

Report No. 24880-KOS

Kosovo, FR Yugoslavia Medium-Term Public Expenditure Priorities

October 16, 2002

Poverty Reduction and Economic Management Sector Unit
Europe and Central Asia Region



Document of the World Bank

Currency Equivalents

Currency Unit= EUR

€1 = US\$0.9875

(as of October 1, 2002)

Metric System

Fiscal Year

January 1 to December 31

ACRONYMS AND ABBREVIATIONS

ALOS	Average Length of Stay
CDF	Comprehensive Development Framework
CEE	Central and Eastern Europe
CF	Constitutional Framework
CFA	Central Fiscal Authority
CG	Central Government
CGB	Central Government Budget
DM	German Marks
DOR	Department of Reconstruction
ECA	Eastern Europe and Central Asia
EC	European Commission
EFC	Economic and Fiscal Council
EU	European Union
FRY	Federal Republic of Yugoslavia
FYROM	Former Yugoslav Republic of Macedonia
GG	General Government
GGB	General Governmental Budget
GDP	Gross Domestic Product
GFS	Government Finance Statistics
HDS	Health and Demographic Survey
IAC	Interim Administrative Council
IB	Integrated Budget
IMF	International Monetary Fund
JIAS	Joint Interim Administrative Structure
KEK	Korporata Energjetike E Kosoves, Kosovo Energy Company
KFOR	Kosovo Force
KTA	Kosovo Trust Agency
KTC	Kosovo Transition Council
KPC	Kosovo Police Corps
LDK	Democratic League of Kosovo
LFS	Labor Force Survey
LSMS	Living Standards Measurement Survey
MoFE	Ministry of Finance And Economy
MOH	Ministry of Health
MPS	Ministry of Public Services

MTEF	Medium Term Expenditure Framework
NGO	Non-Governmental Organization
OECD	Organization for Economic Cooperation and Development
O & M	Operations and Maintenance
OSCE	Organization for Security and Cooperation in Europe
PAC	Public Accounts
PDK	Democratic League of Kosovo
PHC	Public Health Care
PIO	Principal International Officer
PISG	Provisional Institutions of Self Government
PRIP	Public Reconstruction and Investment Program
PUH	Pristina University Hospital
RIMS	Reconstruction Intervention Monitoring System
SEE	South Eastern Europe
SRSG	Special Representative of the UN Secretary General
SFRY	Socialist Federal Republic of Yugoslavia
SME	Small and Medium Enterprise
SOE	Socially Owned Enterprise
UMIC	Upper Middle Income Countries
UN	United Nations
UNHCR	United Nations High Commission for Refugees
UNICEF	United Nations Children's Fund
UNMIK	United Nations Interim Administration in Kosovo
VAT	Value Added Tax
W & S	Public Sector Wages and Salaries
WHO	World Health Organization

Vice President:	Johannes F. Linn
Country Director:	Christiaan Poortman
Sector Director:	Cheryl Gray
Sector Manager:	Kyle Peters
Task Team Leader:	Marina Wes

Acknowledgements

This Report is based on the findings of several missions that visited Kosovo between March and September 2002. A working draft was discussed with the Government and UNMIK during a mission that visited Kosovo in early October 2002. The analysis in this report covers the period from late-1999 until September 2002.

The Team that prepared the Report wishes to thank UNMIK and the Government of Kosovo for the constructive discussions during the different missions. This report has benefited in particular from a two-day discussion workshop, held in Mitrovica in June 2002, attended by 60 representatives from the Government and UNMIK, and jointly sponsored by the World Bank and the Ministry of Finance and Economy. During this workshop preliminary findings of work completed by the Authorities and the Bank Team in the context of the 2003 budget cycle were discussed.

Marina Wes is the principal author of the Report, drawing from background papers and contributions prepared by a team composed of Tim Gilbo, Ardo Hansson, Alessandro Magnoli, Ingrida Rosa (overall report preparation), Jeanine Braithwaite, Hjalte Sederlof (Social Protection), James Stevens, Mary Venner (education), George Boulton, Jim Campbell, Laura Rose (health), and Alta Folscher (budget management). The report also benefited from insightful and constructive comments from the peer reviewers, Dimitri Demekas (IMF) and Mark Sundberg.

This Report was prepared under the general guidance and advice of Kyle Peters, Christiaan Poortman, and Andras Horvai. The Report also benefited from valuable comments and suggestions received at different stages of preparation from Jean Jacques de St Antoine, Sidi Boubacar, Peter Darvas, Janet Dooley, Bernard Funck, Balazs Horvath, Davina Jacobs, Pierella Paci, and Steven Symansky. Processing assistance from Mala Johnson is gratefully acknowledged. Helpful logistical assistance was also received from Arijeta Baruti, Leonora Emini, Mirlinda Gorcaj, and Burim Jakupi.

The macroeconomic framework presented in this Report was prepared in close collaboration with the IMF Team, led by Dimitri Demekas. The Report has also benefited from comments by key counterparts at the EC.

TABLE OF CONTENTS

EXECUTIVE SUMMARY	I
MEDIUM TERM ECONOMIC OUTLOOK.....	II
MEDIUM TERM EXTERNAL FINANCING REQUIREMENTS	IV
PUBLIC EXPENDITURE POLICIES AND PRIORITIES	IV
SUMMARY TABLE: REVIEW OF PUBLIC EXPENDITURE PRIORITIES	VII
1. THE STRATEGIC SETTING.....	1
A. BACKGROUND.....	1
B. THE NEW POLITICAL STRUCTURES AND THE ECONOMIC CHALLENGES	2
C. THE REFORM AGENDA	7
D. THE MEDIUM-TERM MACROECONOMIC OUTLOOK.....	9
E. MEDIUM-TERM FISCAL AND EXTERNAL FINANCING REQUIREMENTS.....	11
F. REPORT OUTLINE	14
2. RESOURCE MOBILIZATION FOR PUBLIC EXPENDITURE.....	16
A. RAISING REVENUES FOR THE CENTRAL GOVERNMENT: THE TAX SYSTEM.....	17
B. REVENUES IN A REGIONAL CONTEXT.....	18
C. FINANCING MUNICIPAL SPENDING:	23
D. FORECASTS OF LOCALLY GENERATED REVENUES	26
3. RESTRUCTURING SPENDING: CROSS-SECTORAL POLICIES.....	28
A. AGGREGATE PUBLIC SPENDING: THE KOSOVO INTEGRATED BUDGET.....	28
B. GENERAL BUDGET SPENDING: ECONOMIC CLASSIFICATION.....	30
C. GENERAL BUDGET: FUNCTIONAL CLASSIFICATION	44
D. THE MEDIUM TERM OUTLOOK	46
ANNEX 3.1: METHODOLOGICAL ISSUES ON PUBLIC SECTOR PAYROLL DATA.....	48
4. RESTRUCTURING SPENDING: SOCIAL SECTOR ISSUES.....	50
A. SOCIAL PROTECTION.....	50
B. HEALTH.....	57
C. EDUCATION	69
5. PUBLIC EXPENDITURE PLANNING AND MANAGEMENT	81
A. WHAT IS IN PLACE?	82
B. BUDGET MANAGEMENT ISSUES AND THE MTEF APPROACH.....	83
C. BUDGET IMPLEMENTATION: FURTHER IMPROVING ACCOUNTABILITY AND TRANSPARENCY	88
D. THE INSTITUTIONAL ASPECTS OF PUBLIC EXPENDITURE MANAGEMENT	91

TABLES

Table 1.1	Medium-Term Macroeconomic Projections	10
Table 1.2	Medium-Term Fiscal Financing Requirements	12
Table 1.3	Medium-Term External Financing Requirements	13
Table 2.1	General Government Revenues as a Share of GDP, in a Comparative Context	19
Table 2.2	Tax Rates, International Comparisons	20
Table 2.3	Tax Authority Staffing Levels, Comparative Context	20
Table 2.4	Locally Generated General Government Resources	27
Table 3.1	Kosovo Public Employment as a Percentage of Total Employment, by Function	36
Table 3.2	Civil Service Employment by Function and Level of Government	37
Table 3.3	Regional Comparisons of Public Employment (as a Share of Population)	38
Table 3.4	An Illustrative Wage Bill Scenario	40
Table 3.5	Estimated Recurrent Cost Requirements of the Donor-Funded Reconstruction Program In Kosovo	42
Table 3.6	Consolidated General Government Spending, as a Share of GDP	45
Table 4.1	Basic Pension Scheme – Scenarios	55
Table 4.2	Simulation of Severance Costs for a Cohort of 10,000 State Enterprise Workers	56
Table 4.3	Comparative Health Financing and Outcomes	60
Table 4.4	Pharmaceutical Expenditure as a Percent of Total Health Expenditure	65
Table 4.5	An Indicative Restructuring Scenario for Health Staffing	67
Table 4.6	Pre-School, School and University Enrolments	69
Table 4.7	Net Enrolment Rates by Age Groups and Gender/Ethnicity	71
Table 4.8	General Budget Spending on Education by Subsector	72
Table 4.9	Potential Savings through Increased Student Teacher Ratios	78
Table 5.1	Institutional Design of the Budget Process	94

CHARTS

Chart 1.1	The Institutional Structure	3
Chart 1.2	2002 Central Government Budget	5
Chart 2.1:	Resources for Public Spending 2000-2002	16
Chart 2.2	2001 General Budget Revenue	17
Chart 2.3	Consolidated General Government Revenues as a share of GDP	21
Chart 3.1	Consolidated General Government Recurrent Spending	31
Chart 3.2	General Government Budget Spending on Wages and Salaries	32
Chart 3.3	General Government Budget Spending on Non-Wage Goods and Services	32
Chart 3.4	General Government Budget Spending on Subsidies	33
Chart 3.5	General Government Budget Spending on Capital Investment	33
Chart 3.6	Average Government Wage as a Share of Per Capita GDP	34
Chart 3.7	Average Annual Public Sector Wage Rates by Sector	35
Chart 3.8	Kosovo Integrated Budget Spending	43

Chart 3.9	General Budget Spending as a Share of Total Spending, by Functional Classification	45
Chart 3.10	Kosovo Integrated Budget 2005	47
Chart 3.11	1998-2000 Expenditure By Economic Type, European Union	47
Chart 3.12	The Structure of Public Sector Employment	49
Chart 4.1	Infant Mortality Rate And Per Capital Health Expenditure In Current US\$ (selected regional indicators)	58
Chart 4.2	Pre-School Enrolment Rates	70
Chart 4.3	Primary School Teacher's Salaries, Relative to per Capita GDP	74
Chart 4.4	Tertiary Enrolment Rates	75

BOXES

Box 1.1	Political and Administrative Governance in Kosovo.....	4
Box 1.2	The Scope And Organization of the Public Sector In Kosovo	6
Box 4.1	Fiscal Devolution in Education.....	80
Box 5.1	The Medium-Term Expenditure Framework.....	85
Box 5.2	The New Constitutional Framework.....	95

EXECUTIVE SUMMARY

1. **The combination of sound economic policies, institution building, and large-scale donor assistance has yielded impressive results in Kosovo¹ over the past three years.** Real GDP growth is estimated to have been 11 percent in 2001 alone. At about US\$900, GDP per capita in 2001 was about twice as high as the officially recorded level in the mid-1990s. Driven by massive private and official transfers, indicators of disposable income and consumption suggest an even stronger recovery of aggregate demand since 1999. Significant progress has also been made in putting in place the enabling environment for a market economy: macroeconomic stability has been achieved, an institutional framework for fiscal policy is in place, and the basic legal and institutional framework needed to encourage private and financial sector development has been established.

2. **Since the end of the conflict in June 1999, Kosovo has been gradually progressing towards self-government.** Following the adoption of the Constitutional Framework in May 2001 and the Kosovo-wide elections in November 2001, responsibility for administering the territory is now shared between UNMIK and a Kosovar self-Government. While the Provisional Institutions of Self Government (PISG) have significant responsibility in governing Kosovo, the Special Representative of the UN Secretary General (SRSG) retains the power to ensure security (in coordination with KFOR), exercise a number of specific reserve powers, and set the “broad parameters” of fiscal policy, including the overall budget.

3. **Achieving the new Government’s objectives of a rapidly growing economy with increased private sector employment and an overall improvement in living standards will require decisive implementation of a broad-ranging structural reform agenda.** These reforms will also enhance the economy’s flexibility and resilience to shocks. First, there is ample scope to improve the investment and private sector climate. Kosovo has yet to establish an adequate business environment, where the rules of law are respected, property rights and claims are recognized, contracts can be enforced and investors have access to capital. The institutional capacity to administer and enforce the existing legal framework can still be enhanced and further legislation, including in the areas of property rights and competition, should be adopted. Second, the competitiveness and productivity of the economy can be improved, including through the restructuring of public utilities and privatization/ liquidation of socially owned enterprises, following the recently approved KTA regulation.

¹ Kosovo, Federal Republic of Yugoslavia; hereinafter Kosovo.

4. **Measures also need to be taken to ensure that the benefits of growth accrue equitably to all groups in Kosovo.** Despite the impressive economic recovery, poverty is still widespread, with survey results suggesting that over half the population was poor in late 2000, with 12 percent living in extreme poverty. The access to and quality of education and health care services need to be improved, and a policy and planning framework should be put in place to develop a medium-term poverty alleviation strategy.

MEDIUM TERM ECONOMIC OUTLOOK

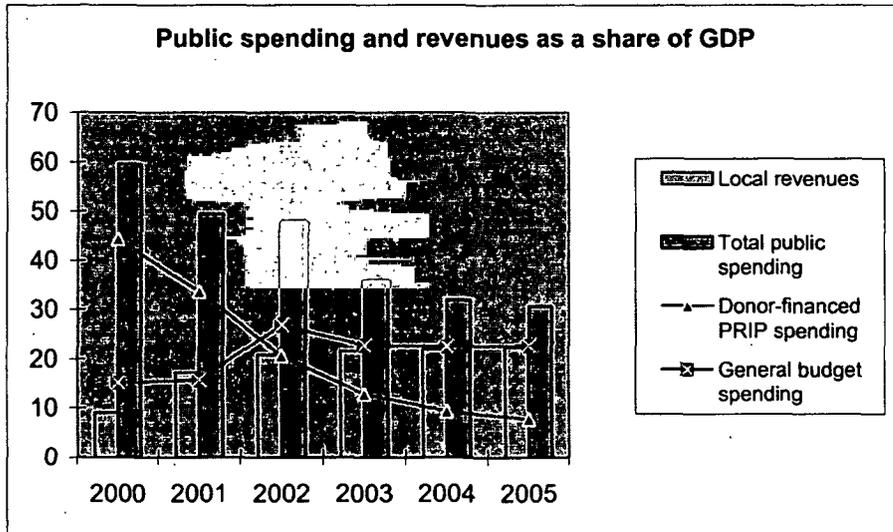
5. **If the authorities make continued progress on the structural reform agenda, economic prospects are good in the medium term.** Real GDP could be expected to grow by an average of around 5 percent in the period 2003-05. Implicit in these growth assumptions is a very strong private sector performance, a continued inflow of foreign diaspora remittances, a sufficiently gradual withdrawal of donors, and progress towards the resolution of Kosovo's final status. Under this scenario, inflation is projected to decrease from more than 10 percent in 2001 to 3 percent by 2005. Low inflation will be supported by the continued use of the euro, prudent fiscal policy, and the gradual reduction of aid flows and the international presence in Kosovo.

6. **The conduct of fiscal policy will be critical to ensuring macroeconomic stability and a climate conducive to domestic and foreign investment, as well as improving living conditions among the most vulnerable members of society.** Following the adoption of the DM as a parallel currency in late 1999, Kosovo successfully converted to the use of the euro in early 2002. While the adoption of a hard currency has played a critical role in bringing about macroeconomic stability, it also puts a larger burden on fiscal policy. Given the political and legal uncertainties surrounding borrowing, both domestic and external, as well as an inadequate institutional framework to support it, and without a monetary policy instrument, the fiscal policy stance will depend critically on a strong domestic revenue effort, a careful calibration of expenditures to support both public investment and critical social expenditures, and importantly, continuing donor support, albeit at a lower level.

7. **Local revenues can be expected to finance an increasing share of public expenditures.** Local tax revenues have performed impressively since 1999, increasing from 9 percent of GDP in 2000 to 16 percent in 2001. Kosovo's overall tax revenues as a share of GDP, as well as its tax rates, remain low relative to other economies in the region, and continued efforts to strengthen tax administration and broaden the tax base are expected to lead to further increases. Nevertheless, in the context of lower growth, and with most measures to achieve large increases in revenues already implemented, the potential for further increases will be more limited. It is estimated that the local revenue to GDP ratio will increase to 22 percent by 2005.

8. **Total public spending in Kosovo has been in excess of 50 percent of GDP in both 2000 and 2001.** Around 75 percent of this spending has been donor-financed, with the remainder covered by locally generated revenues. Most donor funds have financed capital projects in the context of the Public Reconstruction and Investment Program (PRIP). As Kosovo's immediate reconstruction effort is phasing down, investment – and

public spending - needs are declining. However, Kosovo is also facing the challenges of development and transition to a market economy, a challenge complicated by particularly pronounced underinvestment during the nineties.



Note the chart assumes that the central budget cash balance accumulated in 2000 and 2001 is spent entirely in 2002, largely in connection with the refurbishments in the energy sector.

9. **Estimating the economy's public investment requirements and the appropriate level of recurrent spending, as well as benchmarking expenditure levels against international comparators, suggests that a public spending to GDP ratio of roughly thirty percent would appear appropriate for Kosovo by 2005; with one third of public spending covering investment needs.** To meet remaining post-conflict needs and lay the basis for sustainable growth, public investment spending in Kosovo should remain higher than in other economies for some time to come. Private investment especially FDI is likely to be limited in Kosovo over the medium term, because of the incomplete legal framework and general uncertainty related to the resolution of Kosovo's final status. Public investment needs, underpinning a 5 percent growth scenario, are therefore expected to remain high at about 10 percent of GDP in 2005, although declining from 35 percent in 2001.

10. **A ratio of recurrent spending to GDP around 20 percent would appear appropriate by 2005.** Over the medium term recurrent budget spending should stay relatively lower in Kosovo than in other regional and European economies. In the presence of KFOR and UNMIK, a number of functions that normally require budget financing are covered by alternative funding sources. As KFOR and UNMIK withdraw, further non-discretionary recurrent cost items will have to be absorbed by the budget,

driving the spending to GDP ratio up at that stage. In addition, further spending pressure may also emerge from debt service payments.²

MEDIUM TERM EXTERNAL FINANCING REQUIREMENTS

11. **Even with a strong revenue effort in the near term, local revenues will remain insufficient to cover all of Kosovo's fiscal expenditure needs over the medium term.** As the authorities have no access to borrowing or seignorage, the resulting financing gap will need to be covered by donor grants. Kosovo's total financing needs during 2003-2005 are projected at around €810 million. More than half of these needs (€440 million) are expected to be met from the disbursement of the remaining already pledged donor funds. After accounting for changes in cash balances, net capital flows and errors and omissions, and a small amount of humanitarian assistance, this leaves a residual financing gap of €310 million to be covered by disbursements from new donor commitments.

12. **Donor assistance remains crucial for achieving sustainable public finances.** Closing the remaining financing gap will require about €500 million of new donor commitments over the three year period 2003-2005. About €450 million of these commitments will be needed to finance the PRIP. With €175 million of new commitments for the PRIP made in 2003, €150 million in 2004, and €125 million in 2005; this would generate €260 million of new disbursements for the PRIP over the period 2003-2005. The remaining €50 million of new commitments would be for general budget support. Although locally generated revenues will roughly be able to cover recurrent costs, increased capital expenditure will need to be absorbed by the General Budget.

13. **The macroeconomic scenario outlined above is associated with substantial risks.** The above scenario of a sustained rebound in growth and living standards assumes (i) implementation of a coherent medium-term program of institutional strengthening and reform; (ii) continued, well-targeted donor support for Kosovo; and (iii) a relatively favorable external environment. A faster and more decisive implementation of the wide-ranging structural reform agenda will be required, including to enhance the economy's competitiveness and productivity and improve the investment climate.

PUBLIC EXPENDITURE POLICIES AND PRIORITIES

14. The macro scenario outlined above has made implicit assumptions on the allocation of public spending. Given the tight overall resource constraints in Kosovo, and in the face of declining donor support and limited access to external finance, difficult choices and trade-offs on spending decisions will need to be made. The main challenge will be to develop expenditure policies which will preserve macro-stability and ensure that public services are sustainable, comprehensive, and efficiently provided. Public spending policies need to lay the basis for broad-based equitable economic growth, and

² This report assumes that no debt service payments are made during the 2002-2005. This is an assumption for the purpose of this report only and is not meant to prejudge any settlement that might be reached between the parties during this period regarding Kosovo's share of the FRY debt.

target the most needy, in an effective and efficient fashion. Through the introduction of the Medium Term Expenditure Framework (MTEF) approach in 2002, UNMIK and the PISG have started to make progress in adding a medium-term context to budget policy.

15. This report identifies the following important expenditure measures that require action:

- **Reallocate spending across sectors** to improve outcomes. Subsidies account for too large a share of public resources and are crowding out spending in other critical areas. The public sector wage bill is crowding out operations and maintenance spending, and public sector wage and employment policies need to be reassessed. In the face of declining donor support and considerable remaining investment needs, greater capital expenditures will need to be financed by local tax revenues.
- **Improve the efficiency of existing spending**, in particularly in health, education and social protection. Significant efficiency gains can be achieved by (i) right-sizing and restructuring health sector staffing, (ii) improving procurement of pharmaceuticals, and (iii) rationalizing the hospital sector. In education, there is significant scope to cut teaching and non-teaching staff and to increase student teacher ratios at all levels. The social assistance scheme should be restructured to target the extremely poor and raise their living standards to at least the food poverty line. There appears to be little room for increases in pensions over the next few years.
- **Make strategic additional investments in education and health** to increase access and quality and thus to promote growth while protecting the most disadvantaged. The authorities may want to consider increasing general budget spending on health over the coming years to enable the system to offer a wider range of services. Targeted investments are likely to be needed to address the large inequalities in education attainment that exist in Kosovo, and to attract and retain disadvantaged pupils including girls and minority groups.
- **Strengthen the effectiveness of the budget as a policy tool.** Policy formulation and decision making mechanisms in Kosovo remain fragmented, and no coherent vision of budget development exists among different stakeholders. In order to strengthen the effectiveness of the budget as a policy tool, an economy and sector policy framework that defines the objectives, priorities, needs and outcomes for key sectors and the economy as a whole needs to be further developed. It is also critical that a more comprehensive resource framework is prepared, which ends the separation of the recurrent and the donor-financed investment budgets.
- **Further improve transparency and accountability** While the establishment of good financial management systems within the three post-conflict years is laudable, critical gaps should be filled as a matter of urgency. The financial management act and the procurement regulation should be finalized and

implemented. The internal audit capacity needs to be improved and the auditor general's office established. To improve transparency, budget allocation and spending information needs to be made public at local and municipal levels, and regular in-year spending information should be made available to Parliament. Accountability can also be improved by developing the role of Parliament in maximizing its oversight function.

The attached Table summarizes the main cross-sectoral and sectoral expenditure reform measures proposed by the report.

SUMMARY TABLE: REVIEW OF PUBLIC EXPENDITURE PRIORITIES

Sector/Objective	Performance measure	Priority Public Measures	Specific Financing Implications
Public sector wages			
1. Manage down the public sector wage bill as a share of total budgetary spending	<ul style="list-style-type: none"> Spending on public sector wages should grow at a slower rate than budgetary spending 	<ul style="list-style-type: none"> Public employment growth should be controlled and directed to areas where there are shortages. Downsizing measures should be implemented selectively, including in education and health. Wages should not increase across the board. The current wage structure is characterized by little wage differentiation. Public sector wage growth should be directed to areas (i) where wages are disproportionately low, and (ii) where it is problematic to attract and retain skills. A more comprehensive review of pay, employment and civil service structure needs to be undertaken prior to any restructuring of public sector wages and employment. 	<ul style="list-style-type: none"> The report identifies a biased prioritization of public sector wage and salary spending over non-wage goods and service spending; the public sector wage bill crowds out operations and maintenance spending and general budget spending on capital goods. Spending on the general budget public sector wage bill should only increase in line with GDP to enable increased general budget spending on operations and maintenance and capital investment. Since wages constitute more than a third of budget spending, any increase in wages or employment will have a very large impact on total spending.
2. Improve the efficiency and effectiveness of the public administration.	<ul style="list-style-type: none"> Civil service reform prepared and implemented 	<ul style="list-style-type: none"> The development of an appropriate and systematic human resource management system for the Kosovo public service needs to be advanced further. Training and capacity building is critical for the future development of the Kosovo civil service. Better wage bill internal control systems need to be developed to prevent disproportionate wage creep and overspending 	
Education			
1. Improved effectiveness and increased efficiency in resource use	<ul style="list-style-type: none"> Raise student teacher ratios Devolution of financing to municipalities 	<ul style="list-style-type: none"> Develop a plan to downsize teaching and non-teaching staff and increase the student-teacher ratio. Introduce capitation-based formulae for dormitory and pre-school grants. Explore options for small municipalities to establish school consolidation and cross-municipality regional-level management. Develop plan to reduce non-education related subsidies in higher education (dormitories, food programs). Develop plan to implement fees at the tertiary level. 	<ul style="list-style-type: none"> The authorities may want to consider increasing general budgetary spending on education. Given demographic pressures on the system, the need to increase enrolments, particularly in secondary education, and the decline in donor funding; efficiency gains alone will not be sufficient for funding the education system. There is some scope to shift resources within the sector. For instance, increasing student-teacher ratios to 25:1, decreasing the share of non-teaching staff in the wage bill

Sector/Objective	Performance measure	Priority Public Measures	Specific Financing Implications
2. Improved access to education, in particular for the poor, girls, and minority groups.	<ul style="list-style-type: none"> ▪ Increase enrolment in primary education to nearly 100 percent. ▪ Increase enrolment in secondary education to 80 percent for all groups (by 2006). 	<ul style="list-style-type: none"> ▪ Analyze factors affecting demand for basic education and drop-out rates, and prepare and pilot initiatives to increase school attendance. ▪ Use information system to monitor impact of new financing system on educational access in rural areas and for minorities; ensure that financial incentives for higher class sizes do not reduce access or attendance. ▪ Introduce financial support packages to children in poor families. ▪ Restructure schools in urban areas and establish new schools in suburbs. 	<ul style="list-style-type: none"> ▪ by 33 percent and reducing unit costs at the tertiary level by 20 percent, yields cost savings of €15 million annually. This is equivalent to a saving of 20 percent of the 2002 education budget; almost 1 percent of GDP. ▪ These fiscal savings could be used: (i) to make strategic investments to fund higher participation in primary and secondary education; (ii) to increase funding of early childhood education programs; (iii) to improve the quality of education at all levels; and (iv) to fund capital investment.
3. Improving the quality of education and measuring learning performance.	<ul style="list-style-type: none"> ▪ Introduce standardized testing. 	<ul style="list-style-type: none"> ▪ Increase quality of teachers through preparation and implementation of teacher-training programmes. ▪ Improve curricula and availability of textbooks. ▪ Improve statistics on indicators and set targets of educational attainment, such as repetition and progression rates and educational attainment by age cohorts. ▪ Arrangements for publication of school expenditure accounts should be introduced. 	
Health			
1. Develop a strategic vision for reform and modernization of the health sector	<ul style="list-style-type: none"> ▪ Development of a MOH health sector policy paper. ▪ Implementation of clear referral protocols. 	<ul style="list-style-type: none"> ▪ Define coherently the benefit package and beneficiaries of public health expenditure. ▪ Define the role of private sector service provision. ▪ Reduce duplication and overlap between PHC and hospital sectors and define clear referral protocols based on long term strategy. ▪ Restrict capital investments to those associated with restructuring according to overall strategic plan, including for facilities, equipment etc. 	<ul style="list-style-type: none"> ▪ The authorities may want to consider increasing general budgetary spending on health to enable the authorities to offer a wider range of services, while simultaneously implementing measures to increase the efficiency of existing spending. The current low level of public spending and the lack of a social safety net is forcing people to make significant informal payments to unregulated providers.

Sector/Objective	Performance measure	Priority Public Measures	Specific Financing Implications
2. Improve quality, availability and equity of health service delivery.	<ul style="list-style-type: none"> ▪ Increase revenue raised through official co-payments. ▪ Reduce out-of pocket payments for essential health services. ▪ Improve availability of pharmaceuticals at point of dispensing. 	<ul style="list-style-type: none"> ▪ Bring informal private payments into the official health system by improving enforcement of official contributions system, and regulate private provision. ▪ Improve access to poor by reducing overall demand for out-of-pocket payments for health services. ▪ Improve availability of pharmaceuticals through supply chain and dispensing arrangements. ▪ Introduce basic systems of accountability including business planning and financial accountability at municipal and facility level and wider public transparency on revenue and expenditures and the results of expenditures at these levels. 	<ul style="list-style-type: none"> ▪ Particularly significant efficiency gains can be achieved by (i) restructuring health sector staffing, (ii) improving procurement, and (iii) rationalizing the hospital sector. Identified fiscal gains could amount to around 0.5 percent of GDP annually; additional gains can be realized, particularly through hospital restructuring in line with health policy. ▪ Overall spending on health salaries may need to be increased because the cost of increases in professional staff salaries will outweigh savings from reduced support and administrative staff numbers, and the average wage level in the sector is low. In an indicative scenario spending on health salaries would increase by 0.4 percent of GDP over three years.
3. Improve the efficiency of existing health spending to create increased fiscal space for restructuring of the system.	<ul style="list-style-type: none"> ▪ Reduced number of total health staff. ▪ Increased number of and remuneration of professional staff. ▪ Reduction of per unit pharmaceutical costs. ▪ Increased percentage of hospital procedures performed on an ambulatory basis. ▪ Reduction in ALOS. 	<ul style="list-style-type: none"> ▪ Decompress salary structure by increasing salary for professional staff relative to lower levels. ▪ Reduce numbers of administrative/support staff while increasing number of professional staff. ▪ Improve the efficiency of procurement, supply and dispensing of pharmaceuticals. ▪ Improve planning, management and accountability of health sector spending. ▪ Increase proportion of elective procedures performed on an ambulatory basis. ▪ Rationalize organization of hospitals. 	
Social Protection			
1. Restructure the social assistance scheme to target the extremely poor and raise their living standards at least to the food poverty line	<ul style="list-style-type: none"> ▪ Extremely poor reached with a targeting error of 25 percent. Targeting errors, both of inclusion and exclusion are currently relatively high, and it is estimated that the extremely poor benefit from less than 20 percent of program resources. ▪ Poverty monitoring and assessment capacity established and regular surveys instituted. 	<ul style="list-style-type: none"> ▪ Restructure the social assistance scheme by (i) setting the eligibility threshold at the food poverty line; and (ii) introducing a targeting mechanism (proxy means testing) that will minimize errors in defining the extremely poor. ▪ Introduce poverty monitoring on a regular basis to measure outcomes from changes in social protection programs and to reduce targeting errors. 	<ul style="list-style-type: none"> ▪ At the time the existing social assistance system was designed, statistically representative information on vulnerable groups was not available. Now that this information has become available, significant fiscal savings can be achieved. Refining eligibility criteria, and assuming 25 percent leakage, can lead to annual savings of €14 million, equivalent to 38 percent of current social assistance spending, and almost 1 percent of GDP. ▪ Increases in pension payments should be limited to increases in the food poverty line. Care should be taken in establishing a disability pension scheme as experience in

Sector/Objective	Performance measure	Priority Public Measures	Specific Financing Implications
2. Put in place an affordable pension scheme	<ul style="list-style-type: none"> A functioning fiscally sustainable basic pension system in place. 	<ul style="list-style-type: none"> As outlined in the Pension Law, limit increases in the basic pension to the food poverty line. The current level of 28 euros is not low relative to international comparators. If a disability pension scheme is established, it needs to be carefully designed. The disability pension should be set at a flat rate amount no higher than the basic pension and enacted using strictly drawn and clear criteria for eligibility. 	<p>other economies indicates such schemes can have serious fiscal implications.</p> <ul style="list-style-type: none"> The potential budgetary implications of layoffs, associated with the restructuring of socially owned and public enterprises, could be very significant. Some estimates suggest that as many as 40,000 workers are eligible, which could cost the budget €25 million for this group of workers. Savings from the social assistance scheme will need to be reallocated to the pension scheme to help ensure sufficient budgetary funds are allocated for pension spending.
3. Increased labor market flexibility	<ul style="list-style-type: none"> Labor market mobility as determined by voluntary job changes. 	<ul style="list-style-type: none"> Develop affordable and appropriate strategies for (i) large-scale lay-offs; (ii) job reinsertion support; and (iii) monitoring labor demand and supply on national and local markets 	
Budget Management			
1 Maintain fiscal discipline	<ul style="list-style-type: none"> Aggregate KCB actual spending levels close to budgeted levels. 	<ul style="list-style-type: none"> Merge the CFA and the MoFE. Prepare a more comprehensive resource framework. The lack of linkages between the PRIP, primarily financed by donors, and the general budget, has been a serious obstacle. Design a coherent vision and system of budget development needs and communicate to all stakeholders. The sequencing of the budget process needs to take into account the complexity of the institutional set-up in Kosovo, while maximising political accountability for budgetary choices while recognizing the authority of the SRSB. Transparency and accountability need to be further improved: (i) the financial management act and procurement regulation should be finalized and implemented; (ii) the internal audit capacity needs to be improved and the auditor general's office established. Budget allocation and spending information needs to be made public at local and municipal levels, and regular in-year spending information should be made available to Parliament. Build Kosovar capacity for fiscal and public expenditure management at central and sectoral level. 	<ul style="list-style-type: none"> With limited scope for overall increases in public expenditure, one of the main opportunities over the medium term for achieving improved public spending results lies in a more efficient use of existing resources. Two important objectives of next year's MTEF exercise should be (i) to encourage line ministries to focus on ways of improving resource use within existing sector budgets; and (ii) to further strengthen the effectiveness of the budget as a policy tool.
2 Improve effectiveness of spending	<ul style="list-style-type: none"> Shifts in functional spending allocations shift in line with policy priorities. Shifts in economic spending allocations in line with policy priorities. 		
3 Improve operational efficiency of system	<ul style="list-style-type: none"> Efficiency gains targeted and realised of per annum. 		
4. Predictable public expenditure management	<ul style="list-style-type: none"> Integrated and comprehensive system of public expenditure management developed. A comprehensiveness budget. Transparent allocation and use of resources. Political involvement in budget process institutionalized. 		

1. THE STRATEGIC SETTING

A. BACKGROUND

1.1 **Kosovo was traditionally the poorest part of the former Socialist Republic of Yugoslavia (SFRY).** In 1988—the last full year of autonomy under the SFRY constitution—recorded output per head was 28 percent of the SFRY average. Over the succeeding six years, GDP contracted by 50 percent, falling to less than US\$400 per head by 1995, according to official statistics. This was correlated with massive neglect of industry, mining and infrastructure in Kosovo during the nineties.

