KOSOVO

GEARING POLICIES TOWARD GROWTH AND DEVELOPMENT

Rakia Moalla-Fetini, Heikki Hatanpää,
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Preface

Kosovo is a province of Serbia in Serbia and Montenegro with a population of some 1.9 million and an area of about 11 thousand square kilometers. Following the end of the war of March–June 1999, the United Nations (UN) Security Council, in Resolution 1244 (June 10, 1999), placed Kosovo under temporary UN administration, while reaffirming the sovereignty of the Federal Republic of Yugoslavia (FRY) over the territory.

According to a new constitutional framework adopted May 15, 2001, responsibility for administering the territory is now shared between the UN Interim Administration Mission in Kosovo (UNMIK) and a Kosovar self-government, the Provisional Institutions of Self-Government (PISG), which took office in April 2002. While the final status of Kosovo is yet to be determined, the UN Security Council (UNSC) has indicated its support for a set of standards, whose achievement could pave the way toward discussions on Kosovo's final status. A comprehensive review of progress toward these standards is expected in 2005.

At the request of UNMIK, and later the PISG, and together with the rest of the international community, the International Monetary Fund (IMF) has been assisting institution building and the formulation and implementation of economic policy in Kosovo. This work has been closely coordinated with the World Bank and other multilateral and bilateral donors. Apart from technical assistance provided by the IMF's Fiscal Affairs Department, Monetary and Financial Systems Department, and Statistics Department, the European Department has provided macroeconomic policy advice on an ongoing basis.

This report builds on two previous similar reports, produced in 2001 and 2002—*Kosovo: Macroeconomic Issues and Fiscal Sustainability,* by Robert Corker, Dawn Rehm, and Kristina Kostial, and *Kosovo: Institutions and Policies for Reconstruction and Growth,* by Dimitri G. Demekas, Johannes Herderschee, and Davina F. Jacobs. It is principally based on the work performed during four staff visits spanning a 15-month period from January 2003 to March 2004. The staff teams were led by Rakia Moalla-Fetini and comprised Heikki Hatanpää, Anastassios Gagales, and David Moore (EUR), Kentaro Ogata and Brian Olden (FAD), and Zia Ebrahim-Zadeh and Natalia Koliadina (PDR), and were assisted by Shehadah Hussein, the head of the IMF liaison office in Pristina. We hope that the analysis and recommendations of this paper will contribute to informing the debate about economic policies, in particular, and about the broader issues that will shape Kosovo's future.

The authors would like to thank the following people for their detailed and insightful comments: Alessandro Leipold, David O. Orsmond, Karl Driessen, Anne-Marie Gulde-Wolf, Vassili Prokopenko (in particular for his help on the analysis of the health of the banking system), Tito Cordella, and other colleagues in the IMF and the World Bank. The authors are also grateful for editing by Thomas Walter, research assistance by Madhuri Edwards, and processing of text and tables by Ana Rosa Reyes Labarca. Sean M. Culhane of the IMF's External Relations Department oversaw the production of the final publication.

The views expressed are the sole responsibility of the authors and do not necessarily reflect those of the IMF or its Executive Directors.

Acronyms and Abbreviations

BPK	Banking and Payments Authority of Kosovo
CPI	Consumer Price Index
DDG	Donor-designated grants
EFC	Economic and Fiscal Council
EU	European Union
FDI	Foreign direct investment
FRY	Federal Republic of Yugoslavia
GNDI	Gross national disposable income
HBS	Household Budget Survey
IT	Internet technology
KEK	Korporata Energjetike e Kosovës (Electricity monopoly)
KFOR	Kosovo Force
KGB	Kosovo General Budget
KTA	Kosovo Trust Agency
LFS	Labor Force Survey
MFE	Ministry of Finance and Economy
NFA	Net foreign assets
NPL	Nonperforming loans
NPV	Net present value
PIP	Public Investment Program (Donor funded)
PISG	Provisional Institutions of Self-Government
POE	Publicly owned enterprise
SFRY	Socialist Federal Republic of Yugoslavia
SOE	Socially owned enterprise
SOK	Statistical Office of Kosovo
SRSG	Special Representative of the Secretary-General
TFP	Total factor productivity
TREPCA	Mining conglomerate (lead and zinc mining and associated operations)
UN	United Nations
UNMIK	United Nations Interim Administration Mission in Kosovo
UNSC	United Nations Security Council
VAT	Value-added tax

I

Overview and Policy Conclusions

Nearly 5 years into the postconflict transition, Kosovo finds itself at a critical juncture. While there are many positive signs, including progress in institution building and noteworthy macroeconomic stabilization, there are also reasons for concern. First and foremost, the pace of recovery has been too slow to meet people's demands and expectations. The episodic ethnic flare-ups serve as a warning that the achievements of the past few years are still fragile, and that the economy could fall into a vicious circle where the lack of economic development hampers political stability and the lack of political stability undermines economic development.

For Kosovo to make the right choices, the authorities should take stock of the achievements so far, deepen the understanding of the challenges ahead, and develop appropriate policy responses—also the broad aims of this paper. With most rehabilitation work nearly completed and a basis for macroeconomic stability in place, the most pressing challenge is to achieve economic growth that is sufficiently (i) strong to make a dent in unemployment, and (ii) regionally and socially inclusive to foster national reconciliation. This challenge is all the more daunting in the face of declining foreign assistance and private inflows, on which the economy is still heavily dependent. The underlying message of this paper is that Kosovo's deeply rooted problems will not be solved by any one "quick-fix" solution but require instead concerted initiatives and sustained efforts across a range of areas to kick-start a process of self-generating growth. Resolution of Kosovo's final status would provide the right enabling environment to the extent that political uncertainty may hinder investment and economic activity more generally.

Economic Structure and Long-Term Prospects

Under the impetus of a massive infusion of foreign assistance and private inflows, the Kosovo economy staged an exceptionally strong recovery immediately after the end of the conflict. However, the very dependence on such foreign inflows renders the gains achieved so far fragile and the economy vulnerable.

The analysis of the underlying macroeconomic structure and the role of the donor sector suggests that today's level of economic activity is being propped up by foreign assistance and external private inflows to the tune of 50 percent of GDP. By hiring local employees and purchasing local goods and services for consumption by the community of expatriates and peacekeeping soldiers, as well as for donor-financed projects, the donor sector is creating an artificial "export" market for Kosovo goods and services equal to about 20 percent of GDP. Also, the nature and stability of private inflows on the order of 30 percent of GDP, which are financing the remainder of the current account deficit, are still largely unclear, as the officially estimated flow of workers' remittances is much smaller.

Behind the large current account deficit of the domestic sector lie extremely weak fundamentals, as evidenced by large domestic dissavings, which were also characteristic of the Kosovo economy during the 1970s and early 1980s. A sudden reversal in private inflows or an overly rapid withdrawal of foreign assistance would lead to a painful retrenchment. The near-term outlook, even under a more benign scenario, does not look promising if further declines in foreign assistance were to compound the waning of the ongoing fiscal stimulus.

The gains achieved so far not only are fragile but have left major developmental challenges largely unaddressed. These include entrenched high structural unemployment, a depleted stock of human capital, and dilapidated main public utilities and infrastructure. Although the headline unemployment figure of 55 percent overstates the extent of the problem, unemployment is nonetheless likely to be very severe. The staff team estimates that the employment rate is about 33 percent and the unemployment rate about 30 percent, even after factoring in informal employment.

It would be unrealistic for policymakers to aim to reduce unemployment sharply. However, this paper argues that a reasonable macroeconomic framework should target an employment growth rate of at least 3 percent, which will make some inroads in tackling unemployment. Achieving this objective is likely to require investments of 25–27 percent of GDP per annum over the next decade, which, together with the increase in employment and solid gains in total factor productivity, could sustain growth at about 5–5½ percent.

However, given the extremely low domestic savings, Kosovo's own resources are not sufficient to finance the required investment, and relying on foreign borrowing to fill the gap would be imprudent. This paper develops a financing scenario that could underpin the above macroeconomic framework. It assumes prudent borrowing that aims to limit the buildup of external debt to no more than 30 percent of GDP over the next 10 years—from the technical working assumption of zero today, pending clarification of the issue of liabilities and assets from the former Federal Republic of Yugoslavia. The scenario reveals that a financing gap of about €300 million annually would persist over the medium term, albeit on a declining trend. To the extent that the inherited debt is not zero, as may indeed be likely, Kosovo's financing needs will be affected accordingly.

Addressing Kosovo's problems would therefore require sustained and combined efforts by both the authorities and the donor community. On the part of the authorities, strong policies will be required to preserve macroeconomic stability, speed the reform of the public enterprise sector, and accelerate the overall pace of market reform. As for the donors, their continued involvement could support the authorities' policies until the economy's fundamentals strengthen, and governance and market institutions reach maturity. To that end, achieving clarity about policies and financing needs will be essential, albeit difficult—a task partially attempted in this paper. To increase foreign assistance's contribution to the domestic economy and improve its developmental impact, an increasing share should be channeled through the budget. This will allow it to play a greater role in boosting growth and will reinforce both ownership and transparency.

The Fiscal Framework

Kosovo has made strides in building institutions for autonomous fiscal management, and, although still at a formative stage, the Kosovo General Budget (KGB) is rapidly approaching maturity. The nearly fivefold increase in tax revenues since 2000 and the slower expansion of expenditures have laid the basis for a strong fiscal position, offering a unique opportunity for fiscal policy to help address Kosovo's developmental challenges. However, liberal carry-forward of unused appropriations and unhealthy competition between reserved and transferred-power agencies have impeded progress in elaborating a clear fiscal strategy.[1] In the context of plentiful resources and weak capacity for expenditure management, this approach carries the risk of setting fiscal policy on a wasteful and unsustainable course.

The important steps taken recently to reform budgeting procedures will, it is hoped, allow a much-needed debate on an appropriate fiscal strategy. The strategy should, in the short to medium term, be based on two pillars:

- Reining in the expansion of current spending to preserve a comfortable current budget surplus, to help finance public investment, and to ensure long-term sustainability; and
- Stepping up work on medium-term strategies for education, health, and basic infrastructure, and elaborating on a well-prioritized public investment program directed at enhancing physical and, especially, human capital.

The medium-term fiscal framework should thus be anchored on a rolling 3-year growth rate for current expenditures. At the same time, the level of capital expenditures and the related overall budget balance should be consistent with a sustainable financing

[1]The government functions transferred to the Provisional Institutions of Self-Government (PISG) following the adoption of the Constitutional Framework in 2001 are called transferred powers, whereas powers reserved for the Special Representative of the Secretary-General (SRSG) are called reserved powers.

strategy—making prudent use of accumulated government assets and eventual borrowing, and taking into account the likely paths of foreign grants and donor-financed investment.

Kosovo has been remarkably successful in rebuilding its tax system, with a tax-to-GDP ratio already close to 30 percent, surpassing initial expectations and tax performance of countries at a similar stage of development. The system relies on traditional broad-based taxes with low nominal rates and few exemptions, which limits its distortionary effects. Further development of the tax system should ensure cost-effectiveness and avoid the risk that poor implementation will weaken tax compliance.

However, and paradoxically, this strong tax performance reflects, in part, the main structural weaknesses of the economy. First, foreign assistance not only provides an indirect support to the tax base by sustaining a higher level of economic activity, it also directly contributes some 3 percentage points of GDP to tax revenues through taxes on the implicit “exports” created by the donor sector. Second, private inflows, which currently allow an unusually high level of domestic absorption, boost the level of expenditure-based taxes commensurately.[2] Further risks to tax revenues may arise from political pressures to lower rates and/or grant exemptions, and a phasing out of the peacekeeping forces’ mission.

The very limited scope for further expansion of the civil service wage bill underscores the need for prudent wage and employment policies. The proposed pay scale reform is a step in the right direction, with several associated benefits justifying the expected cost. However, the cost of the proposed meal allowance to all civil servants is significant and unwarranted. The pension and social transfer system is well designed and provides adequate minimum protection to the most vulnerable citizens. To ensure its sustainability, coverage should be expanded only cautiously, the real level of benefits kept broadly stable, and the eligibility criteria strictly enforced.

Monetary and Financial Frameworks

The monetary framework, anchored by the use of the euro, has served Kosovo well. The use of an external anchor for domestic policies has imposed financial discipline, securing a low-inflation environment. It is also likely to have played a major role in achieving a high level of monetization by avoiding the credibility problems that would have been associated with a domestic currency. For long-term development—the main challenge facing Kosovo today—the financial stability and facilitation of trade with Europe promoted by the use of the euro are likely to outweigh the costs of losing a stabilization instrument. To improve this trade-off, it will be important to further enhance labor and goods market flexibility.

Most of the perceived shortcomings in the performance of the financial sector—low credit volume, short maturities, and high lending interest rates—reflect, to a large extent, its short life span and its still nascent institutional capacity. A faster expansion of domestic credit would have compromised the quality of banks’ loan portfolios, given the still weak risk management capacity, the enterprise accounting and corporate governance shortcomings, and the weakness of the judicial processes. It would also have exacerbated inflationary pressures and inflicted greater damages on competitiveness. A more aggressive push for maturity transformation would have been imprudent, given the untested stability of bank deposits, and the absence of a lender of last resort and of ties to world financial markets.

The authorities should continue to focus their efforts on maintaining the soundness of the banking sector, strengthening the legal system to protect creditors’ rights and nurture a credit culture, and establishing a regulatory framework for external auditing and accounting standards. Enforcing the anti–money laundering law will reinforce the public’s growing trust in banks.

However, some policy intervention may be justified because Kosovo’s unresolved political status creates negative externalities that individual banks and financial institutions cannot absorb on their own. Political uncertainty exacerbates credit and liquidity risks, affects the growth of a stable deposit base, and complicates long-term investment decisions. This paper notes possible policy options, and the authorities are encouraged to carefully weigh their pros and cons.

Structural Reforms

While the achievements in the fiscal and financial areas have been remarkable, progress in structural

[2]A decrease in domestic absorption of 15 percent of GDP, which might correspond to a more stable level of private inflows, would translate into a loss of expenditure-based tax revenues equivalent to about another 3 percent of GDP, in addition to the indirect negative impact from lower economic activity.

reforms has been limited and has held back self-generating growth.

Even though privatization of socially owned enterprises (SOEs) was resumed recently—after changes to operating policies to increase transparency and ensure medium-term viability—the long pause has damaged prospects to attract investment, and the highly politicized disagreements between the PISG and UNMIK have undermined investors' confidence. Privatization should proceed without further delay, and legislation defining land-use rights for liquidation cases should be promulgated promptly.

Limited progress in restructuring the publicly owned enterprises (POEs) has entailed significant economic costs. The de facto closure of the main mining company has virtually shut down an important sector of the economy, and the current social transfers to some of its workers are inefficient, onerous, inequitable, and a source of ethnic tensions. Similarly, faltering progress in restructuring the electricity company is depriving the economy of a reliable supply of electricity—a most serious impediment to private sector development—and generating quasi-fiscal losses of about 7 percent of GDP annually. Incorporating POEs and endowing them with strong and stable corporate governance will be critical to stemming their losses, unleashing their economic potential, and attracting much-needed private capital in would-be subsidiaries. Meanwhile, much greater transparency and closer monitoring are required, particularly of budgetary resources used by POEs.

Steady progress has been made in putting in place the main building blocks of the legal framework for private sector development; the main challenge is to develop the implementation capacity to enforce it. After years of neglect, policies to support an export-friendly environment need to be pursued more actively in the future.

II

Recent Economic Trends, Short-Term Vulnerabilities, and Medium-Term Challenges

Kosovo staged a very strong recovery after the end of the conflict. However, the economy's heavy reliance on foreign inflows renders the gains achieved so far fragile and the economy vulnerable, while significant developmental challenges remain largely unaddressed. The economy is operating far below potential, with no more that one adult out of three holding a job and the ranks of job seekers swelling annually by an additional 30,000 young people. After years of exclusion from the job market and the steady decline of the education system, human capital has been severely eroded, with the majority of citizens lacking the necessary education and training to lead a robust economic growth. Despite extensive rehabilitation, major deficiencies in public utilities and infrastructure continue to be a serious drag on competitiveness and investment profitability. Finally, the large environmental liabilities will be extremely costly to tackle.

Recent Economic Trends

Following the end of the conflict, large amounts of foreign assistance and private inflows underpinned an exceptionally strong rebound in economic activity. The economy—which had relied on federal transfers equivalent to 40 percent of its GDP annually—witnessed a steady decline starting in the early 1980s with the drying up of these transfers and the subsequent disintegration of the former Federal Republic of Yugoslavia. GDP per capita declined from about €1,800 in 1981 to below €300 in the late 1990s and now stands at about €930 in constant 2003 euros (Figure II.1). During 2000–03, foreign assistance totaled €4.1 billion, equivalent to over twice Kosovo's 2003 GDP,[1] and private inflows added another €2.4 billion.

A sharp decline in foreign assistance, the end of the postconflict construction boom, and the lagging impact of an unintended fiscal tightening in 2001 seem to have brought the economy to a grinding halt in 2002.[2] Reflecting a fall of over 20 percent in total foreign assistance, the demand for local goods and services originating from the donor sector is likely to have contracted by about €100 million, exerting a contractionary impact on output of some 4 percent (Figures II.2–II.3 and Statistical Appendix Tables 1–4). A sharp decline in housing investment due to the completion of most reconstruction, and the slowdown in expatriates' demand for rental housing, exerted additional contractionary pressures. Lastly, the unexpectedly strong performance of the newly established tax system—which outstripped the pace of rising budgetary spending—may have slowed the economy further. Available evidence seems to support this assessment, including the sharp deceleration in the growth of recorded commercial imports, the fall of inflation—which had turned negative by end-2002—and reports of anemic growth in most

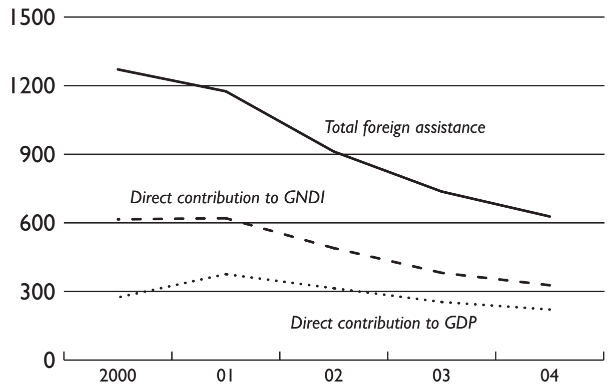
[1] This amount excludes the salaries of the UN peacekeeping soldiers (Kosovo Force, KFOR) and of many expatriates seconded by the administrations of their respective countries. Soldiers' salaries alone could double the amount; during the 4-year period 2000–03, the KFOR presence amounted to about 143,000 soldier-years.

[2] Owing to severe data deficiencies, assessment of recent economic trends is only tentative. Recent improvements in the range and quality of data provide a firmer basis—albeit still weak—for an analysis of the most recent past (see Appendix I).

Figure II.1.
Per Capita GDP, 1981–2003
(In constant 2003 euros)

Sources: IMF staff estimates; and various issues of Yugoslavia's statistical yearbooks.

Figure II.2.
Foreign Assistance, 2000–04
(In millions of euros)



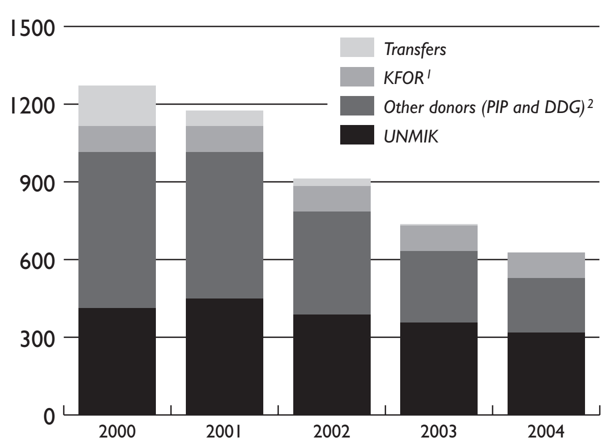
Sources: Kosovo authorities; and IMF staff estimates.

sectors from business surveys and representatives of the banking community.[3]

In 2003, a sizable fiscal expansion may have offset further declines in foreign assistance and private investment, allowing some recovery. A large fiscal expansion in 2003—with an increase in spending contributing 7 percentage points to GDP growth—may have offset the impact of a further decline in foreign assistance and private investment. Together with some supply recovery in agriculture, this may have boosted growth to some 3 percent. Notwithstanding the acceleration of spending, the overall budget balance remained positive, leading by end-2003 to an accumulation of government assets of over €300 million, equivalent to about 17 percent of GDP (see Table II.1).

Notwithstanding large current account deficits, the banking system in recent years accumulated sizable assets abroad—funded by a sharp increase in deposits—providing evidence of significant private inflows (Table II.2 and Statistical Appendix Table 5). By end-2003, the banking system's foreign assets had reached a level equivalent to 40 percent of GDP, of

Figure II.3.
Components of Foreign Assistance, 2000–04
(In millions of euros)



Sources: Kosovo authorities; and IMF staff estimates.
[1]Excluding KFOR's direct imports and peacekeeper salaries.
[2]Public investment program and donor-designated grants.

[3]Half of the 300 large enterprises surveyed by UBO Creations for EURECNA (February 2003) reported a decline in their output in 2002, with the decline exceeding 30 percent in one-third of the cases. Using survey data on 600 enterprises appearing in *SME Development in Kosova–Annual Report 2002*, prepared by Riinvest, the staff team estimates that business turnover is likely to have declined by close to 10 percent. The rapid credit expansion in 2002 is interpreted, partly, as a sign of weakness, reflecting the squeeze on companies' profit margins and their need to turn to banks to finance their working capital.

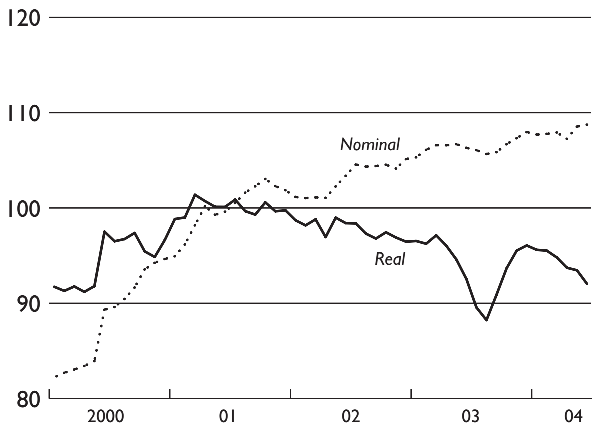
Table II.1
General Budget, 2000–03
(In percent of GDP, unless otherwise indicated)

	2001	2002	2003
Revenues	19.8	28.8	32.8
Percent increase in euros	150.1	55.5	18.0
Expenditure	15.1	23.2	30.3
Percent increase in euros	20.6	63.7	35.5
Budget balance	4.7	5.6	2.5
Government assets	9.6	15.1	17.1
In millions of euros	156	263	307

Sources: Kosovo authorities; and Fund staff estimates.

which a little less than half reflected government assets deposited at the Banking and Payments Authority of Kosovo. About 15 percent of the buildup of net foreign assets is likely to have reflected a fall in the public's cash holdings of euros and a commensurate increase in bank deposits.[4] The remainder points to large private inflows, the nature of which is not fully clear.[5] They may represent (i) workers' remittances

Figure II.4.
Effective Exchange Rates, 2000–04
(2001 = 100)



that are not properly captured by the "official" estimate, (ii) various forms of investment by the Kosovar diaspora, notably in housing, or (iii) export receipts from illegal activities—a possibility that cannot be precluded, given widespread concerns about organized crime in Kosovo.[6]

Trends in Kosovo's real effective exchange rate seem to suggest that, following a strong initial appreciation, competitiveness was gradually restored, thanks to a significant slowdown in inflation (Figures II.4 and II.5).[7] The initially strong real appreciation reflected the foreign-inflows-driven high domestic inflation—which caused a strong real appreciation vis-à-vis the euro area—and a significant real depreciation of the Yugoslav dinar and the Turkish lira.[8] A gradual correction started in mid-2001 as price pressures subsided in response to the decline in aid flows and a weakening in domestic demand. These favorable price developments fully offset the impact of further nominal appreciation. The latter was much

[4]A decline of some €110 million in currency in circulation, following the changeover to the euro in 2002, explains part of the €315 million increase in the banking system's net foreign assets in 2002. Euros in circulation are a foreign asset held by the private sector. A shift from the private sector's preference for cash to a preference for deposits leads, ceteris paribus, to a change in the holdings of foreign assets from the private to the banking sector, with no impact on the balance of payments.

[5]Present estimates of the balance of payments suggest that, in addition to €700 million of workers' remittances and pension receipts from abroad, the economy attracted €1.2 billion in other private inflows during the past 3 years (equivalent to 65 percent of GDP in 2003).

[6]The authorities have recently adopted an anti–money laundering law to start addressing this problem. Better border controls and measures to curb cigarette smuggling will also help.

[7]No data are available on Kosovo's competitiveness in terms of unit labor costs. Anecdotal evidence suggests that unit labor costs are relatively high due to particularly low labor productivity. Evidence of wages above marginal productivity abounds in loss-making POEs where sales receipts barely cover wages and intermediate input.

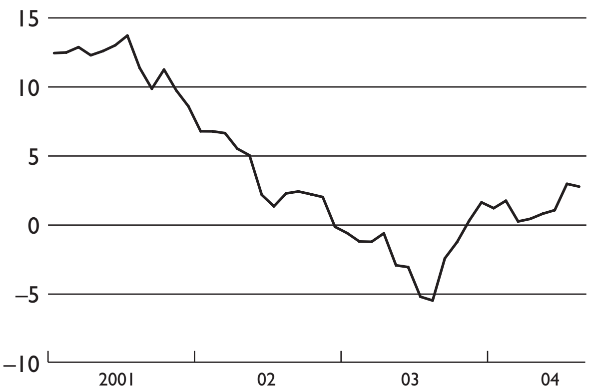
[8]Serbia and Montenegro and Turkey account, respectively, for 16 percent and 9½ percent of Kosovo's trade.

Table II.2
Balance of Payments, 2001–03
(In millions of euros, unless otherwise indicated)

	2001	2002	2003
Current account			
(after foreign assistance)	–140	–201	–284
(in percent of GDP)	–8.6	–11.6	–15.8
Change in currency in			
circulation (increase)[1]	–31	132	24
Change in banking system's	–212	–315	–48
NFA (end-of-period stock)[1]	335	649	697
Other identified capital			
transactions	20	–39	–34
Unidentified inflows	363	423	341

Source: Fund staff estimates.
[1]Adjusted to remove the impact of the one-off spike at end-2001 due to the euro cash changeover.

Figure II.5.
Consumer Price Index, 2001–04
(Year-on-year percent change)



Source: Kosovo authorities.

smaller than the effective appreciation in the euro zone, mainly because the currencies of Kosovo's main trading partners are either linked to the euro or did not depreciate vis-à-vis the euro as much as the U.S. dollar did.

Aid Dependency and Short-Term Vulnerabilities

In Kosovo, as in other postconflict regions, the parallel structures created by the international presence complicate the analysis of foreign assistance. The international structures are best seen as a separate sector. This sector, which may be called the donor sector and whose budget is financed by taxpayers in donor countries, runs a parallel structure of public spending. Part of that spending is reflected in wages to a large community of international civil servants, foreign experts, international police and judges, and foreign peacekeeping soldiers (Statistical Appendix Table 6).[9] Other public expenditures are covered by Kosovo's general budget and are financed by taxes paid by the domestic sector, namely, Kosovar households and firms.

In such a context, the overall external current account deficit overstates the extent of the underlying imbalances, as foreign assistance is, in some sense, financing more than the "true underlying" deficit of the domestic economy. First, part of the deficit reflects the cost of activities related to the nonnormalized political situation, which will be phased out eventually. Second, the cost of the activities that would not be phased out and would simply be transferred to an eventual new political structure would be much lower, given the differential between expatriates' and civil service wages.[10] Third, some of the donor spending covered one-off expenditures related to postconflict reconstruction with a heavy import content and, hence, neither reflected a "structural" deficit nor made a significant contribution to domestic output.

In these circumstances, a more appropriate measure of the true underlying macroeconomic imbalances is the current account deficit of the domestic sector only. The analytical framework presented in Box II.1 shows that this deficit is consistent not with the entire amount of foreign assistance but with its contribution to the domestic economy only. In turn, foreign assistance's contribution to the domestic economy is best seen as a "virtual export market" for Kosovar goods and services, which are in the form of local employees' hiring and purchases of domestic goods and services for consumption by the community of expatriates and peacekeeping soldiers, as well as for donor-financed projects.

Using this framework reveals that, although the consolidated current account deficit of the economy as a whole was on the order of 77 percent of GDP in 2003, the fundamentals of the economy are best captured by the underlying current account deficit of the domestic sector only, which was on the order of 50 percent of GDP (Statistical Appendix Tables 7 and 8). The difference reflects the gap between total foreign assistance, which was about 40 percent of

[9]The donor sector budget includes the budget of UNMIK and KFOR, as well as spending by the rest of the international community, under the umbrella of the so-called public investment program (PIP). PIP covers direct donor spending on reconstruction and rehabilitation projects, technical assistance and training, and capital participation in local commercial banks.

[10]Expatriates' wages are 20–25 times higher than civil service wages and explain, in part, the higher cost of the public services provided by the donor sector. Compared with a GDP per capita of €930 in 2003 and budgetary expenditures by the KGB of €280 per person—covering most areas of traditional government spending, such as education, health, and social protection—public expenditures by the donor sector amount to €380 per person. If KFOR soldiers' wages are included, public spending by the donor sector would be about €680 per person—which is equivalent to more than 70 percent per capita GDP.

Box II.1. Analytical Framework for an Analysis of Foreign Assistance in Kosovo

To analyze foreign assistance in Kosovo, it is useful to think of the Kosovo economy as consisting of three sectors: (i) the donor sector; (ii) the government (the Kosovo general government budget, or KGB); and (iii) households and firms, including socially owned enterprises (SOEs) and privately owned enterprises (POEs). Total direct spending by the donor sector can be decomposed into (i) expatriates' wages, W_{exp}; (ii) wages of local employees, W_{le}; and (iii) spending on goods and services. Let G_{UNMIK} be UNMIK's spending on goods and services, I_{PIP} be the PIP component of spending on goods and services, and G_{KFOR} be KFOR's spending on goods and services. Letting FA be total foreign assistance, we would have

$$FA = W_{exp} + W_{le} + G_{UNMIK} + I_{PIP} + G_{KFOR}.$$

Equilibrium in the goods market is given by adding the demand originating from these three sectors, plus regular exports X:

$$Y = (C_H - M_H^C) + (I_H - M_H^I) + G_g + (I_g - M_g^I) + (G_{UNMIK} - M_{UNMIK}^G) + (G_{KFOR} - M_{KFOR}^G) + (I_{PIP} - M_{PIP}) + (C_{\text{exp}} - M_{\text{exp}}^C) + X;$$

where C_H and M_H^C are private consumption and its import content, I_H and M_H^I are private investment and its import content, G_g is government's consumption, I_g and M_g^I are government investment and its import content, and M_{UNMIK}^G, M_{PIP}, M_{KFOR}^G, and M_{exp}^C are the import contents of the respective expenditure items.

