike in the Eurozone. Among the domestic risks the ERP notes pandemic-related restrictions, pressure to roll out new social schemes and fiscal risks related to publicly owned enterprises. In contrast to previous years,

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<sup>1</sup> The IMF Article IV consultation (2022).

the ERP does not provide high and low-growth scenarios, though the latter could have served as a useful reference, given the optimistic baseline GDP projections.

**The ERP baseline scenario appears overly optimistic and is beset by high uncertainty.** Though the recovery was impressive in 2021, it was mainly driven by exceptional financial inflows from the diaspora without pronounced changes in the production structure. Compared to the previous year's ERP projections, the level of estimated GDP at market prices is 6.2% higher than it was in 2021. The upward revisions of 11.9% in 2022 and 15.9% in 2023 seem overly optimistic. Potential GDP growth is estimated at 6.4% in 2021 and set to ease off gradually to 5.4% in 2024, which is at odds with the assumed surge in investment. Moreover, the assumed downside risk of higher energy prices already started to materialise in late 2021. High import costs, increased energy consumption in winter months and insufficient domestic power generation, exacerbated by the partial shutdown of Kosovo B power plant, resulted in temporary power cuts and high energy subsidies (EUR 120 million or 1.5% of 2021 GDP).<sup>2</sup> A substantial new risk stems from the fallout from the Russia's war against Ukraine, in particular via further increases in food and energy prices. These adverse developments are likely to reduce disposable income, merchandise exports and GDP growth.

Table 1:

**Kosovo - Macroeconomic developments**

	2020	2021	2022	2023	2024
<b>Real GDP (% change)</b>	<b>-5.3</b>	<b>9.7</b>	<b>7.8</b>	<b>7.1</b>	<b>6.8</b>
<i>Contributions:</i>					
- Final domestic demand	-0.1	9.0	8.4	9.2	8.4
- Change in inventories	-0.1	-0.1	0.4	0.0	0.0
- External balance of goods and services	-5.1	0.8	-0.9	-2.1	-1.6
Employment (% change)	-4.4	3.5	:	:	:
Unemployment rate (%)	25.9	25.8	:	:	:
GDP deflator (% change)	1.4	2.4	2.5	2.1	1.9
CPI inflation (%)	0.2	3.3	2.5	2.2	2.0
Current account balance (% of GDP)	-7.0	-4.9	-5.5	-6.5	-7.2
General government balance (% of GDP)	-7.6	-1.4	-4.6	-3.7	-3.0
Government gross debt (% of GDP)	22.4	22.5	25.5	27.2	28.7

Sources: Economic Reform Programme (ERP) 2022.

**Inflationary pressures are expected to abate, but the 2022 inflation forecast is optimistic.**

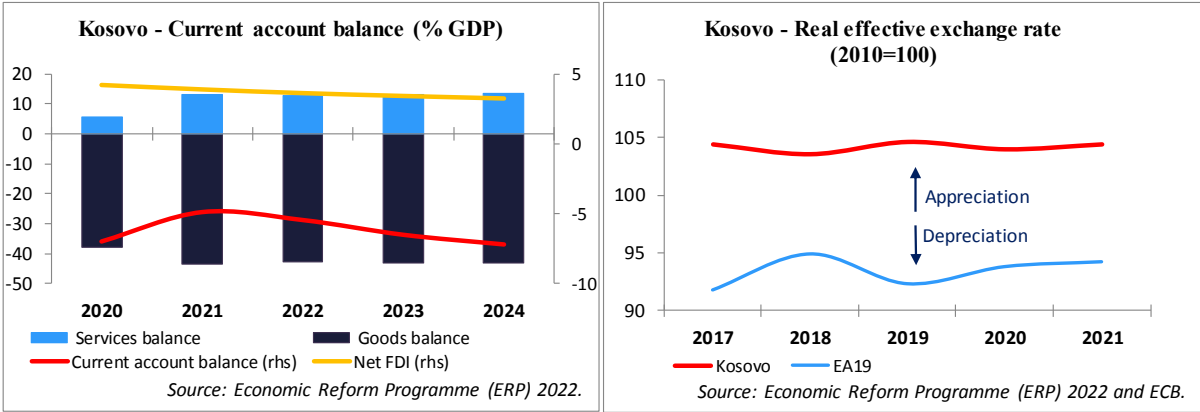
The ERP expects average annual inflation to fall to 2.5% in 2022 from 3.3% in 2021 on the back of a gradual stabilisation of energy prices and fewer supply disruptions caused by the pandemic. This projection is rather benign compared with the IMF forecast of 3.9% for 2022 and given increasing price pressures in late 2021. Inflation rose over the course of 2021 from 0.6% in the first quarter to 6.7% year on year in December. The main drivers were rising food and energy prices and the one-off increase in communication tariffs. Most energy prices are regulated in Kosovo. The decision of the Electricity Regulation Office to bring in a two-tier

<sup>2</sup> A share of EUR 30 million is earmarked for securing imports of electricity, while the bulk of energy subsidies (EUR 90 million) will be used to keep electricity prices unchanged for small consumers, i.e. households using up to 800 kW, and partially compensate price increases for larger consumers (more than 800kW). The latter subsidy, which will be financed from the economic recovery programme for 2022 (EUR 200 million), is not well-targeted as it will be given without adjusting for beneficiaries' income. The tariffs for non-household consumers, including industrial customers, small and medium-sized enterprises, businesses and wholesale customers, remain unchanged. Large companies, e.g. Ferronickel or Trepca, which are not supplied in the regulated energy market, face higher energy prices without any compensation.

tariff structure for household consumers, maintaining electricity prices for households consuming less than 800kWh unchanged and doubling them for households consuming more than 800kW, is likely to push up inflation in 2022.

**Diaspora-related inflows helped reduce the current account deficit in 2021, but high import growth is projected to widen the external gap in the coming years.** Following the easing of travel restrictions, exports of services (mainly diaspora tourism from Western Europe, but also transport services) rebounded by a stunning 89.4% in 2021. Exports of goods, which are much smaller and rely on a narrow product base including base metals, manufactured articles, plastics and prepared foodstuffs, increased by 60% despite the high electricity prices in the second half of 2021 affecting the main export product, base metals. The sizeable increase in imports (by 33.2%) led to a widening merchandise deficit from 38.5% of GDP in 2020 to 44.4% in 2021. The surplus of services trade is estimated to have increased from 5.8% to 13.3% of GDP over the same period. The overall trade deficit fell slightly from 32.6% to 31.1% of GDP in 2021, and the ERP projects it to remain above 30% during 2022-2024. The key factor partly offsetting the trade deficit is remittances, which increased by 20% in 2021 to reach 15.8% of GDP. Further unofficial remittances (2.5% of GDP) are reflected by larger errors and omissions in 2021. Overall, the current account deficit is projected to widen gradually from 4.9% of GDP in 2021 to 7.2% in 2023, due to a robust increase in imports. In terms of the saving-investment balance, the strong increase in both private and public capital spending is seen as the main driver of the forecast widening of the external deficit.

Graphs: external competitiveness and current account



**Due to financial inflows from the diaspora focusing on real estate investment, net foreign direct investment (FDI) increased in 2021 to cover nearly 80% of the current account deficit.** Further support for FDI came from reinvested earnings in the financial sector due to the ban on dividend distribution. Net foreign direct investment is estimated at 3.9% of GDP in 2021. The bulk was directed to non-tradeable activities, with real estate and financial services accounting for 68% and 22% of all foreign direct investment inflows respectively, doing little to enhance export capacity. Kosovo’s net international investment position improved from -12.3% of GDP in 2020 to -9.5%, mainly driven by rebound in GDP. Around two thirds of gross liabilities consist of foreign direct investment, typically considered a more stable source of financing, conducive to limiting external vulnerabilities. Reserve assets remained rather low, covering three months of imports in the third quarter of 2021, down from 3.2 in 2020.

Table 2:

**Kosovo - Financial sector indicators**

	2017	2018	2019	2020	2021
<b>Total assets of the banking system (EUR million)</b>	3 870	4 186	4 761	5 365	5 960
<b>Foreign ownership of banking system (%)</b>	88.1	86.8	86.7	86.5	85.5
<b>Credit growth (aop)</b>	11.5	10.9	10.0	7.1	15.5
<b>Deposit growth (aop)</b>	6.8	8.7	16.2	11.6	12.4
<b>Loan-to-deposit ratio (eop)</b>	80.3	81.9	77.6	74.5	76.5
<b>Financial soundness indicators (eop)</b>					
- non-performing loans	3.1	2.7	2.0	2.7	2.1
- net capital to risk-weighted assets	18.1	17.0	15.9	16.5	15.3
- liquid assets to total assets	37.9	38.5	38.7	39.8	37.4
- return on equity	21.3	20.4	18.9	14.0	17.6
- forex loans to total loans (%)	0.2	0.1	0.1	0.1	0.1

Source: National Central Bank.

**Helped by the economic rebound, the mainly foreign-owned banking sector remained stable and continued to expand.** In February 2021, the Central Bank of Kosovo (CBK) issued a third guide on loan restructuring for a period of nine months, which helped banks avoid increasing provisions. In the second half of 2021, as the economic recovery gained pace, the CBK gradually lifted the pandemic-related support measures<sup>3</sup>, without a negative impact on bank asset quality so far. Timely regulatory forbearance and large inflows from the diaspora supported rapid credit growth, in particular for households. Bank loans accelerated from 7.1% in 2020 to 15.5% in 2021, while new loans to households, mainly for consumption purposes, rose by 51%, nearly reaching the level of new loans to non-financial corporations in 2021. New mortgage lending to households surged by 75%. Although overall the credit risks remain contained, the ERP mentions challenges in evaluating risks from the rapid credit expansion in the household segment. The growth of deposits increased from 11.6% in 2020 to 12.4%. Financial soundness indicators remained satisfactory, e.g. the loan-to-deposit ratio and non-performing loan (NPL) ratio<sup>4</sup> stood at 76.5% and 2.1%, respectively. Bank profitability has surged with the average return-on-equity ratio reaching 17.6% in 2021, up from 14% in 2020. The ERP does not provide quantified forecasts for the financial sector, but the underlying assumption, which appears broadly plausible, is that the largely foreign-owned banking sector will remain stable and profitable.

<sup>3</sup> The IMF estimates that by October 2021, only 1% of all loans remained under the pandemic-related forbearance.

<sup>4</sup> Stable NPL ratio was also supported by the denominator effect, i.e. high credit growth.

### 3. PUBLIC FINANCE

**The 2021 budgetary outcome has considerably improved due to surging revenue and conservative spending.** The ERP estimates the 2021 headline budget deficit to be 1.4% of GDP, which corresponds to a deficit of 0.8% of GDP under the fiscal rule definition<sup>5</sup>. This outcome would comply with the fiscal rule prescribing a deficit ceiling of 2% of GDP, though this rule has been suspended since 2020. The 2021 deficit outturn is much lower than in 2020 (7.6% of GDP) and also undershoots the target of 6.4% set in the revised 2021 budget. Government deposits recovered to 4% of GDP from 3.5% in 2020. The lower deficit resulted primarily from an extraordinary increase in government revenue, which is estimated to have risen by 26.8% from 2020, exceeding the revised 2021 budget projection by 6.8%. Tax revenue increased by 29.8% with healthy growth in direct and indirect tax income, up 25% and 31% respectively on 2020. By contrast, public spending increased by only 2.5% and its share in GDP dropped by 2.9 percentage points due to robust GDP growth. Implementation of the revised 2021 budget was uneven among different spending categories. Capital spending reached only 75.8% of the revised budget allocation (although this is still an improvement over previous years), while the execution of current expenditure was roughly in line with the initial plan. The largest increase in spending was in the category of goods and services (9.6%) due in particular to the purchase of vaccines. Spending on social transfers and subsidies fell by 2.9% due to the higher level in 2020, but it was still at 11.1% of GDP in 2021 compared to the pre-crisis level of 8.8%. The ERP estimates the costs of the economic revival programme in 2021 at 3.2% of GDP, which is below the crisis-related stimulus of 4.2% of GDP provided in 2020. The bulk of pandemic-related support in 2021 was spent on transfers to vulnerable households and firms (2.5% of GDP). In addition to direct support measures, the government exempted mining firms from paying royalties for five months and applied a reduced VAT rate for hotels and catering services. Together these measures are estimated to have resulted in a loss of budget revenue of 0.2% of GDP.

**The fiscal strategy for 2022-2024 aims to support the economic recovery mainly through capital investments, while maintaining stable public finances and complying with fiscal rules.** The fiscal strategy projects tax revenue to fall slightly from the historical high of around 26% of GDP reached in 2021<sup>6</sup>, when it was supported by an extraordinary increase in diaspora travel and some formalisation gains, stemming from implementation of pandemic-related measures. Public spending is forecast to be frontloaded, rising to 32.7% of GDP in 2022 before falling to 30.7% in 2024. As in the past, the ERP assumes a very large increase in capital spending in 2022 (by 2.9 percentage points), which should taper off in 2023-2024, bringing investment as a share of GDP to well above 9%. Expressed as a percentage of GDP, government spending and social transfers are projected to ease off steadily in 2022-2024, but to remain above their pre-crisis levels.

