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2006 Economic and Fiscal Programmes of potential candidate countries

by Directorate-General for Economic and Financial Affairs

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Contents

INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs publishes its overview and assessments of the 2006 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 reduced, exercise was started with the potential candidate countries, with the submission and assessment of annual EFPs as important element.

The EFP have two objectives: first, to outline the medium-term policy framework, including public finance objectives and structural reform priorities needed for EU accession; and, second, they offer an opportunity to develop the institutional and analytical capacity necessary to participate in EMU with a derogation from 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 Pre-Accession Fiscal Surveillance Procedure.

The EFPs were to be submitted between mid October and 1 December 2006, which all countries complied with. Most have been made public by the countries and can be found on the web under following addresses:

Albania	http://www.minfin.gov.al/downloads/EFP_2006_En2.pdf
Bosnia and Herzegovina	-
Montenegro	http://www.gom.cg.yu/files/1170154012.pdf
Serbia	http://www.mfin.sr.gov.yu/html/pdf/Memorandum%20on%20the%20budget/Memorandum%20on%20the%20budget%2006.11.06.zip

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OVERVIEW

1. SUMMARY AND CONCLUSIONS

Albania, Bosnia and Herzegovina, Montenegro and Serbia submitted by 1 December 2006, for the first time, an *Economic and Fiscal Programme* (EFP). 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. economic and fiscal surveillance procedure of candidate countries and, eventually, participation in the economic policy co-ordination and budgetary surveillance mechanisms of Economic and Monetary Union (EMU). This exercise starts therefore following the successful example of the Pre-accession Economic Programmes submitted by candidate countries.

The submitted programmes have made a start contributing to this objective. They contain very 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 to their neighbours and to raise social standards in the countries.

Clearly, economic stabilisation and structural reforms which are necessary to accomplish a successful catching up to and integration with the EU will take time. A gradual strengthening of administrative capacity in the area of economic and fiscal policy will have to go hand in hand with these policy efforts. Yet, the degrees of ambition and precision in policy implementation contained in the programmes do not always live up to their own general objectives and the general policy challenges. With the notable exception of Serbia, the programmes demonstrate the ample room for further improvements in the economic and fiscal policy planning and the long and challenging process ahead for the policy makers in the countries, against the backdrop of emerging and often weak states.

Continuing this exercise of submitting, assessing and discussing the Economic and Fiscal Programmes will support the countries on this way. The EU is in a position, as for former and present candidate countries to provide an important anchor in this effort. A further 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, will increase the EU's effectiveness in this respect.

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, a so-called Economic and Fiscal Programme (EFP) to the European Commission. This initiative is an important step in supporting countries in their economic development, integration with the EU and deepening and focusing the policy dialogue on economic and fiscal issues between the authorities of the potential candidate countries and the Commission. The EFPs are similar in structure and devotion to the Pre-accession Economic Programmes (PEPs) submitted since 2001 by acceding and candidate countries, though more limited in scope.

All invited countries submitted their EFPs timely by 1 December. The drafting of such a programme for a first time naturally posed challenges to the authorities, in particular where states or state institutions are young, small and in rapid development. Yet, the submissions largely comply with the content, structure, format and information requested. In particular the Serbian EFP represents a very comprehensive and analytically well-founded policy document. Yet, in all cases scope for further improvements exists, in particular in the case of Bosnia and Herzegovina. Most programmes present a fairly consistent economic and fiscal policy framework. The programmes cover the period 2006 to 2008, although in some cases, notably in Serbia's EFP, they partly extend to 2009.

In the case of Serbia and Bosnia and Herzegovina, the formation of new governments following recent parliamentary elections affects the relevance of the submitted programmes: after the nation-wide elections in Bosnia and Herzegovina on 1 October 2006, the EFP does not necessarily reflect the policy intentions of the new governments. Parts of the programme, and in particular the fiscal section, are outdated; they do not fully reflect developments which took place in 2006 and the budgets for 2007 now being adopted. These circumstances were taken into consideration when drafting the assessment of the Bosnian EFP. In Serbia, the EFP was submitted by the outgoing government, well before the elections on 21 January 2007. These circumstances obviously increase the uncertainty about the implementation of programme. In Montenegro, preparing the programme was overshadowed by the only recently attained independence and the elections held in September. This left relatively limited time for drafting the programme.

3. THE 2006 PROGRAMMES

The submitted programmes have proven to be important contributions to economic policy planning and to preparing the countries for the challenges of further economic integration with the EU. They contain very useful overviews of economic policy plans over a broad range of issues over the next few years. Overall, the programmes partly comply with the content, structure, format and information requested, however, to different degrees and with ample room for further improvements in the economic and fiscal policy formulation of the countries. The EFPs should be seen as part of a learning process, where the EFPs over time should encourage improved fiscal and economic policy planning capacities in the countries. With the exception of Bosnia and Herzegovina, the programmes have been made public by the countries[1].

The programmes give the following broad indications:

- *Macroeconomic frameworks*: Continuing trends over 2005 and 2006, the programmes project continued robust GDP growth in 2007 and 2008. These projections probably reflect the respective estimates of potential growth rates in these countries. These are satisfactory, but, given the low starting conditions, could certainly be higher if the supply-side conditions in these countries would be more conducive to growth. Rising investment and strong export growth are expected to play an important role in supporting growth. Inflation is expected to further ease in Serbia, supported by the new monetary regime and to stay relatively low in the other countries. No changes to the current monetary frameworks are envisaged: Albania and Serbia expect to continue

[1] Albania: http://www.minfin.gov.al/downloads/EFP_2006_En2.pdf ;
Montenegro: http://www.gom.cg.yu/files/1170154012.pdf ;
Serbia: http://www.mfin.sr.gov.yu/html/pdf/Memorandum%20on%20the%20budget/Memorandum%20on%20the%20budget%2006.11.06.zip

their policies of (implicit in the case of Albania) inflation targeting[2]. Montenegro intends to maintain the euro as a currency in use and Bosnia and Herzegovina to keep the euro as anchor of its currency board regime.

- The macroeconomic scenarios seem overall relatively coherent and realistic[3]. For Bosnia and Herzegovina, the scenario lacks some details. More generally, the scenarios would have benefited from a more comprehensive elaboration in certain areas, such as labour markets in Albania, the composition of growth in Bosnia and Herzegovina or an external outlook in the case of Albania and Bosnia and Herzegovina.

- The *fiscal frameworks* for Albania, Montenegro and Serbia are relatively consistent and realistic. These programmes foresee continued fiscal consolidation in order to strengthen macroeconomic stability.

  The Serbian EFP is ambitious, comprehensive and detailed. It foresees government spending to decline relative to GDP and a balanced budget by 2008. This ambitious framework will require strong policy commitment and vigorous implementation. In Montenegro, a personal income tax reform, with a flat tax of 15%, is foreseen for 2007. Public expenditure is also expected to decrease relative to GDP and the consolidated budget to continue to show a small surplus over the programme period. The fiscal scenario for Albania focuses on a continued strengthening of fiscal management. Government revenues and expenditures are both expected to slightly rise, mainly to allow for higher capital spending. The programme projects a budget deficit culminating at close to 5% of GDP in 2007 and narrowing to 4% in 2008.

  The EFP of Bosnia and Herzegovina does not contain any consolidated fiscal framework. Instead, developments and policy orientations are presented separately for the state and the two entities. In addition, projections are largely outdated since they do not reflect important developments in 2006. They are also not consistent with the, draft or adopted, budgets, for 2007. Also, the fiscal outlook is based on optimistic GDP growth assumptions which are not even consistent with the macroeconomic framework presented in the EFP. As a result, fiscal policy intentions and trends in this country are difficult to assess.

2006 Economic and Fiscal Programmes: Key indicators

	2005	2006	2007	2008
Growth (GDP, real, annual % change)				
Albania	5.5	5	6	6
Bosnia and Herzegovina	5.8	5.9	6	6.2
Montenegro	4.3	5.5	6	6
Serbia	6.8	7	7	7
Unemployment rate (%, LFS)				
Albania	n.a.	n.a.	n.a.	n.a.
Bosnia and Herzegovina	31.1	31	30.6	30
Montenegro	18.4	n.a.	n.a.	n.a.
Serbia	n.a.	14.6	14.1	13.2
Current account balance (% of GDP)				
Albania	-8.6	-8.6	-7.9	-7.4
Bosnia and Herzegovina	n.a.	n.a.	n.a.	n.a.
Montenegro	-9.1	-9.2	-9.5	-9.4
Serbia	-9.8	-11.6	-10.6	-9.8
Inflation (CPI, annual % change)				
Albania	2.4	3.0	3.0	3.0
Bosnia and Herzegovina	2.9	7.0	2.0	1.5
Montenegro	1.8	2.1	3.4	3.0
Serbia	16.5	12.8	6.8	7.0
Government balance (% of GDP) *				
Albania	-3.4	-4.1	-4.8	-4.0
Bosnia and Herzegovina	n.a.	n.a.	n.a.	n.a.
Montenegro	-2.4	-0.1	0.1	0.8
Serbia	1.9	1.3	0.8	0.1
Government gross debt (% of GDP) *				
Albania	54.6	54.9	54.2	53.6
Bosnia and Herzegovina	n.a.	n.a.	n.a.	n.a.
Montenegro	42.7	37.1	36.8	36.2
Serbia	52.9	38.8	33.7	30.2

* general government, national acc. standards
Source: EFP 2006

2 Discussions on a possible change in Albania's monetary policy towards explicit inflation targeting are ongoing. Yet, it is not likely that such a change will be implemented over the programme period.

3 Unlike in the case of the PEPs for candidate countries the Commission does not carry out its own regular economic forecasts for the countries, which could serve as benchmark in assessing the economic scenarios.

- *Structural reforms*: The EFPs outline current or envisaged structural reforms mainly of the enterprise sector, financial sector, labour markets and public administrations. The outlined reform agendas are often comprehensive, but often not very precise and the relationship between the structural reforms and the fiscal framework, i.e. the possible fiscal impacts of reforms, is often unclear.

  Albanian structural reforms aim at supporting macroeconomic stabilisation and ensuring more rapid economic growth. The envisaged measures are generally well explained, but the reform agenda is vast and the programme would have benefited from better prioritising of key reform measures. The Bosnian reform agenda is partly outdated and reforms are presented separately for state and entity levels, with consistency and compatibility not always being clear. The overall strategy of the outlined reforms is also vague. A faster speed of reform and stronger commitment to structural reforms by the new governments is required. The Serbian programme aims to foster economic restructuring, competition and employment. The programme gives sufficient space to measures to improve the overall business and entrepreneurial environment. The Montenegrin EFP itself does not cover structural reforms. These are presented in a separate document attached to the EFP, updated in 2005 and outlining key reform activities until 2007. However, neither quantitative estimations nor fiscal effects of these reforms are provided.

4. THE EFPS AND 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

ALBANIA

1. SUMMARY AND CONCLUSIONS

- Albania's first Economic and Fiscal Programme for 2006-2008 is a broadly consistent economic policy document, outlining a fundamentally sound medium-term framework. The programme should help strengthening guidance for economic policy making. Given its pioneer character, the document nevertheless only partly complies with the content, form and data requested. Its macroeconomic and fiscal scenario is mostly in line with the framework of other policy documents which it complements. However, there exist a few divergences from the macroeconomic and fiscal framework under the current IMF programme, which need to be further clarified.

- Over the past two years, the Albanian economy has benefited from robust growth with a satisfactory degree of shock resilience, accompanied by low inflation and exchange rate stability. The fundamentals of fiscal policies aimed at fiscal consolidation and increasing efficiency of public administration have been pursued further and fiscal indicators have accordingly continued to improve. However, enhancing export competitiveness and implementing measures to improve the external account imbalances remain among the major challenges for the Albanian policy makers over the medium term.

- The programme's policy mix of continued fiscal adjustment and stability-oriented policies appear to be adequate. Nevertheless, as of the date of finalising this assessment, it is unclear to which extent the programme's fiscal framework remains valid. Based on information available as of early May 2007, the government intends to implement important fiscal measures that had not been indicated in the programme. This fact limits the value of the programme for policy planning and information. For this reason, it would be highly desirable if future programmes present -to the extent feasible- detailed information on all specific planned fiscal policy measures, their expected budgetary effects, as well as the potential fiscal risks involved to fully assess the quality and sustainability of the proposed measures. In this respect, particular attention should be given to the reform of the tax administration, expenditure quality, continuing public debt reduction and accelerating efforts to strengthen the administrative capacity of public debt management with the focus on reduction of the identified vulnerabilities and outstanding deficiencies.

- The structural reform agenda seems overall challenging and will require a strong commitment by the Albanian authorities as well as a swift removal of those obstacles that have seriously delayed reforms in the past, in particular as regards the privatisation, judicial system reform, and restructuring of publicly-owned enterprises. The presentation of envisaged structural reforms would have benefited from a clearer definition of objectives and specific measures, including estimates on the respective budgetary effects involved.

2. INTRODUCTION

In July 2006 Mr Almunia, Commissioner for Economic and Financial Affairs, 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 EFPs are a further step in the increased policy dialogue on economic and fiscal issues between the authorities of the potential candidate countries and the Commission. It will be a yearly exercise and the programmes will be assessed by the Commission. The scope and content of the EFP is similar to the Pre-accession Economic Programmes which are submitted each year by candidate countries, although the scope of the EFPs is smaller.

Albania submitted its first Economic and Fiscal Programme (the "EFP") on 1 December 2006, covering the period 2006-2008. The programme, coordinated by the Ministry of Finance, is the result of the cooperation of the Albanian government and the Bank of Albania. The programme was approved by the Council of Ministers in November 2006. It is largely consistent with other policy documents, such as the as the Government Program 2006-2009, the Medium-Term Budget Program 2007-2009, as well as with the National Strategy for Economic and Social Development (NSSED) of November 2001 and on Progress Reports of NSSED from May 2003, May 2004 and July 2005. The EFP is in broad compliance with the policies of the IMF programme under the PRGF/EFF arrangements as laid out in the Memorandum on Economic and Financial Policies from January 2007. However, a few discrepancies exist, which need to be further examined.

The programme only partly complies with the requirements stated in the outline for the 2006 EFP in terms of content, form and data. The programme provides a mostly factually correct summary of recent macroeconomic developments and sets out a broadly coherent and consistent macroeconomic framework, although more emphasis could have been put on unexpected developments. The programme would benefit from presenting also alternative scenarios, in particular such, where some key assumptions (i.e. on energy) are modified. The programme presents its medium-term fiscal and other policy objectives and provides a detailed account of ongoing and planned structural reforms. Nevertheless, the programme suffers from lack of a number of requested indicators and projections as well as from a limited quantitative assessment of the impact and a clear timetable of the proposed policy measures. As a result, the capacity for a comprehensive analysis of some issues and related policies remains correspondingly restricted. It is unclear to what degree the provided data are in line with ESA 95.

The programme's key objective is to formulate economic and fiscal policies as well as structural reforms to be implemented over the medium term. These policies and reforms are aimed at macroeconomic stabilisation and ensuring a high economic growth, as well as the establishment of a regulatory framework and sector policies in accordance with EU standards. The programme also highlights the key elements and objectives of the new public debt strategy and sets operational targets for its implementation. The structural reform agenda largely consists of the continuation of a broad array of initiatives in the field of export competitiveness, reforms for attracting foreign investment, privatisation of strategic sectors, financial sector, labour market and administrative reforms.

3. MACROECONOMIC DEVELOPMENTS

3.1. Recent macroeconomic developments

Albania maintained a fairly stable macroeconomic environment throughout 2005 and 2006, characterised by strong GDP growth and subdued inflation. Nevertheless, the repercussions of the energy crisis at the end of 2005, combined with weakening economic activity in the construction sector, decelerated GDP growth to an estimated 5.5% in 2005 and 5% in 2006. Economic growth continued to be led mainly by domestic demand fed by booming credit and significant remittances inflows.

Average annual inflation remained moderate and stood at 2.4% in 2005 and 2006, thereby remaining at the lower end of the Bank of Albania's informal 3±1%inflation target range. After a temporary drop in the first quarter of 2006, modest inflationary pressures resumed in the second quarter of 2006. In order to contain these, the Bank of Albania tightened its monetary policy stance in July and November by raising the main policy rate each time by 25 basis points. The lek appreciated against the euro by approximately 3% in nominal terms during 2005, while it remained relatively stable vis-à-vis the euro throughout 2006.

The labour market situation continued to improve. The unemployment rate (based on the official registered data) fell somewhat to 14.2% in 2005 and further to 13.8% in 2006. The trends in employment are nevertheless difficult to assess due to limited reliability of the available data and significant informal employment, particularly in the agricultural and construction sectors.

Table 1: **Macroeconomic developments**

	2005	2006	2007	2008
Real GDP (% change)	5.5	5.0	6.0	6.0
Contributions:				
- Final domestic demand	5.0	4.8	4.5	5.1
- Change in inventories	n.a.	n.a.	n.a.	n.a.
- External balance of goods and services	0.6	0.2	1.5	0.9
Employment (% change)	n.a.	n.a.	n.a.	n.a.
Unemployment rate (%)	n.a.	n.a.	n.a.	n.a.
GDP deflator (% change)	1.18	1.21	1.25	1.29
CPI inflation (%)	2.4	3.0	3.0	3.0
Current account balance (% of GDP)	-8.6	-8.6	-7.9	-7.4

Source: EFP 2006

External deficits widened considerably in 2005 and the estimates of the authorities for 2006 do not suggest a reversal. According to the programme, the trade deficit widened to 23.8% of GDP in 2005 and remained close to this level also in 2006. The financing of the trade deficit remained largely dependent on significant remittances and other current transfers estimated at 12% of GDP in 2005 and 13.5% of GDP in 2006. As a result, the current account deficit reached 8.6% of GDP in 2005 and was expected to reach the same level also in 2006.

The programme presents a fair overview of recent economic developments in 2005 and the first half of 2006 for most economic indicators. Nevertheless, some important data are not provided at all (e.g. labour market indicators). In certain cases the factual description would have benefited from more clarity and accuracy.

3.2. Macroeconomic scenario

The macroeconomic scenario appears overall fairly consistent. Nevertheless, the outlook for the labour market indicators is largely missing, restraining the coherence of the projections. No alternative scenarios are presented, which limits the robustness of the submitted projection in case one or more of the key underpinning assumptions are not met. In particular, the assumptions of not encountering any serious energy crisis or absence of quick and unexpected increase of the oil prices in the world market might be seriously challenged, taking into account the developments witnessed since autumn 2005. In this context, the most recent difficulties encountered since December 2006 of securing reliable power supply and their possible impact on the economic developments represent a particular cause of concern. Furthermore, an external outlook is missing, which could further underpin the macroeconomic framework. Future programmes would considerably benefit from including and discussing the main assumptions about expected external economic developments, in particular those related to the world economy, as requested by the programme outline.

Overall, the presented macroeconomic scenario is broadly coherent with the outlined policy-mix, which is at the same time mostly in broad compliance with the policies of the IMF programme under the PRGF/EFF arrangements as laid out in the Memorandum on Economic and Financial Policies from January 2007. Nevertheless, a few divergences can be found between the programme's scenario and the government's medium-term macroeconomic and fiscal framework agreed with the IMF during the latest (second) review of the ongoing programme in early November 2006, in particular as regards the projections of budget revenues (more optimistic in the EFP), expenditure ceilings (higher in the EFP)[4], public debt and balance of payments.

The chapter devoted to the macroeconomic framework for 2006-2008 would gain from a better focus on the projected outlook over the programme period, while shifting the descriptive and mostly repetitive overview of the recent developments to Chapter 1. In a number of cases, the description of the past developments takes dominance, while the discussion on the underlying assumptions and justification of the presented projection is limited only to a few comments, without providing an explicit justification of the assumed evolution (in particular apparent in the external sector overview), which often seems to amount to a simple extrapolation of the observed trends in the future.