1.2 **The deteriorating economic conditions of the 1990s were significantly accelerated during the crisis of the late-1990s, which culminated in the conflict of 1999.** Industrial output collapsed. Agricultural production, upon which a majority of the Kosovar population depend, plummeted; livestock herds were lost or killed; and, a planting season was missed. Moreover, virtually all social services and government systems were brought to a complete standstill. There was also significant damage to infrastructure, especially the stock of private housing.

1.3 **Since the end of the conflict in June 1999, there has been considerable progress towards peace and economic recovery on all fronts in Kosovo.** On the basis of the UN Security Council Resolution 1244, the Secretary General established UNMIK as the transitional administration of Kosovo; to be replaced over time with provisional self-governing local institutions. When UNMIK arrived in Kosovo in mid-1999, it faced the massive task of restarting the basic institutions of government and economic activity, as well as overseeing the rapid return of the nearly 1.3 million refugees and internally displaced persons.

1.4 **UNMIK and the Kosovars have made impressive progress in putting in place the enabling environment for a market economy.** This effort was assisted by the implementation of a massive donor assistance program, which started in 1999, and which helped set the stage for economic reconstruction and recovery. These broad-ranging and coordinated efforts have been implemented on a fast track to help Kosovo make up for lost time. Key achievements in the sphere of economic policy include:

- (a) Establishing macro-economic stability including through the adoption of the Dmark and the successful conversion to the euro;
- (b) Establishing the institutional framework for fiscal policy and designing and implementing a budget increasingly financed through local taxation;
- (c) Establishing a liberal and transparent trade and customs regime that positions Kosovo to realize its potential for growth through increased foreign trade;
- (d) Creating the basic legal and institutional framework needed to encourage the growth of private small and medium enterprises and to transfer viable existing public enterprises into private hands; and

- (e) Establishing an institutional and regulatory framework for banking in line with international standards, and attracting a few banks which have begun operation.

1.5 During the past three years, the combination of sound economic policies, institution building and large-scale donor assistance has yielded impressive results. GDP growth, estimated at 11 percent in real terms in 2001, has been driven by reconstruction spending, private transfers from Kosovars living abroad, and the presence of some 50,000 expatriates in Kosovo. According to recent estimates, 2001 GDP per capita was about US\$900, about twice as high as in the mid-1990s. Indicators of disposable income and consumption suggest an even stronger recovery of aggregate demand. In 2001, consumption and investment combined were estimated to be more than twice as high as 2001 GDP, reflecting the magnitude of foreign assistance. Furthermore, with remittances in 2000 (and 2001) estimated at some 30 percent of GDP, national income is significantly higher than GDP. Due to massive official and private transfers, imports are estimated to have reached close to 163 percent of GDP in 2001. These large official and private transfers have helped to cover the trade deficit, and thus generate a roughly balanced current account.³

1.6 Kosovo has also made impressive progress in macroeconomic stabilization. Following the adoption of the DM in 1999, prices are estimated to have grown at an average rate of 2-3 percentage points per quarter in 2000 and 2001, reflecting the gradual removal of exemptions from sales tax, VAT and customs duties. Kosovo successfully converted to the use of the euro in early 2002. While the adoption of a hard currency has been critical in helping to establish macroeconomic stability, it also places a relatively heavy burden on fiscal policy.

1.7 Despite the impressive economic recovery, poverty is still widespread. Recent survey work and poverty analysis undertaken by the World Bank shows that over one half the population was poor in late 2000.⁴ Moreover, this analysis also found that about 12 percent of the population lived in extreme poverty, i.e. had insufficient income to afford food consumption above the minimum daily caloric requirements. There are also significant issues in education and health. In education, striking inequalities exist across income, ethnic groups and gender. Problems are especially apparent at the secondary school level, where only one-half of Albanian girls between the ages of 15-18 were enrolled in school in end-2000. Enrolment is even lower for the non-Albanian, non-Serb children. The limited health data suggest that Kosovo ranks the lowest in Europe on virtually every health indicator. Infant mortality, maternal health and the decline in immunization coverage are areas of particular concern.

B. THE NEW POLITICAL STRUCTURES AND THE ECONOMIC CHALLENGES

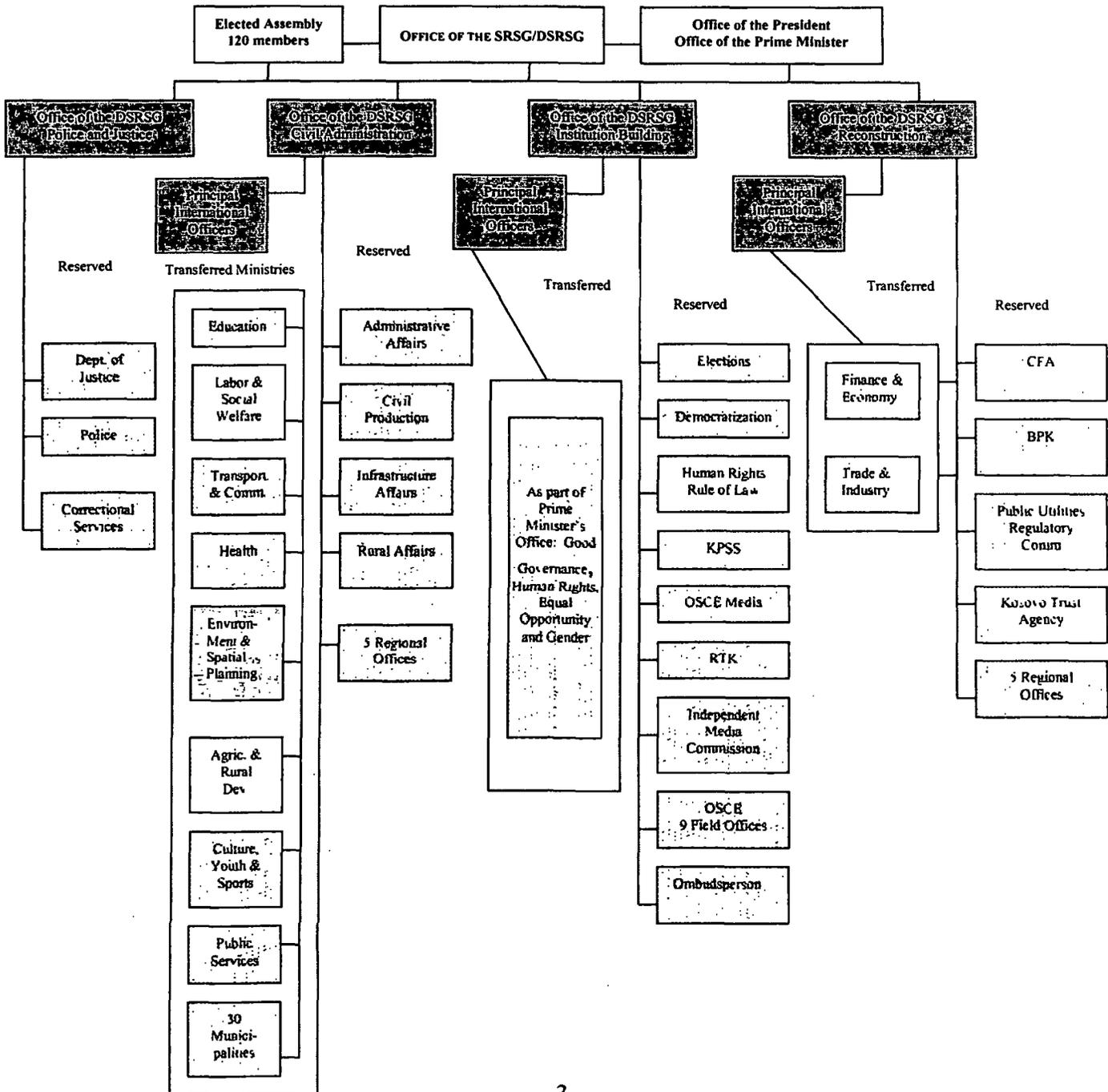
1.8 Over the past three years, in addition to the progress made in restarting the basic institutions of government and economic activity, Kosovars have become increasingly involved in the political sphere and in economic policy discussions and implementation. The adoption of Kosovo's new Constitutional Framework (CF) by the Special Representative of the UN Secretary General (SRSG) in May 2001, and the subsequent Kosovo-wide elections in November 2001, have been the most critical steps in handing over substantial authority to the

³ Transfers associated with the activities of KFOR are not included in any of these figures.

⁴ World Bank Poverty Assessment.

local population. The framework for the new Kosovo Government Structure is outlined in Chart 1.1. The establishment of this framework and the new Kosovo Government, which took power on March 4, 2002 are key achievements in the past year. While the Provisional Institutions of Self Government (PISG) have significant responsibility in governing Kosovo, the Special Representative of the UN Secretary General (SRSG) retains the power to ensure security (in coordination with KFOR), exercise a number of specific reserve powers, and set the “broad parameters” of fiscal policy, including the overall budget. Box 1.1 outlines the unique political and administrative governance structure in Kosovo.

Chart 1.1: The Institutional Structure



Box 1.1: Political and Administrative Governance in Kosovo

Since the end of the conflict in June 1999, Kosovo has been gradually progressing towards self-government. On the basis of UN Security Council Resolution 1244, the Secretary General established the UN Interim Administration in Kosovo (UNMIK) as the transitional administration. Resolution 1244 also provides that UNMIK is to organize and oversee the development of provisional institutions for democratic and autonomous self-government pending a political settlement, including the holding of elections, and transferring authority and administrative responsibilities as these institutions are established. UNMIK established four pillars or areas of responsibility for international agencies to guide political and institutional development in Kosovo: (i) Pillar 1 for humanitarian issues (led by the UNHCR); Pillar 2 for civil administration (led by the UN); Pillar 3 for democracy building and elections (led by the OSCE); and Pillar 4 for economic development and reconstruction (led by the EU).

In order to help prepare for the first phase of self-government, the Kosovo Transition Council (KTC) was established early on to include representatives from ethnic Albanian, Serb and other groups. It served as the highest political consultative body, providing the main political parties of Kosovo a forum for input into UNMIK decisions.

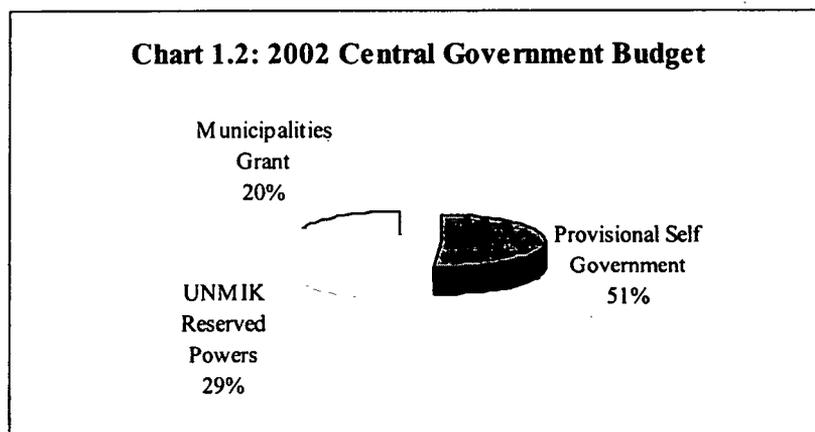
Local participation was broadened in January 2000 with the establishment of a Joint Interim Administrative Structure (JIAS) with joint representation of UNMIK staff and local leaders. Under the JIAS structure, responsibility for administration was distributed among 20 departments across four pillars. Each department was co-headed by an international advisor and a Kosovar expert. The Kosovar co-heads constituted a Council of Ministers, a body formed to assist in policy discussions and implementation. Later in 2000, an Interim Administrative Council (IAC) was formed, consisting of four international members and four Kosovars, which had authority over all civilian affairs, except matters pertaining to public safety and general security. UNMIK held municipal elections in October 2000, following which local assemblies were created. The second round of municipal elections are scheduled for October 2002.

On March 4, 2002 the Kosovar Assembly elected Mr. Ibrahim Rugova President of Kosovo and Mr. Bajram Rexhepi Prime Minister of the new Government. This was a critical step in establishing the Provisional Institutions of Self-government as foreseen in the Constitutional Framework adopted by the Special Representative of the UN Secretary General (SRSG) in May 2001. The establishment of the Provisional Institutions of Self-Government includes:

(i) The Assembly of Kosovo, consisting of 120 members, of which 100 are directly elected through the electoral process and 20 seats are 'reserved' for additional representatives of non-Albanian Kosovo communities. Fourteen parties are represented, of which the Democratic League of Kosovo (LDK) is the largest party with 47 seats, followed by the Democratic Party of Kosovo (PDK) with 26 seats. The Kosovo Serb Povratak coalition is the third largest party with 22 seats; (ii) The President of Kosovo is Ibrahim Rugova; and (iii) The Government of Kosovo, formed under Prime Minister Bajram Rexhepi, consists of ten ministries and the Office of the Prime Minister. Ministers' cabinets include five political appointees per Minister. Each Minister is also supported by a non-political civil service, headed by a Permanent Secretary. Five out of 11 permanent secretaries have so far been appointed. In each Ministry there is also an UNMIK Principal International Officer (PIO).

While the Provisional Institutions of Self-government have significant responsibility in governing Kosovo, the SRSG remains the final authority. The SRSG, through reserved powers, continues to have direct responsibility for law and order, the judiciary, the protection of minorities, the concluding of agreements with states and international organizations, the administering of state and socially-owned property, and decision making in key economic areas.

1.9 Along with the transfer of power from UNMIK to the PISG, a transfer of public sector resources is also taking place. The 2002 budget marks an important stage in the transfer of power. Chart 1.2 shows, the significant transfer of budgetary authority in the past year: 72 percent of public resources from the Kosovo Central Budget are under the authority of the PISG and the municipalities in 2002; in 2001 all general budget resources were under the authority of UNMIK. This presents a very significant opportunity and challenge for laying the institutional basis for sound fiscal management in Kosovo. (See Box 1.2)



Source: Kosovo Consolidated Budget 2002.

1.10 The new Government in Kosovo and its new budgetary authority come at a time when it is critical to address some fundamental questions on how to support the long-term development of Kosovo. To reach beyond recovery to longer term sustainable growth, Kosovo will need to make further progress in fundamentally reforming its economy and its public finances. Donor support has provided a very large flow of investment resources that are gradually phasing down to lower levels as the reconstruction effort matures. At the moment, Kosovo does not have access to external borrowing. It will need to rely increasingly on its own resources and potential. This makes targeted and efficient public spending one of the highest policy priorities in Kosovo. Tough choices and trade-offs will need to be made and the strategic and selective determination of medium-term priorities will be critical in ensuring fiscal sustainability in the medium term.

Box 1.2: The Scope and Organization of the Public Sector in Kosovo

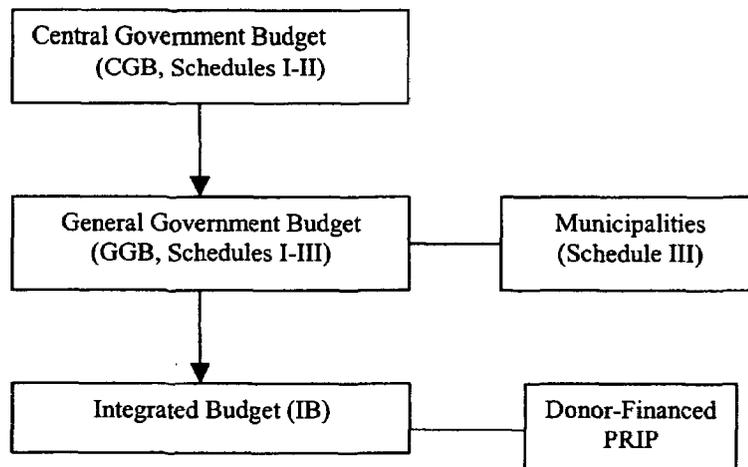
The public sector in Kosovo is composed of (i) the central government, (ii) 30 municipal governments, (iii) the public enterprise sector (iv) reconstruction spending through the PRIP, (v) off-budget spending by UNMIK and KFOR.

The central government consists of all central agencies financed by the budget; in Kosovo this is composed of Schedules I and II of the budget, where Schedule I covers the PISG and Schedule II the reserved powers. The central government and the municipal governments combine to form the General Government Budget (GGB). Municipal budgets are covered by Schedule 3.

Public enterprises are excluded from the government sector but are included in the definition of the public sector. Public enterprises will only be covered in this report as they affect the central budget.

There are also a range of major off-budget public spending items, in particular donor-financed public reconstruction spending (until recently administered by the Department of Reconstruction), and spending on UNMIK and the Kosovo Force (KFOR). PRIP spending is combined with the Consolidated General Government Budget to form the Kosovo Integrated Budget (KIB)

Public sector components



1.11 Prioritization of expenditures is fundamentally political. In its new program, the Kosovar Government has outlined broad economic priorities. These include:

- (a) fostering economic development and growth, and increasing employment, through creating the conditions for a market-based economy;
- (b) improving the living standard of vulnerable groups, and enhancing the quality of and access to education and health; and
- (c) ensuring an efficient and transparent public administration.

1.12 Implementing the ambitious Government program and mobilizing sufficient budgetary resources will be a real challenge. As described in detail in Chapter 5, the authorities are starting to cost out these medium-term policy priorities through work towards a medium-term expenditure framework (MTEF). This medium-term planning process has already begun to tighten the links between policy, planning and budgeting, and will also contribute to the integration of the capital and recurrent budgets.

C. THE REFORM AGENDA

1.13 Achieving the new Government's objectives of a rapidly growing economy with increased private sector employment and an overall improvement in living standards will require decisive implementation of a broad-ranging structural reform agenda. These reforms will also enhance the economy's flexibility and resilience to shocks. This reform program will require three main pillars:

- improving the investment and private sector climate;
- enhancing the economy's competitiveness and productivity; and,
- ensuring that the benefits of growth accrue equitably to all groups in Kosovo.

1.14 **Improving the investment and private sector climate.** A basic requirement for fostering growth through investment and new business creation is an environment that provides a high degree of security and predictability. Kosovo has yet to establish an adequate business environment, where the rules of law are respected, property rights and claims are recognized, contracts can be enforced, and investors have access to capital. The even and fair enforcement of laws and regulations is also critical. Recommended policy measures to promote investment and business creation include:

- (a) Reviewing, formulating and adopting new legislation in selected areas, including mortgages, bankruptcy, property rights, and competition; and developing the institutional capacity to administer and enforce this legal framework. These measures would also provide further incentives for existing firms to move from the informal to the formal economy.
- (b) Establishing a secure agricultural land market to promote rural growth. This will require establishment of a formal process to resolve land ownership disputes while simultaneously implementing systems for the registration of titles and development of a secure land market.
- (c) Increasing the capacity of the judicial system to deal with commercial disputes. At a minimum, a more developed legal framework, expansion and rationalization of court capacity, improvements in documentation and verification, and training for consistency and standards are needed. In the long run, the introduction of a uniform commercial code would be helpful.

- (d) Further improving compliance with tax and customs administration so that all consumers and producers are treated equally and operate on a level playing field.
- (e) Developing the financial system (particularly commercial financial services) and strengthening banking supervision to increase the levels of financial intermediation. Strengthening the institutional capacity of commercial banks to meet the financing demands of SMEs, especially as donor programs are wound down, will be essential for future growth of the private sector.

1.15 Enhancing the economy's competitiveness and productivity. The remarkable growth in construction and trade since the end of the conflict will not be sufficient to increase competitiveness and productivity over the medium term. Specific structural measures to diversify the economy and encourage private sector led growth include:

- (a) The start of privatization and/or liquidation of socially owned enterprises, following the recently approved KTA regulation. Its implementation would promote economic growth through the development and growth of new enterprises (including SMEs), the formalization of the economy, and a more efficient utilization of assets. In the meantime, a hard budget constraint should be enforced against SOEs to ensure that they do not enjoy advantages over their private sector competitors and do not squander limited budget resources through direct or indirect subsidies. This would include enforcing tax and utility payments and imposing tight controls on borrowing.
- (b) Development of strategies for restructuring public utilities. The private sector cannot flourish without reliable energy, and adequate transport and telecommunications services. Such strategies to improve the quantity and quality of services and the financial performance of the public utilities should encompass (i) rationalization of the operations of utilities, (ii) corporatization of the restructured units to improve governance and accountability, and (iii) introduction of private sector participation (including through leases, concessions and management contracts). This needs to be accompanied by a development of the supporting legal and institutional framework to regulate these sectors. In the mean time, payment discipline must be restored to ensure viability of supplies, and disconnection policies need to be adopted and enforced to enable utilities supplies to consumers in arrears.
- (c) Making choices about investment in the education and health sectors. These decisions will also have a major impact on the competitiveness of Kosovo in the medium term.

1.16 Ensuring that the benefits of growth accrue equitably to all groups in Kosovo. While broad-based labor intensive economic growth will allow many Kosovars to regain income security, such growth may leave behind some members of society,

including the poorly educated or those in poor health. The further development of Kosovo's human resource base will be critical for sustainable growth. Given the tight resource constraints and the prevalence of poverty in Kosovo, a medium-term strategy for poverty alleviation should be designed based on analysis of poverty in Kosovo. Priority measures include:

- (a) Designing poverty indicators and developing a poverty monitoring system. Data of the poverty profile need to be available at regular intervals to guide economic policy formulation;
- (b) Reviewing the existing system of social assistance with a view to improving its targeting and focusing interventions on the extremely poor;
- (c) Improving education outcomes by removing bottlenecks to access and attainment, in particular in the enrolment of the poor, girls, and minority groups in both primary and secondary education;
- (d) Reducing barriers to health care utilization, including formalization of the co-payment system to reduce the scope for under-the-table payments, provision of a package of basic health care services to the poor, and ensuring proper access of lower-income municipalities and minority groups to health care services; and
- (e) Developing a policy and planning framework to implement a medium-term poverty alleviation strategy.

D. THE MEDIUM-TERM MACROECONOMIC OUTLOOK

1.17 If the authorities continue to make progress on the stabilization and structural reform agenda, economic prospects appear good in the medium-term. Under this reform scenario, *real GDP* could be expected to grow by an average of 5 percent over the period 2003-2005 (Table 1.1). Such growth rates are roughly in line with those seen in Albania following a period of internal conflict, but well below rates in Bosnia and Herzegovina, which suffered a longer and more devastating conflict than Kosovo. Implicit in these growth assumptions are a very strong private sector performance including in agriculture, a continued inflow of foreign diaspora remittances and a sufficiently gradual withdrawal of donors.

Table 1.1: Medium Term Macroeconomic Projections

	2000	2001	2002	2003	2004	2005
	(in millions of euros)					
Consumption	2317	2572	2809	2834	2785	2803
Investment	959	946	871	706	575	585
Change in inventories	40	48	40	40	40	40
GDP	1414	1747	1990	2163	2339	2530
Workers' remittances	472	524	526	507	441	437
Factor income from donor-related employment	177	163	132	107	71	50
GNP	2063	2434	2648	2777	2852	3016
Nominal GDP growth		23.6	14	8.7	8.2	8.1
Real GDP growth		11.0	7	4.5	4.5	5.5
Increase in GDP deflator		11.3	6.5	4	3.5	2.5
	(in percent of GDP)					
Consumption	163.9%	147.2%	141.2%	131.0%	119.1%	110.8%
Investment	67.8%	54.1%	43.8%	32.6%	24.6%	23.1%
Workers' remittances	33.4%	30.0%	26.4%	23.4%	18.9%	17.3%

Source: IMF, MoFE/CFA

1.18 **Investment** levels, declining from 68 percent of GDP in 2000 to around 23 percent by 2005 are needed to meet remaining post-conflict and transition needs, to make up for the backlog of maintenance, and underpin the 5 percent growth scenario. Given the large remaining investment needs and the relative paucity of private investment, exacerbated by continued uncertainty over Kosovo's final status, public investment needs are forecast to remain higher than in other economies in the region, equivalent to around 10 percent of GDP by 2005.

1.19 **Inflation** is forecast to decline from 10 percent in 2001 to less than 3 percent by 2005. Low inflation will be supported by the continued use of the euro and prudent fiscal policy. The gradual reduction of aid flows and the international presence will also place downward pressure on inflation. By decreasing investment and consumption, it will also have a negative impact on economic growth, as well as on the budget (directly by diminishing the grant financing of the budget deficit and indirectly by decreasing tax revenues).⁵ The rebound of the private sector, if synchronized with the donor withdrawal, should be able to absorb some of the released work force.

1.20 With external aid financing projected to decline rapidly over the coming years, imports are forecast to decrease from 145 percent of GDP in 2002 to around 45 percent of GDP by 2005. This decline will test the sustainability of Kosovo's economic recovery. Exports of goods and services will also decrease slightly over the forecasting period, driven by lower exports of services reflecting the declining presence of internationals.

⁵ Imports directly associated with the donor program are tax exempt.

However, exports of goods are expected to increase as structural reform leads to increased economic activity and productivity in Kosovo.

1.21 Although donor spending is currently roughly on par with GDP, its contribution to GDP is much lower.⁶ A large part of donor expenditure, for instance payments to international consultants that are not spent in Kosovo, has no impact on GDP. Estimates by the IMF suggest that the effects of donor spending accounted for roughly one-third of GDP in 2001. These calculations suggest that a 10 percent reduction in donor expenditure would reduce GDP by 3.8 percent. The sensitivity of GDP to donor expenditure will be gradually reduced in line with the reduction of the reliance of Kosovo on donor support.

E. MEDIUM-TERM FISCAL AND EXTERNAL FINANCING REQUIREMENTS

1.22 **A public spending to GDP ratio of roughly 30 percent, with one third spent on public investment, seems appropriate for Kosovo by 2005.** As outlined in Chapter 3 of this report, estimating the economy's public investment requirements and the appropriate level of recurrent spending against international comparators, suggests that a spending to GDP level of roughly 30 percent would be necessary in the medium term to underpin the growth scenario outlined above.

1.23 **Local revenues will finance an increasing share of fiscal expenditures.** As described in Chapter 2 of this report, continued efforts to strengthen tax administration and broaden the tax base are expected to further increase the ratio of locally generated revenues to Kosovo's GDP. However, as most measures to achieve large increases in such revenues have already been implemented, the potential for further increases will be more limited. The analysis assumes that this ratio will be increased to 22 percent of GDP by 2005, up from 9 percent in 2000.

1.24 **The fiscal financing gap will decline but remain large.** Table 1.2 shows that these additional local revenues will remain insufficient to cover all of Kosovo's fiscal expenditure needs over the period 2003-2005. As the Government of Kosovo currently has no access to external borrowing or seignorage, and has little if any ability to borrow domestically, the resulting financing gap will need to be covered by donors.⁷ Projects that already identified sources of donor financing will generate disbursements of €440 million towards covering these financing needs for 2003-2005.

⁶ The net impact of donor expenditure on GDP consists of direct expenditure by donor organizations plus transfer payments and wages/salaries, to the extent that they are locally spent, minus the import content of these expenditures.

⁷ The Report assumes no foreign borrowing. This assumption stems from the existing legal situation and the need to put in place an appropriate framework for sustainable and responsible public borrowing, as well as issues related to Kosovo's existing debt. It is possible that after legal clarification and the establishment of an appropriate framework some of the financing requirements could be covered by external borrowing.

Table 1.2: Medium-Term Fiscal Financing Requirements

(in millions of euros)

	2000 (act)	2001 (act.)	2002 (proj.)	2003	2004	2005	2003-2005
Central Government (CG)							
Domestic revenues	127	298	405	448	487	527	
CG expenditure 1/	220	276	527	473	502	537	
CG Budget Balance	-93	22	-122	-25	-15	-10	
CG financing needs				25	15	10	50
PRIP							
Already identified financing			411	220	130	90	
PRIP expenditure	542	551	411	280	220	200	
PRIP balance			0	-60	-90	-110	
PRIP disb. from new commitments			0	60	90	110	260
TOTAL financing needs				85	105	120	310
Total New Donor Commitments, 2003-2005				200	165	135	500
PRIP new commitments				175	150	125	450
CG Budget Support				25	15	10	50

Note: This implies new commitments of about EUR 500 million over the 2003-2005 period, including EUR 50 million for budgetary support.

New PRIP commitments decline from EUR175 million in 2003 to EUR 125 million in 2005.

1/ Policy adjustments will still be required to bring currently proposed spending patterns to this level of spending.

Source: IMF, MoFE/CFA, World Bank Staff estimates

1.25 Newly pledged donor finance will be needed to meet priority investment needs and to ensure the sustainability of the General Budget as revenue measures gradually take hold while new expenditure commitments come on budget. The analysis of international comparators and the wide range of expenditure needs presented in Chapter 3 of this report suggest that Kosovo will require recurrent public expenditures of about 20 percent of GDP in the medium-term. This analysis also suggests that Kosovo's public investment needs, while continuing to decline rapidly, will remain at around 10 percent of GDP in 2005.

1.26 Donor assistance remains crucial for achieving sustainable public finances. Closing the remaining financing gap will require €500 million of new donor commitments over the three year period 2003-2005. About €450 million of these commitments will be needed to finance the PRIP. Were €175 million of new commitments for the PRIP made in 2003, €150 million in 2004, and €125 million in 2005, this would be expected to generate €260 million of new disbursements for the PRIP over the period 2003-2005. The remaining €50 million of new commitments would be for budget support. Although locally generated revenues will roughly be able to cover recurrent costs, increased capital expenditure will need to be absorbed by the General Budget.

1.27 Kosovo's external financing requirements will be substantially lower than in the 1999-2002 period. As Kosovo holds no official foreign exchange reserves and will have very limited inflows of equity and debt capital, its current account deficit will by definition be close to balance. Given Kosovo's reliance on grant financing, the best indicator of its total financing needs is its current account balance net of official transfers.

Based on the macroeconomic scenario outlined above, Table 1.3 shows a rapid reduction of these financing needs from 2001 to 2005, primarily reflecting the winding down of the main emergency reconstruction phase. In 2002, the change may not be dramatic, as donor-financed public investment spending may still reach an estimated US\$411 million, or 21 percent of GDP. However, such investment spending is expected to be halved between 2002 and 2004. Remittances as a share of GDP are forecast to decline slightly over the medium-term, but equivalent to an estimated 17 percent of GDP by 2005, they will continue to have a considerable impact on the Kosovo economy.

Table 1.3: Medium-Term External Financing Requirements

(in millions of euros)

	2000	2001	2002	2003	2004	2005
Net exports of goods and services/1	-1333	-1158	-1128	-934	-767	-722
Factor income from donor-related employment	177	163	132	107	71	50
Workers remittances	472	524	526	507	441	437
Official grants	766	629	430	310	235	210
Current account balance (including grants)	82	158	-40	-10	-20	-25
Current account balance (excluding grants)	-684	-471	-470	-320	-255	-235
Financing needs	684	471	470	320	255	235
Already identified PRIP funding	542	551	411	220	130	90
Already identified undesignated budget funds	102	60	10	0	0	0
Humanitarian assistance	36	18	9	5	0	0
Other/2	-83	-159	40	10	20	25
Financing sources	597	470	470	235	150	115
Financing gap				85	105	120
o/w required central government financing				25	15	10
o/w disbursement from new PRIP commitments				60	90	110

1/ Excludes imputed services provided by donors

2/ Includes net capital flows, changes in cash balances, and errors and omissions

Source: IMF, MoFE/CFA, World Bank Staff estimates

1.28 Even with successful implementation of the reform agenda and a relatively favorable external environment, the macroeconomic performance outlined above will require significant donor financial support. While Kosovo has passed the emergency phase and much of the reconstruction has been completed, it still faces many of the same structural issues as other poor, rural, transition economies. Kosovo's total financing needs from 2003-2005 are projected at around €810 million. More than half of these needs (€440 million) are expected to be met from the disbursement of the remaining already pledged donor funds.⁸ After accounting for changes in cash balances, net capital flows and errors and omissions, and a small amount of humanitarian assistance, this leaves a residual financing gap to be covered by disbursements of €310 million from new donor commitments.

⁸ 'Already identified financing' in Tables 1.2 and 1.3 refers to these funds.

1.29 **The macroeconomic scenario outlined above is associated with substantial risks.** The above scenario of a sustained rebound in growth and living standards assumes (i) implementation of a coherent medium-term program of institutional strengthening and reform; (ii) continued, well-targeted donor support for Kosovo; and (iii) a relatively favorable external environment. Kosovo has very little cushion to absorb the consequences of any significant downward deviation in one or more of these areas. If the reform effort is weaker than expected, for instance because of the Government's untested capacity or resistance to reforms from vested interests, private sector development as well as the willingness of donors to support Kosovo would be negatively affected. Real GDP growth under this scenario would be lower. On the other hand, lower GDP growth could also arise from developments exogenous to Kosovo, including an inadequate level of external financing. Lack of progress in resolving Kosovo's final status might also slow down private investment and growth.

F. REPORT OUTLINE

1.30 To date, fiscal policy in Kosovo has focused on establishing tax collection capacity, activating essential public services, and building up the capacity to administer budget funds. Initial progress has been very impressive both in terms of regaining macro-stability and initiating economic growth, and in establishing the basic institutions of government. The challenge now is to develop tax and expenditure policies which will preserve macro-stability and ensure that public services are sustainable, comprehensive, and efficiently provided. In particular, and against a background of widespread poverty, public spending needs (i) to lay the basis for broad-based equitable economic growth, and (ii) to target the most needy.

1.31 This Report addresses three cross-cutting key challenges for the budget process in Kosovo:

- (a) The need to promote fiscal discipline by ensuring that public expenditure is planned within a realistic macroeconomic and fiscal framework,
- (b) The need to facilitate strategic prioritization and restructuring of public expenditure by linking more explicitly government policies to expenditure priorities; and
- (c) The need to ensure more efficient use of public resources through improvements in procedures for budget planning and management.

1.32 The Report is selective in covering sectoral issues, dealing only with those that are transferred powers and have the largest (potential) impact on Kosovo's fiscal stance. In the face of limited financial and human resources, there is a need to be realistic in selecting the goals of reform.

1.33 The Report consists of three parts. The first part of the Report focuses on resource mobilization for public expenditures. Chapter 2 outlines the sources and trends in public sector revenues in Kosovo since the end of the conflict and provides forward-looking prospects.

1.34 The second part of the report (Chapters 3 and 4) provides a broad external assessment of public expenditure allocation in Kosovo, focusing in particular on the allocative and technical efficiency of public spending in Kosovo. Chapter 3 assesses aggregate public spending levels and deals with cross-sectoral expenditure issues through an analysis of the economic and functional composition of the General Budget. Chapter 4 focuses on selected social sector policy and expenditure issues. The examination of the allocation of expenditures in this report focuses on the public sector wage bill and spending on pensions, social assistance, health, and education. Spending in these sectors accounts for the majority of the budget.

