TOWARDS ECONOMIC VIABILITY OF KOSOVA

(Challenges, Policies, Opportunities)

FRIEDRICH EBERT STIFTUNG

RIINVEST

INSTITUTI PËR HULUMTIME ZHVILLIMORE
INSTITUTE FOR DEVELOPMENT RESEARCH

TOWARDS ECONOMIC VIABILITY OF KOSOVA

(Challenges, Policies, Opportunities)

This draft paper is prepared to serve as basis for roundtable discussion which is supported by Friedrich Ebert Stiftung

RIINVEST
INSTITUTI PËR HULUMTIME ZHVILLIMORE
INSTITUTE FOR DEVELOPMENT RESEARCH

FRIEDRICH EBERT STIFTUNG

Prishtina
5th December, 2005

Project Team:
Muhamet Mustafa, Project Leader
Isa Mustafa
Venera Demukaj
Petrit Gashi
Besnik Krasniqi
Gazmend Ahmeti
Salvador Bajrami
Durim Hoxha
Fadil Aliu
Lumir Abdixhiku
Alban Zogaj

Editor:
Riinvest Institute

Redactor:
Sejdi Osmani

Copy editing:
Iain Wilson

Design:
Elbunit F. Krasniqi

Printed:

Acronyms and Abbreviations

CEPES – The European Center for Higher Education
CIS – Commonwealth of the Independent States
DFID – Department for International Development
EAR – European Agency for Reconstruction
EBRD – European Bank for Reconstruction and Development
EIB – European Investment Bank
EU – European Union
EWR – Early Warning Report
FDI – Foreign Direct Investments
FTA – Foreign Trade Agreements
GDP – Gross Domestic Product
GTZ - Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) (German Technical Cooperation
IFI – International Financial Institutions
IMF – International Monetary Fund
KEK – Kosova Energy Corporation
KTA- Kosovo Trust Agency
MEF – Ministry of Finance and Economy
NATO – North Atlantic Treaty Organization
OECD – Organization for Economic Cooperation and Development
PIP – Public Investment Program
PISG - Provisional Institutions of Self-Government
PTK – Post Telecommunication of Kosova
R&D – Research and Development
SDC – Swiss Development Coorporation
SEE – South East Europe
SIDA – Swedish International Development Cooperation Agency
SME – Small and Medium Enterprises
SOK – Statistical Office of Kosova
TFP – Total Factor Productivity
UN – United Nations
UNESCO – United Nations Educational Scientific and Cultural Organization
UNMIK- United Nations Interim Mission in Kosovo
US – United States
USAID – United States Agency for International Development
VAT – Value Added Tax
VSK – Pre War Statistics
WB – World Bank
WTO – World Trade Organization
WWII – World War II

TABLE OF CONTENTS

Executive Summary

This paper addresses challenges, policies and opportunities in building an economic viability of Kosova. It has been prepared in the context of activities to prepare the Kosova Development Strategy and Plan and ongoing negotiations on the future status of Kosova. The objective is to analyze prospects for sustainable economic growth and viability for Kosova and identify policies and actions to be adopted by the Government and other stakeholders with the support of the international community.

A country may be deemed economically viable when the available human, physical and financial resources are effectively used to provide economic growth and increase the welfare of its inhabitants. While the resource endowment matters, effective use of resources to provide sustainable growth and increasing welfare is even more important. The process of growth is associated with a broad spectrum of policies including financing development, public infrastructure, regulatory framework, government intervention, industrial policies. In transition economies strong market oriented reforms and the achievement of economic and political stability have been proven as very important factors also.

Theoretical background and experiences in many countries suggest that economic growth increases with improvements in education, financial depth, trade openness and availability of public infrastructure. It decreases with an extensive tax burden and in the absence of policies conducive to macroeconomic stability (inflation, overvalued exchange rates, banking crises) and, also, by negative terms of trade. An appropriate mix of economic policies accompanied by increased institutional capacity and quality will generate beneficial pattern of self-sustaining growth.

Governance and sovereignty are closely interrelated since sovereignty is critical to ownership and acceptance of the institutions of governance, legitimacy and acceptance of the law, and the ownership and management of resources, all of which are critical to long term investment in growth including institutional and human development. The absence of sovereignty heightens political uncertainty, reduces the possibility for choice.

In the post war situation the limited participation of Kosovars in governance has had negative effects on economic growth and viability. Negative effects include: uncertainty regarding the ownership and use of natural resources (including land and minerals) as well as of the assets of public and socially owned enterprises (POE, SOE) delaying, inter alias, their privatization, difficulties in the enforcement of financial/economic as well as other legislation, limited scope for cooperation with international and regional

institutions (WTO, WB, IMF, EU), constraints to the development of trade relations with other countries, barriers to the mobilization of local/Diaspora savings and the attraction of FDI.

In terms of resource endowment both human and natural Kosova could build competitive advantages. How ever in addition to the political status critical factors in further building of economic viability are improvements in governance, rule of law, education and public infrastructure. This have to contribute to better investment environment which will mobilize local and Diaspora resurges and as well FDI and channel them into investment. Achieving high growth rates after 2008 (8-10%) are necessary to absorb new entries in a job market and reduce unemployment. Dynamic growth also is a precondition to address imbalances in macroeconomic configuration. (Between GDP and consumption, very high trade deficit, imbalances in the labor market, the size of the budget and capital investment needs).

Kosova as an emerging developing country despite the fact that is relatively well endowed with resources faces many challenges to achieve needed dynamics in economic development. Structural problems such as: lack of proper public infrastructure, unemployment, deindustrialization and trade deficit originating form difficult heritage especially during 90s require further support of International Community through effective technical and financial assistance and cooperation. Based on the experiences so far, one can expect that Kosova will face difficulties in a mid term to ensure necessary capital public investments due to its structural problems. Therefore, the IFI and donors' support is necessary in this segment. Main destinations of further support could be:

- Support in further capacity building in the area of development management and governance
- Providing financial assistance in facing current budget difficulties for public investment , especially in medium term
- Establishing proper and full capacity relations with International Financial Institutions.

1.INTRODUCTION[1]

This paper addresses challenges, policies and opportunities in building an economic viability of Kosova. It has been prepared in the context of ongoing work to prepare the Kosova Development Strategy and Plan and ongoing negotiations on the future status of Kosova. The broad objective is to analyze prospects for sustainable economic growth and viability for Kosova and identify policies and actions to be adopted by the Government and other stakeholders with the support of the international community.

The paper is based on earlier work by Riinvest and others including PISG, EU Pillar IV, World Bank (WB), International Monetary Fund (IMF).

The paper is a contribution to the Round Table Discussion "Towards the Economic Viability of Kosova", to be held in Prishtina on 8th December 2005, organized by Riinvest with the participation of representatives of PISG, UNMIK and development partners including the WB, IMF, regional and bilateral agencies. The Round Table is being sponsored by Friedrich Ebert Stiftung.

Section 2 of the paper outlines the road to economic growth in terms of theory and the experience of successful countries. Section 3 highlights the importance of economic viability for Kosova, reviews the growth of the economy since 1948, and identifies a number of preconditions and determinants of future growth. Section 4 sets out three growth scenarios leading to an estimate of growth 2005-15 and identifies major sources of growth. Section 5 provides an estimate of investment needs 2005-15 and only tentatively indicates possible sources of financing. Section 4 and 5 are of indicative nature and are aimed to stimulate discussion. Section 6 deals with the management of public expenditure. Section 7 emphasizes the need for sustained financial and technical support by the international community. This is a first draft of the paper and will be upgraded further based on discussion and feed back.

Riinvest would like to thank Friedrich Ebert Stiftung for the support in preparing this paper and round table discussion. Finally, authors would like to stress that opinions and conclusions presented in this paper are the responsibility of Riinvest and do not necessarily reflect the opinions of the other parties involved in Forum 2015.

1 Prepared by Riinvest team: Muhamet Mustafa, Isa Mustafa, Venera Demukaj, Besnik Krasniqi, Gazmend Ahmeti, Salvador Bajrami, Fadil Aliu

2. THE ROAD TO ECONOMIC GROWTH AND VIABILITY

2.1 Economic Viability

A country may be deemed economically viable when the available human, physical and financial resources are effectively used to grow and increase the welfare of its inhabitants. While the resource endowment matters, effective use of resources to provide sustainable growth and increasing welfare is even more important.

2.2 Economic Growth

Long term sustainable economic growth is essential for achieving economic, social and political development, stability and ensuring economic viability. Developments in the theory of economic growth since the end of World War II are summarized in the footnote and inform this analysis.[2] Economic growth involves an increase in real output with a shift in production frontiers (capacity). Growth does not occur randomly and is a response, inter alia, to the quality of public policies especially those affecting investment, productivity, technological innovation and externalities. While the growth

2 The post World War II evolution of theories of economic growth has been summarized in five main stages ((see Development Economics, M. Todoro) as follows:
(1) In the 1950's Linear Stages of Growth Models – reflecting the experience of the Marshal Plan and developing countries. The model was promoted by Rostow. It argues that the transition by traditional societies from underdevelopment to development, the take off to self-sustaining growth and maturity needs, first of all mobilization of domestic and international savings. The closely related, well known, more investment more growth concept supported by the Harrod – Domar Model was developed during this period..
(2) In the 1960s Structural Change Models - developed by Lewis to explain and promote the shift from subsistence agriculture to urbanization and a diversified manufacturing and service economy. The two sector model explained the labor surplus in agriculture and it transfer to the modern high wage sector. The model does not fit the actual situation in many developing countries where there is urban unemployment. The main direction of structural change is from: agriculture to industry; accumulation of physical and human capital; changes in consumer demand; growth of cities and urban centers; farmers around small cities; with a decline in family size due to a focus on quality of education.
(3) In the 1970's Dependence theory – developed by neo-Marxists in the post colonial period. Continuing underdevelopment was explained in term of continuing dependency on metropolitan centers with the failure of FDI and markets.
(4) In the 1980's the neoclassical counter-revolution - What matters is the supply side with the focus on macroeconomic policies, free markets, dismantling public ownership, minimizing government regulation . The main reasons for underdevelopment are poor resource allocation and too much state intervention. Growth is stimulated through: free markets, privatization, free trade and export promotion, welcoming FDI, eliminating price distortions.
(5) In the 1990's the new Endogenous Growth Theory - What matters is the governing system of the production process rather than outside forces with growth as a natural consequence of long run equilibrium.

of output contributes to human development, high quality growth requires fair access by all members of society to the increased opportunities for education, health and income generation. The process of growth is associated with a broad spectrum of policies including financing development, public infrastructure, regulatory framework, government intervention, industrial policies. In transition economies strong market oriented reforms and the achievement of economic and political stability are key factors.

In an increasingly globalized economy, developing countries face major challenges in achieving economic growth due, especially, to:

- Inadequate savings and investment
- A labor force with a low level of education and skills
- Deteriorating terms of trade
- Weak institutions

In recent times countries in East Asia and OECD member states have experienced long term growth. In East Asia, China and the "tiger" economies - South Korea, Singapore, Taiwan, and Thailand - have experienced long term growth[3] . However there are two opposing views as to the main driving force. One view cites capital accumulation together with the increasing quality (rather than productivity) of the labor force as the major factor; whilst the other cites the assimilation/acquisition and mastery of foreign technology. Total Factor Productivity (TFP), that is the share of physical capital in output and channels through which human capital influences output, also plays a role. However, in the case of East Asia, many would agree that capital accumulation, rather than TFP, was the driving force. However, the long run is of key importance and here TFP, rather than capital accumulation, is considered to be the major source of growth. Accordingly, the ideal combination to ensure growth would be factor accumulation in the medium term and technological progress in the longer run.

A second group of countries, members of the OECD, have experienced long term sustainable growth. However, the rate of growth has been lower than in East Asia and there is evidence that poor countries can achieve faster growth rates. In early 2003 a major OECD study on sources of economic growth in member countries[4] found that disparities in growth rates originate largely from differences in labor utilization followed by differences in investment in physical and human capital, macro policies and size of government. The study found, also, that; high taxes (on wages and profits) discourage growth, while financial markets are conducive to growth; and trade openness had a positive impact.

The main conclusions of a recent overview on "The Sources of Economic Growth"[5] , based upon a comprehensive econometric analysis of the experience of 78 countries, can be summarized under two headings (a) Structural policies and institutions and (b)

3 See Abdul Senhadji, Shigeru , Kahu, Murat (IMF papers)
4 See Martin Neil Billy, Institute for International Economics OECD.
5 See N. Loayza (WB) R.Sato (Universidad Catolica Chile)

Causes and characteristics of growth. According to the study governments can influence long term growth through structural policies, stabilization policies and institutions. The key policy areas are:

- Education and human capital formation, which impact on the effectiveness of other types of capital and facilitate technological absorption (measured through enrolment rates).
- Financial depth, development of financial markets (measured by the ratio of private domestic credit: GDP).
- International trade openness, which impacts on the level of competitiveness, market, technological innovation and, also, the level of the TPF (measured by the ratio of trade volume: GDP).
- Government burden (measured by the ratio of Budget: GDP).
- Availability of public services and infrastructure.
- Governance (institutional capacity and quality, absence of corruption, enforcement of contracts, law and order).

In the case of industrial policies that promote specific sectors the study found that adverse results could be expected due to distortion effects and that it is difficult to determine any single "engine of growth". While industrial policies could provide initial growth the impact was not sustainable in the absence of second generation/ subsequent reforms.

The study confirmed that stabilization policies (fiscal, monetary and financial) positively influence stability and investment. It found that high inflation and risk of balance of payment imbalances, originating inter alia from exchange rate distortions and often accompanied by banking crises, inhibit economic growth. In addition, the study found that the role of the financial sector is key to channeling savings into investment.

These findings suggest that economic growth increases with improvements in education, financial depth, trade openness and availability of public infrastructure. It decreases with an extensive tax burden and in the absence of policies conducive to macroeconomic stability (inflation, overvalued exchange rates, banking crises) and, also, by negative terms of trade. An appropriate mix of economic policies accompanied by increased institutional capacity and quality will generate beneficial pattern of self-sustaining growth.