Real sector

For the period 2007-2008, the programme forecasts continued strong GDP growth of 6% annually, which is by 1% higher than the average for the period 2002-2006. Growth is expected to be driven by domestic demand, rising investment and an increasing contribution from net exports. Private consumption is expected to be the main contributor to growth; for the period 2006-2008 it is estimated to contribute to real GDP growth by 3.2% on an annual average. Although this might be realistic, the document may have wished to explain more clearly the key driving factors behind. Contribution of capital formation to real GDP growth is seen to increase, mainly on the back of increased public investment. In line with the programme's overall objective of improving the external account imbalances, the negative contribution to GDP growth from the trade imbalance observed in 2005-2006 is expected to be reduced, against the background of accelerated export growth and more tempered import growth. Combined with the projected increase in tourism receipts, the overall contribution of external demand to economic growth is foreseen to rise. On the supply side, construction, agriculture and services are each expected to grow on average between 1 and 2% annually. Rising investments in the energy sector, infrastructure and transport are seen as the main stimuli to enhance growth dynamics in the service sector.

The programme does not provide any discussion or projections of labour market trends or productivity developments. While acknowledging the current limited availability and reliability of the respective historical data, efforts should be made to further strengthen the

[4] These divergences are discussed in more detail in chapter 3.

statistical and forecasting capacity. In this respect, it is important to establish firm-level surveys in both manufacturing and services sectors, in parallel to the launching of labour market surveys, while improving the data accuracy. The programme would have benefited from a more detailed assessment of the determinants of employment and productivity developments, in terms of wages, labour productivity and unit labour costs etc, and their effect on growth over the medium term.

Growth projections seem overall plausible and broadly in line with the stability-oriented macroeconomic policy mix of the programme. They largely concur with the estimates of the IMF and other international institutions. Nevertheless, as highlighted above, the projections of growth rest on a number of critical assumptions, inter alia on stable electricity supply. In this respect, the important power supply disruptions experienced since December 2006 might possibly pose a tangible threat to the outlook's validity. These disruptions might have indeed impact not only on the economic growth, but might also have repercussions in the form of potential inflationary pressures resulting from higher electricity import prices, further widening of the current account deficit as a result of higher import volumes or significant worsening of the financial situation of KESH. Additional risks stem from the relatively high rates of credit growth, external imbalances or from vulnerabilities resulting from the relatively high level of domestic public debt, its short average maturity (rollover risk) and related insufficient debt management capacity.

External sector

As noted above, the programme provides only a limited qualitative assessment of the presented outlook and the sustainability and financing of the external deficits over the programme period. The programme projects a gradual narrowing of the current account deficit from 8.6% of GDP in 2006 to 7.9% of GDP in 2007 and further to 7.4% of GDP in 2008. It outlines a scenario of accelerating growth of merchandise exports while merchandise imports are projected to grow more slowly, as it was the case in the last quarter of 2006. The narrowing of the external imbalances is seen as a result of rising production capacities for exports induced by machinery and equipment imported during the past years, together with stronger FDI (as a result of resumed privatisation and improved business environment), ongoing enterprise restructuring and increase of the popularity of tourism. The trade deficit is projected to be reduced from 23.9% of GDP in 2006 to 22.9% of GDP in 2007 and 2008. The programme does not contain a competitiveness assessment on the basis of projected real effective exchange rate trends.

Overall, future programmes would considerably benefit from a more extensive discussion of the factors determining the projected evolution of the current and capital accounts, a description of the main policy objectives (such as broadening of the export base and strengthening export competitiveness, improving business climate to enhance the FDI) and policy measures to achieve them. Also, given the foreseen sizeable increase of public investment in 2007 and 2008, a discussion whether this is expected to have some implication on the balance of trade (by possible temporary rise of capital goods imports) would be useful.

3.3. Monetary and exchange rate policy

The programme contains a comprehensive description of the monetary and exchange rate policy framework. The exchange rate regime of Albania is an independent float, although the Bank of Albania occasionally intervenes in the foreign exchange market with the objective of smoothing temporary fluctuations and to accumulate needed reserves. The primary objective of the Bank of Albania is to maintain price stability, achieved by pursuing a policy of implicit inflation targeting. An annual inflation rate of 3% with a fluctuation band ±1% has been set as specific objective, to be effectively implemented in the central bank's strategy through changes in the repurchase rate.

The macroeconomic policy mix appears broadly adequate with respect to the outlined programmes objectives. The programme mentions that no major policy changes are planned over the programme period and that the Bank of Albania maintains the current exchange rate framework and policies. However, discussions on a possible change in the Bank of Albania's monetary policy towards an explicit inflation targeting regime have been initiated, with the aim of enhancing transparency and credibility of its policy. Although it is not expected that such a change will be implemented over the programme period, the document would nevertheless have gained from a brief reference of the state of play of these discussions, as well as of pros and cons of considered alternative policy options and challenges that the authorities are likely to be confronted with if the alternative policy regime is introduced.

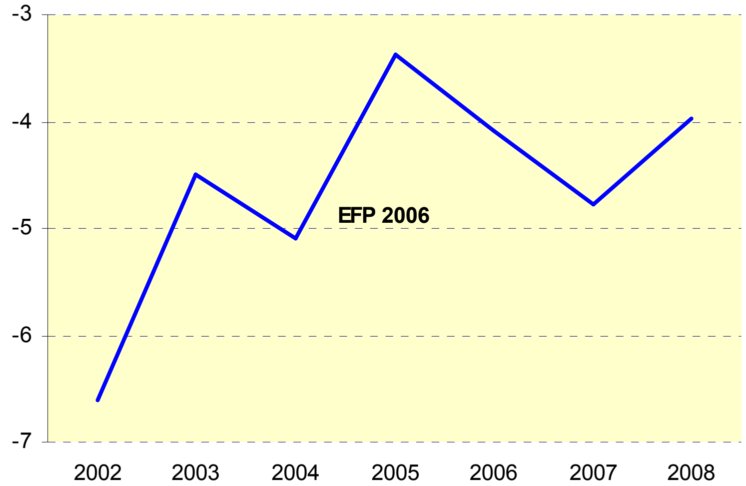
No information on the expected development of the real exchange rate is provided. The inflation path outlined in the programme foresees annual inflation to fluctuate over 2007-2008 around 3%, i.e. the mid-point of the targeted range. The programme identifies the main factors expected to determine the price levels in 2007-2008 well: rapid growth in credit to private sector, expected increase in foreign exchange inflows, increases in administered prices and pressures from commodity markets. Although not explicitly required by the latest EFP outline, future programmes would benefit from a brief description of the main channels of the transmission mechanism and a discussion on the link between the financial sector and monetary stability.

4. PUBLIC FINANCE

The programme presents a fairly coherent and consistent medium-term public finance framework with fiscal projections for the main categories on the revenue and expenditure side of the consolidated general government budget. The programme contains some information on fiscal policy measures envisaged during the programme period. It would have benefited from a more in-depth and systematic description of intended fiscal measures and their quantitative budgetary effects, possibly including a sensitivity analysis of the impact of changes to main assumptions. The overall envisaged fiscal adjustment seems appropriate, encouraging and consistent with developments in recent years. Sometimes it is difficult to detect whether the programme is already sufficiently backed by permanent structural policy measures on the revenue and expenditure side. While acknowledging the pioneer character of the programme, the document would have also certainly benefited from a larger degree of precision in this respect. It is not clear to what degree the presented data are compatible with ESA 95.

Continued fiscal consolidation combined with strengthening of fiscal management is presented as the key instrument to maintain a small, but efficient, government, in order to reduce vulnerabilities resulting from public indebtedness, to improve the business climate and to attract FDI. The share of both general government revenues and expenditure in GDP is projected to somewhat increase (the latter mainly in order to allow in particular for a higher capital expenditure). The programme projects a budget deficit culminating in 2007 close to 5% of GDP, with a slight decline to 4% of GDP in 2008. Public debt is programmed to decline by over 2% of GDP during 2006-2009. The scenario slightly diverges from the macroeconomic and fiscal framework assumed under the current IMF programme. The EFP assumes a more optimistic scenario in terms of revenue projection, higher cap on public spending and a higher budget deficit over the programme period. This is a cause of concern since these differences, although not overly sizeable, might signal a change in fiscal strategy. Hence, a clarification of the reasons for the identified divergences would have been desirable (if these are for instance due to assumed increased absorptive capacity in capital spending or due to other important reasons).

Chart 1: Budgetary developments
(general government balance, % of GDP)



4.1. Fiscal architecture and governance

In Albania, the responsibilities concerning fiscal decision making and the mechanisms for fiscal governance are defined mainly by two key legal acts. First, the Albanian Constitution defines two levels of the governance structure -Central and Local government- and defines the key pillars of the regulatory framework for the respective intergovernmental relations. Second, the Organic Budget Law of July 1998 defines governmental fiscal relations and processes in more detail. According to this law, the Ministry of Finance is responsible for drafting legislation in the area of public finance. It is the Government's chief adviser and the executive body for fiscal policy, and the management of public funds and expenditure.

The EFP mentions that a new draft of the Organic Budget Law was expected to be presented to the Assembly in December 2006. According to our information as of early February, this has not yet happened and the draft law was still under discussion in the Ministry of Finance, subject to inter-service consultations and approval by the Government tentatively foreseen in spring 2007. The new draft law is a result of a number of initiatives and discussions ongoing since 1998, on the basis of the need to define a better regulatory framework for a vast number of fiscal processes, with the aim at better reflecting their increasing complexity. The draft law proposes new provisions regulating the processes of the Medium-Term Budgetary Programme, fiscal relations among central and sub-national governments, the process of strengthening public expenditure management, adoption of best practice on public accounting and public financial statistical standards, the public administration reform aimed at increasing accountability and fiscal transparency.

The programme correctly identifies decentralisation and development of appropriate financial relations between central government and sub-national levels as an important issue. Over recent years, Albania witnessed important transfer of roles and responsibilities from national to local levels, empowering municipal authorities in areas such as infrastructure and public services, regional economic development, public order and social protection. Increased fiscal autonomy at local levels implied also a transfer of additional resources from the central government to municipalities. Since January 2007, the responsibility for collection and management of small business tax revenues falls to local administration. Against this background, it is vital to ensure that the institutional capacity of the local administration is strengthened accordingly in order to efficiently assume the new tasks.

Future programmes would benefit from a more detailed description of the budgetary process in terms of reporting, decision-making, implementation and audit procedures, and if possible, also outlining perceived deficiencies and envisaged changes to the current structure and procedure.

4.2. The fiscal framework

In 2006, the relatively prudent fiscal stance both contributed to and benefited from a favourable macroeconomic environment. Combined with solid progress in implementation of reforms aiming at improving the tax administration and reducing tax evasion, this led to higher than expected revenues. Mainly for this reason, together with considerable under-spending of planned capital expenditure, the programmed general government deficit of around 4% of GDP was undershot and amounted instead, according to Albania's latest estimates, to 3.2% of GDP. The programme might have mentioned that the slow execution of capital expenditure is partly a result of capacity constraints in some ministries and weak procurement management. In light of a favourable budget performance in the first half of 2006, in terms of risen tax revenues, the authorities reached an agreement with the IMF on a supplementary budget for the second half of 2006. It was adopted by the Assembly on 31 July and included additional expenditure of 2.2% of GDP. A large part of this amount has been allocated as additional investment in infrastructure projects. The authorities progressed in implementing a number of measures to reform the tax administration and public finance management throughout 2006. These measures relate to strengthening fiscal discipline, tax administration efficiency, tax collection as well as improving the quality of public expenditure and building capacity for debt management. Most of these measures yielded some first solid results; hence the authorities should feel encouraged to continue their rigorous implementation. In particular, the strengthening debt management capacity should get prominent attention.

The programme projections for 2007 are largely in line with the Budget Law, as adopted by the Assembly on 30 November 2006. The programme envisages a budget deficit of 4.8% of GDP in 2007, with revenue- and expenditure-to-GDP ratio at 25.8% and 30.6% respectively. Revenue projections for 2007, based on the 2006 projected outcome, are generally plausible. In this context, it might nevertheless be noted that particularly the recent energy crisis could lower economic growth below the projected 6% in 2007, which may also have repercussions for revenue collection. Some safety margin is provided by the fact that, as in 2006, any extra revenue from further improvements in administration and strategic privatisation proceeds that might materialize in 2007 are not accounted for in the budget. If some of these revenues are materialized, they are expected to be allocated in a supplementary budget following the mid-year budget review. The large contingency in the 2007 budget in the amount of 0.9% of GDP provides for additional safety margin.

Table 2: **Composition of the budgetary adjustment** (% of GDP)

	2005	2006	2007	2008	Change: 2005-08
Revenues	24.4	25.6	25.8	26.8	2.4
of which:					
- Taxes and social security contributions	22.0	23.1	22.1	24.2	2.3
- Other (residual)	2.4	2.5	3.7	2.5	0.1
Expenditure	27.8	29.7	30.6	30.7	3.0
of which:					
- Primary expenditure	13.9	15.2	15.7	16.2	2.3
of which:					
Gross fixed capital formation	4.6	6.1	7.1	7.2	2.6
Consumption	9.3	9.1	8.7	8.9	-0.4
Transfers & subsidies	4.0	4.2	4.2	3.4	-0.7
Other (residual)	6.7	7.2	7.6	8.3	1.5
- Interest payments	3.1	3.1	3.0	3.0	-0.2
Budget balance	-3.4	-4.1	-4.8	-4.0	-0.6
Primary balance	-0.3	-1.0	-1.8	-1.0	-0.8
Gross debt level	54.6	54.9	54.2	53.6	-1.0

Sources: EFP, ECFIN calculations

Main revenue-related measures are related to a further improvement of efficiency in tax collection, with a special focus on strengthening the Large Taxpayers Office, reviewing the role of the Tax Police and efforts aiming at formalising and reducing of tax evasion. In addition, the programme envisages an establishment of a special task force with the aim of formulating and monitoring regulatory reforms in the area of business development and attracting foreign investment. The 2007 budget does not consider any changes in tax rates (except reduction of customs duties). The programme notes that any tax policy reforms directed at reducing the tax burden shall be introduced at a measured pace, to ensure that revenue gains are sustainable. Such a policy approach is very welcome and of paramount importance for the soundness and sustainability of the public finance in Albania. In this context, the programme could however have made clearer that any further tax cuts will be implemented only upon a sufficient prove that improvements in tax administration and collection are indeed permanent.

In terms of expenditure policy for 2007, infrastructure, health care and education will remain the priority sectors for government expenditure. Although allocation of spending across economic and social sectors is broadly in line with other high-growth countries, Albania should accelerate the transition to economic tariffs (in the water sector), the provision of adequate financing of operations and maintenance (notably in water and road sectors) and the establishment of institutional frameworks for private investment (in the transport and energy sectors). The emphasis is on reducing the subsidies, the burden of the debt servicing and reallocating these resources towards priority capital expenditures, in particular related to infrastructure projects and poverty reduction expenditures. The objective to further improve the expenditure quality and to increase the share of capital expenditure to total spending by investing in the priority sectors is certainly desirable in order to sustain solid economic growth. The programme envisages a 20% increase in wages in the education and health sector in mid-2007, to be mostly financed from the Reserve Fund for pensions and Wage Policy.

For 2008, the programme envisages a continuation of the favourable trends in tax collection and an increase of the revenues-to-GDP ratio by 1% to 26.8%. This projection, as noted above, diverges from the medium-term fiscal framework under the current IMF programme, which assumes a more conservative scenario with revenues estimated at 26.2% of GDP. On the expenditure side, the programme projects total expenditure to further increase close to 31% of GDP, thus exceeding the cap for public spending at 30% of GDP agreed with the IMF. The budget deficit in 2008 is then programmed to decline to 4% of GDP.

The reasons for these divergences should be carefully examined in order to avoid any unwarranted signals as regards the commitment of the authorities to continued fiscal consolidation. The presented scenario, by allowing the expenditure envelop to grow beyond the agreed benchmark, might pose a risk of diminishing the incentive to set well-defined development and expenditure priorities, which remains key for the conducting a credible fiscal policy.

4.3. Debt developments

The public debt-to-GDP ratio has been substantially reduced over recent years, from 71% in 2000 to 55% in 2006. However, the level of domestic public debt at 37.8% of GDP at the end of 2006 remains still relatively high and a more vigorous stance for further debt reduction is critical. In addition, the average maturity of domestic public debt is still short and efforts that would enable its lengthening need to be accelerated. Albanian Government's external debt is estimated at around 17% of GDP at the end of 2006, representing around of 31% of total public debt.

The EFP provides for a very comprehensive description of the recently completed public debt management strategy. The strategy very well identifies the main risks and challenges related to maturity, exposure to exchange rate risk, capital market liquidity and operational risk and investors' diversification. The strategy's objectives are adequate and address the key vulnerabilities resulting from the current debt structure. The programme aims at lengthening the maturity of the total debt (increasing the long-term debt ratio to total public debt from around 30% in 2007 to around 45% in 2009), decreasing the borrowing costs, developing new debt instruments and considerably strengthen the administrative and risk management capacity of Debt Directorate within the Ministry of Finance. The programme also aims at reducing somewhat the domestic currency exposure through a modest shift to external borrowing. The document correctly argues that through an increased access to foreign official financing and longer-term external commercial instruments, such strategy would lower the cost of debt service and reduce reliance on short-term dated domestic bonds, hence also reducing their respective rollover risk. While this strategy has certainly a solid rationale, the assumption of an increase of external debt by 4% relative to GDP during 2007-2009 seems to contradict the presented macroeconomic framework: The annexed tables project a gradual reduction of the public debt from 54.9% of GDP in 2006 to 52.6% of GDP in 2009, mainly as a result of the projected reduction of the stock of domestic debt by around 2.1% of GDP, while assuming the external debt-to-GDP ratio *stable* at around 17%. In this context, while the assumption on the decreasing debt to GDP ratio seems plausible and desirable, clarification of the reasons for inconsistency of this assumption with the budget 2007 would be welcome.

4.4. Fiscal risks

The programme presents a limited overview of risks potentially affecting fiscal (revenue) indicators, in addition, without any discussion of their potential impact[5]. These identified risks mainly relate to economic growth sustainability that could be possibly threatened by a declining inflow of remittances and other private transfers, power supply disruptions, oil price volatility and a potential worsening of trade balance following the Stabilisation and Association Agreement[6]. Other potential risks, such as risks linked to structural reforms or large infrastructure projects (for example the Durres-Morine corridor etc) or stemming from explicit or implicit contingent liabilities, are not mentioned. Another type of risk is a possible pre-matured reduction of the tax burden, without a sufficient track-record of the improved revenue collection that would justify such an action. Should one or more of these risks materialise, the actual budget outcome over the EFP period would turn out to be less comforting than envisaged in the programme.

5 Future programmes would significantly benefit from including an analysis of the sensitivity of the revenues to GDP and discussion on the elasticity of various revenue sources. Indeed, a more complete analysis, covering also the sensitivity of expenditures, would have been even more revealing, notably since the macroeconomic framework is optimistic in its growth projections.

6 It would be more accurate to say that revenues from custom fees are expected to decline as a consequence of the entry into force of the Interim Agreement.

Box1: The EFP and the European Partnership economic priorities

The revised European Partnership (EP) between the European Union and Albania was adopted by the EU Council of Ministers on 9 November 2005. Its purpose is to identify the main priority areas where action is needed for Albania's progress towards further integration into the EU. A distinction is made between short-term priorities, which are expected to be accomplished within one to two years, and medium-term priorities, which are expected to be accomplished within three to four years. Thereby, in principle, some of short-term priorities should have been met by now. As a response to the EP, Albania adopted in July 2006 an action plan, outlining specific measures foreseen to address the EP priorities.