**The headline deficit is set to widen in 2022 to 4.6% of GDP, and narrow afterwards.** The budget deficit, as per the fiscal rule definition, is projected at 1.8% of GDP in 2023, reflecting

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<sup>5</sup> The fiscal rule places a cap on the fiscal deficit of 2% of forecast GDP, excluding capital projects financed by privatisation proceeds and donors ('investment clause'). This exemption for donor-financed investments can be invoked until 2025, provided the public debt ratio remains below 30% of GDP. A further rule provides that the increase in the public wage bill cannot exceed nominal GDP growth. Government deposits used as fiscal buffers are legally required to stay at 4.5% of GDP as long as the government uses privatisation proceeds. The debt rule provides that public and publicly guaranteed debt cannot exceed 40% of GDP.

<sup>6</sup> In 2019, the tax revenue to GDP ratio was 24%.

the authorities' plan to return to compliance with the deficit rule next year, and to fall to 0.8% in 2024. While a more supportive fiscal stance focusing on much-needed investment is justified in 2022, given very cautious spending in 2021 and the still fragile recovery, the assumption that revenue will remain permanently higher is beset with a high degree of uncertainty in terms of the development of the pandemic and financial inflows from the diaspora. The ERP does not refer to any reforms to widen the tax base or review social transfers. The assumption of an extraordinary increase in capital spending is not sufficiently underpinned by concrete measures to improve investment management or disbursement from the investment clause. Though the fiscal projections represent a commendable target, the ERP provides few details on how Kosovo can achieve the target.

Table 3:

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

	2020	2021	2022	2023	2024	Change: 2021-24
<b>Revenues</b>	25.4	28.7	28.1	27.9	27.7	-1.0
- Taxes and social security contributions	22.4	25.9	25.2	25.1	25.0	-0.9
- Other (residual)	3.0	2.8	2.9	2.8	2.7	-0.1
<b>Expenditure</b>	33.0	30.1	32.7	31.6	30.7	0.6
- Primary expenditure	32.6	29.7	32.2	31.0	30.1	0.4
<i>of which:</i>						
Gross fixed capital formation	5.6	5.5	8.4	9.2	9.5	3.9
Consumption	14.2	13.1	12.8	11.9	11.3	-1.8
Transfers & subsidies	12.8	11.1	10.6	9.8	9.2	-1.9
Other (residual)	0.0	0.0	0.4	0.1	0.2	0.2
- Interest payments	0.4	0.4	0.5	0.5	0.6	0.1
<b>Budget balance</b>	-7.6	-1.4	-4.6	-3.7	-3.0	-1.6
- Cyclically adjusted	-3.6	-2.6	-4.7	-3.4	-2.3	0.3
<b>Primary balance</b>	-7.2	-1.0	-4.1	-3.2	-2.4	-1.4
- Cyclically adjusted	-3.2	-2.2	-4.2	-2.8	-1.7	0.4
<b>Gross debt level</b>	22.4	22.5	25.5	27.2	28.7	6.1

Sources: Economic Reform Programme (ERP) 2022, Commission calculations.

**The 2022 budget assumes strong growth in both public revenue and spending.** The 2022 budget projects public revenue at 28.1% of GDP, which is 15.7% higher than the revised 2021 budget. Compared to the outturn of 2021, tax revenue is set to rise by 7.9% in 2022 with a smaller increase in indirect tax revenue (5.7%) and higher growth in direct tax income (17%). Total expenditure is projected to reach 32.7% of GDP in 2022, which is 8.7% higher than the spending forecast in the 2021 revised budget. The main reason for this increase is forecast to be capital spending (27%) while current expenditure is set to grow by a modest 3.2% in 2022. Compared to the outturn of 2021, current and capital spending should increase by 3.3% and 67% respectively, with the surge in capital spending not supported by the previous track record of investment expenditure. The 2022 budget includes new child and maternity allowances (0.6% of GDP). The allocation for war veteran pensions is set in line with the legal ceiling of 0.7% of GDP which has been repeatedly exceeded in the past. Debt interest payments are set to remain unchanged at 0.5% of GDP in 2022. The 2022 budget also includes a blanket allocation for the economic revival programme amounting to 2% of GDP. This includes 1.3% of GDP for subsidies and transfers as well as 0.7% of GDP for contingencies for pandemic-related downside risks. The headline deficit is set at 4.6% of GDP which corresponds to a deficit of 2.9% of GDP under the fiscal rule definition. Government cash deposits are planned to decrease slightly to 3.5% of GDP from 4% in 2021.

**The priorities set in the government programme are not well reflected in the budget.** The ERP doesn't include information on all new initiatives stemming from the government programme. Some, such as child and maternity allowances, are included in the 2022 budget, but it is not clear whether other elements in the programme such as raising the minimum wage or increasing affordable housing will be added in 2022. The ERP does not provide much detail as to the continuation of the economic recovery programme in 2022. It does not mention the latest government initiatives, such as energy subsidies (EUR 120 million) or the increase in basic, disability, invalidity and family pensions up to EUR 100.

**The increase in public debt was less pronounced than anticipated in the previous ERP, but the domestic investor base remains shallow.** On the back of strong economic recovery and revenue growth in 2021, the debt-to-GDP ratio is estimated to have grown only marginally, to 22.5% from 22.4% in 2020.<sup>7</sup> While this outcome is way below the 2021 ERP projection of 28.7%, these figures do not include the liability stemming from tax-free withdrawals of 10% of pension savings from the Kosovo Pension Saving Trust (KPST), which the government promised to reimburse from 2023.<sup>8</sup> Domestic debt, which is held by a narrow investor base, increased by 16% in 2021. The KPST's share of domestic debt fell slightly from 47% in 2020 to 45%, while the Central Bank of Kosovo and commercial banks hold a further 20% and 30% of domestic debt respectively. Foreign debt rose by 9.6% in 2021 on the back of financing from international donors. This includes EU macro-financial assistance (the second and final instalment of EUR 50 million was disbursed in June), World Bank loans (EUR 32.2 million) and Council of Europe Bank lending (EUR 17 million). The ERP assumes a 2.9 percentage point increase in the public debt ratio in 2022, to 25.5%, and a continued gradual drift upwards to 28.7% in 2024. The ERP projects government deposits at some 3.5% of GDP in 2022-2024, which would provide sufficient capacity to face potential new shocks. The KPST still has room to buy new bond issuances in the coming years, but it is approaching the legal limit<sup>9</sup>. Risk management policies also limit the ability of commercial banks to hold more government debt.<sup>10</sup> As Kosovo does not have access to international debt markets due to the lack of an international credit rating, it needs to diversify the investor base for government securities in order to secure sufficient financing while safeguarding government deposits. This could include insurance companies, non-financial private firms and possibly retail investors, including from the diaspora. Together, these categories currently hold only about 5% of domestic debt. In 2021, Kosovo issued its first diaspora bonds, albeit in small amounts, in an effort to tap additional sources of financing.

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<sup>7</sup> In March Kosovo Agency of Statistics has revised the debt-to-GDP ratio to 23.4% in 2021.

<sup>8</sup> The IMF estimates the liability to KPST at 1.8% of 2020 GDP.

<sup>9</sup> Government securities should not exceed 30% of KPST assets.

<sup>10</sup> The absence of a sovereign risk rating results in a 100 per cent capital risk weight for Kosovo's government securities.

**Box: Debt dynamics**

The sustained though gradually decreasing primary deficit in 2022-2024 is expected to be the main reason behind the steadily increasing public debt. This debt-increasing factor is partly offset by the impact of economic growth and inflation. Interest expenditure is forecast to stay low and roughly stable at 0.5-0.6% of GDP in 2022-2024. Positive but low contributions to the debt-to-GDP ratio are expected to come from stockflow adjustments in 2022-2024.

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

	2020	2021	2022	2023	2024
<b>Gross debt ratio [1]</b>	<b>22.4</b>	<b>22.5</b>	<b>25.5</b>	<b>27.2</b>	<b>28.7</b>
Change in the ratio	4.9	0.1	2.9	1.8	1.4
<i>Contributions [2]:</i>					
<b>1. Primary balance</b>	<b>7.2</b>	<b>1.0</b>	<b>4.1</b>	<b>3.2</b>	<b>2.4</b>
<b>2. "Snowball" effect</b>	<b>1.3</b>	<b>-2.0</b>	<b>-1.6</b>	<b>-1.6</b>	<b>-1.6</b>
<i>Of which:</i>					
Interest expenditure	0.4	0.4	0.5	0.5	0.6
Growth effect	1.0	-1.9	-1.6	-1.7	-1.7
Inflation effect	-0.1	-0.5	-0.5	-0.5	-0.5
<b>3. Stock-flow adjustment</b>	<b>-3.5</b>	<b>1.1</b>	<b>0.5</b>	<b>0.2</b>	<b>0.6</b>

[1] End of period.

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

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

Source: Economic Reform Programme (ERP) 2022, ECFIN calculations.

**The fiscal scenario is a commendable combination of investment-led fiscal support to the recovery and return to compliance with the fiscal rules, but implementation is beset by substantial risks.** Highly optimistic GDP and revenue projections are the main downside risk to the budget. On the spending side, the fiscal scenario assumes moderate growth of current expenditure and a very ambitious surge in capital investment. There are risks of higher growth in current spending due to new initiatives included in the government programme, such as raising basic pensions or bringing in maternity and child benefits, while existing schemes might prove more costly than expected. In particular, spending on war veteran pensions has repeatedly breached the legal cap of 0.7% of GDP due to a lack of reclassification of beneficiaries and other cost-saving measures. Moreover, the government programme foresees raising the minimum wage, which is currently used as a lower bound for war veteran pensions and thus could lead to further increases in this spending category. The government has been revising the Law on Salaries for Public Employees since mid-2020 and plans to table a new proposal in the spring. The new law should set a uniform wage grid and improve compensation fairness, while the fiscal implications should in principle be contained if the wage bill rule is respected. The under execution of capital investment is a long-standing issue and there is a substantial risk that the much higher allocation for 2022 will not be fully implemented, which therefore is an upside risk to the budget balance. The poor performance by publicly owned enterprises and the accumulation of arrears are further downside fiscal risks.

### ***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 percentage points would bring the debt-to-GDP ratio to 30.8% instead of 28.7% in the baseline scenario if the deficit rule is followed in 2025-2035
- 2) If, due to higher spending, the primary balance deteriorates by 2 percentage points of GDP in 2024-2034 and the deficit rule is not followed, debt would increase to 53% of GDP by the end of 2035, i.e. 23.8 percentage points higher than in the baseline scenario.
- 3) A 1 percentage point 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 offset by lower primary deficits.

The sensitivity analysis underscores the importance of compliance with the 2% deficit rule, which acts as a debt stabiliser. Moreover, it is important to keep current expenditure under control, in anticipation that financing from privatisation funds will end over the medium term.

**The quality of public finance suffers from long-standing issues such as inappropriate targeting and transparency of social transfers, weaknesses in investment management and a limited tax base.** Though fiscal support for vulnerable groups was well-targeted under the economic revival programme, a large share of specific category-based social transfers, including war-related pensions financed from the budget, are not focused on alleviating poverty. Decoupling war veteran pensions from potential changes to the minimum wage would help contain overspending risks. Kosovo brought in child benefits and maternity allowances and increased basic, disability, invalidity and family pensions to the minimum benchmark of EUR 100 without making proper assessments of their long-term costs. Further progress is needed to improve the administrative capacity to run capital projects, especially donor-financed projects under the investment clause. As a positive step, Kosovo allocated EUR 50 million for expropriation purposes in the 2022 budget with the aim of unlocking the potential of project implementation. It could improve the planning, execution and *ex post* evaluation of the public investment programme by implementing the recommendations made under the IMF Public Investment Management Assessment and by ensuring the efficient functioning of the Procurement Review Body. On the revenue side, the challenge is to strengthen the tax base, as the implementation of the free trade agreement with Turkey and the Stabilisation and Association Agreement with the EU will result in lower customs revenue. The tax base is weakened by widespread informality and numerous exemptions, preferential tax rates and special regimes. While some tax exemptions, e.g. lower VAT for restaurants and catering, might have been justified during the pandemic, it would be important to produce a comprehensive review of tax expenditure in order to assess the revenue foregone and shape future policies.

**While fiscal stimulus is justified in 2022, the medium-term sustainability and credibility of public finance would clearly benefit from the planned return to the deficit rule.** The 2022 budget projects a return to the 2% deficit ceiling by 2023. The development of debt-to-GDP ratio will have major repercussions on the use of the fiscal rule investment clause. According to the fiscal rule definition, the exemption from the 2% deficit ceiling of capital projects financed by privatisation proceeds and donors can be used until 2025, provided that public debt remains below the prescribed ceiling of 30% of GDP. A benign ERP projection of public debt is dependent on high GDP and public revenue growth, which are beset by uncertainty. To avoid the risk of suspending the investment clause while accommodating Kosovo's large investment needs, a possible solution could be to align the investment clause

to the general debt ceiling of 40% of GDP. Fiscal governance would also benefit from moving ahead with plans to set up an independent fiscal council, drawing on the options paper prepared recently with the help of the IMF. 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.

