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Acronyms and Abbreviations

ATM	Automated Teller Machine	MAFRD	Ministry of Agriculture, Forests and Rural Development
BEEPS	Business Environment and Enterprise Performance Survey	MFI	Micro Finance Institutions
BPK	Banking Payments Authority of Kosovo	MFN tariff	Most Favored Nation tariff
CRU	Central Regulatory Unit	MIGA	Multilateral Investment Guarantee Agency
EAR	European Agency for Reconstruction	MoEST	Ministry of Education, Science and Technology
EMIS	Education Management Information System	MoLSW	Ministry of Labor and Social Welfare
EU	European Union	NGO	Non-Governmental Organization
FDI	Foreign Direct Investment	OECD	Organization for Economic Cooperation and Development
FTA	Free Trade Agreement	OPIC	Overseas Private Investment Corporation
FYR Macedonia	Former Yugoslav Republic of Macedonia	PIP	Public Investment Program
GDP	Gross Domestic Product	PISG	Provisional Institutions of Self-Government
GNI	Gross National Income	POS	Point of Sale
GNDI	Gross National Disposable Income	POE	Publicly Owned Enterprise
IDA	International Development Association	SAM	Serbia and Montenegro
KCB	Kosovo Consolidated Budget	SEEREM	South East European Regional Energy Market
KEA	Kosovo Export Association	SFR Yugoslavia	Socialist Federal Republic of Yugoslavia
KEK	Korporata Energjite e Kosova (Power Corporation of Kosovo)	SME	Small and Medium Size Enterprise
KEM	Kosovo Economic Memorandum	SOE	Socially Owned Enterprise
KPST	Kosovo Private Savings Trust	SSTC	Skill/Occupational Standards, Testing and Certification System
KTA	Kosovo Trust Agency	UN	United Nations
LC	Letter of Credit	UNMIK	United Nations Interim Administration Mission in Kosovo
LFS	Labor Force Survey	VAT	Value Added Tax
LMIS	Labor Market Information System	WTO	World Trade Organization
LSMS	Living Standard Measurement Survey		

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EXECUTIVE SUMMARY

1. **The Kosovo¹ economy inherited in 1999 had been damaged by poor economic policies, broken external trade and financial links, international sanctions, a lack of investment, and ethnic conflict.** Output halved in the early 1990s, and fell by at least another 20 percent as a result of the conflict at the end of the decade. Inflation remained at very high levels throughout the 1990s due to monetary financing of fiscal and quasi-fiscal deficits resulting eventually in financial insolvency. By the end of the decade, income had collapsed, half of the population was unemployed, and more than half was poor.
2. Since 1999, there has been a shift toward liberal market policies. An open trade regime was put in place with no quantitative barriers and a single 10 percent tariff rate. The use of foreign exchange was legalized for all domestic transactions, initially establishing the Deutsche Mark and later the euro as the de facto local currency. The Banking and Payments Authority of Kosovo (BPK) was established to handle domestic payments, licensing and supervision of the banking sector. The Ministry of Economy and Finance (MOEF), with responsibility for the budget, and a tax system and administrative structure have also been established.
3. **The macroeconomic data indicate that there has been a recovery of economic activity and positive growth since 2000.²** GDP growth, reflecting high levels of public and private investment, reached 21 percent in 2001 and has since averaged 4.3 percent. GDP per capita, approximately US\$400 in 1995, has increased to around US\$790 in 2003. As a result of sizeable remittances and payment from seasonal workers employed abroad, Gross National Disposable Income (GNDI) is estimated to be much higher; about US\$1170 per capita in 2003. Price stability has been achieved, with inflation rates coming down from double digits in 2000 to close to zero inflation in 2003. Improved budgetary performance and rising private savings have helped to cut current account deficits by more than half in this period. Private sector activity shows signs of recovery, with construction activity exhibiting considerable strength and banking credit more than doubling in each of the last three years.

¹ Kosovo, Serbia and Montenegro, hereinafter Kosovo.

² Estimates of macroeconomic data are based on the IMF and Kosovar authorities estimates concluded in November 2003. Due to the weak statistical base in Kosovo, many of the data are constructed using assumptions. They are subject to frequent revision and should be treated with caution. With support from the IMF, the EU and SIDA efforts are underway to greatly strengthen statistical capacity, particularly in compiling economic data.

4. **The recent growth performance has however, been driven by a post-conflict boom financed by official aid flows and is unlikely to be sustainable.** Growth rates have already fallen from double digits (21.2 percent in 2000) to an estimated 4.7 percent in 2003. The macroeconomic situation in Kosovo is unusual in that, for the last four years, foreign finance has funded a sizeable trade deficit, currently in the region of 125 percent of GDP. Between 1999 and 2003 the international donor community spent an estimated €1.96 billion in Kosovo, in addition remittances have added about another €550m per annum over this period. Since 2000, donor grants have fallen by 70 percent, and are forecast to continue to decline. As the external financing falls there is considerable uncertainty as to how the remaining trade deficit will be financed. The challenge for policymakers in Kosovo is to maintain macroeconomic stability, prevent further output falls and sustain higher growth rates.

5. Prospects for economic growth will largely depend upon the success of two overarching and inter-dependent factors (i) implementation of a policy program that promotes private sector led growth, including completion of the reconstruction effort (ii) the maintenance of peace and security for all peoples of the region and a clarification of the political and legal arrangements. Investors will also require some assurance over continuation of liberal economic policies regardless of political developments. Implementation of the policy program should also assist in establishing political and institutional stability and the rule of law. Prospects for addressing the issue of Kosovo's political status are linked to achieving a set of standards – the 'Standards before Status' principle. These standards aim to ensure that functioning democratic institutions, the rule of law, sound economic legislation and policy framework and the free movement of all peoples is in place. Clearly, ensuring a stable and secure environment for investors and setting up a minimum of functioning institutions is required to mitigate risks from an uncertain environment, that could result in a rapid fall in incomes and social indicators. Improving prospects for growth are critical for addressing the high rates of unemployment, which is itself a contributing factor to the security and stability situation.

6. For the immediate future, access to capital markets and concessional external financing will continue to be limited. In addition, the uncertainty associated with the current security situation, institutional and legal set up, political outcomes in the region, and enforceability of legal contracts detracts the necessary foreign direct investment (FDI) to revitalize industrial sectors. Estimates of FDI inflows indicate that less than €30m has been invested since 1999.³ The delayed and sporadic progress with privatization of the former socially-owned and restructuring of the publicly-owned

³ All FDI estimates are tentative. See RIINVEST (2002a).

enterprises (SOEs and POEs) is hindering this even further. Private-sector led growth is further hampered by low domestic savings.

7. In the meantime, improving the environment for small and medium-size enterprises (SMEs) will maximize growth and export prospects. The Investment Climate Assessment concluded that a sound legal framework for a free-market economy has largely been put in place, and that the business environment is generally perceived to be more favorable by domestic SMEs than is the case in many countries in the region. Implementation and enforcement of the new policy and legal framework, however, is not consistent across the province, and efforts should be made to build capacity in weaker administrations.

8. Businesses consider the unreliable power supply as the biggest barrier to their operations. This is the single most important policy issue on which progress has been insufficient and is costing both the public and private sector greatly. A speedy resolution to the short-term power supply problem is a prerequisite for broad-based growth.

9. Reform in the power sector is urgent not only because of the current constraint and additional cost to the rest of the private sector, but also because of the potential for substantial gains from joining the regional energy grid and exporting power to the region. Kosovo's sizeable lignite deposit is potentially one of the most economic in Europe. The shortage of alternative new power sources elsewhere in the South East Europe region provides an opportunity to mine lignite for power generation and sales to the region. To benefit from such an opportunity would require rehabilitating the existing infrastructure, including the lignite mines; restructuring the industry in line with the establishment of the regional grid; and bringing in private sector operators to expand the power generation and mining businesses for export.

10. The mining sector might also provide job-creating opportunities, but not without a concerted effort to facilitate exports and attract FDI. As part of the SFR Yugoslavia, Kosovo's socially-owned enterprises produced ore and processed minerals to supply the rest of the country. Once a major industry, these mining and processing operations have suffered from a decade of poor maintenance and management, damage caused during the conflict, and social and environmental legacies. As a result they are largely non-operational today. However, there are prospects for revitalizing the industry. Although Kosovo's deposits are modest by global standards, they enjoy a competitive advantage in being close to Western Europe with relatively low transport costs to markets. The overarching obstacle to growth in this sector is that operations cannot restart or recover without major capital injections and technical improvements. Attracting the necessary FDI requires finding solutions to address political risks and to overcome delays and false-starts with the privatization process.

11. A growth strategy for the agricultural sector should focus on prospects for agro-processing and commercial farming interests. Kosovo is endowed with fertile land and a temperate climate suitable for agricultural production. The shock to domestic production caused by the conflict resulted in a destruction of farm assets and a reliance

on agricultural and food imports. Many assets have been replaced since then, but agricultural imports continue to provide intense competition to domestic producers. Agricultural productivity and yields are low as a result of small farm sizes, limited capital stock, lack of technical expertise, and poor use of inputs. It is therefore unlikely that Kosovo will have a comparative advantage in the production of high volume, low value commodities such as grains. On the other hand, the small-farm sizes indicate greater potential for production of vegetables, meat and poultry, which have already seen an increase in commercial production and exports.

12. Although there has been an increase in private sector activity since 1999, this has not yet translated into a reduction in high unemployment. The best policy course for addressing the unemployment issue, is one that provides for labor-intensive growth. Policymakers should resist the temptation to burden the currently flexible labor market with additional regulation and higher payroll taxes that would only serve to increase the costs and lower the mobility of labor. Women and youth account for a disproportionately high share of the unemployed. Unemployment is not, so far, a result of restructuring the enterprise sector. The authorities should design affordable, targeted labor-restructuring packages for redundant labor in the SOEs and POEs to be restructured in the future.

13. Maintaining macroeconomic stability will be necessary to maximize growth prospects. Despite the inevitable distortions associated with the large foreign inflows, the economy does have a certain degree of balance: the adoption of the euro provides a stable exchange rate and low inflation; and the lack of recourse to borrowing either domestically or internationally provides the authorities with the ultimate budget constraint and only fiscal and structural policy instruments to achieve macroeconomic stability. The budget in Kosovo must therefore either balance or yield a surplus unless there are accumulated reserves from previous surpluses. Fiscal discipline together with better-than expected domestic revenue performance, have so far resulted in budget surpluses accumulated over the last three years. The accumulated cash balance was estimated to be approximately 25 percent of GDP by end 2003.

14. The healthy domestic revenue performance to date enabled public capital and recurrent expenditures to continue as international financing withdrew, as well as the build-up of a cash reserve. In the short-term, the accumulated reserves can be used for modest capital expenditures to complete the rehabilitation of infrastructure to encourage growth, and ease the transition to a smaller public sector in the economy. However, there are a number of fiscal risks that argue for fiscal prudence to avoid any dramatic output shocks and policy reversals in the future. First, the revenue base is narrow and heavily reliant on taxes collected on imports. With the external financing falling off, and the fall in GDP growth, the fiscal position is vulnerable to a fall in imports. Second, there has already been a rapid increase in government expenditures, including recurrent costs such as public sector wages, over the last few years. In addition, further down the line, there may be potential claims on public expenditure associated with a political settlement, such as external debt service obligations. **The authorities must resist the pressure to spend on unsustainable recurrent costs and ill-conceived capital projects and to be prudent in this election year, to ensure that costly policy reversals will not be needed should growth slow down and the cash reserve be depleted.**

15. As a small land-locked economy Kosovo's future depends critically on its ability to open its borders and benefit from international trade. Empirical evidence demonstrates that small states can achieve high growth rates when the economy is open, there are no controls on capital flows, the business environment is unencumbered by regulation and a liberal labor market exists, resulting in a mobile labor force.⁴ Kosovo has so far pursued trade policies that place it on the road to join the most liberal trading regimes in the world. There is room for improving this regime even further and an across the board reduction in the tariff rate to 5 percent is recommended. Revenue implications will need to be taken into account, and measures taken to increase revenues from VAT where necessary. Pressure from interest groups to differentiate the tariff rate in order to harbor a greater degree of protection should be resisted. Kosovo already faces considerable non-tariff barriers to trade, in a region where trade has fallen especially since the break-up of the SFR Yugoslavia; it should therefore continue to pursue policies aimed at encouraging exports rather than production for the domestic market.

16. To conclude, progress has been made since the end of the conflict in 1999. Progress with reconstruction, macroeconomic stability and establishing public institutions have so far resulted in economic growth, and improved per capita incomes. However, to sustain broad-based economic growth and poverty reduction beyond the post-conflict boom, with limited policy instruments, there are several challenges ahead. A conducive business environment and a reliable power supply, fiscal sustainability, a liberal trading regime, and flexible labor market are all required. In addition, progress with privatization and pursuing a path to insulate investors from political risk, will assist with attracting inward investment to key economic sectors that might lead the way in an export-oriented growth strategy. The authorities have agreed an action plan for implementing Standards over the next 18 months. The need to meet these Standards places an additional premium on sound economic policies and reforms during this period.

⁴ See for example, Slovenia, Cyprus, Latvia and Ireland.

1. INTRODUCTION

Much Has Been Achieved With The Reconstruction Program

1.1 Following the cessation of hostilities in 1999, the international community and the Kosovars began reconstructing public infrastructure, providing public services, and putting in place a new legal framework, establishing a democratic political structure and a civilian administration in Kosovo.⁵ Despite this, bouts of violence continue. The recent flare-up in ethnic tensions underscores the need to accelerate economic reform and insulate investors against political risks to ensure that prosperity, peace and stability are secured for all groups in Kosovo.

1.2 There has been considerable progress with the reconstruction effort. The international donor community successfully mobilized support for Kosovo and a total of €1.96 billion of donor funds was spent between 1999 and 2003 (see Charts 1.1 and 1.2). As Table 1.1 shows this has produced tangible benefits such as repaired roads, schools and health centers. Positive economic growth, originally driven by the post-conflict reconstruction spending from a low base was estimated to be more than 20 percent in 2001. In recent years this has begun to decline to more sustainable rates. However the growth rate of about 3.5 percent estimated in 2003 needs to be raised if unemployment and poverty are to be rapidly reduced.

Chart 1.1: Donor funds spent and committed, 1999-2003

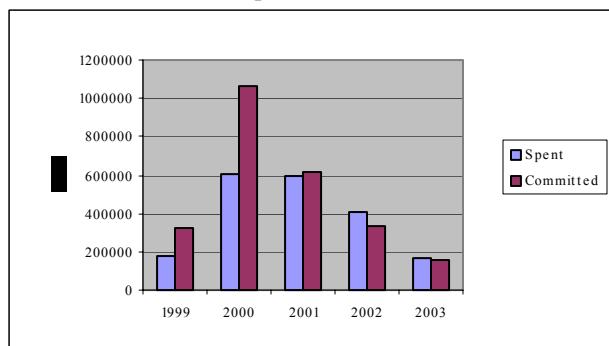
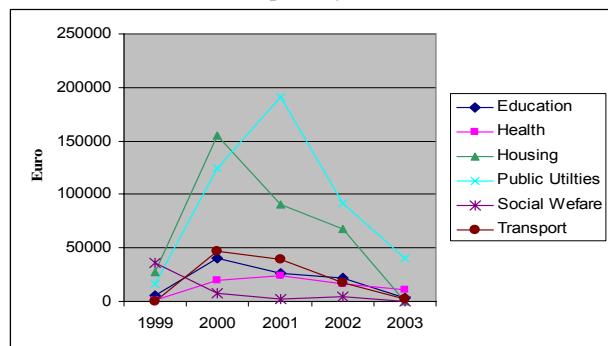


Chart 1.2: Donor funds spent by sector, 1999-2003



Source: RIMS data, Donor Coordination Unit, MOEF.

⁵ Kosovo, Serbia and Montenegro, hereinafter Kosovo.

Table 1.1: Outcome Indicators of Infrastructure Reconstructed and Repaired

	1999	2000	2001	2002	2003	Total
Km. of road	0	487	926	36	26	1,475
No. of houses	0	1,1782	5,828	2,074	0	19,684
No. of schools	81	89	110	99	80	459
No. of health care centers	10	28	46	18	73	175
No. of household hours with electricity (million)	4.0	4.6	5.1	5.6	5.5	24.8
m ² landmines cleared (million)	4.7	27.5	0.2	0.3	0	32.7

Source: Donor Coordination Unit, MOEF.

Governance is Characterized by a Dual Administration

1.3 The final political and legal status of Kosovo is to be settled during future negotiations. Following the end of the conflict in 1999, Kosovo came under the administration of the United Nations Interim Administration Mission in Kosovo (UNMIK) under the terms of UN Security Council Resolution 1244.⁶ In 2001, a Constitutional Framework was agreed establishing the Provisional Institutions of Self Government (PISG), and defining a division of responsibilities between the PISG and UNMIK. This unique governance arrangement has resulted in radical departures from the economic policies associated with the former Socialist Federal Republic of Yugoslavia (SFR Yugoslavia).

1.4 This dual administration also results in a challenging governance environment that is addressed throughout the report. Generally, the handover of responsibilities to the PISG has proceeded well. Successful implementation of policies that cut across the shared responsibility, however, will require continued cooperation between both administrations.

The Challenges That Lay Ahead

1.5 Prospects for economic growth depend upon the success of two overarching factors (i) mitigating risks related to political uncertainty and the maintenance of peace and security in the region; and (ii) implementation of a policy program that promotes private-sector led growth, including completion of the reconstruction effort. Such a package of reforms might include the following measures:

⁶ UN Security Council Resolution 1244 reaffirmed the commitment to the sovereignty and territorial integrity of Serbia and Montenegro and also called for “substantial autonomy” for Kosovo.

- Within a sound fiscal position proceed with prioritized capital projects to complete the rehabilitation of infrastructure, but resist unsustainable spending on recurrent expenses such as the public sector wage bill.
- Pursue improved trade relations within the region. Maintain a uniform tariff rate and reduce the rate across the board. Consider a compensating revenue effort to raise taxes from VAT, including through improved administration.
- Proceed with privatization of socially-owned enterprises and restructuring of publicly owned enterprises, including privatization of land-use rights of SOEs slated for liquidation.
- Strengthen the capacity of the municipal courts to implement and enforce creditors rights and contracts.
- Rehabilitate the power sector, including lignite mines, and pursue a strategy for integrating with the regional power grid.
- Develop a strategy for the revitalization of the rest of the mining sector.
- Address overstaffing issues in POEs and SOEs, address transitional unemployment issues and facilitate redeployment to alternative productive activities.
- Keep the labor market relatively unencumbered by payroll taxes. Facilitate employment search by linking information systems to enterprise surveys and the provision of vocational training.

1.6 If the local administration is to successfully tackle the challenging policy recommendations contained in this report, the international community will need to continue to provide technical expertise and support capacity building. In addition, the external position leaves Kosovo vulnerable to external shocks. The withdrawal of international finance over the coming years should therefore proceed gradually. In addition, under all medium-term projections considered for this report, donor grant finance will continue to be required through to 2010.

1.7 Under the policy of “standards before status”, discussion on Kosovo’s final legal and political arrangements will depend on progress toward a range of benchmarks. Detailed Standards for Kosovo were elaborated by the Special Representative of the UN Secretary General (SRSG) in December 2003 and have been endorsed by the UN Security Council (see Annex 1). The Kosovo Standards Implementation Plan was launched by UNMIK in March 2004.⁷ A comprehensive review of progress is expected in mid-2005, and decisions on how and when to begin discussions of final status are anticipated to follow this review.

⁷ Kosovo Serbian representatives have raised reservations about the Kosovo Standards Implementation Plan.

1.8 Political uncertainty and divisions in Kosovo have the potential to impact on progress toward the Standards and ultimately, discussions on final status. Although much has been achieved, the recent events in Kosovo serve as a reminder of how much more needs to be done. The ethnic hostilities and frustration among the people of Kosovo, differences among the main political parties and the strained relationship between UNMIK and the PISG, as well as the Presidential and Assembly elections due in October 2004, add to the uncertain political climate and the challenging environment in which to achieve progress in the implementation plan.

Box 1.1: Standards for Kosovo

The self-described goal of the Standards for Kosovo is to set out the minimum requirements for “a Kosovo where all – regardless of ethnic background, race or religion – are free to live, work and travel without fear, hostility or danger and where there is tolerance, justice and peace for everyone”. The Standards set out minimum requirements under eight broad headings:

- (i) Functioning democratic institutions
- (ii) Rule of law
- (iii) Freedom of movement
- (iv) Sustainable returns of displaced people and respect for the rights of all communities and their members.
- (v) A competitive market economy.
- (vi) Fair enforcement of property rights.
- (vii) Constructive and continuing dialogue between the PISG and Belgrade on technical issues.
- (viii) The transformation of the Kosovo Protection Corps into a civilian emergency operation that represents all communities in Kosovo.

A key theme throughout the Standards is the need for Kosovo to move toward European standards. Senior policy-makers in Pristina recognize that Kosovo’s future is likely to depend on greater European integration.

1.9 This report considers the prospects for improving economic growth in Kosovo, by first looking at the essentials, without which growth will not be sustained beyond the post-conflict boom, and then looking at the particulars of several sectors. The essentials are covered in Chapter 2: macroeconomic stability and Chapter 3: a conducive business climate. In Chapter 4, we examine the prospects for export-led growth in the power, mining and agriculture sectors. These are three sectors in which Kosovo could have a comparative advantage, as it is relatively well endowed with (i) lignite, (ii) other minerals, and (iii) fertile agricultural land; enjoys free trade with the EU and is geographically located close to Western European markets. Finally, in Chapter 5 we review the labor market outcomes and policies for a liberal labor market and an appropriately skilled labor force.

2. MACROECONOMIC PERFORMANCE

A. BACKGROUND AND RECENT DEVELOPMENTS

2.1 The economy inherited in 1999 had been damaged by poor economic policies, broken external trade and financial links, international sanctions, a lack of investment, and ethnic conflict. Data for this period are limited, but it is estimated that output declined over fifty percent in the early 1990s, and at least another twenty percent as a result of the conflict at the end of the decade. Inflation remained at very high levels throughout the 1990s due to monetary financing of fiscal and quasi-fiscal deficits. These deficits reflected an attempt to protect consumption in the face of a substantially smaller resource base. The result was ultimately industrial decay and financial insolvency. By the end of the decade, income had collapsed, half of the population was unemployed, and more than half was poor.