3. Economic viability and its importance for Kosova

3.1 "Can Kosova be economically viable?"

This question, frequently raised in the context of the future political status, is a very important one directly questioning the feasibility of an independent Kosova. On the other side the quality and dignity of life of Kosovars. The question is raised, usually, in terms of the size of Kosova (population, area), its natural resources and the present and potential level of development. However, there is ample evidence that size per se (in terms of population and area) and natural resources endowment have little bearing on economic viability (Hong Kong, Lichenstein, Luxembourg, Monaco, Singapore).

"Who will ensure economic viability for Kosova if not Kosovars themselves?" is the virtually unanimous response of Kosavars. Historical evidence suggests that the well being and economic growth of Kosova has been proportionate to the opportunity afforded to Kosovars to govern their own affairs and, also, to the level of political stability.

As noted earlier, growth and viability are directly related to the quality of governance, the capacity and level of education of the population, and technological innovation. Governance and sovereignty are closely interrelated since sovereignty is critical to ownership and acceptance of the institutions of governance, legitimacy and acceptance of the law, and the ownership and management of resources, all of which are critical to long term investment in growth including institutional and human development. The absence of sovereignty heightens political uncertainty, reduces the possibility for choice, acceptance of laws and capacity for economic governance.

In the post war situation the limited participation of Kosovars in governance has had negative effects on economic growth and viability. Negative effects include: uncertainty regarding the ownership and use of natural resources (including land and minerals) as well as of the assets of public and socially owned enterprises (POE, SOE) delaying, inter alia, their privatization, difficulties in the enforcement of financial/economic as well as other legislation, limited scope for cooperation with international and regional institutions (WTO, WB, IMF, EU), constraints to the development of trade relations with other countries, barriers to the mobilization of local/disaspora savings and the attraction of FDI.

Sovereignty is a prerequisite for Kosova for many reasons, among them the creation of the conditions necessary for long term investment to ensure growth, overcome underdevelopment and enable Kosova to prosper economically in an interrelated world.

3.2 Economic Growth in Kosova 1948-2004

Kosova achieved its highest rate of economic growth and development from 1965-75 together with related qualitative changes in the production structure. The annual increase in domestic output averaged 6% from 1966-70 and 7.5% from 1971-75 with moderate growth of 3.6% annually from 1976-1980 as shown in Table 1 below. During this period the economic and political system of the Former Republic of Yugoslavia (FRY) was decentralized to a certain extent while the constitutional position of Kosova in the FRY political and economic system was the same as that of other Republics and Vojvodina. In fact, following the extension of economic competencies in 1970s, Kosova enjoyed a greater degree of independence and self-government in social and, especially, economic development with Kosova having access to loans from international financial institutions and managing its own regional development policy. These growth rates are similar to current growth rates in some developing countries (Table 2)

However, at the beginning of 1980, due to the economic and political crisis in ex-Yugoslavia, the political and economic situation of Kosova changed dramatically. Growth in domestic output fell to an annual average of 1.8% in the early 1980's declining to 1.1% from 1986-88. The situation deteriorated even further from 1989-99 with output declining by an average of 5% annually with output per capita decreasing from some $700 per head to $400, or almost halving. The Serb regime revoked the constitutional order, installed a neo colonial regime supplanting the territorial and political autonomy of Kosova and introduced a form of apartheid. Socially and publicly owned enterprises, as well as educational and cultural institutions fell under oppressive measures with governance installed from Belgrade. More than 70% of Kosovar Albanian employees were expelled from their work places. Domestic production fell to 10-30% of capacity. The Kosova market was restructured or manipulated by the regime in such a

Table 1. *Economic growth 1948-2005*

Period	Annual increase in domestic output (%)
1948-65	5.7
1966-70	6.0
1971-75	7.5
1976-80	3.6
1981-85	1.8
1986-88	1.1
1989-99	-5.0
2000-01	10-16
2002-05	(-3) - (+4)

***Source** : Pre war statistics - VSK; post-war - IMF staff estimates* way as to absorb goods imported from Serbia, sold at higher prices and of lower quality than in the world market.

Since the end of the 1999 war, following NATO intervention, Kosova has been administered by UNMIK under UN Resolution 1244. It has embarked on a new phase of democratic, social and economic development. Following the economic rundown and extensive war damage, reconstruction started from a low base. During the Emergency Phase from mid 1999-2002 the international community provided substantial support for post war reconstruction and revitalization. The reconstruction program was largely successful, a dynamic economic recovery was initiated and economic activity especially in the services, trade and construction sectors were revitalized rapidly contributing to the high annual rate of GDP growth of 10-16.

However, since 2002 the pace of economic development has decreased, there are signs of an aggravation of social problems, with an increase in the already high level of unemployment. The slowdown is attributed, mainly, to a sharp decrease in external financial assistance (around 75% compared to the period until 2005), unfavorable economic policies for investment, sharing of institutional responsibility between UNMIK and PISG, compounded by political uncertainties relating to the status of Kosova. These factors have impacted adversely and heavily on sustainable economic development.

In considering the prospects for economic growth in Kosova, given a positive resolution of the status negotiations, it may be useful to consider the experience of other countries in transition especially those with a low income per capita as shown in the following Table 2.

Table 2. *Economic Growth in Southeastern Europe and other countries (%)*

	1998	**2001**	**2002**	**1998-2003**
Countries of SEE (*)	3.3	7.1	6.9	5.4
Other Countries of SEE (**)	-0.2	8.1	5.8	5.1
Armenia	7.3	9.6	12.9	7.7
Azerbaijan	10.0	9.9	10.6	9.7
Tajikistan	5.3	10.2	9.1	7.1
Development countries	3.5	4.1	4.6	4.5
Industrial countries	2.7	1.0	1.8	2.4

Source: *IMF Working Paper: "Analysis of Recent Growth in Low Income CIS Countries. 2004.*

3.3 Preconditions for Future Growth and Viability

Experience suggests that a number of preconditions must be met in certain key areas in order to achieve economic growth and viability including the following:

- Human resources and level of education
- Resource endowment (natural resources)
- Capital accumulation and investment
- Institutional capacities
- Stabilization and other economic policies in place
- Quality of public infrastructure

3.3.1. Human Resources and Level of Education

3.3.1.1 Population

According to the last Census of Population based on which statistical trend it was estimated that in 1991 Kosova had 1,956,000 inhabitants. Pending the results of a new Census planned for 2006, two Household Surveys undertaken in August 1999 and January 2003 by Riinvest provide some indications regarding the dynamics and structure of the population. It is estimated that over the ten year period 1991-2001 the population in the survey areas increased by approximately 26%. If this increase is applied to the 1991 Census estimate of 1,956,000 then by 2001 the population would have reached approximately 2,460,000 (including migration component). After taking account of the increase over the last two years 2002-2004 and migration component the 2005 population is estimated about 2.5 million. According to the outcomes of the aforementioned surveys undertaken by interviewing 3,500 families during August 1999, every family had approximately 1.1 members abroad, which gives us approximately 350,000 Kosovars living abroad. If we add to this the number of Serb minorities and other displaced minorities after the war (100,000), we would then have approximately 450,000 Kosovars who currently live abroad. This will give us the number of Kosova residents: approximately 2- 2.1 million inhabitants.

Table 3. *Kosova - Estimated Resident Population - 2015(No. of inhabitants)*

	2003	2015
1.6	2,000,000	2,380,000
1.7	2,000,000	2,400,000
1.8	2,000,000	2,434,000

Source: *Riinvest, September 2004*

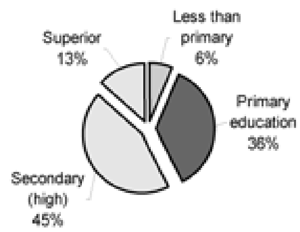
It is expected that approximately 2.4m inhabitants will live in Kosova in 2015. The annual growth rate is estimated at 1.6-1.8% and is unlikely to decline because the population is still young with 63% under the age of 30. On the other hand the migration component could increase if Kosova fails to ensure economic development and create jobs for its young population. An absolute increase in the population up to 2015 for approximately 400,000 new inhabitants represents serious demands on development in relation to education and other public services.

3.3.1.2 Level of Education

The population over the age of 18 years has an average of 11 years of schooling including 11.5 years for men and 10.3 for women.[6] This is typical of middle income developing countries.

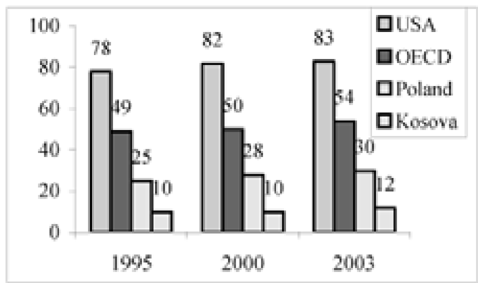
According to the household and labor market survey, conducted by Riinvest in December 2002, only 13% of the population in the 25-64 years age group has superior (tertiary) education – see Fig. 2.8 - with 18% of males and 8% of females. This compares with 23% of males and 20% of females in the EU; 36% of males and 32% of females in Japan; and 37% of total population of US.

Fig. 2.8. Level of education in Kosova (age group 25-64)



The number of registered students in universities in Kosova in 2005 was approximately 15-20% of the respective group age. In other transition countries, such as Poland, it was 30%; in the USA 80%; and in other OECD countries 54% (see Fig. 2.9). On average, there are 1,000 students in higher education for every 10,000 inhabitants, compared to 1,350 in Macedonia and 4,243 in Slovenia. The population of both countries is similar in size to that of Kosova.

Fig. 2.9 Numbers in higher education (% age group)



CEPES/UNESCO, 2002 (mimeo)

The level of education and employment are closely linked. With 63% of the population under 30 years there is a large and expanding workforce. Given the current level of university education Kosova is at a comparative disadvantage compared with some transition economies, some developing countries as well as the industrialized countries. Moreover, the local labor market increasingly requires those with higher education. To overcome this disadvantage and meet demand it is necessary to give high priority to and make a substantial investment to expand intake and upgrade the quality of higher education in line with EU standards. While the younger generation quite often speaks a foreign language this should be developed further through the provision of a variety of courses, especially in English at the University. The University budget amounting

6 EWR, Riinvest, September 2005

to about Euro 13 million annually, or 0.54% of GDP and 1.8% of the national budget, is very modest in relation to the critical importance of higher education for the workforce and growth of the economy.

3.3.2. Natural Resource Endowment

In terms of natural resources – minerals, land, water - Kosova is relatively well endowed compared to its neighbors. Lignite and mineral resources are potentially important sources of growth but in order to exploit them it will be necessary to attract FDI/strategic investors with modern technologies. The intensity of use of land resources in agriculture is relatively low and there is substantial potential for growth through intensification linked to a switch to higher value commodities and value added processing and marketing. Water resources, although a problem in eastern Kosovo, are unlikely to be a limiting factor as there is considerable scope for increasing efficiencies in conveyance and use as well as redistribution.

3.3.2.1 Mineral Resources

Kosova has considerable mineral resources, especially lignite, which is high quality and relatively cheap to exploit, as well as important deposits of lead, zinc, nickel and manganese. Mineral resources are summarized in the following table. With some exceptions - including lignite mining for the existing power stations, the recent privatization and imminent re-opening of Ferronickel with a strategic investor, possible development of a new power plant and associated lignite mine - it is not possible at present, to effectively exploit mineral resources. This is due, in part, to the outmoded technology and poor condition of existing plants and mines and the need to attract substantial international strategic investors. The attraction of large scale FDI requires improvement in the investment environment, which is substantially dependent, in the first instance, on resolving the issue of political status.

Table 4. *Kosova - Mineral Resources - 1985 (Million tones)*

I.	**Energy**	
1.	Lignite (milliard tones)	12.0
2.	Oil (milliard tones)	1.0
II.	**Metals**	
1.	Bauxite	5.0
2.	Lead and Zinc	75.0
3.	Nickel	40.0
4.	Chrome (`000 tones)	0.6
5.	Iron	5.0
6.	Manganese	6.36
III.	**Non metallic minerals**	
1.	Sabulous Quartz and Quartz	30.0
2.	Magnesium	17.0
3.	Heat resistant clay	8.0
4.	Asbestos	20.0
5.	Bentonit	120.0
6.	Tuf	30.0
7.	Cement	175.0
8.	Ornamental stones	5.0

Source: *Kosovo Strategy of Development 1985-2000 (Office of Plan and Development of Kosova)*

3.3.2.2. Land Resources

Although Kosova is relatively small in terms of area - some 10,908 km. sq. - there is a substantial variation in terrain, vegetation, climate, land capability and use. The area of arable land is relatively large at 56% of the total area and almost half comprises good and medium quality soils (15% and 29% respectively). Of the high and medium quality land 11% is humus soil, mainly in the Kosova Valley, 8.4% is carbon fulvous soil, and 7.8% alluvial ravines and dark soils in the serpentine cliffs. Most of the area with poor soils lies in the low hill and mountainous regions and consist of fulvous and dry soil, diluvia soil, backwater and other non-cultivatable soils. Arable agriculture is concentrated on the better soils of both western and eastern Kosova and is substantially dependent on irrigation.

