



## Next Steps for Kosovo's Medium-Term Economic Development

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Over the last three years, Kosovo's reconstruction was an impressive success, but its economy is still far from being self-sustainable. Given its particular history, Kosovo has also been facing a particular **governance challenge**. In 1999 UNMIK, and in 2002 the new Government, had to be built up largely from the scratch, with little institutional heritage to draw upon. Further building institutional capacities is an imperative of development.

One of the important lessons from 10 years of transition is that countries with relatively weak or nascent governance structures should refrain from a sophisticated industrial policy and rather concentrate on

- (i) **macroeconomic fundamentals**,
- (ii) a generally **favourable environment for private enterprises**, and
- (iii) **basic infrastructure supporting business activities**.

In the following it is argued that Kosovo today, rather than a grand development strategy, needs a **policy refinement and implementation effort** to monitor those policies that have already been developed, and the concrete steps for their implementation. Particular attention should be given to identify concrete projects which are able to (i) mobilise additional external or internal resources, (ii) go into implementation quickly, and (iii) render equally quick, visible results.

For practical reasons, **coordination** should be limited to the necessary minimum, in order to avoid endless bargaining who should coordinate what. Coordination efforts should focus on the creation of transparency, and a common understanding of the importance of the goals above.

Both the **Government Programme** and the Kosovo Trust Agency's (KTA) **privatisation and restructuring policies** are the most important planning bases for Kosovo's medium-term economic development, and further steps can build on this groundwork.

## 1. Kosovo's medium-term development planning 1999-2002

Taking into account these challenges, UNMIK's European Union Pillar in 1999 developed a **private sector development strategy** which has laid important groundwork for Kosovo's development.<sup>1</sup> The strategy consequently concentrated on the three fundamentals outlined above. It contained four basic **objectives**, and today the following progress can be noted:

- (i) **Stable macro-economic framework:** Macro-economic stability has been mainly achieved through the introduction of the Euro as the currency in use, and the inability for the Kosovo Budget to run a deficit. In 2002, a first Medium-Term Expenditure Framework has been introduced, allowing for budget expenditure prioritising and planning. In this exercise it has also become obvious that the wish list for projects in the years to come exceeds financing capacities dramatically, even under the most positive scenario of donor fund flows, and that Kosovo's economic development will only be successful if private capital can be increasingly mobilised.
- (ii) **Creation of an effective financial sector:** Effective banking supervision through the establishment of the Banking and Payments Authority of Kosovo (BPK) has allowed for the sound development of the emerging financial sector. The sector, however, is presently still far from providing medium- or long-term investment finance.
- (iii) **Implementation of institutional and legal reforms:** Basic economic legislation has been put in place (Regulations on Business Organisations, Contracts for the Sale of Goods, Pledges, Foreign Investment and recently a Law on Mortgages), and in the course of 2002 major privatisation legislation has been put in place (Regulations on the KTA and the Special Chamber of the Supreme Court), with a Regulation on Land Use Rights still pending. The tax system (VAT, profits tax, wage tax, municipal property tax) is simple, transparent and does not put a heavy burden on enterprises. Exports are duty free, the average import tariff of 10 % is low, and amendments promoting investment are discussed.
- (iv) **Rehabilitation of key infrastructure:** Reconstruction has been a major success, both in social (housing, education and health care facilities) and general infrastructure (roads, railways, water, waste, energy). Reconstruction of transport infrastructure has focused on the rehabilitation of the existing major road and rail networks, and through their further upgrading Kosovo can be sufficiently linked to its neighbours and the trans-European transport corridors. The Pristina airport has not only developed its passenger, but also cargo facilities. For the business environment, an unreliable energy supply still is the major single infrastructure bottleneck. Restructuring with the aim of increasing private sector participation in public utility service provision has only started.