2.2 Since 1999, there has been a shift toward liberal market policies. The former trade regime was replaced by a simple regime with no quantitative barriers and a single 10 percent tariff rate. The use of foreign exchange was legalized for all domestic transactions, initially establishing the Deutsche Mark and later the euro as the de facto local currency. The Banking and Payments Authority of Kosovo (BPK) was established to handle domestic payments, licensing and supervision of the banking sector. A Ministry of Economy and Finance (MOEF), with responsibility for the Kosovo Consolidated Budget (KCB), and a new tax system and administrative structure have also been established.⁸

2.3 Estimates of macroeconomic data are based on the IMF and Kosovar authorities estimates concluded in November 2003. Due to the weak statistical base in Kosovo, many of the data are constructed using assumptions, and are therefore subject to frequent revision. With support from donors including the IMF, the EU and the Swedish International Development Cooperation Agency, efforts are underway to greatly strengthen statistical capacity, particularly in compiling economic data.

2.4 The GDP data indicate that there has been a recovery of economic activity and positive growth since 2000. GDP growth, reflecting high levels of public and

⁸ A more detailed review of the economic institutions created by UNMIK can be found in Demekas, Herderschee, and Jacobs (2002).

private investment, reached 21 percent in 2001 and has since averaged 4.3 percent. GDP per capita, approximately US\$400 in 1995, has increased to around US\$790 in 2003 (see Table 2.1). Gross National Disposable Income (GNDI) is estimated to be about €1034 per capita in 2002 (US\$ 975 per capita); and €1040 per capita in 2003 (US\$1170 per capita). Price stability has been achieved, with inflation rates coming down from double digits in 2000 to zero inflation in 2003. Improved budgetary performance and rising private savings have helped to cut current account deficits by more than half during this period. Private sector activity shows signs of recovery, with construction activity exhibiting considerable strength and banking credit more than doubling in each of the last three years.⁹

⁹ Banking credit increased from a low base, and was concentrated in working capital.

Table 2.1: Key Economic Indicators

	2000e	2001e	2002e	2003e	2004p 1/
National accounts					
Real GDP growth	..	21.2	3.9	4.7	6.5
Investment (% GDP) 2/	35.6	40.0	40.7	38.0	45.3
Gross domestic savings (% GDP)	-198.6	-114.7	-99.4	-85.2	-71.3
Government balance (% GDP)					
Revenue	17.2	28.0	38.9	44.7	45.4
Expenditure	31.5	24.4	33.5	42.5	50.8
o/w capital expenditure	2.3	1.8	3.3	7.8	14.5
Balance (excl. grants)	-14.3	3.6	5.4	2.2	-5.5
Donor grants	21.5	7.3	3.0	2.2	0.0
External accounts (% GDP)					
Exports of goods	0.5	3.0	7.4	8.2	21.7
Imports of goods 3/	156.4	113.7	108.3	99.2	117.4
Workers' remittances	73.7	52.0	42.9	43.2	42.5
Current account before grants	-174.6	-110.2	-96.5	-76.9	-69.8
Savings and investment (% GDP)					
National savings	44.9	38.5	14.8	7.6	7.1
o/w gross domestic	-198.6	-114.7	-99.4	-85.2	-71.3
Investment	66.9	57.7	48.3	40.5	45.3
o/w housing	28.0	30.0	26.4	19.3	16.6
Monetary aggregates (% GDP)					
Broad money	99.6	78.5	70.9	75.4	74.5
Bank credit to private sector	0.4	2.2	6.8	16.1	19.8
Prices					
CPI inflation	..	11.7	3.6	0.0	0
Memorandum:					
Unemployment rate 4/	38	..	

1/ 2000 to 2003 data are estimates (e) and 2004 data are projections (p)

2/ Excluding donor-financed spending.

3/ Excluding donor-related imports.

4/ Excluding persons who declare themselves unemployed and own land.

Source: International Monetary Fund and World Bank staff estimates and projections.

B. MACROECONOMIC STABILITY

Macroeconomic Stability is a Necessary Condition for Growth

2.5 The sustainability of the recent economic growth performance remains an issue, since it has been largely financed by foreign inflows, now in decline. The injection of foreign resources has made it possible to import the goods and services needed to rebuild infrastructure and homes that were destroyed during the conflict; it also

has provided much-needed purchasing power to the Kosovars. However, since 2001, the international community has been steadily reducing aid. International donor grants have fallen by 70 percent between 2000 and 2003. As a result growth has already slowed to single digits. Workers' remittances from the diaspora and seasonal workers were also critical in stimulating domestic demand. Although still high, remittances—including income from seasonal workers who reside overseas for part of the year—have fallen since the immediate post-conflict period, and are currently estimated to be about €300 per capita.

2.6 As foreign assistance and remittances decline, Kosovo clearly needs to replace these flows with export earnings and foreign investment. The authorities will need to ensure macroeconomic stability to facilitate private sector-led growth. Creating new investment opportunities will require restoring peace and security in Kosovo, accelerating privatization and implementing a package of reforms to improve the business environment, and will be assisted by policies to clarify Kosovo's legal and political arrangements.

Maintaining Fiscal Sustainability is Key to Macroeconomic Stability

2.7 With no monetary policy or exchange rate instrument, and without recourse to domestic or external borrowing, sound fiscal policy is critical for macroeconomic stability. Government revenues have increased remarkably since 2000, reflecting both the introduction of new taxes and stronger collection efforts. Total revenue increased from about 17 to 39 percent of GDP from 2000 to 2002, and estimated to have increased to 45 percent of GDP in 2003 (see Table 2.2). The Kosovo Consolidated Budget¹⁰ has also risen over this period, but at a slower rate than revenue growth, from about 32 percent of GDP in 2000 to 42.5 percent of GDP in 2003. Budget surpluses averaged 3.5 percent of GDP during 2001 to 2003, and as a result accumulated cash reserves were estimated to be about 25 percent of GDP at the end of 2003.¹¹

2.8 A budget reserve provides a cushion for the authorities to mitigate against fiscal risks. In the short-term, the budget reserves can be used for modest capital expenditures to complete the rehabilitation of infrastructure, and ease the transition to a smaller public sector in the economy. However, there are a number of fiscal risks that argue for maintaining a reserve position to avoid future output shocks. First, the revenue base is still narrow and reliant on taxes collected on imports and therefore vulnerable to an economic downturn. Second, there are potential claims on public expenditure associated with a political settlement such as external debt service obligations. The

¹⁰ Includes spending by UNMIK and PISG central and local government institutions.

¹¹ Some of the accumulated cash balances will be required for re-appropriation of certain unused appropriations under the terms of the 2004 Budget Regulation.

authorities must therefore ensure that spending plans are well justified and sustainable. Rigorous investment analysis should be undertaken before approving new capital projects. The recurrent costs (e.g. maintenance costs) associated with such capital spending should be included in the cost benefit and sustainability analysis. The projects should be well prioritized on the basis of the medium-term economic development strategy, and the extent of the expenditures should be consistent with a medium-term macroeconomic framework. Pressure to increase public spending, already high, is likely to increase in this election year. The authorities should still proceed cautiously taking into account fiscal contingencies and sustainability considerations. The remainder of this section considers fiscal risks, expenditure and revenue policies for fiscal sustainability.

Table 2.2: Consolidated Government Operations (€ million)

	2000	2001	2002	2003
	(percent of GDP)			
Total revenues	17.2	28.0	38.9	44.8
Central government revenue	16.3	24.7	34.7	42.7
Border taxes 1/	15.4	21.1	28.8	32.5
Domestic direct taxes	0.6	2.5	3.8	4.7
Domestic indirect taxes	0.2	1.1	2.2	2.3
Non-tax revenue	1.0	1.9	2.6	3.2
Municipalities' own source revenue	0.0	1.3	1.6	2.1
 Total expenditure	31.5	24.4	33.5	43.4
Current expenditure	29.2	22.6	30.3	35.9
Consumption	22.4	17.4	21.9	25.8
Wages and salaries	12.4	9.5	10.3	11.1
Goods and services	10.1	7.9	11.6	14.8
Subsidies and transfers	6.8	5.2	8.4	9.7
Pensions	0.0	0.0	1.7	..
Social assistance	0.0	0.0	3.0	..
State enterprises	0.0	0.0	0.0	..
o/w electricity	0.0	0.6	1.6	..
Other	0.0	0.0	0.0	0.2
Capital expenditure	2.3	1.8	3.3	7.4
 Overall balance	-14.3	3.6	5.4	1.4
 Financing	14.3	-3.6	-5.4	-1.4
Changes in designated fund balances	-1.2	-0.6	0.5	0.0
Changes in other bank balances	-6.1	-10.2	-8.9	-3.6
Donor grants	21.5	7.3	3.0	2.2
Designated	5.4	3.7	1.6	2.2
Budgetary support	16.2	3.6	1.4	0.0
 Memorandum:				
UNMIK budget	55.3	38.9	30.7	..
Public Investment Program & NGOs	76.5	46.1	29.3	..
o/w capital participation	5.6	2.8	0.8	..
	131.9	84.9	60.0	..

Notes 1/ Border taxes are customs duties, excises at the border, and VAT on imports.

Source: Kosovo authorities and IMF estimates, 2003.

There Are A Number of Fiscal Risks To Take Into Account

2.9 Potentially, the two most important sources of fiscal risk are (i) assuming debt servicing obligations on a portion of the external debt of Serbia and Montenegro (SAM) and (ii) resolution of the frozen foreign currency deposits of households that were seized by the government of the SFR Yugoslavia. The total SFR Yugoslavia external debt is estimated to be around €1.2 billion, and is currently being serviced by SAM. About 75 percent of this amount is owed to official lenders, who have provided generous restructuring terms. The total stock of debt is so large (approximately 90 percent of Kosovo's 2003 GDP) that, subject to negotiations between Kosovo and SAM, taking on a proportion of debt stock and associated debt service might require significant adjustment.¹² In addition, the experience from former SFR Yugoslavia countries in dealing with the liability from frozen foreign currency deposits shows that considerable political pressure can result in commitments to compensate depositors. In the case of Serbia, compensation commitments total about 28 percent of GDP; in FYR Macedonia commitments were made, but compensation is not being paid. In the case of Kosovo, compensations are expected to be considered alongside other financial considerations such as outstanding pension claims, on the basis of an assessment of the cost of options. A preliminary estimate of deposits seized is around €500 million, or close to 40 percent of Kosovo's GDP.

2.10 Another potential source of fiscal risk is the poor financial performance of the enterprise sector. The inherited publicly-owned and socially-owned enterprises, currently under UNMIK management, represent a serious contingent liability on public resources. The enterprise sector faces problems of outdated and ill-maintained assets, underemployment and an uncertain operating environment that all results in poor financial performance. Potentially, the combined cost of providing financial assistance and retraining could be 0.3 to 0.4 percent of GDP per annum for two years. In all, there are an estimated 18,000 active employees in SOEs and 16,000 in POEs.¹³ In the mining sector alone, there are an estimated 5,000 redundant employees (see Chapter 4). As the process of privatization and closing of businesses advances, it will be critical to establish fiscally sustainable options for dealing with the issue of excess labor and the transition to alternative employment opportunities.

¹² Simulations for SAM as a whole, which at the end of 2002 had a public debt to GDP ratio of about 90 percent, suggest that total public debt service could range between 4 to 8 percent of Kosovo's GDP under a strong economic reform program.

¹³ A survey conducted by RIINVEST, suggests that there may be nearly an equal number of people who are on leave without remuneration. It is believed that restructuring plans could call for compensation of both types of employees.

Expenditure Policies and Resource Allocation

2.11 The budget surpluses and government reserves have resulted in increased pressure for spending, particularly on wages and salaries and social transfers.

Additional budgetary pressure can be expected to arise from the absorption of the cost of services and investments still performed by the international community; and the desire to raise social spending to support growth and development objectives. There has already been a rapid increase in government spending and the potential for inefficient spending clearly rises as the total increases. The budget surplus has arisen in part, as a result of the limited capacity of government agencies to spend, and budget outcomes falling below appropriation expectations. Additional expenditure could therefore increase the inefficiency of government spending even further.

2.12 Expenditure rationalization may be needed to make room for new commitments, to reduce the burden of taxation, and to improve the efficiency and sustainability of expenditures.

A comprehensive review of public expenditure is required to determine the budgetary reallocation needed. However, one clear expenditure concern is the growing public sector wage bill as a result of the recent policies to grant wage increases and to increase the number of new workers. The public sector wage bill is currently estimated to be 11 percent of GDP. Table 2.3 demonstrates the economic and functional breakdown of government expenditures in 2003 and compares with the average over 1995-2001 of expenditures for countries in the region. The public sector wage bill is currently at the high end of the range across the region as a percentage of GDP. Given the pay and grading structure is currently under review, the fiscal impact, sustainability and appropriateness of options to revise the public sector arrangements should be considered in detail before adopting a new salary structure. This should include an assessment of the costs over the medium-term (five years) that should capture all elements of compensation (e.g., including meal allowances) and the suitability of applying a particular grading structure to certain groups such as health and education workers.

2.13 Physical damage during the conflict, and a history of neglect created a backlog of capital investments.

Total public investment is about 10 percent of GDP comprising capital outlays under the KCB (7.4 percent of GDP) and donor financed investments under the PIP (2.6 percent of GDP). Although much has already been achieved, there are a number of sectors where rehabilitation has not been completed and capital investments will continue to be needed in the next few years. Estimates to complete the rehabilitation of the power sector alone indicate about €300 million would be needed to ensure an

adequate power supply – to be financed in part, through international donor funds and internally generated resources.¹⁴

Table 2.3: Economic and Functional Composition of Government Expenditures: Kosovo and Selected Countries 1/

	Kosovo	Bosnia & Albania	Bosnia & Herzegovina	Croatia	Serbia & Montenegro 2/	Slovenia
A. Economic Classification (percent of GDP)						
Wages & salaries	11.1	6.2	..	10.7	10.3	9.8
Goods & services	14.8	3.0	..	10.3	8.0	7.9
Subsidies & transfers	9.7	8.1	19.7	20.3	24.0	19.1
Interest	0.0	3.7	1.1	2.2	1.0	1.6
Capital expenditure	7.48	6.2	6.2	6.3	3.4	3.9
B. Functional Classification (percent of GDP) 3/						
Economic affairs	3.7	..	3.6	6.2	2.3	4.7
Social security & welfare	6.3	..	16.1	18.3	13.1	17.0
Health	4.5	..	6.2	6.8	5.9	5.5
Public order & safety	4.8	..	4.1	2.7	2.0	1.6
Education	6.1	..	5.6	4.4	5.9	5.5
Other	13.9	..	15.8	11.3	9.1	7.5
C. Functional Classification (structure) 3/						
Economic affairs	9.4	..	7.0	12.5	6.0	11.2
Social security & welfare	16.0	..	31.3	36.8	34.2	40.7
Health	11.5	..	12.1	13.7	15.4	13.2
Public order & safety	12.2		8.0	5.4	5.2	3.8
Education	15.6	..	10.9	8.9	15.4	13.2
Other	35.4	..	30.7	22.7	23.8	17.9

1/ Kosovo in 2003. For all others, the amount is the actual spend in 2002.

2/ Excluding Kosovo

3/ The values for Kosovo are budgeted amounts, but for all others the amounts are actual spending.

Source: Kosovo authorities and forthcoming South Eastern Europe Regional Study on Public Expenditure Policies (World Bank)

¹⁴ This does not include the necessary finance from private sector investments that would be needed if Kosovo is to exploit potential to export electricity to the region.

2.14 It is important to recognize that total “public sector” spending is much larger than the Kosovo Consolidated Budget. Effectively, the public sector includes UNMIK’s budget, the donor-financed portion of the Public Investment Program, and various donor and NGO projects. At the end of 2002, the total sum of public expenditure was estimated to be about 60 percent of GDP. The off-budget expenditures have been declining since 2000 and the handover of responsibilities will continue to add to the KCB expenditure needs.

Revenue Policies

2.15 On the revenue side, collections have exceeded expectations, and have provided sufficient resources to cover budgetary commitments to date. In 2004, revenues are projected to reach over 45 percent of GDP. This is high in comparison with low-income countries, and at the high end of the range seen in Central Europe and the Balkans. See Table 2.4.

Table 2.4: A Regional Comparison of Government Revenues (percent of GDP)

	1995	1996	1997	1998	1999	2000	2001	2002
SEE, mean	47.6	45.1	39.9	43.5	45.1	40.9	41.5	43.9
Bosnia and Herzegovina		51.9	39.9	46.3	48.7	48.5	49.6	49.0
Croatia	47.6	49.7	48.3	51.8	48.8	47.2	45.7	45.4
Macedonia		35.7	34.8	33.3	35.4	36.8	34.5	36.1
Serbia and Montenegro						37.5	39.6	43.9
Slovenia		40.5	39.9	40.8	41.4	40.9	41.5	39.5
Kosovo						17.2	28.0	38.9

Source: National authorities, the IMF, and Bank staff estimates.

2.16 **An examination of the level and structure of collections suggests that improved domestic tax collection would assist revenue stability and support business development.** More than three-fourths of tax revenue is collected at the border, which is where enforcement of the tax code is strongest. Only about 11 percent of receipts are from direct taxes. Further investigation of the distortions, equity implications and impact on the trade regime, is required. The informal economy and the volume of transactions that are cash-based hamper domestic tax collection. Of the enterprises that are registered, a small segment does not meet its tax obligations. Between 2000 and 2003 total tax arrears increased from 0.2 percent to 4 percent of GDP, nearly all “presumptive” tax and value-added tax arrears. Close to 60 percent of this amount was owed by 100 companies, suggesting that a relatively focused drive to enforce tax laws could greatly increase payment discipline.

2.17 Tax collection appears worse at the municipal level, as the administrative capacity is weaker. In the case of property taxes, only 13 percent of the bills issued in 2002 and 2003 had been paid at the end of 2003. The problem appears to have worsened in 2003, as only 7 percent of the bills and 11 percent of amounts due were paid that year. In response, legislation was introduced to assist in enforcement of tax collections an

incentive program that provides matching grants to municipalities for every euro collected above a pre-determined threshold is being considered.

Vulnerability to External Shocks

2.18 The economy’s small size and low level of export diversification makes it susceptible to terms-of-trade shocks. A slowdown in the economic growth of its major trading partners would greatly limit potential for export expansion and overall economic activity. The concentration of exports in non-fuel commodities and other low value-added products, and the almost complete dependence upon foreign manufactured goods also leaves the economy sensitive to changes in the prices of tradable goods.

2.19 Given the pressure to raise public sector wages, it is also unlikely that the effect of external shocks could be mitigated by downward adjustments in nominal wages. Under such circumstances, it becomes especially important to have sufficient budget flexibility to limit output contraction. The need to cushion the economy against external shocks puts a premium on strengthening the financial system, ensuring fiscal sustainability, and establishing an environment to attract foreign investment.

2.20 One of the positive aspects of using the euro as legal tender for all transactions is that a fully “dollarized” exchange rate regime precludes currency crises, since there can be no devaluation.¹⁵ In principle, this can help to prevent a banking crisis by eliminating currency mismatches between borrowers’ assets and liabilities. However, dollarization cannot completely shield the economy from real shocks and may in fact make output and investment more volatile since devaluation cannot be used to change relative prices.¹⁶ This risk may be particularly severe for Kosovo in the short term since it faces strict financing constraints.

¹⁵ Full “dollarization” refers generically to informal or official adoption of a foreign currency for all payments.

¹⁶ It should be noted full dollarization does not prevent a severe financial crisis. Lending to poorly performing companies always involves the risk of default. Ultimately, crisis can be avoided if there is a strong regulatory and supervisory framework governing banking relations. For a brief discussion of this issue see Lilian Rojas-Suarez (2003).

Table 2.5: Balance of Payments (percent of GDP)

	2000 est.	2001 est.	2002 est.	2003 est.
Trade balance	-206.9	-127.2	-108.0	-97.4
Exports	0.5	3.0	7.4	8.2
non-expatriate or KFOR	0.5	3.0	7.4	8.2
Imports	207.4	130.1	115.4	105.5
donor-related	51.0	16.5	7.1	6.3
non-donor-related	156.4	113.7	108.3	99.2
Non-factor services	-58.7	-45.2	-39.7	-28.4
Receipts	26.1	17.2	13.6	11.0
expatriate and KFOR	22.1	14.5	11.4	8.5
Payments	84.9	62.4	53.3	39.4
imputed wages of expatriates	60.0	46.7	39.8	28.8
imputed wages of local employees				
other	7.6	5.5	5.3	5.0
Private Transfers	73.7	52.0	42.9	43.2
Workers' remittances	73.7	52.0	42.9	43.2
Factor income	17.3	10.2	8.2	5.7
UNMIK and donor wages of local employees	17.3	10.2	8.2	5.7
Current account balance (before grants)	-174.6	-110.2	-96.5	-76.9
Foreign assistance	152.5	91.0	63.0	44.0
o/w UNMIK	55.3	38.9	30.3	28.0
PIP	76.5	46.1	29.3	13.2
Capital account	22.1	19.1	33.5	32.9
Donor capital participation	5.6	2.8	0.8	0.1
Changes in govt deposits abroad (- increase)	-9.8	0.4	6.1	-0.6
Change in currency in circulation (- increase)	-11.3	18.9	-5.8	-0.5
Change in banking system's NFA (- increase)	-16.1	-39.9	-5.2	-1.5
Change in KPST's foreign assets	0.0	0.0	0.0	-2.4
Errors and omissions	53.5	37.0	37.7	37.9

Source: International Monetary Fund, 2003.

Financing Constraints

2.21 The external financial position has improved markedly since 2000 (Table 2.5). The current account deficit, before grants has almost halved in the last three years to 77 percent of GDP, primarily due to an improvement in the merchandise trade balance as a result of a contraction in imports.¹⁷ The external situation is still far from sustainable: the trade deficit in 2003 was about 97 percent of GDP. Exports have been growing rapidly in the last four years, but from a very low base: merchandise exports are currently only about 4 percent of imports.

2.22 **The decline in foreign assistance has implications for the financing and sustainability of the trade deficit.** The share of the merchandise trade deficit financed by foreign assistance¹⁸ has declined from 73 percent to 45 percent between 2000 and 2003, and consequently the financing burden has increasingly fallen on remittances. However, the growth rate of remittances has also slowed considerably in recent years and is now at about the same as the nominal growth rate of Western European economies. Access to the capital markets is currently constrained as a result of Kosovo's legal situation. Similarly, access to concessional finance has not been an option to date, although the authorities and the UN are currently considering legal arrangements that would enable Kosovo to borrow externally from the IFIs. Furthermore, the need to avoid crowding out the private sector from credit markets means that domestic borrowing is unlikely to be a financing option in the near future.