3.3.2.3 Water Resources

Kosova has at its disposal a water resource of some 2,812.6 million m3. The average water flow from western regions is 59.7 m3/sec and from eastern regions is 29.5 m3/sec. With much of the population, several of the larger cities, including Prishtina, and a significant slice of industrial/commercial activities including thermal power generation located in eastern Kosova there is an overall water deficit in the region. In order to ensure the supply of potable water, water for industry and irrigation three dams and three associated canals were constructed at the edges of the Kosova Valley including: Badovci (above the River Graçanka), Batllava (above the River Batllava, a tributary of the River Llapi) and Gazivodës (above the River Ibër). In addition canals were constructed at Livoçit, Perlepnice and Radoniq. Badovci and Batllava reservoirs supply potable water, water for industry and for irrigation. Over recent years the volume of the Badovci reservoir has been falling, while the Batllava reservoir is likely to fall since the water extraction from the reservoirs is higher than the capacity of the rivers which supply them. The water supply situation for Prishtina and the surrounding areas visibly improved after water was channeled into the Badovci reservoir via the Gazivoda Canal in late 1995. In general, cities face problems with the supply of drinking water, which will be compounded with the resumption/expansion of mining, power generation and other activities including the intensification of agriculture. In order to ensure a safe, larger and reliable supply of water there will be a need to construct additional reservoirs and conveyors in the peripheral areas of the plains.

3.3.3 Investment

Investment in Kosova during the period 2001-05 is summarized in Table 4 below. The current level of investment, 23-25% of GDP, is more appropriate for a mature than an emerging economy, which needs high growth. Channeling savings and deposits to investment and attracting more FDI is a very critical issue. Both private investment activity and donor funded investment declined after 2002 while the small government share has increased. Most private investment is directed to housing and to a lesser extent

Table 5. Investment in Kosova (% GDP)

	2001	2002	2003	2004	2005
All	25.76	24.23	23.63	23.71	24.40
Private	16.19	16.19	13.05	12.53	15,28
Government	0.86	1.71	3.96	5.98	6.03
Donors	8.61	6.49	3.76	2.95	3.09

Source: IMF staff estimates July 2005

to business activities, the declining amount of donor agency investment has focused increasingly on capacity building, government investment has been largely in utilities. Direct investment in manufacturing activities, income generation and job creation is still very modest. The size, structure and quality of current investment activity are not appropriate for fostering high growth rates and job creation. Given the existing level of unemployment, the youthful population and expansion in the number of entrants to the workforce it is necessary to create 25000 -30000 new jobs annually. This would be possible only with dynamic economic growth, which, in turn requires a friendly investment environment, security for local investors as well as FDI, access to IFI funds as well as to prestructural/structural funds through the EU accession process, the latter to modernise social and economic infrastructure.

3.3.4 Institutional and Policy Environment

After the successful emergency phase of reconstruction, and growth involving a construction boom UNMIK and PISG institutions have not been able to establish a policy environment and conditions for stable and lasting economic growth.

On the institutional side the responsibility for governance/management of economic development has been shared by UNMIK and PISG, this duality has led at times to uncertainty, ambiguities and, at times, disagreement regarding responsibilities, competencies, authorizations and actions. Despite expectations, during 2003-04 the transfer of competencies to PISG was very slow and was followed by disputes between UNMIK Pillar IV and government concerning, especially, privatization and, also, aspects of taxation and budget policies. In the face of political uncertainties, less than efficient governance with a marked lack of synergy has had an adverse impact on economic growth.

The basic legal framework for business and commerce has been established and for the most part meets the standards required for building a modern open market economy. However, enforcement mechanisms are still not in place and there has not been sufficient analysis of progress in implementation and enforcement, for example, of contractual obligations. In the northern part of Kosova and in minority enclaves there is no compliance with UNMIK/Kosovar law and no action to secure compliance. These failures have distortion effects in the market; negatively influence the business environment and the rule of law. SME surveys[7] conducted during the last six years show that SME owners and managers consider the main barriers to doing business (from among 14 listed) to be: unfair competition, legislation, corruption, taxation, access to finance. This is typical of a turbulent business environment where there is a lack of capacity and commitment to implement the rule of law. Increasing capacities, accountability and responsibility for implementation of existing laws and ensuring the rule of law appears

7 Riinvest SME Reports 2000, 2001, 2002, 2003, and 2004 to be very critical factors for further advances in building a business environment conducive to economic growth.

The broader economic policy environment seems to be consistent with the need to avoid distortions in the market and to support macroeconomic stability. However, it is necessary to discuss whether these policies are appropriate for an emerging economy and, especially, for new manufacturing and export activities and job creation.

In general the tax burden is somewhere in the middle of that of neighboring countries. VAT is the lowest, corporate tax lower than in Albania but higher than in other countries, tax on wages is similar to others, property tax seems to be higher, custom tariffs for equipment are still not investment friendly. The main difficulty seems to be the application of VAT and bureaucratic difficulties in securing reimbursement. The total fiscal burden of 26 % for most capital goods/ equipment, to be paid at once at the border, is not supportive of investment. There should be space to consider further improvements to achieve a more investor friendly tax policy. A good example, which is often mentioned, is Estonia involving fixed and low taxes, a tax free zone for investors and a small bureaucracy.

Business is based mostly on self financing and on credit provided by a healthy new banking system created during the last five years. However interest rates and repayment periods remain inappropriate for serious investment undertakings. Government should seek ways to bring more competition into the credit market including cooperation with international financial organizations/banks to provide credit lines with better conditions for manufacturing and export sectors. It should seriously consider establishing a specific fast track in the courts for the enforcement of contractual business obligations and mortgages.

Following the completion of FTAs with Macedonia and Albania similar arrangements should be made with other neighboring countries, which would create a better environment for domestic and foreign investment. However, trade relations with Serbia and Montenegro need to be carefully monitored during the negotiating process and be based upon and ensure reciprocity.

3.3.5 Macroeconomic Stability

Euro based financial transactions have contributed to macroeconomic stability. Inflation has been low while starting from November last year deflation was associated with negative growth rate. The budget is moderate in relation to GDP - 26% on the revenue side and 28.5% on the expenditure side with the difference financed from a cumulative cash surplus. Credit is also moderate at 16 % of GDP.

Table 6. *Main macroeconomic indicators (million euros)*

Item	2001	2002	2003	2004	2005
GDP	2,439	2,447	2,420	2,505	2,453
Consumption	2,680	2,623	2,600	2,711	2,660
Investment:	661	603	572	594	600
- Government	6	15	36	169	148
- Private	409	408	404	359	375
- Donors	245	180	132	66	76
Trade balance	- 956	-838	-812	- 848	- 854

Source: *IMF staff estimates July 2005*

However, medium to longer term

macro economic stability is seriously threatened by critical imbalances including:

- Between GDP and consumption
- Very high trade deficit
- Imbalances in the labor market
- The size of the budget and capital investment needs

Total consumption, according to IMF estimates, is 8-9% higher than GDP and is covered by remittances from Kosovars working abroad.

The trade deficit is very high with exports covering only a tiny part of imports - 2000: 2.9 %, 2001: 1.2 %, 2002: 2.7 % and 2003: 3.7 %, 2004: 5%. Correcting this huge deficit is dependent upon successful implementation of integrated policies that lead to the development of businesses able to compete in the domestic market and the development of exports involving both foreign investment and privatization of SOEs.

At present levels of growth there is no prospect of creating sufficient jobs for the net annual inflow of some 25,000 new jobseekers into the labor market. This is a long-term problem (83.1 % of the unemployed in Kosova have been unemployed for over a year).

The Kosova Consolidated Budget of approximately €714 million accounts for approximately 28.5% of GDP. While operating/current expenditures have been capped and revenue is increasing only slowly there is an increasing need to finance essential capital investment. There is high demand to improve transport infrastructure (especially in the rural areas), public infrastructure to support business development and employment, as well as investment to improve the quality of education. All this represents a serious challenge. Despite the progress in building a sustainable budget, revenues cannot cope with the demand for capital investment. Kosova is an emerging economy with an inherited seriously deficient social and economic infrastructure. Needs must be prioritized and funding obtained from international and regional financing institutions as well as through the pre accession/accession processes. Delays in addressing critical investment in public infrastructure including education will have serious knock on consequences for local private investment as well as for FDI and, consequently, on the process of economic development.

The radical slow down in growth has had negative social as well as economic consequences. The reasons for it lie in the unsuccessful management of the transition from the emergency phase of reconstruction towards sustainable economic development, which has been compounded by delay in dealing with status. Support by development partners including the EU was radically and disproportionately decreased before appropriate policies, institutions and local capacities for generation of revenues and new jobs were in place and, seemingly, with little regard for the social and economic consequences.

3.3.6 Infrastructure and public utilities

Existing public infrastructure provides, at best, only for the basic needs of the population and economy. The supply of electricity is not stable with frequent blackouts and substantial imports despite the fact that Kosova is, at least potentially, the lowest cost supplier in the region. The existing supply deficit coupled with the resumption of mining/smelting activities and the potential for exporting electricity has resulted in proposals to rehabilitate the Kosova A thermal plant and construct a new 1000 MW plant and associated lignite mine. Telecommunications are currently the monopoly of the public provider that is unable to provide a quality service while the mobile network is a virtual monopoly, granted by UNMIK, with prices that are among the highest in Europe and the Balkans. Poor and costly telecommunications including IT services are a serious deterrent to business and a poor advertisement for promoting the development of high value services.

While the main road infrastructure may meet basic needs, secondary and particularly rural roads are in very poor condition. The capacity, condition and traffic volume on most main roads is such that it is necessary to spend 50-70% more time than might normally be expected to travel between the main cities and Prishtina with serious implications for costs. Kosova is currently left out of trans European traffic corridors. Improvements to the main corridors Durres - Prishtina - Nish and Mitrovica - Skopje are necessary to reduce transport costs, increase competitiveness and facilitate regional and wider integration. With 85% of Kosova's population living within a radius of 20 km from one or other of the seven main cities the development of the interurban and suburban transport networks is necessary to support urban/rural development. Such improvements would assist in securing more productive use of resources in rural areas and in reducing migration trends to the cities.

3.4. GENERATING ECONOMIC GROWTH

3.4.1. The need for economic growth

As discussed earlier, although postwar reconstruction was largely successful Kosava has yet to move to a sustainable growth path. There are many challenges – 40% of the rapidly growing workforce is unemployed, much of it long term, there are poor prospects for new jobs; the level of education of the workforce and capacity in higher education are inadequate; there is a massively negative trade balance, exports are negligible; economic and social infrastructure is generally inadequate and often in poor condition; investment is low at 25-26% of GDP while consumption is high; the estimated share of the agriculture at GDP is 25%, services 60% ad industry about 15%. These structural challenges and imbalances can be resolved only with strong long term economic growth

3.4.2 Growth Scenarios

Several Central European countries and some Southeastern European countries have achieve high rates of growth during the transition, which Kosova must emulate to meet the challenges outlined above. Their success has been due, mainly, to an effective liberalization processes, increasing their competitive advantage as well as the creation of a business friendly environment. The following three "What if?" growth scenarios are based upon current conditions, the lessons of experience in other high growth transition economies including the key factors impacting on investment and increasing competitiveness.

SCENARIO (1) – LOW GROWTH

Environment/key factors

- Stagnation in implementation of standards, rule of law;

- co - Corruption increasing, ineffective governance;

- Decision on final status postponed;

- Delay in the reform of public utilities and in completing privatization process;

- Limited cooperation with international financial institutions.

→ ***Low GDP Growth - 1-3% Stagnation*** →

Effects/consequences

Worsening of economic and social situation;

- Increase in unemployment and poverty;

- Difficulties with budget deficit;

- Social and political instability;

- Illegal emigration to western countries

SCENARIO (2) MODERATE GROWTH

Environment/key factors

- Political status is addressed, but uncertainties remain; international assistance provided for security issues;

- Participation in TMP process with EU, instead of SAP;

- Institutions make progress in implementing the rule of law;

- Cooperation not membership with WB/IMF;

- Integration in European agreements and in Trans European corridors;

- Successful completion of privatization process and restructuring of public companies.

→ ***Moderate GDP Growth 4- 7%*** →

Effects/consequences

-Increase in employment 3-5% annually (12000-15.000 new jobs), number of unemployed increases???;

- Significant improvement in quality of life with poverty reduction;

- Macro economic imbalances reduced.

SCENARIO (3) DYNAMIC GROWTH

Environment/key factors

- Effective implementation of rule of law and economic policies, corruption is effectively reduced;

- Ambiguity over status is eliminated;

- Integration process with the EU is advanced/realized together with access to structural funds;

- Membership in international organizations;

- Improvement in the quality of education - international standards are reached;

- Friendly environment for foreign and domestic investors.

→ ***Dynamic GDP Growth 8-10%*** →

Effects/consequences

- Unemployment reduced by 6-8% annually (25,000 new jobs created annually);

- Poverty at least halved;

- Budgetary stability;

- Decrease in emigration;

- Social and political stability;

- Development gap with other EU countries reduced.

An estimate of the growth of GDP over the period 2005-15, drawing on these Scenarios is given in Table 6 below and summarized as follows:

• The first phase 2005-08 includes elements of Scenario (1) and (2). During this phase, given the low base and recent low growth, economic growth would increase from 3-5 %. It implies an increase of investment to average 27% of GDP and could result in an increase in employment of 3% annually.

• The second phase 2009-15 is based on Scenario (3). During this phase growth would average 9 % annually. It implies an increase of investment from 27% to 30-35% of GDP, with strong multiplier effects from the cumulative effect of earlier investments, and would result in an increase in employment of 6% annually after 2008. These growth rates would be similar to growth rates experienced in some countries presented in Table 2.

• Total investment over the period 2005-15. Amounts to some Euro 14 billion. Sources of financing are discussed in section below.

Table 7. Projected growth of GDP 2005-15 (million Euro)

Item	Unit	2004	2005	2008	2009	2010	2015
Phase I							
GDP	5% p.a.	2505	2453	2839			
GDP per capita	Euro	1258	1299	1429			
Budget	30%	767	746	852			
Investment		538	713	826			
Employment	'000	430	443	484			
Population	'000	2000	2034	2140			
Phase II							
GDP	9% p.a.				3095	3374	5191
GDP per capita	Euro				1422	1524	2156
Budget	30% of GDP				991	1080	1661
Investment					1083	1181	1817
Employment	'000				513	544	728
Population	'000				2176	2213	2407

3.4.3 SOURCES OF ECONOMIC GROWTH

It is clear that sustainable economic growth in Kosova is unlikely to be driven by any one sector or industry but will come from exploiting opportunities in several sectors of which the following are considered to have the greatest potential:

- SME sector - is currently the most vital with potential for further development as the business environment improves [Scenarios (2) and (3)]. Within the sector the agro processing industry is already engaged in import substitution in the domestic market and has started to export to neighboring countries (milk, meat, juices with scope for expansion. Similarly, construction materials supplies, the construction industry with related services have substantial scope for expansion in a growing economy. At a later stage, given expansion and improved quality in higher/tertiary education, there could be opportunities in high value added services.