The short-term priorities include maintaining macroeconomic stability by accelerating fiscal reforms, in particular regarding the budget process, expenditure management, social protection systems and public sector pay reform. They also encompass reducing the grey and extra-legal economy by effective and non-discriminatory enforcement of tax legislation and intensifying the fight against fiscal fraud, as well as improving macroeconomic statistics and the coverage of the business register, and taking steps to allow for the successful privatisation of Albtelecom. Substantial progress was made in maintaining macro-economic stability and fiscal reforms, including some first encouraging results from the efforts to reduce fraud and grey economy. There have been reasonable improvements as regards statistics and public administration in general. However, the privatisation of Albtelecom registered significant delays. Its successful completion should be one of the top goals on the authorities' agenda for this year.

The medium-term priorities of the European Partnership put emphasis on continuing with fiscal adjustments and consolidation, enhancing the sustainability of the external account deficits by enhancing export competitiveness, continuing with a prudent monetary and exchange rate policy stance and making further progress in privatisation, in particular in the financial and energy sectors. They also call for a strengthening of external audit, financial control management and internal audit, establishing effective procedures for the detection, treatment and follow-up of cases of (suspected) fraud and other irregularities affecting national and international funds, ensuring that provisions in relation to land classification and the use of land are respected and developing and adopting legislation for the taxation of land and real estate. The EFP addresses these areas to a varying degree. In particular, future reform plans with respect to the latter mentioned medium term priorities receive no or only very little coverage in the programme. Overall, the policies outlined in the EFP are broadly supportive of the relevant parts of the European Partnership and its full implementation should therefore facilitate the accomplishment of the economic policies.

Nevertheless, despite a less than fully comprehensive coverage of possible risks, the scenario follows a reasonably conservative approach by providing for a decent safety margin that would reduce the negative impact of possible adverse developments. Firstly, the proceeds from privatisation of strategic sectors are not included in the projection (or the budget). Following the agreement reached with the IMF, half of the potential privatisation proceeds will be used for priority sector investments, while the other half to reduce the stock of domestic public debt. Secondly, the projected tax revenues do not consider possible gains resulting from further possible improvements in the tax administration. Thirdly, there might be additional gains resulting from the efforts to formalise and reduce informal economy and tax evasion. Finally, there is a contingency reserve projected at around 0.9% of GDP in 2007.

In conclusion, against the background of the risks identified, the outlined adjustment path appears broadly plausible and supports the sustainability of public finance.

5. STRUCTURAL REFORMS

In line with the outline, the EFP covers structural reforms related to the enterprise and financial sector, labour market and administrative reform. Supporting macroeconomic stabilisation, ensuring accelerated economic and social development, supporting foreign investment, boosting competitiveness, raising human capital, as well as establishing a regulatory framework and sector policies with accordance with the European standards are some of the main objectives of the structural reform agenda. Within the different areas, the strategies and envisaged measures are generally relatively well explained, though in a number of cases the distinction between new and existing measures is not obvious. There is usually no estimate of the quantitative effects of the intended measures and in a number of cases the presentation lacks a clear timetable. Moreover, the relation between the structural reform agenda and the fiscal strategy is not clearly elaborated. 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 specific measures are discussed under separate headings. Their relationship and prioritisation within a cross-cutting strategy, is not always clear. Given the broad scope of issues, the very comprehensive section would further benefit from an introduction or road map, highlighting the government's major priorities and reform commitments (i.e. in form or a structural reform matrix).

Overall, the presented reform policies seem to be appropriate and broadly supportive to the outlined policy mix. They appear to support the fulfilment of the second Copenhagen economic criterion and are generally well aligned with the main conclusions of the 2006 Progress Report. As the programme does not provide any detailed information on the sequencing of specific reforms, it is difficult to assess implementation risk.

5.1. Enterprise sector

In spite of progress of structural reforms over the past years in this important policy area, the Albanian economy is still suffering from significant inefficiencies and weaknesses that constrain productivity and growth, mainly as a result from considerable shortcomings in the business climate. Also, some earlier announced reforms have been delayed, in particular in the field of privatisation and enterprise restructuring. Therefore, the reconfirmed commitment of the government to accelerate the privatisation process is very welcome, in particular in the telecommunication, insurance and energy sectors. Further elaborations on the government plans, timeframe of the individual steps as well as the assumptions behind the estimated proceeds might have further underlined the main message of this section. With respect to state-owned enterprises, the EFP would have benefited from additional information on planned restructuring and performance improving measures, in particular in case of the electricity utility KESH and water utilities sector that would decrease their reliance on budgetary operating subsidies. Elaboration and possible quantification of the related fiscal impacts of these measures would be welcome.

5.2. Financial sector

The Albanian financial sector is dominated by commercial banks, practically all under private ownership, that are generally well capitalized, liquid and profitable. Banking supervision lies within the responsibility of the Bank of Albania. The regulatory framework for banking supervision is, following its recent comprehensive overhaul, well developed and in a continuing process to be further aligned with best international practice. On the other hand, the regulatory, governance and supervisory framework for the non-bank financial sector and its respective supervision capacity still need to be considerably strengthened, while promoting its transparency and independence. The establishment of the Financial Supervision Authority is indeed considered as a welcome step in this direction and implementation of the Institutional Development Action Plan that would enforce its capacity should become a high priority. The document could have been more pronounced on financial sector related challenges and possible policy responses. One of the key challenges over the medium term will be to manage robust credit growth, improve the execution of collateral (the document could have more elaborate on the state of play of the new legislation under preparation) and substantially strengthen non-banking sector supervision in order to sustain the growth of assets managed by pension and investment funds, insurance and leasing companies. Preparations for establishing a credit information bureau need to be accelerated, with a view to increasing the availability of credit to small and medium-sized enterprises by improving the efficiency of credit risk management.

5.3. Labour market

Recent labour market policies have led to some encouraging results in formalising employment and improving the functioning of the labour market. Nevertheless, the Albanian labour market continues to face significant challenges, such as relatively slow job creation or high youth and long-term unemployment. The effectiveness of programmes for attracting jobseekers remains generally constrained by inadequate design, lack and irregularity of funding and insufficient training capacity. The labour market policies presented in the programme signal the maintaining of a broadly flexible framework and a sound rationale, though more attention should be given to improve clarity of their presentation. Reached or intended improvements to the legal framework must be followed by the commensurate measures and building capacity to enforce legislation. The efficiency of policy design and planning would be further substantially strengthened by developing statistical capacity and data reliability of the key labour market indicators. In this respect, a labour force survey foreseen to be conducted in early 2007 will give a new momentum to this process. In the section on the new programmes to be implemented in the labour market, the EFP gives an overview of the main features of the Programme for the disabled persons (LAP). More details on this programme would be welcome.

5.4. Administrative reform

Public administration reform continues to be a key priority for the Albanian authorities. Despite some solid progress achieved over the previous years, the reform agenda remains very broad and challenging: rationalization of the size and structure of the public sector, reforming the pay system in order to improve transparency and provide appropriate incentives for improved performance and accountability need to be pursued in view of achieving and efficient and lean public sector. While the size and the cost of Albania's wage bill in public sector are in line with regional comparators, institutional capacity and efficiency of the public administration still leaves a large space for further significant improvements. In this context, it is in particular important to ensure a proper compliance with the Law on Civil Service and improving its record of implementation as well as to accelerate progress in the completion of the human resource management information system (HRMIS). The programme could have elaborated more on specific reform measures envisaged to strengthen institutional capacity relevant for the acquis in the economic and financial domain.

5.5. Additional reform areas

The programme provides a brief overview of the objectives and reform policies in the judicial system. This information is extremely useful as outstanding deficiencies of the judiciary indeed seem to hinder the economic development of the country. Enforcement of property rights continues to be weak and only marginal progress has been achieved in improving the system's efficiency. Due to significant delays in the courts it is often difficult to obtain court rulings and enforce contracts. Land ownership rights have not yet been guaranteed, particularly in urban and coastal areas. The related legal uncertainty on collateral recovery still impedes bank lending and investment. Overall, we strongly encourage the Albanian authorities to proceed with the adoption of the outlined legislative acts and subsequent duly implementation of the commensurate measures as soon as possible.

6. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

The main principles of the budgeting process outlined by the programme appear sound and broadly in line with good practice. The document reports on a number of measures that should further improve the quality of public finances and budgetary planning over the medium term. Apart from the measures highlighted and summarized above in chapter 3, the programme foresees that the tax and expenditure policy will be aligned with the strategic objectives set in the National Strategy for Development and Integration (NSDI) for 2007-2013. This strategy defines short, medium and long-term national objectives for each sector, taking into account objectives resulting from the EU approximation and prospective NATO membership. The NSDI, following its anticipated approval in April 2007, is expected to lead the Medium-Term Budget Programme process and thus, to ensure better linking the strategic objectives with budget expenditures.

Furthermore, in order to improve public expenditure management, the programme foresees changes in the area of identification, design and evaluation of public investment projects, as defined in the Action Plan for the Improvement of the Public Investment Management, agreed with the World Bank. Progress in better prioritisation of spending is now expected to accelerate by the recently introduced integrated planning system and establishment of the new public investment department in the Ministry of Finance. It will be necessary to ensure the adequate capacity of the newly established departments rapidly in order to avoid possible risks of delays in implementation of the intended measures. Also, upgrading capacities of the macroeconomic and fiscal directorate and the budget policy department would provide for further improvements in planning and budgeting process. In addition, further improvements are envisioned by the implementation of the new Organic Budget Law, currently under preparation. Also, as noted in chapter 3, the programme foresees a change of the budget composition by gradually increasing the share of capital expenditure to total spending. While this strategy is appears desirable -given the huge investment needs in particular in the infrastructure sector-, cost and benefits of alternative policy choices should be carefully considered that would maximize the potential for high and sustainable growth. At the same time, it is of immense importance to allow for securing sufficient funds to cover operations and maintenance of the existing infrastructure that is in general in very poor condition.

Strengthening the debt management capacity remains critical for a sound implementation of the outlined fiscal strategy and should be one of the key priorities for the Ministry of Finance. Hence, the programme would have gained from an overview of the measures to be implemented to address this very important issue, including a more detailed timetable. For example, the document does not address the planned independent review of the staffing requirements of the debt management unit (including a review of conditions such as competitive salaries) to be carried out by June 2007 and a number of other related measures.

The outlook provides a fairly comprehensive overview of the medium-term fiscal path and intended fiscal policies over the programme period. Future programmes would considerably benefit from a more in-depth discussion of the various implemented or planned measures in the key reform areas (tax administration reform, retirement age/labour market participation, reform of health and pensions systems, efforts to reduce the debt ratio, improving quality of budget expenditure) and their impact on the presented objectives, directly in the light of the public finance sustainability issues. In the context, taking into account very low levels of educational attainment and inadequate health care, the document could have also been more pronounced on the current considerations and intended measures to restructure the existing composition of pubic expenditure, both within and between sectors, as a key element in enhancing the quality of fiscal adjustment, ensuring fiscal sustainability, and strengthening growth.

BOSNIA AND HERZEGOVINA

1. SUMMARY AND CONCLUSIONS

- On 1 December 2006 Bosnia and Herzegovina submitted its first Economic and Fiscal Programme (EFP) to the Commission. The programme broadly covers the period 2006 to 2008, although with some variation between the different sections. The content would have benefited from a more comprehensive inclusion of relevant statistics and from a more consolidated view, in particular of fiscal policy making for the country as a whole. Nevertheless, the programme serves as a basis for looking at the prospective economic and structural reform developments over the programme period.

- Bosnia and Herzegovina held parliamentary elections in October 2006 and the new governments were not yet in place at the time of the submission of the EFP. The policy intentions of the incoming governments are therefore not fully reflected in the programme. In addition, the EFP is not fully updated in line with developments in 2006 until the time of submission. Therefore parts of the programme are outdated, in particular the fiscal section, and not likely to reflect the policy commitments of the new governments. The assessment takes these circumstances into account. It nevertheless tries to examine at the presented outlook and the broader picture on fiscal issues and developments.

- The EFP estimates real GDP growth to have been close to 6% in 2005 and 2006 and foresees the economy to continue to expand at around 6% per year over the programme period. Inflation is expected to decline, after the peak caused by VAT introduction, to 2% in 2007 and 1.5% in 2008. Concerning the external balances, no comprehensive forecast is presented. Exports are expected to continue to expand strongly at above 20% in both 2007 and 2008. The growth scenario presented is reasonable, given the expected continued strong output increases in the metal industry, although with certain downside risks. Inflation expectations seem to be on the low side, given potential regulatory price hikes. Export growth expectations appear, in particularly for 2007, rather optimistic.

- The public finance scenario outlines fiscal developments at state and entity level, but the scenario presented suffers from a number of drawbacks. Firstly, it does not seem to be based on the macroeconomic scenario of the programme, but assumes higher growth rates over the programme period. Secondly, expected primary balances are presented for the entity governments and state level, but no consolidated general balances are presented. A view of the intended fiscal stance is therefore not possible to draw from the programme. In addition, presented fiscal data for 2006 is mostly outdated. The programme outlines efforts made to produce a law on the National Fiscal Council and highlights the still outstanding issues to be addressed. However, the EFP does not outline how these issues are expected to be brought forward.

- The structural reform agenda presented covers a broad range of issues, such as privatisation, banking sector reforms and public administration reform. Planned reforms are described for the different levels of governments, but not always in a comprehensive and consistent way. Moreover, the reform agenda is often vague on timing and content. Overall, structural reforms should be speeded up and firm reform commitments made from the new governments in order to support a strong and sustainable economic development in Bosnia and Herzegovina.

2. INTRODUCTION

In July 2006 Mr Almunia, Commissioner for Economic and Financial Affairs, 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 EFPs are a further step in the increased policy dialogue on economic and fiscal issues between the authorities of the potential candidate countries and the Commission. It will be a yearly exercise and the programmes will be assessed by the Commission. The scope and content of the EFP is similar to the Pre-accession Economic Programmes which are submitted each year by candidate countries, although the EFP is narrower in scope and time horizon.

The Economic and Fiscal Programme (EFP) of Bosnia and Herzegovina (BiH) was submitted to the Commission on 1 December 2006. The time period covered in the programme varies between different sections, but it is mostly up until 2008 or shorter. The EFP has been approved by the Council of Ministers, i.e. the government at the state level. The governments at entity levels, as well as the Central Bank, have also been involved in the preparation of the programme.

On 1 October 2006, parliamentary elections were held in BiH. By the last date of submission of the EFP, new governments at state and entity level had not yet been formed. Hence, the programme submitted was the work of the outgoing administration and since the formation of new governments was taking some time, no update to the programme could be delivered. Parts of the provided programme, particularly in the fiscal area, are therefore outdated and do not reflect the policy intentions of the incoming governments. This is, for example, reflected by the fact that the budget for 2007 recently adopted in the Republika Srpska (RS) is not consistent with the EFP. The assessment will take this into account and point out where the provided programme is deemed not to be relevant any more and not go into detailed assessment of such information.

The programme represents an effort from the side of the authorities to present a forward-looking view of economic developments. However, in several areas it does not comply with the format or the time frame intended for the EFP. For example, even backward looking data is outdated in the fiscal area and there are two different sets of macroeconomic projections presented. The programme also suffers from lack of information in several areas. In combination with parts of the programme being outdated, it is unclear from the EFP exactly what will be the economic and fiscal policy strategy of the governments for the coming years.

3. MACROECONOMIC DEVELOPMENTS

3.1. Recent macroeconomic developments

The EFP estimates real growth rates of the Bosnian economy to have been close to 6% in both 2005 and 2006, while for example the IMF's estimates point to GDP growth of 5% and 6% for 2005 and 2006, respectively. Strong growth in industrial production supported the relatively favourable economic performance. In the RS, industrial production[7] increased by 20% in 2005 and by 19% in 2006, while in the Federation of Bosnia and Herzegovina the industrial production increased by a lower 6% in 2005 and 7.5% in 2006. Industrial

[7] Data is only available at entity level and not for BiH as a whole

production was mainly increased in the metal and mining sectors and in manufacturing, mostly of products with relatively low value added. Despite the industrial expansion, unemployment continued to be high. Official figures showed an increase in unemployment from 43.7% in the third quarter of 2005 to 44.3% in the same quarter in 2006. Unemployment grew in the Federation while it fell in the RS. However, labour statistics are quite unreliable and real unemployment is overall estimated to be somewhat lower. A labour market survey conducted in March 2006 estimated unemployment to be around 30% of the labour force and the participation rate to be 43%.

On the external side, trade flows were strongly influenced by the introduction of VAT in January 2006. The current account deficit shrank significantly, from 22.5% of GDP in 2005 to around 15% of GDP in 2006. The reduction was partly temporary, explained by a shift of imports from 2006 to end 2005, but was also due to better reporting of exports as well as an increase in the export volume. FDI inflows slowed down from 5.3% of GDP in 2005 to around 4% of GDP for the four quarters leading up to end September 2006. In 2006, inflation reached 8.4% in the RS and 7% in the Federation, compared to an inflation rate of 3.7% in 2005 for BiH as a whole After an increase in the reserve requirements of banks, credit growth slowed down somewhat, from 27.3% in 2005 to 23.4% in 2006.

The EFP outlines recent developments in a number of areas, including for industrial production, investment, external accounts and labour markets. However, the presented information does not always generate a very clear and comprehensive overview of recent economic developments. Admittedly, the lack of reliable data for several key variables makes the task more difficult. The EFP therefore often describes alternative variables and facts to try to make up for the absence of relevant data, which makes the picture less concise and reliable. In particular, the lack of a description of GDP growth and its composition as well as the lack of recent data on investments hampers the overview. The analysis of developments on the external side is also not comprehensive and with data presented only up until the first quarter of 2006.

3.2. Macroeconomic scenario

The macroeconomic scenario is limited in scope and contains scarce explanations of the chosen values. The drivers of GDP growth are only partly explained and the outlook for the external sector is largely missing. The scenario entails detailed accounts of expected specific developments, for example concerning investment projects and certain companies, rather than explanations of the aggregate developments. The quality of the scenario is negatively affected by the lack of availability of certain data. Furthermore, the presented framework is not consistent with the macroeconomic figures presented in the fiscal section. As one main purpose of the macroeconomic scenario is to serve as a basis for the fiscal projections and analysis, it clearly reduces the usefulness of the scenario.

Table 1: **Macroeconomic developments**

	2005	2006	2007	2008
Real GDP (% change)	5.8	5.9	6.0	6.2
Contributions:				
- Final domestic demand	8.9	12.7	7.7	14.0
- Change in inventories	2.4	3.2	1.7	0.0
- External balance of goods and services	-4.0	1.0	-1.0	-2.3
Employment (% change)				
Unemployment rate (%)	31.1	31.0	30.6	30.0
GDP deflator (% change)	1.55	5.00	1.89	1.88
CPI inflation (%)	2.9	7.0	2.0	1.5
Current account balance (% of GDP)	n.a.	n.a.	n.a.	n.a.

Source: EFP 2006

The macroeconomic scenario contains a list of macroeconomic goals (to be achieved by 2007) and thereafter a list of general reform priorities of which many is of structural, and not macroeconomic, nature. While most of these goals are commendable, they are not clearly followed up in the rest of the programme. The external assumptions presented, on which the scenario is based, are not in line with the Commission's forecast, in particular for oil prices which are assumed to be at a lower level compared to the Commission forecast.