C. PROSPECTS FOR GROWTH IN THE MEDIUM-TERM

Medium-Term Growth Scenarios

2.23 To explore the economic growth outlook for Kosovo, a number of simulations were conducted to determine possible growth rates in three different scenarios. Clearly, the weak statistical base prevents a more technical econometric forecasting exercise and the lack of robust macroeconomic data should be kept in mind. These simulations provide an illustration of how different assumptions about the future, could result in different economic outcomes. The base case scenario assumes (i) a strong reform effort to improve the trade and investment climate and rehabilitate industrial and agriculture sectors and (ii) action to mitigate political risks such as the clarification of Kosovo's political and legal

¹⁷ It should be noted that there is considerable uncertainty regarding the accuracy of balance of payments estimates. The error and omissions term has been increasing and accounted for 49 percent of the current account deficit in 2003. Given efforts to stem smuggling, however, it is unlikely that unrecorded trade flows fully explain accounting discrepancies and an allowance for smuggling is already included in BOP export estimates.

¹⁸ Includes the UNMIK budget.

arrangements in 2006 which is acceptable to all parties. No assumptions are made as to the exact nature of this political outcome, only the economic impact of greater certainty over the political and legal situation. Assumptions are made explicit in Box 2.1. Two alternative scenarios are considered for comparison. First rapid reforms proceed as per the base case, but the political risks are more severe and political arrangements are not clarified until 2008. The final scenario considered examines the outlook should the reforms proceed slowly, while political risks also remain high.

2.24 Table 2.6 presents the results of these simulations. In the base case scenario investment rises rapidly, from an expected 45 percent of GDP in 2004 to an average of 59 percent of GDP in the next three years.¹⁹ This includes FDI averaging about 15 percent of GDP in 2005 to 2007 attracted to investments in the energy and mining sectors, that later decline to the Central European average of about 4 percent of GDP by the end of the decade. Fiscal discipline is maintained. Reforms lead to a reversal of deficits in the early part of the projection period resulting in an average surplus of about 1 percent of GDP. External conditions improve substantially in this scenario. Export growth is very strong in 2005 to 2007, averaging 11 percent due to a pick up in earnings from agriculture and mining. Export growth rises to almost 29 percent in the latter part of the decade largely as a result of the assumption that the inward investment results in net electricity exports.

¹⁹ The 2004 projection of all variables is assumed to be the same in all scenarios.

Box 2.1: Macroeconomic Scenario Assumptions

A strong reform program comprises the following assumptions:

- Reforms in the enterprise sector, labor market, and energy sector substantially improve the business environment and efficiency of the economy. Integration with regional and other markets is accelerated, which significantly improves export potential, particularly for agricultural products.
- There is a gradual increase in FDI attracted by the privatization program and potential for exports, particularly in the mining sectors²⁰ Privatization receipts, however, are assumed to be negligible, and therefore ignored.
- Fiscal reform includes a gradual reduction of the wage bill from 11.7 percent of GDP in 2004 to the regional average of around 8 percent of GDP by 2010.
- KCB funded capital investment rises significantly starting in 2004 to €200 million, or 14.5 percent of GDP. Subsequently, there is a gradual decline as a percentage of GDP, but in euro terms this remains constant. It is assumed that capacity to spend budgetary allocations improves with the increase resulting in improved public infrastructure, including road networks, schools, health centers etc. The donor-funded PIP is phased out completely in 2005.
- Total donor grant assistance declines steadily to about 3 percent of GDP in 2010 from 30 percent of GDP in 2004.

For the purposes of the simulation, lower political risks are attained through greater clarification of Kosovo's legal and political arrangements which result in the following assumptions:

- Political and institutional stability and the full establishment of the rule of law.
- Access to foreign borrowing is enabled either directly or indirectly, with the IDA and other official lenders. The average terms assumed give equal weight to IDA conditions and terms recently applied by the EIB and EBRD to SAM.
- Owing to the uncertainty regarding net external obligations, foreign debt stock and obligations for the province are assumed to be zero.
- Significant FDI is attracted to Greenfield investments in the power and mining sectors once political and legal arrangements ensure the security of these assets. This includes opening new lignite mines, the introduction of a private sector operated power plant generating sufficient electricity for export, and new investors in lead/zinc mining, which require significant capital imports initially but greatly boost exports in the outer years.

²⁰ It is assumed that in some sectors (e.g. the ferronickeli mining sub-sector) the risk return trade-off is such that political risks can be mitigated fairly easily enabling foreign investment to be attracted and export potential exploited.

Table 2.6: Summary of Simulation Results

	Rapid Reform, Political Risks Mitigated	Rapid Reform, Political Risks Severe	Slow Reform, Political Risks Severe
GDP growth (% real avg.)			
2005-2007	6.7	4.2	2.3
2008-2010	5.0	3.5	2.2
Export growth (% nominal €s)			
2005-2007	11.4	7.1	5.6
2008-2010	28.5	29.9	29.6
Investment (% of GDP)			
2005-2007	37.1	28.6	24.9
2008-2010	24.7	34.0	31.9
Gross domestic savings (% GDP)			
2005-2007	-52.9	-71.4	-77.4
2008-2010	-24.5	-52.1	-64.4
Public investment (% GDP)			
2005-2007	13.3	13.9	7.8
2008-2010	10.0	11.0	7.8
Budget balance (% GDP)			
2005-2007	-3.6	-3.8	1.3
2008-2010	0.4	0.0	1.7
Current account balance (% GDP)			
2005-2007	-52.9	-43.1	-44.8
2008-2010	-24.5	-41.4	-48.6
Foreign direct investment (% GDP)			
2005-2007	14.8	1.2	1.2
2008-2010	8.7	15.0	16.0
Official lending			
2005-2007	5.9	0.0	0.0
2008-2010	7.5	8.3	8.9
Aggregate financing gap in period (% GDP)			
2005-2007	5.0	12.4	13.9
2008-2010	3.1	3.4	8.2
Memorandum:			
Official lending (avg., €s m)			
2005-2007	100	0	0
2008-2010	150	150	150
Workers' Remittances (avg 2004-2010)	663	663	663
Foreign assistance (avg 2004-2010)	175	175	175
Real GDP growth in 2004	6.5	6.5	6.5
GNP per capita in 2010 (€s) 1/	893	865	797
Avg. GNP p.c. growth (2004-2010)	0.6	0.0	-1.4

1/ GNP is defined as GDP plus net factor income, which includes profit repatriation associated with FDI.

Source: World Bank.

2.25 The base case simulation represents the most optimistic outlook for future growth prospects. This scenario results in positive GNP per capita growth. Average real GDP growth would be about 6.7 percent between 2005 and 2007, and 5 percent in the latter part of the decade. The current account deficit rises due to the increase in imports of capital goods associated with the FDI and revitalization of key economic sectors. However, rapid export growth helps to prevent an unsustainable increase in the current account deficit. In this model, the external deficit estimated to be 45 percent of GDP in 2004, rises to 53 percent of GDP on average between 2005 and 2007, and falls to 25 percent of GDP by 2010. These external financing needs are met in part with the FDI inflows, and disbursement from official lenders averaging about 6 percent of GDP in 2005 to 2007 and 7.5 percent of GDP in 2008 to 2010.²¹ This leaves undetermined average financing needs of about 5 percent of GDP in the former period, and 3 percent of GDP in the latter.

2.26 The second and third columns of Table 2.6 show the results of the two alternative scenarios: rapid reform and slow reform with political risks more severe and political and legal arrangements clarified two years later than the base case. In the second scenario, as expected, growth of 4.2 percent per annum would be anticipated initially falling to about 3.5 percent from 2008. This is slower than in the base case, especially in the initial period, resulting in zero per capita GNP growth for the entire period. Some FDI is still assumed to flow into mining sub-sectors, but substantial Greenfield investments are delayed two more years. Export growth in this scenario would be about 60 to 70 percent of the rate projected in the base case. The upshot is lower growth and a higher undetermined financing gap averaging about 8 percent of GDP between 2005 and 2010, which reflect in part reduced access to foreign borrowing in the first half of the projection period.

2.27 If reforms are delayed and the political and legal arrangements are not clarified, progress is further delayed in attracting investments and promoting exports. As a result GDP growth of little more than 2 percent is projected. GNP per capita growth is likely to be negative. As in the former scenario, initially export growth is weak, FDI is low, and external financing is less forthcoming. Financing gaps, after official lending projections, are extremely high averaging 19 percent of GDP, in this scenario.

2.28 It is also interesting to compare the two alternative scenarios with one another. Even with more severe political risks and unsettled legal arrangements, the returns from rapid reform are: higher real growth rates, maintaining GNP per capita, and a more sustainable financing gap achieved before the end of the projection period. Furthermore,

²¹ The current account deficit includes projected interest costs associated with new borrowing and profit repatriation at a rate of 10 percent of the stock of FDI lagged three years. Amortization of debt is zero throughout the projection period because of long grace periods.

it should be emphasized here that we have initially assumed in these scenarios that FDI will be forthcoming with a peaceful resolution to political and legal arrangements for all peoples, mitigation of political risk and a minimum amount of institutional and economic reform. The sizeable Greenfield investments are therefore less responsive to the speed of the reform program. If we were to instead assume that attracting FDI would be less successful with the slower reform program, there would clearly be an even greater difference in the growth, export and FDI performance between the rapid and slow economic reform scenarios.

2.29 These indicative scenarios suggest that rapid implementation of reform, mitigation of political risk and greater clarity of political and legal arrangements satisfactory to all peoples, are likely to lead to higher growth rates and a more sustainable external position. The scenarios are indicative only, however, and it should be clear that the reform program, the clarification of legal and political arrangements satisfactory to all peoples and reduced political risks for investors are assumed to result in significant increased FDI and exports. In reality, the quality of implementation of the reform program will determine the extent to which investment and exports will grow, the nature of access to external, including concessional, lending and ultimately the economy's growth rate and Kosovo's prosperity. Progress with the 'Standards for Status' program is a necessary step toward ensuring this stability. Without the minimum of functioning institutions, there is a risk of creating an unstable environment along with extreme uncertainty, and the associated rapid fall in incomes and social indicators witnessed in the more volatile regions in the world.

D. POLICY RECOMMENDATIONS:

- Ensure that the fiscal position is able to accommodate the adjustment that comes with falling external finance. Maintain budget reserves to cushion public finances and the broader economy and to avoid costly policy reversals.
- Within this fiscal position proceed with well-designed and prioritized capital projects to complete the rehabilitation of infrastructure.
- Resist pressure to spend on unsustainable recurrent expenses, including public sector wages.
- Conduct a detailed analysis of the efficiency of public spending and in addition, develop a medium term expenditure framework to ensure budgetary stability.
- Improve tax administration and the domestic indirect revenue base.
- Review revenue policy to investigate whether there is a high level of taxation establishing a brake on economic growth.
- Pursue the implementation of Standards and take measures to mitigate political risks; and increase legal and political certainty.

3. THE CLIMATE FOR TRADE, INVESTMENT AND FINANCE

A. INTRODUCTION

3.1 This chapter examines the business and trading environment in Kosovo. The first section looks at the international trade regime and trade performance. The second section assesses the business climate from the SME perspective drawing upon the results of an Investment Climate Assessment. The final section examines the state of financial sector development in Kosovo based on a survey of the local financial institutions. Areas that require further investigation and policy recommendations are provided at the end of each of these sections.

B. INTERNATIONAL TRADE

3.2 **From a highly protected regime as part of the SFR Yugoslavia, the trade regime in Kosovo has become one of the most liberal in the region.** Post 1999, Kosovo was recognized as “possessing a customs administration”, and UNMIK was given the authority to establish new trade agreements with other administrations. Kosovo also benefits from the existing trade agreements that were made with SFR Yugoslavia such as the free trade agreement with FYR Macedonia under which all trade between Kosovo and FYR Macedonia is subject only to a 1 percent administration fee. All quantitative restrictions have been dismantled and the exchange rate regime has given way to the adoption of the euro. A uniform tariff rate of 10 percent has been adopted, with a limited list of exemptions (e.g., pharmaceuticals, fertilizers). There are no additional fees or charges that apply to imports or exports.²²

Trade Performance

3.3 The collection of trade data and the different definitions used for internal and international trade hinder analysis of Kosovo’s trade performance.²³ This section

²² The VAT applies to imports but not exports of final goods.

²³ The trade data are not robust and limit analysis of international trade since the break-up of SFR Yugoslavia. Different definitions have been used since 1999 in determining what constitutes international and internal trade, e.g., Ministry of Economy and Finance trade reviews in 2000 and 2001 did not include

examines the trade trends based on merchandise trade data, which does not capture imports by the international community, since 1999.

3.4 Although the situation has improved over the last three years, there still exists a large trade imbalance. The goods and services balance is estimated to have fallen from a deficit of 265 percent of GDP to 125 percent between 2000 and 2003. The merchandise trade data show that exports are currently less than 4 percent of imports. Table 3.1 shows the performance of exports and imports and the main trading partners since 2000. Trade takes place predominantly with the EU, Serbia and Montenegro, and FYR Macedonia, which together make up two thirds of total trade by value. The EU is by far the largest market resulting in a hub and spoke pattern of trade in the region.

3.5 **In recent years Kosovo has managed to export small volumes in agriculture, textiles, electrical equipment and metals, including nickel.** The value of total goods exported is estimated to have increased by over 90 percent between 2000 and 2003, albeit from a very low base. The 2003 value of metals and scrap and the value of food exports, are both estimated to be five times the euro values in 2001. Exports are almost entirely to the EU and the South East Europe region.

3.6 The composition of Kosovo's non-donor financed imports indicates the predominance of current consumption, rather than industrial goods in the value of imports. There is some evidence however of a gradual pick-up in industrial activity. Although machinery imports still only represent about 12 percent of total imports, the value of these imports increased by 70 percent over the 2000 to 2003 period. Food imports, however, are consistently the largest component – and represented about 34 percent of the value of imports in 2003.

3.7 **Kosovo's trade performance should be seen in the context of regional trade relations, which have suffered since the break-up of the SFR Yugoslavia.** The regional trading patterns affect Kosovo – particularly as trade remains minimal between SAM and Croatia, Albania and Croatia, and Albania and SAM.²⁴ Furthermore, trade in the region is less open in general, than the countries of Central and Eastern Europe.

Table 3.1: Export and Import Markets (for merchandise trade)

imports from Serbia and Montenegro. Furthermore, domestic sales to resident expatriates are counted as exports in the National Income Accounts. Merchandise trade performance excludes sales to resident foreigners and imports funded by the donor community that enter duty free and not captured in the statistics. Merchandise exports and imports accounted for only 14 percent and 51 percent respectively of total exports including sales to expatriates, and total imports including those financed by the international community.

²⁴ See World Bank 2003a for a more comprehensive investigation of trade in the Western Balkans.

	Exports				Imports			
	2000	2001	2002	2003	2000	2001	2002	2003
Total (€ m)	18.88	10.65	27.32	36.20	635.2	874.4	988.7	968.5
Of which %								
EU²⁵	30.0	45.5	43.2	38.4	27.0	20.3	23.6	25.9
FYR, Macedonia	26.7	18.7	12.4	19.2	25.6	20.1	15.4	14.6
Serbia	0.1	3.7	16.4	16.5	2.4	20.2	18.0	14.7
Albania	20.8	12.0	5.0	5.2	1.6	3.5	4.9	0.8
Croatia	0.3	1.3	7.0	5.0	0.4	1.1	1.6	3.3
Turkey	8.1	2.4	4.2	4.8	5.2	8.9	7.9	9.5
Montenegro	1.6	6.2	0.5	2.8	16.9	7.1	6.4	1.1
Bosnia & Herzegovina	0.9	2.6	5.1	2.4	4.1	2.6	2.2	2.4
Bulgaria	1.5	0.8	0.6	0.5	6.7	5.7	5.7	4.3
Others	9.9	6.7	5.6	5.2	10.2	10.5	14.3	23.5

Source: Customs Service of Kosovo, Ministry of Finance and Economy.

Trade Relations and Market Access Conditions

3.8 Kosovo and the region benefit considerably from duty-free access to EU markets. In late 2000, the EU established a uniform and generous Autonomous Trade Preference (ATP) scheme, which provides duty and quota free access for practically all exports of South-Eastern Europe to EU markets.²⁶ The EU launched the Stabilization and Association process (SAp) to set the overall legal framework for future economic and political relations between the EU and the five countries of the region.²⁷

3.9 Trade in the region has been fostered by establishing a network of bilateral Free Trade Agreements (FTAs), under the auspices of the Stability Pact Working Group on Trade Liberalization and Facilitation.²⁸ The Kosovo authorities have already concluded a FTA with Albania. At present, this network of bilateral agreements does not constitute a true Free Trade Area as there are different exemptions and timetables for liberalization among the participating countries. In the longer run, the region has agreed to establish a multilateral FTA among all the trading partners of the Balkans.

²⁵ EU data include Switzerland.

²⁶ Quotas are applied to baby beef, textiles and wine.

²⁷ The five countries are: Albania, Bosnia Herzegovina, Croatia, FYR Macedonia and Serbia and Montenegro (including Kosovo).

²⁸ The Stability Pact was created at the EU's initiative in 1999 to foster peace, democracy, respect for human rights and economic prosperity in order to achieve stability in the whole region. In line with the rules and principles of the WTO, and in the context of greater integration with the European Union, the Working Group on Trade Liberalization and Facilitation aims to reduce and eliminate tariff and non-tariff barriers to trade. It has the capacity to co-ordinate, facilitate and review the countries' efforts to expand trade in the region.

Kosovo through its involvement in the Working Group should continue to support the approach to liberalize trade in the region, remove administrative and tariff barriers and work toward the regional FTA.

3.10 There are some concerns that the current bilateral trade agreements are a source of trade distortion and there is potential for abusing the rules of origin where preferential access arrangements exist. In the case of the FTA agreement with FYR Macedonia, there is a widespread perception that falsification of certificates of origin has occurred. In 2001, UNMIK returned 183 sets of customs documents accompanying FYR Macedonia goods back to the customs administration for verification. There is concern that the newly negotiated FTAs will present similar opportunities. The authorities should therefore weigh carefully the potential economic costs and benefits of individual bilateral FTA's during negotiations and should continue to work toward the establishment of a regional FTA.

3.11 Kosovo faces other tax and non-tariff barriers to trade in the region. Goods of Kosovo origin entering Serbia are subject to a 5 percent sales tax, (the difference between the VAT in Kosovo and the sales tax in Serbia) but are otherwise tariff free. Similarly, goods entering Montenegro are subject to VAT and excise if applicable.. In addition to the trade taxes, countries in the region often apply a transit tax for goods traveling through their customs territory (a 5 percent transit fee is applied to goods entering Serbia and Montenegro) and in some cases also a customs-handling fee (e.g., 1 percent in Bosnia Herzegovina). Administrative barriers include the non-recognition of Kosovo license plates for transit through neighboring countries and the lack of a Kosovo barcode for manufactured products.

Trade Policies and Institutions

3.12 There is a uniform 10 percent tariff rate in place on all imports, which is a reasonably low average tariff rate in the region. Excise duties are also imposed exclusively on imports: currently limited to fuels, alcohol, cigars and cigarillos, tobacco, coffee and soft drinks. The one-tier tariff is a transparent regime that reduces the opportunities for smuggling, corruption and rent seeking and the chance for misclassification of products.²⁹ However, as discussed in the next section, the Kosovo business community considers trade policies a constraint. It is argued that the combined rate of VAT and tariffs on imports is high for domestic producers especially those who rely on imported raw materials and semi-finished goods as inputs. However, VAT paid on all inputs, including imports, is credited. Table 3.2 demonstrates the VAT and average tariff rates in the region. Reducing the uniform tariff rate across the board would lower

²⁹ However, there are claims that customs officials use inconsistently applied reference prices.

the cost of imported inputs, and improve the competitiveness of domestic producers even further. Additional investigation of the rates faced by producers in individual sectors and their regional competitors is required to determine the impact on specific economic sectors.

Table 3.2: Regional VAT and Average Tariff Rates

	VAT (%)	Average MFN Tariff (%)
Kosovo	15	10.0
Czech Republic	22	4.6
Croatia*	22	5.0
Albania*	20	7.4
Serbia* ^{1/}	20	9.4
FYR Macedonia*	19	12.6
Poland	22	10.0

Source: *P. Messerlin and S. Miroudot, 'Trade Liberalization in South East Europe; Review of Conformity of 23 FTAs with MOU' Group D'Economie Mondiale, Paris, 2004
Central and Eastern Europe Business Information Center. (<http://www.mac.doc.gov/ceebic>)

3.13 The uniform tariff rate applies to all imported goods. This could deter exports, as Kosovar exporters pay above world market prices on their inputs placing them at a competitive disadvantage. In order to encourage domestic exporters, methods to eliminate the tariff from imported inputs used to produce exports should be considered such as the introduction of a duty-draw-back scheme and possibly export-processing zones (there is mixed evidence on the success of such arrangements and further work would be advised on the potential for their introduction in Kosovo). The current customs code allows for the introduction of a draw-back scheme and additional work to determine how this might be implemented is required.

3.14 The uniform rate results in a low effective rate of protection for domestic businesses – and this has resulted in a growing demand from the business community to differentiate the regime to put in place a lower rate applied to investment goods and raw materials, and maintain the higher rate on consumption goods. A differentiated tariff structure, would substantially increase the effective rate of protection in the domestic market, and would not provide incentives to produce for the external market. Protectionist trade policies have not been sustainable or successful elsewhere and promoting production for exports, rather than the domestic market should be the priority for Kosovo. A much more preferable policy option would be to adopt an across the board tariff reduction to lower the cost of imports and consider additional policies that would encourage production for exports.

Box 3.1: Governance and Trade Related Institutions

UNMIK has responsibility for the customs administration, collecting customs duties and other taxes collected at the border, issuing import certificates, export licenses (EUR-1), and customs documents.³⁰ On the PISG side the Ministry of Trade and Industry is responsible for trade policy, developing the framework conditions for trade and implementing programs for promoting external trade.

Trade related institutions are at a nascent stage and lack the full capacity to assist exporters penetrate foreign markets. The recently established Kosovo Export Association (KEA) could become an effective instrument of assistance to exporters. KEA is a non-profit, industry-sponsored organization, which facilitates the development of business activities through export promotion advocacy, providing training and networking for members, and supporting the general export climate in Kosovo.