Adding and subtracting $(W_{\text{exp}} + W_{le})$ to the right-hand side of the equation, the equation gives the following decomposition of GDP into the main expenditure items: private and public consumption, private and public investment, and net exports:

$$Y = C_H + (G_g + G_{UNMIK} + G_{KFOR} + W_{\text{exp}} + W_{le}) + (I_H + I_g + I_{PIP}) + NEXP_T, \text{ where}$$

$$NEXP_T = (X + C_{\text{exp}}) - ((M_H^C + M_H^I + M_g^I) + (M_{\text{exp}}^C + M_{UNMIK}^G + M_{KFOR}^G + M_{PIP}^I) + (W_{\text{exp}} + W_{le})).$$

The above equations show that the direct contribution of foreign assistance to GDP is equal to the domestic component of UNMIK's spending on goods and services, plus the domestic component of the PIP spending on goods and services (including designated donor grants), plus the domestic component of the local spending of the expatriates and KFOR.

Hence, if we call $DCFA$ the direct contribution of foreign assistance to GDP, we have

$$DCFA_{GDP} = (G_{UNMIK} - M_{UNMIK}^G) + (G_{KFOR} - M_{KFOR}^G) + (I_{PIP} - M_{PIP}^I) + (C_{\text{exp}} - M_{\text{exp}}^C),$$

and the direct contribution of foreign assistance to GNDI (gross national disposable income) is given by

$$DCFA_{GNDI} = DCFA_{GDP} + W_{le}.$$

Having defined down the budget constraints of the three sectors, it is easy to check that the financial savings of the economy is equal to the current account balance, CA, where CA is given by

$$CA = NEXP + WR + W_{le} + FA.$$

If we call $NEXP_{DS}$ the net exports of the domestic sector only, it is easy to check that

$$NEXP_{DS} = X - (M_H^C + M_H^I + M_G^I) = NEXP_T + (FA - DCFA_{GDP}).$$

GDP, and its contribution to GDP, which was on the order of 13 percent only (Statistical Appendix Table 9).

This analysis reveals that today's level of economic activity is being propped up by foreign assistance and external private inflows to the tune of 50 percent—of which 20 percentage points are from foreign assistance. Through the hiring of local employees and the purchase of local goods and services, the donor sector is creating a €380 million (20 percent of GDP) "export" market for Kosovar goods and services. Total private inflows on the order of 30 percent of GDP are helping close the remaining deficit (see Table II.3).

This situation is symptomatic of very weak underlying fundamentals: extremely low domestic savings and wide current account deficits. Excluding the net impact of the donor sector as a source of "export" earnings, the underlying domestic savings rates are largely negative, probably on the order of –30 percent of GDP—despite a substantial amount of public services provided for free by the donor sector. Also, large private inflows and the net contribution of the donor sector have allowed not only high consumption but also fairly high investment rates.

Such weak fundamentals are not a creation of the 1990s conflict but have been with the economy for many decades. Under the former Federal Republic of

TABLE II.3
Underlying Savings/Investment Balances, Domestic Sector, 2001–03
(In percent of GDP)

	2001 Est.	2002 Est.	2003 Est.
Current account balance	–60.1	–53.7	–50.4
Regular exports	1.4	1.6	2.0
Imports	61.5	55.3	52.5
Investment	25.6	24.1	22.3
Underlying domestic savings	–34.6	–29.6	–28.2
Current account financing	60.1	53.7	50.4
Donors' contribution to GNDI	38.2	28.2	21.2
Private inflows	22.0	25.5	29.2
Memorandum item			
Total foreign assistance	72.3	52.6	41.0
Total private inflows	35.7	38.3	32.4
Stock of net foreign asset position of the economy	24.5	38.3	41.3

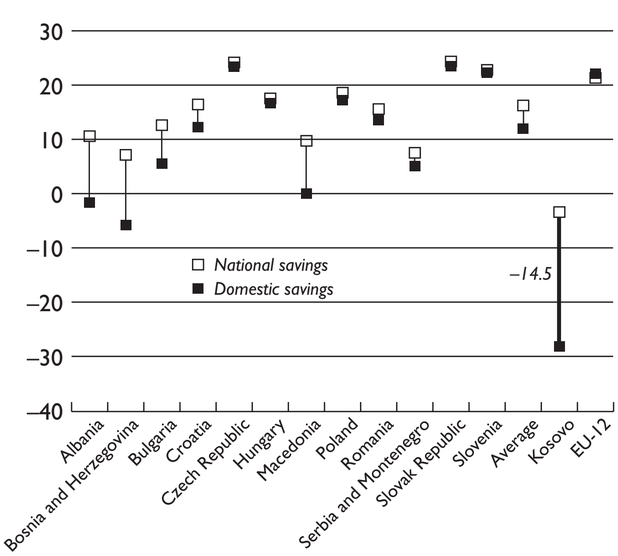
Source: Fund staff estimates.
Note: GNDI = gross national disposable income.

Yugoslavia, Kosovo used to receive sizable transfers from the Federal Fund, which was designed to provide long-term supplementary investment resources to stimulate economic development in the less developed regions. Additional current transfers helped defray some of the costs of basic social services. In 1980, total transfers amounted to 40.7 percent of Kosovo's GDP.[11]

The economy's reliance on private inflows of a largely unidentified nature and untested stability is a main source of vulnerability. While pure workers' remittances have proved to be a stable, and even a stabilizing source of external financing in other economies,[12] it is not clear how much of the private inflows in Kosovo are stable workers' remittances or a form of foreign direct investment by the Kosovar diaspora.[13] According to the official statistics,[14] the level of workers' remittances in 2003 is estimated at 13.7 percent of GDP, comparable to the highest levels in the region. Based on this estimate, the national savings rate would be largely negative and on the order of –15 percent of GDP, by far the lowest of all neighboring countries (Figure II.6). If workers' remittances were about 25 percent of GDP—which may be supported by the evidence presented in Appendix II—the national savings rate would be higher but still negative.

Further declines in foreign assistance would continue to exert contractionary pressures on the economy and weaken the fiscal outlook. The shock to output from a full phase-out of foreign assistance is measured by the balance of payments gap it would generate, which, as estimated above, is tantamount to a loss of export earnings equivalent to 20 percent of GDP. The potential gap in the budget balance reflects both a decline in tax revenues and higher spending. As explained in Chapter III, foreign assistance not only is contributing indirectly to higher tax revenues—by sustaining a higher level of economic activity—but is also contributing about 3 percentage points of GDP to tax revenues from taxes on the local spending of the donor sector. On the expen-

Figure II.6.
Domestic and National Savings in East European and Balkan Countries, 1994–2003
(In percent of GDP)[1]



Sources: IMF, *World Economic Outlook*; and staff estimates.
[1]Data for Bosnia and Herzegovina, and Serbia and Montenegro refer to 1998–2003.

[11]World Bank, "Yugoslavia: Adjustment Policies and Development Perspectives" Report No. 3954-YU, Volume II: The Main Report, 1982.
[12]During economic downturns, workers' remittances may go up as immigrants transfer larger sums of money to their relatives at home to help them through the recession.
[13]This, too, can be expected to be a stable and even increasing source of external financing, as long as the improved business climate continues to expand investment opportunities.
[14]An estimate based on the Household Budget Survey run by the Statistical Office of Kosovo (see Appendix I).

diture side, the gap will not be as large as the actual size of the spending by the donor sector because of the exceptional nature of some of the spending and the wage differential, as explained above.

A sudden reversal in private inflows or an overly rapid withdrawal of foreign assistance would lead to a painful retrenchment. The near-term outlook, even under a more benign scenario, does not look promising if further declines in foreign assistance were to compound the waning of the ongoing fiscal stimulus—as previously saved surpluses are used up. Contractionary pressures from a fall in foreign inflows will be amplified by the fixed exchange rate regime. The latter would prevent, in the short run, an adjustment of the real exchange rate that could offset some of the impact of the shock. However, use of part of the foreign assets accumulated during the past 3 years could mitigate such an adversity.

Medium-Term Growth and Employment Challenges

The most pressing problem facing Kosovo today is the absence of sustained growth and job creation, which are essential to raising living standards. Although this problem is widely recognized, little work has been done to clarify the broad outlook of a macroeconomic framework to address these challenges. The aim of this section is to fill this gap. It uses a growth-accounting methodology[15] to derive the investment requirement for a growth scenario anchored in an employment policy objective and draws implications for the financing needs and policy requirements.

Notwithstanding the severity of unemployment, it would be unrealistic for policymakers to aim at sharply reducing it. Although the seasonally unadjusted headline unemployment figure of 55 percent is likely to overstate the extent of the problem, given the size of the "gray" economy, unemployment is nonetheless rampant: it may be as high as 30 percent, with an employment rate of no more than 33 percent (Box II.2 and Statistical Appendix Table 10). However, high unemployment, like low domestic savings, is not a creation of the recent past; it has been an entrenched problem throughout Kosovo's modern history.[16] The experience of other transition economies in the fight against high unemployment shows that the task is far from easy, even if, in Kosovo, most of the labor shedding associated with the transition has already taken place. Also, a fast decline in unemployment may not be possible before labor productivity has been increased significantly. Indeed, the availability of large workers' remittances may be acting as a mechanism that sets an implicit reservation wage well above market-clearing levels.

A reasonable macroeconomic framework could possibly target an employment growth rate of some 3 percent. Achieving this policy objective, while making a modest dent in the stock of unemployment, will, it is hoped, strengthen confidence and support a virtuous circle of self-reinforcing economic growth and political stability. As shown in the illustrative scenario in Statistical Appendix Table 12, a sustained annual employment growth rate of 3 percent over the next 10 years would create about 145,000 net additional jobs and would bring unemployment down to a more manageable rate of about 25 percent (Figure II.7).[17] Other countries' experience, as reported in Statistical Appendix Table 13, which shows employment growth never exceeding 2.8 percent per annum, provides an additional reality check for the employment objective.

The second building block of the growth scenario is to gauge the minimum rate of capital accumulation needed to support the employment objective.[18] Cross country evidence shows that any growth rate of

[15]The methodology uses rough estimates of the factor income decomposition of GDP, which show a labor share in GDP of some 58 percent and a capital share of 42 percent. Assuming a capital-output ratio of 3 and a depreciation rate of 5 percent we get a net rate of return on capital of 9 percent, which indicates low capital efficiency. Capital efficiency is unlikely to be much higher, as these figures are consistent with a capital stock of €4 billion. This is already on the low side, considering that the estimated housing capital stock is on the order of €3 billion, with imputed rent estimated at €300 million (Statistical Appendix Table 11).

[16]Unemployment in Kosovo was always the highest in all the regions of the former Socialist Republic of Yugoslavia (on average, 79 job seekers for every vacancy, compared with 1.7 in Slovenia). A number of factors contributed to this poor performance, including stronger demographic pressures; poorer labor skills; a regional policy, during the 1960s and 70s, that kept regional income differentials within narrow limits—weakening incentives to migrate; and an industrialization policy that favored capital-intensive sectors, such as energy and mining. During the 1990s, discriminatory layoffs of Kosovar Albanian workers, together with reduced access to formal education, contributed to further deterioration of the situation and to a degradation of workers' skills.

[17]The scenario assumes no decline in the population growth rate (1.7 percent per annum) and a modest 0.5 percent per annum increase in the labor participation rate, as labor market prospects improve.

[18]Of course, the rate of capital accumulation will ultimately depend on the expected rate of return on new investment. Experience in other countries has shown that high growth has unequivocally been associated with high rates of return on investment and high rates of total factor productivity (TFP) improvement. These are, indeed, the main elements in the creation of attractive investment opportunities, which, when acted upon, bring about high investment and high growth.

Box II.2. Unemployment: How Big a Problem?

The headline figure for the unemployment rate, although frighteningly high, is likely to overstate the extent of the problem. According to published statistics, in 2002 only 263,000 people had a job, 321,000 people were unemployed, and the remaining 623,000 people of working age were out of the labor force. These numbers suggest a dismal labor market performance, with an employment rate less than 22 percent, a participation rate of 48 percent, and an unemployment rate at a staggering 55 percent. However, because the two labor force surveys were conducted in winter, when labor demand in agriculture and in construction is relatively weak, and because of the high degree of informality in labor relations, it is likely that the official statistics overstate the problem.

Results of the Labor Force Surveys (LFS), 2001–02

(In thousands, unless otherwise indicated)

	2001	2002
Working-age population	1,144	1,207
Employed	229	263
Unemployed	305	321
Not in the labor force	610	623
Labor force participation rate (in percent)	46.7	48.4
Unemployment rate (in percent)	**57.2**	**55.0**

Sources: Statistics Office of Kosovo LFS 2001 and LFS 2002; and Fund staff estimates.

Staff team estimates of informal employment suggest a figure on the order of 150,000 (Statistical Appendix Table 13). The methodology combines available data on households' total wage incomes and subsistence agriculture with officially recorded employment and salary data. The estimation method (i) converts employment in subsistence agriculture into full-time employment equivalents by assuming that wages in this sector are equal to 85 percent of average net wages in the budget sector, in order to reflect the presumably somewhat lower productivity; and (ii) subtracting the wage remuneration in the formal sector from the household budget survey's estimates of total wage remuneration, it derives employment in the informal nonagricultural sector as a residual using three different levels of wages, ranging from 85 percent to 115 percent of average net wages in the budget sector.

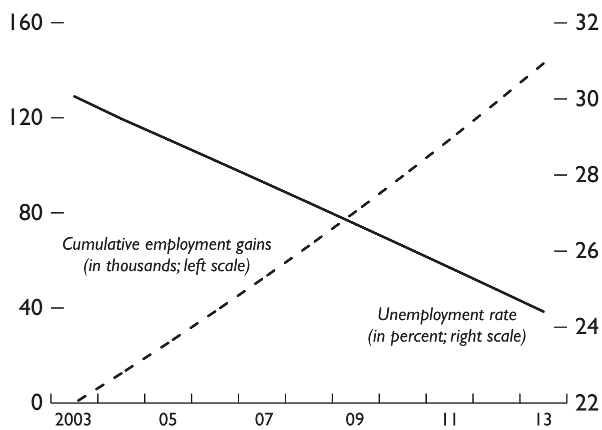
Factoring in informal employment, unemployment is still very severe. Assuming the same participation rate and the same share of active-age population as in the labor force survey of 2002 yields an unemployment rate in the range of 22–30 percent. Considering some biases are inherent in the estimation method (e.g., the fact that some of the officially employed persons are likely to work occasionally in subsistence agriculture) and in the available information on minimum acceptable salaries for unemployed persons, it would seem that the lower end of the employment range (415,000) and, consequently, the higher end of the unemployment range (30 percent) are more plausible.

Labor Force Surveys 2001 and 2002, and Illustrative Scenarios for 2003[1]

	2001 LFS	2002 LFS	2003 Scenario 1	2003 Scenario 2	2003 Scenario 3
Total population (in thousands)	1,868	1,900	1,932	1,932	1,932
Total working-age population 16–64 (in thousands)	1,144	1,207	1,227	1,227	1,227
Employed	229	263	**465**	**436**	**415**
Unemployed	305	321	129	158	179
Not in the labor force	610	623	633	633	633
Working-age population by status (in percent)					
Employed	20.0	21.8	37.9	35.6	33.8
Unemployed	26.7	26.6	10.5	12.8	14.6
Not in the labor force	53.3	51.6	51.6	51.6	51.6
Share of working-age population in total population (in percent)	61.2	63.5	63.5	63.5	63.5
Unemployment rate (in percent)	57.2	55.0	**21.7**	**26.5**	**30.1**
Participation rate (in percent)	46.7	48.4	48.4	48.4	48.4
Dependency ratio	63.3	57.5	57.5	57.5	57.5

Sources: Statistics Office of Kosovo (SOK) LFS, Dec. 2001 and Nov. 2002; SOK 2002/03 Household Budget Survey (HBS); and Fund staff estimates.
[1]Scenarios incorporate subsistence and informal employment, converted into units of full-time employment equivalents.

Figure II.7.
Medium-Term Employment Projections, 2003–13



Source: IMF staff estimates and projections.

employment has always been associated with a much higher rate of capital accumulation. Low labor costs relative to the rental cost of capital are likely to have favored more labor-intensive growth processes, but some increase in the capital-labor ratio has been the rule everywhere.[19] The baseline scenario assumes an increase in the capital-labor ratio of 1.5 percent per year. This is somewhat optimistic but still realistic if appropriate wage and sectoral policies promote labor-intensive sectors.

Achieving the employment objective could sustain growth at some 5–5½ percent but would require annual investments of 25–27 percent of GDP over the next decade (Statistical Appendix Table 14). If supportive macroeconomic and structural policies help achieve annual gains in total factor productivity (TFP) of 2 percent—a reasonable performance based on other countries' experience—growth could be sustained at 5½ percent, with labor contributing 1.6 percentage points, capital 1.8 percentage points, and TFP 2 percentage points. The increase in the stock of remunerated capital (both private capital and the capital invested in POEs and SOEs) would necessitate an investment rate of some 20 percent of GDP, assuming 5 percent depreciation. This investment rate would need to be complemented with public investment to support the assumed gains in TFP. To estimate the latter, a bottom-up approach would be required to determine the cost of remedying the deficiencies in the main public infrastructure and rebuilding the stock of human capital. Such a bottom-up approach, which is a critical underpinning for the elaboration of an appropriate fiscal strategy, has yet to be developed (see Chapter III). A tentative estimate of the necessary public investment could be in the range of 5–7 percent of GDP. Box II.3 presents a sensitivity analysis around the main parameters.

The high negative domestic savings rate is, obviously, the main financing constraint to achieving such growth, and attempting to address this issue by relying on foreign borrowing would be extremely imprudent. In the recent past, the economy was able to finance broadly similar levels of investment, thanks to foreign assistance and private inflows equivalent to 50 percent of GDP. Attempting to close any significant share of the gap through foreign borrowing would be imprudent, as it would lead to a very rapid accumulation of a large stock of external debt. This would repeat the experience of many former Soviet Union countries, which, after 10 years of heavy borrowing, are now facing severe debt-repayment problems. For the economy to continue to grow, foreign assistance needs to continue to supplement available non-debt-creating private inflows until the economy's capacity to generate its own domestic savings phases out, gradually and over time, the need for such support. Withdrawing foreign assistance prematurely and letting the economy fend for itself run the risk of deepening the unemployment problem and renewing the fraying of the social fabric.

The scenario in Statistical Appendix Table 15 illustrates the following broad parameters of a financing strategy that would maintain external solvency while supporting the needed growth:

Private savings. Increased productivity, improved competitiveness, and better access to foreign markets should allow the economy to gradually expand its production possibility frontier and increase savings. Although the speed of such a process is hard to predict, the scenario envisages an increase in domestic savings from –28 percent of GDP in 2003 to about –10 percent by 2013, reflecting an expansion of regular exports to some €600 million.[20] Such a level of

[19]The evidence presented in Statistical Appendix Table 13 shows rates of increase of the capital-labor ratio varying from 1.7 percent in sub-Saharan Africa to 6.9 percent in East Asia.

[20]Of course, the same improvement in the domestic savings rate could also reflect a decline in imports and smaller expansion of exports. But given the size of the domestic market, it is likely that, if Kosovo were to maintain an outward-oriented policy, an improvement in its current account deficit would mainly reflect export growth rather than import substitution.

Box II.3. Sensitivity Analysis of GDP Growth and Investment Requirements

A more rapid increase in the **capital-labor ratio** would lead to higher economic growth, but it would also require more investment. If the annual growth rate of the capital-labor ratio were 2 percent, rather than 1.5 percent, economic growth would be 0.3 percent points higher than in the baseline, but that condition would also require a larger additional investment of 1.4 percent of GDP.

A higher initial level of the **capital-output ratio** would imply a lower underlying rate of return on capital, and would require larger volume of investment. If the capital-output ratio in 2003 were 3.3, rather than 3 percent as in the baseline, implying a net rate of return on capital of 7.8 percent rather than 9.1 percent, additional investment of almost 2 percent of GDP would be required to achieve the same rate of economic growth, as in the baseline.

Lower **TFP** gains weaken GDP growth, and would imply higher investment in relation to GDP. If TFP gains were limited to 1 percent per year, growth would be limited to 4.5 percent and the investment-to-GDP ratio would rise to 25.2 percent.

Sensitivity of Growth and Investment Rates to Changes in Assumptions

(In percent, unless otherwise indicated)

	Baseline Scenario	Sensitivity Analysis Around Baseline		
		ΔK/L=2	K/Y=3.3	TFP=1 percent
GDP growth	5.4	5.7	5.4	4.5
Total investment in percent of GDP	24.3	25.7	26.2	25.2
Net capital share in net output	32.0	32.0	30.8	32.0
Net rate of return on capital	9.1	9.1	7.8	9.1
Assumptions				
Capital-output ratio	3.0	3.0	3.3	3.0
Change in capital-labor ratio	1.5	2.0	1.5	1.5
Contribution to growth by TFP	2.0	2.0	2.0	1.0

exports would not be unrealistic if Kosovo were able to revive its mining and power sectors—which used to generate significant foreign exchange earnings—and discover new export niches.

Private inflows. Their behavior is hard to predict, given the still largely undefined nature of these inflows. Genuine workers' remittances could be expected to remain stable, but their contribution to financing the current account deficit would decline, as their growth may not keep up with the growth of the economy, unless additional emigration is allowed. The rest of the inflows may decline, but regular foreign direct investment could replace it as structural reforms are deepened and as part of the uncertainty about Kosovo's unresolved final status is cleared up. All in all, the scenario assumes that these factors may contribute to keeping the level of private inflows broadly constant at some €550 million over the next 10 years. The economy could also use some of the assets it has accumulated in the past. This would add an extra €70 million of external financing per year.

Foreign borrowing. Borrowing needs to be consistent with the economy's capacity to service debt. Several studies suggest that, beyond a debt-to-GDP ratio of 40–50 percent, the likelihood of a debt correction rises and the impact on growth turns negative, as the deterioration in the perceived creditworthiness of the country discourages domestic and foreign investment.[21] Depending on the magnitude of the debt that Kosovo may inherit from the former Federal Republic of Yugoslavia the amount of new borrowing should be calibrated accordingly. The scenario takes the technical working assumption that the inherited debt is zero and allows a gradual buildup of debt to some 27 percent of GDP in 10 years.[22] This could provide €70 million additional financing per year. To the extent that the inherited debt is not zero, as may indeed be likely, Kosovo's financing needs

[21]See Policy Development and Review Department, *Official Financing: Recent Developments and Selected Issues* (Washington: IMF, 2003), p. 61; "Sustainability Assessments—Review of Application and Methodological Refinements," http://www.imf.org/external/np/pdr/sustain/2003/061003.pdf (Washington: IMF, 2003), p. 36; and Catherine Pattillo, Helene Poirson, and Luca Ricci, "What are the Channels Through Which External Debt Affects Growth?" IMF Working Paper, 04/15 (Washington: IMF, 2004), p. 6.

[22]Information is not available with regard to the amount of debt Kosovo may inherit. Clarification of this may need to await resolution of Kosovo's final status.

will be affected accordingly. To ensure that debt service obligations remain sustainable, new borrowing should be made at concessional terms.[23]

The above analysis shows that, although a financing gap is likely to persist over the medium term, it can be hoped that it is on a declining trend. Today's level of foreign assistance is about €750 million, of which only €380 million finances the current account deficit of the local economy. As political normalization allows a gradual move toward more traditional forms of foreign assistance, the total level of foreign assistance could converge to the level of its current net impact on the domestic economy. This would imply that the level of total foreign assistance could also decline from about €750 million today to some €280 million by 2013.

Addressing Kosovo's problems will therefore require sustained and combined efforts, such as the following, by the authorities and the donor community.

On the part of the authorities, it requires strong policies aimed at (i) an efficient and effective structure of public spending that promotes development and creates an enabling environment for productive private investment, while maintaining fiscal stability; (ii) a speedy reform of the state enterprise sector; and (iii) an acceleration of the overall pace of market reform and of the establishment of the rule of law. Achieving these goals will help achieve strong total factor productivity, a high rate of return on investment, and high growth—which, in turn, will expand the economy's production possibility frontier and strengthen its fundamentals. Together with policies targeted at raising labor productivity, ensuring a better skill match, lowering labor cost, and maintaining labor market flexibility, these reforms will encourage and promote a labor-rich growth.

As for the donors, their continued involvement could support the authorities' policies until the economy's fundamentals strengthen and governance and market institutions reach maturity. Given the emergence of donor fatigue, it is important to reinvigorate the virtuous circle through which foreign assistance supports good policies and good policies provide a basis for continued donor support. To do so, clarity about policies and financing needs will be essential, albeit difficult—a task partially attempted in this chapter. To increase foreign assistance's contribution to the domestic economy and improve its developmental impact, a growing share should be channeled through the budget. This will allow foreign assistance to play a greater role in boosting growth and will reinforce both ownership and transparency.

[23]In the baseline scenario, the debt stock of 27 percent of GDP by 2013 represents 135 percent of exports.

III

Fiscal Strategy, and Tax and Expenditure Systems

Kosovo has made strides in building capacity and institutions for autonomous fiscal management; at the same time, an excellent tax performance has laid a strong fiscal foundation, offering a unique opportunity for fiscal policy to address Kosovo's significant developmental challenges. However, in the context of plentiful resources and weak capacity for expenditure management, the absence of a fiscal strategy could set fiscal policy on a wasteful and unsustainable course. Lack of proper assessment of the main fiscal risks—in the presence of large government assets—raises the risk of creating unsustainable entitlements. Fiscal risks are significant as a result of uncertainties about the main parameters of fiscal solvency. Weak capacity and institutions for expenditure management increase the likelihood of significant inefficiencies.

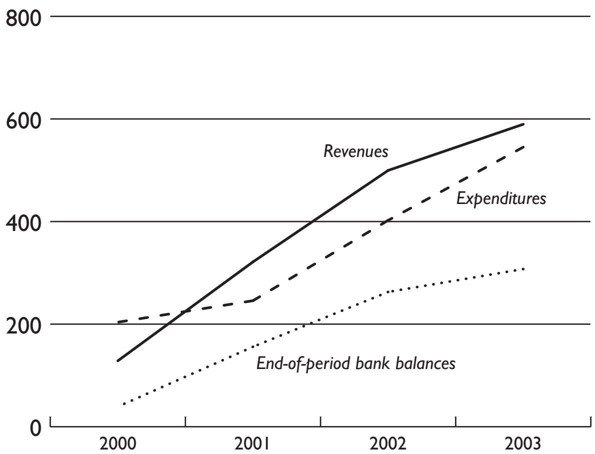
The Main Issue: The Need for a Fiscal Strategy

Under the impetus of fast-rising tax revenues, the Kosovo General Budget (KGB) nearly tripled in 3 years and now covers most public services and all social transfers. From a large deficit, the budget swung into a sizable surplus in 2001, and a continued surge in tax revenues in 2002–03 kept the budget balance solidly positive. By 2003, the budget surplus had reached 2½ percent of GDP, with an underlying current surplus equivalent to nearly 8 percent of GDP, and government assets had reached an amount equivalent to 17 percent of GDP (see Figure III.1, and Statistical Appendix Tables 16–17). A basic Organic Budget Law, promulgated in mid-2003, transferred responsibility for budget preparation and execution to the Ministry of Finance and Economy (MFE), although the Special Representative of the Secretary-General (SRSG) retains the final authority "to set the financial and policy parameters for, and to approve" the budget.[1]

Budgeting on a commitment basis, which served Kosovo well initially, is the main reason for the lack of progress in elaborating a fiscal strategy. Right after the end of the conflict, annual balanced budgets were built on extremely conservative revenue projections, and, to guard against the risk of making unsustainable long-term commitments, the full amount of multiyear projects were appropriated up front. In the event, revenue performance was far better than expected, and the weak administrative capacity put a constraint on actual spending. The confluence of the two practices, together with multiple and protracted budget reviews, led to large unused appropriations, which were liberally carried from one budget cycle to the next. After 4 years of such practice, the buildup of carryforward commitments has reached staggering proportions. While a nearly balanced budget was adopted at the beginning of 2004, the reappropriation of carryforward commitments resulted in total appropriations that are consistent with a deficit of 16 percent of GDP (see Table III.1). This situation has undermined the central role of the annual budget, hindered longer-term planning, and created so much opacity that it is virtually impossible for legislators and policymakers to discern fiscal policy intentions in the existing appropriations.

[1]UNMIK/REG/2001/9 On a Constitutional Framework for Provisional Self-Government in Kosovo, May 15, 2001.

Figure III.1.
Consolidated General Government: Revenues, Expenditures, and Cash Balances, 2000–03
(In millions of euros)



Source: Kosovo authorities.

TABLE III.1
General Budget: Cash and Commitments, 2003–04
(In percent of GDP)

	2003 Cash	2004 Initial Budget	2004 Budget, Incl. Carryforwards[1]
Revenues	32.8	32.7	32.7
Expenditures	30.3	33.4	47.9
Balance	2.5	–0.7	–15.2

Sources: Kosovo authorities; and Fund staff estimates.
[1]Budget as of end-June 2004, including reappropriated commitments carried forward from 2003 and other augmentations to the initial budget.

Lack of progress in elaborating a fiscal strategy is also in part due to the unhealthy competition between "reserved-power" and "transferred-power" agencies. The Constitutional Framework adopted in 2001 transferred to the PISG most government functions except a few related to security and sovereignty,[2] which are referred to as "reserved powers." These functions account for one-third of the total 2004 budget and close to one-half of the central government's budget (Statistical Appendix Table 18). In a situation where not all budget organizations are under the remit of a single body, competition among budget entities has not helped consensus building on priorities. In particular, the delegation of POEs' supervision to a reserved-power agency has not given the PISG adequate incentive to provide the strong political backing necessary for a successful restructuring of loss-making POEs. Unaddressed losses, in turn, have left the SRSG little choice but to unilaterally appropriate resources to cover them.

Important steps are being taken in the context of the 2004 midyear review and the preparation of the 2005 budget to move to a system of budgeting on a cash basis (by lowering appropriations to the level of expected annual cash expenditures). First, the MFE has announced the elimination of the carryover principle, effective January 2005. Second, amendments to the procurement law[3] no longer mandate that the full cost of multiyear projects be committed up front. Third, the MFE is putting greater emphasis on building its own capacity and that of line ministries for cash-flow forecasts and long-term planning. Another welcome development is the simplification of the 2005 budget circular to be more in line with current capacity.

Within the existing political setup, a solution to the split in the budget between reserved- and transferred-power agencies has yet to be found. Meanwhile, improving the working relationship between the MFE and the reserved-power agencies will allow the policy-formulating institutions—the Budget Commission, the PISG, the Economic and Fiscal Council, and the SRSG—to concentrate on strategic budget decisions. To avoid situations in which the SRSG is compelled to appropriate resources against the PISG's will, the PISG and UNMIK need to reach a common understanding on economic priorities and on how these should be reflected in budget allocations.

It is hoped that reform of the budget process will enable a debate about an appropriate fiscal strategy.[4] Consensus should be built on the principle that the

[2]Specifically, foreign affairs, law and order, the judiciary, the protection of minorities, and the administration of publicly and socially owned property.

[3]UNMIK/REG/2004/3 On the Promulgation of the Law on Public Procurement in Kosovo, adopted by the Assembly of Kosovo (Law No. 2003/17), February 9, 2004.

[4]The outline of a medium-term fiscal scenario prepared by the MFE as part of the 2005 budget process is a welcome step.