- Energy Sector – Proposals are currently being developed to meet the large and growing regional power shortage by rehabilitating an existing thermal power plant and building one or more very large new plants based upon the exploitation of the very large reserves of relatively high quality, low cost lignite in Kosova. Given the high level of investment required (some billions of Euro for power plant, mines, transmission systems, etc) and technical complexity the first phase of such a development would extend over a period of at least 7-8 years with substantial long term benefits thereafter in terms of employment and exports. It would also ensure Kosova businesses of a low cost, reliable source of power. However, even in the shorter term, say within 2-3 years, construction activities and other services would bring significant benefits in terms of employment. The development would involve large scale FDI.

- Other minerals and metals - The recent privatization of the Ferronickel enterprise with FDI will generate some 1,000 jobs and enable the resumption of exports. There is potential for the redevelopment of other mines and smelters - lead, zinc, nickel and manganese - that are currently out of production including Trepca mines in StanTërg, Kizhnicë, Novobërdë, and Hajvali. However, the potential scale and commercial viability of the resumption of mining/smelting is not clear. Privatisation is a prerequisite for possible resumption as is commercial viability, which would involve substantial capital investments through FDI.

- Metal and other products (former exporters) – The production of galvanized sheets has resumed at the Ferronickel and Ballkan plants. There may be scope for the resumption or partial resumption of production for export (as in the 1980's) of other metal products such as automobile parts, electro motors, radiators, galvanized zinc sheets, tubes/pipes, batteries, rubber conveyors and belts. This depends mainly on effects of privatization process.

- Agriculture – Farmers, given the small size of farms and plots, are moving from cereals and other low value field crops and expanding the production of high value fruits, vegetables and livestock and meat production where market opportunities exist. Some brand products also could be developed for exports especially if the environmental/ ecological healthy food programs could be launched.

- Value added services – High value added services (I.T,, financial and other) and tourism, especially winter and ski tourism should be considered and explored.

4. INVESTMENT FOR GROWTH AND SUSTAINABILITY

4.1. Tentative projections of investment needed

For Kosova, estimates of investment capacities (for the different sectors & from the various sources) are highly important to enable an indicative platform to be prepared for mobilization of all possible investment resources. They are particularly important for estimating public investment capacities. The following exercise is entirely for illustrative purposes: to outline the plausibility of applying projections for creation of a viable economy in Kosova and also to show how much effort and the kind of effort that is necessary to ensure dynamic economic growth.

Table 8. *Indicative sources of investments (million) based upon Scenario III*

Investment	2004–2015	Percentage
Total	13,894	100
Private	8,237	59.3
Government	3,493	25.1
Donors	895	6.4

Source: *Estimates of Riinvest Institute*

4.2. Potential structure and sources of investment

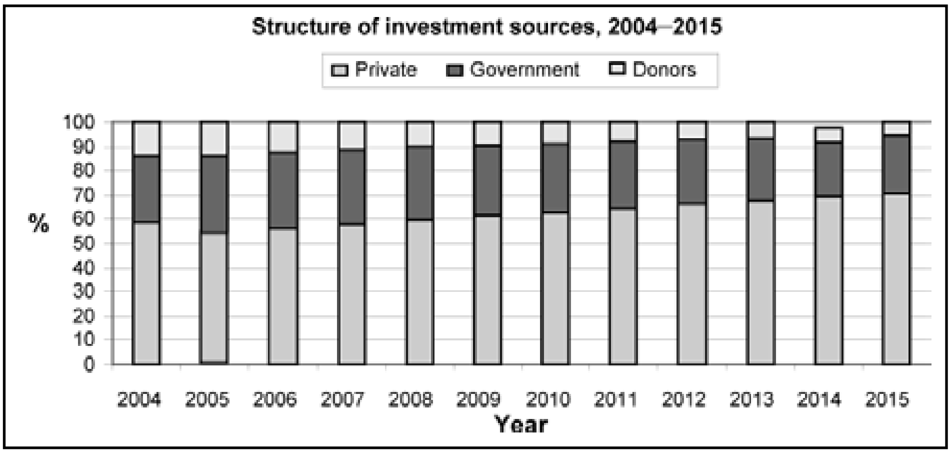
Table 9 provides indicative information on potential sources of investment. During the first phase, up to 2008, some 2,445 million euros could be mobilized from current sources alone. However, in the second phase, from 2009 to 2015, more than four times this sum, some 10.734 billion euros of investments, are planned, following the same pattern as above. During this phase it is foreseen that of particular importance will be the direct engagement of FDI, with ten per cent participation in overall investments, or 1 billion €. Private investments will be constant, and during these years they will represent 55 to 60 per cent of the total amount of investments. This model supports Scenario III, represented above.

Public investments will increase in the years to come, representing some 30 per cent of the total. The main sources of investment will be the budget, treasury bills and loans from International Financial Institutions (IFI). The level of participation of donors will decrease during the second phase.

Table 9*. Expected sources of investment (million €) ?the percentages in the table do not correspond with the figures in the table?*

Years	Private 65%		Public 30%		Donors
	Business	FDI	Budget	IFI	
	55%	10%	28%	1.7%	5%
2004–2008	1,506	16	919	4	1,506
2009–2015	4,830	1,610	2,683	1,073	536

Source: *Estimates of Riinvest Institute*



4.3 Becoming “Investment Friendly”

According to the scenarios presented above it is clear that the factors that will stimulate economic growth will be heavily dependent upon effective, democratic institutions and the rule of law. Meanwhile, a resolved status for Kosova will help create a better investment environment, with normal access to the IFI and through the mobilisation of all necessary private and public, domestic and international sources of investment. Although such investment is necessary it is not sufficient on its own to generate the growth desired. Other economic and institutional conditions must also be in place, such as necessary structural changes, institutional capacities, managerial competence and skilled labour, along with an ability to plan and implement projects.

Given that the status of Kosova is expected to be resolved during 2006 and that the technical and financial assistance of the international community will continue, the above-mentioned two conditions ?which two conditions? could be achieved. Thus, economic growth will most likely depend upon the ability of institutions and human resources to both generate and absorb investments, transforming them into feasible projects and sustainable economic growth. From the elaboration worked through above one can conclude that it is essential for Kosova to become an attractive destination for both foreign and local investors. However, the authors are aware of the current unfavourable conditions for achieving this third scenario, though it is here presented as a means towards creating a prosperous society and economy. This scenario implies significant changes being made towards improving governance of economic development based on the rule of law and increasing human resource capacities through improvements made in the education system and public infrastructure. These must be key priorities that should constitute the focus of the forthcoming Development Plan of Kosova.

All this should build on economic and political stability based upon lasting peace, which in turn requires providing opportunities for all Kosovars and being especially sensitive and generous toward ensuring best standards concerning minority rights. This will be a constitutive part of Kosova's new image as a destination of FDI, which will need to be promoted aggressively.

For policies, we have addressed some deficiencies within 2.3.1 of the present report. The current policy environment (taxation, financing, etc.) are mostly technically and theoretically very correct. However, they should again be tested against their effects on economic growth in concrete Kosovar conditions.

5. TOWARDS A SUSTAINABLE BUDGET

5.1. Progress to date

During the post-war period, Kosova has developed a new budgetary system based upon the experiences of advanced western and transition economies. Central Fiscal Authority (CFA) was administered by UNMIK, which operated the Kosova budget up until 2002. Subsequently, the Ministry of Economy and Finance (MEF) was established and thereafter local authorities received more competencies to administer fiscal and budgetary issues. The taxation base has been continuously broadened; currently it covers the majority of direct and indirect taxes that have been introduced in other economies in transition. A new fiscal administration has been established, while lack of experience has been compensated for through extensive training provided by UNMIK Pillar IV and USAID. An important contribution in strengthening and consolidating the budget and assisting the MEF has been given by the International Monetary Fund and the World Bank.

In the last three years, the Kosova Consolidated Budget (KCB) has been completely financed by internal tax revenues. This fact demonstrates that there is a capacity to build a sustainable budget, which of course is the key to building a sustainable, viable economy. However, due to the obvious structural problems that have already been described budget sustainability will face challenges regarding revenue stability and financing of public expenditures, at least in the mid-term.

5.2. Challenges and deficiencies

Budget revenues generated from border taxes make up around 80 per cent of the overall income, with the level of taxes collected in other bases remaining modest. Hence, in order to increase the level of taxes collected domestically, there is an urgent need to increase the tax administration capacities. This would consolidate the budget and make it more sustainable in the long-term.

After experiencing a budget surplus (cumulative unspent cash) up until 2003, Kosova has since experienced budget deficits, in 2004 and 2005. The budget deficit in 2005 comprised 13 per cent of the KCB, or around 3.8 per cent of GDP. During this period the deficit was covered by the surplus accumulated during previous years. Nevertheless, these funds cannot cover budget deficits in the mid-term, namely after 2006.

Understandably, in order to meet the increasing requirements, in particular investments, there is a need for a larger budget. An expansion of the budget for the coming periods should stem from a more efficient tax collection and more robust economic growth. However, projections of economic growth rate for the next period differ between the research groups making the estimate. In drafting the 2006 budget and projections for 2007, the MEF was reliant on a level of economic growth of 2 per cent. Meanwhile, World Bank projections of mid-term expenditures (2005–2010) used two macroeconomic scenarios that are based on different assumptions, namely speed of the programme of economic reforms and political stability, and the positive impact of these factors upon domestic investments and increasing exports. It is assumed that real GDP growth for 2005 would be around 1 per cent with a gradual increase of up to 3.5 per cent for 2010. In the best case scenario it is estimated that reforms in the energy sector will result in new investments and higher growth, of 3.7 per cent in 2007 up to 5.2 per cent for 2010. Meanwhile, inflation is estimated to be at the level of the EU average, some 1.8 per cent annually. With faster growth the total budget income in 2010 would be around 877 million euros.

The Institute for Development Research, Riinvest, has outlined three possible scenarios of economic development for the next 10 years. The preferred scenario (described above) indicates that by 2010 the Kosova budget would amount to about 1,080 million euros.

Projected budget revenues for 2005 (629 m€) have a share of GDP of around 25.6 per cent. In 2006, budgetary income (656 m€) will have approximately the same percentage of GDP. However, overall budget spending in 2006 is estimated to decrease from that in 2005 as a share of GDP, from 30 per cent to 28 per cent. It is considered that a share of budget consumption of about 30 to 32 per cent of GDP does not present a problem for the economic growth of Kosova. Nevertheless, if expenditures go above this level then, according to some international experiences, this might have a negative impact on economic growth.

The most evident problem for the budget is how to cope with needs for capital investments. Some of these needs have been described above. Capital Investment Projections that were designed in absence of a development strategy were not based on well-defined priorities. Therefore, the PIP, which is drafted and approved by government, should be harmonized with the mid-term Kosova Development Plan and with the main goals of economic development, which are currently being prepared. Based on experiences so far, one can expect that, due to its structural problems, Kosova will face difficulties in the mid-term with acquiring capital public investments. Therefore, the support of IFN and other donors is necessary in this area.

A further increase in budget spending will be necessary in future: for example, there will be new jobs created for new ministries, where office space and other running costs will be needed. Establishing a Ministry of Foreign Affairs and a Ministry of Defence will involve particular budget implications. Meanwhile, for the 2006 budget, the expenditures for the Ministry of Interior and Ministry of Justice have been projected. Reducing the number of international police in Kosova will generate higher costs when employing local policemen and policewomen, buying equipment and providing services that so far have been provided by the international police force. Currently, is impossible to estimate the exact costs of the new functions but it is more than obvious that continuous transfer of powers will be followed with new fiscal implications related to wages and salaries, goods, services and capital investments.

The process of restructuring public companies such as KEK, PTK, Airport, UNMIK Railways, regional heating, water supply and sewage companies have not progressed according to budget projections. A significant part of budget has been used to cover the operational losses of these companies, notably for KEK[8] . Dependence of some of these companies on budgetary funds has been created, while the level of quality of services provided is very low, though at quite high cost. It is clear that budgetary funds compensate for inefficient management and for delays in restructuring and liberalisation of this market. Such a practice has created a paradox, where taxpayers pay for the shortcomings of the KTA and KEK management. Moreover, in the energy sector this has been accompanied by a low level of bill collection (payment) from consumers.

The solution should be sought for in the liberalization of the public services market, by creating conditions for private investments and larger competition in the marketplace. This would discharge the budget from unreasonable obligations and would increase the responsibility of the public companies.

Once its political status is determined, Kosova must take on its share of foreign debt, as a constitutional part of the ex-Yugoslav federation. However, international financial institutions should take into account the fact that the increase in Kosova's foreign debt after 1990 was not a result of hesitation to pay it back, but rather that it was impossible to do so due to the fact that the Serbian regime had taken over and was managing all Publically Owned Enterprises (POEs) and Socially Owned Enterprises (SOEs). Therefore, the debt should be broken down into three periods:

- External (foreign) debt up until 1990;
- Foreign debt from 1990 up until June 1999;
- Continuation after June 1999, to date, of the debt prior to 1990.

Kosova institutions should accept foreign debt accumulated up to 1990 and part of the debt to be serviced after June 1999 according to the maturity plan.

