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2007 Economic and fiscal programmes of potential candidate countries: EU Commission's assessments

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Directorate-General for Economic and Financial Affairs

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INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs publishes its overview and assessments of the 2007 Economic and Fiscal Programmes (EFP) of the potential candidate countries (Albania, Bosnia and Herzegovina, Montenegro and Serbia).

In 2001 a regular economic fiscal surveillance procedure was established for the candidate countries. It aims at preparing countries for the participation in the multilateral surveillance and economic policy co-ordination procedures currently in place in the EU as part of the Economic and Monetary Union. The Pre-Accession Economic Programmes (PEPs) are part of this procedure. The PEPs have developed, since their start in 2001, into increasingly important platforms for the authorities to develop and communicate appropriate economic, fiscal and structural policies over the medium term, consistent with their EU membership aspirations.

For this reason a similar, though slightly reduced, exercise was started in 2007 with the potential candidate countries, with the submission and assessment of annual EFPs as important element.

The EFPs have two objectives: first, to outline a medium-term policy framework, including public finance objectives and structural reform priorities needed for EU accession; and, second, to offer an opportunity to develop the institutional and analytical capacity necessary to participate in the Pre-Accession Fiscal Surveillance Procedure and eventually, in the long-term, in EMU with a derogation in regards to the adoption of the euro upon accession, particularly in the areas of multilateral surveillance and co-ordination of economic policies. The development of the institutional capacity to co-ordinate between the various ministries, government agencies and the central bank is a particularly important aspect ensuring the success of the Economic and Fiscal Programmes.

The 2007 EFPs were submitted by 1 December 2007. All programmes have been made public by the countries and can be found on the internet under following addresses:

Albania	http://www.minfin.gov.al/downloads/PEF2007-2010Finale%20MoF_en.doc
Bosnia and Herzegovina	http://www.dei.gov.ba/ba/?ID=24
Montenegro	http://www.gom.cg.yu/eng/minfin/vijesti.php?akcija=rubrika&rubrika=295
Serbia	http://www.mfin.sr.gov.yu/eng/650/

These assessments were prepared in the Directorate-General for Economic and Financial Affairs under the guidance and coordination of Peter Grasmann and Christophe Pavret de la Rochefordière. The principal authors were Laura Ruud (Albania), Mihai Macovei (Bosnia and Herzegovina), Antonio Sanchez Pareja (Montenegro), and Frank Kohlenberger (Serbia).

The programmes and this assessment were discussed in an experts meeting held in Brussels on 21 April 2008. Representatives from EU Member States, the ECB, the Commission and potential candidate countries attended this meeting.

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Part I

Overview

1. OVERVIEW

1.1. SUMMARY AND CONCLUSIONS

Albania, Bosnia and Herzegovina, Montenegro and Serbia submitted by 1 December 2007 *Economic and Fiscal Programmes* (EFPs). The drafting, assessing and discussing of these programmes serve to strengthen economic planning capacity in the countries as such and to prepare them for the next step, i.e. participation in the economic and fiscal surveillance procedure of candidate countries and, eventually, in the economic policy co-ordination and budgetary surveillance mechanisms of Economic and Monetary Union (EMU).

The recently submitted programmes represent a step forward towards meeting this objective. They contain useful overviews of economic policy plans over a broad range of issues over the next few years. In particular they show the determination of the governments to advance further stabilisation, structural reforms and productivity gains in order to allow sufficiently high growth, in order to catch up with their neighbours and to raise social standards in the countries. The degree of ambition and precision in policy implementation across the programmes is not uniform.

This exercise of submitting, assessing and discussing annual EFPs will continue to support the countries on their way towards European integration. The EU is in a position to provide an important anchor in this effort. A closer integration of this form of pre-accession economic and fiscal surveillance with other instruments of pre-accession economic policy communication, i.e. the economic chapters of the Progress Reports and European Partnerships and the bilateral economic dialogues with the countries, can increase the EU's effectiveness in this respect. Technical assistance in the area of economic policy planning and implementation has proven powerful in the case of candidate countries and might be more amply mobilised for the potential candidate countries. A seminar devoted to economic policy planning organised with the TAIEX Community programme already took place in October 2007 with officials from the four potential countries' ministries of economy and finance and was well received as a

useful means of improving the quality of the subsequent EFP submission.

1.2. BACKGROUND

In July 2006, Commissioner Almunia invited the potential candidate countries Albania, Bosnia and Herzegovina, Montenegro and Serbia to submit, by 1 December 2006, for the first time, an Economic and Fiscal Programme (EFP) to the European Commission.

The assessment of these programmes complements the policy messages given by the Commission in its annual Enlargement package: the economic chapters of the latter are backward-looking as they assess only past developments in the countries. The assessments of the EFPs are forward looking assessing government medium-term plans, crucial for eventual full compliance with the economic Copenhagen criteria.

The EFPs are gradually enabling the authorities to develop and communicate consistent platforms of economic, fiscal and structural policies over the medium-term. Their preparation serves a twofold purpose: to strengthen economic planning capacity in the countries as such and to specifically prepare them for participation in the economic policy co-ordination and budgetary surveillance mechanisms of Economic and Monetary Union (EMU). Consequently, the timing, scope and methodology of the EFPs, even though more limited in scope, follows the Pre-Accession Economic Programmes (PEPs) submitted since 2001 by acceding and candidate countries. The EFPs and their assessments are discussed in a multilateral policy framework with Commission services, potential candidate countries and Member States. The development of the institutional capacity to co-ordinate between the various ministries, government agencies and the central bank is a particularly important aspect ensuring the success of the EFPs.

The experience with the candidate countries' PEPs has shown that the positive results in terms of building up administrative and policy planning capacity and of designing growth conducive and

consistent policies are powerful, but that they take time to accumulate and to materialise.

1.3. THE 2007 PROGRAMMES

Countries were requested to submit their programmes by 1 December 2007. All countries complied with this deadline. All programmes have been made public by the countries.

Table I.1.1:
2007 Economic and Fiscal Programmes: Key indicators

	2006	2007	2008	2009	2010
Growth (GDP, real, ann. % change)					
Albania	5.0	6.0	6.0	6.0	6.0
Montenegro	8.1	7.0	7.0	6.0	5.5
Serbia	5.7	7.0	6.0	6.5	6.5
Unemployment rate (% of LFS)					
Albania	13.9	14.1	13.8	13.7	13.9
Bosnia and Herzegovina	31.0	24.5	24.2	23.6	23.0
Montenegro	14.7	12.2	10.8	9.8	8.8
Serbia	21.6	21.7	21.1	20.4	19.6
Current account balance (% of GDP)					
Albania	-7.3	-8.4	-8.3	-5.5	-4.9
Bosnia and Herzegovina	-9.9	-13.4	-14.0	-14.9	-14.6
Montenegro	-25.6	-32.2	-30.6	-28.8	-23.9
Serbia	-12.3	-14.7	-14.1	-12.6	-11.1
Inflation (CPI, annual % change)					
Albania	2.4	3.0	3.0	3.0	3.0
Bosnia and Herzegovina	6.1	1.9	1.9	1.8	1.7
Montenegro	2.0	6.7	4.0	3.5	3.0
Serbia	12.7	6.4	7.1	5.5	4.5
Government balance (% of GDP) *					
Albania	-3.3	-4.6	-7.9	-3.9	-3.6
Bosnia and Herzegovina	2.7	-0.1	0.1	1.1	1.2
Montenegro	3.4	3.1	0.7	1.0	1.1
Serbia	1.6	-0.5	-0.6	0.5	0.4
Government gross debt (% of GDP) *					
Albania	55.0	53.6	56.2	54.2	52.4
Bosnia and Herzegovina	n.a.	n.a.	n.a.	n.a.	n.a.
Montenegro	35.0	30.6	37.1	34.1	30.9
Serbia	35.6	32.3	28.4	25.5	22.3

* general government, national accounting standards

Source: EFP 2007

When analysing the programmes, the EU Commission assesses whether the provided information is in line with the required standards and whether the programme's overall scenario was plausible and consistent at the time of submission. In the case of the assessment of the 2007 programmes, the global economic environment has turned out to be quite different

from what appeared plausible at the time of drafting those programmes: world market prices for energy, intermediate goods and food remained much higher than expected and turbulences in the financial and banking sector continued much longer than foreseen. As a result, half a year after their submission, the programmes appear to be fairly optimistic. However, taking into account the different economic environment will be part of the 2008 exercise and has not been included into the assessment of the 2007 programmes.

Overall,

- the four programmes present generally consistent and ambitious policy frameworks for economic stabilisation, fiscal policy and structural reform. Their methodology and presentation has improved in several instances compared to the first submission. However, in all four programmes there is still room for further improvement. Overall, countries are committed to strengthen administrative capacities and, in the longer run, to prepare for eventual participation in the economic policy co-ordination and budgetary surveillance mechanisms of Economic and Monetary Union;
- all programmes are based on a fairly consistent macroeconomic and fiscal framework. Against the backdrop of an expected growth moderation of the global economy, the potential candidate countries project a moderation of annual output growth between 5.5% and 7% over the programme period (see table). The submitted programmes were prepared in summer and autumn 2007, when the magnitude of the crisis which erupted in the international banking and financial markets in the course of the summer was not yet fully explicit. As a result growth projections may turn out to be rather optimistic. Albania foresees annual economic growth of around 6%. Bosnia and Herzegovina foresees a slowdown in output growth from 6.1% in 2007 to 5.5% in 2010. The Montenegrin EFP foresees GDP growth to moderately slow from 7% in 2006 to 5.5% in 2010. The Serbia EFP projects a

deceleration of output growth from 7.0% in 2007 to 6.5% in 2010;

- the scenarios foresee that in all countries growth will be based mainly on a rising capital base and overall efficiency gains, which is expected to mitigate consequences from the worsening external environment; however risks to the programmes are more significant than last year, mainly due to increased commodity prices weighing on the external accounts and triggering higher inflation rates, as well as possibly lower exports and reduced FDI. On the demand side, strengthening domestic demand will support growth;
 - the monetary frameworks foresee no major changes to the respective current frameworks, i.e. quasi-inflation targeting in Albania and Serbia, a currency board in Bosnia and Herzegovina and official euroisation in Montenegro.
 - the fiscal frameworks foresee a substantial rise in the deficit in Albania in 2008, which is however projected to be reversed in the following years, an increase in the surplus in Bosnia and Herzegovina after fiscal relaxation in 2007, a gradual improvement to a small surplus in Serbia and a decline in surpluses in Montenegro. For Albania, the 2007 EFP projected the general government deficit to narrow from 4.6% of GDP in 2007 to 3.6% in 2010. Bosnia and Herzegovina plans an improvement from a deficit of -0.1% of GDP in 2007 to a surplus of 1.2% of GDP in 2010. Montenegro intends to move from a surplus of 3.1%¹ of GDP in 2007 to a surplus of 1.1% of GDP 2010. Serbia projects an improvement from a deficit of -0.5% of GDP in 2007 to a surplus of 0.4% in 2010. Albania and Montenegro expect debt ratios to increase in 2008 and decline thereafter to 52.4% and 30.9% of GDP, respectively, by 2010. Serbia projects a decline in public debt from 32.3% in 2007 to 22.3% of GDP in 2010. Bosnia and Herzegovina did not
- provide data on consolidated public debt to GDP.
 - the structural reform agendas, as presented in the EFPs, cover a broad range of areas and reveal a varying degree of ambition. In Albania the reforms are targeted mainly at the improvement of institutional capacity of authorities and the business environment, as well as decreasing informality of the economy, notably by the means of labour market reforms. The programme of Bosnia and Herzegovina covers reforms in the enterprise and financial sectors, labour market, public administration and the pension systems. Montenegro's emphasis is put on the energy sector, the labour market, the business environment, privatisation, and the pension system. The programme of Serbia focuses on the enterprise and financial sector, labour market and social welfare system, public administration and public finance management and includes measures to improve the overall business and entrepreneurial environment. Often, however, the EFPs are very detailed when describing past developments and rather vague when explaining intended reform measures. Furthermore, the links to the macroeconomic and fiscal frameworks within the EFPs would have benefitted from a more explicit discussion. However, overall, the full and determined implementation of those reforms should strengthen the countries' economies, in particular in view of the fulfilment of the Copenhagen economic accession criteria.
 - The structural reform priorities broadly address the reform priorities identified by the EU. The economic priorities of the European Partnerships are to a large degree addressed by all EFPs. However, in the case of Albania several areas would have benefited from a more ambitious and more detailed approach, in particular regarding public finance management and the energy supply infrastructure. In the case of Bosnia and Herzegovina, the EFP could have focused more thoroughly on the business environment as well as on the restructuring of network industries. In addition, more concrete targets

¹ Programme estimation; preliminary data recorded surplus of 8.5% of GDP.

and timetables for the acceleration of enterprise restructuring and the reduction of rigidities in the labour market would have been welcome. In the case of Serbia, in some areas, for example the labour market, reforms rely more on active measures than on reducing regulations and distortions. In addition, for several reform areas it remains unclear to what extent the described measures will help in meeting the objectives of the European partnership priorities.

1.4. THE EFPS AND THE PRE-ACCESSION STRATEGY

The programmes lay out policy strategies, which are to a large degree compatible with and conducive to the economic priorities of the European Partnerships and, more widely to the general objective of meeting the Copenhagen economic criteria for accession, i.e. establishing a functioning market economy and raise competitiveness to a level which would allow the countries to meet competitive pressure within the European Union. In some cases, though, clearer and more convincing information on the specific implementation of these objectives would have been useful.

Technical assistance to potential candidate countries in the area of economic policy planning and implementation has proven powerful and should be continued.

1.5. FOLLOW-UP

The programmes and their assessments by the Commission services were discussed within an experts meeting on 21 April in Brussels, with experts from the potential candidate countries. Member States were invited and also participated in that meeting. The final assessments have been transmitted to the Ministers of Finance of the countries by Mr. Almunia.

This exercise has been, since its start, an annual one. Therefore, the countries will again be invited to submit a programme for 2008-2011.

Part II

Country analysis

1. ALBANIA

1.1. SUMMARY AND CONCLUSIONS

The Economic and Fiscal Programme (the EFP 2007) covers the period 2007–2010 presenting the medium-term framework of economic and fiscal policies in Albania. The programme contributes to consistent policy planning and communication, and to strengthening the institutional and analytical capacity of the authorities. The EFP 2007 broadly complies with the requirements of the European Commission, even if it reveals some analytical and data gaps. The programme integrates the content of several policy documents of the country, maintaining an overall consistency and creating a unified basis for a coordinated policy planning. In particular, it appears broadly consistent with the current IMF three-year 2006–2009 PRGF/EFF¹ programme.

Recent macroeconomic developments have been broadly favourable, with relatively strong economic growth of 5.5% annually in 2006, and fairly moderate inflation at around 3%. The general government deficit was kept below 4% of GDP in 2006; the public debt ratio has decreased. External imbalances continue to be relatively high, with a current account deficit above 7% of GDP. The programme's medium-term macroeconomic scenario is relatively plausible but may overestimate outcomes especially for 2008, as the projections are still based on the spring 2007 external assumptions. The projected macroeconomic environment is supportive to economic growth and appears plausible, remaining highly dependent on the commitment to the projected policies. While detailed external sector projections are not made explicit, within the programme horizon trade imbalances continue to be high, financed by strong inflows of remittances and foreign investments. The main risks to the programme ensue from developments in the global commodities (especially food and energy) and financial markets, but also from the authorities' capability to implement the projected policy mix.

The public finance scenario of the programme is broadly achievable, but not very ambitious, indicating an increasing exposure to possibly volatile developments in international markets. A projected sharp deterioration of fiscal balances in 2008 (fiscal deficit amounting to 7.9% of GDP in the 2007 EFP, later revised to 5.2%, largely induced by a one-off infrastructure project, implemented by foreign companies) is expected to remain neutral to domestic demand. In 2009–2011 the fiscal balance is projected to improve only gradually, the deficit amounting to close to 4% of GDP. The scenario appears to be generally consistent with the projected effects of the recent and planned reforms, although estimations of the budgetary quantitative impact of the reforms are not provided. Possible economic shocks that may affect public finances are not sufficiently discussed in the programme. Regarding government revenues, collection rates remain highly dependent on an increase in administrative capacity and favourable macroeconomic developments. In the area of public expenditure, a deterioration of the state power utility's financial situation may trigger higher subsidies; additionally, low administrative capacity may hinder public investments.

The structural and institutional reform agenda of the programme is adequate, corresponding to the criteria listed in the European Partnership with Albania. The main reform areas continue to be the improvement of institutional capacity and of the business climate, as well as decreasing informality of the economy, notably by the means of labour market reforms. The reforms' impact on the government budget is only partly discussed in the programme. No major policy shifts are projected. The reforms are foreseen to be implemented on a continuous basis throughout the programme horizon.

1.2. INTRODUCTION

In July 2006, Mr. Almunia, Commissioner for Economic and Monetary Affairs, invited the potential candidate countries – Albania, Bosnia and Herzegovina, Montenegro and Serbia – for

¹ The Poverty Reduction and Growth Facility (PRGF) and the Extended Fund Facility (EFF)

the first time to submit by 1 December, an Economic and Fiscal Programme (EFP) to the European Commission. The EFPs are a further step towards an increased policy dialogue on economic and fiscal issues between the authorities of the potential candidate countries and the European Commission. This is a yearly exercise and the programmes are assessed by staff of the European Commission. The scope and content of the EFPs is similar to the Pre-accession Economic Programmes (PEP), which are submitted each year by candidate countries, although the EFPs are somewhat more limited in scope.

Albania's programme was submitted timely on 3 December 2007, covering the period 2007–2010, upon its approval by the Council of Ministers in Albania. The programme is based on and is consistent with the main medium-term strategy documents of the authorities published by the submission of the EFP (Programme of Government, Medium-Term Budget Programme, Sector Strategy for Public Finances, National Strategy for Development and Integration), and it follows broadly the current IMF three-year PRGF/EFF 2006–2009 programme in Albania. In the beginning of 2008 however, the authorities revised the macroeconomic projections for the economic growth even upwards.

The programme is broadly compliant with the requirements of the European Commission. A broad summary of recent macroeconomic developments is presented, a generally coherent and consistent macroeconomic framework is projected and an extensive list of structural reforms is provided. Some relevant data and projections are missing; less emphasis is put on quantitative budgetary effects of reforms and the effects of possible adverse developments to the programme.