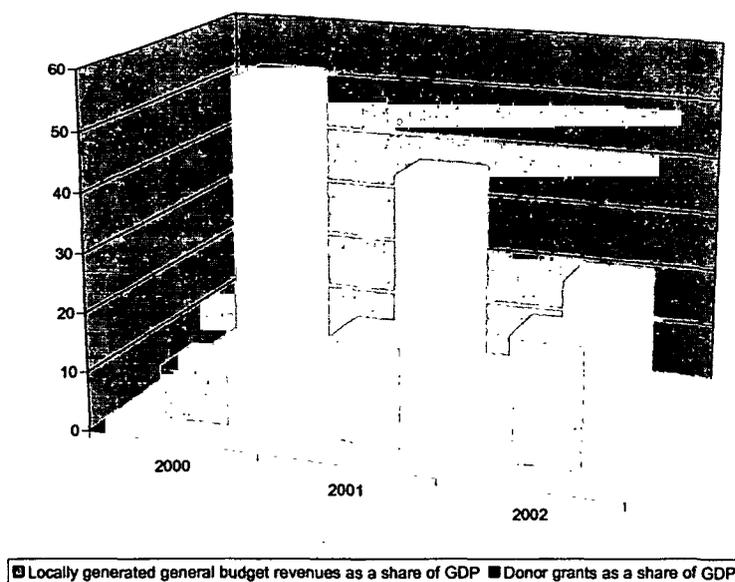
1.35 The third part of the report (Chapter 5) focuses on the institutions for public spending, and highlights that there is sufficient scope to increase the effectiveness of the budget as a policy tool. With the transfer of power from UNMIK to the PISG and the municipalities, an immediate challenge is to put in place the institutional basis for budget formulation and management. While implementing the handover of power from UNMIK to the PISG, a second simultaneous institutional challenge facing Kosovo is to integrate the capital and recurrent budgets.

2. RESOURCE MOBILIZATION FOR PUBLIC EXPENDITURE

2.1 Given Kosovo's unique circumstances, fiscal policy can only take a rudimentary form. With the use of the euro and no domestic financial instruments, there exists no scope for either seignorage or inflationary finance. Furthermore, Kosovo/UNMIK cannot borrow externally. Hence, public expenditures must be fully financed by locally generated tax revenues and donor grants. Fiscal sustainability therefore requires that spending is kept in line with available tax and donor resources.

2.2 Locally-generated revenues have performed impressively since 1999. Nominal General Budget revenues grew by almost 150 percent in 2001 alone, from €129 million in 2000 to €302 million in 2001. As illustrated in Chart 2.1, the contribution of local revenues to total public spending in Kosovo has increased impressively over the past few years. The share of locally generated resources in total public spending (KIB) increased from 15 percent in 2000 to an estimated 44 percent in 2002. This performance has been made possible by the introduction of an increasingly diverse range of taxes; more recently, strengthened tax administration also seems to have played an important role in boosting collections. Chart 2.2 shows the sources of revenue and their relative importance.

Chart 2.1: Resources for public spending 2000-2002



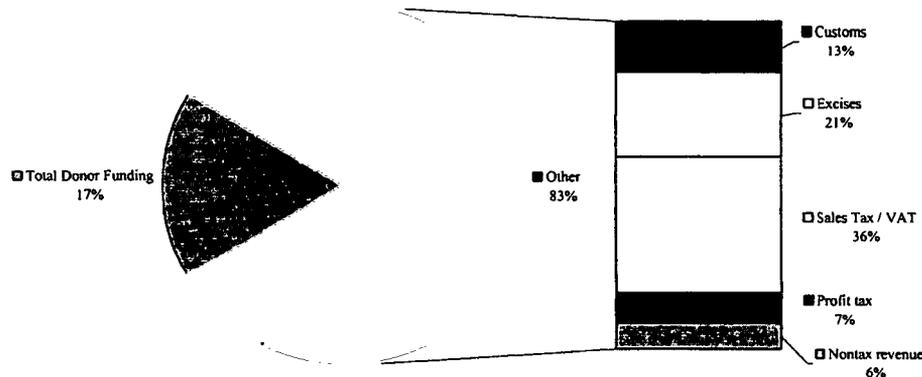
Source: CFA/MoFE

2.3 Donor grants to Kosovo have primarily financed the capital-intensive reconstruction and recovery program; €1.34 billion was spent by end-2001.⁹ In addition, by end-2001 donors had also provided €215 million in direct support to the General

⁹ Spending on reconstruction and recovery and peace implementation activities.

Budget. Locally generated revenues accounted for 83 percent of total budget revenues in 2001, up from 52 percent in 2000 – and around one-third in the final months of 1999.

Chart 2.2. 2001 General Budget Revenue
Total Revenue and grants: Euro 363.9 million



2.4 Chapter 1 outlined the macro-fiscal scenario; this chapter focuses in more detail the revenue assumptions underlying this scenario. It outlines the sources and size of public sector revenues, both at the central and at the municipal levels. It starts with a description of the tax system, and then analyzes how revenue performance in Kosovo compares to other economies in the region. This chapter then turns to considering municipal revenues, including both intergovernmental transfers and own source revenues. The final section of this chapter presents forecasts for locally generated revenues for 2003-2005.

A. RAISING REVENUES FOR THE CENTRAL GOVERNMENT: THE TAX SYSTEM

2.5 A basic tax structure was introduced shortly after the establishment of UNMIK. In the absence of adequate administrative machinery to collect taxes on consumption and incomes, border and boundary taxes have been the major source of revenue for the local recurrent budget of Kosovo. Regulation 1999/3 (August 1999) established a 10 percent customs duty, a 15 percent sales tax and various excise taxes to be charged at border and administrative boundary line checkpoints.

2.6 A uniform 10 percent **customs duty**, with a limited (and decreasing) list of exemptions for food and medical products, has been levied since late 1999. The customs duty is only levied on goods originating from outside the Federal Republic of Yugoslavia

(FRY). Imports from FYR Macedonia, with which FRY has a free trade agreement, are subject only to a 1 percent administrative fee.

2.7 A 15 percent VAT, with the same exemptions as the customs duty, was introduced on 1 July 2001 to replace the sales tax (on imports). The VAT also applies to domestic tax payers. Currently, only those firms that export or have an annual turnover in excess of €50,000 are liable to pay the VAT; there are an estimated 2000 tax payers. Because of the high threshold and low compliance, the efficacy of the tax is currently limited. Reductions in the threshold is scheduled to take place in July 2003 (€25,000) as the capacity of the tax administration strengthens. Voluntary VAT administration is also scheduled to be introduced in 2003.¹⁰

2.8 Relative to the previous sales tax, the introduction of the VAT has reduced the tax burden to importers, particularly of large-scale fixed capital for investment. It also encourages the general growth of exports, by eliminating the potential cascading effect of sales taxes through its tax credit on imported inputs. Excise taxes are levied on both an ad-valorem and a specific basis. The rates vary from 10 to 50 percent.

2.9 A wage withholding tax was implemented in April 2002 at the following monthly rates: €1-50: 0 percent; €51-250: 5 percent; > €250: 10 percent. A comprehensive individual income tax will be introduced in 2003. Local employees of international organizations are exempted from paying the wage tax. This clearly has implications for equity in the short term, with relatively well-paid local employees of international organizations exempt. In the longer term, their influence in the labor market should decline as the rest of the economy expands and international organizations withdraw.

2.10 A presumptive tax on business is levied at a rate of 3 percent of gross receipts in excess of €7,500 per quarter. Since April 1, 2002, a profit tax at a rate of 20 percent has replaced the presumptive tax for enterprises with an annual turnover exceeding €100,000. Enterprises below the threshold may choose to register for the profit tax rather than the presumptive tax if they wish. In addition to these sources of revenue the budget also collects vehicle registration fees and a few other small amounts in the form of charges and user fees.

B. REVENUES IN A REGIONAL CONTEXT

2.11 **Notwithstanding the fact that amongst some in Kosovo the perception exists that their tax burden is high, Kosovo's overall tax revenues as a share of GDP remain very low compared to other countries in the region and the OECD.** As shown in Table 2.1, among a range of transition economies, taxation revenues of all kinds ranged from 15.9 per cent to 42.9 per cent of GDP. For Kosovo in 2001, the figure was estimated at 16 per cent. Although the revenue-to-GDP ratio varies considerably across countries in the region, Kosovo's ratio of 16 per cent is low relative to other economies in the region; it is roughly on par with Albania, generally considered a low revenue raiser. Kosovo continues to be characterized by a very large untaxed sector and overall tax revenues continue to come from a very narrow tax base. In spite of the impressive

¹⁰ Through registration, these businesses would be able to charge VAT on their sales and claim an input credit for VAT paid on purchases.

progress made by UNMIK over the past two years, the tax system in Kosovo remains in its infancy. The strengthening of the capacity of the tax administration will be a gradual process and in the mean time public revenue performance in Kosovo continues to depend primarily on imports.

Table 2.1. General Government revenues as a share of GDP in a comparative context

	Total revenue	Grants	Tax revenue	Nontax revenue	Income and payroll tax	Corporate tax	VAT, Sales or turnover	Excises	Import duties	Social security
Kosovo 2000	17.4	8.3	8.6	0.5	0.0	0.3	4.5	1.4	2.2	0.0
Kosovo 2001	21.0	3.6	16.0	1.3	0.0	1.6	7.3	4.4	2.7	0.0
Albania 1/	23.0	3.8	15.9	3.3	1.1	1.7	7.0	1.6	2.2	3.8
Bulgaria	35.6	0.8	27.6	7.6	2.3	2.4	8.8	3.6	1.3	8.5
Croatia	43.0	0.0	40.8	2.1	3.1	1.5	14.7	4.4	2.9	13.6
Czech Republic	32.9	0.1	31.9	1.0	1.9	2.7	7.1	3.7	0.7	14.7
Estonia	31.7	0.3	28.9	2.3	3.7	1.9	9.0	8.3	0.0	10.6
Hungary	37.5	2.5	32.9	4.4	5.2	2.2	8.4	3.8	1.2	10.7
Latvia	31.5	0.4	27.3	3.7	1.7	2.2	8.2	4.1	0.4	10.4
Lithuania	25.7	0.0	24.2	1.5	2.4	1.0	8.7	3.6	0.4	8.0
Macedonia, FYR	39.0	n.a.	36.2	2.9	n.a.	n.a.	5.4	7.2	3.7	13.0
Poland	33.0	0.0	29.7	3.1	4.6	2.5	7.8	4.0	0.9	9.7
Romania 2/	30.6	0.5	26.6	3.0	2.4	3.0	6.0	3.2	1.6	9.9
Slovak Republic	35.5	0.0	31.1	4.1	3.5	4.0	7.5	3.1	1.5	11.1
Slovenia	39.1	0.1	37.3	1.8	5.8	1.2	11.9	1.9	1.2	13.8
France 3/	41.5	0.6	38.7	3	6.3	1.9	8.0	2.7	n.a.	17.5
Germany 4/	31.5	0.2	26.5	4.9	4.0	0.6	3.3	2.9	n.a.	15.3
United Kingdom 5/	36.4	0.3	34.2	2.1	9.9	4.1	6.8	4.0	n.a.	6.2
United States	20.9	0.0	19.6	1.3	9.8	2.1	0.0	0.5	0.2	6.6
Average SEE	33.1	1.3	30.3	4.0	2.2	2.1	9.1	3.2	2.0	9.0
Average CEE	33.4	0.4	30.4	2.7	3.6	2.2	8.6	4.1	0.8	11.1

Source: IMF Government Finance Statistics Yearbook, 2001; WB staff estimates.

Average share of GDP during 1998-2000 excluding Kosovo, Bosnia and Herzegovina (1998-1999), Macedonia (1996-2000), Albania (2001), Romania (1998-99), France (1996-97), Germany (1996-98), United Kingdom (1996-99)

2.12 Kosovo's tax rates remain very low relative to many other economies in the region. As illustrated in Table 2.2, the VAT rate in Kosovo is the lowest in the region; profit and wage tax rates are also low. Nevertheless, care should be taken with increasing tax rates until compliance is improved and the tax administration strengthened and expanded. As illustrated in Table 2.3, the tax and customs administrations in Kosovo are understaffed relative to other economies in the region. The Kosovar tax administration has one tax official for every 5689 people. For most other countries there is one tax official for less than a thousand people.

Table 2.2: Tax rates international comparisons

	Standard	VAT tax rate		Corporate income
		Other	Treshold(s) Euro	
Kosovo	15		50000	20
Albania	20	n.a	n.a	30
Bulgaria	20	n.a	33300	20
Croatia	22	n.a	n.a	20
Czech Republic	22	5	n.a	31
Hungary	25	12	8900	18
Latvia	18		19900	25
Lithuania	18		13800	24
Macedonia, FYR	19	n.a	n.a	15
Poland	22	7, 12	25300	28
Romania	18	9, 11	7700	25
Slovak Republic	23	10	74800	29
Slovenia	19	8	22000	30

Source: "Corporate Taxes 2001-2002", Price Waterhouse Coopers, IMF Staff reports

Table 2.3: Tax authority staffing levels, comparative context

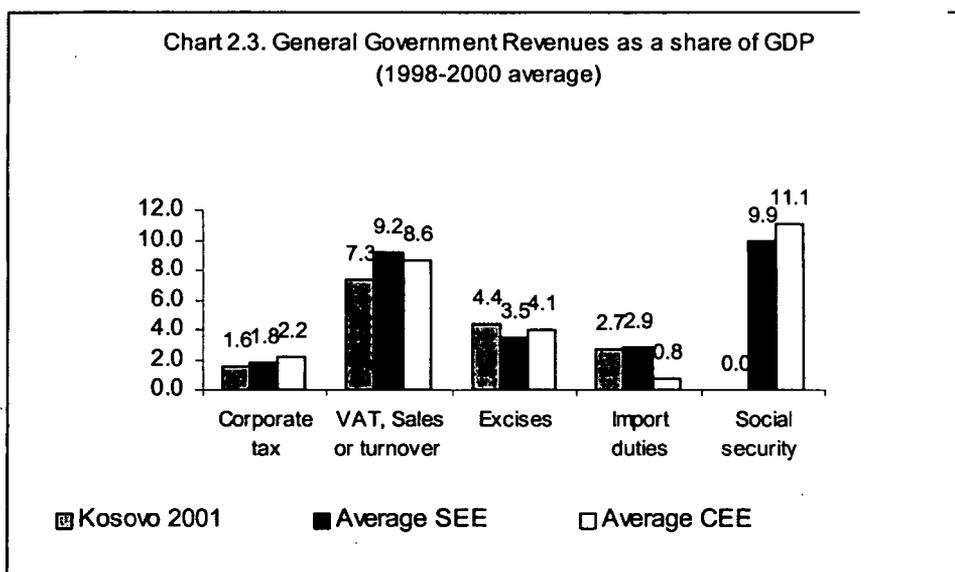
	Tax authority staffing		Year 2000 Tax/GDP	Citizens/tax official
	no.	Population		
Kosovo 2001 tax authority	334	1.9	14.3	5689
Kosovo 2001 tax and customs authority	617	1.9	14.3	3079
Czech Republic	14832	10.3	39.5	694
Denmark*	6500	5.3	50.6	815
Estonia (99)	1274	1.4	35.8	1099
Finland**	6410	5.2	46.5	811
France	81000	58.6	46	723
Germany	126033	82.1	37.8	651
Hungary**	12995	10.1	37	777
Ireland*,**	6205	3.8	31.5	612
Latvia	4200	2.4	34.7	571
Norway**	6000	4.5	40.2	750
Poland (99)	50018	38.7	35.2	774
Romania (97)	18200	22.4	29.5	1231
Slovak Republic	5669	5.4	35.8	953
Slovenia	2500	2	39.3	800
Spain*	27548	39.4	35.3	1430
Sweden	12745	8.9	53.3	698
UK**	85341	59.5	37.7	772
Yugoslavia**	7839	11.2	35.4	1429
Average	26406	20.6	39.0	866

* These authorities also administer Customs.

** These authorities also collect social security contributions.

Source: IMF compilation (using annual reports and other sources)

2.13 The set of tax instruments employed is not as extensive as that in neighboring economies. As shown in Chart 2.3, the most striking difference between Kosovo and other countries in the region is that Kosovo is not raising any revenue from social security, income, and payroll taxes. In south-eastern Europe and central Europe, typically around one-third to one-half of general government revenues is derived from this source. Corporate taxation is also a relatively more important source of tax revenues in other economies in the region than it is in Kosovo. On the other hand, direct taxation, and in particular excise taxes, account for a larger share of total revenues in Kosovo than in other economies.



Source: IMF GFS, MoFE/CFA, World Bank

Policy recommendations

2.14 Tax policy for Kosovo should take into account the practical limitations of the economic situation, and must also lay the basis for a coherent long-term framework as the economy recovers and administrative capacity increases. The usual objectives for a modern tax system apply. It needs to be fair and equitable, and transparent. It should also be efficient in that it does not *unnecessarily* distort resource allocation and offers the least hindrance to Kosovo's economic development. Finally, it needs to be simple so that tax administration can manage it and tax payers comply with it.

2.15 **Kosovo should continue efforts over the medium term to broaden the tax base and to reduce distortions by moving towards less reliance on a narrow range of indirect, trade-based taxes, and extending the level of taxation to the domestic economy.** In assisting the speedy achievement of this goal, practical constraints in the form of tax administration will need to be addressed and overcome. More tax administrators will have to be recruited and trained, and systems to administer revenue collection will have to be developed further.

2.16 Although the Kosovo foreign trade regime has a low and uniform tariff rate, a number of major distortions have crept into the system because of Kosovo's unique position. The tax and tariff treatment is presently different at all four borders/boundaries around Kosovo. The disparity of taxes levied at the various borders is narrowing the tax base, causing significant distortions, and creating room for corruption and fraud. Kosovo should push ahead with planned elimination of the tariff; any revenue losses should be compensated for by increases in the VAT rate or reductions in the VAT threshold.

2.17 A **'partial tariff elimination', exempting imports of capital goods and raw materials from customs duties, is strongly discouraged.** Such a tariff structure would distort the allocation of resources by introducing significant discrepancies in the effective rate of protection.¹¹ Activities with high effective protection would attract scarce economic resources and grow at the expense of other sectors in which Kosovo has a long-term comparative advantage. More specifically, permitting imports of raw materials and capital goods at rates lower than 10 percent penalizes the development of Kosovo's own raw material and capital goods industries, relative to the final goods sector. Such an escalating tariff structure tends to support final goods production at the expense of raw materials, and in the long run encourages assembly-type activities. Introducing a lower tariff for raw materials and capital goods without any other tax policy changes would also represent a foregone opportunity to raise revenue. Finally, a two-tiered tariff is administratively more cumbersome than a uniform tariff, and introduces considerable scope for corruption and fraud.

2.18 Decreasing the threshold for VAT will be important for widening the revenue base and decreasing distortions. Given the size structure of Kosovar business, a reduction of the threshold (to €25,000) currently scheduled for July 2003 will be particularly important from a revenue perspective. If capacity is judged to be insufficient by mid-2003, the authorities should consider delaying the threshold reduction and first strengthen tax administration capacity. A weak administration will create a non-level playing field and will encourage a culture of VAT evasion that may be difficult to eradicate. Voluntary VAT registration can be beneficial for some enterprises and should be implemented as soon as sufficient administrative capacity is in place to ensure that fraudulent refund claims and abuse is minimized. A minimum registration period should also be instituted.

2.19 For the sake of transparency, simplicity and efficiency it continues to be important to focus on the introduction of the major broad-based taxes. Although tax rates are currently relatively low, they should not be increased until compliance is improved and the tax administration strengthened and expanded. A multiplication of charges and fees be avoided at all costs.

2.20 **Special privileges and/or tax incentives to encourage investment should be highly limited, as they are likely to stimulate uneconomic activities and place an additional unnecessary burden on an already over-stretched tax administration.** Experience has shown that case-by-case tax exemptions are generally ineffective. They

¹¹ The effective rate of protection, which takes into account the overall tariff structure, is the percentage by which a country's trade barriers increase the *value added* per unit of output (considering the fact that *tariffs on inputs* matter as well as *tariffs on outputs*). The effective rate of protection increases as the tariff on output increases and the tariff on inputs decreases.

distort the playing field, they lead to a loss of revenues, and are generally not the most important factor in enterprise investment decisions. Certainty and simplicity in the operation of the tax system is a more important determinant of investment than special incentives are.

C. FINANCING MUNICIPAL SPENDING:

2.21 Regulation 2000/45 lay the basis for self-government of Kosovo's 30 municipalities. The regulation confers a wide range of responsibility to municipalities, including providing social services, housing, pre-primary, primary and secondary education and primary health services. Other responsibilities outlined in the Regulation include managing municipal property, licensing and regulating building and other economic activities, and urban and rural planning and use. The design of a devolved structure in Kosovo is complicated by large variations in the size, economic potential, income per capita and administrative and fiscal capacities of municipalities.

2.22 **The benefits of decentralization can only be realized if revenue responsibilities are transferred to the municipalities commensurate with expenditure responsibilities.** For effective fiscal devolution it is important to establish both vertical balance, with each level of government having the capacity to finance its responsibilities, and horizontal balance, meaning that there is an acceptable access to resources across municipalities. As outlined below, fiscal devolution in Kosovo raises a set of specific equity and other issues because of the asymmetric and incremental nature of the decentralization process.

2.23 **The major source of municipal revenues in both 2001 and 2002 was drawn from transfers from the central budget to municipal governments.** Own source revenue mobilization is extremely low, varying from an estimated €0.4 per capita in Djakova to €6.3 per capita in Rahovec in 2002. Total intergovernmental grant transfers range from €25.5 per capita in Pristina to €81.6 in Novoberde. The municipalities have also been receiving revenues from the health co-payment scheme since January 2002. This is only a minor source of revenue, estimated at a total of €1.8 million in 2002.

2.24 There are three separate transfers: a special purpose earmarked grant for primary health care, a special purpose earmarked grant for primary and secondary education, and a General Budget grant. The designated grants were funded from the central budget in 2001.¹² Each of the grants is distributed amongst municipalities based on a formula that takes into account the municipality's circumstances. In education and health the grants are distributed on a per pupil and per capita basis modified by factors which affect cost or need respectively. The general block grant is also distributed on a per capita basis, but is supposed to play more of an equalizing role recognizing differences in per capita fiscal need. It takes into account a broader selection of factors including density of the population, reconstruction backlogs, level of utility services, the number of villages and

¹² Not all health and education spending has been devolved in 2002: in primary health care €6.2 million is channeled through the center for central purchasing of essential medical supplies; in primary and secondary education the devolution process began in July 2002 and teacher salaries were paid from the central budget during the first half of the year.

the proportion of minority population. The system can be commended for favoring rules over discretion.

2.25 The system of municipal own source revenues is divided into two parts: a property tax system and a system of user fees and charges. UNMIK Regulation 2001/23 was passed in September 2001 and lays the legal basis for the immovable property tax pilot program.¹³ All proceeds go to the municipal budget. The tax rate can be determined by the municipality, but shall not exceed two percent of the tax base. Municipalities need to be certified by the CFA prior to participation in the program. Certification depends on the preparation of a property tax roll, setting of the tax rate and the establishment of systems to evaluate properties, bill for the tax, collect taxes, handle appeals and enforce payment. While this measure is necessary to expand immediately the fiscal capacity of the municipalities, it means that the tax is potentially regressive. Care will need to be taken in certifying municipalities that the applicable rates have been varied in accordance with the relative value and in the urban areas, rental levels of properties. As of August 2002, seven municipalities have been certified.

2.26 The property tax cannot be relied upon as a significant source of revenue in the near term. Experience across Europe shows that property taxes generally generate little revenue; they also tend to be highly unpopular. There will also be difficulties in administering the tax, and the tax could prove inequitable if it is not administered carefully.

2.27 Administrative Instruction 2001/3 has been passed which provides direction on a simple and coherent system of municipal user fees and charges based on service cost recovery. User fees are both a financing source and a rationing device to ensure that efficient service levels are produced. For each municipality the regulation on the nature and level of municipal fees and charges needs to be ratified in a hearing with the CFA. The ceiling on the total amount municipalities can raise from this source is cost-recovery based, and low relative to needs.

2.28 As outlined in Chapter 9 of Regulation 2000/45, responsibility for financial decision-making and administration shall not be transferred to the municipalities until an independent auditor has certified that adequate budgetary and financial management systems are in place, and that the municipal civil service has the capacity and ability to implement effectively financial procedures and controls. Until then, the financial management procedures established by UNMIK remain in force. In addition, the Organic Budget Law specifies that municipal revenue must be deposited into a dedicated municipal sub-account of the general revenue fund and expenditure committed and funds released under the same financial management rules and accounting systems applicable to central government. The law also provides that grant funds will not be released to municipalities unless they can demonstrate application of the rules.

2.29 Going forward, a grants commission is proposed as part of the Organic Budget Law, which will recommend to the Minister of Finance and Economy the levels of grants and establish a formula for their distribution amongst the municipalities. The

¹³ Since property ownership is not clear, the property tax is really an occupancy tax.

Commission will comprise the Prime Minister, the Minister of Finance and Economy, two other Ministers appointed by the Prime Minister and three representatives of the Municipalities. The Commission will also recommend to the Assembly the nature and scope of the powers that should be granted to the municipalities for the purpose of levying and collecting fees, charges and local taxes. The Commission also has a mediating function should there be a dispute between the central government and a municipal government.

Policy recommendations

2.30 Formula-based intergovernmental grants, structured to ensure that local governments face a hard budget constraint, must be a significant source of municipal finance for the foreseeable future. The more important taxes (VAT, excise) are collected more effectively at the central level, and the set of tax options available for municipalities will be inadequate in the medium term; grants are also necessary to offset differences in local fiscal capacity. Grants must be formula-based and structured to ensure that local governments face a hard budget constraint. Negotiated or ad-hoc decisions should be avoided as a means for determining the total amount of revenues to be distributed to municipalities and the amount to be granted to each particular municipality. Such discussions inhibit good planning and instill poor incentives for efficient operation. Grants should also not be raised during the year because of poor municipal spending decisions.

2.31 Although grants will remain the main source of municipal finance for some time to come, municipalities should raise the marginal revenues for most services. Local government authority in raising revenue at the margin reconciles the problem of vertical imbalances with local accountability. The fees contained in Administrative Instruction 2001/3 are generally licensing charges and not really charges for the use of services. Municipalities should not be encouraged to raise these fees to the point that they become taxes. User fees can be imposed effectively for financing utilities including garbage collection and disposal, electricity, water, natural gas, and heat. They cannot be counted on to finance the core goods and services budget of municipalities or to raise revenues in excess of those necessary to finance the specific services for which they are collected. Furthermore, the proliferation of many small fees and charges would produce high collection costs and can effectively lead to a series of nuisance charges.

2.32 The incremental and asymmetric nature of fiscal devolution in Kosovo raises equity concerns and the authorities may want to consider establishing a designated capacity building fund. Such a fund could be part of the central budget, and any grant allocations should be matched by municipalities. The purpose of such a fund could be to provide municipalities that do not have sufficient fiscal and administrative capacity, including to raise their own revenues, with designated grant assistance to develop that capacity. Such a step would help to counteract the asymmetrical devolution of revenue raising capacity where the stronger municipalities are likely to be certified first, thereby increasing and prolonging the fiscal capacity gap with weaker municipalities. While the general block grant includes an equalization component (with the distribution calculated on potential capacity rather than actual capacity) this component is designed for an equilibrium grant distribution.

2.33 The authorities may also want to consider establishing a municipal development fund as part of the central budget. Any central budget funding allocations would have to be matched by municipalities. In the face of declining donor contributions, the proceeds of the fund should initially focus on small and medium-scale repair and reconstruction projects. Such a municipal development fund could play an important capacity building role.

2.34 The inclusive membership and real powers of the Grant Commission is commendable and will contribute to the smooth functioning of the intergovernmental fiscal system. However, given that the Commission has real decision making powers the establishment of a well resourced secretariat should be seen as a matter of urgency. In addition to its policy role, the Grant Commission can also play an important role in ensuring transparency in the intergovernmental revenue allocation, including through publication of an Annual Report. This report should contain detail on the fiscal impact of the intergovernmental system, including on the distribution of funds, the cross- and intra governmental spending in the key social spending categories of health and education, the relative spending outcomes in terms of outputs and intermediate outcomes and on the state of municipal finances and the robustness of intergovernmental and municipal fiscal systems. By 2005, the Grant Commission should also consider a more fundamental rethinking of the intergovernmental finance system, as local revenue raising capacity increases, and may start to interact with the distribution of grants among municipalities.

D. FORECASTS OF LOCALLY GENERATED REVENUES

2.35 The main assumptions underlying the locally generated central revenue estimates are: (i) a uniform tariff policy without exemptions, tariffs declining from 10 percent to 6 percent, 4 percent, 2 percent and 0 percent by 2005, VAT at a constant rate of 15 percent with a turnover threshold at €50,000, excise rates remaining unchanged, and profit and income tax remain unchanged. Compliance is assumed to increase for both domestic taxes and boundary taxes. Increased compliance will be made possible by further investments in resources of the tax and customs administrations.

2.36 On the basis of the above-mentioned policies and results, revenue estimates at the central level are shown in Table 2.4. Over the medium term (until 2005), locally generated revenues will increase to 22 percent of GDP. Central government revenues are forecast to increase by about 30 percent by 2005 over 2002 levels. This is driven by an increased collection of excise taxes, the extension of VAT into the domestic economy, and the introduction of the income tax. Municipal own source revenues are forecast to increase significantly over the coming years in large part because of the introduction of the property tax.

Table 2.4: Locally Generated General Government Revenues

	2003 p	2004 p	2005 p
<i>Central Government</i>			
Tax	428	462	503
Customs	45	40	25
Excise	122	136	151
VAT	184	201	216
Presumptive tax	27	27	27
Profit tax	16	19	20
Individual Income tax	16	23	31
Other	18	20	34
Non-tax revenue	20	21	23
Central government revenue	448	487	527
<i>Municipal Government</i>			
Own source revenues (Property taxes, fees and charges)	20	30	40
Total consolidated general government revenue	468	517	567
as a share of GDP	21.7	21.9	22.3

Source: MoFE, IMF

3. RESTRUCTURING SPENDING: CROSS-SECTORAL POLICIES

3.1 The previous chapter focused on the revenue envelope and indicated that Kosovo domestic revenue collections as a share of GDP are below regional comparators. This chapter analyzes current spending patterns and presents an assessment of the aggregate public spending appropriate for Kosovo in the medium term. Policy reform recommendations are presented throughout the chapter, and an illustrative medium term expenditure scenario is presented at the end of the chapter.

3.2 In the immediate post-conflict phase, annual public spending in Kosovo has been in the order of 50 percent of GDP, largely financed by donor investment. While immediate reconstruction effort is phasing down and investment needs are reducing, Kosovo is also facing the challenges of development and transition to a market economy. The need for capital spending will continue to be high in the medium term, largely due to pronounced under-investment during the nineties. In addition, donor-financed reconstruction investments will require maintenance that will need to be financed by the General Budget. Further budgetary pressures may also arise if Kosovo were to service a share of the FRY debt.

3.3 A recurrent theme throughout the analysis in Chapters 3 and 4 is that there is significant scope to increase the efficiency and quality of existing spending. This chapter looks primarily at public spending by economic classification, and focuses in particular on the general government wage bill, which is by far the largest item of General Budget spending. An analysis of resource and efficiency issues in the three largest functional areas is presented in the next chapter.

3.4 A discussion of the medium-term outlook is presented. Based on the specific needs of Kosovo and the experience of other economies in the region, analysis suggests that a public spending to GDP ratio of around 30 percent in the medium term is appropriate to maintain a growth scenario that will lead to fiscal sustainability in the medium term. Even with improvements in the tax base, as discussed in Chapter 2, locally generated revenues will not be sufficient to finance this level of public spending in the near term, and new donor commitments of €500 million over the 2003-2005 period will be required.

A. AGGREGATE PUBLIC SPENDING: THE KOSOVO INTEGRATED BUDGET

3.5 The Integrated Budget (IB) comprises the General Budget (GB) and the Public Reconstruction and Investment Program (PRIP). The latter has been almost entirely funded by donor resources since 1999. Around 75 percent of the IB has been financed by donors in 2000 and 2001, through support to both the PRIP and, on a smaller scale, to the GB.

The Public Reconstruction and Investment Program (PRIP)

3.6 The medium term Reconstruction and Recovery program, prepared in 1999, estimated needs for donor financial grants of US\$2.3 billion over the 1999-2003 period. During the first phase of the program, the original target for commitment of funds by the end of 2000 of US\$1.1 billion was fully met.¹⁴ Donors pledged about US\$2 billion for budgetary support and reconstruction and recovery activities by the end of 2001. For reconstruction and recovery and peace implementation activities, about 91 percent of the pledged funds have been committed, 82 percent contracted, and 69 percent have been spent.¹⁵ Disbursements of these existing commitments will continue through the coming years.

3.7 The capital investment requirements of Kosovo are presented in the Public Reconstruction and Investment Program (PRIP), administered by the MoFE. It was developed based on the medium-term Reconstruction and Recovery Program. Spending under the PRIP was equivalent to about 50 percent of GDP in both 2000 and 2001.

3.8 Public investment levels of 10-15 percent of GDP over the 2003-2005 period are needed to underpin the 5 percent growth scenario. Private investment in Kosovo remains scarce, a problem exacerbated by uncertainty regarding the resolution of Kosovo's final status. To meet remaining post-conflict needs and lay the basis for sustainable growth, public investment spending in Kosovo should remain higher than in other economies in the region. Donor assistance will be critical in fulfilling the necessary public investment requirements. Over the medium term, the general budget should also be able to cover an increasing amount of capital investment, as discussed in more detail below.

General budget spending

3.9 In line with increases in locally generated revenues, the level of general budget spending has increased rapidly since 1999. In 2001, consolidated government spending amounted to 15.7 percent of GDP. However as Chart 3.1 demonstrates, general budgetary spending as a share of GDP remains below all other economies in the region. Notable features of Kosovo general budget spending are:

- (i) GB spending in Kosovo as a share of GDP is low relative to recurrent spending in other countries in the region, even when adjusting for the fact that Kosovo currently is not servicing any debt and that the pension scheme has only just started to develop;
- (ii) The budget is still maturing and further new spending items will have to be absorbed by the budget. Further spending pressure are arising from the transfer of authority to local institutions, and possibly from debt service. Moreover, the bulk of capital spending is yet to be absorbed by the General Budget;

¹⁴ The actual figure reported by donors was closer to US\$1.2 billion.

¹⁵ Data are taken from the database managed by the Joint EC/WB Office for South East Europe, which tracks overall pledges made at donor conferences. More information can be found on www.seerecon.org.