The government in its ERP also highlighted two of the three areas listed above as key structural challenges, namely (i) improving the quality and relevance of the education system to increase employment and mitigate skills mismatches and (iii) tapping into the potential of renewable energy and energy savings and fully opening the energy market. The government described the reorganisation of the health sector in order to provide adequate and accessible health services for all citizens as a third key structural challenge.

While the ERP continues to acknowledge the importance of efforts to tackle the informal economy and improve the competitiveness of the private sector, it does not place it among the three key structural challenges facing Kosovo. However, given the nature and persistence of the challenges in this area and their immediate impact on competitiveness and inclusive growth, the Commission maintains its assessment that tackling the informal economy and improving the competitiveness of the private sector remains a key structural challenge for Kosovo.

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***

**Kosovo records very low activity and employment rates in relative terms.** In 2020, according to official data, only 42.9% of people aged 20-64 were active in the labour market, far below the levels in its regional peers and very far from the EU-27 average of 77.7%. The

employment rate (20-64 years) in 2020 was 32.3%, down 1.9 pps. from 2019 due to the COVID-19 crisis. Data from the first quarter of 2021 show some signs of recovery as the employment rate (15-64) stood at 29.3%, slightly above the same period in 2020 (29.1%) and 1.1 pps. higher than in the first quarter of 2019. A plan to decrease the duration of short-term employment contracts from the current 10 years to 3 years pursues the goal of increasing quality employment.

**There is a stark gender divide in the labour market.** In 2020, the gender employment gap (for people aged 20-64) was 32.8 pps., among the widest in Europe, though it has been decreasing from 39.4 pps. in 2017. Among the reasons is lower involvement of women in entrepreneurship, which is linked to lower access to finance and real estate property, as well as family responsibilities and lack of affordable early childhood education and care facilities (RCC 2021). High reservation wages supported by remittances and a lack of opportunities and affordable transport options in rural areas are other factors linked with low female labour force participation. In September 2021, as part of the recovery package the government introduced maternity leave for women unemployed longer than 12 months. By excluding women in shorter spells of unemployment, this could act as a disincentive for women planning motherhood to take on (formal) work. The draft Labour Law brings 10 days of paternal leave and the option of parental leave for the mother or the father to take after the end of maternity leave. This provides ways to increase the balance in the distribution of care responsibilities. It also aims to encourage the employment of women by reducing costs for employers by taking over a bigger share of maternity leave benefits.

**The provision, accessibility and affordability of early childhood education and care (ECEC) are low.** Kosovo's ECEC policy aims are to provide highly targeted public services for more vulnerable social groups, while expecting the rest to rely on the market or the family. Although the availability of ECEC has been increasing, it remains below regional peers, and new services are increasingly provided by the market, which raises affordability issues (Mustafa 2021). Though the level of participation of children aged 0-5 in ECEC was marginal at 6.2% in the school year 2019/2020, there is a high level participation of children aged 5-6 (92.5%) in preparatory classes offered mainly by primary schools (RCC 2021).

**Young people in Kosovo face a difficult transition from school to employment.** The unemployment rate of young people aged 15-24 was 49.1% in 2020, with more than half unemployed for over 12 months, which puts them in category of long-term unemployed. The share of young people aged 15-29 not in employment, education or training (NEET) was 40.4%. Both figures are very high not only compared to the EU-27 average but also to Kosovo's Western Balkan peers. The lack of jobs is considered to be a key factor fuelling the emigration of young people. To partially address the situation on the supply side, the government has set up a multi-stakeholder group to develop a Youth Guarantee implementation plan.

**The Kosovo education system was ranked among the lowest quality by the 2018 Programme for International Student Assessment (PISA).** Kosovo students' scores are the equivalent to five years of schooling behind the OECD average in reading, and a little over four years behind in mathematics. The performance gap is particularly clear among students belonging to ethnic minorities and people in vulnerable situations. Students in urban areas tend to outperform students in rural areas. Nevertheless, students firmly believe in their own ability to perform, especially when faced with adversity (ranking 9 out of 77). They also perceive their teachers as being very enthusiastic and supportive compared to other economies participating in PISA. One in two upper secondary students is registered in vocational

programmes. The proportion of people (18-24) leaving school early has continued to fall to 7.8% in 2020, which is now lower than the EU-27 average of 9.9%. Keeping young people in education while upskilling them through vocational qualifications has proved to be a successful policy. However, the time spent in school may translate unevenly into learning (ETF 2020).

**Effective quality assurance is one of the weakest points across all levels of education.** This is recognised in Kosovo's Education Strategic Plan for 2017-2021. With government expenditure on education amounting to 4.6% of GDP in 2020, Kosovo was comparable to the EU-27 average of 4.7%, but Kosovo has a higher proportion of children and reform priorities far exceed the funding available. According to the ERP, in 2021, the budget decreased to only 3.1% of GDP. School principals and teachers reported a lack of teaching and learning materials. A consolidated draft of the new Law on Textbooks and Teaching Materials has been produced in 2021, but the procedure for its adoption and for publishing textbooks remains unclear (KEC, 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, with a lack of administrative instructions seeking to address this issue. Existing quality control mechanisms at all levels of education are not consistently applied.

*Reform measure 19 ("Reform in pre-university education and increase of inclusion in early education")* sets out ambitious and well-sequenced activities. The work on textbooks, school inspection and teachers' professional development are overdue; hence, this is a welcome addition to the ERP. It is also positive that the government is planning to build new preschool institutions and to adapt existing schools to their use also as kindergartens. The measure includes developing and approving of a core curriculum for ECEC with its subsequent piloting and the training and mentoring for teachers. The reform has the potential to improve quality in basic education and to ensure a broader inclusion of children in ECEC. However the ERP does not include measures to hire teaching assistants for children with special needs (already budgeted for 2022) to address issues of inclusion.

**Many firms in Kosovo encounter problems due to applicants' lack of skills and low-skilled people lack formal job prospects opportunities.** Finding the right employees with the required skills and competences 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 relevant skills may be the result of insufficient skill formation opportunities in early childhood education, the low quality and lack of work-based learning in initial vocational education and training and in training programmes delivered by the vocational training centres. According to the most recent World Bank's Enterprise Survey on Kosovo from 2019, 44% of the interviewed firms found inadequate education of the workforce as a major constraint, while 36% of them found labour market regulations as a major constraint, both shares being much higher than in its Western Balkans peers. 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 basic skills in the highest demand (World Bank, 2020c). Aligning policies, training programmes and curricula to the current and future needs of the labour market is challenging, although relevant sector studies exist that identify current and future skills needs. Donors financed projects aimed at bridging this gap. The EU ALLED2 project, together with the Kosovo Chamber of Commerce, is developing the Kosovo Skills Barometer. Existing sector studies and occupational standards are not yet used to feed into the development of vocational education and training (VET) planning and curriculum, or active labour market measures. The VET

Council has been made functional and it involves businesses to a satisfactory level. However, the Council meets only rarely. The EU ALLED2 helped develop a new VET funding formula, which is awaiting fine-tuning and introduction. On 26 January 2022, the government adopted a decision to establish an Executive Commission for the development of the VET System according to the needs of the labour market. Its work is planned to address VET governance and financing issues and to discuss setting up a dual training system.

**Reforming the education system at upper secondary and tertiary levels by giving graduates the relevant skills and competences needed to face the challenges ahead is a necessity.** Many graduates remain unemployed as their training does not provide them with the necessary skills required by the labour market. The labour market does not provide sufficient opportunities to employ the graduates. Numerous strategies exist (or new ones are being drafted), but their implementation and the monitoring of progress hinge too often on donor funding. By and large, education and training do not provide students with the digital skills and other competences in line with European and international education standards. The planning and funding of VET is insufficiently geared towards meeting labour market needs. The lack of cooperation with the private sector is partly due to the small size and informal operations of companies and partly to inflexibilities on the side of schools. There is also an issue of fragmented primary and secondary legislation related to VET (Bajrami 2021). The rapid expansion of higher education institutions, programmes and enrolment led to quality issues. Kosovo's labour market generates little demand for academic qualifications, more so for hands-on vocational skills. A recent skills mismatch measurement indicates that over 40% of young workers with a tertiary education are employed in jobs below their level of education. This calls for an enhancement of quality and relevance in higher education, as well as higher investments in school and post-graduation career guidance and counselling (ETF 2022). The current policy puts focus on transition from VET to university, completion rates and support to students in the first year of tertiary education to increase retention, and monitoring of accreditation criteria by Kosovo Agency for Accreditation. However, a broader policy reform of tertiary education is still lacking.

*Reform measure 1 (“Adapting VET to the needs of the labour market”)* presents a more holistic approach to addressing long-term issues in the VET sector, compared to the actions proposed in previous years. The latter had been brought forward from year to year without a proper budgeting and mostly relying on donor activities. A large part of the current VET profiles and curricula is still outdated, in fact only 30% of VET profiles are based on occupational standards (Bajrami 2021), except where different donors (using different models) have already changed them. Newly developed or revised VET curricula are planned; some 15-20 may be introduced in schools in 2022. For the rest, an implementation schedule would be needed, which also integrates teacher development, equipment upgrading and the expansion of work-based learning schemes. To inform the planned curriculum activities, existing skill needs analyses and occupational standards can be used and qualifications be developed in line with the Kosovo Qualifications Framework. Following MESTI's administrative instructions on work-based learning adopted in 2020, school-based career centres could take on a greater role in expanding work-based learning schemes.

*Reform measure 2 (“Increasing and ensuring quality in higher education by strengthening the Kosovo Agency for Accreditation and profiling higher education institutions”)* is well designed and sequenced. After the expected approval of the Law on the Kosovo Agency for Accreditation, the institution is expected to expand its activity in the field of quality assurance, therefore increasing its competences and responsibilities. This has a potential to address the issue of the limited capacity of the agency to monitor that accredited institutions

maintain quality standards. Some of the measures proposed in the previous ERP were dropped, although links with businesses might have helped improve the quality of higher education studies.

**The Employment Agency of Kosovo is making efforts to increase the scope and quality of services provided to jobseekers but lacks staff and budget.** Recently, the Ministry of Finance, Transfers and Labour and Social Welfare launched a series of reforms to modernise the Public Employment Services (PES) in Kosovo. It aims to provide a service tailored to the needs of the client including profiling, counselling, career guidance, training and mediation services as well as online publication of vacancies for employers. However, the 138.5% increase in the number of registered unemployed people in 2020 due to the pandemic (168 980 in total), which has since fallen but still numbered some 85 000 in January 2022, and the high number of jobseekers per employment officer (on average 1 133 in January 2022) makes personalised services impossible. Despite ever increasing tasks, the PES has insufficient financial and qualified human resources. This will become a pressing challenge when the introduction of the Youth Guarantee is brought in, which requires sufficient human resources in PES for its effective implementation. 49.3% of registered jobseekers in 2020 lacked full school education and there is a lack of formal job offers for this category. Most registered jobseekers (40.1%) belonged to the age group 25-39; 16.6% to the age group 15-24. In 2020, due to the closure of training centres, the number of participants in vocational training fell considerably (from 6 607 in 2019 to 3 436 in 2020). However, despite work-related restrictions, the Employment Agency increased participation in active labour market measures (ALMMs) from 4 611 participants in 2019 to 5 631 participants in 2020, mainly due to the increase in on-the-job training and internship programmes. Due to higher number of registered jobseekers, the share of jobseekers covered by ALMMs and vocational training fell from 15.8% to 5.4% (EARK 2021). Overall, 41% of ALMM beneficiaries continue being employed after participation, showing a need to focus not only on quantity but also on quality (GIZ 2019).

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

**Persistent and widespread informality continues to represent a key structural challenge for Kosovo's economy.** Multiple assessments produced over the past decade indicate an estimated figure of informality ranging between 30-39% of GDP. An EU-funded project estimated the preliminary cost of informality to be around EUR 106.8 million as a result of lost income tax revenue and VAT alone (IMF, 2019), representing about 7% of all tax revenue. Over 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, sectors which were hit hard during the COVID-19 pandemic. Indeed, the size of the informal sector limited the ability of the government to target support measures, and informal workers and businesses in some of the hardest hit sectors including tourism and retail were unable to benefit from them.

