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Kosovo
Public Expenditure Review

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Poverty Reduction and Economic Management Unit
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CURRENCY EQUIVALENTS

(Exchange Rate Effective as of May 5, 2010)

Currency Unit	=	Euro (€)
Euro 1.00	=	US$1.29
US$ 1.00	=	€0.77

WEIGHTS AND MEASURES

The Metric System is used throughout the report.

FISCAL YEAR

January 1 to December 31

ABBREVIATIONS AND ACRONYMS

BEEPS	Business Environment and Enterprise Performance Survey
CAAK	Civil Aviation Authority of the Republic of Kosovo
DFID	Department for International Development
DoR	Directorate of Roads
DRG	Diagnostic-related groups
DRI	Department of Road Infrastructure
ECAA	European Common Aviation Area
EFPIA	European Federation of Pharmaceutical Industries and Associations
ERO	Energy Regulatory Office
EU	European Union
FMT	Freedom of Movement Train
HBS	Household Budget Survey
HDM	Highways Design and Maintenance Model
HMIS	Health Management Information System
IFPMA	International Federation of Pharmaceutical Manufacturers and Ass.
IMF	International Monetary Fund
IPA	Instrument for Pre-Accession Assistance
IPF	Infrastructure Projects Facility
IPH	Institute for Public Health
KCB	Kosovo Consolidated Budget
KEK	Kosovo Energy Corporation
KFOR	Kosovo Force (NATO)
KLA	Kosovo Liberation Army
KMA	Kosovo Medicines Agency
KOSTT	Kosovo Electricity, System and Market Operator
KR	Kosovo Railways
KPST	Kosovo Pension Savings Trust
KRPP	New Kosovo Power Project
KTA	Kosovo Trust Agency
LLGF	Law on Local Government Finance
LLSG	Law on Local Self-Government
LPFMA	Law on Financial Management and Accountability
LRIS	Last Resort Income Support
MEF	Ministry of Economy and Finance
MEM	Ministry of Energy and Mines
MEST	Ministry of Education and Science
MLSW	Ministry of Labor and Social Welfare
MOH	Ministry of Health
MRG	Minimum Revenue Guarantee
MTBF	Medium term budget framework
MTC	Ministry of Transport and Communications
NATO	North Atlantic Treaty Organization
NGOs	Non Governmental Organizations
NHA	National Health Accounts
OECD	Organization for Economic Cooperation and Development
PEMTAG	Public Expenditure Management Technical Assistance Project
PHC	Primary health center
PISG	Provisional Institutions of Self Government
PPP	Public Private Partnership
PSO	Public Service Obligation
PTK	Post and Telecom of Kosovo
PUH	Pristina University Hospital
SEDPP	Sustainable Employment Development Policy Program
SEETO	South East Europe Transport Observatory
UNMIK	United Nations Interim Administration Mission in Kosovo
UP	University of Pristina
USAID	United States Agency for International Development
WHO	World Health Organization

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FOREWORD

This report is based on the findings of a series of missions to Kosovo from October 2009 to May 2010. The report was prepared by a team consisting of William Dillinger (task team leader), Agim Demukaj, Borko Handjiski (macro economic framework), Sachiko Kataoka and Flora Kelmendi (education), Pia Schneider (health), Anita Schwarz (pensions), Boryana Gotcheva and Aylin Isik-Dikmelik (social assistance), Jukka-Pekka Strand, Carolina Monsalve, and Martin Humphreys (transport), Henk Busz (energy), and Clelia Rontoyanni (local government). The peer reviewers were Debbie Wetzel (PRMPS) and Ardo Hansson (EASPR). Formatting and editing of the report was provided by Virginia Yates.

The report was produced with the participation of a wide range of Kosovar counterparts. These included officials and staff of the Ministries of Finance and Economy, Education, Science and Technology, Health, Labor and Social Welfare, Transport and Telecommunication, Energy and Mining, and Local Government Administration. Valuable advice was also extended by local experts and staff of international organizations, including Shar Kurtishi (consultant), Alan Packer (ICO) and Annalisa Fedelino (IMF).

CONTENTS

Executive Summary

During most of the 2000s, Kosovo has pursued a highly conservative fiscal policy, restraining expenditures as revenues continued to climb. The Government has now shifted toward an expansionary expenditure policy. In the short term, the Government intends to finance the resulting budget deficits from accumulated savings and borrowing, as well as through the sale of assets and donor budget support. Neither solution is sustainable. In principle, there is room to increase revenues–Kosovo's tax burden is low by regional standards. But the weakness of domestic tax instruments makes this difficult. Restraint on the expenditure side will be required. Given the well-documented shortcomings of public services in Kosovo, this will require an improvement in the quality of public expenditure—an improvement in the efficiency of public service delivery—rather than a reduction in the quantity or quality of services. This report looks for such opportunities in the major programs of Government expenditure.

Education is the largest single program of government expenditure, accounting for about 16 percent of the total. Public spending on education in Kosovo is relatively low by regional standards. Due to the high proportion of school age children in Kosovo's population, spending *per pupil* lags even farther behind. Opportunities to increase spending efficiency are limited. Efforts to improve the efficiency of education spending elsewhere in the region have focused on consolidating under-enrolled schools. With declining enrollment levels, most countries in the region find themselves with too many teachers and not enough pupils. In Kosovo, such opportunities are limited, however. Birth rates are only beginning to decline and the effect of falling birth rates on enrollment will be offset by falling rates of infant mortality. In addition, any savings arising from the consolidation of under-enrolled schools will be offset by the need to reduce overcrowding in others. The Government's plans to increase enrollment rates at the secondary level will also require an increase in spending. The most promising target for spending cuts lies in government subsidies to higher education. Tuition at the University of Pristina was sharply reduced last year. All students—not just those with financial needs—now receive substantial subsidies. The Government could achieve some savings, without depriving poorer students of access to higher education, by reformulating the subsidies as individual mean-tested grants.

Health. The level of Government spending on health is the lowest in the region (as a percent of GDP) and even this modest sum is badly spent. Hospital facilities are under-used and overstaffed. The Government pays too much for pharmaceuticals and buys sophisticated equipment it does not need. In the short term, the MOH can improve expenditure efficiency by reducing staff (particularly non-medical staff), improving competition in pharmaceutical procurement, and confining purchases of high cost medical technology to those recommended in the Health Sector Master Plan. Over the medium term, Kosovo needs to address more fundamental problems arising from the incentives confronting the managers of hospitals and primary health clinics (PHCs). While Kosovo is not yet ready for the introduction of case-based payment systems in public hospitals, immediate steps can be taken to improve the incentives confronting PHCs. The MOH should immediately operationalize the proposed system of performance grants. It should also require each PHC to establish a patient registry, in order to ensure that Government capitation payments reflect the volume of services they actually provide.

There is one action the Government should *not* take. The Government is thinking of establishing a health fund, which would be financed by employee- and employer contributions. Given the high proportion of informality in Kosovo's economy, the contribution base of such a fund would be very limited. High contribution rates, moreover, could discourage formal sector hiring. The Government should therefore continue to finance health expenditures from budgetary revenues.

Pensions. Kosovo's pension system is comprehensive yet cost-effective. Its largest component consists of a flat 'basic' pension of €45 per month (in 2009) provided to all persons over 65, regardless of previous earnings or contribution history. As such, its coverage is broader than the pension systems of comparable countries in the region. Persons who can demonstrate at least fifteen years of contributions under the former Yugoslav pension system are entitled to an additional €35. Workers under the age of 55 are required to put ten percent of their wages into individual retirement accounts, managed by the Kosovo Pension Savings Trust (KPST). Overall, the system works well. The basic pension ensures a minimum subsistence income to all Kosovars who are too old to work. The retirement accounts managed by KPST encourage younger workers to save for retirement. The financial performance of the funds managed by KPST, to date, has been satisfactory. The Government is now under pressure to increase the amount paid to former contributors. This is impractical and unaffordable.

There is also some risk that the Government, with its new authority to issue debt, could prompt KPST to over-invest in Government bonds. A proposed new pension fund law will allow the Central Bank to regulate the allocation of KPST's assets. The regulations should balance Kosovo's domestic investment needs with the need to ensure safety of principal and reasonable rates of return for workers.

Social Assistance. In addition to pensions, Kosovo provides three other forms of social protection. The largest, termed 'last resort income support' (LRIS) provides a meager cash transfer (averaging €61 per month per household) to households meeting rigorous categorical eligibility criteria (e.g., all members are unable to work due to age, disability, etc.) as well as income and asset tests. The program is well targeted—73 percent of the funds reach the poorest quintile—but is subject to errors of exclusion. Sixty percent of the poorest quintile receive no benefits at all. Over time, eligibility criteria should be revised to incorporate a larger proportion of the poorest quintile.

War veterans' benefits account for most of the remaining spending on social assistance. These benefits are not means tested and are not counted in determining eligibility for the LRIS. At the outset, benefits were confined to those directly affected by the war: disabled veterans and the survivors of those killed in the war. Over the last four years, the Government has steadily expanded the definition of eligible groups to include, for example, families of civilian war invalids. Pressures are now mounting to provide a benefit to *all* veterans (military or civilian) over fifty years of age, whether they were injured in the war or not. These pressures should be resisted.

Roads. Spending on roads has increased markedly since 2007, largely due to increased investment in capital works. It is now set to increase further still after the signing of the contract

to construct a motorway on Route 7 across Kosovo. The costs of this work, now estimated at Euro 980 million, could escalate considerably. The work will need very careful supervision and contract management, both of which are in short supply in Kosovo. Spending on maintenance, on the other hand, has remained low and is likely to remain low, resulting in the further deterioration of the existing road network.

In the short term, the Government should ensure that the new motorway does not crowd out essential expenditures on maintenance, by reducing other capital expenditures in the sector. More fundamental institutional and procedural reforms are also required. The rate of return on capital spending has, in general, been compromised by over design, insufficient attention to economic considerations (i.e., demand), poor contract administration, and unrealistic expectations of foreign funding. To begin to address these problems, the existing road data base and software (HDM4) should be fully incorporated into an integrated planning process, yielding a transport investment plan consistent with budget constraints. The procurement law should be amended to permit longer term maintenance contracts. To address capacity constraints at the local level, the Government should consider temporarily reclassifying some local roads as Ministry of Transport responsibilities.

Railroads. Passenger rail service in Kosovo is extremely limited. In spite of heavy subsidies, passenger volume is falling. In the absence of demand, passenger services should be curtailed. The future is in freight. Freight volumes have been increasing in recent years and freight services—largely based on the transport of minerals—are profitable. The productivity of Kosovo Railroads' freight services is nevertheless low by regional standards, due to overstaffing and an over-extended rail network. The Government has ambitious plans to invest in freight-related infrastructure, part of which are proposed to be funded from the budget. These plans are overly ambitious. While there is a need for modest spending to replace and rehabilitate current infrastructure and rolling stock, the Government should devote its energies to reducing overstaffing and network rationalization, before further investment in this sector.

Energy. The Kosovo Energy Corporation operates the lignite mines (which are Kosovo's principal domestic source of energy) and generates and distributes power throughout the country. Despite recent improvements, KEK's service quality remains poor, with frequent outages. KEK also confronts a need for massive new investment. Existing lignite mines are nearly exhausted and the company's two power stations are highly polluting and technically unreliable. The sector is also a drain on the budget. Due to widespread illegal connections and poor billing and collection enforcement, forty percent of the power entering the network is stolen or otherwise not paid for. Subsidies to cover KEK's operating losses consume about four percent of the Government budget.

The Government is looking to private investors to solve most of these problems. It is seeking private investors for a new mining and power generation complex to be built in phases over the next fifteen years. It also intends to privatize KEK's distribution services—a move which it hopes will improve collection performance. These efforts have recently run into obstacles and may not be completed for several years. In the mean time, there is much the Government—and KEK—can do to improve the company's financial performance. These measures would have the incidental benefit of improving KEK facilities' attractiveness to private

investors. Foremost among these is improved collection enforcement. While KEK has recently made major organizational and procedural improvements in billing and collection, these need to be supported by tougher penalties for non compliance and measures to streamline court procedures. KEK can also reduce its operating costs by releasing redundant staff, particularly as new facilities are brought on line. As collection performance improves, the Government should phase out its current import subsidy to KEK, forcing the company to rely more on tariffs, while continuing to compensate KEK for mandated subsidies to low income households and for power sold without charge to ethnic enclaves.

Municipal Finance. Municipal governments play an increasingly important role in the provision of public services. They are currently responsible for providing basic and secondary education and primary health care, along with a variety of administrative and infrastructure services, including the maintenance of municipal roads. The recurrent costs of education and health are largely financed from central government transfers, earmarked for these two purposes. Recurrent spending on other functions is largely financed from a general grant, supplemented by a locally administered property tax and various fees.

Overall, the system of recurrent finance is well designed. The rules for distributing transfers are equitable and objective. Most importantly, they are observed in practice. The system for allocating funding for capital works is less so. Practices vary by sector. School construction is planned and financed directly by the Ministry of Education, with local governments playing only a peripheral role. Primary health clinics, in contrast, are largely financed from municipal discretionary revenues, with little input from the Ministry of Health. Roads fall somewhere in between, with the Ministry of Transport providing significant counterpart funding for local road investments and playing a large role in determining their allocation. While funding for school construction appears to be well targeted, funding for roads is said to be politicized. In the absence of central leadership, the allocation of funding for primary health is largely a reflection of local initiatives. Under current conditions, there is a persuasive case for centralizing funding for these three sectors in their respective ministries and allocating funding according to clearly defined rules. Municipalities should be free to fund less critical sectors from their discretionary revenues.

Conclusion. Overall, Kosovo is in a position to maintain a sustainable fiscal stance while continuing to improve the quality of public services. The public sector is small, relative to GDP, and does not bear a crushing burden of long term obligations—to pensioners, to veterans, to creditors—that threaten the finances of neighboring countries. It is critical, however, that the Government resist pressures to expand entitlements—particularly to pensioners and veterans--that it curtail extravagant plans for capital investment—particularly in the transport sector—and that it undertake fundamental reforms—in the funding of health care, in its financial relationship with KEK, and in the allocation of capital investment funding for municipal schools, clinics and roads—in order to avoid unsustainable deficits in the future.

The table below summarizes the immediate reform agenda. It is divided into three types of actions: (1) actions the Government can take to generate immediate savings; (2) expenditure increases the Government is under pressure to concede that should be resisted; and (3) actions

the Government should undertake to increase the efficiency of expenditure in particular sectors even if they generate no net savings to the budget as a whole.

Immediate Reform Priorities	
Immediate steps to generate savings	
Energy	Enact and enforce tougher penalties against illegal connections and delinquent accounts; streamline court procedures to facilitate this process
Roads	Closely monitor spending on Route 7
Railroads	Cut passenger service, reduce staff, rationalize freight network
Education	Increase tuition at University of Pristina, target subsidies to poor students
Health	Cut non-medical staff, increase competition for pharmaceuticals, cut spending on high tech equipment
Spending pressures to be resisted	
Pensions	Do not increase pensions for former contributors
Social assistance	Do not extend benefits to able bodied war veterans, regardless of age
Budget neutral efficiency measures	
Roads	Shift funding from investment to maintenance, rehabilitation
Municipal finance	Rationalize allocation of investment funding for primary health clinics, local roads
Health	Implement performance grants

Introduction

1. In the context of growing fiscal deficits, this PER is aimed at identifying means to contain the growth of public expenditures in Kosovo while preserving or improving the quality of public services. It addresses six of the largest areas of Government expenditure: education, health, social protection (including pensions), transport (road and rail), and subsidies to the energy sector and municipalities. In each area, it briefly reviews existing performance and then identifies actions that may lead to efficiency gains. The PER has been closely coordinated with the ongoing Bank-managed multi-donor trust fund operation (SEDPP) and the IMF's ongoing dialogue with the Government on these issues. Its output is timed to aid the Government in the preparation of the 2011 budget.

Macro and Fiscal Background

2. Kosovo has experienced consistent economic growth since the end of the conflict in 1999. GDP grew by double-digits in 2000-2001, reflecting the massive donor-funded reconstruction effort after the end of the conflict. Growth afterwards was moderate and driven by continued donor financing, remittances and a gradual recovery in economic activity. Between 2005 and 2007 annual growth averaged around 4 percent, sustained by increasing investment and consumption. Exports also rose rapidly but from a very low starting base, so their contribution was more modest. Growth peaked at 5.5 percent in 2008, on the strength of an expansionary fiscal policy.

Box 1. Kosovo in Brief

Kosovo has a population of about 2.0 million and, with a GDP per capita of €1,760, is one of the poorest countries in Europe. Poverty remains persistent and widespread with 45 percent of the population below the national poverty line. The official unemployment rate is 48 percent; the worst in Europe. This is offset, in part, by a large informal sector. The economy nevertheless remains largely dependent on remittances and donor aid.

3. The global financial and economic crisis has had relatively little impact on the economy, reflecting Kosovo's limited integration with the rest of the world. The negative effects of the crisis have been transmitted through three channels: remittances, exports, and foreign direct investment (FDI). Remittances, which accounted for some 12 percent of GDP in 2008, have held up well so far, despite fears of sharp declines due to recessions in key migrant destinations such as Germany and Switzerland. Although Kosovo's exports of goods suffered a sharp decline (about 20 percent) in 2009, their still small share in GDP (about 5.6 percent) has limited the impact on overall growth. FDI, however, fell from the peak of €440 million in 2007, to €366 million in 2008 and €138 million in the first half of 2009.

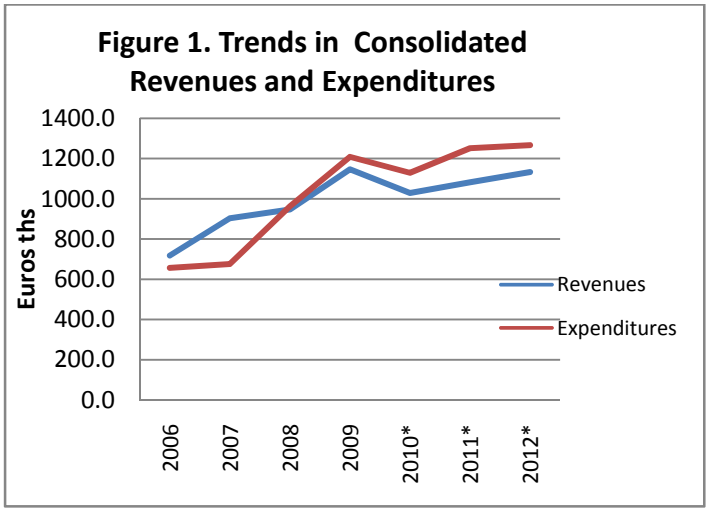
4. Although Kosovo's economy has remained resilient in the face of the crisis so far, the macroeconomic outlook embodies some downside risks. Deteriorating economic conditions in the EU, a major source of remittances and demand for Kosovo's (few) exports, could impede

growth. The country is also facing several external political constraints with economic implications. Progress toward EU accession will require a resolution of Kosovo's international status. The lack of customs controls at the north of Kosovo, as well as the failure of Bosnia and Serbia to recognize Kosovo's customs stamps, passports and license plates, has impeded Kosovo's exports to these markets, as well as the transit of Kosovar products via these countries. Donor support, which has remained high up to now, could begin to decline in the medium term.

5. Domestic factors also affect the economic outlook. The future of the energy sector is not yet clear, and developments in the sector will have a major impact on Kosovo's economy. While the banking sector has remained stable, with deposits as well as credit to the private sector continuing to grow in double digits in 2009, there is some evidence that banks have become more cautious in providing loans, as non-performing loans have begun to slowly increase. Finally, Kosovo's economic prospects will be affected by its success in improving the business environment. In light of these factors, GDP growth is expected to remain moderate, at about 5.5%, in 2010 and 2011. (See Annex Table 1: Main Indicators.)

6. ***Fiscal Policy.*** Until recently, Kosovo has pursued a highly conservative fiscal policy**.** The overall size of the public sector is small. In 2008, government spending was equal to only 25% of GDP—as opposed to 30% in Albania and 45% in Serbia, with expansion constrained, until recently, by the limited coverage of domestic taxes and the Government's inability to issue debt.

7. A new tax system was successfully established after the conflict. Revenue increased five-fold between 2000 and 2004. It slowed in 2005 but accelerated again in 2006 and 2007, partly as a result of reforms in tax policy and administration. Expenditures, meanwhile, grew more slowly and actually declined between 2005 and 2007. The result, as shown in Figure 1, was a significant overall surplus in 2007. More recently, fiscal restraint has ceded to an expansionary fiscal policy. Kosovo's overall budget balance as a percent of GDP fell from a surplus of 6.7% in 2007 to a deficit of 0.4% of GDP in 2008, due mainly to a large increase in capital spending. For 2009, the primary deficit grew to 1.6%.[1] Even this was achieved only on the strength of a large dividend



Source: 2005-2009: GOK financial statements (budget execution); 2010-2012: 2010 budget.

[1] Figures are based on budget execution data and differ slightly from those provided by the IMF. Note that, until 2009, in the absence of debt service obligations, Kosovo's primary balance was equal to its overall balance. In 2009, the Government agreed to begin servicing certain debts incurred by the former Yugoslavian Government. Roughly one third of the total was prepaid in 2009, leaving a balance of €248.3 million at the start of 2010.

payment from the publicly-owned telecom company (PTK) of €200 million. In the absence of the PTK dividend, the deficit would have been 6.8%. The 2010 budget envisages a deficit of about 2.5% of GDP. It would increase to 3.8% in 2011.[2] A significant part of this (€70 million) is expected to be financed by donors, in the form of budget support. In the absence of such extraordinary sources of financing, the Government confronts the prospect of growing deficits in the years to come.

8. In the short term, the deficits may be financed from the sale of additional assets and drawing down reserves. The Government has initiated the privatization of PTK, although details of the privatization have yet to be determined. The MEF estimates that the privatization could bring up to €500 million and could be concluded by 2011. In addition, the recently adopted energy strategy includes a plan to sell KEK, which could generate some additional €40-60 million in privatization proceeds. The deficits can also be financed by drawing down reserves, which were estimated at €380 million at the end of 2009. Over the medium term, however, these sources will be exhausted. In the absence of expenditure cuts, Kosovo will have to borrow.

9. Before 2010, the Government lacked the legal authority to issue debt. However, the new public debt law which was adopted in early 2010 permits the central government, as well as municipalities, to access domestic and external source of finance. The law sets a ceiling on the overall public debt stock at 40% of GDP.[3] Given the current low level of indebtedness (6.4% of GDP) the Government would appear to have significant room to meet its financing needs by borrowing. However, Kosovo is also facing other contingent liabilities related to the former Yugoslavia. These contingent liabilities, toward the Paris Club, London Club and other creditors were estimated by the IMF to total around €442 million. A debt sustainability analysis for Kosovo was recently prepared by the Bank and the Fund. It concluded that Kosovo's current financial trajectory is sustainable. But the debt risk is considered to be moderate, as the DSA concluded that this outcome is sensitive to trends in Kosovo's primary deficit. Lower than expected revenues or rising (non-debt-related) expenditures could readily throw Kosovo off track.

10. Increases in Government revenues may be part of the solution. Kosovo's overall tax burden is relatively low. This is in part due to deliberate policy—official tax rates are relatively low—and partly due to the shortage of convenient tax handles. Kosovo's economy is characterized by a large informal sector. Under-reporting for tax purposes is widespread. In principle, improvements in tax administration could broaden the tax base and increase tax revenue. Some positive steps have already been taken in this direction, including the introduction of taxpayer identification numbers and electronic cash registers. The IMF has been providing support to strengthen tax administration. The MTEF forecasts steady increases in revenues, as shown in Figure 1. Nevertheless, the growing gap between revenues and expenditures cannot be entirely addressed through increased taxation.

11. Much of the adjustment will therefore have to occur on the expenditure side. Given the well-documented shortcomings of public services in Kosovo, this will require an

[2] As discussed later in the report, this figure does not reflect the full costs of the Route 7 motorway.
[3] The ceiling includes public guarantees and municipal debt. Municipal long-term debt is explicitly limited to two percent of GDP.

improvement in the quality of public expenditure rather than a reduction in the quantity or quality of services. The remainder of this report is therefore aimed at advising the Government of opportunities to maintain or improve the quality of public services without increases in spending—i.e., on how to do more with less.

Composition of Expenditure

12. Claims on the budget come from a wide range of sectors. As shown in Table 1, education was the largest single program of government expenditure in 2008, accounting for 16% of the total (including spending on this function by local governments). Transportation—largely consisting of road construction and maintenance, accounted for a similar share of the total. Spending on police, health, pensions and social assistance each accounted for seven to nine percent of total spending. Subsidies to the state power company, KEK, consumed about four percent of the total. Municipal expenditures, excluding municipal spending on education and health, consumed about nine percent of the total.[4] Taken together, these sectors account for about eighty percent of total spending.

Table 1. Sectoral Composition of Public Expenditure (€mn)

	2007 execution	2008 execution	2009 budget	2010 budget	Pct of total 2008	Chg 2008-2010
Education*	127.0	167.0	177.1	169.5	16	2
Transport **	37.7	166.8	116.0	130.8	16	-22
Other central	64.6	101.2	141.2	112.4	10	11
Police	83.9	95.7	102.6	110.8	9	16
Health *	74.0	88.4	113.4	102.9	9	16
Other municipal	61.4	87.0	116.0	129.0	9	48
Pensions	67.0	80.5	89.4	100.7	8	25
MEF/MPA/KTC	102.7	72.7	150.2	93.2	7	28
Social protection	56.1	69.3	69.5	72.9	7	5
KEK subsidies	11.5	42.8	47.1	44.5	4	4
Justice	26.3	29.7	36.4	36.5	3	23
PM/Assembly	11.4	13.9	17.8	21.1	1	52
total of above	723.4	1,015.0	1,176.7	1,124.3	100	11

*Municipal expenditures on education and health are classified under those respective sectors.
** Includes MEF spending on land acquisition for highways.

13. Trends in spending vary among sectors. Between 2007 (execution) and 2010 (budget), spending on education, health, police, and social protection all increased by about one third. Municipal expenditures (other than education and health), on the other hand, doubled. Spending on transport and subsidies to the power company nearly quadrupled—although comparisons of actual and budgeted spending in transport are distorted by the Government's tendency to under-execute the capital works budget. The MTBF projects virtually no change in the sectoral

[4] Figures are based on the actual and commited expenditures as reported in the Kosovo consolidated budget (KCB) execution report for 2008. The KCB includes expenditures on health care (Kosovo has no separate health insurance fund) and most pension expenditures. (As noted in the text, Kosovo has only a small contributory pension fund. Most pension benefits are paid from general revenues.) Subsidies to enterprises are reported net of revenue. The KCB includes municipal expenditures, inlcuding expenditures financed from own source revenue. Data on trends in distorted by shifts in functions from UNMIK to the provisional insitutions of self government (PISG) and then to the Government of Kosovo, accompanied by abolition of Kosovo Trust Agency. Detailed budget execution data for 2009 is not yet available.

composition of spending between 2010 and 2012. Experience, however, demonstrates that the MTBF has very little impact on the sectoral composition of the annual budget.

Education

14. The education system in Kosovo consists of nine years of compulsory basic (primary and lower secondary) education, supplemented by three to four years of non-compulsory upper secondary education.[5] The Government also supports non-compulsory preschools serving children from ages one to six and tertiary education at the University of Pristina.[6] As shown in Table 2, approximately 498,000 students were enrolled in the public education system as a whole in the 2008/2009 academic year, 73% of them at the preprimary and basic (grades 0-9) level. The facilities for basic education consist of 547 main basic schools (grades 0-9) and 422 satellite schools (grades 0-5). Main basic schools can have 1-5 associated satellite schools under their management. Upper secondary schools consist of 44 gymnasium (general education) and 65 vocational schools.

Table 2. Enrollment by Level (2008/09 Academic Year)

	Enrollment	% of Total
Preprimary (age 1-6) & Primary (grades 1-5)	365,473	73
Upper secondary	98,890	20
University of Pristina	33,834	7
Total	**498,197**	**100**

Sources: MFE for pre-university enrollment; University of Pristina for university enrollment.

15. Enrollment rates at the basic level are believed to be close to universal with few gender and geographical disparities.[7] Enrollment rates drop, however, after the lower secondary level, particularly for girls and poor children of both sexes. In 2005/06, the net enrollment rates for upper secondary education were estimated at 74% on average, varying from 67% for the poorest quintile to 81% for the richest, and between 67 percent for girls and 81% for boys.[8] Overall, Kosovo's secondary enrollment rate is among the lowest in Central and South Eastern European region, similar to that of Albania (74%) and Romania (73%) and well below Macedonia (82%), Bulgaria (88%) and Hungary (91%).[9,10]

[5] The government is currently planning to make upper secondary education and one year of preprimary education compulsory. As a result of the development of a new curriculum for vocational education, the government is also planning to amalgamate all vocational education programs into grades 10-12.

[6] This PER does not discuss the University of Mitrovica, an institution serving Serb students in Kosovo managed by municipality of Mitrovica and largely funded by the Serbian Government. Although the Ahthisaari proposal (*Comprehensive Proposal for the Kosovo Status Settlement*, 2007) and *Law No. 03/L-068 on Education in the Municipalities of the Republic of Kosovo* require the Central Government with 'ensuring that the university receives adequate premises and funding for its operation from the budget of the Republic of Kosovo' the university in fact receives no funds from the KCB.

[7] It should be noted, however, that the enrollment rate among some ethnic minorities, *i.e.*, Roma, Ashkali and Egyptians is believed to be much lower than the national average even at the basic education level.

[8] World Bank, 2007, *Kosovo Poverty Assessment Update, Vol. I, Poverty Trends 2003-2005*.

[9] World Bank, EdStats Database.

[10] In the absence of a population census, the enrollment rates are estimated based on the Household Budget Survey (World Bank, 2007, *Kosovo Poverty Assessment Vol. I: Accelerating Inclusive Growth to Reduce Widespread Poverty*). The assessment does not disaggregate the enrollment rate for compulsory education (grades 1-9) into

16. Despite recent increases, public spending on education in Kosovo is still relatively low by regional standards. Government spending on education totaled 4.3% of GDP in 2008.[11] This is below the equivalent figure for Central and South East Europe as a whole (4.8%), and well below such countries as Poland (5.7%); Slovenia (5.7%); and Serbia (4.8%).[12,13] Due to the relatively high proportion of school age children in Kosovo's population, spending *per pupil* lags even farther behind regional averages. In 2009, per-pupil spending on pre-university education was about €243, equivalent to 14% of per capita GDP.[14] The comparable figure for Hungary was roughly 25%; for Bulgaria and Croatia, 23 percent; and for Slovakia, 15%.[15]

17. ***Salary Levels.*** Even this level of education spending represents a substantial increase over previous years. In 2007, education spending totaled only 3.7% of GDP. The increase largely reflects the impact of a rise in teachers' salaries which became effective in October 2008. This was part of a comprehensive teacher licensing and professional development effort intended to improve the Government's ability to attract and retain qualified staff. Prior to the reform, teacher salaries were uniform, differentiated only by grade level (i.e., with different salaries for teachers at preprimary, primary and secondary grades). Under the reform, the Government introduced differentiated pay scales based on qualifications and experience. As shown in Table 3, the base salary for primary school teachers now ranges from €216 (for teachers without formal pedagogical qualifications) to €292 for teachers with advanced degrees, with additional remuneration based on years of experience.[16] Salaries for secondary school teachers remain slightly higher than those of primary school teachers.

18. The reform of teachers' salaries was a long sought and well justified move. The resulting salary compression ratios are now close to the EU19 averages for primary and secondary schools (1.64 and 1.62, respectively). Nevertheless, it was expensive. Under the reform, all teaching staff, other than those found unqualified and those with less than one year of experience, received a raise of some kind. As a result, the 2009 budget for education grants

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primary and lower secondary. The nearly universal enrollments for primary, hence, partially rely on the qualitative evidence from schools and education officials.

[11] Figure includes spending by municipalities and the Ministry of Education and excludes spending financed by student tuitions.

[12] World Bank, 2008, *Kosovo: Policy Note on Public Expenditure on Pre-University Education*, para. 1.21; World Bank, Edstats; World Bank, 2009, *Serbia: Doing More with Less, 2009.*

[13] Because the size of Kosovo's public sector as a whole is relatively small, the proportion of total public spending allocated to education is somewhat higher than in neighboring countries. Excluding tuition fees collected from the students of the University of Pristina, public spending on education comprised 15.4 percent of total Government spending in 2008. This compares to Poland (12.7 percent), Slovenia (12.9 percent) Estonia (14.4 percent) and the Slovak Republic (14.7 percent).

[14] Estimated by the author based on the budget data from the Ministry of Finance and Economy and student data from MEST.