Real sector

According to the macroeconomic framework, the economy is foreseen to continue to expand at a steady pace of 6% in 2007 and 6.2% in 2008. The programme contains only limited information about the expected sources of growth. The EFP foresees growth in final domestic demand to slow down from 12.7% in 2006 to 7.7% in 2007 and thereafter increase again to 14% in 2008. The drivers behind these developments are somewhat unclear, although the increase in domestic demand in 2008 seems to be motivated by an expected increase in investments. Value added of the industry is projected to grow at around 9% per year, while construction will grow strongly by 30% in 2008. The metal and mining sectors and related manufacturing are expected to remain main drivers of growth. Despite the limited analytical foundation, the GDP projections presented seem reasonable, given the likely strong rise of output in the mining and metal sectors over the forecast period, driven by further investments in these sectors. However, there are clear downside risks to the forecast. Because of the low level of diversification in the economy, growth will remain highly exposed to world market price developments, which is also acknowledged in the EPF, and to any changes made in a few large investment plans in the metal sector which is expected to be important drivers for output growth. In addition, the investments supporting continued growth are not necessarily followed by more thereafter, indicating a question of sustainability of the growth rates.

The economic growth is not expected to generate any significant number of jobs over the programme period. The programme notes that the ten largest export companies, which will be important drivers of output growth, only account for about 2% of employment. Labour productivity growth is expected to increase by a strong 11% in 2007 and 9.5% 2008, which probably partly reflects the increasing production capacity in the industry without much additional employment. The programme foresees a small reduction in unemployment from 31% in 2006 to 30% in 2007. However, the employment growth will take place mainly in the public sector, where employment is expected to grow by 1.4% in 2007. The presented labour market data is somewhat un-transparent since no figures for participation rates or population growth are presented. The EFP points out that there is currently no national employment strategy in place and thereby also no coherent vision to reduce unemployment. Labour market statistics remain unreliable, which makes it difficult both to detect ongoing developments and to project the future. However, it is still clear that strong job growth will be difficult to achieve without a further diversification of the economy and improvements in the functioning of the labour market.

External sector

The EFP does not provide comprehensive information on expected developments for the external balances over the programme period (table 3 is missing). The only information provided concerns the growth rates for exports and imports. Exports are expected to continue to grow strongly, at 24% and 21% respectively in 2007 and 2008. Imports are also expected to grow at a similar rate as in 2006 of around 8% of GDP. Strong export growth is motivated by expected foreign investments in production capacity in a number of industries. No estimations of other variables, such as current account deficit or capital account developments, are presented. The lack of an overall view of the developments of the external accounts is a clear drawback of the programme, especially in the context of the currency board and the formulation of an appropriate fiscal policy stance.

In 2006, trade patterns were strongly influenced by the introduction of VAT in January, which made import growth artificially low and which helped to boost exports through better reporting and thereby better capturing of export flows. These features will not be repeated and achieving similar growth patterns, as assumed in the programme, will be more challenging. Planned investments, in particular in the metal sector, over the coming two year period could have a significant positive impact on export levels, but export growth projections seem still fairly optimistic, especially concerning 2007. On the import side, continued relatively strong growth in consumer credit and rising public expenditures, for which there were signs during 2006, could support import growth around the projected levels or higher. In contrast to what's stated in the programme, trade agreements which are now in force should have a positive impact on exports, but might on the other hand increase the incentives for imports, particularly from neighbouring countries.

3.3. Monetary and exchange rate policy

Bosnia and Herzegovina has since 1997 applied a currency board regime, with the DEM and then the euro as anchors. The programme expects this monetary policy framework to remain in place over the medium term. Inflation picked up in 2006, mainly because of VAT introduction, but inflationary pressures are expected to decrease in the coming years, with inflation reaching 2% in 2007 and 1.5% in 2008. These levels are higher than before VAT introduction, when inflation was below 1% for three consecutive years. The inflation forecast assumes that energy and commodity prices will remain fairly stable around current levels and that there will be no hikes in administrative price levels. Inflationary pressures decreased during the second half of 2006, as the impact of VAT on inflation subsided, and inflation was close to zero month-on-month in the last months of 2006 (although higher in the RS than in the Federation). Only limited price deregulation has so far taken place for example concerning energy and increases in prices have been announced in the Federation for 2007. Such developments are likely to create upward inflationary pressures above what is expected in the programme.

The nominal exchange rate with the euro is determined by the currency board. Real exchange rate developments therefore mainly depend on difference in the inflation rate with the euro area and the development of the euro vis-à-vis currencies of trade partners. No information is provided in the programme on the expected development of the real exchange rate.

4. PUBLIC FINANCE

The EFP does not contain a consolidated fiscal framework for Bosnia and Herzegovina. Developments are described only separately for the state level and the two entities and developments for the Brcko district are not included in the programme. In addition, the public finance framework presented is to a large degree outdated. This is partly the case because of the entry of new governments after the elections in October 2006 and changes they are expected to make to fiscal policy. The information presented in the programme is however also not reflecting the fiscal developments which have taken place during 2006 and their consequences for the fiscal developments in the coming years. Also, the fiscal projections are based on fairly optimistic GDP estimates which are not even consistent with the macroeconomic scenario provided in the programme. A main general draw-back of the presented material is that there are no budgetary balances but only primary balances presented for the different levels of government. It is therefore not possible to conclude from the EFP what the budgetary balances for the country as a whole is expected to be over the forecast period.

As a result of these different factors, it is difficult to properly assess intended fiscal policies and likely developments based on the information provided in the EFP. Some of the main fiscal risks that are presented in the programme will be relevant also for the incoming governments, such as the remaining uncertainty regarding the settlement of domestic debt claims. Risks related to the weak coordination of fiscal policies will also remain a serious impediment to a sustainable fiscal framework.

4.1. Fiscal architecture and governance

In BiH, responsibilities over fiscal policy are to a large extent exercised by lower levels of government, primarily the entity level and in the Federation further by local (cantonal) level. Indirect taxation has recently been harmonised across the country and responsibilities moved to the Indirect Taxation Authority (ITA). A common value added tax (VAT) was introduced on 1 January 2006 and revenues are pooled in a common single account. However, how the collected revenues should be divided between the different levels of government has been a controversial issue and during 2006 funds were several times blocked in the single account due to failure to reach agreement. A temporary solution has been found, but it is likely to remain a problematic issue needing a long term solution.

The introduction of VAT was important for supporting the creation of a single economic space. The indirect tax reform also transformed the financing of the state level institutions. Instead of receiving funding from the entity budgets, funding of state institutions is now directly assured via the single account as funds are firstly distributed from the single account to the state institutions in accordance with the state budget. Thereafter the share needed for foreign debt servicing is deducted and the remaining funds are distributed to the entities and the Brcko district and thereafter further distributions to lower levels of governments are made. Transfers from the single account constitute an important revenue source for the entities. In 2006, they accounted for over 60% of the RS entity government's revenues and for around 60% of the Federation entity government revenues as well as for around 50% of the cantonal revenues.

Concerning direct taxation, rules are not harmonised across the country. The RS reformed personal (PIT) and corporate (CIT) income taxation systems during 2006, introducing a simplified income taxation system and lower tax burden for businesses. However, in the Federation, direct taxation reforms were prepared but were not passed in the Parliament. As a result, the corporate income tax rate in the Federation remains a high 30%, the highest in the region. This obviously has an adverse effect on the business climate in the Federation and the functioning of Bosnia and Herzegovina as one economic zone.

On the expenditure side, as well as concerning fiscal balances as a whole, coordination of policies across different layers of government is weak. A National Fiscal Council (NFC) was set up in 2005, based on a voluntary agreement among the participants (the three prime ministers and the three finance ministers). The council should in theory coordinate and set targets for fiscal policy. However, the targets that was agreed for 2006 was not considered binding by the parties and was breached. The NFC has also been rather inactive and has not played a central role in the budgeting process for 2007. The EFP mention some work done to draft a law on the National Fiscal Council, which should formalise and strengthen the role of the NFC in the process of fiscal policy making. Although agreement was reached on some of the areas covered by the law, solutions for some of the most important issues are still outstanding, such as enforcement mechanisms. The RS also raised concerns related to the law's compatibility with the BiH constitution. Work has thereafter stalled, leaving the issue unsolved for the budgetary process of 2007.

In sum, the current system of fiscal architecture and governance has clear deficiencies, with potential serious fiscal consequences over the longer term if not properly addressed. A system where certain fiscal decision makers can misbehave without others being able to intervene creates incentive problems for conducting responsible fiscal policies. In the current setting, to effectively plan fiscal policy will be a challenge. Adding to the challenge is the lack of comprehensive consolidated fiscal statistics, although the situation in this area is improving.

4.2. The fiscal framework

The information in the EFP is mainly based on the framework budget documents for 2007-2009 which was prepared at the beginning of 2006. As a result, the projections presented for 2006 are largely outdated. They do not reflect developments during the year, such as the increases in indirect tax revenues and the corresponding increases in spending that occurred at the different levels of government. Since not even the figures for 2006 are in the correct ranges, the figures for 2007 and 2008 presented in the programme are not likely to reflect coming developments and the new governments' plans.

The macroeconomic projections in this section on which the fiscal framework is based are not consistent with the projections in the macroeconomic framework section of the EFP. The outlined projections are indicated to adhere to a "reform scenario", but no alternative scenario is presented. In the reform scenario, growth rates are expected to remain at 7% per year between 2007 and 2009. The growth estimations clearly seem to be on the optimistic side, which is also evidenced by the fact that they are higher than what is presented in the macroeconomic section of the EFP.

The introduction of VAT and its effects on revenues was admittedly difficult to project and made the fiscal developments of 2006 particularly challenging to forecast. However, the developments during 2006 also point to more general difficulties for the authorities in financial planning and projecting. This is due to the relatively poor quality of statistics and thereby the knowledge about the true developments of different factors and their future trajectory. The institution-building process (mainly at state level), and transfers of competencies between different levels of government, also complicates budgetary planning. During 2006, upward revisions of initial spending plans were abundant, partly reflecting the climate of an election year and the increased revenues from indirect taxes. The budgetary planning capacity has been improving, but still has weaknesses.

4.3. Debt developments

The EFP only contains figures on foreign debt until end 2005, despite more recent data being available. In addition, external debt held by the private sector, which at end 2005 almost equalled the government debt in its size, is not included in the discussions on debt. Government foreign debt has been on a declining trend in the last years and amounted to around 30% at end 2005. A large part of the debt stock is on concessional terms. The World Bank is the largest creditor accounting for 54% of the outstanding debt stock. This explains the relatively low debt servicing costs of about 2% of GDP per year. 39% of debt repayments are due in euro, while the USD accounts for 31%.

The programme expects foreign debt servicing costs to remain at around 2% of GDP per year in the years to come. However, BiH is not likely to get as favourable repayment terms for new loans as for the current debt stock, which creates a risk for increasing debt servicing costs over time even if the size of the debt remains the same. The maturity structure of the debt stock is however not presented in the programme. The authorities have also not conducted any sensitivity analysis of effects of fluctuations in the exchange rates on debt repayments. However, the major issue influencing the government debt stock and debt repayments over the coming years will be the outcome of the rescheduling of the domestic debt claims. The EFP does not contain recent developments concerning the debt restructuring or any recent estimates of the debt servicing costs. The EFP correctly concludes that the final settlements of domestic debt will have significant implications for the primary surplus needed for fiscal sustainability, but the programme does not include the fiscal implications of different settlement options.

There has been progress in adopting legal frameworks, for example for frozen foreign currency deposits, which sets out the terms and conditions for the restructuring of the claims in a sustainable way. However, during the election campaign in 2006, amendments to this law were proposed which would, if adopted, raise short-term debt servicing costs dramatically, endangering fiscal sustainability. This highlights the still potential fiscal risks which will remain until the conditions have been firmly set for the different types of claims.

4.4. Fiscal risks

The EFP points to a number of fiscal risks over the programme period. One of these is the risk of failure to achieve the economic growth objectives, which could have negative implications for the fiscal stance. Another is the fiscal risks posed by the settlement of internal debt. It is also highlighted that newly introduced policies, such as for example the income and profit tax reforms in the RS, raise uncertainty about future revenue streams and thereby increases risks for unexpected budgetary outcomes. These are some of the risk elements, which could result in that real fiscal outcomes could be significantly different from what the authorities will expect in their new budgets. However, there are several other risk factors which would have been worth mentioning. One risk factor is the lack of fiscal coordination in itself and in particular in combination with the emergence of upward fiscal pressures. The adoption of the Law on the Demobilised soldiers in the Federation, for example, highlights the risk of fiscally imprudent policies and legislation and their potential negative fiscal impact over the medium term. Fiscal pressures could also emerge from failure to streamline certain parts of the administration as new institutions are being setup, resulting in a continuation of the recent trend of growing public expenditure.

5. STRUCTURAL REFORMS

The structural reform agenda outlined in the programme broadly covers the most important areas in which reforms are needed. However, the agenda is vague on the overall strategy and aim with the presented reforms. The reforms presented also rather seem to be expressions of wishes than clear, time bound and budgeted activities. The presented agenda is also outdated in several aspects and includes policy objectives that has already been implemented and do not necessarily reflect the policy orientation of the new governments. In addition, reforms are presented at a mix of state and entity levels with mutual consistency not always being clear and with the reform agenda not always covering the whole country. In view of the expected strong exports and GDP growth presented in the programme, more focus on reforms supporting improved business and investment environment could have been warranted, in particular for the Federation.

Box 1: The EFP and the European Partnership economic priorities

The European Partnership (EP) between the European Union and the authorities of Bosnia and Herzegovina was adopted by the European Council on 9 November 2005. The purpose of the European Partnership is to outline a number of priority areas in which progress should be made in order to address identified deficiencies on the road towards EU accession. The partnership contains short and medium term priorities, short term being identified as one year, and the priorities will be updated every second year. Thereby, in principle, the short-term priorities should have been met by now. In response to the EP, Bosnia and Herzegovina adopted on 23 February 2006 an action plan outlining what measures is intended to be taken in order to fulfil the priorities.

Out of the ten identified short-term priorities, three key ones were (i) maintaining macroeconomic stability; (ii) reduce public spending as a share of GDP, and (iii) to improve the fiscal coordination mechanisms in the country. These priorities were deemed relevant in the context of the already relatively high public spending, a large current account deficit and relatively weak coordination structures concerning fiscal policies. Looking at the outcomes since the Partnership was adopted, macroeconomic stability has been further improved and measures were introduced to rein in high credit growth (by raising the reserve requirement rate).

Concerning public expenditure on the other hand, the combination of an election year and strong public revenue inflows after VAT introduction resulted in increased public spending, often on a permanent basis. Efforts to try to identify areas for savings and increased efficiency in public finances also did not take root. In the political context of 2006, agreeing on a Law on the National Fiscal Council, to strengthen coordination mechanisms, also proved difficult and the task was not achieved. In some other priority areas there was more progress during the year. Concerning the restructuring the outstanding domestic debt claims, the process was moved forward, notably by the adoption of a law regarding the restructuring of frozen foreign currency deposits. However, it is still not clear what will be the final terms and thereby the final fiscal impact and further steps are still needed to clarify the situation for other types of claims.

The medium-term priorities of the European Partnership are largely a natural continuation of the short-term ones. Focus is for example put on continued strengthening of fiscal coordination and enhanced quality of the budgeting process. Other priority areas are to address the issues of high unemployment levels and fragmentation of labour market policies as well as enhancing the educational system. The EFP highlights the need for progress concerning EP priority areas such as reduced public spending to GDP and adoption of the law on the National Fiscal Council, but it does not clearly outline how to achieve further progress in meeting these priorities. It will therefore be the responsibility of the new governments to formulate how the short and the medium term agenda expressed in the Partnership could be addressed.

The reform measures outlined in the programme are often rather vague, in particular concerning the timing and more detailed content of expected reforms. This is probably again partly a function of the fact that policies have been formulated by the outgoing governments and the slow reform pace that prevailed in the pre-election phase. A faster reform speed and stronger commitment to structural reforms should ideally be adopted by the incoming governments.

5.1. Enterprise sector

The EFP contains a number of broadly stated priorities, such as faster harmonisation with EU rules concerning the business environment and concerning freedom of movements of goods and services. However, these priorities are not sufficiently translated into specific policy measures. Plans concerning privatisation are outlined somewhat more in detail. However, some of the stated dates, such as finalising privatisation of strategic companies by 2007, seem unrealistic. The programme contains lists of companies that are envisaged to be privatised in the Federation and in the RS over the coming two years. However, since there is no information on the size of the companies, their share of total capital to be privatised or the revenues expected from their stales it is not possible to assess the appropriateness of the privatisation agenda. In addition, for the Federation the list is very similar to what was presented for 2006, when very little was accomplished. Different investment projects, for example in infrastructure, are outlined in the programme, but the structural reform elements related to these investments are unclear.

The programme highlights that in the RS, simplification of the rules for companies will be pursued through the "guillotine" programme. This useful initiative might improve the everyday working climate of companies in the entity, but nothing similar is outlined for the Federation. Concerning SME policies, the prepared SME draft strategy has not been adopted. The EFP outlines a number of reforms, which all seem based on the strategy. However, it is uncertain if and when the strategy will be adopted. This weighs on the realism of the outlined agenda. Moreover, the programme would have benefited from a better analysis of main problems for the SMEs, largely related to deficiencies in the business climate, and specific plans to address these. Several structural reform areas of importance for improved functioning of the corporate sector are also missing from the programme. This is for example the case concerning further improvements of the legal framework for corporate restructuring, in particular in the Federation. Also, structural reform plans concerning utilities and network industries are not outlined in the programme, despite the needs for reforms in these areas.

5.2. Financial sector

The programme contains a long list of planned activities to be carried out related to financial sector reform, as well as a list of measures to be taken in the RS related the financial sector and financing of the private sector. No similar action plan is presented for the Federation, resulting in reform areas not being consistently covered across the country. The information presented is partly outdated, containing measures already achieved at the time of submission, and containing numerous duplications. The programme states as a goal to achieve a solution concerning unified banking supervision, but does not specify why it is needed, the options, or a time plan. A firmer approach in the EFP concerning how this issue is planned to be addressed would have been welcome. Further delays in agreeing on a solution for unified banking supervision will result in a stalemate in improving the regulatory framework and the overall quality of banking supervision and may thereby increase financial sector risks. Accumulating deficiencies in supervision could be particularly dangerous in current times of high credit growth.

Regulation of other areas of the financial sector, such as insurance and leasing, is still deficient, hurting a further sound development in these areas, but plans to strengthen supervision in these sectors are only vaguely outlined in the EFP. Planned and performed reforms concerning private investment funds, an important area to improve the functioning of capital markets and corporate management, are pointed at but without being precise and not up to date with recent developments.

5.3. Labour market

The EFP outlines a number of problems which are seriously hampering the functioning of the labour market, such as the slow privatisation process, unequal social benefits and tax systems between the two entities, and rigid wage setting systems. The programme gives a list of broadly formulated policy goals, out of which some, such as strengthening the business environment and restructuring companies, could (if achieved) improve conditions in the labour market. However, they are not translated into any intended policy actions, leaving the agenda toothless. The only concrete planned measures mentioned in the EFP are those already contained in the action plan in response to the European Partnership priorities. The scope of these activities only reaches until end 2007. The measures are largely focused on strengthening state-level coordination and initiation of certain harmonisations and do not clearly address the main structural problems. The plans are also rather modest, mostly focusing on initiating processes rather than achieving outcomes, and would need to be followed up with strong commitment to generate tangible results. To address the substantive problems in the labour market area, as witnessed by the very high unemployment rates and large informal economy, a more comprehensive agenda would be beneficial. However, any reform process aimed at improving mobility and flexibility of labour markets will be complicated by the complex institutional structure in this area.

5.4. Administrative reform

Reform of the public administration is a crucial reform area to support the creation of more coherent administrative structures within and between different levels of government and to increase the efficiency of the public administration. It is also a vast reform area, involving all the different levels of government, which complicates the process. To address these issues, a Public Administration Reform (PAR) strategy and a first action plan to implement the strategy was adopted at state, entity and Brcko District level in 2006 (See Box 2).