TABLE III.2
Gross Enrollment Rates, 2003
(In thousands, unless otherwise specified)

	Preschool and Preprimary	Primary School	Secondary School	Tertiary School
Between the ages of:	3–5	6–14	15–17	18–21
Number of children in respective age groups[1]				
Data source one	119.6	385.3	132.5	161.4
Data source two	121.9	379.2	121.9	149.4
Number of children enrolled	21.7	296.9	99.9	25.1
Gross enrollment rate				
Data source one	**18.1**	**77.1**	**75.4**	**15.6**
Data source two	**17.8**	**78.3**	**82.0**	**16.8**

Sources: Ministry of Education and Ministry of Finance; and Fund staff estimates.
[1]Unpublished population statistics.

long-term fiscal objective is sustainable, efficient, and effective public spending, financed by equitable and efficient taxes. In the pursuit of this long-term objective, the fiscal strategy in the short to medium term should be based on two pillars:

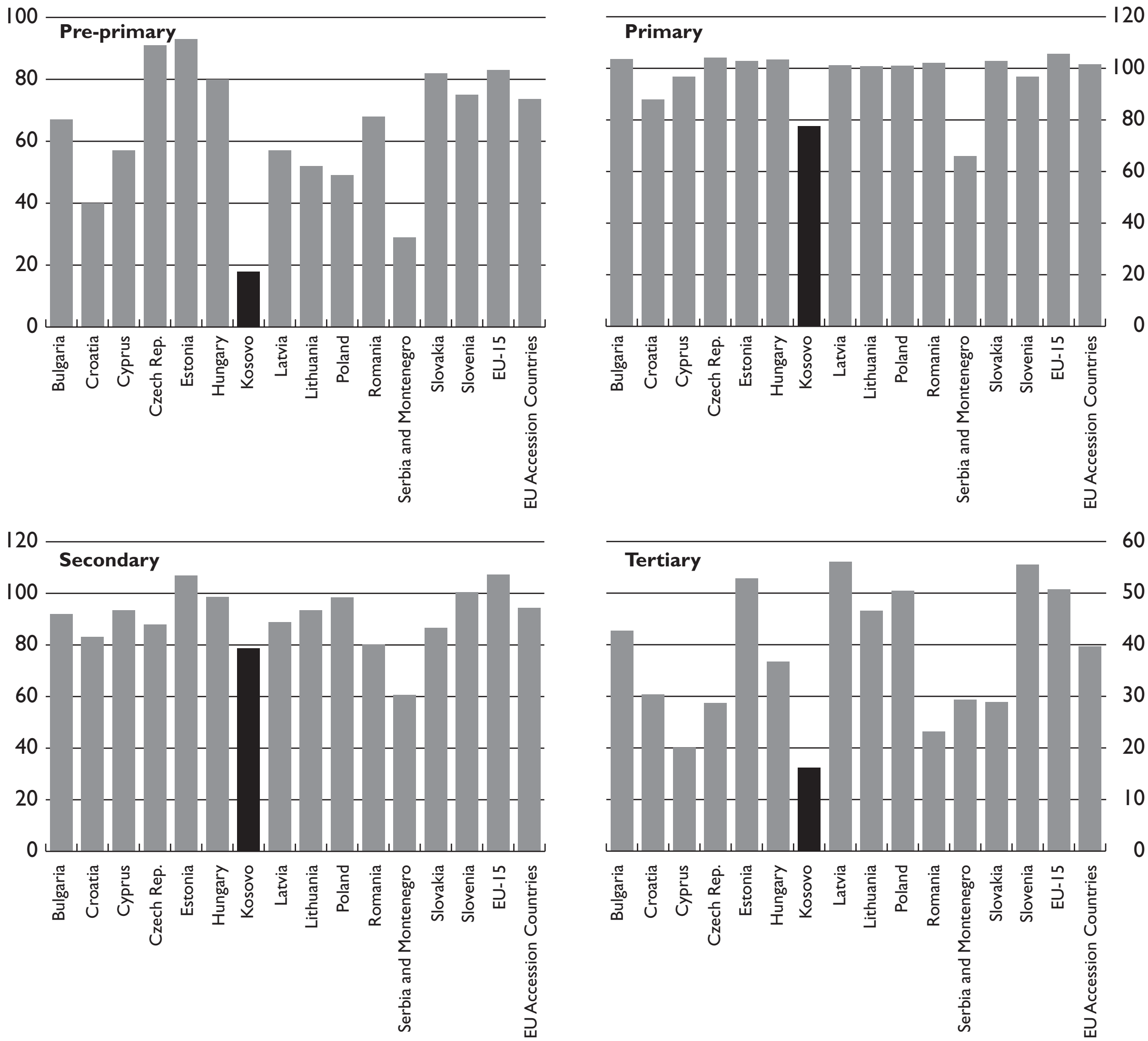
1. Reining in the expansion of current spending to prevent waste, preserve a comfortable current budget surplus to help finance public investment, and ensure long-term sustainability. Given the weakness in expenditure management capacity, a more guarded expansion is warranted to ensure value for money and allow the budgetary process to be informed by evolving policy analysis and strategic planning. Also, a prudent expansion is needed to ensure that the increase in public spending will, ex post, be consistent with medium-term fiscal solvency, thereby avoiding policy reversals. For the time being, the main parameters of fiscal solvency remain in doubt, owing to uncertainties about the growth potential of the tax base, the cost of additional government functions to be transferred to the PISG and of needed public investment, the level of an eventual inherited debt, and the level of foreign assistance.
2. Stepping up work on medium-term strategies for the key sectors and on a well-prioritized public investment program, with the aim of reprioritizing and increasing spending on human and physical capital. As the ability to implement investment projects improves, a level of capital expenditures higher than the current surplus should be encouraged, as long as it is consistent with a sustainable financing strategy—making prudent use of accumulated government assets and eventual borrowing, and taking into account the likely paths of foreign grants and donor-financed investment, as well as overall macroeconomic conditions.

Accordingly, the main anchor of the medium-term fiscal framework should be rolling 3-year growth rates for current expenditures, while the level of capital expenditures and, hence, the overall budget balance should be consistent with a sustainable financing strategy for a well-prioritized public investment.

The sectoral strategy for education is the most critical: unless the government gives a much higher priority to rebuilding the depleted stock of human capital, a powerful development lever will be forgone. Education achievements are very low both in quantity and quality. In the absence of reliable population statistics,[5] gross enrollment rates are uncertain. However, on the basis of available information, the staff team is concerned that Kosovo may be falling short of the basic goal of universal primary education, while access to preschool and higher education is limited. The rate of enrollment in preschool is less than 20 percent compared with a European average of 80 percent; the rate of enrollment in primary and secondary schools may be less than 80 percent, and the rate of enrollment in tertiary education is about 16 percent, compared with a European average of 45 percent (see Table III.2 and Figure III.2). With

[5]Population statistics are very weak and undermine the quality of the entire statistical infrastructure, as no reliable population census has been undertaken since 1981.

Figure III.2.
Kosovo and Selected Economies: Education, Gross Enrollment Rates, 1999/2000



Sources: United Nations Educational Scientific and Cultural Organizations (UNESCO); and IMF staff estimates.

Table III.3
Consolidated Government Budget, Illustrative Scenario, 2002–06

	2002 Actual	2003 Actual	2004 Budget	Illustrative Scenario 2004	2005	2006
			(In millions of euros)			
Revenues	500	590	619	605	616	629
Current expenditures	360	449	634	534	542	546
Current balance	139	141	–15	70	75	82
Capital expenditures	42	96	274	115	150	164
Overall balance	97	45	–289	–45	–75	–81
			(In percent of GDP)			
Revenues	28.8	32.8	32.7	31.9	30.8	30.6
Current expenditures	20.8	25.0	33.5	28.2	27.1	26.6
Current balance	**8.0**	**7.8**	**–0.8**	**3.7**	**3.7**	**4.0**
Capital expenditures	2.4	5.4	14.5	6.1	7.5	8.0
Overall balance	5.6	2.5	–15.2	–2.4	–3.8	–4.0
Memorandum items (In millions of euros):						
Government's bank balances	263	307	19	263	187	106
GDP	1,735	1,797	1,895	1,895	1,999	2,054

Sources: Kosovo authorities; and Fund staff estimates.

most schools operating two to three shifts a day, the quality of education is also likely to be very poor. The share of spending on education in total budgetary expenditures is relatively small and declining;[6] taking into account the spending made by the donor sector, the share of education in total public spending was only about 6½ percent in 2003 (Statistical Appendix Table 19).

A medium-term fiscal scenario in line with the proposed fiscal strategy and consistent with the medium-term growth scenario elaborated in Chapter II is shown in Table III.3. At this stage, the scenario is only illustrative, as its development should be based on the medium-term strategies for the key sectors and the costing of related investment needs. In 2005, the proposed pay-scale reform (see below) plus the full 1-year impact of the new disability pension raise the wage bill and cost of social programs by 15 and 13 percent respectively—assuming a hiring freeze and a leveling off of the number of old-age pensioners. A 2 percent cut in spending on goods and services—to claw back some of their recent excessive increase—plus a 20 percent cut in transfers to POEs should help contain the nominal growth rate of current spending in 2005 at about 1½ percent.[7] This should offset most of the revenue losses from the tariff reform (see Table III.3) and maintain the current budget surplus at about 3½ percent of GDP. In 2006, further cuts in subsidies to POEs could raise the current surplus to a level close to 4 percent of GDP. Combined with some drawdown of government assets, these measures would allow significant volumes of investment to be financed from Kosovo's own budgetary resources. By end-2006, the government's bank balances would have declined to slightly over €100 million, close to the level that should be retained as a cushion for liquidity and risk management.

Assessment of the Performance of the Tax System

Kosovo has been remarkably successful in rebuilding its tax system, surpassing initial expectations. The performance of the new tax system is perhaps the single most positive feature in all economic developments since the end of the conflict. Initial revenue projections envisaged a gradual increase to about 14 percent of GDP by 2006. In the projections, the tax-to-GDP ratio reached 29 percent in 2003, with tax revenues of €520 million, more than doubling the initial projections (see Table III.4).

Higher tax rates, larger tax bases, and better enforcement contributed about equally to this overperformance. First, the main excise tax rates were

[6]It fell from 17.3 percent in 2002 to 15.5 percent in 2003.

[7]Sustainable reductions in transfers to POEs require credible restructuring (see Chapter V). Related to this, the large quasi-fiscal activities of the POEs underscore the need for closer monitoring of a broader definition of the nonfinancial public sector.

Table III.4
Tax Revenues in 2003: Projections in 2000 and Actual Realization
(In millions of euros, unless otherwise indicated)

	Initial Projections in 2000[1]	Actual	Difference (in Percent Total Difference)
Total	250	521	100
VAT	123	219	35
Excises	69	171	38
Customs duty	38	72	13
Income taxes[2]	18	64	17
Other[3]	2	–5	–3

Sources: Kosovo authorities; and Fund staff estimates.
[1]Fund staff projections prepared in 2000.
[2]Wage, profit, and presumptive taxes.
[3]Other taxes, tax refunds, and adjustments.

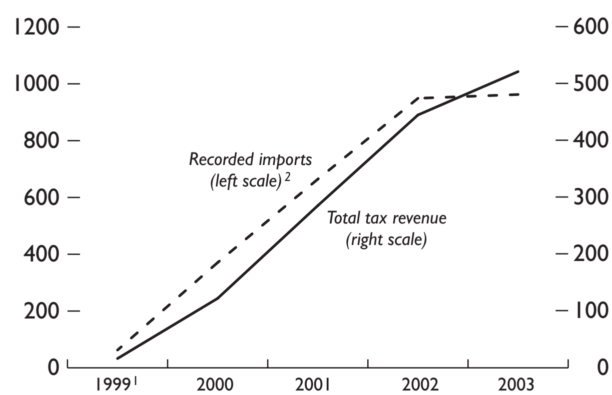
higher than initially envisaged, in particular those on petroleum products, which are 45–80 percent higher than envisaged, and on cigarettes, which are five times higher. Second, the base of the value-added tax (VAT), excises, and customs duties turned out to be larger, as domestic absorption as a share of GDP was larger. Also, corporate taxes yielded significant revenues against the initial expectation that years of disinvestment would depress business profits. Lastly, better tax enforcement and compliance—helped by the greater number of border crossing points, antismuggling units, and patrolling KFOR units, and the larger and more experienced staff for local tax administration—explain the remaining overperformance.

A coherent strategy is to be credited for this success. The strategy called for relying initially on border taxes and for broadening the tax base in phases as the economy stabilized and as institutional capabilities increased. The system was to remain simple and transparent and was to rely on relatively low nominal tax rates and few exemptions. The system was jump-started in August 1999 by the introduction of customs duties, sales tax, and excises on imports. In quick succession during 2000, excise taxes were extended to local production, and a hotel, food, and beverage tax was introduced, followed by a presumptive tax on businesses. Moving quickly to adopt the standard broad-based taxes on personal income and business profits, and on consumption, the authorities changed the sales tax on imported goods into a full-fledged consumption-based VAT in July 2001. In March 2002, wage withholding and profit taxes were introduced, completing the basic architecture of the system. Effective June 7, 2004, the 10 percent uniform import tariff was lowered to zero for selected capital goods, raw materials, and intermediate goods. Finally, effective September 2004, the VAT law was amended to zero-rate irrigation water and certain agricultural inputs (Appendix III presents an overview of Kosovo's tax system).

Consistent implementation of this tax strategy led to sharp increases in revenue collections. The rapid growth in recorded imports—reflecting a sharp improvement in border controls—has been the main factor underpinning the steep increase in tax revenues during 2001–02 (Figure III.3). Increases in excise rates sustained further growth in tax revenues, even as recorded imports leveled off. The phasing in of domestic taxes boosted revenue growth further, with the total share of domestic tax revenues increasing from 5 percent in 2000 to 18 percent by 2003 (see Table III.5).

Kosovo's tax-to-GDP ratio is high compared with other low-income economies, and its tax structure is sound (Statistical Appendix Table 20 and Figures III.4a and III.4b). At 29 percent of GDP, tax revenues, excluding social security contributions and

Figure III.3.
Tax Revenue and Recorded Imports, 1999–2003
(In millions of euros)



Source: Kosovo authorities.
[1]September–December 1999.
[2]Taxable commercial imports.

Table III.5
Sources of Growth in Tax Revenues, 2001–03[1]
(In percent)

	2001	2002	2003
Total tax revenue, annual percentage change	134	56	17
Contribution of:			
Border taxes	106	43	14
Impact of higher recorded imports	75	37	1
Impact of increases in tax rates[2]	31	6	12
Domestic taxes	29	12	6
Direct taxes	19	7	3
Indirect taxes	10	5	3

Sources: Kosovo authorities; and Fund staff estimates.
[1]Central government tax revenues; figures may not add up because of rounding.
[2]Impact of higher excise rates, including cascading impact on VAT.

payroll taxes,[8] are comparable to those in the EU-15 countries. Kosovo's greater reliance on expenditure-based taxes is mainly due to the low yield of personal income taxes, as a large share of wages fall below the equity-based exemption threshold.[9] The share of corporate taxes (i.e., profit and presumptive taxes) in total revenues is well in line with corresponding ratios in other transition economies or even in more developed countries. At 14 percent, the share of import duties is in line with that in other transition economies (Statistical Appendix Table 20).

Close to 80 percent of taxes are collected at the border, and this is often mistakenly attributed to an inefficient domestic tax administration or an excessive tax burden on international trade. In fact, this is mainly reflective of two factors: (i) the high imports relative to domestic consumption explains most of the large share of gross border VAT in total VAT collection,[10] and (ii) traditional excisable products, such as petroleum products, alcoholic beverages, and cigarettes, are produced in limited quantities, if at all. Only 17 percent of border taxes are genuine taxes on imported goods, but this is in line with the experience in other economies at a similar stage of development.

The revenue performance is all the more remarkable considering the relatively low tax rates (Statistical Appendix Table 21). Kosovo's VAT rate is the lowest in the region, and individual income tax rates are among the lowest. The average customs tariff compares well with other transition economies, with the maximum lower than in any comparator economy. The main excise rates are also in line with rates in the region.[11] Finally, employees' and employers' social security contributions are low, minimizing distortions in the labor market.

An otherwise sound policy has nonetheless had some shortcomings. First, the long delay in finding a solution to the adverse impact of the high customs duty on capital and intermediate goods is likely to have hurt export competitiveness and growth. Second, wage tax exemptions enjoyed by local UNMIK employees and local employees of the specialized agencies of the UN continue to distort the tax system and, probably, the labor market. The exemptions cause significant revenue losses (estimated to be in excess of €5 million annually) and post-tax wages that may divert labor resources to less productive uses. The exemptions are also inconsistent with international standards and may encourage other wage earners to evade the tax. Third, problems in the VAT refund system have imposed an extra burden on production and exports.

The strong revenue performance raises an obvious question: Is this too good to be true? To some extent, yes, as the overperformance reflects, paradoxically, the economy's structural weaknesses and the peculiarities of foreign assistance. First, as explained in Chapter II, Kosovo's level of economic activity is supported to the tune of 20 percent by foreign assistance. This, in turn, not only provides a commensurate indirect support to the tax base, but also directly contributes some 3 percentage points of GDP to tax revenues in the form of taxes on the implicit "exports" associated with the donor sector (Chapter II). As illustrated in Statistical Appendix Table 22, about €55 million, or more than 10 percent of total tax

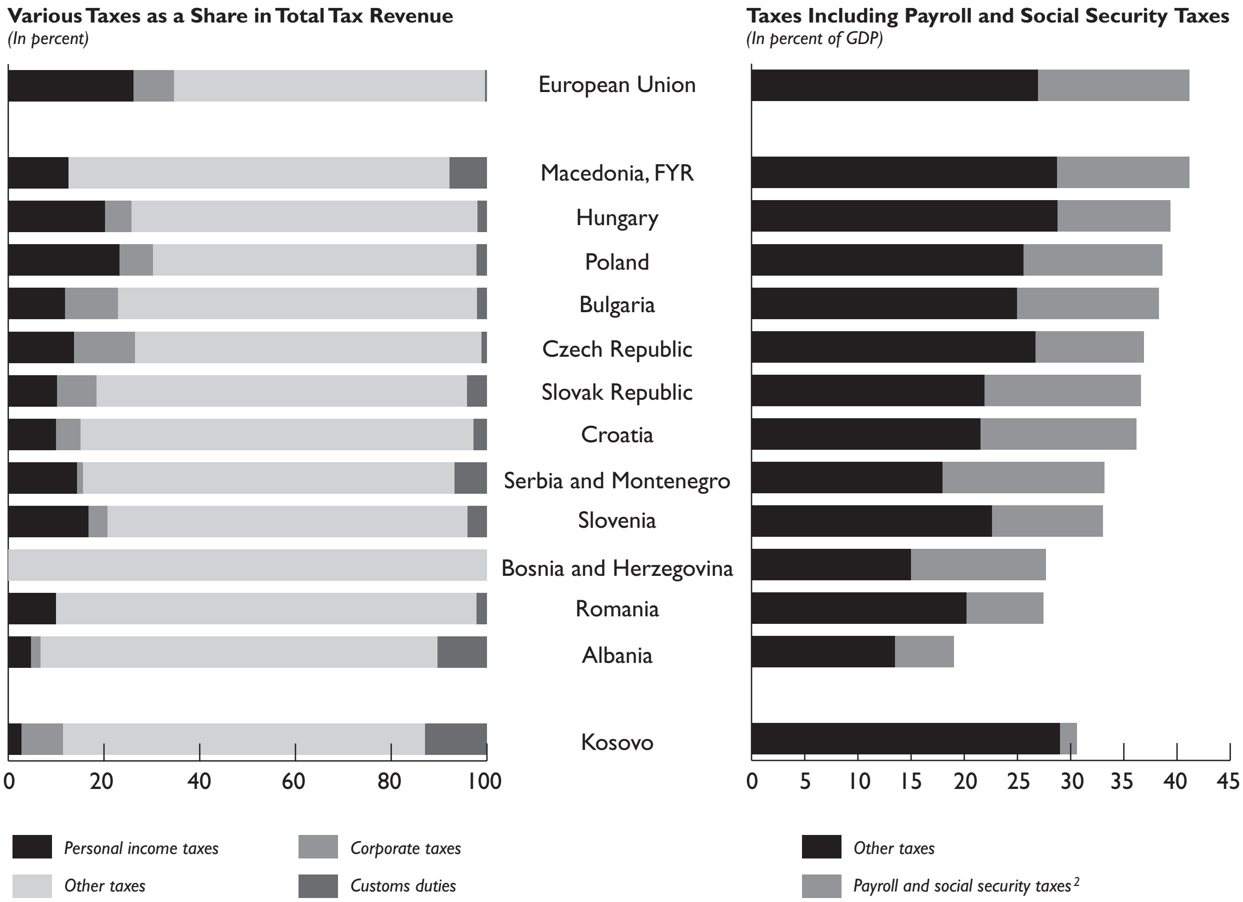
[8]As explained in the following section, the second pillar of Kosovo's pension system, the mandatory individual savings pensions, is funded by mandatory contributions from employees and employers. These pensions are fully funded, defined-contribution pensions. The basic old-age pension scheme is financed from general budget resources.

[9]Because of Kosovo's low wages, high unemployment, and the large role of subsistence agriculture, the potential base for wage taxes is relatively small.

[10]In a small, open economy where both exports and imports are very high, and where the bulk of taxation falls on consumption, one should expect most of the taxes to be collected at the border, reflecting the large share of imports in total consumption.

[11]For tobacco products, excises were actually much lower until recently, when, to discourage outward smuggling, the rates were increased to bring them more in line with the excise rates in neighboring countries.

Figure III.4.
Kosovo and Selected Economies: Taxes, 2002[1]



Sources: IMF, country desk data; and staff estimates.
[1]Data for Kosovo refer to 2003, EU 2001, and Poland 2000.
[2]For Kosovo, this consists of mandatory contributions to the fully funded "Second Pillar" pension scheme.

revenues, is attributed to the local consumption of the large community of expatriates, the KFOR soldiers, and donors' local employees. Second, the level of economic activity is supported to the tune of 30 percent by large private inflows. These help support an unusually high level of domestic absorption compared with GDP. As illustrated in Statistical Appendix Table 23, a decrease in domestic absorption of 15 percent of GDP, which might correspond to a more steady-state level of these private inflows, would lower expenditure-based tax revenues by about 3 percent of GDP, on top of the indirect impact already being exerted by lower economic activity.

Kosovo's tax base is, therefore, as vulnerable as the rest of the economy to its structural weaknesses. Smaller private inflows or lower levels of foreign assistance, if not offset by endogenous growth, will lead to a loss of revenues, which would be further compounded by the induced economic contraction. Additional risks to tax revenues may arise from political pressures to lower rates or grant exemptions, and from a phasing out of the peacekeeping forces' mission, whose presence is contributing to good tax compliance at the border.

Further development of the tax system should be guided by the need to ensure cost-effectiveness to avoid the risk of poor implementation adversely affecting tax compliance. Although there remains further scope for widening the tax base, the authorities should pay close attention to cost-effectiveness. To ensure that further changes to Kosovo's tax system will yield lasting benefits in an environment in which donor-supported technical assistance is diminishing, Kosovo's authorities should further strengthen the capacities of tax and customs administrations to nurture a culture of tax compliance. Overly frequent changes in the tax environment increase both the burden on tax administration and compliance costs to taxpayers.

Expenditure Policy

Expenditure policy so far has been aimed to ensure a minimum coverage of basic public services, and the budget is still at a formative stage. This section discusses the main trends in budgetary expenditures on the civil service wage bill, social transfers, and subsidies and transfers.

Civil Service Wage Bill

The civil service wage bill has increased rapidly over the past 3 years and is expected to reach €175 million in 2004, 60 percent higher than in 2001. This situation reflects both a rapid expansion in hiring and generous wage increases (see Table III.6). Over the past 3 years, close to 15,000 new civil servants have been hired; meanwhile, wages for two-thirds of the civil service were raised by 20 percent in mid-2003, followed by a 33 percent increase in the minimum civil service salary in early 2004.

These developments raise concerns about the fiscal sustainability and efficiency of the wage bill. Indeed, a number of indicators suggest that the scope for further expansion of the civil service wage bill is being exhausted very rapidly, at a time when the budget has yet to assume additional responsibilities—as UNMIK's activities are being phased out—and additional costs will be incurred through the soon-to-be-implemented pay-scale reform. The wage bill currently absorbs about 9½ percent of GDP, a level higher than in most comparator countries (see Table III.7). As a share of government revenues, the wage bill is already almost 30 percent, which is higher than in most other countries (the average in the EU countries is 23 percent). Also, the ratio of the wage bill to total general government spending is higher than in any of the comparator countries; this may be indicative of inefficiencies, although a more detailed assessment of the current input mix in each sector is needed for a proper assessment of overall effectiveness.

The growing size of the civil service relative to private sector employment leaves very little room for additional hiring to cover new areas of responsibility. Although the size of the civil service is not particularly

Table III.6.
Civil Service Employment and Wage Bill, 2001–04[1]
(Excluding salaries paid from designated donor grants)

	2001 Actual	2002 Actual	2003 Actual	2004 Budget[1]
General government wage bill[2]				
In millions of euros	110	131	146	176
Annual percentage change	19	20	11	21
Number of general government employees (avg.)	59,367	63,139	67,452	74,095
Annual percentage change		6	7	10
Average monthly gross wages (in euros)[2,3]	154	173	180	197
Annual percentage change		13	4	10

Sources: Kosovo authorities; and Fund staff estimates.
[1]Assuming constant hiring speed during the year; excluding staff to be temporarily employed during elections.
[2]Including employers' and employees' pension contributions, from August 2002 onward.
[3]The wage bill divided by the average number of employees.

Table III.7
Selected Transition Economies: General Government Wage Bill, 2002
(In percent)

	Wage Bill as a Share of GDP	Wage Bill as a Share of Total Spending	Wage Bill as a Share of Goods & Services	Wage Bill as a Share of Revenue
Kosovo 2003	8.1	26.7	83.9	24.7
Kosovo 2004[1]	9.5	28.0	90.3	29.3
Albania	6.2	21.3	204.4	28.1
Bosnia and Herzegovina	. . .	. . .	. . .	
Bulgaria	4.1	11.8	62.1	11.6
Croatia	11.0	21.9	111.2	24.3
Czech Republic	8.5	18.1	92.9	21.7
Hungary	12.0	22.3	178.6	27.9
Macedonia, FYR	7.8	19.3	123.8	22.5
Poland	11.3	26.2	223.5	30.6
Romania	4.9	15.1	68.6	16.4
Serbia and Montenegro	10.4	22.1	129.9	24.3
Slovak Republic	7.6	17.5	158.6	20.4
Slovenia	9.8	23.0	123.3	25.2
Euro area	10.6	21.8	2.2	23.0
EU	10.3	21.7	251.2	22.6

Sources: Kosovo authorities; IMF, Country desk data; and Fund staff estimates.
[1]Assuming constant hiring speed during the year so that the 2004 budget's head-count ceiling is reached at the end of the year.

high in terms of percent of total population (only 3.6 civil servants for each 100 citizens, see Table III.8), its shares in total employment (about 17 percent) and in formal employment (more than 40 percent) raise concerns about fiscal sustainability. Hence, the need to cover new areas should be met by redeploying civil servants within and across various sectors, supported by appropriate training.

The proposed new pay and grading system would address several of the problems plaguing the current system; preparatory work should be stepped up to allow its uniform implementation as early as possible. If implemented, the new system would provide equal pay for equal work through a consistent approach to job grading and consistent rules for increasing individual pay. It would also provide a clear basis for promotions and allow recognition of the value of increased experience and performance at each job level. Moreover, it would monetize most allowances, allowing rationalization and greater transparency. Furthermore, the proposed increases in the salaries in managerial categories should help the civil service attract and retain the skills it requires.[12] The new system should be phased in uniformly across all agencies as soon as all necessary preparatory work is completed, and wage increases should not be made retroactive.

The benefits of the contemplated new pay scale seem to justify the associated costs. The estimated cost of the proposed pay-scale reform amounts to 1 percent of GDP, which would raise the wage bill to

Table III.8
General Government Employment, 1990s[1]

	In Percent of Population	In Percent of Employment
Africa	2.0	6.7
Asia	2.6	6.3
Eastern Europe and former USSR	6.9	16.0
Latin America and Caribbean	3.0	8.9
Middle East and North Africa	3.9	17.5
OECD	7.7	17.2
Overall	4.7	11.0
Kosovo[2]	**3.6**	**17.0**

Sources: World Bank, *An International Survey of Government Employment and Wages, 1997;* and Fund staff estimates.
[1]Kosovo data is based on 2003 estimates; for all other countries, data are from the early 1990s.
[2]It is assumed that total employment in Kosovo, including informal sector and subsistence agriculture, is about 415,000.

[12]Wage dispersion, that is, the ratio of the highest and lowest grades in the pay structure, would increase from 4.8 to 6.8.

Box III.1. Pensions and Social Protection in Kosovo

The new postconflict pension system, whose basic law was promulgated in December 2001, consists of three pillars.

Pillar I is a basic old-age pension financed from general government revenues. It offers all habitual residents of Kosovo 65 years and older a flat pension whose level is tied to the price of a basic food basket. Since its introduction in mid-2002, the level has been raised to €40 per month from €28 initially.

Pillar II is a mandatory, fully funded, defined-contribution pension scheme financed by monthly payroll contributions by both employees and employers, each of which contribute 5 percent of total gross wages (each of the 5 percent mandatory contributions can be increased by voluntary contributions up to 15 percent of annual salary). Funds are managed by the Kosovo Pension Savings Trust, which is under the supervision of the Banking and Payments Authority of Kosovo (BPK). Participation in this system became mandatory for large employers, including the public sector, in August 2002 and was extended to cover all employers in August 2003. Since August 2003 Pillar II pension contributions have also been collected from the self-employed.

Pillar III is a voluntary supplemental system that can be either defined-contribution or defined-benefit schemes financed by employees and employers. Contributions are transferred to private pension providers (pension funds, insurance companies, or banks) that are licensed and supervised by the BPK. Contributors are eligible to start receiving benefits when they reach 65. At the moment, there are six supplementary pension schemes; all except one are defined-benefit plans financed by the employer.

The main social assistance programs consist of the following:

Social Assistance Program. This program pays benefits to families without resources in which no one is capable of working, or expected to be available for work (category 1), and to families with at least one child under age 5 and in which members capable of working are unemployed and meet certain additional criteria (category 2). The program was introduced in 2000 and was modified in August 2003.

War Invalid Benefits. This scheme, introduced in December 2000, provides benefits for war invalids and the next of kin of those who died as a result of the armed conflict in Kosovo.

Disability Pension. This pension provides benefits for total and permanent disability until the recipient graduates to the old-age basic pension at age 65. The level of benefit is equal to the old-age pension. The law on disability pensions was promulgated in December 2003, and the payment of benefits was set to start in mid-2004.

10½ percent of GDP and to 32 percent of government revenues. These costs seem to be justified in light of the benefits of the reform discussed above; however, the gains in terms of wage dispersion are rather modest, and the competitiveness of the new wages vis-à-vis private sector wages is unclear. Nevertheless, the cost of the proposed meal allowance for all civil servants is significant and unwarranted; it would undo most of the wage decompression and raise the wage bill to close to 38 percent of government revenues. The uncertainty about future government revenues and the resiliency of the economy to an eventual withdrawal of donor assistance call for utmost prudence at this time.

Pensions and Social Assistance

Another achievement in the fiscal area has been the introduction of a well-designed social safety net, which is providing adequate minimum protection to the most vulnerable citizens (Box III.1). The new three-pillar pension system strikes the right balance among long-term fiscal sustainability, the need to provide minimum protection for today's elderly, and the need to ensure that tomorrow's elderly enjoy higher pensions, without putting undue pressure on the cost of labor today. With the recent introduction of a disability pension scheme to complement social assistance to the poor, the social safety net is now covering all those who need income support.