The contracts of this debt were ratified by the Yugoslav Federation and the Parliament of Kosova. With the agreement of foreign creditors, the Kosova budget would plan

8 For the 2005 budget, reserved powers part, it is foreseen to allocate 80.5 million euros for KTA, of which 55.5 million € are for electricity, i.e. KEK (7.5% of budget consumption). In the budget projection for 2006, 67.7 million euros are planned for KTA, of which 44.9 million € (6.5% of budget consumption) are planned for electricity.

to return the external debt created before 1990 and the obligations deriving from this debt after June 1999. The part of the debt that should be repaid according to the maturity plans of July 1990 until June 1999 should be paid by Serbia, since it was managing all POEs and SOEs at that time, and is thus liable for that debt. In addition, the Government of Serbia should be charged with all interests deriving from the debt from this period and also with any new debts created during the period of occupation.

The large number of people employed in the public administration and in service provision not surprisingly has resulted in a large share of the wage bill in the budget consumption. This has started to hinder the sustainability of the budget and, according to IMF estimations, this presents a potential trigger for a budget crisis. A difficult economic situation limits the possibility of reducing the number of employees in the civil service, since it would immediately result in increased unemployment. In addition, decreasing wages and salaries would contribute towards increasing poverty, which currently is quite high. In the long run, this problem could be addressed by continually increasing budget revenues, with the number of civil staff remaining unchanged. A considerable number of employees could be redeployed within the newly established ministries and services. This should create preconditions for a higher efficiency of civil servants and relatively lower share of the wage bill in the total budget consumption. In addition, it would create room for further wage increases for civil servants in the future.

Special attention should be paid to rationalising expenditures for goods and services, since this area has been out of the focus of the recent period. A more rational approach in these two areas would create conditions for more capital investments in infrastructure, education, science and healthcare.

The fiscal decentralization that was orientated towards strengthening the role of municipalities in collecting their own income has not yet reached the results expected. Big differences in property tax levels and insufficient transparency towards taxpayers have resulted in large differences between municipalities in collecting property tax and other municipal budget revenues in general.

It is clear that more attention should be paid to increasing fiscal education of the tax payer and of the institutions. This could be very important for budget sustainability. Establishing a real and permanent communication between government and the taxpayer, along with budget effects on public services provided to the population will be an important factor in increasing budget income and maintaining its stability. It is also important to provide more transparency and accountability over the budget process, aiming at increasing budget consumption efficiency and broadening the tax base. However, regardless of the important role that fiscal education plays, it certainly cannot substitute the enforcing mechanisms that ensure tax payment and collection of bills for public services. Currently, these mechanisms are not functioning properly, and there is no reason to believe they will do so in the future unless changes are made.

6. STRUCTURAL PROBLEMS AND NEED FOR INTERNATIONAL TECHNICAL ASSISTANCE AND COOPERATION

Despite the fact that it is relatively well endowed with resources, Kosova is an emerging developing country and as such it will face many challenges before it can achieve the necessary dynamics for economic development. Its structural problems, such as lack of proper public infrastructure, unemployment, deindustrialization and trade deficit originating from a difficult heritage, especially during the 1990s, require the continued support of the International Community through effective provision of technical and financial assistance and cooperation.

Future international support might be channelled through the following:

- Support for further capacity building in the area of development management and governance;
- Provision of financial assistance in facing current budget difficulties for public investment, especially in the mid-term;
- Establishment of proper and full capacity relations with International Financial Institutions.

The International Community, through the UNMIK administration, UN agencies and other agencies such as AER, USAID, DFID, GTZ, SDC, SIDA etc., have contributed towards overcoming the terrible consequences of war and rebuilding Kosova society, including the establishment of institutional infrastructure based on free elections. However, further development of these institutions requires a new type of support, especially in increasing capacity for law enforcement, governance and management of development. Also, further support in improving the quality of education will pay dividends in increasing Kosova's absorptive capacities for investment and development. The next phase of this assistance should be directed entirely towards increasing capacities rather than towards doing the jobs that the Kosovars themselves should be doing.

Discontinuation of development and lack of investment in public infrastructure and utilities during the 1990s have had very negative consequences on Kosova, particularly on the current conditions for development. The Kosova Consolidated Budget will have difficulties, at least in the mid-term, in providing necessary investment until economic growth is fostered and an improved tax administration further improves tax collection. Supporting the KCB will require direct international financial assistance in this area.

Cooperation with the IMF and WB, which have been present throughout the whole post-conflict period, contributed significantly with technical assistance and direct budget grants during the first years. With advancement of status talks and their finalization new capacities in this cooperation are expected to be established. At the moment, both sides, particularly the Kosova institutions, should work on preparing feasible bankable projects and their proper management during implementation. In this direction, some initiatives already discussed for cooperation with EBRD and EIB need to be reinforced. Cooperation with IFI needs to be established and organized within the MEF and government because of its key importance for building conditions for sustainable development through lasting economic growth.

ANNEX 1.
SUMMARY OF KOSOVA'S ECONOMIC PROFILE

Kosova is located in the centre of the Western Balkans, in a compact, nearly circular territory. Thanks to this layout, its capital, Prishtina, is almost equidistant from Thessalonica, Sofia, Tirana, Belgrade and Podgorica, as well as from Budapest, Bucharest and Zagreb.

In an area of approximately 10,908 km2, there are currently about 2 million resident Kosovars (approximately 183 inhabitants per square kilometre). Approximately 90 per cent of the population is Albanian, while half of the remaining 10 per cent are Serbs. The population density is high and the natural increase is among the highest in Europe. The population is young and energetic: 63 per cent are under the age of 30, with only 5 per cent above the age of 65. About 80 per cent of the population is located at distances less than 20 km from the seven regional centres, which each have more than 100,000 inhabitants. In the next decade, the population of Kosova is expected to increase at an annual average of 1.6 to 1.8 per cent; thus by 2015 it is expected to be home to 2.4 million inhabitants. Non-resident Kosovars comprise one-quarter of the population, having emigrated mainly to Western Europe. Nevertheless, these emigrants remain very connected to their homeland, sending back contributions and remittances that so far amount to about 300 million euros.

With a GDP of approximately 1,200 euros per capita (approximately 1,500 $ at the current exchange rate) and a human development index of 0.735 (Norway 0.944, Macedonia 0.784), Kosova is a developing country, ranked above the middle in the list of developing countries. As a post-conflict country with a disadvantageous heritage in the field of development, it is characterized by sensitive imbalances in its macroeconomic configuration: total consumption exceeds GDP, exports cover imports by only 4–5 per cent and the level of unemployment is between 40 and 45 per cent.

The profile of the economic structure is characterized by a large share of GDP by the service sector (60%) and agriculture (25%), due to the deindustrialization process during the 1990s. Currently, participation of industry in GDP is only 15 per cent. The industrial structure established mostly during the 1970s and 1980s needs renovation and technological regeneration through the privatization process, which has just begun. Agriculture absorbs approximately 22 per cent of the Kosovars' workforce, with limitations for families due to the small plots of land, while the uncompetitive production structure does not ensure quality consumption, even for rural families. Agriculture contributes approximately 9 per cent of revenues (cash) of rural families, while the coverage of consumption by self-produced products varies from 12 per cent (eggs) to 51 per cent (grain). Services are mainly connected with businesses, hotels and civil engineering activities.

The private sector (including farming) contributes at least 60 per cent to GDP with the domination of the vital sector of SMEs. This sector is dominated by trade or commercial enterprises (52%). There is a slight tendency for an increase in manufacturing businesses, mainly in the field of construction, food processing, wood and paper industries and design services. Most private businesses (more than 97%) employ no more than five workers. The trend for investment and entrepreneurship is confronted by inadequate public infrastructure and institutional barriers: unfair competition, inadequate taxes, difficulties in accessing finance and problems in business relations with neighbouring countries.

ANNEX 2.
KOSOVA LABOUR MARKET BALANCE, 2002

Description	Number	Percentage
Resident population	2,050,000	100.0
From 0–15 yrs	662,150	33.3
From 16–64 yrs	1,291,500	63.0
Above 65 yrs	96,370	4.7
Working-age population	1,210,000	59.0
Active	702,000	34.2
Inactive (outside labour force)	508,000	24.8

Source: *Riinvest (2002): Survey of families and the labour market in Kosova*

Bibliography

EU UNMIK Pillar, 2005. Fuelling Kosovo's Growth Engines: A Strategic Vision and Policy Priorities, Economy Policy Office.

Leila Farsakh, 2001. Economic Viability of a Palestinian State in the West Bank and Gaza Strip: Is it Possible without Territorial Integrity and Sovereignty? MIT Electronic Journal of Middle East Studies, Crossing Boundaries: New Perspectives on the Middle East, Vol. 1, May.

IMF, 2001. Kosovo: Budget 2002, February 12.

IMF & World Bank, 1999. The Economic Consequences of the Kosovo Crisis: An Updated Assessment, April 16.

IMF & World Bank, ?. The Economic Consequences of the Kosovo Crisis: A Preliminary Assessment of External Financing Needs and the Role of the Fund and the World Bank in the International Response, ?, ?.

Justin Yifu Lin, ??. Development Strategy, Viability, and Economic Convergence. Peking University and Hong Kong University of Science & Technology.

Riinvest, 1999. Post-War Renewal and Reconstruction of Kosova.

Riinvest, 2001. Post-War Reconstruction of Kosova Strategy and Policies.

Riinvest, 2002. Labour Market and Unemployment in Kosova.

Riinvest, 2003. Trade Policies and Export Promotion in Kosova.

Riinvest, 2003. Kosova Budget System: Policies and Sustainability.

Riinvest, 2004. Education and Economic Development Kosova.

Riinvest, 2004. Local Economic Development and Foreign Direct Investment.

Riinvest, 2005. Profile and Challenges of the Social and Economic Development of Kosova.

Xavier Sala-i-Martin, ??. The independence of Catalonia: the economic viability. Columbia University Press and UPF.

João Mariano Saldanha & Helder da Costa, 1999. Economic viability of East Timor revisited: Outlook for the 21st Century. East Timor Study Group (ETSG), Working Paper: 01.

UNMIK, 2000. Kosovo 2001–2003: From Reconstruction to Growth, December 15.

World Bank, 2000. World Bank Group Transitional Support Strategy for Kosovo Progress Report, April.

World Bank, 2000. The World Bank Program in Support of Kosovo 2000–2001, July 25.

World Bank, 2000. Kosovo: Budget 2001, November 17.

World Bank, 2001. Kosovo Poverty Assessment - Volume I & II, December 20.

World Bank, 2004. Kosovo Economic Memorandum, Report, May.

World Bank, 2005. Kosovo Poverty Assessment: Promoting Opportunities, Security and Participation for All, Report.

?, ?. Poverty Reduction and Economic Management, Unit Europe and Central Asia Region.

?, 2001. Kosovo - Macroeconomic Issues and Fiscal Sustainability, February 1.

EUROPEAN UNION

UNMIK

Police and Justice (UN) | Civil Administration (UN) | Institution Building (OSCE) | Economic Reconstruction (EU)

ECONOMIC POLICY OFFICE

Fuelling Kosovo's Growth Engines

- A Strategic Vision and Policy Priorities -

A contribution from UNMIK EU Pillar to the Kosovo Development Plan

UNMIK EU Pillar
Economic Policy Office
July 2005

Authors: Andreas Wittkowsky
Elinor Bajraktari
Orhan Nikšić

List of contents

1. A Strategic Approach to Kosovo's Development

A sound economic vision will give the people of Kosovo security and hope, potential investors a signal on where to invest and the government and politicians a roadmap for where Kosovo ought to go.

Integration into the EU presents Kosovars with a choice to link their vision with a common European future. However, convergence with the EU requires a structural transformation of Kosovo's economy from low-productivity to high-productivity activities.

Policies that underpin the necessary structural reforms should be the result of an overall analytical framework and should be prioritised and sequenced in an economic development strategy.

1.1 A Vision for Kosovo

Six years after the conflict followed by a busy period of fixing short-term reconstruction problems, Kosovo has yet to come up with an economic vision of its own. The vision will foster clarity, unity and continuity and will provide a clear sense of direction and purpose. It will help align incentives and peoples' reactions to those incentives and it will encourage the mobilisation of resources and their efficient allocation. A solid economic vision will give Kosovo and its people a sense of strategic orientation and will provide potential investors with a clear signal as to where the economy is going and what government's intentions are.

In combination with credible Government actions, the vision will contribute substantially to overcome reported uncertainties about economic policy.[1] In fact, since 1999 Kosovo's economic policies have on average been of a high standard. Uncertainty stems from the lack of communication of the underlying vision and rationale to the population and the business community, as well as the short period of time in which economic policies have been operational. Therefore, it is imperative that the government and economic players divulge an economic vision as soon and as widely as possible.

1 Such as those reported in the Worlds Bank's "Investment Climate Assessment" carried out for the "Kosovo Economic Memorandum", 2004.

Kosovo has the opportunity and choice to anchor this vision into a common European future. The Thessaloniki Agenda of the European Union and the Stabilisation and Association process will allow for a gradual integration of Kosovo into the European family. The speed of this process will, to a large extent, depend on the actions and commitment of Kosovo's policymakers and politicians. The convergence of living standards towards European levels is a strongly shared objective of all Kosovars. However, the integration into the European institutions and the convergence in living standards demand a dynamic Kosovar economy that is competitive in the region and the wider European market.

In this context, the basis of Kosovo's vision should be the achievement of ambitious and sustainable growth rates by identifying the most binding constraints to growth and finding ways of removing them. Hundreds of barriers stand on growth's way and removing each and every one of them is not the way to go. Policymakers should boldly concentrate resources at eliminating the most binding constraints instead of targeting the most malleable ones.

At present, Kosovo's economy relies on a few low-productivity activities that cannot sustain high economic activity in the long run. Economic activities have been distorted by the pull on services exerted by the large international presence and the influx of remittances following the end of the conflict. Gradually this pull is weakening and the Kosovar economy is revealing its structural weaknesses.

To avoid a sharp fall in living standards Kosovo needs an economic transformation from low-productivity activities into higher-productivity ones. This transformation can be achieved through investment promotion, private sector development, improved education and strengthened institutions. The government has a key role to play by ensuring that private sector development and investment not only remain on its agenda, but also become the centrepiece of its programme. The government needs to establish and present itself as a credible partner of the private sector, by closely cooperating with it.