However, despite the strategy and action plan being adopted, public administration reform at different levels of government has so far been moving slowly and not entirely in a coordinated way. For example, Brcko District authorities adopted an entirely new civil service law in 2006, without consultations with the other levels of government, even though harmonisation of the civil service laws is a PAR action plan requirement. This highlights the problems of coordination and the need for a strong co-ordination/implementation structure in order for the action plan to really be implemented. The work of the PAR co-ordination office has also been hampered by the slow recruitment process and understaffing.

The EFP briefly outlines recent developments concerning the PAR process, but do not touch upon the content of the strategy or how and by when the first action plan is to be implemented. It also does not outline any timeline for future actions, such as adoption of the second action plan, in the process of implementing the PAR strategy. For the reform process to be successful in the coming years, strong commitment to the reform strategy of the new incoming governments will be essential, as well as strong coordination ability from the side of the PAR co-ordination office.

Box 2: Public Administration Reform (PAR)

In 2004 - 2005, a system review of the public administration institutions in BiH was carried out in the "horizontal" areas of human resources management, public finance, legislative drafting, administrative procedures, IT and institutional communication. In parallel - and complementary to the system review- functional reviews were carried out in eight key sectors: agriculture, justice, environment, education, health, police, return (of refugees) sector, economy and labour and employment sector. Taken together, these EC-funded reviews provide a strong foundation for a country-wide reform of public administration.

The National Public Administration Reform Co-ordinator's Office (PARCO) was thereafter set up and PARCO designed a comprehensive, country-wide public administration reform strategy. Based on this strategy a first Action Plan was formulated, focussing on the systems of administration, with significant input from high-level civil servants from all levels of government (working groups) and local and international experts.

The PAR Strategy, adopted in mid 2006, has an 8-year timeline and focuses on harmonising and improving general administrative capacity, through the reform of core horizontal systems and structures of governance throughout all levels of administration (human resources management, public financial management, ICT/e-Government, policy making/co-ordination, administrative procedures, institutional communication).

The Strategy also provides directions for creating more coherent administrative structures within and between various levels of administration. The latter should be further operationalised in a second Action Plan. For the implementation of the PAR Strategy various donors have joined forces to set up a PAR fund that is to be managed by PARCO.

6. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

Total government spending is high, around 50% of GDP (informal economy not included) and increasing. At the same time the outcomes in relations to spent resources are relatively poor, in particular in sectors such as education and health. This raises the issue of efficiency of government expenditure. The complexity of the institutional framework contributes to this outcome and the public administration reform process (described above) could prove a useful tool in improving the situation, if used in the right way. Ultimately, efficiency of public expenditure should also be taken into account when considering constitutional reform proposals.

As concerns the composition of spending, it varies significantly between different layers of government. The EFP does not provide consolidated view on spending for different items for the country as a whole. For the state level, for which spending is mostly focuses on administrative expenditure, 67% of spending in 2006 was expected to go to wages, while this share is foreseen to decrease over time to 54% in 2009, as spending on other goods and services increases. For the Federation government, current transfers (of which a large part goes to war veterans) made up close to 60% of total spending in 2006, partly a result of a large part of other types of spending taking place at the cantonal level. The share of spending on transfers will further increase over the programme period as a result of the law on de-mobilised soldiers that was adopted in the Federation in 2006. Part of the financial burden of the law will be carried by lower level institutions, such as employment bureaus. It will likely lead to a "crowding out" of spending on other labour market activities and thereby worsen the quality of the expenditures. The EFP also expects transfers in the RS to rise over the programme period, as disability payments will increase over time. In the RS, spending on wages, transfers and subsidies to companies was expected to amount to over 60% of public expenditure in the entity during 2006. Spending on wages amount in the programme to a high 40% of total expenditure in 2006, despite the fact that the programme is not updated for the upward adjustments that were made during 2006 concerning spending on wages.

This highlights the need to work towards changing the composition of spending. The focus should over time be shifted towards capital and growth enhancing expenditure and away from transfers and wages, including by improving the targeting of the transfer systems and by improving the efficiency of the administration. The programme stresses the need for increased focus on and prioritisation of capital spending, since foreign aid covering the investment needs is decreasing, but no concrete plans are outlined. Investment spending seems to be on the rise in both entities and with parts of the receipts from the privatisation of Telekom Srpske to be used for this purpose in the RS. However, there is a need for a more structured approach in prioritising which investment projects are pursued and also to better coordinate projects across the country. In addition, it is vital to make sure that procedures are used to ensure transparent processes and efficient use of resources in these projects.

Given the size of the public sector and the need for increased spending in certain areas, finding possible savings and trying to reduce overall public expenditure should be a priority. While reducing the share of spending to GDP is stated as a priority in EFP, this is not necessarily reflected in the fiscal part of the programme and certainly not in the policies that were pursued during 2006. Reducing the size of government should be done also in order to create room for reforms on the revenue side, notably concerning payroll contributions. The tax wedge on labour is very high and is part of the explanation behind the large informal sector and relatively high total wage costs in the formal sector.

MONTENEGRO

1. SUMMARY AND CONCLUSIONS

- On 30 November 2006, Montenegro submitted to the Commission its first Economic and Fiscal Programme (the EFP 2006), which covers the period 2006-2008. The programme's main objective is to speed up the economic activity while increasing the living standard of the population. The EFP was elaborated shortly after the independence referendum of May and coincided with the parliamentary elections of September. The quality of the programme suffered somehow as its drafting occurred during the restructuring of several ministries which participated at the elaboration of the document. The programme also reflects certain weaknesses in terms of availability of statistical data, forecasting capacity and quantification of the most important measures envisaged. The combined result of these factors was a final document complying only partially with the content, form and data requested.

- The programme's macroeconomic scenario appears to be rather conservative given the recent acceleration of economic activity. In 2005-2006 the Montenegrin economy benefited from a relatively high degree of macroeconomic stability. GDP grew by 4.3% in 2005 and advanced further by 6.5% in 2006. Retail price inflation (RPI) decelerated to 2% in December 2006. The unemployment rate decreased to 14.7% in December 2006. However, the current account deficit widened to around 31% of GDP in 2006, mainly driven by the continuous widening of the foreign trade deficit. The general government budget recorded a deficit of 2.4% of GDP while the preliminary budget execution points to a surplus of 1.2% of GDP in 2006.

- The fiscal scenario provides a good overview of Montenegro's medium-term fiscal strategy. Aware of the importance of conducting a sound fiscal policy in an officially euroised economy, the authorities aim at consolidating the fiscal stance by implementing budgets which are balanced or in surplus and reduce public debt relative to GDP by almost five percentage points by 2009. Improving the quality of public spending appears as the cornerstone of the programme and is based on reducing public spending relative to GDP, changing the composition of expenditures and decreasing some distorting taxes. Reaping full benefits from the introduction of the flat income tax would require a reduction of the high payroll taxes and the acceleration of the pension system reform in order to limit the size of the informal labour market. The recent good performance of revenues and the envisaged deceleration of expenditures provide the necessary fiscal space to advance reforms, although several fiscal risks remain. The most important one pertains to the obligations of the Compensation Fund deriving from the restitution of confiscated property. Under the current legal framework the outstanding claims may substantially raise public debt.

- A new Economic Reform Agenda covering 2007-2011 is currently under preparation. The main objectives of the structural reform programme presented in the EFP 2006 are those of the previous Agenda: the continuation of enterprise restructuring and privatisation, reinforcement of the financial sector's legal framework, stimulation of employment, and institutional strengthening. However, the policy measures are not always well defined and updated in line with identified structural weaknesses and deficiencies.

2. INTRODUCTION

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

On 30 November 2006 Mr Igor Lukšić, Minister of Finance of Montenegro, submitted to the Commission the first Economic and Fiscal Programme on behalf of the Montenegrin Government. The programme (EFP 2006) covers the period 2005-2008 and is based on existing strategic documents, namely the Economic Reform Agenda for Montenegro, and on the assumption that initiated reforms will be continued. The programme, coordinated by the Ministry of Finance, is the result of the collaboration of several institutions: the Secretariat for European Integration, the Central Bank, the Statistical Office (MONSTAT) and the independent Institute for Strategic Studies and Prognoses (ISSP).

The document partly complies with the content, form and data requested by the Commission although it doesn't go into the details behind the main lines. It also suffers of a lack of quantitative estimates of the effects of the most important measures envisaged in the programme. The projections are mainly concentrated on fiscal and external sector while the forecast of basic macroeconomic indicators are based on estimates by the IMF and by the ratings agency Standard and Poor's. Data on labour is based on records from the Employment Agency (ZZZ) and the Health Fund.

After having improved macroeconomic stability, the programme's main objective is to speed up the economic activity and increase the living standards of the population. Montenegro plans to harmonise national legislation with the acquis communautaire and WTO regulations in order to advance the country's regional and international integration. It aims at consolidating public finances by implementing budgets which are fairly balanced or even in surplus and reducing the public debt ratio. And it intends to continue structural reforms in order to improve the business environment and the performance of the public administration.

3. MACROECONOMIC DEVELOPMENTS

3.1. Recent macroeconomic developments

GDP grew by 4.3% in 2005, reflecting a stronger performance in tourism, construction and forestry. The same sectors were responsible of further acceleration of GDP by 6.5% in 2006. In 2006, tourist arrivals increased by 16% and revenues from tourism by 23.5%, whereas the value of performed construction doubled compared to a year ago. Economic growth had a positive impact on the labour market. Employment rose by 0.6% in 2005, and by 6.1% in the first nine months of 2006 compared with the same period the previous year. Unemployment rate declined to 18.4% at the end of 2005, and 14.7% in December 2006. In 2005 the average net wage was 9% higher than a year ago, and further increased by 15.5% in 2006 to EUR 245.95. Retail price (RPI) inflation at the end of 2005 was 1.8%, driven by prices of agricultural products, change of excise duties on alcoholic beverages, oil prices and vehicle insurance and technical vehicle inspection higher costs. At the end of 2006, RPI inflation was 2% on the back of an acceleration of agricultural and oil prices. The current account deficit widened to 9.1% of GDP in 2005, and further increased to around 31% of GDP in 2006. The inflow of net FDI in 2005 reached EUR 383 million, mostly due to large privatizations. By contrast, during 2006, net FDI were mostly due to green-field investment and registered EUR 475 million, while the outflow of direct investments was EUR 170 million. Broad money (M21) increased by 58.3% in 2005 and advanced more rapidly by 84.5% in 2006. Seasonal fluctuations of the money supply are connected to the main tourist season and the inflows of privatization funds. The annual growth of domestic credit accelerated to around 125% in 2006 from less than 34% in 2005, driven to a large extent by the increase in the amount of loans to households. The execution of the 2006 budget resulted in a surplus estimated at around 1.2% of GDP after a deficit of 2.5% of GDP had been originally budgeted. The better than expected fiscal performance was the result of a strong growth of revenues, which increased by almost 25% from 2005 and outpaced the growth of public expenditures. Public debt continued to decline from 42.7% of GDP in 2005 to 38.3% of GDP at the end of 2006.

The programme gives a comprehensive and updated general overview on recent macroeconomic developments. The programme recognises current shortcomings, notably on national accounts and trade statistics. Additional information on gross added value and labour productivity growth would have been useful.

Table 1: **Macroeconomic developments**

	2005	**2006**	**2007**	**2008**
Real GDP (% change)	4.3	5.5	6.0	6.0
Contributions:				
- Final domestic demand	6.0	6.7	7.7	7.9
- Change in inventories	1.6	0.9	0.9	0.7
- External balance of goods and services	-1.7	-1.2	-1.7	-1.9
Employment (% change)	0.6	n.a.	n.a.	n.a.
Unemployment rate (%)	18.4	n.a.	n.a.	n.a.
GDP deflator (% change)	1.00	1.02	1.06	1.09
CPI inflation (%)	1.8	2.1	3.4	3.0
Current account balance (% of GDP)	-9.1	-9.2	-9.5	-9.4

Source: EFP 2006

3.2. Macroeconomic scenario

The 2006 EFP presents a medium-term macroeconomic programme with projections of key economic variables which cover the real sector, employment, wages, inflation as well as external developments. The document does not provide alternative growth scenarios. The macroeconomic programme is presented in an overall coherent and consistent way. However, the objectives of the programme and the scenario could have been specified more in detail. The policy mix is determined by euroisation and the absence of a proper monetary and exchange rate policy. In consequence, the programme stresses the greater importance of continuing the consolidation of the fiscal policy and increasing the labour market flexibility. Given the current weakness of trade statistics, the programme bases external sector projections on trade on IMF assessments, and foreign direct investments on the privatisation plan. This approach has proven to be very cautious as preliminary figures for 2006 (e.g. tourist revenues and foreign investments) have developed above expectations. Moreover, the programme forecast until 2008 has not been revised upwards and remains prudent.

Real sector

Given that a full set of national statistics is not yet developed, the programme's estimations are based on IMF and on the rating agency Standard & Poor's reports. The 2006 EFP presents a scenario of robust annual growth of real GDP by 6%. Growth will be sustained by private consumption, fuelled by a reduction of unemployment, real growth of salaries, also reinforced by the reduction of the flat personal income tax rate from 2007 and rapid growth of credit. The consumption pressures will also lead to an increase of the end-of-year annual inflation rate to around 3% over the programme period. In 2008, government consumption and gross fixed capital formation will increase more rapidly, compensating an expected deceleration of private consumption. The strong increase of domestic demand will be covered to a large extent by imported goods as the domestic supply is neither large nor sufficiently diversified. Privatisations and a favourable external environment will raise real exports of goods and services by 16.6% annually on average in 2006-2008. Although growth of exports is expected to be stronger than average annual growth of imports at around 14%, it will not be enough to avoid a further widening negative contribution of net exports to GDP, from 1.2% in 2006 to 1.9% in 2008.

Growth projections seem overall plausible and broadly in line with the stability and growth orientations of the programme. On the supply side, the contribution of industry to the increase of gross value added may be lower than forecasted, and is not likely to improve before the end of the privatization and restructuring process. The programme, estimates[8] an average employment growth of around 4.5% for 2007 and 2008. Although a significant part will be covered by seasonal foreign workers in construction and tourism-related activities, the unemployment rate will further decrease between 7% and 10% by 2008. The programme would have benefited from a more detailed assessment of the determinants of employment and productivity developments and their effect on growth over the medium term.

External sector

The 2006 EFP projects a widening of the current account deficit from an estimated 9.2% of GDP in 2006 to 9.4% of GDP in 2008. The scenario has not been updated with recent developments from 2006 which indicate a substantial widening of the current account deficit to around 30% of GDP in 2006. This is attributable to a large increase of the trade deficit to around 50% of GDP as a result of surging domestic credit, strong net FDI and increasing imports by the expanding tourism sector. The programme foresees a continuous albeit moderate growth of merchandise exports of 14.7% average per year until 2008, based on the forecasted increase in prices of aluminium and increased re-export of Chinese merchandise from the port of Bar. At the same time, imports are projected to grow by 14.3% on average during the programme period. However, the recent annual growth rate of imports which exceeded 45% in 2006 renders the projections obsolete. In general, the programme's projections of the external sector appear outdated. In addition, data on

[8] Estimations are based on official records from the Employment Bureau (unemployed), and the Health Fund (employed). There are no solid projections of labour market trends as the statistical office (MONSTAT) is currently preparing a new methodology according to ILO definitions.

merchandise trade is fairly unreliable and a recent revision of the balance-of-payments methodology has moved some items from the income balance to the transfers balance.

The programme assumes that a significant part of the current account deficit will be financed by net FDI inflows. Significant net FDI inflows of some 16.4% of GDP were expected for 2006. The figures are too conservative as preliminary data evaluates a record high figure of above 27.3% of GDP. Moreover, the programme expects investment flows to originate mainly from privatization proceeds. In fact, the investment flows linked to privatization represent only around 16% of total inflows in 2006, while the rest is being originated by greenfield investments. In 2006 more than half of FDI went into real estate. Nonetheless, due to the key economic position of tourism in Montenegro, some of these investments may ultimately contribute to an increase of the productive capacity of this sector. The combined effect of macroeconomic stability, liberal economic regime, low corporate profit tax rate and the national treatment of foreign investors are attracting stronger inflows of net FDI than expected. In this context, the target for net FDI of 10% of GDP in 2008 looks attainable. The reserves of the Central Bank are expected to increase by 11.8% on average during the reference period following the planned transfer of the state's budget deposits from commercial banks to a Central Bank account. At the end of 2005, total external debt represented around 30% of GDP.

3.3. Monetary and exchange rate policy

Montenegro started to use the euro as legal tender in January 2002, replacing the Deutsche Mark, which had been introduced as the only legal tender in 1999. The decision for replacing the Yugoslav dinar emerged from an exceptionally difficult economic and political situation, well before it became an independent country with a European perspective. Montenegro's present use of the euro is fully distinct from euro area membership, as the country does not participate in the joint management of the single currency, including notably monetary policy, and it does not benefit from the rights of a euro area Member State. The central bank is not an issuing bank, and most of its executive functions are related to banking supervision. It also engages in liquidity management operations in favour of the banking sector and issues treasury bills on behalf of the government.

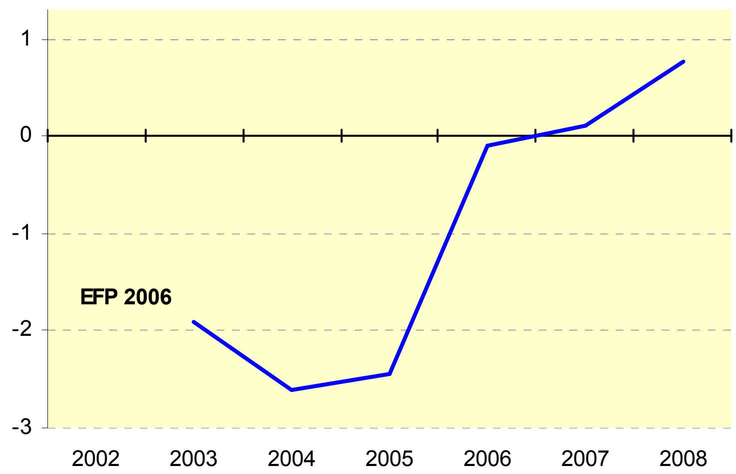
Following price stabilisation of previous periods, the EFP projects average RPI inflation to increase to a 3% level in the upcoming years, due to the building up of domestic demand pressures. In addition, inflation would be higher in 2007 as the administered price for electricity will be revised upwards at the beginning of the year. A risk for higher than projected inflation could also result from an upwards statistical effect, as the retail price index (RPI) will be replaced by the cost of living index (CPI) in 2007, which tends to show higher values of inflation.

Domestic credit increased by almost 125% in 2006, on the back of a surge in consumer lending which grew by close to 300%. Corporate loans also increased strongly by around 105%, but their share in total domestic credit declined from 61.2% in 2005 to 55.9% in 2006. The rapid increase in domestic credit and in particular the surge in consumer and real estate loans needs to be closely monitored by the Central Bank which should also step up efforts to improve its supervision capacity.

4. PUBLIC FINANCE

The public finance framework provided in the programme is sufficiently coherent and consistent with the other parts of the document, such as the description of macroeconomic developments. Nonetheless, it is more difficult to evaluate its consistency with the section introducing structural reforms, as this part of the programme had not been updated by the time of the submission of the programme. The framework describes well the key measures affecting the fiscal stance and the projected evolution of the revenue and expenditure side of the budget, but is less detailed in providing quantitative estimates of the effects of the most important measures envisaged. It would have been useful if the programme had described in a more detailed and systematic manner the fiscal targets and their achievement in 2006. Other weaknesses pertain to the assessment of the fiscal stance by focusing on the state budget rather than on the consolidated one at times or to the inconsistencies between the data included in different tables or between facts provided in the text and other official documents. The programme includes a pertinent analysis of the fiscal challenges faced by Montenegro, although not all important risks seem to be covered. The Montenegrin authorities endeavour to compile fiscal data in GFS 2001 standards, but further efforts are still needed to produce ESA 95 compatible data, in particular as the current budget reporting is still on a cash basis and the inclusion of certain activities on the spending side is questionable.