Although the level of benefits is necessarily modest and many more needs can be readily identified, the authorities should resist the pressure to create unsustainable entitlements. For the social safety net to remain fiscally sound, its cost—which has reached 6 percent of GDP[13]—should be stabilized by keeping benefits constant in real terms and by enforcing the eligibility criteria strictly. Pressures to create general early retirement schemes should be resisted and

[13]Assuming that the already decided policies are fully phased in.

appropriate comprehensive solutions developed to deal with labor redundancy in public sector enterprises (see Chapter V).

Subsidies to Public Enterprises

Budget transfers to POEs are necessary at present but should be phased out as soon as feasible. The lack of progress in the restructuring of POEs is reflected in the large budget subsidies to a number of loss-making POEs. The 2004 budget provides subsidies for operating losses for electric monopoly KEK, mining conglomerate TREPCA, UNMIK Railways, and POEs in the district heating, water, and waste sectors. In addition, subsidies to finance investment are provided to KEK, Trepca, and Airport.[14] In the near term, operational subsidies may, in some cases, be unavoidable. However, as part of the restructuring of POEs, operational subsidies need to be phased out. Incorporating POEs and endowing them with stable and strong corporate governance will be critical to improving their financial performance and attracting the participation of much-needed private capital.

To ensure efficiency, the use of budgetary resources by public enterprises should be made more transparent and monitored more closely. The loss-making enterprises must be subjected to hard budget constraints. Greater transparency and accountability in the use of budgetary subsidies by enterprises under the responsibility of the reserved power would not only accelerate the restructuring and lighten the fiscal burden but also improve the overall budget process by eliminating potential sources of friction between the PISG and UNMIK.

[14]Subject to status determination by the Kosovo Trust Agency (KTA), TREPCA is still identified as an SOE.

IV

Monetary Developments and the Financial Sector

A major challenge faced by Kosovo after the end of the conflict was to choose a monetary framework, reestablish a secure payment system, and rebuild its financial sector. The confiscation and freezing of foreign exchange deposits in the early 1990s, the severe episode of hyperinflation in 1993–94 (2 percent per hour at its peak), and the intensification of ethnic strife obliterated confidence in the banking system, leading to a virtual cessation of all noncash transactions. In response to the massive flight to the safety of foreign exchange cash holdings and the vanishing of the Yugoslav dinar as a medium of transaction, UNMIK legitimized the use of the deutsche mark and other foreign currencies, which, in turn, led to a rapid euroization of the economy.

To address this challenge, a three-pronged strategy was adopted early on. First, a monetary framework anchored by the use of the euro presented itself as a natural choice, given the task at hand and the initial conditions. The pervasive euroization would have been hard to reverse, and trust in a new currency would have been difficult to establish, in light of the unresolved political status. The use of the euro would help maintain macroeconomic stability, rebuild people's trust in the financial sector, and support an outward-oriented development strategy. Second, a Banking and Payments Authority (BPK) was established to foster an efficient and safe payment system and to nurture the development of a sound financial sector in a fully liberalized setting, with no restrictions on interest rates, no compulsory or directed credit, and no restrictions on the movement of capital.[1] Last, and to jump-start commercial banking, its founding nucleus was launched through active policy intervention. The very first bank was created by European development agencies,[2] in January 2000, and another one was started by an American development agency in November 2001. The latter was sold, in early 2003, to a private foreign bank. These two banks continue to dominate the banking system, with assets equal to two-thirds of total banking assets.[3]

Four years on, the strategy is producing significant payoffs. Following a bout of double-digit inflation in 2000 fueled by massive foreign inflows, inflation has decelerated sharply and is now below the euro area average. The financial sector's assets have grown steadily, from virtually zero in early 2000 to 39 percent of GDP at end-2003. The banking system, which represents over 80 percent of the sector, is profitable and appears to be healthy.[4] Banks are adequately capitalized, the quality of their assets is good, their earning indicators are strong, their liquidity is ample, and their exposure to market risk is limited (see Box IV.1).

Notwithstanding these achievements, there are widespread concerns, both in government and in the business community, that financial intermediation is

[1]In 1999, the BPK was charged with providing payments services and bank supervision. Later, its role was enhanced and expanded to include licensing, supervision, and regulation of all financial institutions (including insurance and pension funds).

[2]In late 2001, the European Bank for Reconstruction and Development and the International Finance Corporation became additional shareholders.

[3]In addition to these two foreign-owned banks, there are five mainly domestically owned commercial banks, all licensed in 2001.

[4]It should be noted that, to date, the Fund has not performed formal prudential or supervisory assessments of the Kosovar banking system. However, available data suggest that the banking system remains healthy and adequately capitalized.

Box IV.1. Financial Sector Developments and Banking System Soundness

Kosovo's financial sector has been growing rapidly over the past few years. At the end of 2003, total assets of financial institutions stood at €694 million (approximately 39 percent of GDP), up from €108 million at end-2000. The financial system includes seven commercial banks, eight insurance companies, six pension funds, and 17 microfinance institutions (Statistical Appendix Table 24). All five domestically owned banks were licensed in 2001. They have less management depth than foreign banks, but some of them also have minority foreign shareholders who have been providing technical support.

Available data suggest that the banking sector is healthy and profitable (Statistical Appendix Table 25). In particular:

Banks are adequately capitalized. The average capital adequacy ratio (ratio of capital to risk-weighted assets) was 16.6 percent in December 2003. This ratio has been declining over the past 2 years, reflecting the growing share of loans to the private sector in banks' portfolios. All banks are also complying with the minimum required amount of capital, which the BPK increased to €4 million at end-December 2003 to bring it more in line with EU directives.

The quality of banking assets is good. The ratio of nonperforming loans (NPLs) to total loans was 1.6 percent in December 2003 (down from 2.5 percent in December 2002), and aggregate provisions against loan losses were almost twice as high as the amount of reported NPLs. These data on asset quality should, however, be interpreted with caution because bank credit has recently been increasing rapidly.

Earnings indicators are strong. At the end of 2003, the average return on assets was 1.3 percent, and the return on equity was 18.7 percent. Since 2002, only one bank has been reporting net losses, which—according to the BPK—were due to rather significant start-up expenses related to information technology systems and the opening of several new branches.

Liquidity remains sufficient. Although the share of liquid assets in total banking assets has been declining in recent years, reflecting an increasing share of bank credits, it still represented 58 percent as of December 2003.

The exposure of banks to market risk is limited. The use of the euro substantially reduces the exchange rate risk, as only 1 percent of total loans and less than 3 percent of total deposits are reported to be denominated in foreign (other than euro) currencies. Interest rate risk also remains moderate, given the short length of maturities of banks' assets and liabilities.

Individual bank-by-bank data also do not raise any immediate concerns. All banks are sufficiently capitalized and liquid. Several small banks, however, report relatively high ratios of NPLs to total loans (up to 4.6 percent), and the loan loss provisions of two of these banks are also lower than their NPLs.

The regulatory and supervisory framework is adequate but remains largely untested. The legislation governing the functioning of the BPK and other Kosovar financial institutions is new. The legislation was drawn up on the basis of international best standards and practices. However, in some instances, the BPK has faced undue political pressure, undermining its operational independence.

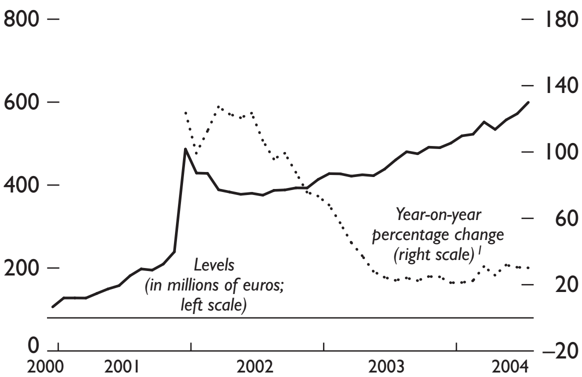
lagging. Although the banking sector has been very successful at mobilizing domestic deposits, less than half of the deposits have funded domestic credit—the rest has been invested abroad. Domestic credit is dominated by short-term trade loans. Long-term lending to the manufacturing sector is negligible. In addition, despite some recent decline, loan interest rates continue to hover around 14 percent, and spreads are still wide (about 12 percentage points). Most business surveys point to the limited access to, and high cost of, bank financing as some of the main impediments to private sector development. All in all, there are concerns that the financial sector has not provided enough support to Kosovo's development.

Following a review of monetization and financial intermediation trends since the end of the conflict, this chapter aims to contribute to an analysis of the perceived weaknesses. We analyze in turn the reasons behind (i) the relatively lagging financial deepening, (ii) the high cost of financial intermediation, and (iii) limited maturity transformation. The chapter concludes with a summary of the main findings and draws some conclusions about possible ways to enhance the role of the financial sector in Kosovo's development.

Trends in Monetization and Financial Deepening

The rapid expansion of the financial sector has been driven mainly by the impressive growth of bank deposits. Since the end of the conflict, these have increased at a brisk pace, almost surprisingly rapidly, given the history of bank failures under the former regime. Deposits grew at an average annual

Figure IV.1.
Bank Deposits, 2000–04



Sources: Banking and Payments Authority of Kosovo; and IMF staff estimates.
[1]Adjusted for euro cash changeover effect.

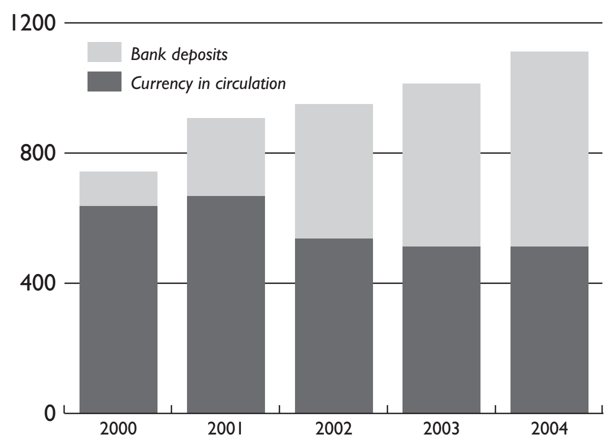
rate of 67 percent in euro terms during 2001–03 and reached a level estimated at about 32 percent of GDP (€600 million) at end-July 2004 (Figure IV.1). The growth of deposits is still running at about 30 percent year-on-year as of end-July 2004 (Statistical Appendix Table 26).

The growth of the deposit base reflected a sustained increase in the demand for broad liquidity and a dramatic shift from cash holdings to bank deposits. Broad liquidity increased steadily at an average annual rate of 10 percent per annum during 2001–03, well in excess of output growth[5] (Figure IV.2). The cash changeover to the euro and the series of measures taken to encourage the use of bank accounts played a catalytic role in the shift from cash to bank deposits.[6] Deposits more than doubled in the run-up to the cash changeover in December 2001, as cash conversion was permitted only for small amounts, and large cash holdings had to be converted into bank deposits. Despite an initial decline in deposits in early 2002, the smooth changeover—which reinforced the public's trust in banks—permanently expanded the banks' deposit base and raised the currency-to-deposit ratio. The latter, which may have been as high as 6 in 2000, is estimated to have declined to about 1.

These developments place Kosovo at a higher level of monetization than countries with similar income levels. As reflected in Figure IV.3, the regression line shows that a level of monetization that would have been in line with other low-income countries' levels would have been a ratio of Broad Money–to-GDP of about 40 percent. In fact at 56 percent, the M2-to-GDP ratio in 2003 compares favorably with the 37 percent average in transition countries and the 52 percent average in the emerging-market economies of Asia and Latin America.

Supported by the strong buildup of bank deposits, financial intermediation has progressed at a vigorous pace. Starting from close to zero at end-2000, loans had reached €328 million by end-July 2004, equivalent to 17 percent of GDP, with growth still running at 90 percent year-on-year as of end-July 2004 (Figure IV.4). Whereas initially banks were accumulating foreign assets as their deposit base was expanding,

Figure IV.2.
Broad Liquidity, 2000–04
(In millions of euros)

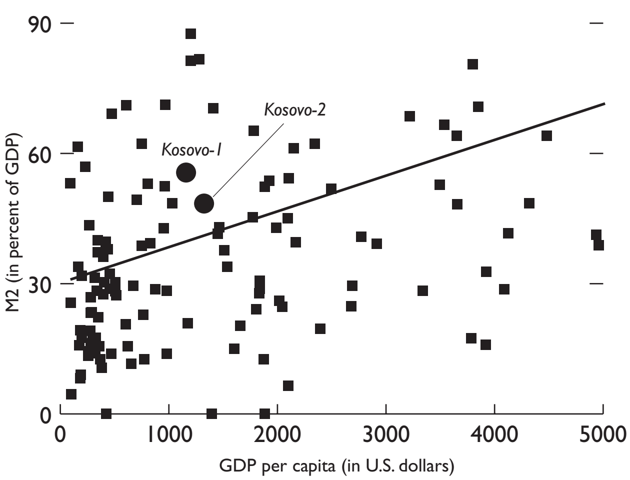


Sources: Banking and Payments Authority of Kosovo; and IMF staff estimates.

[5]Based on staff team's estimates of currency in circulation (Appendix I).

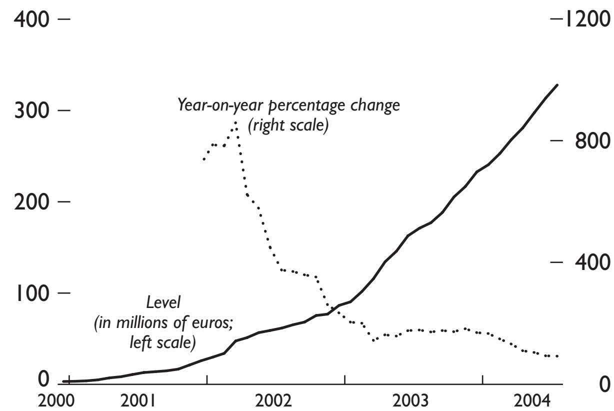
[6]The introduction of an interbank clearing system in 2001 marked an important early step in the authorities' systematic efforts to promote noncash payments. Subsequently, the authorities eliminated cash in the bulk of their transactions. For instance, about 97 percent of government employees currently receive their salaries through their bank accounts, and the government-sponsored basic pensions are all paid to the recipients' bank accounts.

Figure IV.3.
Kosovo and Selected Economies: Financial Depth and Level of GDP, 2002



Sources: Banking and Payments Authority of Kosovo; and IMF staff estimates.
Note: Kosovo-1 relates to 2003 GDP per capita. In Kosovo-2, GNDI is used instead.

Figure IV.4.
Bank Loans, 2000–04



Source: Banking and Payments Authority of Kosovo.

this trend started to reverse in 2003, with banks repatriating some of their foreign asset holdings to lend domestically (Figure IV.5 and Statistical Appendix Table 26).

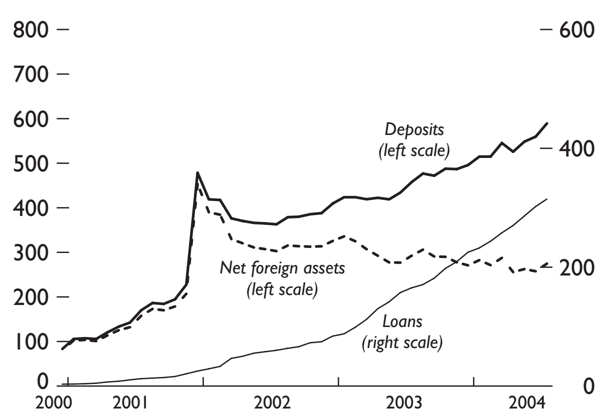
Notwithstanding this rapid expansion, the level of financial intermediation is low compared with other transition economies and Kosovo's own level of monetization. At 16 percent of GDP, the loans-to-GDP ratio is among the lowest in the world.[7] The average loans-to-GDP ratio in emerging economies in Asia and Latin America is about 63 percent, and over 120 percent in developed countries. Furthermore, 5 years after the start of the transition, much faster progress has been achieved in many other transition economies than in Kosovo (Figure IV.6). Also, whereas informal credit plays a significant role in other countries, it is believed to be negligible in Kosovo. The loans provided by the 17 microfinance institutions add only 11 percent to the size of market.

[7]There are about 50,000 bank loans and microfinance credits, which is equivalent to 25 loans for each 1,000 people. This is another indicator of low financial intermediation.

Reasons for the Relatively Lagging Financial Deepening

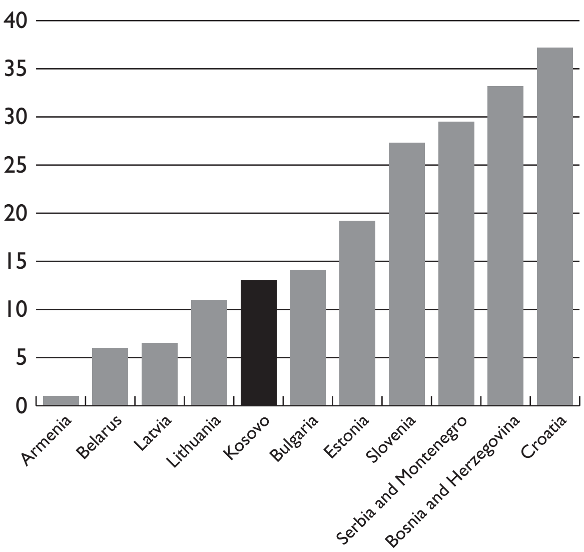
Relatively shallow financial deepening along with high monetization reflect (i) the still high preference for cash and (ii) the relatively small share of deposits

Figure IV.5.
Banks' Main Balance Sheet Items, 2000–04
(In millions of euros)



Source: Banking and Payments Authority of Kosovo.

Figure IV.6.
Ratio of Loans to GDP, Transition Countries
(In percent; five years after the beginning of the transition process)



Source: Roberto Zahler, see footnote 11.
Note: Bulgaria, Estonia, and Latvia have currency boards.

invested in domestic assets. Basically, whereas monetary assets represent about 60 percent of GDP, only about half are bank deposits, and only about half of these are used to fund domestic loans. It is interesting to compare this picture with that in a country at the other extreme of banking sector financial intermediation. In Germany, for example, monetary assets are equivalent to 140 percent of GDP, of which 133 percent of GDP equivalent is bank deposits, and bank loans are equivalent to 160 percent of GDP. In that case, both monetization and intermediation are high—with intermediation even higher than monetization—because banks capture almost all monetary assets and mobilize additional resources to fund their domestic loan portfolios.

What explains this still relatively limited degree of financial deepening, considering high and growing monetization? Elements of an answer can be found in the following: (i) an analysis of balance of payments developments, as the counterpart to low domestic lending has been reflected in an accumulation of net foreign assets by the banking system; (ii) an analysis of savers' behavior, which may explain their high preference for cash; and (iii) an analysis of banks' behavior, which may shed light on the relatively low propensity of the banking system to lend domestically.

From the perspective of balance of payments, the accumulation of foreign assets may be seen as a positive response of the economy to the massive external inflows and to the shift in the composition of monetary assets toward deposits. First, as explained in Chapter II, the flows of foreign assistance and private transfers, which were massive, led to a clear overheating of the economy. This was evidenced by double-digit inflation, which persisted until late 2001. If a larger share of these inflows had financed higher spending, overheating would have been more severe, and wage and price pressures would have inflicted greater damage to competitiveness. In this sense, the accumulation of foreign assets—which was tantamount to a sterilization of excessive inflows—was an opportune and welcome response. It built reserves on which the economy can draw in the future to mitigate the impact of negative shocks. Second, some of the increase in bank deposits and, consequently, some of the rise in banks' foreign assets simply reflected cash coming from "under mattresses" and its being deposited in banks. As such, it represented a transfer of foreign asset holdings from the household sector to the banking sector, which, fortunately, had a neutral impact on the net foreign asset position of the consolidated economy.[8]

Regarding savers' strong preference for cash, it may be explained by the size of the "gray" economy, the less-than-full trust in the banking system, a lingering sense of insecurity, and the low-opportunity cost of holding cash.[9] Surveys of depositors revealed that they are less concerned about the return on their deposits than about the safety and security of their savings. Also important is the lingering sense of insecurity, which may cause people to want to hold onto cash in case of possible emergencies. Fairly low returns on euro deposits, which diminish the opportunity cost of holding cash, may also be playing a role, even if only marginally.

[8]The above reasoning serves to dispel the widespread notion in Kosovo that the accumulation of foreign assets by banks and by the BPK (on account of budget surpluses) reflects an export of Kosovo's savings to finance investment in the rest of the world. Such a notion fails to recognize that on a net basis Kosovo has run large current account deficits and has benefited from savings in the rest of the world to sustain a level of consumption 30 percent higher than its domestic income.

[9]These factors also help explain why there are very few deposits with maturities longer than 3 months, despite interest rates as high as 4½ percent offered by some domestic banks.

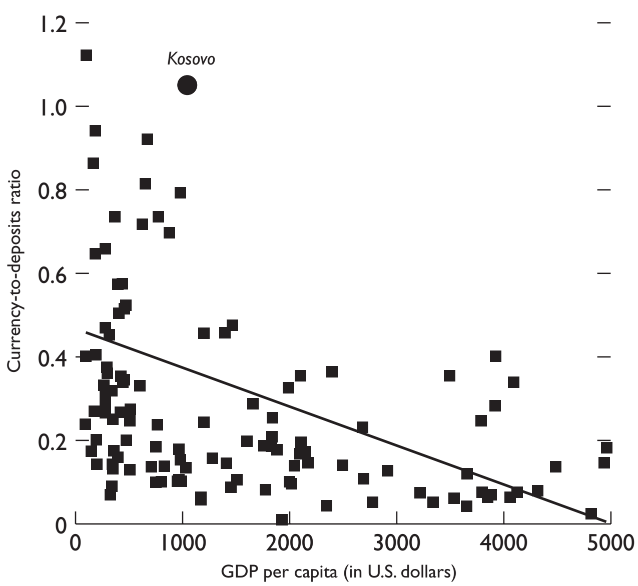
In a sense, the strong preference for cash prevents the full realization of the potential for financial deepening from high monetization. Kosovo's currency-to-deposit ratio, of about 1, is one of the highest in the world (Figure IV.7). The average in transition countries is less than 0.4; in emerging economies in Asia and Latin America it is about 0.15, and in developed countries it is below 0.05. If confidence in banks continues to strengthen and ways to economize on the use of cash can be realized, a decline in the currency-to-deposit ratio to 0.25 could generate additional loanable funds of €234 million—which is equivalent to about 70 percent of outstanding domestic credit.

Regarding the banking system's seemingly low propensity to lend domestically, the problem is multifaceted, involving capacity for credit risk management, enforcement of creditors' rights, liquidity management, and the demand for creditworthy investment projects. This constellation of factors has played out differently for different banks, with a clear demarcation between the largest bank and the other banks. Indeed, the average loan-to-deposit ratio of 44 percent masks a large difference between the largest bank, with a ratio of 25 percent, and the other banks, with ratios hovering around 60 percent (Figure IV.8). Whereas other banks expanded their deposits and lending activities at equal speed from the beginning, the largest bank—given its dominant position—initially took a much more guarded attitude toward domestic lending, choosing instead to invest most of its assets in foreign securities. Starting in 2003, the bank has stepped up its domestic lending activities and has even started to unwind its foreign asset position to fund a larger domestic loan portfolio (Figure IV.9).

Banks' lending (excluding the largest bank) is, at the moment, close to the liquidity risk ceiling encouraged by the BPK, namely, that loans not exceed 65 percent of deposits. The rationale behind this prudential limit is threefold.

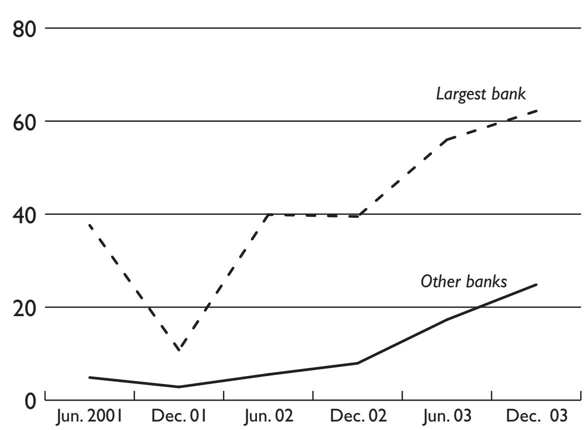
First, such a limit is meant to ensure that the speed at which credit expands is in line with banks' risk management learning curve. Rapid credit expansion may have stretched to the limit some banks' capacity to assess risk, raising concerns about the quality of their loan portfolios. Even though the indicators of the quality of banking assets are good (see Box IV.1 and Statistical Appendix Table 25), these indicators are to be interpreted with caution, as they are backward looking and may not capture potential prob-

Figure IV.7.
Kosovo and Selected Economies: Currency-to-Deposits Ratio and Level of GDP, 2002[1]



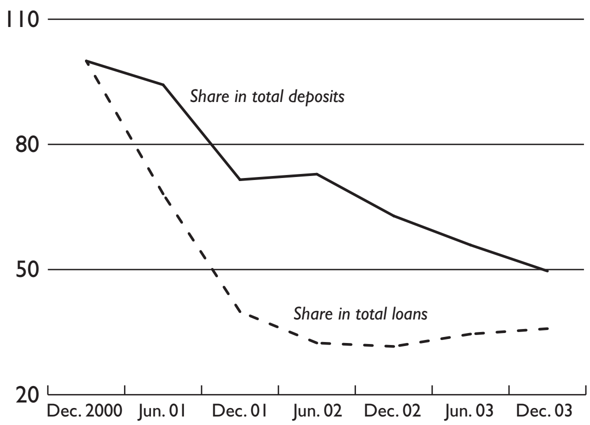
Sources: Banking and Payments Authority of Kosovo; and IMF staff estimates.
[1]Countries with per capita GDP under US$5000. 2003 data for Kosovo.

Figure IV.8.
Loan-to-Deposit Ratio, 2001–03



Source: Banking and Payments Authority of Kosovo.

Figure IV.9.
Share of the Largest Bank in Deposits and in Loans, 2000–03



Source: Banking and Payments Authority of Kosovo.

lems, especially in an environment of rapid credit expansion.[10] The situation is aggravated in Kosovo by the primitive financial accounting and cash-flow forecasting of many borrowers. This means that assessment of amounts recoverable on loans depends largely on past payment experience and could be overvalued.

Second, the limit is also meant to ensure that the speed at which credit expands is in line with the gradual buildup of the capacity of the judicial system to enforce creditors' rights. At the moment, court performance is weak, and appeals and adjournments are easy to obtain—a situation that might encourage a culture of nonpayment, given the lack of effective sanctions for noncompliance.

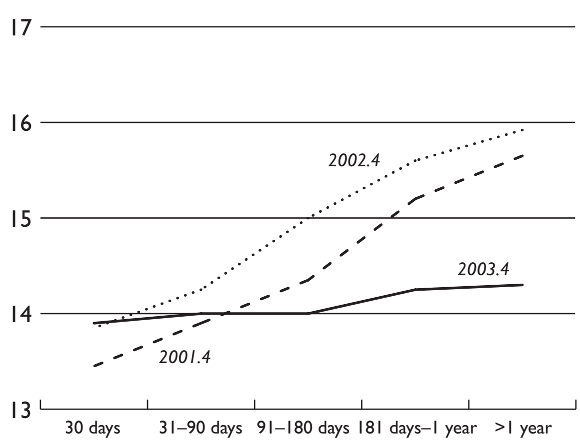
Third, the need for a prudent approach to managing liquidity risk is justified by the absence of a lender of last resort, the very limited ties of domestic banks to the international financial market, the absence of an interbank market in Kosovo, and the untested stability of banks' predominantly short-term deposits. Banks' exposure to liquidity risk is heightened by the fact that a substantial share of bank deposits belongs to one large public enterprise.

In contrast to the practice of the smaller banks, the largest bank's business strategy has focused on providing a reliable payments system and on securing its depositors' savings. By doing so, it has adopted a much more prudent lending strategy and has the strongest financial soundness indicators. As mentioned above, the bank has recently started to play a more active role in the domestic loan market. The argument often cited by the bank's managers—that the low level of lending is explained by the lack of bankable projects and the low profitability of investment—may in fact reflect its relatively large lending potential compared with the volume of profitable lending opportunities. At the same time, the volume of profitable projects also reflects the high lending interest rates.

Reasons for the High Cost of Financial Intermediation

Despite some decline, loan interest rates and spreads remain high. Loan interest rates continue to hover around 14 percent, while deposit rates are around 2½–3 percent (Figure IV.10). A flattening of the yield curve in the past 3 years has led to a small

Figure IV.10.
Loans' Nominal Interest Rate
(In percent)



Source: Roberto Zahler, see footnote 11.

[10]In such an environment, few good companies are likely to have outstanding loans with several banks, as most banks would regard them as "best credit risks." Thus, the likelihood of systemic risks would increase if these few firms were to fail.

increase in short-term interest rates and a more significant decline in longer-term rates. Meanwhile, the deposit interest rate structure has remained fairly stable. Loan interest rates are higher than in most transition countries and in the Balkans, even considering the time spent in transition.

The high cost of financial intermediation reflects the interplay between large inefficiencies and a high risk premium in an overly concentrated sector (see Table IV.1). In a recent study, Zahler decomposed the 13½ percent estimated cost of financial intermediation into costs related to loan loss provisioning, overhead costs, and capital requirements and returns on capital.[11] The results reveal the following:

Loan loss provisioning for both domestic and foreign banks account for 4–4½ percentage points of the cost of financial intermediation. The average loan loss provisioning is 200 percent of NPLs—far in excess of prudential requirements—owing to the perceived high macroeconomic risks and overall political uncertainty.

Overhead costs account for 7 percentage points of the overall cost of financial intermediation for domestic banks and 4½ percentage points for foreign banks. High overhead costs probably reflect the high cost of information due to the small size of the market, the predominance of small and medium-sized enterprises, the absence of a collective credit information bureau, and weak competition. These costs are compounded in domestic banks by overstaffing and overbranching.[12]

Prudential capital requirement and the high return on capital—made possible by fairly high concentration[13]—explain the remaining cost. The BPK requires a minimum capital of 12 percent of risk-weighted assets, whereas rates of return on equity demanded by banks range from 40 percent to 10 percent, with a system average of 20 percent. The relative efficiency of foreign banks and their dominant market position are captured as higher ex post rates of return on equity (5 percentage points of their overall cost of intermediation), which, ex ante, reflect a higher risk premium.

Table IV.1
Cost of Financial Intermediation
(In percent of loans)

	Domestic Banks	Foreign Banks
Total cost (percent)	13.5	13.5
Due to:		
Loan loss provisions	4.5	4.0
Overhead expenditure	7.0	4.6
Return on capital	2.0	4.9

Source: Zahler, see footnote 11.

Reasons for the Limited Maturity Transformation

Despite some recent lengthening, loans are still predominantly short term and maturity transformation is limited, most notably for domestic banks. For the banking system as a whole, 40 percent of all loans have a maturity shorter than 1 year, another 40 percent between 1 and 2 years, and the remainder over 2 years. For domestic banks, the share of loans up to 1 year is as high as 70 percent, and only 3 percent of loans are over 2 years; for foreign banks, meanwhile, the share of loans up to 1 year is only 16 percent, and the share for over 2 years is 50 percent. On the liability side, demand deposits represent about 55 percent of the total, and the bulk of savings deposits have maturities of up to 1 year.