**Informality has significant and multiple negative consequences for the broader economy.** Firstly, it reduces the tax base, limiting the fiscal space to invest more in priority areas such as education, health and infrastructure. Secondly, it creates an uneven playing field amongst businesses and is a deterrent for additional, much-needed private-sector investment, including foreign direct investment. Unfair competition from informal businesses has

consistently been identified as a major obstacle to doing business in Kosovo (World Bank et al, 2019a; EBRD, 2016)<sup>11</sup>. Informality also impairs the competitiveness and export potential of Kosovo's private sector: firms operating in the informal sector have more difficulty accessing finance and tend to carry out less in research and development and innovation and to hire fewer workers. Lastly, workers in informal sectors have more limited (or no) access to social protection and additional benefits, and are therefore more vulnerable when they lose their job or leave the labour market. Their access to training is also negatively affected, which 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 – exacerbated by the deficiency 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 the general low level of trust in government and institutions and to weak enforcement.** High tax rates are not considered to be a major contributor to the phenomenon in Kosovo (income, individual and VAT tax levels are relatively low compared with 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 indicate an overall low level of law enforcement and tax control by local authorities as a potential underlying cause of high levels of informality, though there has been recent progress on this front.

**The government's strategy to combat the informal economy, adopted in May 2019, includes relevant measures to address the problem and improve monitoring mechanisms but implementation needs to be improved and the action plan extended beyond 2021.** Among the targets set 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. The first action plan (2019-2021) set out actions in key areas such as statistics and risk and impact assessments, business registration and greater cooperation among agencies such as the tax administration and the customs authority. Despite recent reporting on implementation of this plan, there is still room to improve implementation, monitoring and reporting. The emergency measures taken during the early stages of the COVID-19 crisis proved useful in incentivising undeclared and informal workers to register at the Employment Agency of Kosovo, and businesses to disclose turnover and profit figures in order to be considered for business and employment support schemes.

*Reform measure 10: "Reduction of the informal economy"* aims to implement selected priorities of the strategy and has been rolled over from last year's ERP. While the reform measure is relevant and reflects the Commission's assessment, many activities remain at an early stage, though recent progress has been demonstrated by the tax administration stepping up enforcement. The activities now rolled over to 2022 and 2023 including a continued risk-based approach to enforcement and increased cooperation among the relevant agencies seem credible and significant to tackle to some degree the size of the informal economy, if they are

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<sup>11</sup> 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% for the region (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)

implemented in full and to the planned timeline. The targeted increases in tax revenue are ambitious, but increases in tax revenue are an imperfect indicator, capturing not only compliance gains but also gains from economic growth. A better indicator would focus on the size of the tax gap, which requires more consistent monitoring. A measure related to tackling tax evasion in the real estate sector was dropped in this year's ERP, despite it remaining a significant issue. The government has stated its intention to develop the Labour Force Survey to better understand the level of inclusion of women and men in the informal economy and will use this to better inform the next ERP.

**Kosovo's formal entrepreneurial landscape is dominated by non-specialised, family-owned micro-companies characterised by low productivity and export competitiveness.** This is directly reflected in the persistently high current account deficit figures (4.9% in 2021) and more so in the highly imbalanced trade of goods, with imports over five times higher than exports. Though year-on-year exports of goods increased by 21% in 2020, further analysis has shown that this was largely driven by higher international demand for nickel and a post-pandemic rebound effect. Exports of services, currently showing a large surplus, grew at a faster pace than imports of services (89.5% compared to 48.8%), in 2021. Unless this trend is reversed, it is likely to deepen the trade deficit even further, thus raising Kosovo's external vulnerabilities. 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 offset the current account deficit, are unable to fill the gap and have not led to increases in the growth of domestic productivity.** Kosovo has primarily attracted investment in areas with limited scope for productivity spillover effects such as real estate and related activities (34% of FDI stock), financial intermediation (17%) and manufacturing (12%), with some smaller investments in the agriculture, mining and energy sectors<sup>12</sup>. In addition, FDI is limited to a handful of countries, namely states with a sizeable, well-established Kosovo diaspora. Export-oriented FDI has been very scarce, and overall figures are relatively low, passing the EUR 300 million figure only once in the past seven years. Remittances are used almost exclusively for consumption purposes and are four times higher than overall FDI (World Bank, 2020a).

**Increasing private sector productivity would improve export competitiveness, increase job opportunities and push up wages.** This is particularly the case considering the increase in average wages over the past decade, partly resulting from rising public-sector wages. In order to regain labour cost competitiveness in export markets, productivity will need to increase faster.

**Tackling informality would help private sector development in Kosovo, and there are a range of other measures to be taken to improve the business environment.** These include simplifying, merging and abolishing licences and permits and cutting the length of commercial dispute settlements. Unfortunately, the ERP has dropped the reform measure from last year that aimed to make the commercial court operational. In addition, efforts must be made to improve trust and confidence in the judicial system to improve certainty in contract enforcement. In a recent survey, 43% of firms identified the court system as a major obstacle to doing business (World Bank, 2020). Lastly, the country should look at measures to further digitise of public services. Some preparation has been made regarding the elimination

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<sup>12</sup> *Foreign investment in Kosovo*, on [www.santandertrade.com/en/portal/establish-overseas/kosovo/investing](http://www.santandertrade.com/en/portal/establish-overseas/kosovo/investing)

of unnecessarily permits and reorganisation of licenses on the e-Government platform but progress on implementation is needed (OECD SIGMA, 2021).

*Reform measure 9: “Improving the doing business environment by reducing the administrative burden, inspection reform”* is rolled over from last year’s ERP. The aim is to reduce the administrative burden by simplifying and digitalising permitting and reforming the inspections system. The horizontal nature of both reforms will require solid administrative capacity and coordination when planning and implementing the activities, and after streamlining the inspection bodies. The targets in the ERP related to the inspection bodies seemly overly ambitious, with a 50% reduction from one year to the next, after several years of no progress. The sharp reduction in the number of permits and licences does not appear justified by capacity building as the sole stated activity in this area for 2023. The reforms will require considerable political commitment to advance at the central state administration and municipal levels. Employment of 20 new labour market inspectors foreseen in last year’s ERP was not achieved and while funding for employment and training of new inspectors is planned, a specific target for the number of new labour market inspectors has been dropped from the ERP.

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

**The supply of energy is unreliable and insufficient to meet rapidly growing demand and is one of the main constraints on Kosovo’s competitiveness, curbing productivity.** The outdated power system relies on two old, inefficient and highly polluting brown coal (lignite) power plants which together generate over 90% of electricity: Kosovo A (five units) and Kosovo B (two units). Renewable energy sources, namely small hydropower plants and wind generation, account for just over 5% of electricity. Energy demand and consumption continues to grow quickly, having doubled since 2000. This, together with the ageing power plants, inefficient consumption and insufficient flexibility to adapt consumption in peak periods, means that electricity has to be imported and exported to balance the system. Since Kosovo tends to import at times of high prices and export at times of low prices, this creates significant costs. This scenario is particularly challenging for Kosovo in light of the ambitious Green Agenda for the Western Balkans. Potential disruption due to obsolete generating capacity and dependency on energy imports could undermine Kosovo’s growth potential and the competitiveness of its industries.

**The reliability of energy supply is still below the average for Europe and Central Asia.** Despite some improvements on this front, 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 data from the latest EBRD-EIB-WBG Enterprise Surveys (BEEPS VI, data collected between December 2018 and October 2019), 62% of Kosovan firms experienced on average eight power outages per month.

**These structural challenges exacerbated the energy crisis in Kosovo brought on by the unprecedented increase in energy prices in Europe in the second half of 2021.** Faced with high prices, higher demand and following the shutdown of one of the units at Kosovo B, the government declared a state of emergency. It imposed rotating power outages and allocated EUR 120 million in subsidies to support consumers.

**Kosovo has taken steps to diversify its energy production mix, with new wind farm and solar projects, but the main generation capacities planned will continue to rely on coal.**

Kosovo is preparing a new energy strategy for the period 2022-2031, focusing first on 2022-2025. This could include the option of extending the lifetime of the highly polluting Kosovo A power plant and using gas power generation. With a 25.7% share of energy from renewable sources in gross final energy consumption in 2019, Kosovo surpassed its 25% target for 2020. However, this was mainly achieved by revising the definition of renewable energy sources to include biomass for heating, which is widely used by household customers, rather than by making any substantial investment in renewable energy. Using a more stringent definition, by one measure renewable energy contributes just 6% to the total energy mix.<sup>13</sup> Biomass, primarily fuelwood, remains a significant energy source for heating homes due to cheaper prices, leading to significant air pollution and the attendant negative health effects, particularly during winter months. Kosovo has made limited efforts to improve support schemes for renewable energy projects. The law currently prescribes a support scheme based on administratively set feed-in tariffs; however, since December 2020 it suspended the allocation of feed-in tariffs. Work on designing alternative competitive support schemes remain at an early stage. The falling cost of renewable energy and interest from financial actors in investing in Kosovo offer new opportunities to diversify the energy mix. There is an increase in renewable energy investments and several projects already planned to develop major wind and solar energy sources.

**There is significant potential for savings by taking energy efficiency measures.** Some efforts were made to increase energy efficiency incentives for the private sector and households. Distribution losses remain high compared to regional standards, with technical losses of about 13% and commercial losses of about 7% leading to total losses of approximately 20% in 2020. Moreover, investing in and maintaining the distribution network at low levels. Kosovo's Energy Efficiency Fund, with a capitalisation of around EUR 20 million largely from international donors, continued issuing public calls to improve energy efficiency in municipalities. There are plans to extend financing to cover the residential sector in 2022. The EBRD, supported by the EU and in partnership with local partner banks and micro-finance institutions, has begun providing credit for households, which account for 39% of final electricity consumption, to make energy efficiency improvements and there is scope for more such investment.

*Reform measure 5: "Developing EE [energy efficiency] and RES [renewable energy sources] policies in view of the green transition"* is a combination of two reform measures rolled over from last year. It aims to improve energy efficiency, especially in the residential sector, increase the generation of renewable energy and create the conditions needed for investment. In the past year, the Energy Efficiency Fund has financed energy efficiency improvements in municipal buildings, and the reform measure is now well focussed on the residential sector, in line with the findings of this assessment. However, the concrete measures described in the ERP refer primarily to changes to the energy certification of buildings. As of last year, the country lacks the financing and the ambition required to address the challenges, and is only due to issue an action plan to encourage household energy efficiency in 2024. Kosovo should ensure timely transposition and implementation of the Energy Efficiency Directive following its adoption as part of the Clean Energy Package by the Energy Community in November 2021. The reform measure also emphasises increasing renewable energy and unlocking private investment, in line with the challenges identified in this assessment. Again, however, the measure lacks ambitious targets and an explanation of how investment in renewable energy will be financed or incentivised. The Energy Community is expected to adopt new

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<sup>13</sup> (OECD, 2021)

renewable energy targets for 2030, in line with the EU's targets, and this will require Kosovo to take substantial additional steps. These targets could be reflected in the upcoming Kosovo energy strategy.

**There is no open trading in the electricity market and energy tariffs do not yet fully reflect costs.** Though Kosovo has made some progress in phasing out cross-subsidies between different categories of customers and in implementing the third energy package, the retail market is still only partly deregulated (for the supply of high voltage customers). The Energy Regulatory Office (ERO) initiated an extraordinary tariff review taking into account the significant increase in the wholesale electricity prices in 2021. As most consumers in Kosovo are supplied by the universal supplier, the cost reflectivity in setting universal supply tariffs is an important principle to ensure the financial stability of the electricity sector. Kosovo still needs to develop a programme to protect vulnerable customers in line with the Energy Community requirements, especially in light of rising energy prices and the difficulties experienced in targeting support measures.

**Progress has been made on regional integration.** A new connection agreement between KOSTT (the transmission system operator) and the European Network of Transmission System Operators for electricity (ENTSO-E) entered into force. This brought into operation the 400 kV interconnection line (with a German investment of EUR 75 million) between Kosovo and Albania, in December 2020 which had remained unused for three years. A further key step was taken in November 2021 with the signing of the memorandum of understanding between Energy Regulators in Kosovo and in Albania to recognise each other's electricity trade and supply licences. By the end of 2022, Kosovo and Albania plan to finalise electricity market integration with the full operationalisation of electricity exchange ALPEX. Market integration will increase the utilisation of cross-border transmission capacities, enabling more efficient utilisation of electricity networks, and increasing competition for the benefit of customers.

*Reform measure 6: "Reforming the energy market"* is a new measure that encompasses the plans described above for the electricity exchange with Albania (ALPEX) and a platform to enable customers to compare prices. The measure responds to challenge identified both by the ERP and in this assessment, namely the lack of open trading on the electricity market, subsidised and fixed tariffs and the lack of regional integration. However, as with the other reforms in this sector, the plans described in the ERP do not contain enough detail on the intended changes to make them a credible statement of intent. They also seem to require prior significant measures to liberalise the energy market, such as addressing the bulk supply agreement between Kosovo Energy Corporate (KEK) and Kosovo Electricity Supply Company (KESCO), to produce their intended impact on competition, prices and investment.

**The Economic and Investment Plan and the Green Agenda for the Western Balkans will contribute to the green and digital transition, in particular the use of renewable energy sources, which should help boost Kosovo's competitiveness.** A substantial investment package, which is at the heart of the Economic and Investment Plan, will direct the vast majority of support to key productive investment and infrastructure. This will reflect and support the twin green and digital transition and help develop a connected, competitive, knowledge-based, sustainable, innovation-oriented and thriving economy. Following the 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.