- (iii) The donor-financed reconstruction program has recurrent cost implications that need to be covered by the General Budget. More generally, in light of more than a decade of neglect and under-spending, operations and maintenance needs are very large;
- (iv) General budget spending in the social sectors appears to be on the low side in selected areas (Chapter 4);

3.10 A recurrent spending to GDP ratio of around 20 percent seems appropriate for Kosovo in the medium term. It seems appropriate that over the medium term general budget spending should stay relatively lower in Kosovo than in other regional and European economies. In the presence of UNMIK and KFOR, a number of functions that normally require budget financing are covered by alternative funding sources (incl. defense spending). As KFOR and UNMIK withdraw, further non-discretionary recurrent cost items will have to be absorbed by the budget, driving the spending to GDP ratio up at that stage. In addition, further spending pressure may also emerge from debt service payments, as discussed below.

3.11 There is significant scope to increase the efficiency of existing general budget spending. Significant fiscal savings can be obtained through rationalization in a number of areas. Many of the retrenchment measures outlined in the chapters are achievable only in the medium term, as part of a continuous reform effort in all major expenditure programs.

B. GENERAL BUDGET SPENDING: ECONOMIC CLASSIFICATION

3.12 This section provides details on the main economic classes of public spending. It looks at wages and salaries in particular detail, as this category represents the largest non-discretionary spending item.¹⁶ The key allocative patterns in Kosovo, which can be derived from Charts 3.1-3.5, are:

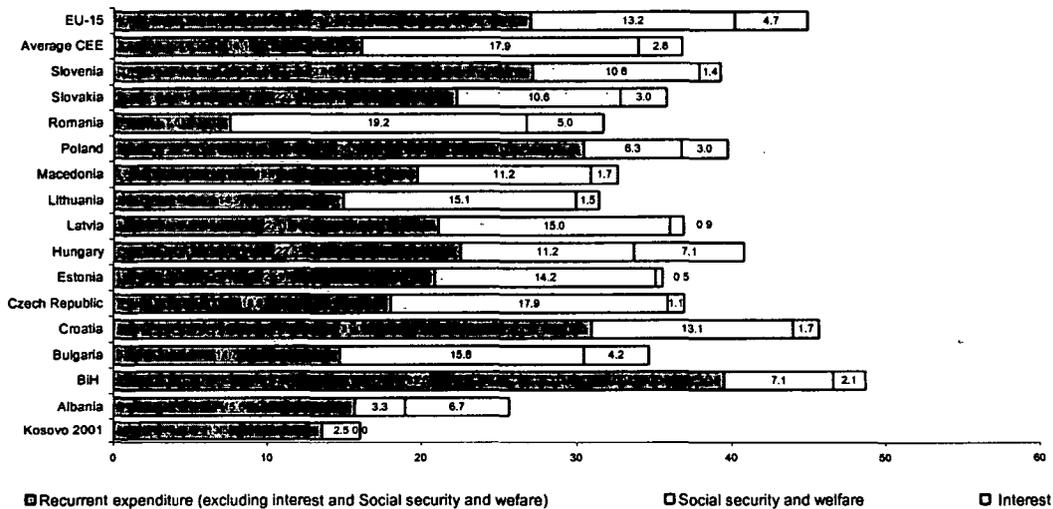
- (b) GB spending in Kosovo as a share of GDP is low relative to recurrent spending in other countries in the region, even when adjusting for the fact that Kosovo currently is not servicing any debt and that the pension scheme has only just started to develop (Chart 3.1).¹⁷
- (c) At 4.4 percent of GDP, spending on non-wage goods and services is low relative to the average for transition economies of around 7.7 percent, and the EU average of 9.6 percent. Although, this can in part be explained by the lack of defense and security spending in the General Budget, spending on operations and maintenance needs to be increased. Estimated maintenance costs of the donor-funded reconstruction effort are presented later in the chapter.

¹⁶ In collaboration with the CFA and the MoFE, it has been estimated that of the €17 million of municipal spending in 2001, €10 million was on wages and salaries, with the remainder being classified under non-wage goods and service spending.

¹⁷ General budget spending in 2002 has increased significantly, in part because of the spending of the cash balance accumulated in 2000 and 2001.

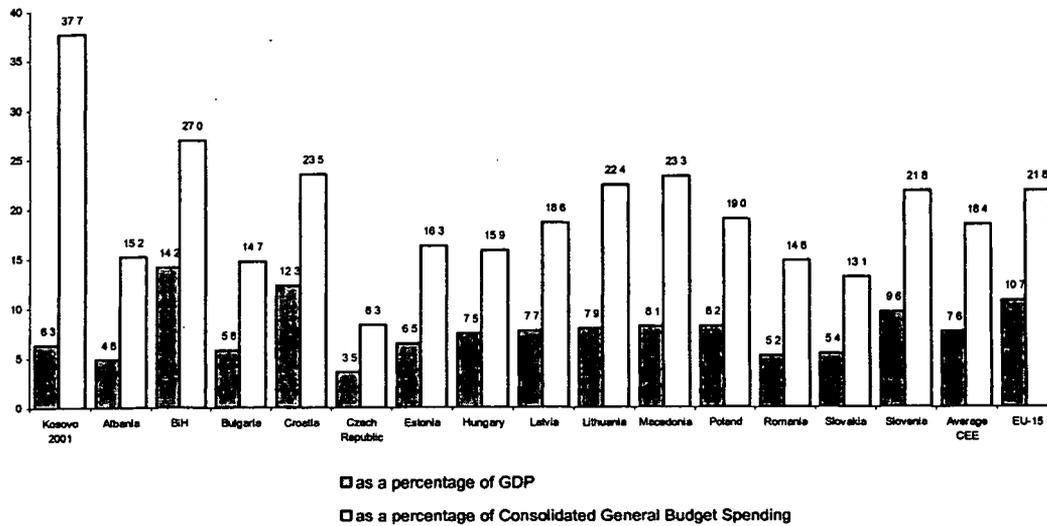
- (d) Subsidies to public enterprises are large at 14.4 percent of total spending and equivalent to 2.3 percent of GDP in 2001. Further rises in subsidies would be a worrying trend.
- (e) General budget capital spending was approximately 1 percent of GDP in 2001, relative to an average of 4-4.5 percent of GDP for other European economies. However, most capital spending remains outside the GB and is donor financed through the PRIP; such spending was equivalent to 38 percent of GDP in 2000 and 34 percent in 2001. In 2002, this figure is estimated to decline to 21 percent of GDP. Over the coming years, and as donor funding declines, the General Budget will need to increasingly absorb domestically funded capital investments, as the needs remain very large, particularly in infrastructure.
- (f) Kosovo is not currently servicing any foreign debt. Debt service payments could seriously constrain fiscal space over the medium term

Chart 3.1. Consolidated General Government Recurrent Spending, Average 1998-2000
(In % of GDP)



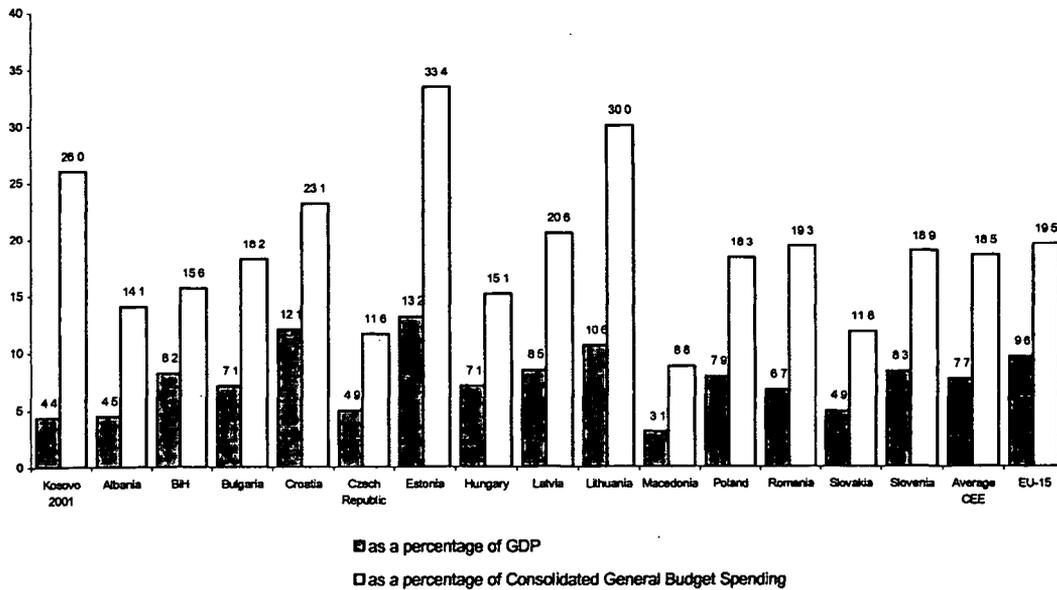
Source: IMF GFS, CFA/MoFE, World Bank. Kosovo data are for 2001. All other data are 1998-2000 averages.

Chart 3.2. General Government Budget Spending on Wages and Salaries



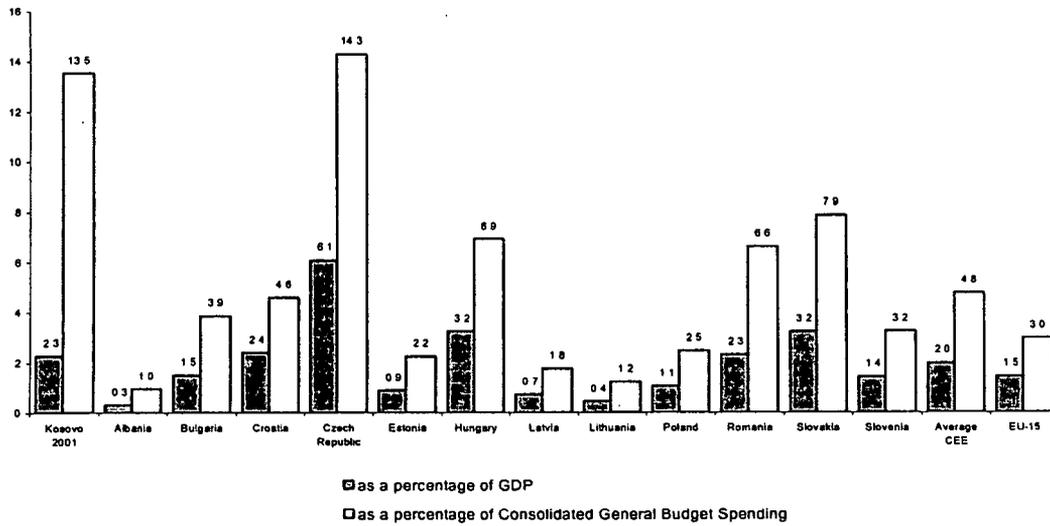
Source: IMF GFS, CFA/MoFE, World Bank. Kosovo data are for 2001. All other data are 1998-2000 averages.

Chart 3.3. General Government Budget Spending on Non-Wage Good and Services



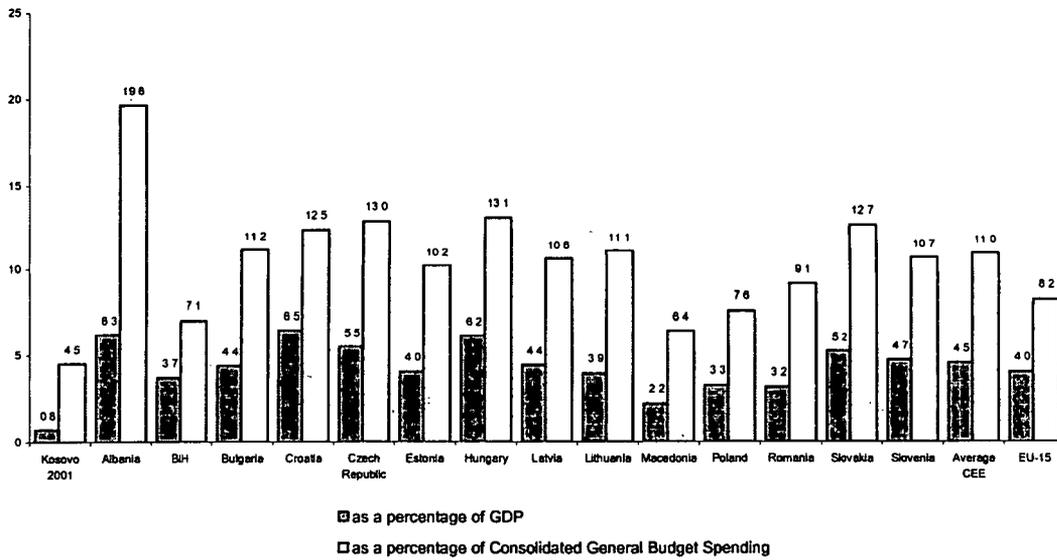
Source: IMF GFS, CFA/MoFE, World Bank. Kosovo data are for 2001. All other data are 1998-2000 averages.

Chart 3.4. General Government Budget Spending on Subsidies

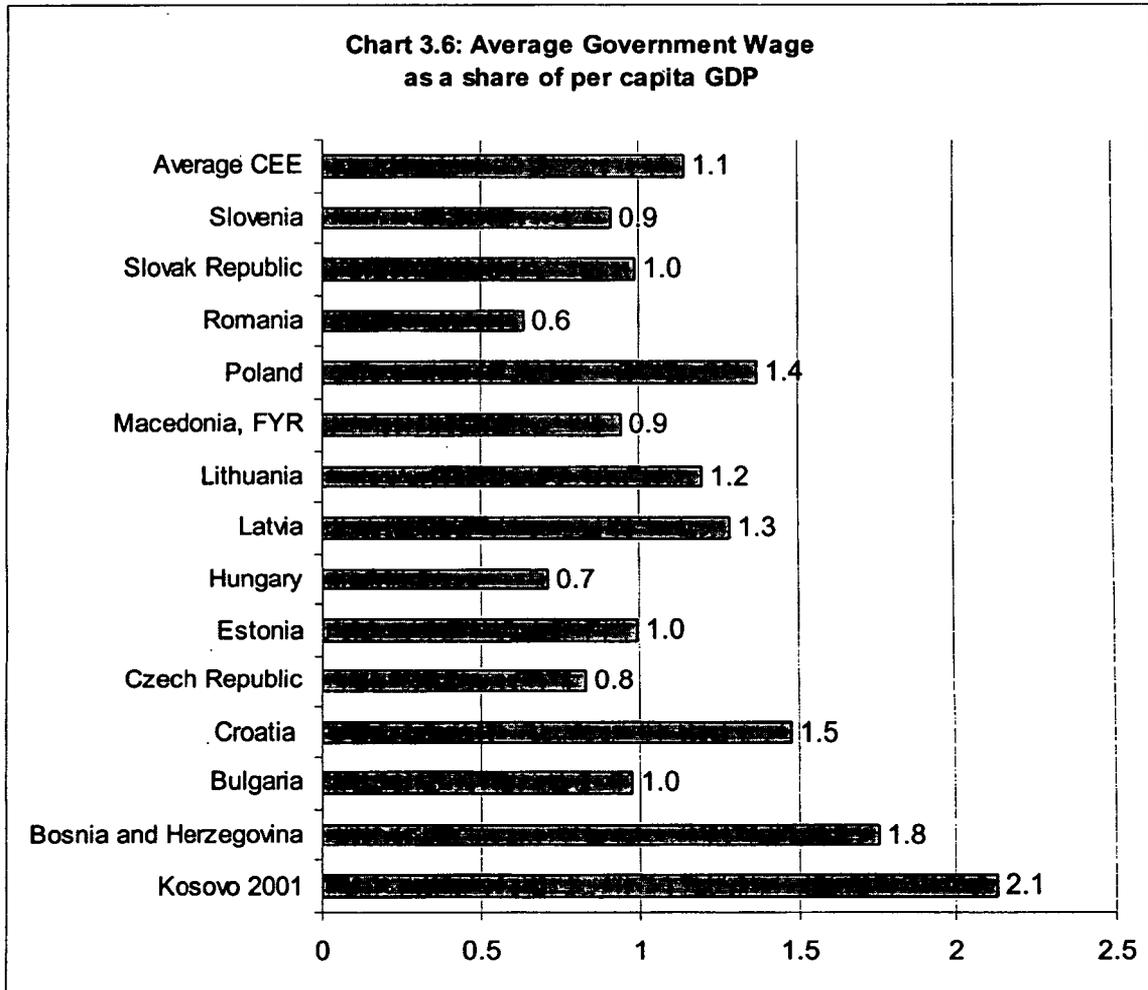


Source: IMF GFS, CFA/MoFE, World Bank. Kosovo data are for 2001. All other data are 1998-2000 averages.

Chart 3.5. General Government Budget Spending on Capital Investment



Source: IMF GFS, CFA/MoFE, World Bank. Kosovo data are for 2001. All other data are 1998-2000 averages.



Source: WB Administrative and Civil Service Reform Thematic Group, CFA
 1/ Croatia, FYR Macedonia, Poland 1991-95; 2/ FYR Macedonia 1991-95

The public sector wage bill¹⁸

3.13 The average annual public sector wage at a consolidated general government level was €1800 in 2001, slightly higher than levels in neighboring economies. Average labor earnings per working person, including those employed by donors, were €2000 in 2001.¹⁹ This pay difference is in line with international experience, and shows that public sector pay is generally 10 to 20 percent below private sector remuneration for similar work.

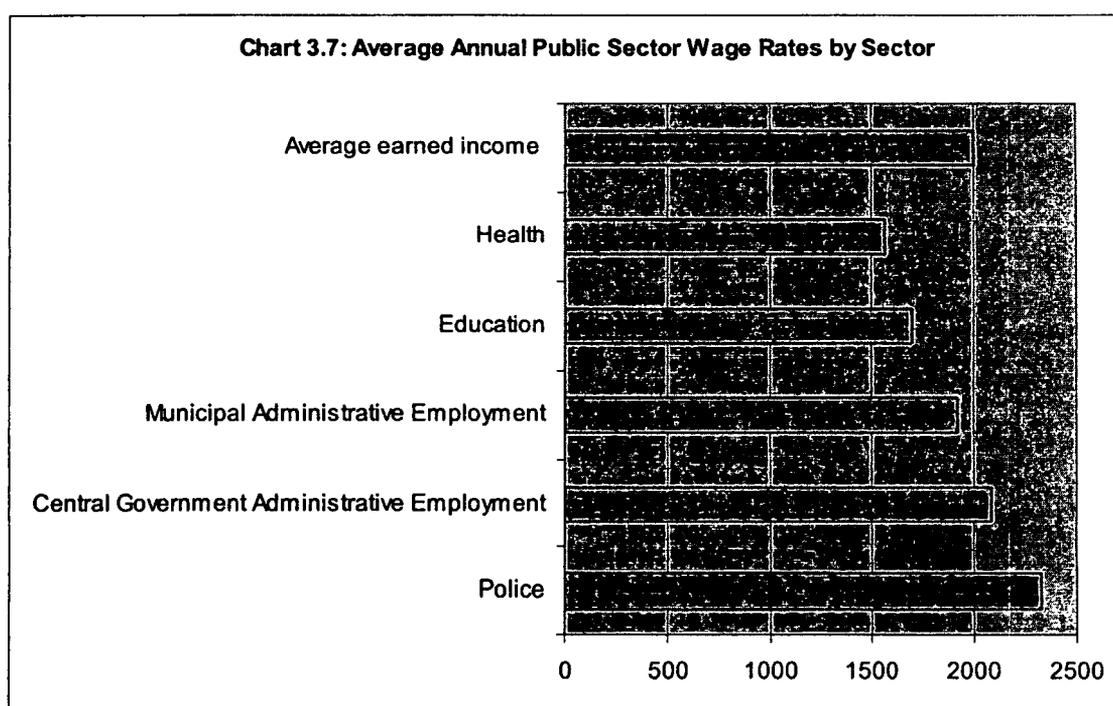
3.14 **The average government wage to GDP per capita ratio suggests that wages are on the high side from a fiscal sustainability perspective.** In 2001 the average wage in the Kosovo public service was equivalent to 1.8 times the per capita GDP. The comparators in Chart 3.6 show that the Kosovo civil servants earn more as a share of GDP per capita than those in other countries in the region. The higher Kosovo multiple can be explained both by the low labor participation rate and the likelihood of high

¹⁸ Data issues for this section are discussed in Annex 3.1.

¹⁹ Data are taken from *The New Kosovo Government, 2002 Budget*, Table 10.

informal economic activity. Nonetheless, given part dependence of revenues on measured GDP, and the reality of low participation and therefore greater dependence on state services, the high average wage to GDP ratio raises fiscal sustainability considerations and should be taken seriously as a policy-influencing indicator

3.15 Whereas on an aggregate level the average public wage in Kosovo is adequate, the aggregate multiple hides considerable differences across sectors and levels of government. Employees in central government general administrative and police services have significantly higher average wages than their counterparts in education, health and municipalities; the lowest multiple is being paid to health employees (Chart 3.7). While wage levels in central government general administrative services have been increasing (at least in nominal terms), pay rates have been declining in education, health and sub-national general administrative sectors as employment levels have exceeded budgeted targets. This is problematic for the distribution of skills across the civil service and could affect the quality of service delivery in the key social sectors over the medium term.



Wage data: CFA March 2002 (unpublished 2001 Mid-year budget review and Preliminary Outcome tables CFA 2001: Kosovo Budgets
Average earned income: Calculated as the total earned national income divided by the number of workers.
Sources: CFA 2002: The New Kosovo Government Budget Summary 2002, pg 32.

3.16 The salary structure in Kosovo is relatively compressed. Given the dearth of data, it is difficult to analyze the structure of government employment with regards to wage category and skills and the internal consistency of wage policy. The only available indicator is the salary scale multipliers by level of employment. The multiplier ranges from 2.5 for unskilled workers (average annual salary of €920) to 10 for department heads (average annual salary of €3681), which yields a salary compression ratio of 4.

Worldwide salary compression ratios vary from 3.1 to 20, with a norm of about 7.1. Kosovo clearly sits at the lower end of the range. This may influence the ability of the public service to attract skilled workers in critical managerial positions. There is already evidence from the health sector that the low wages paid to workers with scarce skills limits employment and hampers the effectiveness of health service delivery. There is also anecdotal evidence of public managers moving workers up the salary scale notches to improve their pay.

3.17 There is little fiscal space available to expand employment in the public sector. Table 3.1 shows that public sector employment as a share of total employment in Kosovo is several times as high as in other economies in the region. Nevertheless, Kosovo employs slightly fewer people per capita than other countries in the region. This can at least in part be attributed to the fact that the post-conflict labor market in Kosovo has some structural distortions. The 1999 conflict and its consequences have severely constrained the employment capacity of the productive sector of the economy. While estimates of unemployment vary widely, they indicate a range between 30 to 50 percent.

Table 3.1: Kosovo public employment as a percentage of total employment, by function

	Administrative Central Government	Education	Health	Sub National	Police	General Government
Kosovo 2001 as a multiple of ECA average	3.3	4.9	3.2	2.2	1.6	3.7
Kosovo 2001	4.2	16.1	7.6	2.8	2.2	35.2
ECA average	1.3	3.3	2.4	1.3	1.4	9.6
CEE average	0.9	2.9	2.1	0.9	0.6	7.4
Middle income country average	1.4	2.8	1.7	1.4	0.7	8

Source: World Bank Administrative and Civil Service Reform Thematic Group, CFA.

3.18 Table 3.2 shows an overall increase of 8261 employees (equivalent to 14 percent) between 2000 and 2002. Consistent with the transfer of power from UNMIK to the PISG, employment growth is fastest in central government general administrative services. Employment growth in the health sector has also been particularly high.

Table 3.2: Civil service, employment by function and level of government

	2000		2001		2002	2001	2002
	Budget	Actual	Budget	Actual	Budget	% change	% change
Consolidated General Government*	56971	56971	58130	62409	65187	9.5	4.5
Central Government	52082	52082	53194	57473	59741	10.4	3.9
Municipalities	4889	4889	4936	4936	5446	1.0	10.3
General Administrative Government**	18597	18597	20461	20351	24387	9.4	19.8
Central Government	9233	10708	11050	11457	13,466	7.0	17.5
Municipalities	4889	4889	4936	4936	5446	1.0	10.3
Health	10582	10582	10582	13558	12630	28.1	-6.8
Education	27792	27792	27087	28500	28170	2.5	-1.2
Police	4475	4475	4475	3958	5,475	-11.6	38.3

* Total central government + total municipal government employment.

** Employment at central and municipal level respectively - total health, education and police employment.

Source: CFA March 2002 (unpublished): 2001 Mid-year budget review and Preliminary Outcome tables, CFA 2001: Kosovo Budget, CFA 2002: The New Kosovo Government Budget 2002.

3.19 **There has been a consistent and increasing tendency to underestimate the spending on wages in the budget formulation process, with commensurate overspending on the wage bill.** In 2001, actual spending on public wages exceeded the budgeted target by almost 11 percent. This deviation has been driven by overspending in the health sector, where wage spending exceeded the budget target by an estimated 30 percent in 2001. Although this overspending has been occurring in an expansionary environment buoyed by larger than expected revenues, considered wage bill policy choices and explicit mechanisms to control wage spending are needed to ensure spending is managed against aggregate budget growth to promote cross-sectoral allocative efficiency.

3.20 **Relative to other countries' employment in the late 1990s, public employment in Kosovo is slightly distorted towards education.** Comparing the composition of sectoral employment as a percentage of the population yields the following results (Table 3.3): In education public employment as a percentage of the population is on par with the comparator country average (1.4 percent versus 1.5 percent in Kosovo), whereas in other sectors Kosovo tends to be below the comparator country average. Public employment in health is below regional averages. Employment in the central government administrative structure, sub-national administrative structures and in the police force are well below regional averages. Kosovo's employment profile is more typical of the middle-income average rather than that of a CEE or ECA country.

Table 3.3: Regional comparisons of public employment
(as a share of population)

	Administrative Central Government	Education	Health	Sub-national	Police
Kosovo 2001	0.39	1.47	0.7	0.25	0.2
Lithuania	1.26	3.95	2.5	0.49	0.5
Czech Republic	4.76	0.72	0.3	2.32	..
Hungary	1.46	2.34	2.21	1.56	0.02
Croatia	1.88	1.22	0.71	0.43	0.89
Macedonia, FYR	2.14	1.03	0.83	0.06	0.37
Slovenia	1.42	1.26	0.91	0.17	0.23
Albania	0.05	1.47	0.86	0.2	0.54
Bulgaria	0.38	1.05	1.13	0.38	0.05
Romania	0.51	1.06	0.63	0.51	0.24
Bosnia and Herzegovina	0.14	0.49	0.21	1.99	..
Poland	0.42	1.17	0.85	0.29	0.02
Average ECA	0.61	1.58	1.15	0.61	0.68
Average CEE	0.45	1.43	1.04	0.45	0.31
Middle income countries Average	0.45	1.2	0.7	0.59	0.3

CFA March 2002 (unpublished): 2001 Mid-year budget review and Preliminary Outcome Tables

CFA 2001: Kosovo Budget

CEE – Central and Eastern Europe

ECA: Eastern Europe and Central Asia

Source: WB Administrative and Civil Service Reform Thematic Group

3.21 The Kosovo civil service may struggle to attract and retain scarce skills. The quality of public servants, and therefore of public spending, depends on pay incentives, non-monetary incentives, and management. Although pay appears adequate on average, it may not be sufficient to attract scarce skills at the top end of the labor market. Furthermore, while international experience shows that public sector pay is generally slightly below private sector remuneration for similar work, greater job security is usually seen as a compensating factor. UNMIK regulation 2001/36 establishes the Kosovo civil service as a contract-based (rather than career-based) institution.²⁰ The maximum period of employment is three years and contracts are renewable. While this provides maximum flexibility in terms of changing the level and composition of employment (contrary to many other countries where rigidity in public employment has a commensurate effect on wage spending), it has an impact on the ability to attract and retain skills.

3.22 Human resource management systems in Kosovo are still in their infancy, and the legislative framework is still being established. Public service employment in Kosovo is not centrally controlled. This creates the need for particularly robust controls on wage spending within the budget process to control overall spending levels. Currently

²⁰ UNMIK Regulation 2001/36 established the Kosovo Civil Service and the framework principles, such as the terms of employment, the right to trade-union membership, limits on industrial action and a code of conduct. It also establishes an independent civil service oversight board and the senior public appointments committee.

sectoral evidence points to wage expenditures that are not reflected in the wages and salaries line. The new financial management handbook being developed for central and local government use stipulates the need to clear wage spending through the commitment system on a regular basis. This is a positive move and prevents a situation where sectoral managers are protected from the consequences of their employment and wage decisions through central and automated payment of wages and salaries.

Policy recommendations on public sector wages

3.23 There is very little fiscal space to increase the public sector wage bill at an aggregate level. Given international experience as well as the need to absorb new spending items onto the budget, the public sector wage bill should not increase as a share of expenditure but be managed down. While spending on public sector wages can grow, it should grow at a slower rate than the aggregate budget.

3.24 With the establishment of the PISG and further Kosovarization, increased employment growth pressure is likely, in particular in central administrative services. The overall fiscal constraint implies that any such growth would need to happen within the current spending envelope, by right-sizing the functional distribution of employment or by adjusting wage levels. It implies that tough choices would need to be made about the range of functions the state fulfills. Significant and sustained GDP growth could play an important role in increasing the overall resource envelope.

3.25 Wages should not increase across the board, but only where (i) they are disproportionately low, or (ii) where it is problematic to attract and retain skills.

- (a) Pay levels in police services and general administrative services at a central level are high, compared to the rest of the public service. On the other hand, the indicative analysis in this chapter suggests that doctors in the health sector and sub-national administrative employment would appear to be two areas where targeted pay increases could be made within the current spending envelope.
- (b) The freeze on general salary levels in central government administrative employment should not be applied to all salaries in the managerial cadre. The public service needs to attract and retain skilled Kosovars into these positions to support the development of institutional public management capacity. One way of managing the differentials, attract managers and allow for skilled personnel to be paid attractive salaries would be the early creation of a senior civil service, that could operate outside of the civil service wage scales and where pay would be determined by the profile of the individual applying for posts as much as by the post, to allow for market-related remuneration for scarce skills. The management of this cadre could also be purely performance oriented, a management paradigm that is easier to implement at this level.

3.26 Employment growth should be controlled and directed to areas where there are shortages. International comparisons indicate that employment in sub-national

administrative functions is well below comparator countries. Given the decentralization of expenditure functions there may be need to reserve space within the wage bill for increased employment at this level. Even accounting for the young average age of the population in Kosovo, employment in education in Kosovo is high relative to other economies. As discussed further in Chapter 4, a slight reduction over the medium term will create fiscal savings that can be employed either in the sector or elsewhere.

Table 3.4: An Illustrative Wage Bill Scenario

	2001 Actual			2003 Scenario			2004 Scenario			2005 Scenario		
	Wage Bill (€ m)	No. employed	Average Annual Wage (€)	Wage Bill (€ m)	No. employed	Average Annual Wage (€)	Wage Bill (€ m)	No. employed	Average Annual Wage (€)	Wage Bill (€ m)	No. employed	Average Annual Wage (€)
General Government Services	21.1	10,522	2,002	24.3	11,048	2,203	27.0	11,601	2,324	29.7	12,181	2,440
Health	21.1	13,346	1,578	29.1	12,679	2,295	30.9	12,045	2,566	32.5	11,443	2,843
Education	48.3	27,890	1,732	60.4	27,193	2,223	65.7	25,493	2,576	71.0	23,900	2,972
Police	10.5	4,788	2,195	11.3	4,692	2,408	11.5	4,598	2,495	11.6	4,506	2,572
Municipal Administrative Services	9.5	4,936	1,918	13.0	5,183	2,512	15.1	5,960	2,539	17.5	6,854	2,557
Total Central Government Wage Bill (€ million)	100.9			125.2			135.0			144.9		
Central Government Wage Bill (% of GDP)	5.8%			5.8%			5.8%			5.7%		

3.27 A quick analysis of current staffing and salary levels indicate that there is scope to achieve the wage and employment realignments proposed in this section while only increasing the wage bill in line with GDP growth. Table 3.4 indicates the effects of an indicative scenario in which (a) employment levels in the KPC are reduced by 6 percent by 2005 and wages grow in line with inflation; (b) general government administrative employment is increased by 15 percent to allow for Kosovarization and wages in this section increased slightly in real terms to finance decompression and a higher than inflation increase in managerial pay; (c) employment in education is cut by 14 percent by 2005 and savings are reallocated within the sector to decompress wages; (d) employment levels in health are reduced by 14 percent at the administrative level, with targeted increases of employment and wage levels at the physician level; and administrative employment at sub-national level is increased by 38 percent (from a low base) together with wage increases above inflation. The result of the restructuring is improved equity in pay between the sectors, and a realignment of employment with the public sector developmental needs. While this restructuring scenario may be overly simplistic, it indicates that restructuring of public employment in line with policy goals can be achieved without markedly increasing the public wage bill.

3.28 A more comprehensive review of pay, employment and civil service structure should be undertaken prior to any restructuring of public wages and employment levels. Given the lack of fiscal space to extend the wage bill, it is particularly important to

improve the quality of spending. Preliminary work suggests that such a study needs to focus on (i) the current structure and skill distribution of civil service employment relative to needs, and (ii) wage differential problems within and between sectors and levels of government. Such work will lay an important basis for future policy decisions.

3.29 Better wage bill internal control systems need to be developed to prevent disproportionate wage creep and overspending. These controls may include measures to bring all wage-related spending onto the wages and salaries lines, controls to prevent promotion of staff to access higher pay brackets in lieu of salary increases and controls on in-year and short-term employment. These controls can either be specific and rule driven, or through the overall budget management system where caps on spending can force managers to absorb the consequences of all their wage-related spending within their own current and future budgets. The latter system could be supported by provisions to allow flexibility to managers as to how public services are to be delivered, including outsourcing.

3.30 The development of an appropriate and systematic human resource management system for the Kosovo public service needs to be advanced further. In particular, further progress on a legislative and policy framework for human resource management needs to be made, including (i) the definition of the powers, responsibilities and functions of agency heads and the required steps for the delegation of these responsibilities to subordinates; (ii) the development of detailed policy frameworks for recruitment and selection of staff, for the evaluation, pay progression, promotion and career pathing of public service employees, and for disciplinary procedures and dismissal of public servants. A job classification system also needs to be developed, to ensure that equivalent job weights earn equivalent wages.

3.31 Training and capacity building is critical for the future development of the Kosovo civil service Given the need to build local institutional capacity a Kosovo human resource management system would need to pay particular attention to the recruitment of Kosovars into key management positions, and provide for their training.

Non-wage goods and services

3.32 The present indicators point to a biased prioritization of wage and salary spending over non-wage G&S spending in Kosovo when compared with other transition economies in the region. The ratio of W&S to O&M spending in Kosovo was 1.45 in 2001 relative to the sample average of just below one for the region. The underfunding of non-wage goods and services spending will lead to further depreciation of existing infrastructure and capital assets. Experience throughout the developing world has shown that the productivity of public investments and programs that are already in place has been seriously jeopardized by the failure of governments to provide adequately for their operation and maintenance over time.