The limited maturity transformation reflects the prudence with which liquidity risk has been managed. There are three main reasons for this prudence. First, with only 4 years of history to go by, it is difficult for banks to determine the level of "core deposits," that is, those sight and short-term deposits that are constantly renewed or prolonged and that, hence, could largely be assumed to be permanent.[14] The uncertain political and economic outlook adds to the difficulty in ascertaining the level of core deposits. Second, 45 percent of deposits are held by firms, with a high degree of concentration among a few large ones. These institutional deposits are generally regarded as more volatile than individual deposits, because they are mostly current accounts and tend to be much larger. Economic difficulties in any one of the large firms may significantly drain banks' liquidity.

[11]Roberto Zahler, "Financial Sector's Role in Economic Development in Kosovo," unpublished (Zahler Co, Santiago, Chile, 2004).

[12]Bank assets per employee in domestic banks average €190,000, against €600,000 in foreign banks in Kosovo, and bank assets per branch in domestic banks average €1.7 million, against €15 million in foreign banks.

[13]The Herfindahl index, which is equal to the sum of the square of each bank's market, is 2.8. An index higher than 1.8 is usually regarded as describing a highly concentrated market.

[14]In mature banking systems, banks usually count on 75–85 percent of sight and short-term deposits to be constantly renewable and, hence, stable.

Third, the lack of a lender-of-last-resort facility and the weak links with international financial markets necessitate a more prudent management of liquidity risk, and explain why domestic banks, which have virtually no access to any potential source of short-term liquidity, have been constrained in their ability to offer longer-maturity loans.

Conclusions and Ways Forward

The following key findings emerge from this analysis and make it possible to draw a few conclusions about the way forward.

First, the choice of a monetary framework anchored around the use of the euro has served Kosovo well. The use of an external anchor for domestic policies imposed financial discipline—securing a low-inflation environment—and is likely to have played a major role in achieving a high level of monetization and a rapid expansion of financial assets. It did so by avoiding uncertainty and the lack of confidence and credibility problems that would have been associated with the old or a new domestic currency. The use of the euro deprives the economy of one stabilization policy. But for long-term growth and development—which is the main challenge facing Kosovo today—the benefit from financial stability promoted by the use of a stable currency plus the benefit from trade facilitation with Europe that is promoted by the use of the euro are likely to outweigh the costs of having one less stabilization instrument. If Kosovo is to improve this trade-off and mitigate the loss from the absence of an independent monetary policy, it must preserve and further enhance the flexibility of the labor and goods markets.

High monetization and a healthy and stable banking system provide a solid foundation for further progress in financial intermediation. Safeguarding the soundness and stability of the financial system will continue to sustain a robust growth in banking assets by strengthening, inter alia, incentives to move from cash to bank transactions. Together with improvements in investment opportunities, the buildup of financial assets will provide a basis for further financial intermediation. To a large extent, the accumulation of foreign assets by the banking system in the past 4 years was not a sign of weakness but a welcome response of the economy to the large external inflows and the sharp drop in currency in circulation. If the increase in bank deposits had been used to extend domestic credit, Kosovo's current account deficit would have been larger, inflationary pressures stronger, and damages to Kosovo's competitiveness greater. Through the banks' accumulation of foreign assets, the economy built up a valuable reserve it can use to mitigate the impact of negative shocks in the future.

Most of the perceived shortcomings in the performance of the financial sector reflect, to a large extent, its short life span. The absence of institutional history meant that there was practically no institutional capacity and business experience to draw from. A faster expansion of domestic credit would have compromised the quality of banks' loan portfolios, given banks' growing but still weak risk management capacity, the accounting and corporate governance structure at the level of enterprises, and the judicial procedures and practices used in applying a new set of laws. A more aggressive push for maturity transformation would have been imprudent, given the untested stability of bank deposits, the still high overall uncertainty, and the absence of a lender of last resort and of ties to international financial markets.

To enhance the financial sector's contribution to Kosovo's development, the authorities should remain focused on maintaining a sound financial system and establishing a legal system conducive to a healthy credit culture. The BPK's perseverance in strengthening effective and proactive bank supervision will ensure that the financial sector remains healthy and profitable. Continuing to strengthen the legal environment to protect creditors' rights and nurture a credit culture will support further growth in domestic lending and a decline in interest rates. Indeed, when the legal system is not supportive, banks try to avoid legal recourse and, hence, either are more cautious in extending loans to new and untested clients or charge a higher risk premium. The recently launched credit information bureau should help reduce information costs and facilitate risk evaluation. Strengthening the regulatory framework for external auditing and accounting standards is also important. If the largest bank in Kosovo were to increase its lending activity, its greater efficiency would help bring down the cost of financing intermediation. However, this might price some local banks out of the market, and the authorities should stand ready to encourage mergers among those banks. Enforcing the anti–money laundering law would reinforce the public's growing trust in banks.

Because Kosovo's unresolved political status creates negative externalities that individual banks and financial institutions cannot absorb on their own, some policy intervention could be justified. Political uncertainty adds to the credit and liquidity risks that banks have to deal with; it affects the growth of a stable and long-term deposit base and complicates long-term investment decisions. Moreover, because Kosovo has no sovereign rating, banks are unable to obtain an institutional rating and, hence, cannot borrow from outside. To address this market failure, various policy options may be contemplated, and the authorities are encouraged to carefully weigh the pros and cons of those or of alternative policies. The following are some possible options:

Providing credit guarantees to local banks to access international capital markets or to mobilize additional domestic long-term funds could help lengthen maturities and would promote the development of long-term domestic savings instruments.

Providing a limited guarantee to banks' mortgage loans could help jump-start mortgage loans, which, in turn, could promote labor-intensive investment in housing.

Auctioning off to domestic banks medium-term loans from the government or from some donors could also help lengthen maturity. These funds may be tied to lending to small and medium-sized enterprises, if these enterprises were found to be more prone to choose labor-intensive investment.

Finally, the BPK could explore the possibility of obtaining a contingency credit line. It could use this line to provide short-term liquidity to banks if and when it is required; it may also want to help banks establish linkages with international capital markets, which could yield significant efficiency gains through better liquidity management, exposure to foreign expertise, and market discipline acquired through greater transparency.

V

Structural Reforms

Although the achievements in the fiscal and financial management areas reviewed in the previous chapters have been remarkable, progress in structural reforms has been more limited, as noted in the following:

- Good progress has been made in building the legal framework for private sector development—notably with the enactment of the mortgage, bankruptcy, and immovable property rights registry laws. However, the capacity to enforce new legislation remains very weak, and complex and nontransparent municipal regulations impose a heavy cost on businesses.
- Progress has also been made recently in tackling various trade issues, which for a long time had hindered exports and subjected local production to unfair competition. Exports to the European Union—which is subject to a zero tariff—have been hurt by difficulties in obtaining travel documents, car license plates, and trademarks, and by high transit costs. Exports to neighboring countries have been hurt by high tariff and nontariff barriers, including by partners with whom Kosovo had free trade agreements. Export competitiveness was further damaged by the delay in finding a solution to the high import tariff and by a malfunctioning VAT rebate system. Policies to promote an export-friendly environment need to be pursued more actively for exports to become the engine of growth and to diminish the need for foreign assistance.
- Progress has stalled in the main areas of SOE privatization and POE restructuring, which are the focus of this chapter.

Privatization of SOEs: Issues and Developments

A process of "commercialization" of SOEs was started in late 2000 as an interim measure while a privatization strategy was being designed. Given the silence of UN Security Council Resolution No. 1244 on SOE privatization and the complex property rights issues involved, UNMIK opted initially for a process of commercialization that involved leases for a fixed period. Over 70 SOEs were advertised, and 16 were leased.

A privatization strategy, adapted to Kosovo's unique circumstances, was finally agreed on in mid-2002, following protracted negotiations. The strategy offered a compromise solution to three contentious issues related to employees' rights, creditors' rights, and the use of SOE land:[1]

- In recognition of the fact that the SOEs' employees had a larger stake in their enterprises than the rest of the population—even if the "social ownership" developed in the former Federal Republic of Yugoslavia did not confer any actual transferable ownership rights—it was agreed that a 20 percent fee levied on the sales price would be distributed to current workers who had worked for the enterprise for at least 3 years.
- In recognition of the rights of potential creditors and former owners, UNMIK insisted and the PISG accepted that all privatization proceeds be

[1]The approach recognized explicitly that there would always be some residual uncertainty regarding ownership. However, strict application of appropriate operational policies was counted upon to reduce this uncertainty to manageable levels.

held in trust until resolution of Kosovo's final status.

- In recognition of the legal impediments to an outright sale of SOE land, a formula was developed allowing the sale of transferable 99-year leases for the use of the land.

To implement this strategy, the Kosovo Trust Agency (KTA) was established in June 2002 and supporting legislation was promulgated. The KTA was given the mandate to supervise SOEs and POEs, with a view to enhancing their value, viability, and governance. The KTA regulation outlined a "spin-off" model that authorized it to sell shares in new corporations through competitive tenders and enshrined the principle that the sales proceeds were to be held in trust. In parallel, a Special Chamber of the Supreme Court was established to deal with claims from potential creditors or former owners. The procedural aspects of the privatization process were specified in the KTA's operating policies, approved in February 2003. The last obstacle was removed with the promulgation, in May 2003, of the land use regulation allowing the sale of transferable unencumbered 99-year leases for the use of the land of privatized SOEs.

The privatization process had gotten off to a promising start when it was halted in October 2003, pending clarification of legal issues. The first wave of tenders, consisting of seven SOEs, was announced in mid-May 2003, and a second wave, comprising another 20 SOEs, was launched shortly thereafter. Investors' interest was encouraging in both rounds—with total winning bids amounting to €29 million—and the experience was generally regarded as a success. However, concerns about the integrity of the process and the background of bidders soon surfaced. Those concerns, together with a reassessment of legal risks faced by the KTA's expatriate managers, led to a sudden cancellation of the already announced third wave.

Suspension of privatization reopened the discussion on some politically sensitive issues and strained the relationship between the PISG and UNMIK. Representatives of the PISG were strongly opposed to what they perceived as an unnecessary and detrimental delay in the privatization process. They argued that some of the proposed changes in the KTA's operating policies—such as the increased emphasis on a case-by-case review of the validity of transformations and mergers that had affected some SOEs, and the plans to transfer larger shares of the SOEs' liabilities to the new owners—could be advantageous to Serbian entities that might assert ownership or creditor claims against some of the SOEs. UNMIK maintained that a temporary halt was needed to ensure the integrity and long-term viability of the process.

Privatization was resumed in July 2004, following changes to the KTA's operating policies, but the nearly 1-year suspension has been harmful, and further delays should be avoided. The changes in the KTA's operating polices that were intended to increase transparency and solidify the legal basis of privatization may have been warranted to ensure the integrity and long-term viability of the process. Nevertheless, the long pause and the highly politicized disagreements between the PISG and UNMIK damaged prospects to attract investment and contributed to a deterioration of the business climate. Privatization on the basis of the already agreed upon strategy should proceed without further delays. Also, and because the bulk of SOEs are unlikely to attract buyers as an ongoing concern, liquidation should be made possible by extending the applicability of the land use regulation to liquidation cases.

Restructuring of POEs: Issues and Developments

POEs play a major role in the economy as they are the sole providers of public utilities and are responsible for managing Kosovo's main natural resources.[2] Years of neglect, disinvestment, and mismanagement have undermined their financial position, depriving the economy of a reliable and efficient supply of public utilities and draining public finances.

From the outset, a restructuring strategy was clear, and consensus about it was widespread. The restructuring strategy recognized the legal impediments to outright privatization and called, instead, for a restructuring aimed at turning POEs into commercially viable entities by improving their operational efficiency and reducing their financial losses. Incorporating POEs and endowing them with strong and stable corporate governance were viewed as critical to improving their financial performance and to eventually attracting much-needed private capital through capital participation in would-be subsidiaries.

However, progress in implementing this strategy has been limited, contributing importantly to the difficulties in jump-starting a process of self-generating growth. Progress has been made in restructuring the

[2]The POE sector consists of the electricity monopoly, KEK; the main telecommunications company, PTK; UNMIK Railways; the airport; and a number of service providers in the water, waste, irrigation, and district heating sectors. In total, there are 55 POEs.

airport facilities, in enhancing the profitability of the telecommunications company, and in reorganizing the water sector. However, the lack of improvements in the main POEs in energy and mining has entailed great economic costs, as these sectors potentially have the strongest international comparative advantage and overall economic multipliers. Lack of progress in dealing with the heavy social and environmental legacies at TREPCA, the main public enterprise in mining, has basically shut down what used to be one of the main sectors of the economy. Similarly, faltering progress in restructuring KEK, the electricity company, has deprived the economy of a reliable supply of electricity—a bottleneck that has been identified in most business climate surveys as the most serious impediment to private sector development. Moreover, operational losses and large investment needs have cost the Kosovo budget and donors dearly.

The main difficulty involved in restructuring POEs has not been reducing excess employment but reforming their governance and dealing with their quasi-fiscal activities. Except for the problems at TREPCA (see below), the degree of excess employment in public enterprises is relatively moderate. The number of surplus employees in the POE sector (excluding TREPCA) is estimated at about 6,500, or about one-fourth of total employment.

The political setup in Kosovo and the underlying ethnic conflict have made the restructuring of POEs an unusually tough challenge. Efforts to restructure some of the POEs, in particular KEK, have been hampered by a lack of support from the people and from the PISG, as the latter has felt excluded from the decision-making process. Furthermore, social policies, as well as labor issues in these POEs (see below), have had ethnic dimensions that have made it harder to build a consensus on appropriate solutions. Moreover, focusing on long-term restructuring strategies for the sectors while neglecting the short-term restructuring of the POEs has weakened the effectiveness of the policy advice provided by donors.

Lack of progress in restructuring POEs will put an increasing strain on budgetary resources, as donors are showing signs of fatigue. Since the end of the conflict, donors have shouldered most of the cost of shoring up the finances of loss-making POEs. However, increasing dissatisfaction with the lack of progress is making them less willing to continue to do so. In the absence of access to external financing, this has led to increased demands on budgetary resources in the form of operational and capital subsidies.

To stem the POEs' losses, minimize the associated fiscal pressure, and meet the large investment need in some POEs, any budgetary support or loan guarantees should be tied to the steady implementation of sound and credible restructuring strategies. As long as an enterprise is 100 percent publicly owned, any loans to that enterprise are, in essence, the same as direct borrowing by the budget. In both cases, existing or future public assets will be mortgaged, and such risk should be taken only if adequate safeguards are in place to ensure an efficient use of the borrowed resources. Also, the use of budgetary or donor resources requires much greater transparency and closer monitoring in order to allow the accountability that is needed to build up and maintain stakeholders' trust in the restructuring process.

The remainder of this section analyzes the main problems at TREPCA and KEK, and discusses the key areas where urgent solutions are needed to stem mounting losses and prevent further deterioration.

The Problems at TREPCA

A vertically integrated company engaged primarily in mining and processing of lead and zinc, TREPCA used to be a large employer and an important source of foreign exchange earnings. In the early 1980s, TREPCA's financial health started to suffer from inadequate investment, maintenance, and repairs. The dismissal of most of its Albanian workers in 1990 led to a further deterioration. After the end of the conflict, KFOR ordered the closure of the smelter as the level of pollution was deemed unacceptable; as a result, all production stopped. Since then, TREPCA has been administering a line in the KGB of some €8.5 million per year, mainly to cover social welfare payments, which were designed from the beginning to benefit some but not all workers and former workers.

The current social transfers are inefficient, onerous, inequitable, and a source of enduring social and ethnic tensions. They are inefficient, as some workers continue to receive salaries, whereas they could be more productively employed. They are onerous because, assuming no change in policy,[3] the staff team estimates that the net present value (NPV) of the stream of budgetary outlays over the next 40 years would equal €94 million (5 percent of GDP; see Table V.1). They are inequitable for both TREPCA workers and other unemployed workers: the existing policy is de facto offering a severance package equivalent to 15 years' salary to some workers, 3.2 years' salary to others, and no payments to the

[3]That is, assuming that the current benefits continue until workers reach the age of 65.

TABLE V.1
Social Welfare Payments to TREPCA Workers
(In euros, unless otherwise specified)

	Number of Workers[1]	Monthly Payment[1]	Total Cost in Thousands of Euros		Cost per Worker	
			2004	In NPV terms	In NPV terms	Ratio to average annual wage
Total	**9,509**		**6,062**	**93,709**	**9,855**	
Working	2,448	181	5,320	79,342	32,411	15.0
Receiving stipend	2,061	30	742	14,367	6,971	3.2
Not receiving any benefit	5,000	0	0	0	0	0.0

Sources: Kosovo authorities; and Fund staff estimates.
[1]Data as of October 2003.

remaining 5,000 former workers. Under the existing labor law, the cap on severance pay is equal to 5 months for 30 years of service or more.

In response to the pressure from miners, at the beginning of 2004 the government introduced a temporary early retirement scheme for over 3,000 TREPCA miners. This entitlement was supposed to last for only 6 months but has been extended for another 6 months because of the delays in developing a comprehensive solution.

Such a comprehensive solution to the labor problem at TREPCA is needed urgently to reform the existing policy and to revitalize this important sector. The solution needs to strike the right balance among multiple objectives: (i) political feasibility, (ii) achievement of some fiscal savings, given the high uncertainty about the fiscal outlook and competing claims for budgetary resources, (iii) restoration of equity among TREPCA workers to address the social and ethnic tensions in the Mitrovica area, (iv) awareness of the precedent it will set for other POE labor redundancy programs, and (v) creation of the right incentive for redundant workers to seek jobs elsewhere (the severance program package should thus be complemented with redeployment assistance, including new training).

The Problems at KEK

Since the end of the conflict, one of the most serious problems confronting UNMIK has been dealing with the ever-deteriorating situation at KEK. KEK used to be a profitable provincial power company—a vertically integrated POE that mined good-quality lignite to generate and distribute electricity within Kosovo. However, inadequate maintenance and war damage during the 1990s, plus three recent major calamities (extensive damage from lightning, a power plant fire, and a mine slide), have eroded KEK's production capacity. Despite €500 million in grants for maintenance and repairs (equivalent to about 28 percent of Kosovo's 2003 GDP), KEK has been unable to provide a reliable supply of electricity to meet customer demand. Businesses estimate that power shortages and the need to use backup generators add 10 percent to their overall costs.

Despite repeated attempts to overhaul KEK's operations and management, large commercial losses and uncollected bills continue to undermine its financial position. It is estimated that in 2003 KEK lost about 43 percent of its generated electricity to technical and commercial losses that originated in outright theft through illegal connections and in indirect theft through meter tampering. Furthermore, of the remaining 57 percent of electricity that was billed, KEK was able to collect only 72 percent of the total. Through the combined effect of both sources of loss, 60 percent of total electricity distributed in 2003 was consumed for free (Table V.2).[4]

Losses at KEK are tantamount to quasi-fiscal losses or implicit subsidies, which are estimated at about 7 percent of GDP annually (Box V.1). Donors, the Kosovo budget, and the capital previously invested in KEK have borne the brunt of these losses. Despite significant donor grants and budgetary transfers, maintenance and repairs are falling short of the amount necessary to maintain the capital stock.

Quasi-fiscal losses at KEK are among the highest compared with transition countries, and unlike in other economies, low tariffs are not the main cause (Figure V.1). Only four neighboring Central Asian

[4]According to a report prepared by Swedish Development Advisors, only 20 percent of households pay for their electricity consumption. See *Korporata Energjetike e Kosovës (KEK), Corporate Issues, Relevance of Current Measures* (Swedish Development Advisors), January 2004.

Table V.2
KEK Real Balance and Uncollected Bills, 2003
(In gigawatt-hours unless otherwise specified)

	2003 Prel. Est.
Total supply	3,910
Generation net	3,263
Imports	647
Total sales	2,347
Domestic sales	2,058
Exports	289
Losses	1,563
Percent of net supply[1]	**43.2**
Billed electricity (in millions of euros)	102.2
Bill collections (in millions of euros)	73.2
Percent of billed electricity	**71.6**
Paid electricity (in percent of net supply)[1]	**40.7**

Source: KEK.
[1]Net supply is defined as supply minus export.

countries have quasi-fiscal power sector losses more severe than Kosovo's. In Tajikistan losses are close to 20 percent of GDP, and in Uzbekistan, Azerbaijan, and the Kyrgyz Republic they are slightly above 10 percent. In most countries, the main cause of the quasi-fiscal losses in the power sector is the setting of electricity tariffs far below their cost recovery level. In Russia, for example, almost all quasi-fiscal losses are caused by average tariffs (US$0.015 per kilowatt-hour) set at about 50 percent of cost recovery. In comparison, in Kosovo more than 80 percent of the losses are due to commercial losses and low bill collection, problems that are much harder to tackle.

An ill-conceived "social policy" of providing free electricity to the poor and to Serb enclaves is one of the root causes of the problems at KEK. The so-called "social case ruling" was part of a directive issued by UNMIK in September 2002 on the payment of debt for electricity services. Under this directive, a full debt write-off was granted to social assistance beneficiaries and other disadvantaged people.[5] However, customers eligible for this debt relief did not pay their bills even after the expiration of the special treatment period, believing that such treatment would be renewed.[6] Above and beyond its static cost and misallocation of resources, the policy has had a detrimental dynamic impact on consumers' payments morale and KEK's workers' ethics.

Building UNMIK-PISG joint ownership of a sound and credible strategy to restructure KEK is critical. The Working Group on Energy (with representatives from the PISG and the KTA) should provide a useful forum for building joint ownership of the necessary, and often politically unpopular, measures required to improve KEK's efficiency and to turn it into a commercially viable enterprise.[7]

Co-ownership of a credible strategy should be expressed in a concerted campaign that sends a clear message to the public. Such a strategy would require enactment of a satisfactory law to curb theft and creation of specific enforcement mechanisms. At the same time, there would be a need to design and implement a targeted social assistance system to provide lifeline support for the most vulnerable, either in the form of a direct budget subsidy or a very low tariff rate for a limited first tariff block.[8] There will also be a need to review the taxation of petroleum products to encourage a shift to alternative fuels and to ensure affordable energy for the majority of the people. The excise rate for gas oil (LPG) could be lowered to zero with no direct revenue losses, as there are virtually no imports (and no domestic production).[9] The excise rate on low-quality heating oil could also be lowered to zero when chemical marker technology becomes available, to prevent leakage to lower-rate (or exempt) products.

A financing strategy to cover KEK's investment needs should be elaborated and agreed on as quickly as possible. KEK's investment needs are very large and require a concerted approach by the authorities and the donor community to elaborate a financing strategy that combines the use of budgetary resources, donor grants, and private capital participation. Commitment of this financing package up front is needed to ensure orderly investment spending and halt the wastage involved in stopgap measures.

[5]No regulation has been issued granting exemption to Serb enclaves. But their nonpayment has been a continuous practice, as well as a source of tension between UNMIK and the PISG.

[6]An amendment to the 2002 administrative directive in February 2004 (UNMIK/AD/2004/2) may have been interpreted as a de facto renewal of the provision in the initial directive.

[7]A new team took over KEK's management in July 2004 under a management contract with an Irish power company. A system of measurement, monitoring, and verification of management's performance should be agreed with the new management team.

[8]Staff has estimated that a tariff of 0.5 cents per kilowatt-hour (kWh) for the first 250 kWh during the five winter months and 150 kWh during the remaining months, and an average tariff of 7 cents per kWh for consumption higher than these levels—which is revenue neutral—would support the most vulnerable, while the average cost of electricity to the nonpoor would increase by only about 6 percent.

[9]There may even be some small positive revenue impact as LPG imports would be subject to VAT and customs duty.

Box V.1. Estimating Quasi-Fiscal Losses at KEK

Following a methodology developed at the World Bank to analyze quasi-fiscal losses in public power companies,[1] quasi-fiscal losses at KEK can be decomposed into three components:

- **Losses due to excess system losses.** Assuming that normal technical losses are about 10 percent of generated electricity, the staff team estimates that implicit subsidies due to commercial losses amounted to about €72.2 million in 2003.
- **Losses due to collection failure.** Given a collection rate of 71.6 percent in 2003, the staff team estimates that collection losses amounted to €29 million in 2003, based on an average end-user tariff of €0.05 per kilowatt-hour.
- **Losses due to tariffs set below recovery levels.** On the basis of a World Bank estimate of recovery cost tariffs of €0.06 per kilowatt-hour, the staff team estimates that losses related to this third factor were about €20.6 million in 2003.

All in all, quasi-fiscal losses are estimated at €121.8 million (7 percent of GDP).

[1]World Bank, "Monitoring Financial and Technical Performance in Infrastructure in the ECA Region," to be published.

Figure V.1.
Kosovo and Selected Economies:

Sources: World Bank, "Monitoring Financial and Technical Performance in the Infrastructure Sector in the ECA Region"; and IMF staff estimates.

Appendix I. National Income Accounts and Balance of Payments Estimates

The purpose of this appendix is twofold. First it explains the main gaps in the data and the difficulty they create in assessing macroeconomic developments since the end of the conflict. Second, it explains the data sources used to compile national accounts and balance of payments estimates for 2003. The margin of error in the estimates for 2003, compared with estimates for previous years, is much narrower, reflecting the improvement in the quality and range of the data, most significantly of the data on commercial imports.

Main Gaps in the Data and Difficulty in Assessing Macroeconomic Developments

The following is a list of the main types of data and sources that could be used to construct estimates of the national income accounts (and of the main expenditure components of GDP) and the balance of payments:

- Fairly accurate and consistent data are available from the Ministry of Finance and Economy (MFE) regarding the fiscal sector's activities during the past 3 years.

- Less accurate data, but nonetheless broadly comparable and consistent, on donor assistance during the past 3 years have been assembled recently. They cover the following:
  - — The budget of UNMIK—mainly wages of expatriates and local employees and purchases of goods and services (source: UNMIK).
  - — The so-called public investment program (PIP) and donor-designated grants (DDGs). PIPs and DDGs are donor-financed projects such as housing and rehabilitation, training and technical assistance, equipment supply, and capital participation in the local banking system. PIPs and DDGs can also be decomposed into wages of expatriates and local employees and into purchases of goods and services (source: MFE).
  - — Budget support grants (source: MFE).
  - — Humanitarian assistance to the households (sources: donors and MFE).

  Although the margin of error in estimating foreign aid is manageable, the margin of error in estimating its impact on GDP and gross national disposable income (GNDI) is much larger. Data are weak on the share of this spending that falls into domestic goods, be it the local consumption of locally produced goods by expatriates and soldiers, or the local content of spending on goods and services, or the hiring of local labor.

- Consistent monetary statistics have also been compiled by the Banking and Payments Authority of Kosovo (BPK) since end-1999 and provide reliable estimates on the changes in the net foreign asset position of the banking system. Given that Kosovo does not have its own currency and instead uses the euro, changes in euros in circulation (if the changes had been known) would have provided information on another item of Kosovo's balance of payments. The changeover to the euro in early 2002, provided a unique opportunity to establish a point estimate of the stock of currency in circulation just prior to the time of the changeover (late 2001). The large buildup of bank deposits in the run-up to the changeover, plus official data on the net exports of cash by the banking system during 2002, suggest that the changeover resulted in a sharp decline in currency in circulation and a corresponding structural shift toward bank deposits. Much of this changeover-driven decline in currency in circulation took place in the last few weeks of 2001, whereas there was a modest increase in currency in circulation when the euro notes and coins were put into circulation in early 2002.

In the balance of payments estimates, these abrupt swings are smoothed out, and the bulk of the reduction in currency in circulation is shown to take place during 2002. The persistence of large net exports of cash by the banking system seems to primarily reflect the offsetting net inflows through informal channels rather than a continued shift from cash to bank deposits. Subsequently, the data on the cash exports and imports that go through the banking system cannot be used alone to derive a reasonable estimate for the currency in circulation. Instead, estimates of the balance of payments assume that the growth of broad money was equal to the growth rate of GNDI, and that the amount of currency in circulation was derived as a residual. Given the robust growth in bank deposits during 2003, this implied a moderate decline in the amount of euro cash in circulation.

- Data regarding private sector activities are scant, and no data sources have tracked any one of the main aggregates through time. The estimates of private consumption in 2002 and 2003 are based on the Household Budget Survey (HBS) 2002/03, which covered the period between June 2002 and May 2003. This was the first HBS run by the Statistical Office of Kosovo (SOK). A Living Standards Measurement Survey, run by the World Bank in 2000, is not comparable to the HBS in terms of design, timing of the survey, survey tools, sampling methodology, and data aggregation. Making the results from both surveys comparable would require reaggregation of components, sample adjustments, extrapolation of household archetypes using labor categories, data aggregation into income groups, and seasonality and inflation adjustments. This exercise has not been performed; hence, it is impossible for the moment to attempt to produce comparable estimates of national income accounts for 2000. Those for 2001 are already very tentative and based on a weak assumption that private sector consumption in real terms remained flat in 2002 compared with 2001.
- A major source of uncertainty in the private sector's macroeconomic aggregates comes from the uncertainty in population data. With the last reliable population census dating back to 1981 and the large population migration before, during, and after the conflict, the size of the population today, as well as its evolution during the past 3 years, is known within a margin of 15 percent, with some researchers quoting figures that would widen the margin to 25 percent. The national accounts are currently based on the consensus estimate of the population of 1.9 million in 2003, with an average size of the household estimated at 6½ people.[1]
- No systematic surveys of private investment have been performed, and current estimates are extremely preliminary and subject to sizable future revisions. This is one area that has the greatest uncertainty.
- Prior to 2002 there were no reliable data on workers' remittances. Estimates of workers' remittances in 2002 and 2003 were derived from the 2002/03 HBS. Appendix II provides a detailed discussion of the possible margin of error in such estimates.
- Finally, estimates on private sector imports are main source of errors in compiling national income accounts and balance of payments. In the initial years after the end of the conflict, the customs administration was still building itself up, and a large share of imports went unrecorded. As the customs authorities increased the numbers of cross-border check points, more and more of the imports started to be recorded. The level of recorded imports in 2003 (€1,042 million)

[1]According to civil register data, the Economic Policy Department of the Ministry of Finance and Economy (MFE) estimated that the population above the age of 16 is 1,234,500. Using an average of the proportion of the population age 17 and above from the 2000 Living Standards Measurement Survey (62.8 percent), the December 2001 SOK labor market survey (64.1 percent), and the MFE estimates yields a population estimate of 1,948,000.

seems to suggest that most imports are now captured in customs import data. Given that commercial imports are equivalent to about 54 percent of GDP, the uncertainty about the level of imports in previous years has a huge impact on GDP growth estimates. Basically, if imports in 2001 were 10 percentage points higher or lower than currently estimated, it would have lowered or increased the growth rate of GDP by 7½ percentage points in 2001 and would have a similar impact on the growth rate in 2002.

Estimates of GDP and the Balance of Payments in 2003

The staff teams used several main data sources and assumptions to estimate GDP and the balance of payment in 2003. These are discussed in the following paragraphs.

Private Sector Consumption and Investment

Staff teams based estimates of private consumption on SOK's 2002/03 HBS. We adjusted the 2002/03 HBS estimate on three counts. First, the estimate of imputed rent was adjusted downward by 25 percent because its share in private sector consumption was found to be too high and out of line with the experience in other economies. The adjustment led to a decline in the share of imputed rent of total consumption from 24 percent to 18 percent.[2] Second, an estimated monthly expenditure of €20 per household was added to consumption to reflect spending on durable goods, which was not reported in the HBS. Third, households' spending was also adjusted to account for the unpaid consumption of electricity, using KEK data and assuming that households' debt amounted to 70 percent of the unpaid balance, to reflect the share of household electricity consumption in total electricity sales (Table AI.1). An assumption also had to be made to derive separate estimates for 2002 and 2003 from the 2002/03 estimate. Real per capita consumption was assumed to be constant between 2002 and 2003. Our estimate of nominal aggregate household consumption for 2002 and 2003 thus reflects the average CPI inflation rate in 2003, SOK's estimated population growth rate of 1.7, and a constant average size of the household equal to 6½ people.