Chart 1: Budgetary developments
(general government balance, % of GDP)



Montenegro's fiscal strategy for 2007-2009 aims at consolidating public finances by implementing budgets which are balanced or in surplus and reducing the public debt ratio by around 5% points to 32.5% of GDP at the end of the period. A reform of the tax system is envisaged that would reduce the tax burden on the economy, with the main change being the introduction of a flat personal income tax of 15% in 2007. According to the programme, the tax will be further cut to 12% in 2009 and 9% in 2010. The government also plans to reduce the level of public expenditures to around 40% of GDP in 2009 and 35% of GDP in 2011, from around 47% of GDP in 2006. The reduction of the relative share of public expenditures to GDP will be largely attributable to a nominal increase in spending which is lower than the nominal growth of GDP. This process is meant to influence positively the development of the private sector and boost up economic activity in Montenegro.

4.1. Fiscal architecture and governance

The programme briefly describes the budgetary process and the legal framework and institutions which ensure the public financial management in Montenegro. Substantial progress was achieved in recent years in terms of reforms that enhance the transparency and accountability of the public sector governance. The new Budget Law adopted in 2001 provides a comprehensive framework for implementing the budget policy and the budget execution is facilitated by the fairly smooth operation of a Consolidated Treasury Account. A new Law on Public Procurement was adopted in 2006 which aims at harmonising legislation with the EU directives and strengthens procurement procedures and practices. Internal and external audit functions are being implemented, but they are not fully operational and effective yet because of serious capacity constraints. The gradual separation of current and capital expenditures received a new impetus in the 2007 budget exercise, as the coverage of investment projects by the capital budget was widened.

The good progress achieved so far needs to be further consolidated. A more accurate projection of public revenues and expenditures would improve the quality of budget planning. The implementation of program budgeting in line ministries and the development of a medium-term fiscal framework needs to be continued in order to strengthen the link between policy making, planning and budgeting. A better reporting, oversight and consolidation of municipal budgets into the general government budget is also necessary to increase transparency and accountability. Data in the general budget do not fully cover extra-budgetary operations and liabilities of local governments, and the accuracy of the information reported at the local level might not always comply with the same quality standards. A closer monitoring of the accounts of state-owned enterprises is required in order to limit quasi-fiscal activities and reduce the potential risk to the budget posed by the accumulation of losses and arrears. The control function would clearly benefit from a gradual move towards decentralising and strengthening internal audit.

4.2. The fiscal framework

A deficit of 2.5% of GDP was initially budgeted for 2006, but the year ended with a preliminary surplus of 1.2% of GDP in national accounting standards. The improved fiscal performance was due to substantially higher than expected revenues while expenditures increased at a lower pace. This also provided fiscal space for building up reserves worth of 1.7% of GDP and redeeming around 2.5% of GDP in public debt. In October 2006, the budget law was amended in order to increase both sides of the budget as a result of the good performance of revenues while the deficit target was broadly maintained.

The acceleration of economic activity in 2006 and the improved fiscal collection triggered an increase of revenues of around 25% vis-à-vis the 2005 execution, reaching around 50% of GDP. Revenues were also 18% higher than originally planned and were driven by the substantial increase in indirect taxes, in particular VAT and custom duties (around 40% higher than in 2005). The collection of social contributions increased by around 18% from 2005, on the back of higher employment and increased formalisation of labour contracts. Revenues from the property tax increased almost four fold since 2005 due to the strong net FDI which partly fuelled a vibrant real estate market. The reduction of the corporate tax rate to 9% in January 2006 led to a less than proportionate decline of revenues representing about 0.5% of GDP. Budget expenditures increased by around 16% vis-à-vis 2005, while the spending on goods and services increased substantially more than budgeted. Despite an average growth of salaries in public administration of around 17% in 2006, the public sector wage bill increased only marginally over 2005. The increase in transfers and social benefits was lower than the overall growth rate of public spending. Capital expenditures, as captured in the capital budget, increased by 20% from 2005 to 2006, but represented less than 80% of the budgeted amount.

Table 2: **Composition of the budgetary adjustment** (% of GDP)

	2005	2006	2007	2008	Change: 2005-08
Revenues	40.1	46.8	44.9	43.2	3.1
of which:					
- Taxes and social security contributions	36.1	40.9	39.4	37.7	1.6
- Other (residual)	4.0	5.9	5.5	3.1	-0.9
Expenditure	41.9	46.9	44.8	42.4	0.5
of which:					
- Primary expenditure	17.1	18.5	19.2	18.2	1.1
of which:					
Gross fixed capital formation	4.5	4.3	5.1	4.8	0.3
Consumption	12.6	14.2	14.2	13.4	0.8
Transfers & subsidies	14.9	15.6	14.4	13.6	-1.3
Other (residual)	8.7	11.6	10.7	9.7	1.0
- Interest payments	1.2	1.2	1.0	1.0	-0.3
Budget balance	-2.4	-0.1*	0.1	0.8	3.2
Primary balance	-1.1	1.1	0.6	1.3	2.4
Gross debt level	42.7	38.3	36.8	36.2	-6.5

*: actual provisional outcome: +1.2%; Sources: EFP 2006, ECFIN calculations

The budget adopted for 2007 is based on conservative projections regarding the revenue and the expenditure side, if the preliminary budget execution for 2006 is considered as a starting point. Expected revenues and expenditures are almost flat in comparison with their respective 2006 levels, although an increase of around 17% of the public sector wage bill stands out. Together with the 2006 increase, the projected rise of the public wage bill in 2007 to support the public administration reform may impact negatively fiscal sustainability. Capital spending is, projected to increase by around 60% in 2007, which seems optimistic in light of the under-spending which occurred in 2005 and 2006. The 2007 budget allows a sufficient margin for the possible loss of revenue following the introduction of the flat personal income tax. Overall, a likely higher growth of total revenues would provide the fiscal space necessary to cover the increasing amount of restitution claims and advance reforms on the labour market. The programme projects a small budget surplus of 0.1% of GDP in 2007, while the 2007 budget was adopted with a surplus of about 0.6% of GDP on the basis of a higher estimation of revenues. The 2008 and 2009 budgets are expected to remain in surplus at about 0.8% and 0.4% of GDP respectively. At the same time, both revenues and expenditures are projected to decline to around 40% of GDP, but the programme should have provided more specific measures for the achievement of this objective.

4.3. Debt developments

Public debt of Montenegro amounted to EUR 701.1 million or 38.3% of GDP at the end of 2006. The public debt-to-GDP ratio declined substantially from around 88% of GDP in

2002. At that time, the rescheduling of debt with the IBRD and Paris Club creditors and a final agreement with Serbia on the liabilities towards the London Club creditors had not taken place. The current amount of debt is not fully defined due to the unfinished negotiations on the succession of the former Socialist Federal Republic of Yugoslavia and the liabilities taken over according to the Law on Restitution of Property Rights and Compensation. According to the programme, the authorities do not foresee a significant negative impact on the indebtedness level as a result of these unsettled liabilities. However, the recent increase in the amount of recognised restitution claims raises concerns about the total amount of obligations that the Compensation Fund will have to cover. As of end-2006, the restitution committee granted about EUR 82 million for 426 solved claims out of a total of around 9,000. The authorities are working on a solution to amend the current legal framework, in the absence of which, the outstanding claims could even exceed the existing debt stock.

Between 2003 and 2006 the public debt ratio declined further by around 15% of GDP largely due to the growth of nominal GDP and the use of privatisation receipts to reduce debt obligations. The programme includes a projection of the evolution of public debt relative to GDP until 2009. The projected decline of the public debt ratio to 32.5% of GDP in 2009 appears to take into account not only on the expected nominal GDP growth, privatisation revenues and achievement of budget surpluses that would allow for a larger decline, but also future liabilities deriving from the obligations of the Compensation Fund.

The debt management strategy is oriented towards repaying the relatively expensive sources of financing, such as the domestic bank loans and T-Bills. The reliance on budget arrears as a source of financing has also decreased substantially from around EUR 100 million in 2002 to 15.4 million at the end of 2006. The authorities are considering the option of issuing Eurobonds on the international capital market in order to benefit from a cost advantage vis-à-vis issuances on the domestic market.

4.4. Fiscal risks

The programme highlights a number of risks to the sustainability of public finances. The first two refer to the volatility of budget revenues stemming from the thin diversification of Montenegro's economy and the composition of revenues perceived as over-dependent on imports. The two reasons for concern appear as well founded. Aluminium production and tourism account for a large share of the economy. Consequently, a significant deterioration of international market conditions would hurt economic growth and budget revenues. Similarly, the currently good performance of budget revenues is due to a large extent to customs duties and VAT collections (of which around 70% stem from imports) that may reverse in case the net flows of FDI dwindle or consumption slows.

Box 1: The EFP and the European Partnership economic priorities

The Council of Ministers adopted on 22 January 2007 a decision on the principles, priorities and conditions in the European Partnership (EP) with Montenegro. The Partnership identifies the short, medium and long-term priorities for Montenegro in order to move closer to the European Union and will be the key tool guiding the country's effort in this regard. Some of the short-term priorities are already being met while the government is currently concluding an action plan outlining specific measures addressing the EP priorities.

The short-term priorities include some broad objectives like sustaining macroeconomic stability or continuing with the restructuring and privatisation process. Other priorities include much more specific goals, some of which are already being implemented, like integrating capital expenditures into the government budget or adopting specific legislation such as the insurance law. Some priorities are linked to specific processes and are also expected to be implemented swiftly, such as adjustments to the trade regimes in order to render them compatible with the Stabilisation and Association Agreement (SAA).

The medium-term priorities included in the European Partnership are a natural continuation of the short-term ones. They put emphasis on continuing fiscal adjustment and consolidation to reduce external imbalances, ensuring a more flexible labour market or promoting the development of the private sector by improving the business environment. The EFP addresses these areas to a varying degree. The programme is more consistent with general priorities requiring longer implementation, like the reform of the labour markets, the pension system or measures for maintaining macroeconomic stability.

Overall, the policies outlined in the EFP are broadly supportive of the relevant parts of the European Partnership and its full implementation should therefore facilitate the accomplishment of the economic policies.

The liabilities of the Compensation Fund set up under the Law on Restitution of Property Rights and Compensation and the additional obligations that may arise in the process of EU accession are seen as other risks to fiscal sustainability. As mentioned in the previous chapter, the fiscal risk posed by the compensation of confiscated property appears substantial. If the restitution law remains in its current format, the impact of the obligations of the Compensation Fund on the amount of public debt is likely to be substantial. On the other hand, the EU accession should not represent a fiscal burden for Montenegro. The initial costs of strengthening the public administration and institutional capacity in Montenegro are likely to be offset by the subsequent savings resulting from a more efficient public sector. In addition, Montenegro will benefit from various pre-accession financing instruments that will alleviate budgetary spending pressures.

Two more fiscal risks related to local governments and state-owned enterprises that are not covered by the programme would have merited to be addressed. Local governments have sizeable extra-budgetary activities and arrears and they should be better captured in the consolidated budgetary framework. Moreover, the Ministry of Finance needs to carefully supervise their financial operations and issuance of debt. The quasi-fiscal activities of state-owned enterprises are fairly large and include debts and arrears to the government, company debts covered by state-guarantees, intra-company transfers and some tax subsidies. While there is no overall estimate of the amount of quasi-fiscal deficits, the World Bank reports that for example, in the case of one company – EPCG – the state-guaranteed debt represents about 7.5% of the 2005 GDP and its arrears to the budget account for about 0.8% of GDP. Such contingent liabilities are not captured by the general government reporting and could easily turn into a fiscal burden for the budget.

5. STRUCTURAL REFORMS

The EFP itself does not cover structural reforms. These are presented in a document, the *"Economic Reform Agenda for Montenegro, 2002-2007 – Reports and Recommendations" (ERA*), attached to the EFP. The document, updated in 2005 and outlining key reform activities until 2007, presents a comprehensive view on the main objectives, achievements, problems and specific initiatives for implementation of the reform process. However, neither quantitative estimations nor fiscal effects are provided for in any of the presented initiatives. A new economic development programme covering the period 2007-2011 is currently under preparation by the new government. In the previous ERA, policy measures were focused on the continuation of enterprise restructuring and privatisation in order to underpin the government's objective of improving the economic performance of the enterprise sector. Among other, the programme sets as its objectives the reinforcement of the financial sector legal framework, stimulation of employment, institutional strengthening, as well as the design of various policy strategies and programmes. Policy measures are not always well defined and are not systematically updated in line with structural weaknesses and deficiencies identified. Moreover, as the structural reform agenda was elaborated well before the EFP's fiscal strategy, there is no consistent relation between the two.

5.1. Enterprise sector

The privatisation process is well advanced. At present, some 85% of the capital of former publicly-owned enterprises is already privatised. The majority of remaining companies still under state ownership are the airports, railways, public institutions of general interest (health, education, social protection and culture) and the utilities controlled by the municipalities. The main privatizations planned for 2007 are the insurance company Lovćen, 5 small hydro-power plants from the electric power company EPCG, and the wine producer Plantaže. In 2007, privatization plans will be prepared for the port of Bar, shipyard Bijela, the railways, the airports and the air transport company. The privatisation process should be concluded in 2008. Once the process is over, the Development Fund will be transformed. The main challenges identified in the Economic Reform Agenda for the successful conclusion of the privatization and post privatization processes are: solving pending restitution claims, the resolution of bankruptcy companies, monitoring the implementation of the privatization contracts and related investments. The agenda does not provide for an estimate on savings or revenues resulting from privatisation, or for an updated implementation schedule.

5.2. Financial sector

The banking sector is the main pillar of the financial sector in Montenegro, although it is still quite small, reflecting the limited size of the economy and the limited degree of financial intermediation. The fast pace of the reforms have rendered obsolete most of the objectives proposed in the Economic Reform Agenda attached to the EFP. Also driven by the completion of the privatisation process in 2006, the sector has started to expand rapidly. Total domestic credit growth rose by around 125% in 2006. At the end of 2006, aggregate lending by the banking sector amounted to 46.1% of GDP. The recently witnessed surge in domestic credit, and in particular consumer lending, enhances the credit risk in the banking system. It may lead to a deterioration of asset quality and increase of non-performing loans without proper prudential and supervision measures. The new banking law, to be adopted by mid-2007, intends to reinforce bank corporate governance and risk management in line with Basel II core principles as well as to mitigate vulnerabilities. Moreover, given the strong foreign bank participation, the central bank aims at strengthening international cooperation. As a result, the new banking law introduces the concept of consolidated supervision.

The insurance sector is still small and dominated by non-life, especially by mandatory Third Party Liability (TPL) motor insurance. However, the life insurance sector is growing strongly. A new insurance law was adopted in December 2006 which is in line with the International Association of Insurance Supervisors' (IAIS) core principles and EU directives. It establishes an independent agency to supervise the sector, which until now was de facto unsupervised.

5.3. Labour market

Despite declining unemployment and continuous increase of employment, the labour market continues to face significant challenges. Main reasons are the structural character of unemployment, the strong seasonality pattern (construction, agriculture and tourism), and the significant impact of the informal sector. The current legal framework provides for high dismissal costs, low wage flexibility and a fairly high tax wedge. Consequently, employment and participation rates are low, the unemployment rate of young people is high, and a significant share of job seekers is long-term unemployed. According to the EFP, a set of active measures are being undertaken through a series of programmes[9] and have been responsible so far for the creation of around 20,000 new jobs in 2006. In addition, the Economic Reform Agenda (2002-2007) presents the broad lines for a series of initiatives to stimulate the transfer of employment from the informal sector, the creation of new jobs, reduction of barriers by streamlining legislation, and a program of protection at work especially adapted to small and medium enterprises. The primary measures identified in the agenda for achieving these objectives are the reduction of the level of employment protection in the labour law, the change of the minimum wage concept and further reduction of labour costs, the reduction of the fiscal burden for employers, and the definition of procedure for settling labour disputes. However, there are no estimations of the budgetary impact of these measures, and the implementation schedule.

5.4. Administrative reform

The adoption of the Law on Civil Servants and State Employees in 2004 established the legal framework for the administrative reform. The Economic Reform Agenda provides an analysis of the context and main lines for its effective implementation until 2006. The process of accession to the EU and the need to reinforce administrative capacity to deal with new responsibilities sets the framework for the reforms. Moreover, the new situation of the country after its independence in 2006 has intensified the need for more solid institutions able to cope with new responsibilities (i.e. defence or foreign affairs) which were previously dealt with by the State Union of Serbia and Montenegro. The agenda points out the risk of

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[9] Programme of ongoing incentives to employment and entrepreneurship, programme for legalization of existing and generating new jobs, program for employing interns, the 'opportunity for the young' program and the program to encourage entrepreneurship and employment.

duplicating administrative tasks while increasing the number of administrative bodies. It also recognises that for small states it is relatively more costly to build the institutional framework. Therefore, it proposes a new organization of public administration based on optimised work efficiency, improved technical equipment and motivated professional staff.

To that end, the agenda presents three main lines of action: a code of conduct defining, among other, merit based recruitment and objective dismissal policies, the development of a salary system related to performance, and the development of a program of continuous functional training. The economic impact of these measures is not evaluated. The agenda recognises that all these reforms should be presented with a fiscal and regulatory impact analysis. However, the agenda also acknowledges the need for foreign expertise in order to develop the appropriate evaluation methodology. This reform does however not address local administrations. The government is currently working on amendments to the law on local governance financing. The amended law will increase the redistribution from the equalising fund to the poorest municipalities and will define the rate ceilings for local taxes and the property tax, while strengthening the supervision of local governments' expenditures.

5.5. Other reform areas

The reform of the pension system remains one of the key priorities of the structural reform agenda. The stated reform objective is to establish a sustainable multi-pillar system financed primarily from contributions, providing adequate pensions to citizens while fostering the development of capital markets. To this end, after the successful implementation of the first pillar in 2004, the strategy focuses on the introduction of the third pillar (voluntary pension insurance) preceding the second pillar (the obligatory pension insurance). The Law on voluntary pension funds should be ratified by mid-2007, and the setting up of the first pension funds could take place during the second half of 2007. The introduction of the second pillar (privately managed mandatory pension funds) will be implemented at a later stage, as part of the new Economic Reform Agenda 2007-2010. Institutionally, the reform will be reinforced by investment guidelines and sound regulation limiting the risks assumed on financial markets. However, the State will not guarantee the operations of the voluntary pension funds.

6. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

The multi-annual fiscal strategy presented in the programme aims primarily at improving the quality of public finances in Montenegro. The envisaged reforms are based on three main pillars: a reduction of public expenditures relative to GDP, a change of the composition of public spending and a decrease of some distorting taxes. All planned measures are directed towards alleviating the tax burden on the individuals and the economy in order to stimulate employment, the development of the private sector and accelerate growth.

The ratio of public expenditures to GDP at close to 49% of GDP (in national accounting standards) in 2006 is relatively high compared to other Central and East-European countries, which also enjoy more dynamic growth. The fairly high spending ratio may also be attributable to an under-estimation of GDP due to less developed national accounting statistics and a large informal sector in Montenegro. Nonetheless, several categories of public spending appear to be on the high-side. The public sector wage bill, at around 14% of GDP in 2005, is much larger than in the EU-25 and in particular in the new Member

States. Although it declined to around 13.3% of GDP in 2006, the wage bill is projected to return to above 14% of GDP in the 2007 budget. The relatively high wage bill drives up public spending on health and education which are above regional levels and close to EU-25 or OECD levels, without matching their outcomes. Social transfers to households, at about 17% of GDP in 2005 and 2006 are comparable to the regional average, but relatively high in comparison with several new Member States. The expenditures on public order and defence are about twice as large as the average of the new member states and represent a legacy of the regional conflicts that accompanied the break-up of the former Socialist Federal Republic of Yugoslavia.