The banking sector provides only limited options for trade finance: As we discuss later in this chapter, only one commercial bank provides letters of credit for imports, and the lack of a modern banking sector causes payment problems throughout the region. In Kosovo, payments for imports are in cash, bank deposits and in some cases bank guarantees are accepted.

Policy Recommendations

3.15 The following trade policies are recommended:

- Improve regional market access through improved relations with regional trading partners; especially with FYR Macedonia and Serbia and Montenegro; and through greater involvement in the Stability Pact Working Group for trade development and facilitation. The objective should be to reduce non-tariff barriers to trade and have Kosovo recognized by regional partners as a customs territory and make sure customs administrations include Kosovo in their schedules as such. Kosovo should push for a regional FTA.
- Maintain the uniform tariff structure and reduce the rate across the board (for example to 5 percent to be in line with the average protection in the less protected markets in the region). The revenue implications of the policy should be fully considered, and if necessary should be partially offset with compensating measures to raise revenues from VAT, either by raising the rate or lowering the threshold.
- Further investigation of accompanying policies to facilitate a growth in exports should be considered. These include:

³⁰ The Tax Administration has responsibility for domestic VAT collection.

- The potential to introduce a duty drawback system for all capital goods and intermediate inputs used for exports.
- The possible benefits of establishing export processing zones, bonded warehouses and similar tax-free environments for exports.
- The introduction of accelerated depreciation for investment.

C. THE BUSINESS ENVIRONMENT

3.16 The quality of the business environment is determined in part, by the nature of the regulations imposed on businesses and the effectiveness of institutions charged with enforcement of those regulations. It is also affected by the level and quality of infrastructure services, access to finance, the level of competition, and the degree of physical security.

3.17 To assess the state of the local business climate results were used from a 2003 Investment Climate Assessment based on a survey of small and medium-sized firms throughout Kosovo; discussions with municipal officials; and follow-up interviews with enterprises. The survey sample was drawn from four sectors: manufacturing, construction, transport and communications, and wholesale/retail trade and allows for comparisons to be made with similar surveys made elsewhere in the region, and across different regions of the territory.³¹ This provides us with an understanding of the constraints to doing business for those firms already operating in Kosovo.

³¹ The sample, drawn from the enterprise registration database maintained by the Kosovo Business Registry, included 319 small and 10 medium-size firms. The survey was comprised of the following sectors: wholesale/retail trade (99), transport and communications (82), manufacturing (77) and construction (71). The sample includes firms based in the municipalities of Pristina (120), Prizren (43), Peja (41), Mitrovica (45), Gilane (37) and Gjakovica (43).

Box 3.2: Structure And Recent Dynamics Of The Enterprise Sector

The enterprise sector in Kosovo is comprised of about 30,000 formal businesses and is dominated by micro-enterprises.³² Most firms are organized as sole proprietorships or partnerships, employing less than four persons (half having only one employee), and typically engaged in wholesale or retail trade or service activities (60 percent of all firms). Kosovo's economy has traditionally been dominated by production of primary products, particularly in agriculture, extraction of lignite for power production, and other mineral processing. Even today, very few firms are involved in significant value-adding activities. Other major sectors of importance (by number of firms) include manufacturing (15 percent), construction (10 percent), and transport, storage and communication (5 percent).³³

Private commercial investment (excluding housing) grew from 5.4 percent of GDP in 2000 to 11 percent in 2002 and 2003. This is comparable to Serbia and Montenegro at 11.3 percent in 2002 and Albania with 12.5 percent.³⁴ Average capacity utilization among enterprises is approximately 72 percent. Total private investment in Kosovo, which averaged about 37 percent of GDP during 2001-2002, is estimated to have dropped to 30 percent of GDP during 2003.³⁵ Housing construction has been the main driver of investment since 1999 (financed mainly by remittances) and as of 2003 it was estimated to comprise 64 percent of total private investment, down from 70 percent in 2002.

As of the end of 2002, sales among enterprises remained robust, with more than half of all surveyed firms reporting an average increase in sales of 26 percent during 2002 compared to the previous year (see Figure 3.1). In addition, the number of firms reporting increased sales during 2002 increased by 60 percent over 2001. It appears that 2002 may have marked the beginning of a shake-out of weaker firms, with more successful firms gaining market share and driving less efficient firms out of business. This is evident from Figure 3.1, where the proportion of firms reporting a decline in sales grew; it is expected that this trend continued throughout 2003.

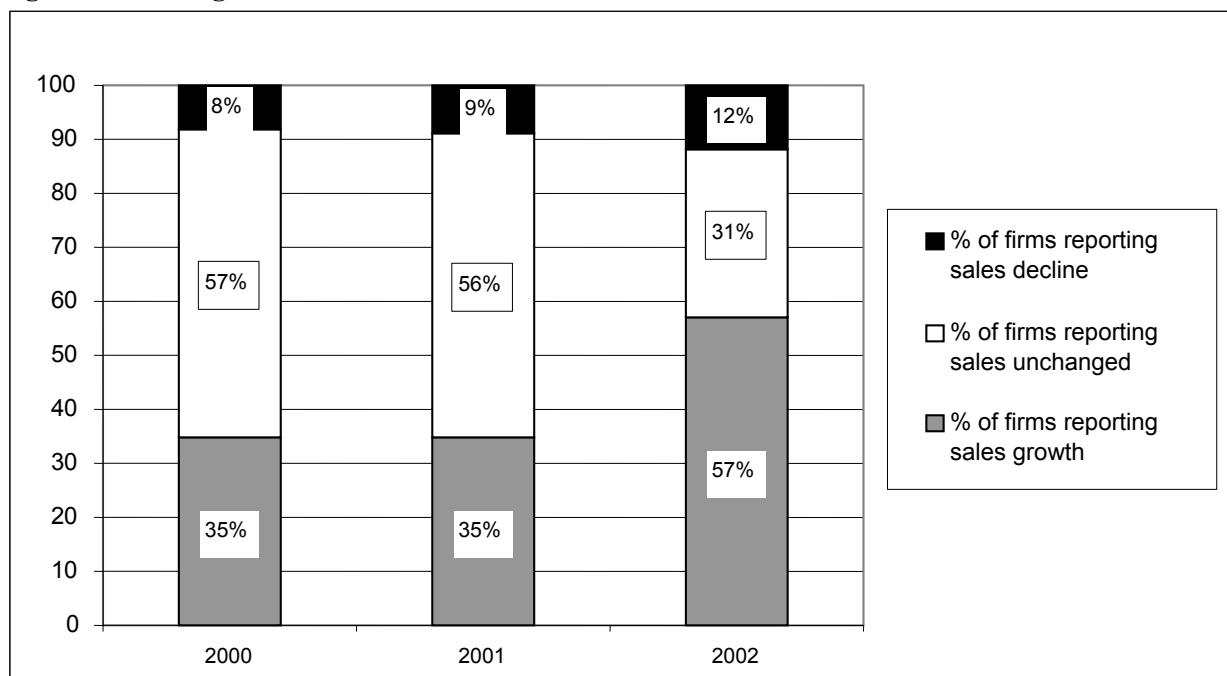
³² The number of registered firms has declined from about 50,000 in 1999 (when interim registration was required), to 30,000 as of December 2003 (after re-registration was required). A large portion of the difference is accounted for by the fact that multiple units of a parent company were issued separate registration numbers under the interim registry, while today all such entities are issued a single registration number. It is also assumed that many of those registered in 1999 were “paper” companies that never actually operated. The remainder either went out of business or became informal. No estimate exists of the informal firms operating in Kosovo, but the total number is believed to be significantly higher than 30,000.

³³ Source: Kosovo Business Registry. Data on value-added by sector is not available.

³⁴ Source: Ministry of Finance and Economy. Excludes socially-owned and publicly-owned enterprises. The PREM/DEC reference indicator for private investment as a share of GDP is 15.3 percent.

³⁵ IMF/World Bank staff estimates. Total and commercial investment includes SOEs and POEs.

Figure 3.1: Changes in Sales, 2002 to 2003



Positive Aspects Of Kosovo's Business Environment

3.18 The Assessment concludes that the business environment is considered relatively favorable by SMEs. During the last four years a range of new commercial laws have been promulgated, all oriented toward EU standards and new public and private institutions have been established to support implementation of these laws. Thus the basic building blocks are in place for a market-oriented economy. It is of interest to note that when asked about factors which prevent firms from starting a new business or investing in an existing business, only 12 percent cited the political uncertainty as a factor, while 70 percent cited lack of capital, 10 percent competition with domestic or foreign firms, and only 3 percent referred to a poor investment climate.

3.19 Entry barriers measured in terms of ease of access to land and costs of compliance with regulatory and administrative requirements are generally low. The lowest ranking general constraints were business licensing and operating permits, labor regulations, access to land, and skills and education of the workforce. These conditions, combined with relatively good access to financing and a high degree of competition,

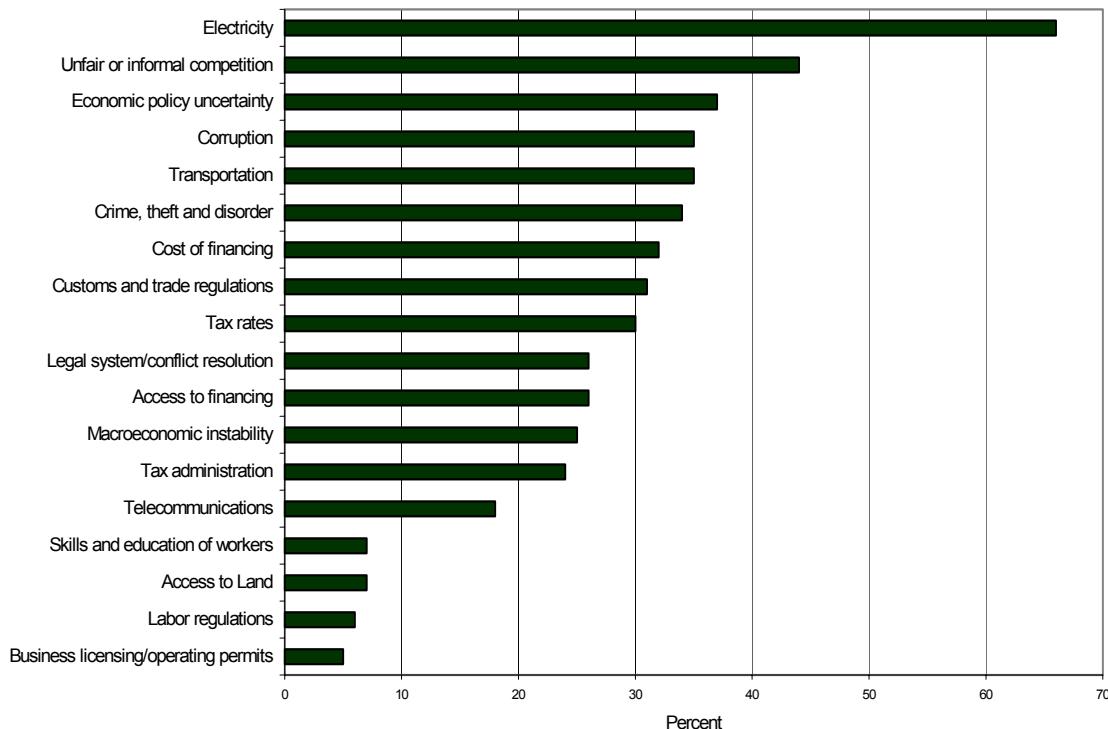
mean that entrepreneurs face relatively few barriers to starting a business. These indicators compare favorably to countries within the region. While only 5 percent of Kosovo respondents indicated that obtaining business licenses and operating permits was a “major” or “very severe” constraint, 23 percent of Albanian firms and 17 percent of Macedonian firms identified this as a major constraint.³⁶ With regard to access to land, only 8 percent of Kosovar businesses felt this was a significant constraint, while twice as many Albanian firms cited land access as a significant problem.

3.20 Macroeconomic stability, a fundamental pre-condition for growth, is also a positive feature of the business environment in Kosovo, cited by only 25 percent of firms as a significant constraint. Ranking of this indicator was considerably higher in Albania (59 percent), and somewhat higher in Serbia and Montenegro (37 percent) and Macedonia (35 percent).

3.21 **Competition (measured by the number of competitors, market share and price competition) is also quite robust.** Eighty percent of firms indicated that they compete in their main product markets with more than 20 other firms, and almost half of respondents reported more than 20 suppliers. Three-quarters of firms control less than 5 percent of market share for their main product line. Finally, two-thirds of all enterprises indicated that if they raised their prices by 10 percent, their customers would buy at much lower quantities or would stop buying from them entirely. This price pressure further indicates that enterprises operate in a fairly competitive environment. However, product differentiation among firms in some of the sampled sectors does not vary greatly (this is particularly the case for wholesale and retail trade firms), and in these cases, one would not expect a very high degree of price competition.

³⁶ Data for other countries are drawn from the BEEPS 2002 survey results. Caution should be observed in comparing the results of business environment surveys from countries in the region. First, respondents do not compare their conditions to other countries when selecting a ranking, but place them in relative order of importance given their internal conditions. Second, the surveys outside of Kosovo included only one category of ranking of constraints above the “moderate” category (“major”), while Kosovo respondents could choose between two rankings above “moderate” – “major” and “very severe”.

Figure 3.2: Evaluation of General Constraints to Operations
 (percent of firms ranking constraint as "major" or "very severe")



Source: Investment Climate Assessment, World Bank 2003.

Constraints In The Business Environment

3.22 Frequent power shortages are a fundamental constraint to all enterprises, imposing higher operating costs, production losses, and reducing competitiveness (see Figure 3.2). On average, firms reported 90 days of power outages during 2002, with an average duration of six hours per day. The most severe conditions are reported in Gilane and Prizren, where outages are experienced 112 days per year. Prizren also reported the highest average duration of outages at 10 hours per day. By comparison, Albania experiences about half as many days of power interruptions as Kosovo, with 47 days per year on average. Firms in Serbia and Montenegro, Macedonia and Croatia experience 10, 6 and 3 days of outages per year, respectively. A new electricity connection in Kosovo requires 28 days on average , while in neighboring countries a new

connection takes only three days.³⁷ Power shortages resulted in average production and sales losses to firms of about 5 percent of annual sales. In addition to these losses, the need for alternative sources of power further increase operating costs for firms. Three-quarters of all enterprises have had to purchase generators. The cost of purchase and operation of a generator represents an additional two percent of operating costs; 3.5 percent for manufacturing firms. The total cost to firms of inadequate power supply translates to about 8-9 percent of annual sales, which either reduces profit, is passed on to consumers through higher product prices, or both.

3.23 Forty-four percent of all firms cited unfair or informal competition as a significant constraint.³⁸ Many respondents cite the absence of reciprocal treatment of Kosovar exports under trade agreements within the region (particularly FYR Macedonia and SAM) as giving their regional competitors an unfair advantage and a constraint on their access to markets. Kosovo exports have not enjoyed free-trade treatment, primarily due to non-tariff barriers, and at least until recently, evidence that at the Macedonian border reciprocal treatment was not being afforded.³⁹

3.24 There is no reliable estimate of the extent of informality in Kosovo, but it is believed to be quite extensive.⁴⁰ A number of factors contribute to this. First, Kosovo is still largely a cash-based economy (only 43 percent of firms use banks to conduct business and only 12 percent of sales are on credit), and in this environment, undocumented transactions are more easily concealed. Second, the burden on enterprises of compliance with administrative and regulatory requirements (and frequent inspections by authorities), combined with corruption, may create an environment that leads to a greater incidence of informality. Survey results reveal that among municipalities where a higher proportion of firms rank tax administration, regulatory enforcement and corruption as “major” or “very severe” constraints (specifically Prizren and Gjakovica), a higher proportion of firms in these municipalities also identify informal competition as a severe constraint.

³⁷ BEEPS 2002 surveys.

³⁸ Informality may take a number of different forms: at one end of the spectrum are firms that seek to be totally “invisible” from the authorities, and avoid official registration and licensing and evade payment of any taxes. At the other end of the spectrum are firms that are semi-informal, who may be registered, and who may pay taxes, but fail to report all income or may avoid payment of employee-related benefits.

³⁹ It should be noted that the business environment survey was conducted prior to recent discussions with Macedonia that—according to the latest export trials—have resolved this issue.

⁴⁰ One indicator of the extent of informality can be observed with regard to official GDP data. GDP for 2002 was estimated to have increased by 2.5 percent, although survey results show that 57 percent of firms reported an average increase in sales for 2002 of 26 percent; only 12 percent of firms reported a decline in sales. Respondents also estimated that an average firm in their area of activity reports only 69 percent of actual sales to the tax authorities.

3.25 In addition, firms may remain in, or return to, the informal sector as the overall tax burden and the total cost of labor increases, as is the case in Kosovo with the introduction in 2002 and 2003 of profit taxes, wage taxes, property taxes, and pension contributions. Although from a zero or low base, the *expansion* of the tax regime may have created incentives for firms and employees to shift or remain in the informal sector. As many of these taxes have been in operation for only one or two years, an assessment of the burden and impact on informality, should be undertaken, but changes to the tax regime are not recommended at this time. Possible shifts from a direct (wages and profit taxes) to an indirect burden of taxes (by raising the VAT compliance, or rate) might be considered in time.

3.26 The level of tariffs and taxes applied to Kosovo imports of capital goods and raw materials is also cited as a factor that adversely impacts the competitiveness of Kosovar manufacturing firms seeking to compete in regional markets.⁴¹ Because the cumulative tariff and VAT on Macedonian imports is only 16 percent, Kosovar producers perceive of this trade policy as giving Macedonian firms an unfair competitive advantage. The proposed tariff reduction should address this constraint on the business community by lowering the cost of inputs. The VAT paid on inputs is credited and therefore contrary to the perception this is not be an additional “tariff on imported inputs” paid by Kosovar producers, but is often a cost that is borne up front, which given the difficulty of accessing long-term and trade financing causes a constraint.

3.27 With respect to customs and tax administration, many firms expressed dissatisfaction with excessive delays in processing VAT refunds, and improper reference pricing. VAT refunds frequently require three months or longer to process. Such delays would not be particularly significant if most import transactions were credit-based, but with a high degree of cash-based transactions such delays represent an interest-free loan to government and constrain cash flow of a typical Kosovo enterprise. Aside from VAT rebate concerns, a majority of importers contend that the most significant trade-related administrative obstacle is improper application of reference pricing. Many firms argue that they are paying effective trade taxes far in excess of 26.5 percent due to improper valuation of imports, even when they present customs officials with required documentation verifying actual costs of imports. Numerous firms interviewed during the follow-up to the survey reported that it is not uncommon for them to pay effective taxes of 50 or even 100 percent⁴². While there are also attempts by firms to under-invoice their

⁴¹ Tariffs are uniform at 10 percent, VAT at 15 percent, and the cumulative effect perceived by businesses is therefore 26.5 percent.

⁴² UNMIK Customs applies GATT and revised Kyoto valuation rules in accordance with UNMIK Regulation 2004/01 – The Customs Code. It should be noted that other valuation methods are therefore for valuation purposes before the reference pricing method. The new automotive clearance system being introduced by UNMIK Customs will include a valuation database.

imports to evade full payment of tariffs and VAT, an investigation of the discretion allowed in the application of reference prices should be considered.

3.28 The survey demonstrates that regulatory and economic policy uncertainty is a concern for domestic SMEs. This affects future investment and employment decisions, as investors cannot assess risks and cost-benefit results of future investments with any degree of confidence. Among all firms, 37 percent cited regulatory and economic policy uncertainty as a significant constraint; 51 percent among manufacturing firms. Respondents' evaluation of this constraint partly reflects a constantly evolving legal environment that, to some extent, is an unavoidable by-product of transition. It also reflects on-going shifts in authority from UNMIK to PISG and evolution of policy as a result of the transfer, and current debates on key policy issues such as the trade regime and privatization policy. Furthermore, there are considerable variations by region, with the municipalities of Gilane, Prizren and Gjakovica having the worst administrative and regulatory constraints.

3.29 Evidence from the survey regarding the incidence of official corruption is somewhat difficult to interpret. More than a third of respondents identified corruption as a major or very severe obstacle to doing business in Kosovo. The proportion is higher among manufacturing enterprises (48 percent), and in the municipalities of Prizren (58 percent) and Gjakovica (48 percent). However, only a small proportion of firms admitted making informal payments for any given public service. This may mean that respondents perceive of public services as more corrupt than they are in fact.⁴³ For those making payments, the total cost averages one percent of annual revenue. The highest average payments are associated with tax inspections (€668), registering immovable property rights (€168), and the issuance of land use permits (€100).

3.30 With respect to business-government relations, the vast majority of firms view the delivery of government services as efficient (81 percent), and three-fourths feel that there is predictability in changes to laws and rules that materially affect their businesses. However, of all groups who seek to influence laws or regulations that could have a substantial impact on a respondent's business, organized crime ranked the highest (20 percent felt that organized crime had a "somewhat" or "very influential" impact). Further, 7 percent of firms admitted making protection payments to organized crime equal to 2 percent of their annual sales.

⁴³ It could also mean that firms were hesitant to admit that they themselves had made informal payments to public officials.

Foreign Direct Investment, Restructuring and Privatization

3.31 While political risk may not be a major concern for domestic investors, it is clearly a significant obstacle facing potential foreign investors, including those from the diaspora. This fact is further compounded by other factors, such as the absence of full protection of immovable property rights: there are unresolved property claims by absentee and displaced Kosovars; and the immovable property registry is not yet functioning. Until now, foreign direct investment (FDI) has been limited, with only significant investments in the banking sector. There has been a degree of interest and participation from investors within the region during the first three rounds of the privatization program. The size of these potential investments indicate that such investors are prepared to take limited financial risks at this stage, perhaps to establish a presence in the Kosovo market should improved political conditions eventually open the door to further opportunities and justify a higher investment profile.

3.32 The role that political risk insurance could play in mitigating the risks borne by private investors should be considered further including provision by the Multilateral Investment Guarantee Agency (MIGA). The United States Overseas Private Investment Corporation (OPIC) has extended political risk insurance for foreign investors in Kosovo, although coverage is only guaranteed under the present interim arrangements until a future internationally recognized government can ratify the OPIC agreement already concluded with UNMIK.