The authorities foresee the continuation of favourable economic environment conditions over the medium-term, supporting economic growth. Extensive institutional changes in the recent past (affecting the business climate, labour markets, and administrative capacity) are expected to foster economic activity in the coming years. The public debt ratio to GDP is expected to decrease by the end of the programme period as a result of somewhat

improving fiscal balances in 2009–2010. However, the foreseen sharp deterioration of fiscal stance in 2008 (due to a large one-off infrastructure project) may have adverse effects on the macro-economic environment of the country. Structural reforms focus on the implementation and amendment of the recently introduced measures, compliant with the criteria of the European Partnership with Albania.

1.3. ECONOMIC OUTLOOK

1.3.1. Recent macroeconomic developments

The Albanian economy has experienced a relatively favourable development in recent years. Annual real growth has remained above 5% since 2003 (according to revised statistics 5.5% in 2006; in the EFP 2007, 5.0%, see Table 1), inflation continues fluctuating between the targeted bands of 3% +/-1 percentage point on average, and exchange rate volatility vis-à-vis the euro has been relatively low. Investment growth has accelerated supported by strong credit growth, especially in mortgage loans, while (private) consumption growth has somewhat moderated. Energy supply shortages have not affected the economy severely, yet. Exports growth continues to exceed imports growth, leaving the trade balance still highly negative (above 20% of GDP), of which close to 2/3 is covered by remittances. The current account deficit remains above 7% of GDP, financed partly by foreign direct investment, while other capital inflows continue to remain significant. The labour market has posted signs of recovery, with the number of employed somewhat increasing, the unemployment rate decreasing (below 14%)¹, and labour productivity accelerating. Fiscal policy has remained accommodating, with the budget deficit exceeding 3% of GDP (down however from much higher levels in the past), and the public debt ratio to GDP still decreasing (below 55% of GDP).

¹ The latest statistical data differ somewhat from data reported in Table 1 that present the statistics and projections provided in the 2007 EFP.

The programme adequately covers the main recent developments in the economy. However, some data, especially on the labour market are still missing.

1.3.2. Medium-term macroeconomic scenario

The programme scenario may overestimate the outlook for economic growth as it relies on the external economic environment assumptions based on the European Commission's spring 2007 forecast. The programme may underestimate the level of interest rates, the euro exchange rate vis-à-vis the US dollar and the prices of commodities, and overestimate the world and the EU-27 economic growth. The authorities still see the programme plausible, as during the revision of the macroeconomic and fiscal framework (published in January 2008), even an acceleration of economic growth is projected for 2009 and 2010.

While the scenario is relatively coherent and consistent, some important projections, notably as regards the external sector, are not explicitly presented. As regards the contributions of economic aggregates to economic growth, the volatile dynamics of some indicators is not explained, and several data and projections are missing.

The programme's objectives are challenging, reflecting the most favourable rather than the most likely developments. The policy-mix described in the programme is supportive to the scenario, highly depending however on the

success of current and envisaged structural reforms. Compared to the programme of the last year, while the main projections have remained similar, the expected structure of the GDP growth has been revised considerably (see below).

Real sector

The programme envisages higher economic growth (6% in real terms) than in previous years (5.5% in 2006, according to revised statistics revision issued after the EFP 2007 submission). Compared to projections of the previous programme, an acceleration of investment growth is envisaged, largely due to a public large-scale one-off infrastructure project. On the other hand, private consumption growth has been revised significantly downward. For 2008, the contribution of net exports to the real economic growth has been revised being positive, with significantly lower exports and imports growth compared to the 2006 EFP. In terms of economic sectors, services are expected to remain the main source of the growth, followed by construction. The contribution of manufacturing is projected to decline compared to 2006 while the contribution of agriculture is expected to increase.

Some recovery has been envisaged in the labour market supported by ongoing reforms to improve the business climate as well as training programs. In particular, the number of employed is expected to increase in a faster pace, and the unemployment rate to decrease somewhat. Labour productivity is expected to continue increasing, although somewhat slower than in

Table II.1.1:

Macroeconomic developments

	2006	2007	2008	2009	2010
Real GDP (% change)	5.0	6.0	6.0	6.0	6.0
<i>Contributions:</i>					
- Final domestic demand	5.2	7.6	6.0	6.7	6.3
- Change in inventories	n.a.	n.a.	n.a.	n.a.	n.a.
- External balance of goods and services	-0.2	-1.6	0.1	-0.7	-0.3
Employment (% change)	0.1	0.4	0.4	0.5	0.5
Unemployment rate (%)	13.9	14.1	13.8	13.7	13.9
GDP deflator (% change)	1.23	1.27	1.31	1.24	1.40
CPI inflation (%)	2.4	3.0	3.0	3.0	3.0
Current account balance (% of GDP)	-7.3	-8.4	-8.3	-5.5	-4.9

Source: EFP 2007 submission (actual data for 2006 and 2007 may differ)

2006, remaining most likely lower than the wage growth.

The programme provides one macroeconomic scenario without alternatives. The projected real growth rates of the economy seem plausible, however subject to a high number of external and domestic adverse developments. The risks to the scenario are not discussed; the programme mentions a number of possible shocks (positive and negative) being included in the projections. In addition to the listed risks of increasing global prices of commodities and deterioration of external balances (including possibly increasing energy imports), the economic growth in Albania remains highly dependent on the progress of creating a favourable business environment.

Inflation

Under the programme inflation is expected to remain moderate until 2010. The central bank continues to define price stability as its main objective, maintaining its current target (annual growth in consumer prices to remain within a band of 3% +/-1 percentage point) and instruments. Inflation expectations are foreseen to remain contained. Moderate inflation would support sustainable development of the economy; if necessary, the central bank would use the instrument of open market operations. The target is likely to be met; however, risks of higher inflation levels remain, especially due to unanticipated effects of higher energy prices and the uncertainty as regards global food prices.

Monetary and exchange rate policy

In the medium-term (not restricted to the programme horizon), the central bank will aim at moving from the current implicit inflation targeting towards explicit inflation targeting. The planned adjustment of the monetary policy framework would not cause significant changes in the operational framework, including monetary instruments. The adjustment would rather focus on explicit identification and clarification of the procedures, aiming at a more transparent rule-based system.

Albania will maintain a floating exchange rate regime in the programme horizon. Volatility of the lek, the national currency vis-à-vis the euro is

expected to remain contained and consistent with macroeconomic developments. The exchange rate of the lek will remain mainly determined by the market. However, the Bank of Albania preserves the right to intervene in the foreign exchange market if necessary, increasing its currency reserve and softening short-term currency fluctuations caused by the irregularities (e.g. seasonal effects) of the market. This stance has so far well contributed to macroeconomic stabilisation. For the future, tensions cannot be excluded between the implicit inflation targeting policy and the authorities' continued interventions on the foreign exchange market. Furthermore in case the fiscal restraint foreseen as of 2009 would not suffice to curb down current account deficits, it is also doubtful -in view of the high degree of euroisation and limited effectiveness of monetary transmission mechanisms -that monetary policy would be able to address external sector imbalances. In the policy mix, the onus thus remains on fiscal and structural policies to curtail external imbalances, supported by prudential policies of credit growth containment.

External sector

The external sector performance is expected to remain sustainable but it will be subject to several risks. The trade deficit relative to GDP is projected to decline gradually (from 20.1% in 2007 to 15.9% in 2010) owing to a foreseen sharp decline in imports growth. In view of the remaining high level of the trade deficit, and of the reliance of Albania on remittances to close a large share of this gap, it is regrettable that the programme did not include any projections of current account developments¹. Further discussion would also have provided useful insight on the sustainability of the savings and investment dynamics of the economy's current rhythm of growth. The current account deficit levels are expected to remain sustainable, provided the macroeconomic and the business environment remains sufficiently attractive for capital inflows. Current structural reforms contribute to the current favourable environment, but the authorities need to ensure irreversibility

¹ In the respective additional tables only the IMF projections were provided.

of the reforms. Foreign direct investment inflows are expected to remain relatively strong but other capital inflows will continue to constitute a relatively significant share. The Bank of Albania expects to maintain relatively large currency reserves (covering more than 4 months of imports), which appears achievable in view of the regular lek appreciation trend and the central bank's net selling position (for the lek) on the foreign exchange market.

The programme indicates that the Bank of Albania prepares regulations of capital account liberalisation in the medium term (the time horizon not specified) in the framework of adjustment to the *acquis communautaire*. The possible effects of further liberalising the capital account are however not discussed, which is regrettable given the magnitude of possible impacts on the real economy, in particular in some sectors such as real estate and construction.

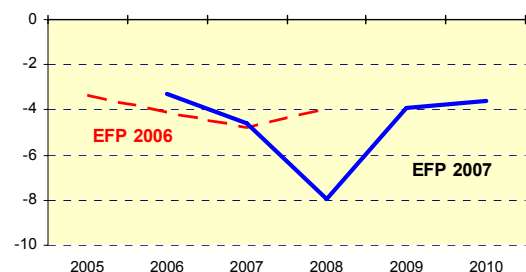
Main risks to the programme

The programme presents a rather optimistic but plausible macroeconomic scenario. Increasing global food and energy prices are however expected to inhibit both external and domestic demand and affect growth. The current turmoil in global financial markets may also affect the Albanian economy through higher interest rates, resulting from the increased uncertainty in global liquidity conditions. While a sharp increase in global interest rates could endanger economic growth, on the other hand increases in retail interest rates could help to contain the fast credit growth in Albania. The financial sector is expected to remain solid and the banks operating in Albania are not likely to suffer from losses in international sub-prime mortgage markets. In order to cope with possible unexpected macroeconomic developments the authorities need to follow prudent fiscal policies and continue with structural reforms, also building the financial sector buffers. A failure of the authorities to substantially improve the business environment would potentially affect FDI and the whole economy.

1.4. PUBLIC FINANCE

The fiscal framework of the programme is well integrated in the overall policy objectives and soundly based on the presented medium-term economic framework. The programme does not mention possible relations of its objectives with the Progress Report assessment or European Partnership priorities. The presented framework is coherent, consistent and relatively comprehensive, and to a large extent also influenced by the current IMF programme. The key measures on the revenues and expenditure side are well explained but not supported by quantitative estimates. The envisaged budgetary development is oriented to improving fiscal balances (except for the one-off effect of a large-scale infrastructure project in 2008). Fiscal risks are insufficiently analysed, with only some risks identified as being low (a more accurate account of risks is provided in the public debt section). The fiscal scenario is strongly based on anticipated successful results of structural reforms that are expected to favourably affect revenues. The programme does not provide any sensitivity analysis of the impact of changes to main assumptions on the fiscal position. Government statistics are compiled mainly based on the GFS 1986 methodology, differing therefore somewhat from the ESA 95 requirements. The programme does not explain any deviations.

Graph II.1.1: Budgetary developments
(general government balance, % of GDP)



The fiscal strategy foresees public revenues to increase slightly relative to GDP, with a decreasing role of the profit tax and customs revenues. General government expenditure is projected to remain at the level of 31% of GDP except for 2008 when a large-scale one-off

infrastructure project is planned. The general government budget deficit is projected to increase to 7.9% of GDP (recently revised to 5.2%) in 2008 and thereafter to decrease to below 4% of GDP in the following years (see chart 1). Public debt is projected to reach 56% of GDP in 2008, decreasing to 52% in 2010.

1.4.1. General government balances and debt

Actual balances and medium-term perspectives

The 2007 EFP projects a deterioration of fiscal balances in 2007 compared to 2006, the general government deficit reaching 4.6% of GDP in 2007, still 0.2 percentage points lower than projected in the 2006 EFP. Preliminary estimates suggest that the deficit remained below 4% of GDP in 2007 mainly due to underspending in capital expenditure. The budget revenues are projected to be 1.1 percentage points of GDP higher compared to the 2006 EFP. Higher revenues were supported by the introduction of the flat tax system on personal income and higher excise tariffs on fuels and alcoholic drinks, changes effective from 1 July 2007. Customs revenues are projected to decrease due to lowering the customs tariff to zero on imported vehicles, but also due to a reduction of customs duties resulting from WTO and SAA commitments. Additionally, changes were introduced in national taxes and local taxes, the net effect of which is projected to remain modest on the budget in 2007. The budget expenditures are projected to increase somewhat less than the revenues, the main increasing components being higher expenses on personnel and on social and health insurance compared to the 2006 EFP. The capital expenditures are also projected to increase modestly, affected by the newly introduced procedures of public investment. Changes in the public debt management are projected to decrease expenditures on interests of domestic debt in 2007. The impact of a large one-off government subsidy to the national power utility is not discussed in the programme; the effect is expected to remain below one percentage of GDP. Overall, the programme lacks ambition as the margin of manoeuvre gained from increases in revenue is being used

mainly to increase expenditure and only marginally to reduce the deficit.

For 2008, a further sharp deterioration of the fiscal balance is projected. The government budget deficit forecast for 2008 is 7.9% of the projected GDP in the 2007 EFP (recently revised to 5.2%), coinciding with the approved government budget for 2008. Budget revenues (as a ratio to GDP) are projected to remain at a level comparable to 2007 (26.4% of GDP, see Table 2), affected mainly by the reduction of profit tax (effective from 1 January 2008). The lower tax rate aims at extending a taxable basis and creating a more favourable business environment. Temporarily lower profit revenues are projected to be compensated by increased excise duties and higher local tax rates (effective since 2007), as well as improving revenue collection. Also, planned privatisations are expected to reduce revenues from public enterprises. For 2008, the expenditures are foreseen to increase by 2.8 percentage points of GDP to 34.3% of GDP mainly due to planned large scale infrastructure projects. According to recent information the government is now committed to cut down planned investments in 2008, in order to achieve a significantly lower fiscal deficit. In parallel, the EFP foresees that current expenditures will decrease slightly relative to GDP, as personnel costs and social and health care insurance costs are projected to return close to the level of 2006. Policy changes of reducing subsidies and increasing expenses of the local government, as a result of continuous decentralisation process, are expected to have relatively low impact on the consolidated budget. Infrastructure projects are planned to be financed partly by loans.

The government budget for 2008 is consistent with the planned one-off surge in capital expenditures. Increasing financing needs are foreseen to be covered mainly by foreign borrowing (public debt increasing by 2.55% of GDP). The projected increase in public investments is foreseen to be virtually neutral to domestic demand as large-scale infrastructure projects are being mainly implemented by foreign companies. The experience of recent years however raises doubts on the government capacity to implement such increases in projected public investments, and lower

expenditure outcomes are not excluded. Additionally, the plan to reduce subsidies is ambitious. In order to reduce the need for government support in public enterprises, the latter need to have a development strategy based on increased self-financing. An action plan is urgently needed especially in the case of the loss making power utility, notably by increasing tariffs to cost-recovery levels. In the 2008 adopted budget current expenditures are relatively contained, but in view of elections in 2009 the government will also need to resist to pressure to increase them. On the revenue side the tax administration needs to be strengthened further in order to ensure the projected collection. Public revenues also remain largely dependent on the overall economic performance, requiring a credible and sustainable policy mix.

In 2009–2010, the government expects to reap the benefits from a number of policy measures. The revenue collection is expected to improve and expenditures are projected to return down to below 2007's level (as a ratio to GDP). The budget deficit is expected to be reduced below 4% of GDP, with revenues reaching 27% of GDP and the expenditure down to 31% of GDP. The forecast appears broadly achievable, assuming a favourable macroeconomic environment and the successful implementation of reforms. After the expansionary stance of 2007–2008, the government will need to come back to a more conservative fiscal policy and continue with structural reforms in order to promote a favourable business climate. The above-listed risks apply also in 2009–2010.

Fiscal risks are only briefly discussed in the submitted programme. The revenue risks of non-collection of taxes and the uncertainty of the recovery of profit tax revenues are considered to be low. Regarding the uncertainty of success of the respective reforms, the risks may be underestimated. Risks on the expenditure are not discussed.

Debt levels and developments

The public debt ratio is projected to fall gradually except for a one-off increase in 2008, reaching 52.4% of GDP in 2010, from 53.6% in 2007. This declining trend is due to a lower increase in net borrowing compared to the

foreseen GDP growth. Privatisation revenues are expected to decrease considerably after a peak in 2007, lowering to below 1% of GDP in 2009–2010¹, therefore the deficit will have to be mainly financed through public borrowing. Exchange rate risks to the public debt management are relatively low as 70% of the debt is denominated in domestic currency and 30% in foreign currency. The 2007 EFP foresees an increase of the share of the external debt compared to domestic debt, which may increase exchange rate risks, although it may reduce interest rate risk, as mentioned in the programme. Interest rate volatility risks are also foreseen to be reduced by increasing the share of long-term domestic debt (from the current 30% to 67% in 2010, relative to total domestic public debt).

Budgetary implications of major structural reforms

The programme does not provide any quantitative information on the budgetary impact of major structural reforms, except for the general aggregated data on the projected government budget. A net-effect of major structural reforms on the country's fiscal position is likely to be relatively small. The planned structural measures broadly address important structural weaknesses of the economy and therefore are likely to contribute to the country's growth potential.

1.4.2. Quality of public finances

The programme explains the government's policy to improve the quality of public finances, listing main revenue and expenditure measures. While budget execution has recently been broadly in line with plans, difficulties have occurred in implementing projected public investments. Tax administration is in the process of being improved, by extending the taxable basis (introducing a flat income tax rate) and improving revenue collection (including through offering better services for tax-payers). Additionally, the foreseen strengthening of management control and tax administration

¹ Revenues from the projected privatisation of the companies of strategic sectors are not included.

auditing are expected to improve public finances. The medium-term budget programming has identified priority sectors of public investments, thereby improving expenditure planning. Budget execution is expected to improve also after the adoption of new procedures as regards public investments.

The structure of public spending broadly supports economic growth; an increasing share – 20% in 2006, 29% in 2008 – of the budget is being spent on capital expenditure. The share of subsidies is low and decreasing, personnel costs are held at a pre-determined level relative to GDP. In the coming years, operating and maintenance expenditures are foreseen to increase, reflecting the government policy to refocus its activities on its core missions. Furthermore, local governments' expenditure is projected to increase both in absolute and relative terms, in line with increasing decentralisation. Recent tax changes and continuing improvements in tax administration represent essential efforts to reduce the share of the informal economy and ensure a sufficient revenue collection. Some of the main challenges for a more efficient use of public finances remain an effective tax administration, a downsizing of informal economic activity, more productive investments and an avoidance of populist expenditure.