The medium-term fiscal framework envisages a gradual reduction of public expenditures to around 40% of GDP in 2009 and 35% of GDP in 2011 mainly by a slower increase in nominal terms of expenditures relative to GDP growth. The reduction will mostly affect current expenditures, in particular the public sector wage bill and the social transfers to households. The strategy appears to be growth oriented and a reduction of the public sector wage bill together with the number of employees in state administration (700 employees in 2007) would reinforce not only the efficiency of public finances, but also the reform in the public administration. Capital spending is set to increase relative to GDP, although the administrative capacity to implement investment projects needs to be improved. In both 2005 and 2006 capital expenditures were below the planned levels and the amounts earmarked for capital spending seem to be over-allocated also in 2007.

The introduction of a flat personal income tax of 15% in 2007 is designed to reduce the tax wedge on labour which is fairly high and partially explains the existence of a fairly large informal labour market. According to estimates of the Employment Agency of Montenegro, the size of the informal labour market represents around 20% of the registered employment. The high payroll taxes mentioned by the majority of employers as the most common reason for establishing labour relations outside of the formal sector needs to be reduced so that the introduction of the flat personal income tax provides the desired benefits. In this respect, the programme is rather evasive and the presentation of detailed plans about the reduction of social contributions and of the size of the informal labour market would have seemed appropriate. Advancing the reform of the pension system and the introduction of a privately-managed second pillar will also provide incentives for the formalisation of labour contracts. The reform of the pension and health systems which have recorded chronic structural deficits is not properly addressed in the programme. The foreseen measures cannot be adequately assessed in the section of the programme on structural reforms which is not updated and the fiscal part does not provide a sustainability analysis of the financial status of the two sectors.

SERBIA

1. SUMMARY AND CONCLUSIONS

- In December 2006, Serbia submitted to the European Commission a revised Memorandum on Budget and Economic and Fiscal Policy for 2007 with projections for 2008 and 2009. The document is broadly in line with the content, form and data requested for the 2006 Economic and Fiscal Programme (the 2006 EFP). It presents a generally coherent macroeconomic framework, including projections for key macroeconomic variables and medium-term fiscal targets. It builds on the Budget Memorandum of April 2006.

- In Serbia, GDP grew by 5.4% year-on-year during the first nine months of 2006. Consumer price inflation declined to 12.8%. Employment fell by 2.8%. Average real wages grew at 10.1%, in line with labour productivity gains. On the external side, the current account deficit widened to 11.6%, but at the same time, due to larger foreign financing, foreign exchange reserves increased substantially. The general government budget recorded a surplus of 1.6% of GDP[10] and public debt fell to 38.8% of GDP. The macroeconomic scenario presented in the programme is optimistic and implies a bold continuation of structural reforms in particular as far as enterprise restructuring and privatisation is concerned, but also renewed and strong efforts for expenditure rationalisation. The projected developments in the monetary and external sectors are credible.

- The public finance scenario is plausible and consistent with developments in recent years. Although, the fiscal expansion of the fourth quarter of 2006 has set fiscal policy on a collision course with the programme's objectives. The fiscal strategy of the programme is to stimulate employment through the reduction of wage and corporate income taxes and aims at changing the expenditure structure away from public consumption towards capital expenditures. Expenditures and revenues to GDP are programmed to gradually decline and to open space for private sector activity. The budget surplus is projected to be reduced but a deficit is not foreseen over the entire program horizon. Public debt is projected to further decline. The fiscal scenario requires the continuation of structural reforms, in particular in respect to enterprise privatisation and restructuring as well as a return to a more restrictive fiscal policy stance. The analysis of fiscal risks would have benefited from additional information and quantification. The programme covers a broad range of structural reforms related, among others, to the enterprise and financial sector, labour market and social welfare system, public administration, business environment, education, health care, judiciary, public procurement and state aid. The programme envisions different forms of cooperation with the private sector, such as concession granting and public-private partnerships, without further elaboration in which cases this might be applied. The programme does not provide a timeframe for the completion of the restructuring of the enterprise sector. A large number of support schemes to foster SME development may suggest the need for some streamlining to provide efficient and well-targeted support. Labour market reforms focus on active labour market policies, in particular on tax rebates for specific target groups. On the financial sector, the programme could have been more pronounced on challenges and possible policy responses to the adverse

[10] This is based on the government's accounting methodology, which reports mobile phone license fees as revenue and which does not account for the payment of pension arrears.

impact of liability euroisation on monetary transmission mechanisms, the high degree of exchange rate indexation of loans and unhedged foreign exchange positions, and the relatively high share of non-performing loans.

2. INTRODUCTION

In July 2006, the Commissioner for Economic and Monetary Affairs, Mr 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 EFP is a further step towards an increased policy dialogue on economic and fiscal issues between the authorities of the potential candidate countries and the Commission. This is a yearly exercise and the programmes will be assessed by the Commission. The scope and content of the EFP is similar to the Pre-accession Economic Programmes which are submitted each year by candidate countries, although the EFP are somewhat narrower in scope.

Serbia has submitted to the European Commission a revised Memorandum on Budget and Economic and Fiscal Policy for 2007 with projections for 2008 and 2009. This document, which was prepared by the Ministry of Finance, forms the foundation of the republican draft budget for 2007 and was adopted by the government of Serbia on 2 November 2006, in line with the requirements of the Serbian budget system law. It was submitted to parliament together with the draft 2007 republican budget, which however has not adopted it in light of the 21 January 2007 early general elections in Serbia. To ensure operability of government functions during the first three months of 2007, the Serbian government has adopted a decree on temporary financing.

The submitted programme complies with the requirements stated in the outline for the 2006 EFP in terms of content, form and data. It provides a broad summary of recent macroeconomic performance, a coherent and consistent macroeconomic and fiscal framework, and an overall assessment of structural reforms. The requested tables are complete and seem to be compiled correctly. However, it remains unclear to what extend the data is in line with the ESA 95 accounting standard.

The programme aims to achieve robust GDP growth amid continued disinflation accommodated by significantly rising investment expenditure, in 2006 and 2007. The projected slowdown in investment growth in 2008 and thereafter will be balanced by an acceleration of private consumption in 2007 an 2008. The role of the state in the economy is set to decline as fiscal revenues and expenditures to GDP are programmed to be gradually reduced. Fiscal policy will provide a stimulus to the economy in 2007 and 2008 as the primary balance is being reduced by 1.1 and 0.6 percentage points of GDP, respectively. However, the primary and conventional budget will remain in surplus throughout the programme horizon. Public debt is projected to decline from 38.8% of GDP in 2006 to 30.2% in 2008. Tight monetary and exchange rate policies are assumed to support disinflation. The structural reform agenda aims at boosting export activity and domestic supply through privatisation of enterprises and attracting of greenfield investment, improving the business and entrepreneurial environment, and stimulating employment. In addition, further legislative alignment with EU rules in a broad range of policy areas remains an important priority.

3. MACROECONOMIC DEVELOPMENTS

3.1. Recent macroeconomic developments

The programme projects a continuation of robust GDP growth in 2006, and estimates GDP to have grown by 7%, following a growth rate of 6.8% for 2005. However, in light of the release of third quarter GDP at 4.6% and the substantial downward revisions of GDP numbers for the first and second quarters of 2006 (to 6.2% and 5.6%, respectively), GDP growth for the whole of 2006 will turn out to be significantly softer than estimated by the programme. For the first three quarters of 2006 GDP grew at an annual average of 5.5%.

Consumer price inflation declined in 2006, reaching an annual average 12.8%, following an upwards spike to 16.5% in 2005. Employment fell by 2.8% in 2006, compared to a moderate recovery of 0.9% a year earlier. Labour productivity increased by 10.1% in 2006, compared to 5.6% in 2005. Average real wage growth has been strong but remained broadly in line productivity gains. The investment ratio reached 19.8% of GDP compared 15.8% a year earlier.

On the external side, the current account deficit widened to 11.6% of GDP in 2006, following 9.8% in 2005, as the trade balance widened by 12.4% year-on-year. Exports grew stronger than imports, expanding by 36% and 23%, respectively, but accounted for about 50% of imports only. Financing of the external deficit has improved and foreign direct investment - having grown by 42.5% year-on-year - almost completely covered the current account deficit in 2006. Foreign financing in the form of loans to the private sector has grown by 15.3% in 2006 compared to year earlier. As a result of the strong increase in capital inflows, foreign exchange reserves grew by 54% to about EUR 8.1 billion at end 2006, more than 10 months worth of 2006 imports.

The programme presents a clear and concise picture of past economic developments and covers all relevant data available at the time of submission.

Table 1: **Macroeconomic developments**

	2005	2006	2007	2008
Real GDP (% change)	6.8	7.0	7.0	7.0
Contributions:				
- Final domestic demand		7.3	10.7	9.2
- Change in inventories		2.0	0.1	0.1
- External balance of goods and services		-2.3	-3.7	-2.2
Employment (% change)	0.9	-2.8	1.2	1.6
Unemployment rate (%)	n.a.	14.6	14.1	13.2
GDP deflator (% change)	14.5	15.0	8.4	7.3
CPI inflation (%)	16.5	12.8	6.8	7.0
Current account balance (% of GDP)	-9.8	-11.6	-10.6	-9.8

Source: EFP 2006

3.2. Macroeconomic scenario

The 2006 EFP presents a coherent and comprehensive medium-term macroeconomic programme with projections for key economic variables, covering real sector, employment, wage, inflation as well as external sector developments. Alterative scenarios are not developed. The policy mix laid out in the 2006 EFP is compatible with the macroeconomic scenario, suggesting a bias towards tighter monetary and exchange rate policies. The envisioned accelerated structural reforms, aiming at reducing the state involvement in the economy, boosting export activity and encouraging domestic and foreign investment, play an important role in realizing the macroeconomic projections.

The external outlook is based on IMF's September 2006 World Economic Outlook and is broadly in line with the Commission's autumn 2006 forecast. Projections for GDP growth in the USA and for global growth are somewhat more optimistic in the 2006 EFP than in the Commission's forecast. However, this is partially offset by lower projections for world import growth and higher projections for oil prices in the 2006 EFP. Therefore, the net effect of the difference in projections on the baseline scenario of the 2006 EFP can probably be considered as minimal.

Real sector

Real GDP is projected to grow at an annual rate of 7% over the programme horizon, mainly driven by a strong contribution of investment expenditures in 2006 and 2007, by an increasing contribution of private consumption in 2007 and 2008, and by an improvement in net exports in 2008. Growth of private consumption is projected to rise from 1.5% in 2006 to 6.4% in 2008 while growth of government consumption is expected to slow from 7.5% in 2006 to 2.2% in 2008. Gross fixed capital formation is forecast to slow to 14.2% in 2008 from a very high 43% in 2006. Export and import growth is expected to slow from 30.1% and 21%, respectively in 2006 to 15.9% and 13.1%, respectively in 2008.

On the supply side of GDP, growth of the service sector is projected to slow from 12.2% in 2006 to 8.4% in 2008, but will remain the fastest growing sector of the economy, contributing about 5 percentage points to gross value added growth. This is followed by the industrial sector, which is projected to grow steadily at about 5% and to contribute annually about 1.3 percentage points to growth. Growth in the construction sector is projected to slow from 10.5% in 2006 to 5.3% in 2007 and accelerate again to 6.9% in 2008, reflecting the planned granting of concessions for motorway construction projects. Its contribution to gross value added growth is projected to remain steady at an annual 0.2-0.4 percentage points. The agricultural sector is projected to stage a come back from a 1% decline in 2006 and to expand at 3.6% by 2008, supported by access to IPA funding. Its annual contribution to growth is expected to stay at about 0.5 percentage points. Employment is projected to recover in 2007 and grow at a rate of 1.2% and at 1.6% in 2008 compared to a decline of 2.8% in 2006. Labour productivity is projected to grow at 5.7% and 5.3% in 2007 and 2008, respectively, following a restructuring related spike of 10.1% in 2006. Growth of average real wages is projected to stay in line with productivity gains. However, this is somewhat at odds with the substantial loosening of income policies at the end of 2006.

Projected growth is based on a rebalancing of growth towards consumption, which is assumed to be driven by productivity gains and associated gains in real wages as well as growing credit to the private sector. Admittedly the potential for consumptive private demand in Serbia remains substantial. However, there remain doubts as to whether private consumption can in fact accelerate as strongly as projected, in particular against the backdrop of only moderate employment growth. Labour productivity growth is projected to fall over the programme horizon, in line with slowing fixed capital formation, to more moderate levels. In addition, export growth is projected to slow somewhat but to remain at a still robust 16% in 2008.

Taken together, the presented macroeconomic framework provides a set of broadly plausible and consisted assumptions. However, caution is might warranted related to the medium-term sustainability of GDP growth and the possible future speed of real convergence, in particular against the backdrop of the slowdown in GDP growth in the course of 2006. Using a Hodrick-Prescott filter we estimate potential annual GDP growth in Serbia at maximum at 6%, which is significantly below the projected annual growth rate of the 2006 EFP of about 7%. However, we do not view the latter as completely unachievable over the medium-term, assuming a reinvigorated structural reform momentum aiming at an increase in private sector activity, further liberalisation and strengthening of the entrepreneurial environment.

External sector

The current account deficit is projected to narrow gradually from 11.6% in 2006 to 9.8% on 2008 as absorption remains high. While export growth is assumed to outpace imports, the trade balance is projected to remain in deficit (export accounting for about ½ of import) and is set to widen by 15.4% between 2006 and 2008. However, about ½ of the trade deficit is financed by current transfers, which are assumed to grow by 14.4% under the programme timeframe.

Domestic saving is projected to rise substantially by 5.7% of GDP between 2006 and 2008, driven by an increase in domestic private and public saving of 5.0 and 0.7 percentage points of GDP, respectively. Over the same horizon, domestic private and public investment is projected to increase by 2.1 and 1.9 percentage points of GDP, respectively.

On the financing side of the balance of payments, foreign direct investment covered 95% of the current account deficit in 2006. This ratio is projected to decline to about 64% by 2008 as FDI slows. Debt creating inflows, primarily to the private sector, are projected to slow but continue to be substantial, resulting in growing private sector indebtedness which could raise external vulnerabilities. Nevertheless, external debt is projected to decline somewhat to 45% of GDP in 2008 from 60% in 2006. Taken together, capital inflows more than offset the current account deficit under the programme horizon. Consequently, foreign exchange reserves are projected to increase by 46% between 2006 and 2008.

The programme would have benefited from an analysis of projected external balances and their link to fiscal policy.

3.3. Monetary and exchange rate policy

In September 2006, the National Bank of Serbia (NBS) has changed its monetary policy framework to inflation targeting. The 2006 policy target, which was defined as core inflation to stay within a range of 7-9% at year end, was undershoot as core inflation stood at 5.9% in December 2006. For December 2007, the policy target range has been set at 4-8%.

The switch to a new policy framework was partly the result of disillusionment Serbia has experienced in the recent past with other monetary regimes, including combinations of various forms of pegs and monetary targeting. To a large extent, this disillusionment was related to strong capital inflows and the pressure they created under a highly managed exchange rate regime. In particular, strong capital inflows have exposed the difficulties in simultaneous targeting low inflation and external balance and ultimately risked undermining the price stability orientation and reputation of the NBS.

The key policy instrument under the new policy framework is the fixed interest rate on 2-week repurchase agreements, which is used to control money market liquidity and for signalling of the monetary policy stance. The exchange rate regime will ultimately be freely floating, once the NBS has completely withdrawn from foreign exchange market interventions.

Adjustments of the key policy rate are based on the assessment of the current economic situation, inflation developments and their medium term projections. The policy key rate will be raised if a significant and persistent threat to meeting the inflation objectives is identified and vice versa. The size and timing of the adjustments will be based on a view of monetary transmission, respecting its lags and the currently dominant role of the FX channel. Adjustments in policy instruments take place on pre-announced meeting dates of the Monetary Policy Council. The outcomes of the decision-making meetings and reasoning are announced to the public.

The new monetary policy framework is in line with the objectives of the 2006 EFP, which are to substantially reduce inflation, strengthen the Dinar, foster a gradual retreat of the NBS from the currency market and strengthen financial sector stability.

The nominal exchange rate of the dinar vis-à-vis the euro is projected to depreciate by 6.7% under the programme between 2006 and 2008. Annual average consumer price inflation is projected to decline form 12.8% in 2006 to 6.8% in 2007 and to reach 7% in 2008, which is consistent with the NBS policy target for 2007. In real terms, this implies a real appreciation of the Dinar vis-à-vis the Euro of about 3% between 2006 and 2008.

To realise the programmed inflation path monetary and exchange rate policies will need to remain tight, given the projected strong growth of aggregate demand, partly driven by a moderate relaxation of the fiscal stance, and the likely need to adjust administered prices in early 2007, which was delayed in 2006. A moderate appreciation of the real exchange rate would help to reduce inflationary dynamics stemming from stronger aggregate demand. However, this could in turn lead to a deterioration of the trade and current account balances as a larger proportion of domestic expenditures could be directed towards imports. Nevertheless, it seems unlikely that financing of the external deficit is to cause serious difficulties in the near term, in particular against the backdrop of fiscal surpluses, declining public foreign debt and continuing real sector restructuring.

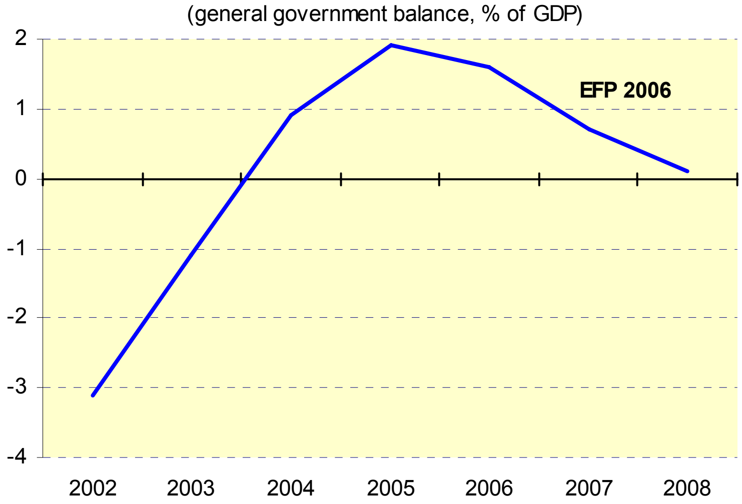
In recent years, annual average inflation increased from 9.7% in 2004 to 17.3% in 2005 amid substantial fiscal tightening. However, strong capital inflows under a crawling pegged exchange rate regime have fuelled domestic credit growth which augmented inflationary pressures. In light off this, the policy shift towards greater exchange rate flexibility was critical to help reduce inflation in 2006.

4. PUBLIC FINANCE

The presented public finance framework is overall coherent, consistent and sufficiently comprehensive. The key measures on the revenue and expenditure side are well explained. However, the programme would have benefited from a quantitative impact evaluation of the most important fiscal measures on the revenue and expenditure sides. The envisaged budgetary developments are plausible and consistent with developments in recent years. The analysis of fiscal risks would have benefited from additional information and quantification. The fiscal scenario rests on a bold continuation of structural reforms in particular enterprise sector restructuring and privatisation as well as renewed and strong efforts for expenditure rationalisation. The programme would have benefited from an impact sensitivity analysis of changes to main assumptions on the fiscal position. It remains unclear to what extent the data is in line with the ESA 95 accounting standard.