[15] OECD, 2009, *Education at a Glance 2009*, Table B1.4 for OECD; World Bank, 2008, Kosovo: Policy Note on Public Expenditure on Pre-University Education, p. 11 for Croatia; UNESCO (http://stats.uis.unesco.org) for Bulgaria.

[16] It should be noted that the number of teachers falling in the maximum category (MA/PhD and about 45 years of experience) is very small (less than 0.1 percent).

(which finance teachers' salaries at the municipal level) were increased by 20% to accommodate the salary increase alone.

19. Post-reform salaries now appear to have reached adequate levels.[17] The average teacher's salary is now €274. This is about 7.5% higher than the average wage for administrative positions in the public sector.[18] But it is about twenty percent below the average salary in the private sector and 25 percent below the average salary of teachers in the private sector.[19] Altogether, the new teacher salary levels appear to be comparable to those of similar professionals in the public sector but slightly lower than those in the private sectors. Anecdotal evidence suggests that the salary reform has succeeded in motivating existing teachers and attracting new university graduates. Indeed, in response to growing student demand, the Ministry has doubled enrollment in the Faculty of Education in the academic year 2009/10.

Table 3. New Teacher Salary Scales
(€, monthly)

	Base salary based on qualification		With experience-based additional salary		
	Primary	Secondary	Lower bound	Upper bound	Median
Unqualified / Beginner teachers	216	236	216	238	227
5-year secondary teacher school	238	260	239	260	250
2-year Higher Pedagogical School	257	281	260	288	274*
BA (3-year & 4-year) degrees	274	300	289	306	298
Masters and Ph.D degrees	292	319	307	370	339

Source: MEF.
*The MEF used €274 as the basis of teacher salaries when calculating the education grants for each municipality (*Midterm Expenditures Framework 2010-2012*).

20. As a result, there would appear to be little justification for further increases in the level of teachers' salaries in the next few years, except for adjustments for cost-of-living increases and the small annual increase according to years of experience. Over the longer term, the Government is considering introducing performance based salary increases. As part of its effort to improve education quality, the Government has established a Teacher Licensing and Career Development Council and charged it with devising a professional development and performance evaluation mechanism that will provide teachers with an opportunity to strengthen their qualifications and move up the career ladder as well as a structure that motivates and rewards high performers.[20] It will, however, take a few years for the mechanism to be developed and become operational.

[17] When measured as a percentage of GDP per capita (a standard indicator in cross-country comparisons), teacher salaries in Kosovo are higher than in surrounding countries, largely because Kosovo's reported GDP per capita is relatively low.

[18] Formal sector wage comparators are based on data from the Tax Administration of Kosovo and represent averages for January-June 2009.

[19] Employees in the private education sector primarily consist of lecturers and other staff in private tertiary educational institutions and specialized private vocational schools such as languages. Given the qualifications required for such positions, they are not strictly comparable to teachers in pre-university education. The number of employees in this category was 2,324 in 2008 and 2,136 in 2009, compared to about 22,000 public school teachers.

[20] Administrative Instruction, No. 16/2008, On Teacher Licensing and Salary Differentiation, grants a temporary license and a regular license to teachers. Those on temporary license (about 10 percent of the current teaching force) need to meet certain qualification and training criteria to receive a regular license. If they fail to meet the criteria

21. ***Staffing Levels.*** Pressure for increased spending may instead come from increased enrollment. In principle, increased enrollment could derive from two sources. The first is an increase in the school age population. Unlike other countries in the region where the birth rate has already declined dramatically, Kosovo is at an earlier stage of its demographic transition. The crude birth rate in 2008 is estimated at 16 per thousand. This is fifty percent higher than the average for Eastern Europe as a whole and considerably above the level of neighboring countries.[21]

22. Falling birth rates have led to a decline in the school age population in neighboring countries, as households which once sent a three or four children to school now only send one or two. It is not clear that this has occurred yet in Kosovo. In the absence of a recent population census, trends in household size cannot be determined with any accuracy. There is nevertheless some evidence that household sizes are beginning to fall. Total primary enrollment in Kosovo declined by about 7.6% between the academic years 2004/05 and 2008/09. As the enrollment rate at the primary level was close to universal in both years, this is believed to reflect a decline in the primary school age population. Were this trend to continue, enrollment levels would fall over time, other things being equal. Falling rates of infant mortality, on the other hand, will increase the number of school age children. Kosovo has the highest infant mortality rate in Europe, with rates ranging from 35 to 49 for every 1,000 births each year. Improvements in child mortality rates will increase the number of infants surviving to school age.

23. The second potential source of growth is increasing *rates* of enrollment, particularly at the secondary level. Consistent with the Government's effort to improve the coverage of secondary education, enrollment at the lower secondary level already increased by about seven percent between 2004/05 and 2008/09 and in upper secondary by 38% and is expected to continue to grow.[22] In the absence of census data, figures on current enrollment rates cannot be precisely determined for each grade.[23] Available data do, however, permit a calculation of the dropout rate—i.e., the percentage of children who fail to continue in school after the completion of a given school year. This provides a crude but useable indicator of the proportion of children in a given age cohort who complete the entire cycle of basic and secondary education.[24]

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within a three year period, then they lose the right to teach. On the other hand, teachers on a regular license can be promoted to career, advanced, mentor, or meritorious teacher status. In order to move from one grade to another, teachers need to take training and receive a positive performance evaluation. Details of the number of credits and types of training, and the performance evaluation are currently being developed by the Teacher Licensing and Career Development Council.

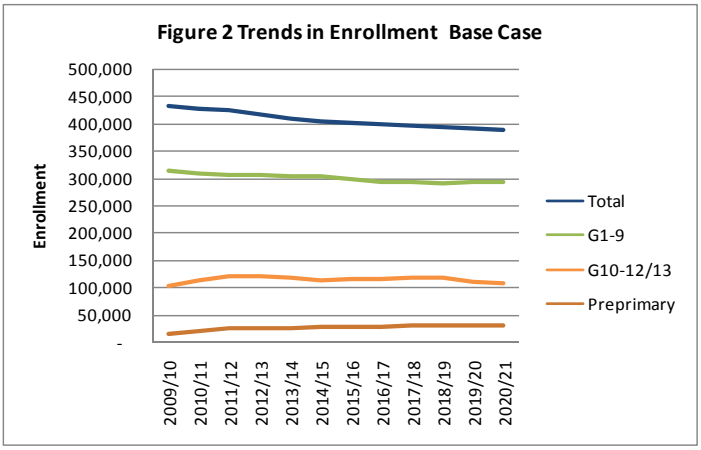
[21] The rate for Kosovo was estimated by the author. According to the UN's World Population Prospects 2008 Revision, the birth rate for Eastern Europe as a whole was 10.4 per thousand. For Serbia it was 11.6; Macedonia, 10.9; and Albania, 14.7.

[22] The latter increase in part reflects the addition of an additional year of upper secondary education in 2006/07.

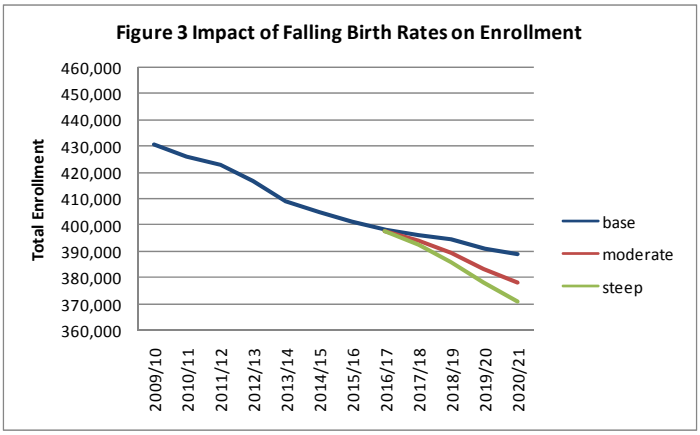
[23] Neither the gross enrollment rate (the number of students in a given grade divided by the number of children eligible for that grade) nor the net enrollment rate (the number of students in a given grade eligible for that grade divided by the number of children eligible for that grade) can be estimated.

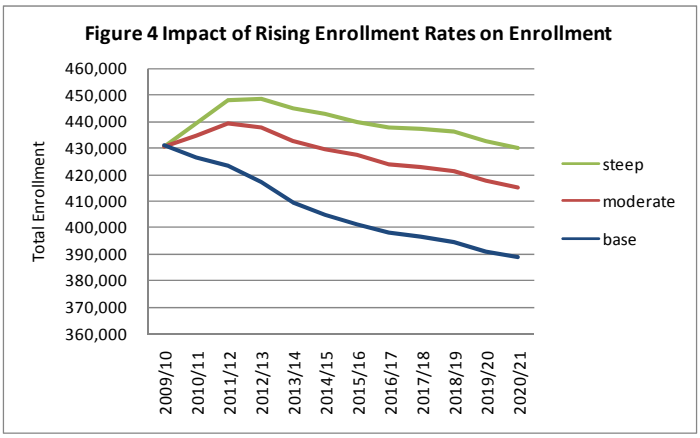
[24] For purposes of these calculations, the dropout rates includes students who complete 12 years of basic and secondary education but fail to complete the 13th.

24. Figures 2-4 illustrate the possible magnitude of these two influences on enrollment levels. Figure 2 illustrates a base scenario, in which the number of births per year remains at its current level (34,000 per year) and the child mortality rate gradually improves from the current 42 deaths per thousand to a 30 per thousand by 2020. It assumes no changes in dropout rates at the basic and secondary levels and a slight improvement at pre-primary level. As shown, total enrollment would gradually decline under this scenario, with declines at the primary and secondary level more than offsetting increases at the pre-primary level. Overall, enrollment would drop by 14% between the 2009/10 and 2020/21 school years.



25. Figure 3 illustrates the impact of a declining number of births on enrollment. The upper (blue) line indicates total enrollment under the base scenario. The moderate (red) line assumes that the ratio of births to population falls to 14.8 per thousand (the level of Albania) by 2015. The steep (green) line assumes they fall to 13.8 per thousand by that year.[25] All other assumptions of the base scenario remain unchanged. As shown, even an immediate fall in the birth rate would not affect enrollment until the infants born in the first projection year reach school age. As a result, the impact of demographic decline would be only noticeable after 2017. Thereafter, the impact would be increasingly marked. Under the steep decline scenario, enrollment at the preprimary level would be 15 percent lower than under the base scenario by 2021. Enrollment at the primary level would be five percent lower. Enrollment at the secondary level would not yet be affected.





26. Reductions in dropout rates would have a more immediate and substantial impact on total enrollment. The base scenario shown in Figure 4 assumes no change in dropout rates at the basic or secondary level. (As such it is identical to the base scenario in Figure 3.) The moderate scenario assumes that the cumulative dropout rate at the basic level would decline from an average of 11% to 7.7%, the transitional dropout rate from basic to secondary from 12% to 5%, and the cumulative dropout rate at the secondary level from 15% to 4%. The steep scenario assumes that dropout rates at the basic level would drop to

[25] In the absence of reliable demographic data, Kosovo's population is assumed to remain constant over the projection period.

3.9%, at transition to 5%, and at the secondary level remaining at 4%.[26] As shown, falling dropout rates would largely offset the impact of falling initial enrollment levels under the base scenario. Under the moderate dropout rate reduction scenario, total enrollment would decline by only five percent over the eleven year projection period (as opposed to ten percent under the base scenario). Under the steep scenario, enrollment in the 2020/21 school year falls by only two percent. Different grade levels would be affected differently. As enrollment at the basic level is already nearly universal, the largest potential increases are at the secondary level. Under the moderate dropout rate reduction scenario, enrollment at the secondary level would decline by only two percent over the projection period (rather than declining by 18 percent under the base case). Under the steep reduction scenario, secondary school enrollment would increase by six percent.

27. These shifts in the number and profile of the student population have several fiscal implications for the Government. Growth in enrollment at the upper secondary level, if any, will require an expansion in the number of teachers at that level. But over time, the decline in enrollment at the basic level will allow the number of basic school teachers to be reduced. Efforts to improve the efficiency of education spending elsewhere in the region have, in fact, focused on closing or consolidating under-enrolled basic schools. With declining enrollment levels, most countries in the region find themselves with too many teachers and not enough pupils. These countries reduce costs by dismissing redundant teaching staff.

28. In Kosovo, any such gains are likely to be limited, however. Any savings arising from the consolidation of under-enrolled school is likely to be offset by efforts to reduce overcrowding in others. In aggregate, the number of existing under-enrolled classrooms—the pool of potential targets—is fairly small. Classroom sizes in Kosovo are high. In 2008/09, the average class size in grades 1-9 was 24. The average in grades 10-13 was 32. This is considerably higher than in surrounding countries such as Slovenia (17.5 and 19.2, respectively), Hungary (19.9 and 21.2), and Serbia (10.6 and 9.0).[27] It is true that rural-urban migration has emptied out some schools in rural areas and urban outskirts. While pupil teacher ratios in large urban schools are generally between 22 and 29, ratios in smaller schools are considerably lower. But the number of under-crowded schools is far exceeded by the number of overcrowded ones.

29. Table 4 summarizes the number of basic schools by enrollment size for 855 of the 969 basic schools (547 main and 422 satellites) for which school-level data is available.[28] While the Government defines a pupil-teacher ratio (PTR) of 21.3 for majority students and 14.2 for minority students for budgeting purposes, it currently does not regulate the minimum and

[26] Because it is unclear if and when the government might cease grade 13 in vocational schools, the scenarios did not change the transition rate from grades 12 to 13. However, termination of grade 13 may result in a reduction of about 12,000-15,000 students from the pre-university education system.

[27] Data for 2007. OECD, 2009, Education at A Glance 2009; World Bank, 2009, *Serbia: Doing More with Less Addressing the Fiscal Crisis by Increasing Public Sector Productivity.*

[28] Of 547 main schools and 422 satellite schools, this table covers all main schools except one and only 73 percent of the satellite schools. The data is incomplete because five municipalities did not disaggregate enrollment data by main and satellite schools, and reported all satellite school students and teachers under the associated main school. This means that the size of 113 main schools are inflated and the magnitude of small satellite schools are underrepresented.

maximum class sizes. The following analyses of school-by-school data assumes a minimum class size of 15 and maximum of 30.

30. An analysis of 539 medium-to-large basic schools[29] suggests that only 46 have the right number of teachers according to this rule. Nearly 200 schools have too many teachers--an oversupply of 1,047 teachers in total. But nearly 280 have too few teachers--an undersupply totaling 1,638 teachers.[30] Right-sizing all 539 schools would therefore require an increase in teaching staff of 591, a four percent increase over existing levels.

31. Eighty-two schools (27%) had fewer than 25 students and another 63 (20%) had between 25 and 50. Pupil-teacher ratios in the smallest size category ranged from 1.5 to 11, while those for the second smallest size category were slightly higher at 12-14. In principle, expanding the number of multi-grade classes (e.g., 'one-room school houses') in those small schools could generate considerable savings. The scale of such savings was estimated through an analysis of 182 of the 199 schools with less than 100 students that provide teacher data.[31] If the maximum number of teachers per school is defined to be one for schools with 1-5 students, two for those with 6-15 students, three for those with 16-25 students, five for those with 26-50 students 5, and 7 for those with 51-100 students, the government could save 242 teachers (27% of 883 teachers in these schools). This estimate, of course, assumes that teachers would be sufficiently trained to provide multi-grade teaching.

Table 4. Number of Basic Schools by Enrollment Size (2008/09)

No. of students	<25	25-50	51-100	101-300	301-500	>501	Total
Satellite (grades 105)	82	63	55	95	14	0	309
Main (grades 1-9	7	8	18	117	192	204	546
Total	89	71	73	212	206	204	855

Source: MEST, EMIS Department. Data was collected for the purpose of implementing the school financing reform in 2009.

32. The onus of rationalizing the basic school network rests with individual municipalities. It is the municipalities, rather than the Government, that have the authority to close schools. In principle, municipalities already face a strong financial incentive to do so. Since 2005, funding for basic education has been provided to individual municipalities on the basis of enrollment.[32] In making these calculations, enrollment figures are first converted into full time equivalent teachers (FTEs) using fixed pupil teacher ratio (PTR) norms for basic and secondary schools,

[29] Defined as schools with more than 135 students or 15 students per grade. Schools with more than 135 students can be satellite schools with 1-5 grades, but due to lack of relevant data, it was assumed that all schools with more than 135 students are main basic schools offering 1-9 grades.

[30] Note that since there is no data on teachers for 21 schools, these schools are likely to be satellite schools and their teachers are likely to be covered under their respective main schools. If this is the case, some of those main schools over-report the number of teachers.

[31] Even though some of the small schools may be main schools, it is assumed that all schools with less than 100 students are satellite schools in this analysis. Schools with 101-135 students were not included in either analysis because these schools can equally be main or satellite schools, and without knowing which type, neither analysis could produce any meaningful findings.

[32] Capitation based financing was officially introduced in 2002, but was not strictly implemented until 2005.

respectively, and for majority and minority students.[33] These are then converted into Euro amounts on the basis of current salary levels.[34] But capitation financing has failed to produce substantial savings to date. There is little likelihood that the revised formula will either.

33. The explanation lies in part with the funding formula and the municipal decision making process. As funding for education is provided to municipal governments, rather than individual schools, local councils are free to over-fund sparsely enrolled rural schools, provided they are willing to under-fund overcrowded urban schools. They can therefore continue to maintain low pupil teacher ratios in rural areas, albeit only by maintaining high pupil teacher ratios in cities.

Box 2. Rural Access to Education

Rural facilities could be adapted to serve the growing demand for preschool education. Bank-financed education projects have been assisting some countries, e.g., Albania and Armenia, in developing a preschool class in rural schools. Evaluation of those programs has shown significant improvements in school readiness among rural children. Efforts to close rural schools will also have to be complemented by improvements in transportation to and from rural areas. A recent study showed that lack of access and long distance are the primary reasons for rural students dropping out of high school.* Fifty-three percent of dropouts and 60 percent of their parents specifically referred to distance as a major reason for failing to continue in upper secondary school. Another study found that the availability of transportation particularly encourages young girls to continue studying at the secondary level.** Equitable expansion of access to upper secondary education requires the provision of dependable transportation services.

*Saqipi, Blerim, et al., 2008, *Report on Student Dropout in Kosova Schools Study Issues, Factors Influencing It and Recommendations*. Besides the supply-side factors, demand-side factors included financial constraints and lack of interests both among students and parents.

** Gougeon, Thomas D., 2009, External Evaluation Project Evaluation of Education Participation Improvement Project II.

34. To address this problem, the Government is experimenting with extending the capitation based funding system to individual schools.[35] It has started with three pilot municipalities. To date, the pilot municipalities have only delegated control over goods and

[33] In the final 2010 education grant calculations, the definition of a minority student was changed from that used in previous years. A majority student is now defined as one who belongs to the majority language of instruction in the municipality and so a minority student is one who is taught in a language not that of the majority of students in the municipality. Hence, Serb students can be majority and Albanian students minority. This is a fairer definition for funding purposes since the higher per student cost of a minority student arises from the school teaching in a second language and hence having smaller classes for the minority or from schools with minority language students being smaller than majority student schools.

[34] In 2009, the formula was modified. The revised formula lowers the normative PTRs for preschool and vocational education and provides additional amounts for schools in mountainous areas. It also specifies norms for administrative and support staff and provides funding for maternity and sick leave. See World Bank & USAID, 2007, *Kosovo Selected Issues in Fiscal Decentralization* for detailed discussion on the original formula. Maternity and sick leaves were introduced in the 2009 education grant calculations.

[35] A Bank-financed project supports the reform. It also offers one-time municipal development grants to pilot municipalities participating in the project to facilitate network rationalization. The reform is also accompanied by school autonomy reform, *i.e.*, the delegation of financial management authority to the school level. These reforms are together intended to encourage individual school directors to be more accountable for their management of the school and to efficiently and effectively spend the predetermined budget. The first phase of the reform started in January 2009.

services funding to individual schools.[36] It was planned that each of the three municipalities would start using the capitation formula to allocate salary funding to at least five of the schools within their respective jurisdictions in early 2010, but this has not been implemented yet, due in part to a lack of appropriate legislation.. Now that the administrative instructions on formula funding at the municipal level has been approved (in April 2010), the Government plans to implement capitation-based salary funding in the three municipalities in September 2010. Even though the Government has planned to expand the reform to the remaining municipalities in 2011, it is not advisable to rush the reform process because sufficient training and preparation are the key to successful implementation.

35. If this is to succeed, strong political commitment at the municipal level will be required. Unlike class consolidation within individual schools, network rationalization implies school closures. This is likely to be unpopular, particularly where it implies the dismissal of teachers who live in the community and the bussing of students—including very young students—to places that parents regard as distant. The Government can help offset some of these constraints, by providing financial support to municipalities facing substantial school closures. This could include funding for severance payments and for the purchase of school busses (where public provision of transportation is more cost effective than outsourcing it). It could provide also resources to refurbish "central" (or new "merged") schools and to hire accountants.[37]

36. The Government should also pursue its efforts to focus new school construction on areas with rising enrollment and severe overcrowding. The Government's approach to planning for school construction has historically been somewhat *ad hoc*. This is now changing. The Government's first priority is to eliminate triple- and quadruple-shift schools, mostly located in urban areas. These schools inevitably are forced to shorten classroom teaching hours, typically covering only 35-40 minutes per class, instead of the 45 minutes required by the national curriculum. Since 2008, the Government has constructed 65 new schools, of which 58 are basic education schools. Most were located in urban areas and were intended to absorb students from the overcrowded facilities. As a result, the number of triple- and quadruple-shift schools fell from about 100 (ten percent of the total) in 2007 to 58 (as of May 2009), only one of which was running on a quadruple-shift. In 2009, 41 basic schools were under construction and 11 triple-shift schools were receiving annexes with support from a donor. The Government intends to eliminate all of the triple- and quadruple-shift schools by September 2010. Another priority has been to replace container schools in rural areas with regular school buildings. This goal has already been met, with eight schools built in 2008 and seven more in 2009.[38] By the end of 2009, all students in container schools were placed either in newly constructed regular school buildings or neighboring schools.

[36] It has nevertheless been reported that there have been observable savings in spending on utilities. Actual data to compare the changes in utility spending is not available at this moment.

[37] Under the Bank-financed project, the government is evaluating the first-year implementation of school financing reform. The evaluation report has been drafted in March, 2010, but is not reflected in this PER.

[38] A more cost effective option might have been to transport the students in those schools to neighboring schools. MEST claims, however, that it analyzed each case and concluded to build a new school only where neighboring schools were already quite full and/or too far away.

37. ***Higher Education.*** Reforms are also required in the funding of higher education. The University of Pristina (UP) is the primary provider and only public institution in Kosovo offering higher education in the Albanian language.[39] As shown in Table 5, enrollments at the UP have rapidly increased in the recent years, from 29,000 in the academic year 2006/07 to a planned 44,000 in 2009/10. Nevertheless, it is estimated that only 21-24% of the freshman-age population entered the UP in 2007/08 and that this percentage rose to 26-30% in 2009/10. This is much lower than the OECD average for university (Type A) education (university education): 55 percent. An additional 21-23 percent of the cohort entered private tertiary education institutions (TEIs) in 2007/08, but most of the private TEIs offer only Type B (non-university, vocationally oriented) tertiary education (see Box 3).

Table 5. Enrollment at U of Pristina

School Year	2006/07	2007/08	2008/09	2009/10*
BA programs	27274	28757	31010	40920
MA programs	1766	2118	2824	3080
Total	29040	30875	33834	44000

Source: U Pristina: General Administration.
* Estimates for budget planning.

38. Government financing for higher education is fairly modest. In 2008, subsidies from the Kosovo Consolidated Budget to the UP totaled €11 million, or about one percent of total Government expenditure.[40] In 2009, the Government increased the budget for subsidies to €12 million, and further to €15.4 million in 2010, primarily to accommodate salary increases for university staff.[41] As a result, subsidies to higher education will total about 1.3% of total government spending in 2010, or about 11% of total spending on education. This is considerably lower than comparable figures in neighboring countries: Bulgaria allocates 17% of its education budget to higher education; Poland, 18%; and Bulgaria 19%.[42]

Box 3. Private Tertiary Education in Kosovo

Private tertiary education institutions (TEIs) started to grow only recently, but rapidly in Kosovo. The number of entering students totaled 1,316 in 2004/05 and increased to 8,517 in 2007/08. In 2008, however, the government conducted an accreditation process for all 33 of the private institutions calling themselves 'universities'. All, except one, were transformed to "colleges", "institutes", and "higher professional schools", depending on their capacities and profile. During this process (which has extended into the current 2009/10 academic year), none were allowed enroll new students. To compensate for this temporary constraint on private enrollment, MEST increased the number of openings at the UP. Planned enrollment in the 2009/10 academic year is 30 percent high than in 2007/08.

[39] The Government is also planning to establish a new public university in Prizren and has budgeted €2 million as a reserve item in the final 2010 budget for this purpose. Because the details of the plan is yet to be developed, this PER does not examine the possible impact of the establishment of the new university. However, it is critical that such a plan be evaluated within the overall context of the tertiary education sector and its fiscal implication thoroughly analyzed before funds are committed.

[40] Figures exclude income generated by the University from tuitions and administrative fees.

[41] As defined in Article 5.3 (c) of *Law on Higher Education*. In 2009, the Government increased salaries for professors, lecturers and non-teaching staff by 30 percent: the net monthly salary is now €1,000 for university professors, €500-1,000 for other teaching staff (associate professor, teaching adjunct, etc.), and €500 for teaching assistants.

[42] World Bank Edstats.

Box 4. Returns to Higher Education

In principle, there is a case for Government subsidies to higher education. Increasing access to higher education can help promote economic growth. Only seven percent of employees in Kosovo have a university degree or higher, compared to 15 percent in SEE and 24 percent in the Europe and Central Asia region. According to the 2008 BEEPS*, 46 percent of firms in Kosovo indicated that lack of "skills and education of workers" is a problem doing business. By the same token, higher education can improve individual employment prospects. Unemployment rates are extremely high in Kosovo, estimated at 45 percent of the labor force and as high as 76 percent among youths. There is evidence that expanding higher education could reduce these levels. More than 50 percent of males and 20 percent of females claim they are not seeking jobs because of a lack of relevant education and training. Less than 10 percent of the labor force with lower secondary or lower education are employed, while 76 percent of those with university education are employed. But the principal economic benefits of higher education are largely captured by individual graduates in the form of higher wages. The 2008 BEEPS found that the average wage for high skilled labor is not only considerably higher than the wage of unskilled workers but even higher than the wages of skilled workers in the rest of southeast Europe. This suggests that the majority of university costs should be ultimately financed by the students, rather than by the taxpayers.

*World Bank, 2009, *Business Environment Enterprise Performance Survey (BEEPS) 2008 Brief Analysis Kosovo*.

39. This does not, however, suggest that subsidies should be increased immediately. Even within the education budget, Kosovo has more pressing priorities, given the extent of overcrowding in basic schools and expected growth in the enrollment at upper secondary level. The quality improvement and upgrading of the existing private TEIs to Type A institutions would help increase the overall higher education enrollment capacities without increasing the Government budget. There is also an economic case for restraining subsidies to higher education. As described in Box 4, there are high private returns to higher education. As a result, students (and their families) with the means to pay a significant proportion of the costs of their tertiary education should be expected to do so. Evidence from the fledgling private sector suggests that some students are willing and able to pay annual tuitions as high as €1,200-1,700—more than ten times the tuition for a full time student at the University of Pristina.

40. The Government, however, is moving in the opposite direction. In 2008, revenues from tuitions and administrative fees generated €8.277 million, or about 42% of the UP's total income. Roughly €2.83 million of this was generated from tuitions alone. Of this amount, in turn, roughly 43% was generated from self-financed full-time students who paid an average annual tuition of €770. Another 24% was paid by part-time students (at an average annual tuition of 770). Subsidized full-time students, although accounting for 75% of the student body, accounted for only 35% of tuition revenue. The government has now reduced tuitions for all three types of students. As of the 2008/09 academic year, it entirely abolished the category of 'full-time self-financed students'. All full-time students are now subsidized. It also reduced the average tuition for full-time subsidized students from €130 per annum to €100 per annum. And it reduced the tuition for part-time students from an average of €730 per year to a uniform €500. As a consequence, tuition revenue dropped by 40% in the 2008/09 academic year.

41. Across-the-board cuts of this magnitude are unjustifiable. Raising tuitions, on the other hand, runs the risk of excluding students from low income households. But such cases could be subsidized through individual mean-tested grants, rather than across the board tuition subsidies. The UP, in fact, already provides full or partial tuition fee waivers to certain categories of students, including students whose families are recipients of social assistance grants, and students who are war invalids or whose parents died in the 1999 conflict. Such subsidies could be extended to take in a wider range of students. The Government is now undertaking an analysis of tuition options, in connection with a World Bank-funded Institutional Development for Education Project. This is expected to provide specific recommendations on the design of tuition subsidies.

Health

42. Kosovo has the worst health outcomes in the Balkans. As shown in Table 6, on every indicator—life expectancy, maternal death rates, infant and child mortality, immunization rates and tuberculosis incidence—Kosovo ranks far below neighboring countries, often by a factor of two. Infant and child mortality rates, which are twice as high as in neighboring countries, result from readily preventable problems—perinatal conditions, respiratory diseases and diarrhea. Communicable diseases and malnutrition are still common among vulnerable groups. About one-third of children under-five suffer from vitamin A deficiency, and 20 percent have stunted growth. Environmental problems such as air pollution, waste management and heavy metal pollution affect the population's health: the Mitrovica municipality reports the highest blood lead levels in the world.[43] On average less than 50 percent of households are connected to public sewage, which drops to 7 percent in rural communities. Given the rate of progress in providing basic services, Kosovo is unlikely to meet the 2015 Millennium Development Goals (MDG) targets.

Table 6. Health Indicators for Kosovo and Neighboring Countries, 2007

Indicators	Kosovo	Serbia	Albania	Bosnia	Mace-donia	EU
Life expectancy at birth, total (years)	69	74	76	n/a	n/a	79
Maternal deaths (per 100000 live births)	28.4*	12.68	16.75	n/a	13.34	6.01
Infant mortality (per 1,000 live births)	20.6*	7.11	7.8	n/a	n/a	4.56
Under 5 mortality (per 1,000)	69 (2002)	8.14	12.4	n/a	n/a	5.47
Immunization, measles (percent of children)	<80	92	98	83.5	98	92.8
Tuberculosis incidence per 100000	52 (2005)	26.6	13.9	60.5	25.7	15.5
UNDP Human Development Index (HDI)	0.734	0.821	0.807	0.802	0.808	n/a

Source: WHO health for all data 2006; UNDP Second Millennium Development Goals Report for Kosovo 2008; MOH: Perinatal situation in Kosovo 2000-2008.
*Note: Infant deaths (proxied by perinatal deaths) and maternal deaths in Kosovo include only deaths in health facilities.

[43] UNICEF: www.unicef.org/kosovo.

43. The infrastructure of public health care in Kosovo consists of the central University Hospital of Pristina, seven regional hospitals owned by the Ministry of Health, and a network of primary health centers (PHCs) owned by the municipalities. As shown in Table 7 the Government budget is the primary on-budget source of financing for the public health care system. (Unlike neighboring countries, Kosovo does not have a health insurance fund financed from employee contributions.) Of the €94 million in public sector expenditures in 2008, 93 percent came from the government budget. The Government's budget support for hospitals takes the form of direct transfers from the Treasury. Funding for PHCs is provided on the basis of formula- driven transfers to their respective municipal owners. In addition, patients are supposed to pay user fees for health services and drugs in hospitals and primary care centers, based on the price list issued by the MOH, and with exemption for lower-income groups. These accounted for the remaining seven percent of on-budget financing and are considered 'own source revenues'.[44]

Table 7: Level of Health Spending, Country Comparison

Health expenditure, 2006	Kosovo (2009)	Alba-nia	Roma-nia	Turkey	Bulgaria	B&H	Mace-donia	Serbia
Public (% of GDP)	2.3	2.4	3.5	3.5	4.1	5.2	5.6	5.7
Public (% of total gov't expenditures)	7.6	8.6	12.4	13.9	12.1	14	15.8	15.1
THE per capita (current US$)	108	187	256	352	297	296	249	336
Private (% of THE)	38.5	62.7	23.1	27.5	43.0	44.8	29.4	30.3

Source: WHO health for all database 2006: http://www.euro.who.int/hfadb.

44. A large proportion of total health care spending in Kosovo, however, occurs outside the budget, in the form of out-of-pocket payments by private individuals. As shown in Table 8, such payments are believed to account for nearly forty percent of total health spending in 2008.[45] Much of this amount is most likely spent on informal payments to health staff working in the public sector and for the purchase of drugs and supplies (disinfectant, cotton swaps, and clean needles) which are out of stock in public facilities and must be purchased—at considerable markups—by patients themselves. Some is also spent on care in private facilities and abroad.