3.33 There are more than 500 socially-owned enterprises (SOEs) slated for privatization in Kosovo. Transfer of SOEs to the private sector will lead to more efficient use of these assets and ultimately will help to stimulate economic growth. Implementation of the privatization program should therefore be a high priority for the authorities. Of more than 500 SOEs, only about 75 to 100 will be tendered as going concerns under the “spin-off” model; the remainder would be liquidated and their assets sold piecemeal. For many of the liquidation cases the most valuable asset will be land, privatization of which would enable the expansion of existing firms as well as new start-ups. Thus far, however, the Government has dealt with the issue of land use-rights (long-term, freely-transferable leases) for only those enterprises privatized through spin-offs. No regulation has been promulgated dealing with land use-rights for liquidation cases, and this is hindering implementation of a part of the program that could make a substantial contribution to Kosovo’s medium-term growth prospects.

3.34 Policy Recommendations

- Proceed with privatization and restructuring of POEs and SOEs.
- On a priority basis, promulgate legislation enabling privatization of land use-rights of socially-owned enterprises slated for liquidation.
- Investigate options for political risk insurance including possible use of MIGA products.
- Review VAT rebate procedures to ensure timely processing of rebates.
- Improve administrative practices with regard to reference pricing of imports (importer documentation requirements, regular updating of reference prices, etc.) to ensure fair and standardized treatment of imports.

- Review local regulatory and administrative practices (licensing, permitting, inspections) especially in the municipalities of Prizren and Gjakovica to reduce unnecessary compliance burdens on enterprises.

D. FINANCIAL SECTOR DEVELOPMENT

3.35 This section assesses the state of the financial sector and identifies constraints that hinder its development based on an informal survey of the lending sector. Although credit to the private sector has expanded considerably, the deposit base is predominantly short term thus constraining long-term lending activity. Political uncertainty is found to have some impact on limiting the maturity of the deposit base: savers fear their savings might not be secured. The survey results are based on interviews with representatives of six commercial banks and four MFIs⁴⁴ and provide the basis for the conclusions and recommendations aimed at improving banking intermediation in Kosovo at the end of the section.

Financial Intermediation

3.36 The financial sector in Kosovo has been built from scratch over the past four years, and consists of seven registered banks, ten Savings and Credit Associations, twelve micro-finance institutions (MFIs), four other non-bank financial institutions, and eight insurance companies. The Banking and Payments Authority of Kosovo (BPK), established in 1999, is the regulatory and supervisory authority for the banking and insurance sector. The legal, regulatory, and supervisory framework for the banking and insurance sector is in accordance with international standards and recognized best practices in the region. With support from donors, BPK has made considerable progress in strengthening its capacity to effectively regulate and supervise the financial sector.

3.37 The depth of the banking sector as measured by total loans to the private sector and total deposits as a percentage of GDP has been increasing rapidly. At the end of 2002, total loans to the private sector represented 6.5 percent of GDP, which increased to over 17 percent by end 2003. Similarly, deposits increased from 33 to 39 percent of GDP between 2002 and 2003. Such increases are from a low base, and Kosovo still has a low level of financial intermediation when compared to other countries in the region. This reflects a banking sector and a financial infrastructure recreated from scratch less than four years ago after a 10-year absence of any kind of lending to the enterprise sector and the gradual dismantlement of the main elements of any financial infrastructure.

⁴⁴ The sample represents 86 percent of the total assets of the banking sector and 77 percent of the total lending market, or 80 percent of the bank-loan market.

3.38 **Kosovo is a heavily cash-based economy.** At the end of the conflict, Kosovo's financial system was in chaos. All the Yugoslav banks had pulled out, taking their customers' deposits with them; the centralized payments system had ceased to exist; the pool of persons with banking experience was limited; and the legal environment was weak. Unlike most countries of the region, not only did Kosovo make almost no progress in the transition to a market economy in the 1990s, but it also suffered the consequences of a disruption in public confidence in the banking system for an extended period of time. Although account holding is relatively widespread in Kosovo, payments are still made predominantly in cash, and the size of money circulating outside the banking system is significant as measured by the deposit/broad money ratio, which increased from 47 percent in December 2002 to 70 percent in December 2003.

Table 3.3: Banking Intermediation Indicators for the Region, 2002

	Kosovo	Bosnia-Albania	Bosnia-Herzegovina	Croatia	Macedonia	Slovenia	Turkey	Greece
Deposits/GDP	33.4	40.1	39.6	70.6	24.3	59.6	50.8	90.7
Credit to Private Sector/GDP	6.6	5.9	25.9	51.1	20.4	41.3	15.4	109.3
Interest spread	12.0	7.9	9.8	9.6	8.8	5.2	N/A	5.3

Source: World Bank estimates based on IMF, and national central banks data.

3.39 **Rather than the banking sector, enterprises tend to rely on own funds and family and friends for their working capital and investment financing needs.** Heavily influenced by remittances, these represent the main sources of financing for enterprises in Kosovo. According to the survey, loans from commercial banks or MFIs cover only about 40 percent of the financing needs of borrowers.

3.40 Branches and sub-branch networks are extensive in Kosovo and extend into relatively remote areas. Banks are present in all municipalities including the six cities in the sample for the investment climate assessment.⁴⁵ However, the range of banking products and services available is still narrow and consists of basic instruments. These consist of working capital and investment loans, overdrafts and letters of credit (LCs). Although LCs represent less than 4 percent of the banking business of each bank and are about €50,000 on average. Some banks plan to develop new products such as leasing and discount of receivables over the next 12 months. Not all banks offer checks and plastic cards, and even when available, and they are mainly used for customs payments by a portion of clients. Only the two largest banks offer electronic credit payment instruments and have been approved for membership in the SWIFT system of international payments. They have also developed a network of about 40 ATMs and planned to double their

⁴⁵ With the exception of Zvecan, all banks have at least a sub-branch in every municipality.

networks over the next 12 months. These two banks issue own-brand debit cards and PINs to their customers, although only a small number of customers use them. Both of these banks are planning to issue internationally branded (Visa, MasterCard) debit cards, followed by credit cards.

3.41 The bulk of deposits is short-term and potentially unstable, and tends to constrain the banking sector in extending longer-term credit. Sight deposits are 59 percent of total assets, of which half are individual deposits. Four of six banks ranked the maturity of the deposit base as a major or very severe obstacle to banking sector development. Also, half of the banks considered competition from other lenders offering longer-term loans as a major obstacle to their development. This should lead to a gradual reduction of the short-term interest rates on loans. However, in order to increase the maturity of their deposits, banks with shorter-term deposits might decide to offer higher interest rates on deposits and apply higher interest rates on loans that only risky/bad borrowers will be willing to pay. Deposits are highly concentrated in the two foreign-owned banks. At the end of 2002, deposits in these two banks accounted for 74 percent of the total deposits of the system. Competition in the market for deposits is extremely aggressive among local banks. Greater competition in the banking sector is producing a decreasing interest rate spread, although the current spread is still significantly higher than that observed in other countries of the region.

3.42 Political uncertainty appears to negatively affect the growth of a stable and longer-term maturity deposit base. According to the survey, the uncertainty of the political and legal arrangements affects only indirectly the banking/lending business by limiting the maturity of the deposit base. Although the increasing deposit/currency ratio shows a slow but steady increase in public confidence in the banking system, the uncertainty of the current situation results in concerns about the security of property and savings.

3.43 Despite the political uncertainty lending is growing, and total loans to the private sector have increased by 177 percent and amounted to €163 million in June 2003, which represents nearly a doubling of the stock of total loans registered at the end of 2002. The average interest rate on both working capital and investment loans is 14 percent. Lending to the agriculture sector is still at minimal levels: accounting for only 2 percent of the portfolio as of June, 2003.⁴⁶ Lending activity is always secured against collateral that ranges between 100 and 300 percent in the case of a bank loan, and 100 and 200 percent in the case of a loan provided by an MFI. Land, commercial property, personal assets and machinery, are the most important sources of collateral. Evaluation of

⁴⁶ Most of the lending to agriculture is done through specialized agriculture credit lines by non-bank financial institutions and MFIs. As of June 30, 2003, the loan portfolio of the MFIs amounted to about €35.2 million for about 18,000 loans.

collateral was considered to be a minor obstacle by the banking sector, and lack of clarity of land titles does not seem to constrain lending development. However, half of the banks considered unreliable financial information as a major obstacle to sound lending.

3.44 The quality of the loan portfolio of the banking system is good, but is expected to deteriorate. Although the share of non-performing loans is still at a reasonable level, it is expected to increase over time as loan portfolios mature and the credit expansion continues. Provisions against loan losses were, respectively, about 3 percent, and 3.5 percent of the outstanding loan portfolio in December 2002 and June 2003.

Table 3.4: Quality of the Loan Portfolio

	December 31, 2002	June 30, 2003
Total loans (€)	86,498,000	162,444,000
Total past due loans (over 30 days) in €	3,139,000	5,873,000
Total non-performing loans (over 90 days) in €	836,000	2,288,000
Total loss loans	1,588,000	1,415,000
Past due loans/total loans (%)	3.6	3.6
Non-performing loans/total loans (%)	0.96	1.40
Loss loans/total loans (%)	1.80	0.87

Source: BPK.

3.45 Enforcement of creditor rights and of contracts is a key constraint. Out of 10 lenders, seven ranked enforcement of creditor rights as a very severe or major obstacle. Deficiencies in court procedures allow the process to be abused. Municipal court performance is weak, and appeal and adjournments are excessively easy to obtain, which might encourage a culture of non-payment given the lack of effective sanctions for non-compliance. The unpredictability of the judgment, length of the process, complexity of the procedural law governing the process, lack of clarity of the procedures, and execution of the judgment were considered the major obstacles in enforcing creditor rights. Only two banks have never taken any legal action against a borrower in default; the remainder have taken a total of about 300 legal actions. However, for half of the lenders, the percentage of legal cases completed is less than 1 percent and the time required to complete a case was about 18 months.

3.46 An effective and efficient anti-money laundering regime is still far from being implemented. A cash-based economy makes Kosovo vulnerable to money laundering activities and terrorist financing. The survey results conclude that money laundering is not evident, and rules are in place prohibiting banks and financial institutions from engaging in money laundering activities. However, there are indications that Kosovo could attract such activity. Kosovo's geographical position is on a well-known route for trafficking of drugs, weapons and persons. In addition, many sectors represent potential vehicles for laundering money such as the insurance and construction sectors. A regulation for prevention and detection of money laundering and terrorist financing became effective on March 1, 2004. As Kosovo is not yet a member of the Council of Europe, it is not eligible for the technical assistance that the Council has provided to neighboring countries.

Policy Recommendations

3.47 The results of the survey and the still nascent stage of the banking sector indicate the need to continue to strengthen the banking sector's role in mobilizing savings and extending credit for productive activities as follows:

- Strengthen the capacity of the municipal courts to implement and enforce creditors rights and contracts. This would introduce and reinforce a strong compliance culture with sound lending practices.
- Improve the development of a functioning credit market by strengthening accounting and financial reporting for both financial and non-financial entities. This would (i) provide lenders with a more accurate assessment of the enterprise sector's financial conditions; (ii) enhance transparency and quality of regulatory reporting from banks, and (iii) provide BPK with a more accurate, independent assessment of lenders' financial conditions, which is particularly important in a situation where supervisory functions are still in a developmental stage.
- Build the institutional capacity necessary for successful implementation of an effective strategy to prevent and fight money-laundering and terrorist financing.

4. POTENTIAL AND CONSTRAINTS TO GROWTH AT THE SECTORAL LEVEL

A. INTRODUCTION

4.1 This chapter examines the medium-term outlook and obstacles to growth in three economic sectors in which Kosovo has a considerable endowment and potential comparative advantage: energy, mining, and agriculture. The key issues affecting growth at the sectoral level include (i) those found to be hindering the SME sector generally such as a lack of a regular power supply and unfair or informal competition, and (ii) those affecting the investment climate for foreign investors including delays to privatization and the difficulty of attracting FDI without measures to mitigate political risk.

4.2 Sector specific recommendations are made at the end of each section. In the energy sector, rehabilitating the power generation and lignite mines is critical before prospects from exporting to the regional energy market can be pursued. A comprehensive strategy for recovering the mining sector is a necessary first step the authorities need to pursue, as well as significant FDI for mining operations to restart and/or expand operations. In the agriculture sector, commercial agro-processors represent the best source of potential growth. Facilitating links with foreign investors to improve technical knowledge and productivity would improve the competitiveness of Kosovar businesses.

4.3 The first section considers the energy sector. Following this we look at the mining sector, including the issues affecting lignite mining. Finally, in section three prospects for growth in the agricultural sector are considered.

B. THE ENERGY SECTOR

Background and Recent Developments

4.4 Kosovo is heavily dependent upon a lignite fueled power supply. Kosovo's main energy resource is its extensive reserves of high calorific value lignite deposits, the reserves of which are estimated at over 10 billion tons. Kosovo has no other fossil fuel resources, natural gas import and supply infrastructure, nor oil refinery, and only modest hydroelectric potential.

4.5 **At present, the power sector is unable to deliver 24-hour supply and additional costs are borne by businesses and households using their own stand-by generators.** The electricity network covers almost 100 percent of the households and is organized as a vertically integrated utility: Kosova Energjetike E Kosovo (KEK) – a publicly-owned enterprise (POE). The power system is actually a truncated part of the former Yugoslav system. It can only meet its domestic demand on the basis of exporting

surplus electricity generation during off-peak hours, and importing from the neighboring power systems during peak hours.⁴⁷ Currently, its nominal installed generation capacity of about 1,513 MW is only able to generate around 640 MW on account of old age of the units, decades of inadequate maintenance, physical damage caused during the conflict and more recently a lightning strike.⁴⁸ Consequently its surplus base load power generation has shrunk, and it has become a net importer of electricity. This has led to serious power shortages, and the introduction of four hours of supply being followed by two hours of load shedding, forcing households and businesses to use small standby generating sets using imported liquid fuels. Rehabilitation of one of the thermal generating plants, Kosovo B, is underway with EU financing; two small units of Kosovo A may not be worth rehabilitating; and for the rehabilitation of the three larger units of Kosovo A, no financing is as yet available.

4.6 The power sector has become a serious drain on public resources despite the reasonable average electricity tariff of about €0.06 per kWh at the retail level. Presently it loses about 18 percent of its gross available power⁴⁹ by way of technical losses and a further 23 percent by way of theft of power. KEK bills the remaining 59 percent, and collections in 2002 were only 59 percent of the amount billed. Residential consumers with a 75 percent share of total sales were the worst defaulters. Thus in 2002 only about 34 percent of the gross available power were converted into revenues.⁵⁰ This ratio should be close to 90 percent in a well-run utility of this small size. The revenues lost by the power sector in 2002 are estimated at €109 million or about 8.5 percent of the GDP in that year.⁵¹ The accounts receivable of the power utility at €144 million (as at the end of September 2003) far exceeded the value of its annual sales. KEK is technically insolvent and depends on public revenues and donor assistance not only for the rehabilitation of assets but also for its maintenance needs and to pay for the net imports of power.

⁴⁷ It is interconnected to its neighbors with 400 kV and 220 kV transmission lines. Its power system is a part of the Second UCTE Synchronized Zone consisting of the power systems of Albania, Bulgaria, Greece, Kosovo, Macedonia, and Serbia Montenegro.

⁴⁸ Net available capacity is 1340 MW. KEK has two thermal power plants Kosovo A (five units for a total of 800 MW, mostly between 30 and 40 years old) and Kosovo B (two units for a total of 678 MW) and a hydro plant of 35 MW.

⁴⁹ Gross available power consists of domestic generation plus net imports.

⁵⁰ This ratio improved to 41.3 percent in the first nine months of 2003.

⁵¹ About 10 percent of the deficit is explicable in terms of the average rage tariff in 2002 being around 90 percent of the normative tariff. The rest of the deficit is fully attributable to high losses and poor billing and collection.

Medium Term Outlook

4.7 The abundant lignite resources hold potential for the energy sector to become an engine of growth instead of being a constraint and a drain on public resources. The lignite deposits have a low sulfur and ash content, sufficient lime concentration to absorb sulfur during combustion, and an attractive overburden to lignite ratio, making mining very economic. With modern mining practices introduced, electricity produced by using low cost lignite would be very competitive in the region.

4.8 Prospects for the energy sector are good if Kosovo can become a net-exporter to the regional market. UNMIK is a signatory to the Athens Memorandum of 2002 establishing the South East European Regional Energy Market (SEEREM)⁵² to promote regional electricity trade on the basis of market competition. The demand in SEEREM countries is expected to grow at 2 percent per year calling for capacity additions of the order of 4.5 GW through 2012, thus providing Kosovo an excellent market for exports. An export oriented 1000 MW unit in Kosovo could generate export revenues of the order of €225 million or 17 percent of present GDP.

4.9 To enable participation in the regional market, Kosovo has set up a central regulatory unit, which includes an Electricity Regulator. An Energy Office for energy policy formulation and sector oversight has also been established. Plans to unbundle the sector and set up an independent transmission system operator are being prepared. New laws on electricity, energy, mining, district heating and regulations under these laws are being drafted to enable the implementation of reforms envisaged under the Athens Memorandum and the related EU directives.

4.10 The government has also prepared a White Paper outlining its strategy for the sector, which includes (i) ensuring funds are available for electricity imports; (ii) preventing theft of power and improving collections; (iii) improving corporate governance of the power utility through the use of a management contract; (iv) constructing a 400 kV line to Albania to enable a smoother exchange of hydroelectric power from Albania and thermal power from Kosovo; (v) integrating the power sector of Kosovo with SEEREM to expose it to regional competition; and (vi) relying on private investments for new lignite production and to establish a new power generating capacity needed by 2008 to replace the retiring capacity, meet the incremental demand and to increase substantially electricity exports. Progress is being made with respect to implementing this strategy: Management Contractors to turn around the management of the power utility KEK are being recruited and discussions to construct the new line with

⁵² The signatories to the Athens Memorandum as participants are: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania, Turkey, Serbia and Montenegro, UNMIK and the European Community.

Albania are well underway with the support of the World Bank. However, without rapid progress, the energy sector will continue to be a constraint to the business environment, a fiscal risk and forgo opportunity costs from possible future export growth.

Obstacles to Growth

4.11 An improved power supply requires (i) an improvement in KEK's operational and financial performance and (ii) improved arrangements for contracting and financing electricity imports. The current constraint on the business environment requires immediate action on these two fronts. With an improvement in the billings and collections rates, and progress with management reforms and labor restructuring, KEK can expect to improve its own operating position. At the same time early planning and financial commitments for electricity imports will give the KEK management greater flexibility to ensure the most cost-effective solution when contracting with regional energy suppliers.

4.12 The weak management of KEK and corporate governance arrangements compound resolution of a more reliable power supply. KEK lacks senior and middle level executives with adequate professional experience. The utility relies on technical and management expertise of international staff through EU-funded arrangements. Its corporate governance is weak as most positions in its supervisory board are vacant for considerable periods. In the context of shared responsibilities between UNMIK and PISG, the supervisory board also lacks cohesion. As a POE, KEK falls under the responsibility of the Kosovo Trust Agency, and therefore UNMIK under the constitutional framework. However, the need for extensive support of the PISG and the use of public funds makes KEK a particular cause for concern for the PISG and the Ministry of Finance and Economy, in particular. This raises the need for close cooperation between the two administrative elements in Kosovo, and makes even more important the need for strong corporate governance and management arrangements.

4.13 The police and justice system need to support the KEK disconnection campaigns to improve its collection rates. The police and justice system are unable to protect KEK's property rights and provide the needed support to KEK to control theft, prosecute and punish those who steal power. A recent campaign of KEK to detect theft of power and disconnect supplies to illegal consumers, merely resulted in over 10,000 cases pending in the courts, while the offenders kept on illegally reconnecting themselves to the supply system.

4.14 The standard remedy of privatizing distribution facilities to improve performance is not practical. The ownership of the power sector assets is not clear. UNMIK as custodian established KEK simply to operate the facilities and established KTA to act as the trustee of owners.

4.15 Rehabilitation of the assets has taken place piecemeal and is still not complete. Public funds and continued donor support are needed to complete the rehabilitation and reconstruction of the energy infrastructure. Table 4.1 provides reasonable estimates of the investment requirements over the next five years. In the absence of satisfactory and assured financing plan, KEK is not able to prioritize and

prepare a rational implementation plan for these investments. Rehabilitation of assets also needs to take into consideration the environmental liabilities of the existing plants and the need to comply with the new Environmental Protection Law and European Standards. Environmental concerns from the power plants include carbon dioxide emissions, dust filtering, the higher than necessary ash content in the lignite as a result of inefficient mining practices and frequent fires at the mines, and Nitrogen Oxide emissions particularly from Kosovo B.

4.16 In the medium-term, the successful rehabilitation of the infrastructure would lift the current constraint on power generation and distribution capacity. Lignite supply, however, could become a major constraint. Upon completion of the ongoing rehabilitation of the generating units expected in 2004, the available capacity would reach about 800 to 900 MW. The two mines operated by KEK have a serious backlog of overburden removal and dilapidated equipment. The current mining operations are also operating under risks created by the unsafe and short-term mining methods adopted during the 1990s and by a landslide in 2002. Further, these two mines are expected to be depleted by 2008 and a new mine will need to be opened to meet the future needs. The next section includes a more comprehensive assessment of the mining sector, including lignite mining.

Table 4.1: Proposed Energy Sector Investment Program from the PIP (€ million)

No.	Item	2004-2005	2006-2008	Total
1.	Power generation: Rehabilitation	67	-	67
2.	Power Transmission	25	39	64
3.	Dispatch	13	6	19
4.	Power Distribution	125	90	215
5.	Lignite Mining	57	100	157
6.	District Heating	19	20	39
7.	Liquid fuels	19	4	23
8.	Natural gas	-	-	-
9.	Energy efficiency & renewables	2	4	6
10	Environment Action Plan	4	14	18
11	Other miscellaneous items	4	3	7
	Total	335	280	615

Source: White Paper Version September 2003.

Policy Recommendations

4.17 In order to make the sector an engine of growth, a range of sector reforms has to be undertaken for sustained implementation. These include stabilizing the power supply; introducing the new performance-based and incentive-linked Management Contract to upgrade corporate governance, control of corruption and prevention of power theft, and improve billing and collection to industry norms; restructuring of KEK; defining legal and regulatory framework and making the energy regulator fully functional; integration of Kosovo into regional energy market; and strengthening institutional capacity to improve energy trade with the utilities in the region.