The fiscal strategy of the programme is to stimulate employment through the reduction of wage and corporate income taxes. The programme's strategy aims at changing the expenditure structure away from public consumption, social transfers and subsidies towards an increase in capital expenditures. In addition, expenditures and revenues to GDP are programmed to gradually decline and to open space for private sector activity. The budget surplus is projected to be reduced but a deficit is not foreseen over the entire program horizon. Public debt is projected to further decline.

Chart 1: Budgetary developments
(general government balance, % of GDP)



4.1. Fiscal architecture and governance

The Serbian budget systems law defines roles and responsibilities of public finances of the Republic of Serbia, and regulates the budget system and public finance management at all levels of government (the budget of the republic as well as budgets of local authorities, including the mandatory social security funds). Planning, preparation, adoption and execution of the republican budgets, budgets of territorial autonomies and local self-governments, as well as of financial plans for the social security funds, are uniformly regulated by the budget systems law.

The parliament passes the law on the republican budget, while local parliaments adopt respective budget laws of local authorities. The financial plans of the mandatory social security organisations are passed by the competent body of the organisation, in accordance with law and other regulations. Unless otherwise stipulated by law, bodies responsible for preparing budgets and financial plans allocate autonomously total receipts and outflows, in accordance with the law.

The finance minister is responsible for the execution of the budget and the government is accountable to the parliament as far as the execution of the budget is concerned. The relevant executive bodies of the local authority are accountable to the local parliaments in respect to execution of the budget of the local authority. The relevant bodies of a mandatory social security organisation are accountable to the government for execution of the organisation's financial plan. Reports on the execution of the respective budget are submitted to the national and local parliaments, respectively.

The finance minister, and/or the local administrative authority responsible for finance are required to monitor regularly the execution of the budget and inform the government and/or the relevant local authority body at least twice a year. The ministers responsible monitor regularly the execution of the financial plans of mandatory social security organisations and inform semi-annually the government and the minister of finance.

The treasury of the republic together with treasuries at local level of government constitute the backbone of public finance management and inform the general public through the submission of annual financial statements of the budget of the republic and through monthly publication of data on public revenue and expenditures for all levels of government. The Law on the State Audit Institution regulates the audit of the annual financial statements of the republic and other levels of government.

The system of public finance of Serbia has undergone substantial revision and reform between 2001 and 2005. The budget system law has been at heart of this reform together with the transformation of the public payments agency into a modern treasury administration. The tax system has been decisively reformed and public finances have been based on a solid foundation with the adoption of the value added tax law, the public procurement law, the public debt law, the law on the tax procedure and tax administration as well as the law on state audit institutions. These elements have helped lay the foundation of an institutional framework for an efficient management of public finances of Serbia.

4.2. The fiscal framework

In 2006, the general government balance reached an estimated surplus of 1.6% of GDP, compared to 1.3% of the revised 2006 budget on stronger than planned revenues, while expenditures were kept in line with the revised budget. In particular tax and other revenues recorded gains compared to budget projections. On the expenditure side, substantially lower interest payments than foreseen, partially related to early debt repayments, helped to compensate higher than planned expenditures for consumption, subsidies, social transfers and investment, partially related to expenditures ahead of early elections and the start of the implementation of the National Investment Plan.

Compared to 2005, total expenditure to GDP grew by 0.2 percentage points to 38.4% of GDP in 2006, mainly driven by a 1.1 percentage point increase in capital investment, related to expenditures under the National Investment Plan and a 0.3 percentage point increase in expenditures for social welfare. However, expenditures for social insurance benefits, subsidies and interest payments declined by 0.8, 0.5, and 0.3 percentage point of GDP, respectively.

In the 2006 EFP, expenditures for public employees were projected to decline in 2006 by 0.3 percentage points of GDP in line with the reform of the public administration. This was not achieved due a strong increase in public sector wages. However, interest expenditures turned out lower than programmed and expenditures for social insurance benefits and subsidies were reduced in line with the programmes objective, reflecting changes in the pension adjustment formula and a reduction of subsidies to public enterprises. Expenditures for capital investments were increased in line with the programme's objective.

Total revenues declined by 0.2 percentage points to 39.9% of GDP in 2006 compared to a year earlier and remained 0.2 percentage points higher than foreseen in the revised budget.

Revenues from personal and corporate income tax increased by 0.2 and 0.3 percentage points of GDP, respectively compared to 2005, caused by the continued robust increase in economic activity. Non-tax revenues grew by 1.2 percentage points on license income for the second mobile operator as well a higher revenues related to fines, as well as administrative and court taxes. However, the overall decline of revenues was driven by a 1.7 percentage point decline of revenues from valued added tax, caused by strong export gains, resulting in higher VAT refunding, and a 0.1 percentage point decline in revenues form customs duties related to the trend appreciation of the Dinar and the resulting impact on import values.

In line with the legal provisions under the budget systems law, the outgoing Serbian government has submitted a draft 2007 budget to parliament. However, in light of the early elections, which were held on 21 January 2007, the parliament has not deliberated nor voted on the draft 2007 budget. To ensure operability of government functions during the first three months of 2007, the Serbian government has adopted a decree on temporary financing, allowing for expenditures in the order of ¼ of the revised 2006 budget.

For 2007, the general government surplus is projected to decline to 0.7% of GDP compared to 1.6% of GDP in 2006, as a result of a 1.6 percentage point reduction in total revenues compared to a 0.9 percentage point reduction in expenditures. On the revenue side the programme envisions further reductions in the overall fiscal burden of the Serbian economy to 38.3% of GDP by reducing direct taxes, which will only be partially offset by higher indirect taxes, in particular taxes on consumption. Cuts in direct tax rates will be supported by measures to broaden the tax base, in particular by measures to reduce the grey economy and to improve tax compliance. This is a sensible approach and has show to be effective in other transition economies.

For 2008, the programme broadly envisions a continuation of trends of 2007. It foresees additional reductions in revenues and expenditures by 1.5 and 0.8 percentage points to 36.8% and 36.7% of GDP, respectively. The general government budget surplus is projected to decline further but to remain in surplus at 0.1% of GDP. Tax revenues are projected to slightly increase by 0.1 percentage points of GDP while social contributions and other revues are projected to fall by 0.4 and 1.2 percentage points, respectively. Government consumption and subsidies are planned to be reduced by 0.9 and 0.3 percentage points of GDP, respectively, as public sector reform and enterprise restructuring continue to result in lower public expenditures. Public investment is projected to increase by 0.4 percentage points to a solid 4.8% of GDP in line with the policy objective to rebalanced public expenditures towards economic development and away from public consumption, social transfers and subsidies.

Table 2: **Composition of the budgetary adjustment** (% of GDP)

	2005	2006	2007	2008	Change: 2005-08
Revenues	40.1	39.9	38.3	36.8	-3.3
of which:					
- Taxes and social security contributions	36.5	35.1	33.9	33.6	-2.9
- Other (residual)	3.6	4.8	4.4	3.2	-0.4
Expenditure	38.2	38.4	37.5	36.7	-1.5
of which:					
- Primary expenditure	17.6	19.0	19.5	19.0	1.4
of which:					
Gross fixed capital formation	1.9	3.0	4.4	4.8	2.9
Consumption	15.7	16.0	15.1	14.2	-1.5
Transfers & subsidies	19.3	18.4	17.5	17.1	-2.2
Other (residual)	--	--	--	--	--
- Interest payments	1.3	1.0	0.6	0.6	-0.7
Budget balance	1.9	1.6	0.7	0.1	-1.8
Primary balance	3.2	2.5	1.4	0.8	-2.4
Gross debt level	52.9	38.8	33.7	30.2	-22.7

Sources: EFP, ECFIN calculations

4.3. Debt developments

Public debt declined substantially to 38.8% of GDP in 2006, compared to 52.9% in 2005, driven by the Paris Club debt write-off, which was related to the positive conclusion of the IMF programme in February 2006, early repayment of debt owed to the IMF and World Bank, as well as the clearing of pension arrears. In addition, robust GDP growth and the appreciation of the Dinar have helped reduce the public debt level. The programme envisions a further reduction of public debt, albeit at a somewhat lower pace than in 2006. Gross debt is projected to decline to 33.7% and 30.2% of GDP, in 2007 and 2008, respectively, helped by a projected fiscal surpluses and further planned early repayment to international financial institutions, as well a continuation of the strong economic expansion. Domestic debt, primarily in the form of three- and six-month treasury bills and long-term frozen foreign exchange savings bonds, and foreign debt account for about 42% and 58% of total debt, respectively. The separation of Kosovo debt from Serbia debt could result in an additional reduction of Serbia's public debt by about 4.8% of GDP. At end 2005, local government debt, which is backed by a guarantee of the central government, accounted for about 30% of total debt of the Republic of Serbia. As of 2006, local authorities are allowed to borrow from international markets up to a maximum of 50% of their total local budget current revenues generated in the previous year with the approval of the Ministry of Finance.

Public debt is managed by the debt management department of the Serbia treasury. Its main tasks are to manage, monitor and report on public debt. The public debt management strategy is an integral part of the budget memorandum, which is what Serbia has submitted as her 2006 EFP. A medium-term objective of the Serbian authorities is to further develop the local currency government bond market with the aim to reduce currency risk exposure. The authorities intend to issue long-term Dinar denominated bonds, with the primary purpose of replacing debt denominated in foreign currency. However, until this is well advanced the recent shift towards a more flexible exchange rate regime, calls for strengthened risk management capacities at the debt management department of the treasury.

4.4. Fiscal risks

The programme correctly identifies stable and high GDP growth as a main risk factor for revenue generation. In particular, export growth will need to remain at above 15% annually, according to the 2006 EFP, to ensure a medium-term sustainability of projected annual GDP growth of around 7%. Indeed, keeping GDP growth at a high rate will be a challenge and requires a reinvigorated structural reform momentum aiming at a fast increase in private sector activity, further liberalisation and strengthening of the entrepreneurial environment. In addition, the recent real appreciation of the Dinar could undermine export competitiveness of Serbian producers and therefore adversely affects public revenues.

The 2006 EFP considers the persistently high current account deficit as a potential trigger for a foreign currency crisis in the near future, which could result in a significant depreciation of the Dinar and surging inflation and therefore calls for a reduction of the current account deficit to 5% of GDP. This assessment seems somewhat over scaled, in particular against the favourable fiscal backdrop, and is also not echoed by other parts of the document. While it is true that the Serbian current account deficit remains persistently large, it was easily financed in the recent past. Furthermore, Serbia's external debt is projected to decline somewhat to 45% of GDP by 2008. It is worth noting that a medium-term current account deficit of around 10% of GDP is not unusual for a fast growing transition economy. In addition, it is comforting that a large share of Serbian imports seems to be used to improve the potential output of the economy, rather than being consumed. Having said that, a decline of foreign investor's confidence towards Serbia could of course, have an adverse effect on the feasibility of financing Serbia's external deficit.

Other fiscal risks stems from potential government liabilities, which could arise from government guarantees issued for loans received by lower levels of authority, by enterprises or by other state-controlled institutions. It could have significant adverse fiscal effects, should a local level of government effectively default on its liabilities. However, the provisions of the public debt law put a cap on the lending of lower level authorities. These provisions together with a careful monitoring of developments by the debt management department of the Serbian treasury should help to contain this risk sufficiently. The risk stemming from guarantees to public and state-owned enterprises should be addressed best by their speedy and comprehensive privatisation.

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.

Finally the programme mentions external shocks, including lower operation profits worldwide and in EU countries, increasing prices for oil in world markets, and a global slowdown of growth as fiscal risk factors.

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

Box1: The EFP and the European Partnership economic priorities

The second European Partnership between the European Union and Serbia and Montenegro, including Kosovo, was adopted by the European Council on 10 January 2006. The European Partnership outlines specific prioritises in which progress is to be made in order to address identified deficiencies for further integration with the European Union. The Serbian authorities have responded to the European Partnership by adopting an action plan outlining how they intent to meet the priorities. The level of attainment of these priorities is the basis on which the European Commission evaluates, in its annual progress report, Serbia's advancement with EU integration. Short-term economic requirements, which are expected to be accomplished within one to two years include (i) to sustain macroeconomic stability, (ii) to continue to formalize the grey economy and to broaden the tax base, (iii) to speed up the restructuring and privatisation of socially- and state-owned enterprises, (iv) to complete the banking sector reform, (v) to reform the system of regulated and administered prices, (vi) to develop a stable and functioning land/real estate market, (vii) to promote employment and combat unemployment, and (viii) to align the Serbian trade regime with autonomous trade regimes and WTO rules.

The medium-term priorities included in the European Partnership are a natural continuation of the short-term ones. They put emphasis on continuing fiscal adjustment and consolidation to reduce external imbalances, ensuring a more flexible labour market or promoting the development of the private sector by improving the business environment. The EFP addresses these areas to a varying degree. The programme is more consistent with general priorities requiring longer implementation, like the reform of the labour markets, the pension system or measures for maintaining macroeconomic stability.

Overall, the policies outlined in the EFP are broadly supportive of the relevant parts of the European Partnership and its full implementation should therefore facilitate the accomplishment of the economic policies.

contingent and implicit liabilities, including the restitution of property nationalised after 1945. It is therefore impossible to assess whether the projected fiscal path is sustainable with the deficit and debt projections.

5. STRUCTURAL REFORMS

The 2006 EFP presents a coherent, broadly consistent and very 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, education, health care, judiciary, environment and public procurement. The presentation is largely descriptive, providing information on past and ongoing reforms with a strong emphasis on legislative harmonisation with EU rules and 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 the promotion of exports and attracting of 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 structural reform measures as well as clear timetables for their implementation.

5.1. Enterprise sector

The 2006 EFP states that amendments to the privatization law and the bankruptcy law will provide for an acceleration and more efficient restructuring of large socially-owned enterprises included in the list of enterprises undergoing restructuring with negative capital. In particularly the provision under which state-owned creditors are allowed to withdraw their claims and to collect them from sale proceeds is reported to have improved enterprise restructuring. Indeed, this provision seems to have accelerated the process of privatisation somewhat. The programme envisions that the privatisation of about 800 enterprises with majority socially-owned equity will be completed by end-2007. The preparation of these enterprises for privatization is accompanied by comprehensive social programs for laid-off workers. The restructuring programs of large enterprises are accompanied by SME developed programs, with a view to enable the SME sector to absorb the redundant workers from large enterprises. In this context, the National Investment Plan foresees investments of more than EUR 165 million into the promotion of entrepreneurship, employment and economic growth in 2006 and 2007.

The 2006 EFP envisions that the restructuring of public enterprises will be accelerated over the programme horizon on the basis of adopted strategic development plans and restructuring programmes. In order to boost efficiency and reinforce financial discipline all public enterprises undergo currently restructuring of their organization, management, ownership and operation. Non-core activities will be spun off and core activities are prepared to privatisation procedures. Furthermore, the programme mentions the privatisation of public utilities at the local level, which would be privatised as defined by the public utility sector privatisation strategy. In addition, the programme envisions different forms of cooperation with the private sector, such as concession granting and public-private partnerships, without further elaboration in which cases this might be applied. Other than for socially-owned enterprises the programme does not provide an explicit timeframe for the completion of the restructuring of the enterprise sector. It remains unclear on which basis estimates on privatisation revenues provided in the fiscal part of that document were made. The programme presents a large number of support schemes to foster the development of the SME sector which appear to party overlap, suggesting a duplication of initiatives.

5.2. Financial sector

Privatisation of the Serbian banking sector has been completed, with the successful privatisation of six state-owned banks in 2005 and 2006. Further reforms are intended to focus on an increasing the level of competition in the banking sector and on the creation of a modern banking system which should serve as a driver for economic development. The 2006 EFP comprehensively describes recent and planned initiatives to align financial sector legislation with EU directives and standards of the Basel Committee for Banking Supervision. The integrated supervision of banks, insurance companies, leasing companies and voluntary pension funds lies within the responsibility of the National Bank of Serbia, which is to be further strengthened under the Supervisory Development Plan. 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, and the high share of non-performing loans.

5.3. Labour market

Despite a recent moderate increase in employment, the Serbian labour market continues to face significant challenges, such as high unemployment even adjusted for substantial hidden employment, low participation rate, and real average wage increases above labour productivity gains, also the gap has substantially narrowed in recent years. According to the 2006 EFP the labour market strategy of Serbia attempts to strengthen the foundations for job creation through improvements of labour market institutions and harmonisation of regulations with EU and ILO standards. According to the programme, a new set of active labour market measures were implemented in the context of the National Employment Plan 2006 to 2008. These comprised more focused support to particularly sensitive groups, including payroll tax relief for employing first time job-seekers under 30 years of age and for employing persons over 45 years of age. The programme envisages to expanding active labour market policies to boost self-employment and encourage entrepreneurship. In addition, social programmes are foreseen to cushion the effects of redundancies related to enterprise restructuring. The programme would have benefited form estimates of the fiscal impact of the National Employment Plan. On occupational safety and health it is planed to intensify harmonisation activities with relevant EU directives and to attain European standards in labour inspection procedures.

5.4. Administrative reform

The reform of the Serbian public administration has well advanced in recent years. However, the 2006 EFP envisions additional reforms of the government administration and local government until 2008 to further improve the public administration. Or that purpose, the Public Administration Reform Strategy has been harmonized with the government's Action Plan for realizing the European Partnership priorities. The main objectives of the reform are directed towards decentralisation and depolitization of the Serbian administration. A reform of the salary system is underway with the aim to rationalise salaries. T he programme remains silent on the fiscal impact of the reform strategy and on how the recent substantial salary increases for civil servants relates to it.

5.5. Additional reform areas

In addition to the above, the 2006 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 in the context of the recent IMF programme. The pension reform aims at increasing the efficiency of the first pillar and at strengthening of capitalized voluntary pension funds. Within the next three 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. It is foreseen to clear all pension arrears by 2010. The presentation of the pension reform in to 2006 EFP would have benefited from estimates of its fiscal impact.

6. THE QUALITY AND SUSTAINABILITY 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. For details please refer to section 3.1 of this document. 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.

The medium-term objective of the 2006 EFP is to reduce the overall level of taxation as the Serbian public sector still has a too large claim on the economy, distorting and crowing-out private sector activity. Indeed, a strengthening of the private sector is crucial to keep the envisioned strong economic expansion on track. In addition, the proposed tax policy measures are feasible and sustainable as they do not necessarily undermine the medium-term fiscal stability of Serbia. Having said that, the continuation and even acceleration of structural reforms as well as a return to a more restrictive fiscal policy stance, following the pre-election period, will proof crucial to achieve the programme's objectives. In particular enterprise restructuring and privatisation as well as rationalisation of public expenditures will need to be pursued vigorously as soon as a new government has been formed, to be able to realise ambitious expenditure reductions, projected in the programme. Overall, the programmed reductions in expenditure are in line with past experience: Between 2004 and 2006, total expenditures were reduced on average by about 1 percentage point of GDP annually.

As far as the composition of the budget is concerned, the programme envisions further reductions of wage and corporate income taxes to reduce costs on production and labour and to stimulate employment growth. In addition and in line with the policy objective to rebalance current public expenditures towards economic development and away from public consumption, social transfers and subsidies, public investment is projected to increase substantially under the programme horizon. This ought to be achieved through the implementation of the National Investment Plan which foresees total capital investment in the amount of EUR 1.675 billion, to a large extend financed through privatisation revenues and a reduction in budget surpluses. This hastily-prepared investment plan should be revisited in light of its possible adverse impact on macroeconomic stability, in particular on current account and inflation, poor supervision and transparency of projects, as well as rational investment needs in Serbia.

The programme does not provide information on the long-term sustainability of public finances. Possible challenges to the long-term sustainability are not addressed explicitly.