[44] The lack of a robust, standardized data set to measure the actual service delivery performance in Kosovo makes policy analysis difficult. The existing data on the population's demographic characteristics, health status and service use are highly contradictory. A Health Management Information System (HMIS) for Primary Health Care (PHC) is being developed and implemented with the support of the Government of Luxembourg starting in Prizren. Hospital performance data is collected by hospitals and available to the MOH. Administrative data collected from PHC is incomplete since 2007 as several municipalities have not sent the required data to the Institute for Public Health (IPH) for compilation. The first and only National Health Accounts (NHA) audit was conducted in 2005 providing first time detailed information on the flow of funds from all sources to users in the health sector. Without consistent and accurate data on the effectiveness of health services, it is difficult for the Government to know which services are under-performing, and consequently develop policy measures to act on.

[45] This figure is derived from household budget survey (HBS) data. The 2008 HBS estimates that households spend about 2.3 percent of total consumption expenditure on health. This suggests total private spending of €56 million in that year. In Government administrative data, however, hospitals reported patient revenues of only €1.13 million in 2008 and municipalities declared own source revenues (OSR) on health from patient payments of €4.4 million in 2008. The difference–€51 million–is presumed to be paid by patients in other forms, as noted in the main text.

Table 8. Trends in Health Expenditures in Kosovo

	2005	2006	2007	2008	2009*
Total health expenditures (€, mln)	107.80	115.05	121.21	136.15	158.22
→ Public spending	71.40	71.80	67.43	78.39	89.28
→ Private out-of-pocket	30.80	42.81	52.81	56.64	62.01
Of which:					
Patient payments in hospitals		2.22	0.61	1.13	2.31
Patient payments in PHC centers		2.59	n/a	4.40	2.71
Patient payments not accounted for		*37.99*	*n/a*	*51.11*	*55.58*
→ Donors (off-budget)	5.60	0.44	0.97	1.12	6.93
Public spending on health					
In % of GDP	2.9	2.3	2.0	2.0	2.3
In % of total government expenditures	9.7	10.0	10.2	8.3	7.6

Sources: Public: Treasury data; Private: Kosovo household budget survey, Donors: direct interviews. 2005: National Health Accounts (NHA).
*2009: budget for public and donors; and extrapolation for private OOP. SOK: Kosovo household budget survey 2008; MOH and MLA.

45. The level of Government spending on health is the lowest in the region. As shown in Table 8, spending in 2009 was equivalent to 2.3 percent of GDP, close to the level of Albania (2.4 percent) but far below the level of former Yugoslav republics or recent EU accession countries. While health spending as a percent of GDP has remained stable over time (see Table 8), it has declined as a percent of government spending over the last five years. From 2005-2007, Kosovo spent about ten percent of general government expenditures on health, corresponding to about €33 per capita per year. Since then, the proportion has fallen steadily, to 8.3 percent in 2008 and 7.6 percent in 2009. Unlike other countries in the region, the Government does not appear to be taking advantage of rising revenues to increase spending in the sector.

46. Even this modest sum is badly spent. This is evident in several respects. First, facilities are underused. As shown in Table 9, utilization rates in hospitals and PHC facilities are low compared to other countries. Hospital bed occupancy rates in Kosovo averaged 58 percent in 2008, well below the levels of recent EU members, including Slovakia (68%), Hungary (69%), and Estonia (71%), as well as Serbia (69%). Even at the University of Pristina hospital, an average of only 74 percent of beds were occupied in 2008. PHC centers report similarly low utilization rates, with an average of only 1.9 visits per capita per year. As shown in Table 10, this is slightly above the level in Albania but far less than in Turkey or the former Yugoslav republics.

Table 9. Utilization of Hospital and Outpatient Care, Country Comparison

Utilization	Kosovo	Albania	Turkey	B&H	Macedonia	Serbia
Hospital admission per 100 population	7.9 (2008)	8.7	10.5	8.2	9.4	14.3
Outpatient visit per capita per year	1.9 (2006)	1.4	5.6	3.3	6	8.9

Source: WHO health for all database 2006: http://www.euro.who.int/hfadb. Data is for 2007 or most recent year.

47. There is also evidence of overstaffing, at least at some levels. Kosovo's health employment density is six health staff per 1000 population in 2009. This is considerably higher than the density of 4.4 reported by Turkey in 2004. Of the total health workforce, only 16 percent are physicians and 44 percent, nurses. The remaining 40 percent are non-medical support personnel. While the ratio of physicians to population is low compared to other countries and the number of nurses has dropped substantially (from 7,700 nurses in 2003 to 5,857 nurses in 2008) the number of non-medical staff appears to be relatively high.

48. Wage levels, on the other hand, appear to be inadequate. As shown in Table 10, the ratio of health care salaries to per capita GDP—a standard measure used in international comparisons—is much higher in Kosovo than in the three comparator countries for which data is available. This comparison is affected, of course, by the higher per capita GDPs in the comparators. In absolute terms, the salaries of medical professionals are not particularly high. The current compensation of a general practitioner—a base salary plus a €44 monthly allowance—is below the average salary in the economy (approx. €300). Many health professionals continue to work in the public sector only because they can generate additional income from private practices and from informal fees they charge to patients. The Ministry of Health would like to increase base salaries of government doctors in the course of a pay and grading reform for health staff. While this could lead to an increase in the wage bill, it would be a necessary precondition for proposed crackdowns on dual employment and informal payments.[46]

Table 10. Remuneration of Health Professionals / Capita GDP, Country Comparison, 2007/08

	Base salary, month	Salary/GDP per capita			
Health professional	Kosovo 2008	Ko-sovo	Slo-vakia	Czech Rep.	Hun-gary
Nurses	€176	1.19	0.7	0.8	0.8
Specialists	€273	1.85	n/a	1.4	1.6
General Practitioner (GP)	€234	1.59	1.3	n/a	1.6

Source : OECD Health Data 2009 for Slovakia, Czech and Hungary.

49. The Government pays too much for pharmaceuticals. All pharmaceutical procurement is conducted by the MOH. Although medicines are purchased through open tenders and the Kosovo Medicines Agency (KMA) has licensed 56 wholesale providers, competition is limited. In 2007 only 42

[46] The MOH would like to increase the base salary to €500 for specialists, €400 for GPs, €250 for nurses and technicians, and a 30% increase in the base salary of administrative staff + €44 allowance for admin staff only.

percent of tenders attracted three or more bids. As there is no reference pricing system for pharmaceuticals, Kosovo may be paying more than necessary even for drugs that are purchased on the basis of multiple bids.[47]

50. The Government also spends too much on medical technology. Against the advice of the Master Plan, the MOH has invested substantially in high-cost medical technology over the past years. The Master Plan recommends only three CTs and one MRI for Kosovo, given the small geographic size of the country. The MOH, however, has ignored this recommendation. The Government now owns eight CTs and one MRI and plans to purchase a linear accelerator.[48] The uncoordinated way in which technical equipment is acquired means that maintenance is difficult and expensive, breakdowns are frequent, and the necessary staff has to be identified, hired and trained to operate equipment (including specialists such as physicists not available in Kosovo). Adding more CTs and MRIs would result in high-cost medical equipment standing idle and would waste scarce resources. Any capital investment planning for health infrastructure should instead be guided by the recommendations in the Health Sector Master Plan.[49]

Table 11. Government Health Spending on Treatment Abroad €, 2006-2009

Treatment abroad	2006	2007	2008	Jan-Oct 2009	Total
Number of cases treated	73	110	433	297	913
Average costs per case, in €	6,135	6,355	6,034	6,583	6,259

Source: Ministry of Health and Ministry, Kosovo, 2009.

51. Finally, too much is spent on medical treatment abroad. On average, the Government spends approximately €6,300 per case sent for treatment abroad. (Table 11) Although this may be less expensive than investing in tertiary care to deliver these services in Kosovo, it is a benefit that is largely confined to the well off. Since patients still have to co-pay for travel expenses and accompanying costs, this program is only available to patients who can afford paying for these expenses. Any restructuring of the PUH should thus aim at reducing the number of patients who need to go abroad for treatment.

52. ***Immediate Reforms.*** In the short run, there is a need for action on several fronts. One is staffing. The MOH should restrain any growth in the number of non-medical staff. While the number of physicians and nurses falls within international norms, the number of non-medical staff is excessive. The Government should also consider outsourcing certain functions. The Quick Gains study recommended that the MOH and municipalities contract out maintenance and services such as cleaning, laundry and food preparation in their respective hospitals and PHCs, in order to spur efficiency and reduce costs. Such arrangements should use standard framework contracts with a maximum duration of 24 months. As outsourcing does not *always* result in lower costs, it should be preceded by a cost cost-effectiveness analysis, conducted by the MEF.

[47] Review of the Public Purchasing System and Opportunities for Quick Gains Savings in Kosovo. The World Bank, Sept. 2009.

[48] Private sector providers offer an additional 12 CTs and 2 MRIs.

[49] Coper, Leone and Andrew Parkes, *Health Sector Master Plan* February 2009.

53. Reforms are also required in the procurement of pharmaceuticals. The Government should continue to procure essential products centrally. But to improve competition and reduce prices, it should:[50]

- Establish a standard process to determine reference prices (price benchmarks).
- Provide public access to contract awards and contract administration, including information related to the price of each medicine.
- Base the quantities to be purchased on competent demand analysis.
- Expand the number of bidders by announcing simplified contract notices in international newspapers and contacting the European Federation of Pharmaceutical Industries and Associations (EFPIA) the International Federation of Pharmaceutical Manufacturers and Associations (IFPMA) and other similar institutions.
- Use the "lowest priced eligible tender" as the appropriate contract award criteria.

54. To restrict excessive purchases of high cost medical technology, the Government should confine purchases to those recommended in the Master Plan. The Government could also negotiate service contracts with private providers as an alternative to purchasing high-cost medical technology outright.

55. ***Reforming the Payment Systems.*** Over the medium term, Kosovo needs to address more fundamental problems arising from the incentives confronting the managers of hospitals and PHCs. The current hospital payment mechanism does not reward performance. Hospitals are funded through an annual line-item allocation intended to cover operating costs. The amount allocated to each hospital is based on input factors such as bed- and staffing norms, encouraging hospitals to employ more inputs (e.g., staff) rather than maximizing the volume or quality of services they produce. To address this problem, most European countries have moved to some form of case-based payment system. Some, for example, reimburse hospitals on the basis of the volume of specific diagnosis-related groups of treatments (DRG) they provide, thus directly paying hospitals on the basis of volume. Kosovo is not yet ready for a full implementation of a DRG-based payment system. Such reforms would have to be accompanied by institutional reforms, including increased hospital management autonomy and investments in information systems. But the MOH could consider piloting these reforms in one regional hospital with the support of the donor community before introducing it in all hospitals.

56. At the same time, hospital management should be professionalized. In most health centers and hospitals in Kosovo, the director position is held by a physician who divides his time between management tasks and professional activities as a medical staff. As health facilities receive more management autonomy, managers will become responsible for making decisions regarding the financing and structure of a facility. They will need to evaluate procedures and health care efficiency to analyze the effectiveness of various departments and work to reach financial goals and maintain budgets. Hospital managers should thus be required to have either a Master's of Health Administration or a Master's of Business Administration with professional

[50] Review of the Public Purchasing System and Opportunities for Quick Gains Savings in Kosovo, The World Bank. Sept. 2009.

knowledge in financial analysis, management, economics, health care and health policy. Also, hospital management is a full-time job. Directors should not be allowed to see patients.

57. ***PHCs.*** More immediate steps can be taken to improve the incentives confronting primary health clinics. At present, the health grant for PHCs is distributed on a simple capitation basis. The amount is defined by the Grants Commission[51] and uses a formula consisting of the estimated number of annual visits to all health centers (2.8 visits per capita), the cost of each visit (€3.90) and the estimated population living in the facility catchment area. Starting in 2009, a five percent performance element was supposed to be introduced into the formula. The PHCs, however, failed to submit the required performance data. As a result, the total grant (the health grant plus performance element) continued to be allocated to municipalities' health directorates as an equal amount per capita. In 2009, the total allocation was €10.28 per capita, somewhat less than the amount dictated by the formula (€11.46) This is budgeted to increase to €11.10 per capita (net of any performance payment) in 2010.

58. The Government should act immediately to operationalize the performance grant. Individual PHCs are supposed to report their performance data to the Institute of Public Health (IPH), which is responsible for analyzing and submitting PHC performance results for payment. To encourage PHC centers to submit the required data, the 2010 performance payment should be paid only to municipalities that have done so. This data would include the 2007, 2008 and 2009 figures for PHC utilization and morbidity in line with WHO requirements. Data would not be considered valid until it has been approved by the IPH and audited by an independent agency, separate from the Ministry of Health. To permit PHC managers to respond to this incentive, their management autonomy should be expanded. They should be allowed to make decisions about staffing, pharmaceuticals, maintenance and service provision. Regular performance and financial audits of health facilities would enhance the management's incentive to perform well.

59. The MOH should also require each PHC to set up a patient registry, in order to ensure that capitation payments reflect the volume of services they actually provide. In the absence of a recent census or a patient registry system, funding for PHCs is, in effect, allocated on the basis of purely hypothetical population estimates. Facilities located in areas that have lost population are presumably overpaid and those in places that are growing are underpaid. But population figures, even if they were accurate, would not necessarily reflect the volume of patients served by a given PHC. Some patients seek treatment in other municipalities; some in the private sector. To address this problem, each PHC should be required to establish a patient registry. The capitation amount would be determined on the basis of the number of individuals registered with the facility, rather than the population of its catchment area.

60. The amount of the capitation payment itself should be reviewed. It is not clear, at this point, if amount of the payment in per capita terms matches the actual cost of delivering the package of primary services to which patients are entitled. Inter alia, the grant may have to be increased to reflect Government-imposed increases in factor costs, such as the proposed increase in the wages of medical professionals. Once better data are available, the capitation amount should be adjusted to better reflect variations in the costs of providing the standard package of

[51] Kosovo Law on Local Government Finance, 2008, Art. 25.5.

primary services, such as those that arise from variations in the age/gender characteristics of the registered population and those imposed by each facility's geographical situation.

61. ***Reorienting Health Care.*** In the final analysis, the MOH will also need to change the fundamental orientation of its health interventions: toward prevention and toward the poor. Given the health profile of Kosovo, such interventions should include anti-smoking campaigns, food handling education program, road safety programs, workplace injury prevention, communicable disease prevention, diabetes management, and cardiovascular risk reduction, as well as the enforcement of environmental and sanitary legislation.

62. The Government should also shift the orientation of health spending toward the poor. The poor suffer most when the public health care system does not deliver. The MOH should therefore target health services to low-income areas and ensure the availability of medical material and pharmaceuticals in health facilities in poorer areas, and in facilities where Roma seek care. The MOH could also target specific health programs, including reproductive health care, nutrition, and Tuberculosis and HIV/AIDS prevention to lower-income groups. The next household survey should include a health module to better understand inequalities in care-seeking behavior and financing of health care.

63. ***Health Insurance?*** In April 2006, the Kosovo Assembly approved a health insurance law, which would have introduced a contributory system for health financing based on payroll taxes. Fortunately, the law was later withdrawn. Kosovo is not yet ready for a contribution based health insurance system. This is in part because so much of the labor force works outside the formal sector. The burden of insurance contributions would therefore fall on the relatively small proportion of the labor force on which contributions could be imposed. This could, in turn, discourage firms from hiring staff on a formal basis. It is also not clear that the Government yet has the capacity to implement and manage such a fund.

64. Instead, the Government should continue to finance health expenditures from budgetary revenues. It should, however, consolidate the various existing funding flows into a single pool to pool risks. Over time, the expansion of formal sector employment, combined with institutional reforms recommended above—increased management autonomy at the facility level, output based financing—could provide the basis for an insurance based health care model.[52] But not yet.

Social Protection

65. The main components of Kosovo's social protection system are a tax-financed pension, a supplementary contributory pension, a tax-financed disability pension (benefit), a targeted social assistance program and various war veteran-related benefits. In addition to these cash transfer programs, the overall safety net also includes social services for families and individuals at risk, delivered by a network of Centers for Social Work (CSW) and Departments of Social Welfare in the municipalities. National and international NGOs participate in the

[52] The Ministry of Health has commissioned a study of options for providing a more secure source of financing for the health care sector. Its report is expected in June of 2010.

delivery, and sometimes also in the financing, of social care services. Informal safety nets such as remittances also play an important role.

66. Overall, Government spending on social protection is fairly modest. In 2008, spending on social protection, including pensions, was equal to only 3.6 percent of GDP. (In 2009, it was expected to increase to 3.8 percent of GDP.) In Albania, in contrast, it was seven percent of GDP; in Montenegro, 12 percent, and in Serbia, 16.5 percent of GDP. Spending on social protection consumed about fifteen percent of consolidated government expenditures in 2008. As shown in Table 12, pensions consumed the largest share of this: about sixty percent. Social assistance consumed about 25 percent; and veterans benefits, the remainder.[53]

Table 12. Composition of Social Protection Spending

	2008, Euro	% of total	2009*
TOTAL, o/w	134,568,308	100.0%	145,714,500
PENSIONS, o/w	80,526,060	59.8%	88,141,784
Basic pension	65,873,400	49.0%	58,970,660
Early retirement benefit	2,775,750	2.1%	4,326,660
Contributory pension	11,876,910	8.8%	24,844,464
SOCIAL Assistance, o/w	36,164,536	26.9%	37824560
Last-resort income support	26,118,836	19.4%	27,300,000
Disability benefits	10,045,700	7.5%	10,524,560
WAR VETERAN BENEFITS, o/w	17,877,712	13.3%	19,748,156
Families of martyrs	5,753,835	4.3%	
War invalids	2,273,071	1.7%	
Civilian invalids as a result of war	1,769,169	1.3%	
Civilian victims of war	7,591,750	5.6%	
Caretakers for war invalids	24,665	0.0%	
Caretakers for families of war invalids	23,966	0.0%	
Others	441,256	0.3%	

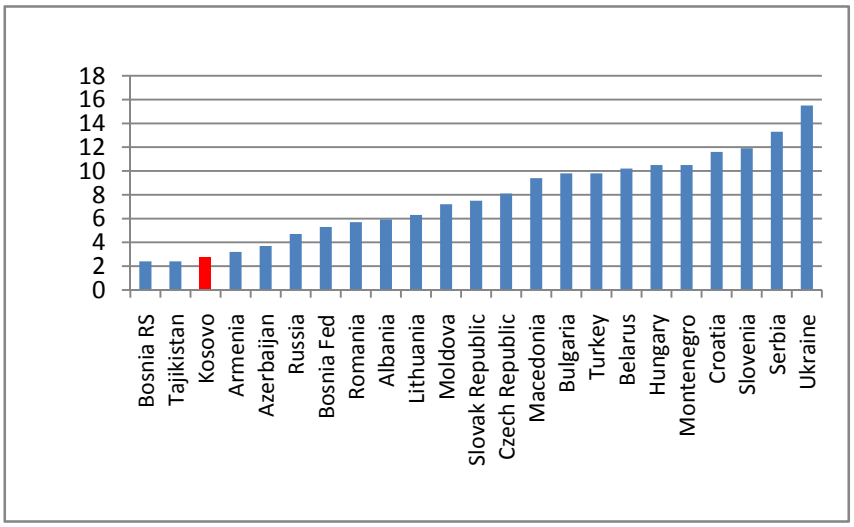
*Budget.

[53] The safety net also includes Government financed social services for families and individuals at risk which are delivered by a network of Centers for Social Work (CSWs), and active labor market policies. National and international NGOs participate in the delivery, and sometimes also in the financing, of social care services. Informal safety nets such as remittances also play an important role.

Pensions

67. Kosovo's pension system is comprehensive yet cost effective. The entire pension system, including disability pensions, currently costs the Government about 2.7% of GDP. As shown in Figure 5, this is less than in nearly every other country in the region.

Figure 5. Pension Spending as Percent of GDP



68. The low cost of Kosovo's pension system is an unintended consequence of the war. Prior to the war, workers and retirees in Kosovo participated in the former Yugoslav pension system. This system was a defined benefit system where retirees received benefits based on their years of service and the salaries they had earned while working. The pensions were fully indexed to wage growth so that the living standards of the elderly kept par with the living standards of the working age population. It was a generous system with men able to receive 85% of their wage after 40 years of contributions and women the same with even fewer years of contributions. Retirement ages were low, at 58 for men and 53 for women. In addition, special privileges were granted for a wide range of workers, allowing them to retire with more generous benefits and earlier than the specified retirement age. The system was financed on a pay as you go basis (PAYG), where contributions from current workers, set at 31% of wage, were used to finance pension benefits for beneficiaries.

69. Even without the war, the system would have been unsustainable. There are several reasons. First, the benefit level was too high. The average western European system provides a benefit (replacement) rate of about 60% or less after 40 years of contribution, indexed after retirement to inflation, not the 85% promised by the former Yugoslav system indexed after retirement to average wage growth.

70. Second, the process of economic transition was leaving the former Yugoslavia with a relatively high proportion of its older population eligible for pension benefits and a relatively low proportion of the working age population contributing to the pension system. In the former Yugoslavia, a majority of the labor force was employed in state- and socially-owned enterprises.

As contributors to the pension system, they were eligible for benefits on retirement. The transition process (exacerbated, in Kosovo, by the war) resulted in the closure of large state-owned enterprises, rising unemployment and the growth of an informal labor market. While new privately owned enterprises sprang up, enforcing pension contributions legislation against them has proven difficult. As a result, pension obligations were rising while pension contributions were falling.

71. Other former Yugoslav republics are still struggling with this problem. Kosovo was forced to address it immediately. With the collapse of much of the formal economy, and along with it, pension contributions, tax revenues (and the disappearance of most pension records) the successor administrations had no way to fulfill the obligations of the former pension system. Under these circumstances, the decision was made to abandon these obligations and instead provide all old people (ages 65 and above) with a monthly benefit equal to the extreme poverty line. This was to be financed out of the budget. The basic pension was initially set at €28 per month in 2002. It was supposed to be indexed annually to inflation (according to the law) but has instead been adjusted irregularly. The level was raised to €40 per month in 2005 (which was roughly equal to the overall poverty line), and again to €45 in 2009 to accommodate accumulated inflation since 2005. This basic pension is currently being paid to 128,000 people and costs the Government approximately €65 million per year.

72. In addition to the basic pension, an administrative act issued by the Government in 2007 permits people who can demonstrate that they made at least 15 years of contributions under the old system to receive an additional €35 on top of the basic pension. A budgetary cost of about €13 million has been designated to cover this additional benefit which goes to about 28,000 pensioners.

73. In addition to these two pensions, workers below the age of 55 are required to put 10% of their wages (half paid by the employer and half by the employee) into a new institution, the Kosovo Pension Savings Trust (KPST).[54] These contributions are deposited in individual accounts and invested on behalf of the workers. Interest earned on contributions is attributed to the individual accounts. When the worker reaches retirement age, the total amount in the individual account, contribution plus interest, becomes available to finance retirement for the worker. While the balances are eventually intended to be annuitized, an annuity market does not yet exist in Kosovo. Since the balances of those reaching retirement are still small, KPST is providing monthly amounts of €100 until the funds in the account are exhausted, with unused funds continuing to draw interest. Unlike the former defined-benefit pay-as-you-go-financed pension system of the former Yugoslavia, this second component generates no fiscal liabilities for the Government. People receive only the value of their own accumulated assets.

74. The funded pillar in Kosovo, managed by KPST, had 286,908 contributors at the end of November 2009 with assets under management of €361.2 million in November 2009. Benefits were paid to 3,491 individuals totaling €3.2 million. Its contributors are estimated to represent about 31% of the employed in Kosovo, with the remaining employed working in the

[54] Older workers could contribute to the KPST on a voluntary basis, but it was considered unfair to require them to contribute as they were unlikely to build up a sizable pool of savings before retirement, particularly since part of the contribution financed the administrative costs of the system.

informal sector, although precise numbers are difficult to obtain in Kosovo given the lack of a census. About 10% of the money collected each year is not immediately allocated to participant accounts due to information problems but the KPST is working to resolve this problem and to allocate this money to the individual accounts.

75. KPST is regulated by the Central Bank and managed by a seven member Board of Governors, four of whom must have a minimum of 10 years professional experience in finance, economic, or pension studies. Under its authorizing legislation, KPST is allowed to invest in 5 classes of international instruments and 4 classes of domestic instruments.[55] Of the domestic instruments, only certificates of deposit currently exist in Kosovo, although the new debt law will allow government authorities to issue debt. At end-2008, 7.1% of the total portfolio under management was invested in certificates of deposit at Kosovar banks, namely Raiffeisen Kosova and ProCredit Kosova.[56] All of the remaining portfolio was invested abroad. Administrative costs of one percent of assets were typically charged to each account, although the administrative charges were reduced to 0.9 percent of assets in 2008 and a proposal has been sent to the Assembly to reduce the costs to 0.8 percent of assets in 2010. These costs cover the fees paid to asset managers, staff salaries and equipment and the cost of annually printing and mailing out statements to each contributor.

76. Although KPST's financial performance has been affected by the financial crisis, it has generally performed well. Prior to the crisis, KPST was listed among the top three small European pension funds by the well-known trade publication, Investment and Pensions Europe. The global financial crisis hit the assets of KPST hard as it did all financial assets invested in capital markets. The share price fell from €1.22 to a low of €0.86, a decline of 29.4 percent in 2008. The share price has since rebounded to €0.96 by November 2009, still well below its pre-crisis level. KPST also made the decision to pay all those cashing out their pension accounts in 2009 at least the value of the nominal contributions they had made so that beneficiaries did not face the full brunt of the financial crisis. These funds were paid out of the surplus in administrative fees. The current arrangement with KPST nevertheless appears to be working well. Despite the hit from the global financial crisis, the KPST portfolio is in position to gain when global capital markets recover. Experience from past crises suggests that the recovery can be as strong, although over a longer time frame, as the initial downturn.

77. There is some risk that the Government, using its new authority to issue debt, might pressure KPST to over-invest in Government bonds. Fortunately, a new draft pension fund law

[55] Permissible international investments include bank accounts and deposits in banks regulated by a banking authority in an OECD country, securities issued by OECD governments, securities issued by local governments of OECD countries if guaranteed by national government, securities registered with an OECD securities market regulator and which are listed on a stock exchange regulated by an OECD securities market regulator, and mutual and investment funds established in OECD countries. Domestic instruments are limited to bank accounts and deposits with banks licensed by the Central Bank of Kosovo, securities by the Kosovo Government, corporate securities registered with the securities regulator of Kosovo and listed on a licensed exchange and mutual and investment funds regulated by a competent authority in Kosovo.

[56] The term for the Board of Governors also expired in September 2008 and the Assembly did not vote in a new Board until April 2009. Without a Board, the management of the KPST could not invest any of the incoming contributions, resulting in 14.2% of the total portfolio being held at the Central Bank of Kosovo at end 2008, up from 2.5% the previous year.

will allow the Central Bank, as regulator, to draw up a list of permissible investments for KPST and set maximum limits for investment in each type of asset. The regulations should balance Kosovo's domestic investment needs with the need to ensure safety of principal and reasonable rates of return for workers.

78. ***Performance.*** Before proceeding to an evaluation of the current pension system, it is worth reviewing its objectives. Pension systems have two primary objectives. The first is poverty reduction—specifically, to alleviate poverty in old age. The second is more subtle: to encourage people—even middle class people—to set aside money during their working lives to help finance their retirements. While one might think that such decisions should be left to individuals, experience has shown that working people tend to under-save and then lobby for Government aid once they leave the active labor force. Mandatory pension contribution system can alleviate this risk.

79. The poverty alleviation objective is well addressed in the Kosovar pension system through the basic pension. The current policy allows all old people in Kosovo to maintain a minimum living standard. In fact, from this standpoint, the coverage of Kosovo's basic pension system is better than in neighboring countries which rely on contribution-based pension systems. As only 30-50 percent of the current working age population in these countries is employed in jobs paying contributions, in 20 years some 50-70 percent of their populations will reach retirement age without any provision for old age security.

80. Improvements could, nevertheless, be made. To ensure that the level of benefits keeps up with inflation, the Government should adjust levels annually, as required by law (but not done in practice). Budget resources permitting, the level of the basic pension should be raised to match the poverty line, which includes non-food necessities as well as the food requirements now captured in the extreme poverty line.

81. For the objective of encouraging savings for retirement, Kosovo currently has the funded, defined contribution system managed by KPST. In pension parlance, KPST is a second pillar pension. As such, it has two features which distinguish it from the basic pension. First, it is funded from employer and employee contributions rather than from taxes. Second, the level of benefits accruing to an individual retiree reflects his/her lifetime contributions to the system, rather than his/her financial situation at the time of retirement or any government-guaranteed level. This has three important implications. First, it relieves the government of any obligation, either to contribute to the system or to guarantee any particular level of benefits to retirees. Second, it meets no explicit redistributive objective. People who have contributed little to the system during their working life can expect to receive little from it once they retire. Third, it changes the nature of the risk borne by workers, making it dependent on the performance of the financial market rather than the political risks inherent in a collective pension scheme.

82. Second pillar pensions have become increasingly popular in Europe as the actuarial soundness of defined benefit pension systems has declined. More so than in Kosovo, these countries are in the midst of a demographic transition. As birth rates fall and life expectancies increase, the number of active workers contributing into existing unfunded pension systems has declined while the number of retirees drawing benefits from them have increased. In response,

fourteen central and eastern European countries have already introduced funded components to their pension systems. As shown in Table 13, the majority of workers in Bulgaria, Romania, Poland, and the Baltic countries are covered by second pillar pensions, as are 45 percent of the workers in Hungary and 25 percent of those in Macedonia. Western European and non-European OECD countries are also moving to add funded components to their pension systems and many have already done so.

Table 13. Second Pillar Pensions in Eastern Europe

Country	Starting Date	First (or Zero) Pillar	Size of Second Pillar as Percent of Payroll	Projected Pension Fund Assets in 2020 as Percent of GDP	Share of Workforce in funded Pillar in 2003/6	Switching Strategy to New System
Hungary	January 1998	PAYG DB	8 percent	32 percent	45 percent	Mandatory new entrants Voluntary others
Poland	January 1999	PAYG DC/NDC	7.3 percent	34 percent	70 percent	Mandatory <30, Voluntary 30–50
Latvia	July 2001 (NDC January 1996)	PAYG DC/NDC	4 percent growing to 10 percent by 2010	25-30 percent	72 percent	Mandatory <30, Voluntary 30–50
Croatia	January 2002	PAYG DB	5 percent	25 –30 percent	60–70 percent	Mandatory <40, Voluntary 40–50
Bulgaria	January 2002	PAYG DB	5 percent		70 percent	Mandatory <42
Estonia	July 2002	PAYG DB	6 percent	20 percent	75 percent	Voluntary (opt-out +2 percent)
Russia	January 2002	PAYG DC/NDC	4 percent (6 percent in 2008)	n.a.	33 percent	Mandatory <50
Kosovo	January 2002	Universal/min. consumption basket level	10 percent	8 percent (end-2006)	30 percent	Mandatory
Lithuania	January 2004	PAYG DB	5.5 percent	35-40 percent	55 percent	Voluntary
Slovakia	January 2005	PAYG DB	9 percent	20 percent	73 percent	Mandatory new entrants
Macedonia	January 2006	PAYG DB	7.12 percent	26 percent	25 percent	Mandatory new entrants
Romania	Registration completed Contributions beginning with June 2008	PAYG DB	2 percent in 2008 growing gradually to 6 percent until 2016	9 percent	65 percent (from the total of PAYG)	Mandatory <35 Voluntary 36-45

83. Overall, Kosovo's present pension system can be considered to adequately perform its essential objectives. It provides both poverty relief for the elderly and a mechanism to encourage active workers to save for retirement, without creating unsustainable fiscal liabilities for the Government. It is, nevertheless, under attack. Existing retirees and soon-to-be retirees complain that it cheats them of pension rights they acquired while contributing to the former Yugoslav pension system. As noted earlier, in Kosovo the contributions and rights of current and soon-to-

be pensioners, accumulated under the former Yugoslav system, were not preserved. All old people, regardless of contribution history, receive only a €45 pension. The only concession to former contributors is the provision allowing those who can prove a history of pension contributions under the old system to receive €80 rather than €45 per month. This has provoked considerable political resentment.