1.2 Key Principles for an Economic Development Strategy

Policies that underpin the necessary structural reforms should be the result of an overall analytical framework and should be prioritised and sequenced in an economic development strategy. This is not an easy task given the multitude of variables that affect living standards and the complex web of interconnections through which these variables feed upon each other. Designing an economic development strategy for Kosovo is even more challenging because of the scarcity of statistics and the brief period of time in which Kosovo has stood as an independent economic entity with a separate institutional arrangement and set of policies. Specific issues have been to a large extent thoroughly explored, mainly by foreign advisors who have established a large presence in Kosovo, however they need to be brought together in an overarching framework that identifies the areas of priorities that can be tackled effectively. It is important that policy issues be not analysed in isolation, as is often the case, but in conjunction with each other and in a systemic manner.

Following the 2004 elections, the Government took the decision to embark on a Kosovo Development Plan (KDP) and is now creating the institutional architecture for working it out. This is an encouraging outcome of the work of the Economic Strategy and Project Identification Group (ESPIG). Created in March 2003, and composed of representatives of the government, the UNMIK administration and the donor community, the group actively promoted the importance, urgency and necessity of the KDP.[2] The Government has now taken the driver's seat. The shape of the resulting strategy will depend a lot on the process of formulation; not least on who participates and whose views will dominate.

A few principles will need to drive the formulation work, independently of the process and the participants:

1. Although the overall goal for Kosovo should be the enhancement of human capabilities, the most appropriate way to achieve it is through sustainable economic growth.[3] Having recently emerged from the pre- and post-conflict damages, Kosovo cannot achieve the enhancement of human capabilities by relying on redistributive policies when there's little to redistribute. There is a widely shared consensus now that growth is the best instrument for poverty reduction and improvement of living standards.[4]

2. A growth strategy needs to take into account the fact that Kosovo's resources are very limited and must be used efficiently in the areas where the returns are highest. Most economic development or growth strategies do a great job of assessing the weaknesses in an economy but less so in assessing the roots of the weaknesses and the recommended cures.[5] Here they often offer broad and abstract principles, such as good governance, rule of law, property rights, sound macroeconomics, sustainable fiscal policy, which are of little help if not properly translated into operational policies. Also, the prescribed remedies are sometimes far removed from the local circumstances and are derived mainly from the experiences of other countries. While the experiences of other countries are useful most of the time, the importance of the local context trumps everything else.

3. The growth strategy needs to make a good job at prioritising interventions. Take

2 See ESPIG Policy Papers Nos. 1 and 2, available on the EU Pillar website www.euinkosovo.org.
3 A good definition of human capabilities is given by Amartya Sen in "Development as Freedom". This definition includes things such as decent living standards, good educational achievement and health, security and involvement in decision-making.
4 World Development Report 2005, World Bank.
5 "Growth Diagnostics", Dani Rodrik, Ricardo Hausmann and Andres Velasco, Harvard University

any national development strategy formulated thus far and most likely you will see that for every symptom (growth constraint) there is a prescription (reform). Thus countries are faced with a long list of reforms from which they pick and choose those which are more feasible politically, administratively and financially. In resemblance to the sailor who plugs a hole in his boat while another one opens, countries keep reforming but the list of reforms only gets longer.

4. The biggest challenge in development is the proper diagnosis. A headache could be the result of a dozen ailments. A good doctor does not prescribe a dozen drugs, hoping that one of them will kill the disease. He carefully identifies the root of the problem and targets it forcefully. If the disease has spread in other areas, he subsequently deals with them too. Avoiding the root and dealing with less critical areas is the surest road to failure.

Therefore, the assessment of growth constraints is critical, but equally critical is the sequencing and targeting of interventions. The general attitude – any reform is good – is wrong. What makes this attitude even worse is the fact that places like Kosovo have limited resources, including political capital. They should be deployed where their impact is largest.

Typically the impact of interventions is largest when they target the most binding constraint. After the most binding constraint has been removed, one then moves on to the next one and tackles it. If one agrees with the combination of the four principles listed above, then the Kosovo economic development strategy boils down to identifying a few very binding constraints to growth and to removing them through carefully targeted interventions.

In this context, this paper has two aims:

1. to highlight the need and urgency for a vision and economic development strategy for Kosovo;

2. to contribute to the current development debate by arguing that the structural transformation that Kosovo desperately needs can be achieved through two focal courses of action: (i) the mobilisation of the traditional sectors, such as mining and energy, and (ii) the encouragement of non-traditional activities yet to be discovered. The revival of the traditional sectors is the least risky way for generating the resources that are needed for the promotion of non-traditional activities. In addition, the growth of both traditional and non-traditional requires the removal of the main barriers that hamper the transformation process, especially in education, institutional setting and investment promotion.

2. Growth Potentials

In marked contrast with the first post-conflict years, Kosovo's economy today is sputtering and this is a manifestation of the difficulty to create sustainable growth. A long-lasting revival requires the mobilisation of all internal sources of growth.

The potential in the traditional sectors of mining, energy and agriculture is large and efforts should be made, especially through the privatisation process, to squeeze as much growth as possible out of them.

Yet, in the long run other sources are needed to sustain higher living standards. These other sources have yet to be discovered by local entrepreneurs through the trial and error process. The government has the key role in promoting the discovery of non-traditional activities, which are inherently riskier than traditional ones.

The most proximate determinant of growth is investment, because it creates jobs and output. Even though the presumed direct relationship of investment with growth and development has somewhat been discredited recently by new empirical evidence, it is widely accepted that in the absence of investment growth will fail to pick up. In other words, investment is a necessary but not sufficient condition for growth.

Post-conflict massive foreign aid and remittances of diaspora Kosovars were crucial in pulling Kosovo out of the human and economic plight that had advanced significantly in the late 1990's. Reconstruction and stabilisation proceeded quickly and delivered tangible results in many areas, including poverty alleviation and economic development.

However, investment rates in post-conflict Kosovo have been very low by regional and world standards. The IMF has calculated that investment in the domestic sector in 2003 was 22.3% and the estimation for 2004 was 22.8%.[6] Even these figures underestimate the gravity of the situation because a large part of investment flows has not been channelled into productive activities, but was driven by the post-war boom in construction and services to the donor community (both of which are in decline).

Moreover, while initial growth rates were respectably high, and also the result of the low base from which reconstruction started, the source of the recovery was extremely narrow.[7] Most of the growth came from only two sectors: construction went through

6 "Kosovo - Gearing policies toward growth and development", IMF Report, November 2004.
7 The most recent World Bank growth estimate for 2002 is 1.2% ("Kosovo Monthly Economic Briefing", April 2005). The IMF has revised its estimations of growth rates for Kosovo several times. Despite all this statistical

a massive boom in response to the destruction of the housing stock during the conflict,[8] and trade flourished as a result of increased donor and consumer consumption financed mainly through foreign aid and diaspora remittances.

Not surprisingly, this narrow type of growth proved unsustainable and since 2002 the economy has been in a much slower motion. Inflows of foreign assistance have declined and the boom in the construction and service sectors has subsided. Growth has failed to pick up in the agriculture and manufacturing sectors, areas where intensified economic activity is more sustainable and benefits are inherently more evenly distributed.

Most economic activities today are concentrated in the agriculture and service sectors. The share of agriculture in the economy is large (one third) and in the last decade has increased, not because of an expansion of agricultural production but as a result of the collapse of the manufacturing sector, especially the decline of SOEs and POEs. The service sector is oriented towards trading and servicing to a large degree the donor community (restaurants, taxi services, hotels, etc). There are no manufacturing successes to boast. Mining has largely collapsed, and the energy sector is not viable yet either.

The largely negative trade balance reflects the weakness of all sectors in the economy. In 2003 exports stood at 1.9% of GDP and covered only 3.7% of imports. Food imports made up 33.8% of merchandise imports and the primary products' trade deficit as a percentage of the overall trade deficit was 60%.

2.1 Traditional Activities

The potential for growth in the traditional areas is substantial and agriculture, energy and mining, boosted by privatisation, are likely to be essential for kick-starting the engine of growth. Once a net exporter of agricultural products, Kosovo today has a largely negative trade balance in the sector. Minerals and energy were the staple of the economy and generated a significant amount of income and many jobs. Due to the abundance of resources and the ease of extraction, especially in the case of lignite, which is the source of energy generation, Kosovo has a comparative advantage in both mining and energy.

2.1.1 Agriculture

The higher up Kosovo will move in the agricultural value-added chain, the higher will be the level of economic activity it can sustain. Farming is an agricultural activity that inherently involves relatively little value-added, as opposed to agro-processing, for

uncertainty, there is overall consensus that Kosovo enjoyed double-digit growth in both 2000 and 2001.
8 USAID's report "An assessment of property rights in Kosovo", March 2004, put the number of destroyed houses during the conflict at 300,000.

instance. Even within farming certain activities have more value-added than others. Given the small size of land plots, the cultivation of fruits and vegetables involves more value-added than does the planting of cereals.

Taking into consideration the current low level of productivity in agriculture, the potential for improvement is large. Kosovo's high potential for productivity gains should be used to stimulate growth in the short-run. Two things are important for the development of the agricultural sector:

1. Farmers need support in areas as diverse as the adoption of agricultural technology from neighbouring countries, extension services, access to finance, marketing and distribution, product quality and safety, coordination and the formation of associations.

2. Land consolidation has to happen before productivity picks up. The average farm size is 2.2 ha divided on average in 8 plots,[9] and consequently production is not mechanised. Even though land titling and registration are far from perfect, they are not the main factor that keeps land fragmented. Farmers see land as the only opportunity to ensure survival. Land is a subsistence mechanism. With very few opportunities outside the agriculture sector, farmers are behaving rationally by not selling their own plot.

An increased productivity in agriculture will be accompanied by a shift in the labour force. A significant share of the labour force will have to move from agriculture to the manufacturing and service sectors (two-thirds of the population are employed in the agriculture sector). The fragmentation of land and the large share of population engaged in agriculture are interrelated. In the absence of a healthy manufacturing sector exerting demand on the labour and land markets, the structural transformation will not happen and the social importance of subsistence agriculture will remain crucial.

At the policy level Kosovo has a choice between a protectionist regime with trade barriers or heavy production subsidies as in the Common Agriculture Policy of the European Union, or a liberalised agenda which puts the agriculture sector in competition with regional and EU players. The protection of agricultural products improves the chances of success for farmers, but places a heavy burden on consumers and agro-processors in the case of customs tariffs, or taxpayers in the case of subsidies. The ongoing regional liberalisation in South East Europe is a way of creating an area of limited competition, in which Kosovo producers can gain experience necessary to cover the wider European market.

9 *"The Kosovo Greenbook", Strategic Document of the Ministry of Agriculture, Environment and Rural Development, May 2003.*

2.1.2 Energy

The importance of the energy sector is two-fold: (i) improved security of electricity supply would support the overall development of the private sector; and, (ii) energy exports to the regional market could generate substantial revenue. Kosovo has an advantage in the production of lignite-based electricity. Lignite reserves are estimated to be large (around 14.3 billion tons). Kosovo's cost of coal-fuelled electricity is the lowest in the region (0.62 Euro/GJ, as opposed to 0.88 Euro/GJ for Bulgaria, and 1.34 Euro/GJ for Serbia and Montenegro)[10] because of the ease of extraction (an average ratio of 1.7 m3 of overburden – topsoil – to 1 ton of coal) and the good quality of coal (6.28-9.21 MJ/kg).[11] The low cost in the production of electricity, combined with an expected increase in energy demand in the region and the emergence of a common energy market following the Athens Memorandum of 2002, set Kosovo in a favourable position vis-à-vis the other countries in the Regional Energy Market.

The Generation Investment Study, commissioned by the European Commission and carried out by the World Bank, confirms that Kosovo has large potential for large-scale electricity production and exports.[12] According to the report, with suitable investments Kosovo could add another 4,000 MW to its installed capacity and could become a large exporter in a rapidly expanding regional market.

However, to take advantage of these opportunities in the energy sector, Kosovo needs an upgrade of the existing institutional and legal framework. While progress has been made with the creation of the Ministry of Energy and Mining, the Energy Regulatory Office and the Independent Commission for Mines and Minerals, further work remains to be done in improving the existing laws and regulations.[13]

2.1.3 Mining

The mining sector presents opportunities for exports and earning of foreign currency and if privatised quickly it could be used to support growth in the medium run. In the 1990s the industry declined as a result of neglect and lack of capital investment. In addition to lignite, Kosovo is well endowed with lead, zinc, nickel and magnesium. However, the mining sector presents three serious problems. First, the reactivation of mines is fraught with difficulties and in many countries it failed. Thus it is unrealistic that mining in Kosovo will ever reach the scope it had in Yugoslav times. Second, large capital investments are required to revive the mining sector. Third, mining in modern times is capital intensive, so the benefits in the labour market would be negligible and the unemployment problem would remain.

---

10 Source: "REBIS: GIS - Final Report", PwC Consortium, Funded by the EU CARDS Programme, 31 December 2004.

11 "Energy Strategy and Policy of Kosovo", The White Paper, Joint UNMIK -- PISG Energy Office, September 2003.

12 "REBIS: GIS - Final Report", PwC Consortium, Funded by the EU CARDS Programme, 31 December 2004.

13 IPA Energy Consulting and Norton Rose, Energy Sector Technical Assistance Project II, 25 March 2005.

2.1.4 *Opportunities and Threats*

The mobilisation of traditional activities will be crucial for Kosovo's economy in the short-to-medium run. Agriculture can be harnessed to yield results in the short run (a couple of years) and mining and energy in the medium run (five to ten years). Yet there are challenges involved:

• Large investments are required to revive the mining and energy sectors, and here Foreign Direct Investment is of crucial importance. The necessary conditions for attracting foreign investors have to be clearly kept in mind.