**Box: Monitoring performance in light of the European Pillar of Social Rights<sup>14</sup>**

The European Pillar of Social Rights, proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission, sets out 20 key principles and rights on equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion for the benefit of citizens in the EU. The European Pillar of Social Rights Action Plan, adopted on 4 March 2021, aims at rallying all relevant forces to turn the principles into actions. Since the 20 principles provide a compass for upward convergence towards better working and living conditions in the EU, they are equally relevant for candidate countries and potential candidates. The new reinforced social dimension for the Western Balkans includes an increased focus on employment and social reforms through greater monitoring of relevant policies (EC, 2018). The Western Balkans Ministers' Declaration on improving social policy in the Western Balkans (6 November 2018) confirms that they will use the Pillar to guide the alignment of their labour markets and welfare systems with those of the EU.

**Relative to the EU-27 average, there is scope for improvement in most available indicators of the Social Scoreboard supporting the European Pillar of Social Rights.**

**Kosovo presents very low employment levels.** Low employment is fuelled by a marked gender employment gap at 32.8% in 2020, though it has been falling since 2017. This gap is in part due to the low provision of early childhood education and care. However, the share of young people not in employment, education or training has been increasing since 2019. The potential of a large young population to boost growth and employment is thus not utilised. Instead, the insufficient labour demand and resulting excess of labour supply prompt emigration.

KOSOVO		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Better than EU avg., improving
	Individuals' level of digital skills (basic or above basic)	Worse than EU avg., improving
	Youth NEET (% of total population aged 15-29)	Worse than EU avg., deteriorating
	Gender employment gap	Worse than EU avg., improving
	Income quintile ratio (S80/S20)	Worse than EU avg., trend N/A
Dynamic labour markets and fair working conditions	Employment rate (% of population aged 20-64)	Worse than EU avg., no change
	Unemployment rate (% of population 15-74)	Worse than EU avg., improving
	Long term unemployment rate (% of population 15-74)	Worse than EU avg., trend N/A
	GDHI per capita growth	N/A
Social protection and inclusion	At risk of poverty or social exclusion (in %)	Worse than EU avg., trend N/A
	At risk of poverty or social exclusion rate for children (in %)	Worse than EU avg., trend N/A
	Impact of social transfers (other than pensions) on poverty reduction	Worse than EU avg., trend N/A
	Disability employment gap	Better than EU avg., trend N/A
	Housing cost overburden	Worse than EU avg., trend N/A
	Children aged less than 3 years in formal childcare	Worse than EU avg., trend N/A
	Self-reported unmet need for medical care	Worse than EU avg., trend N/A

**Investments in the education system, in particular the early stages, is very limited.** The vast majority of children under the age of 5 receive no formal early childhood education and care. In the school year 2019/2020, the share of children in pre-school education was only around 8.5% (KEC 2021). However, Kosovo continuously improved its share of early school leavers, which decreased from 12.7% in 2016 to 7.8% in 2020 (below the EU average of 9.9%).

**Kosovo's performance on social inclusion, social protection and poverty alleviation is weak.** 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 many cannot afford the services, because they do not receive assistance from government subsidy programmes (Social Assistance Scheme). The impact of social transfers (other than pensions) on poverty reduction is among the lowest among candidate

countries and potential candidates. A planned reform of the SAS is ongoing and expected to improve the targeting 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. Data is not yet available in Eurostat. The quality of LFS data needs to be improved. Statistics on Income and Living Conditions was conducted once in 2018. Specific challenges exist with regard to establishing indicators based on population data, e.g. in the area of education.

<sup>14</sup> The table includes 16 headline indicators of the Social Scoreboard, used to compare performance of EU Member States (<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. The assessment includes the country's performance in relation to the EU-27 average (performing worse/better/around the EU-27 average; generally 2020 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). For data see Annex B. NEET: neither in employment nor in education and training; GDHI: gross disposable household income.

## 5. OVERVIEW OF THE IMPLEMENTATION OF THE POLICY GUIDANCE ADOPTED AT THE ECONOMIC AND FINANCIAL DIALOGUE IN 2021

Every year since 2015, the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey has adopted targeted policy guidance for all partners in the region. The guidance represents the participants' shared view on the policy measures that should be implemented to address macro-fiscal vulnerabilities and structural obstacles to growth. The underlying rationale of the policy guidance is similar to that of the country-specific recommendations usually adopted under the European Semester of macroeconomic coordination for EU Member States. The Commission evaluates implementation of the policy guidance in the following year's ERP assessments. The table below presents the Commission's assessment of the implementation of the 2021 policy guidance jointly adopted by the EU and the Western Balkans and Turkey at their Economic and Financial Dialogue at Ministerial level on 12 July 2021.

Overall: Partial implementation (41.7%) <sup>15</sup>	
2021 policy guidance (PG)	Summary assessment
<p><b>PG 1:</b></p> <p>Provide well-targeted and temporary pandemic-related fiscal support to vulnerable households and businesses; provided the economic recovery is well entrenched, foresee in the 2022 budget and medium-term expenditure framework a gradual return to the 2% deficit ceiling, according to the fiscal rule definition, by 2023.</p> <p>With a view to ensuring efficient, fair and sustainable public spending, revise the law on public salaries and prepare a review of the social security system, including war veteran pensions.</p>	<p>There was <b>limited implementation</b> of PG1.</p> <p>1) <b>Substantial implementation.</b> The government implemented around EUR 234 million (3.2% of GDP) pandemic-related fiscal measures out of the EUR 420 million planned in the economic revival package. Fiscal measures mainly took the form of subsidies and transfers to vulnerable families and persons, employment and support to affected businesses. The fiscal support measures were broadly well-targeted, however, the government included and implemented new measures within the revival programme such as child benefit and maternity allowances. These initiatives come at a high fiscal cost and are implemented without a prior in-depth analysis. They risk becoming a permanent feature through new legislation.</p> <p>The government ended 2021 with a low headline budget deficit (1.4% of GDP) on the back of high revenue and under-execution of capital spending. Although it already met the fiscal rule for the budget deficit ceiling of 2% of GDP in 2021, the government envisages a return to the fiscal rule in 2023, as planned under the suspension decision.</p> <p>2) <b>Limited implementation.</b> Following the Constitutional Court decision of July 2020, which declared the <i>Law on Salaries for Public Employees</i> unconstitutional, the government set up a working group tasked with revising the law. A new law governing public-sector salaries could have a significant impact on an efficient functioning of the public administration in Kosovo and stability in this regard. However, preparatory work to standardise positions in the institutions would need to be completed before a new payment system could be put in place. A revised version</p>

<sup>15</sup> For a detailed description of the methodology used to assess policy guidance implementation, see Section 1.3 of the Commission's Overview and Country Assessments of the 2017 Economic Reform Programmes available at [https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments\\_en](https://ec.europa.eu/info/publications/economy-finance/2017-economic-reform-programmes-commissions-overview-and-country-assessments_en).

<p>Undertake a review of tax expenditure quantifying the size of the revenue forgone from exemptions and reduced rates.</p>	<p>of the law was planned to be put for public consultation in February, but it was delayed.</p> <p>In terms of the <i>social security system</i>, the government has not achieved any concrete results so far, although it has planned to reform the Social Assistance Schemes through the World Bank loan and technical assistance. However, Parliament failed to vote for this financial agreement, therefore implementation of the reform and implementation method is uncertain. In relation to war veteran pensions, following the establishment of the working group at the former Ministry of Labour, a condition that was met under the EU MFA loan agreement, no further developments have been made to re-classify the beneficiary list of this pension scheme. Actual expenditure for this scheme continues to exceed the initial annual budget allocations, exceeding by around EUR 20 million in 2021.</p> <p>3) <b>No implementation.</b> The authorities didn't announce or adopt any decision to start reviewing tax expenditure. Following the adoption of the Law on Economic Recovery at the end of 2020, the government extended the list of temporary tax exemptions, while applying temporary reduced tax rates to certain categories, without a proper impact assessment.</p>
<p><b>PG 2:</b></p> <p>Improve the execution of capital spending by implementing the administrative instructions on the planning, selection, execution and monitoring of capital projects and advancing multi-annual project planning.</p> <p>To reduce the risk of contingent liabilities, improve the financial oversight and accountability of publicly owned enterprises, including their regular quarterly reporting.</p> <p>Take next steps towards establishing an independent body for fiscal oversight, based on the recommendations of an options paper.</p>	<p>There was <b>limited implementation</b> of PG2.</p> <p>1) <b>Partial implementation.</b> The execution rate of capital spending rose to 76% in 2021 from 65% in 2020 and 60% in 2019. Nevertheless, implementation of adopted administrative instructions on improving implementation of capital projects remains challenging, particularly given the limited administrative capacities. The government allocated an additional EUR 50 million for expropriation purposes in the 2022 Budget Law, aiming to unlock the potential by running new projects. In addition, the new Article 25 in the 2022 Budget Law aims to facilitate budget allocations for international financial institutions capital projects, depending on their maturity. The government plans to further improve the interoperability between the public procurement system with government financial management information systems.</p> <p>2) <b>Partial implementation.</b> A fiscal risk assessment of publicly owned enterprises is included in the MTEF 2022-2024 and subsequently in the Revised Budget Law of 2021 and 2022 and the ERP. The assessment is limited to high-risk publicly owned enterprises, excluding others. Publication of the quarterly financial statements of publicly owned enterprises has been discontinued, following the publication of Q4 2020 of financial statements. The government has not amended the Law on Publicly Owned Enterprises and does not include this in the legislative agenda for 2022. Changes to the law should aim at improving the rules and procedures on governance and oversight of publicly owned enterprises.</p> <p>3) <b>No implementation.</b> The government has not taken any steps to set up the independent body for fiscal oversight, following finalisation of the options paper on the matter.</p>

<p><b>PG 3:</b></p> <p>Maintain a strong financial sector regulatory framework in line with international best and EU practices, ensure sound credit risk management, a transparent display of asset quality, adequate provisioning, and develop a more integrated framework for measuring household indebtedness.</p> <p>Further reduce the remaining institutional and legal obstacles to swift and effective NPL resolution.</p> <p>Ensure the central bank’s effective functioning by undertaking an in-depth analysis of the staffing requirements in its key policy areas, especially financial stability and financial sector supervision and filling the vacant positions in the board needed to restore its quorum.</p>	<p>There was <b>partial implementation</b> of PG3:</p> <ol style="list-style-type: none"> <li>1) <b>Substantial implementation.</b> Financial stability challenges were monitored closely and prudential measures related to the pandemic were phased out in time. A new framework for measuring household indebtedness has been developed and it is close to completion. Provisioning remained adequate, with the coverage ratio increasing slightly in 2021.</li> <li>2) <b>Limited implementation.</b> The central bank plans to change legislation to enable the development of a secondary market for non-performing loans. Parliament adopted a law to create a new stand-alone commercial court, which might increase the efficiency of the court system.</li> <li>3) <b>Partial implementation.</b> No in-depth analysis of the staffing requirements in key policy areas was carried out, and no new staff has been hired in the financial stability and banking supervision departments. The vacant positions in the Central Bank Board were filled and the quorum was achieved in November 2021.</li> </ol>
<p><b>PG 4:</b></p> <p>Adopt a coherent long-term energy and climate strategy for lowering carbon emissions, including plans for a phase-out of coal and fossil fuels subsidies as committed under the Sofia Declaration.</p> <p>In line with the commitments of the Green Agenda for the Western Balkans: increase energy efficiency incentives for the private sector and households and improve the support schemes for renewable energy projects with the introduction of competitive bidding/auctions;</p> <p>Adopt an action plan for the gradual adjustment of energy tariffs reflecting actual costs and providing mitigation measures for vulnerable consumers.</p>	<p>There was <b>limited implementation</b> of PG 4.</p> <ol style="list-style-type: none"> <li>1) <b>Partial implementation:</b> A new 10-year national energy strategy is in the final drafting stages and is due to be published for public consultation in Q2 2022.</li> <li>2) <b>Limited implementation:</b> The Energy Efficiency Fund, with a capitalisation of EUR 20 million, continued to support improvements in energy efficiency of public buildings, but plans to extend financing to the private residential sector are still at an early stage. The renewable energy feed-in tariff regime has been suspended since December 2020. The government is preparing, with support from USAID, a law on renewable energy sources and a new competitive support scheme with the aim of adopting both by the end of 2022.</li> <li>3) <b>Limited implementation:</b> The Energy Regulatory Office announced new electricity tariffs which entered into force in February 2022 following an extraordinary review of tariffs in light of rising energy costs in 2021 and 2022. Prices remained the same for households consuming up to a threshold of 800 kWh (approximately 78% of households) and increased for those consuming exceeding this level, introducing an element of cost-reflective tariffs. There were no changes for business operators. Beyond this extraordinary review, there is currently no action plan for the gradual adjustment of energy tariffs to reflect actual costs. The government committed EUR 90 million to subsidise energy costs for regulated tariff customers.</li> </ol>
<p><b>PG 5:</b></p> <p>Update the action plan of the 2019–2023 National Strategy for the Prevention and Combating of Informal Economy, Money Laundering, Terrorist Financing and Financial Crimes, and ensure its</p>	<p>There was <b>limited implementation</b> of PG 5.</p> <ol style="list-style-type: none"> <li>1) <b>Partial implementation:</b> The government has published a draft updated action plan of the National</li> </ol>