84. It is true that other European countries have managed the transition to defined-contribution based pension systems more gradually than Kosovo. In most cases, when such pensions were introduced, current pensioners continued to receive the same level of benefits they had been receiving under former PAYG defined benefit system, although usually with reduced indexation. Workers who had contributed in the old system but had not yet retired received a reduced benefit on retirement, usually prorated by the years of contribution under the old system and subject to lower rates of indexation and higher retirement ages. These prorated benefits, typically called acquired rights, were partially paid by the Government, as the pension contributions of workers (and their employers') were increasingly diverted into the new, funded, system. In most of central Europe some component of a traditional defined benefit system was retained alongside the funded system, in order to provide a minimum level of benefits to the elderly poor (in the absence of a basic pension) and to diversify the sources of old age pensions so as not to force retirees to fully depend on second (or third, voluntary) pillars. A portion of employee and employer contributions was also retained, to finance the Government's existing pension obligations.

85. For Kosovo, however, this is not an option. There are two reasons. First, the documentation that would be required to equitably compensate former contributors does not exist. While some contribution records in Kosovo were copied and kept before the administration was moved to Belgrade, Kosovar workers worked all over the former Yugoslavia, and their contributions were recorded in the place where their employers were headquartered. As a result, what is available to the Kosovar authorities for verification is only a fraction of the total work histories of Kosovar citizens. In addition, work histories contained in work booklets each worker carried had to be matched against those provided by employers on their list of employees. In addition to the incomplete records held by Kosovar authorities, many individuals lost their work booklets in the context of the conflict. Second, the budget resources that would be required to pay such pensions—even if they could be determined—are not available. Kosovo is in no better position than any other member of the former Yugoslavia to pay pensions arising under the former regime. Any effort to raise such resources by, for example, imposing additional payroll contributions would be inequitable and counterproductive. The burden of such taxes would fall disproportionately on those who are employed in the so-called formal sector. It would also increase the propensity of their employers to fraudulently under-report earnings or refrain entirely from hiring employees on a formal basis.

86. The Government might therefore be well advised to counter pressure for increased compensation through increased public education. It should explain to workers and retirees what the new system is and why these decisions were taken. Retirees, in particular, need to understand that the former Yugoslav system was not sustainable, and that retirees and workers throughout the former Yugoslav system have experienced reduced benefits, and while some aspects of their situation may be unique, the Kosovar Government is building an old age system

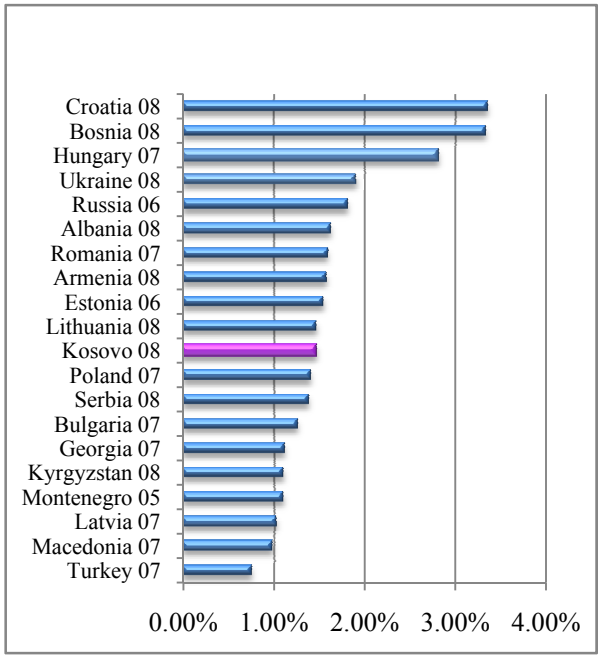
which will protect generations of future Kosovar workers without experiencing the financial sustainability problems that are currently affecting pensioners and workers in many other European countries. While current pensioners are indeed receiving less than they had expected, any attempt to provide greater benefits for those with verifiable work histories will create more inequity for those with unverifiable work histories, will potentially raise labor costs and reduce formal sector of employment even further, and will prevent the development of a sustainable pension system for current and future workers.

87. ***Latest Developments***. Under pressure from pensioners, the Government is now considering proposals to raise the level of benefits, both for the basic pension and for the contributory supplement. Various proposals are being considered with differing levels of benefit increases. One proposal would grant a flat 25 percent increase in pension benefits to all persons who can demonstrate that they contributed to the former Yugoslav system, effective in 2011. All other pensioners would receive an increase of eleven percent. The World Bank is working closely with the authorities to evaluate these proposals.

Social Assistance

88. Overall, Kosovo spends about 1.5 percent of GDP on social assistance (including veterans benefits). This is similar to the level prevailing in other Eastern European countries. As shown in Figure 6, it is higher than the spending in Montenegro and FYR Macedonia, slightly less than Albania, and considerably less than in Bosnia and Herzegovina and Croatia.[57] Within the Western Balkan region, the level of social assistance spending is strongly influenced by variations in veterans' benefits. If this factor is removed, the levels of social assistance, particularly in Kosovo and Bosnia, would be considerably lower than the level shown in the chart.

Figure 6. Public Spending on Social Assistance (% of GDP)



Source: MLSW, MFE, IMF.

[57] Comparisons are provisional because the reference countries' social assistance is comprehensive, comprising a mix of programs aimed at mitigating different risks throughout the life cycle while Kosovo operates one last resort-income support social assistance program, a disability benefit program and ten war veteran related programs.

89. Total public outlays on social assistance declined both in nominal terms and as a share of GDP in the 2005-2007 period, falling from 1.68 percent of GDP in 2005 to 1.37 percent of GDP in 2007. Total spending on social assistance has since recovered. It was budgeted to reach 1.5% of GDP in 2009 and remain at that level in 2010. The composition of social assistance spending, however, has changed drastically.

90. Kosovo has three principal social assistance programs. The largest is the so-called last-resort income support (LRIS) scheme, accounting for about half the total. The LRIS takes the form of a cash transfer to households in which one or more members qualifies either as 'dependent' or 'not able to work'. This includes persons over 65 years of age, permanently disabled adults, children under the age of 15, single parents with children under 15 years of age, and families in which all members are unemployed. As elaborated below, the eligibility criteria for the LRIS are very narrowly defined and documentation requirements are rigorous.

91. War veterans benefits are the second largest, but most rapidly growing, category of social assistance. In 2008, veterans' benefits accounted for about one third of social assistance spending. Benefits are extended to a wide range of persons affected by the war, including not only disabled veterans and the families of those who died fighting, but also civilian victims of the war and their families.

92. *Disability pensions* account for the remaining twenty percent of social assistance spending. The disability pension provides cash payments to working age Kosovars who have permanent and severe disabilities that render them entirely incapable of working.

93. As shown in Figure 7, spending on the LRIS declined rapidly from 2004 to 2008, falling from 1.1% of GDP in 2004 to 0.7% of GDP in 2009. As a result, as of 2009, the LRIS program accounted only for 47% of the total spending on safety nets, while it accounted for 73% of the total safety net spending in 2004. The number of beneficiaries (both in terms of individuals and families covered) has been declining as well (Table 14). In 2008, 35,617 families (154,768 individuals) received the benefits; down from 38,335 families (161,049 individuals) in 2007, also in contrast to 2004 when 46,444 families (184,974 individuals) were covered. The total number of individuals covered in 2008 accounted for 95% of total individuals covered under the three main programs (Table 15).

Figure 7. Trends on Spending on Social Assistance

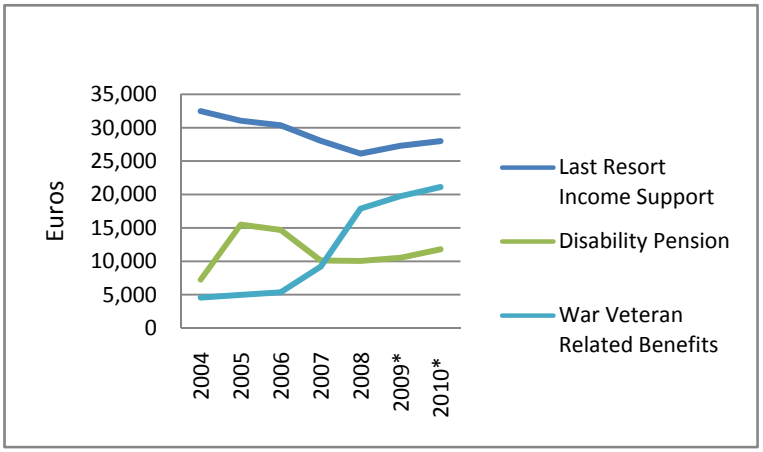


Table 14. Average Monthly Number of Beneficiaries for Non-Contributory Social Benefits in Kosovo

Programs	*Beneficiary*	2004	2005	2006	2007	2008
	Families	46,444	42,876	41,672	38,335	35,617
Last Resort Income Support	Individuals	184,974	178,121	174,131	161,049	154,768
Disability Pension	Individuals	2,867	18,861	21,760	17,595	18,605
War Veteran Related Benefits	Individuals	6,548	7,068	7,405	9,034	10,453
Total Safety Nets	Individuals	194,389	204,050	203,296	187,677	183,827

Source: Ministry of Labor and Social Welfare.

94. At the same time, the spending on the veteran-related benefits more than tripled, from 0.15 percent of the GDP in 2004 to 0.50 percent of GDP in 2009. A large portion of this increase has been due to the full implementation of the new law (Law No. 2003/23) which expanded benefits (as discussed below). Disability pensions increased from 2004 to 2005 but then declined in 2007 and have since stabilized at about 0.3% of the GDP. The initial increase from 2004 to 2005 was largely due to a new disability law becoming fully effective (the law was promulgated in November 2003, and the pensions were paid as of mid-2004) and a corresponding increase in the number of beneficiaries. The subsequent decline and stabilization appears to reflect the strict application of access rules after 2006, closer monitoring of the cases and lengthy procedures for eligibility determination and awarding benefits.[58]

95. Of the four main social protection programs—the basic pension and the three social assistance programs--only one is explicitly targeted to the poor: the LRIS. As a result, the targeting accuracy of all social protection programs as a group is modest, with only 45% of total benefits going to the poorest 20% (quintile) of the population.[59] The generosity of benefits—measured as the percent of social protection benefits in the total income of the poorest quintile—is also relatively low. Social protection benefits represent 49 percent of the total consumption of the poorest quintile in Kosovo. This is a considerably lower proportion than in most other Eastern European countries, where social protection payments (including typically generous social insurance transfers) represent 87 percent of the consumption for the poorest quintile.

96. ***Last Resort Income Support.*** The targeting effectiveness of the three programs varies substantially. The LRIS is narrowly targeted on two categories of poor families/households.[60] Category I comprises families/households where all members are qualified as 'dependent' or not able to work. These are persons over 65 years of age; adults with permanent incapacity to work; full time care givers of a person(s) with a permanent disability, or of a person(s) over the age of 65 needing full-time care, or of a child(ren) under the age of 5; children under the age of 15 or aged 15-18 if in full-time education; single parents with children under 15 years of age and

[58] The performance audit of the administration of the disability pension scheme conducted in 2008 by the Office of the Auditor General, reveals that applicants are 'experiencing severe delays in receiving a decision on their application' and that the processing time is two times higher than the provided by the law (Law No. 2003/23). Doc No. 21.7.9-2008-08, published in June 2009.

[59] Twelve percent go to the richest quintile.

[60] The latest poverty assessment for Kosovo (World Bank, 2007) estimates that 45% of the population is poor while 15% of the population is extremely poor (have difficulty meeting basic nutritional needs).

without other adult in the family. Category II comprises families/ households where along with the dependent family members there are family member(s) who are able to work. Every member of the family who is capable of working is registered with the Department of Labor and Employment of the Ministry of Labor and Social Welfare (MLSW) and is actively searching for work. Also, families belonging to Category II must have at least one child aged less than 5 years or should have full custody over an orphan aged less than 15 years.

97. In addition to the categorically determined eligibility, the families which fall within these two very narrowly defined categories are subject to rigorous income and asset tests. All types of income are taken into account, the very few exceptions being income from the basic pension, disability benefits, certain lump-sum and once-off payments to families eligible for LRIS, food grown for own consumption, and certain types of loans and grants. Incomes from basic, disability and war veteran benefits are not considered but the number of recipients of such benefits is deducted from the overall number of family members. The income test however does not capture incomes from remittances and informal work. The asset test treats as non-reckonable[61] assets, the possession of a property used as a primary residence, land up to 0.5 ha (hectares), a motor vehicle used solely for family purposes and pension savings under the Mandatory Individual Savings Plan—the KPST. All other assets are considered reckonable and the possession of any one of them immediately renders the family ineligible for financial assistance. Along with the income and asset test, at the moment of application, the families are required to submit evidence of payment of their electricity bills. Eligibility determination includes also a home visit. Eligibility is verified every six months.

98. Eligible families are entitled to a cash transfer, the level of which is determined by a formula in which the monthly cash benefit is the difference between a monthly gross standard rate (MGSR), fixed in nominal terms by the Ministry of Economy and Finance in cooperation with the MLSW and the actual income received by the family. The MGSR varies according to family size. At present it ranges from €40 per month for a one-member family to €80 for families with seven or more members, with the average being €61.[62] The difference in the MGSR rate for families of different sizes implicitly assumes large economies of scale. For example, the increment after the third member is only €5, which is presumably far less than the marginal cost of feeding an additional mouth. Families with more than seven members (who account for around 11 percent of the LRIS recipient families) receive no more than families of seven.

99. Not surprisingly, the explicitly poverty-targeted LRIS program has a much higher targeting accuracy than the system of social protection as a whole, with 73 percent of the benefits going to the poorest quintile and over 80 percent going to the poorest 40 percent of the population. Less than three percent of the benefits leak to the richest quintile. This is among the best targeting accuracies of similar programs across ECA countries. (Nguyen, Sundaram, and Tesliuc, forthcoming). Program generosity is among the highest in ECA – the benefit represents 43.4 percent of the pre-transfer consumption of the poorest 20 percent of the population. The coverage of the LRSI program, however, is less impressive with only 39 percent of those in the

[61] i.e., exempt from the calculation of eligibility.

[62] The benefits have been increased by €5 per month per family beginning in 2009. This amount represents no more than the cumulative increase in the cost of living for the minimum benefit whereas it does not even cover the cumulative inflation for the larger families.

poorest quintile receiving benefits. This means that 60 percent of the poorest quintile is not covered by the main poverty-targeted program.

100. The LRIS program nevertheless leaves out certain vulnerable groups. One such group consists of poor families with children aged older than five. Similarly, poor families who have a small plot of land (but over 0.5 ha), regardless of whether the land is arable/usable and located close to their residence, are not eligible to receive the benefit.[63] People who are nominally eligible for the LRIS may also be excluded due to the sheer volume of documentation required to prove eligibility. The current system requires applicants to provide an excessive number of documents for verification purposes and requires recertification more frequently (every six months) than most of other ECA countries (which require it only annually). As a result, some families that are, in fact, eligible for the LRIS may not receive it. Some of the design elements of this program may also have longer term adverse effects on poverty. The linking of eligibility to unemployment status (i.e., only those who are officially registered as unemployed are eligible for LRIS benefits) may discourage beneficiaries from seeking work.

101. One way of addressing these issues in the medium to long term would be to relax certain requirements under certain conditions. Eligible families, for example, could be permitted to own small parcels of land, provided it has little market value, for example. The Government could also adopt a more comprehensive set of criteria that would define families in "need" based on an assessment of means and assets or the predicted values of such (i.e., a hybrid means test formula where the eligibility thresholds can be set according to different groups and/or budgets). This approach, if designed and implemented carefully, would extend coverage to the working (but in need of help) poor and hence alleviate the current disincentives for work inherent in the program. The same approach and criteria could be used as the basis for determining eligibility for other programs (such as disability benefits, or any other programs that may in the future be poverty-targeted such as veteran related benefits.

102. In the short term, since the implementation of the LRIS program is working reasonably well, efforts should be concentrated on improving the management information system by introducing real time data exchange between the central and social assistance municipal databases. The shift to program implementation at municipal level should be closely monitored to ensure that the quality of implementation would not deteriorate.

103. ***The War Veteran Related Benefits,*** administered by the Department of War Invalids and Martyrs in the MLSW, pay benefits to various categories of people who were affected by the armed conflict in Kosovo, directly or indirectly. These include the families of those who died in the conflict (martyrs); war invalids, their caretakers and their surviving dependents, civilian war invalids, their caretakers and surviving dependents, families of missing Kosovo Liberation Army (KLA) fighters; families of civilian victims of war; and families of missing civilians. The benefit amounts depend on the number of martyrs or missing or the degree of disability. The monthly benefits range from €35 (for the caretaker of a civilian war invalid) to €351 (for a family with four or more martyrs or missing KLA members). The average benefit is €155 per month. These benefits are categorical with a one-time eligibility period and are not poverty-targeted.

[63] The access to land may be also restricted or denied because of disputes on its ownership, location in border zones, land mines related hazards and other circumstances.

Table 15. Spending on War Veteran Benefits in Kosovo, 2006-2009

	2006	2007	2008	2009
War Veteran Benefits o/w	5,333,262	9,173,104	17,877,712	19,748,156 **
Martyrs' Families*	3,266,825	4,001,447	5,753,835	4,931,418
War Invalids *	1,047,849	1,623,630	2,273,071	2,191,595
Caretaker for War Invalids		10,565	24,666	28,836
Families of War Invalids After Death		9,981	23,966	26,477
Families of Missing KLA persons		13,514	50,170	45,308
Families of Civilian Victims of War *		2,512,555	7,591,750	6,711,265
Civilian War Invalids*	1,018,589	1,001,413	1,769,169	1,670,024
Caretaker for Civilian War Invalids			3,826	6,538
Families of Civilian War Invalids After Death			16,630	19,914
Families of Missing Civilians			370,630	370,560

Source: MLSW.
*Actual Spent as of October 2009.
**Total Amount from 2009 Budget.

104. The costs of war veterans' benefits have been increasing due to changes in eligibility rules. At the time the benefits were first introduced (in 2000 under UNMIK Regulation No: 2000/66) benefits were authorized pensions for only four groups: military invalids, civilian invalids, families of martyrs, and civilian victims of war. For purposes of eligibility, the Armed Conflict in Kosovo was deemed to have occurred over the 16 month period between 27 February 1998 and 20 June 1999. The law that currently regulates[64] veterans' benefits extends benefits in two respects. First, it extends the duration of the war for the purposes of defining eligibility for military invalids and families of martyrs to the eight year period running from 30 December 1991 to 19 September 1999. Second, it adds several additional groups of beneficiaries. These include benefits for families of missing civilians and KLA members and caretakers of war invalids. As shown in Table 15, these now account for about 2.5 percent of total spending on veterans' benefits. As a result of this expansion of benefits, total spending on veterans' benefits equaled 0.47 percent of GDP in 2008.[65]

[64] Law on the Status and the Rights of the Families of Martyrs, Invalids, Veterans and the members of the KLA and of the Families of Civilian Victims of War.

[65] In addition to the monthly cash transfers, there are also additional benefits/entitlements for each category of beneficiaries and their families (such as medical or physical rehabilitation, free health care, scholarships for education, professional re-training etc.). These are not documented separately either in the general budget nor in the relevant ministries' systems. Their cost is unknown.

105. While there are legitimate reasons to provide financial recognition to victims of the war, further expansion should be restrained. Reforms, instead, should focus on three areas. First, the Government should continue its policy of confining benefits to victims of the war, rather than extending benefits to those who participated in it. Bosnia followed the latter path and provides a cautionary lesson. As described in Box 5, Bosnia extended benefits to all demobilized soldiers.

Box 5. War Veterans' Benefits in Bosnia and Herzegovina

In the 2000s, and especially since 2004, Bosnia and Herzegovina experienced exponential increase in the number of recipients of war veteran related benefits and related spending. These benefits were extended to demobilized soldiers, medal holders and families of fallen soldiers. The benefits for civilian victims of war expanded as well. The additional benefits were introduced at a time the fiscal constraints were relaxed following economic growth and were aimed mostly at recognition of services during the war period. However, with the financial and economic crisis unfolding, this benefit system became financially unsustainable, and even more socially inequitable. The spending on veterans' benefits only exceeded 3 percent of GDP while the spending on social programs targeted to the poor and vulnerable remained at less than 0.5 percent of GDP. While hundreds of millions are spent on benefits every year, there is hardly any evidence of an impact on poverty. The poorest fifth of the population receives only 18 percent of the benefits. Moreover, the current benefit system does not meet the needs of the most vulnerable even among the veteran population. 27 percent of veteran-related benefits go to the richest fifth of them and those veterans in the poorest fifth receive less than 15 percent of these funds.

This situation is putting strong pressure on the governments of the Federation of Bosnia and Herzegovina and Republika Srpska to reduce public spending, including through difficult decisions to phase out the benefits for demobilized soldiers and introduce means-testing for a range of currently categorical benefits. Under the proposed new benefit structure, full provision of veteran benefits would be confined to individuals who are more than 60 percent disabled, and children of fallen soldiers. Civilian victims of war who are more than 60 percent disabled will also be eligible for cash benefits, while the other categories of beneficiaries will be eligible to receive cash benefits only if they are socially and economically in need. Demobilized soldiers will be offered vocational training and support to find employment instead of passive cash assistance in the form of fiscally unsustainable special unemployment benefits. Despite the obvious positive impact of such changes on improving equity in social assistance, promoting investment in human capital and reducing the disincentives for labor force participation, the changes will be difficult to sell politically.

This resulted in a level of spending equal to three percent of GDP. The country is now attempting to scale back these obligations, confining full benefits only to the substantially disabled and to the families of fallen soldiers. Under the proposed reforms, other categories of beneficiaries would be eligible to receive cash benefits only if they are socially and economically in need. In place of cash payments, able bodied veterans would be offered vocational training and support to find employment. OECD countries, similarly, tend to confine veterans benefits to the disabled and the surviving dependents of fallen soldiers (see Box 6).

Box 6. War Veterans' Benefits in Germany, the USA, and the UK

Certain OECD and EU countries provide compensation for war victims, and in some cases, their surviving dependents. They have certain common features: (1) They are almost exclusively made available to people who have become disabled during wars as members of the military and equivalent services, or have suffered from the direct effects of war (such as when civilians are injured during a military action) or of violent actions by occupying forces; (2) They are related to the degree of acquired disability and lost capacity to work; and (3) The financial need of the beneficiary is considered when the amount of the benefit is granted.

In Germany, the Federal War Victims Relief Act provides disability compensation for military personnel, prisoners of war and war-affected civilians. Injured persons are also entitled to medical treatment, domestic help and rehabilitation. People with severe disabilities are entitled to pensions linked to the level of disability and lost earning capacity. In the event of the injured person's death as a result of injury, the dependents may claim widow's, widower's, orphans' or parents' pension. The benefit is means tested.

In the USA, the Department of Veterans Affairs extends benefits to veterans, service members and their families. They include cash compensation for disabilities resulting from military service; pensions for war-time veterans who are permanently disabled, over 65 years of age and with limited income; health care services (hospital and out-patient care, readjustment counseling, health and rehabilitation for homeless veterans; placement in residential care and nursing homes, alcohol and drug dependency treatment); vocational training, supporting rehabilitation services and employment for veterans with military service connected disability; training in approved courses; home loan guarantees and refinancing under lower interest rates; life insurance. Dependents and survivors of service members who died on active duty, veterans who died from service-related disabilities and veterans who have been paid 100% disability compensation at the time of death may receive death pension and parents' assistance. Both are means-tested.

In the UK, the War Pension Scheme and the Armed Forces Compensation Scheme provide benefits for injured or disabled members of Her Majesty's Armed Forces; civil defense volunteers; and civilians disabled as a result of enemy action in the 1939-1945 war. The Veterans' Welfare Service provides advice, guidance and practical help on how to access these benefits.

Sources: Websites and publications of the national war veterans' benefits administrations.

106. In Kosovo, however, there are currently plans to expand benefits to all veterans over fifty. The proposed law, 'On the Status and the Rights of the Heroes, Invalids, Veterans, members of KLA, Civilian Victims of War and Their Families,' would provide cash transfer for all veterans above age 50, regardless of disability, in addition to extending the eligibility period for civilian victims of war. This would be extremely ill advised, given the country's current fiscal constraint and the large share of social assistance spending already consumed by veterans' benefits. Instead, the government should consider modeling its approach to veterans' benefits on OECD practices (see Box 6) which emphasize means-testing and providing services tailored to the specific needs of veterans.

107. Second, the Government should take steps to reduce fraud. Though the existing information systems seem to be working reasonably well in collecting the data on numbers of beneficiaries and expenditures, it is not clear whether the controls on fraud and error are sufficient. The administration of war veteran programs in Kosovo is not integrated with the

administration of other social protection programs. As a result, cross checking within and between registries is not possible at this point. The MLSW plans to address this problem by introducing a Management Information System that would integrate the registries for all social benefits it administers.

108. Finally, the Government could consider means-testing veterans' benefits and integrating them with other forms of social assistance. Some veterans' benefits may be 'leaking' to higher income households, although in the absence of data, the scale of such leakage is unknown. By the same token, veterans' benefits, if they were taken into account in measuring household income, might render certain recipients of LRIS benefits ineligible. Such a decision—to means test and integrate veterans' benefits—cannot be taken solely on financial grounds. If the sole aim of veterans' benefits were to alleviate poverty, then means testing and integration would make sense. But if the aim is also to provide financial recognition to victims of the war, the argument is less persuasive.

109. ***Disability Benefits.*** The disability pension pays a flat amount, equal to the basic pension benefit, to all habitual residents of Kosovo who are between 18 and 65 years of age and have a medically-confirmed permanent and severe disability, rendering them 100 percent incapable of working. The disability must have been in place for at least one year before the candidate applies.[66] Persons who are receiving basic pensions or war veteran benefits are not eligible for disability benefits. Eligibility for disability pension stops at the age of 65 when the beneficiary is transferred to the basic pension scheme.

110. The number of persons receiving disability pensions is relatively modest and the costs of the program, correspondingly small. In 2004—the year the program began—disability pensions were paid to 15,077 recipients at a total cost of €7.248 million. In 2005 (the first full year of implementation) the number of recipients grew to 21,251 and the cost reached €15.48 million. In 2008, the number of recipients of disability pensions declined to 18,605 while the cost of the program contracted to €10 million or close to 0.22 percent of GDP. The average monthly benefit was €45.

111. Fraud appears not to be a major problem. The law establishing the current disability pension system goes to some lengths to reduce opportunities for fraud. Claims of disability must be certified by an MLSW Doctors Commission. This requirement is applied both to new applicants and recipients under the old (pre-2004) system. (Doctors Commissions have been established in the capital of Pristina, and in regional centers.) The 100 percent disability criterion is further verified by determining whether the applicant is employed. Two sources are checked. The first is the tax administration office, which certifies whether the individual has earned any income. The second is the Ministry of Trade and Industries, which certifies whether the individual has a business registered to his/her name. The disability pension program was subject to a performance audit for the period July 2007–June 2008, by the Office of the Auditor General

[66] This also requires that the disabled individual not be self-employed. Persons capable of employment or actually employed in any manner including self-employment are not eligible for disability pension. The employment criterion is checked through two sources; first is the tax administration office where it is inquired whether the individual earned any income, and second is the Ministry of Trade and Industries where it is checked that the individual does not have a business registered to his/her name.

of Kosovo. This found considerable delays at every stage of the application process and certain procedural irregularities arising from management's limited access to data that allows the monitoring of the processing of applications; absence of control over the computerized determination of eligibility; and insufficient segregation of duties between the authorization and payment of pensions. Nevertheless, benefits were found to be paid on time and in the correct amount.[67]

112. Mechanisms for determining whether a beneficiary is receiving other forms of social assistance (such as basic pension or war veterans' pension) do not function so effectively, however. Currently this cross-checking requires a physical exchange of files. This is slow and prone to errors. The proposed Integrated Management Information System will help to address this problem.

113. In principle, the disability pension could also be faulted for its failure to means-test. Benefits are payable regardless of the recipient's income or assets. The 100 percent disability requirement presumably acts as a de facto means of excluding those with adequate alternative sources of income, as it disqualifies anyone with a job.[68] But this criterion applies to the individual, not to his or her family. Disabled persons supported by higher-income households therefore continue to be eligible. In principle, this loophole could be closed by shifting to the sort of comprehensive household-income and asset-based definition of eligibility described above.

114. Should partially-disabled persons also receive benefits? Some countries provide disability benefits to those who are less than fully disabled, For example, some countries in Eastern Europe and the Western Balkans provide disability benefits to people who are not eligible for disability insurance and have disability rates of 50 percent or 60 percent and higher. They also finance caregivers for the disabled. But Kosovo cannot afford to do so now. Even countries that do provide such benefits are increasingly forced to means-test them. In more prosperous times, Kosovo could consider following this example.

115. Kosovo has, however, introduced a benefit for families of children with permanent disabilities.[69] This program was introduced in June 2008 (with implementation beginning in early 2009). It pays a flat monthly benefit of €100 Euros per child to the families of children (0 to 18 years of age) with permanent disabilities. The child needs to be certified as fully disabled by a MLSW Medical Committee. The number of beneficiaries was reported to be around 2,300 as of October 2009. As the scheme is new, its performance has yet to be fully documented. However, close monitoring of applications and eligibility would seem to be required.

116. ***Conclusion.*** Overall, Kosovo's current system of social assistance is quite parsimonious in its benefits and rigorous in its documentation requirements. Spending in this category should be protected. At the same time, however, the Government should resist pressures to expand veterans' benefits to those who were not injured, directly or indirectly, by the war. In

[67] Performance Audit Report on the Administration of the Disability Pension Scheme, Ministry of Labor and Social Welfare. Office of the Auditor General, Document No. 21.7.9-2008-08, Pristina, 2009.

[68] By definition, 100% disability should imply permanent and irreversible disability and lack of ability to work and live independently.

[69] Termed '*Material Support for Families of Children with Permanent Disability*'.

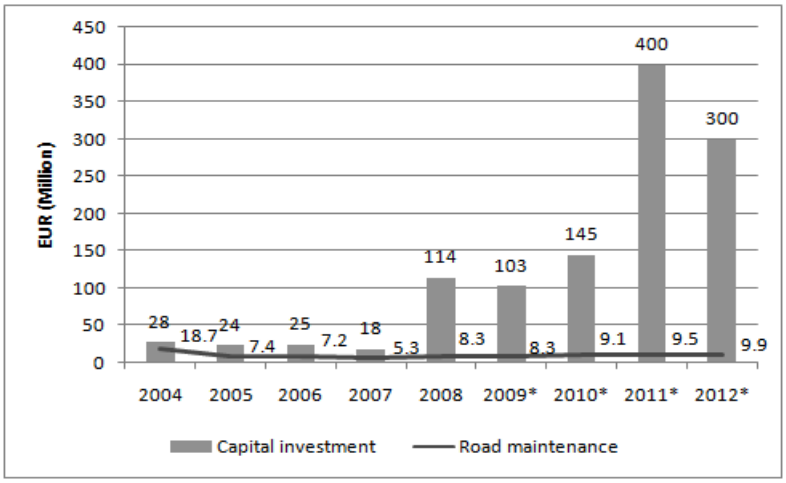
this context, it should specifically refrain from enacting the additional benefits proposed in the draft Law on the Status and Rights of Heroes. And it should proceed with the planned Integrated Management Information System to facilitate eligibility verification and fraud control for all forms of social assistance.[70] Over the longer term, there may be a case for means-testing disability payments and veterans' benefits and integrating the various forms of social assistance. And in the even longer term—once reliable data on household characteristics becomes easily available, there will be a case for amending the current eligibility criteria for the LRIS which are based mostly on categorical restrictions and income tests, by introducing indicators with higher potential to predict household welfare.

Transport

The Road Sector

117. Kosovo's road network of 8,522 km is characterized by uneven quality and limited reach. Kosovo has 632 km of primary roads, 1,319 km of secondary roads and 6,571 km of local roads.[71] (A road network map is provided as Annex B). The road network density of 0.78km/km2 is higher than the Western Balkans regional average of 0.56 km/km2. However, Kosovo lags behind other lower middle income countries in the region when road density is adjusted by population size. Kosovo has 3.6 road-km/1,000 people compared to 8.6 road-km/1000 people in Europe and Central Asia. There have been no reliable recent surveys of the condition of the primary and secondary network. However, one recent study[72] which sampled the local road network, estimated that 94 percent of inspected roads on the local network are in poor or very poor condition and in need of urgent reconstruction. It was also estimated that a number of bridges and structures on both magistral, regional and the local road network, are in need of urgent repair.

Figure 8. Actual and Budgeted Maintenance and Capital Spending on Roads



[70] The Government should also improve the quality of household level micro-data and other technical information (i.e., detailed accounting of the income sources in the HBS survey instrument) in order to strengthen the empirical basis for policy making in this areas.

[71] Egis BCEOM International & COWI *Kosovo – Multi-Modal Transport Strategy and Action Plan*, p. 12 (Final version, May 2009).

[72] The World Bank, *Improving the Management of Secondary and Tertiary Roads in South East Europe,* Washington, DC: 2008.