## 2. Cornerstones of Kosovo's medium-term development 2003-2005

The post-1989 emergency measures and the 1999 conflict resulted in a **dramatic decline of the socialist enterprises**, which have hardly been reviving since. This, however, might be a blessing in disguise, as it has contributed to a major economic reorientation of economic activities to competitive production for the market (albeit on a low scope), rather than funnelling scarce Kosovo resources to uncompetitive old industries.

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<sup>1</sup> UNMIK EU Pillar: A strategy for private sector development in Kosovo. Pristina, January 2000.

In spite of satisfactory growth rates (13% in 2001, ca. 8% in 2002), Kosovo's economy is still **far from sustainability**. This is particularly reflected in an extremely high trade deficit, in which imports (2.1 bn Euro in 2001) outnumber exports by a factor of 10. Growth has been significantly driven by foreign aid inflows and remittances from abroad.

Thus, it is of crucial importance to continue working on the four objectives above, in order to develop further the framework for a **self-sustaining private sector**. Respective policies are presently mainly expressed in the Government programme (with particular emphasis on legislation, the implementation of institutional reforms, and a stable macro-economic framework) and the policies of the KTA (privatisation and restructuring of public enterprises).

The following **cornerstones** determine Kosovo's medium-term economic development:

- (i) **The Stabilisation and Association process (SAP) provides for a clear perspective of Kosovo's integration into European structures.** With the SAP tracking mechanism now in place, Kosovo has embarked on a path towards further gradual accession to the European Union and its institutions. Under the SAP, Kosovo will ensure increasing compatibility of its legislation and institutions with the EU *acquis*, and will in return receive access to the EU market (which is already granted on a non-reciprocal basis), aid, and institutions. In this respect, an early (re-)integration into the South Eastern regional market is an important precondition. Kosovo's progress in the SAP is largely dependent on the ability to develop a functioning market economy based on competitive enterprises. Given the tight budget constraints, only limited public resources will be available for promoting the private sector.
- (ii) **Kosovo has no competitive comparative advantages.** Kosovo is rich in two production factors, namely labour and minerals (including lignite). Labour, however, is relatively expensive (compared to neighbouring entities), and skills only partly meet the needs of modern enterprises. Kosovo's deposits of minerals and lignite could be the base for a resource based industry (ore concentration and energy production for export), but these industries are capital intensive and face the problem of high investment needs combined with only limited forward and backward linkages into the economy, in particular with respect to employment.
- (iii) **The development vision should rather focus on enterprises than on sectors.** Most old enterprises suffered serious neglect in the 1990s and only part of them were able to resume or maintain production after 1999. Those that survived, and the newly established private enterprises, were more or less able to do so in a competitive market environment. Hence Kosovo, in comparison to other places in transition, is much less burdened with old industrial sectors that put a strain on the budget by demanding a sectoral industrial policy. Moreover, because of the lack of competitive comparative advantage, and the complexities of sector planning in a nascent governance environment, it is sensible to focus Kosovo's development on the initiative of private entrepreneurs irrespective of any a-priori sector concepts. Exceptions are agriculture (generally a lead sector for economic take-off and of high importance for poverty reduction), the financial sector (for its essential role in mobilising capital), and general infrastructure (for reasons laid out below).
- (iv) **Infrastructure development should be rather demand than supply driven.** Infrastructure provision in the European Union has in many cases followed a supply side approach, i.e. national and local governments have tried to provide developed industrial areas without concrete demand, hoping to attract investors in an increasing regional competition. The

result is that costly developed industrial areas have remained and still remain unused, and that investment in them must often be considered as failed. Transition countries do not have the resources for such a luxury, and this is the more true for Kosovo. Thus, supply side driven investment in infrastructure must be limited to the sectors where adequate supply is essential for the *overall* business climate, and that is electricity and the major transport links to markets. All other infrastructure (in particular remote access roads, water and sanitation) should be developed on a demand base, that is in hand with concrete investor interest, in order to optimally use scarce resources.