1.4.3. Institutional features of public finances

The transparency and efficiency of the budgeting process has been improved gradually, extending the number of budget institutions involved in the medium-term budget programming. The recently adopted new organic law on state budget clarifies the identification of responsibilities of governmental institutions and sanctions, and strengthens the role of international standards of accounting. A more efficient collection of tax revenues is supported by newly introduced measures, including enhancing tax-related information and simplifying access to the relevant services. In the coming years a revenue collection is likely to benefit from the introduction of a flat income tax in 2007. Foreseen revisions of the current taxation legislation as well as its implementation are expected to increase a revenue collection by increasing transparency and reducing opportunities for tax evasion or corruption. Investments in tax administration are expected to be effective, increasing total fiscal revenues with limited public expenditure. The foreseen introduction of the framework for local governments' borrowing should be prepared very carefully in order to reduce risks to the sustainability of public finances in general.

Table II.1.2:

Composition of the budgetary adjustment (in % of GDP)

	2006	2007	2008	2009	2010	Change: 2007-10
Revenues	25.5	26.9	26.4	26.7	27.4	0.4
<i>of which:</i>						
- Taxes and social security contributions	21.6	22.7	22.9	23.4	24.0	1.3
- Other (residual)	3.9	4.2	3.4	3.4	3.4	-0.9
Expenditure	28.8	31.5	34.3	30.6	31.0	-0.5
<i>of which:</i>						
- Primary expenditure	26.0	28.7	31.2	27.5	28.0	-0.7
<i>of which:</i>						
Gross fixed capital formation	5.7	7.1	9.8	6.2	6.4	-0.8
Consumption	8.8	9.0	8.9	8.8	9.1	0.1
Transfers & subsidies	4.3	4.6	4.0	3.6	3.4	-1.2
Other (residual)	7.2	8.0	8.5	9.0	9.2	1.2
- Interest payments	2.8	2.9	3.1	3.1	3.0	0.1
Budget balance	-3.3	-4.6	-7.9	-3.9	-3.6	1.0
Primary balance	-0.5	-1.8	-4.8	-0.8	-0.6	1.1
Gross debt level	55.0	53.6	56.2	54.2	52.4	-1.2

Sources: EFP submission (actual data for 2006 and 2007 may differ), ECFIN calculations

1.5. STRUCTURAL REFORMS

The structural reform framework provided in the programme is relatively coherent, consistent and comprehensive. Reform commitments are broadly clear, but would have benefited from a more structured presentation. The identified structural reforms correspond to overall policy objectives and are consistent with the assessments in the Commission Progress Report and the European Partnership priorities; in the text however these linkages are not presented. The reforms aim at improving the business climate and fostering principles of free market economy, strengthening the authorities' administrative capacity, and decreasing informality of the economy. The reasoning for the choice of measures is relatively weakly presented; the programme focuses rather on listing these measures. Quantitative estimates of the measures' effects are not provided either (except for labour market measures); most of the measures are envisaged to be implemented throughout the programme period. The strategy is supportive to the fulfilment of the Copenhagen economic criteria and the overall policy-mix of the country, focusing on the main rigidities of the economy.

1.5.1. Structural reforms and European Partnership

The programme addresses all economic priorities of the European Partnership with Albania¹. However, several priorities would clearly benefit from a stricter or more detailed approach. The special emphasis on strengthening public finance management is welcome but is insufficient for the purpose of general fiscal consolidation especially in the light of a projected sharp deterioration of fiscal balances. Regarding the enterprise sector, the EFP signals the continuation of regulatory reform and privatisation of state-owned enterprises which should improve the business climate. However the programme does not provide any related action plans. This leaves a question as to whether and to what degree such reform measures will

actually be taken. Additionally, the issues of developing the infrastructure and in particular the energy supply are only broadly addressed despite of their key importance for a favourable business climate. Labour market reforms presented in the programme are likely to increase employment and to reduce informal economy; in addition to described professional trainings, supportive general education system reforms could have been presented.

1.5.2. Product and capital markets

Product and capital market reforms presented in the programme to a large extent correspond to the policy criteria listed in the European Partnership of Albania. One of the core reforms, regulatory changes for improving the business climate, is in a process of implementation and should contribute to a more favourable business environment in the coming years. Secondly, preparations for the privatisation of the remaining 'strategic' state-owned enterprises have been started; the programme however does not give any clear time schedules for this. The business climate should also benefit from improving competition conditions as a result of the Competition Authority's increasing administrative capacity. A revised institutional framework of public procurement and a strengthening the relevant authorities' administrative capacity are likely to facilitate public investments in Albania. As the main legislative changes are already in force, the focus will be on the measures' implementation in the coming years.

The presented reforms appear broadly adequate. The efficiency of the measures will depend largely on their implementation and continuous enforcement. The budgetary costs and benefits of the reforms are not quantitatively presented but are reflected in projected higher fiscal revenues of the programme, especially after 2008. As regards the restructuring of the state-owned power utility and privatisation of its distribution arm, the implementation and finalisation of the reform remains unclear. The uncertainty of the process affects directly the business environment and thereby does not eliminate a continuous risk to public finances.

¹ Council Decision (2008/210/EC) of 18 February 2008 (Official Journal L80/1 of 18. February 2008)

Capital market reforms address mainly efficiency and supervisory issues in the banking sector. The measures for increasing the financial market's efficiency (planned to be adopted in 2008) are expected to reduce financial risk (law on repos, legal framework of transactions) and increase competition (extension of investor base). The introduction of a credit register at the Bank of Albania in the beginning of 2008 is likely to improve transparency in the credit market thus contributing to containing risks. The recent law on banks (adopted in June 2007), focusing rather on administrative than fundamental revisions, brings legislation closer to European standards and improves transparency in the banking sector.

1.5.3. Labour market

Labour market reforms remain highly relevant in Albania especially due to relatively high unemployment rates (above 13%) and a large share of informal economic activities. The programme foresees the continuation of a number of current labour market measures and presents numerical objectives, e.g. higher employment rates and an increased number of vocational training participants. The measures are likely to be effective, addressing also the respective medium-term criteria of the European Partnership of Albania (employment and vocational training, women inclusion). The programme focuses on the extension of current measures. The adopted or foreseen legislative changes seem to support current developments rather than introducing major changes. The impact of planned employment policies on the government budget is foreseen to be relatively limited (below 0.2% of GDP). Unemployment allowance expenses should remain limited, despite of an increase in the allowance, effective from January 2008 (in parallel with an increase in minimum salary). Social insurance expenditures are also projected to remain at the current level (6% of GDP).

1.5.4. Other reform areas

Other reforms discussed in the programme focus on the administrative capacity of the government and the judicial system. The undertaken and foreseen reforms correspond broadly to the priorities listed in the European Partnership of Albania. The revision of the organisational

structures according to the functions of public entities, and creating systems for effective use of human capital with respective compensation policies, are likely to contribute to strengthening administrative capacity and public-sector governance. Regarding the reforms in the judicial system, the programme does not cover some (non-economic) priorities mentioned in the Partnership (e.g. witness protection or coordination between prosecutors and police).

The reforms need to be accomplished carefully, with real effects on the administrative capacity. The reform process is planned to continue in the coming years supporting the implementation of commitments made under the Interim Agreement and the Stabilisation and Association Agreement. Budgetary impacts of the reforms are not discussed in the programme. The foreseen salary increase of public administration (including in the judiciary) has to be limited in view of the planned ceiling of total governmental personnel expenditures.

2. BOSNIA AND HERZEGOVINA

2.1. SUMMARY AND CONCLUSIONS

In December 2007, Bosnia and Herzegovina (BiH) submitted to the European Commission a Memorandum on the Budget and Economic and Fiscal Policy for the year 2008 with projections for 2009 and 2010. The programme covers the period 2008-2010 and aims at consolidating public finances, including a significant reduction of the share of the general government budget in GDP. The programme broadly complies with the content, form and data required, but in general its objectives are not adequately backed by concrete policy measures. In addition, several required data are missing. Nonetheless, the programme is very useful as a policy making tool and in some respects represents an improvement in comparison with the previous one.

The 2007 EFP estimates real GDP growth to have been around 6.1% in 2007, close to the 6.2% recorded in 2006. Economic growth is expected to further accelerate to 6.5% in 2008 and remain strong at around 5.5% in 2009 and 2010. Domestic demand is foreseen to become the main driver of growth, as the contribution of net exports turns negative. The growth scenario is plausible, although with clear downside risks for 2008, and chances for a better than expected performance towards the end of the programme period. The downside risks for 2008 derive primarily from the impact of the projected slowdown of the global economy as a result of

the recent financial turmoil. The inflation, labour market and external sector projections seem optimistic, but overall the macroeconomic scenario supports relatively well the fiscal objectives of the 2007 EFP.

The public finance scenario gives a good overview of the country's fiscal targets for 2007-2010, the envisaged improvement of fiscal coordination among the main stakeholders and the identified risk factors. The document presents for the first time a consolidated fiscal framework for the country. It loses in terms of comprehensiveness by not presenting the individual fiscal frameworks of the main entities and the state budget. As a result, the key measures on the revenue and expenditure side are not sufficiently explained. In line with the European Partnership Priorities and the findings of the Progress Report, the 2007 EFP plans a significant improvement in the quality of public finances. Its general intention is however not backed by concrete policy measures or a convincing track record. In addition, the 2008 adopted budgets seem to diverge from the depicted trends. The planned fiscal consolidation occurs only in the last two years of the programme period after a significant relaxation projected for 2007. Significant fiscal pressures arise from the settlement of domestic contingent liabilities, the large commitments taken on social spending and public wages and the costs associated with the creation and strengthening of state-level institutions.

Table II.2.1:

Macroeconomic developments

	2006	2007	2008	2009	2010
Real GDP (% change)	8.3	6.1	6.5	5.5	5.5
<i>Contributions:</i>					
- Final domestic demand	1.3	10.4	8.2	7.2	6.2
- Change in inventories	-1.1	-0.1	-0.1	-0.1	-0.1
- External balance of goods and services	8.1	-4.2	-1.7	-1.7	-0.7
Employment (% change)	n.a.	4.8	4.7	4.5	4.4
Unemployment rate (%)	31.1	29.0	n.a.	n.a.	n.a.
GDP deflator (% change)	6.00	1.80	1.50	1.60	1.60
CPI inflation (%)	6.1	1.9	1.9	1.8	1.7
Current account balance (% of GDP)	-9.9	-13.4	-14.0	-14.9	-14.6

Source: EFP 2007 submission (actual data for 2006 and 2007 may differ)

The structural reform agenda is in general supportive for the fulfilment of the Copenhagen economic criteria and broadly follows the findings of the Progress Report. More emphasis on the necessary improvement of the business environment and attracting foreign direct investment would have been beneficial, as well as, in particular in the Federation, better defined objectives and timetables for the implementation of reforms. In certain areas, the programme could have underlined more specific policy measures that can be realistically implemented over the programme period rather than only describe longer-term objectives for institutional reform. The programme hardly provides any quantitative estimates of the effects of the reform measures envisaged.

2.2. INTRODUCTION

In July 2006, Mr. Almunia, Commissioner for Economic and Monetary Affairs, invited the potential candidate countries Albania, Bosnia and Herzegovina, Montenegro and Serbia for the first time to submit by 1 December, an Economic and Fiscal Programme (EFP) to the European Commission. The EFPs are a further step towards an increased policy dialogue on economic and fiscal issues between the authorities of the potential candidate countries and the European Commission. This is a yearly exercise and the programmes are assessed by staff of the European Commission. The scope and content of the EFP is similar to the Pre-accession Economic Programme (PEP) which is submitted each year by candidate countries, although the EFP is somewhat more limited in scope. By 1 December 2007, all potential candidate countries, including Bosnia and Herzegovina had submitted their EFPs to the European Commission.

The 2007 EFP of Bosnia and Herzegovina covers the period 2007-2010 and was submitted to the Commission within the requested deadline. The programme was adopted by the Council of Ministers of BiH, being regarded as a key document on the path towards European integration. The programme's fiscal framework was drafted by the Ministry of Finance and Treasury of BiH (state level) on the basis of the data submitted by the entity Ministers of Finance

which have prepared individual budget framework papers for the period 2008-2010. The budgets adopted for 2008 seem to diverge from the budget framework papers 2008-2010 on which the 2007 EFP was based, particularly in terms of levels of revenue and expenditure.

The programme broadly complies in terms of content, form and data with the requirements stated in the outline for the 2007 EFP, albeit further improvements are necessary. The general objectives need to be more adequately backed by concrete policy measures, whose economic or fiscal impacts should be quantified to the largest extent possible. In several areas, the programme should have focused more on specific policy measures that can be implemented at the existing level of competences within the programme period. Although progress was achieved in providing the required data, some of the tables were missing or not filled in properly.

The EFP provides a fairly coherent macroeconomic framework, with plausible projections for economic growth, although clear downside risks exist for 2008. The foreseen structural reforms are broadly adequate, but the overall strategy is sometimes unclear. In many instances more concrete commitments and timetables would have been necessary, as well as an increased focus on the improvement of the business environment. The programme aims primarily at improving the quality of public finances, by reducing the share of public expenditure and revenue in GDP and restructuring the spending side towards growth enhancing categories. However, this is not backed by concrete policy measures or a convincing track record. The planned fiscal consolidation is back loaded to the last two years of the programme period, while a sizeable fiscal relaxation is projected for 2007. The external public debt is relatively low, but a settlement of remaining domestic claims in line with the repayment capacity of the budget remains an important challenge in the near future.

2.3. ECONOMIC OUTLOOK

2.3.1. Recent macroeconomic developments

In 2006, real GDP growth accelerated from 3.9% in the previous year to 6.7%, driven by a notable rise in net exports. Government consumption picked up on the back of strong fiscal revenues after the introduction of the value-added tax (VAT), while private sector consumption decelerated. Economic activity grew strongly in sectors such as manufacturing, wholesale and retail trade, tourism and financial intermediation. Industrial output expanded by 7.5% in the Federation of Bosnia and Herzegovina (Federation) and by 19.1% in the Republika Srpska (RS), led by the manufacturing sector. In 2007, economic activity remained robust in the manufacturing sector where output grew by 13.8% in the Federation and decelerated to 4.1% in the RS, but declined in the utilities sector, lowering the growth of total industrial output to 9.1% in the Federation and 1.4% in the RS. Real GDP was likely to rise again by around 6% in 2007 on the back of a strong increase in domestic demand, witnessed inter alia by a widening of the current account deficit.

After having narrowed from 18% of GDP in 2005 to 8.4% of GDP in 2006, the current account deficit was set to widen again in 2007 by around 5 percentage points of GDP. The wide swings in the current account deficit are largely due to a one-off factor – VAT introduction, which led importers advance their imports from the first quarter of 2006 to the last one of 2005. Net FDI grew to 5.8% of GDP in 2006 and surged to around 14% of GDP in 2007 on the back of large privatisations, more than fully covering the current account deficit. Inflation which had picked-up to 6.1% in 2006 as a consequence of the introduction of the VAT receded significantly within the first three quarters of 2007. Following a severe increase in food prices, end-of-year inflation picked up to 4.9%, but the average growth of CPI remained subdued at 1.5% in 2007. The labour force survey reported a modest decline in the unemployment rate to 29% in April 2007 from around 31% a year earlier, while the recorded participation rate remains quite low at around 44% of the working age population.

The 2007 EFP provides a fairly comprehensive and up-to-date overview of recent macroeconomic developments at the time of submission. The programme describes well the underlying economic trends in both 2006 and 2007 and several projections for 2007, including those of real GDP growth and current account deficit, appear to be fairly accurate and in line with DG ECFIN estimates. The analysis of economic activity from the demand side of national accounts is less coherent, probably also due a lower reliability of statistical data. In this context, it is worth mentioning that a real GDP growth rate for 2006¹ is being used that is higher than the official one, probably in order to have a starting point for the projections of GDP's components by the expenditure approach. The late 2007-early 2008 pick-up in inflation mainly due to substantially higher food and oil prices is not recognised by the programme and the information on the developments of labour productivity and unit labour costs could have been more detailed. The programme also fails to explain the deviations of actual developments from estimates presented in the previous EFP (Table 5 is missing).

2.3.2. Medium-term macroeconomic scenario

The external outlook on which the programme is based is reasonable, although not fully in line with the Commission's external assumptions, as revealed in the autumn forecast. The main difference pertains to the real GDP growth rates for EU-27, which the 2007 EFP assumes to be substantially lower in 2007 and somewhat higher in the following year, generating a likely upward bias for the country's economic growth rate in 2008. Another meaningful difference refers to a much lower price of oil assumed by the programme, thereby increasing downside risks.

The macroeconomic scenario is fairly coherent, despite some weaknesses in terms of consistency and comprehensiveness. The description of the

¹ The Agency for Statistics of Bosnia and Herzegovina (BHAS) reports that real GDP grew by 6.7% in 2006. The higher growth rate of 8.3% stems from a recent attempt to calculate GDP from the expenditure side, which the BHAS qualifies as "experimental compilation – preliminary data".

drivers of economic growth is not entirely correlated with the figures presented in table 1a. In addition, the fiscal assumptions of the macroeconomic framework differ from the programme's mid-term fiscal scenario. The outlook for the external sector is briefly described, but the more detailed projections of sectoral balances in 2008-2010 are missing from table 1d. The programme would have benefited from the presentation of alternative macroeconomic scenarios, although the presented framework appears to be fairly plausible, despite downside risks for the 2008 growth projection.

Real sector

The 2007 EFP is based on a scenario of relatively robust economic activity. Real GDP growth is expected to remain strong at 6.1% in 2007, further accelerate to 6.5% in 2008 and subsequently decelerate to 5.5% in 2009 and 2010. Domestic demand is foreseen to become the main driver of growth as the contribution of net exports turns negative over the programme period. Gross fixed capital formation is recovering from the decline recorded in 2006 and grows above the GDP's real rate of change. On the supply side, industrial production is expected to grow at annual rates between 8 and 10%, driven by the implementation of new capital projects in infrastructure and energy and on-going investments in expanding the capacity of the existing processing units. The gross value added generated in agriculture will rebound in 2008 and 2009, following the decline in 2007 caused by the drought, while output in the construction sector will peak in 2007 and slow down in the following years. Employment is projected to increase by around 4.5% on average during 2007-2010, while the unemployment rate would drop significantly. Labour productivity is projected to increase by 7.3% in 2007 and decelerate within the 2-4% range during 2008-2010, remaining however above the wage growth rate.