• In agriculture other players have consolidated their positions and have occupied the most obvious niches. Heavily subsidised and intensive farming in the EU generates surpluses that leave little room for competition. Regional players such as Bulgaria and Romania have brought their agriculture sectors in good shape and will soon become the beneficiaries of EU funds.[14]

• Relying exclusively on commodities, such as minerals and energy, is not a wise strategy. The prices of commodities are volatile and in the case of minerals the long-term trend is on the decline.

One quick stimulus will come from the revived privatisation process. The privatisation of SOEs will help in saving those industrial cores that have a real economic potential. The privatisation process is also aiming at attracting FDI, not only because of the superior technology and managerial skills that come with it, but also as a signal of a good business environment for other interested foreign investors.

2.2 Non-traditional Activities

As the traditional sectors can accelerate growth, but cannot sustain it in the long run, the development of new activities becomes crucial. These activities can be called non-traditional because Kosovo has yet to discover them. Which will be those activities? No one knows with certainty, because the development of non-traditional activities is a process of discovery by trial and error, or self-discovery.

By "discovery of new activities" we are not necessarily referring to inventions or innovations, but also to the profitable adoption of other countries' technologies. Given their limited pool of skills and their tiny research and development budgets, places like Kosovo have little scope for innovations and inventions. If a technology works in a country, there is no guarantee that it will work profitably in another one. The adoption of technology is as beneficial and as risky as a new invention.

14 The Common Agriculture Policy of the EU channels large dollops of agricultural funds to the farmers of EU member countries. In addition, structural funds are directed to underdeveloped areas.

In general the discovery of new activities moves the economy into higher value-added areas. Moreover, for places with a very narrow production base, like Kosovo, the discovery process is the only way in which the economy can diversify. Diversification is necessary because it: (i) safeguards the economy from external shocks that hit its commodity base; (ii) takes excessive competitive pressures away from existing companies leading to higher profit margins and increased investment; and (iii) creates a platform for a greater number of future discoveries and investment ideas.

At present, it is very obvious that Kosovo's entrepreneurs – be they foreign or local – show relatively little interest in investing in new areas. Instead of exploring new investment opportunities, Kosovo's investors are entrenched in the traditional sectors and are undercutting each other's profitability. In the existing (traditional) activities competition is fierce.[15] However, with strong links with the Western world established by thousands of Kosovar emigrants, especially in Germany and Switzerland, there should not a significant shortage of entrepreneurial skills. So what is keeping investment in productive activities low?

The main brake on investment demand in new activities stems from uncertain profitability and a higher risk than in the case of investment in traditional activities. To discover the cost of a new product and the subsequent profit, someone has to try to produce it. If the investment succeeds, other investors will quickly copy the idea without incurring high risks and will subsequently drive the price down, to the dismay of the original investor who has not recouped his investment yet. If the investment fails, the original investor will have to bear the full cost of the failure.

The discovery of profitability in new activities benefits the society as a whole, whereas the cost of failure in the discovery process is borne by the individual. This mismatch between returns to the society and costs to the investor will result in under-investment in new activities – a classical case of market failure. Government can bring this type of investment to an optimal level by supporting (directly or indirectly) new activities in non-traditional areas. The rationale is that these activities create positive spill-over effects in the society and for this they should be rewarded.

Moreover, investors need certain conditions to be in place before they can begin to operate. This does not relate only to physical infrastructure, education, capital supply (savings) but also to supporting institutions such as distribution and marketing networks, downstream suppliers and upstream buyers, research and development, help with customs, storage and advertising. His investment will be profitable only if these other complements exist. Sometimes firms achieve coordination themselves (for example by forming an export board or a joint Research & Development institution), in other cases, however, only the government can provide the investments required.

15 The World Bank's "Investment Climate Assessment", 2003, found that "eighty per cent of the firms compete in their main product markets with more than 20 other firms and almost half of respondents reported more than 20 suppliers. Three-quarters of firms control less than 5 percent of market share for their main product line. Finally, two-thirds of all enterprises indicated that if they raised their prices by 10%, their customers would buy at much lower quantities or would stop buying from them entirely".

3. Growth Constraints[16]

Despite being low by world standards, savings do not seem to be the main constraint on growth simply because there is already plenty of liquidity in the banking sector and interest rates in general are not extremely high.

The present quality of education and business skills in general is a brake on private investment demand, whereas, with the exception of electricity, infrastructure does not present a major bottleneck to private sector development.

The institutional setting is not a barrier yet, but an expanding economy will outgrow it if strengthening measures are not taken.

Investment promotion is weak but investment promotion is the most important instrument in the discovery of new non-traditional activities.

We begin the diagnostics of growth constraints by examining five proximate general determinants of investment:

(i) savings
(ii) education,
(iii) infrastructure,
(iv) the institutional environment and
(v) investment promotion.

For each of them we determine whether they are a binding constraint on investment and to what extent they are suppressing growth. While savings are the classical supply factor of investment, the other factors are related to the demand side of investment. Investment promotion in particular addresses the obstacles to develop new activities as outlined above.

3.1. Savings

At a first look it seems that savings are to blame for Kosovo's low investment rates. In the last five years domestic savings have been highly negative (between -35 and -25%). These are extremely low rates even by developing country standards. Isn't the savings

16 This section uses a growth framework created by Rodrik, Velasco and Hausmann of Harvard University in their paper "Growth Diagnostics", March 2005, Harvard University, (http://ksghome.harvard.edu/~drodrik/barcelonafinalmarch2005.pdf).

rate directly correlated with investment? Shouldn't low savings rates be addressed with policies centred mainly on the financial sector and financial intermediation? Not necessarily! Low savings rates could well be a symptom of low investment rates.

Although Kosovo has a low supply of savings, many indicators alert us that this is not the most binding constraint. Commercial banks have plenty of funds available, a part of which they have invested abroad and have been awash with liquidity at a time when private sector investment rates have been the lowest in the world. They can attract deposits with relatively modest interest rates, whereas lending rates are not extraordinarily high.[17] Kosovo is among the top ten countries with the largest inflows of remittances per capita, but most of this money finances consumption. A walk around any major city reveals a boom in construction that would dissuade anyone who thinks that Kosovo lacks investment funds.

By contrast, a low investment demand seems to be the most binding constraint. In principle, tackling both the savings supply and investment demand is OK, but this is not an efficient use of scarce resources and political capital. Imagine if somehow the savings rate in Kosovo increased to a decent level and investment funds were easily available. Would that solve the problems? Almost certainly not! On the contrary it could cause additional problems, such as a deterioration of the balance sheets of the banking sector and an increase in the amount of non-performing loans (a phenomenon well experienced by some donors in the reconstruction period).

So from a policy standpoint it makes more sense to focus on the demand for investment funds, which will subsequently put pressure (through higher interest rates) on the financial sector to mobilise more savings.

3.2. Education

Education is a key determinant of investment, and subsequently economic growth. People with higher skills on average generate more and better investment ideas and are more successful in their undertakings. Education facilitates innovation and the adaptation of foreign technologies and increases labour productivity. Moreover, it is an important factor that foreign investors take into account when deciding on where to invest.

The ultimate objective of an educational system is to prepare qualified individuals who can respond to the economy's demand for skilled labour. The skills and qualifications that a participant acquires through education are primarily dependent on the infrastructure, institutions and quality of education, as well as on incentives that make effective learning an attractive activity.

Kosovo's educational system has been in serious decline since 1989. During the

17 *"2004 Annual Report", Banking and Payments Authority of Kosovo, 2004.*

1990s, a set of informal structures emerged in parallel to the official institutions run by the Yugoslav government, and schooling took place in private homes and was delivered in an uncoordinated and non-standardised fashion. Mainly as a result of this "lost decade", today there is a lack of skills in many areas, especially in hard sciences, engineering, law and business services.

While a lot of progress has been achieved, the situation is far from being stabilised, especially at the tertiary level. Efforts have been made by the donor community to re-establish the system and rehabilitate the infrastructure and to fill the decade-long gap. However, large donor-driven investments in school infrastructure have not been matched by equivalent improvements in the quality of teaching. The scarcity and quality of teachers, curricula, textbooks, computers, labs and other facilitating tools is the major bottleneck in the system.

The quality of teaching at the university level has a direct impact on the quality of students.[18] The University of Pristina supplies thousands of graduates every year but it appears that their skills in many cases do not meet the needs of the market. A shortage of skills reported by World Bank and USAID surveys[19] , at a time when there is a high number of unemployed with the kind of skills required in the market, indicates that the problem of quality is more severe than the problem of quantity. In response to demand for high-quality skills, a few private universities offering degrees in business administration and licensed schools offering a myriad of foreign language courses have emerged. The quality of graduates from private schools is substantially higher.

Education is a very important policy area, which demands commensurate attention and resources from the government and other relevant actors:

(i) education in itself, removed from the context of its relationship with investment of growth, is a virtuous goal because it increases human capabilities and enhances human dignity.

(ii) the relationship between education and investment is two-sided: education affects investment (the supply of skills leads to more investment ideas), and investment exerts a pulling force on education. This relationship underlines the need to consider investment and education as inseparable (increased spending in education should go hand in hand with increased focus on investment in productive sectors). These phenomena strengthen the argument for a firmer focus on investment.

(iii) the quality of education depends on demand for skills from the productive sectors. Pressures from the demand side should be carefully monitored, and quick actions should be taken to relieve them with increased supply. The private sector can certainly take some of that pressure away, but the government needs to help too,

18 According to a Riinvest study (2004) of the education sector, the quality of teaching in the primary and secondary levels is considered less problematic ("Education and Economic Development of Kosova", Riinvest Report, February 2004).

19 World Bank "Investment Climate Assessment" 2003; World Bank Country Economic Memorandum 2004; and "Constraint Study", Kosovo Cluster and Business Support Project, USAID, April 2005.

especially in its regulatory capacity. Another option is to expand the number of students who study abroad by establishing programmes that provide scholarships and information about foreign universities.

3.3. Infrastructure

Poor electricity supply is one of the most constraining factors of the enabling environment. In all business surveys conducted after the conflict, electricity appears consistently on top of the lists of problems as perceived by entrepreneurs.[20] Despite the recent improvement of the situation, power cuts are still frequent and, in many cases, unpredictable. Problems in the electricity sector are serious constraints to business development for many reasons:

- They lower productivity by disrupting the process of production.
- Alternative sources of energy increase the cost of production and make firms uncompetitive in the home and foreign markets.
- Electricity connections in Kosovo take longer than in any other country in the region.
- Inefficient electricity supply increases the price of electricity, which directly affects the cost of production.
- The electricity situation directly affects the foreign investment as investors are disheartened by the uncertainty of the supply of electricity.

Transport, in contrast to widespread perception, is not a major bottleneck at the moment, even though it could become a strain on growth if Kosovo's economy in the medium run becomes export oriented. With the exception of a few rural areas, Kosovo's cities and villages are relatively well connected.[21] It has been estimated that Kosovo's road network totals around 8,500 km. The main and regional road network makes up around 25% of the network but carries 60% of all vehicle journeys.[22]

However, growth in traffic is expected to increase as a result of three factors that affect directly the demand for transportation. An economic recovery and a gradual increase in average incomes, Kosovo's young population and the spread of unchecked settlements and building patterns will put substantial pressure on demand for transport in the next 5 to 10 years. At the same time, Kosovo could face a large growth in car ownership rates. It is estimated that in a mid-term perspective the amount of traffic could potentially increase two to four-fold.[23] In order to avoid future bottlenecks it is wise to prepare for

20 "Investment Climate Assessment", Country Economic Memorandum, World Bank, 2004, and "Constraint Study", Kosovo Cluster and Business Support Project, USAID, April 2005.
21 Road density measured in km per square km is 0.18 in Kosovo, compared with 0.15 for developing countries, 0.15 for East Asia, 0.11 for Europe and Central Asia, 0.15 for Latin America and the Caribbean, and 0.08 for Sub-Saharan Africa. Source: "Kosovo Development Plan diagnosis", draft by Cast Consulting, January 2005.
22 Road User Charges Study, Roughton International, 2004.
23 Draft Multi Modal Transport Policy and Plan", MTC – Pillar IV, Barry Hutton, May 2005

a multi faceted transport strategy with a view of engaging private sector investment in the form of private-public partnerships.

The biggest challenges in the transport area are road maintenance and integration in the regional road networks. Without proper attention paid to maintenance and upgrading to common standards, the presently stable transport situation could reverse dramatically. Moreover, if the benefits of regional and EU integration have to materialise, the road network must be properly connected to regional corridors VIII and X. The connection with Albania will take time to happen, partly depending on progress on Albania's side.

Given Kosovo's extensive road network and the relatively large number of private vehicles, the railway is not seen as a major priority for the transportation of people or goods in general. However, if the mining sector is to become an important engine of growth in the medium run, the export (and import for processing, for example from northern Albania) of minerals will need to be supported by a reliable railway network.

Pristina Airport has gradually been modernised over the last years, but in order to meet international standards as a civilian airport, it needs to be further upgraded.

3.4. Enabling Institutional Environment

The enabling environment is used to describe the political, legal, economic and administrative institutions under which investment takes place. So far the policy emphasis in Kosovo has been in the creation of a conducive "enabling environment", with the hope that investment will materialise.

Despite recent progress, Kosovo has a long way to go in the establishment, registration and enforcement of property rights. One problem is the lack of property records which were transferred to Serbia during the conflict and which are not available yet. The result is a lack of confidence in collateralised business transactions. Commercial banks are wary of this problem when they lend based on collateral. Another problem is weak human capacities in municipal courts, which are responsible for the enforcement of contracts and property rights. This is reflected in the backlog of commercial cases, which on average leaves a case in the hands of a judge for 18 months. KEK, for example, is having a hard time settling contractual issues with its clients in the case of electricity disconnections.