118. Spending on roads has increased markedly since 2007. As shown in Figure 8, total highway spending ranged from €18 million to €31 million over the 2005-2007 period, but then increased to €126 million in 2008. The increase in spending has been driven by capital investments, which increased from €18 million in 2007 to €114 million in 2008. Spending is expected to increase markedly again with the signing of the contract with the American-Turkish joint venture to construct a motorway on Route 7, at an estimated cost of €980 million, before VAT. These costs could escalate considerably, as detailed financing plans for this contract were not prepared prior to the signing of the contract.[73]

119. Provisional estimates suggest that the expenditure requirements in 2010 for this contract alone will amount to €145 million; followed by €400 million in 2011, €300 million in 2012, and €150-180 million in 2013. This will require offsetting reductions elsewhere, postponement of all other required capital works on the road network , and a halt to development plans. Maintenance spending, on the other hand, has fallen slightly from its 2004 peak and totaled only €8.3 million 2008, which is estimated to be approximately forty percent of what is necessary. It is projected to continue at this modest level, accelerating road deterioration, which will be expensive to repair at a later stage.

120. ***Underfunding Maintenance.*** The growing disparity between capital and maintenance spending is increasingly raising questions about the Government's priorities. In pursuing its commitment to develop, upgrade or rebuild significant parts of the road network, the Government is failing to allocate sufficient resources to maintenance. This is ill advised from an economic and social perspective. Under-maintained road assets increase costs for road users in terms of additional time, fuel and vehicular wear and tear. On an NPV basis, it would be less costly to properly maintain the existing road assets each year than allow them to deteriorate and then have to substantially reconstruct them later. And investment in maintenance consistently shows better returns than new capital investment in expensive capital projects. A World Bank study[74] estimates that a total of $45 billion worth of road infrastructure was lost in 85 developing countries in the 1970-1980s. The loss could have been averted with preventive maintenance costing less than $12 billion. Indeed, as noted in the study, the failure to maintain roads is tantamount to an act of disinvestment, for it implies the sacrifice of past investments in roads.

121. A recent analysis of road maintenance requirements in Kosovo[75] estimates that the cost of restoring and maintaining the primary and secondary road network to good condition over the next three years would cost a total of €128 million, or an average of about €43 million per year (see Table 16). This is nearly five times the amount that is budgeted for maintenance in the

[73] In the absence of detailed designs, the contract is a unit price contract, in which unit prices are defined and fixed for a defined period (in this case three years), but quantities are not specified. An admeasure contract, in contrast, would have included defined quantities and defined unit prices (defined in the bid of the contractor), reducing the risk to the Government.

[74] The World Bank, *Road Deterioration in Developing Countries – Causes and Remedies* (Washington, DC: 1988).

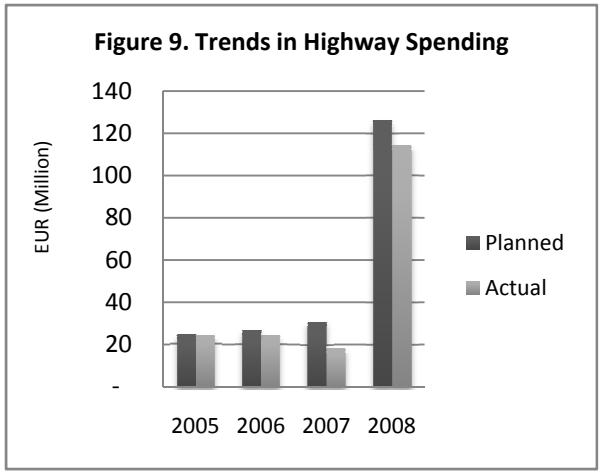
[75] HDM-4 analysis of Kosovo road network provided by MTC (September 2009).

MTEF.[76] At the same time, it is only about forty percent of the amount the MTEF proposes the Government spend—from the general budget—on capital works.[77]

122. It is extremely important that the signing of the contract for Route 7 should not crowd out necessary expenditures on maintenance on the remainder of the network. Increased spending on road maintenance could be phased in a number of ways. First priority should be given to routine and periodic maintenance to maintain the condition of existing assets. This is estimated to cost €22 million annually, or 2.6 times what is expended on maintenance currently. Clearing the backlog could be phased depending on available fiscal space. Addressing the backlog, including the paving of unpaved roads, over five years instead of three would reduce the total annual expenditure from €43 million to €34 million. Addressing it over ten years would reduce the figure to €28 million.

Table 16. Maintenance Needs and Planned Spending on Central, Regional Roads
(€ mln)

Year	2010	2011	2012	2010-12
Maintenance-routine and winter	13.0	13.0	13.0	39.0
Maintenance-scheduled periodic	9.0	9.0	9.0	27.0
Maintenance-backlog	12.0	12.0	10.0	34.0
Maintenance- bridges	5.0	5.0	5.0	15.0
Paving unpaved roads	5.0	4.0	4.0	13.0
Subtotal	44.0	43.0	41.0	128.0
Budget allocation for maintenance	9.1	9.5	9.9	28.5
Maintenance financing gap	34.9	33.5	31.1	99.5



123. ***Capital Investment Selection.*** The Government's decision to proceed with Route 7 on its current terms is evidence of a wider problem. There is considerable evidence that decisions on the allocation of funding for capital construction are driven by subjective rather than objective reasons. As a result considerable amounts are spent on projects which have relatively low economic benefits. The Government has taken some steps to improve project selection. As part of recent World Bank-funded technical assistance[78] the Ministry of Transport acquired an asset management system, called the Road Information Database (RID) to assist in the planning of works on the road network, and provide an economic basis for allocating capital expenditures (as well as recurrent expenditure) within the road sector. Eight staff members from the Directorate of Roads and the MTC were trained in the use of the RID and HDM-4 software. The database was used to identify expenditure priorities on the road network for the MMTS and the Ministry of Transport's budget request for 2009. However, there is evidence—at least in the aggregate—that the new system is not being used as intended.

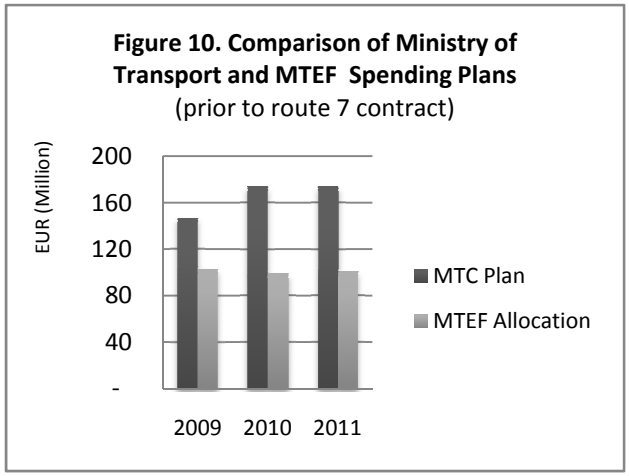
[76] MTEF 2010-2012, p.47.

[77] Medium-Term Expenditure Framework (MTEF) 2010-2012 pp.48-49; See Annex D.

[78] Kosovo: Public Expenditure Management Technical Assistance Project (PEMTAG), completed in March 2009.

124. ***Project Implementation.*** While project disbursements tend to match budget allocations (Figure 9) project implementation in the sector is consistently subject to cost overruns and questions about long-term sustainability – evidenced by the early repair of some sections of road around Pristina. The problem reflects procedural, technical, and human resource constraints. Works are often begun before the detailed design and costing is complete, or with weak designs, necessitating frequent variation orders. Contract management is poor, with variation orders routinely granted for the maximum (10 percent) allowed by law, with little robust assessment of the technical need, and ultimately poor quality. Supervision is also weak, with too many projects per engineer, too little trained staff, and with the Department of Roads unable to fire ineffectual engineers or hire replacements. All these problems contribute to major concerns about the sustainability of capital investment in the road sector – and the level of scrutiny on the construction of the new motorway on route 7.

125. ***Budgetary Realism.*** In addition, funding is uncertain, as the MTC's capital spending plans are not consistent with the resource envelopes allocated by the Ministry of Finance. As shown in Figure 10, MTC's annual spending plans have routinely exceeded the MTEF envelope by 30-40 percent. For the future, the Ministry of Finance has indicated that any road investment exceeding the ceiling should be financed from external sources. But the MTC's expectations concerning the availability of external financing would appear to be unduly optimistic. As shown in Annex C the MTC proposes a €2.2 billion 20 year investment plan. Most of this would be financed from the central budget. Over the 2010-2012 period, the total financing required from outside the general budget for Routes 6 and 7 alone would be €539 million.[79] To plug the financing gap, the MTC hopes to attract funding from private investors through Public-Private Partnership (PPP) schemes and loans from International Financial Institutions (IFI).



126. But the availability of IFI financing is uncertain. The World Bank currently has no concrete plans to lend to the transport sector in Kosovo. Support from the EBRD is also limited as Kosovo has not been accepted as one of its members. The EU's main program in Kosovo is the Instrument for Pre-Accession Assistance (IPA), which is expected to channel approximately €60 million in 2009 and €65 million annually over 2010-2012 for all sectors of the economy.[80] Support for large infrastructure projects has not been indicated as a priority by the European Commission, which has preferred to provide technical assistance for transport project preparation and regional initiatives. In 2009, IPA will allocate €2 million for supporting the Regional Transport Treaty.[81] Another example of EU assistance is funding from the Infrastructure Projects Facility (IPF) for a feasibility study for the Route 10 railway.

[79] MTEF 2010-2012 with World Bank adjustments for Route 7 spending.

[80] Indicative, unofficial figures provided by the European Commission Liaison Office to Kosovo.

[81] Ibid.

127. Attracting private financing for a Public Private Partnership (PPP) scheme on Routes 6 and 7 is also likely to be difficult if not unrealistic in the short to medium term. In addition to overcoming investors' concerns over country risks, the Government will also have to prove the two projects' financial viability. Given that almost half of the sections on Routes 6 and 7 generate negative NPVs,[82] this would require considerable financial support from the Government, in the form of a capital grant for construction and a minimum revenue guarantee (MRG) or an 'availability' payment to guarantee an adequate financial rate of return. The costs of such financial support/guarantees would largely offset the financial benefits of private participation and therefore any plans for a PPP scheme should be postponed until the financial parameters on the proposed sections improve as a result of greater traffic volumes or redesign of projects.

128. Financial simulations suggest that none of the PPP candidate sections on Routes 6 and 7 would be feasible with the projected traffic, construction costs and toll revenue.[83] The most promising sections around Prishtinë would still need substantial government subsidies, around 25 percent of construction cost, to reach the target return of 15 percent.[84] In addition, either toll levels would have to be similar to EU rates or the Government would have to heavily subsidize operations as forecast traffic alone would not make the projects financially viable.[85] The alternative, as discussed below, would be to significantly reduce construction costs through lower design speeds, reduced cross-profiles for platform and lanes and fewer interchanges.

129. The Government will also need to develop the institutional capacity to manage PPP projects. A PPP unit "Partnerships Kosovo" was launched in November 2007 under the Ministry of Finance and Economy to prepare the legal framework for PPPs and to assist with project identification, development and implementation. In July 2008, a new law on PPPs and concessions[86] was issued, and since then PPPs have remained high on the Government's political agenda to help bridge the infrastructure financing gap. The Government of Kosovo has identified Pristina International Airport (PIA) as a test case for its new legal and institutional PPP framework (see Box 7). The outcome of the PIA bidding process will be critical for the Government's PPP agenda. If the ambitious preparation schedule is met and a concession agreement signed with good value for the taxpayer, the Government and private investors would be encouraged to continue PPP preparations for some of the high-profile road projects, such as Route 7. If the bidding process is considerably delayed, private investors could have doubts about the institutional and legal capacity of the Government to complete a PPP transaction. The PPP pilot concession for Pristina Airport should be completed and lessons from that learned before launching PPP schemes for other projects, including Route 7.

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[82] According to the MMTS, 24 out 53 of project sections1 have a negative NPV; See Annex D.

[83] Based on financial model outcomes for selected, sufficiently large PPP candidate projects as analyzed in Egis BCEOM International & COWI *Kosovo – Multi-Modal Transport Strategy and Action Plan – Final Strategy and Action Plan* (Final version, May 2009) pp.76-77. While these simulations were based on old cost estimates of Route 7 construction cost, the results would likely be similar with new estimates.

[84] Ibid. p.76.

[85] Ibid. p.77.

[86] Law No.03/L-090 On Public-Private-Partnerships and Concessions in Infrastructure and the Procedures for Their Award

Box 7. PPP Scheme for Pristina International Airport

The Government of Kosovo has identified Prishtinë International Airport (PIA) as a pilot project for a Public-Private Partnership (PPP) scheme. The proposed project concept envisages a complete overhaul of the airport, including the construction of a landmark terminal building, a control tower and parking areas. The Government has commissioned a group of transaction advisers to organize the bidding process and lead concessions negotiations. The current plan is to select the preferred bidder by the end of 2009 from 3-8 qualified investors. Financial close should be reached by May 2010 for a 20-year concession (Design-Build-Finance-Operate-Transfer) with an estimated construction cost of €85-200 million.

PIA is currently operating at a profit with 89 percent of revenues generated by aeronautical charges. In 2008, when the airport served 1.2 million passengers and handled 14,000 aircraft operations, these charges reached €21.8 million, an increase of 11.4 percent from the previous year. The Government believes that a private operator could fulfill the economic and operational potential of the airport modernization, which has a projected IRR of 30 percent. The Government also expects to receive an annual concession fee in the order of 12-16 percent of gross revenue, which would generate up to €300-400 million in the last 10 years of the concession.

130. Overall, the projects should be considered as medium to long-term objectives, reflecting the lack of viability due to the high cost estimates, lack of sufficient traffic demand and inadequate financial resources

131. ***Road user charges*** In principle, additional funds for road maintenance and construction could be generated from road user charges (RUCs). RUC revenues are already substantial in Kosovo. As shown in Table 17, they generated €120 million in 2006. (This is roughly equivalent to the amount spent on road construction and maintenance in 2008 and the amounts budgeted for 2009.[87] As shown in Table 17, the majority of RUCs are generated through fuel taxes.

Table 17. Revenues from Road User Charges and Taxes

Type of Revenue	2005	2006
Revenue from petrol tax (€ mln)	42.6	39.6
Revenue from diesel tax (€ mln)	61.2	62.1
Revenue from vehicle registration fees (€ mln)	-	5.7
Revenue from vehicle road taxes (€ mln)	8.3	8.5
Revenue from vehicle import taxes (€ mln)	16.8	4.4
Total (€ mn)	135.0	120.0

Source: ECORYS *Strengthening the Financial Sustainability of the Roads Sector in Kosovo – Final Report* (Rotterdam: 2007).

132. There is potential to increase revenues from certain forms of RUCs, subject to careful consideration of affordability for road users. Although fuel tax rates in Kosovo are close to EU norms,[88] vehicle taxes are considerably below them. Kosovo's vehicle taxes also fail to differentiate among vehicles of different size, weight and axle load.[89] As

[87] Road user revenues are not earmarked for spending in the road sector, for example through a road fund, as they are channeled to the Kosovo Consolidated Budget (KCB).

[88] The minimum required under EU Directive 2003/96/EC is €0.359 per liter of unleaded gasoline. However, the directive was amended in 2004 to provide transitional arrangements for new accession countries—permitting on a

heavier vehicles cause most damage to roads, this violates the principle of 'user pays'. Raising the tax on personal vehicles (under 3.5 tons) from the current €60 to the EU minimum of €185, and the tax on heavy goods vehicles from €130 to the EU minimum of €515, could increase revenue from RUCs in the medium to long term. However, the implementation of any such increase would depend on its affordability for road users and the impact on businesses using heavy vehicles. Given the low GDP per capita in Kosovo relative to EU countries, the convergence of RUCs to EU levels would have to be gradual.

133. The outlook for other forms of RUCs is less promising. As shown in Table 17 vehicle import taxes generated only €4.4 million in 2006. Other RUCs such as those for transit and special weights and dimensions did not generate much either. As all Kosovo's neighbors impose transit charges, Kosovo could consider introducing them. Imposing a transit charge of €10 per day, for example, could raise €2.32 million per year from the estimated 155,000 trucks transiting Kosovo.[90] More revenue could also be generated by raising the vehicle import tax on heavy vehicles.

134. ***Directions for Reform*** Faced with limited internal and external financing resources, the Government will have to prioritize. Top priority is maintenance—starting with routine maintenance of the existing network and proceeding to rehabilitation to repair the damage caused by deferring maintenance in the past. (Although €100 million has been budgeted for road rehabilitation[91] for 2010-2012, much of this in fact represents upgrades and new construction rather than rehabilitation per se. That funding should be reallocated to routine/periodic maintenance.) Where rehabilitation is no longer sufficient to remedy the consequences of prolonged neglect, reconstruction will be required.

Table 18. Cost Estimate of Route 7

Year	Cost (EUR million)
2010	145
2011	400
2012	300
2013	135
2014	1
Total	981

Source: MTC
Note that this full cost estimate includes VAT, contingencies and additional costs.

135. The Government has decided to construct Route 7 at a target cost of €569 million;[92] with contingencies and other additional costs the true cost would be closer to €980 million. Phasing of implementation would help improve the project's fiscal sustainability. Table 18 shows that the road is planned to be constructed over 2010-2013 with high capital outlays in each year. The Government would be well-advised to phase project implementation over a longer period with close regard for current and projected traffic demand.

136. Looking beyond Route 7, construction of any road on a new alignment ("greenfield alignment") should be started only if it has a technically and economically viable design consistent with current and projected demand and will not

temporary basis to apply exemptions from or reduced levels of taxation—through Council Directive 2004/74/EC and 2004/75/EC. For example, Poland has until 1 January 2012 to apply the 2003 directive.

[89] ECORYS, *Strengthening the Financial Sustainability of the Roads Sector in Kosovo* – Final Report (Rotterdam: 2007) p.11.

[90] Ibid., p.152.

[91] As noted earlier, some projects labeled as "rehabilitation" should actually be categorized as "upgrade" or other capital investment.

[92] To that effect, the Government signed a memorandum of understanding with a Bechtel-led consortium on April 12, 2010.

compromise spending on maintenance, rehabilitation and reconstruction. This could involve horizontal phasing, i.e., delaying the less viable sections until traffic levels increase, or transverse phasing, e.g., building both sides of a divided highway, but with lower geometrical characteristics – narrower overtaking lanes, for instance. For example, on Route 6, the southern part towards Macedonia (Lipljan-Doganaj sections) has good economic results and should be prioritized. The costly mountainous section Doganaj–Macedonia border has little projected traffic and should be redesigned.

137. Over the longer term, more fundamental institutional weaknesses in the roads sector will have to be addressed. First, the process of project selection should be improved through the use of robust asset management systems and economic decision models. The existing Road Information Database, including road condition surveys and traffic counting, and HDM-4 for the main and regional roads should be fully incorporated into an integrated planning process to provide a more objective basis for transport sector planning and spending.[93] The resulting investment plan should then be agreed between the Ministry of Transport and Ministry of Finance so that the MTC plan complies with the fiscal ceiling given in the MTEF.

138. To improve project execution, works should not be initiated until designs and costing are complete. Failure to carry out proper preparation frequently results in overpricing of construction works, implementation delays and poor construction quality. Efforts to improve supervision will require improvements in staffing. According to the MTC, low public sector salaries make it difficult to hire and retain staff capable of performing this function. The MTC has recently contracted a technical laboratory to monitor the quality of road construction works. This is a step in the right direction. The Government should also consider raising salaries for key staff involved in contract administration

139. Organizational arrangements in the sector should also be considered. Within the MTC, the program of maintenance is the responsibility of the Department of Roads Infrastructure (DRI), with the supervision of works undertaken by an implementing agency, the Directorate of Roads (DoR). The DoR is also responsible for preparing annual maintenance plans, collecting data on traffic and road safety, checking overloading and advising the municipalities on road management. The funding of the maintenance of the main network is an allocation to the MTC by the Ministry of Finance and the Economy (MFE) from the Kosovo Consolidated Budget (KCB). One peculiarity in the setup is that the contract management function is held by a special procurement department in the MTC and not by the DoR or DRI.[94] This institutional arrangement presents a number of difficulties, not least of which is the existence of two institutions involved in the management of a small network, with limited responsibilities and autonomy in the case of DoR. A recent report has highlighted the need for institutional reform, suggesting two options for reorganization: (1) full integration of DoR inside the MTC, so that only one institution remains; and (2) the creation of a separate Road Agency, replacing the DoR.[95] However, while MTC staff seem to favor the second option, no reorganization is currently planned.

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[93] Current efforts in this regard include the consultancy services by BCEOM/DAVOS Invest to strengthen the Road Information Database and HDM-4 under MTC.

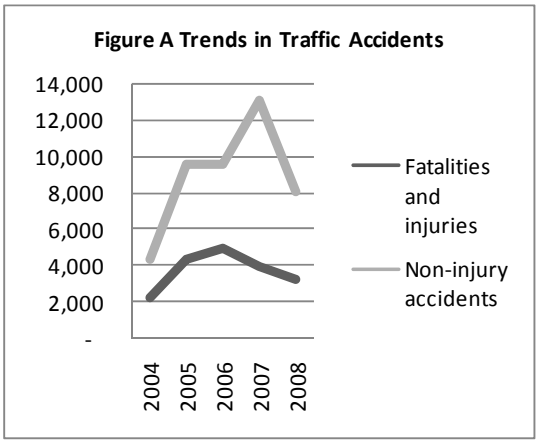
[94] ECORYS, (2007). *Strengthening the financial sustainability of the road sector in Kosovo.*

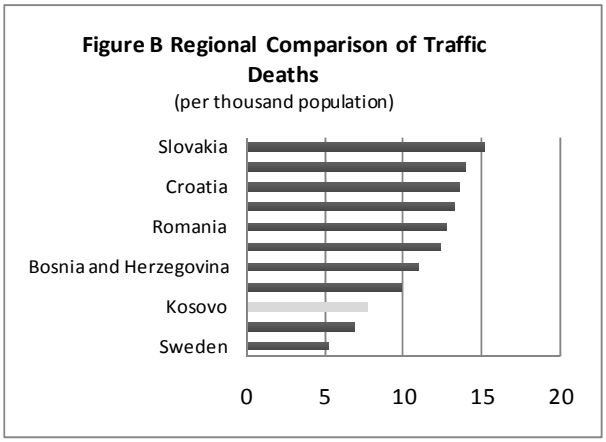
[95] See European Commission Liaison Office to Kosovo (2009).

Box 8. Road Safety

Despite improvement in recent years, the poor road safety record in Kosovo remains a significant economic and social concern for the country. The number of accidents increased from 6,564 in 2004 to 17,001 in 2007 (see Figure A), but since 2006, both fatality and injury rates fell through 2008. The number of accidents, both serious and non-injury, has been falling in recent years and the fatality rates are not as high as elsewhere in the region when normalized by population size and number of vehicles (see Figure B). The fatality rate per 10,000 vehicles has halved in Kosovo from 6.2 in 2005 to 3.3 in 2008, while in Serbia and Bosnia and Herzegovina the fatality rates stayed the same or slightly increased in the same period. Despite the improvement, the fatality rate in 2008 in Kosovo was still three times higher than the rate in the "safest" European Union countries, such as Sweden and the UK. In 2009, road safety is expected to deteriorate compared to recent years. In the first eight months alone, the number of injured and accidents was higher than in 2008 in total, with the rate of fatalities being almost the same.

The Government has launched initiatives to promote road safety and create guidelines to incorporate safety considerations into transport sector planning. The establishment of Road Accident and Analysis Software has strengthened the capacity of the police to record accidents and prosecute miscreants included measures to improve road safety. Working groups with representation from a broad base of stakeholder groups have been established within the MTC for black spot identification and alleviation, and road safety audits. Since these mechanisms were introduced, 14 black spots have been identified and corrected. In addition, manuals and training have been provided in a number of key road safety areas, and considerable support provided to the establishment of a Road Safety Council, and implementation of road safety campaigns. The budget plan for 2010 allocates some funding for black spot alleviation, and includes a budget line for the Road Safety Council. Now that the Government has the basic institutional mechanisms in place, it should strive to maintain the institutional momentum to improve road safety.





140. The legal framework governing the sector should be revised. The current Road Law and Procurement Law do not provide an adequate legal framework for the development of road infrastructure. A draft law amending and supplementing the 2003 Road Law has been prepared by the MTC. The updated Law will: (i) define the maximum permitted simple axle load for road construction; (ii) introduce a specific definition of motorways and two categories of regional roads; and (iii) classify the road network in line with EU regulations. The new law would also grant the MTC more independence to regulate the funding, administration, concessioning,

maintenance and reconstruction of roads. Changes should also be made to the Procurement Law as it pertains to maintenance contracting. The current law only allows 1+1 year maintenance contracts, which is too short for efficient performance- or output-based maintenance contracting. With a longer contract, companies could more easily plan and budget their maintenance operations and maximize maintenance quality.

141. Institutional capacity should also be strengthened at the municipal level which oversees three-quarters of the road network. With co-financing from the municipalities, the MTC allocated considerable funding in 2008: about €40 million, to improve the condition of the local road network. [96] It is up to the municipalities to maintain these roads in good condition. This is problematic given their limited institutional and financial capacity and demonstrated propensity to neglect maintenance in favor of new construction.

142. As discussed in the next chapter, municipalities receive a general grant from the KCB to cover a wide range of functions. Different sectors compete for these funds; and within the infrastructure sector a choice has to be made between capital or recurrent expenditures. At the local level, the end result is usually that maintenance loses out in favor of other sectors or in favor of new construction. Problems also exist with capacity at the local level, mainly in terms of technical capabilities and financial planning. Another issue is the under-maintenance of "transit" roads, or regional and main roads which cross municipalities. While the MTC also provides funding for construction of these roads, their maintenance under the current law is technically the responsibility of the municipalities. Overall, relying too much on the municipalities for maintenance puts at risk the sustainability of road improvements made by the central government. One solution would be to reclassify some municipal roads as MTC responsibilities until municipalities have improved their institutional capacity. To assist in institutional development, the MTC could also provide technical support and budget monitoring to municipalities on the importance of road maintenance.

The Railway Sector

143. The development of the Kosovo railway network is closely linked to wider regional initiatives. As a member of the South East Europe Transport Observatory (SEETO)[97] Kosovo includes 150km of SEETO core network railway links (Route 10).[98] As one of SEETO's aims is to promote cooperation in infrastructure development in the region, major investments in the member countries will in theory be coordinated among the neighbors. A recent initiative in regional development is a Transport Community Treaty being prepared between the European Commission and the Western Balkans.[99] It is also intended to facilitate market access between

[96] The 2008 budget allocation is €17.2 million.

[97] SEETO is a regional transport organization established by the Memorandum of Understanding for the development of the Core Regional Transport Network (MoU) signed 11th June 2004 by the Governments of Albania, Bosnia and Herzegovina, Croatia, the Former Yugoslav Republic of Macedonia, Montenegro and Serbia and the United Nations Mission in Kosovo and the European Commission.

[98] Egis BCEOM International & COWI *Kosovo – Multi-Modal Transport Strategy and Action Plan – Outline Strategy Report* (Final version, May 2009) p.1.

[99] Ibid. p.1.

countries in the region and the EU and will cover road, rail and maritime transport and provide a framework for planning and implementation of reforms and investments in the transport sector.

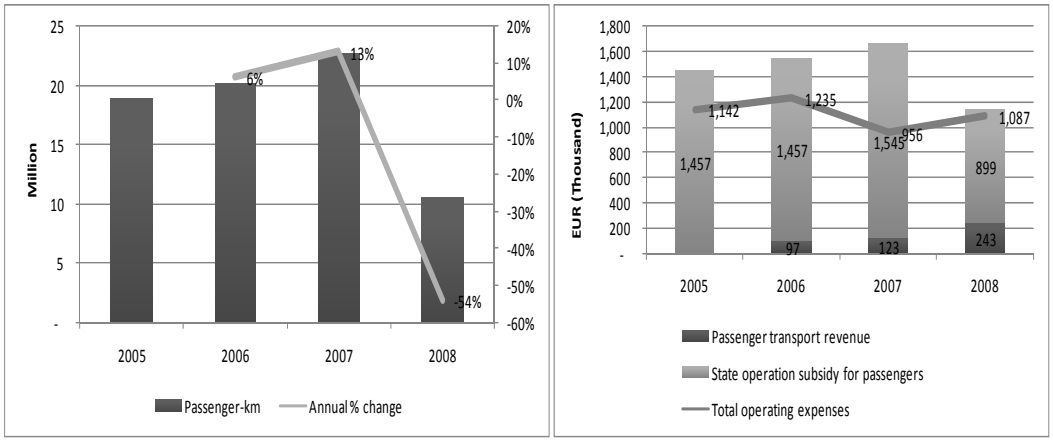
144. Integration into the regional railways structures is a key goal for the Government of Kosovo as it aims to restore the viability of its railway operations. A railway offering regional transport services would be more competitive with road transport. A near-term challenge for Kosovo Railways (KR) is to restore political relations with Serbia and be accepted for full membership in all international and European railway institutions. Modernizing the regional Route 10 railway line to Serbia, the main railway infrastructure priority for the Government, would require cooperation from the northern neighbor for project preparation to continue.

145. Kosovo has 333 km of single track non-electrified rail system with standard gauge. Despite limited maintenance, it is mostly in good/fair condition due to limited traffic. The track runs through many mountainous areas necessitating numerous tunnels and bridges. Principally, there are two lines (North to South) and (North East to West). The North-South line traverses the country from the border with Serbia to the border with Macedonia for a total of 141.3 km on the SEETO core Route 10. The North East to West Line comprises three branches: the East Line from the border with Serbia to Fushë Kosovë (42 km); the West Line from Fushë Kosovë to Pejë (81 km); and the West-South Line from Klinë to Prizren (58 km). The maximum speed limit is 70 km/hr, even though the geometry of parts of the network would permit speeds of up to 160 km/h. Reconstruction has been the main objective of donor assistance to date, focusing on urgent repairs on the main network, leaving the issue of accumulated maintenance backlog unaddressed. The signaling system is being refurbished.

146. ***Passenger Operations.*** Passenger traffic has fallen considerably since the break-up of Yugoslavia. Today Kosovo Railways operates only three passenger services: the north-south Freedom of Movement Train (FMT) introduced and supported by UNMIK as a means to give Kosovo's enclave-stranded Serb population some freedom of movement; the Prishtinë-Pejë service; and the Prishtinë-Skopje service. Overall passenger volume (passenger-km) fell by 54 percent in 2008 from the previous year (see Figure 11) largely due to the suspension of the Freedom of Movement Train.[100]

[100] After Kosovo's independence in early 2008, Serbian Railways took control of the section north to Mitrovica. As a result, the number of passengers carried by FMT fell dramatically, by two-thirds, from 2007 to 2008. As of November 2009, the FMT remains suspended on this northern section with no sign of resolution to the underlying political problems. Figures are from: Kosovo Railways J.S.C. Annual Report 2008 (January 2009), p.11: Number of passengers carried on the FMT in 2007 was 304,133 while in 2008 that number was 102,624; In Figure 6, passenger volume is measured in terms of *passenger-km.*

Figure 11. Kosovo Railways Passenger Service Indicators



a) Passenger Volume 2005-2008 b) Passenger Revenue and Costs 2005-2008

147. While the FMT is intended to be social service, the latter two are ostensibly "commercial" services, where the revenues from ticket sales, along with so-called Public Service Obligation (PSO) payments, are supposed to allow the railway to cover its costs. Passenger service as a whole is nevertheless heavily subsidized. State subsidies—including the PSO—accounted for about eighty percent of revenue in 2008. As a proportion of Government spending, however, passenger subsidies are relatively small, due to the small scale of services. In 2008, subsidies were equivalent to 0.8 percent of total government spending.

148. The cost-effectiveness of passenger operations has been deteriorating in recent years. The cost per passenger-km was approximately 6 cents/passenger-km in 2005-2006, improving to 4 cents/passenger-km in 2007. However, in 2008, the ratio jumped to 10 cents/passenger-km and stayed at that level in the first half of 2009, reflecting the large fall in passenger volumes (passenger-km). For the same reason, subsidies under the passenger service obligation per passenger-km also increased in the period. Given the increased unit cost of passenger operations, measures should be considered to reduce costs in line with lower passenger traffic volumes.