The programme's economic growth projections are plausible and do not deviate significantly from the estimates of the Commission or other IFIs. A more accurate alignment of the programme's external assumptions with the Commission's autumn forecast, whose

projections are reinforced by the recent developments of the world economy and financial markets, would have probably resulted in a slightly different growth scenario. A lower growth rate in 2008 would probably be compensated by a faster economic pick-up in 2009-2010, view also supported by the programme's main assumption regarding the accelerated implementation of structural reforms during 2008-2010. The expected labour market improvements appear to be somewhat optimistic, given the significantly lower average growth rate of employment in 2006 and 2007 in comparison with the projections in table 1c. The programme also does not bring forward convincing arguments for the projected large decline in the unemployment rate. Finally, the growth of labour productivity, which appears to be overestimated for 2007, does not exceed the projected increase of real wages during 2008-2010 (according to data in table 1 c), contrary to one of the programme's assumptions.

Inflation

In constructing the 2008-2010 inflation scenario the programme starts from the correct assumption that preserving the currency board against the euro would "peg" inflation in BiH to the one projected in the Euro Area, except for the deviations triggered by factors which are outside of the monetary policy environment. Later, these factors are deemed to result in a lower level of inflation in BiH compared to the Euro Area, by mainly assuming that the high level of unemployment would foster a reduction of the unit labour costs through labour productivity growing above wages. However, this seems unlikely for several reasons. First, the evolution of labour productivity and real wages in 2007 and the projections for 2008-2010 from table 1c do not support the argument of falling unit labour costs. Second, there are other factors among which the Balassa-Samuelson effect, the on-going fiscal relaxation and increase in aggregate demand, the high credit growth and further expected hikes of administered prices which would argue in favour of a higher increase in inflation in BiH than in the Euro Area. In conclusion, considering also the recent surge in inflation and the programme's optimistic assumptions on the price of oil, the projected

inflation rates declining from 1.8% in 2008 to 1.5% in 2010 (table 1.6) do not seem realistic.

Monetary and exchange rate policy

Bosnia and Herzegovina has pegged its domestic currency to the euro under a currency board arrangement, which has functioned smoothly since 1997. The programme expects the current monetary and exchange rate policy framework to remain in place over the medium term. As the nominal exchange rate is fixed against the euro, the evolution of the real exchange rate is determined by the inflation or unit labour cost differentials vis-à-vis the euro area. By projecting lower inflation and declining unit labour costs, the programme implicitly assumes a slight depreciation of the real exchange rate against the euro, whereas the trend of the past two years has indicated a slow appreciation. It would have been beneficial if the programme had also assessed the dynamics of credit growth in light of the recently announced increase in reserve requirements which is also likely to have an impact on aggregate demand in the coming years.

External sector

In comparison with the 2006 EFP, the current programme provides a more comprehensive scenario for the evolution of the external sector. In addition to the information on the trade balance, i.e. growth rates for imports and exports of goods, it includes projections of the current account deficit and a very brief assessment of developments in the balance of services, income and current transfers. However, as in the previous EFP, estimates of the external balances are not provided (table 1 d is missing) as well as of the capital account developments.

The current account deficit is projected to have increased to 13.4% of GDP in 2007 from 9.9% of GDP in 2006 (subsequently revised downward to 8.4% of GDP). This is mainly the result of a widening of the trade deficit by around 22% from 2006 to 2007, as exports decelerate significantly in 2007 while imports gather speed again. The widening of the current account deficit is projected to slow to around 14-15% of GDP in 2008-2010, primarily due to a deceleration of imports. The medium-term

scenario seems to be somewhat optimistic, given the estimated robust increase in domestic demand over the period and the acceleration of capital investment projects, which would require significant imports of equipment and raw materials. The assumed improvement in the terms of trade (Table 1b) may not take place given the ascent of energy prices over international metal prices. At the same time, the implementation of new trade agreements cannot be regarded only as increased opportunities for exporters, but also as potential incentives for growing imports if the foreign goods have a competitive advantage.

Main risks to the programme

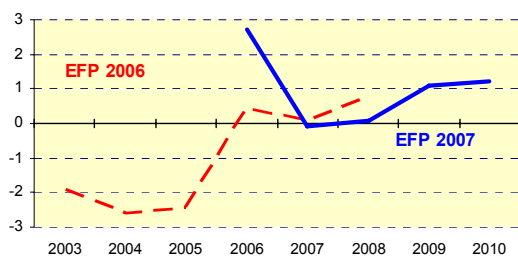
Overall, the programme is based on an economic scenario that given the worsening international environment appears now rather optimistic for the year 2008. The main risks to the programme might ensue from further price increases of energy and commodities or from declining external demand following the projected economic slowdown on a global scale. The risks of contagion from the "sub-prime" financial crisis appear to be limited so far, particularly in light of the improving structure of external financing towards non-debt creating capital flows. In addition, the banking system is subject to fairly strict regulations regarding the currency and maturity mismatches that the banks are allowed to engage into. A possible deterioration in financing conditions as an effect of the global credit-crunch could help decelerate the relatively high credit growth, but may also impact negatively domestic growth. On the other hand, the 2006/2007 slippage in fiscal policies which undermines external competitiveness through wage pressures and reduced investor confidence raises concerns as to the sustainability of the current fiscal path.

2.4. PUBLIC FINANCE

The 2007 EFP presents for the first time a consolidated fiscal framework for Bosnia and Herzegovina, which represents an improvement compared to the previous programme. At the same time, the current programme leaves out the presentation of the individual fiscal frameworks of the main entities and the state budget, which

would have facilitated the interpretation of developments, as well as the explanation of the key policy measures and their impact on the budgets. As a consequence, the main weakness of the programme relates to its very scarce description and quantification of the fiscal and other structural reforms on which the fiscal targets are based. The fiscal objectives of the programme are very closely linked to the European partnership priorities and the findings of the Progress Report, but their achievement is questionable given the insufficient explanation of the implementation policies and current fiscal developments. Fiscal risks are being identified in a broadly adequate way and data was processed in order to comply with the GFS 2001 accounting standards (although the methodology is not fully harmonised between the various budgets), representing a good starting point for the transition to ESA 95.

**Graph II.2.1: Budgetary developments
(general government balance, % of
GDP)**



The fiscal part of the 2007 EFP envisages a gradual but significant reduction of the share of revenue and expenditure to GDP of around 4 percentage points from 2007 to 2010. This would be achieved by restructuring the expenditures for social transfers and public sector wages towards spending items which stimulate economic growth. On the revenue side, the projected decline is triggered by a reduction of the share of revenues from indirect taxes. Although the programme claims that a fiscal consolidation is planned for the period 2007-2010, it appears that an improvement of the general government balance will only take place in 2009 and 2010, after a significant relaxation of about 3% of GDP in 2007.

2.4.1. General government balances and debt

Actual balances and medium-term perspectives

The 2007 EFP's budgetary target for 2007 deviates only marginally from the previous year's EFP, but the starting point differs considerably due to the better than projected revenues in 2006. As a result, in comparison with 2006, when a surplus of 2.9% of GDP was recorded, fiscal policy was relaxed in 2007. The magnitude of this relaxation may however turn out to be lower than the current estimated one (i.e. 3% of GDP), as the programme's projected budget deficit of 0.1% of GDP seems conservative and the budget execution could actually end up with a surplus in 2007.

After a robust increase in revenues by around 3% of GDP in 2006 on the back of the introduction of VAT, a significant deceleration of revenues from indirect taxes was expected in 2007. This less optimistic scenario did not materialise, mainly due to lower than expected VAT refunds and higher customs revenues. The collection of revenues from indirect taxes was high in 2007, growing at an annual rate of about 13%. However, the budget execution for the first nine months of 2007 also shows that expenditures for social transfers and public sector wages increased significantly. The increase of the public sector wage bill was high in both entities, at around 24% y-o-y in the RS and 20% in the Federation, while social benefits increased by around 24% y-o-y in the Federation over the same period. It is difficult to assess whether the programme's fiscal target for 2008 is fully in line with the target set in the 2008 budget, given the decentralised budgetary process in BiH. Nonetheless, the budgets adopted for 2008 seem to diverge from the budget framework papers for 2008-2010 on which the 2007 EFP was based, particularly in terms of levels of revenue and expenditure.

According to the programme, both revenue and expenditure are likely to decline by 3.4% of GDP and 4.5% of GDP respectively from 2007 to

2010¹. The decline in revenues is driven by a reduction of the share of revenues from indirect taxes in GDP, while revenues from direct taxes are expected to grow at the same pace as GDP. Indeed, the signature of the Stabilisation and Association Agreement and the gradual elimination of customs fees between the EU and BiH will lead to a reduction of customs revenues, but in the absence of any announced change in indirect tax rates it is less clear why the other indirect revenues should decline so strongly as a percentage of GDP, despite a likely increase in VAT refunds in 2008. This is somewhat counterintuitive given the better than expected performance of VAT revenues in 2007 (after the exceptional 2006) and the growth pattern for 2008-2010 based on a robust increase in consumption and domestic demand. On the other hand, the changes in the direct taxation framework which are quite substantial both in the RS (in 2007) and in the Federation (in 2008 and 2009) are hardly discussed while they may have a significant impact on revenue collection.

On the expenditure side, no concrete measures are mentioned regarding the projected decrease

of the social transfers and public sector wage bill, while both categories grew strongly in 2007. In addition, the 2008-2010 budget framework documents envisage further increases in the public sector wage bill in the RS by around 16% in 2008 and smaller ones at the State level, while the draft state wage law and the proposed changes of the minimum wage in the Federation would maintain this trend. In February 2008, public sector wages increased significantly in the RS, however this was to a large extent an accounting effect determined by changes in the legislation on the calculation of salaries. With respect to transfers, increases in agricultural subsidies and further hikes of war veterans' benefits and of pensions seem inconsistent with the targeted reduction of social transfers and subsidies. In conclusion, the projection of revenues seems conservative and the actual outcome may surpass the programme's estimates, but the envisaged decline in expenditures is less realistic given the lack of concrete policy measures and of a convincing track record, or even in comparison with the 2008 adopted budgets. In this context, the projected budget targets appear somewhat optimistic for the period 2008-2010, particularly as the fiscal consolidation is expected to take place only towards the end of the programme period, in 2009 and 2010. Eventually, even if the

¹ The figures provided differ from the historic IMF data primarily due to the non-inclusion of foreign-financed capital spending.

Table II.2.2:

	Budgetary adjustment (% of GDP)					Change:
	2006	2007	2008	2009	2010	2007-10
Revenues	41.0	41.4	39.9	39.0	38.0	-3.4
<i>of which:</i>						
- Taxes and social security contributions	35.6	34.9	33.5	32.8	31.9	-3.0
- Other (residual)	5.4	6.5	6.4	6.2	6.1	-0.4
Expenditure	38.3	41.5	39.7	38.0	37.0	-4.5
<i>of which:</i>						
- Primary expenditure	37.8	41.0	39.2	37.5	36.5	-4.5
<i>of which:</i>						
Gross fixed capital formation	2.0	4.0	3.6	3.5	3.5	-0.5
Consumption	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Transfers & subsidies	13.1	13.6	12.9	12.2	11.8	-1.8
Other (residual, incl. consumption)	22.7	23.4	22.7	21.7	21.2	-2.2
- Interest payments	0.5	0.5	0.5	0.5	0.5	0.0
Budget balance	2.7	-0.1	0.1	1.0	1.0	1.1
Primary balance	3.2	0.4	0.6	1.5	1.5	1.1
Gross debt level	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: EFP submission (actual data for 2006 and 2007 may differ), ECFIN calculations

programmed fiscal balance can be achieved towards 2010, the size of general government is unlikely to be reduced –both on the resources and expenditure side- as foreseen in the programme and fiscal space will thus not have been achieved to the same extent.

The fiscal risks identified by the 2007 EFP are both of economic nature, such as an unsustainable increase in public debt following the settlement of domestic claims or an unexpected decline of revenues from indirect taxes, and of a more political nature, regarding the state-level cooperation in terms of strengthening central institutions and fiscal and economic coordination. Indeed, the settlement of domestic contingent liabilities appears as one of the most important fiscal risks. Another one relates to the fiscal pressure exerted by the creation and strengthening of state-level institutions whose increasing fiscal cost needs to be better controlled and offset by savings in other areas. Additional risks stem from the need to raise the current levels of public capital spending in order to match the decreasing donor assistance for investments, the large commitments taken on social spending or public wages, transitional costs of pension reform if a second pillar is introduced or likely inappropriate set-ups of public-private partnerships. Strengthening fiscal discipline and coordination between the main stakeholders is also important for the long-term fiscal sustainability in the context of the currency board arrangement.

Debt levels and developments

The external public debt of Bosnia and Herzegovina is relatively low (below 20% of GDP at the end of September 2007) and has been declining in recent years. In addition, a large part of the debt stock was contracted on concessional terms, which explains the relatively low cost of debt servicing of about 0.5% of GDP per year. The World Bank is the largest creditor, accounting for more than half of the outstanding debt stock. Other important creditors are the Paris Club, London Club and the European Investment Bank. On the other hand, the settlement of domestic claims may increase the stock of public debt significantly in the next years. The 2007 EFP provides a good overview of recent developments concerning the

settlement of domestic claims, including the amount of liabilities resulting from the freeze – and de facto confiscation - of the population's foreign currency deposits under the former Yugoslav federation and war damages, which together are estimated in the programme at around 20% of the 2007 nominal GDP. This figure, which according to a preliminary verification of claims may actually be lower, does not include contingent liabilities stemming from the restitution claims for property confiscated during the socialist regime.

A settlement of outstanding domestic claims in line with the repayment capacity of the budget remains one of the most important fiscal challenges in the near future. A prudent stance is being facilitated by the adoption of debt laws in the Federation, RS and at the state-level which limit government borrowing by introducing sub-ceilings on the level of debt service relative to current revenue in the preceding year. The programme projects relatively stable interest expenditures at around 0.5% of GDP from 2008 to 2010. It is however not made explicit how this cost can be kept at such levels, given that the cost of external debt is expected to increase once the current loan agreements on concessional terms are replaced by more expensive debt and the interest payments on the new domestic debt commitments will start kicking in.

Budgetary implications of major structural reforms

The programme does not provide a clear picture of the impact of structural reforms on the country's fiscal position. The matrix of policy commitments (annex 3) was not filled in and some important structural measures in the field of taxation, privatisation or enterprise restructuring are not properly described or quantified. For example, the budgetary impact in the RS of the 2007 reform of personal income taxation and reduction in corporate taxation should have been assessed. At the same time, the programme would have gained in quality if the planned reforms of personal income and corporate taxation in the Federation had been properly explained, including an estimate of their budgetary and labour market impact. Similarly, the 2007 EFP does not discuss the management

and criteria for the use of privatisation receipts by both entity governments.

2.4.2. Quality of public finances

The programme provides only a brief overview of efforts made to improve the quality of public finances in the areas of budgetary planning and the composition of public spending. With the aid of foreign technical assistance, progress was made in the introduction of multi-annual and programme budgeting, but the 2007 EFP is not detailed enough on the extent to which the improved budgeting procedures have been implemented. On the other hand, it is more comprehensive about improvements made to the budgeting process, including a harmonisation of fiscal reporting in the country that should be brought into line with international standards, also a likely result of the adoption of the Law on the Fiscal Council of Bosnia and Herzegovina. An improved composition of public spending, where more resources are allocated for capital investments and less for government consumption and social transfers is one of the main objectives of the 2007 EFP. Together with the projected reduction in the relatively high share of public spending in GDP it should provide more space for the development of private sector activities and enhance the growth potential of the economy. However, as mentioned before, these objectives may not be achieved, notably as they are not adequately supported by well explained policy measures.

The efficient use of resources in the public sector represents a major challenge for the country, as revealed inter alia by the World Bank in its latest "Public Expenditure and Institutional Review". An inefficient use of resources was identified in particular in the public administration, education and health sectors and to a certain extent also in the area of social protection. The programme does not address these issues sufficiently, despite the fact that the gap between the large outlays in these areas and the more modest outcomes does not seem to close. The public sector wage bill rose fast in 2007 and further increases are expected in 2008, while its share in GDP is already higher than the EU-27 average and appears disproportionate in comparison with some of the new Member States. Meeting the challenges of institutional capacity building,

particularly in the context of the state building process, would require a better prioritisation of public expenditure and restraining spending at all government levels over the medium-term. Social transfers are also relatively high and the components which are means-tested for poverty reduction are crowded out by the war veterans' benefits which continue to grow quickly. The significant differences between the levels and dynamics of officially registered and survey-based labour data point to the existence of a fairly large and growing informal labour market. One of the main reasons is the excessive labour tax wedge which affects primarily the Federation. The programme mentions the legal initiatives to be in effect in the Federation as of 2008 in order to correct this problem, but the implementation seems to drag on. The reform of personal income taxation was postponed until 2009 and the reduction of the high social contribution rates as of 2008 is rather insignificant. On the other hand, the reform of direct taxation was finally adopted in the Federation and the corporate tax rate was cut from 30% to 10% as of 2008.

2.4.3. Institutional features of public finances

The fiscal architecture of Bosnia and Herzegovina derives from the federal state structures created by the Dayton Peace Agreement. Direct taxation is under the competence of the two entities and the autonomous Brcko District, while the 14 cantons of the Federation also enjoy a large fiscal autonomy. Indirect taxation was harmonised across the country and a common value added tax (VAT) was introduced on 1 January 2006, consolidating the creation of a single economic space. Indirect tax revenues are pooled in a common single account, but their sharing between the different sub-national levels remains a controversial issue, as a permanent allocation formula has not yet been found.