<p>implementation.</p> <p>Implement incentive measures with an aim to formalise informal employment and businesses, and address tax evasion in identified high-risk sectors in line with the strategy and the action plan.</p> <p>With an aim to prevent evasion of property income tax, improve transparency by publishing all sales prices of real estate property.</p>	<p>Strategy for public consultation.</p> <p>2) <b>Partial implementation:</b> Over 4 000 employees formalised their employment status as a result of the requirements of Covid-19 fiscal support measures. A further approximately 2 700 informal employees were newly registered as a result of inspection visits by the tax authority. Together, this represents significant progress in efforts to expand formal employment, though incentives related to temporary fiscal support measures are necessarily time-limited. The tax authority takes a risk-based approach to compliance enforcement and has cooperated with the customs agency in the control of goods categorised as high-risk, in line with the strategy and action plan. Action and outcomes on further measures is not sufficiently reported in the Economic Reform Programme or elsewhere.</p> <p>3) <b>No implementation:</b> Sales prices of real estate property transactions are not systematically published. Property tax collection continues to face challenges related to administrative capacity and inter-institutional coordination and cooperation.</p>
<p><b>PG 6:</b></p> <p>Thoroughly apply existing quality assurance mechanisms at all levels of education through increased school inspections and effectiveness of quality coordinators, as well as monitoring of study programmes by the Accreditation Agency.</p> <p>Develop a system to monitor and forecast the skills needs in the labour market to facilitate the alignment of the education and training systems and of reskilling and upskilling provision to labour market needs.</p>	<p>There was <b>substantial implementation</b> of PG 6:</p> <p>1) <b>Partial implementation:</b> The Accreditation Agency has successfully completed accreditation cycles in higher education over the last two years. The Agency has also prepared the document on the monitoring methodology and post-accreditation procedures that will serve as a guide for the Agency, higher education institutions, international experts, and the general public to implement fair and transparent post-accreditation and monitoring procedures. The document meets Standard 2.3 of the European Quality Assurance Guidelines for Higher Education (ESG) which requires quality assurance agencies to complete the accreditation cycle with post-accreditation procedures aimed at continuously improving the quality of higher educational institutions. Quality coordinators have been appointed in all schools but the selection of competent quality coordinators remains problematic as does the proper definition of incentives to take up the role of quality assurance coordination (fewer teaching hours of normal duties so that they can focus on their QA coordinator role, QA linked to their professional development and their performance assessment etc.). The situation is concerning when it comes to school inspections. No inspections were carried out in schools over the last two years, which authorities attribute to the pandemic. As of September 2020 only 2% of schools had been inspected.</p> <p>2) <b>Partial implementation:</b> With support from donors, the Employment Agency created established the Labour Market Barometer and Skills Barometer in 2021. Though the tool has limited features, the Agency aims to add more features and enhance the skills forecast barometer. What will be crucial is the translation of skills needs into standards, qualifications, curricula, teacher profiles, funding arrangements and equipment specifications. The newly formed Executive Commission</p>

<p>Establish an inter-ministerial task force involving relevant ministries, their agencies and stakeholders to develop a Youth Guarantee Implementation Plan.</p>	<p>on VET intends to revisit reforms to address the skills mismatch.</p> <p>3) <b>Full implementation:</b> An inter-ministerial task force involving relevant ministries, their agencies and stakeholders was set up and a Youth Guarantee coordinator was appointed in October 2021. The task force and the Coordinator are now working, with support from EU-ILO technical assistance facility, to develop a Youth Guarantee implementation plan.</p>
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## ANNEX A: ASSESSMENT OF OTHER AREAS AND STRUCTURAL REFORM MEASURES INCLUDED IN THE ERP 2022-2024

### *Healthcare*

**The health system in Kosovo guarantees universal access to healthcare in theory, but services are not free.** The system is predominantly tax funded with the state acting as both the purchaser and the provider of healthcare services. Public spending on healthcare totalled 4% of GDP in 2020, a sharp increase from 3% of GDP in 2019 which was due to the COVID-19 pandemic. A Health Insurance Fund was set up in 2018, but is not yet operational and no system of health insurance is in place. With only 1.8 doctors and 2.4 hospital beds for 1 000 inhabitants, Kosovo has one of the lowest rates among its Western Balkan peers. The emigration of health professionals is a serious and long-standing issue (FSSHK 2014).

Healthcare services are not free at the point of use; a small user fee (co-payment) is required from all patients, except for vulnerable population groups who are exempt by law, including households that receive social assistance. A large share (40.5% in 2018) of health-related expenditure is paid out-of-pocket (OOP), which raises many concerns about the equality and equity of access to healthcare services, particularly for vulnerable groups. The system does not provide targeted, financial risk protection for the poorest segments of the population. For some treatments that are unavailable, people have to travel abroad and the fund that reimburses this care is only EUR 6.5 million, which does not cover the needs and results in high OOP expenditure.

Financial protection for vulnerable categories of the population to cover costs for prescribed inpatient and outpatient care is low due to a very low budget of EUR 24 million for the reimbursement of medicines. Nearly 10% of the population in Kosovo (self-) reported unmet healthcare needs in 2018, placing Kosovo among the worst performers in the Western Balkans. Based on 2016 data included in the Health Sector Strategy for 2017-2021, 18% of inhabitants cannot afford to access primary healthcare. Since 2017, with the support of donors, the government has set up home visits to counter this issues, but the supply is insufficient to cover the needs.

#### **Measure 4: ‘Improving health services’**

The reform measure is centred on mandatory health insurance, offsetting up the Health Information System and universal healthcare. The adoption of the law on health insurance has been postponed to September 2022. The target in 2024 is to collect health insurance premiums from 100% of public-sector employees and from 65% of private-sector employees. The government plans to exempt vulnerable categories of the population, defined via a proxy means test which is to be developed under a project linked to an upcoming World Bank loan (not yet adopted in Parliament), from the payment of premiums.

Apart from a feasibility study planned for 2022, the programme lacks information on the plan to set up the much-needed Health Information System. It is not clear how the government intends to involve the private sector in the universal health coverage scheme, since numerous private hospitals and services already exist in Kosovo and many healthcare workers are leaving the public sector to find jobs in the private sector. The government links the measure and strategic objectives to the Health Sector Strategy for 2017-2021, which has expired. A new strategy is missing.

### ***Public financial management***

**Public financial management priorities are not yet adequately reflected in the new dedicated section of the ERP.** The ERP provides a state of play of international assessments of aspects of public administration reform and public financial management (PFM) and notes that the results of these assessments will feed into the forthcoming public financial management strategy. Unfortunately, however, the ERP does not provide a diagnostic tool to identify the key obstacles facing Kosovo in this area as assessed by the Public Expenditure and Financial Accountability (PEFA) programme or the OECD SIGMA initiative. Neither does it make a link to how improvements to the public administration and public financial management could help unlock competitiveness and inclusive growth. Specifically, public financial management systems should be strengthened by (1) linking strategic policy and budget planning for sectoral policy priorities and credibly reflecting these in the medium-term expenditure framework; (2) improving the public investment management system in line with the Public Investment Management Assessment (PIMA) recommendations, while making the Public Procurement Review body functional and integrating the module on green investment; (3) improving domestic revenue mobilisation by aligning the current tax policy with international standards to combat the informal economy; (4) developing the country's capacity to conduct spending reviews and ensure that the findings inform the budgeting process to support expenditure prioritisation and create fiscal space for new priorities (i.e. improving social services and green transition). The new PFM strategy 2022-2026 needs to be based on most recent diagnostics and on an inclusive process. The government has stated that it will consider including gender responsive budgeting and fiscal policies in line with UN SDGs and the Law on Gender Equality in the next ERP. Improving capacities in the finance ministry is key for a credible leadership on PFM reforms.

Adding PFM reform measures in the ERP would increase its credibility. The implementation of the key reform measures proposed by the Government requires decisive reforms of PFM structures and institutions.

### ***Green transition***

The elements of this area related to energy efficiency and renewable energy and the associated Reform Measure 5 are analysed in Section 4, under key challenge #3.

**Kosovo continues to face numerous environmental challenges such as climate change and air, water, waste and soil pollution.** The country has some of the worst air pollution in Europe, with an annual mean exposure to particulate matter almost three times the World Health Organization recommended highest levels. The ERP acknowledges this situation and its causes (reliance on coal power plants, emissions from the transport sector, etc.) and describes the current air quality monitoring system. However, it does not propose further significant measures to tackle air pollution. Instead, the analysis focuses primarily on recycling, biodiversity and wastewater treatment. Kosovo also has relatively limited and

unevenly distributed freshwater resources. The problem of limited freshwater resources will be exacerbated by the impact of climate change (OECD, 2021).

#### **Measure 7: “Reducing environmental pollution and preserving biodiversity”**

The activities proposed under this measure are only partial and insufficient to address existing problems. Most of the activities are legislative or strategic planning measures, while the actual implementation measures are not clearly described. There is little discussion on implementing the Waste Management Strategy, on preparing priority investment projects (for example, wastewater treatment plants), developing capacity at central and local level or on inter-municipal cooperation agreements for joint integrated waste management etc. Furthermore, the planned activities in the ERP include only very partially the work planned under IPA financed projects or by the implementing partners, in particular by KfW. The targets to increase the number of protected nature areas do not address the problem highlighted in the diagnostic part that the management of existing nature areas remains ineffective. However, the new measures to encourage recycling (a deposit refund system for plastics, aluminium and glass) is welcome, credible and comes with a reasonable timeline. These measures would benefit from more outcome-oriented targets, for example recycling levels as opposed to the number of return sites.

#### ***Digital transformation***

**The digitalisation of the economy is gradually advancing.** With 99% of households having access to a broadband internet connection, Kosovo has reduced the infrastructure gap between urban and rural areas. The Economic and Investment Plan for the Western Balkans will continue to fund investment in digital infrastructure to roll out 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 Regional Roaming Agreement since 1 July 2021. In addition, two very important commitments were made in Podgorica during the Western Balkans Digital Summit of October 2021: the Memoranda of Understanding on interoperable Western Balkans and Free Flow of Data in the Western Balkans region. However, Kosovo needs to continue to develop the legal framework and infrastructure needed to stimulate e-commerce and enable international electronic payments. Additional work is also needed 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 implementation of relevant measures in this field, particularly by allocating the necessary financial and human resources.

#### **Measure 8: “Extension of ICT infrastructure and services for socio-economic development, advanced public services, as well as digitalisation of the education system”**

The measure to extend ICT infrastructure is rolled over from the last ERP and revised to cover multiple policy actions. The measure is comprehensive, well planned and substantial progress could be made if actions described are implemented. The plan correctly identifies the challenges in the sector and highlights opportunities and ways forward. It is encouraging that actions are planned to further develop an e-government portal to better deliver effective electronic services to individuals and businesses. In terms of budgeting, the plan is to implement the measure through combined national and IPA funds. Indicators could be extended to better reflect and measure the proposed activities.

## ***Business environment and reduction of the informal economy***

This area and the Reform Measures 9 and 10 are analysed in Section 4, under Key Challenge 2.

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

**Kosovo's performance is still very poor on research, development and innovation** (governance of RDI policies, public research system, public-private links, innovation in firms and human resources for innovation), and the country has one of the lowest scores in the Western Balkans region<sup>16</sup>. The sector suffers as a result of chronic fragmentation and lack of capacity in implementing innovation policy and the lack of overall systematic 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. Over the past year however some positive developments took place that might stimulate a new dynamic in the sector. The authorities appointed a National Scientific Council in 2021, which by law is in charge of drafting the national research programme. Kosovo has successfully completed negotiation with EU and is now a fully associated member of the Horizon Europe programme, though it needs to improve its performance in accessing grants. Action is ongoing to develop and operate the Kosovo Research Information System. In the government programme for 2021 – 2025, Kosovo envisaged setting up an “Innovation and Entrepreneurship Fund”, collecting innovation-related statistical data, and applied to participate in the European Innovation Scoreboard. Work to prepare a smart specialisation strategy started in 2019 using the methodology of the European Commission's Joint Research Centre. Though it has completed an analysis to identify the scientific priorities and a communication mechanism for stakeholder consultation is in place, progress remains slow.