3.33 Spending on goods and services is currently inadequate to maintain public assets. The future recurrent cost implications of the donor-financed capital investment projects are not being thoroughly worked through during the preparation of the PRIP. Nor are considerations given to the ways and means of financing these additional recurrent expenditures. Rough calculations of operating and maintenance costs for facilities created

by the donor-financed investment program are shown in Table 3.5. In the absence of information on the recurrent cost requirements of completed projects in Kosovo, 'r' coefficients based on the experience in a restricted sample of developing countries are applied sector by sector to the donor-financed reconstruction program that has been implemented since 1999. The 'r' coefficient measures the ratio of net recurrent expenditure requirements to the total investment outlay. These rough aggregate estimates may involve substantial error.

3.34 Table 3.5 suggests that roughly €85 million will be required annually to service recurrent costs related to the donor-financed capital reconstruction effort alone. It is difficult to know what share of these needs has already been absorbed by the budget. However, the budget formulation process is currently not attempting to quantify and mobilize resources for the recurrent cost needs of these projects. It is important to mention that these calculations do not take into account pressures on the budget resulting from capital investments completed prior to 1999 and outside the PRIP. For instance, it has been estimated that US\$360 million would be required over the next 10 years to bring the road network back into a satisfactory condition. This amount does not include any new road construction.

Table 3.5: Estimated recurrent cost requirements of the donor-funded reconstruction program in Kosovo
(in EUR millions)

	Total expected to be committed by end-2002	r coefficient (lower bound)	r coefficient (upper bound)	Estimated annual recurrent cost requirements	Estimated annual recurrent cost requirements	Estimated annual recurrent cost requirements (average)
Agriculture	107.75	0.06	0.14	6.5	15.1	10.8
Private Sector						
Development	176.2	0.01	0.01	1.8	1.8	1.8
Transport	125.59	0.03	0.09	3.8	11.3	7.5
Energy	404.64	0.01	0.01	4.0	4.0	4.0
Telecom	9.67	0.01	0.01	0.1	0.1	0.1
Water & waste	119.04	0.05	0.05	6.0	6.0	6.0
Housing	239.56	0.00	0.03	0.0	7.2	3.6
Health	132.81	0.15	0.34	19.9	45.2	32.5
Education	100.77	0.12	0.25	12.1	25.2	18.6
Mine-clearing	28.29	0.00	0.00	0.0	0.0	0.0
Institutions	360.64	na	na	na	na	na
Other	156.41	na	na	na	na	na
Total Reconstruction Spending	1961.37	0.44	0.93	54.1	115.8	84.9

The r coefficient is the ratio of annual recurrent expenditures required after completion of the project for proper utilization of the capacity or facility through the budget. The r coefficients have been taken from Peter Heller, "The Underfinancing of Recurrent Expenditures". Source: WB-EC Joint Office database.

Policy recommendations on non-wage goods and services spending

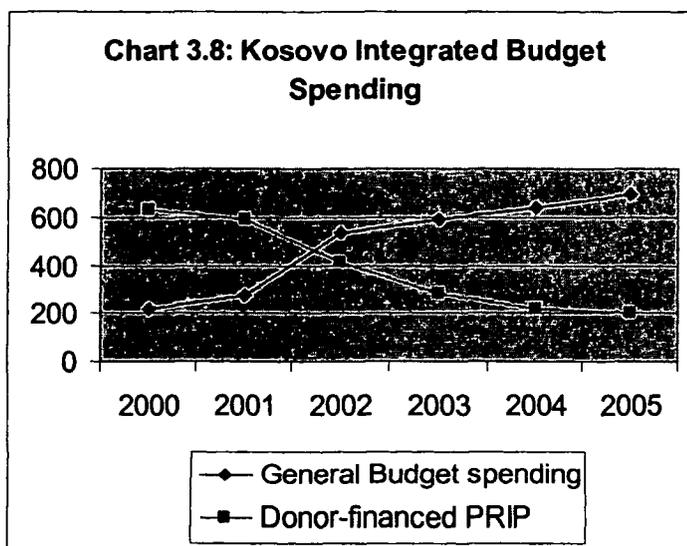
3.35 **The authorities may want to consider increasing the share of general budget spending allocated to operations and maintenance.** The public sector wage bill is crowding out operations and maintenance spending. This is a very costly way of rationalizing expenditures as inadequate provision for operations and maintenance will significantly reduce the effectiveness of both capital and recurrent spending.

3.36 **The Government ministries should develop more disaggregated estimates of recurrent cost needs for specific sectors and sub-sectors.** In particular, needs for upgrading maintenance in transport, health and education should be identified and budgeted for as a matter of priority.

3.37 **The recurrent implications of capital expenditure need to be carefully considered.** There is a risk that donor policies could lead to an over-investment in new projects and an under-financing of the recurrent costs of existing projects. Further steps need to be made towards integrating the investment and recurrent budgets to ensure that when capital expenditures are planned adequate provisions are made for operations and maintenance. Donors should not shy away from providing long-term recurrent financing, particularly if it implies funding local costs.

Capital spending

3.38 To date, donors have played a key role in the financing of capital spending, with disbursements under the PRIP amounting to 38 percent of GDP in 2000 and 34 percent of GDP in 2001. At about one percent of GDP, general budget financed capital spending in Kosovo is much lower than the average for other transition or European economies. By 2005, and as disbursements of donor grants decline to an estimated 8 percent of GDP, general budget financed capital spending as a share of GDP should increase significantly, both to provide adequate counterpart funding for externally financed projects and to contribute to domestically financed investments. (Chart 3.8)



Source: MoFE/CFA.

Other economic categories

3.39 **Budget subsidies to public enterprises are very large.** As a share of GDP, subsidies in Kosovo are higher than the average for other transition or European economies. As a share of total public spending, subsidies to enterprises are almost 15 percent, which is extremely high by any standard. In 2001, budget subsidies to public enterprises amounted to €40 million, and they have remained high in 2002. The largest recipients were the Trepca mining complex, the electricity company KEK, the district heating companies and the water and waste companies. Due in part to one-time engineering and management improvements proposed for KEK, subsidies are likely to remain high over the next few years. The district heating system faces severe difficulties

with losses and payment arrears and thus poses another fiscal risk, while only providing for 5 percent of heat demand in Kosovo.

3.40 Currently there is no provision in the General Budget for debt service.²¹ For illustrative purposes, if Kosovo were to start servicing 10 per cent of the FRY debt, debt service payments would reach US\$85 million annually by 2005, equivalent to 15 percent of forecasted General Budget expenditures in that year, and could increase to US\$150 million annually by the second half of the decade. Clearly, this would put immense pressure on Kosovo's fiscal situation.

Policy recommendations

3.41 **Greater capital expenditures will need to be financed by the General Budget.** The quality of projects in the public investment pipeline should be watched very closely. By 2005 domestic revenues should be financing around at least 2.5 percent of GDP in capital investment through the general budget.

3.42 **Proper rationalization plans need to be created for all existing subsidies to public utilities and pressures for further subsidies should be resisted.** As a first step, strengthening collection rates among utilities by enforcing payment discipline (among both residential consumers and SOEs) would reduce the need for budget subsidies to these entities. Payments for only 34 percent of the electricity supplied were collected in 2001, while technical and non-technical losses amounted to 47 percent of energy supplied. The electricity company (KEK) thus accumulated large payment arrears from consumers and defaulted on payments to input suppliers and wages to staff. A key obstacle is the legal and technical inability of KEK to disconnect individual residential power and heat consumers.

3.43 Measures needed to address the low collection rate include: (i) elimination of unmetered consumption, (ii) computerization of consumer accounts enabling monitoring of each account and follow up on arrears through court system; and (iii) well-designed incentive schemes for collection staff. In addition, some adjustments in the tariff structure would support the financial state of KEK. While longer term strategies for restructuring KEK and other public utilities are being developed, further budgetary subsidies will be needed. In 2002, a large part of the subsidies for KEK is being financed by the accumulated cash balance. A further allocation from the general budget will be needed for future years, including for imports of electricity.

C. GENERAL BUDGET: FUNCTIONAL CLASSIFICATION

3.44 **The major expenditure items in the budget relate to labor and social welfare, education, and health.** They jointly they account for about half of General Budget spending. As a share of GDP, social sector spending in Kosovo (education, health, social security and welfare) is less than the average for other European economies (Table 3.6). Part of the explanation for the low social security and welfare spending in Kosovo is that

²¹ This report assumes that finance no debt service payments over the medium term. This is an assumption for the purpose of this report only and is not meant to prejudge any settlement that might be reached between the parties during this period regarding Kosovo's share of the FRY debt.

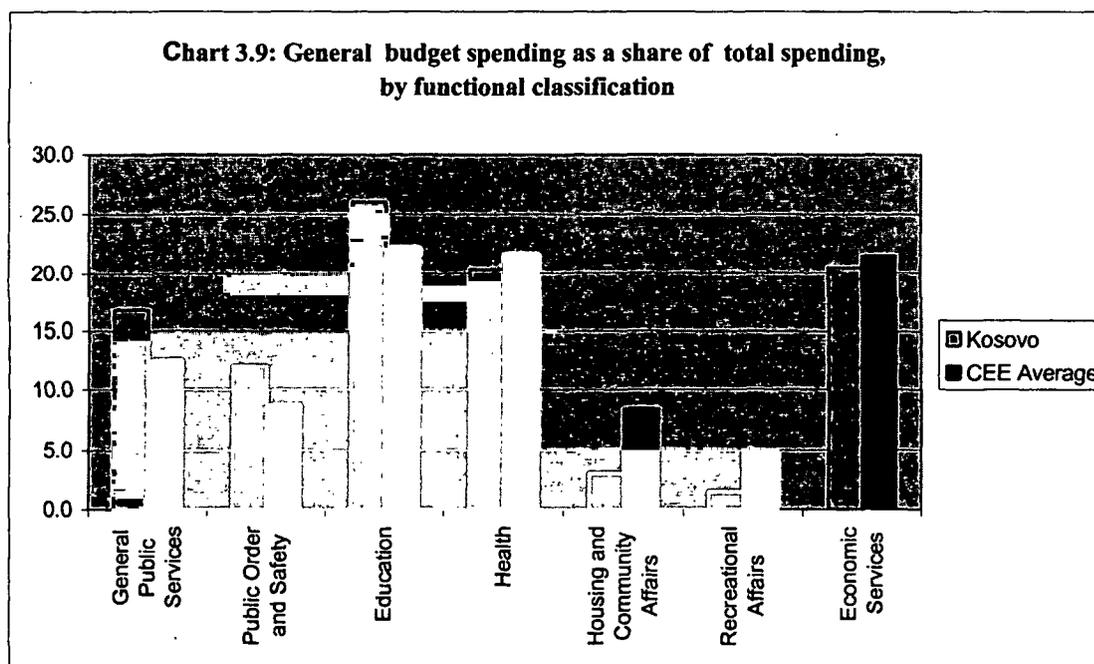
no pension payments were made in Kosovo in 2001; a simple system is being introduced in 2002 (see Chapter 4). Health spending as a share of GDP in Kosovo seems particularly low relative to other countries in the region, whereas spending on general public services appears to be approaching regional averages.

Table 3.6: Consolidated General Government Spending, as a share of GDP (average for 1998-2000)

	Kosovo	Lithuania	Latvia	Estonia	Czech				Slovak			EU	
					Republic	Poland	Romania	Hungary	Bulgaria	Slovenia	Republic Average		
General Public Services	2.2	1.6	3.3	3.1	2.4	2.4	1.4	3.9	3.5	4.0	3.2	2.9	-
Defense	0.7	1.1	0.9	1.5	1.8	1.5	1.8	1.1	2.9	1.1	1.9	1.5	2.0
Public Order and Safety	1.6	2.1	2.4	2.5	2.0	1.8	1.6	1.6	2.4	1.7	1.8	2.0	-
Education	3.5	6.0	6.5	6.6	4.2	5.7	3.2	4.8	4.1	5.6	4.0	5.1	5.3
Health	2.7	4.6	3.9	5.7	6.6	4.3	3.4	4.4	3.8	5.8	7.0	4.9	6.6
Social Security & Welfare	2.5	11.2	15.1	11.2	14.2	19.2	10.6	15.0	13.1	17.9	10.8	13.8	-
Housing & Commun. Ame	0.4	0.8	2.2	1.3	3.1	3.2	1.8	1.4	1.7	1.6	2.1	1.9	-
Recreational, Cultural	0.2	1.0	1.3	2.3	1.0	0.8	0.5	1.2	0.8	1.2	0.9	1.1	-
Economic Services	2.7	4.0	5.3	4.3	6.0	2.9	4.9	5.0	5.0	5.2	6.8	4.9	-

Source: IMF GFS, World Bank, MoFE/CFA

3.45 As a share of total spending, the functional distribution in Kosovo is roughly in line with that of other transition economies. Chart 3.9 show General Budget spending as a share of total spending, by functional classification, and excluding defense and social protection spending.²² Going forward, and to converge with the average spending levels in other transition economies, roughly equiproportionate increases in all sectors may be appropriate.



Note: excludes defense and social security spending

Source: World Bank, CFA, MoFE. Data for Kosovo are for 2001. CEE data are averages for 1998-2000.

²² Defense and pension spending were not covered by the Kosovo budget in 2001 and are therefore excluded.

D. THE MEDIUM TERM OUTLOOK

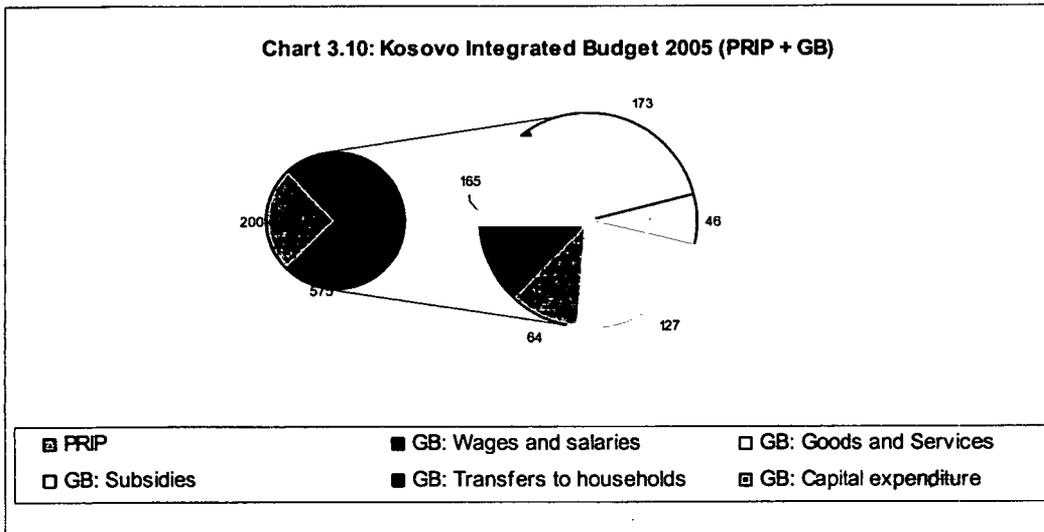
3.46 As outlined above, a total public spending to GDP ratio of roughly 30 percent would appear appropriate for Kosovo in the medium term, with around one-third of this financing public investment needs. There is significant scope to increase the allocative and technical efficiency with which money is currently being spent. In the area of allocative efficiency, the analysis in this section has suggested that over the medium term Kosovo may want to consider

- (a) Increasing the share of capital spending in the General Budget;
- (b) Reducing subsidies as a share of GDP and in share of total spending;
- (c) Restraining wage and salary spending, with increases only in line with increasing in GDP;
- (d) Increasing operations and maintenance spending as a share of GDP.

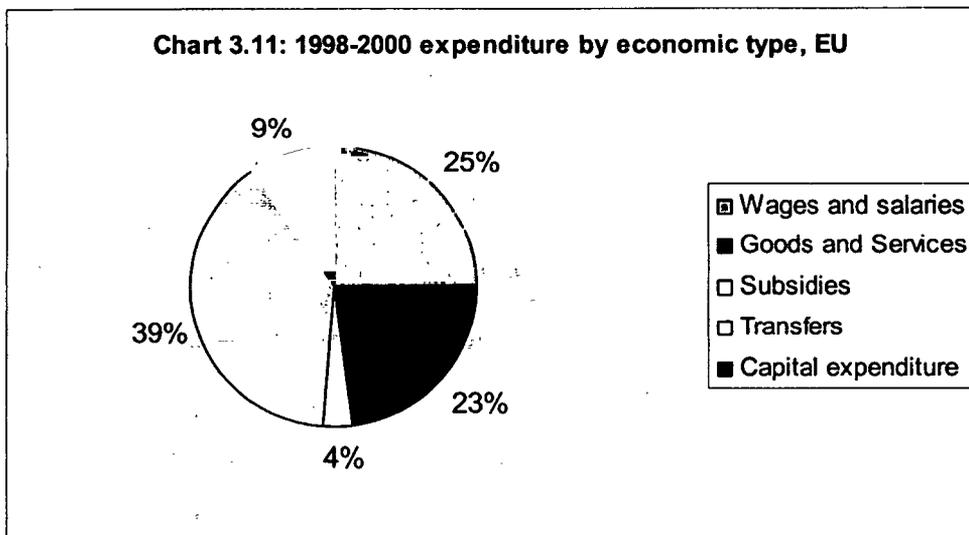
3.47 An illustrative scenario of what public spending in Kosovo could look like in 2005 is presented below (Chart 3.10). For comparative purposes, current spending by economic classification for the EU is also presented (Chart 3.11). The main features of the scenario outlined in 3.10 are the following:

- (e) Wage and salary spending would be held roughly constant at 6.5 percent of GDP, up from 6.3 percent in 2001. As discussed above, this roughly constant share of public wage spending should be supported by a comprehensive restructuring and reform package of the public sector work force. Such reforms should target: (i) a reduction in aggregate public employment levels; (ii) increased wage differentiation; and (iii) better wage bill control systems. A more comprehensive review of pay, employment and civil service structure needs to be undertaken prior to any restructuring.
- (f) Non-wage goods and services would increase to around 6.8 percent of GDP, up from 4.4 percent in 2001. Spending on goods and services is currently inadequate to maintain public assets and there is a biased prioritization of wage and salary over operations and maintenance spending. Unless this is addressed quickly, there is a risk of further depreciation of existing infrastructure and capital assets as well as insufficient maintenance of PRIP and other post-conflict investments. Efforts should also be made to improve the efficiency of existing goods and service spending, in part through improved procurement and internal audit procedures (see Chapter 5).
- (g) Enterprise subsidies would reduce from 3.7 per cent of GDP in 2002 to 1.8 percent by 2005. Current budget subsidies are large by any standard. Reducing subsidies will require putting in place proper rationalization plans for all existing subsidies and resisting pressure for new spending.

- (h) Transfers to households would increase to 5 percent of GDP. This increase is accounted for to a large extent by the introduction of the pension scheme (see Chapter 4).
- (i) Capital spending financed by the General Budget would increase to around 2.5 percent of GDP by 2005, up from 0.8 percent in 2001. In the face of declining donor support and considerable remaining investment needs, greater capital expenditures will have to be financed by the General Budget.



Source: World Bank staff estimates.



Source: World Bank staff estimates.

ANNEX 3.1: METHODOLOGICAL ISSUES ON PUBLIC SECTOR PAYROLL DATA

3.48 The data used are derived from budget documentation, both published and provided by the Central Fiscal Authority²³. This data can depart significantly from central pay-roll data. However, because (i) not all employees are on the central payroll as yet; (ii) additional monetary rewards may be included in the wages budget line that is not on the payroll; and (iii) we did not have payroll data across the three years. At the outset it is necessary to note that the analysis has been hampered by significant gaps in the available data. For instance, no data are available on the skill structure of the civil service, which is a major gap.

3.49 The results of the survey should be seen as indicative rather than conclusive. Sectoral evidence points towards some wage spending recorded in lines other than the wages and salaries budget line. This would mean that the wage bill and wages might both be underestimated. On the other hand it is clear from the numbers that the quality of employment data improves over the three years under review, and may therefore still not be a particularly accurate reflection of employment.²⁴

3.50 In order to make the data comparable to other countries in the region,²⁵ the data have been manipulated to separate out municipal pay and employment from central government employment across the three years, and to separate out health and education from general government services pay and employment (see Chart 3.9 on the structure of the dataset). In spite of the decentralization, and to treat categories consistently across three years, wage payments to health and education professionals have consistently been recorded at a central level in education and health, and at a municipal level in administrative functions. In tandem, the transfers have also been recorded at central government levels in health and education and at the municipal level in the municipal administrative functions.

3.51 In comparing the Kosovo results to other countries in the region, where education and health employment and wages are recorded make no difference in many of the statistics, since the comparison is for health and education employment no matter whether it is central, sub-national or split between them, and because the Kosovo comparator year is 2001, when the problem did not apply. In future repeats of this exercise there would be more value in moving the health and education grant and commensurate wage spending to sub-national government, once spending in 2002 has established a benchmark.

²³ The main sources of data are as follows: 2000 -- 2000 Final Outcome Table provided by CFA; 2001 Budget book for employment data; 2001 -- Original budget documentation, Mid-year budget review and Preliminary Outcome tables provided by the CFA; 2002 -- Budget Schedules 1, 2 and 3 and The New Kosovo Government Budget 2002 budget document).

²⁴ More recent data from the MPS show a somewhat different distribution of public employment and significant increases in education and health staffing levels over the past year.

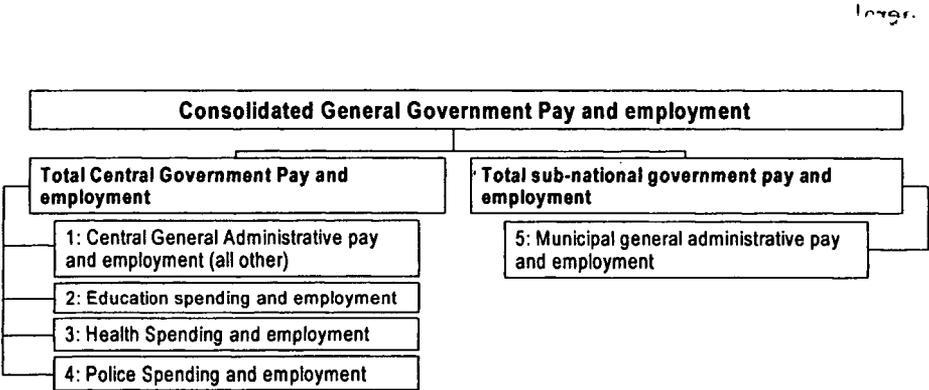
²⁵ A 1999 cross country comparative study broke wage data down into central government administrative employment, local government administration employment; education employment and health personnel (Schiavo-Campo et al, 1999). The dataset for the study has since been updated with data for the period 1996 to 2000 (De Tommaso dataset: <http://www1.worldbank.org/publicsector/civilservice/cross.htm>).

3.52 The above manipulations have enabled us to establish five mutually exclusive spending categories, combining to form total central government wage spending and total sub-national government wage spending (minus education and health which were kept at a central level with the grant spending consistently across the three years). Chart 3.12 illustrates the structure.

3.53 The analysis of pay and employment is also hampered by poor data quality. For example, the establishment since 1999 of a civil service in Kosovo may not be reflected fully in the change in public employment from 2000 to 2001 as recorded. The changes from 2000 to 2001 are probably influenced as much by tighter budgeting and record-keeping practices than by actual employment trends, with the 2000 actual numbers being intended employment rather than actual employment. It is likely that actual employment was less. It is to be expected that the lack of difference between 2000 budget and actual employment numbers is not a perfect reflection of reality. However it remains the only consistent dataset and provides good indications of trends, even if the magnitude of the trends cannot be determined with extreme accuracy.

3.54 The 2001 baseline data used for the development of a wage bill scenario was sourced from updated CFA employment and wage bill data, incorporating adjustments made between March 2002 and July 2002 to the 2001 actual spending data.

Chart 3.12: The structure of public sector employment



4. RESTRUCTURING SPENDING: SOCIAL SECTOR ISSUES

4.1 The preceding chapter summarized the main trends in the allocation of public funds across government functions and economic categories, and showed that the budget is dominated by spending on health, education and social welfare. This chapter offers a closer look at these three main elements. Each of the sub-sections will provide (i) an overview of the sector including performance outcomes where available, (ii) an analysis of expenditures, (iii) an analysis of efficiency and equity in service provision in the sector, and (iv) policy recommendations including measures to improve the efficiency of existing public spending.

A. SOCIAL PROTECTION

Overview and issues

4.2 The consequences of the 1999 conflict on the living standards of the population were severe: the World Bank Poverty Assessment estimated that some 50 percent of the population is poor, and of those, some 12 percent were extremely poor at the end of 2000. Although poverty is widespread, one of the findings of the LSMS is also that a significant proportion of the poor are relatively close to the poverty line and not subject to severe poverty. Since poverty is relatively shallow, a center pillar of a poverty reduction strategy must therefore be a focus on the renewal of private sector driven economic growth. While the living standards of most poor families can be expected to rebound gradually from poverty as the economy grows and job opportunities increase, the living standards of the extremely poor may not. For this group of individuals, specific anti-poverty interventions are required.

4.3 The current social protection system in Kosovo is limited in scope. In many ways this is an advantage because it means that Kosovo does not have to dismantle structures inherited from previous regimes that would not be appropriate for its current conditions. The main cash transfer programs are a targeted social assistance (poverty) benefit and a recently enacted old-age benefit (a so-called basic pension). A network of social work centers provides counseling and referral services to individuals and families at risk (i.e. juvenile offenders, orphans, victims of domestic violence, etc.). A network of employment offices remaining from the pre-conflict period registers job seekers and has recently started providing job-search assistance and some pre-service training. Work disability pensions are currently being debated. Modest child protection programs, and a recently enacted old-age benefit (a so-called basic pension), complete the formal system. The safety net is complemented by informal, mainly kinship-based mutual support and (declining) assistance provided by NGOs and charitable organizations.

4.4 In most developed countries, a substantial part of social protection expenditure is financed by social insurance contributions paid by workers and employers, not through the General Budget. General budget resources are normally reserved for social assistance-type non-contributory schemes, such as the Kosovo social assistance scheme and the basic pension scheme. It is unlikely that Kosovo will be able to move to contributory

financing of social protection programs for some time. The formal sector of the economy is of modest size, and wages are low. Experience in similar situations elsewhere points to major difficulties in capturing wage income accurately and suggests that enforcement could be problematic, while the absence of a well-functioning payments system means that withholding is not an option, except perhaps in the public sector. Moreover, the machinery to collect a wage tax is only in the process of being put into place. The Kosovo social protection system can therefore be expected to remain heavily dependent on General Budget resources for the near future.

4.5 Currently, some 68 million euros or 3.4 percent of GDP are allocated to cash transfers, including their administration. The bulk, some 92 percent, is for the social assistance program and the basic pension scheme. Over the next two years, these expenditures are expected to increase by almost half, mainly as a result of increased expenditures on the basic pension scheme. If work disability pensions are introduced, it is possible that there will be a significant additional jump in cash transfers; however, it is currently not possible to estimate the additional budget resources that the introduction of a disability pension would require.²⁶

4.6 The level of expenditures on cash transfers in Kosovo is on average some 6 percentage points of GDP less than in similar countries in southeastern Europe. More broadly, social protection spending in other transition economies in Central and Eastern Europe ranges from 5 to 15 percent of GDP, with an average of around 10 percent; the average for middle income countries around the world is 5 percent. In part, the relatively low social protection spending in Kosovo reflects the very modest size of the basic pension scheme, which adjustments to the scheme in subsequent years will only modestly change. At the same time, the social assistance program in Kosovo could be considered to be better funded than in other economies. At 2.2 percent of GDP, it compares with a range of 0.5 percent and 1.5 percent of GDP in transition countries in instances where social assistance payments can be identified.²⁷ Arguably, spending on social protection in Kosovo is at the low end of prudent spending for transfer programs. However, depending on what objectives are set for social protection programs in Kosovo, efficiency improvements within programs – and especially focusing social assistance on the extremely poor, who are less likely to be able to take advantage of economic gains – may well provide significant improvements in the poverty situation, while maintaining a relatively modest share of public expenditures in transfer programs. These issues are discussed in more detail below.

4.7 The Government is currently considering several measures to enhance the system: (a) it is reviewing the social assistance scheme to improve targeting and preparing a social assistance law; (b) it is strengthening social care service provision; (c) it is putting into place a mandatory advance funded pension scheme, as well as legislation for voluntary occupational pension schemes; (d) it is considering the introduction of a disability pension; and (e) it has introduced a new Labor Code to provide a legislative and regulatory framework for the labor market.

²⁶ The introduction of severance pay required by the new Labor Code may place further demands on the budget, to the extent that lay-offs will occur in connection with eventual privatization of state enterprises (see the section on *Labor and Other Programs* further on in the text).

²⁷ Albania, with 4.2 percent of GDP spent on social assistance (1997), stands out as an exception.

4.8 Main sector challenges and reform objectives. In developing a social protection system that will protect the poor as well as facilitate exit from poverty, the main challenges the Government faces relate to affordability and administrative capacity. While need is extensive, fiscal capacity is likely to remain modest for a long time; and skills and experience in managing and administering social programs still is largely dependent on foreign technical assistance. Under such circumstances, the scope for expanding existing programs and introducing new programs is limited. Already, there are major concerns about the affordability of the old-age pension and the disability pension, as well as any large-scale lay-offs to which the new Labor Code and its severance stipulations may apply. Moreover, indications of budget allocations for social protection over the next few years do not allow for either expansion of current programs or introduction of new ones. Under these circumstances, the main focus should be on (i) improving administration of current programs; and (ii) prioritizing the most vulnerable Kosovars while ensuring fiscal affordability.

Social assistance

4.9 The Kosovo social assistance program was introduced in 2000. It is designed to target poor households, while being fiscally sustainable and administratively simple with easily identifiable categories. At the time the program was designed, statistically representative information on vulnerable groups in the post-conflict environment was not available. Therefore, the program does not make a distinction between the poor and the extremely poor, nor does it attempt to raise well-being to some pre-defined level, i.e., no notional poverty line was set.

4.10 The social assistance program pays benefits to two categories of beneficiaries:

- (a) *Category One:* families without resources where no one is capable of work, or expected to make themselves available for work (e.g. single mothers, children);
- (b) *Category Two:* families with at least one child under 5, or caring for an orphan under 15; other members capable of working should be registered as unemployed; no member can own a motorized vehicle or more than half a hectare of land; no resources are being provided by relatives outside the family.

4.11 The benefit is set at 33 euros/month for the first family member; an additional Euros 13 is provided for the second; the benefit then increases by 5 euros for each additional member up to five members, i.e., a family of five or more that meets the eligibility criteria receives 61 euros. In 2001, 33 million euros were paid out as social assistance benefits to 56,000 households (200,000 individuals). In 2002, 37 million euros have been budgeted for the social assistance benefit.

4.12 Although the social assistance scheme is targeting categories that display high poverty risk, at the same time it generates a relatively high degree of targeting errors –

both of exclusion and inclusion.²⁸ The extremely poor only benefit from 18.3 percent of total program resources, while the non-poor receive as much as 35 percent.²⁹ Categorical targeting is thus leading to substantial leakages and inefficiencies in the allocation of scarce resources.

Policy recommendations

4.13 Social assistance should focus on the extremely poor. The initial design of the scheme was never intended to be a long-term solution. The social assistance scheme should be restructured to target the extremely poor by (i) setting a poverty line at the food poverty line; (ii) introducing proxy means-testing to improve targeting; (iii) aiming at containing targeting errors to 25 percent; and (iv) considering the conditioning of continued receipt of social assistance for poor children who regularly attend school and health clinics.

4.14 The LSMS finds that that an extremely poor individual would on average need an additional 73 euros per year to reach the food poverty line.³⁰ Assuming perfect targeting, the cost of a social assistance program designed to eliminate extreme poverty would be around 18 million euros, or 1.3 percent of GDP. With a more realistic assumption of a 25 percent leakage, the cost of social assistance would rise to 23 million euros, or 1.7 percent of GDP. Currently, Kosovo allocates some 37 million euros for the social assistance program, or 2 percent of GDP. Assuming 25 percent leakage, changing the benefit level to target the food poverty line could lead to an annual fiscal saving of €14 million in the medium term³¹. Some upfront investment would be required to improve targeting, but this should be modest relative to the overall scale of fiscal savings.

4.15 Improve targeting through the introduction of proxy means-testing. Since the initial design of the social assistance scheme, more information has become available; building on these criteria can help to improve the efficiency of the scheme. Given the widespread informal economy and the high reliance on remittances, it is extremely difficult to verify household income. To better target resources to the truly needy, a few “proxies” for income could be defined and applied as filters. The *Poverty Assessment* notes three indicators that strongly correlate with extreme poverty: a high dependency ratio³², being a rural household with less than a half hectare of land; and not having a

²⁸ To a large extent, *errors of inclusion* may reflect the fact that eligibility is determined mainly on the basis of documentation presented by the applicant. It may also reflect the environment – it is particularly difficult for a benefit officer to establish need in an environment where there is a large informal sector and extensive family- and kinship-based safety nets. *Errors of exclusion*, as measured by the World Bank’s *Poverty Assessment*, reflect the effects of the *cash limit*. Proxy indicators for poor families were in part chosen in order to limit the number of eligible families to the available envelope, thus explicitly generating errors of exclusion.

²⁹ World Bank Poverty Assessment.

³⁰ Analysis of the LSMS, as presented in the World Bank Poverty Assessment, finds that the extreme poverty gap, i.e. the gap between actual consumption and the food poverty line, is only 2.5 percent of the of the food poverty line. In other words, an extremely poor individual needs an average of 73 euros annually to reach the food poverty line.

³¹ If inflation is taken into account and the food poverty line is adjusted annually, savings will be somewhat smaller. Given current benefit levels, a 6 percent adjustment for inflation would lower efficiency savings by €1 million.

³² An average size of seven, including numerous children and at least one elderly member.

working adult in the household. Targeting could be further fine-tuned by using proxy means testing, which yields a scoring formula based on a larger number of proxies for consumption-based poverty and which would enable the authorities to differentiate among the poor based on the degree of their poverty.³³

Pensions

4.16 A three-pillar pension system is being developed for Kosovo consisting of a basic pension, a mandatory advance funded scheme and voluntary occupational schemes. Legislation has been prepared for all three schemes, and the basic pension was introduced in July 2002. This analysis focuses on the basic pension and the possible work disability pension, since it is too early a stage to assess the fiscal implications of the administrative expenses necessary to operate the funded scheme.

4.17 The basic pension is a Government-sponsored non-contributory universal scheme. It is conceived as a flat rate monthly benefit available to all residents of Kosovo, as well as Kosovar refugees living outside the territory, age 65 and over, irrespective of prior contributions or work history. In that sense, it is an old-age social assistance program. It is pay-as-you-go and financed from the General Budget. The scheme took effect in July 2002. The benefit has been set at 28 euros, in line with the estimated value in 2001 of the food basket that serves as a benchmark (poverty line), for extreme poverty among households. It is estimated there are about 135,000 eligible individuals.