Estimates of private investment are extremely tentative because no surveys properly quantify this aggregate. We based our estimate of private investment in 2003 on imports of construction materials and other investment goods adjusted for labor costs and taxes. We assumed the share of local materials in private investment to be below 15 percent, as inferred from anecdotal evidence. Private investment in 2003 amounted to 17 percent of GDP.

The Government Sector

In accordance with the budget outturn in 2003, we estimated government consumption at €322 million on a cash basis.[3] It is likely that government consumption on an accrual basis was somewhat higher in 2003; however, for the sake of simplicity and because of the lack of detailed data, we did not adjust for the difference between government consumption on a cash basis and an accrual basis. The same budget data provide an estimate for government investment spending amounting to €96 million in 2003.[4]

The Donor Sector

Using data collected from the various pillars of UNMIK, the staff team built an estimate of total spending under the UNMIK umbrella and decomposed it into its main relevant components to build the national income accounts. We estimated UNMIK spending in 2003 at €356 million.[5] Of this amount, €258 million was wages of about 6,220 man-year equivalent expatriates, whose local spending was estimated at €40 million (that is, €542 per month).[6] Another €50 million was wages paid to about 4,357

[2]A world average, including all developed countries where the cost of housing is much higher than in developing countries, is only 15 percent. A world minimum of 1.1 percent is recorded in Peru, and Italy and Greece show shares of about 15 percent. Moreover, in the 2002/03 HBS, the estimate reflects not an extrapolation of actual rents paid but the subjective assessment of the rental value for each survey respondent.

[3]That is, government consumption reflects current expenditures, excluding subsidies and transfers. This concept of government spending excludes spending financed from donor-designated grants.

[4]These figures include the part of public enterprise investment expenditure that was financed directly from the budget.

[5]This excludes part of the salaries of the expatriates working in Kosovo for Pillar III who are seconded by their governments. It includes only that part of their salaries that is paid to them from the Pillar III budget.

[6]About three-fourths of the expatriates employed in Kosovo are in the police force. We estimated their average local consumption at about €450 per month. Other expatriates' local consumption is estimated at €1,300 per month.

Table AI.1
Private Sector Consumption
(In euros, unless otherwise indicated)

	2002/03 HBS Monthly Consumption Per Household		Total Consumption (In millions of euros)	
	Unadjusted	Adjusted	2002	2003
Total	**490**	**488**	**1,682**	**1,728**
Purchased goods				
Food purchased	176	176	607	623
Tobacco	18	18	61	63
Nonfood	72	72	248	255
Health	7	7	24	25
Communications	31	31	105	108
Recreation and culture	4	4	15	16
Education services	3	3	10	11
Restaurants and hotels	3	3	9	9
Miscellaneous goods and services[1]	8	14	49	51
Consumer durables[2]		20	70	72
Food produced at home or fetched	53	53	184	189
Imputed rent[3]	115	87	298	307
Memorandum items:				
Population (in thousands)				1,900
Average size of household				6.5

Sources: Statistical Office of Kosovo; and IMF staff estimates.
[1]Miscellaneous goods and services were adjusted for unpaid consumption of electricity by households using KEK data, and assuming that their debt amounts to 70 percent of the unpaid balance.
[2]Data from the Household Budget Survey (HBS). Consumer durables were missing from the estimates of household spending of the HBS and had to be added.
[3]The level of the imputed housing rent estimated by the 2002/03 HBS was adjusted down because hypothetical rents of house owners exceed those paid by housing renters by about one-third.

full-time-equivalent local employees. The remaining €49 million was spending on goods and services, of which €14 million was estimated to be imported goods.[7]

The Donor Coordination Sector at the Ministry of Finance and Economy compiles an estimate of spending by other donors outside UNMIK's umbrella, the so-called PIP (including donor-designated grants). Total reported spending in 2003 was €275 million, of which €106 million was for reconstruction and rehabilitation, €2 million for the supply of equipment, €113 million for training and technical assistance, €20 million for other expenditures, and €5 million for participation in commercial banks' capital. DDGs amounted to €29 million. We assumed that spending on equipment, plus 75 percent of spending on reconstruction and rehabilitation and other expenditures (a total of €96 million), was spending on goods and services, of which €28 million was on imported goods.[8] We assumed the import content of DDG spending to be equal to 94 percent of the total, as suggested by the information provided by the Ministry of Finance and Economy on the breakdown of spending for projects. The rest of the spending was assumed to be wages. We assumed that wages of expatriates (€97 million) account for two-thirds of the PIP wage bill of €145 million, and that the balance of €48 million was wages paid to local employees. Expatriates were assumed to spend one-quarter of their salaries locally (€24 million), of which two-thirds was spent on domestically produced goods and services (€18 million).

[7]Only Pillars III and IV provide information about the import content of their consumption of goods and services. We assumed that the share of imports in goods and services consumed by Pillars I and II was equal to the weighted average of the import content of consumption reported by Pillars III and IV.

[8]The import content of spending on goods and services by both UNMIK and the PIP is assumed to be equal to 30 percent, which is the share reported by Pillars III and IV.

No official data on KFOR spending were available. The staff teams had to rely on scanty information provided in a press release.[9] According to that 2003 press release, KFOR procured €75 million in goods and services locally[10] and paid €25 million in wages to local employees (6,000 employees at an hourly wage of €2). Staff estimated that KFOR's 19,000 soldiers stationed in Kosovo spend about €42 million in local consumption outside their barracks (€6 per day per soldier), of which €24 million goes for locally produced goods (€3.5 per day per soldier). No information was available about the import content of KFOR's spending on locally procured goods and services, so we assumed that the share of imports declined from 80 percent in 2001 to 40 percent in 2003, because the economy was recovering from the conflict and domestic sourcing opportunities were improving. The value of imported goods and services used by KFOR was estimated at €30 million in 2003. It is assumed to be fully reflected in commercial imports, along with the soldiers' consumption of imported goods. On the basis of these estimates of UNMIK's budget, the PIP, and KFOR, we added to public consumption a total wage bill of €478 million—of which €355 million was for expatriates—and €123 million of UNMIK's and KFOR's spending on goods and services. The PIP component of spending on goods and services (including DDGs)—€126 million—was treated as investment spending and added to total investment. Wages of expatriates (€355 million) and imports of goods and services by all donors—a total of €99 million, including €55 million for the PIP (including DDGs), €14 million for UNMIK, and €30 million for KFOR—were added to imports as an offsetting item.[11]

[9]KFOR Press Release (February 9, 2003).

[10]No information on KFOR's direct import of goods and services was available. These were implicitly set at zero, along with soldiers' wages. This, of course, underestimates the amount of overall donor spending, but it has a neutral impact of the contribution of the donor sector to the local economy.

Net Exports

The estimates of merchandise exports are based on customs data—€36 million in 2003 (up from €27 million in 2002 and €23 million in 2001). As explained above, we estimated sales to the expatriate nonresident community at €150 million. Tourism receipts, mainly for spending by visitors to the expatriates, were assumed to equal one-quarter of the local consumption of the expatriate community. Given the improvement in the customs data, we assumed no unrecorded exports from 2003 onward.

The estimates of private imports are based on BRICO data in 2003. The c.i.f. value of imports in 2003 was estimated at €968 million. We assumed no smuggling from 2003 onward, as customs data are believed to capture the vast bulk of all imports. The total value of imports also includes imports of pharmaceuticals and electricity estimated at €20 million and €23 million, respectively.[12]

We estimated remittances and pensions receipts from abroad using HBS data (complemented by data on domestic pension payments in 2003). The estimates amounted to €241 million in 2003, which includes remittances reported in the HBS (€174 million), pensions from Serbia (€35 million), and other pensions from abroad (€32 million). The estimate of remittances was based on the HBS monthly transfer of €49 per household. The estimate reflects remittances of €295 per month to 16.6 percent of the households and no remittances for the rest of the households.

[11]Given that donors' imports reported in BRICO donor imports were declining much more rapidly than their activities in Kosovo, the staff team's working assumption was that the difference between donors' imports (€99 million) and those reported in BRICO commercial imports (€25 million) (that is, €74 million) were imports through commercial channels, and, hence, the difference was reflected in commercial imports.

[12]BRICO estimates of commercial imports in 2003 are consistent with the value that can be derived from border taxes.

Appendix II. Estimating Workers' Remittances

According to the 2002/03 Household Budget Survey (HBS) compiled by the Statistical Office of Kosovo (SOK), remittances from abroad during the 12-month period from June 2002 to May 2003 amounted to €174 million (Table AII.1). This corresponds to a monthly average of €49 per household, which in turn reflects monthly remittances of €295 to 16½ percent of the households and no remittances for the rest of the households. In other words, about 50,000 households received on average slightly over €3,500 during the year, and the rest of the households did not receive any remittances.

This estimate is likely to be subject to the usual range of underestimation typical of income survey–based estimates. Remittances, like other sources of income, tend to be underestimated in income surveys. Survey participants tend to underreport their income, in particular its components that are infrequent or irregular—which is often the case with remittances. For instance, the HBS may not fully capture the money received from visiting relatives living abroad. Households may also be hesitant to report the full amount of remittances out of fear of drawing undesired attention to their own finances. Furthermore, respondents may be reluctant to report remittances from their relatives who may be working abroad without appropriate documentation.

Beyond the usual range of underestimation typical of income surveys, the HBS may also seriously underestimate workers' remittances. An attempt is made below to assess the possible margin of error by pulling together existing information, for example, on the number of Kosovars residing abroad and their ability and willingness to send money back to their relatives in Kosovo, plus whatever can be gleaned from data on incoming wire transfers.

Limited data are available on migration from Kosovo, with gaps particularly severe during the periods of high migration. Following the 1965 reforms in the former Socialist Federal Republic of Yugoslavia (SFRY) and the emphasis on efficiency, mounting unemployment was addressed in part by liberalizing exit requirements. That allowed an increasing number of Yugoslavs to leave for work in Western Europe, which was experiencing a labor shortage. The exodus peaked about 1973, when an estimated 1.1 million Yugoslavs were working abroad (12 percent of the labor force). The migration of workers provided a safety valve, and their remittances became a very important source of foreign exchange. Kosovo's migration patterns during this period broadly resembled those of the rest of Yugoslavia.

After 1973, recession and increasing unemployment problems in host countries resulted in a substantial return of foreign workers to their home countries. According to the 1981 population census and data from host countries compiled by the Federal Bureau of Employment, only 770 thousand workers remained abroad (8 percent of the former SFRY labor force).[13] For Kosovo, the number of migrant workers working abroad continued to increase during the 1970s, from 22,000 in 1973 to 26,600 in 1981, probably reflecting the much higher level of unemployment in Kosovo.

[13] World Bank, "Yugoslavia: Adjustment Policies and Development Perspectives, World Bank Study," Report No. 3954-YU, 1983.

TABLE AII.1
2002/03 HBS SOK's Estimate of Workers' Remittances

	Households Not Receiving Remittances	Households Receiving Remittances	Total/Average
Share of households (in percent)	83.4	16.6	100
Total income (in euros per month per household)	300	433	322
Of which: Remittances from abroad	0	295	49
Number of households	247,929	**49,348**	297,277
Total yearly remittances (in millions of euros)	0	174	174

Source: Statistical Office of Kosovo (SOK) Household Budget Survey; and Fund staff estimates.

The returns of migrant Yugoslav workers continued during the 1980s, and it is estimated that the total number of Yugoslav migrant workers stood at 650,000 in 1988. However, the trends for Kosovo continued to diverge from the general Yugoslav patterns as more than 50,000 people emigrated from Kosovo between 1981 and 1987, for economic as well as political reasons.[14]

In the 1990s the breakup of the former SFRY resulted in large outward migration, mainly from those areas that were most affected by the conflict. The latest available data for 11 countries in Western Europe point to a total foreign population of 3.3 million from the former SFRY, of which about 60 percent are from Serbia, Montenegro, and Kosovo.[15] Unfortunately, none of these foreign data sources identifies Kosovo separately. Using the same 15 percent share as in the 1981 population census would yield an estimate of 291,000 Kosovars. However, it is likely that Kosovo's share would have increased given the more dire situation there. Starting from the 1981 population census, assuming a natural growth rate of 2 percent for Albanians and 1.2 percent for the rest of the population,[16] and using SOK resident population estimates for 2002, one gets an estimate of total Kosovars living abroad of about 470,000, of which about 220,000 are Kosovar Albanians (Table AII.2). This would be consistent with an increase in Kosovo's share, up to 25 percent, which seems reasonable in light of available data on vital statistics.[17]

This rough estimate of the total number of Kosovars living abroad provides an upper bound for deriving a reasonable estimate of the number who are actually making transfers to their families in Kosovo. It is likely that those who make transfers are mainly

[14]Dijana Plestina, "Regional Development in Communist Yugoslavia—Success, Failure and Consequences," Westview Press, 1992.

[15]John Salt, "European International Migration: Evaluation of the Current Situation," European Population Papers Series, No. 5, March 2002.

[16]In the early 1980s, the population growth rate for Albanian Kosovars was estimated at 2.6. However, this rate has been on a declining trend and, according to SOK's estimate, now stands at about 1.6 percent.

[17]This method of combining data from the presumably reliable 1981 census with vital statistics data to derive an estimate of the total population was used in a joint report by the SOK, United Nations Population Fund (UNFPA), and International Organization for Migration (IOM). The report, "Demographic, Social, Economic Situation and Reproductive Health in Kosovo Following the 1999 Conflict," was prepared on the basis of a survey conducted between November 1999 and February 2000. The report estimated that, in the absence of departures since 1981, Kosovo's total population would at the time have been 2.3 million.

TABLE AII.2
Estimates of Kosovar Living Abroad
(In thousands)

	1981[1]	2003[2]	2003[3]
Total population	1,611		2,400
Albanians	1,241		1,918
Residents	1,220	1,700	1,700
Living abroad	20		217
Others	371		482
Residents	364	232	232
Living abroad	6		250

Sources: Kosovo authorities; and Fund staff estimates.
[1]According to the 1981 population census.
[2]Staff projection based on the Statistical Office of Kosovo 2002 estimate for the total resident population and an annual growth rate of 1.7 percent.
[3]Staff estimate of population living abroad based on an assumption of a natural growth rate of 2 percent for ethnic Albanians and 1.2 percent for others.

among the pool of Kosovar Albanians living abroad. It is also likely that Kosovar women living abroad have a lower probability of being employed than men and an even lower probability of making transfers.

On the basis of a 2003 survey run by SOK, it was estimated that 170 thousand Kosovars are reported by their families residing in Kosovo as being usually absent from Kosovo. According to the survey, close to 80,000 of these "absentees" were working-age males and 35,000 were working-age females.[18] These numbers seem reasonable in light of the rough estimate of the total number of Kosovars living abroad established above.

Hence, given the above evidence, the likely number of emigrants sending remittances might be on the order of 100,000, which corresponds roughly to the working-age males reported in SOK's demographic and health survey, plus 50 percent of the working-age females. Obviously, some of the working-age males may be unable (e.g., unemployed or students) or unwilling to send money back to relatives in Kosovo, and some of the assumed 50 percent of females abroad might not be making any transfers. On the other hand, it is likely that some of the other Kosovars living abroad who have not been reported by their families as absent from Kosovo would in practice send money occasionally to their more distant relatives in Kosovo.[19]

Regarding the average amount of remittances per worker living abroad, the estimate produced by the HBS seems plausible, but it is likely to suffer from some underreporting bias. The reported average amounts of about €3,500 represent about 13 percent of a worker's annual salary in Germany.[20] For the sake of comparison, evidence about Latino workers in the United States suggests that immigrant workers send home about 15 percent of their income.[21] Data reported by Western Union, a dominant player in the market for wire transfers of workers' remittances in Kosovo, reported that its typical clients transfer an annual amount of about €5,000 on average. Since Western Union's clients are likely to be among the richer remitters, this average is unlikely to be representative for remittances as a whole. Nevertheless, considering the underreporting bias that usually plagues income surveys, the actual average amount of remittances may well be somewhat higher than the €3,500 figure reported in the HBS.[22] In the absence of a reasonable means to quantify the size of underreporting, a conservative estimate of 5 percent could be used for the sake of illustration.

All in all, the evidence reported above gives support to the conjecture that workers' remittances as reported in SOK's HBS are significantly underestimated. Although it is impossible to reliably quantify the likely extent of such underestimation, the above discussion suggests that the real figure might be on the order of €370 million, corresponding to about 100,000 workers abroad remitting an average annual amount of €3,700.

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[18]Statistical Office of Kosovo, "Kosovo Demographic and Health Survey 2003. Preliminary Results." Draft chapters, April 2004.

[19]A recent study about remittances originating from the United States found that over 60 percent of adult foreign-born Latino people living in the United States send remittances regularly and another 10 percent send them occasionally. Although the flow of money declines among those with longer tenure, a substantial proportion of Latino immigrants send money back to their relatives even after having been away from home for 20 to 30 years, and over 50 percent of all remittance senders have lived in the United States for more than 10 years (Multilateral Investment Fund of the Inter-American Development Bank, "Sending Money Home: Remittance to Latin America and the Caribbean," May 2004).

[20]Since Germany is thought have the largest population of Kosovars, it is used in this example. Average annual earnings of all employees in Germany in 2003 amounted to €26,700 (Data from the Federal Statistical Office Germany).

[21]According to the recent Inter-American Development Bank survey, Latino adult immigrants making remittances from the United States transfer on average about US$3,000 annually, which corresponds to about 15 percent of their median annual income of about US$20,000.

[22]Considering the motives for less than full disclosure of remittances in the HBS discussed above, it would seem logical that nonreporting rather than underreporting would be the primary source of downward bias.

Appendix III. Kosovo's Tax System—Evolution and Current Structure

This appendix first reviews the key steps in the development of Kosovo's tax system and then describes its current structure. Tables AIII.1–5 provide a brief summary of the evolution and main features of the key taxes.

Key Steps in Developing Kosovo's Tax System

The system was jump-started in August 1999 by the introduction of customs duties, sales tax, and excises on imports. The excise taxation was extended to local production in January 2000; however, collection of domestic excise taxes did not start effectively until in 2003. This was followed by the introduction of a hotel, food, and beverage tax on the gross receipts of hotels and restaurants in February 2000. A presumptive tax on businesses became effective in July of the same year. Moving quickly toward adopting the standard broad-based taxes on personal income and business profits, and on consumption, the sales tax on imported goods was changed into a full-fledged consumption-based value-added tax (VAT) in July 2001. In March 2002, wage-withholding and profit taxes were introduced, completing the basic architecture of the system. Some adjustment to the structure of the wage-withholding tax was introduced in early 2003, representing a pragmatic solution to the political tension that would have resulted from the doubling of the rates under the previous policy (see Box AIII.1). Finally, in June 2004, the 10 percent uniform import tariff was replaced by a two-tier structure, with 0 percent for selected capital goods, raw materials, and intermediate goods. A 10 percent tariff was retained for other goods.

Kosovo's Current Tax Structure

Customs Duties. The duties are 0 percent for selected capital goods and certain raw materials, and a 10 percent flat rate for all other goods except medical supplies, electricity, wheat, goods intended for humanitarian purposes, and goods imported by the United Nations, UN agencies, and nongovernmental organizations (NGOs). Imports of goods originating from Serbia and Montenegro are not subject to customs duties. A 1 percent administrative fee is applied on goods originating from Macedonia that are exempt from duties under a memorandum of understanding implementing the existing Federal Republic of Yugoslavia (FRY)–Macedonia free trade agreement.

Excises. Specific excises are levied on petroleum, alcohol, and tobacco products. Ad valorem excises are levied on coffee and soft drinks. Motor vehicles are subject to an excise that is a combination of ad valorem and specific excises. Excisable value of goods consists of customs value plus customs duties payable, or their value calculated from the retail price. Both imported and domestically produced goods are subject to excises; however, the reach of domestic excise collections is not yet comprehensive.

Value-Added Tax. A uniform 15 percent VAT rate is applied on the value of imports (inclusive of excises and customs duties), intra-FRY inflows, and domestic taxable goods and services. Certain organizations (UN, KFOR, diplomatic missions, etc.) are excluded from VAT. Contractors supplying goods or services to the excluded organizations are entitled to a rebate of VAT paid on imports and domestic inputs in relation to contracts with such organizations. For capital goods, a deferment procedure is in place that grants

TABLE AIII.1
Customs Duties

Origin of Goods	Customs Duties/Fees
Albania (2003 Free Trade Agreement)	Most goods exempt from duties, others subject to 10 percent customs duty
Macedonia (1996 Free Trade Agreement)	1 percent administrative customs fee on goods
Serbia and Montenegro: Intra-FRY Flows	Not subject to customs duties
Serbia: Intra-FRY inflows	Not subject to customs duties
Rest of world	10 percent customs duty

Goods Exempt from Customs Duties

REG No.	2004/13	2000/55			1993/3
Effective on	7-Jun-04	1-Jun-01	27-Oct-00	6-Oct-00	1-Sep-99
Milk				X	X
Cooking oils and fats				X	X
Vegetables			X	X	X
Fruits			X	X	X
Wheat flour			X	X	
Pharmaceutical products	X	X	X	X	X
Medical and surgical instruments and apparatus	3	X	X	X	X
Stamps and valuable papers[1]	3	X	X	X	X
Agricultural fertilizer[2]	3	X	X	X	
Goods imported by UNMIK, KFOR, UNHCR, ICRC, Red Cross and Red Crescent Societies, and NGOs with public benefit status	X	X	X	X	X
Goods imported by foreign diplomatic and consular missions for their official use	X	X	X	X	X
Goods funded from the proceeds of grants made to UNMIK by governments, government agencies, governmental or NGOs, in support of humanitarian and reconstruction programs and projects in Kosovo	X	X	X	X	

Goods with a Zero Rate of Customs Duty

REG No.	2004/13
Effective on	7-Jun-04

Selected raw materials and capital goods listed in Parts B and C of the Annex to UNMIK Regulation 2004/13.

Source: UNMIK regulations and administrative directions.
[1]Classified in heading 4907 of the Harmonized Customs Tariff.
[2]Classified in chapter 31 of the Harmonized Customs Tariff.
[3]Zero rate of customs duty under REG/2004/13.

TABLE AIII.2
Excise Tax Rates and Exemptions

REG No.	UNMIK/REG/2003/23		UNMIK/REG/2000/2[1, 2]										REG/1999/3[3]
Amendments			2002/16	2001/38	2001/15		2000/56			2000/35	2000/26		
Effective on	1-Oct-03	1-July-03	1-Aug-02	1-Jan-02	1-Oct-01	3-Jul-01	1-Apr-01	1-Jan-01	1-Nov-00	16-Jun-00	27-Apr-00	22-Jan-00	1-Sep-99
Coffee	Ad valorem 30%												DM 3 per kg
Soft drinks	Ad valorem 10%												Ad valorem 10%
Beer	0.15 euro per liter		DM 0.3 per liter							Ad valorem 20%			Ad valorem 15%
Wine	0.20 euro per liter		DM 0.4 per liter							Ad valorem 20%			Ad valorem 5%
Other fermented beverages	0.15 euro per liter		DM 0.3 per liter							Ad valorem 20%			
Undenatured ethyl alcohol (>80%)	1 euro per liter of alcohol		DM 2 per liter of alcohol							Ad valorem 50%			Strong drinks: 50%
Undenatured ethyl alcohol (<80%)	1 euro per liter of alcohol		DM 2 per liter of alcohol							Ad valorem 50%			Alcohol/ethanol: 15%
Cigarettes[4]	10 euros per 1000 cigarettes	6 euros per 1000 cigarettes	2 euros per 1000 cigarettes		DM 4 per 1000 cigarettes					Ad valorem 25%			Ad valorem 25%
Cigars and cigarillos[4]	1 euro per conventional unit	50 cents per conventional unit	Ad valorem 50%							Ad valorem 25%			Ad valorem 10%
Other tobacco[4]	10 euros per conventional unit	6 euros per conventional unit	Ad valorem 50%							Ad valorem 25%			Ad valorem 10%
Gasoline	30.0 cents per liter			27.5 cents per liter	50	45	40	35	30 pfennig per liter	Ad valorem 50%			Ad valorem 50%
Gas oil	27.5 cents per liter			25.0 cents per liter	45	40	35	30	25 pfennig per liter				
Diesel	27.5 cents per liter			25.0 cents per liter	45	40	35	30	25 pfennig per liter	Ad valorem 50%			Ad valorem 50%
Kerosene	27.5 cents per liter			25.0 cents per liter	45	40	35	30	25 pfennig per liter	Ad valorem 50%			
Heating oil[5]	27.5 cents per liter			25.0 cents per liter	45	40	35	30	25 pfennig per liter	Ad valorem 50%			
Mobile phones				Ad valorem 15%									Ad valorem 15%
VCRs				Ad valorem 15%									Ad valorem 15%
TV sets				Ad valorem 15%									Ad valorem 15%
Satellite dishes				Ad valorem 15%									Ad valorem 15%
Motor vehicles	Ad valorem 20% + 500 euro each				Ad valorem 20% + DM 1000 each								
Exemptions	Following goods: Raw and auxiliary materials, imported by licensed persons, to be used in the manufacture of goods for export. Goods to be used exclusively for humanitarian purposes and not to be offered for sale for consumption. Following persons/entities: Foreign diplomatic and consular missions UN, UNMIK, KFOR, international inter-governmental organizations and government agencies (goods for official purposes) Contractors to UNMIK and KFOR (imported goods to be used exclusively in connection with the contracts) Registered NGOs with public benefit status (gasoline, kerosene, diesel, ethanol, mobile phones, satellite dishes, TVs and VCRs)												Goods imported by UNMIK, KFOR, UNHCR, Red Cross and Red Crescent Societies, registered NGO

Source: UNMIK regulations and administrative directions.
[1]Excise taxes are defined as taxes levied on designated goods sold for consumption in Kosovo (REG/2000/2: 1).
[2]Excisable value of goods consists of customs value plus customs duties payable, or their value calculated from the retail price (REG/2000/2: 2.1).
[3]Listed goods that are imported and destined exclusively for Kosovo are excisable. Excise duties are collected at the border posts (REG/1999/3: 1.2).
[4]The excise regime for tobacco products was reformed in 2003 by introducing banderols and by phased increase of excise rates.
[5]Effective on October 1, 2002, imported heating oil used by district heating facilities for heating purposes and by persons/entities for manufacturing purposes is exempt (refundable).

TABLE AIII.3
VAT[1]

		VAT	Imports	Intra-FRY inflows	Supplies	Sales Tax	Service Tax[2]	Sales Tax[3]
Regulation No.		Amendment by REG/2002/17 REG/2001/11				REG/2000/3	REG/2000/5	REG/1999/3
Effective date		1-Aug-02 31 May 2001 (Applicable from 1 July 2001)				22-Jan-00	1-Feb-00	1-Sep-99
Input tax credit		Consumption type VAT (full credit for capital goods)				No credit for input tax		
Rate		15%				15% of c.i.f. value + duty/excise payable [For goods produced in Kosovo, collection of sales tax is suspended]	10% of gross receipts of hotel, food, and beverage providers	
Zero rated		Exports, including intra-FRY outflows / International transportation of goods and passengers. Applies to certain agricultural products and irrigation of farming land from September 1, 2004 (UNMIK REG/2004/35).						
Threshold		50,000 euro turnover per calendar year 100,000 euro turnover per calendar year					10,000 DM/month (15,000 DM/month before 23 May 2000)	
Turnover		Gross receipts of a person from all supplies, including zero-rated supplies, exclusions, and exempt supplies (added by REG/2002/17) made by such person in Kosovo						
Exemptions						Exempted goods: —Goods sold for export —Following categories of goods[4]: 1. Pharmaceutical products 2. Medical and surgical instruments and apparatus 3. Milk 4. Cooking oil and fats 5. Vegetables 6. Fruits 7. Wheat flour —Goods to be used exclusively for humanitarian purposes and not to be offered for sale in Kosovo —Goods funded from the proceeds of grants made to UNMIK in support of humanitarian and reconstruction programs/projects (Director-General of the UNMIK Customs Service determines) Exempted entities: —Foreign diplomatic and consular missions —UNMIK, UN agencies, KFOR, etc. on goods used for official purposes —UN contractors: same as VAT —Registered NGO: same as VAT	None	Exempted goods: —Exports —Pharmaceutical products —Medical and surgical instruments and apparatus —Milk —Cooking oils and fats —Vegetables —Fruits —Stamps and valuable papers —Goods imported by UNMIK, KFOR, UNHCR, ICRC, Red Cross and Red Crescent Societies, NGOs registered with the United Nations —Goods imported by foreign diplomatic and consular missions for their official use
	Exclusion—No VAT, can claim credit for input tax.	—Following imports, intra-FRY inflows and supplies	Imports	Intra-FRY inflows	Supplies			
		funded by grants made in support of humanitarian and reconstruction programs and projects in Kosovo	X	X	X			
		made by/to diplomatic representatives or liaison offices	X	X	X			
		made by/to UNMIK, UN agencies, KFOR, the World Bank, and international intergovernmental organizations	X	X	X			
		medicines, medical services, pharmaceutical products, or medical and surgical instruments and apparatus	X	X				
		of traveler's personal effects and tourist duty-free goods	X					
		—A fine or penalty levied by UNMIK authorities						
	Exemptions—No VAT, no credit for input tax.	—medicines, medical services, pharmaceutical products, or medical and surgical instruments —public education services / financial services —transfer of title or lease of land or residential property —a supply made by a person who imports or makes intra-FRY inflows but whose turnover does not exceed the threshold —a supply of permits or licenses for a fee by a municipal or public authority.						
	Rebate—Refund of VAT paid on import or intra-FRY inflow.	Import or intra-FRY inflow:						
		By	Used exclusively					
		Contractors for UNMIK, UN agencies, KFOR, WB, and international organizations	in connection with the contract					
		NGO with public benefit status	for the public benefit purposes (No rebate for: alcohol, alcoholic drinks, soft drinks, tobacco products, petroleum products, and cosmetics)					
		Need to be requested within 1 year	No time limit for requests.					
VAT liability		Accrual basis (the earlier of invoice, delivery, or payment)						
Tax period		Calendar month (declaration/payment have to be made by the end of the following month). VAT on capital goods import can be deferred/set off against the output tax up to 6 months.						

Source: UNMIK regulations and administrative directions.

[1]Sales tax and Service tax regulations were repealed effective on 1 July 2001, from which date VAT was applicable.

[2]Hotel, Food, and Beverage Service Tax. REG/2000/5 was amended by REG/2000/31 of 23 May 2000.

[3]As a temporary measure, a 15 percent sales tax was levied on the taxable value of all imported goods destined exclusively for Kosovo.

[4]Exemptions for categories 3 and 4 applied only to October 27, 2000, and exemptions to categories 5, 6, and 7 applied only to June 1, 2001.