The authorities are aware of the fact that fiscal decentralisation in the context of sharing a single currency may encourage a free-rider behaviour with potentially destabilising effects for the currency board arrangement. The strengthening of fiscal coordination within the framework of the National Fiscal Council is endorsed by all parties involved. The 2007 EFP describes the

most recent developments for the adoption of the Law on the Fiscal Council. Both the RS and the Federation have forwarded draft pieces of legislation to the BiH Presidency and Council of Ministers, which only differ with respect to the method of financing the National Fiscal Council and which would constitute an important step towards developing a coordinated fiscal framework. The programme expects an adoption of the law in early 2008. In the economic dialogue with the country and in the European Partnership Priorities, the Commission has recommended an improvement of fiscal coordination in the country by combining institutional cooperation with the adoption of fiscal rules. Institutional cooperation in the National Fiscal Council could address primarily issues related to the allocation of indirect tax revenues from the single account, setting budgetary targets, financing of the joint state institutions and agreeing common internationally accepted standards for a transparent budgeting process. In addition, the adoption of fiscal rules would ensure the necessary fiscal discipline without being constrained by the more intricate cooperation mechanisms.

2.5. STRUCTURAL REFORMS

The 2007 EFP covers a broad range of structural reforms in the enterprise and financial sectors, labour market, public administration and the pension systems. More attention could have also been devoted to on-going or planned reforms in the education, health, judiciary or social welfare sectors. The presentation is largely descriptive and the agenda is vague on the overall strategy in certain areas. In most instances, the reform plans are not backed by concrete measures, commitments or timetables for achieving the policy objectives. As a result, the programme very rarely provides quantitative estimates of the effect of the reform measures envisaged. The relation between the structural reform agenda and the fiscal strategy is hardly elaborated and annex 3 containing the matrix of policy commitments was not provided.

2.5.1. Structural reforms and European Partnership

In general, the reform strategy is supportive for the fulfilment of the Copenhagen economic criteria and broadly addresses the economic priorities under the European Partnership¹ and the findings of the Progress Report. Improving the quality of public finances, adopting the Law on the National Fiscal Council, privatising state-owned enterprises, optimising corporate governance, better performing labour markets and reforming the pension systems are all policy objectives described in the 2007 EFP. However, increased focus on the improvement of the business environment and attracting foreign investment would have been necessary, as well as on restructuring the network industries. Also, more concrete objectives and timetables for the acceleration of the privatisation process, restructuring and the liquidation of loss-making enterprises, in particular in the Federation, would have been welcomed. In a similar vein, the reform commitments to reduce structural rigidities on the labour market, the main reason for the high unemployment rates, appear to play only a secondary role on the reform agenda.

2.5.2. Product and capital markets

The programme presents several reform areas related to the functioning of product markets, such as the continuation of enterprise privatisation and restructuring, strengthening corporate governance and state aid control, and SME development. Judging by the number and importance of the companies listed for privatisation, the privatisation agenda in the Federation appears to be more ambitious than in the previous programme. However, when the programme was drafted the privatisation plan was not yet confirmed by the Federation Parliament. An overview of the amount of capital privatised so far, including clear commitments for the remaining capital and the envisaged timetable to finalise the process is missing for both entities. Equally important, the restructuring of state-owned enterprises is hardly mentioned while the liquidation of the loss-

¹ As adopted by the Council of the European Union on 18 February 2008 under reference number 5349/08.

making ones is only briefly discussed for the RS. The programme fails to outline the reform plans in the utilities and network industries, albeit the strong need for further reforms in these sectors.

The programme describes somewhat briefly the financial sector reform plans, with more emphasis on the activities implemented in the RS, not only in the banking sector, but also in the leasing and insurance areas. Integrated supervision across all segments of the financial sector is presented as a possible option in the RS, while the programme is mute about envisaged plans in the Federation. A country-wide integration of banking supervision is also mentioned as an objective, but it remains unclear how it fits with plans in the two entities. Regardless of the future institutional set-up, the programme lacks information about concrete measures to improve the current activity of financial supervisors by strengthening their expertise or technical and regulatory capacity. In a similar way, an assessment of how risks are being managed in the rapidly growing financial markets (including the recent monetary policy changes of the CBBH) would have been very useful. Important projects, such as the recent setting-up of the domestic inter-bank money market and other plans to develop financial markets or finalise privatisation in the financial sector would have also deserved some attention.

2.5.3. Labour market

The programme enumerates several actions that would be needed in order to reduce the very high unemployment rate and encourage labour force participation, but which are not adequately linked either to planned or on-going policy measures. In addition, the programme focuses in particular on active labour market policies and institutional changes whose adoption does not seem to be straightforward, rather than on direct measures to increase the flexibility of the market. The weak labour market indicators that affect both the Federation and the RS and which relative to their size do not differ significantly between the two entities result primarily from the structural rigidities that distort both labour markets. Tackling the issues related to the high taxation of labour, relatively large and poorly targeted social transfers and the rigid wage-setting mechanisms represents a prerequisite for

a sustainable reduction of unemployment. These measures need to be complemented by active labour market policies, reforms in the education system that would address the current skills gap and enhanced labour mobility, as described in the programme, but more concrete measures and commitments are necessary. Therefore, it would have been useful if the programme had assessed the labour market impact of the personal income tax reform in the RS and the plans outlined in this area in the Federation, as well as other specific reforms that would increase the flexibility of the labour market.

2.5.4. Other reform areas

The 2007 EFP highlights two other reform areas, namely the reform of the public administration and of the pension system. The reform of the public administration plays an important role in improving the fiscal efficiency of the public sector and creating the structures capable of adopting and implementing the *acquis* in Bosnia and Herzegovina. The programme describes briefly the progress made in the implementation of the Public Administration Reform (PAR) strategy and the preparation of the second Action Plan. Besides the general objectives of these actions, a more detailed description of the specific areas to be improved and of the results achieved so far would have been welcomed.

Plans to reform the pension system are becoming more tangible as the RS intends to adopt relevant legislation in 2008 and the Federation will allegedly define its strategy in this area in the spring of 2008. Accelerating the pension system reform would come at the right time when the large privatisation receipts from the RS could be used to cover the financing gap of the early phases of the implementation process. In addition, the likely introduction of a mandatory capitalised pension system would reinforce the measures already taken to increase labour market participation in the formal economy.

3. MONTENEGRO

3.1. SUMMARY AND CONCLUSIONS

Montenegro submitted its second Economic and Fiscal Programme by end-November 2007. The programme, covering the period 2006-2010, has improved significantly since last year and the government intends to use the EFPs as budget memorandum in future. The current EFP formally complies with the outline provided by the Commission, though content coverage is sometimes unbalanced and data required some additional updates. The stated overall objective of the programme is to make Montenegro one of the best destinations for investments, with a view to foster economic development, improving living standards of its population and strengthening the rule of law. The document is consistent with previous strategic policy documents adopted by the authorities, and could become an essential support for aligning the future programme budget when implemented in 2009.

During the last two years the country has enjoyed a very rapid economic expansion above 7% in real terms, supported by a vast inflow of foreign direct investments (FDI), fast growing tourism and improved performance of the manufacturing industry. A prudent fiscal policy and higher than expected tax revenues have led to budget surpluses exceeding 3% of GDP and declining public debt to 32% of GDP by end-2007. However, the very strong expansion of lending, rapid growth of asset prices and rapidly growing wages have generated strong demand pressures boosting consumption and investments and inducing strong imports resulting in massive current account deficits over 40% of GDP in 2007. In addition, exceptional energy and food prices shocks in the second half of 2007 have pushed average annual inflation to 4.2% by year's end from 3% recorded in 2006. Risks ensuing from the difficult international environment are more pronounced than in last years' submission. Higher volatility of commodity prices may further weigh on the country's already high external imbalances and on inflation. The heavy reliance of Montenegro

on capital inflows in the financial sector and real estate development makes it more exposed than neighbouring countries to spill over effects from the current international financial crisis.

The programme's public finance scenario provides a good overview of past, present and future fiscal policy. The government has been loosening the fiscal stance. Nevertheless, fiscal policy has been fairly prudent and the budget recorded significant surpluses in the last two years. The EFP foresees that fiscal policy will continue to cut taxes, pay down debt and spend more in capital. The challenge for the medium term will be to maintain a prudent stance against emerging macroeconomic risks, despite large needs for nation-building and an ambitious national infrastructure programme. The not negligible fiscal risks are clearly identified and stem in particular from potential adverse developments in world trade and possible massive financing needs for infrastructures. The programme also expresses confidence in the stringent though limited monetary policy of the central bank, aiming at curbing credit growth and does not consider any particular risk from the high growth and levels of credit activity. Yet, previous experiences in other countries with credit growth have proven fairly ineffective.

The programme reviews the main structural reforms challenges. Main reform areas are the energy sector, to ensure adequate electricity supply for the expanding economy, raising flexibility and mobility on the labour market, the business environment, in order to enhance competitiveness and attract investments, privatisation, in order to limit liabilities and quasi-fiscal losses from public enterprises, and, finally, the pension system to alleviate pressure on public finances. Some sections of the institutional reform agenda are, however, quite general policy documents, without clarifying the economic objective and content of these and without proper estimates of savings and benefits of these reforms.

3.2. INTRODUCTION

In July 2006, Mr. Almunia, Commissioner for Economic and Monetary Affairs, invited the potential candidate countries Albania, Bosnia and Herzegovina, Montenegro and Serbia for the first time to submit by 1 December, an Economic and Fiscal Programme (EFP) to the European Commission. The EFPs are a further step towards an increased policy dialogue on economic and fiscal issues between the authorities of the potential candidate countries and the European Commission. This is a yearly exercise and the programmes are assessed by staff of the European Commission. The scope and content of the EFP is similar to the Pre-accession Economic Programmes (PEP) which are submitted each year by candidate countries, although the EFPs are somewhat more limited in scope.

Montenegro submitted the Economic and Fiscal Programme (the “2007 EFP”) on 29 November 2007. The programme has improved significantly over the previous first one. Henceforth, the government intends to use the EFPs as budget memorandum. The current EFP complies with the outline provided by the Commission. However, the analytical content varies over the different sections. The document presents a favourable macroeconomic outlook, including fiscal targets and projections of main macroeconomic indicators for the period 2008-2010, as well as some alternative scenarios. The EFP provides more detailed data than in the previous year, although the country still suffers from a weak statistical system, particularly for national accounts. Fiscal data are based on the IMF's GFS 2001 system while debt figures already follow allegedly the EU's ESA 95 accounting framework. The structural chapter is in general quite extensive, except for a few critical reforms (e.g. labour law). Overall, the EFP is in line with other policy documents¹, also addressing economic priorities highlighted in the European Partnership and in the last Commission's Progress Report.

¹ The Government's Economic Programme for 2008, the budget for 2008, the Economic Reform and Development Agenda (2007-2011), the National Employment Strategy (2007-2010), the privatisation plan for 2008, and the energy development strategy.

The key objectives of the 2007 EFP are to be achieved within balanced public finances. They are the following: a) promoting economic development by facilitating investments through the reduction of direct taxation and contributions to be replaced by indirect taxes, and the development of infrastructure; b) strengthening the rule of law by developing institutions and administrative capacity. This should be achieved by establishing new state agencies and making more attractive work conditions in the public sector, and c) improving living standards by enhancing the education, health and social protection systems. These will also require, apart from appropriate system reforms, additional investment in infrastructure projects. The fiscal space necessary to ensure the sustainability of all these investments will be provided by rising revenues and continuous restructuring of public debt with simultaneous resort to concessional loans from international financial institutions.

3.3. ECONOMIC OUTLOOK

3.3.1. Recent macroeconomic developments

Preliminary estimates for 2006 indicate a record-high expansion of the GDP above 8% in real terms. Tourism, construction and financial intermediation were the main driving factors of growth, especially during the second half of the year. In that year, macroeconomic stability was further consolidated. Annual average consumer price inflation reached 2%. Employment expanded by 4% while the unemployment rate fell below 15% at year end. The fast expansion of the economy was possible thanks to massive net FDI inflows (24% of GDP) accompanied by surging imports of goods and services. Despite a rapid growth of exports, the current account balance registered a deficit of 26% of GDP.

The programme estimates are broadly in line with preliminary data for 2007. The fast economic growth continued at 7.1%, driven by an excellent tourist season and strong domestic demand fuelled by soaring credit growth. Industrial production registered a marked contraction in the utilities sector while manufacturing recorded annual expansion by

9.3% year on year. Price stability was maintained during the first half of the year, but prices increased rapidly afterwards due to supply shocks (food and energy). Average inflation accelerated to 4.2% in 2007, while in December it peaked to 7.7% year on year. The labour market continued improving, with employment growing as in previous year. The unemployment rate decreased to 12% at year's end. Average real net wages rose by 15%, with above-average increases in public administration, construction and financial intermediation. The deficit in the trade balance continued to widen as imports of goods grew much faster than exports. The current account deficit surged beyond 30% of GDP, induced by strong FDI inflows along with rising foreign loans.

Overall, the programme provides a rather comprehensive economic overview despite some gaps in the data coverage where shortcomings in official statistics could not be solved.

3.3.2. Medium-term macroeconomic scenario

The baseline scenario foresees no significant external shocks during the forecasting period. The external outlook assumes a continuous expansion in tourism and related sectors at present growth rates and the increase of exports of goods driven by higher aluminium prices against the backdrop of the strong global demand for metals. The assumptions presented for the external environment also include higher global demand in volume and prices. Given the size of trade with Serbia, this section would have usefully also revealed the implicit assumptions on the exchange rate of the euro against the Serbian dinar.

The macroeconomic framework is coherent, though quite basic. Moreover, given the high level of foreign investments since 2005, an alternative scenario is also presented. The current programme uses a specific national macroeconomic model, developed by the Central Bank and Ministry of Finance. Like in the previous exercise, it also recurs to nominal values to estimate the growth of the main GDP components. Yet, it is expected a conciliation with the official data from the statistical office for future exercises, once they are available.

As in the previous exercise, Montenegro has presented a fairly prudent growth scenario. The outlook for inflation seems quite realistic. In particular, after the exceptional rise of electricity prices in 2007, future increases should be much more moderate. However, the programme rests on a continued very high inflow of foreign capital, counterbalancing current account deficits well above 20% of GDP over the entire programme period. In this context, it is clear that success in attracting foreign investments will continue feeding a high level of imports of this narrow and very open economy.

The policy mix proposed in the programme (of restrictive financial sector supervisory and fiscal policies), contains some risks. Previous experiences in neighbouring countries to limit credit growth have proven fairly ineffective. Montenegro does not seem an exception. With more than 80% of their banks owned by foreign capital, local branches may limit themselves to receive commissions for facilitating credits from the head office once the quota of loans fixed by the Central Bank is reached.

The main differences of the EFP 2007 compared with previous submission are a much more dynamic economic expansion due to an underestimated growth of the domestic demand, and the exploding deficit of the current account balance resulting from the unexpected surge of net FDI.

Real sector

The baseline scenario marks a different path after 2008. Beginning of the year a series of restrictive measures on credits should moderate lending activity and reduce private consumption. In addition, the 30% increase of public sector wages from beginning of the year should fade off in the coming periods. In 2009 and 2010 it is foreseen a moderate deceleration of GDP in line with further reduction of the aggregate demand but also due to declining investments (-3.3% per year on average). By contrast, the labour market should continue enjoying an annual average expansion of 3.4%, as a consequence of the completion of the privatisation process, the new and more flexible Law on Labour, lower contribution rates and the implementation of specific measures to reduce unemployment

below 9% rate by end-2010. Overall, the catching-up process should continue, with annual labour productivity growing by more than 3% annually on average.

The alternative scenario is similar to the baseline one, except for a higher inflow of net investments -and the corresponding broadening of the current account deficit- by additional 3.4 percent points on average per year. In this scenario, the influx of foreign loans will remain high. These will result in higher deficit of net exports along the increase in gross fixed capital formation. This scenario cannot be discarded given the upside volatility risks record in the recent past.

To cope with the lack of national accounts statistics, the programme recurs to alternative sources of information to provide a broad projection of macroeconomic developments. Hence, estimates for gross fixed capital formation are mostly based on FDI flows rather than physical investments. Moreover, investment growth does not make the part between the share of construction and equipment (critical given the fast growth of real estate sector and the fact that more than half of foreign investments are related to real estate, much of it residential and reinvested abroad). Additional information could also have included the increasing participation of foreign labour as supplementary growth factor and pointing to a tightening of the local labour market. Overall, growth estimates seem quite realistic as they are supported by hard data on surging tax collection and commercial transactions statistics.

Inflation

Given the small size of the economy, supply shocks on the energy and food markets are having a higher impact on the inflation than the surging domestic demand fuelled by the expansive credit activity, the revenues from sale of assets, rising employment and swelling wages. The programme foresees that inflation, after reaching a high peak in 2007, will decline as the effect of these shocks is disappearing and second round effects are not expected to materialise. The Central Bank administrative measures should reduce the rapid expansion of credit to households and therefore, the pressure of the

aggregate demand on inflation while preserving investments. The success of these measures will largely depend on the ability of borrowers to circumvent them by addressing foreign lenders. After 2008, a period of moderate prices (between 3% and 3.5%) should follow as domestic consumption aligns with much more moderated revenues, and foreign investments stabilise.

Monetary and exchange rate policy

The country's unilateral euroisation provides a very restricted scope for using monetary instruments. Interest rates follow international markets (i.e. EURIBOR) plus a risk premium, and monetary activities are currently focused on reducing the fast growing credit activity, notably to households. Until recently, the share of deposits had been continuously higher than credits, providing for a high degree of liquidity. However, lending is accelerating faster, surpassing deposits by end-2007. A series of measures should improve the financial stability of the system from 2008; notably, the adoption of a new Bank Law implementing Basel II principles and standards in the market. Moreover, commercial banks have been granted access to the credit register of the Central Bank, thereby improving the quality of their risk management. The share of bad loans is still low; yet a reversal of the economic trend could result in considerable rise in un-serviced debts. In addition, the coordination of these policies with a more restrictive fiscal one from 2009 should provide for the necessary space for reducing the current account deficit and better preparing for possible external shocks.

External sector

The scenario for the external sector focuses essentially on the trade balance and FDI, main factors shaping the current account performance. The baseline scenario assumes the absence of external shocks, and a slight downward trend of the large current account deficit to 24% of GDP by 2010. The expected reduction on domestic demand resulting from a restrictive credit policy should somewhat limit imports, given the still strong growth of investment and an expansive fiscal policy up to 2009. However, the services balance might improve more significantly. Indeed, tourism revenues have been rising twice

as fast as the number of visitors and this trend is expected to prevail in the medium term following massive investments in the sector. In 2007, revenues from services matched for the first time exports', and it may surpass them easily given current trends in tourism. On the other hand, transfers and capital income sub-balances should remain stable during the mid-term, recording small surpluses between 2% and 4% of GDP.