4.18 In the immediate term the following issues should be brought to a swift resolution:

- Continue to disconnect those not paying their bills, accompanied by a concerted effort to ensure there is no illegal reconnection. Facilitate the speedy recovery of unpaid dues by the power utility, by strengthening capacity of the police and courts to enforce contract obligations and prosecute theft of power and corruption.
- Undertake a review of the size of the monthly consumption limit of residential consumers in the lowest block in the tariff, reduce substantially from the present high level of 800 kWh, and introduce a lifeline rate for this lowest tariff block.
- Complete the rehabilitation of power generation plants, mining equipment and the transmission and distribution network, in accordance with an investment program agreed between UNMIK and PISG. Priorities should be rehabilitation of generation capacity and ensuring adequate provision of maintenance expenditure for the rehabilitated plants, reduction of non-technical losses, and improvement in customer service. The reforms necessary for the lignite mines are covered in more detail in the following section.
- Improve forecasting Kosovo's requirements for importing electricity and ensure adequate budgetary arrangements are (i) available and (ii) transparent for funding such imports.
- Put in place governance arrangements so that there are clear reporting lines for KEK management to the Board, and from the Board to the authorities. Ensure that management under the new Management Contract are given adequate autonomy for operations, and are held accountable for performance.

4.19 In the medium term the authorities need to implement sector and market restructuring measures to comply with obligations under the Athens Memorandum for participation in the SEEREM; measures to encourage consumers to shift from electricity to more cost-effective but environmentally clean fuel for space heating and cooking; productivity improvements through staff rationalization and skill up-gradation; phased liberalization of the market; and establishing a framework to attract private sector investments in power sector. These measures are elaborated below:

- Staff the Office of the Electricity Regulator and make it fully functional.
- Establish an independent Transmission System Operator.
- Unbundle the existing composite tariff into separate tariffs for generation, transmission, distribution and supply as determined by the electricity regulator.
- Define and issue grid code, commercial codes, market rules and rules for third party access to transmission system.
- Explore environmentally clean alternative fuels, and investigate further the possibility for reducing the taxes on liquid fuels, for space heating and cooking purposes. This will improve not only help improve the payment

- of electricity bills by the consumers but also and reduce the peak demand during the winter months.
- Downsizing plans should be implemented to reduce excess KEK labor, and at the same time, upgrade skills of remaining staff, and provide incentives for productivity improvements.

4.20 In the long term, additional reforms will also be required to:

- *Restructure the power sector.* First, KEK should be corporatized as a joint stock company with five self contained business units within KEK for mining, generation, transmission, distribution and supply businesses with clear separation of assets, accounts and staff among them. The internal trade among them should be based on contracts using the unbundled tariffs (determined by the regulator) as transfer prices.
- *Liberalize the market.* Once the tariffs are rebalanced, commence liberalization of market by allowing non-household consumers (i.e., 110 kV consumers initially) to buy power from domestic or foreign generators at market prices. Gradually the consumption threshold for eligible consumers would be reduced to cover all non-residential consumers. Generators with public supply obligation will supply captive consumers through suppliers with public supply obligation at regulated prices.
- *Prepare for the introduction of private-sector operators.* To attract private investment, the reform of the sector, together with a clearly defined role for a new power investor will need to be undertaken. Consideration may be given to a sector structure where a private investor also has control of a captive lignite mine (rather than having one investor to handle all coal mining in Kosovo). Also since a good part of KEK's generating capacity would be retired by 2008, consideration should be given to including a public supply obligation for any new private power operator. These issues need to be resolved and made explicit in Requests For Proposals to be issued for a new plant.

4.21 In the absence of interest on the part of private investors, and or delays in the reform of the sector there is a need for a fall back strategy to replace the retiring capacity in 2008-2010. Private investment in the power sector of emerging markets has declined steeply in recent years and many have actually disinvested their recently acquired assets. In the case of Kosovo, there is the additional uncertainty for investors and lenders. A fall-back strategy would involve: opening a new lignite mine and constructing the minimum needed additional capacity, financed partly by the internally generated cash of KEK, partly by the government budget and potentially loans from bilateral and multilateral lenders.

C. THE MINING SECTOR

Background and Recent Developments

4.22 Kosovo's mining industry prior to 1991, and historically, was significant as both a source of strong economic activity and export earnings; and an employer

with more than 17,000 miners at that time. However, from 1991 to 1999 the industry suffered chronic neglect with little reinvestment in mining operations and associated processing facilities. At many operations, production fell and negative environmental and social legacies escalated. The 1999 conflict only served to accelerate sector decline, damaging key production assets at several operations. Once an engine of economic growth, the industry has suffered significant diminished asset value. This section examines prospects for reviving mining in the following minerals⁵³ lignite, lead and zinc, ferronickel, magnesia and crushed stone that at this point in time, demonstrate the best potential. The importance of the deposits and the current state of the operations are summarized in the remainder of this section. Constraints and prospects for restarting operations are considered in the subsequent sections before concluding with several policy recommendations.

4.23 *Lignite.* As discussed in the previous section Kosovo has significant lignite deposits, which if generated into electricity could be of considerable value when sold on the regional market. Two mines (Mirash and Bardh), operated by KEK are currently operational. They are located next to the power generating plants. The physical condition of the mines is critical and has already suffered the consequences of a major landslide in 2002, which covered production benches with 30 million m³ of overburden. Furthermore, the mines are not or on a firm commercial footing, being part of the vertically integrated power structure.⁵⁴

4.24 *Lead and Zinc.* Kosovo is also well endowed with lead/zinc deposits of modest size and grade, distributed along a geological belt that extends along the Eastern side of Kosovo, and well linked to transport networks. The zinc market remains strong and Kosovo has the potential to be either a regional exporter of primary metal and/or value-added products. Trepça currently owns the deposits, a large socially-owned enterprise, which until 1999 was engaged in, integrated lead and zinc mining and associated manufacturing operations.⁵⁵ Trepça formed the nucleus of the former Yugoslav industrial complex, and continues to have more than 10,000 miners on the books. Operations were interrupted by in 2000 when KFOR closed the operation for environmental reasons. Between 2000 and 2003 there has been strong donor support to rehabilitate the mines

⁵³ Other sub-sectors reported to have potential in Kosovo but not assessed for this report include bauxite, cement, and precious metals.

⁵⁴ Western operations of a similar production schedule with significantly greater use of technology operate with approximately 500-1000 workers.

⁵⁵ In the mid 1990s a Greek metals company (Mytileneos Holdings S.A.) signed several contracts with the Serbian Agency of Foreign Trade to recapitalize the Trepça operation with the expectation of taking an equity stake during the eventual privatization of the complex. This is an issue to be determined within the context of the wider legal issues.

with the intention to resume the mining operations later this year, and export lead/zinc concentrate.

4.25 *Ferronickel*. Kosovo has two nickel deposits used in the production of ferronickel within a geologic belt that extends beyond its borders into Albania. Ferronickeli is a SOE and former exporter of high-value ferronickel for use in the steel and manufacturing industries of central and Western Europe. Prior to 1998, Ferronickeli's economic impact was extensive and employed 2000 workers, however the operation performed poorly and production was declining in the mid- 1990s due to technical problems and finally production stopped in 1999 when NATO bombing caused damage to the buildings although the production facilities remain largely in tact. The financial requirements to restart the plant are largely unknown as there has been no independent assessment of the plant closure procedures and the extent of bomb damage.

4.26 *Magnesite*. Stolezc and Golash Magnesia are two SOEs that operate regionally and employ approximately 400 workers. The geologic resource has been shown to be suitable for the production of both caustic and sinter magnesia, which are a potential source of export earnings. The physical state of the production kilns is unknown, but given the age of the kilns and the vintage of the technology employed, new production capacity rather than rehabilitation is likely to be required. Production has not restarted since 1999. However, currently, a self-appointed volunteer management of the former operation is working to restart the operation and have commenced mining of crushed stone from the magnesia mines.

4.27 *Crushed stone and construction materials*. This is a private sector SME industry that currently consists of licensed and unlicensed operators. The full employment in this field is unknown and turnover is estimated to be between €5 and 10 million per year.⁵⁶. This is the one sector not dependent upon attracting foreign direct investment for growth, as the capital required is significantly lower. Private venture capital has already been used to establish one sizeable operation.

Medium Term Outlook

4.28 **While Kosovo's deposits are modest by global standards, they enjoy competitive advantage in being close to Western Europe markets with relatively low transport costs to markets.** Historically, the price of mineral commodities in real terms has been declining for several decades. Nonetheless technological improvements have increased productivity gains to offset the falling prices. Mineral prices are known to follow a cyclical pattern and are currently strong.

⁵⁶ Source: World Bank estimates.

4.29 With political will and strengthened administrative capacity, several sub-sectors could become attractive investment opportunities for private investors, and in time be expected to yield employment opportunities and export potential.

However, the crushed stone construction materials sector offers growth prospects with a minimum of investment and the least exogenous constraints. Ferronickeli offers privatization opportunities while the major issues facing Trepça and KEK should be resolved through interim strategies first. Given the unknowns surrounding the Magnesia operations additional research into their potential is required.

4.30 *Crushed Stone and Construction Materials.* The crushed stone sub-sector is a source of rural employment, relying on domestic sources of investment capital and professional staffing. Although individual operations are currently modest employers there has been considerable demand for this sector as a result of the reconstruction/construction post-1999. Informal operators should be licensed and pay royalties that have the opportunity to provide public revenue sources. On a per tonne basis, royalty payments from construction material sales are generally high on a per unit basis relative to the sales price of the commodity. Quality material from licensed operations could contribute toward longer lasting infrastructure.

4.31 *Ferronickel.* The demand for ferronickel is currently strong and the plant is competitively located close to the European market. In particular, the complex is located on a rail system that facilitates importation of local Albanian ore concentrates and international concentrates via the deep-sea port at Thessaloniki. Successful privatization of Ferronickeli could inject meaningful private investment and restart operations. A ferronickel operation, offers prospects of strong export earnings, high-paying employment (1,200 at full capacity), and strong royalty earnings.

4.32 *Trepça.* The medium-term outlook for lead and zinc export is good given the global market and world prices. The interim management of Trepça has defined a sound, modest strategy for restarting mining operations. This would allow for the export of metal concentrates to be started without relying on significant FDI. Downstream manufacturing and processing could then be considered once the mines are operational and the environment improved for privatization and/or bringing in a private investor. This is also a pragmatic solution that would separate the potentially large-scale environmental issues associated with the smelting and manufacturing of lead/zinc products. In the interim the benefits would arise from employment (mining operations could employ 2,000) and a modest contribution in terms of royalties. With private investment attracted to operating the plant this would be much more significant over time. Furthermore, operating mines form a catalyst that attracts exploration investment, and could lead to additional future production.

4.33 *Lignite.* With the successful implementation of a reform strategy to put the mining operation on a commercial footing, there is considerable scope for the mining operation to be a successful and critical aspect of the strategy for power exports. A reform program would require additional investment and to separate out KEK's business units, as well as addressing the need for labor restructuring.

4.34 While the business structure of KEK does not allow for a transparent internal pricing structure between the mining operations and the power generation business, a

(conservative) estimate of the transfer price for current operations would be approximately €5 per tonne, or €35 million in annual revenues. An export power strategy in which 30 percent of lignite production is sold for power generation in the domestic market and 70 percent for power targeted towards the export market could result in additional sales of 5-7 million tonnes, or €30 – €42 million, per year if the lignite mines can be successfully rehabilitated and in time, additional producing pit sometime around 2008.

4.35 *Magnesia*. The principal market for the former operation was Serbia, and to a lesser degree Russia, Poland, and Italy. Markets may also exist in Slovenia and Bosnia. The closure in 1999 coincided with a significant structural change in magnesia markets brought about by the high-quality, low-cost product from China displacing traditional producers of caustic and sinter magnesia. As such, a magnesia plant in Kosovo would face considerable competition from China. The most likely prospects for such an operation to succeed would be to access regional markets in the Mediterranean and Germany, subject to competitive operations being established. Buyers in the region have already shown expressions of interest, however the operating condition of the two plants remains unknown.

Obstacles to Growth

4.36 **Recovery of the mining sector is impeded by four interrelated factors** (i) the need to attract significant financing to restart operations; (ii) the uncertain political and institutional situation which is dissuading private sector investment; (iii) social, environmental and legal concerns that need to be addressed in order to attract quality investors and (iv) governance arrangements that lead to divergent opinions within key agencies on recovery strategies.

4.37 **The overarching obstacle to growth in this sector is that operations cannot restart or recover without major capital injections and technical improvements.** Table 4.2 below estimates the magnitude of the inflows needed. In order to attract FDI, the key concern facing private investors is likely to be their risk and financial exposure. With the exception of the large lignite deposits, the other mineral resources of Kosovo are generally of regional interest, offering moderate levels of economic reward and thus meritting moderate levels of investment risk. The following factors will weigh heavily on the minds of foreign investors evaluating prospects for doing business in Kosovo (i) clear mining rights and titles (mining legislation), (ii) attractive and competitive fiscal conditions (tax liability), (iii) ownership and control of operations (mining legislation), (iv) political stability and transparency of governance (government institutions), and (v) availability of infrastructure.

**Table 4.2: Estimation of Mining Sector Foreign Direct Investment Requirements
(U S million)**

No.	Item	Estimated FDI US\$ m
1.	Lignite	50-175
	Recovery of the Mirash and Bardh pits	50-75
	Development of a new lignite field	100
2.	Ferronickeli	23-250
	If plant was shut down properly	23
	If plant shut down was suddenly, causing damage to processing conduits	100-250
3.	Lead and Zinc mine deposits (Trepça)	30
4.	Magnesia	N/A

Source: World Bank estimates.

4.38 A coherent approach to recovering the sector has not yet been developed and key policies and legislation for development are not in place. The governance arrangements for the mining operations are shared across UNMIK and the PISG. This is leading to conflicting development strategies, duplication of effort, and decision-paralysis on important social and environmental issues that threaten to impede recovery and privatization efforts. Whereas the Central Regulatory Unit (CRU) – Mining Directorate is taking steps to develop new offices for the (i) administration of mineral titles, (ii) monitoring and reporting of mineral production, and (iii) collection and dissemination of geological information; the Ministry of Trade and Industry is duplicating some tasks. Although the Energy Office sits between the CRU and KEK, it is realizing delays on key programs targeted towards public safety in the relocation of residents threatened by landslides resulting from the lignite operations. Against this backdrop, efforts directed to privatization cannot help but become conflicted with one or more agencies in this policy vacuum. To this end, the greatest progress has been realized on programs that have been undertaken piece-meal and in some cases without the full approval and budgetary commitment of the authorities. A new Mining Law and mineral development policy, currently being drafted, will provide the enabling environment for investors to conduct mining in Kosovo, but administrative reform is badly needed.

4.39 As much of the sector consists of former SOEs, the assets are currently held in trust by the KTA, and are slated for privatization, which has so far been delayed. (See Chapter 3). Progressing the privatization program at this stage, especially without resolution of the issues raised above, risks attracting speculators who will not necessarily have the intention of putting the assets back into production. Such a process introduces significant risks and long-term consequences for the recovery of the sector.

4.40 Assuming the framework falls into place, there are also social and environmental factors that do not foster an enabling environment and unless resolved will also discourage quality private investors. First the authorities need to address labor restructuring in a number of operations, notably Trepça and KEK. The labor restructuring issues are most acute at Trepça where the risk of social unrest and

ethnic disharmony is also the greatest. There are currently 9,500 persons registered as actual or former employees of Trepça. There is an interim program to provide stipends and partial salary to about 4,000 of these. All payments are strictly an interim measure introduced from July 2003 to June 2004. The mining operations of KEK are estimated to be overstaffed by at least 50 percent of the 4,000 miners currently employed. Additional restructuring will also be needed thereafter in line with technological improvements. Additional complexities exist with the need to relocate a nearby village, which sits in the path of future development.⁵⁷

4.41 There are several environmental legacy issues, notably at Trepça and the lignite mines. The environmental issues at Trepça are related to (i) the mining operation and (ii) processing. On the mining side there are abandoned mine waste disposal areas and acidic waters draining from these and the mines. On the processing side the plants were closed as a result of the environmental concerns associated with the heavy metal contamination in the ground and water. In the case of lignite, there are atmospheric emissions from uncontrolled combustion of significant quantities of lignite in the pits as well as the stockpile of flyash (waste product of burned lignite) that has not been appropriately disposed of. Finally, land subsidence around the current pits is causing landslides and altering the flow of sub-surface waters. Current proposals for new investors to assume full responsibility for past environmental legacy issues are likely to further discourage inward investment.

4.42 In the case of the case of the crushed stone and construction materials industry the constraints are similar to those facing all SMEs. In particular licensed operators face unfair competition arising from the informal production of construction materials.⁵⁸ Referred to as “illegal” operators, unlicensed Kosovar operations are similar to artisan mining in other parts of the world.

4.43 Finally, as an energy intensive industry, recovery of the mining sector is dependent upon obtaining a reliable power supply. As we have seen, the power sector is currently not able to provide this. Alternatives such as directly contracting with suppliers in neighboring countries connected to the SEEREM grid remain to be developed.

⁵⁷ Unless the backlog of maintenance and overburden removal is addressed, the mine has reached its physical limits. However, removal of the overburden requires relocation of the nearby village. Furthermore, the current steepness of the pit slopes is well above EU safety standards. Both the village and the mines face the threat of additional landslides that could interrupt the critical supply of lignite and/or injure residents. Until relocation is complete, the mines are under the threat of continued landslides that could temporarily interrupt lignite supply. The power plant stockpiles two weeks of lignite.

⁵⁸ This result was found during interviews with industry representatives, and is also supported by the findings of the Investment Climate Assessment discussed in Chapter 3.

Policy Recommendations

4.44 To conclude, Kosovo does have economic mineral deposits that even in the short term have the potential to improve regional employment prospects through the implementation of interim rehabilitation strategies. In the medium term the sector could become an engine of growth, subject to the successful implementation of industry strategies targeted at attracting private investment to recover the sector.

4.45 This interim period provides a window of opportunity in which the authorities should:

- Improve coordination between UNMIK, PISG, and donors and define a common vision for mineral sector development, the policy should be integrated with energy, environment and social strategies.
- Develop appropriate mineral development laws and regulations that: provide security of tenure and a licensing system for minerals exploration, development and exploitation. The laws should emphasize the primacy of the private sector as the operator of the mines and the role of the State as the regulator.
- Establish a modern cadastre office, to provide for issuance and registration of mining titles.
- Strengthen institutional and technical capacity to manage the implementation of the regulatory framework. In particular, resolve critical social, environmental and safety concerns such as the labor restructuring issues in Trepça and KEK and relocation of the village adjacent to the lignite mines and implement rehabilitation strategies for recovering mining operations in Trepça and KEK.
- Proceed with a well-managed and cautious privatization strategy with great attention paid to the need to attract quality investors to the sector. Consider Ferronickeli as a priority candidate.
- A concerted effort is needed to introduce incentives for the informal crushed stone operators to license their operations, pay royalties, and to comply with environmental and other regulatory standards.
- A comprehensive analysis of the construction materials sector should fill gaps in the geologic information base with new geological mapping of construction material sources; and develop, by location, an inventory of the quality and quantity of construction material production.

D. THE AGRICULTURE SECTOR

Background and Recent Developments

4.46 **Kosovo is endowed with fertile land and a temperate climate suitable for agricultural production.** Though plagued by small farm sizes, low productivity and the absence of advisory services, agriculture still contributes an estimated one third of Kosovo's GDP, employs two thirds of the population and provides about 18 percent of the value of total exports. The shock to domestic production caused by the conflict, resulted in a reliance on agricultural and food imports, which continues to provide intense

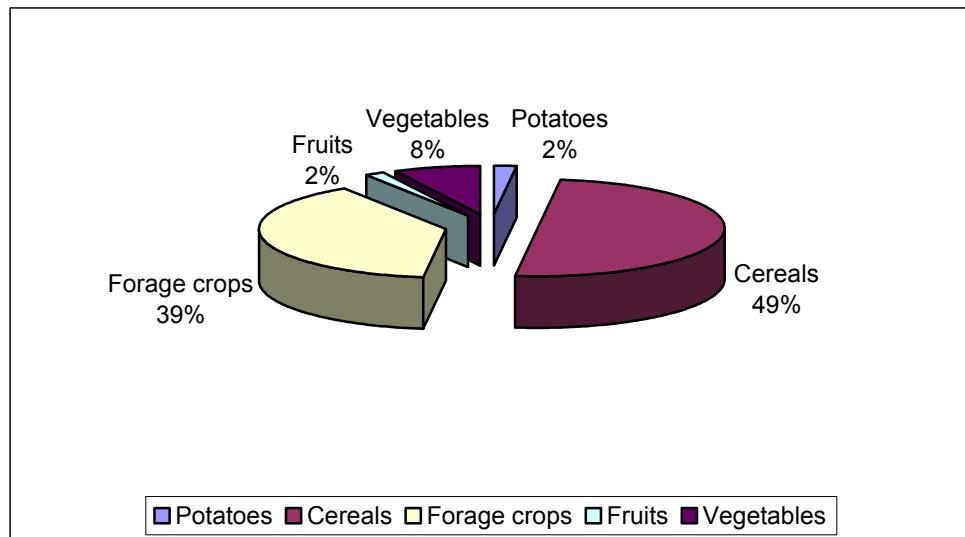
competition to domestic producers. Given the endowment of fertile land, and the abundance of labor working in the agricultural sector, the sector could be a potential source of growth. However, productivity, yields, quality and reliability of supply are just some of the issues that need to be addressed before the sector can compete with products produced in neighboring countries. These are elaborated in the constraints to growth section. Prospects for the sector to develop over the medium-term are then considered before developing a series of policy recommendations.

4.47 The sector suffered greatly during the conflict as most of its capital, machinery and livestock was destroyed. Revitalization has occurred due to the inflow of remittances from the diaspora and emergency donor-funded interventions to restore the livestock inventory, repair and provide new machinery, and rebuild capacity of the agricultural institutions. Since then, agricultural production has rebounded and the sector has shown signs of recovery and expansion. However, the total area harvested has declined by 7 percent between 1998 and 2001, and the total sheep and cattle population have fallen by an estimated 53 and 65 percent over this period.

4.48 The agrokombinats that dominated the agricultural sector prior to 1999, have collapsed. They applied capital-intensive techniques and produced commodities for the SFR Yugoslavia market. They were also the major supplier of agricultural inputs. Now most of the SOEs have collapsed and, in many cases the land remains idle. About 12 percent of total agricultural land (of which 75 percent is pastures or fallow) is owned by the 23 agrokombinats. Of those still in operation they are understaffed, lack inputs and equipment and are producing inefficiently at low capacity. The assets of a number of SOEs have been leased to the private sector for a fixed term, pending a more permanent solution to privatization and restructuring.