TABLE AIII.4
Profit and Presumptive Taxes

<table>
<tr><th></th><th>Profit Tax</th><th colspan="4">Presumptive Tax</th></tr>
<tr><td>Regulation No.</td><td>UNMIK/2002/3</td><td colspan="4">UNMIK/2000/29</td></tr>
<tr><td>Effective date</td><td>20 February 2002 (applicable to taxable profit from 1 April 2002)</td><td colspan="4">20 May 2000 (applicable from 1 July 2000)</td></tr>
<tr><td rowspan="2">Taxpayers</td><td colspan="5">Taxpayers of profit tax are not liable for presumptive tax.</td></tr>
<tr><td>—Business organization required to prepare financial statements in accordance with REG/2001/30 [1]
—Business organization that opts to prepare financial statements in accordance with REG/2001/30 [1]
—PE of a nonresident person
—Registered NGOs</td><td colspan="4">—All other persons (any entities and natural persons) that engage in any economic activity for profit (registered nonprofit organization is exempt)</td></tr>
<tr><td rowspan="7">Rate</td><td rowspan="6">20% of taxable profit (9/12 of annual taxable profit for 2002)</td><td colspan="4">—Small taxpayers: flat tax
(gross receipts in all previous calendar quarters < 7,500 euro)
—Large taxpayers: flat tax + 3% × (quarterly gross receipts − 7,500 euro)
Flat tax: euro/quarter</td></tr>
<tr><td>Location</td><td>A[2]</td><td>B[3]</td><td>C[4]</td></tr>
<tr><td>Businesses/Professionals</td><td>200</td><td>150</td><td>100</td></tr>
<tr><td>Entertainment</td><td>200</td><td>150</td><td>100</td></tr>
<tr><td>Transport</td><td>125</td><td>100</td><td>75</td></tr>
<tr><td>Artisans</td><td>37.5</td><td>37.5</td><td>37.5</td></tr>
<tr><td>Insurance company: 7% of gross premiums</td><td colspan="4">—Insurance company: 10% of gross premiums</td></tr>
<tr><td>Tax period</td><td>Calendar year</td><td colspan="4">Calendar quarter</td></tr>
<tr><td>Declaration</td><td>Due by 1 April of the year following the tax period</td><td colspan="4"></td></tr>
<tr><td>Payments</td><td>Quarterly installments (same due dates as presumptive tax) based on estimated taxable profit or on the taxable profit for the preceding year.</td><td colspan="4">15 days after the end of each calendar quarter</td></tr>
<tr><td>Exempt incomes</td><td colspan="5">—Incomes exclusively used for the public benefit purposes by a registered NGO with public benefit status
—Dividends received by a resident taxpayer from a resident company that paid Kosovo profit tax
—Income from a contractor, other than a local contractor, generated from contracts for the supply of goods and services to UNMIK, UN agencies, and IAEA
—Income of the Banking and Payments Authority of Kosovo</td></tr>
<tr><td rowspan="3">Depreciation</td><td colspan="5">Category 1 (Buildings and other construction structures) — Segregated asset account, 5% declining-balance depreciation
Category 2 (Automobiles, computers, office furniture/equipment, etc.) — Pooled account, 20% declining-balance depreciation
Category 3 (Plant and machinery, heavy transport vehicles, etc.) — Pooled account, 15% declining-balance depreciation
*Expenditure less than 1,000 euro on asset in category 2 or 3 = current expense</td></tr>
<tr><td colspan="5">Amortization of leasehold improvements: straight-line depreciation over the length of the lease</td></tr>
<tr><td colspan="5">Amortization of intangible assets: straight-line depreciation for the useful life</td></tr>
<tr><td>Business loss</td><td colspan="5">Carry forward up to 5 years</td></tr>
<tr><td>International taxation</td><td colspan="5">—Transfer pricing: ALP = CUP or resale price/cost-plus method
—Foreign tax credit (up to the amount of tax that would be paid under Kosovo profit tax)
—15% withholding tax on dividends, interest, or royalties to nonresidents (subject to pre-1999 Yugoslavia Double Tax Agreements)</td></tr>
</table>

Source: UNMIK regulations and administrative directions.
[1]"Business organizations" covers companies (joint stock and limited liability), public and socially owned enterprises.
[2]A = Pristina.
[3]B = Prizren, Gjilan, Peje, Gjakova, and Ferizaj.
[4]C = Elsewhere.

TABLE AIII.5
Personal Income Tax (Wage-Withholding Tax)

Regulation No.	REG/2003/3		REG/2002/4	
Effective date	1 January 2003		1 March 2002 (applicable from 1 April 2002)	
Rates	Tax period 2003, and after		Tax period 2002 (9 months: April–December)	
	Taxable income < 960 euro	0%	< 600 euro × 9/12	0%
	960 euro < taxable income < 3,000 euro	5%	600 euro × 9/12< <3,000 euro × 9/12	5%
	3,000 euro < taxable income < 5,400 euro	10%	> 3,000 euro × 9/12	10%
	> 5,400 euro	20%		
Tax period	Calendar year		Calendar year (April 2002–December 2002)	
Deduction	Mandatory contributions by employees to funded pension schemes approved by the competent government authority.			
Excluded income	Wages received by: –foreign diplomatic and consular representatives and foreign personnel of Liaison Offices in Kosovo –foreign representatives, foreign officials, and foreign employees of international governmental organizations and international NGOs with public benefit status –foreign representatives, foreign officials, and foreign employees of donor agencies or their contractors or grantees carrying out humanitarian aid, reconstruction work, civil administration, or technical assistance within Kosovo –foreign and locally recruited officials of UNMIK, UN agencies, IAEA –foreign personnel of KFOR			
Withholding	Each employer is responsible for withholding tax from the gross wage income (after pension contribution deduction) of its employees during each payroll period.			
Declaration	Taxpayers requiring adjustment (further tax/refund) need to submit a tax declaration, by 1 April of the year following the tax period.			

Source: UNMIK regulations and administrative directions.

6 months' deferment for payment of VAT on imported capital goods. Taxable persons with turnover greater than €50,000 are subject to VAT and can get an input tax credit for the VAT paid on imports or domestic purchases. Taxable persons who are below the threshold can elect to be VAT filers.

Presumptive Tax. The tax is 3 percent of gross sales over €7,500 per quarter, plus a standard amount for the first €7,500 per quarter. (For eligibility thresholds, see Profit Tax below.) The planned introduction of the comprehensive personal income tax and the corporate income tax (which replaces the earlier profit tax) would eliminate the presumptive tax as a stand-alone tax.

Profit Tax. Profit tax is 20 percent on taxable profit (gross sales less allowable expenses); for insurance companies it is 7 percent of gross premiums. The tax is applicable to companies (with annual sales of €100,000 or more, or assets over €50,000, or those who otherwise opt to pay profit tax instead of presumptive tax), to all public enterprises and socially owned enterprises, to NGOs (in respect of any non-public benefit income), and to all permanent establishments of nonresidents.

Wage Tax. The wage tax has four brackets: 0 percent for annual income up to €960, 5 percent for annual incomes of €960 to €3,000, 10 percent for annual incomes of €3,000 to €5,400, and 20 percent for annual incomes over €5,400. The wage-withholding tax is levied on a monthly basis and reassessed on an annual basis. After the planned introduction of the comprehensive personal income tax, wages would be taxed together with all other sources of personal income (e.g. interest, pensions, rental income, royalties, business income, lottery winnings, capital gains, and dividends will be considered as taxable income. Rental income of individuals is already taxable under the presumptive tax but compliance with this tax is low. The application of the new comprehensive income tax to capital gains will be deferred until 2010).

Box AIII.1. Wage Tax

The wage tax regulation issued in March 2002 introduced a simple tax structure: 0 percent for monthly wages below €50, a marginal rate of 10 percent for wages between €50 and €250, and a marginal rate of 20 percent for wages above €250. To phase in the new tax, the regulation prescribed that the rates be halved during the first 9 months, that is, until end-2002.

Instead of doubling the rates after the phasing-in period, the regulation modified the tax structure to accommodate a number of considerations. In early 2003, the doubling of the rates that was called for by the regulation was felt to be politically too difficult to implement. Consequently, the authorities proposed, and a visiting IMF mission agreed, that the tax structure be adjusted as follows: 0 percent rate for monthly wages below €80, 5 percent for wages between €80 and €250, 10 percent for wages between €250 and €450, and 20 percent for wages above €450. This change was deemed appropriate for the following reasons:

- First, the new rate structure, with a maximum rate of 20 percent was commensurate to the profit tax rate and preserved horizontal equity among taxpayers, minimizing the scope for tax avoidance.
- Second, although very few wage earners were initially subject to the 20 percent rate, having higher rates in the structure sent the right signal to the public that they will be contributing more as their financial positions strengthen.
- Third, the change introduced greater progressivity, which is likely to increase the perception of its fairness, thus enhancing tax compliance and nurturing the general public's trust in the tax system, an important consideration at this nascent stage.
- Fourth, the revenue loss was estimated to be manageable.

STATISTICAL APPENDIX

TABLE 1
Main Indicators, 2001–05

	2001 Est.	2002 Est.	2003 Est.	2004 Proj.	2005 Proj.
Real growth rates (in percent)					
GDP	. . .	1.2	3.1	3.2	1.7
Contribution of foreign assistance to GDP growth		–3.9	–3.3	–1.7	–1.2
GNDI	. . .	–0.2	1.1	1.8	0.8
Price changes (in percent)					
CPI	11.7	3.6	1.0	1.5	2.0
GDP	21.6	5.5	0.5	2.2	3.7
Real effective exchange rate (CPI based)	8.6	0.9	–1.0	–0.5	0.0
General government budget (in percent of GDP)					
Revenues	19.8	28.8	32.8	31.9	30.8
Expenditures	15.1	23.2	30.3	34.3	34.6
Of which: Capital	1.3	2.4	5.4	6.1	7.5
Current balance	5.9	8.0	7.8	3.7	3.7
Overall balance	4.7	5.6	2.5	–2.4	–3.8
Overall balance (after grants)	7.2	6.2	2.5	–2.4	–3.8
Savings/investment balances (in percent of GDP)[1]					
Domestic savings	–63.1	–51.5	–47.5	–40.7	–32.2
Investment	40.7	34.5	29.3	27.8	28.8
Current account balance (before foreign assistance & remittances)	–103.7	–86.0	–76.8	–68.5	–61.0
Workers' remittances and donor local employees' wages[2]	24.8	22.5	20.2	18.5	17.1
Foreign assistance[3]	70.4	52.0	40.7	32.9	25.9
Current account balance	–8.6	–11.6	–15.8	–17.1	–18.0
Savings/investment balances (in percent of GDP)[4]					
Domestic savings	–34.6	–29.6	–28.2	–24.5	–20.7
Investment	25.6	24.1	22.3	22.8	24.5
Current account balance (before foreign assistance & remittances)	–60.1	–53.7	–50.4	–47.3	–45.2
Workers' remittances[2]	13.4	13.9	13.4	12.9	12.2
Donors' contribution to GNDI	38.2	28.2	21.2	17.3	15.0
Current account balance	–8.6	–11.6	–15.8	–17.1	–18.0
Savings/investment balance of the private sector	–15.8	–18.2	–18.3	–14.7	–14.2
Savings/investment balance of the government	7.2	6.7	2.5	–2.4	–3.8
Donors' contribution to GDP (in percent of GDP)	23.1	18.1	14.1	11.7	10.1
Main aggregates (in millions of euros)					
GDP	1,625	1,735	1,797	1,895	1,999
GDP per capita (in euros)	870	913	930	964	1,000
GNDI per capita (in euros)	1,086	1,119	1,118	1,143	1,171
Workers' remittances[2]	217	241	241	244	244
Foreign assistance[3]	1,144	902	732	624	518
Direct contribution of foreign assistance to GDP	376	314	254	221	203
Direct contribution of foreign assistance to GNDI	620	490	381	327	300
Population (in thousands)	1,868	1,900	1,932	1,965	1,999

Source: Fund staff estimates.
[1]Savings/Investment balances of the entire economy, i.e., the domestics sector and the donor sector.
[2]Including pensions from abroad.
[3]Total foreign assistance excluding capital transfers.
[4]Savings/Investment balances of the domestic sector.

TABLE 2
GDP, Real Changes and Contribution to Growth, 2002–05

	2002 Est.	2003 Est.	2004 Proj.	2005 Proj.
		(Real changes; in percent)		
Consumption	**–4.4**	**–0.5**	**–1.4**	**–3.5**
Households	–1.4	1.7	1.0	1.7
Government	–9.3	–4.5	–6.0	–14.0
General government	35.3	24.5	8.7	–5.6
Donor sector	–19.0	–15.0	–13.8	–19.6
Investment	**–12.3**	**–12.5**	**–2.2**	**4.4**
Donor investment	–28.6	–31.0	–24.6	–12.6
Investment expenditure in the KGB[1]	96.5	127.6	17.6	27.9
Private investment (including POEs and SOEs)	–8.0	–19.3	0.8	1.0
Net exports of GNFS				
Exports	–22.0	–15.2	0.3	–4.2
Local consumption of expatriates	–25.3	–22.1	–8.7	–19.3
Other exports	13.4	32.7	38.0	37.3
Imports	–14.3	–10.3	–6.8	–7.4
Donor related imports	–23.4	–19.6	–17.0	–22.4
Imports related to donor financed spending	–22.8	–19.3	–16.3	–22.4
Imports related to humanitarian assistance	–51.5	–45.5	0.0	0.0
Other imports	–6.4	–3.7	–0.8	0.0
Of which: Private consumer goods	–3.7	–0.4	–2.7	–0.5
Private investment goods	–12.8	–23.3	0.8	0.9
GDP	**1.2**	**3.1**	**3.2**	**1.7**
		(Contribution to GDP growth)		
Private consumption	–1.3	1.6	0.9	1.6
Government consumption	3.8	3.6	1.5	–1.0
Private investment	–1.9	–4.2	0.1	0.2
Government investment	1.2	3.1	0.9	1.7
Net exports excluding foreign assistance	4.2	2.6	1.2	1.0
Exports	0.2	0.5	0.8	1.0
Imports	4.0	2.1	0.4	0.0
Foreign assistance	–3.9	–3.3	–1.7	–1.2
Memorandum item:				
Real growth of private sector disposable income	–7.0	–2.8	4.0	1.2
Private consumption in percent of disposable income	96.5	101.4	97.9	97.1

Source: Fund staff estimates.
[1]Including POE and SOE investment financed directly from the budget.

TABLE 3
GDP at Current Prices, 2001–05
(In millions of euros, unless otherwise indicated)

	2001 Est.	2002 Est.	2003 Est.	2004 Proj.	2005 Proj.
Consumption	**2,651**	**2,630**	**2,651**	**2,666**	**2,643**
Households	1,646	1,682	1,728	1,771	1,837
Public	1,004	948	923	895	806
General government	165	253	322	367	373
Wages	110	131	146	170	195
Goods and services	55	121	176	197	178
Donor sector[1]	839	695	601	528	433
Wages	676	576	478	407	326
Expatriates	490	427	355	301	229
Local employees	185	149	122	106	97
Goods and services	163	119	123	121	107
Investment	**661**	**598**	**526**	**528**	**576**
Donor sector[1]	245	180	126	96	86
General government	21	42	96	115	150
Private investment	395	376	304	317	340
Housing	300	255	199	206	221
Other	95	121	105	111	119
Net exports of GNFS	**–1,686**	**–1,493**	**–1,379**	**–1,299**	**–1,220**
Exports	269	217	186	190	185
Local consumption of expatriates (incl. soldiers)	246	190	150	139	114
Of which: re-exports	67	51	46	49	40
Other exports	23	27	36	51	71
Imports	1,955	1,710	1,565	1,488	1,405
Imports related to donor financed spending	888	700	577	493	390
Wages of expatriates	490	427	355	301	229
Wages of local employees	185	149	122	106	97
Other goods and services	213	124	99	86	64
Imports related to the humanitarian assistance	18	9	5	0	0
Other imports	1,049	1,001	984	996	1,015
Of which: private sector consumer goods	663	652	662	657	667
private investment goods	228	203	159	163	168
GDP	**1,625**	**1,735**	**1,797**	**1,895**	**1,999**
Workers' remittances	217	241	241	244	244
Wages of donor sector's local employees	185	149	122	106	97
GNDI	**2,028**	**2,125**	**2,161**	**2,245**	**2,341**
Memorandum items:					
Total foreign assistance	1,175	912	737	628	523
Of which: Direct contribution to GNDI	620	490	381	327	300
Private sector disposable income	1,785	1,742	1,703	1,808	1,893
Private sector consump. in percent of disposable income	92	97	101	98	97
GNDI per capita (in euros)	1,086	1,119	1,118	1,143	1,171

Source: Fund staff estimates.
[1]Donor sector includes UNMIK, KFOR, and other donor spending under the umbrella of the so called "public investment program," and spending financed by designated donor grants (DDGs). This presentation excludes wages of KFOR personnel as well as consumption of goods imported directly by KFOR.

TABLE 4
Savings/Investment Balances, 2001–05
(In percent of GDP)

	2001	2002	2003	2004	2005
Consumption	**163.1**	**151.5**	**147.5**	**140.7**	**132.2**
Private	101.3	96.9	96.1	93.5	91.9
Government	10.1	14.6	17.9	19.4	18.7
Donor sector	51.6	40.0	33.5	27.9	21.7
Domestic savings	**–63.1**	**–51.5**	**–47.5**	**–40.7**	**–32.2**
Private	–17.4	–19.5	–21.9	–16.5	–14.3
Government	5.9	8.0	7.8	3.7	3.7
Donor sector	–51.6	–40.0	–33.5	–27.9	–21.7
Factor income and current transfers	**28.4**	**24.0**	**20.5**	**18.5**	**17.1**
Remittances, local employees' wages, and other private transfers	24.8	22.5	20.2	18.5	17.1
Budgetary support	2.5	1.0	0.0	0.0	0.0
Humanitarian assistance	1.1	0.5	0.3	0.0	0.0
National savings	**–34.7**	**–27.5**	**–27.0**	**–22.2**	**–15.1**
Private	8.5	3.5	–1.4	2.0	2.8
Government	8.4	9.1	7.8	3.7	3.7
Donor sector	–51.6	–40.0	–33.5	–27.9	–21.7
Total investment	**40.7**	**34.5**	**29.3**	**27.8**	**28.8**
Private	24.3	21.7	16.9	16.7	17.0
Government	1.3	2.4	5.4	6.1	7.5
Donor sector	15.1	10.4	7.0	5.1	4.3
Current account balance (before foreign assistance)	**–75.3**	**–62.0**	**–56.2**	**–50.0**	**–43.9**
Private	–15.8	–18.2	–18.3	–14.7	–14.2
Government	7.2	6.7	2.5	–2.4	–3.8
Donor sector	–66.7	–50.4	–40.4	–32.9	–25.9
Foreign assistance[1]	**68.7**	**51.0**	**40.7**	**33.1**	**26.2**
Current account balance (after foreign assistance)	**–6.7**	**–11.0**	**–15.5**	**–16.9**	**–17.8**
Private sector savings/investment balance	–14.7	–17.7	–18.0	–14.7	–14.2
Government savings/investment balance	9.7	7.7	2.5	–2.4	–3.8

Source: Fund staff estimates.
[1]Excludes budgetary support and humanitarian assistance.

TABLE 5
Balance of Payments, 2001–05
(In millions of euros, unless otherwise indicated)

	2001 Est.	2002 Est.	2003 Est.	2004 Proj.	2005 Proj.
Goods and services balance	**–1,686**	**–1,493**	**–1,379**	**–1,299**	**–1,220**
(in percent of GDP)	*–103.7*	*–86.0*	*–76.8*	*–68.5*	*–61.0*
Trade balance	**–962**	**–871**	**–856**	**–845**	**–847**
Exports	269	217	186	190	185
Regular exports	23	27	36	51	71
Local consumption by expatriates[1]	246	190	150	139	114
Imports	1,231	1,088	1,042	1,035	1,032
Donor imports	213	124	99	86	64
Imported directly	190	90	25	0	0
Included in commercial imports[2]	23	34	73	86	64
Imports related to humanitarian assistance	18	9	5	0	0
Other imports	1,000	955	938	949	968
Commercial imports	992	953	969	990	986
Donor imports included in commercial imports[2]	*–23*	*–34*	*–73*	*–86*	*–64*
Pharmaceutical	9	14	20	22	23
Electricity (funded by general budget)	22	22	23	23	24
Nonfactor services	**–725**	**–622**	**–523**	**–453**	**–373**
Payments	725	622	523	453	373
Donor related	676	576	478	407	326
Wages of expatriates	490	427	355	301	229
Wages of local employees	185	149	122	106	97
Non-donor-related	49	47	46	46	47
Factor income	**402**	**390**	**364**	**351**	**341**
Workers' remittances	217	241	241	244	244
Wages of local employees of UNMIK & donors	185	149	122	106	97
Current account balance (before foreign assistance)	**–1,284**	**–1,103**	**–1,015**	**–948**	**–878**
(in percent of GDP)	*–79.0*	*–63.6*	*–56.5*	*–50.0*	*–43.9*
Foreign assistance	**1,144**	**902**	**732**	**624**	**518**
(in percent of GDP)	*70.4*	*52.0*	*40.7*	*32.9*	*25.9*
Of which UNMIK	449	387	356	317	203
PIP	532	377	246	189	219
Current account (after foreign assistance)	**–140**	**–201**	**–284**	**–324**	**–360**
(in percent of GDP)	*–8.6*	*–11.6*	*–15.8*	*–17.1*	*–18.0*
Capital Account	**–223**	**–222**	**–57**	**11**	**58**
Donor capital participation	31	10	5	4	5
Changes in government deposits abroad (–increase)	–12	–49	–4	0	0
Change in currency in circulation (–increase)[3]	–31	132	24	0	0
Change in banking system's NFA[3]	–212	–315	–48	39	85
Changes in BPK's NFA (–increase)	–99	–194	–108	44	**75**
Changes in banks' NFA (–increase)	–113	–121	61	–5	10
Change in KPST's[4] foreign assets	0	0	–35	–32	–32
Errors and Omissions	**363**	**423**	**341**	**313**	**302**
Memorandum items:					
Net external asset position	398	664	742	735	682
(in percent of GDP)	*25*	*38*	*41*	*39*	*34*
Government deposits abroad (excl. DDG)	63	15	11	11	11
Foreign assets of KPST[4]	0	0	35	67	99
NFA of banking system	335	649	697	658	572

Source: Fund staff estimates.
[1]Includes local personal consumption of expatriates employed by UNMIK, PIP, and KFOR, plus their visiting relatives.
[2]Includes import content of locally procured goods and donor imports through commercial channels.
[3]Based on adjusted end-2001 data to remove the one-off spike in banks' deposits and net foreign assets at the time of the euro cash changeover.
[4]Kosovo Pension Savings Trust (KPST).

TABLE 6

Foreign Assistance, 2000–05

(In millions of euros, unless otherwise indicated)

	2000 Est.	2001 Est.	2002 Est.	2003 Est.	2004 Proj.	2005 Proj.
Total foreign assistance	**1,271**	**1,175**	**912**	**737**	**628**	**523**
(in percent of GDP)		*72.3*	*52.6*	*41.0*	*33.1*	*26.2*
Foreign assistance excluding capital participation	1,229	1,144	902	732	624	518
UNMIK's budget, PIP (incl. DDGs), and KFOR	**1,115**	**1,116**	**885**	**732**	**628**	**523**
Wages[1]	601	676	576	478	407	326
Expatriates (excluding soldiers' salaries)	416	490	427	355	301	229
Number of expatriates	*58,155*	*54,745*	*41,319*	*26,773*	*22,069*	*17,577*
Local employees	185	185	149	122	106	97
Number of employees	*19,946*	*20,136*	*17,022*	*14,540*	*12,998*	*12,197*
	9,290	*9,206*	*8,729*	*8,423*	*8,163*	*7,949*
Goods and services	472	409	299	249	217	193
Of which: Imports	380	213	124	99	86	64
Capital participation	42	31	10	5	4	5
UNMIK budget	**413**	**449**	**387**	**356**	**317**	**203**
Wages[1]	281	360	343	308	270	171
Expatriates	218	296	288	258	226	141
Number of expatriates	*6,983*	*7,628*	*7,087*	*6,220*	*5,874*	*4,197*
Local employees	63	64	55	50	44	29
Number of employees	*5,461*	*5,687*	*4,900*	*4,357*	*3,828*	*2,542*
Average salary	*11,490*	*11,340*	*11,207*	*11,408*	*11,582*	*11,603*
Goods and services	132	88	44	48	46	32
Of which: Imports	52	24	14	14	13	9
Other donors (PIP and DDG)	**602**	**567**	**398**	**275**	**211**	**219**
Wages[1]	295	290	208	145	111	129
Expatriates	198	195	139	97	75	86
Number of expatriates	*3,172*	*3,118*	*2,233*	*1,553*	*1,195*	*1,380*
Local employees	97	96	69	48	37	42
Number of employees	*8,485*	*8,449*	*6,122*	*4,183*	*3,170*	*3,655*
Goods and services	264	245	180	126	96	86
Of which: Imports	261	129	69	55	42	25
Capital participation	42	31	10	5	4	5
KFOR	**100**	**100**	**100**	**100**	**100**	**101**
Wages[1]	25	25	25	25	25	26
Personnel	0	0	0	0	0	1
Number of soldiers	48,000	44,000	32,000	19,000	15,000	12,000
Local employees	25	25	25	25	25	25
Number of employees	*6,000*	*6,000*	*6,000*	*6,000*	*6,000*	*6,000*
Goods and services[2]	75	75	75	75	75	75
Of which: Imports	68	60	41	30	30	30
Budgetary support	**121**	**41**	**18**	**0**	**0**	**0**
Humanitarian assistance to households	**36**	**18**	**9**	**5**	0	**0**
Of which: Imports	36	18	9	5	0	0

Source: Fund staff estimates.

[1]Excludes additional salaries paid by respective governments for employees that are seconded by their government, and soldiers' wages.

[2]Excludes additional spending on direct imports for which no data are available.

TABLE 7
National Income Accounts and the Balance of Payments at Current Prices, 2001–05
(In millions of euros, unless otherwise indicated)

	2001 Est.	2002 Est.	2003 Est.	2004 Proj.	2005 Proj.
National accounts					
Consumption	**2,651**	**2,630**	**2,651**	**2,666**	**2,643**
Households	1,646	1,682	1,728	1,771	1,837
General government	165	253	322	367	373
Donor sector	839	695	601	528	433
Investment	**661**	**598**	**526**	**528**	**576**
Private investment	395	376	304	317	340
General government	21	42	96	115	150
Donor sector	245	180	126	96	86
Net exports of GNFS	**–1,686**	**–1,493**	**–1,379**	**–1,299**	**–1,220**
Exports	**269**	**217**	**186**	**190**	**185**
Regular exports	23	27	36	51	71
Local consumption by expatriates (incl. soldiers)	246	190	150	139	114
Imports	**1,955**	**1,710**	**1,565**	**1,488**	**1,405**
Domestic sectors	1,000	959	943	946	975
Imports related to donor-financed spending	955	751	623	542	430
GDP	**1,625**	**1,735**	**1,797**	**1,895**	**1,999**
Workers' remittances	246	190	150	139	114
Wages of donors' local employees	67	51	46	49	40
Donor budget support and humanitarian assistance	59	27	5	0	0
GNDI	**2,087**	**2,152**	**2,166**	**2,245**	**2,341**
Balance of payments					
Current account balance (before foreign assistance and remittances)[1]	**–1,686**	**–1,493**	**–1,379**	**–1,299**	**–1,220**
(in percent of GDP)	*–103.7*	*–86.0*	*–76.8*	*–68.5*	*–61.0*
Exports	269	217	186	190	185
Imports	1,955	1,710	1,565	1,488	1,405
Factor income	**402**	**390**	**364**	**351**	**341**
Workers' remittances	217	241	241	244	244
Wages of donors' local employees	185	149	122	106	97
Foreign assistance	1,144	902	732	624	518
(in percent of GDP)	*70.4*	*52.0*	*40.7*	*32.9*	*25.9*
Current account balance (after for. assist. & remittances)	**–140**	**–201**	**–284**	**–324**	**–360**
(in percent of GDP)	*–8.6*	*–11.6*	*–15.8*	*–17.1*	*–18.0*
Net change in foreign assets	–223	–222	–57	11	58
Unidentified private capital inflows	**363**	**423**	**341**	**313**	**302**

Source: Fund staff estimates.
[1]Foreign assistance, including wages of donor's local employees.

Table 8
Analytical Presentation of the National Income Accounts and the Balance of Payments, 2001–05
(In millions of euros, unless otherwise indicated)

	2001	2002	2003	2004	2005
National accounts					
Consumption	**1,811**	**1,935**	**2,049**	**2,138**	**2,210**
Private sector consumption	1,646	1,682	1,728	1,771	1,837
Government consumption	165	253	322	367	373
Investment	**416**	**418**	**400**	**432**	**490**
Private sector investment	395	376	304	317	340
Government investment	21	42	96	115	150
Net exports of GNFS	**–977**	**–932**	**–907**	**–896**	**–904**
Exports	23	27	36	51	71
Imports	1,000	959	943	946	975
Donors' contribution to GDP	**376**	**314**	**254**	**221**	**203**
(in percent of GDP)	*23.1*	*18.1*	*14.1*	*11.7*	*10.1*
GDP	**1,625**	**1,735**	**1,797**	**1,895**	**1,999**
Workers' remittances	217	241	241	244	244
Wages of donors' local employees	185	149	122	106	97
Donor budget support and humanitarian assistance	59	27	5	0	0
GNDI	**2,087**	**2,152**	**2,166**	**2,245**	**2,341**
Balance of payments					
Current account balance (before for. assist. & remittances)	**–977**	**–932**	**–907**	**–896**	**–904**
(in percent of GDP)	*–60.1*	*–53.7*	*–50.4*	*–47.3*	*–45.2*
Exports	23	27	36	51	71
Imports	1,000	959	943	946	975
Workers' remittances	217	241	241	244	244
Donors' contribution to GNDI[1]	620	490	381	327	300
(in percent of GDP)	*38.2*	*28.2*	*21.2*	*17.3*	*15.0*
Current account balance (after for. assist. & remittances)	**–140**	**–201**	**–284**	**–324**	**–360**
(in percent of GDP)	*–8.6*	*–11.6*	*–15.8*	*–17.1*	*–18.0*
Net change in foreign assets	–223	–222	–57	11	58
Unidentified private capital inflows	**363**	**423**	**341**	**313**	**302**

Source: Fund staff estimates.
[1]Equals contribution to GDP plus wages of donors' local employees plus budget support plus humanitarian assistance.

TABLE 9

Foreign Assistance and its Direct Contribution to Aggregate Demand, 2000–05

(In millions of euros)

	2000 Est.	2001 Est.	2002 Est.	2003 Est.	2004 Proj.	2005 Proj.
Total foreign assistance	**1,271**	**1,175**	**912**	**737**	**628**	**523**
Wages[1]	601	676	576	478	407	326
Expatriates	416	490	427	355	301	229
Local employees	185	185	149	122	106	97
Goods and services	472	409	299	249	217	193
Imported goods	380	213	124	99	86	64
Direct imports	380	190	90	25	25	
Reflected in commercial imports[2]	0	23	34	73	86	64
Locally produced goods	91	196	175	150	132	129
Current transfers						
Humanitarian assistance	36	18	9	5	0	0
Budgetary support	121	41	18	0	0	0
Capital participation	42	31	10	5	4	5
Memorandum items:						
Local consumption by expatriates[3]	251	246	190	150	139	114
Imported goods	68	67	51	46	49	40
Local goods	183	179	139	104	90	74
Direct contribution to GDP[4]	**274**	**376**	**314**	**254**	**221**	**203**
Direct contribution to GNDI[5]	**615**	**620**	**490**	**381**	**327**	**300**
Of which:						
UNMIK	202	192	141	135	125	87
KFOR	109	110	110	100	94	89
PIP	148	258	212	141	108	123

Source: Fund staff estimates.