In the previous EFP, the components of the balance of payments were briefly, though systematically, reviewed one by one. By contrast, in the current edition the information has improved but it is scattered amongst several sections of the document. As in previous exercise, the development of imports seems systematically underestimated and exports of goods overestimated, while the opposite may apply to services and investments forecasts.

The main assumptions for the financial and capital accounts are based on an increasing share of foreign loans (above 6% of GDP) due to restrictions on domestic credit and a still high, but decreasing, rate of net FDI inflows covering the current account deficits. In the medium term, reserves of the Central Bank should grow by at least 5% per annum, while portfolio investments oscillate around very low 0.3% of GDP. For instance, and given the size of the economy, the sale and refurbishing of a luxury tourism resort or the building of a shopping mall may easily change estimates by 10% of GDP. Moreover, the completion of the privatisation process, including network industries, is planned to take place during the forecasting period. For this reason, an alternative scenario has also been established on the hypothesis of net investments inflows higher by 3% of GDP.

Main risks to the programme

The main risks to the programme might ensue from further increases of energy and food prices, a decline of international aluminium prices or weaker tourism revenues. A combination of those factors would affect growth and the external account's already high imbalances. In view also of the considerable current account deficit and capital inflows, risks of contagion from the international financial crisis are more

pronounced than in neighbouring countries and could particularly affect the local financial market and real estate investment, which have been booming in the past years. While credit growth has continued to expand, the banking system remains subject to fairly strict regulations, which were even recently reinforced by the adoption of a new legislative framework, broadly in line with the Basel II core principles for effective banking supervision. Yet, a possible deterioration in financing conditions as an effect of the global credit-crunch could help decelerate the very high credit growth.

3.4. PUBLIC FINANCE

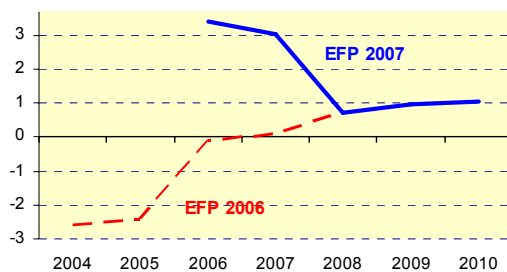
The fiscal framework foresees a further change of the composition of revenues by gradually increasing the share of indirect taxes while reducing direct taxation and contributions. So far, this strategy has proven very successful, as demonstrated by the surge from all types of revenues. The programme reveals that economic priorities listed in the European Partnership¹ are being carried out; notably, the integration into general government accounts of capital budget and extra-budgetary funds, or the implementation of medium-term budgeting. The current framework is quite comprehensive, well structured and more detailed than in previous exercise. Key fiscal measures are presented, yet quantitative estimates for some measures are missing or incomplete. The analysis of fiscal risks offers several very basic scenarios for macroeconomic, fiscal or debt risks without minimum common baseline indicators linking the three fields. Yet, it does not consider any risk from high levels of credit activity. Fiscal data is based on GFS 2001 accounting standards on a cash basis.

The pro-cyclical fiscal strategy of the government consists of taking full advantage of the current strong economic growth to finance the strengthening of the administrative capacity in the country, to invest in infrastructure projects and to reduce public debt. In a second phase, after 2008, it concentrates on the consolidation of

¹ Council Decision 2007/49/EC of 22 January 2007 (OJ L 20, 27.1.2007, p.16)

public expenditures except for capital investments, given the long-term nature for their completion. The revenue side will be characterised by the gradual declining of the tax wedge compensated by incomes from taxes related to consumption and contributions from a growing workforce. Overall, the budget should continue registering surpluses, even if more moderately than recorded in the past.

**Graph II.3.1: Budgetary developments
(general government balance, % of
GDP)**



3.4.1. General government balances and debt

Actual balances and medium-term perspectives

An unexpected and very strong growth of revenues characterised the 2007 budget execution, resulting in a record-high surplus above 8% of GDP. The strong acceleration of the economy and robust import expansion accounted for the higher than planned VAT collection, accounting for almost one third of the overall budget revenues. Additionally, the proceeds from corporate income tax also rose strongly above target, reflecting the improved performance of the real sector. Personal income tax collection also grew significantly by 14.8% year-on-year, despite the introduction of the reduced personal income tax, with a flat rate of 15%. By contrast, total spending grew at 16.7% year-on-year, to 47% of GDP. Spending for gross wages expanded considerably from 11.1% of GDP in 2006 to 14.5% in 2007. Transfers to state funds and local self-governments also increased, but moderately. The government decided to reallocate the budget surplus achieved until mid-October by revising the budget in order to further reduce foreign public debt by 8.3%,

raising wages of civil servants by 30%, and increasing capital expenses to 7% of GDP. Yet, by year's end the budget still recorded a surplus of 8.5% of GDP.

From 2008 the extra-budgetary funds¹ are integrated into the state budget, thereby improving the transparency and efficiency of the public finances. The final budget includes estimations of spending by regulatory bodies, but not for local self-governments neither the balances of the most important public enterprises. It will be a record large budget, as expenditure will reach around 50% of GDP. It targets very high capital investments of 8% of GDP. On the other hand, current expenditures should fall by 2% of GDP. Transfers to institutions and individuals will increase sharply due to methodological changes with the inclusion of several funds and other items (namely health and army staff) into the budget. However, there will be no more increases of the public sector wage bill as the government already adopted a decision to freeze the minimum income for 2008. From the revenue side, recent signs of cooling down of the real estate market and the reduction of custom duties could jeopardise revenues from these items. Yet, if the strong economic growth is maintained as foreseen, other taxes, contributions and some privatisation receipts should provide sufficient leeway to compensate for any shortcomings.

The strategy for 2009 and 2010 foresees continuing fiscal reforms by further reducing taxation in order to stimulate entrepreneurship and competitiveness. As a consequence, revenues from taxes and contributions are expected to decrease by 3.7% on average each year. However, consolidated expenditures will also decrease progressively; reaching 46% of GDP by 2010, despite the fact that capital expenditure will further increase by an additional half point of GDP per year. The main reasons behind the fall of public spending in this period will be the reduction of the number of public sector's employees, and the differential effect between public spending and economic growth

¹ Pension and Disability Insurance Fund, Health Insurance Fund, Employment Agency, Development Fund and Compensation Fund.

rates. In conclusion, it is expected a budget surplus in both exercises of some 1% of GDP. During this period there is a risk of surging massive investments bringing significant contingent liabilities when the construction of two main road corridors starts. Preliminary estimates point to a final cost of some EUR 2.7 billion (exceeding current GDP), spread in ten years.

Table II.3.1:

Further reductions of the tax burden

	2008	2009	2010
Personal income tax (flat rate)	15%	12.0%	9%
Health insurance contribution ^(*)	12%	10.5%	9%
Pension insurance contribution ^(*)	21%	20.5%	20%

^(*) To be paid by employer including the employee's share.

The fiscal risks identified in the programme are sorted in two groups. Some relate to external factors (reduction of imports and therefore lower VAT revenues, volatility of the tourism and aluminium markets, pressures to reinforce public administration to cope with EU standards), and others from financing massive investments on infrastructures. The EFP presents an alternative scenario in each case. In the first alternative one, it assumes the materialising of upside risks, with faster growth fuelled by higher than expected foreign investments and domestic credit accompanied by additional imports, boosting domestic demand and resulting in annual balance surpluses close to 3% of GDP. By contrast, the second alternative scenario considers the impact in case of a surge in capital expenditures financed by issuing public debt, and resulting in a strong public deficit above 8% of GDP and public debt surging above 50% of GDP. This worst-case scenario is not very plausible in the timeframe presented, as construction projects will require a more gradual phase-in curve; however, the construction of infrastructure through private-public partnerships (PPPs) may involve contingent fiscal risks. Finally, the programme shows confidence in the astringent monetary policy of the Central Bank, and does not consider any risk from the current high level of credit activity should the contingent liability materialises or in case of a sudden interruption of credit flows.

Debt levels and developments

Almost two years after the independence of the country, public debt has not yet been completely settled with all lenders. Nevertheless, the amounts in question should not change substantially from present debt levels. In 2007, the stronger than expected fiscal performance has allowed for earlier repayments of foreign loans, the complete refund of treasury bills and the settling up of budgetary arrears. However domestic liabilities started to grow faster than foreign ones due to the settlement of restitution claims process, bringing the debt level to 32.4% of GDP at the end of 2007 (somewhat higher than the EFP estimates). These restitution liabilities and additional loans from international financial institutions for infrastructural projects should push up the public debt to 37% of GDP in 2008. Thereafter, the programme presents three different scenarios. The base scenario assumes public debt to decline gradually to 31% of GDP by 2010. A second one presents a less dynamic economic growth of 2%, though debt would remain *ceteris paribus*, at same level as in 2008. In the worst-case scenario (low economic growth, primary deficit and increase of interest rates)¹, public debt could reach 40% of GDP by 2010. These scenarios are not articulated with those presented previously under the fiscal risks section, which considered a much higher debt level (53% of GDP by 2010).

The structure of debt exhibits very low currency risk (89% of foreign debt is in euro). There is also predominance of concessional loans, mostly fixed (77%) with low (between 2 and 5.8%) interest rates. Moreover, the structure of credit has long repayment and grace periods up to 10 years. Past fiscal surpluses have been primarily spent on additional debt repayments and building reserves. Debt relief will not be able to rely much on privatisation revenues as these will fade away soon, after completion of the privatisation process. However, this should also bring other positive effects by decreasing the level of public liabilities as, though not accounted as public debt, indebtedness of public enterprises has been significant (around 6% of GDP).

¹ Values for these model parameters are not available.

Budgetary implications of major structural reforms

According to the programme, the net effect of major structural reforms will not have a significant impact on the country's fiscal position, at least until 2010. The programme expects high levels of public spending close to 50% of GDP in order to provide for developing public infrastructures and state building (in the physical and administrative sense). Overall, the measures presented in the baseline scenario address important structural weaknesses and therefore are likely to contribute to the country's growth potential and regional development. However, the resulting fiscal impact from construction of two major motorways are not included in the baseline scenario, given that the implementation phase is not yet established and it will be certainly more gradual than presented under the fiscal risks section (i.e. higher annual expending by 10% of GDP resulting in an annual public deficit of 8% of GDP). On the other hand, the programme does not evaluate the budgetary impact of reforms from the revenue side. For instance, the impact resulting from the new labour law intended to improve market flexibility and mobility.

3.4.2. Quality of public finances

As mentioned above, the estimates behind the fiscal framework are fairly prudent. This is some insurance against the risk of overestimating future tax revenues by refusing to take into account the temporary and exceptionally current favourable conditions. Indeed, during the last two years (2006-2007), large surpluses have been systematically higher than planned.

Overall, the change in structure of spending presented in the programme is conducive to supporting growth by enhancing capital spending on projects necessary to foster tourism industry and improving regional integration. In 2007, both current and capital expenditures expanded markedly, driven by increases of gross salaries and construction of public buildings. From 2008 onwards, the weight of salaries in the budget will decrease gradually while capital spending will be sustained and increased. Despite further reduction as from 2009 of taxes and contributions, the estimated revenues for next

years should decrease but still provide some prudential margin. General government balances target annual surpluses of 1% of GDP, and building up of reserves some 2.5% of GDP per year during the period 2008-2010. New borrowings are limited to financing projects from international financial institutions (under concessional terms). Moreover, according to the budget law any surplus must be used for repayment of the public debt, additional investment on capital projects and/or increase of reserves.

3.4.3. Institutional features of public finances

The current composition of the budget contains several improvements vis-à-vis previous years. So far it has integrated all the extra-budgetary funds and regulatory bodies, improving the transparency and accountability of public accounts. Capital expenditures are presented in a separate chapter and displayed by spending units too. Cash and debt management is done through a consolidated treasury account. The budget law rises to 10% of the allocated funds the amount that a spending unit can redirected between lines. However, the budget does not include spending of neither local self-governments nor the balances of the most important public enterprises. Implementation in 2008 of the new law amending the Law on financing of Local Self-Governments should improve the sources of financing to municipalities, capped up by an equalization fund. In the meantime, work continues in order to implement program budgeting, extending appropriations to two-year periods into the capital budget and implementing a medium-term budgetary framework.

3.5. STRUCTURAL REFORMS

The programme presents a very comprehensive record of areas and activities of reform, many of them already in progress. Yet, the quality and detail of each section is quite uneven, reflecting the participation of diverse administrations. These fragmented contributions are articulated with the overall policy objectives and summarised under the first chapter of the programme. As the programme underlines, the ultimate and common objective of the reforms presented is to create an environment

encouraging investments, and particularly, foreign direct investments. The quantitative estimate of implicit liabilities resulting from planned reforms is not always evident, even if some gross estimates are occasionally possible using the different pieces of information scattered along the document.

The reform package presented in the programme aims to reinforce the dynamics and competitiveness of the economy. The introduction of the flexicurity concept in the new labour law, the continuation of active labour market policies and improvements of the education system address structural unemployment, one of the major challenges of the economy. In addition, the programme also foresees a strengthening of the fiscal balances to ensure the feasibility of these reforms. On the other hand, the implementation of the voluntary pension and health insurance systems and the completion of the privatisation process are expected to reduce budgetary strains. Furthermore, in order to increase the feasibility of the ambitious programme of infrastructure development with sufficient guarantees, the EFP foresees the use of public-private partnerships and concession strategies to maximise fiscal resources, limit substantial contingent liabilities and sharing risks with private investors.

3.5.1. Structural reforms and European Partnership

The 2007 EFP presents an extensive and detailed reforms chapter covering all economic priorities of the European Partnership for Montenegro, as adopted by the Council in January 2007. Overall good progress is being made by the authorities in addressing most priorities, notably the short-term ones. As regards the medium-term priorities, the programme presents concrete measures to further liberalise the labour market, in particular a new labour law implementing the "flexicurity" concept, as well as reforms of the education and social security systems, to promote adaptability and skills of the labour force. Moreover, to enhance the business environment –another Partnership priority–, the EFP presents future tax policies and a number of specific actions to remove identified obstacles. In addition, it provides an indicative list of the largest companies tabled for restructuration and

privatisation, and conversely a very detailed calendar with concrete initiatives to strengthen the Central Bank's supervisory capacity. Amongst other reforms the EFP also displays a comprehensive energy sector reform. It encourages specific financing mechanisms such as public-private partnerships (PPP) and concessions to develop transport infrastructure. Finally, in order to address external imbalances, several policy measures concerning the tourism industry and related areas such as environment and spatial planning, are also addressed.

3.5.2. Product and capital markets

The privatisation process is quite advanced. There is a possibility that this process will be completed by 2010. The programme foresees that revenues from this process (2.4% of GDP per year) are to be reinvested in education, health and repayment of public debt. The EFP displays a very clear picture of the main companies listed for privatisation and their estimated value. Yet, projections of the privatisation revenues seem underestimated (18% of the total nominal value). This could be explained by an eventual postponement of the sale of the electric company (EPCG) after 2010, and the concession regime –not sale– foreseen for the use of the infrastructures of the port of Bar and the railways.

The European Commission's last Progress Report¹ identified the reform of the energy sector as one of the key issues given the broad impact on the economy. The government has adopted shortly afterwards an ambitious Energy Development Strategy to address the electric power deficit and consequent high imports. The EFP projects the implementation costs of the strategy until 2025 at EUR 2 billion. However, there are no concrete forecasts of their budgetary impact as the first five-year action plan defining sources and models of financing is not yet available. EPCG anticipates that the most urgent and immediate investment (a second block for the thermo-power plant by 2011), would need some EUR 175 million, and proposes a recapitalisation scheme for securing investments through a joint venture, thus limiting exposure of

¹ SEC(2007) 1434 of 6.11.2007.

Box II.3.1: Montenegro - The cost of state building

Following the independence of the country in 2006, a reorganisation of the state administration to develop new administrative capacities started immediately.

At present, most state-building tasks are well advanced. So far, 24 new institutions and agencies, totalling some 1,281 staff members, have been established and incorporated into the consolidated budget.

However, only a part of these agencies and personnel are really new institutions. Most have been spun off from ministries.

The list is not yet complete, and the budget does not include yet, for instance, the Agency for Insurance Supervision. In these cases, the required operational funds are being allocated from the budget reserves. The gross impact of the new institutions amounts to almost 9.8% of the consolidated budget (or 4.6% of GDP) in 2008.

Table 1:

New Institutions	(EUR '000)
Accreditation Agency	220
Administration for Medicaments	593
Agency for Intellectual Property	324
Agency for Protection of Environment	2 608
Anti Money Laundering Administration	441
Civil Aviation Administration	1 922
Compensation Fund	8 530
Forest Administration	7 282
Human Resources Agency	611
Hydro-Meteorology Institute	1 375
Institute for Metrology	522
Institute for Refugees	481
Institute for Standardisation	675
Intellectual Property Institute	324
Maritime Security Administration	1 116
Ministry of Defence	48 631
Public Procurement Commission	196
Real Estate Directorate	10 445
Secretariat for European Integration	938
State Audit Institution	926
Tobacco Agency	103
Transport Directorate	24 184
Veterinary Directorate	2 565
Waters Administration	884
TOTAL	115 895

Source: 2008 Budget Law

public finances. In the meantime, the government adopted the decision for the legal unbundling of the company into several functional units, which should be completed by end 2009. From the revenue side, a new tariff system was put into place mid- 2007, though it does not cover completely production costs yet, resulting into quasi-fiscal losses. Still, total subsidies in the general government budget to all sectors represent half a point of GDP per year, and government transfers for energy expenditures to the socially most vulnerable groups a mere 0.1% of GDP.

Reforming the transport sector will require, apart from a sound and well planned strategy, massive capital investments. It will create the conditions for further economic and regional development, supporting not only hauling activities, but also facilitating development of tourism in the central and northern regions as well as much needed labour mobility. The programme presents a detailed list of projects and some estimated costs. Concerning the port of Bar, the railways and the air transport sectors, the programme confirms

that improvement can only be secured through restructuration and subsequent privatisation. Infrastructure maintenance of these companies will remain in public hands and will be covered by fees from customer companies.