4.18 Current pension levels in Kosovo are not necessarily low relative to international comparators. At 28 euros per month, the pension is currently equivalent to about 37 percent of per capita GDP. Minimum pension guarantees and world-wide universal flat pensions tend to be in the range of 15-25 percent of GDP per head, while the average public pension level as a share of GDP per head in eastern Europe is 38 per cent.³⁴

4.19 Some current proposals suggest increasing the pension to Euro 35 in 2003 and Euro 40 in 2004. Such increases would lead to unsustainable levels of pension spending and are probably not necessary. LSMS data show that the extreme poverty gap—the difference between the average consumption and the food poverty line - is only 73 euro per year for an extremely poor person. In other words, the average extremely poor individual would only need 73 euro per year to achieve the minimum food requirement, and 200 euros per person per year would be required to lift the average poor household out of poverty. More recent proposals by the Ministry of Finance and Economy for a basic pension level of Euro 33 and 36 for 2003 and 2004, respectively would be affordable.

Policy recommendations

4.20 **It will be fiscally unaffordable over the next few years to increase the real value of the pension significantly above current levels.** Table 4.1 outlines the fiscal

³³ The adoption of proxy means testing saves significant resources that are spent on administrative costs in countries with full means testing.

³⁴ Nevertheless, absolute pension levels in Kosovo are lower than in most other countries in Southeastern Europe, with the exception of Albania.

impact of different pension scenarios. Current plans to increase the pension to 36 euros a month by 2004 appear reasonable. However, raising the pension to 40 euros a month, as has been discussed, would bring annual pension spending to €69 million in 2004, which is unsustainable in the current fiscal framework. Indexation of the pension to inflation – as defined in the Pension Law - is more reasonable, and would increase pension spending to some €55 to 62 million by 2004, within the envelope currently budgeted for the basic pension.³⁵

Table 4.1: Basic pension scheme - Scenarios

	2002	2003	2004
GDP (Euros 000)(1)	1,990,000	2,163,000	2,339,000
KCB Pension allocation (Euros 000)(2)	24,336	55,440	63,360
Monthly pension(3)	28	33	36
Monthly pension(4)	28	30	32
65 and over(5)	135,000	140,000	144,000
65 and over(6)	120,000	122,400	124,848
Pension, case A (Euros 000)(7)	22,680	55,440	62,208
Pension spending as share of GDP	1.1	2.6	26.6
Pension, case B(7)	20,160	24,235	26,967
Pension spending as share of GDP	1.0	1.1	1.2
Pension, case C(7)	22,680	50,400	55,296
Pensions spending as share of GDP	1.1	2.3	2.4
Pension, case D(7)	20,160	44,064	47,942
Pensions spending as share of GDP	1.0	2.0	2.0
Pension at Euros 40/month			69,120

(1) Government estimates

(2) The allocation for 2002-2004 is based on actuals for 2002 and government estimates for 2003 and 2004

(3) The monthly pension reflects government estimates (MOFE 9.11.02)

(4) The monthly pension reflects inflation indexation according to the GDP deflator

(5) The numbers are drawn from "Creating a Modern Pension system i

(6) The series has been reduced by 10%

(7) Case A reflects the MOFE pension series and the higher estimate of pensioners; case B the MOFE series and the lower estimate of pensioners; case C reflects the deflator-indexed pension series and the higher estimate of pensioners; case D reflects the deflator indexed pension series and the lower estimate of pensioners

Source: MoFE, CFA, staff estimates

4.21 Disability pensions. Experience in other economies has shown that a key consideration should be fiscal sustainability since an overly generous disability scheme can contribute to pension fund insolvency. If a disability pension is introduced, it should be set at a flat-rate amount equal to the poverty gap for the disabled, be no higher than the

³⁵ Information on registration of pensioners as of September 2002 suggest about 70,000 pensioners have registered so far.

basic pension, and be enacted using strictly defined criteria for eligibility. Kosovo may want to consider using a 100 percent disability criterion, in which case the numbers of potential recipients would be well below the 10,000 that has been mentioned. This would also facilitate implementation of the scheme.

Labor and other programs

4.22 **Severance pay** The Kosovo authorities are in the process of developing employment and training strategies for the medium term. The authorities are not only faced with high levels of unemployment, but also the perspective of large-scale lay-offs, as state enterprises are restructured. According to the new Labor Law severance pay of between one month's salary for 2 to 4 years of service to five months' for 30 years or more of service is payable³⁶. The policy of the KTA in the area of severance is still being designed. To the extent that workers have maintained formal labor contracts with state enterprises that are to be restructured – irrespective of whether such contracts have been honored or not with the payment of wages – they may be eligible to severance under the Law. With as many as an estimated 40,000 people working at SOEs in the early 1990s, it will be fiscally impossible to finance severance pay for all.

4.23 Table 4.2 shows an indicative calculation of severance costs of around €6 million, assuming 10,000 workers receive severance pay. If 40,000 people are deemed eligible, and assuming the same distribution as workers, these costs could amount to as much as €24 million, which is not affordable.

Years of service	Severance scale	Number of workers	Average wage eur	Cost € 000
2-4 years	1 month's wage	700	135	95
5-9 years	2 months' wage	1,000	145	290
10-19 years	3 months' wages	4,500	180	2430
20-29 years	4 months' wages	3,100	208	2575
30 and over	5 months' wages	700	165	580
Total				5,970

(1) Source: Various publications of the Ministry of Labor and Social Welfare. The distribution of workers and average wages are inferred from results of a wage survey conducted by the Kosovo Regional Employment Centers in December 2001. Consequently, the Table is only indicative.

4.24 **Fostering.** A modest fostering program is currently underway. While not a significant element of the budget, fostering payments seem surprisingly generous – they include a stipend of €50 for accepting a child, and subsequently monthly payments of €77 per child. In 2002, €89,000 is allocated for this purpose, rising to €951,000 next year. This is linked to a planned increase in coverage to children over two years of age and to disabled children.

³⁶ UNMIK regulation 2001/37.

Policy Recommendations

4.25 It is premature for Kosovo to introduce an unemployment benefit at this point in time. Many countries have restricted their labor compensation programs to severance, for fiscal and practical reasons. It is administratively costly to set up and monitor compliance of unemployment benefits. Particularly in Kosovo where there is a large informal sector, it would be very difficult to certify that unemployment benefit recipients were actually not working. At some point in the future, Kosovo may want to consider the pros and cons of an unemployment benefit, but it would be premature to introduce an unemployment benefit at this point in time.

4.26 Poverty monitoring through a program of regular surveys should be instituted. Poverty monitoring needs to be introduced on a regular basis to measure outcomes from changes in social protection programs and to contain targeting errors. The recent household survey and poverty assessment provide a good basis for identifying poor and vulnerable population groups and refining safety net strategies. Maintaining an ongoing survey based on this initial effort will be crucial to good social policy-making in the future. The household survey should be repeated at regular intervals (annually or biannually) to track trends in living standards and to provide estimates of the number of the poor and the extreme poor and the poverty gaps (differences between their consumption and the poverty line). Other social indicators should be monitored. KOS recently conducted its first labor force survey (LFS), and it is important that the LFS be repeated at regular intervals, to track changes in employment and activity. A full Health and Demographic Survey (HDS) is also strongly recommended to provide data on morbidity and disability.

B. HEALTH

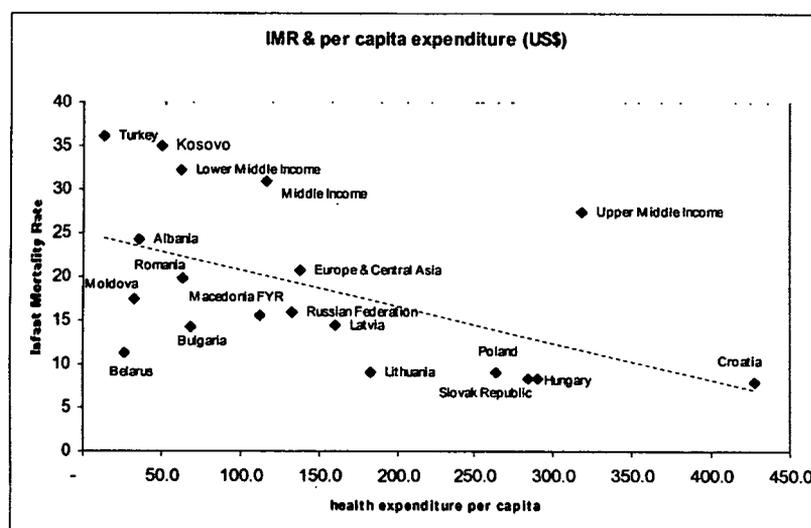
Overview

4.27 Kosovo has a tradition of health care provision on a publicly financed and publicly provided basis. From 1989 the health system suffered significant decline with the dismantling of health care financing arrangements. Large sections of the population were excluded from using the main systems and became dependent on a parallel system funded directly by citizens. Since 1999, the public component of the health care system has been financed from the General Budget managed by the UNMIK Department of Health and Social Welfare. The Ministry of Health (MOH) has succeeded the Department following the elections in November 2001. Responsibility for the management of primary health care services was devolved in 2001 to the municipal administrations.

4.28 In common with other economies in the region, the system has historically been, and remains, centralized and hospital dominated. There are six hospitals (4856 beds) providing secondary care services, and much of the hospital caseload is confined to minor and intermediate treatment regimes. The main Pristina University Hospital, comprising almost 50 percent of the total bed complement, acts as the main center for undergraduate medical education and as a referral and tertiary care service for the whole of Kosovo. The public health care (PHC) system at the municipal level comprises health houses, family health centers and ambulancias providing primary health care and some specialist and

maternity services at the community level. An Institute of Public Health supervises or directly provides a number of health promotion and preventive services.

Chart 4.1: Infant Mortality Rate and per capita health expenditure in current US\$ (selected regional indicators)



Source: WB database on health, KIS/IOM/UNFPA 1999

4.29 Health outcomes are amongst the worst in the region. The crude birth rate for Kosovo is 17.7 per 1000 population.³⁷ Life expectancy is estimated as 71.5 and 76.5 for males and females respectively³⁸, maternal mortality rate and infant mortality rates as 12.6 and 35 deaths per thousand live births respectively.³⁹ While life expectancy figures put Kosovo on the positive side of regional trends, by most indicators Kosovo health outcomes are the worst among all transition economies. In particular, and as illustrated in Chart 4.1, the infant mortality rate is high relative to both transition economy and lower middle-income country averages, and may have increased further since 1999. The package of basic services provided by the health system is not defined, and essential tertiary and ancillary services are simply not available. As the level of overall health spending (both public and private) is not significantly below regional averages, these outcomes imply significant inefficiencies in existing service provision.

4.30 Limited services are offered by the health system. In terms of hospital performance, current bed levels at 2.1 per 1000 population is low in the regional context. Average length of stay (7.9 days) and average occupancy (69.2 percent) performance appear moderate. However, the hospital system currently provides only basic health care services, which distorts regional performance comparisons. As there is little fiscal space to expand the range of health care services in the short to medium term, and for tackling what appear to be relatively high levels of avoidable morbidity and mortality, short-term efforts should focus on securing increased value from existing spending.

³⁷ 2001 birth estimates from WHO/UNICEF 2002.

³⁸ IPH, 2000.

³⁹ KIS/IOM/UNFPA 1999.

4.31 Public health care is decentralized. Responsibility for the management of primary health care services was devolved in 2001 to the municipal administrations⁴⁰. Of spending on PHC of €23.2 million outlined in the 2002 budget, €17 million (73 percent) is expected to take place at the municipal level. This spending is to be funded by a €15.2 million dedicated health grant to the municipalities from the General Budget and an additional €1.8 million to be raised through a system of formal co-payments⁴¹.

4.32 Aggregate health spending is reasonable, but public spending is very low. Based on 2001 figures, Kosovo spent an estimated 7.18 percent of its GDP on health, of which 2.78 percent was from public resources from the General Budget, 0.82 percent was from donor resources, and 3.58 percent was from private sources. This overall level of spending is at the low end of regional averages, but is broadly in line with the level of spending in CEE countries. However at 2.78 percent of GDP, public spending is well below the regional and European average of 5-6 percent. Table 4.3 illustrates comparative public and private spending and health outcomes in other countries. The budgeted public financing of health in 2002 is €51.5 million. Of this €25.25 million is earmarked for hospital services, €19.73 million for primary health care services (PHC), €5.48 million for other services (blood transfusion, mental health, public health, occupational health and administration) and €1.03 million for central services.

4.33 Private spending on health is significant and unregulated. In 2001 private spending on health, in the form of out-of-pocket expenses for private services and pharmaceuticals, official co-payments and informal payments to professional staff in the public system, is estimated to be 3.58 percent of GDP⁴² (compared with public spending of 2.78 percent of GDP). This comparatively high level of finance passing through the unregulated private and 'informal' sectors does not support the implementation of a rational health strategy and undermines efforts to achieve sustainability and improve service delivery.

4.34 Although data is incomplete, the private provision of health care is growing rapidly, especially in areas, such as dentistry, ambulatory services and diagnostic services. The private sector is largely unregulated, and minimum standards of patient care and protection are not enforced; the rapid increase in private provision raises access and equity concerns. Specialists holding full-time contracts in public institutions often provide private health care, and clear conflicts of interest exist.

⁴⁰ UNMIK Regulation 2000/45, passed into law in August 2000.

⁴¹ Introduced by former Department of Health and Social Welfare Instruction 2001/17.

⁴² Calculated using data from joint World Bank/FAO/UNDP Living Standard Measurement Survey (LSMS).

Table 4.3: Comparative Health financing and outcomes

	Public percent of GDP	Private percent of GDP	Total Exp. percent of GDP	Life expectancy 1999	Infant Mortality Rate 1999	Physicians per 1000 people 1990-98	Hospital beds per 1000 people 1990-98	ALOS (days) 1990-98
<i>Albania</i>	3.5	0.5	4	72	24.3	1.4	3.2	8*
<i>Belarus</i>	4.9	1.1	6	68.4	11.3	4.3	12.2	18
<i>Bulgaria</i>	3.8	0.8	4.7	71.1	14.3	3.5	10.6	14
<i>Croatia</i>	8.1	1.5	9.6	73	7.9	2	5.9	11*
<i>Hungary</i>	5.2	2	6.4	70.6	8.4	3.5	8.3	9
<i>Kosovo*</i>	2.8	3.6	6.4	71.5-76.5	35**	0.86	2.1	7.9
<i>Latvia</i>	4.2	2.6	6.7	69.8	14.4	3.4	10.3	14
<i>Lithuania</i>	4.8	1.5	6.3	72.1	9.1	3.9	9.6	12
<i>Macedonia, FYR</i>	5.5	1	6.5	72.8	15.5	2.3	5.2	15
<i>Moldova</i>	6.4	2.1	8.4	66.6	17.4	3.6	12.1	18
<i>Poland</i>	4.7	1.7	6.4	73.2	9.1	2.3	53	10
<i>Romania</i>	2.6	1.5	4.1	69.5	19.8	1.8	7.6	10
<i>Russian Federation</i>	4.6	1.2	4.6	65.8	16	4.6	12.1	18
<i>Slovak Republic</i>	5.7	1.5	7.2	72.7	8.3	3	7.5	11
<i>Slovenia</i>	6.6	0.9	7.6	75.1	4.9	2.1	5.7	11
<i>Turkey</i>	2.9	2.9	5.8	69.5	36.2	1.2	2.5	6
<i>Austria</i>	5.8	2.4	8.3	77.9	4.4	3	8.9	9
<i>Belgium</i>	7.9	1	8.9	78	5.4	3.4	7.2	11
<i>Germany</i>	7.9	2.7	10.6	77	4.8	3.5	9.3	12
<i>Greece</i>	4.7	3.6	8.3	77.9	6	4	5	10
<i>Netherlands</i>	6	2.5	8.6	77.7	5.1	2.6	11.3	34
<i>United Kingdom</i>	5.6	1.1	6.7	77.2	5.7	1.7	4.2	10
<i>Averages</i>								
<i>Middle income</i>	2.5	2.6	5	69.3	31	1.8	3.4	12
<i>Lower middle income</i>	2.3	2.5	4.7	69.3	32.2	1.9	3.5	13
<i>Upper middle income</i>	3.4	2.9	6.2	69.2	27.5	1.6	3.3	8
<i>Europe & Central Asia</i>	1.9	2.8	4.8	69	20.8	1.2	2.5	12
<i>High Income</i>	4	1.6	5.2	77.9	5.7	2.8	7.2	14
<i>Europe EMU</i>	6	3.7	9.7	77.7	5.1	3.9	7.6	12

Source : WB database on health, KIS/IOM/UNFPA 1999 for Kosovo

* 2001 data, excluding donor funded investments which amounted to 0.82% of GDP.

** 1999 estimate.

4.35 Approximately €2 million was reported in participation payments collected under a formal co-payment scheme approved by the Ministry of Health (MOH) in 2001, significantly less than the planned estimate. These revenues go towards municipal budgets, and are planned to augment the current health grants for the provision of PHC. Little is known about private expenditure on pharmaceuticals and fees paid to private providers of health care services, as yet unregulated, or informal payments paid in conjunction with the use of public health care facilities. Anecdotal evidence indicates that patient use of the informal or formal private sectors is not necessarily through choice but

through coercive deflection of patients to the sector, an inability of the public sector to finance and supply basic pharmaceuticals, and because of low perceived quality and poor response of the public health care services.

4.36 Capital expenditure has been largely financed by donors. Donor expenditure has played and continues to play a significant part in the financing of the health care system with 2001 donor expenditure in health of €14.31 million (0.82 percent of GDP). Donor support has been the principal source of non-recurrent capital investment. In 2002, capital investment in health from the publicly financed budget is planned at a very low €0.63 million (0.03 percent of GDP). This level cannot sustain investment needs for the future.

4.37 The equity of access to health care is poor. The heavy reliance on unregulated private service provision and expenditure raises serious issues regarding the availability of health services to the poorest segments of society. The 2001 World Bank Poverty Assessment reported the cost of service as the major barrier to health care access, with an average 28 percent of those who did not seek treatment for a medical problem citing cost as the primary reason, a figure that rises to 40 percent for the poorest. The cost barrier is likely to have a significant impact on the high infant mortality rate, with 15 percent of pregnant women not seeing a healthcare worker and 20 percent giving birth at home without professional assistance.

4.38 Key challenges of the health system in the near term include:

- (a) Relatively high levels of avoidable mortality and morbidity;
- (b) A lack of basic facilities and equipment;
- (c) The complete absence of major medical services, particularly costly tertiary care specialties;
- (d) The need to reconfigure the delivery system from its current hospital focus to a more primary health care based system;
- (e) Dependence upon unregulated private contributions and service provision constraining the government's ability to strategically influence development of an efficient and sustainable health system over the longer term;
- (f) The absence of a sound contemporary information base on all aspects of health indicators and health system financing and performance;
- (g) Relatively low levels of key professional (medical, nursing and therapist) staffing to the population;
- (h) A lack of education and training opportunities to reconfigure the staffing across secondary and primary care.

Efficiency of Health Expenditure

4.39 Analysis of key regional indicators suggests that in overall terms, resources invested in health care in Kosovo are low, in particular relating to the level of key

professional staff to population, the level of in-patient beds to population, and the range of services, in particular in tertiary care. However, a more in-depth analysis of major spending areas suggests that there is significant scope for improvements in technical and administrative efficiency of the current health care system. Significant efficiency gains could be achieved by; (i) restructuring health sector staffing, (ii) improving procurement, and (iii) rationalizing the hospital sector.

4.40 Staffing. The staffing situation in the health sector in Kosovo is characterized by relatively high staffing levels for the volume of activities undertaken and the range of services offered. However the high overall numbers conceal a significant shortfall in levels of key skilled staff (doctors, nurses and therapists) and high levels of support staff for whom, in the under developed Kosovo economy, public sector employment represents an alternative to unemployment. This is especially true in facilities that are catering exclusively for minority populations. As a result there has been upward pressure on staffing numbers, and wage levels in the health sector have remained low and compressed, with corresponding negative effects on service provision efficiency. The medical staffing position is further confused by misdistribution and difficulties in recruitment of key workers in the poorer areas, where little opportunity exists for professional development and income enhancement.

4.41 In 2001 wages and salaries accounted for almost 45 percent of public health expenditure from the General Budget, or 1.24 percent of GDP. Year on year analysis shows a consistent level of about 13,500 staff, including the PHC sector now under the control of the Municipalities. Government employment in health amounts to 0.6 percent of the population, marginally under the OECD average (0.7 percent) and below that of EU border states (0.9 percent). Declared salaries and wages figures do not reflect full staffing costs, as facilities commonly make additional payments to staff from locally generated income sources (i.e. co-payments, rents and fees) which are recorded in the 'Goods and Services' budget line and not recorded as staffing costs. The projected cost of a proposal to formalize the current 'unsocial hours' payments currently made at PUH sector wide are €1.5 million - €3 million, and would bring overall compensation payments to about 50 percent of the health sector budget.

4.42 2002 data reveal that to bring staffing expenditure down to currently budgeted levels (without regard to desired service levels or system restructuring) will require a decrease of 793 staff. Existing estimates of severance costs go as high as €890,000 (depending on years of service of staff made redundant), or an additional 1.75 percent of the 2002 health budget. However current overstaffing levels imply additional costs of €143,000 annually, based on average salaries. Such reductions should be strategically implemented, based on the two axes of redistribution required in health staffing; (a) more professional staff and less support staff; and, (b) a likely shift towards community based preventative services from hospital based services. The strategic rationalization of facilities and expected redistribution of staff between hospital based and community based care will require redeployment and retraining, and place additional short term demands on the budget, on top of expected severance payments.

4.43 The actual number of doctors in Kosovo is likely to be higher than the payroll suggests as, payroll data does not reveal the number of doctors working in positions of

management at either facility or central Ministry level or the number of doctors working in the private sector. Current information supports an estimate of 2,000 – 2,250 doctors in Kosovo, giving a doctor/population ratio of approximately 100 per 100,000 population. This is the lowest figure in the southeast Europe region, and is only a third of the average for transition economies. The nurse/population ratio is similarly low.

4.44 Human resource management and development within health facilities remains an 'ad-hoc' process. MOH and Ministry of Public Service guidelines exist, but discrepancies are reported in their implementation. Dissatisfaction amongst health personnel is rising, mostly in regard to remuneration packages and the lack of clear guidance from the MOH. While there is little scope for across the board increases in health sector income levels, the current income level does not appear to motivate key professionals. Low public sector salaries, linked to scarcity, are resulting in unregulated growth in private sector services, which is likely to worsen access to health services for socially disadvantaged groups.

4.45 **Pharmaceuticals.** In 2001 the budget for pharmaceuticals and medical supplies was an indicative €17.9–20.4 million, representing 37-42 percent of the total health sector budget⁴³ and 70-80 percent of the 'Goods and Services' budget (€25.2 million). Based on known centrally contracted sums, Kosovo's public pharmaceutical expenditure (€8.325 million) represents 17.7 percent of total public health expenditure.

4.46 These figures do not take account of pharmaceuticals and medical supplies procured by hospitals and health houses independently from the central budget (a frequent occurrence in 2000 and 2001), as the inadequate 'goods and services' classification does not currently allow the tracking of such expenditure. Recording expenditures under a sub-category of pharmaceuticals and medical supplies is not part of existing accounting practice. Actual expenditure on pharmaceuticals and medical supplies may have been less than envisaged and funds may have been diverted into other 'goods and services' and to 'wages and salaries'.⁴⁴

4.47 Private expenditure on pharmaceuticals is also considerable. Best estimates indicate that 2001 private pharmaceutical expenditure at €33.2 million⁴⁵. This figure indicates an estimated 34 percent of total health expenditure goes towards pharmaceutical products, which is very high in comparison with regional averages, although not uncommon in weak and transitional economies. Regional comparisons from WHO's Health For All (HFA) database suggest that pharmaceutical expenditure in Kosovo is high, and over double the OECD average of 15 percent. Table 4.4 provides comparative data which demonstrates clearly that Kosovo's total spending on pharmaceuticals is notably higher than other regional countries.

4.48 Anecdotal evidence suggests wholesale prices in Kosovo reaching up to 450 percent of available international prices, which may have significantly affected the

⁴³ CFA budget notification to DHSW; 09/12/00 DHSW finance department. Note these figures subsequently changed in 2001; however the final accounts have yet to be reconciled and published.

⁴⁴ *The Pharmaceutical Sector in Kosovo, June 1999 – May 2001*, Martin Auton, 2001. p11 and information from WB funded HCFD study in December 2001.

⁴⁵ Based on work by a WHO consultant, a 2001 family health survey by the Gjakove District Health Office, and the results of LSMS survey data.

efficiency of the 2001 central pharmaceutical tender⁴⁶. Distribution problems have also been evident, resulting in shortages of centrally procured drugs that can only be filled by costly emergency procurements⁴⁷. Other barriers to efficient procurement and distribution include: (a) Combined roles of staff in the procurement, contracting, storage and distribution processes are combined; (b) Lack of transfer of accountability for the utilization of pharmaceuticals to the municipalities, hospitals and professionals through budgets; (c) Lack of specific accounting at facility level to support expenditure monitoring and control; (d) Lack of proper systems to influence, monitor and control utilization; (e) Tension in public pharmacies between the proper supply of essential products to the citizens and the pressures for retail sales of higher priced pharmaceuticals through out-of-pocket payments from patients; (e) Difficulties in retaining skilled pharmacists in the public system on public sector compensation. If centralized procurement were able to achieve a reduction in wholesale purchase prices from the reported 450 percent above international prices and achieve consistent supply potential annual savings of €2 – 5 million (0.11 – 0.29 percent of 2001 GDP) could be realized. This estimate does not include measures to improve pharmaceutical spending in hospitals, which are also likely to be considerable.

4.49 For 2002, the MOH is undertaking an assessment of the Essential Drugs List that will, once completed, influence the allocation of 2002 expenditures and the procurement tender for 2002/3. An indicative estimate of the 2002 allocation was not available. Procurement will be based on a consultative process to gauge supply requirements. In the absence of detailed historical expenditure data the basis for the future assessment of requirements is not known. Any delays in the procurement process may force facilities to resort to costly ad hoc purchases to maintain supplies.

4.50 **Hospitals.** The hospital sector, which consumed 44 percent of the health budget in 2001, is a key area in which savings can be realized. At 2.1 beds per 1000 population⁴⁸, Kosovo appears to have a relatively lean hospital infrastructure in comparison to ECA averages. Average length of stay (ALOS) is reported as 7.9 days and average bed occupancy of 69.2 percent overall. Against regional comparisons beds/population is well below Upper Middle Income countries (UMIC) and only a quarter of the ECA average. However, the hospital system currently provides only basic health care services. High cost, high technology tertiary and referral services are simply not provided thereby distorting regional performance comparisons. An examination of current levels of activity suggests significant scope for rationalization and freeing up of resources in the short term.

⁴⁶ The administration and Pharmaceutical Procurement Unit (PPU) entered into a contract for the period June 2001-May 2002 for pharmaceuticals and medical supplies valued at €14.15 million.

⁴⁷ As detailed in PUH – Pharmacy System, Preliminary Report, March 2002.

⁴⁸ Currently there are a total of 4,586 in six hospitals in Kosovo.

Table 4.4: Pharmaceutical expenditure as percent of total health expenditure

	1996	1997	1998	1999	2000
Czech Republic	25.5	25.3	25.5	27	23.9
Kosovo	-	-	-	-	34.0 (2001)
Slovenia	17.4	17.9	18.9	19	19.6
FYR Macedonia	9.6			17.2	13.5

Source: WHO Euro, HFA, January 2002. – WB Calculations for Kosovo.

4.51 The current Kosovo hospital organizational model mirrors that in many health systems in central and Eastern Europe. It is departmentally organized with little ‘corporateness’ in terms of overlap and sharing of facilities and support services. In operating theatres for example, Prishtina University Hospital (PUH) with its departmental structure has 26 operating theatres for a surgical workload of 15,000 surgical cases. The hospital’s campus arrangement and departmental pattern of organization is a major handicap in technical efficiency achievement. PUH has a significant impact on resource consumption representing about 50 percent of the Kosovo hospital budget, or about 22 percent of government spending on health.

4.52 Data emerging from a current study at PUH reveals a high proportion of patients attending outpatient clinics on their fifth or higher attendance for the same diagnostic or treatment episode. This suggests an extravagant return rate for patients. The ratio of new patients to return patients is a useful performance indicator to monitor whether hospitals are over-recalling patients for outpatient care and are not using the PHC system effectively for continuity of care and follow up.

Policy Agenda

4.53 **A strategic vision of the health sector is needed, both for public and private provision.** Although estimated total spending on health, both public and private, at 7.18 percent of GDP (including donors) compares reasonably favorably with other countries in the region, health outcomes are poor. Low public spending and lack of a safety net is forcing people into inefficient private spending. The public sector must further focus its role, and define more clearly and coherently the benefits and beneficiaries of public health expenditure. A strategic vision must be outlined for the role of the private sector in health provision, and adequate regulatory and enforcement mechanisms designed to protect patients and align private health care provision with public health objectives, while harnessing the capacity of certain groups of citizens to contribute to health care costs.

4.54 **General budget spending on health should be progressively increased.** Government spending on health at 2.8 percent of GDP is noticeably low by regional standards and authorities may want to consider increasing it to the regional norm of around 5 percent of GDP. New spending, and savings from efficiency gains from existing spending, needs to be targeted towards areas that will have greatest effect on outcomes, such as improving the quality of and access to PHC and preventative health services in

line with an overall long term health strategy. Public spending will need to provide for a some increase in the health wage bill to allow for decompression of the health wage structure and an increase in the remuneration of health professionals, while decreasing the numbers of non-professional and administrative staff. The amount of capital spending in health will need to increase as donor financing phases out, and new investments should only be made towards the modernization and restructuring of the delivery system to improve its effectiveness in the long term. Improving the effectiveness of public spending should take priority over the introduction of new services.

4.55 Informal private health spending needs to be formalized and regulated towards supporting health policy objectives. A key issue facing the health sector is the future role of private financing. Strenuous efforts need to be made to enhance the existing co-payments scheme, with a long term goal of eliminating under the counter or unofficial payments. This will likely be a difficult process, and will require concerted effort over the medium term. Key factors that will need to be considered include:

- Whether public health services offer a viable alternative to unregulated private providers.
- Overall remuneration of health professionals, and their incentives to enforce the co-payment system.
- Exemptions from co-payments, and the difficulties they create for enforcement.
- The transparency of financial management at the facility level.
- Historical and cultural traditions of under-the-counter payments or 'gifts' to health professionals.

4.56 The restructuring of health sector staffing would strengthen incentives and lead to efficiency gains. The essential strategic issue in relation to staffing is to reduce the overall level of staffing by reducing the high level of support service staff and significantly increasing the number and remuneration of key professional workers. Quantity of health workers must be replaced by quality through overall numerical reductions and the introduction of greater salary differentials, based upon performance-based salary structures. This would result in an overall reduction in numbers, but should allow for a progressive increase in health sector wage spending, to be compensated for by restraining growth in wage spending in other sectors (paragraph 3.25). 'Across the board' wage increases for health workers should not be contemplated at this time, as this would reduce the fiscal space available for salary decompression.

4.57 A quick analysis of current staffing and salary levels indicate that there is scope to achieve such realignments over the next few years provided that fiscal space is created through the overall structuring of public sector wages. Table 4.5 indicates the effects of an indicative scenario through to 2005 in which (a) salaries of doctors and head nurses are increased by 30 percent annually; (b) the number of doctors is increased by 10 percent per year; (c) average salary growth of administrative and the lowest grade of nurse/medical technicians (which may currently include a significant number of misclassified non-medical staff) is increased by 10 percent annually and their numbers decreased by 10 percent annually. Under this scenario, the overall number of staff would decline by 2,163 (16 percent), and the health sector real wage bill would increase by 49

percent from 2002 levels, or 0.41 percent of GDP. This extra health spending could only be justified if growth in wage spending in other sectors was restrained, as illustrated in chapter 3.

Table 4.5 – An indicative restructuring scenario for health staffing

	2002			2003			2004			2005		
	No	Ave Wage €/mo	% of wage bill	No	Ave Wage €/mo	% of wage bill	No	Ave Wage €/mo	% of wage bill	No	Ave Wage €/mo	% of wage bill
Admin/Support	4,533	113	29%	4,080	124	26%	3,672	136	23%	3,305	150	19%
Nurse/Medical tech (1)	6,107	120	42%	5,496	132	37%	4,947	145	32%	4,452	160	27%
Other Nursing	530	147	4%	530	175	5%	530	213	5%	530	262	5%
Doctors	2,176	199	25%	2,394	259	32%	2,633	337	40%	2,896	438	49%
Total Health Staff	13,346			12,500			11,781			11,183		
Overall wage bill (2002€, million)	21.65			23.38			26.63			31.37		
Percent increase in real wage bill (from 2002)	-			11%			26%			49%		
Increase in wage bill, percent of GDP	-			0.11%			0.24%			0.41%		

4.58 Improving the efficiency of procurement and supply of pharmaceuticals could lead to significant savings. Improvement in the procurement, supply and dispensing of pharmaceuticals offers considerable scope for fiscal savings, which could be then redirected towards other priorities. The distribution, supply, dispensing and reimbursement arrangements for publicly procured pharmaceuticals should be clearly differentiated and separated procedurally, and a simple system for monitoring and auditing pharmaceutical and medical supply prescribing and dispensing should be introduced as soon as possible.

4.59 In neighboring Albania a basic PC-based system of prescription monitoring in PHC was introduced in June 1998 including feedback to prescribing doctors⁴⁹. In a pilot district prescribing costs were reduced by 41 percent, resulting in countrywide introduction in mid 2000. If a similar system were introduced in Kosovo and modest savings of 50 percent the level achieved in the Albanian pilot resulted, this would equate to €0.65 million annually through PHC prescribing efficiency alone⁵⁰. Other basic systems such as the use of evidence-based formularies, the establishment of clinical pharmaceutical budgets in hospitals, and the delegation of drug budget accountability could also contribute to economies in this key and sizeable area of health expenditure.

4.60 Significant efficiency improvements can be achieved in the hospital system. The hospital infrastructure is excessive and needs considerable reduction and re-engineering to match level of provision with current functions and performance. Much

⁴⁹ Contracting for Primary Care Medicines Management in Albania. Institute for health Sector development, IHSD Issue Note, 2000.

⁵⁰ Potential savings through hospitals is impossible to estimate currently without basic accounting data of drug use in hospitals.

clearer referral protocols are required between the PHC and the hospital sector in order to reduce duplication and overlap and to reinforce the position (embraced in Kosovo health policy) of the PHC sector as the gatekeeper to the hospital, responsible for continuity of care on a community-based and family centered basis. While it is difficult to estimate precisely what savings can be made, on the basis of the discussion below it seems reasonable to expect that costs savings in hospitals of the order of 20 percent are achievable and free up around 0.25 percent of GDP.