[1]Excludes additional salaries paid by respective governments for employees that are seconded by their governments.

[2]Procurement of imported goods through local suppliers. It is estimated as the difference between the estimated import content of donors' spending on goods and services, and donor imports as reported by the BRICO system.

[3]Including local consumption by soldiers and visiting relatives of expatriates.

[4]Equals spending on local goods and services plus expatriates' local consumption of local goods.

[5]Equals contribution to GDP plus wages of donors' local employees plus budget support plus humanitarian assistance.

TABLE 10
Illustrative Estimation of Total Employment[1]

	Scenario 1	Scenario 2	Scenario 3
Total labor remuneration (in millions of euros)[1]	**894**	**894**	**894**
Number of full-time employee equivalents	464,758	436,325	415,309
Average wage (in euros/month)	160	171	179
In subsistence agriculture	**187**	**187**	**187**
Number of full-time employee equivalents	125,078	125,078	125,078
Average wage (in euros/month)	124	124	124
In other sectors (official and informal)	**707**	**707**	**707**
Number of employees	339,680	311,247	290,231
Average wage (in euros/month)	174	189	203
Civil service	114	114	114
Number of employees	64,780	64,780	64,780
Average wage (in euros/month)	146	146	146
POE employees	59	59	59
Number of employees	17,286	17,286	17,286
Average wage (in euros/month)	285	285	285
SOE employees	34	34	34
Number of employees	16,183	16,183	16,183
Average wage (in euros/month)	174	174	174
Employees of private enterprises	49	49	49
Number of employees	13,477	13,477	13,477
Average wage (in euros/month)	305	305	305
Sole proprietors	55	55	55
Number of employees	26,736	26,736	26,736
Average wage (in euros/month)	171	171	171
NGO employees	18	18	18
Number of employees	3,248	3,248	3,248
Average wage (in euros/month)	456	456	456
Local employees of donor sector	96	96	96
Number of employees	8,416	8,416	8,416
Average wage (in euros/month)	951	951	951
Informal sector	**283**	**283**	**283**
Number of full-time employee equivalents	189,554	161,121	140,105
Average wage (in euros/month)	124	146	168
Wages, in percent of civil service wages	**85**	**100**	**115**
Informal sector, in percent of total employment[2]	**56**	**52**	**48**

Sources: SOK 2002/03 Household Budget Survey (HBS); Ministry of Finance, Monthly Macroeconomic Monitor (MMM) January 2004; and Fund staff estimates.

[1]Aggregate wages for the subsistence agriculture and other sectors based on 2002/03 HBS data, wage and employment data for official sectors based on MMM data for the latter half of 2002 and the first half of 2003, adjusted for estimated taxes.

[2]Excluding subsistence agriculture.

TABLE 11
GDP Factor Remuneration Decomposition, 2003
(In millions of euros, unless otherwise indicated)

	2003
GDP at market prices	**1,797**
Indirect taxes	462
GDP at factor costs	**1,335**
Labor remuneration	771
In subsistence agriculture[1]	161
In other sectors	610
Wages (net of tax)[2]	595
Wage taxes	15
Return on stock of housing	307
Return on other capital	**257**
Enterprises' operating surpluses	**115**
Profit-making enterprises[3]	142
Loss-making public enterprises[4]	–**27**
Depreciation	141
Memorandum items:	
Assumed capital output ratio	3
Capital stock	4,003.8
Amortization	200
Assumed rate of depreciation (in percent)	5.0
Net return on capital	363.2
Implied net rate of return (in percent)	9.1
Labor share of output (in percent)	57.8
Capital share of output (in percent)	42.2
Net capital share in net output (in percent)	32.0

Source: Fund staff estimates.
[1]It is assumed that 85 percent of the value of home-produced or fetched food is attributable to labor inputs.
[2]Excluding UNMIK and donor wages of local employees.
[3]Derived from profit tax data, assuming effective profit tax rate of 20 percent.
[4]Approximated by current transfers from the budget to public enterprises. It is assumed that direct transfers from donors to these enterprises are all capital transfers.

Table 12

Medium-Term Employment Projections, 2003–13

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total population (in thousands)	1,932	1,965	1,999	2,033	2,067	2,102	2,138	2,174	2,211	2,249	2,287
Growth rate		*1.7*	*1.7*	*1.7*	*1.7*	*1.7*	*1.7*	*1.7*	*1.7*	*1.7*	*1.7*
Total population 16–64 (in thousands)	1,227	1,247	1,268	1,290	1,312	1,334	1,357	1,380	1,403	1,427	1,451
Employed	415	428	441	454	467	481	496	511	526	542	558
Growth rate of employment		***3.0***	***3.0***	***3.0***	***3.0***	***3.0***	***3.0***	***3.0***	***3.0***	***3.0***	***3.0***
Unemployed	179	179	179	180	180	181	181	181	181	181	180
Not in the labor force	633	640	648	656	664	672	680	688	696	705	713
Percentage in working age population 16–64											
Employed	33.8	34.3	34.7	35.2	35.6	36.1	36.6	37.0	37.5	38.0	38.5
Unemployed	14.6	14.3	14.1	13.9	13.7	13.5	13.3	13.1	12.9	12.7	12.4
Not in the labor force	52.0	51.4	51.1	50.9	50.6	50.4	50.1	49.9	49.6	49.4	49.1
Dependency ratio (working age pop. in total pop.)	63.5	63.5	63.5	63.5	63.5	63.5	63.5	63.5	63.5	63.5	63.5
Participation rate	**48.4**	**48.6**	**48.9**	**49.1**	**49.4**	**49.6**	**49.9**	**50.1**	**50.4**	**50.6**	**50.9**
Increase in participation rate		*0.5*	*0.5*	*0.5*	*0.5*	*0.5*	*0.5*	*0.5*	*0.5*	*0.5*	*0.5*
Unemployment rate	**30.1**	**29.5**	**28.9**	**28.4**	**27.8**	**27.3**	**26.7**	**26.1**	**25.6**	**25.0**	**24.4**

Source: Fund staff projections.

Table 13

Cross-Country Evidence on Labor Growth and Capital Accumulation[1]

(Average, 1960–94)

	Contribution to Growth				
	TFP	Capital accumulation	Labor force	Human capital	Total growth
East Asia	0.28	4.50	1.27	0.44	6.49
South Asia	0.55	2.87	0.99	0.25	4.66
Sub-Saharan Africa	–0.56	1.79	1.39	0.22	2.83
Middle East and North Africa	–0.03	3.99	0.84	0.25	5.05
Latin America	–0.39	2.31	1.22	0.28	3.42
Industrial countries	0.06	2.87	0.27	0.19	3.39
World	–0.16	2.75	0.97	0.25	3.80

	Annual Growth Rates in Percent			
	Capital	Labor	Capital labor ratio	Labor productivity
East Asia	9.38	2.44	6.93	4.05
South Asia	5.13	2.25	2.88	2.41
Sub-Saharan Africa	4.16	2.44	1.72	0.39
Middle East and North Africa	6.33	2.27	4.06	2.78
Latin America	4.44	2.54	1.90	0.88
Industrial countries	4.48	0.75	3.73	2.64
World	5.00	2.16	2.84	1.64

Source: IMF Staff Paper, *Sources of Economic Growth: An Extensive Growth Accounting Exercise*. Vol. 47, No. 1.

[1]The top part of the table reports the results derived in the IMF staff paper on the growth contribution of total factor productivity, capital accumulation, labor force, and human capital. The bottom part calculates the corresponding annual growth rates of capital, labor, capital labor ratio, and labor productivity.

TABLE 14

Baseline Medium-Term Growth Scenario, 2003–13

(In millions of euros, at constant 2003 prices, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
GDP at market prices	**1,797**	**1,899**	**2,004**	**2,114**	**2,229**	**2,350**	**2,474**	**2,606**	**2,742**	**2,885**	**3,033**
GDP at factor costs	**1,335**	**1,410**	**1,488**	**1,570**	**1,656**	**1,745**	**1,838**	**1,935**	**2,036**	**2,142**	**2,253**
Labor remuneration	**771**	**794**	**818**	**843**	**868**	**894**	**921**	**948**	**977**	**1,006**	**1,036**
Number of employees, in thousands	415	428	441	454	467	481	496	511	526	542	558
Growth of employment, in percent		3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Average wage per month, in euros[1]	155	155	155	155	155	155	155	155	155	155	155
Gross return on capital	**563**	**589**	**615**	**643**	**672**	**702**	**734**	**767**	**801**	**837**	**875**
Capital stock	4,004	4,184	4,372	4,569	4,775	4,989	5,214	5,449	5,694	5,950	6,218
Growth in the stock of capital, in percent		4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Gross rate of return, in percent[1]	14.1	14.1	14.1	14.1	14.1	14.1	14.1	14.1	14.1	14.1	14.1
Total factor productivity		**27**	**55**	**85**	**116**	**149**	**183**	**220**	**258**	**299**	**341**
Memorandum items:											
Contribution to growth		**5.7**	**5.6**	**5.5**	**5.4**	**5.4**	**5.3**	**5.3**	**5.2**	**5.2**	**5.1**
Labor		1.7	1.7	1.6	1.6	1.6	1.5	1.5	1.5	1.4	1.4
Capital		1.9	1.9	1.9	1.8	1.8	1.8	1.8	1.8	1.8	1.8
TFP		2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Capital labor ratio	9.6	9.8	9.9	10.1	10.2	10.4	10.5	10.7	10.8	11.0	11.1
Percent increase		1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Gross Investment		380	397	415	434	454	474	495	518	541	565
Investment in percent of GDP		**20.0**	**19.8**	**19.6**	**19.5**	**19.3**	**19.2**	**19.0**	**18.9**	**18.8**	**18.6**
Change in the stock of capital		180	188	197	206	215	225	235	245	256	268
Depreciation		200	209	219	228	239	249	261	272	285	298
Depreciation rate, in percent		5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Memorandum items:											
Public investment, in percent of GDP		5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Total investment, in percent of GDP		**25.0**	**24.8**	**24.6**	**24.5**	**24.3**	**24.2**	**24.0**	**23.9**	**23.8**	**23.6**
Implied ICOR		**4.4**	**4.5**	**4.5**	**4.5**	**4.5**	**4.5**	**4.5**	**4.6**	**4.6**	**4.6**

Source: Fund staff estimates and projections.

[1]Total factor productivity gains will of course be distributed either to workers in the form of an increase in real wages or to owners of capital in the form of higher rate of return on capital.

TABLE 15

Financing Strategy for the Baseline Growth Scenario, 2003–13

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
	(In percent of GDP)										
Current account balance	–50.4	–48.6	–46.9	–45.1	–43.3	–41.5	–39.7	–37.9	–36.1	–34.3	–32.5
Regular exports	2.0	3.8	5.6	7.4	9.2	11.0	12.8	14.6	16.4	18.2	20.0
Imports	52.5	52.5	52.5	52.5	52.5	52.5	52.5	52.5	52.5	52.5	52.5
Investment	22.3	25.0	24.8	24.6	24.5	24.3	24.2	24.0	23.9	23.8	23.6
Underlying domestic savings	–28.2	–23.6	–22.0	–20.4	–18.8	–17.1	–15.5	–13.8	–12.2	–10.5	–8.8
Current account financing	50.4	48.6	46.9	45.1	43.3	41.5	39.7	37.9	36.1	34.3	32.5
Donor net	20.9	15.0	14.4	13.7	13.1	12.5	11.8	11.2	10.5	9.9	9.2
Private inflows	29.5	28.4	27.2	26.1	24.9	23.8	22.6	21.5	20.3	19.2	18.0
Drawdown on net foreign assets		2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Borrowing		2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
	(In millions of euros at constant 2003 prices)										
Current account balance (excl. aid and private transfers)	–907	–924	–939	–953	–964	–974	–981	–986	–989	–988	–985
Regular exports	36	72	112	157	205	259	317	381	450	525	607
Imports	943	996	1,051	1,109	1,169	1,233	1,298	1,367	1,438	1,513	1,591
Investment	400	475	498	521	546	571	598	626	655	685	717
Underlying domestic savings	–506	–448	–441	–432	–419	–403	–384	–361	–334	–303	–268
Current account financing	907	924	939	953	964	974	981	986	989	988	985
Donor net	376	286	289	291	292	293	292	291	288	284	279
Private inflows	530	538	545	551	555	558	559	559	557	552	546
Drawdown on net foreign assets		47	50	53	56	59	62	65	69	72	76
Borrowing		52	55	58	61	65	68	72	75	79	83
Memorandum items:											
Net foreign assets	742	695	645	592	536	478	416	351	282	210	134
Stock of external debt		52	110	174	244	320	404	496	596	706	824
In percent of GDP		2.8	5.5	8.2	10.9	13.6	16.3	19.0	21.8	24.5	27.2

Source: Fund staff projections.

TABLE 16
Consolidated Government Budget (GDP), 2000–04
(Excluding donor designated grants; in percent of GDP)

	2000 Actual	2001 Actual	2002 Actual	2003 Actual	2004 Original budget	2004 Budget as of June	2004 Indicative staff proj. & recom.
Total revenues	12.1	19.8	28.8	32.8	32.7	32.7	31.9
Taxes	11.4	17.5	25.6	29.0	28.1	28.1	27.6
Border taxes	10.8	15.0	21.0	23.6	22.9	22.9	22.0
Domestic direct taxes	0.6	1.8	2.8	3.5	3.6	3.6	3.8
Domestic indirect taxes	0.0	0.8	1.6	2.2	2.3	2.3	2.7
Tax refunds	. . .	. . .	. . .	–0.9	–0.7	–0.7	–0.9
Adjustments	. . .	. . .	0.2	0.4	. . .	. . .	. . .
Nontax revenues	0.7	2.2	3.2	3.8	4.5	4.5	4.3
Total expenditure	19.2	15.1	23.2	30.3	33.4	47.9	34.3
Current expenditure	17.6	13.8	20.8	25.0	26.5	33.5	28.2
Wages and salaries	8.7	6.7	7.6	8.1	9.9	10.0	9.0
Goods and services	4.1	3.4	7.0	9.7	7.6	12.0	9.6
Subsidies and transfers	4.7	3.7	6.2	7.1	7.1	10.1	8.8
Of which: Pension and social assistance	. . .	. . .	3.2	4.6	5.0	. . .	5.4
Reserve	0.1	0.0	0.0	0.1	1.9	1.3	0.8
Capital expenditure	1.6	1.3	2.4	5.4	6.9	14.5	6.1
Current balance	–5.5	5.9	8.0	7.8	6.2	–0.8	3.7
Overall balance	–7.1	4.7	5.6	2.5	–0.7	–15.2	–2.4
Budgetary support grants	11.3	2.5	0.6	0.0	0.0	0.0	0.0
Overall balance after budgetary support	4.3	7.2	6.2	2.5	–0.7	–15.2	–2.4
Financing	–4.3	–7.2	–6.2	–2.5	0.7	15.2	2.4
Changes in bank balances	–4.3	–7.2	–6.2	–2.5	0.7	15.2	2.4
Memorandum items:							
Government's bank balances	3.7	9.6	15.1	17.1	15.5	1.0	13.9
GDP (in millions of euros)	1,063	1,625	1,735	1,797	1,895	1,895	1,895

Sources: Kosovo authorities; and Fund staff estimates.

Table 17

Consolidated Government Budget (Euros), 2000–04

(Excluding donor designated grants; in millions of euros)

	2000 Actual	2001 Actual	2002 Actual	2003 Actual	2004 Original budget	2004 Budget as of June	2004 Indicative staff proj. & recom.
Total revenues	128.5	321.3	499.6	589.6	619.3	619.3	604.6
Taxes	121.5	284.8	444.4	520.7	533.2	533.2	523.7
Border taxes	115.2	243.4	364.5	424.9	434.5	434.5	417.7
Domestic direct taxes	6.4	28.8	48.3	63.5	68.4	68.4	72.2
Domestic indirect taxes	0.0	12.5	27.8	40.1	44.3	44.3	50.4
Tax refunds	. . .	. . .	. . .	–15.7	–14.0	–14.0	–16.5
Adjustments	. . .	. . .	3.7	7.9	. . .	. . .	. . .
Nontax revenues	6.9	36.5	55.2	68.9	86.1	86.1	81.0
Total expenditure	203.8	245.7	402.3	545.1	632.3	907.9	649.2
Current expenditure	186.8	225.1	360.4	448.7	501.8	634.0	534.2
Wages and salaries	92.3	109.5	131.4	145.7	187.6	190.4	170.1
Goods and services	43.3	55.4	121.3	173.7	144.3	227.8	181.9
Subsidies and transfers	50.4	60.2	107.7	127.0	134.7	192.0	167.2
Of which: Pension and social assistance	. . .	. . .	56.3	81.8	94.2	99.6	103.0
Reserve	0.8	0.0	0.0	2.4	35.2	23.8	15.0
Capital expenditure	17.0	20.6	41.9	96.4	130.6	273.9	115.0
Current balance	–58.3	96.2	139.3	141.0	117.5	–14.7	70.4
Overall balance	–75.3	75.6	97.3	44.6	–13.0	–288.6	–44.6
Budgetary support grants	120.6	41.1	9.6	0.0	0.0	0.0	0.0
Overall balance after budgetary support	45.2	116.7	106.9	44.6	–13.0	–288.6	–44.6
Financing	–45.2	–116.7	–106.9	–44.6	13.0	288.6	44.6
Changes in bank balances	–45.2	–116.7	–106.9	–44.6	13.0	288.6	44.6
Memorandum items:							
Government's bank balances	39.1	155.8	262.7	307.4	294.3	18.7	262.8

Sources: Kosovo authorities; and Fund staff estimates.

Table 18

Kosovo: Share of Reserved Power Budget Organizations in the Kosovo General Budget, 2000–04

	2000 Actual	2001 Actual	2002 Actual	2003 Actual	2004 Budget
General government	203	242	402	542	916
Central government	203	229	313	403	692
PISG budget organizations	. . .	. . .	168	196	383
Reserved power budget organizations	203	225	145	207	310
KTA[1]	34	32	11	37	148
Police, prison, and justice	15	22	35	54	88
Others	154	171	99	116	74
Municipalities	. . .	13	89	139	224
Memorandum items (in percent):					
Share of central govt. in general govt. budget	100	94	78	75	76
Share of reserved power in central govt. budget	100	100	46	0	45
Share of KTA in reserved power budget[1]	17	14	8	18	48
Share of police, prison, and justice in reserved power budget	7	10	24	26	28

Source: Kosovo authorities.

[1]Before the establishment of KTA, i.e., for 2000 and 2001, expenditures of entities subsequently placed under the KTA's control.

TABLE 19
Kosovo: Functional Classification of Budgetary Expenditures, 2002–03

	2002 Actual		2003 Actual	
	In millions of euros	In percent	In millions of euros	In percent
Total	402.3	100.0	542.6	100.0
Education	69.6	17.3	84.2	15.5
Health	54.3	13.5	55.0	10.1
Social protection	60.3	15.0	87.0	16.0
Economic affairs	67.6	16.8	115.8	21.3
Public order and safety	42.8	10.6	76.6	14.1
General services[1]	90.7	22.5	98.4	18.1
Defense	0.0	0.0	0.0	0.0
Environmental protection	0.0	0.0	1.0	0.2
Housing and community amenities	10.1	2.5	15.2	2.8
Recreation, culture, and religion	7.0	1.7	9.4	1.7
Memorandum items:				
Total public spending including donor sector	1,304	. . .	1,275	. . .
Share of education in total public expenditure	. . .	6.0	. . .	6.6

Source: Kosovo authorities.
[1]Including expenditures not classified in any other category.

TABLE 20
Kosovo and Selected Economies: General Government Revenues, 2002[1]
(In percent of GDP)

	Total Revenue	Nontax Revenue	Tax Revenue	Income Tax	Payroll Tax	Corporate Tax	Sales Turnover or VAT	Excises	Import Duties	Social Security Taxes	Other Taxes
Kosovo	34.4	3.8	30.6	0.9	0.0	2.7	12.2	9.4	4.0	1.6	0.1
Albania	22.1	3.0	19.0	0.9	1.8	0.4	6.8	1.4	2.0	3.8	2.0
Bosnia & Herz.	43.0	4.8	38.3	. . .	0.0	. . .	8.5	. . .	. . .	13.3	16.4
Bulgaria	35.6	8.1	27.4	3.3	0.0	3.0	8.3	4.1	0.6	7.3	0.9
Croatia	45.2	4.1	41.1	4.1	0.0	2.1	15.1	5.6	1.2	12.5	0.6
Czech Republic	39.3	2.6	36.6	5.0	0.0	4.6	7.7	3.5	0.4	14.7	0.6
Hungary	43.1	4.5	38.6	7.8	0.1	2.1	10.1	3.5	0.8	12.9	1.2
Macedonia, FYR	34.7	1.6	33.0	4.2	0.0	. . .	8.4	4.7	2.6	10.4	2.7
Poland	36.9	0.0	36.9	7.9	0.2	2.4	7.6	4.1	0.7	10.0	1.1
Romania	29.6	1.9	27.6	2.8	2.0	. . .	6.9	2.1	0.6	10.7	2.5
Serbia and Mont.	42.5	3.1	39.4	5.7	0.0	0.5	11.5	4.8	2.7	10.6	3.6
Slovak Republic	37.3	4.1	33.2	3.4	0.9	2.7	7.5	2.9	1.4	14.4	0.0
Slovenia	38.7	2.5	36.2	6.1	1.8	1.4	8.0	3.2	1.5	12.9	1.3
EU	41.3	0.2	41.1	11.0	1.1	3.6	7.3	3.8	0.2	13.2	2.0

Sources: Kosovo authorities; IMF, country desk data; and Fund staff estimates.
[1]Data for Kosovo refer to 2003, for EU 2001 and for Poland 2000.

TABLE 21
Tax Rates in Selected Transition Economies
(In percent)

Country	VAT General	VAT Lower Rate	Customs Duties (Avg.)[1]	Min-Max Customs[2]	Excise Tax[3]	Corporate Tax	Individual Income Tax	SSC Tax Employer	SSC Tax Employee
Kosovo	15.0	n.a.	10.0[4]	0–10	10–30	20.0	0–20	5.0	5.0
Albania	20.0	. . .	8.7	2.5–16	20–40	25.0	. . .	34.2	11.7
Bosnia & Herz.	. . .	. . .	7.8	0–15	. . .	. . .	. . .	—	—
Bulgaria	20.0	. . .	11.5	0–75	—	19.5	15–29	34.7	1.0
Croatia	22.0	0.0	6.3	2–64	5–30	20.0	15–45	—	—
Czech Republic	22.0	5.0	6.0	0.2–125	—	28.0	15–32	—	—
Hungary	25.0	12.0	11.7	1.7–127.5	10–35	16.0	20–40	—	—
Macedonia, FYR	18.0	5.0	14.6	0–60	7.50	15.0	18.00	1.6–21.2	—
Poland	22.0	7.0	13.9	0.7–544.2	25–65	19.0	19–40	20.4	18.7
Romania	19.0	. . .	16.9	0–248	6–80	25.0	45.00	—	—
Serbia and Mont.	17.0	. . .	10.0	0–40	20–30	20.0	. . .	. . .	. . .
Slovak Republic	23.0	10.0	6.0	0.2–125	—	19.0	19.00	38.0	12.0
Slovenia	20.0	8.5	10.3	0.7–45	50.00	25.0	17–50	22.1	16.1

Sources: Kosovo authorities; IMF, Fiscal Affairs Department (FAD) database; CEEBIC; and government tax websites.
Note: n.a. = no taxes; — = taxes are levied but not available.
[1]Data for customs duties refer to 2002.
[2]Data for each country refer to the latest period available: Romania, 1999; Serbia and Montenegro, 2000; Macedonia, 2001; Bosnia and Herzegovina, Croatia, Hungary, and the Slovak Republic, 2002; Bulgaria, the Czech Republic, Poland, and Slovenia, 2003; and Albania, 2004.
[3]In many cases, specific excise rates are used in addition to ad valorem rates. For example, in Kosovo, mostly specific rates are used.
[4]Data for Kosovo refer to 2003. Effective June 7, 2004, a zero rate of customs duty was introduced for selected raw materials and capital goods.

TABLE 22

Estimated Contribution of Foreign Assistance to Tax Revenues: An Illustrative Calculation Based on 2003 Data

(In millions of euros, unless otherwise indicated)

	Estimate 2003
Total taxes related to foreign assistance	**54.9**
Wage taxes paid by local employees	**1.4**
UNMIK's local employees	Tax exempt
Other donors' and NGOs' local employees	1.4
Expenditure-based taxes on personal consumption[1]	**46.0**
Local employees of donors	22.0
Local consumption by expatriates	15.0
Local consumption by KFOR soldiers	9.1
Other donor-related tax revenues	**7.4**
Donor spending on goods and services[2]	4.9
Donor-financed investment[2]	2.5
Memorandum items:	
Total tax revenues	521
Share of tax revenues related to foreign assistance (in percent)	10.5

Sources: Kosovo authorities; and Fund staff estimates.

[1]VAT, excises, and customs.

[2]In principle, donors' spending on goods and services and on investment is tax exempt. However, it is likely that these expenditures have some tax component, partly because subcontractors that supply taxable goods and services to the main contractors supplying donors are not eligible for a VAT rebate. In addition, goods sourced locally by donors may contain some customs and excise taxes. In the above calculation, it is assumed that donors' spending on goods and services contains 4 percent taxes and 2 percent investment spending.

TABLE 23

Declining Domestic Absorption and Tax Revenues: An Illustrative Calculation Based on 2003 Data

(In millions of euros, unless otherwise indicated)

	Estimate 2003	Illustration: Decline in Domestic Absorption
Domestic absorption[1]	2,450	2,156
Domestic absorption = tax base (percent of GDP)	136	120
Effective expenditure-based tax rate on domestic absorption (percent)	16	16
Total tax revenues	521	417
Less taxes derived from foreign assistance	55	0
Less direct taxes[2]	62	62
Equals: Expenditure-based taxes from domestic absorption[3]	404	355
Total revenue impact		–103
Foreign assistance		–55
Lower domestic absorption		–48
Total revenue impact (percent of GDP)		–6
Foreign assistance		–3
Lower domestic absorption		–3
Memorandum item:		
Taxes without foreign assistance and assuming domestic absorption of 120 percent of GDP (percent of GDP)		23

Sources: Kosovo authorities; and Fund staff estimates.

[1]Total domestic absorption, i.e., consumption and investment, excluding the donor sector.

[2]Excluding direct taxes related to foreign assistance.

[3]Border taxes and domestic indirect taxes derived from domestic absorption.

TABLE 24

Financial System Structure, 2000–03

	Dec. 2000			Dec. 2001			Dec. 2002			Dec. 2003		
	Number	Assets (EUR m)	Percent total	Number	Assets (EUR m)	Percent total	Number	Assets (EUR m)	Percent total	Number	Assets (EUR m)	Percent total
Commercial banks	1	103	95	7	357	89	7	486	87	7	568	82
Private												
Domestic	0	0	0	5	136	34	5	142	25	5	196	28
Foreign	1	103	95	2	221	55	2	344	62	2	372	54
Other nonbank financial institutions												
Insurance companies	0	0	0	3	20	5	7	36	6	8	47	7
Pension funds	0	0	0	0	0	0	1	0	0	6	40	6
Microfinance institutions	7	5	5	14	23	6	16	36	6	17	35	5
Other	0	0	0	0	0	0	0	0	0	1	4	1
Total financial system	8	108	100	24	400	100	31	558	100	39	694	100

Source: Banking and Payments Authority of Kosovo.

TABLE 25

Financial Soundness Indicators for the Banking Sector, 2000–03

(In percent, unless otherwise indicated)

	Dec. 2000	Dec. 2001	Dec. 2002	Dec. 2003
Capital adequacy				
Regulatory capital to risk-weighted assets	23.0	32.1	22.0	16.6
Capital (net worth) to assets	6.0	6.3	5.9	6.2
Asset composition and quality				
Nonperforming Loans (NPLs) to gross loans	0.0	0.6	2.5	1.6
Provisions to NPLs	0.0	493.2	118.2	199.1
Loans to the largest borrower (of total loans)	1.6	3.6	3.1	2.7
FX loans to total loans	0.0	0.0	0.0	1.0
Earnings and profitability				
Return on assets	1.7	1.4	0.6	1.3
Return on equity	28.7	22.3	9.7	18.7
Liquidity				
Liquid assets to total assets[1]	94.0	91.1	75.0	57.6
Liquid assets to short-term liabilities[2]	103.1	156.9	99.7	79.4
Deposits to total (non-interbank) loans	2,835.5	1,007.1	447.3	225.4
Loans (non-interbank) to total deposits	3.5	10.0	22.4	44.4
FX liabilities to total liabilities	0.1	0.4	2.8	2.8
Deposits of the largest customer (of total deposits)	5.2	10.0	10.5	16.8

Source: Banking and Payments Authority of Kosovo.

[1]Liquid assets include cash, balances with BPK, and placements with other banks.

[2]Short-term liabilities are those maturing in 90 days or less.

TABLE 26
Monetary Survey, 2000–04
(In millions of euros)

	2000 Dec.	2001 Dec.	2002 Dec.	2003 Dec.	2004 Jul.
Net foreign assets	122.6	583.3	649.5	697.0	687.1
BPK	52.1	293.7	345.4	453.7	436.6
Assets	61.7	296.2	345.8	454.0	437.2
Liabilities (incl. UNMIK's deposits)	9.6	2.6	0.4	0.3	0.6
Commercial banks	70.5	289.7	304.1	243.3	250.5
Assets	83.1	308.6	328.3	272.4	285.3
Liabilities (incl. expatriates' deposits)	12.6	18.9	24.2	29.1	34.8
Net domestic assets	–16.4	–96.6	–235.9	–195.8	–87.6
Net claims on the central government	–5.7	–69.8	–258.6	–317.5	–298.4
Claims	0.0	0.0	0.0	0.0	0.0
Deposits	5.7	69.8	258.6	317.5	298.4
Net claims on nonbank financial institutions	0.0	–21.6	–32.0	–31.9	–29.5
Loans to the private sector	3.1	25.9	86.5	232.8	327.9
Other items net	–10.9	–30.1	–23.2	–49.2	–67.7
BPK	–4.8	–19.0	4.0	–7.6	–9.7
Commercial banks	–6.1	–11.1	–27.1	–41.6	–58.0
Bank deposits[1]	106.2	486.8	413.6	501.2	599.5
Demand deposits of nonfinancial enterprises	77.4	144.1	163.4	160.4	155.8
Demand deposits of individuals	21.2	217.9	121.9	143.3	152.9
Savings deposits of nonfinancial enterprises	4.6	31.3	23.9	74.8	129.2
Savings deposits of individuals	3.0	93.5	104.4	122.7	160.1
Memorandum items:					
Bank deposits 12-month percent change	. . .	358.4	–15.0	21.2	30.2
Loans to private sector 12-month percent change	. . .	723.3	233.8	169.1	91.7
Staff estimate of cash in circulation[2]	637.2	668.0	536.3	512.1	512.1
Staff estimate of broad money (M2)[3]	743.4	906.3	949.9	1,013.3	1,111.6

Sources: Banking and Payments Authority of Kosovo; and Fund staff estimates.
[1]Unadjusted data on deposits based on the BPK's monthly monetary statistics.
[2]Staff estimate of cash in circulation. End-2001 estimate adjusted for the one-off effects related to the euro cash changeover.
[3]Deposits plus currency in circulation.