After the privatisation of the financial sector, reforms are focused on development of the institutional and regulatory framework and the introduction of new instruments. The EFP presents a detailed calendar with initiatives for strengthening the supervisory role of the Central Bank. The greater exposure of banks has induced the adoption of a series of bylaws to reduce credit risk. The programme expects, the evolution of the banking business towards new activities underdeveloped until now (i.e. private pension funds, leasing, brokerage, dealer, investment banking and issuing of debit securities). From an EU accession perspective, it is still necessary to adopt a whole set of EU directives and standards, and notably, regarding the possibility for foreign banks to freely open branches in Montenegro without affiliation. The adoption of a new law on banks and by-laws,

will introduce Basel II core principles as well as OECD's bank corporate governance rules.

Concerning capital markets, reforms are expected in the form of the possible merger of the two stock markets of the country, the transformation of current closed investment funds into open ones, adopting regulations on issuance of debit securities or securities on the basis of real estate. The reform of the insurance market will be advanced with the establishment of the Agency for Insurance Supervision in 2008, giving a new impulse for the development of other forms of insurance, apart from incumbent mandatory ones, such as life, property or voluntary health insurances.

The law regulating financial leasing is quite tolerant and does not compel leasing companies to supervision. Moreover, in view of providing the industry with access to more advantageous finance, the law provides a favourable fiscal treatment, excluding interest from the tax base when calculating VAT on sales. Further reforms will focus on avoiding double taxation (of leasing company and clients) on real estate sales.

The programme also presents several measures, apart from the reduction of the fiscal burden to enterprises, to reduce business barriers, promote development of entrepreneurship and reducing the share of the informal economy. Notably, the simplification of business licenses procedures, the development of the spatial plan, the use of on-line business registration, and credit guarantee instruments for SMEs. Yet, the budgetary impact of these measures could only be indirectly measured by extrapolating potential fiscal revenues from an increased business activity resulting from these measures.

3.5.3. Labour market

The programme foresees that employment will continue expanding along with economic growth, but also reflecting the same regional disparities for both. To address labour market rigidities, the government prepared a new Labour Law based in the flexicurity concept, enabling more flexibility to employers to negotiate work conditions while providing workers with improved assistance and benefits to look for employment. Meanwhile, given some tightness

in the market, enterprises are recurring more frequently to employ non-residents and young people, which are more mobile and skilled. The Employment Agency is dedicating some 0.2% of GDP per year to active labour market programmes, focusing on the more difficult, in terms of employability, sector of the population. Other measures include new laws on economic and social council, on peaceful solution of labour disputes and on national qualifications.

After the consolidation of the social security system and the recent introduction of voluntary pension funds, the authorities are considering carrying out further demographic and comparative studies before proceeding with the introduction of the second pillar. These reforms are providing space for further reduction of social contributions, therefore reducing significantly contributions to 9% of gross wages by 2011 and increasing labour competitiveness. However, the EFP also highlights the transition deficit that will need to be filled when abandoning the current intergenerational solidarity system. Fiscal revenues will decrease in parallel with contributions, but they still will need to cover pension for workers subscribed under the previous system. Finally, the system of social assistance will also be improved and concentrated on the most vulnerable groups.

3.5.4. Other reform areas

Following the reform of the education system with the introduction of new curricula in elementary schools and the introduction of private sector institutions in higher education, the next phase in the reform process will consist on investments in new equipment and buildings. The reform of the health care system is challenged by the fact that appropriation for medical services exceeds government consumption. The programme presents the introduction of the voluntary health insurance as the most appropriate solution to improve the sector without jeopardising public finances.

4. SERBIA

4.1. SUMMARY AND CONCLUSIONS

- In December 2007, Serbia submitted to the European Commission a Memorandum on the Budget and Economic and Fiscal Policy for the year 2008 with projections for 2009 and 2010. The document is to a sufficient extent in line with the content, form and data requested for the 2007 Economic and Fiscal Programme (the 2007 EFP). It presents a generally coherent macroeconomic framework, including projections for key macroeconomic variables and medium-term fiscal targets. The document could help to align the country's policy mix with the economic conditions and the country's orientation towards meeting the economic Copenhagen criteria for EU membership.
- In 2007, Serbia's GDP growth accelerated to 7.5% year-on-year, driven by strong domestic demand. Retail price inflation rose to 10.1% year-on-year in December 2007. The current account deficit widened to exceed 16% of GDP. At the same time, due to large capital inflows, foreign exchange reserves increased substantially. The general government budget recorded a surplus of 0.5% of GDP in 2007, following a surplus of 1.6% of GDP¹. Public debt declined to 32.3% of GDP from 35.6% of GDP in 2006. The macroeconomic scenario presented in the programme is optimistic and implies strong efforts for expenditure reduction and bold continuation of structural reforms in particular as far as enterprise restructuring and privatisation is concerned. The projected developments in the monetary and external sectors are not fully plausible. Risks to the macro-economic programme are significant. In particular, the growing uncertainties as regards the future course of the country as well as the deteriorating international environment are likely to trigger a slowdown of capital inflows to Serbia.
- The public finance scenario in the 2007 EFP is overall coherent, consistent and sufficiently comprehensive. The fiscal strategy of the programme is to reduce public expenditures as a share of GDP by 2 percentage points over the programme horizon, to help reducing the country's large foreign trade deficit. The envisaged budgetary developments are ambitious and not entirely consistent with developments in recent years. The key measures on the revenue and expenditure side are mentioned. However the programme would have benefited from more detailed elaboration of the measures. The scenario does not appear to be adequately taking into account the recent deterioration of external accounts. This would have mandated a tighter fiscal stance, also in view of the limited margin of manoeuvre of monetary policy. The programme would have benefited from a quantitative impact assessment of the most important fiscal measures on the revenue and expenditure sides. Even though fiscal risks are comprehensively identified, their presentation would have benefited from additional information and quantification.
- The 2007 EFP presents a coherent, broadly consistent and sufficiently comprehensive structural reform framework, covering a wide range of structural reforms related to the enterprise and financial sector, labour market and social welfare system, public administration and public finance management. The structural reform agenda aims to foster economic restructuring, enhance competition, stimulate employment and rationalise social spending. The programme gives sufficient space to measures to improve the overall business and entrepreneurial environment and to attract foreign investors. The relation between the structural reform agenda and the fiscal strategy is elaborated in a few cases. The programme would have benefited from the

¹ Based on the government's accounting standards, which report among others mobile phone license fees as revenue.

presentation of clear timetables for the implementation of the most important structural reform measures. The structural reform strategy is broadly supportive for the fulfilment of the Copenhagen economic accession criteria.

4.2. INTRODUCTION

In July 2006, Mr. Almunia, Commissioner for Economic and Monetary Affairs, invited the potential candidate countries – i.e. Albania, Bosnia and Herzegovina, Montenegro and Serbia – for the first time to submit by 1 December, an Economic and Fiscal Programme (EFP) to the European Commission. The EFPs are a further step towards an increased policy dialogue on economic and fiscal issues between the authorities of the potential candidate countries and the European Commission. This is a yearly exercise and the programmes are assessed by staff of the European Commission. The scope and content of the EFP is similar to the Pre-accession Economic Programmes (PEP) which are submitted each year by candidate countries, although the EFPs are somewhat more limited in scope.

By 1 December 2007, Serbia submitted to the European Commission a Memorandum on the Budget and Economic and Fiscal Policy for the year 2008 with projections for 2009 and 2010. This document, which was prepared by the Ministry of Finance, forms the foundation of the republican draft budget for 2008 and was adopted by the government of Serbia in October 2007, in line with the requirements of the Serbian budget system law. It was submitted to parliament together with the draft 2008 republican budget, the latter of which was adopted by parliament on 26 December 2007.

The submitted programme complies with the requirements stated in the outline for the 2007 EFP in terms of content, form and data. It provides a summary of recent macroeconomic performance, a coherent and consistent macroeconomic and fiscal framework, and an overall assessment of structural reforms. The requested tables are mostly complete and seem to be compiled correctly. Fiscal data of the Republic of Serbia is presented in line with the

Government Financial Statistics (GFS) methodology.

The fiscal strategy of the programme aims to reduce public expenditures relative to GDP by 2 percentage point over the programme horizon, in order to help reducing the country's large, and in the recent period further rising, foreign trade deficit. It is planned to reduce expenditures for public consumption as well as for transfers and subsidies. Capital expenditure, which is foreseen to contract during the first year of the programme, will increase again in the following years and remain unchanged over the programme horizon. Gross public debt is projected to gradually decline to 22.3% of GDP by 2010. The structural reform framework covers a wide range of areas related to the enterprise and financial sector, labour market and social welfare system, public administration and public finance management

4.3. ECONOMIC OUTLOOK

4.3.1. Recent macroeconomic developments

In 2006, Serbia's GDP grew by 5.7%, primarily driven by increases in domestic demand. However, improving supply side factors, such as gains in gross fixed capital formation and labour productivity, appear to be playing a growing role in contributing to growth. The most dynamic sectors of the economy were the service sector and construction, while agricultural production declined. Inflation continued to recede and stood at 6.6% year-on-year in December 2006. As a result of earlier privatisation and economic restructuring, exports grew by 43.4% in 2006, outpacing imports at 25.9%, the latter of which however were boosted by strong aggregate demand and a 16.5% real appreciation of the effective exchange rate. The current account deficit widened to 12.3% of GDP, while capital inflows were very strong, particularly in the form of foreign direct investment and external borrowing, accounting for 13.8% and 9.5% of GDP, respectively. However, economic growth was not sufficient in 2006 to generate net employment, which declined by 3.8%.

In 2007, economic activity accelerated and the 2007 EFP projects GDP to have grown by 7.0%, driven by strong gains in the construction and service sectors. Agricultural production is expected to have declined by 7.5% related to the regional drought. Retail price inflation is projected to have accelerated to 8.5%, driven by soaring global oil prices and the drought related price increases for farming products. As a result of the stronger growth of imports of goods and services, the current account deficit is projected to have widened to 14.7% of GDP. Employment fell during the first eight months of the year by 1.1%, related to enterprise privatisation and restructuring. Average net wages grew by 23.6% between January and August, while wages in the public sector rose by an even stronger 27%.

In contrast to the 2007 EFP projections, annual inflation rose to 10.1% in December 2007 as inflationary pressures resurfaced mid-year, driven by soaring global oil prices and the drought related price increases for agricultural and food products. In addition, stronger aggregate demand, due to increased public spending, and lack of competition in the local market played a role in boosting retail prices in 2007. Core inflation, which serves as a monetary policy target, declined marginally to 5.4% in 2007 and remained within its target band.

The external account is set to have deteriorated stronger than projected under the 2007 EFP and the current account deficit has exceeded 16% of GDP, on a growing trade deficit and a decline in net current transfers. Foreign direct investment is

set to have slowed in 2007 while debt-creating inflows remained strong. As a result, foreign exchange reserve accumulation of the NBS has slowed.

Overall, the programme presents a clear and concise picture of past economic developments and covers all relevant data at the time of submission. However, data released since submission of the 2007 EFP have already rendered several macroeconomic projections inaccurate.

4.3.2. Medium-term macroeconomic scenario

The external outlook described in the 2007 EFP assumes a moderation of world growth in 2007 and stability until 2010. Growth of international trade is expected to slowdown in 2007 and to remain stable over the programme horizon. The external assumptions are broadly in line with Commission's expectations of the autumn 2007 forecast. However, the 2007 EFP expects real GDP growth in the European Union to decelerate less strongly than predicted by the Commission's forecast. In addition, the price of crude oil is assumed to remain volatile, however to a lower degree than assumed by the Commission's forecast.

The framework presented is sufficiently comprehensive, but appears too optimistic and not fully plausible. It does not provide alternative scenarios. It is uncertain to what extent the programme's main objectives and intermediate

Table II.4.1:

Macroeconomic developments

	2006	2007	2008	2009	2010
Real GDP (% change)	5.7	7.0	6.0	6.5	6.5
<i>Contributions:</i>					
- Final domestic demand	8.6	16.1	9.8	8.3	5.8
- Change in inventories	0.1	0.1	0.1	0.1	0.1
- External balance of goods and services	-3.0	-9.2	-3.9	-2.0	0.6
Employment (% change)	-2.1	-1.3	0.7	1.2	1.5
Unemployment rate (%)	21.6	21.7	21.1	20.4	19.6
GDP deflator (% change)	14.90	7.90	6.80	5.70	4.60
CPI inflation (%)	12.7	6.4	7.1	5.5	4.5
Current account balance (% of GDP)	-12.3	-14.7	-14.1	-12.6	-11.1

Source: EFP 2007 submission (actual data for 2006 and 2007 may differ)

goals are achievable. In particular, it appears that the proposed fiscal adjustment will not be sufficient to reduce inflationary pressures and stem a continuing deterioration of the current account deficit. In addition, the envisioned policy mix might not be fully appropriate as it leaves the burden of additional adjustment needed to a large extent in the hands of monetary policy, which given the high degree of euroisation lacks effective transmission mechanisms and has tight margins of manoeuvre. The macroeconomic scenario is based substantially on the accomplishment of the programme's restrictive fiscal policy and accelerated structural reforms. In the 2007 EFP, GDP growth is projected at 1 percentage point lower in 2008 and 2009 than in the 2006 EFP, amid a deteriorating global economic backdrop.

Real sector

Real GDP growth is projected to slow to 6.0% in 2008 and accelerate again to 6.5% in 2009 and 2010. The temporary slowdown in 2008 – from a strong 7.5% in 2007 – is a result of more restrictive fiscal and other policy measures, intended to curb domestic demand and reduce external imbalances. On the demand side, final domestic demand is expected to slow to 9.8 percentage points in 2008 and continue slowing in 2009 and 2010 to 8.3 and 5.3 percentage points, respectively, on a declining contribution by personal and public spending to 1.8 and 0.4 percentage points, respectively. The contribution of investment to GDP is expected to fall to 4.5 percentage points in 2008 and to gradually decline to 3.7 percentage points by 2010. The contribution of net exports is assumed to increase to -3.9 percentage points in 2008 and -2.0 percentage points in 2009 and start contributing positively to GDP growth in 2010 in the order of 0.6 percentage points of GDP.

On the supply side of GDP, agricultural output is projected to recover strongly in 2008 and increase by 5% year-on-year, following the drought related decline in 2007, and continue to grow at 2% thereafter. Industrial production is projected to expand at 5.3% in 2008 and gradually accelerate to 5.7% by 2010. Following very strong growth in construction, the sector is expected to slow to 8% in 2008 and decline

gradually to 7% by 2010. The service sector, which has been a major driver for growth in recent years, is projected to decelerate to 5.8% in 2008 and recover to 7.0% and 7.9% in 2009 and 2010, respectively. Employment is projected to increase by 0.7% in 2008 and accelerate to 1.5% by 2010. Labour productivity growth is projected to drop to 5.3% in 2008 and continue declining gradually to 5.0% by 2010.

Using a Hodrick-Prescott filter we estimate potential annual GDP growth in Serbia at a maximum of 6%, which is broadly in line with the projected average annual growth rate of the 2007 EFP of 6.3%.

Inflation

Inflation is projected to decline to 6% in 2008 and gradually continue declining by 1 percentage point per year until 2010. The programme projects core inflation to gradually shift downwards over the programme horizon to 2 – 4% by 2010. Given the strong inflationary pressures, which resurfaced in 2007, fiscal policy will need to follow a more restrictive than planned course in 2008 to help reduce headline inflation in line with projections of the 2007 EFP. The envisioned gradual reduction of core inflation over the programme horizon will only be achievable when the National Bank of Serbia further tightens monetary conditions and is supported by a more restrictive fiscal policy.

Monetary and exchange rate policy

The National Bank of Serbia's main policy objective is to achieve stable inflation, while supporting the government's economic policy to reduce the external imbalance and to boost economic growth, without compromising its primary objective. The National Bank of Serbia has begun to shift to an inflation targeting regime, with the two-week repo rate being the main policy instrument, which however can be accompanied by regulatory measures where necessary. Reserve requirements and prudential measures are being used to curb credit growth and aggregate demand. The policy target is the annual core inflation rate. The target range for 2007 was set at 4 – 8% and is projected to decline gradually to 2 – 4% by 2010. The

National Bank of Serbia limits foreign exchange market interventions to prevent extreme fluctuation of the exchange rate from occurring. While monetary policy would normally be expected to deliver adjustments which are unlikely to be attained with the announced fiscal policy, the lack of effective monetary transmission mechanisms and the untested record of the Central Bank on its inflation targeting policy may actually imply that it will not be able to adequately match fiscal policy in containing rising external imbalances. The onus within the policy mix is thus expected to remain on fiscal policies to address these imbalances.

The programme indicates that, in line with provisions under the Stabilisation and Association Agreement (SAA), the National Bank of Serbia is envisioning full liberalisation of capital movements to take effect four years after the SAA has entered into force, i.e. beyond the horizon of the current programme.

External sector

According to the 2007 EFP, the current account deficit is projected to decline to 14.1% in 2008 and 14.6% and 11.1% in 2009 and 2010, respectively. Against the backdrop of the stronger than projected deteriorated of the current account deficit in 2007 to 16% of GDP, this seems optimistic and would require a significantly tighter policy mix, than what is envisioned under the 2007 EFP.

Export growth is projected to reach 25.8% in 2008 and gradually slow to 21.6% in 2010. The share of exports in GDP is projected to increase from 27.1% in 2006 to 38.9% in 2010. At the same time the export structure is expected to shift from intermediate products to consumer and capital goods, helped by the finalisation of privatisation of socially-owned enterprises and increasing investment, in particular FDI. However, the high dependency on energy and intermediate products as input factors for the Serbian economy is expected to keep imports high as well. Capital inflows, in particular in the form of FDI and foreign borrowing are projected to remain more than sufficient to finance the current account deficit. FDI are projected to account for 6.4% of GDP in 2008 and decline to 5.7% of GDP in 2009 and 2010, respectively.

However, this will require a speedy finalisation of corporate restructuring, including liquidation, and privatisation and a substantial improvement in the business environment.