The macroeconomic environment in Kosovo is very stable. Inflation is very low, with signs that deflation is setting in recently. The balanced budget rule does not allow the government to run budget deficits, and hence there are no risks related to debt sustainability. Financial instability, which is mainly a result of exchange rate volatilities, has been removed with the adoption of Euro. There is no risk of depreciations and a subsequent swelling of liabilities. Longer-term fiscal commitments are low, even though the recent collective bargaining agreement has increased the risks of higher future liabilities. Commercial banks are behaving very cautiously by not taking excessive risks.

In 2003, the World Bank's "Investment Climate Assessment" concluded that in Kosovo "the business environment is considered relatively favourable by SMEs".[24] The tax system is simple, transparent and does not put a heavy burden on enterprises (one of the lowest tax burdens in the region). Exports are duty free, a VAT of 15% is among the lowest in the world, the average import tariff of 10 % is low, and exemptions for capital goods and input imports are in place. In addition, the basic economic legislation has been formulated, and the institutional infrastructure has been created and is being maintained. Kosovo boasts a relatively low red tape (bureaucracy), low regulatory requirements, no restrictive and costly labour rules, easy access to land, and relatively low corruption in the public administration.

The issue of the status has become the refrain of the political talk in Kosovo, but the impact of the status on the economy has been overdone. The status has become the scapegoat that bears the sins of everything that goes wrong in Kosovo. However, as status is less of an issue for local than for foreign investors, it cannot alone explain the scarcity of investment by local residents. The investment rate is low even when the impact of the status is taken into consideration. Counterfactually, we can try to imagine Kosovo's development perspective if status were not a problem. Would investment be released in large quantities if uncertainty related to political issues and the status were resolved? Almost certainly not! Even allowing time for the effects of such a resolution to work through, success would be very unlikely. The status is a factor but not the most binding constraint.

Certainly, the image of Kosovo needs to be improved. Many people, especially in the West, associate Kosovo with war and destruction, and trust in political stability has been hampered in the wake of March 2004. Still, the institutional environment is better than its reputation.

The best way to improve Kosovo's image is to maintain and foster the existing achievements. In general, the institutional framework has not become a serious binding constraint to investment yet, but there is a real risk that an expanding economy might outgrow the weak institutional setting. This institutional environment is huge and under-researched. A full institutional review is necessary for Kosovo at this stage. Broadly speaking, the most daunting institutional challenges at the moment are (i) the inexperience of public institutions and the weakness of the systems that underpin their operations; and, (ii) the inadequate capacity of the emerging civil service.

24 *"Kosovo Economic Memorandum", World Bank, May 2004.*

3.5. Investment Promotion

In certain areas, the government should not just create an enabling environment but also stimulate investment through carefully designed and administered incentives. The question is which activities should be supported. The consensus so far has weighted towards the sectors that have traditionally provided income and jobs for Kosovars – agriculture, energy and mining. Given their contraction in the last two decades and Kosovo's abundant resource supplies, the potential for growth in the traditional sectors is indeed large.

However, in the discovery of non-traditional activities, the government has a crucial role by actively promoting investment. As discussed above, if left unattended, there will be an undersupply of investment in non-traditional activities. Typical activities with which the government can help include:

- Venture capital (high risk capital)
- Matching of grants
- Research & Development
- Extension services in agriculture
- Marketing and distribution assistance
- Technological assistance
- Adoption of agricultural technology from neighbouring countries
- Investment coordination
- Product quality and safety
- Harmonisation of standards

The involvement of the government in investment promotion activities is not without risks – governments can fail too, either because they lack sufficient resources or because of weak capacities. Kosovo's government has a particularly hard budget constraint given its inability to run budget deficits. And the relatively short time of its existence and inexperience of civil servants make it particularly vulnerable to rent seeking.

At present, investment promotion activities are insignificant in comparison with the scale of the challenge the government is facing. There is a need for a coordination mechanism in the government that pushes for legislation or regulation of investment activities. The creation of an Investment Promotion Agency under the Ministry of Trade and Industry in July 2005 is a step in the right direction. Now it is essential that the new institution takes a strong pro-active role and that the existing investment promotion tools are used efficiently.[25]

More importantly, differentiation has to be made between investments in traditional activities and investments in non-traditional activities. So far, almost all new activities

25 For example, the website of the business registration agency (http://www.arbk.org/) as of 10 May 2005, had only 135 hits, of which a couple came from the writers of this report.

have taken place in the traditional sector where firms are pricing each other out of the market.

Also, international assistance in the area of investment promotion needs to be better focused and coordinated. Most interventions take place in an ad hoc fashion and driven by donor demand. There are a number of actors involved in the provision of technical and financial assistance but there is no coherent strategy for how to channel this assistance more effectively. Good examples of activities that have an investment promotion component are the USAID KCBS project which aims at creating business associations and improving business counselling services, with an overall improved investment coordination outcome.

One important element of investment promotion is assistance with financing. Non-traditional activities are inherently high-risk because their costs have yet to be discovered. Sharing the costs of these discoveries is one way of promoting economic transformation. Commercial bank lending in Kosovo is short-term and not available for start-ups (discovery activities). Collateral requirements are at levels of 150-200% of loan amount. No venture capital scheme makes financing available to start-ups. Given the risks of discovering the profitability of new activities (non-traditional activities), there exists no mechanism for the sharing of risks. No form of venture capital exists and that makes the funding of new ideas almost impossible.

In agriculture, there is a plan to set up a rural development fund. Agricultural loans make up only 2% of total credit in the commercial banking sector.[26] Microfinance activities are modelled as schemes that promote social cohesion and reduce gender and ethnic disparities, rather than sources of promotion of non-traditional activities. The EU's ABU programme provides advising services and loans to commercial farms. It provides long-term loans of up to 5 years at an interest rate of 10%. Presently it has 10 million Euros in outstanding loans. Early borrowers did not do very well, although the success of the programme remains to be seen.

26 *The Kosovo Greenbook, 2003.*

4. Conclusion: Policy Goals and Priorities

This paper has highlighted the need for a structural transformation of the Kosovar economy. Such economic transformation should be underpinned by a widely shared economic vision and conducted through an economic development strategy. The transformation should be sufficiently fuelled with resources and should overcome the barriers that stand on its way.

The shift from low-productivity (traditional) to high-productivity (non-traditional) activities underlies the structural transformation that Kosovo needs to undergo. This transformation will not happen unless

- available physical and institutional resources are properly mobilised;
- the major constraints to investment have been removed; and
- all the policy framework is oriented towards the achievement of the transformation goal.

Many resources will be released if the traditional sectors of energy and mining are revived and managed prudently. By using these resources to develop new higher-productivity activities, Kosovo will be able to sustain a higher level of economic activity and living standards.

The largest barriers at the moment are the quality of education, inadequate supply of electricity and lack of investment promotion activities. The government should boldly remove these barriers with well-targeted interventions. In particular, systematic investment promotion should move to the top of the list of government's priorities. At this stage a comprehensive private sector development strategy, based on a sound review of the instruments and resources at hand, is essential for harnessing the entrepreneurial spirits of the Kosovar people.

All sectoral strategies and policies should be guided by this vision of structural transformation. It is common these days to lose sight of the fact that policies are instruments that can be used to obtain different economic outcomes. In many cases, policymakers go after standard policies without asking themselves the question: what do I want to ultimately achieve with this policy? For example, the goal of the development of a sound financial sector is virtuous per se, but once its soundness has been secured one should think of the role it can play in the structural transformation.

The following section lists the main policy sectors and gives an outline of how they can support the economic transformation of Kosovo. The necessary prioritisation and sequencing needs to be undertaken in the course of drafting the economic development strategy.

A - IMPROVING THE ENABLING ENVIRONMENT

Overall goal: To guarantee the safety and security of citizens and their property by enhancing the rule of law, and the effectiveness of the civil service.

- Legislation – Complete the essential legislative framework. Indigenise the legislative framework by adapting it to local conditions. Achieve coordination in the process of formulation of legislation.

- Law enforcement – Ensure the inviolability of property rights by consolidating the courts and police, by strengthening property rights, and by improving the enforcement of contracts and explore additional mechanisms of arbitration.

- Public institutions – Strengthen the capacity of public institutions to cope with increasing demands of an expanding economy, and create a high-quality civil service that facilitates the interaction of the government with the private sector.

- Tax policy – Generate adequate resources for the maintenance of the civil service, institutional and physical infrastructure, and public services, without becoming a barrier to private sector development. In the light of tax competition from neighbouring countries, design a tax policy that gives Kosovo a competitive edge in the region.

- Expenditure policy – Allocate resources on activities with the highest returns. Concentrate more resources in the areas where the barriers to the transformation are highest (lack of investment promotion, poor education, inadequate electricity supply).

- Administration of Public Finances – Ensure probity and efficiency in public finances.

B - PRIVATE SECTOR AND INVESTMENT PROMOTION

Overall goal: To achieve a structural transformation of the economy, from an agriculture-based economy into a manufacturing- and service- based one and to shift productive activities from low-productivity into high-productivity areas.

• Privatisation – Use an accelerated and strengthened privatisation process to invigorate the mining and energy sectors in particular, and the productive sectors in general. Use privatisation to release resources and assets, which can be put to better use by the private sector.

• Mining – Invigorate mining through an effective privatisation process, which will set the stage for substantial exports and earning of foreign currency.

• Agriculture – Realise the potential of productivity gains in the agricultural sector by encouraging farmers to improve the efficiency of their current operations and to undertake new investment ideas. Support land consolidation by improving the efficiency of the land market through strengthened property rights and contracts.

• Trade policy – Further design a trade policy that on one hand does not hurt consumers, and on the other encourages the development of a healthy private sector. Use trade policy to provide incentives to the emergence of non-traditional activities and to attract FDI.

• Financial Sector – Make the financial sector a cornerstone of private sector development. Shield it from excessive risk-taking, and at the same time promote instruments to enable it to finance viable high-return projects.

• Investment promotion – Create a healthy private sector with a well-diversified activity base that sustains growth in the long run by promoting private sector investment in general and by prioritising investment in non-traditional activities with carefully targeted incentives and institutional support.

• Tax policy – Provide adequate incentives to private sector development.

C - HUMAN RESOURCES DEVELOPMENT

Overall goal: To upgrade the human resource base to respond to demands for skills in the private sector and the public administration.

• Education – Improve (i) the infrastructure of the education system (number and physical condition of schools, kindergartens, etc.); and, (ii) the quality of the supply of education (textbooks, teacher quality, curricula, etc.). Understand growth prospects and closely observe the labour market for signals of demand for certain skills and qualifications and quickly act to stimulate their supply.

• Social policy – Provide safety nets for supporting the disadvantaged in the economic transformation process that will lead to dislocations in the labour force.

D - INFRASTRUCTURE DEVELOPMENT

Overall goal: To accelerate growth in the medium run, and to support the structural transformation in the long run.

- Energy – Upgrade the energy sector to (i) improve electricity supply security in support of the development of the private sector; and (ii) export energy to the regional market to generate substantial revenue.

- Transport – Maintain and upgrade roads to effectively respond to demand from the private sector. Improve connections with the main regional transport corridors in order to take full advantage of trade opportunities.

RIINVEST PUBLICATIONS

Since 1996 Riinvest has produced an extensive list of publications in English, including the following:

1. Towards Economic Viability of Kosova (Challenges, Policies, Opportunities), 2006
2. Kosova Socio-Economic Profile and Development Challenges, 2005
3. Socio-Economic Profile and Development Challenges, 2005
4. Privatization in Kosova:Forwards and Backwards, 2004
5. Education and Economic Development of Kosova, 2004
6. Rural Development in Kosova, 2004
7. SME Development in Kosova, Annual Report -2003
8. Trade Policies and Export promotion in Kosova , 2003
9. Kosova Budget System-Policies and Sustainability, 2003
10. Developments in Building up the Taxation Policy & A Follow-up Report on Developments in SME Finance, 2003
11. SME Development in Kosova-2002 (Annual Report, 2002), 2003
12. Corruption and its impact in the Kosova's economy, (Research report , 2003)
13. Labor Market and Unemployment in Kosova, 2003
14. Foreign Direct Investments in Kosova , Research report, 2002
15. Selected Aspects of the Social Situation and development of the pension system in Kosovo, Research Report, 2002
16. SME Development in Kosova-2001 (Annual Report 2001), 2002
17. Local Economic Development, Research Report, 2002
18. International Conference: Privatization of SOEs and the Reform of Utilities in Kosova (Collection of Papers), 2002
19. Directory of Business Financing in Kosova, 2002
20. SME Development in Kosova-2000 (Annual Report 2000), 2001
21. "SME Finance – A Regional Perspective", Research Report, 2001.
22. "SME Financing and Development", Research Report, 2001.
23. "Key Issues in Building a Taxation Policy in Kosova", Research Report, 2001.
24. "Socially Owned Enterprises and their Transformation/Privatization", Research Report, 2001.
25. "Post-War Reconstruction of Kosova – Strategy and Policies", Research Report, 2001.

26. “War Consequences and Reconstruction on 193 Socially Owned Enterprises”, Survey Report, 2000.
27. “Socially Owned Enterprises Privatization”, Research Report, 2001.
28. “Post – War Reconstruction of Kosova (Strategy and Policies), Research Report, 2001.
29. “War Consequences and SME Development”, Survey Report, 2000.
30. “War Consequences and SME Development”, Survey Report, 1999.
31. “War Consequences on Family Economies and Businesses”, Survey Report, 1999.
32. “Establishment and Functioning of Local Government Institutions in Kosova”, Project Team, 2000.
33. “Post-War Renewal and Reconstruction of Kosova”, Collection of Papers, 1999.
34. “Development Strategy of Kosova and SME Generation”, Collection of Papers, 1999.
35. “The Economic System of Open Economy and Transition in Kosova”, Collection of Papers, 1998.
36. “Economic Activities and Democratic Development of Kosova”, Project Team, 1998.
37. “Business, Problems and Perspective”, Team of Authors, 1996.
38. “English-Albanian and Albanian-English Dictionary of Marketing Terms”, Dr. Nexhmi Rexha, 1996.