149. To this end, operation at some stations or lines could be suspended or closed down. The traffic to Skopje is particularly low. Given that the train from Prishtinë to Skopje generated a loss of €620,000 with ticket revenue of only €97,000[101] rationalization of operations on this line should be considered. Staffing on passenger lines should be reduced accordingly.[102]

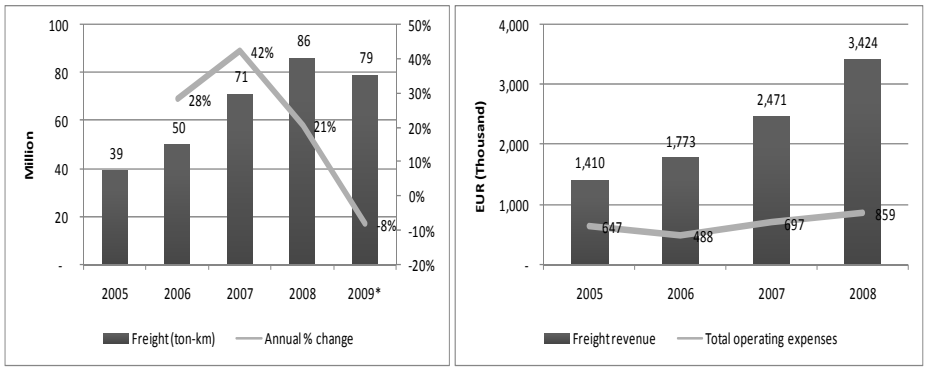
150. ***Freight Service.*** The future is freight. Freight volumes grew substantially between 2005 and 2008 (see Figure 12.) In 2008, KR increased its freight transport volume by 21 percent from the previous year which, while impressive, was less than planned as the global financial

[101] Kosovo Railways J.S.C. *Annual Report 2008* (January 2009), pp.2, 12.

[102] Ibid., pp.12-13.

crisis caused the railway company's main client, Ferronikeli[103] to transport only 46 percent of the planned amount of minerals. Another large client, Llamkos, producer of galvanized iron, transported only 53 percent of planned goods, while freight traffic for military transport (Italian KFOR) was greatly reduced by the closure of the northern railway line.[104] Volumes fell by thirty percent in first half of 2009, again largely due to the impact of the global financial crisis on the demand for base metals and minerals. Once the economic crisis passes, and assuming the mining industry also recovers, freight traffic volumes are expected to start increasing again.

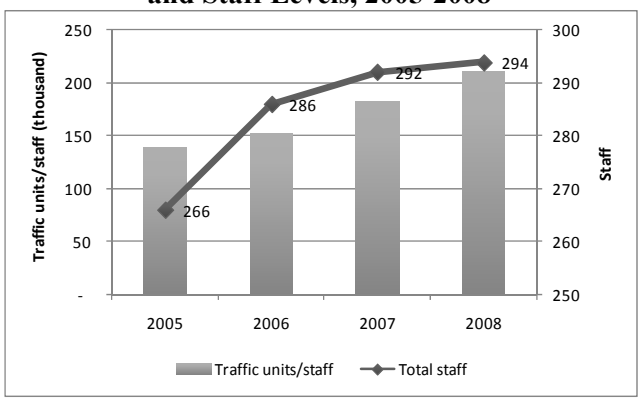
Figure 12. Kosovo Railways Freight Service Indicators



a) Freight Volume 2005-2009 (*forecast). b) Freight Revenue and Costs 2005-2008.

151. As Table 19 shows, freight operations were profitable from 2005-2008 with increasing annual revenues. Average revenue per freight net-ton-km also increased markedly. There is, nevertheless, room for productivity improvement. As shown in Table 20, railway productivity in Kosovo lags behind most regional and EU benchmarks. Staff productivity, for example, remains below all other countries in Central and Eastern Europe except Albania. While staff productivity appears to have improved in the last four years (see Figure 13), this is largely due to increased traffic volumes. Staffing numbers also increased during this period; just not as fast as traffic. As traffic volumes slow, productivity indicators are likely to fall. The Railways should consider shedding staff.

Figure 13. Kosovo Railways Traffic Units per Staff and Staff Levels, 2005-2008



[103] Ferronikeli ore mining and metallurgical complex was set up in 1984 to produce ferronickel for exports. It produced and exported 6,800 tons of nickel per year before 1990 but after the conflict in 1998 the company was idle for three years. Now the plant has reopened and it is one of the largest nickel smelting and mining operations in Europe, with 13 million tons of nickel ore in three open-pit mines.

[104] Kosovo Railways J.S.C. *Annual Report 2008* (January 2009), p.14.

Table 19. Revenues and Costs of Freight Railway Operations

	2005	2006	2007	2008
Freight revenue	1,410,243	1,772,526	2,471,017	3,423,642
Materials	137,670	214,808	104,149	252,029
Fuel and energy	379,799	227,177	1,243,359	1,366,530
Wages and salaries	130,000	130,000	137,027	179,189
Total operating expenses (excl. depreciation)	647,469	488,426	1,484,535	1,797,748
Operating profit	762,774	1,284,100	986,482	1,625,894

Source: KR.

Table 20. Regional Comparison of Average Revenue per Traffic Unit

Country	Year	Passenger traffic				Freight traffic			
		Traffic Units (million PKM)	Operating revenue (million local currency)	Average revenue / Traffic Unit		Traffic Units (million NTKM)	Operating revenue (million local currency)	Average revenue / Traffic Unit	
				Local currency	Euro cent			Local currency	Euro cent
Bulgaria	2005	2,389	141	0.06	3.02	5,163	269	0.05	2.66
	2006	2,422	165	0.07	3.48	5,225	274	0.05	2.68
	2007	2,423	187	0.08	3.95	4,711	302	0.06	3.28
Romania	2005	7,960	1,620	0.20	5.62	13,906	1,879	0.14	3.73
	2006	8,049	2,478	0.31	8.67	11,900	1,812	0.15	4.29
	2007	7,417	2,164	0.29	8.27	10,200	1,860	0.18	5.17
Macedonia	2005	94	100	1.06	1.74	530	1,278	2.41	3.93
	2006	105	108	1.03	1.68	614	1,459	2.38	3.88
	2007	109	115	1.06	1.72	778	1,863	2.39	3.91
Croatia	2005	1,266	310	0.25	3.31	2,835	641	0.23	3.06
	2006	1,362	336	0.25	3.37	3,305	724	0.22	2.99
	2007	1,611	371	0.23	3.14	3,870	764	0.20	2.69
	2005	910	1,563	1.72	2.02	3,565	7,150	2.01	2.35
Serbia	2006	837	1,626	1.94	2.45	4,232	8,817	2.08	2.63
	2007	762	1,716	2.25	2.87	4,552	8,851	1.94	2.48
	2005	19	1.46	0.08	7.69	18	1.14	0.06	6.34
Kosovo	2006	20	1.55	0.08	7.72	23	1.77	0.08	7.59
	2007	23	1.67	0.07	7.32	31	2.47	0.08	8.07

Source: World Bank data and Kosovo Railways.

152. Network rationalization is also required. As shown in Table 21, freight traffic density (as well as passenger traffic densities) in Kosovo are markedly lower than in other surveyed countries. The ratio of total traffic units per km of network is lower than the EU average or any other country in the region. The existing traffic does not warrant maintaining the whole network of 333 km operational. Some lines should be abandoned.

153. The ambitious investment plan of the railways should be scaled down to reflect the lack of demand and limited financial resources. Table 22 presents the total cost of the railway infrastructure projects (new investments and improvements) identified in the EU multi-modal strategy prepared in consultation with the MTC. The ambitious investment program would average €22 million per year from 2009-2030, out of which 25 percent would be covered from

Table 21. Regional Indicators of Railway Productivity, 2007				
Country	Staff Productivity (Traffic Units/Staff)	Freight Traffic Density (ton-km per km of line)	Passenger Traffic Density (passenger-km per km of line)	Traffic Units/km of Network
France	758,302	1,439	2,825	4,263,904
Germany	717,545	2,685	2,205	4,889,902
EU	683,260	1,806	1,806	3,611,468
Hungary	227,783	1,044	783	1,314,021
Poland	491,034	2,243	880	3,122,148
Croatia	383,989	1,313	592	1,904,849
Czech Republic	432,001	1,788	722	2,510,484
Serbia	253,967	1,112	200	1,394,854
Bosnia-Herzegovina	196,122	1,260	53	1,312,812
Bulgaria	409,148	1,171	602	1,772,535
Romania	315,820	1,265	697	1,962,051
Albania	52,235	125	121	245,863
Kosovo	**182,893**	**92**	**68**	**160,375**

the KCB. The cost of related rolling stock purchases could reach €234 million, depending on which infrastructure projects are implemented.[105]

154. However, implementing the investment program is plainly unrealistic, and completely unreflective of current and projected demand. Indeed, as noted in the EU study, the feasibility of the identified projects would still need to be analyzed from a financial and economic perspective.[106] Even if the case could be made, the indicated 75 percent funding contribution from the EU and IFIs is speculative as no concrete funding plans for financing them exist. Such large investments in railways would require trade-offs within the transport budget, for example down-scaling the investment plan for the road sector. The railway investment plan should therefore be treated as a reference list of investment needs in an optimistic rail traffic scenario, and not a realistic framework for the medium to long-term.

155. There is nevertheless a need for modest replacement and rehabilitation of current infrastructure and rolling stock. All signaling, interlocking and telecommunication systems are between 20-30 years old with speed restrictions on each section of the rail network.[107] As to rolling stock, all freight wagons and the bulk of passenger wagons and locomotives are over 40

Table 22. Railways Infrastructure Investment Plan 2009-2030			
Railway project	Description	Total Cost (Euro Mln)	To be completed at end of
Fushë Kosovë - Prishtinë	Double track electrification 160 km/h	29	2015
Fushë Kosovë - Ferisaj	Double track electrification 160 km/h	38.1	2015
Prishtinë multimodal station		10	2015
Fushë Kosovë - airport	Single track 160 km/h electrification	14.6	2015
Raid/road freight terminals		8.5	2011
Fushë Kosovë - Mitrovicë	Single track 160 km/h electrification	42.1	2019
Bardh - Pejë	Single track 160 km/h	77.9	2021
Klinë - Prizren	Single track 160 km/h	58.1	2022
Ferisaj - Hani I Elezit	Double track electrification 160 km/h	72.4	2025
Prishtinë - Podujevë	Single track 160 km/h	39.7	2026
Prizren - Vermice (Albania)	New line single track 160 km/h	13.4	2027
Mitrovicë - Leshak	Single track 160 km/h electrification	63.1	2030
Total		**466.9**	

Source: Egis BCEOM International & COWI *Kosovo – Multi-Modal Transport Strategy and Action Plan – Railway Transport Action Plan and Investment Plan* (Final version, March 2009) p.2.

[105] Egis BCEOM International & COWI *Kosovo – Multi-Modal Transport Strategy and Action Plan – Outline Strategy Report* (Final version, May 2009) p.19.

[106] Egis BCEOM International & COWI *Kosovo – Multi-Modal Transport Strategy and Action Plan – Railway Transport Action Plan and Investment Plan* (Final version, March 2009) p.2.

[107] Kosovo Railways.

years old. Some modernization of the signaling and telecommunications equipment has started but a major track upgrade program is yet to be launched. In 2008, capital investments in railways totaled only €2.5 million.[108]

156. As in the roads sector, fundamental institutional reforms are also required. Steps have recently been taken to improve the regulatory and legal framework for the railway sector. In June 2008, a new Law No 03/L-076 on the railways was issued. The law was defined to a significant extent by the EU and reflects the Government's desire to harmonize its legislation with the railway acquis communitaire.[109] Article 3 of the new Law foresees the creation of an independent Railway Regulatory Authority to regulate the railway sector. The new law also stipulates the separation of Kosovo Railways into two bodies—one in charge of operation and maintenance of infrastructure; and one in charge of train operations. To separate the accounting and managements functions, the Government has started in 2009 the legal preparations for creating two joint stock companies: the Kosovo Railways Infrastructure J.S.C, (INFRAKOS) and the Kosovo Transport Railways Operations J.S.C., (TRAINKOS). The Council of Ministers is expected to approve the legal separation by the end of 2009.[110] The Law also allows other passenger and freight train operators to apply for licenses and operate in Kosovo, in line with EU directives.

157. Changes in organization and staffing will be required to operationalize the new law. At present railway related issues in the Ministry of Transport and Communication (MTC) are handled by small number of staff within the Railway and Civil Aviation Department. New institutions should be established as specified in the new railway law and EU rail acquis,[111] including the Railway Regulatory Authority, Licensing Body, Safety Authority, and Accident Investigation Body. The Government's plan is to finalize their budgetary and financial framework by the end of 2009 and launch the new bodies by 2010.

Aviation

158. The recently created Civil Aviation Authority of Kosovo will guarantee that Prishtinë International Airport (PIA) operates in compliance with the standards and practices of the International Civil Aviation Organization (ICAO). Since 2005, the airport has been managed by Prishtinë International Airport Holdings J.S.C., entirely owned by the Kosovo Trust Agency (KTA), and its wholly owned subsidiary, Prishtinë International Airport J.S.C. To comply with relevant International Civil Aviation Organization (ICAO) standards and practices, the airport was certified until 2008 by the Icelandic Civil Aviation Authority (ICAA), which performed

[108] Kosovo Railways J.S.C. *Annual Report 2008* (January 2009), p.2.

[109] The transport acquis communautaire contains all the relevant Directives, Regulations and Decisions, together with all principles of law and interpretations of the European Court of Justice, all international transport agreements to which the EU is a party, including what is now termed as the ECMT acquis, and all relevant Declarations and Resolutions of the Council of Ministers.

[110] Information received during a World Bank visit to the Department of Railway and Civil Aviation Transport Department, October 22, 2009.

[111] The Government has appointed consultants to help establish the railway regulatory authorities and aims to have them created by the end of 2010.

regulatory oversight of air traffic controller licensing. The temporary technical assistance that was provided by the ICAA cost ca. €3 million/year from 2004-2008. However, the recently established Civil Aviation Authority of the Republic of Kosovo (CAAK)[112] has replaced ICAA, taking over all regulatory responsibilities, including aviation safety. The CAAK should be technically competent to ensure that its regulatory activities are performed in line with ICAO standards and recommended practices as well as with the EU aviation acquis.[113] However, technical assistance may still be needed in the future in areas such as issuing an air operator certificate for a future Kosovo airline.

Energy

159. The Kosovo Energy Corporation (KEK) is the integrated lignite mining, electric power generation, and power distribution company serving Kosovo. Despite recent improvements in performance, KEK service quality remains poor. Load shedding is still a frequent (though diminishing) occurrence. While outages have gone down from 14.7 percent of demand in 2008 to less than 9 percent in 2009, the lack of a reliable supply of energy remains a major impediment to doing business, especially for SMEs.[114] On the generation side, KEK's two large power stations are highly-polluting by EU standards. The older plant, Kosovo A, is particularly poorly maintained and technically unreliable.

160. The poor performance and condition of the energy sector are a drain on government finances. Recurrent subsidies to KEK totaled €42.8 million in 2008. These largely take the form of import subsidies. The 2009 budget allocated €62 million for import subsidies, although only €50 million was spent. The 2010 Budget subsidy for power imports has been set at €40 million. KEK has requested that the unspent portion of the 2009 subsidy (€12 million) be carried over to 2010. In addition to recurrent subsidies, the Government makes grants and loans to KEK for capital investments. KEK has currently five such loans on its balance sheet: two loans for the mining division (totaling €145 million) and three for the generation division (totaling 24.8 million). Only one of these (for €10 million) is in arrears.

161. But KEK confronts a need for massive new investment. All of the lignite currently mined by KEK for power generation comes from two old mines that will reach exhaustion by mid-2011. KEK is now opening up the Sibovc mine, which should produce over three million tons in 2010 and about six million tons in 2011. In 2010 alone, KEK Mining needs a loan of up

[112] CAAK was established on January 1, 2009 under Law No. 03/L-051 on Civil Aviation as an independent civil aviation regulatory agency.

[113] Kosovo has also signed onto the agreement that established the European Common Aviation Area (ECAA) Agreement which extends the application of the complete European Community aviation law to ECAA partners with respect to economic regulation, aviation safety and security, air traffic management, environmental protection, passenger protection and competition rules. In consequence, the Agreement will lead to harmonized safety standards across Europe.

[114] According to the 2009 BEEPS survey, 9 out of 10 firms in Kosovo identified the inadequate electricity supply as a problem for doing business, and one third of firms stated that it is the main obstacle.

to €75 million for further development of Sibovc SW mine and possibly another €118 million loan for the purchase of compact coal excavators and associated conveyor belts.[115]

162. Kosovo also has to build a new power plant. KEK's A units are on average over 35 years old, with the oldest units being over 45 years old. The A plant is one of the largest single-point sources of pollution in Southeastern Europe and has to be decommissioned at the latest by the end of 2017. Kosovo B is expected to be able to run until about 2030, but only after major rehabilitation. The Government's Energy Strategy[116] calls for development of a new power plant of up to about 1,000 MW to be built in phases over 10-15 years to supply both the domestic and the regional market.[117] This new plant complex, together with the new mine, is known as the New Kosovo Power Project (KRPP), and would permit the closure of Kosovo A by 2015 (at which time the first unit(s) of KRPP would be on line and rehabilitation of Kosovo B completed). At the same time the Government also intends to privatize Kosovo B and KEK Distribution.

163. The Government intends to rely on private investors to finance these investments. Through the Lignite Power Technical Assistance Project (2006) the Bank has supported Kosovo's efforts to attract world class strategic investors for the development of the new lignite mine and a new 500-600 MW power plant. However, KRPP has recently encountered several obstacles. Several of the originally prequalified bidders have withdrawn, citing financial considerations and changing corporate strategies. Four bidders were prequalified in February 2010 for a smaller size new power plant, the Sibovc mine, and rehabilitation of Kosovo B. As a result of these delays the proposed privatizations of KRPP, Kosovo B and KEK Distribution is expected to take place at best by mid -2011.

164. In the meantime, there is much the Government and KEK can do to improve the KEK's financial performance. Such measures will not only reduce the need for Government subsidies. They will also improve KEK's attractiveness to private investors, increasing the price the Government ultimately receives for it and hastening the date on which that occurs. The following sections of this chapter focus on the principal measures KEK has taken and the Government and KEK should take to increase the company's revenues and reduce its expenditures.

165. ***Reductions of Commercial Losses.*** Commercial losses have been long standing problem at KEK. In 2009, 44 percent of the energy entering the network was either stolen or otherwise not paid for.[118] This figure includes 9 percent for energy going to the Serbian enclaves. While this is an improvement over 2008, when the corresponding figure was 52 percent, the

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[115] As discussed below, the Ministry of Energy and Mines hopes that private investors will be able to provide some of this funding.

[116] *Energy Strategy of the Republic of Kosovo for the period 2009-2018, as amended and approved by Parliament April 2010.*

[117] A 500 MW unit could generate 3,700 GWh/year at 85% availability. Kosovo A currently produces about 1,300 GWh and imports are 500 GWh. This would leave about 1,900 GWh to serve any unmet domestic demand and the regional export market.

[118] This includes electricity KEK had to deliver to the minority areas, until 2009 equivalent to another 11% (non-paid) of energy available for sale. The corresponding figure for 2009 is about 9%.

figure is still high. Commercial losses in part reflect widespread illegal connections. Out of KEK's estimated 435,000 customers, only 405,000 are actually being billed. About fourteen thousand have illegal connections. Another 16,000 live in ethnic enclaves are currently beyond the reach of the billing system. Meter tampering and low collection rates[119] are also a problem.

166. With the advice and assistance of private management consultants, in place since January 2007, KEK has already taken significant measures to address these problems. To improve accountability, separate district managers are now appointed for each of KEK's seven service districts. All personnel within each district now report to those managers. Those staff, in turn, are responsible for all the energy delivered to a 10 kV feeder (a substation supplying a subregion of a district) and ensuring that it is billed and collected. To this end, the teams are responsible for meter reading, billing, theft detection. Feeder Teams must account for all energy delivered to a feeder, ensure the meters are read properly to bill for that energy, and disconnect those consumers that are stealing electricity or not paying their bills. Their performance is monitored through efficiency indicators which focus on the number of meters read per day, number of bills delivered, number of disconnections per day, etc. A monthly monitoring system identifies the worst performing feeder teams, which are then examined more closely. Employees not meeting targets have their pay reduced and receive a written warning, and are terminated if performance does not improve. The number of employees being disciplined has recently increased. Regional Directors have been appointed to further improve control and performance. In addition, meter readings are now performed on a 5-day reading cycle rather than the previous 21 day cycle, and bills are distributed within 3 days after meter reading rather than 21. A bonus system has been introduced for staff in districts where collections exceed targets.

167. In addition, a revenue protection organization has been established within KEK's Internal Audit Office under the supervision of the Audit Committee of the Board of Directors. This is a critical internal control function aimed at improving the billing for energy consumed and reducing the level of commercial losses caused by customer theft and employee corruption. Fifteen employees have been hired and trained and the plan is to add more staff. So far about 200 charges have been filed against customers and over 50 against employees. Also, about 200 recommendations for disciplinary action against staff have been made, including dismissals. Procedures have been changed to improve internal control and operations and a number of large scale investigations were performed.

168. A new field enforcement unit, still in the process of being staffed, has also been created. This will report directly to the Managing Director of KEK. Its mission is to deal with very difficult commercial loss identification and prevention cases. Disconnection of "problematic" customers will be handled by this unit and law enforcement units will be utilized when necessary. However, according to KEK ninety percent of the time police assistance is not required. It appears that key constraints preventing progress in dealing more effectively with theft and non-payment relate to corruption among some KEK employees and interference by powerful outside interests. (Privatization is expected to largely solve that particular issue, since private owners would be in a much better position to stop such behavior.)

[119] The percentage of billings that are actually collected.

169. KEK has also taken measures to facilitate payment. Until the end of 2007 the number of electricity bill payment options was very limited and often required queuing a long time at a few locations. Since then, however, many additional collection points have been established and about 20 mobile units are regularly going to the rural areas. Also, the KOS-Giro system

Box 9. A Better Board

Politically motivated changes in KEK management and its Board (KEK had three Managing Directors and four Boards of Directors in 27 months) caused gaps in institutional memory, management style and morale, and further contributed to KEK's poor past performance. The situation has improved somewhat. A new Board took up its functions in February 2009. For the first time its members have received general training on corporate governance and training in KEK-specific issues. An Audit Committee was formed and is up and running. In order to further strengthen KEK's governance, new bylaws and a code of corporate governance were approved in December 2009. To date, both the Board and the Audit Committee have performed in a more competent manner than their predecessors. In addition to the private consultants that have been advising KEK management since January 2007, a strategy to improve human resource management and match staff capabilities with job requirements is now being put in place.

(payment of electricity bills via all commercial banks in Kosovo) started up at the end of 2007. Daily electronic transmittal of payments has been successful and the information is being posted accurately to each KEK customer's account. A direct debit mechanism was put in place by the Central Bank throughout Kosovo starting in 2009, which could provide another opportunity to allow KEK's customers to use the banking system. That system is now fully operational as well. Several banks allow payment to be made via ATM and sometimes the internet, but such applications are still limited and not yet widely used. For most household consumers the increase in the number of collection points has been the most significant change so far.[120] KEK has also launched a metering improvement program aimed, in part, at reducing meter tampering. The program is underway but expected to take five years, since it involves about 400,000 meters. The estimated budget for the technical component of this project over the next 5 years is €70 million.[121]

170. As a result of the above measures KEK registered tangibly improved results during 2008 and 2009. Commercial losses declined from 49 percent in 2006 to 35 percent in 2009 (excluding minority areas (56 percent and 44 percent, respectively, if one includes the minority areas.) At the same time, energy billed as a percentage of energy available for sale went up from 69 percent in 2006 to 79 percent in 2009 and energy collected as a percentage of energy billed increased from 74 percent in 2006 to 82 percent in 2009. These are significant achievements in a difficult environment. KEK's energy accounting data are shown in the Annex.

[120] Direct payment to KEK employees, other than those employed at official collection stations, is specifically prohibited.

[121] The metering program will also enable small scale consumers to take advantage of time-of-day tariffs. Although such tariffs are in principle available to all consumers, only industrial and large commercial consumers can make effective use of them. KEK is reluctant to offer such tariffs to household and small commercial customers in part because the current meters have no battery backup. As a result, due to load shedding, their clocks have become inaccurate. The clocks are also vulnerable to tampering.

171. Nevertheless, KEK's efforts to track and facilitate payments will not fully pay off unless they are backed up by the threat of dire consequences for theft and non-payment. To strengthen that threat, reforms in the judicial process for enforcing penalties will be required.

172. Nationwide there are currently about 200,000 cases pending before the courts, of which over 20,000 have been brought by KEK. Out of these there are about 11,800 pending civil cases for non-payment of electricity with a total value of €38 million and an average court backlog of two years, and about 8,500 criminal cases for theft of electricity and other electricity related offences with an average backlog of 3 years. Since the statute of limitations on debts is one year for persons and three years for commercial entities, it is important to speed up the judicial process for these cases. The Kosovo courts are currently finding it very difficult to cope with their caseload due to a combination of long-standing problems (e.g., judges' low motivation on account of low pay) and temporary constraints (e.g., delays in the re-appointment process for judges). At the same time, inefficient case management practices and insufficient use of information technology are also to blame.

173. The judicial system could give priority to KEK claims via special chambers in the courts. This has been done before with postal, water supply and district heating claims. Given the value of the arrears payable to KEK pending before the courts (€38 million, or €3,220 per customer), along with the deterrent value of swift adjudication of high profile cases and consequent permanent improvement in collections, this option would be well justified. However, such a procedure would still deal with cases on an exceptional rather than routine basis, which is undesirable given the magnitude of the problem. The Government should therefore also consider an administrative adjudication procedure, with an accelerated full court process only in case of non-compliance with the outcome of the administrative procedure. Using standardized (and computerized) model judgments could also greatly expedite courts' processing of routine non-payment cases. Finally, there is at present no common reporting system on court decisions, so that each judge needs to reach decisions without ready access to the decisions of other judges. Such a reporting system should be introduced as soon as possible—ideally by adding this functionality to the existing Case Management Information System—in order to come to consistent interpretation of the law and help expedite the judicial process.

174. The provisions in Kosovo's existing Provisional Criminal Code appear to be inadequate to deal with energy theft. In many countries the lack of a clear law on electricity theft is a problem, since at the time of drafting of the electricity laws no one anticipated that electricity would be stolen so widely and so easily. This problem is sometimes compounded by uncertainty in the legal community about the nature of electricity, i.e., whether intangible electric current is a "thing" or a "commercial good" in legal terms and therefore can be considered as something that can be stolen.[122] Therefore, an amendment to the Criminal Code should be introduced specifically to make energy theft a criminal offense, along with having an illegal connection, meter tampering, and collusion by KEK employees.

[122] A task force on the amendment of the Criminal Code has been organized under the auspices of the Ministry of Justice. Initial reaction to MEM's proposed amendments was reportedly negative, since the members of the task force feel that energy is a "good" and that it is as such covered under the Criminal Code. However, that does not mean that the judges will interpret it the same way.

175. The Ministry of Energy and Mines (MEM) has now tabled concrete and well-conceived proposed draft amendments to the Criminal Code. They cover the basic offenses typically included in such a code, namely: (i) illegal connection to the network; (ii) drawing and using of electricity without approval of the licensee; (iii) tampering and bypassing of meters; and (iv) aiding or abetting of these offenses. One element currently missing in the proposed amendments is to allow the utility to levy financial and other penalties, such as denial of future electricity connection to the particular premises/owner, recovery of past consumption at penalty rates, etc.[123] Inclusion of such an amendment is strongly recommended.

176. The proposed amendments to the Criminal Code will require careful preparatory work before they go into effect and much effort on enforcement afterward. Before the law comes into force, the Government will need to build a constituency for change by consulting with stakeholders (consumers, labor unions and utility employees). Special administrative courts and/or judicial mechanisms or procedures should also be in place at the time the amendment comes into force. Enforcement itself should start with several widely publicized high-profile cases involving influential individuals or firms, so that the average consumer sees that the process is fair and not biased against the little man. This will also help rapid settlement of other cases and may make the theft problem disappear remarkably quickly. Since enforcement of debt judgments has also turned out to be a problem in Kosovo, the Government could also consider the use of liens on property or the use of private enforcement agencies who have been licensed by the State. This latter option has recently been introduced in Macedonia and Albania. Experience has shown that amnesties, on the other hand, are not effective. KEK has, in both 2008 and 2009, granted amnesty to unauthorized consumers if they wanted to have a legal connection, but with little result.

177. Urban planning and enforcement of building licensing procedures is needed. Throughout Kosovo construction is taking place without prior planning permission which has, inter alia, serious consequences for the electricity supply. Yet, in accordance with standard utility practices KEK will not connect buildings that do not satisfy certain minimum technical parameters. To avoid that the apartment owners start stealing electricity, however, KEK has made temporary connections to meet basic electricity needs. Eventually, it may have to install transformers in suboptimal locations in or around the buildings. The temporary connections will be regularized once all permitting requirements have been met. The Government should exert pressure on municipal authorities to enforce building licensing procedures and building codes help build up their capacity to do so and improve urban planning in general. Local authorities should force developers who build without the required permits to make the necessary modifications to these buildings at their own expense.

[123] Such penalties would be relatively mild by the standards of some other countries. Section 184 of the Criminal Code of Turkey, for example, provides prison sentences from 1 to 5 years for anyone who illegally constructs or continues to operate a building with an illegal electrical connection. The Andra Pradesh (India) Electricity Act of 2003 specifies up to 3 years imprisonment and/or a fine for making illegal connections, meter tampering and equipment destruction. For actual consumption the prison term may be extended to five years for larger consumers.

178. ***Minority Areas***. Enforcing collection in minority enclaves will be more problematic. In mid-2009 Agreements to Regularize Electricity Service in virtually all minority areas South of the Iber were entered into between community leaders and KEK district managers. In essence, these agreements commit KEK to refrain from disconnecting service to customers covered by the agreement on account of past arrears as long as those consumers pay their current monthly invoices on time for at least 12 consecutive months (36 months for commercial customers). Demand declined by 20 percent as soon as these consumers started paying. This is less than the 40 percent drop often seen in other countries because in Kosovo there is no natural gas system that could absorb the demand for heating.

179. But about two-thirds of the electricity sent to the minority areas flows to the unregulated area North of the Iber. Since that area was not following KEK's dispatch instructions during times of system overload the area was disconnected in October, 2009. EMS (the Serbian transmission company) sends the area up to 30 MW per day (the maximum capacity it can supply) and charges KEK for it, which it can do since EMS is the regional transmission operator and keeps the books on transit flows. From its side KEK instructs the Umani hydropower plant to run about 6 hours per day to give the area some electricity for humanitarian reasons, while using the water for the cooling of Kosovo A and B (KEK could also use a bypass pipeline and not generate electricity). This output is equivalent to about 8 MW. In total KEK loses currently about 32 MW/day (275 GWh or €15 million per year at its sales price of €55/MWh) to the North. Since the operating cost of Umani is very low and the imports are paid for by GoK this is pure bottom line loss. KEK has the technical capability to bypass the North if necessary and shed that load, but that would mean de facto separation.

180. One option under discussion would be to have a newly-created energy services company to provide services to KEK in the North. This would be subject to the company's s registration in Kosovo and it entering into a service contract with KEK. Under the proposal, the company would register, seal and read all meters and be KEK's agent under a fee-for-service contract. While KEK has been proactive in dealing with the minority areas' consumers, this is really first and foremost a public policy issue involving not only the Government but also the international community. Resolution of the North of the Iber issue would result in further financial gains: an immediate loss reduction of 275 GWh per year, or about 5.5 percent of the energy entering KEK's network.

181. ***Reductions of Technical Losses.*** Technical losses (i.e., losses attributed to network design or overload) in the system are high, averaging 17 percent at the distribution level.[124] By West European standards a well functioning system the size of Kosovo's should have losses of only around 7 percent. However, reducing losses to that level will require major investments.

182. The main culprit is the low level of voltage. The vast majority of KEK's customers live in areas currently being served at the 0.4 kV level, which entails significant distribution losses. In developed economies the service level is normally at 10kV and all customers have their own transformer. As a result, distribution network losses in those systems are about half of those in Kosovo. Raising the voltage for all customers to 10 kV will reduce technical losses by

[124] Since 2006 transmission is the responsibility of a separate company, the Kosovo Electricity Transmission, System and Market Operator (KOSTT).

about 50 percent. It would also be a deterrent for customers to illegally connect themselves, since coming into contact with a 10kV line can be fatal. But bringing it up to 10 kV would be costly. It is estimated that bringing all customers up to 10 kV would cost around €500 million.[125] At current tariffs, these investments would not be economical--the payback period would be decades rather than more normal 5-7 years.