### **Measure 11: “Improving the environment for research, innovation and entrepreneurship”**

Since the previous ERP, Kosovo has improved the activities under this measure and taken on board feedback from the previous ERP assessment and other policy dialogue fora. There are a number of positive activities that merit a greater of focus on outcomes, for example the aim to join the European Scoreboard and create a National Innovation Fund. In general, there is a need to explain how certain funding measures are complementary to ongoing support from the EU and other international partners such as the EBRD, for instance support to businesses and incubators. This component should provide resources such as trainings, business consulting services and mentorship that are essential to the success of start-ups and idea generation. There were no activities related to support for or focus on young entrepreneurs or partnerships with stakeholders including industry, the diaspora and the NGO sector. As in previous years, the plan lacks key indicators for the R&D sector and the benefits of innovation processes. The envisaged financial support appears sufficient for the activities targeted and is entirely funded from the national budget, but at 0.1% remains far below the required 0.7% of GDP set by law. There is no mention of how Kosovo will make the most of its new Horizon Europe membership, nor reference to the research data (on researchers, publications, funding per higher education institution spent on R&I, research infrastructure) currently being collected by the ERASMUS+ KRIS project (led by the International Business College Mitrovica) in

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<sup>16</sup> OECD (2021), *Competitiveness in South East Asia – a policy outlook 2021*.

cooperation with Austrian Development Agency. Lack of data is a challenge in Kosovo, and this is the first such whole-scale initiative to aim to tackle it.

### *Economic integration reforms*

**Kosovo is highly reliant on imports and suffers from a chronically high trade deficit.** Despite this trend, the trade deficit narrowed by 10% in 2020 on the previous year, to reach EUR 2.82 billion. Though the export of services helps offset the persistent goods trade deficit to a certain degree, these are mostly dominated by expenditure by non-residents (mainly diaspora members) in Kosovo, accounting for around 80% of all services exports in 2019. Most of the goods Kosovo exports are still basic raw materials and mineral products, reflecting a low degree of product diversification. Trade with the EU and the CEFTA region accounts for almost all trade. Due to exports rising higher than imports over the last 10 years, Kosovo has improved the 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, i.e. 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 prospects for young people in Kosovo, which is also important given 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% 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, 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 Kosovar firms. There is potential to attract more FDI: Kosovo has a good strategic location, a young population, relatively low labour costs and a 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. The measures planned under this area do address this challenge.

### **Measure 12: "Improving cross-border trade through trade facilitation"**

The measure and its expected outcome is well justified, having been rolled over from last year. The link to the common regional market and the Green Agenda for the Western Balkans is an important additional measure. Ratification of Additional Protocol 6 of CEFTA 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 has been delayed to 2022,

with ratification in 2023, which is a more realistic timetable. However, some activities, such as WTO membership negotiations, entail additional political risk and depend on external factors.

### **Measure 13: “Further development of quality infrastructure and empowerment of the role of market surveillance authorities”**

The activities planned for 2022 are realistic. Several were planned for 2021 but delayed, and others originally planned for 2022 are on track. The mitigating measures of capacity building and staff training are important and should be followed up properly, particularly since the IPA-funded project has ended. The activities planned for 2022 and 2023 are reasonable and well sequenced, closely reflecting the timetables laid out in the previous ERP. Kosovo has significantly increased the budget since the previous ERP, a welcome change particularly given the end of the IPA-funded project.

#### ***Energy market reforms***

This area and the Reform Measures 5 and 6 are analysed in Section 4, under key challenge 3.

#### ***Transport market reforms***

**Transport links are less of a constraint on Kosovo’s competitiveness than issues connected to other sectors, but improving 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 allocated to of road and railway network maintenance and with an increasing amount of capital investment directed towards prestige projects without a clear transport, environmental or development rationale. On rail, the continuing works on 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). It 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 is needed, including maintenance and integration with European networks, as well as an upgrade of the legislative framework to align it the EU acquis, to improve 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 overcome transport-related constraints on Kosovo’s economy.

### **Measure 14: “Further development and modernisation of transport”**

This is a new measure in the ERP encompassing some of the main actions to reform the transport sector. The activities are ambitious, comprehensive and include the adoption and implementation of transport-related legislation, drafting and adoption of sectoral strategies and alignment with EU acquis. It is encouraging that the government plans to amend the Law on Railways and the Law on the Establishment of the Road Traffic Safety Agency. The coordination structures are essential in developing successful road safety policies. The lack of proper maintenance plans is the major reason for slow and unreliable transport services. The measure does not include the development of a multiannual maintenance plan underpinned by

sufficient financial resources. It lacks activities to improve road transport climate resilience and the use of alternative fuels. The implementation budget is planned to be covered mainly by national funds and unspecified grants. The indicators for the measure are relatively vague.

### *Agriculture*

#### **Kosovo's agricultural sector is beset by low productivity and high production costs.**

Although it remains relatively large, the sector's share of gross value added continues to fall, though it accounts for a significant share of informal employment. 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 and access to finance<sup>17</sup>. Less than a fifth of Kosovo's arable land is irrigated. Although the government has developed some measures to address some of these issues (e.g. irrigation systems and organic farming), further investment and action are needed to ensure the measures are implemented and to boost 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.) that have lower 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 set up 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 more support for the sustainable transformation of Kosovo's agri-food system and rural development.

#### **Measure 15: "Structural changes in the agriculture sector"**

As in last year's ERP, the activities listed under this reform measure focus mainly on drafting documents rather than implementing projects or activities. Given 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 sector, such as the small average farm size, land loss to unplanned urban expansion, low productivity and high production costs, low product diversification, inefficient water management, poor irrigation infrastructure and water quality, outdated technology, limited storage capacity, weak or dis-functional links between primary producers and processors, and between producers and market, and the lack of specialisation. Though Kosovo rightly prioritises irrigation, the measures are rolled out at a slow pace, with no concrete actions until 2023, and the plan does not address the quality of water taken from highly polluted rivers. As in other measures, the plan lacks a mention of EU support under IPA (for example, a EUR 10 million project for irrigation under IPA 2020 managed by the World Bank is not referenced).

### *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

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<sup>17</sup> 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).

(around 14%). Manufacturing is dominated by food processing and non-metallic mineral products, accounting for 70.3% of all exports (with metals and rubber and plastics products accounting for 42% of the total). Though, 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 micro, small and medium sized enterprises with low levels of integration in global value chains, low shares of innovation and attracting low levels of foreign direct investment. While a comprehensive policy framework is currently being studied, existing support services for these companies are weak. Inter-ministerial coordination in this policy area is weak and the responsible institutions lack implementation capacity. In particular, the Kosovo Investment and Enterprise Support Agency (KIESA) appears to lack the resources, technical capacity and experience to fulfil its broad range of objectives in terms of attracting FDI and increasing competitiveness of local firms. 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 16: “Increasing competitiveness in the production industry”**

Ongoing work to frame a coherent industrial policy is a positive step; however the implementation of activities under this carried-over measure is slow. For example, restructuring KIESA or establishing complaint mechanisms for investors and after-care programmes for investment should already be in place, following Stabilisation and Association Agreement commitments. KIESA support programmes to SMEs should also encourage gender balance and women entrepreneurship. A significant share of the estimated costs are for the construction of infrastructure in economic zones. However, the plan still lacks a feasibility study on industrial zones assessing their return on investment and contribution to economic development. Such industrial parks may also privilege companies selected with unclear criteria. Some positive steps were taken to boost KIESA's capacity, including increased staffing and financial resources, but additional steps are needed to enable the agency to fulfil its objectives and to promote links between multinational enterprises and SMEs. Specifically, further reflection regarding the financial and staff capacities and resourcing needs of KIESA should be undertaken.

#### ***Services***

**Despite 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 57.7% of GDP and 67.9% of total formal employment, this sector constitutes the backbone of the private sector (comprising 86% of registered firms). It is mainly composed of non-tradeable activities (accounting for more than two thirds of all sector turnover). Trade in services has been dynamic in recent years, reflected in a sustained service trade surplus and it has made a significant contribution to Kosovo's current account, driven by the travel and hospitality industries and ICT services. Notwithstanding this, exports of services are strongly dependent on travel services (which represented 65% of all services exports in 2020, lower than in previous years). However, most of the travel services provided were for visits by members of the Kosovo diaspora (rather than tourism), which raises concerns as to its long-term growth potential. The sector has also 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 for firms, especially small and medium enterprises, to technology and finance.

#### **Measure 17: “Increasing competitiveness in the tourism and hospitality sector”**

The measure to develop tourism products in Kosovo’s tourist regions has been rolled over from previous ERPs, without much progress in concrete implementation. 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, timeframe and ownership. As such, the proposed measure is rather limited in terms of making the country more attractive, appealing and recognisable. The measure does not factor in the impact on the environment and the need for inter-institutional cooperation to alleviate that impact. However, 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. The costing of the measure is not properly assessed and does not factor in donor funding including from IPA, such as a EUR 2 million contribution to enhancing tourism infrastructure in Prizren or a EUR 2 million contribution to a project in Janjevë/Janjevo.

#### **Measure 18: “Increase competitiveness in the sector of trade in services”**

The measure is feasible and the finalisation of negotiations for mutual recognition of professional qualifications in the CEFTA format has been extended to 2022. The activities planned annually for 2022, 2023 and 2024 are realistic and the sequencing is sound. Ratification of the CEFTA Additional Protocol 6 on trade in services is still lacking and has been delayed for some time, but does not appear in this measure. The Point of Single Contact, has been set up and is being piloted. The plan does not specify the number of sectors to be digitalised in 2022 or any indicators/targets for 2022. The budget appears too small given the number of activities planned for the three-year period in the proposed reform measure. The twinning project is due to end in November 2022, it is therefore unclear whether IPA funds are expected in 2023.

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

This area and the relevant reform measures 1, 2 and 19 are analysed above in Section 4, under key challenge #1.

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

This area and the relevant reform measure 3 are analysed above in Section 4, under key challenge #1.

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

**Kosovo has yet to tap the potential of social dialogue.** Trade unionisation in the private sector is low and affected by the high level of informality in the labour market. However, the structure of the labour market hampers the development of fair relationships 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 bring in tripartite social dialogue in the process of drafting policies and legislation. The

capacity of social partners, in particular 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, which has been postponed and integrated into the revision of the Labour Law.

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

**Kosovo has very high poverty rates by EU and regional standards.** The EU-SILC survey in 2018 revealed that Kosovo had the highest at-risk-of-poverty (27.9%) and at-risk-of-poverty or social exclusion (56.7%) rates were the highest among enlargement countries. The level and structure of social spending does not cover the needs of the poorest. Expenditure on social protection, which increased to 8.1% of GDP in 2020, is very low in normal times (6.9% of GDP in 2019 and 5.5% of GDP in 2021), well below regional levels and almost three times lower than the EU-27 average (19.3% of GDP in 2019, 22.0% of GDP in 2020). The structure of expenditure is also problematic. The highest share of domestic non-contributory social spending (over 90%) was on complex category-specific pension schemes, leaving only 10% available for social services and social assistance benefits. The government plans to reform the Social Assistance Scheme through a project under a World Bank loan, however this has not yet been approved by the Parliament. The reform aims to improve the focus of the scheme. According to the latest Household Budget Survey (2017), over half of all households in Kosovo were unable to pay utility bills once or twice during the year. For 44% of households, family budgets were under continuous strain and any increase in one area of household spending or utilities meant that a family had to reduce spending on other basic necessities. From September 2021 a new universal cash child benefit was introduced for children aged 0-2 and is expected to be extended to children aged 2-16 by 2023.

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

The reform measure is overall well designed and the new elements such as training for social workers and defining basic social services are welcome. Quite a few measures are rolled over from last year, mainly legislative initiatives that were not adopted given the political instability. The actions should provide a good base for improving social assistance coverage, however it is discouraging to see that this year’s ERP does not include the announced deep sector reforms to ensure that social assistance is means tested and focused on reducing poverty. The integrated case management for social services is not mentioned for 2023 or for 2024.