- (v) **Resource mobilisation must follow international supply criteria.** Given the size of the Kosovo Budget, it is clear that investment to support private sector development cannot rely on internal sources alone. Even if access to sovereign borrowing was available today, it would not be able to significantly contribute to mobilising external resources, simply as no international financial institution would lend substantial amounts to Kosovo based on the present revenue projections. Thus, there are three major opportunities to mobilise external resources, that should be focussed upon:
- a. **Bankable projects:** Wherever there is a reasonably positive return on investment, international banks and guarantee facilities are much more likely to develop an interest to engage in drawing up a project financing package involving the private sector, that is needed to meet financing needs.
  - b. **Trans-European networks:** The European Union's trans-European network planning gives clear indication which intraregional transport infrastructure has chances to receive funding support in form of grants, technical assistance or preferential credit.
  - c. **Bilateral donors:** Although there is a clear trend that donors will withdraw, well presented needs will further be able to attract their support.
- (vi) **Kosovo needs a proven track record of foreign private business attraction, both in privatisation and in Green field investment.** For all efforts to mobilise private investment, be it directly with the support of international banks and guarantee schemes, it is essential that Kosovo presents a positive track record to the international business community. In this respect, the experience of investors with the upcoming privatisation and the private sector participation in public services and infrastructure will be as closely monitored as experiences with Greenfield investment.

### 3. Next steps

Many of the above policies are already transferred powers of the Government and the Municipalities, while some remain reserved powers to the UNMIK European Union Pillar and the KTA:

- **The Government** has the overall authority for private sector development (MTI), the agricultural sector (MAFRD), transport and communications (MTC), and spatial planning (MESP). The **Municipalities** also have an important role in spatial planning and in facilitating access to land and municipal services for private investors.

- **The EU Pillar and the KTA** have the responsibility for a privatisation that meets international legal standards and the restructuring policies and actions for public enterprises in order to enhance efficiency and allow private sector participation. Moreover, the Pillar has an important role in facilitating international economic relations, in particular where status issues are at stake.

It is essential to have a clear understanding of, and enhance, the **mutually dependent interaction** between these institutions and their actions: Privatisation and private participation in infrastructure will not be successful unless Kosovo can prove to the business community it has a reliable business environment, and this is mainly within the hands of the Government, the Municipalities, and the local courts now. On the other hand, creating a reliable business environment will not do the job alone if basic general infrastructure is not in place, and successful privatisation does not give important signals to the international business community:

- **The Government** in its Programme rightly put a strong focus on legislation improving the business environment. Still a debate is outstanding if there are other **measures to stimulate private business without spending scarce resources**. The newly established tracking mechanism in the European Union's Stabilisation and Association process will also put certain requirements on Kosovo's legislation. Thus, the Government, under the lead of the MTI or the OPM, might
  - Review which legislation has the quickest impact on the business environment, and has high importance for the SAP (such as property rights).
  - Identify international best practice for business support with scarce resources (such as a one-stop-unit supporting investors on their way through the institutions).
  - Initiate a dialogue between Government and Municipalities in order to ensure that investors' access to Kosovo is facilitated.
  - Initiate a institutionalised dialogue with the international business community that has a lead role in spreading the perception of Kosovo's business climate.
- **The EU Pillar and the KTA** first and foremost need to spend additional efforts on **refining and monitoring policy formulation and respective steps for their implementation**, including the formulation of projects. Thus, the Pillar should
  - Continue the process of defining medium-term policies and their implications.
  - Define a priority list of projects out of the MTEF wish list, taking the criteria for mobilising additional capital (outlined under 2.(v) above) as guidelines.
  - Engage in a permanent progress monitoring exercise, identifying bottlenecks and mobilising short-term relief.

Under the present conditions in Kosovo, a step by step approach in these areas, with a institutionalised feed back mechanism to reality (i.e. the real business community), should be given higher priority than a somewhat abstract grand design of a development strategy. A regular consultation between Government, KTA, and major investors might be able to identify bottlenecks upfront.