4.49 The vast majority of agricultural land and livestock is owned by the private sector: approximately 88 and 95 percent respectively. Small farms with rudimentary production technology, producing primarily for home-consumption, dominate agricultural production. Seventy percent of households own an average land size of 3.5 hectares. A further 15 to 20 percent are semi-commercialized farms with about 5 hectares; and 10 percent are fully specialized commercial producers. The current cropping pattern in Kosovo is shown in Figure 4.1.

Figure 4.1: Cropping Pattern in Kosovo, 2001



Source: Statistics on Agriculture in Kosovo, Statistical Office of Kosovo, Food and Agricultural Organization of the United Nations, MAFRD, 2001.

Medium Term Outlook

4.50 **It is unlikely that Kosovo will have a comparative advantage in the production of high volumes, low value commodities such as grains. It is much more likely given the small land holdings, that vegetables, meat and poultry will provide growth prospects** Although cereals (wheat and maize) remain the dominant crops in Kosovo, total production has fallen since the 1990s (wheat fell by 25 percent between 1989 and 2001and maize by 19 percent from the mid-1990s to 2001), partially due to the loss of machinery making extensive-type farming operations uneconomical. Where we have seen growth in domestic production, as well as exports to EU and regional markets, is in fruits, vegetables, animal products and wine. Vegetable exports have averaged 64 percent of agricultural and food exports and around 10.5 percent of total exports and major trading partners include Albania, Italy, and Germany.

4.51 **Fostering the agrifood sector is the fastest and most promising approach for agricultural private sector development, and this will rely in the first instance on improving conditions for upstream semi-commercial and commercial farmers.** During the last couple of years, there has been a growth in private sector agro-processing

activity, mainly in: fruit juice, poultry, flourmills and bakeries; slaughterhouses; and small dairies.⁵⁹ The prospects for the agricultural sector are reliant on growth in commercial and semi-commercial operations and in the agro-processing or agrifood sector.

4.52 Growth upstream can be expected to create more jobs for farmers in the supply chains. To ensure that farmers are incorporated into the supply chain the necessary extension and support services need to be provided to improve local productivity. Local associations will also need to be better organized if they are to respond to these opportunities. One full time agricultural producer might create indirectly three to four more jobs, which if there is a domestic supply response could result in an additional 100,000 to 150,000 jobs in total. Certain sub-sectors that already show signs of growth and potential comparative advantage include:

- Vegetable production especially potatoes,
- Meat production, and
- Poultry sector and egg production.

4.53 Although not yet proven, marketing research in fruit production, viniculture, dairy and production for niche markets: honey, flowers, mushrooms, medicinal and culinary herbs, and sheep cheese, suggest there may also be potential for Kosovo to export in these sub-sectors.

Obstacles to Growth

4.54 **At the moment agricultural productivity and yields are low, as a result of small farm sizes, lack of technical expertise and poor use of inputs.** Faced with needing to find savings to restock their farms, many farmers reduced their use of inputs. In the case of dairy farmers, low quality feed results in low yields in winter months. There has been some recovery in crop production and yields, while low, have improved to 3 tons/ha. Small farm-sizes mean that farmers cannot take advantage of economies of scale e.g., in the use of mechanization. This is particularly the case for large-scale low value-added crops, but is also a constraint in scaling-up vegetable and fruit production. In many cases even basic production knowledge is limited, and access to the technical expertise and marketing skills required to produce quality products that can compete in export markets is a major constraint to agriculture production. For example, livestock producers were found to have limited knowledge of least-cost feeding requirements and veterinary needs results in milk yields of 1,500 liters per cow per annum.

⁵⁹ There are approximately 1,350 registered businesses in the food, beverages and tobacco sector.

4.55 The SOEs are no longer playing a critical role in providing collection points, price information, quality control standards, and agricultural inputs, and the public and private sector are only gradually filling the vacuum. Producer, processor and trader organizations have recently been established, many driven by financial assistance from donors and less by the market needs within a specific activity. Very few associations have been successful in providing assistance in the form of input procurement, production assistance, access to credit, marketing of produce, training and other activities. A recent survey indicated that almost half of all the farmers had never received any form of advisory services. With greater organization in the sector, the fixed costs of attaining technical information and best practice is shared among producers. With insufficient information on how to improve continuity of supply and quality products, the majority of farmers remain engaged in subsistence agriculture.

4.56 Agricultural imports that receive production and export subsidies place Kosovo farmers on an uneven playing field. Table 4.3 shows the value of agricultural imports from the region. Production subsidies and export subsidies for agriculture are given in many of the originating countries. For example, in the case of milk, subsidies of 8.5, 6.6 and 6.0 cents per liter are provided in Montenegro, Slovenia and Serbia respectively. Agricultural subsidies in neighboring countries enable better quality products at lower prices to enter the market in Kosovo.

Table 4.3: Kosovo Imports By Type And Countries Of Origin (€ million)

Imports	2002	2003/1	Source
Agricultural & Food Products	97.76	86.58	
Live animals; Animal products	20.06	16.39	Austria, Bulgaria, FYROM, Germany, Greece, Hungary, Poland, Slovenia, Serbia, US
Vegetable Products	11.51	13.25	Ecuador, FYROM, Greece, Italy, Serbia, Sri Lanka, Turkey
Animal or Vegetable Fats and oils and their cleavage products; Prepared edible fats; Animal or Vegetable Waxes	2.85	2.92	Bulgaria, FYROM, Greece, Serbia
Prepared Foodstuffs, Beverages, Spirits and Vinegar, Tobacco and Manufactured Tobacco Substitutes	63.34	54.02	Austria, Croatia, FYROM, Greece, Serbia, Slovenia, Turkey
Non Agricultural, Non food Imports	234.96	182.43	
Total	332.72	269.01	

Note: 1/ Data until the third quarter 2003.

Source: Agricultural Statistics Database, MAFRD, UNMIK Customs Administration

4.57 Kosovo is unable to meet the safety, sanitary and phytosanitary and other requirements for food products. The basic requirements are in place, but of increasing importance are the requirements of private buyers, which often are greater than the public safety standards, and include additional specifications relating to quality, packaging, quantities and reliability of delivery. Private-sector standards are part of the competitive

strategy of major market players that increases product differentiation. Meeting these standards remains a challenge.

4.58 Although credit has grown considerably, only 2 percent of the total credit given by commercial banks in 2002 was to the agriculture sector. The main problem is the lack of quality of investment projects and the risks involved in lending to the agricultural sector. In addition, only a limited range of financial products is on offer and few are designed for the credit needs of the agricultural enterprise. Credit is extended either in the form of large loans for big producers, or very small, high interest, short-term micro-finance loans for seasonal activities. The higher-end of the market is better able to access credit for larger agro-processing firms.

4.59 Finally, problems referred to elsewhere in the report, such as the difficulties in attracting FDI, the uncertain status of SOEs, and the constraints felt by the SME sector all apply in the agriculture sector. In particular, the incomplete rehabilitation of rural roads, irrigation network and for agro-processors, the power sector, raises the costs of production. Additionally, unresolved issues of land administration and ownership constrain farmer's investment decisions, restrict the land-market, and cause problems in accessing credit.

Policy Recommendations

- Transferring technical knowledge is needed to improve productivity, production capacity and increase the competitiveness of domestic producers and agro-processing firms. The public sector should refrain from initiating a universal extension service for all farmers. Rather, the focus should be on facilitating the entry of foreign agro-processors that typically provide relevant information, in response to the information needs demanded by the commercial farm sector.
- Improve capacity to address food safety and standards concerns by ensuring that the appropriate regulations are in place and are enforced, including implementation of the Veterinary Law, Seed Law, and Plant Protection Law.
- Incorporate special agricultural safeguard measures in trade agreements and the Customs Code to address cases of unfair competition from agricultural imports. These should be specific time bound retaliatory measures, similar to those outlined in the WTO Agreement on Agriculture.
- Complete rehabilitation and possible extension of rural infrastructure including rural roads, irrigation and the power sector.
- Develop a sound land administration system by supporting the creation and enforcement of property rights, titling and registration programs, mechanisms for transfer of land rights, dispute resolution and revenue collection is needed.

E. SECTORAL CONCLUSIONS

4.60 To conclude there are a number of constraints facing all three economic sectors. While there are prospects for recovery and export led growth, substantial progress with

rehabilitation, reform as well as a favorable external climate will all be required. Substantial export earnings might be anticipated in the energy and mining sectors in time, however given the considerable investment required, security of assets and political stability are likely to be a pre-requisite. In the agriculture sector, there are signs of recovery already with an increase in production and agro-processing activity. Pursuing joint-ventures and links with foreign firms will maximize opportunities for the technological upgrades needed to make Kosovo producers more productive and competitive in the region.

5. THE IMPACT OF THE LABOR MARKET

A. INTRODUCTION

5.1 Even with the relatively favorable trade and business environment, official surveys demonstrate persistently high rates of unemployment in Kosovo. The 2001 and 2002 Labor Force Surveys (LFSs) indicate that approximately fifty percent of the labor force was unemployed during these years.⁶⁰ Such high rates are not a new phenomenon: the unemployment rate was estimated to be 36 percent in 1990 and 68 percent at the end of the decade. Still, the rates are high compared to other Southeastern European countries, despite a relatively low level of payroll taxes and a flexible labor market. Seasonal employment in the agriculture sector and informal market cushions the impact of formal unemployment, and for many households, access to remittances from family members moderates the impact on incomes.

5.2 The analysis that follows finds that with seasonal and informal work taken into consideration we find that the official rates would be brought down to a seasonally adjusted unemployment estimate between 23 and 33 percent.⁶¹ Unemployment is predominantly long-term, and the unemployed are mainly women, youths and less-educated. Unemployment is not yet due to labor restructuring but rather to insufficient demand in the formal sector. In the second section of this chapter we examine the labor market institutions and legal framework to assess the flexibility of the labor market, before looking in more detail at the issue of youth unemployment and drawing some conclusions and policy recommendations in the final section.⁶² The key message is that the labor market is considered relatively flexible and policies should concentrate on generating growth and job creation, rather than active labor market policies that are unlikely to have a positive effect unless there is output growth.

⁶⁰ The lack of time-series data clearly limits analysis, particularly the absence of survey and administrative data on employment and wages for 1990-1999. The 2001 and 2002 Labor Force Surveys represent the best insight into the functioning of the labor market and the dimensions of unemployment. They are the primary source used in this chapter.

⁶¹ Based on data comparisons Living Standards Measurement Survey (LSMS), 2000 RIINVEST Survey, 2003 and the World Bank Study of the Informal Market, conducted by Prism Research.

⁶² For additional analysis of the Kosovo labor market see World Bank (2003b).

B. LABOR MARKET OUTCOMES

High, Long-Term Unemployment Persists Despite an Increase in Employment Opportunities

5.3 There has been an increase in formal employment since the end of the conflict beyond levels at the end of the 1980s. Non-seasonal employment measured by the 2002 LFS was about 255,000 workers, compared to 243,000 in 1989. Nearly 50 percent of these jobs are in the public sector. Of those employed in the private sector, the majority is employed in small and medium-size enterprises: 91 percent work in a firm with nine or fewer employees, and 64 percent are in the agriculture sector.

5.4 At the same time unemployment has remained high, even by regional standards. The registered unemployed number 258,000. From the LFS, the unemployment rate using the standard International Labor Organization (ILO) definition was 47 percent in 2002, almost fifty percent higher than the rate in Macedonia, and significantly higher than other Balkan countries.⁶³

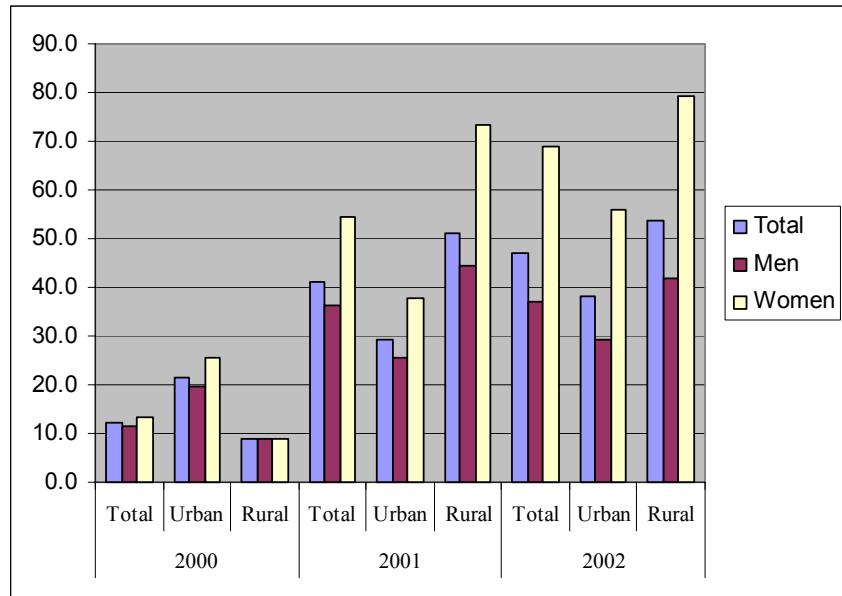
5.5 Unemployment is particularly difficult to measure in Kosovo. A survey of informal sector activities in Kosovo revealed that Kosovars think of work as essentially formal employment (i.e., with a secure and steady paycheck). As a result, many do not consider themselves to be “working” even though they would be counted as employed in standard labor market analysis. Of those surveyed approximately half were working in the informal sector by two criteria of informality, (i) whether they had a signed contract and (ii) whether the enterprise was registered. They were engaged in a variety of informal activities the most common of which was growing crops in a garden or private plot and about one third of informal jobs were in a small, unregistered enterprise. This could suggest that approximately an equivalent number work in informal employment, as are formally employed.

5.6 As can be expected, given the predominance of the agricultural sector in employment in Kosovo, unemployment is highly seasonal. Chart 5.1 compares the results of the Living Standards Measurement Survey (LSMS) data in June 2000 with the LFS data of winter 2001 and 2002. A comparison of rural unemployment rates during December and June demonstrate that in the summer months, unemployment may be as low as 10 percent, while in the winter it rises to between 40 and 50 percent. Some of this difference may be due to the different survey approaches used, but in urban areas, there is

⁶³ LFS unemployment rates were adjusted to not count as unemployed those persons whose only way of searching for a job consisted of “being registered with employment offices”. The definition of unemployed used is he/she is of working age, not employed, seeking work in the last four weeks and available for work.

a much smaller difference between the unemployment rates measured by the three surveys. (Although unemployment is still higher in 2001 and 2002).

Chart 5.1: Rural and Urban Unemployment Rates, 2000 to 2002



Source: LSMS June 2000, LFS November/December 2001 and 2002.

5.7 World Bank estimates adjusting for seasonality and the extent of informality result in alternative unemployment rates of between 23 and 33 percent in 2002. Alternative estimates were produced adjusting for the fact that the LFS data report unemployment at its seasonal peak, and secondly using results from the informal study that show respondents to adjust for those working in the informal sector that (i) may not have been included as participating in the labor force and (ii) if counted in the labor force, classified as unemployed.

Young Population and Low Labor Force Participation

5.8 The population in Kosovo is one of the youngest in Europe: one-third is under 15, and about half is under 24. Only about 6 percent of the population is older than 65. High population growth after World War I came to a halt in the 1990s. Ethnic and political tensions in the region resulted in reduced fertility, increased mortality, and induced many individuals to emigrate. Still, the natural rate of increase is believed to be one of the highest in Europe, and the lower population growth in the 1990s may therefore be a temporary phenomenon.

5.9 Labor force participation rates are extremely low, even by regional standards. In 2002, the rate is estimated to be 41 percent, and only 27 percent for women. According to the LFS data, participation rates are also lower in urban areas. Education is an important determinant of labor force participation, not surprisingly, the probabilities of participation increase with all level of education.

5.10 Analysis of the LFS results allows a decomposition of the registered unemployed, revealing that in 2002 only about 29 percent of those registered as unemployed were actually unemployed by the ILO definition. There are incentives to register, even if working informally, as access to social assistance requires beneficiaries to be registered at an employment office. Conversely, about 154,000 would be considered unemployed by the ILO definition, but were found not to approach employment offices to register as unemployed. See Box 5.1.

5.11 We find that the number of discouraged workers has more than halved from 18,000 in 2001 to 7,000 in 2002. Discouraged workers are those that are (i) not employed, (ii) available (able and ready) for work, (iii) wanted to work, but (iv) not looking for a job because they believe that there are no suitable work available. Given the number unemployed increased from 159,000 to 228,000 over this period, it indicates that discouraged workers have simply become unemployed.

Box 5.1: Labor force status of registered unemployed, 2002

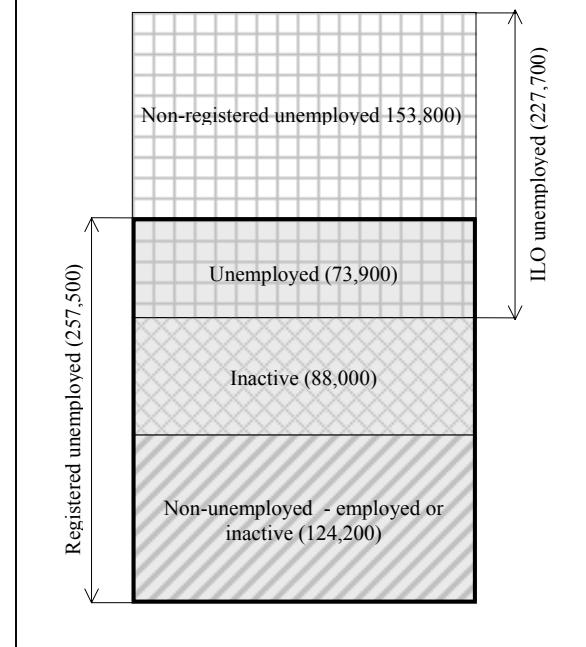


Table 5.1: Characteristics of the Labor Market, 2002

	2002
Unemployment rate (in %)	47.2
Males	36.9
Females	68.9
Aged 15-19 years	79.4
Aged 20-24 years	69.0
Youth unemployment (as share of total unemployed)	40.6
Long-term unemployment (as share of total unemployed)	73.1
Labor force participation rate (in %)	41.3
Males	55.5
Females	26.9

Notes: Long-term unemployment is for more than 1 year.

Source: World Bank estimates based on LFS, 2002 .

Long-Term Unemployed, Women And Youths Are Disproportionately High Among The Unemployed

5.12 As Table 5.1 shows long-term unemployment constitutes the majority of the unemployed: LFS data indicate 73 percent have been out of work for more than one

year. Of the unemployed 47 percent have been unemployed between two and four years, and a further 25 percent have been unemployed for more than four years. Data from 2001, reveal that of those with previous work history, 36 percent were last employed before 1999. Given the prospects for finding work are generally found to diminish with time spent in unemployment, addressing the low mobility out of unemployment is a concern for government policy.

5.13 There is an extremely high unemployment rate among women: almost 70 percent of women were unemployed in 2002. The rate is worse for young women: among the 15 to 24 years age group it is almost 95 percent in urban areas. More generally, youth unemployment is a particular feature of the labor market. Almost 41 percent of the unemployed in Kosovo is aged between 15 and 24 (both male and female) and 88 percent are first time job-seekers. The youth unemployment rate is approximately twice that of the adult unemployment rate.⁶⁴

5.14 The higher the educational level of workers, the greater their employment and the lower their unemployment, rates. Of those with unfinished or elementary education, unemployment rates are 66 and 64 percent respectively. With each level of education attained unemployment rates fall on average. Among those with high school or university education the unemployment rates are as low as 33 percent and 10 percent respectively. Although in urban areas there is a lower unemployment rate (50 percent) among those with unfinished schooling compared to those with elementary education (62 percent).

5.15 The probability of unemployment however, is somewhat higher by 6 percentage points for non-Serbian minorities in urban areas, and by 8 percentage points for Serbs, in rural areas. **There are no statistically significant differences along ethnic lines determining the probability of employment.**

Labor Market Restructuring

5.16 **Lay-offs account for only two percent of the unemployed, and hence unemployment is not a result of SOE restructuring.** In Kosovo, where the public enterprise sector has been in decline for at least the last decade, labor restructuring problems are not of the same magnitude as experienced elsewhere in Eastern Europe and the Former Soviet Union. However, the delays to SOE and POE restructuring mean that the issues of overstaffing in many of these, remain to be addressed. As we shall see in the next chapter overstaffing in KEK and the need to address the excess labor still on the books of the lead/zinc mine are concerns for the revitalization of the power and mining sectors.

⁶⁴ Data are from LFS 2001 see Kolev and Sagent (2003).

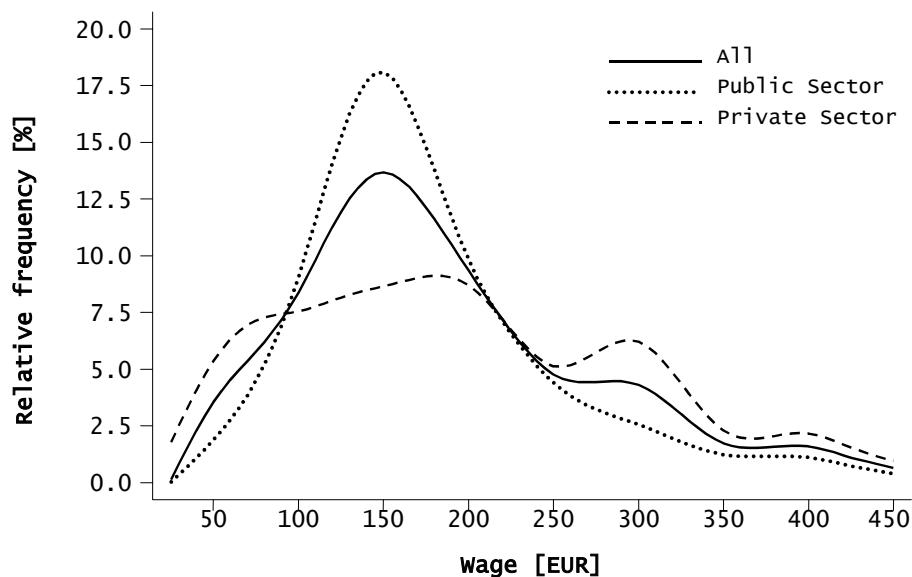
C. LABOR MARKET INSTITUTIONS

5.17 A well functioning labor market can help ensure that growth is labor-demanding, that workers are allocated to jobs where their skills can be most productively used and that accurate signals are provided for investments in human capital. Labor market institutions have a role to play in facilitating labor mobility by providing labor market information to address frictions in the market and providing information to training providers on skills mismatches.