4.61 Major cost savings could be realized through undertaking some basic elective workload for many common elective diagnostic and surgical procedures on an ambulatory basis, as is common in European countries. There is no recorded day case activity in Kosovo hospitals, which should be remedied as quickly as possible. As an example one can look at data for Ear Nose and Throat (ENT) procedures. In Kosovo the 170 occupied beds (2001) indicates a rate of 0.08 beds/1000 population contrasting favorably with 0.195 in Slovakia (2000) but poorly with 0.027 in the UK where a more complex case mix is undertaken, and where almost a third of all inpatient work is now undertaken on an ambulatory basis. Reconfiguration of hospital services towards ambulatory day care is certain to realize significant efficiencies.

4.62 As an indicative example, if the ALOS was reduced by 1 day from 7.9 to 6.9 through improved organisation and management, 136,053 bed days would be saved resulting in a reduced bed need of between 350 and 400 beds. Furthermore, if overall bed occupancy could be improved by 10 percent to 80 percent then resources involved in supporting over 500 beds could be available for redistribution. However, the budgetary savings linked to such a reduction of 900 beds (nearly 20 percent of current capacity) would only accrue if the redistribution process were properly managed. Taking a few beds from each ward would not necessarily remove any cost from the system – fundamental internal reorganisation and management of hospitals is necessary.

4.63 A modern day surgical unit of 24 places supported by four operating theatres could handle up to 12,000 cases per annum working a normal day for five days per week. Even allowing for the operating theatres functioning at half this level of efficiency, 10 to 12 operating theatres should be capable of undertaking the surgical workload for the PUH, which currently has 26 operating theatres. This represents a significant opportunity for rationalization and cost savings.

4.64 **The planning and management of health spending can be strengthened.** The present MOH payroll and accounting systems do not, in their present state, support effective management of a large and significant block of public expenditure. Job definitions need to be reviewed, staffing and payroll definitions need to be more specific and accurate, all staffing costs need to be properly financed as part of the remuneration system. Goods and services expenditure needs to be broken down to enable proper accounting for and monitoring of expenditure to facilitate cost control and enable management performance to be monitored. The devolution of health care provision needs to be strengthened through the corresponding delegation of financial accountability and budgets, and the introduction of business planning and accountability systems to the municipal and facility level.

C. EDUCATION

Overview

4.65 In late 1999 the pre-existing Kosovo Albanian education system, which had been operating as an unofficial 'parallel' system during the previous decade, was quickly re-established as the officially recognized public education system. In early 2000 UNMIK established a Department of Education and Science and began a process of reform including curriculum revision, teacher retraining and the decentralization of education finances and school governance. In March 2002, following the election of a self governing Kosovo Assembly, a Minister of Education was appointed and the UNMIK Department of Education became the Ministry of Education, Science and Technology.

4.66 In 2000 UNMIK changed the starting age for compulsory schooling from seven to six as the first stage of implementing a new 5-4-3 structure: with five years of primary and four years of lower secondary making up nine years of compulsory schooling, plus three years of upper secondary.⁵¹ A large number of additional children age 6 are now attending school. The effect of the extension of compulsory education to nine years will be to retain about 6000 students who would have left school in the system. A new curriculum and training for teachers for the new year 9 will also be required. The budget implications of these reforms have not been costed yet, but will need to be assessed fully and taken into account in the budget planning stage. School and university enrolment numbers are illustrated in Table 4.6.

Table 4.6: Pre-school, school and university enrolments

	Albanian	Serb	Other ethnic groups	Total
Preschool (0-6) ¹	5,627	1,716	90	7,433
Preprimary (5-6)	13,255	288	186	13,729
Primary (year 1-8)	284,638	14,782	9,534	308,954
Secondary (year 9-12)	85,090	7,033	1,870	93,993
University Faculties	..	..	..	14,359
University High Schools	..	..	..	4,149

1 Preschool: children aged 0 to 6 years in separate facilities (kindergartens, nurseries)

2 Preprimary: children aged 5-6 years in preprimary classes attached to primary schools

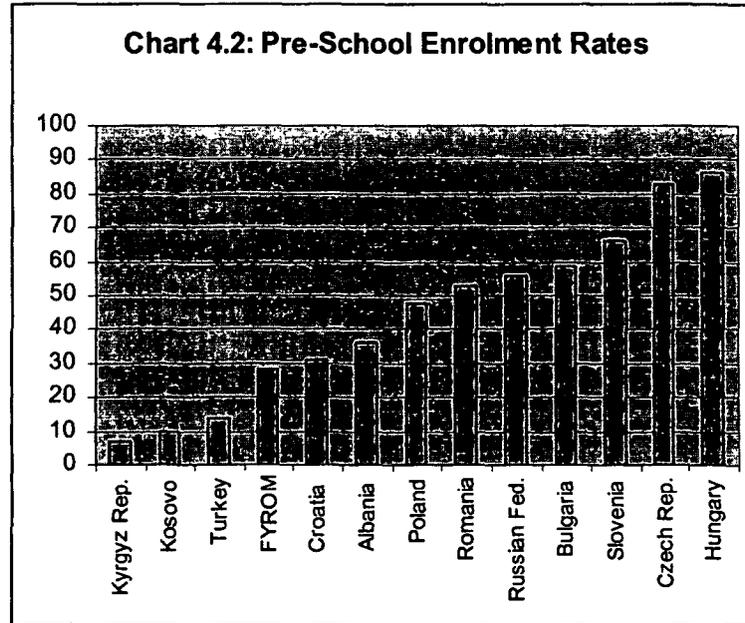
Source: Schools - EMIS Oct 2001 enrollments; University - Finance Section, Pristina University 2001

4.67 Enrolment in early childhood education is very low (Chart 4.2). Attendance at preschool by children from low income families can be an important factor in addressing the educational disadvantage caused by poverty.⁵² Public expenditure on early childhood education can be justified, therefore, on both educational and equity grounds. It would not be realistic in current economic conditions, however, to extend traditional center-based preschool care to all children, given the high cost of this form of early childhood

⁵¹ As part of the overall reform package, there are also plans to revise the curriculum and to upgrade teacher skills.

⁵² World Bank 2000, *Making Transition Work for Everyone, Poverty and Inequality in Europe and Central Asia, Chapter 7, Improving Capabilities: Education* pp 228-256.

education. Other community based options, with lower costs, should be encouraged to provide more options for young children.



Source: World Bank, EMIS data.

4.68 There is currently no objective measurement of the quality of education in Kosovo. Most exams are set by teachers, and often administered orally. There are nevertheless indications that the quality of education being provided is not appropriate for the needs of a modern economy. Similar to other education systems in the region, the curriculum is excessively focused on facts and specialized training – rather than problem solving and analytical skills. The number of hours of teaching received by children at the primary level is relatively low. In primary grades 1 and 2, children have 722 contact hours per year, relative to 850-950 hours in much of western Europe, and an OECD average of around 800. At the tertiary level, the faculties at the University of Pristina have not been subject to any external assessment of standards, and qualifications awarded are only recognized in Albania and Kosovo. Teacher quality is also uneven and morale is allegedly low. Furthermore, textbooks and other training materials are dated and not always available. Some physical facilities remain inadequate. While two shifts a day may be an efficient use of public resources, three per day raises questions about the amount of efficient instruction that pupils receive.

4.69 **There are large inequalities in education attainment in Kosovo, in part related to age, gender and ethnicity.** Based on the LSMS primary school enrolment in Kosovo, at around 97 percent, is nearly universal. However, the disaggregation in Table 4.7 raises some important concerns. For instance, only 77 percent of children under 14 from 'Other' ethnic groups attend school and the gender difference within this group is large; with only 69 percent of girls enrolled and 85 percent of boys. LSMS data show that inequality in secondary school enrolment is even more dramatic. Gender inequality in secondary education was of particular concern among Albanian girls: in 2000 only just over half of the Albanian girls aged 15-18 were enrolled in school.

Table 4.7. Net enrollment rates by age groups and gender/ethnicity

	Male	Female	Total
<u>Albanian</u>			
14-Jun	98.2	96.8	97.5
15-18	74.2	56.2	65.3
Total 6-18	91	84	87.6
<u>Serb</u>			
14-Jun	100	99.1	99.5
15-18	86.9	92.9	89.9
Total 6-18	95.2	96.9	96.1
<u>Other</u>			
14-Jun	85.4	69.3	76.8
15-18	54.4	40.3	46.4
Total 6-18	77.4	61.1	68.5

Source: World Bank, Poverty Assessment

4.70 **Public expenditure on education in Kosovo is relatively low.** As discussed in Chapter 3, public expenditure for education was equivalent to 3.4 percent of GDP in 2001. This is quite low relative to regional standards, especially taking into account Kosovo's young population profile, but quite typical of middle income countries globally.⁵³ Donor funding has been significant over the past three years, particularly in school building reconstruction and rehabilitation. While some of these repairs related directly to damage during the 1999 conflict, a more significant share was to compensate for the lack of investment and maintenance over the past decade. The third source of financing for the education sector is derived from private contributions. Although primary and secondary education are officially free, and tertiary fees are set at a very low level, many families report making significant contributions to the cost of education⁵⁴.

⁵³ If funds provided by donors for capital investment are included, education spending increases to the equivalent of 4.2 percent of GDP in 2001.

⁵⁴ World Bank Poverty Assessment.

Schools, teachers and university facilities reportedly levy a range of unauthorized fees for 'extra' tuition, exam preparation, additional textbooks and other charges.⁵⁵

4.71 Wages and salaries of both teaching and non-teaching staff accounted for roughly 80 percent of the General Budget in education 2001, which is high relative to other European economies. Approximately 87 percent of the education budget is used for schools, most of which is delegated to the municipalities in the form of a block grant (Table 4.8). The remaining 13 percent is allocated to the central administration and tertiary education. Schools are therefore the main focus of the analysis in this section. General Budget spending does not yet include a number of significant costs that will have to be met over the next few years. The most obvious is capital spending on school buildings and facilities required to meet acceptable standards and reduce overcrowding.

Table 4.8: General Budget Spending on Education by Subsector (2000 - 2002)

Program	2000		2001		2002	
	Actual	Percent	Actual	percent	Budget	percent
Preschool Education*	1,307.6	2.3%	2,298.0	3.8%	3,232.8	4.4%
Primary Education*	36,870.2	64.9%	37,684.0	62.5%	45,080.1	60.8%
Secondary Education*	11,315.2	19.9%	12,258.7	20.3%	13,427.4	18.1%
Boarding Facilities/Dormitory	157.7	0.3%	254.0	0.4%	124.1	0.2%
Special Needs Education Institutions	641.5	1.1%	469.0	0.8%	815.5	1.1%
University and Higher Education	6,154.9	10.8%	6,395.0	10.6%	9,890.9	13.3%
National University Library	139.5	0.2%	242.0	0.4%	265.4	0.4%
Educational Administration	251.2	0.4%	732.0	1.2%	1,012.0	1.4%
Teacher Training	..	..	..	..	191.7	0.3%
Curriculum Development	..	..	..	..	65.0	0.1%
Total	56,837.9	100.0%	60,332.7	100.0%	74,105.0	100.0%
Total Kosovo Budget	285,600		288,200		383,708	
Education as a percentage of total budget	19.9%		20.9%		19.3%	
Estimated Kosovo GDP	1,414,000		1,747,000		1,990,000	
Education as a percentage of GDP	4.0%		3.5%		3.7%	

Sources: CFA Kosovo Budget 2001, Kosovo Budget 2002, Education Funding Formula

* Preschool, primary and secondary includes funds spent by Municipalities

4.72 Almost half of the 2002 education budget is for earmarked education grants for the thirty municipalities of Kosovo⁵⁶. The initial UNMIK recurrent budgets for education were generated almost exclusively as a function of teacher numbers. As is typical of such a traditional education finance approach, this provided a significant incentive to increase employment in education and a disincentive to maximizing the efficient use of personnel and facilities. Beginning in 2001, UNMIK began a staged implementation of a funding mechanism based on a centrally defined per student funding

⁵⁵ An Administrative Instruction authorizing the licensing and regulation of private schools was issued by UNMIK in September 2001; several schools, mainly with religious affiliations, have registered so far. Private schools must meet basic requirements for curriculum, staffing, and facilities.

⁵⁶ During 2001 funds for goods and services spending were allocated to each municipality through a system of funds warrants. The warrant system devolved responsibility for decisions about the use of goods and services funds to the local level, but the spending was recorded as spending by the Department of Education and the accounting system did not keep records of the amounts used by each Municipality. The Department of Education retained control over the amounts allocated to each Municipality and withdrew part of the initial allocation during the year in order to fund unanticipated increases in teacher costs.

formula and block grants to Kosovo's thirty municipalities. The grants cover the following costs of operating schools during 2002: (i) goods and services; (ii) capital funds for minor repairs and maintenance; (iii) salaries for support staff and administrative staff including school directors for 12 months; and (iv) salaries for teaching staff for 6 months from July 2002. While the number of teaching positions for which a given municipality is eligible is derived from the formula and teachers are hired locally, teachers continue to be paid from a central payroll. Box 4.1 provides more detail on fiscal devolution.

4.73 An instruction authorizing the licensing and regulation of private schools was issued by UNMIK in September 2001 and several, mainly Christian and Muslim religious schools, have registered so far. Private schools must meet basic requirements for curriculum, staffing and facilities.

4.74 **Key challenges** The education system in Kosovo faces inadequate governance and management capacity and capability to implement and maintain infrastructure initiatives in education information, financial, monitoring and accountability systems. Such infrastructure capacity is critical to tackling:

- (a) inadequate physical conditions and lack of basic facilities in many school buildings,
- (b) severe overcrowding in urban schools with many primary schools operating in two or three shifts,
- (c) out of date curriculum and teaching practices,
- (d) relatively low retention in secondary education,
- (e) lack of options in vocational education,
- (f) low attendance by girls and some minority groups, especially in rural areas, and
- (g) poor academic standards at tertiary institutions.

Expenditure efficiency

4.75 **Staff costs** There is significant scope for efficiency gains in particular in wage costs. Public employment in Kosovo is skewed towards education (Chapter 3). Even taking into account the young age profile of the Kosovo population, employment in education seems to be on the high side. The average student/teacher ratio is 19.4 for primary schools and 18.8 for secondary schools. This is slightly below the UNMIK guidelines which for planning purposes suggest guidelines of 20 for lower primary and 25 for upper primary and secondary. Globally, average student/teacher ratios are 24.9 for upper middle income countries and 35.8 for low and middle income countries.⁵⁷ In most EU countries the student teacher ratio in primary education is around 22.

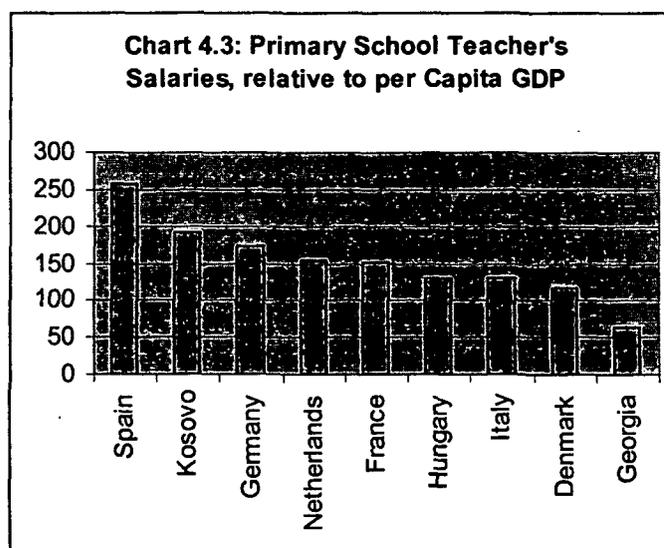
⁵⁷ International data are taken from World Development Indicator Database. Data for Kosovo are from the EMIS, October 2001. More recent data from April 2002 suggest only marginal differences.

4.76 The relatively low number of students per teacher is driven by a range of factors, including (i) the inefficient use of teachers, (ii) small rural schools and (iii) the needs of ethnic communities. As is common in many other transition economies, teachers in Kosovo (from grade 5 onwards) are only qualified to teach one subject, resulting in considerable inflexibility in the use of teaching resources, and inefficiencies in the provision of teachers, particularly for small schools. The standard weekly workload for teachers at all levels is only twenty 45-minute teaching lessons for 38 school weeks.

4.77 The average student-teacher ratios hide serious overcrowding of (mostly urban) facilities balanced by under-utilization of other facilities across or even within sectors. Rural schools often have small class sizes, which contributes to the low average student teacher ratios. It is estimated that of 1100 schools in Kosovo, 435 have less than 150 students. Closing under-utilized schools and transporting children to larger centers would likely have a negative impact on the equity of access to education; the poor condition of the rural roads and concerns about security and safety will reportedly discourage parents from allowing children, in particularly girls, to travel to school.

4.78 Although minority language classes and Serb schools often have very low student teacher ratios, this is not a major factor driving the overall student teacher ratio in Kosovo because of the relatively small number of students in these groups. The average student: teacher ratio for Albanian primary and secondary schools, without the Serb teachers and students, is only marginally higher at 19.7 compared to 19.3.

4.79 As shown in Chart 4.3, wage levels for primary school teachers, relative to GDP, are high relative to other countries⁵⁸. With almost a quarter of wage and salary payments intended for non-teaching staff, there appears to be an excess of administrative staff in many municipalities. In OECD countries an average of 18 percent of current education spending is for the compensation of non-teaching staff.⁵⁹



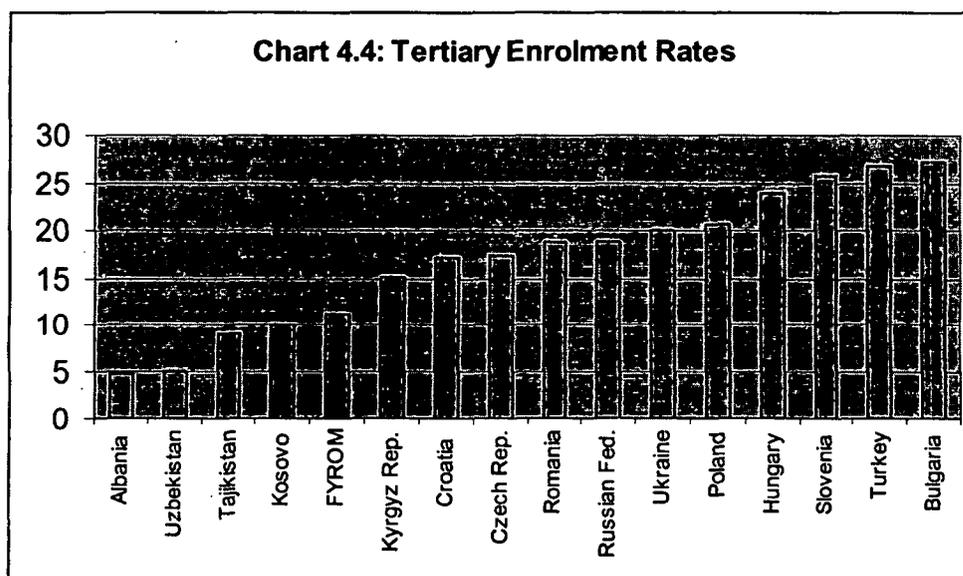
Source: UNICEF.

⁵⁸ This effect is less pronounced for the secondary school teachers.

⁵⁹ OECD data.

4.80 **Operating costs.** Funding for the operational costs of schools is also included in the block grant to municipalities and calculated on the basis of student numbers. The current level of the goods and services budget for municipalities is generally considered to be insufficient to cover the cost of routine repairs and maintenance. Experience in other economies has shown that municipalities tend to use the non-wage component of the education budget to offset the high wage costs of teachers and other staff⁶⁰. The major operating cost for schools is currently heating; from 2002 all municipalities are expected to pay for the electricity used by schools. Textbooks have so far been donor-funded, but replacements will need to be absorbed by the budget or by private contributions. Given the small scope of goods and services funding, procurement practices are not currently likely to be a major source of inefficiency.

4.81 **Universities.** Tertiary enrolment rates in Kosovo are very low (Chart 4.4) Kosovo spends around €335 per university student, equivalent to around 37 percent of per capita GDP. This is consistent with the amounts spent in other Eastern European countries and is around the same as average spending per student in the EU (36 percent of per capita GDP) and in high and upper middle income economies (37 percent). Although the University has not been subjected to any external assessment of quality, it appears that the quality of outcomes is much lower than is achieved with the amounts spent in the comparator countries. Particularly significant is the lack of any research capacity at Pristina University and the limited availability of laboratory equipment and library facilities.



Source: World Bank

4.82 Some of the costs of reform and expansion of tertiary education could be sourced from increased fees, particularly for subjects with high employment potential, such as English language. The introduction of full fees, with a scholarship or loan scheme, could be considered in the medium term. The collection of university fees and the operation of

⁶⁰ Although devolution is still in its infancy, there is already some evidence that municipalities may pursue a similar policy of using goods and services funds to increase their staffing.

a scholarship system would be a major administrative task and it is unlikely that the capacity exists to manage it in the short term. It may also be difficult to justify charging full cost fees until the University is in a position to provide something of value in return, that is, a tertiary qualification which is widely recognized outside Kosovo.

Policy recommendations

4.83 Plans to introduce new curricula need to be pursued. New primary and broad-based secondary curricula should be compatible with European standards and increase the relevance of the system to the emerging market economy. The preparation of new curricula needs to be accompanied by donor-financed teacher training programs. New curricula can also serve to promote efficiency gains as fewer under-utilized specialized teachers will be needed to deliver broad-based courses.

4.84 Standardized assessment of student attainment needs to be introduced. This outcome information is vital to effective policy development and planning. Core learning standards for basic education need to be set (different from prescriptive curricula) and standardized assessments should be produced for core subjects in basic education. Analysis of links between expenditure allocations and educational outcomes will assist in a better allocation of education expenditures. Indicators of school and system performance should be made widely available. The full benefits of a decentralized block grant system can only be recognized if authorities in Kosovo have the capacity to measure performance of students and schools in some standardized way so as to allow comparison and to reallocate central funding to problem areas.

4.85 Information availability needs to be improved. High priority should be given to helping authorities at all levels ensure the availability of reliable administrative, financial and performance information. This is a prerequisite for a productive dialogue on education reform, and for facilitating strategy and policy development. Establishing effective monitoring arrangements and maintaining and improving current data collection in education, and making the information widely available, should also be a priority. The role of the Ministry of Education in supporting these mechanisms is pivotal. In shifting its attention from education provision to education monitoring, the regular analysis of expenditure patterns across and within municipalities against educational achievements as well as the establishment of standard costs or guideline cost bands for regular items of education provision should be immediate priorities.

4.86 General budget spending on education will need to be increased over the medium term. Given demographic pressures on the system, the need to increase enrolments, particularly in secondary education, and the decline in donor funding, efficiency gains alone will not be sufficient for the funding of the education system. General Budget spending for education, which is currently below regional norms, will need to be increased as a share of GDP to about 4-4.5 percent. This will be facilitated by growth of GDP and tax revenues. Failure to provide for some limited growth in spending will put at risk efforts to increase education access and attainment in Kosovo.

4.87 More than 80 percent of the education budget was spent on wages and salaries in 2001, with the remainder spent on operations and maintenance. More typically,

international experience shows that personnel spending is in the range of 50-65 percent of total spending, with lower income countries more likely to be located at the top-end of the range. Over the medium term, personnel spending should only increase in line with GDP growth, so that additional resources can be used to make room for increased operations and maintenance spending, and capital investment. In the medium term, wage and salary spending should not account for more than 65 percent of education spending, with the remaining resources being assigned to operations and maintenance spending (25-30 percent of spending), and capital spending (5-10 percent of spending).

4.88 The funding formula needs to be monitored to ensure that all students receive a minimum standard of education and that resource allocation is transparently equitable. The introduction of the per student formula has been a great first step in improving efficiency in education. When such a system is started, historical funding patterns are an important basis for setting the formula. Going forward, and as the system develops further, more sophisticated, equitable and efficient formulae should be developed. Currently, the power for improved efficiencies at the school level is diminished somewhat by the fact that the block grant is destined for the municipality, and there are no explicit guidelines to municipalities as to how they should allocate their funds to schools. An important next step will be the development of guidelines by the Ministry for some allocative process based on a formulae for assigning funds to schools.

4.89 One of the main advantages of the per student block grant formula is that it is intended to bring about a more equitable distribution of resources. However, close monitoring by the Ministry of Education will be needed to ensure that centrally established norms are respected and that the funding is used in the best interest of students and teachers. The Ministry of Education should focus its attention on monitoring the funding system in relation to performance outcomes, in particular in rural areas and among minority language groups. It will be important to ensure that financial incentives for higher class sizes and school consolidation do not reduce access or attendance in rural areas or among minorities. The formula also may need to be modified over time to target public resources on disadvantaged groups or areas which are not performing up to established standards. Alternatively, targeted programs aimed in particular at ensuring that all children are enrolled in compulsory education should be considered.

4.90 Future evaluations of the scheme will also need to ensure that the small size of local government jurisdictions is not compromising the management of education in Kosovo as has been the case in a number of other transition economies. Per student financing can normally mitigate this problem, since the allocation can easily be transferred with students who attend schools in other jurisdictions. This is being done in Lithuania, for example, where a new financing formula provides for a "student basket" of inputs for each type of program, which can be transferred when students attend schools outside their own locality⁶¹. Efforts should be made to extend the formula system to pre-school and dormitory funding.

⁶¹ Alternatively, to address the scale-economies problem of too small municipalities, a process of regional-level management for schools could be established (as in the Czech Republic).

4.91 **Measures to attract and retain disadvantaged pupils are needed to ensure improved access to education for all** The LSMS shows that public expenditure on education favors the better off. This is primarily due to a strong inverse correlation between poverty and utilization of education services, particularly in secondary education. Funding for development of the system should reflect a more pro-poor bias. Increasing the enrolment of girls and minority groups is likely to require targeted investment.

4.92 More imaginative ways of reaching groups like the Roma, who are one of the most needy communities in Kosovo, will need to be identified. In addition, schemes targeting the free provision of education inputs (books, materials, and equipment) could be considered for areas or groups where learning performance is lagging or poverty is prevalent. Targeted public funding should be provided for pre-schools to better concentrate on poor children.

4.93 **There is significant scope to shift resources within the education sector.** There is scope to cut non-teaching staff and increase student-teacher ratios at all levels. As shown in Table 4.9, increasing the average student teacher ratios to 25 for both primary and secondary education would generate €9 million of annual savings. To achieve this, employment in education would have to be reduced by some 4,500 teachers. Non-teaching staff accounts for almost a quarter of the education wage bill, which is very high. Reducing administrative staff could easily lead to annual savings of €3 million. Methods of achieving higher ratios would include increasing the number of subjects a teacher can teach, and the number of hours taught. It is important that donor funded in-service training programs should focus on broadening teacher competencies, while at the same time reducing the number of highly specialized subjects. The new Ministry of Education should also make it a high priority to gradually mandate higher teaching loads. Subject to further analysis, the decompression of currently highly compressed teachers' salaries should be related to improved competence and better working practices of teachers. Effective multi-level teaching at small primary schools should also be rewarded.

Table 4.9: Potential savings through increased student teacher ratios

	Students (Oct 01)	Current teachers (FTE)	If student-teacher ratio increased to:	Number of teachers required (FTE)	Excess teachers (FTE)	Salary savings (‘000 Euro)
Primary	309051	15,894	20	15,453	441	796
			22	14,048	1,846	3,331
			25	12,362	3,532	6,372
Secondary	93993	5001	20	4,700	301	594
			22	4,272	729	1,437
			25	3,760	1,241	2,448
Maximum total potential savings						8,819

4.94 Given the high levels of unemployment in Kosovo, there will be political pressure to allow teacher numbers to increase at the expense of other school inputs, even when the conditions that would allow staff reductions are in place. The effect of this is likely to be a reduction in spending on maintenance and goods and services, which would have a long term detrimental effect on education standards. Working together, the Ministries of Education and Finance in Kosovo will need to maintain the incentives currently in place through the funding formula to rationalize the teaching staff, which will serve to improve the quality and financial sustainability of Kosovo's education system in the long term.

4.95 Funds saved by reducing non-teaching staff, and increasing student-teacher ratios, as well as any additional funds, could be reallocated to the following funding priorities:

- (a) to fund higher participation in secondary education
- (b) to fund a small increase in wage levels of teaching staff linked to performance;
- (c) to improve the quality of education at all levels;
- (d) to fund capital investment;
- (e) to increase funding of early childhood education programs.

4.96 **Concern about the misuse of public funds needs to be addressed.** There is widespread concern about the scope for corruption and misuse of public funds. Steps are being taken to reduce the scope for fraud and theft through improvements in the processes for budget expenditure and the payment of public sector salaries by direct bank transfers. The expansion and strengthening of financial reporting and monitoring, and of the internal audit function in the Ministry of Education and in municipalities, are also required. Finally, the accountability benefits of the decentralization of education to local level government will only be realized if the decentralization program includes efforts to build the capability and capacity of the local authority and at community level to hold education managers to account.

4.97 **Local accountability needs to be improved.** Five mechanisms can be utilized to improve local accountability. First, information on appropriated and actual education funding allocations to individual municipalities and within municipalities to individual institutions should be made public. This information should be juxtaposed with institutional data (teacher pupil ratios, pass rates, attendance rates, enrolment rates etc) and information on the comparative cost of education provision and educational achievement across the different municipalities and across the different institutions within the municipality. Second, the school boards should be empowered by enshrining their powers, functions and legal responsibilities in national legislation or regulation and through a systematic training program, especially in financial management. There should also be provision for a complaints procedure, which allows for anonymous whistleblowing on irregularities. Third, the community should be encouraged to be involved in school development and maintenance. Fourth, regular provision of in-year education management reports to the local assembly should be required. Fifth, all tender awards at a local level should be publicized including the winner and cost, if relevant at an institutional level.

Box 4.1: Fiscal devolution in education

Grants are provided for (i) funding for teaching staff salaried for primary schools; (ii) funding for teaching staff salaries for secondary school; (iii) funding for operating costs for primary schools; (iv) funding for operating costs for secondary schools; (v) funding for pre-schools; and (vi) funding for dormitories.⁶² All but the latter two grants are calculated on the basis of a per pupil funding formula. The most important item in the funding formula is the number of students attending schools in the municipality. However, additional funding amounts are included to take account of (i) small remote schools and satellite schools, (ii) children with special needs attending normal schools; and (iii) minority students. Since the formula is publicly available, it also serves to establish transparency of public funding for the education sector.

As pre-school is non-compulsory and dormitories are direct subsidies, these funding grants for 2002 were based on funding received in 2001. An effort should be made to bring both these spending categories onto the formula system for 2003. Funding of the early childhood sector could be based on the unit of hourly attendance with two rates of subsidy based on the age of the child. As for the funding of dormitories, almost all existing dormitories are used for a variety of purposes other than housing secondary students, and there have been reports of fully staffed dormitories without any students. The current funding based on historic payments is inequitable and an unnecessary burden on the education budget.

The introduction of the per-student block grant formula increases incentives for efficient use of the education budget; local officials now have an incentive to address efficiency issues and to better justify requests for further resources from the center. In some cases the grant the municipality receives is not sufficient to fund the number of staff currently on the payroll; special funding arrangements have been put in place in 2002 to cover transitional funding for teachers so allow municipalities time to adjust staff numbers. A few municipalities are taking steps to reduce staff numbers. There is a risk, however, that the Ministry of Education and many municipalities will follow the pattern observed in other transition economies and reduce spending on other essential inputs including maintenance and textbooks to finance a higher wage bill. In practice, the Ministry of Education has already begun attempts to hold back funds earmarked for devolved municipal grants for education in order to fund unanticipated increases in teacher costs. The success of central authorities in stopping this practice and maintaining incentives for efficiency will be crucially important for the long term sustainability of publicly-financed education in Kosovo.

⁶² The Ministry of Education, Science and Technology may, from time to time, make additional grants to municipalities for special purposes not covered by the other grants. This could include, for example, funds for major capital projects, special programs for girls or minorities, and funds to deal with unexpected situations. The Ministry must be transparent in the use of these special grants, giving all municipalities an opportunity to apply, and they must be used for the specific purpose for which they are provided.

5. PUBLIC EXPENDITURE PLANNING AND MANAGEMENT

5.1 This chapter looks at the institutional basis for sound public expenditure management. An economy's institutional arrangements, both formal and informal, have a decisive influence on budgetary outcomes at three levels: (i) aggregate fiscal discipline; (ii) allocation of resources in accordance with strategic priorities; and (iii) efficient and effective use of resources in the implementation of strategic priorities. These three levels are strikingly interdependent. The pursuit of aggregate fiscal discipline is often done in such a way as to undermine both level 2 and level 3 performance – arbitrarily reordering priorities and devastating service delivery and operational performance more generally. Similarly, a lack of discipline and budget realism in making strategic policy choices leads to a mismatch between policies and resources, resulting in inadequate funding for operations.

5.2 Since the inception of the UNMIK administration in 1999 a number of institutional arrangements have been put in place to manage both domestic and donor-generated resources. These arrangements have developed broadly in line with internationally accepted modern budget and financial management practices. Budget development in Kosovo has been focused mostly on controlling inputs and accounting for cash. However, on the budget planning side, both the Central Fiscal Authority (CFA) and the former Department of Reconstruction (DOR) instituted mechanisms to link spending plans to policy, but these took second place to controlling the aggregate level of spending, given the human resource constraints under which both institutions were operating.⁶³

5.3 Focusing on mechanisms that will ensure fiscal discipline was an appropriate response: the hard budget constraint is very hard indeed since Kosovo currently has no access to borrowing. Should the CFA at any point have run out of cash, it would have been unable to pay salaries and honor commitments. For equally valid reasons, now is the time to start looking for mechanisms that will systematically encourage more effective and efficient spending within the tight fiscal constraint. While the 2000 and 2001 budget years recorded surpluses, rising expenditure responsibilities and declining donor support are likely to put pressure on public managers in Kosovo to spend money better. In many ways Kosovo finds itself in a fortunate position to bring about such a shift: its ability to control cash and provide timely spending information provides a platform for more sophisticated budget development initiatives to ensure that managers use the resources entrusted to them effectively and efficiently.

5.4 Spending money better is not the only challenge. The changing institutional environment with the decentralization of expenditure responsibilities to municipalities and the creation of the new Constitutional Framework (CF) structures at central level requires systemic budget management responses. Overall the ability of Kosovo to integrate these different challenges into a coherent framework of public expenditure management will be critical to its future. Up until now Kosovo has responded to specific budget management challenges through narrow technical reforms. Now is the time to

⁶³ The Central Fiscal Authority (CFA) was established by regulation 1999/16 at the end of 1999.

take a broader view and integrate these reforms into a coherent and mutually reinforcing set of institutional arrangements for economic governance.

5.5 This chapter both takes stock of the significant progress to date and defines the overall objectives of a medium-term reform agenda. One recurrent theme is that the evolving and complex governance structure poses significant challenges on public expenditure management in Kosovo. The first part of this chapter outlines the public expenditure management systems currently in place in Kosovo. The main reform challenges in three areas are then addressed: (i) budget planning issues, including the challenge of making the budget a more effective policy tool through the MTEF process, (ii) budget implementation issues and the need to further improve accountability and transparency; and (iii) economic governance issues and challenges in improving the institutional environment for public sector management.