183. Technical losses can also be due to system overload. Therefore, whenever possible, KEK is upgrading the lines on as needed basis (line extensions to new customers or new residential or commercial developments), installing new transformers, moving oversized transformers to places that need larger transformers, etc. KEK used its own money during 2009 to invest €5 million in distribution networks and expects to invest about €25-30 million of its own funds during 2010. No Government funds will be sought for that purpose. At this annual investment level technical losses are expected to be reduced by one half of one percentage point each year or 25 GWh, equal to €2.5 million at import prices. However, it should be noted that as long as the 0.4 kV system exists technical losses are unlikely to go below 14 percent even in a best case scenario. Overall, KEK's focus for the next few years should primarily be on reducing commercial losses, which require relatively little investment compared to technical loss reduction.

184. ***Reductions in Operating Expenses.*** The financial burden that KEK imposes on government could be reduced by reducing KEK's operating expenses. KEK is overstaffed. As of mid-November 2009 KEK had 7,811 employees, of which Mining had 3,404; Generation 1,621; Distribution 2,401; Corporate Services 188; Finance 166; and Headquarters 31. The average staff cost is about €480/month (€5,760/year), significantly higher than the average staff cost in the rest of the economy[126], but in line with staff costs in surrounding countries that still have state-owned electricity utilities. Staff costs constituted about 31 percent of KEK's operating expenses in 2009, the second largest operating expenditure category after material and supplies (36 percent).

185. Staff increased during 2009 because KEK had to bring in qualified new people for the Internal Audit Office (Financial and operational Audit), Field Enforcement, Finance, Information Services (IS), etc. For example, the company hired qualified new IS staff to centralize all IS so there is one common interlinked database throughout the company. This should help reduce corruption and theft, with support from the Internal Audit and Field Enforcement units (see section on Commercial Loss Reduction). KEK also added about 80 employees due to its decision to re-establish the electro-engineering department with the Network Division. This function was outsourced in 2006 but that proved to be counterproductive for such a core function.

186. As shown in Table 23, staff could be reduced by about 5,000 (65 percent) or about two-thirds, although the final reductions on this scale can only be completed after equipment upgrades are in place. For example, following closure of the Mirash and Bardh mines the new

[125] The cost breakdown is as follows: (i) transformers for every one of KEK's 432,000 customers at a cost of €400-500 per transformer and associated equipment (€ 250 million); (ii) replace all 0.4 kV lines (5,500 feeders) with 10 kV lines in order to make theft impossible (€250 million). Source: Financial Recovery Plan, KEK, 2005.

[126] Average gross wages in Kosovo, excluding the public sector, were €340/month in 2009

mining division will need only about 1,000 staff instead of the current 3,400 employed at present. Kosovo A and B could be run with far less staff than the current 1,600, especially after Kosovo A closure. The staff employed in distribution has already been downsized somewhat and automation of substations will cut that further since there will be no more manual switching, which currently occupies 300 staff. Distribution could go down further from 2,400 to 1,200 staff. (As KEK currently has no downsizing program in progress, the proposed schedule of cuts is likely to be delayed.)

187. KEK is in the process of reorganizing the company and intends to reduce staffing levels, beginning with a voluntary buyouts program. The Board has approved the voluntary buyout program's process. In order to get the buy-in from the unions, management proposes to pay five times what the current labor law requires for employees having served 20 years or more. Those who are declared redundant but do not accept the package will get three months' notice, during which they can try to find another job within the company. If they do not succeed then they will only get the severance payment required by law.

188. By the end of 2010 KEK could have 1,000 staff less than at present. With annual staff costs of about €44 million, such a 13 percent staff reduction would translate into zero net savings in 2010 (the redundancy packages would cost €5.8 million during 2010, assuming average compensation equal to 12 months of wages) but in savings of €5.8 million p.a. starting in 2011. If another 1,000 staff per annum accept the package through 2014, the cumulative savings at constant salaries would be €1.5 million in 2012, culminating at €28.8 million in savings per year by 2015, a year after the redundancy program would be completed. If the ERO allows KEK to keep the savings and use them for investments and operating expenses such as power imports, this would be a net gain for the budget as well. Of course, some of the gains will be offset by salary increases as the company shrinks and better qualified people are retained.

Table 23. Redundancy Program Savings

	2010	2011	2012	2013	2014	2015	Total
Staff (start of year)	7,800	6,800	5,800	4,800	3,800	2,800	-
Staff reductions	1,000	1,000	1,000	1,000	1,000	0	5,000
In € Million:							
Savings (gross)	5.8	11.5	17.3	23.0	28.8	28.8	86.4
Program costs	5.8	5.8	5.8	5.8	5.8	0.0	28.8
Savings (net)	0.0	5.8	11.5	17.3	23.0	28.8	57.6

* Assuming constant average employee costs of €480/month.

189. The Government should support KEK in its efforts to right-size the company and terminate corrupt, incompetent and/or redundant employees. Furthermore, it should not force KEK to hire anyone and should allow the KEK Board to instruct management to terminate employees that are members of Parliament or members of Boards of Directors of companies that are providing services to KEK. The redundancy program, if fully implemented, will have significant social and political implications and Government should take appropriate measures to mitigate the impact of this, including introducing training programs to help people find other jobs.

190. ***Restructuring Subsidies, Increasing Tariffs.*** Subsidies should be restructured and tariffs should be increased. The principal Government subsidy to KEK is a so-called import subsidy. At present, this covers virtually all of KEK's expenditure on imported power. The subsidy started as a response to a surge in imported power prices (as well as an implicit recognition by the Government that it bears indirect responsibility for KEK's difficulties in enforcing payment of electricity bills). Starting in 2000 KEK had to import substantial amounts of electricity from neighboring countries because of increasing domestic electricity demand and the poor condition of its own equipment. The situation was especially acute during 2000-2002, when almost twice as much power had to be imported as today. The price of imports increased gradually from about €30/MWh during 2000-2002 to €54/MWh in 2006. In 2007, however, the price of imported power suddenly jumped to an average of almost €84/MWh, reflecting electricity shortages in the SEE region as a whole. Consequently, KEK's budget for power imports reached €45 million (540 GWh) in 2007, of which the KCB funded €15 million. In 2008 spot prices were at times as high as €130-150/MWh. The cost of power imports reached €52 million (458 GWh) that year, of which the Budget funded €48 million. [127]Due to the economic slowdown, electricity demand in the SEE region has slumped by about 10 percent. Prices have fallen at times to about €40/MWh as sellers sought to offload surplus capacity. To date, KEK has been unable to fully take advantage of these drops in spot prices as it had to contract for its basic import requirements through the end of the heating season (March 31). In 2009, subsidies to KEK totaled €50 million. According to the company's preliminary financial statements for 2009, this constituted 22 percent of KEK's operating income in 2009.

191. There is no rationale for subsidizing energy imports, provided the cost of imports is appropriately provided for in the tariff setting methodology. It is costly to the Government and, as noted in Box 10, it distorts the prices confronting consumers, leading to over-consumption. The import subsidy no longer functions as temporary compensation for spikes in the price of imported power. In effect, it merely functions as a general subsidy to KEK, allowing the company to break even despite its commercial losses.

192. Eventually, and with the exceptions noted below, all of KEK's operating costs should be covered by tariffs. At present, tariffs are regulated by the Energy Regulatory Office (ERO). ERO's tariff methodology is intended to allow tariffs sufficient to cover all operating and maintenance costs as well as a return of 13.8 percent on certain assets and a small depreciation charge. Appropriately, the calculation of operating costs currently excludes expenses covered by Government subsidies; e.g., power imports. Less appropriately, the tariff calculation does not take into account KEK's inability to collect from Serbian enclaves in the northern part of the country or about half of the losses suffered by KEK due to its inability to enforce collections through the judicial system. ERO believes that existing tariffs would be adequate to allow KEK to make a profit if KEK's billing and collection performance improved and its overstaffing were reduced. As a result, ERO believes that electricity tariffs can be kept virtually constant, especially if Government helps KEK to reduce theft and commercial losses further. For 2010, ERO has ordered average tariffs to remain at their 2009 level, despite KEK's request for a 13.6

[127] The Ministry of Energy and Mines also claims that the terms of KEK's contract with Ferronikeli forces KEK to lose money, as the price charged to Ferronikeli is less than the price of imports. The Ministry recognizes, however, that KEK would be losing money even if Ferronikeli purchased its power directly from the grid.

percent increase. This means that during 2009-2010 tariffs have been kept constant in nominal terms and significantly declined in real terms.

Box 10 Raising Revenues, Rationing Demand

In addition to raising revenues, raising tariffs would reduce demand, reducing the need for imports or expensive investments in generating capacity. The most effective tariff demand-side management measure for Kosovo would be introduction of a tariff structure that reflects the cost of serving each category of consumer. Unless customers receive the proper price signal, they have limited incentive to control their demand. Once consumers pay for their electricity consumption demand typically drops by about 20% (40% if alternative heating methods are available such as gas).

There is now an element of cross subsidy in KEK's tariff structure. KEK's 2009 tariff application showed that households (accounting for more than 60% of the demand) were paying only 76% what it costs to serve them, while all other classes in total were paying slightly more than cost. This suggests that tariffs on households should be increased while those on other classes of customers should be reduced. The ERO, however, rejected KEK's proposal to reduce the cross subsidy and increased all tariff categories by 2.5% across the board.

The measures to reduce theft and improve collection rates (discussed in the main text) will also help ration demand. In addition, the Government can reduce demand for power by encouraging: (1) the replacement of incandescent bulbs with CFL bulbs; (2) the use of non-electric forms of heating (including wood and liquefied natural gas); (3) cogeneration (such as using waste heat from power generation to provide district heating to Pristina; and (4) adoption of building codes which encourage efficient energy use. These are all described in Annex F.

193. It is true that if KEK were less overstaffed and if the company's billing and collection performance were better, tariff increases might not be required. In fact, the Government could begin reducing the so-called import subsidy. But these improvements cannot be achieved overnight. More importantly, they cannot be achieved without the active support of the Government, through revised enforcement legislation and the support of the police and the courts. Rather than simply rejecting tariff increases, ERO, together with the Government and KEK, should agree upon a transition path, which would specify actions to be taken by both the Government and the company, targets for operating efficiency improvements and commercial loss reductions, and corresponding targets for tariff increases and subsidy reductions. How quickly subsidies can be reduced will depend on how quickly KEK is able to reduce energy theft and improve collection performance. In a situation like Kosovo's, where a large number of illegal consumers are hooked up to the network and others simply don't pay their energy bills, care must be taken to ensure that the burden of subsidy cuts does not fall entirely on those customers who have legal connections and pay their bills on time.

194. Other reforms in the tariff and regulatory regime are also advisable. Allowances for depreciation may need to be increased, to ensure that tariffs generate sufficient revenue to finance the replacement of existing assets as they deteriorate. Clarifications in regulatory terms will be required to address the concerns of potential private investors in KRPP, Kosovo B, and KEK Distribution. These include the definitions of the regulatory asset base (which is quite low at the moment) the allowed return on equity, the amount and price of power to be imported to cover losses and the portion of bad debt allowed in the end-users' tariff.

195. ***Targeted Subsidy for "Social Cases"***. Although tariffs should become the primary source of KEK's operating revenues, there are rationales for two remaining kinds of subsidies. The first would subsidize power to low income households. The Government already recognizes the need to subsidize the electricity consumption of poor households in order to enable them to pay their bills. A "social cases" subsidy of €4.5 million, corresponding to electricity consumption of 400 kWh/month/social case consumer, is provided each year in the budget.[128] This amount is paid with a one-year delay directly to KEK rather than to these consumers, to ensure that there is no leakage. Currently only 30,000 households receive the subsidy. KEK has proposed that the Government expand the scheme by covering all households in "extreme poverty" as defined by the World Bank, i.e., about 50,000. If this proposal were to be adopted, the subsidy to the social cases would increase by about €3.0 million to €7.5 million, unless the kWh/month allowance were to be decreased at the same time. Since many of these extremely poor consumers currently cannot pay their bills this would increase KEK's cash flow and improve its collection performance correspondingly. For the Government this measure would be essentially budget neutral as KEK's increased collections would enable Government to decrease subsidies to KEK for power imports by the same amount.

196. ***Subsidies for Ethnic Enclaves.*** There is also a case for the Government to subsidize KEK for the costs providing power North of the Iber, where it is providing power but is not able to charge. As noted earlier, the area to the South of the Iber is now paying but the area to the North is still not paying while consuming about 275 GWh/year, resulting in major financial losses. Hence it is reasonable for KEK to receive subsidies for these costs. At the same time, the Government should support KEK in any measures that it can realistically undertake to reduce its losses there.[129]

Municipal Finance

197. In the past decade, municipalities have played a major role in the provision of public services in Kosovo and accounted for a large share (approximately a quarter) of public expenditure. With the entry into force of the Constitution of Kosovo, which includes provisions on decentralization, and the new laws on Local Self-Government (LLSG) and Local Government Finance (LLGF) in June 2008, Kosovo municipalities have seen their functions and their budgets expand.

Organization and Functions

198. Kosovo currently has 36 municipalities, which are expected to increase to 38 by the end of 2010 in line with the provisions of Constitution, the Law on Local Self-Government, and the Law on Municipal Boundaries of 2008. Municipalities were the first local institutions to be established after Kosovo was placed under UN temporary administration at the end of the

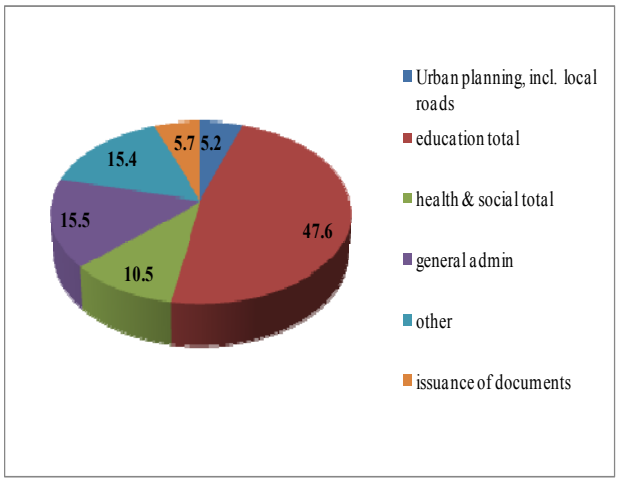
[128] This is well above the 200 kWh recommended by the World Bank but may be justified due to the need for electricity as a supplementary source of heating. Efficient stoves might enable reduction of this allowance.

[129] The international community has always exerted significant pressure to keep supplying the North as well.

conflict in 1999. Municipal competences initially included responsibility for primary and secondary education, primary health, and the range of public services that are typically assigned to the municipal level such as waste collection, street lighting, etc.

199. As shown in Figure 14, education is by far the largest functional category of municipal expenditure, accounting for nearly half the total. Spending on health accounts for another ten percent. Fifteen percent is spent on 'general administration', a category which includes the costs of the offices of mayors and CEOs municipal assemblies, municipal inspectorates, and departments of budget, finance and procurement. Spending on urban planning which includes maintenance and construction of local roads, accounted for only five percent of the total.

Figure 14. Municipal Expenditures, by Function, 2008 (in percent)



200. The new Constitution authorizes the transfer of additional functions to local governments. To date, the process has been completed only for social assistance. The transfer of culture, youth, and sport is currently underway. Water supply and district heating are now defined as municipal competencies, although the companies providing these services have yet to be decentralized. (Two district heating companies are in process.) In addition, a number of functions previously exercised by central government (e.g., business registration) are now defined as 'delegated' functions, to be administered at the municipal level. Serb-majority municipalities are also endowed with 'enhanced' functions in the areas of culture, three with secondary health, and – in one case – higher education.

Sources of Municipal Revenues

201. Municipalities derive the vast majority of revenues from intergovernmental transfers. The current system of local finance is based on the Law on Local Government Finance (LLGF) of 2008, which was first implemented in the budget for 2009. The LLGF limits municipalities' own revenue raising authority to a property tax, fees for construction permits, business and professional license fees, a motor vehicle fee, and various other fees and charges, along with income from the rental or sale of municipal property. In 2009, fees from construction permits for the first time exceeded revenue from the property tax.[130] These sources are defined as 'own source revenues' and account for only 22 percent of revenue in 2008.

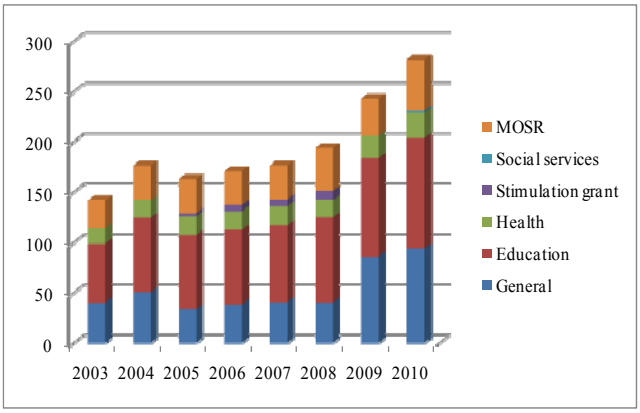
202. Municipalities instead derive most of their financing from central government transfers. As defined in the LLGF, these consist of three principal grants. The first is a general grant, which: is not earmarked, is based on a fixed share of central government revenues, and is

[130] IMF Fiscal Affairs Dept., *Republic of Kosovo: Next Steps in Fiscal Decentralization* March 2010.

distributed largely on the basis of population. The second and third are specific grants earmarked for education and for health, respectively. These are based on the hypothetical costs of providing these two services, and distributed on the basis of enrollment and population, respectively. (Details are provided later in this chapter.) In addition to these transfers, the LLGF (Art. 5, 6, 25, and 26) requires the central government to provide additional transfers for delegated and enhanced functions. However, the law does not specify how these transfers are to be calculated, thereby allowing a measure of discretion.

203. Municipalities may obtain additional funds, for capital investments, by requesting co-financing from central ministries for their capital projects. However, co-financing of municipal capital projects by central ministries is not channeled through municipalities' budgets, but takes the form of parallel financing.[131] Finally, municipalities may, in time, obtain access to credit. Until recently, municipalities did not have the legal authority to take on debt liabilities, but the possibility of municipal borrowing subject to controls by the Ministry of Finance was provided for in the LLGF and the Law on Public Financial Management and Accountability. The new public debt law now allows municipal borrowing (though no international borrowing), subject to limits monitored by the MEF and certain other conditions, including unqualified external audit reports of municipal accounts.

Figure 15. Municipalities' Sources of Financing (€, mln)



Sources: MEF Treasury; MEF Budget Department.

204. ***Trends in Revenues.*** The last several years have seen remarkable growth in municipal revenues. As shown in Figure 15, total recurrent revenues increased by 53 percent between 2005 and 2009. The budget for 2010 calls for a further increase of 13 percent. Most of this increase occurred between 2008 and 2009 (a 28 percent year-on-year increase) and, as shown in Figure 15 was largely due to an increase in the general grant. This in turn was largely due to sudden increase in the share of central revenues to be shared with local governments. In 2008 the general grant (along with a related property tax stimulus grant) amounted to only 6 percent of central budget revenues. In 2009, this percentage was increased to ten percent. As a result, total central transfers to municipalities as a share of central revenue (government tax and customs revenues) increased from 18.75 percent in 2008 to 25 percent in 2009.[132]

205. The projected increase in transfers in the 2010 budget is more modest, although still higher than projected growth in central government revenues. This is largely due to projected

[131] Serb-majority municipalities may also receive additional financing from Serbia, which does not affect the level of the transfers they receive from the Kosovo central budget. At present funds from Serbia are not recorded in the Treasury system nor do the recipient municipalities actually report them to the central government.

[132] These calculations are based on actual central budget tax and customs revenues for 2008 and 2009, while the projection for 2010 is based on the draft budget submitted to the Parliament.

increases in the health and education grants. These two grants account 54 percent of the overall budgeted increase in central transfers to municipalities.

206. In the past few years, municipal own-source revenues have also grown impressively—by just over 80 percent between 2005 and 2009, exceeding projections in the budget for the first time in 2008. However, this tendency was reversed in 2009, when municipal own source revenue declined slightly. A recent IMF draft report[133] suggests that the sharp increase in central transfers, which took effect in 2009, in conjunction with the timing of the municipal elections of November 2009, may have discouraged local tax effort. A recent report by the IMF concludes that municipalities still have considerable scope to increase their own source revenues, especially by increasing property tax rates and improving tax collection; introducing fees for the legalization of unauthorized construction; and indexing other fees to inflation.[134]

Overall Performance

207. Overall, the existing system of local government finance is well designed and functions fairly effectively. Like most European systems, it has three ostensible objectives. The first is to provide local governments with access to a broad based tax base (or bases) in the absence of such instrument under municipal control. This it does by allocating ten percent of central revenues to the general grant. The second is to ensure some degree of equalization in discretionary resources. This it does by distributing the general grant largely on the basis of population. The third is to ensure a basic level of funding for key social services. This it does by establishing separate earmarked transfers for education and health and distributing them according to indicators of need.

208. ***General Grant.*** The specific design of each transfer largely ensures transparency and objectivity. As noted earlier, the total amount to be transferred under the general grant is fixed at 10 percent of budgeted central government revenues (excluding extraordinary revenues such as privatization proceeds, central budget organizations' own source revenues, and loans). This is distributed among individual municipalities on the basis of (relatively) verifiable and objective criteria. Eighty nine percent of the grant is distributed on the basis of population; six percent on the basis of land area and five percent on the basis of minority populations.[135] To provide additional funding to small jurisdictions, an amount equal to €140,000 per year, less €1.00 per capita, is distributed to all municipalities with populations under 140,000.

209. Because population dominates the distribution criteria, the general grant is highly equalizing (compared to a system that requires local governments to rely on their own tax bases or distributes a share of centrally collected taxes on the basis of origin—a common practice in the region). As a result, disparities in per capita discretionary revenues are less pronounced in Kosovo than in surrounding countries. The macroeconomic risk associated with the general grant

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[133] IMF Fiscal Affairs Dept. *Republic of Kosovo: Next Steps in Fiscal Decentralization* March 2010.

[134] Ibid.

[135] Current population data are not accurate, as 20 years have passed since the last census – a period of significant demographic change and migration, which have greatly expanded the population of some municipalities. A new census is to be held in mid-2011.

is also minimal. Because the overall amount of the grant is specified as a fixed percentage of government revenues, it does not constitute a fixed or open ended fiscal commitment on the part of the Government. The amount of the general grant will rise (or fall) as central government revenues rise and fall. While this creates a certain amount of uncertainty for municipal governments, it is not unreasonable to expect municipalities to share in fiscal fate of the Government.

210. There is, moreover, evidence that the system is being largely observed in practice. The amount of funding allocated to the general grant in the budget has, in fact, corresponded to the amount specified by law. The law provides that, if actual central government revenues exceed the budgeted amount by more than five percent, the amount of the general grant will be increased by a corresponding amount in the following budget year. The Government has done so. In a reverse scenario (i.e. were revenues to fall short of projections by more than five percent), the law is silent, but presumably the Government may be entitled to claw back the difference in the following year.

211. ***Earmarked Grants.*** Like the general grants, the design of the earmarked grants ensures transparency and objectivity. As noted in earlier chapters, both are formula based. For education, the total amount to be distributed is derived from an estimate of cost of the wage bill for teachers in basic and secondary schools. This is determined by converting enrollment figures into full- time-teacher equivalents using fixed pupil: teacher ratio norms for each type of school. These are then converted into Euro amounts on the basis of current salary levels. The total amount is then distributed among individual municipalities on the basis of each municipality's reported enrollment in schools of each type. The health grant, similarly, uses a formula consisting of the estimated number of annual visits to all health centers (2.8 visits per capita), the cost of each visit (€3.90) and the estimated population living in the facility catchment area.

212. Because they are earmarked, both grants ensure that funds are in fact spent on these two functions. Unlike the general grant, they do present certain macroeconomic risks to the central government. The two specific grants are open-ended. The overall amount allocated to each grant in each year varies depending on student enrollment, pupil teacher norms, and salaries (in the case of education) and population, average visit costs, and norms on the frequency of visits (in the case of health). As a result, the Government could find itself obliged to increase funding for the education and health grants even as its own revenues were declining.

213. This risk is mitigated by two factors. First, the Government itself controls some of the determinants of its own grant obligations. In particular, it controls the level of wages for teachers and health care workers. These in turn determine the level of the per student payment, in the case of education, and the average cost per visit in the case of health. By restraining the growth of wages, the Government can reduce the amount it is obligated to pay under the two grants. Second, the demographic outlook—at least for the education grant—is favorable. As noted in the earlier chapter on education, enrollment levels are not expected to rise. (In the absence of a reliable demographic data, the outlook for population cannot be determined.)

214. Municipalities, on the other hand, run the risk that the central government will increase the costs of these two services (by, for example, increasing salaries) without making

corresponding increases in the earmarked grants. Indeed, this appears to have occurred with ad hoc salary increases for health workers, for which municipalities have been only partially compensated. Under these circumstances, municipalities would be forced to subsidize these services from their discretionary revenues. To date, the Government has shown considerable eagerness to increase wages in education and health. It granted a large pay increase to teachers in September 2008 which was not anticipated in the budget. The Government did, nevertheless, make an extraordinary transfer to municipalities to cover teachers' salaries for the last three months of 2008 and revised the Grants Commission decisions governing future transfers (which had been based on the earlier salary levels) to reflect those increases in the future.

215. In the health sector, similarly, the Government topped up the health grant to reflect a 10 percent pay increase granted to all public sector employees in early 2009. On the other hand, no adjustment to the health grant was made either in 2009 or 2010 to accommodate a monthly allowance of €44 that the Government granted to all health staff in late 2008. The allowance increased the wages of municipal health workers by €3.11 million in 2009. In the absence of an increase in the health grant, municipalities had to cover the cost of this allowance from their own source revenues. Although the MEF argues that municipalities formally agreed to this arrangement (in the form of a memorandum of understanding) some municipalities claim that they were forced to agree to it to ward off strikes from healthcare workers. They now claim they lack the resources to pay it. The Government has gone on to grant a 30 percent wage increase for doctors (later apparently extended to all health workers) effective of January 2010. To date, this has been only partly compensated by an increase in the health grant. For municipalities, the total cost of the increase will be at least €3.8 million (if this increase is limited to doctors). In December, the Government authorized a top-up of the health grant of €2.5 million. The remaining €1.3 million was expected to be transferred to municipalities in the mid-year budget review, but this may not actually happen in view of anticipated expenditure cuts related to an agreement with the IMF and the Government's efforts to reallocate funds to cover the costs of the new highway project to Albania.

216. This pattern of ad hoc, centrally imposed wage increases, followed by partial or delayed increases in the education and health grants sets an unfortunate precedent. If the practice continues, it will undermine the credibility of the transfer system and diminish the transparency and predictability that are key virtues of the system's design.

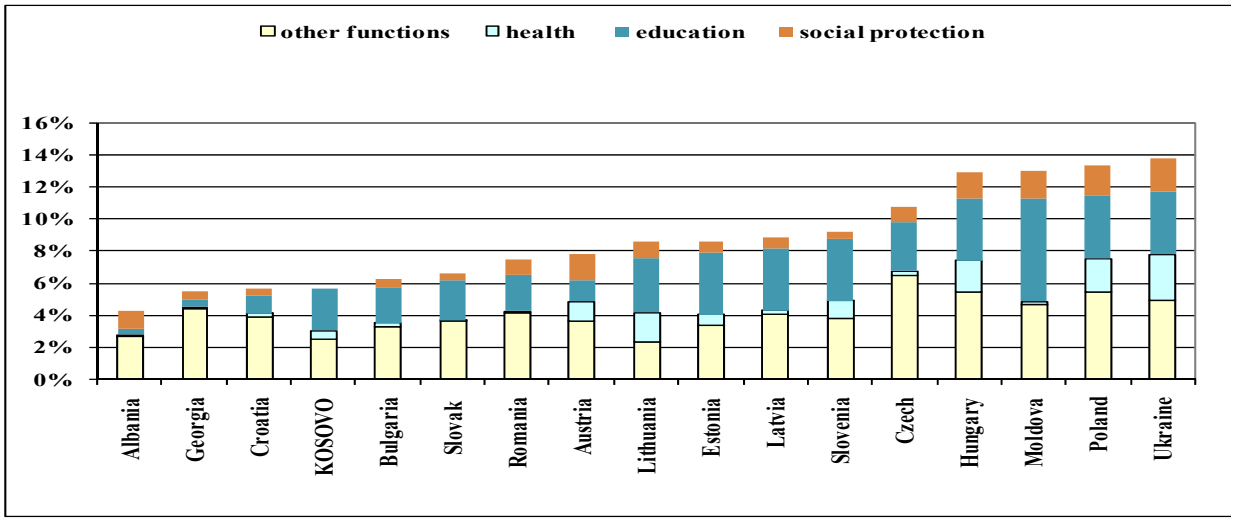
217. ***Are Local Governments Overfunded?*** From the perspective of a public expenditure review, the details of transfer design beg a more fundamental question: is the overall level of central government transfers to municipalities too high? Or too low? One could argue that the level of grants for education and health is too low. If the aim of these two transfers is to finance the full salary costs of basic and secondary education (in the case of education) and the operating costs of primary health clinics (in the case of health), the current levels of funding—*if current levels of municipal spending are taken as a guide*—is too low. Total municipal spending on education and health exceeded the amounts of the education and health grants by 14.8 and 11.8 percent respectively in 2008. Preliminary budget execution data for 2009 suggest that municipalities have continued to help finance education and health from their own source revenues, as spending on education and health exceeded the earmarked grants by 4.2 and 14.6 respectively. These results must be considered inconclusive, however. It is entirely conceivable

that municipalities are deliberately subsidizing education and health in order to provide higher quality services than the two grants would allow. (In the case of health, the results are also distorted by the inclusion of patient copayments in the category 'own source revenue'. Such payments generated €4.4 million in 2008. If that amount were added to the municipalities' receipts from the health grant, the total would far exceed the aggregate level of municipal spending on health.)

218. In the case of the general grant, the question is more complicated. Some countries have attempted to define the 'right' level of local government spending by defining physical norms for each of the services provided by local governments and calculating the cost of achieving them. This approach is difficult to implement with any degree of accuracy or fairness. Many of the functions performed by local governments are difficult to cost out. (How much should it cost to maintain streets? What is the right level of subsidies for garbage collection?) Moreover, the cost of meeting a given norm, even if it could be defined, varies widely among jurisdictions.

219. As a result, arguments over the correct level of local resources often rely on international comparisons. Figure 16 compares the scale of local government spending in

Figure 16. Municipal Expenditures (as % of GDP)



Kosovo with a sample of other Eastern European countries. At first blush, the scale of local government in Kosovo seems quite low. In the comparator countries, local expenditures range from 4.3 percent of GDP (Albania) to 13.7 percent (Ukraine). For Kosovo the figure is 5.6 percent. (5.15 percent in 2008). Even after allowing for variations in the functions assigned to local government [136] the scale of local government in Kosovo appears modest. Local expenditures, net of spending on education and health, total only 2.5 percent of GDP, compared to a group average of 4.3 percent. This does not, however, suggest that local funding for municipal governments should be increased. The size of the Kosovo public sector as a whole is limited by size of the economy and the difficulty the Government has in mobilizing revenues.

[136] Local governments that are responsible for paying teachers' salaries, for example, tend to have relatively high levels of spending.

Increasing transfers to local governments would reduce the fiscal space available to the central government. In the absence of evidence that local functions are more important than those of the central government or that they are performed more efficiently, the case for increasing transfers to municipalities has yet to be made.

220. There may, however, be a case for temporarily increasing the general grant to compensate for the proposed conversion of some local government staff into civil servants. The proposed civil service pay and grading reform will have cost implications for the municipalities, resulting from the elimination of current pay differences among staff employed in equivalent posts, temporary compensation for staff whose base salary would decline due to the grading reform, and salary decompression to increase the pay differentials among posts of different grades. Given that municipalities employ approximately a third of the estimated number of public employees who are expected to receive civil service status and that the annual additional cost of the pay and grading reform at approximately €9 million for the first two years, rising to €10 million once salary progression related to performance evaluation is introduced, the annual cost for municipalities is expected to be in the region of €3.0- €3.3 million.[137] Provisions for this increase have already been included in the 2010 budget under the MEF budget. Over time, as municipalities are able to adjust to the increase by reducing staff numbers or cutting other expenditures financed from discretionary revenues, this additional funding could be eliminated and the general grant confined, as before, to ten percent of central government revenues.

Box 11. Are Municipalities Overstaffed?

Municipalities do not seem to be significantly overstaffed. Some 85 percent of municipalities' staff are engaged in direct service delivery in education and primary health.* A recent analysis by an Inter-Governmental Working Group found that municipal administrations staffing is only 13 percent above the norms recommended by the methodology. The analysis is based on a model organogram of 55 positions that are considered the minimum required to exercise all municipal functions for each municipality and additional staff positions for larger municipalities according to their population.

While the Government has established ceilings for municipal employment** it is therefore not clear that these are called for. There is certainly no reason to believe that such ceilings would have any effect on the level of intergovernmental grants. Neither the general grant nor the two earmarked grants are based on levels of local employment.