5.18 Since 1999, previous labor market legislation was put out of force and the labor market has functioned in a virtually unregulated way, with few formal arrangements regulating employment relationships and wage determination. Above all, the Labor Relations Law and collective agreements are no longer in effect. Kosovo's labor market policies are generally on track to provide the flexibility that characterizes well-functioning labor markets in market economies. In particular, the low level of payroll taxes is extremely important in keeping the cost of labor down.

5.19 Since Kosovo has been operating under exceptionally little labor market regulation, and in the absence of a collective bargaining framework, the market largely determines wages. The average monthly wage amounted to € 197. In 2002, private sector wages exceeded wages in the public sector by an average of 16 percent, and exhibited a much greater degree of dispersion. Note the data precede the 20 percent wage increase granted to some public sector workers in mid-2003 and the 5 percent increase budgeted in 2004. Chart 5.2 shows the distribution of net monthly wages.

Chart 5.2: Distribution of Net Monthly Wages by Public and Private Sector, 2002



Source: World Bank (2003b).

5.20 Men's wages were about 10 percent higher than women's on average and the gap is greatest in the private sector. However holding individual characteristics constant the gap is much lower overall, and statistically insignificant in the public sector. Similarly the gap between Albanian and Serb earnings is insignificant in the public sector, yet in the

private sector Serbs earn 36 percent less than Albanians. This may be a result of difficulties in access to jobs and suitable opportunities, which result in accepting lower pay. There are positive returns to education in both the public and private sectors. Although these premiums are low by international standards and further investigation as to why this might be the case is warranted.

5.21 While standards should rise with development “too much too soon” could undermine the Kosovo’s comparative advantage of a relatively low cost, labor abundant economy. Indeed, the risk of income poverty is substantially smaller for those employed and higher for those unemployed than the average risk for the population. Risks of income poverty greatly increase for those unemployed for more than two years, and for households where no member is working. Generating employment should therefore be the overriding concern.

5.22 To ensure workers rights, a basic Labor Code was put in place (“Essential Labor Law in Kosovo”, Regulation No.2001/27) in 2001. The labor code provides a flexible regulatory regime. It is appropriate for the present, where there is a large informal and SME sector. Experience shows that there is an inherent trade-off between increasing standards and security and keeping labor costs low in order to favor employment intensive output. As the market develops, a somewhat more elaborate code, especially with regard to employment and working conditions, including temporary and part-time work, notification requirements and unfair dismissal provisions, would be called for. Provision for temporary and part-time employment are important elements in increasing labor market flexibility and employment opportunities which go hand in hand with increasing the participation of women in the labor force.

5.23 Under the Ministry of Labor and Social Welfare, regional and municipal employment offices have been established in all regions. Also under the responsibility of the Ministry are eight Vocational Training Centers, which identify training needs and provide training for the registered unemployed.

5.24 Two important income support programs that have an important bearing on the labor market have been introduced: a new pension scheme and a poverty-targeted social assistance program. These are the main income transfer programs in place. While they represent a safety net for the poor, there are no schemes targeted explicitly at unemployed workers. A modest payroll tax has been introduced to finance a funded pension scheme.⁶⁵ Policymakers should be cautious about unduly increasing the payroll tax as a means of

⁶⁵ Indicatively, assuming a wage elasticity of labor demand of - 0.5, which is at the lower bound for OECD countries, a 10 percent increase in the payroll tax would increase gross wages by around 4 percent and induce about a 2 percent decrease in formal employment. Lowering payroll taxes will also have a fiscal impact. Assuming a wage elasticity of - 0.5, the 10 percent increase in payroll taxes would lead to an 8 percent increase in revenues.

financing various safety net programs: low payroll taxes are a positive feature of the Kosovo labor market which keep labor costs down, especially compared to neighbors. Still, over time safety net programs that focus on the labor market would have an important role to play in increasing labor market efficiency and worker welfare— well-designed, they facilitate the job search process and the transition between jobs, serving as a conduit for a better resource allocation, increased earnings and higher employment.

D. YOUTH, SKILLS AND ACCESS TO JOBS

5.25 As in other countries in Southeastern Europe Kosovo faces high unemployment rates among the youth. In fact the ratio of youth to adult unemployment rates in several neighboring countries is even higher than that in Kosovo, ranging from 2.2 (FYR Macedonia) to 3.9 (Romania). Clearly, one of the necessary conditions for improving access to jobs for young adults is an increase in aggregate output and demand. However, given the unemployment rates of youth are much higher than for adults, we examine in this section whether they face any additional supply-side constraints or barriers to successfully finding employment.

5.26 In examining whether the youth face any particular constraints we consider the following possibilities (i) their skills are not appropriate for the labor market and (ii) the youth face particular barriers to entry to the SME sector where there has been most job creation.

5.27 In 1991-92 the majority of ethnic Albanians left the formal education system in protest over Belgrade-introduced policies, and entered what has become known as the parallel education system. The 1999 conflict brought further dislocation, extended closures and widespread damage to school facilities. Since then, under the UNMIK and PISG administrations, schools have been repaired and children encouraged back into the formal system. However, the cohorts most affected by these disruptions are now facing the difficulties in the labor market today: those aged 19-24. Although given that teenagers (aged 15 to 19) are facing even higher unemployment rates this would imply that even under the new education system, graduates face difficulty finding a job.

5.28 There has been considerable progress in addressing the challenges to rehabilitate and upgrade school facilities, school curriculum and training of teachers. In 2003, 16 percent of government expenditure was allocated to education, which is high compared to the region. Furthermore, there is no conclusive evidence that under funding education programs is associated with higher youth unemployment. Although further investigation would be needed to draw any conclusions it might be the case that the efficiency and

equity of spending is much more significant in youth employment than the overall level of spending.⁶⁶

5.29 An alternative hypothesis is that job-seekers without a prior employment history have a greater risk attached to them by employers, as a result of an education signaling failure, caused by disruptions and lack of a tried and tested certification system for exit from education. However, business surveys find that the majority of employers have a higher regard for workers the higher their education level. The majority considers the performance of workers with university education as very good, and secondary education as very good or average, suggesting the education system does still provide a reliable signaling effect. However, lack of practical knowledge was considered the main problem with recruiting new graduates. Lack of work experience especially when combined with low skills would, therefore, represent a barrier to employment entry for school leavers.

Table 5.2: Worker Evaluation by Formal Education Qualification

Evaluation Criteria	University (%)	Secondary School (%)
Very Good	72.5	32.1
Average	26.2	60.9
Not Satisfied	1.3	7.0
N.A.	---	---
Total	100	100

Source: Promoting Economic Development Through Civil Society: Second Phase: Results of the Survey of Small and Medium Private Enterprises (SME) in Kosova, RIINVEST, December 2002.

5.30 **Generally we find that surveys of the SME sector do not find that the skills of the labor force are a major obstacle to their business.** Given the majority of enterprises are engaged in low-skill operations this may not be surprising, and it remains to be seen whether new service-based enterprises, e.g., in finance or IT sectors would similarly consider the labor force, particularly the youth, as possessing adequate skills.

5.31 The predominance of the SME sector in job creation raises the question as to whether the youth face any particular barriers to self-employment such as (i) lack of business skills, (ii) difficulty in securing start-up funds and (iii) more limited social capital and networks. While this might be the case for other countries in the region it is not borne out by the evidence in Kosovo. The share of self-employment in total employment is actually higher for youths than it is even for adults.

⁶⁶ See Kolev and Sagent (2003).

5.32 Finally, it could be the case that the youth are willing to spend longer in unemployment while searching for work. While there is no unemployment benefit scheme in Kosovo, the presence of remittances in household income might raise the reservation wage of the unemployed including the youth. Furthermore, the returns to seasonal work or work in the informal sector may compare favorably with the wage for first-time employees in the informal sector. These are all issues that could benefit from further investigation, but go beyond the scope of this report.

E. POLICY RECOMMENDATIONS

5.33 The following policy recommendations are proposed:

- Resist the introduction of unemployment insurance or assistance. The uncertainty surrounding future fiscal risk, and the need to be prudent with recurrent public expenditures make such large commitments with public resources unattractive policy options at this point in time. Moreover, given the high rates of unemployment and the need to ensure a regionally competitive labor force, now is not the appropriate time to add to the payroll tax and labor costs.
- Strengthen the social assistance benefit, to better target the poor including the unemployed who are also poor.
- Improve labor mobility by improving the Labor Market Information System and linkages with the Education Management Information system. The data should be used together with enterprise survey information to improve targeting of vocational training at employment centers and facilitate job search.
- Given youth and women unemployment concerns, pursue the most cost-effective interventions to improve employability by improving access and quality of primary and secondary general education.
- Address overstaffing in POEs, SOEs and other public institutions in a comprehensive way that facilitates the redeployment of workers to more productive activities and within a fiscally sustainable envelope.

STANDARDS for KOSOVO

"A Kosovo where all - regardless of ethnic background, race or religion - are free to live, work and travel without fear, hostility or danger and where there is tolerance, justice and peace for everyone."

Presented Pristina,10 December 2003

Standards for Kosovo

I. Functioning Democratic Institutions

The Provisional Institutions of Self-Government (PISG) are freely, fairly and democratically elected. The PISG governs in an impartial, transparent and accountable manner, consistent with UNSCR 1244 and the Constitutional Framework. The interests and needs of all Kosovo communities are fully and fairly represented in all branches and institutions of government. Those communities participate fully in government. The laws and functions of the PISG approach European standards. The PISG provides services for all people of Kosovo throughout the territory of Kosovo; parallel structures have been dismantled.

Elections

- Elections are regular, transparent, free and fair, conforming to international standards, allowing the full and peaceful participation of all communities and ethnic groups.
- Internally-displaced persons and refugees continue to be fully included in the Kosovo election process and their ability to vote is facilitated.
- An independent, representative and multi-ethnic Central Election Commission administers elections.
- A range of democratic political parties contests elections.
- A comprehensive legal framework covering political party operation and finances is adopted and enforced.

Provisional Institutions of Self-Government (PISG)

- All communities are proportionately represented at all levels of the PISG, in accordance with applicable legislation. The PISG and local municipal government decide and enact legislation in an open, accountable and democratic manner.
- All official languages are respected throughout the institutions of government.
- The PISG and municipalities ensure the availability of basic public services, such as health care, utilities and education, without discrimination, to all communities in Kosovo.
- The civil service is professional, impartial and accountable, representative of all communities in Kosovo and includes a significant proportion of women.
- All communities have fair access to employment in public institutions.
- Codes of conduct and enforcement procedures exist to provide for transparent and accountable government; recommendations of the Ombudsperson are given full weight.

- Regular and independent audits of the KCB, Assembly, government ministries and municipalities.
- Allegations of misconduct are thoroughly investigated, elected officials and public servants responsible for unethical, fraudulent, or corrupt behavior are effectively disciplined.
- Proposed Assembly legislation is reviewed and cleared by the Assembly Committee on Rights and Interests of Communities prior to adoption by the Assembly.
- Women participate in the institutions of the PISG at rates that equal or exceed rates in the region and the interests of women are fully reflected in its policies and legislation.
- The proposals on decentralization of the Council of Europe have been examined and considered with the aim to create functional structures of local government.
- Parallel structures for the provision of services have been dismantled or integrated into PISG structures.

Media and Civil Society

- A range of private, independent print and broadcast media exists, providing access to information for all communities throughout Kosovo.
- There is an independent and effective media regulatory authority, aspiring to European standards, recruited without discrimination and according to merit
- Hate speech, or any form of incitement, is condemned by political leaders, the media regulatory authority and media commentators.
- Publicly-funded media devotes a full and proportionate share of its resources and output to all ethnic communities.
- Non-governmental organizations, in particular those representing minorities, are able to operate freely within the law and individuals are free to join them without discrimination.

II. Rule of Law

There exists a sound legal framework and effective law enforcement, compliant with European standards. Police, judicial and penal systems act impartially and fully respect human rights. There is equal access to justice and no one is above the law: there is no impunity for violators. There are strong measures in place to fight ethnically-motivated crime, as well as economic and financial crime.

Equal Access to Justice

- All crime is thoroughly investigated, regardless of the ethnic background of the victim or perpetrator.
- The prosecution and conviction of perpetrators of crime is consistent and effective, regardless of the ethnic background of victim or perpetrator.
- Substantial progress has been made in solving the most serious murders and assaults against members of ethnic minorities.
- Witnesses are effectively protected from intimidation and retribution.
- Crime clearance rates for crimes of violence against persons of all communities are roughly equivalent.
- Misconduct by judges, prosecutors, attorneys, police, and penal system employees is routinely investigated and appropriately punished.
- There are professional codes of conduct for judges, prosecutors, lawyers and other members of the police and penal system, including a Bar Association representative of all Kosovo communities.
- Acts of retribution against individuals involved in disciplinary processes are rare and such individuals are adequately protected.
- All communities are fully and fairly represented amongst judges, prosecutors and in the Kosovo Police Service (KPS) and Kosovo Corrections Service (KCS).
- Institutions are functioning to train and educate the police, judges, lawyers, and penal system managers.
- An effective and impartial system of justice in the civil law sector is accessible to members of all communities in Kosovo.
- The backlog of civil law cases in courts is steadily being reduced.
- Judgments in civil law matters are being enforced, court execution officers are functioning, and court fines are routinely being paid.
- Legislation in civil law matters is reviewed and developed to ensure greater conformity with European standards.
- Alternatives to litigation for resolving civil disputes are expeditiously developed and effectively used.
- There is effective action to eliminate violence against women and children, trafficking and other forms of exploitation, including preventative education and provision of legal and social services to victims.

No One is Above the Law

- All crimes, especially those of violence that promote inter-ethnic hatred and fear are thoroughly investigated and resolved, and perpetrators are brought to justice and punished.
- Incidents of organized crime, trafficking, crime rooted in extremism, terrorism, and economic crime are vigorously investigated and local judges and prosecutors effectively prosecute and try perpetrators. The percentage of unsolved cases of crime rooted in extremism or terrorism is steadily declining.
- Perpetrators of assaults on judges, prosecutors, KPS officers and witnesses are fairly tried in local courts and are sentenced appropriately.
- Mechanisms of regional and international cooperation are functioning for police and judicial authorities, including transfer of suspects and sentenced persons, and mutual legal assistance to jurisdictions.
- There is full cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY), including arrest of indictees and provision of witnesses and information.
- Those war crimes not addressed by the ICTY are prosecuted fairly in Kosovo.

Economic and Financial Crime

- Effective legal, financial and administrative mechanisms that conform to EU standards are in place to tackle economic crime in both the public and private sectors, including seizure of illegally-acquired assets.
- There is a clear understanding amongst the vast majority of public sector employees of ethical conduct requirements, especially regarding conflict of interest.
- Adequate investigative mechanisms have been created and are functioning effectively.
- Money laundering legislation is effectively implemented and suspicious financial transaction reporting is in place.

III. Freedom of Movement

All people in Kosovo are able to travel, work and live in safety and without threat or fear of attack, harassment or intimidation, regardless of their ethnic background. They are able to use their own language freely anywhere in Kosovo, including in public places, and enjoy unimpeded access to places of employment, markets, public and social services, and utilities.

Freedom of Movement

- All communities are able freely to exercise rights to social, cultural and religious expression, including attending ceremonies and access to relevant sites.
- Military and police escorts are no longer needed; members of all ethnic communities have access to safe and public transportation.

- Public employees from minority communities are able to work in majority areas without difficulties.
- The number of crimes specifically related to movement by minorities (e.g. stoning incidents) is significantly reduced and infrequent.
- Political leaders, without prompting, condemn and take action against acts of violence against ethnic communities and their members.

Free Use of Language

- Meetings of the Assembly and its committees are conducted in all official languages.
- Official municipal and ministry documents are translated in a timely manner into all official languages.
- Personal documents are issued in the native language of the recipient.
- Official signs inside and outside municipal and ministerial buildings are expressed in all official languages.
- Names of streets, cities, towns, villages, roads and public places are expressed in Albanian, Serbian and any other language of a community that lives there in a significant number.
- Municipalities and ministries provide adequate interpretation and translation services for all communities, including translation of all official documents and interpretation for all official meetings in relevant languages.

IV. Sustainable Returns and the Rights of Communities and their members

Members of all communities must be able to participate fully in the economic, political and social life of Kosovo, and must not face threats to their security and well-being based on their ethnicity. All refugees and displaced persons who wish to return to Kosovo must be able to do so in safety and dignity.

Rights

- The laws of Kosovo provide a full range of protection for human rights and the rights of communities and their members, consistent with European standards.
- A comprehensive and effective structure is in place within the PISG to monitor compliance with human and community rights and to respond to violations.
- Existing mechanisms within municipalities responsible for protection of human and community rights (Municipal Community Offices, Municipal Assembly Communities and Mediation Committees) have adequate resources and staff, and are functioning effectively.
- Kosovo participates in the Council of Europe implementation process for the Framework Convention for the Protection of National Minorities and fully implements recommendations resulting from that process.
- There is fair distribution of municipal and ministerial resources to all communities.
- The educational curriculum encourages tolerance and respect of the contributions of all communities to the history of Kosovo.

Returns

- The number of municipalities with sustainable returns increases, including an increase in returns to urban areas, the pace of returns overall accelerates, and the level of unmet demand for return has been substantially reduced.
- Returnees to Kosovo are able to participate in the economy and job market without discrimination and limitations based on the freedom of movement. Health care, social services, education and public utilities are available to returnees on a level equal to that of the rest of the population.
- Returnees face no greater risk of violence than the population as a whole, and police and the judiciary respond promptly and without discrimination to crimes, irrespective of the ethnic background of the victim.
- Municipalities and ministries are able to assume responsibility for returns within all communities in a manner consistent with European standards.
- Funding is allocated from the KCB to support returns projects and smaller communities.
- Visible support of the returns process by community leaders and public information and education efforts supported by the PISG create a climate of tolerance and support for the right to return.
- PISG support for returns, including financial assistance, is distributed equitably to all communities.

V. Economy

The legal framework for a sustainable, competitive market economy is in place and implemented. The minimum essential conditions are a legal and institutional base which act without discrimination against any individual or company; a regulatory system conducive to business that is capable of holding governmental officials and the private sector accountable; a tax regime that sustains the essential functions of government and an infrastructure that provides basic services and facilitates investment. The goal is to move Kosovo towards the achievement of European standards.

- Basic economic legislation is in place and enforced.
- Relevant government institutions and services are functioning.
- The budget process is functioning and meeting all legal requirements.
- Economic statistics are available and regularly published, including on GDP, inflation, trade and unemployment.
- Privatization and liquidation of Socially Owned Enterprises are well advanced; Municipal Authorities and relevant governmental structures support a smooth and reliable transfer of ownership rights.
- Restructuring of Publicly Owned Enterprises, based on independent audits, is progressing and fully backed by the PISG.
Supervision over commercial banking, insurance and pension scheme is reliable and effective.
- Kosovo wide billings approach *100 percent* of services provided by KEK, PTK and water sector utilities, and collections approach at least the levels of neighbours.
- Tax revenue fully funds the recurrent budget, and an increasing share of the

- public investment.
- Tax compliance indicators are substantially improving.
- Revenue raising is free from political influence.

VI. Property Rights

The fair enforcement of property rights is essential to encourage returns and the equal treatment of all ethnic communities. This requires that there is effective legislation in place, that there are effective property dispute resolution mechanisms; that rightful owners of residential, commercial and agricultural lands are able to take effective possession of their property and that there is an accurate system for transfer, encumbrance and registration of property as well as the prevention of coerced property sales.

- Property Rights.
- Legislation is in place that is consistent with European standards.
- Illegal occupants have been evicted from properties and the property returned to its rightful owners.

Municipal courts resolve property issues without discrimination against minority communities and do so at a rate comparable to European court systems.

- The Police enforce these decisions routinely and without discrimination.
- The Housing and Property Directorate and the Housing and Property Claims Commission have effectively resolved their backlog of cases.
- There is an effective system to remedy disputes over agricultural and commercial property.
A property rights registry has been established and is functioning and municipal cadastral surveys have been completed.
- Municipal authorities cease unlawful or unjustified attempts to develop public lands that have long-established informal settlements by minority communities or other vulnerable groups.
- Informal settlements of vulnerable minority groups have been legalized and regularized.

Preservation of Cultural Heritage

- Kosovo's cultural heritage is respected as the common patrimony of all of Kosovo's ethnic, religious and linguistic communities.
- All communities are entitled to preserve, restore and protect sites important to their cultural, historical and religious heritage with the assistance of relevant authorities (PISG), in accordance with European standards.
- There shall be neither discrimination nor preferential treatment of cultural heritage properties of any community.

VII. Dialogue

There is a constructive and continuing dialogue between the PISG and their counterparts in Belgrade over practical issues. Kosovo's cooperation within the region is developed. Belgrade-Pristina dialogue.

- There are regular meetings of the working groups (initially four: missing persons, returns, energy and transport & communications) and all working groups are multi-ethnic.
- Meetings take place in atmosphere of constructive cooperation, respecting the rules of procedure and utilizing available international expertise.
- The working groups make progress in resolving practical issues of mutual concern.

Regional

- Working arrangements are in place to provide advanced cooperation in the fields of: freedom of movement (including border crossings), trade and economy, police and justice, public administration, and regional parliamentary exchanges. There is participation in bilateral and multilateral arrangements to benefit stability in the region.

VIII. Kosovo Protection Corps

The Kosovo Protection Corps (KPC) thoroughly complies with its mandate, as stated in the Constitutional Framework, as "a civilian emergency organisation, which carries out in Kosovo rapid disaster response tasks for public safety in times of emergency and humanitarian assistance." The KPC operates in a transparent, accountable, disciplined, and professional manner and is representative of the entire population of Kosovo. The KPC is capable of enforcing discipline and is fully funded in a transparent way.

- The KPC performs its mandated functions in full compliance with the rule of law.
- All Kosovo communities are fully and fairly represented in the KPC without being subject to discrimination.
- Funding is transparent and independently audited.
- The number of KPC installations has been reduced by at least one-third; contingent size is reduced to 3,052 active members and 2,000 reserve members.
- All misconduct is punished, under a rigorous Disciplinary Code and Performance Review System. The KPC has engaged in a comprehensive campaign to recruit in ethnic minority communities.
- The KPC has devoted a proportionate share of reconstruction activities to ethnic minority communities.
- A Terms of Service Law for active and reserve members has been adopted and implemented.

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