A. WHAT IS IN PLACE?

5.6 The first three years of budget management in post-conflict Kosovo have seen the establishment of a commendable framework for public expenditure management. Many of the technical principles of sound budget management are in place.

- (a) Funds are spent in accordance with a pre-formulated, publicized and authorized annual plan;
- (b) Basic tax and customs administrations have been established and are being developed;
- (c) A treasury function was established, with a consolidated fund and appropriate checks and balances on fund releases against budget;
- (d) Sufficient flexibility in budget management is maintained, including through a contingency reserve allowing for expenditure and revenue uncertainties, and a mid-year budget review process;
- (e) Expenditures are recorded on a modified cash accounting basis, within a pre-determined GFS compliant chart of accounts;
- (f) Regular internal and external reporting routines are in place; and
- (g) Audits are conducted.

5.7 In addition the Ministry of Finance and Economy (former Department of Reconstruction) and the Central Fiscal Authority (CFA, controlling the Kosovo Consolidated Budget) cooperated to establish mechanisms improving the link between affordable spending and appropriate policies.

- (a) Spending plans have been increasingly cast within macro-economic forecasts and revenue constraints.
- (b) A comprehensive development framework approach was introduced on a sectoral level to help departments think through the link between objectives, spending and services (2000). In 2001 budget hearings and a

distinction between the cost of current policies and new spending proposals were introduced to improve the allocative process.

- (c) Supportive budget documentation is published providing good contextual information, including a macro-economic outlook and revenue discussion and the policy base of sectoral spending.
- (d) Forward projections were introduced in 2002 to allow for a medium term planning perspective, although the quality of the projections is accepted to be low.

5.8 Accounting and financial management information systems are computerized. The core accounting and procurement modules of an off-the-shelf financial accounting package were implemented early at central level. Further modules have been added since and the roll-out to spending agencies and municipalities is underway. By putting in place a relatively disciplined budget process, the Ministry of Finance and the CFA have also encouraged early warning of changes in policy or new policies, enabling at least some debate at the central level as regards affordability and spending impact. Instances of in-year spending that was not approved have been reported; it would be important for future budget management to ensure compliance in such cases.

5.9 *Challenges* Budget development in Kosovo has until recently been more compliance focused and aimed at fiscal discipline rather than at mechanisms to enhance the efficiency and effectiveness of public spending. While sticking to the previous record of fiscal discipline, it is now time to start looking for mechanisms that will systematically encourage more effective and efficient spending. Second, while many transparency milestones have been established, gaps remain. Closely related to this is the need to tighten the accountability system. Key factors here are the lack of framework financial management legislation, delays in the establishment of the Auditor General's Office, and weak internal auditing functions. The final set of issues relates to the capacity to strengthen the operation of the system in the new institutional setting.

B. BUDGET MANAGEMENT ISSUES AND THE MTEF APPROACH

5.10 If the budget is to be an effective policy tool then the budget process should include the following key elements: (i) a macro-fiscal framework that defines the available resource envelope; (ii) an economic and sector policy framework that defines the objectives, priorities and outcomes for key sectors and the economy as a whole; and (iii) budget expenditure allocations that translate authorities' policy priorities into expenditure decisions in a cost-effective fashion. If carried out effectively, the budget planning process can be a very powerful instrument in facilitating the consensus needed for policy trade-offs called for by hard budget constraints.

5.11 Despite very impressive progress over the past three years, a number of challenges remain:

- (a) A comprehensive resource framework for the budget remains absent;
- (b) Policy formulation and decision making processes are fragmented; and
- (c) The effectiveness of the budget as a policy tool needs to be improved.

These challenges can all be addressed as part of the emerging MTEF approach.

5.12 A more comprehensive resource framework needs to be prepared In the analysis of budgetary management processes, it is essential to examine the scope of the budget to ensure that it is a comprehensive measure of all fiscal activity in Kosovo. The separation between the investment and the recurrent budget remains the main obstacle in preparing a comprehensive resource framework. Making external assistance subject to the procedures of planning, authorization and accountability provided by the budget is necessary for a number of reasons. It will enable authorities (i) to establish an appropriate balance between capital and recurrent spending, (ii) to meet operations and maintenance costs of donor-funded investments, and (iii) to plan towards the budgetary impact of the phasing down of donor assistance. This is of particular importance since many of the present on-budget expenditures are largely non-discretionary, thereby reducing the role of the budget as a policy instrument.

5.13 Some progress has been made in trying to integrate the PRIP and the General Budget into a comprehensive resource framework. Nevertheless, further mechanisms need to be put in place to include and account for use of the management of donor-controlled funds at the sectoral and central level.

- (a) Systematically organized information flow should take place from each Ministry to the Donor Coordination Unit in the MoFE consistent with the budget process.
- (b) The reporting of project financial information needs to be made consistent with the budget classification structure.
- (c) A requirement for estimating future recurrent cost implications of on-going and new investment projects needs to be established.

5.14 Budget development policy coherence needs to be improved. The fiscal management framework is a key factor in effective and coherent budget policy in Kosovo. There is an urgent need for Kosovo to formulate a coherent vision of budget development, communicate this vision clearly to stakeholders, sequence its implementation carefully, and demonstrate success as implementation goes along to build support. The benefits of this will go beyond improved mechanisms for allocative efficiency. A supportive set of budget documentation will be critical to this process. The institutional fragmentation of the economic policy and budget formulation processes in Kosovo calls for improved and formalized coordination mechanisms.

5.15 There is scope to improve the effectiveness of the budget as a policy tool. Effectiveness of the budget as a policy tool is determined by the ability of the budget process to discipline policy choices and to direct expenditure decisions toward policy priorities. Although the budget process and institutions are still at an early stage of development, Kosovo embarked in 2001 on a challenging program towards improving the effectiveness of the budget process through an MTEF approach.

5.16 The MTEF process needs to be further developed In the Spring of 2002, Kosovo began to introduce an MTEF-type approach to public expenditure management. This was driven by the following objectives: (i) improving budget coverage by

integrating the donor-financed investment program (PRIP) into the budget; (ii) improving the linkage between the policy planning process and resource allocation; and (iii) introducing a medium-term perspective in the planning of government expenditures in the face of declining donor support.

Box 5.1 The Medium-Term Expenditure Framework

The medium-term expenditure framework is a budget formulation tool that is intended to allow expenditures to be driven by policy priorities and disciplined by budget realities over the medium term. The framework is intended to facilitate a number of important outcomes: improved inter- and intrasectoral resource allocation by effectively prioritizing all expenditures; greater budgetary predictability for line ministries, more efficient use of public money, and greater political accountability for public expenditure outcomes through more legitimate decision making processes.

An MTEF consists of a top-down resource envelope, a bottom-up estimation of the current and medium-term costs of existing policy, and the matching of these costs with available resources in the context of annual budget cycle. The top-down resource envelope is essentially a macroeconomic model that indicates fiscal targets and estimates revenues and expenditures. To complement the macro model, a series of bottom-up sectoral reviews, using the comprehensive development framework, analyzing sector policies and activities are undertaken along a parallel track.

The value added of the MTEF approach comes from an integration of the top-down resource envelope with the bottom-up sector programs. It is at this stage that the policy making, planning and budgeting processes are joined. Once the strategic expenditure framework is developed, the government defines the sectoral resource allocations, which are then used by the sectors to finalize their programs and budgets. Key to the sectoral review process is the notion that within the broad strategic expenditure framework, which reflects resource constraints as well as government policy, sectors have autonomy to manage by making decisions that maximize efficiency and effectiveness.

Experience with MTEFs in other countries has illustrated that:

- The MTEF cannot be implemented as a single reform; it is many interrelated reforms. It also needs to be done in line with other basic budgetary reforms, including in the areas of budget execution or reporting. Budget comprehensiveness, that is the extent to which the budget takes account of all public expenditures, including donor funds, is important for a successful MTEF.
- In part because of capacity constraints, a full-fledged MTEF cannot be introduced at once, and its introduction is therefore normally phased, either intentionally or unintentionally.
- The MTEF needs to be integrated with the annual budget process. The MTEF should not operate as a parallel system, and the approved budget should effectively constitute the first year of the MTEF.
- The MTEF should be managed as an integrative process; the Budget Office alone cannot handle the formulation of the MTEF.

5.17 The MTEF process this year involved two main elements. The first element was the preparation of a macro framework that provides the basis for projecting the resource base and expenditure allocation. This framework was prepared by the MoFE and budget ceilings were subsequently established. The second element was the sector strategy frameworks, which establish the overall policy objectives for the sectors. During the second quarter of 2002, the MoFE used a planning exercise using enhanced comprehensive development framework matrices, aimed to facilitate planning in the transferred Ministries.

5.18 The MTEF approach planned as part of the 2002 budget cycle has a number of elements in line with international practice. For example the development of an MTEF through to the budget in the first year include trying to bring all outflows and inflows on budget, and requiring spending plans to be based on strategic objectives and planning and basing requests for funding from the line on changes in policy, motivated by the contribution to strategic objectives.

5.19 Not surprisingly, there were a number of weaknesses in the exercise which will need to be addressed going forward.⁶⁴ These include: (i) the uneven treatment across sectors; (ii) the failure to provide spending ceilings to spending agencies; (iii) the limited analysis of issues relating to the main economic and functional spending categories; (iv) the lack of clear prioritization within sector expenditure programs, limiting their operational usefulness; (v) the limited involvement of the sector ministries with the MTEF exercise; and (vi) the limited progress towards an integrated approach to the analysis and budgeting of recurrent and investment spending. The initial MTEF exercise also highlighted (i) the absence of background data and analysis against which to make informed decisions, and (ii) the very limited information that is currently available on the efficiency of public service provision.

5.20 Internalizing and further developing the MTEF process will be key for the authorities in defining and meeting their longer-term strategic development priorities within a fiscally viable framework, and in an environment of diminishing donor assistance. The introduction of a full MTEF will have to be a gradual process, as capacity constraints become less binding and budget supporting systems develop over time.

5.21 With limited scope for increasing public expenditures, one of the main opportunities over the medium-term for achieving improvements in public services lies in a more efficient use of existing resources. Therefore, an important objective of the 2004 MTEF analysis should be to encourage line ministries to focus on ways of improving resource use within existing sector budgets. This analysis could focus around four groups of issues:

- (a) *cost-effectiveness* Line ministries should initiate a process of reviewing their major spending programs to assess their cost effectiveness and to identify ways in which resource efficiency could be improved;
- (b) *cost-recovery* Increased cost recovery offers opportunities for achieving more effective use of scarce budgetary resources. The next round of the MTEF should include a discussion of cost recovery strategies for a few key sectors. Water supply, where increased cost recovery is essential to increased operations and maintenance spending, and electricity, where

⁶⁴ A number of problems were experienced with the enhanced comprehensive development sector matrices. To some extent, these problems reflected the need to strengthen the underlying analyses on which the matrix was based rather than the limitations of the matrix itself. There was a tendency to include too much detail in the matrix thereby obscuring the focus towards priority actions and funding requirements. Line ministries were also sometimes unclear as to what type of information should be included in each column.

increasing collections and reducing subsidies from the budget are pressing issues, would appear to be suitable candidates.

- (c) *contracting out* Line ministries should be required to identify the scope for contracting out of services as part of their sector submission for next year's MTEF. Simultaneously, the MoFE and the CFA should develop "good practice guidelines" for facilitating the implementation of contracting out arrangements.
- (d) *balancing investment and recurrent spending* The 2002 MTEF process identified substantial requirements for new public investment across sectors. In each sector an appropriate balance will need to be struck between allocations for investment spending and those for operations and maintenance if the rehabilitated infrastructure is not to quickly deteriorate. The MTEF expenditure strategies in 2002 give little indication that such analysis has been undertaken.

5.22 The following further steps are also recommended to ensure that progress will be made.

- (a) Next year's MTEF exercise should include a more detailed analysis of the public expenditure implications of key government policy initiatives that cut across sectors, including the public administration reform program. The MTEF could also be the principal instrument for implementing a possible poverty reduction strategy that the Government has expressed interest in designing.
- (b) Before embarking on the 2003 MTEF process the structure and purpose of the MTEF and the MTEF process should be thrashed out and communicated to line ministries. Amongst other the need to frame expenditure bids in the context of policy changes, the nature and purpose of the forward estimates (ie are they forward estimates of the cost of existing policies and will they roll over as the budget figures, depending on the resource envelope and unless policies are changed), the role of contingencies and the process and roles of the central and line ministries should be clearly communicated. These elements would need to be developed and clarified to an agreed set of rules of engagement between agencies in the budget process in order to engineer a shift from funding based budgeting to policy based budgeting. Currently the annual focus both in terms of structure and process in the MTEF detracts from such a shift.
- (c) More emphasis needs to be placed on the identification of monitorable performance indicators. The line ministries should develop indicators and measures closely linked to the programs being measured rather than indicators that detect long-term trends (such as life expectancy). Output information can then feed into the budget allocation process. Pilot sectors should be identified to develop sectoral approaches that are strategic, performance oriented and comprehensive, including the development of inclusive strategic approaches, sectoral data-bases on all inputs and

capturing relevant output information against inputs, and relevant indicators.

5.23 Meeting these requirements will demand an earlier start of the preparation of the MTEF. The budget preparation timetable should cover the entire fiscal year. During the first half of the year the multi-year implications of the current and coming years' spending should be analyzed through a consultative process, as an input to the preparation of the annual budgets. There should not be a separate MTEF and Budget Round, since this unnecessarily duplicates processes and weakens the MTEF round. A joined allocative phase, where the budget is set as the first year of a MTEF, should succeed an earlier priority setting phase where strategic policy, revenue and expenditure issues are identified and reviewed and which culminates in decisions on macro-fiscal ceilings and macro expenditure priorities and the publication of these in a pre-budget statement. The CFA and the MoFE will also need to consider measures necessary to ensure that the participation of the line ministries in the MTEF exercise is made more effective.

5.24 One institutional mechanism that could strengthen the MTEF process would be the introduction of standing Joint Medium Term Expenditure Committees that operate early in the MTEF process and investigate specific and on-going issues within sectors. These committees would build on the foundations established by the CDF matrices and would have membership of the MoFE and the relevant line ministries. Where required, other players including the municipalities could also be brought in.

C. BUDGET IMPLEMENTATION: FURTHER IMPROVING ACCOUNTABILITY AND TRANSPARENCY

5.25 The strength of a public expenditure management system in maintaining aggregate fiscal discipline and allocating resources efficiently depends to an important extent on how well the institutions for financial accountability function. A well-functioning system of financial accountability encompasses: (i) financial management processes (budgeting, accounting, reporting and auditing) that can provide a system of adequate controls and generate information on transactions to allow review and analysis; (ii) an adequate institutional framework providing the necessary checks and balances to improve government performance and avoid mismanagement and abuse; and (iii) mechanisms for ensuring that essential information reaches those who need it.

5.26 Kosovo has made significant progress in many of these areas. Kosovo publishes good budget documentation; spending proposals are framed within the macro-economic context and in terms of sectoral policy decisions; ex-ante spending information is reasonably reliable; and the budget is classified consistently across years and across spending categories and levels of government. Timely actual spending information is available during the fiscal year, including information on outstanding commitments.

Financial controls in the budget execution process

5.27 Expenditure in Kosovo is controlled through periodic fund allocations against the budget to spending agencies that commit expenditures against their releases through a system of fund warranting. Accountable persons for each of these functions are tasked

with checking whether sufficient money is available to cover the expenses and the integrity of the spending commitment. At the approval stage, it is also checked whether the expenditure supports the policy of Kosovo. Recurrent non-discretionary spending such as salaries are covered under the same scheme, but may be released in bulk at the start of the year.

5.28 In previous years fund releases were late, given the uncertainty of revenue collection and the need to keep spending within the available cash. This created spending bottlenecks at the end of the year, with resultant underspending⁶⁵. In 2002 fund releases are earlier, more periodic and more predictable, which should smooth expenditure patterns. However, the draft financial management guidelines still provide leeway for the MoFE to modify releases depending on the type of appropriation, the projected expenditure flow requirement of a specific appropriation and the revenue profile. It also allows space to adjust funding releases according to the in-year budget priorities for expenditure. While this is necessary to maintain affordable expenditure levels, and within such constraints, to ensure that the most critical activities are funded first should there be shortfalls, the instruments should be used with caution in order not to undermine planning discipline, distort allocative efficiency and detract from line department accountability.

5.29 Kosovo operates a modified cash accounting system. All payments are made and accounted for centrally by the Treasury Department (previously in the CFA, now in the MoFE). The expenditure control system allows the recording of commitments. Accounting for revenues and expenditures are increasingly real time. Previously the paperwork for all transactions at a central and municipal level was handled at the CFA, which created delays and bottlenecks. With the roll-out of the accounting system to municipalities and spending agencies, recording commitments and expenditures can be decentralized and speeded up. Similarly, revenue inflows are increasingly handled through the developing banking system, limiting the amount of cash handled by public officials and with daily reconciliation, allowing improved monitoring of revenue levels.

5.30 *Internal oversight, control and enforcement:* The level of internal control until now depended mostly on establishing systems that assigned clear responsibility and left an audit trail should accountability need to be enforced down the line. The recent approval of financial management legislation, including amongst other sanctions for mismanagement of public funds, will fill some of the gap in this regard, but is in itself not sufficient. Occasional checks through internal auditing procedures, a robust early warning system and thorough analysis of sectoral expenditure patterns are required to operationalize accountability. There is an internal auditing function centralized in the CFA, but it does not have sufficient capacity and (as a result) acts on requests from ministries to execute audits rather than initiate random checks. Also, most of the scarce capacity at the CFA was focused on designing, implementing and running basic systems of expenditure control and accounting; very little time has been available to operate a robust internal warning system on the back of the good and timely information generated by these systems.

⁶⁵ Underspending also results from the start-up nature of many policy initiatives. Spending departments often underestimate the time it would take to develop the necessary systems to run specific policies (i.e., the payment of social welfare entitlements) and, as a consequence request money too early.

Public sector accounting

5.31 Kosovo has established an accounting system that is in line with accepted international accounting practices. Up until 2002, the accounting of all budget operations was done by the Treasury Department of the CFA, including those of municipalities. This allowed the system to be standardized, both as regards payment procedures and classification under a centrally determined GFS compatible chart of accounts. Pursuant to the establishment of municipal assemblies and the devolution of revenue, expenditure and financial management responsibilities to municipalities, the maintenance of municipal sets of accounts is being rolled out to municipalities. However, the coding framework and procedural framework for municipal financial management is still centrally determined, particularly by making municipalities subject to the proposed Law on Public Financial Management and accountability.

5.32 Similarly, UNMIK Regulation 2001/30 applicable to business organizations provides for the keeping of accounts and financial records of public entities. In addition, the proposed new Financial Management legislation provides for regular audits of financial records and the preparation of interim and final financial reports for submission to the Assembly.

5.33 The development of a chart of accounts has been progressive. In the latest iteration, applicable to the 2002 fiscal year, expenditures can be classified to a sub-sub program level, allowing line agencies to extract more detailed management accounting reports.

5.34 Another issue has been the treatment of both disbursed and expected designated donor grants through the system, with identification of the country of origin, the organization, the purpose, the project, and types of expenditure. While the necessary systems are in place within the central accounting system to capture funds once they've entered the system, it is unclear how the MoFE is to integrate this system with the RIMS database to keep track of expected grants and spending against them. Similarly, it is not clear how Kosovo will capture spending on state services that is externally funded and where the money is not channeled through the Kosovo Revenue Fund. While there is no legal obligation to account for such funds, further progress and resolution of these issues will be required to facilitate the effective integration of the PRIP and the Kosovo Consolidated Budget in future.

Public procurement

5.35 Sound and transparent procurement rules play a critical role in increasing the efficiency of public expenditures and public service delivery. Yet the public procurement system in Kosovo is underdeveloped with weak legislative and institutional frameworks. These weaknesses create considerable room for low value for money in public contracting, and for abusive procurement practices.

5.36 Procurement in Kosovo is still managed in terms of an outdated Administrative Instruction which was put in place pending more robust regulations. While the regulations assigns accountability and prescribes procedures depending on the type of

goods procured and the magnitude of the outlays, it is not sophisticated enough to fulfill the needs of an expanding public service, does not provide sufficient control over the propriety, economy and quality of goods procured through monitoring, analysis and oversight, and does not require sufficient transparency about the recipients and cost of awarded contracts.

5.37 There is a new set of draft regulations and administrative instructions which includes all the ingredients of an economic and efficient public procurement system and separates the implementation function from an oversight and control function. The regulation should be promulgated as a matter of urgency and sufficient resources mobilized to ensure their implementation.

Policy Recommendations

5.38 **Accounting capacity in municipalities and public enterprises needs to be strengthened.** While the centrally determined legal framework for reporting and accounting standards in the municipalities and the public enterprises is sufficiently robust, the capacity of these agencies needs to be strengthened. The capacity of the MoFE to monitor compliance with the regulatory frameworks also needs to be strengthened. A regulatory framework for the approval, management and reporting on donor funds that are not channeled through the Kosovo Consolidated Budget should be developed, taking into account the progress made both within the CFA systems and the RIMS database and including the specification of the classification of spending compatible with main budget spending under these funds.

5.39 **External Audit capacity needs to be developed.** Regular audits of the budget are carried out. However, the creation of an independent Auditor General function still lags, awaiting the finalization of the Auditor General regulation. The draft regulation proposes that the Audit Office would function independently of the PISG, reporting to the SRSB and thereafter to the Assembly. The external audit function is critical to the transparency and reliability of public sector financial management systems. With the institution of the new assembly and the inclusion of designated public entities under the authority of the Auditor General the need to establish the independent Auditor General that the Constitutional Framework (CF) calls for is even more urgent. External auditing results should be made available more easily.

5.40 **Procurement capacity needs to be developed.** At both the central and municipal level, there needs to be the capability to conduct competitive procurement, and a system to monitor procurement efficiency and integrity should be developed.

D. THE INSTITUTIONAL ASPECTS OF PUBLIC EXPENDITURE MANAGEMENT

5.41 The year 2002 is particularly significant for public expenditure management in Kosovo. It is the first full cycle in which decision-making structures and processes must reflect an appropriate balance of power between UNMIK and the new Government. The establishment of an elected Government also means that the budget process has to provide for political involvement in decision making. It is self-evident that the first year of provisional self-government presents many opportunities to mould the system and

address problem areas within a coherent management framework. Inversely, there is also a risk that the established systems will deteriorate during the handover.

5.42 In May 2001 the promulgation of Regulation 2001/19 set up a framework for the phased transfer of power between an elected Kosovo Government and the international civil presence in Kosovo, UNMIK. The CF divides the functions of Government into two streams of executive and legislative power, within the final authority of the SRSG. For the bulk of Government services, the PISG take intermediate legislative and executive authority while for the remainder of the functions, the SRSG takes full authority. While the CF thus clearly divides the line functions of government (those that sector ministries can provide policy advice on from a narrow sector perspective) between the PISG and the SRSG, it is much more ambiguous on the central functions (those fulfilled by central agencies and whose policy advice is cross-cutting and has an overall national welfare perspective). This creates challenges for decision-making processes before the fact, and reporting lines after the fact. See Box 5.2 for further details on the mechanisms for economic governance currently in place in Kosovo.

5.43 **Mechanisms for economic governance** At the central level, it is critical that the CFA and the MoFE are merged as soon as possible, while respecting the reserved powers of the SRSG as laid out in the CF. It is also important that the sequencing of and authority over budgetary decisions is clarified. The governance of decisions within the executive branch of government is not straightforward in Kosovo. The political layer of the executive branch of government includes the cabinet of the elected Kosovo government, but also include the SRSG, who, while a representative of the UN, acts as a political decision-maker. It is important that the current arrangements managing the budget in Kosovo support the development of an accountability relationship between the PISG structures and the people of Kosovo. If the current (or planned) institutional arrangements do not support the development of such a relationship, the risk is high of setting a precedent of less than accountable government.

5.44 In this context, there are two priority challenges:

- (a) Reflecting the correct balance of power between the SRSG and the PISG in the budget process while maximizing PISG autonomy and accountability;
- (b) Establishing a strong accountability relationship between the executive branch of the PISG and the Assembly, and between the Assembly and the people of Kosovo.

5.45 **Finding a balance of power between the SRSG and the PISG.** The assignment of expenditure responsibility and authority requires a complex sequencing of consultation and decision-making points that allows the highest level of autonomy for the PISG while recognizing the final authority of the SRSG. This implies that the consensus must be built throughout the budget process, rather than be negotiated at the end when changes to earlier parameters are technically and politically difficult. In terms of effective budget management the signing off on key decisions at key points (and publication of those) promotes discipline in the process and reduces opportunity for patronage down the line.

The decisions on the division of revenue between the major functions of government and between the levels of government provide such sign-off and consensus building points⁶⁶.

5.46 The proposed Law on Financial Management and Accountability makes provision for a process of power sharing that sees the Economic and Fiscal Commission review the MoFE proposed budget and the SRSG make amendments to it before it is transmitted to the Prime Minister and Assembly. While this makes provision for sequenced power sharing and avoids conflict, it does not separate at a political level considerations on the macro-economy and fiscal policy from sectoral expenditure bids. The potential for the avoidance of tough trade-offs in the face of fiscal policy considerations is further exacerbated by the proposed facility for line ministries to register their dissatisfaction with their proposed ceilings in the MoFE budget proposal directly with the EFC, and no provision for a round of debate between the MoFE and the SRSG. These issues can be avoided if the budget decision-making process is separated and two-tiered, once for the establishment of an aggregate fiscal framework, and secondly for the allocation to spending departments and municipalities within the decided expenditure envelope. Preferably the envelope should be published together with major policy considerations in a pre-budget statement. Table 5.1 provides more detailed proposals on the institutional design of the budget process.

5.47 **Establishing horizontal authority between the legislative and executive branches of the PISG.** The role of the Budget Committee seems to be limited to review and oversight.⁶⁷ There are no clear provisions for the Committee to make amendments to the Budget itself, neither are there any clear limitations on its power. The CF assigns it 'general responsibilities' on the budget, and clarification will need to be provided within the overall public expenditure management system.⁶⁸ Even in the absence of effective powers, the role of the Assembly should not be restricted to oversight after implementation. The Budget Committee can also contribute to the PISG's approach to budget policy through: (i) briefings by and discussions with the Minister of Finance and Economy on the broad budget parameters; (ii) reviewing Ministries' annual reports and the mid-year review of the budget to determine current spending capacity and review proposals; and (iii) holding public hearings and calling on the financial agencies and ministries for information and explanation before advising the Assembly on the budget. Constructive external engagement leads to greater accountability and better spending.

⁶⁶ The current institutional structure in Kosovo provides three main divisions of revenue: (1) between the functions of government; (2) between the levels of government and (3) within the central level, between the PISG and the Reserved powers.

⁶⁷ Executive Decision no 2001/12 on the Provision Rules of Procedure of the Assembly of Kosovo assigns to the committee responsibility (i) for reviewing all laws and proposing amendments to be considered by the Assembly; and (ii) for 'examining the annual reports and the audited financial statements of the Kosovo Consolidated Fund relevant to the budget of the PISG and other audit reports relating to the operations of the Assembly, the President, the Government, Ministers or other activities of the PISG...' The committee submits reports on these statements to the Assembly for debate.

⁶⁸ There are different models world-wide for interpreting 'general responsibilities'. In addition to ex-post oversight responsibilities, some parliaments can amend the budget before approval. These powers however are often limited. In some countries, Parliament can adjust both revenues and expenditures; in other countries Parliament can make adjustments as long as the balance remains the same; and in yet other countries revenues and expenditures can only be adjusted downwards.

Table 5.1: Institutional design of the budget process

Key Stage	Revised proposal
<p>Key Stage 1</p> <p>MTEF Track 1</p> <p>Setting the Revenue and key policy proposals of the budget</p>	<p>The MoFE prepares macro-economic and fiscal policy issues and revenue papers for submission to the SRSG and Cabinet before a meeting of the EFC. Cabinet formulates a position on the revenue proposals and on the main expenditure priorities and mandates EFC members. The EFC, under chairmanship of the SRSG, meets to discuss and advises the SRSG on the revenue proposals and the main expenditure policy parameters for the budget. Should there be major disagreement between the SRSG and the EFC, or major dissent within the EFC these should be recorded in the public MTEF document.</p>
<p>MTEF Track 2</p> <p>Preparation of bottom up CDFs</p>	<p>Spending agencies prepare CDFs on the basis of instructions by the Ministry, contained in a first budget circular, backed by training workshops. The CDFs, on the basis of ongoing policy and policy changes, sets out financial requirements in terms of the rolled over forward estimates, and requested changes to the estimates based on policy changes.</p>
<p>Key Stage 2</p> <p>Internal MTEF documentation prepared and ceilings issued to spending agencies</p>	<p>On the basis of the SRSG decision on the macro-parameters of the budget, a technical committee with membership from UNMIK and the MoFE reviews submissions by and holds hearings with spending agencies and drafts a MTEF internal policy document setting out the main allocations of available revenue and highlighting the trade-off decisions at the margin. This paper is taken through a political consultation round. The SRSG acting on the advice of the EFC, issues broad-band guidelines for the division of revenue between the levels of government and at the central level, between the spending agencies. The latter effectively establishes a division of revenue between the PISG and the Reserved Powers. The MoFE tables the MTEF document as a pre-budget policy statement in the Assembly. This document records any differences between the SRSG and the EFC, or major dissent within the EFC.</p>
<p>Key Stage 3</p> <p>Preparing the budget</p>	<p>The MoFE issues the budget circular and spending agencies prepare budget requests with forward projections within their new ceilings, incorporating changes to the overall resource ceiling and their allowed policy changes, based on their early CDF submissions and the issued ceilings. The MoFE finalises budget proposals with the spending agencies and amalgamates the results into a draft budget, with key trade-offs at the margin highlighted for consideration by the EFC. The documentation on the PISG functions is submitted to Cabinet for consideration. Cabinet, through the MoFE, prepares documentation for the EFC that sets out the spending choices at the margin of the PISG spending band. The documentation on the Reserved Powers is submitted to the SRSG, who similarly prioritises trade-offs at the margin within the spending bands issued to the Reserved Powers. The MoFE prepares a revised macro-economic and revenue forecast to determine the final revenue constraints on the budget.</p>
<p>Key Stage 4</p> <p>Approving the budget</p>	<p>The EFC meets to consider the combined effect of the trade-offs highlighted at the margins of both institutional structures and the revised revenue limits and advises the SRSG. Consensus is reached within the EFC before the SRSG signs off on the final decisions. The MoFE subsequently prepares the Budget Documentation. The PISG budget is submitted to cabinet and to parliament for approval, within the context of the overall budget. The SRSG signs the resulting appropriation regulation. The budget documentation records any major differences between the SRSG and the EFC, and dissent within the EFC.</p>

Box 5.2: The new Constitutional Framework

Control over economic, fiscal and budget policy in Kosovo is complex. The CF creates two elected levels of government (central, municipal) within the final authority of the Special Representative of the Secretary General (SRSG), and a separation of authority at the central level, between what is commonly referred to as the Reserved Powers and the PISG. It establishes a system of exclusive and joint competences between the SRSG and the PISG that overlaps with the assignment of responsibilities between the local and central levels of government.

I. Legal framework for power sharing between the PISG and the SRSG at the central level The CF makes the following specific provisions for power sharing in the fiscal area between the PISG and the Reserved Powers at the central level:

- The framework provides for the PISG to have responsibilities in the fields of economic, financial, fiscal and budget policy. This power is qualified by the provision that the SRSG retains final authority over monetary policy, setting policy and budget parameters, and approving the budget.
- The operation of the Customs service equally is a joint arrangement, with the SRSG retaining final authority for the service and appointing the head, and the PISG having to cooperate with the SRSG on operational matters.
- The SRSG appoints the members of the Economic and Fiscal Council⁶⁹, the Governing Board of the BPK, the Auditor General, and the chief executives of the Customs Service and the Tax Inspectorate.
- The SRSG has authority over the interpretation of the scope of PISG powers or any other parameters in the CF

II. Legal framework for budget management between the executive and legislative branches of the PISG The Government consists of the Prime Minister and 10 Ministers. It has responsibility to make and implement policy in the PISG areas of competence and deliver services reliably. It has to ensure that available funding is allocated effectively and efficiently with due attention to transparency and accountability. It should also establish anti-fraud and anti-corruption measures.

- The Assembly adopts laws and resolutions in the areas of responsibility of the PISG. Either the Government or the members of the Assembly may submit laws.
- The Assembly has a Budget Committee with general competencies in budgetary and financial matters, and responsibility for ensuring that all proposed laws with budgetary implications are accompanied by a financial impact statement.
- The President (elected by the Assembly) reports to the Assembly on the state of affairs in Kosovo at least once a year. The Ministers are tasked with reporting regularly on their affairs to Parliament.

III. Legal framework for municipal and intergovernmental finances As regards municipal and intergovernmental finances, responsibility for public services is either exclusively or jointly assigned between the central and local levels, within the context of a marked revenue gap at local level. The autonomy of the local level to make policy decisions, spend and account for expenditures is neither constant nor absolute, but devolving and subject to an array of conditions:

- Municipalities fall under the administrative supervision of the central authority to ensure compliance with the law and the maintenance of recognized standards.
- Administrative responsibility is to be transferred to municipalities pending certification by an independent auditor on the sufficiency of systems for budget and financial management and the ability of the municipal civil service to implement the systems. Before certification municipalities are administered under the supervision of the Municipal Administrator and through a Municipal Finance Officer.

⁶⁹ The Economic and Fiscal Council is set up in terms of the CF to provide the SRSG with advice on economic and fiscal issues. The SRSG shall set budget parameters and approve the final allocations on advice of the council, for example and also convenes and chairs the council.

- Even then the SRSG and the Municipal Administrator retains responsibility of oversight and powers of intervention. The Municipal Administrator approves the municipal budget.
- Municipalities can raise revenue from fees, charges and property taxes. However they need to be certified by the CFA to participate in the pilot property tax program⁷⁰. In addition the kind and level of fees and charges need to be approved by the central authority before implementation.
- Both the SRSG and the PISG are given oversight responsibilities as regards municipalities. The CF gives the PISG the responsibility for amongst other, overseeing compliance with responsibilities and powers delegated to municipalities and assisting the municipalities with budget and financial management system development. The responsibility of the SRSG has a base in the CF, but arises more concretely from Reg 2000/45 where UNMIK appointed Municipal Administrators and Finance Officers are responsible for municipal finances until such time as a municipality is certified to take over administrative control; after then the UNMIK officials still retain oversight responsibilities and intervention powers.

⁷⁰ Certification depends on the preparation of a property tax roll, setting of the tax rate and the establishment of systems to evaluate properties, bill for the tax, collect taxes, handle appeals and enforce payment.