Main risks to the programme

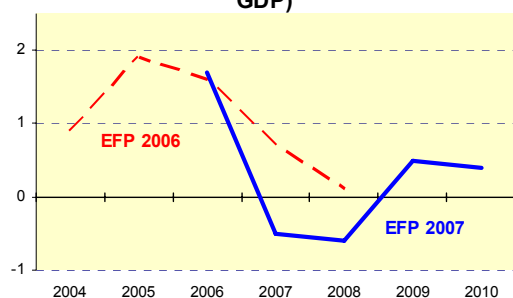
Overall, the 2007 EFP correctly identifies as major risk factors, persistent high domestic demand, lower-than-expected FDI and a possibly slowing down of world growth. In particular, risks to the programme might ensue from exogenous shocks, in the form of further price increases of energy and raw materials or of declining external demand reflecting weaker growth of important export markets, such as Germany and Italy. The risk of negative direct effects of the financial crisis is believed to be limited, in view of the low known exposure to the US mortgage market of foreign owned banks (mostly Austrian, Italian and Greek) operating in Serbia. However, the indirect effects of a severe credit contraction in global financial markets would most likely also be felt in Serbia. On the domestic side, an overall less restrictive fiscal policy stance combined with a continuing strong increase of public sector wages would add to inflationary pressures and contribute to a further deterioration of external accounts. In addition, political uncertainty could undermine foreign investor confidence and reduce capital flows to the country.

4.4. PUBLIC FINANCE

The presented public finance framework is well integrated into the overall policy objectives, and soundly based on the presented medium-term economic framework. The programme does not refer to remarks in the Progress Reports or European Partnership priorities. The public finance framework is overall coherent, consistent and sufficiently comprehensive. The key measures on the revenue and expenditure side are mentioned. However the programme would have benefited from more detailed elaboration of the measures. In addition, the scenario does not appear to be adequately taking into account the recent deterioration of external accounts. This would have mandated a tighter fiscal stance, also in view of the limited margin of manoeuvre of monetary policy. The programme would have

benefited from a quantitative impact assessment of the most important fiscal measures on the revenue and expenditure sides. Even though fiscal risks are comprehensively identified, their presentation would have benefited from additional information and quantification. The fiscal scenario rests on renewed and strong efforts for expenditure reduction as well as a bold continuation of structural reforms, in particular enterprise sector restructuring and privatisation. While the programme provides a short analysis of the exchange rate and interest rate sensitivity of public debt servicing costs, the presentation would also have benefited from an analysis of changes to main assumptions in respect to the fiscal position. The authorities claim that fiscal data of the Republic of Serbia is presented in line with the Government Financial Statistics (GFS) methodology¹.

**Graph II.4.1: Budgetary developments
(general government balance, % of
GDP)**



The fiscal strategy of the programme is to reduce public expenditures as a share of GDP by 2 percentage points over the programme horizon, to help reducing the country's large, and in the recent period further growing, foreign trade deficit. It is planned to reduce public consumption expenditures as well as transfers and subsidies, which are projected to decline by 1.4 and 0.5 percentage points of GDP, respectively over the programme horizon. Capital expenditure, which is foreseen to contract most strongly in the first year of the programme, will increase again in the following years and remain unchanged over the programme

horizon. The amount of fiscal adjustment will be strongest during the first and second year of the programme. The budget balance is programmed to increase by 0.9 percentage points of GDP and be in surplus from 2009 onwards. Public debt is expected to decline by 10 percentage points of GDP.

4.4.1. General government balances and debt

Actual balances and medium-term perspectives

In 2007, the consolidated budget recorded a surplus of 0.5% of GDP compared to a planned 0.6% of GDP deficit under the 2007 budget law. Two factors contributed to the better than planned budget execution in 2007. Firstly, during the first half of the year, due to delays in forming a new government following parliamentary elections in January, public expenditures of the Republic of Serbia and compulsory social security organisations were put under provisional financing restrictions, legislatively capping expenditures. Revenues benefited from increased payroll taxes and social security contributions, as a result of increased wages and higher than planned revenues from VAT, excise as well as custom duty, stemming from higher consumption expenditures and imports. The amendments to the income tax law, which entered into force in January 2007, reducing the tax rate and introducing a tax exempt minimum income, are estimated to have resulted in a revenue loss of 1.2% of GDP. However, this was partially offset by increased revenues due to substantially higher wages. In addition, a lower tax on real estate transfers and the abolishing of this tax for first home buyers, affected adversely public revenues.

Compared to a year earlier, fiscal policy turned significantly more expansionary in 2007, driven by a 28% increase in wage expenditures and an 83% increase in capital expenditures, primarily under the National Investment Plan. Overall, expenditures grew by 21% year-on-year compared to a revenue increase by 16.3%. The consolidated fiscal surplus declined from 1.6% of GDP in 2006 to 0.5% of GDP in 2007. Excluding one-off license fee revenues, the fiscal surplus stood at 0.4% of GDP in 2006 and declined to a deficit of 1.0% of GDP in 2007. In

¹ This view is not shared by the IMF, which assesses the fiscal position in surplus of 0.7% of GDP in 2005 and in deficits of 1.5% of GDP in 2006, 1.8% in 2007 and 2.1% in 2008.

the medium term an aggravating factor is the fact that nearly half of the growth in expenditure was of a permanent nature, which will make future adjustments more difficult.

The 2007 EFP budget targets for 2008 are broadly in line with the 2008 budget law, which was adopted by parliament in December 2007. The main objective of fiscal policy over the programme horizon is to strengthen macroeconomic stability by reducing Serbia's foreign trade imbalance and external vulnerability.

For 2008, the 2007 EFP envisages the reduction of consolidated public expenditures by 1.1 percentage points to 39.5% of GDP. Key measures to achieve this are thought to be a freeze of the real amount of payroll expenditures for budgetary beneficiaries, a 5% reduction of subsidies, and a 10% reduction of public investment expenditures. As a result of the later, gross fixed capital formation will decline by 0.7 percentage points to 4.1% of GDP. The programme would have benefited from more detailed elaboration of the planned measures. While the envisaged fiscal measures may help to reduce aggregate demand, which was fuelled by excessive wage increases in the recent past, it remains uncertain whether the planned adjustment will be sufficient to stem the rapid deteriorated in Serbia's current account. In addition, a rebalancing of public expenditures away from investments to current spending, contributes to a deterioration of the quality of public finances and does not bode well for Serbia's potential output, given the country's substantial public investment needs¹. Revenues are planned to decline by 1.2 percentage points to 38.9 % of GDP. The consolidated budgetary balance is foreseen to reach a deficit of 0.6% of GDP.

In the remaining period under the programme horizon, expenditures are projected to decline to 38.6% of GDP, driven by a decline in current expenditures as well as transfers and subsidies, more than offsetting again rising investment

expenditures in 2009 and 2010. Total adjustment of expenditures over the programme horizon is foreseen to reach 2 percentage points of GDP, most of which will occur in 2008 and 2009 and will mainly be driven by declining expenditures, as a percent of GDP, for the public sector wage bill as well as subsidies, in particular for unprofitable socially-owned enterprises. For the same period, revenues are projected to remain broadly stable at 39% of GDP. As a result, the consolidated fiscal balance is set to improve and reach a surplus of 0.4% of GDP by 2010.

The programme correctly identifies stable and high GDP growth as a main risk factor for revenue generation and public debt developments. In this context, strengthening of public debt management, in particular monitoring of borrowing by towns and municipalities, will be crucial to prevent excess public borrowing. The 2007 EFP considers the persistently high and further rising current account deficit as a potential trigger for a foreign currency crisis in the medium term, especially should FDI, current transfers or external lending dry-up. The 2007 EFP provides a sensitivity analysis of the impact of a depreciation of the exchange rate and an increase of the interest rate on public debt servicing costs. Other fiscal risks stems from potential government liabilities, which could arise from government guarantees issued for loans received by lower levels of government, by enterprises or by other state-controlled institutions. The risk stemming from guarantees to public and state-owned enterprises should be addressed best by their speedy and comprehensive privatisation. This would also help to reduce fiscal risks related to expenditures for subsidising socially- owned companies. Privatisation proceeds and concession fees are a potential source of risk for public finances. A decline of these revenues could jeopardize the sustainability of the fiscal situation as well as of public debt. In addition the granting of concessions needs to be scrutinised carefully to ensure that they do not lead to expenditures in the following periods, as has been the experience in other transition economies.

Regrettably, the 2007 EFP does not provide any quantification of the fiscal risks associated with the existing or new government guarantees, concessions and other contingent and implicit

¹ It is worth noting, however, that investment expenditure under the NIP in 2006-07 did not entirely consist of spending that would normally be considered investment.

liabilities, including the restitution of property nationalised after 1945. It is therefore impossible to fully assess whether the projected fiscal path is sustainable with the deficit and debt projections. The 2007 EFP does not consider any potential risks related to Kosovo's status settlement. In addition, there remains a risk that the optimistic expenditure projections may not materialise, given the absence of underlying concrete policy measures.

Debt levels and developments

Gross public debt is projected to gradually decline from 32.3% of GDP in 2007 to 22.3% of GDP in 2010, on fiscal surpluses in 2009 and 2010, assuming a continuation of strong GDP growth, stability of the exchange rate, and absence of any significant shocks in global markets. Risks to these projections stem from potential borrowing for large-scale infrastructure projects and the settlement of liabilities arising from restitution through security issuance. The 2007 EFP provides a basic analysis of the exchange rate and interest rate sensitivity of public debt servicing costs.

Budgetary implications of major structural reforms

The 2007 EFP does not provide for a matrix on policy commitments of annex 3 of the outline.

However, the 2007 EFP does provide some quantitative details on budgetary implications of some structural reform areas, in particular as far as public administration reform is concerned. Payroll expenditures are expected to decline by 0.5% percentage points of GDP over the programme horizon. Increased efficiency of the fiscal sector is expected to allow for a decline in expenditures for procurement of goods and services in the order of 0.8% of GDP. The envisioned accelerated restructuring of socially owned-enterprises will allow for a reduction of expenditures for subsidies, which are foreseen to be phased out in 2008.

4.4.2. Quality of public finances

The 2007 EFP foresees measures to improve the transparency of public finance and to strengthen budget management. A new law on the budget system is currently under preparation with the objective to improve the transparency and efficiency of public finances. Among others, the introduction of a mid-term investment plan as part of the budget memorandum and the preparation of three-year budgets are foreseen. On expenditure control, the creation of the State Audit Institution is expected to lead to a more stringent enforcement of responsibilities and to improve public finance in general. To strengthen budget management, measures are foreseen to improve the administrative functions of the

Table II.4.2:

Composition of the budgetary adjustment (% of GDP)

	2006	2007	2008	2009	2010	Change: 2009-10
Revenues	39.8	40.1	38.9	39.2	39.0	-1.1
<i>of which:</i>						
- Taxes and social security contributions	35.1	35.4	35.3	35.7	35.6	0.2
- Other (residual)	4.7	4.7	3.6	3.5	3.4	-1.3
Expenditure	38.2	40.6	39.5	38.7	38.6	-2.0
<i>of which:</i>						
- Primary expenditure	18.1	20.5	19.4	19.3	19.1	-1.4
<i>of which:</i>						
Gross fixed capital formation	3.1	4.8	4.1	4.5	4.8	0.0
Consumption	15.0	15.7	15.3	14.8	14.3	-1.4
Transfers & subsidies	19.2	19.4	19.3	18.9	18.9	-0.5
Other (residual)	-	-	-	-	-	-
- Interest payments	0.9	0.8	0.7	0.5	0.7	-0.1
Budget balance	1.6	-0.5	-0.6	0.5	0.4	0.9
Primary balance	2.5	0.3	0.1	1.0	1.1	0.8
Gross debt level	35.6	32.3	28.4	25.5	22.3	-10.0

Sources: EFP submission (actual data for 2006 and 2007 may differ), ECFIN calculations

Treasury Administration, particularly in the area of cash and public debt management. As far as expenditure management is concerned, already in the previous period, efforts were made to improve the connection between the budget and policy planning, with the introduction of budget programming.

Over the programme horizon, the 2007 EFP projects expenditures to decline to 38.6% of GDP, driven by a decline in current expenditures as well as transfers and subsidies, more than offsetting rising investment expenditures in 2009 and 2010. Total adjustment of expenditures over the programme horizon is foreseen to reach 2 percentage points of GDP, most of which will occur in 2008 and 2009 and mainly will be driven by declining expenditures, as a percent of GDP, for the public sector wage bill as well as subsidies, in particular for unprofitable socially-owned enterprises. For the same period, revenues are projected to decline by 1.1 percentage point to 39% of GDP. As a result, the consolidated fiscal balance is set to improve by 0.9 percentage point and reach a surplus of 0.4% of GDP by 2010.

4.4.3. Institutional features of public finances

The development of a comprehensive budgetary planning process is well advanced in Serbia. The law on budget system defines roles and responsibilities in the budgetary process. While a comprehensive legislative framework for public finance is in place, some elements of the existing legislation still need to be fully implemented, such as the creation of an administration for public debt management and the state audit institution. In addition, the budgetary process could be strengthened by improvements in expenditure planning, execution and control. Efforts to introduce multi-annual budgets go in the right direction.

4.5. STRUCTURAL REFORMS

The 2007 EFP presents a coherent, broadly consistent and sufficiently comprehensive structural reform framework, covering a wide range of structural reforms related to the enterprise and financial sector, labour market and social welfare system, public administration and

public finance management. The presentation is largely descriptive, providing information on past and ongoing reforms with an emphasis on institution building activities. The structural reform agenda aims to foster economic restructuring, enhance competition, stimulate employment and rationalise social spending. The programme gives sufficient space to measures to improve the overall business and entrepreneurial environment and to attracting foreign investors. The relation between the structural reform agenda and the fiscal strategy is elaborated in only a few cases. It is therefore difficult to assess to what extent and in which particular areas the structural reform agenda could underpin the implementation of the fiscal strategy. The programme would have benefited from the presentation of the estimated fiscal impact of the most important structural reform measures as well as clear timetables for their implementation. The structural reform strategy is broadly supportive for the fulfilment of the Copenhagen economic criteria.

4.5.1. Structural reforms and European Partnership

The 2007 EFP addresses most of the economic priorities under the European Partnership¹, such as the finalisation of privatisation and restructuring of the socially-owned enterprises, improving public finance management, labour market reforms, state aid and competition policy, the education system as well as measures to improve the business environment. In addition, measures to further strengthen financial supervision, to promote restructuring of the insurance sector and to improve the health and pension systems are appropriately addressed. However, in some areas, for example the labour market, reforms rely more on active measures than on reducing regulations and distortions. For several reform areas it remains unclear to what extent the described measures will help in meeting the objectives of the European partnership priorities. In addition, the strategy for the restructuring of state-owned enterprises could have been developed in more detail and the programme does not explicitly address measures

¹ As adopted by the Council of the European Union on 18 February 2008 under reference number 5353/08.

to develop a stable and functional land/real estate market, including the preparations of cadastre legislation, as well as efforts to formalize the grey economy. In that sense, the 2007 EFP falls somewhat short in fully and appropriately addressing all economic priorities under the European partnership.

4.5.2. Product and capital markets

Restructuring and privatisation of socially-owned enterprises has significantly advanced since transition started in 2001. To finalise this process, it is planned to amend the privatisation law to facilitate the sale or liquidation of the remaining socially-owned enterprises by end-2008. Resolution of the more difficult cases is under way, including through bankruptcies. Regarding state-owned enterprises, the 2007 EFP is less clear. Previously announced ambitious plans to sell a part or a majority stake in the national airline, and to launch IPOs for the electricity, telecom, airport and pharmaceutical companies seem to be holdback by apparent lack of consensus within the government coalition. The 2007 EFP foresees to strengthen competition policy, also in line with requirements under the SAA. The need to improve the business and investment environment is recognised and the 2007 EFP foresees to step up efforts in enacting relevant systemic laws and in enforcing their implementation. Efforts in promoting SMEs and entrepreneurship are foreseen to remain high on the government's agenda. On state aid policy, implementation is planned along the lines of the requirements under the SAA and WTO accession. The implementation of the state aid control law will provide for the establishment of an independent state aid control body, within one year of the entering into force of the SAA.

Comprehensive reform of the legislative and regulatory framework is intended to help development of the financial markets in Serbia. To help deepen capital markets it is planned to allow large utility enterprises to be listed on the stock exchange. Financial market supervisory functions of the Securities Commission are foreseen to be reinforced and reporting arrangements will be implemented based on the International Financial Reporting Standards (IFRS) and the principles of the International Organisation of Security Commissions (IOSCO).

These are all welcome steps in further developing the Serbian capital market, which is needed to help diversify the financial system and contribute to greater stability.

Reform of banking system is ongoing as the new law on banks, which is in line with relevant EU directives and standards of the Basel Committee on Banking Supervision, is being implemented. However, transition from a compliance-oriented regime to a risk-based supervision is likely to be gradual. Privatisation of the banking sector is expected to continue and the EFP foresees that the remaining government holdings in banks will be sold. As far as the non-banking financial sector is concerned, the regulatory framework of the insurance sector is planned to be further developed and the sector's supervision being strengthened. Privatisation of the insurance sector is set to continue. The 2007 EFP also addresses reforms of the leasing sector as well as the voluntary pension and investment fund industries.

Overall, the programme could have been more pronounced on financial sector related challenges and possible policy responses, such as the adverse impact of liability euroisation on monetary transmission mechanisms, the high degree of exchange rate indexation of loans and unhedged foreign exchange positions, the high share of non-performing loans, and the underdeveloped dinar government bond market.

4.5.3. Labour market

The Serbian labour market continues to face significant challenges, such as high unemployment even adjusted for substantial hidden employment, and real average wage increases above labour productivity gains, also the gap has substantially narrowed in recent years. According to the 2007 EFP the labour market strategy of Serbia envisages raising employment by boosting labour productivity through investment in human resources and completion of privatisation. A new employment law is planned to improve labour market flexibility and to facilitate partnerships between employers, job-seekers and labour market institutions. Funding and coverage of labour market policy measures is foreseen to be increased to 0.5% of GDP over the programme

horizon. In addition, it is foreseen to strengthen the foundations for job creation through improvements of labour market institutions and harmonisation of regulations with EU and ILO standards.

4.5.4. Other reform areas

In addition to the above, the 2007 EFP covers several other reform areas. One particularly worth mentioning is the envisaged further reform of the pension system, which has already been subject to adjustments. The pension reform aims at increasing the efficiency of the first pillar and at strengthening of capitalized voluntary pension funds. Within the next two years the pension system will be reformed in several respects with a view to reduce its dependency on the government's budget. By 2009, pension adjustment will occur twice yearly in line with cost of living compared to the current Swiss formula with quarterly adjustments. The retirement age will gradually increase to 60 years and 65 years for woman and men, respectively, alleviating some of the budgetary pressures related to demographic developments. The presentation of the pension reform in to 2007 EFP would have benefited from estimates of its fiscal impact.