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

Area/sector	2016	2017	2018	2019	2020	EU-27 Average (2020 or most recent year)
<b>Energy</b>						
Energy imports dependency (%)	23.6%	30.0%	29.3%	30.5%	29.5%	57.5%
Energy intensity: Kilograms of oil equivalent (KGOE) per thousand Euro	451.30	409.03	398.07	392.34	413.88	110.18
Share of renewable energy sources (RES) in final energy consumption (%)	24.47%	23.08%	24.62%	24.22%	24.40%	22.09%
<b>Transport</b>						
Railway network density (metres of line per km <sup>2</sup> of land area)	30.5 <sup>w</sup>	30.5 <sup>w</sup>	30.5 <sup>w</sup>	30.5 <sup>w</sup>	30.5 <sup>w</sup>	49.0 <sup>(2018)</sup>
Motorisation rate (Passenger cars per 1000 inhabitants)	144.0 <sup>w</sup>	154.6 <sup>w</sup>	157.2 <sup>w</sup>	162.0 <sup>w</sup>	164.4 <sup>w</sup>	519 <sup>(2018)</sup>
<b>Agriculture</b>						
Share of gross value added (agriculture, forestry and fishing)	10.2%	9.2%	8.1%	9.0%	8.9%	1.8%
Share of employment (agriculture, forestry and fishing)	4.2% <sup>w</sup>	4.4% <sup>w</sup>	3.5% <sup>w</sup>	5.2% <sup>w</sup>	4.8% <sup>w</sup>	4.3%
Utilised agricultural area (% of total land area)	38.2% <sup>w</sup>	38.2% <sup>w</sup>	38.5% <sup>w</sup>	38.6% <sup>w</sup>	38.6% <sup>w</sup>	40.6%
<b>Industry</b>						
Share of gross value added	24.3%	24.1%	24.2%	23.4%	24.1	19.5%
Contribution to employment (% of total employment)	18.0% <sup>w</sup>	17.4% <sup>w</sup>	14.3% <sup>w</sup>	15.1% <sup>w</sup>	16.3% <sup>w</sup>	18.2%

<b>Services</b>						
Share of gross value added	56.4%	56.5%	57.2%	57.6%	57.7%	73.1%
Contribution to employment (% of total employment)	66.3% <sup>w</sup>	65.3% <sup>w</sup>	70.3% <sup>w</sup>	67.1% <sup>w</sup>	67.9% <sup>w</sup>	71.0%
<b>Business environment</b>						
Rank in Global Competitiveness Index (Source: World Economic Forum)	N/A	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	N/A
<b>Research, development and innovation</b>						
R&D intensity of GDP (R&D expenditure as % of GDP)	N/A	N/A	N/A	N/A	N/A	2.32%
R&D expenditure – EUR per inhabitant	N/A	N/A	N/A	N/A	N/A	EUR 694.60
<b>Digital economy</b>						
Percentage of households who have internet access at home	N/A	89%	93%	93%	96%	91%
Share of total population using internet in the three months prior to the survey [NB: population 16-74]	N/A	82.9% <sup>w</sup>	87.7% <sup>w</sup>	90.7% <sup>w</sup>	96% <sup>w</sup>	88%
<b>Trade</b>						
Export of goods and services (as % of GDP)	23.8%	27.3%	29.1%	29.3%	21.7%	46.7%
Import of goods and services (as % of GDP)	51.2%	53.1%	57.3%	56.4%	53.9%	42.9%
Trade balance (as % of GDP)	-41.1%	-42.0%	-44.7%	-44.1%	-41.7%	N/A
Early leavers from education and training (% of population aged 18-24)	12.7% <sup>w</sup>	12.2% <sup>w</sup>	9.6% <sup>w</sup>	8.2% <sup>w</sup>	7.8% <sup>w</sup>	9.9%
Young people not in employment nor in education and training (NEET) (% of population aged 15-29)	37.5% <sup>w</sup>	35.1% <sup>w</sup>	37.4% <sup>w</sup>	40.0% <sup>w</sup>	40.4% <sup>w</sup>	13.7%
Children aged less than 3 years in formal child care (% of under 3-years-olds)	N/A	N/A	N/A	N/A	N/A	35.3% <sup>(2019)</sup>
Individuals who have basic or above basic overall digital skills (% of population 16-74)	N/A	21%	N/A	28%	N/A	56% <sup>(2019)</sup>

<b>Education and skills</b>						
Early leavers from education and training (% of population aged 18-24)	12.7% w	12.2% w	9.6% w	8.2% w	7.8% w	9.9%
Young people not in employment nor in education and training (NEET) (% of population aged 15-29)	37.5% w	35.1% w	37.4% w	40.0% w	40.4% w	13.7%
Children aged less than 3 years in formal child care (% of under 3-years-olds)	N/A	N/A	N/A	N/A	N/A	35.3% <sup>(2019)</sup>
Individuals who have basic or above basic overall digital skills (% of population 16-74)	N/A	21%	N/A	28%	N/A	56% <sup>(2019)</sup>
<b>Employment and labour market</b>						
Employment rate (% of population aged 20-64)	32.3% w	34.4% w	33.2% w	34.2% w	32.3% w	71.7%
Unemployment rate (% of labour force aged 15-74)	N/A	N/A	29.4% w	25.5% w	25.8% w	7.1%
Long term unemployment rate (% of labour force aged 15-74)	N/A	N/A	N/A	N/A	N/A	2.5%
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.	32.8 pps.	11.0 pps.
Disability employment gap (percentage points difference in employment rates between people with and without a disability)	N/A	N/A	19.7 pps.	N/A	N/A	24.5 pps.
Real gross disposable income of households (per capita increase, Index = 2008)	N/A	N/A	N/A	N/A	N/A	107.23
<b>Social protection system</b>						
At-risk-of-poverty or social exclusion rate (% of population)	N/A	N/A	56.7%	N/A	N/A	21.9%
At-risk-of-poverty or social exclusion rate of children (% of population aged 0-17)	N/A	N/A	N/A	N/A	N/A	24.2%

Impact of social transfers (other than pensions) on poverty reduction	N/A	N/A	5.42%	N/A	N/A	32.68%
Income inequality - quintile share ratio (S80/S20) (Comparison ratio of total income received by the 20% of the population with the highest income to that received by the 20% with the lowest income)	N/A	N/A	15.58	N/A	N/A	5.24
Housing cost overburden (% of population)	N/A	N/A	11.3%	N/A	N/A	9.9%
<b>Healthcare</b>						
Self-reported unmet need for medical care (of people over 16)	N/A	N/A	9.7%	N/A	N/A	1.8%
Out-of-pocket expenditure on healthcare (% of total health expenditure)	N/A	N/A	40.5% <sup>z</sup>	N/A	N/A	15.57% <sup>(2018)</sup>

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.

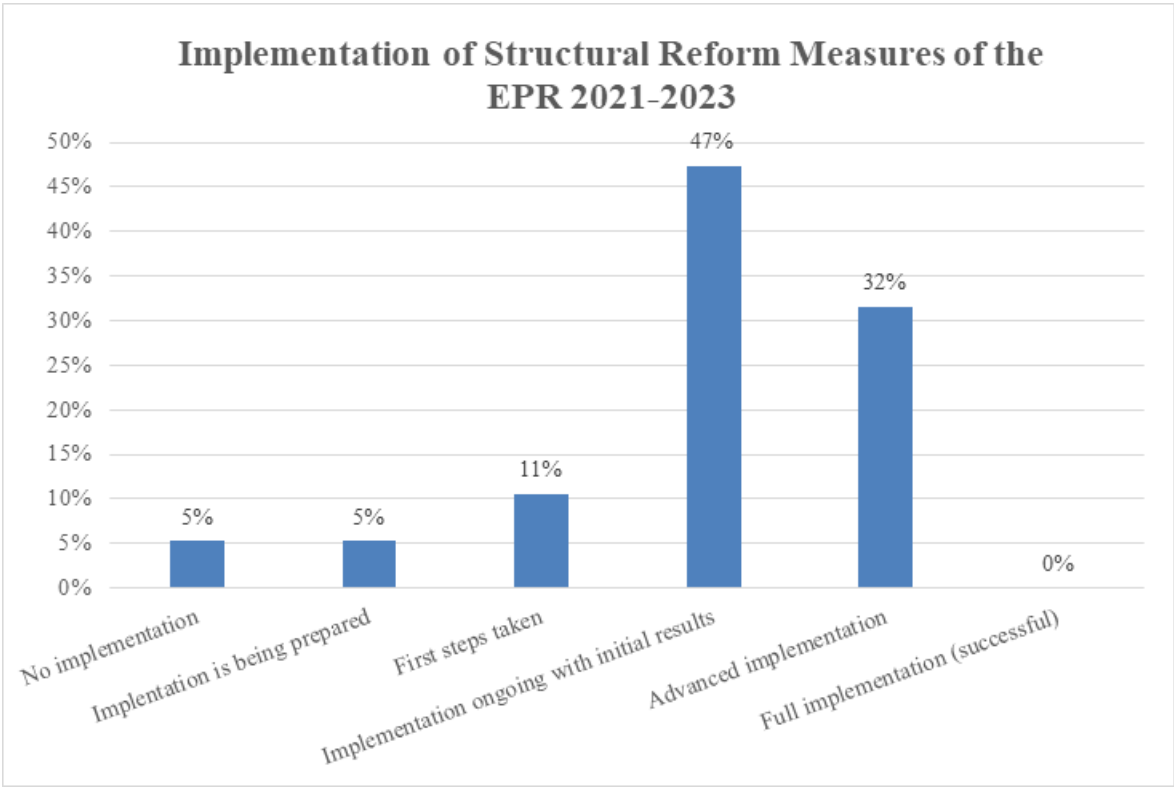
z: Kosovo – Ministry of Health “National Health Accounts 2018” - <https://msh.rks-gov.net/wp-content/uploads/2021/07/ENG-NHA-Report-2018-11-July-2021-Final-with-Annex-1.docx>

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

**ANNEX C: PROGRESS WITH STRUCTURAL REFORM MEASURES FROM THE ERP 2021-2023**

Kosovo made relatively good progress in implementing the measures in 2021, given the many obstacles posed by the ongoing pandemic. It achieved an average score as reported in the ERP of 3.2 out of 5, an improvement over its 2020 score of 2.5. The reporting on the planned activities is generally thorough and provides a fair description of the level of implementation. The implementation indicators for Reform Measure 8 on the establishment and functionalisation of the Commercial Court indicates full implementation, but the Court is not yet operational.

Implementation is higher in some measures, such as Reform Measure 4 (increase of competitiveness in the production industry), 16 (new curricular framework in vocational education and training system) and 18 (improving public employment and vocational training services). It scores lower in other measures, such as Measure 5 (increasing competitiveness in the tourism and hospitality sector) and Measure 7 (improvement of the business environment by reducing the administrative burden and inspections reform). However, this reflects to some extent the difference in level of ambition in the reform measures and the specific breakdown into measurable activities.



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

The government adopted the Economic Reform Programme 2022-2024 and submitted it to the Commission on 31 January 2022, within the set deadline. It is in line with the previously approved medium-term fiscal strategy and national development strategy, and the forecasts and amendments made in response to the COVID-19 crisis. No components of the ERP are lacking.

### *Inter-ministerial coordination*

The ERP was centrally coordinated, with the Ministry of Finance, Labour and Transfers as National Coordinator in close cooperation with the Strategic Planning Office in the Prime Minister's Office. They were supported by area coordinators from the line ministries. The inter-ministerial coordination process worked well, especially given the ongoing constraints posed by the pandemic and related restrictions. However, coordination between the Ministry of Finance, Labour and Transfers, the Strategic Planning Office and the National IPA Coordinator was clearly less strong, since the IPA activities are only minimally or incorrectly reflected in the costing part of the structural measures.

### *Stakeholder consultation*

The draft ERP was made available online with two weeks for stakeholders to provide their feedback, in line with the rules on minimum criteria for public consultation. Due to COVID-19-related restrictions on public gatherings, it was not possible to organise a high-level, in-person consultation meeting with representatives from civil society organisations, business organisations, international financial institutions and donors. Written comments are annexed to the ERP with an indication of whether they have been accepted or rejected, though they include only comments from a small number of international and civil society organisations with no comments from the business community.

### *Macroeconomic framework*

Though the programme acknowledges a number of risks, the baseline scenario assumes that the strong recovery in 2021 will continue over the forecast timeframe, which is highly uncertain, and requires a careful assessment. External assumptions are based on the projections made in the European Commission's autumn forecast and the IMF's October 2021 World Economic Outlook. The ERP doesn't provide alternative 'low growth' and 'high growth' scenarios which would be useful to illustrate the likely impact of some expected developments and risks, such as underspending of capital investment or increase in energy prices, in Kosovo's economy. The forecasts for the labour market and the financial sector are still lacking.

### *Fiscal framework*

The fiscal projections are based on the adopted 2022 budget. The ERP assessment of fiscal projections is based on the ERP annex data, which include some corrections made after the ERP was submitted. For 2022, the ERP envisages a roughly stable ratio of public revenue to GDP while public expenditure is set to increase from the 2021 level, due to a large surge in capital investment. The 2021-2022 fiscal data are not fully consistent with the main text. The

revised fiscal tables, including data on cyclical adjustment, were provided after submission. The ERP provides a useful debt sustainability analysis with three negative shock scenarios.

### *Structural reforms*

The structural reform priorities follow the guidance note and cover the new areas such as public financial management, the green transition and digital transformation. With some exceptions, the reporting on implementation of the policy guidance is sufficient, but additional explanatory information could have been included in the actions where there is only initial or limited implementation. The reporting on implementation of structural reforms is generally sufficient, though there are some discrepancies between the stated stage of implementation and the description of progress. The programme meets the limit of a maximum 20 reform measures, though in many cases they are too broadly defined to reflect clear priorities and specific plans. The programme slightly exceeds the page limit set. Table 9 is filled in correctly. Tables 10a and 10b and table 11 are only partially correct; especially concerning is the fact that the IPA funds are not included in the tables. There are some inconsistencies in the way that the implementation of the reforms is rated. Table 12 is filled in correctly.

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