*In 2008, municipalities employed 28,825 teachers, 5,825 primary health staff, 4,826 administrative staff, and 1,282 non-teaching school staff.
**The guidelines recommend one administrative employee per 780 citizens for municipalities with few than 100,000 population. For larger municipalities, it recommends one additional staff member per 1,000.

221. Additional grants may also be required to finance some of the competencies to be transferred to local government. (See Table 24.) The LLGF requires the central government to transfer funds to the municipalities for the exercise of delegated and enhanced functions, but does not specify a formula for these transfers. In practice, the Government has based the amount on the level of spending by the central government agency responsible for the function in the

[137] DFID, *Kosovo: Fiscal Impacts Analysis of the Draft Law on Civil Service Salaries*, September 2009. This estimate is based on a low-case scenario which assumes that the grading exercise is not abused to inflate employees' salaries through over-grading (i.e., by exaggerating the tasks included in their job descriptions to place them in a higher grade).

year prior to its decentralization. So far, this approach has also been used to allocate funds for new 'own competences' (e.g., social assistance), even though according to the LLGF municipalities' own functions are supposed to be financed from the general grant or own source revenues. As a result, the transfer of these functions has been budget neutral for both central and local governments. In the future however these additional grants for own functions should be phased out. If the municipalities can demonstrate that these functions cannot be adequately financed from their own source revenues and the general grant, as foreseen by the LLGF, the formula for the general grant may need to be revised at that time.

Table 24. Competences Subject to Transfer to Municipalities

Competence	Legal status	Status of implementation
Social Welfare	Social services: own competence; Administration of benefits: delegated	Social services transferred in March 2009
Municipal utilities	Own	Appointment to utilities' boards and legal transfer of ownership pending
Culture, Youth, Sport	Own	Under preparation (budgetary provision included in the 2010 budget)
Business Registration	Delegated	Subject to ongoing automation efforts to integrate municipal and central business registers; pilots under implementation in eight municipalities
Primary Health	Own	Transfer of residual functions currently exercised by the MoH pending
School Education	Own	Transfer of residual functions currently exercised by the MEST pending
Management of Municipal Property	Own	Municipal property legally transferred from Kosovo Property Agency
Public Housing	Own	Pending
Cadastral Registration	Delegated	Pending; costs of Municipal Cadastral Offices already covered by municipalities
Forestry Protection	Delegated	Pending
Municipal Borrowing	Own	Subject to enactment of Law on Public Debt
Voter Registration	Delegated	Pending
Secondary Health	Enhanced: applies to North Mitrovica, Gracanica, Strpce	Pending; the municipality of North Mitrovica has not been set up yet
Cultural Affairs	Enhanced: applies to all municipalities with Kosovo Serb majority	Pending
University Education	Enhanced: applies to North Mitrovica	Pending; the municipality has not been set up
Police Commanders	Enhanced: applies to all Serb-majority municipalities	Pending

222. The cost of Serb-majority municipalities' enhanced functions (secondary health for three municipalities; higher education for North Mitrovica) will also impose additional costs, as these functions are partially financed from the Kosovo budget. The Government of Serbia

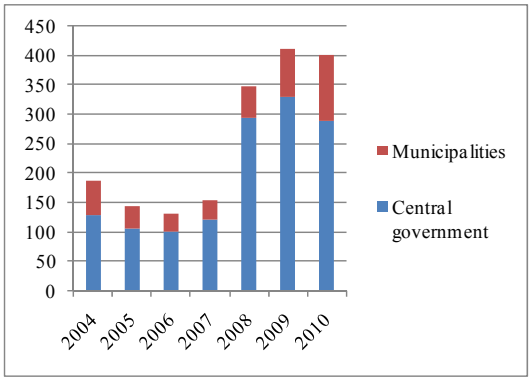
provides partial financing as well.) (While the cost of the secondary health facilities is expected to be modest (in the region of €1.0–1.5 million), the cost of establishing a Serbian-language university in North Mitrovica remains to be estimated. These costs as well as the expenditures related to establishing the new municipal administrations are expected to be covered by a special contingency of €3.3, which is included in the MTEF and the 2010 budget. As two of the five municipalities concerned are due to be administratively and legally established only in summer 2010, the enhanced functions are likely to materialize only toward the end of the current MTEF period.

223. Finally, the Government will also have to think through its policy on subsidizing public utilities, once these are transferred to the municipal level. So far, the central government has provided limited subsidies to the decentralized utilities most at risk of infrastructure and service delivery failure. In the 2010 budget, these subsidies amount to €1.25 million for two municipal heating utilities (a 16 percent increase from 2009) and €0.6 million for municipal water and waste management utilities. Some municipalities believe they can restore the financial health of their utilities by improving tariff collections. However, international experience—including the recent experience with water companies in Albania--suggests that decentralization does not necessarily produce improvements in financial performance. According to the LLSG, tariff-setting power lies with municipal assemblies, which might be tempted to keep tariffs at below cost-recovery levels for political reasons. Municipalities may also have as much difficulty as the central government has had in cracking down on water theft.

Capital Investments

224. Although municipalities spend about one quarter of the budgets on capital works (figures for 2008), they account for only a small proportion of total public investment in Kosovo. As shown in Figure 17, municipalities accounted for only 15 percent of total public sector capital investment in 2008.

Figure 17. Capital Expenditures by Level of Government, 2004-2010



225. Under the LLGF, municipalities may finance capital projects from their own source revenues and the general grant, or through funding by donors or central government bodies. In 2008, roughly 80 percent of municipal capital spending was financed from own source revenues and the general grant, with the remainder from the now-defunct property tax fund. In practice, most municipalities' tend to supplement these sources with co-financing from central ministries or donors.[138] Co-financing for municipal-level capital projects by central ministries, however, does not appear in the budgets or expenditure data of the municipalities, but is accounted as part of ministries' budgets. Financing or co-financing by central ministries in 2009

[138] Co-financing (or 100 percent) financing for municipal-level capital projects by central ministries does not show up in the budgets or expenditure data of the municipalities, but is accounted as part of ministries' budgets.

represented approximately an additional 48 percent of capital expenditures budgeted by municipalities.

226. Different ministries use different systems for allocating their co-financing among municipalities. Capital investments for the construction of new schools, for example, are managed by the Ministry of Education and Science (MEST). In this case, it is the ministry that selects – in consultation with municipalities – the locations for school investment, prepares the proposed projects for submission to the PIP process, includes these projects in its budget, acts as the contracting authority for procurement purposes, supervises the work, and finally delivers the new schools to the municipalities, which are then responsible for the maintenance of the facilities. In some cases municipalities have built new schools with their own resources (or donor financing), but the bulk of municipal capital expenditures in education concern school maintenance.

227. The Ministry of Transport and Communications (MTC) provides substantial amounts of co-financing for municipalities' road investments. The MTC's budget for 2010 includes €12 million for co-financing of municipal projects (local roads construction or asphalting) and over €1 million for the construction or rehabilitation of local roads. In the absence of any transparent criteria for allocating these resources, however, political favoritism is said to strongly influence the distribution of these funds.

228. The Ministry of Health (MoH), on the other hand, takes no lead in planning the construction of new PHC facilities. New PHC facilities are instead initiated by individual municipalities, which must allocate funds from their own resources or obtain donor financing. If a municipality does not have sufficient funds to build or renovate PHC facilities on its own, the MoH may step in to provide co-financing from its own budget, but only in response to municipalities' requests and on a very small scale. (The MoH budget for capital investments at the municipal level was just under €1 million in 2009 and is €0.5 million in 2010.)[139] Like the MTC, the MoH does not appear to apply any clear criteria for allocating its financial support. As a result of its lack of leadership in PHC investment allocation and the absence of any criteria for allocating what little financial support it provides, the pattern of investment in PHCs varies considerably from the recommendations of the Health Sector Masterplan.

229. The budget of Ministry of Economy and Finance (MEF) includes some funding for capital investments in municipal utilities. In 2009-2010 the MEF allocated a total of €1.0 million to upgrade facilities in the two municipally owned district heating companies. It also budgeted €3.3 million for capital investments in municipal water and waste management utilities. The funds, however, were not spent because no companies were decentralized.[140] If and when the district heating companies, water companies, and other utilities that legally fall within the municipal purview are in fact decentralized, the MEF will have to devise a strategy for allocating investment funding for them as well.

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[139] According to the budget for 2010, only three municipalities are planned to receive MoH financing for the construction of new PHC facilities, while one will receive small support towards PHC renovations, and two more will receive small-scale financing for equipment purchases.

[140] The funds have been carried over into 2010 and will be divided among a large number of relatively small projects.

230. According to the LLGF (Art. 33.h), the Grants Commission is responsible for reviewing the capital expenditures for municipalities that central budget organizations propose to finance from their own budgets. This provision is aimed at ensuring a measure of transparency and fairness in the allocation of central ministries' financing of municipal-level capital projects. In practice, however, the Grants Commission has so far not exercised this authority. In the absence of any clear rules or criteria, it would in any case be difficult for the Grants Commission to do so.

231. One solution to this problem would begin by making a clear distinction between infrastructure sectors that are of national interest, either for social reasons (e.g., schools and PHCs) or to ensure network coordination (e.g., roads.) For these sectors, investment decisions would be centralized in their respective ministries. Funds would be allocated to individual projects on the basis of clearly defined criteria (in which economic rates of return would play a prominent role). Co-financing by the line ministries could be allocated through a competitive process, whereby municipalities would propose projects and provide evidence of their compliance with the announced criteria. Counterpart funding by municipalities could be required but would not be a primary consideration in the allocation of funds. Proposed co-financing of municipal infrastructure by line ministries should be submitted to the Grants Commission for review, as required by the LLGF to ensure that the criteria for the selection of projects are applied consistently.

232. The second category of investments—those of purely local interest—would be financed entirely from own source revenues (including the general grant). This could for example, include parks and urban amenities, as well as urban upgrading. The choice of such projects would be entirely at the discretion of local governments. Although municipalities will soon acquire the authority to borrow to finance capital works, this practice should not be encouraged or relied upon. The essential preconditions for a functioning municipal debt market do not yet exist in Kosovo. Lenders are not familiar with municipal governments. Municipal governments are not familiar with long term financial commitments. And most importantly, the central government does not have a strong track record of saying 'no' to municipal governments which, in the event of a financial reversal, may seek a Government bailout.

Municipalities' Fiscal Autonomy

233. Many difficulties in the current system appear to stem from its rigidity. At present municipalities' autonomy is restricted in three ways. First, budget circulars issued by the Ministry of Economy and Finance (MEF) to municipalities contain ceilings for wages and salaries, regardless of the source of financing. Secondly, the MEF applies staffing limits for each municipality. Thirdly, municipalities need prior approval from the Minister of Finance in reallocating funds during budget execution even when using their own source revenues and the general grant. These restrictions are based on the provisions of the annual Appropriations Law. These restrictions predated the adoption of the LLGF and LPFMA of 2008 and were intended to comply with a fiscal rule agreed with the IMF, which was in turn intended to limit the growth of

current expenditures.[141] The possible reinstatement of such a fiscal rule should in future exclude municipal expenditures financed from own source revenues and the general grant. Likewise, a possible rule requiring that under-executed capital appropriations be clawed back from the implementing budget organization during the mid-year budget review, which is currently under consideration, should also exclude municipal projects that are financed from municipalities' own resources. Applying such a rule might violate the LLGF and indeed the Constitution, which guarantee municipalities' right to "autonomously manage" own source revenues and proceeds from the general grant.

234. Municipalities argue that the annual Appropriations Law has been unduly restrictive and actually contradicts the provisions of the LLGF and the Law on Financial Management and Accountability (LPFMA) that give municipalities autonomy over the management of their own source revenues, the general grant, and – in the case of majority-Serb municipalities - funds for enhanced functions and funds that they may receive from Serbia. According to the LLGF (Articles 2.3, 7.2) municipalities have the right to determine the use of and manage the expenditure of their own source revenues and general grant proceeds – subject to observing public financial management procedures specified in the LPFMA. On the other hand, the LLGF (Art. 31.2) also empowers the Minister of Finance to issue additional general guidelines with regard to current and capital expenditures that are binding on municipalities.

235. In recognition of municipalities' fiscal autonomy, the LPFMA (Art. 19 and 20) exempts municipalities (and also independent agencies) from the expenditure ceilings by economic category that the MEF establishes for central-level budget organizations through its budget circulars. The LPFMA (Art. 30.5) also exempts municipalities from the requirement to seek prior approval from the Minister of Finance to make adjustments of over 5 percent to the appropriations contained in the annual appropriations law for appropriations financed from their own source revenues or the general grant.[142] Instead, it is sufficient for the mayor to obtain the approval of the municipal assembly and inform the MEF of the adjustment. Adjustments to appropriations to wages and salaries are an exception and continue to require MEF (or Government or Parliament) approval irrespective of the source of financing.

236. In practice the restrictions on municipalities' use of their own source revenues and the general grant seem to be causing significant problems. These include the high administrative burden that in-year reallocations (virements) requiring MEF or higher approval place on the MEF and municipal administrations. The cumbersome procedures involved in making in-year reallocations, combined with the MEF's stringent enforcement of expenditure ceilings for the wages and for the goods and services categories, reportedly also drive *some* municipalities to spend more on capital investment than they would have otherwise chosen to. This may occur because it is currently very difficult for municipalities to channel higher-than-expected own

[141] The fiscal rule is derived from the Letter of Intent signed in November 2005, which covered the period 2006-2008. The fiscal rule provided that the real growth in public expenditure would be limited to no more than 0.5 percent per annum. This was subsequently revised to exclude capital expenditure. However, with expansion of expenditures in 2009 in the Kosovo Consolidated Budget, the IMF spending rule was effectively discarded.

[142] According to Article 30 of the LPFMA, the Minister of Finance may approve adjustments between 5 and 15 percent; adjustments between 15 and 25 percent require Government approval, while those above 25 percent require approval by the Parliament.

source revenues or savings in budgeted capital expenditure (e.g., resulting from in-year co-financing by a central ministry[143] or a donor) to hire more staff, increase existing staff salaries, or contract additional services above the relevant ceilings.

237. It would therefore appear wise to remove the budget ceilings on expenditures by economic category as well as the requirement for MEF approval for in-year re-allocations among economic categories. On the other hand, it seems somewhat premature to remove the staffing and wage bill ceilings prior to the adoption of the upcoming legislation on the civil service. This legislation is expected to confer civil servant status (and thereby tenure conditional on satisfactory performance) on employees of municipal administrations (but not to teachers or healthcare personnel), who would be included in the single pay and grading structure of the civil service. The implementation of the new pay and grading structure will involve a substantial administrative effort, which would be complicated if municipalities were able to hire new staff or increase salaries on the eve of the reform.

238. The civil service pay and grading reform will also have cost implications for the municipalities, resulting from the elimination of current pay differences among staff employed in equivalent posts, temporary compensation for staff whose base salary would decline due to the grading reform, and salary decompression to increase the pay differentials among posts of different grades. Given that municipalities employ approximately a third of the estimated number of public employees who are expected to receive civil service status and that the annual additional cost of the pay and grading reform at approximately €9 million for the first two years, rising to €10 million once salary progression related to performance evaluation is introduced, the annual cost for municipalities is expected to be in the region of €3.0 – €3.3 million.[144] As relevant provision has been included in the 2010 budget under the MEF budget (also for the period 2010-2012 to be included in the revised MTEF), it would seem logical that the central government would cover this additional cost through a special transfer. Following the end of a transitional period (presumably three years), this cost should be fully absorbed by municipal budgets. To avoid a major fiscal shock to municipal budgets at the end of this three year period, municipalities will need to plan in advance so that they reserve adequate space in their budgets for this purpose. Once the civil service reform has been implemented and provided that municipalities' expenditures continue to remain within their resource envelopes, the Government could consider removing staffing and wage bill limits for municipalities.

[143] Ministries provide co-financing for municipal projects unforeseen in the initial Appropriations Law as a result of either additional funds appropriated to them during the mid-year budget review or re-allocation from other low-performing projects.

[144] DFID, *Kosovo: Fiscal Impacts Analysis of the Draft Law on Civil Service Salaries*, September 2009. This estimate is based on a low-case scenario which assumes that the grading exercise is not abused to inflate employees' salaries through over-grading (i.e., by exaggerating the tasks included in their job descriptions to place them in a higher grade).

Annexes

Annex A: Kosovo Main Indicators, 2007-2012

Kosovo : Main Indicators，2007－12

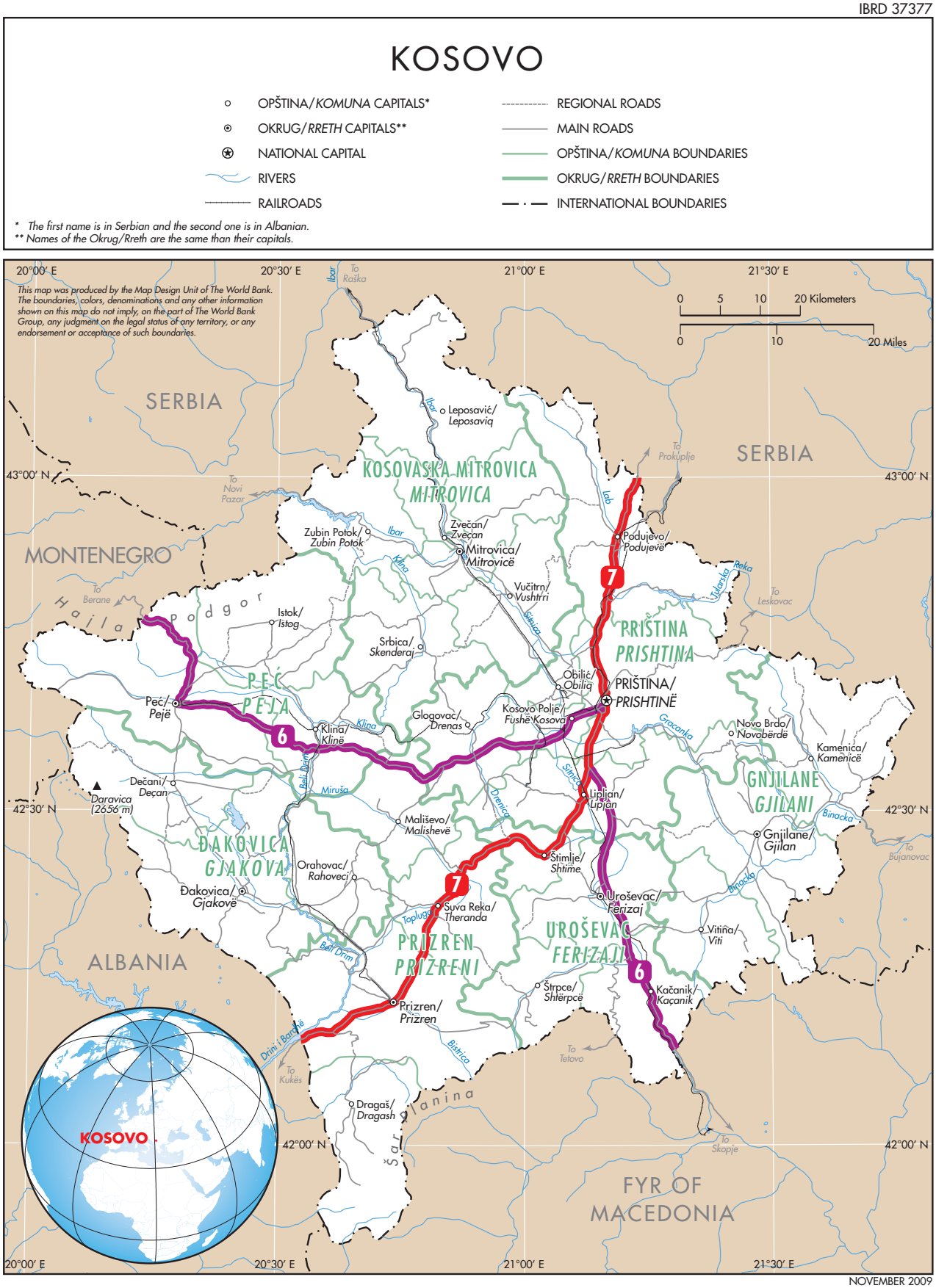
	2007	2008	2009	2010	2011	2012
		Est.	Est.	Proj.	Proj.	Proj.
Real growth rates (percent)						
GDP	4.0	5.4	4.0	4.8	6.3	5.4
GDP per capita	2.7	3.8	2.5	3.3	4.7	3.9
Consumption	6.1	3.7	2.6	3.9	3.2	3.7
Investment	3.9	15.5	12.6	9.2	23.0	6.5
Exports	11.7	4.2	-1.2	12.7	9.0	11.2
Imports	11.8	6.0	3.5	7.9	10.2	4.5
Price changes (percent)						
CPI, period average	4.4	9.4	-2.4	1.5	1.7	2.2
CPI, end of period	10.5	0.5	0.1	1.6	2.3	2.1
GDP deflator	5.2	7.0	-4.0	1.6	2.0	1.9
General government budget (percent of GDP)						
Revenues 1/	26.3	24.5	29.9	27.5	26.6	26.7
Primary expenditures	19.2	24.7	30.5	31.1	34.3	32.0
Of which						
Capital and net lending (including the highway)	2.8	7.6	11.8	12.0	15.3	13.3
Capital expenditures on the highway 2/	…	…	…	2.4	7.2	5.7
Overall balance	7.1	-0.2	-0.8	-3.8	-7.9	-5.6
Overall balance, excluding the highway	7.1	-0.2	-0.8	-1.4	-0.7	0.1
Debt financing, net	…	0.0	-0.2	0.0	0.0	4.7
Privatization	0.0	0.0	0.0	0.0	6.8	0.2
Stock of government bank balances 3/	11.6	10.8	9.0	5.9	5.8	6.5
Financing gap	0.0	0.0	0.0	1.1	1.5	1.7
Savings-investment balances (percent of GDP) 4/						
Domestic savings	-12.6	-12.6	-11.3	-10.6	-7.8	-7.4
Transfers excluding general government (net)	14.6	13.9	12.9	13.1	13.2	13.3
Net factor income	6.4	4.1	2.5	2.8	3.0	3.5
National savings	8.4	5.4	4.1	5.3	8.4	9.4
Investment	26.0	28.9	29.3	30.6	35.2	33.9
Current account	-17.6	-23.4	-25.2	-25.2	-26.8	-24.6
Current account balance (incl. official transfers)	-8.8	-16.0	-18.7	-18.3	-21.0	-19.6
Of which: official transfers 1/5/	8.7	7.5	6.4	7.0	5.8	4.9
Net foreign direct investment	12.6	8.9	7.8	8.6	15.8	8.4
Portfolio investment (net)	-1.2	1.7	-1.0	-0.3	-1.4	-1.5
Memorandum items:						
GDP (thousands of euros)	3,411	3,849	3,843	4,091	4,434	4,764
GDP per capita (euros)	1,605	1,784	1,754	1,840	1,965	2,080
GNDI per capita (euros)	1,942	2,105	2,024	2,133	2,285	2,429
Population (thousands)	2,126	2,158	2,190	2,223	2,256	2,290

Sources: Kosovo authorities; and IMF staff estimates.

1/ Assumes budget grants of 60 million euro per year. These are closely tied to an IMF program.
2/ Based on the authorities' cost estimate of €750 million.
3/ Starting in 2010, minimum bank balance recommended by staff.
4/ Savings-investment balance of entire economy, including donor sector.
5/ Total foreign assistance excluding capital transfers.

Annex B: Map of Road and Railway Network in Kosovo

IBRD 37377



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Annex C: MTC Road Infrastructure Investment Plan

Description	Cost (Euro Mln)
Route 6	
New Route 6 4-lane Lipjanit- Babushi (part of section 6-5)	127
New Route 6 4-lane Babushi - M25-3 (part of 6-5)	68
New Route 6 4-lane M25-3 - Doganaj (6-6)	59
New Route 6 4-lane, Doganaj - border (staged)	376
Widening M9 Vragoli - Sllatinë (part of section 6-4)	13
Widening M9, Sllatinë-Komoran (part of section 6-4)	26
Widening M9, section 6-3 (part from Komoran - Arrlat)	14
Widening Arrlat - Kijeve	27
Widening Kline- Kijeve	30
Widening Kline -Pejë	57
Section 6-1a (Upgrade R106 North route to Montenegro)	36
Sub-total	**834**
Route 7	
Section 7-1 Merdare- Podujeve	35
Section 7-2 Podujeve - Besi	103
New section 7-5.2 (Lipjan junction-Shtime)	49
New section 7-5.1 (Prishtinë-Lipjan junction)	27
New section 7-4 North Prishtinë interchange (Kastriot)-South Prishtinë	33
New section 7.3 Besi-North Prishtina interchange (Kastriot)	42
Section 7-6 Shtime –Suhareke	587
Section 7-7 Suhareke – Prizren	153
Section 7-8 Prizren – Morine (Prizren South - Vermice (Border)	86
Section 7-8 Prizren – Morine (Prizren North - South)	36
Sub-total	**1,153**
Other projects	-
New connection Route 6-7, "South Prishtinë" Route 7-Vragoli	24
New connection Route 6-7, "South Prishtinë" Caglavice-Route 7	25
Widening M2, Mitrovicë- Vushtri	23
Widening M2, Vushtri- Milosheve	40
Construction Route 7 Prishtinë to Airport	47
New connection R216 Mutivode - Tuxhevce	20
Prizren- border Macedonia - Tetovë	31
Paving R118 Mushtisht - Vërbeshticë	4
Upgrading R107 Xerxe(R110) - Prizren	29
Upgrading R107 Gjakova - Pejë	41
New Road Leposavic - Pollate	44
Extension R217 Ballaban - Zubin Potok	18
Sub-total	**345**
Total	**2,331**
Planned financing sources	
Total KCB	1,569
Total KCB Route 6& 7	1,430
Total Private	456
Total IFI	306
Total	**2,331**

Annex D: Multi-Annual Expenditure Framework for Road Investment, 2010-2012

Projects funded under the MTEF	2009 budget	2010 estimate	2011 estimate	2012 estimate	Total 2010-2012
Bridge maintenance and construction	12,000,000	10,000,000	6,000,000	6,000,000	22,000,000
Horizontal and vertical signaling	2,500,000	2,500,000	2,500,000	2,500,000	7,500,000
Highway R7 Merdare-Morine (M25)		119,000,000	92,500,000	94,500,000	306,000,000
Road rehabilitation	53,241,485				0
Rehabilitation of road Prishtinë-Pejë (M9)	25,541,485				0
Rehabilitation of road Prishtinë-Mitrovicë (M2)	8,023,260				0
Rehabilitation of local and regional roads	19,676,740				0
IT system for traffic safety (software)	-	1,000,000	-	-	1,000,000
New road constructions	23,300,000	10,000,000			10,000,000
Co-financing program with Municipal Assemblies	11,875,000	7,000,000			7,000,000
Total capital spending	**102,916,485**	**99,500,000**	**101,000,000**	**103,000,000**	**353,500,000**
Total operational expenses	**13,056,394**	**13,382,804**	**13,717,374**	**14,060,308**	**41,160,486**
Total allocated spending	**115,972,879**	**112,882,804**	**114,717,374**	**117,060,308**	**394,660,486**
Additional funding requirement 2010-2012		**2010 estimate**	**2011 estimate**	**2012 estimate**	**Total 2010-2012**
Highway R7 Merdare-Morine (M25)		26,000,000	307,500,000	205,500,000	539,000,000
Pristina-Airport railway line		1,000,000	1,000,000	1,000,000	3,000,000
Electrification of railway line Leshak-Hani I Elezit		5,000,000	7,500,000	10,000,000	22,500,000
Railway facilities (Signaling, safety walkways))		5,900,000	7,950,000	7,950,000	21,800,000
Establishment of Helicopter unit		4,625,250	361,000	1,000,000	5,986,250
Driving polygon		4,000,000	2,000,000	1,000,000	7,000,000
Drivers license (devices, databases)		1,695,000	1,380,000	2,310,000	5,385,000
Software equipment		4,880,000	3,300,000	3,300,000	11,480,000
Total additional capital requirements		**53,100,250**	**330,991,000**	**232,060,000**	**616,151,250**
Total additional operational expenses		**8,787,718**	**10,908,416**	**11,734,469**	**31,430,603**
Total additional requirements		**61,887,968**	**341,899,416**	**243,794,469**	**647,581,853**

Source: Ministry of Finance and Economy, Ministry of Transport.
*Forecast with World Bank adjustments to account for Route 7 expenditure.

Annex E: Economic and Financial Returns of Proposed Road Investments[145]

Sections with positive economic return:

Project No.	Project description	Length (km)	Opening year	Investment Cost	IRR	NPV	NPV/C
2.2	New Route 6 4-lane Lipjanit- Babushi (part of section 6-5)	21.6	2012	127.224	20.5	127.989	1.01
20.3	New Section 7-5.1 Pristina -Lipjan junction	11.1	2015	26.993	28.5	91.24	3.38
9.1	Widening M9, Sllatinë-Komoran (part of section 6-4)	11.2	2011	26.392	41.1	87.42	3.31
28.0	New Construction route 7 Prishtina to Airport	6.2	2012	47.393	36	84.7	1.79
7.1	Widening Fushë Kosovë - Vragoli	4.2	2009	11.767	129.9	45.7	3.88
8.1	Widening M9 Vragoli - Sllatinë (part of section 6-4)	8.8	2010	25.008	129.9	45.7	1.83
20.2	New Section 7-4 North Pristina (Kastriot) - South Pristina (Caglavice)	6.7	2015	33.231	25.8	42.66	1.28
24.1	New Connection Route 6-7, "South Pristina" Caglavice-Route 7	4.0	2015	25.480	19.7	40.38	1.58
24.2	New Connection Route 6-7, "South Pristina" Route 7-Vragoli	3.7	2015	23.505	19.7	40.38	1.72
20.1	New Section 7.3 Besi - North Pristina interchange (Kastriot)	9.2	2015	42.450	21.8	38.85	0.92
26.0	Widening M2, Prishtinë- Milloshevë	9.2	2009	21.690	35.4	33.93	1.56
3.2	New Route 6 4-lane Babushi - M25-3 (part of 6-5)	11.6	2012	68.206	12.7	30.51	0.45
27.0	Widening M2, Vushtri- Milosheve	16.9	2010	39.837	17.83	26.263	0.66
48.0	Paving to finish connection 209 Gadime - Bresallc	11.8	2009	6.17	29.2	20.3	3.29
10.1	Widening M9, Komoran-Arrlat (part of section 6-4)	6.1	2012	14.319	22	13.14	0.92
31.0	New Road R216: Tuxhevce - Mutivode	12.6	2017	20.078	39.7	12.52	0.62
36.0	Upgrading R107 Gjakova - Peje	34.6	2012	40.817	12.4	11.33	0.28
32.0	New Road Prizren- border Macedonia - Tetovë	15.0	2022	31.025	27.8	11.25	0.36
35.0	Upgrading R107 Xerxe(R110) - Prizren	24.2	2012	28.625	12.6	8.61	0.30
3.3	New Route 6 4-lane M25-3 - Doganaj (6-6)	10.1	2012	59.489	8.2	4.575	0.08
20.4	New Section 7-5.2 Lipjan junction - Shtime	8.3	2017	49.137	9.2	4.41	0.09
46.0	New Road Leposavic - Pollate	27.4	2022	43.545	17.8	3.2	0.07
10.2	New Motorway along M9, Arrlat-Kijeve (part of section 6-3)	11.5	2017	61.180	8.5	2.93	0.05
19.0	New section 7-2 Podujeve - Besi	16.8	2017	102.826	7.7	2.58	0.03
11a	Widening Kijeve - Kline	12.5	2017	29.535	9.1	1.71	0.06
16.2	New connection to Montenegro	22.6	2017	8.142	21.2	1.02	0.13
25.0	Widening M2, Mitrovicë- Vushtri	9.8	2011	23.061	12.5	0.595	0.03
10.2a	Widening Arrlat - Kijeve	11.5	2017	27.172	7.8	0.59	0.02
34.0	Paving R118 Mushtisht - Vërbeshticë	26.3	2012	3.690	40.2	0.36	0.10

Sections with negative economic return:

Project No.	Project description	Length (km)	Opening year	Investment Cost	IRR	NPV	NPV/C
13.0	New Motorway 6-2b Leshan - Kline	8.2	2017	43.518	7	-0.12	0.00
14.0	New Motorway M9, Pejë-Leshan, Route 6.2a	18.1	2017	96.132	7	-0.12	0.00
47.0	New extension R217 Ballaban - Zubin Potok	11.1	2022	17.61237	5.3	-0.36	-0.02
12.1	New Road Kline by-pass (2 lanes) from M9-R105	5.1	2022	8.098	0.8	-0.95	-0.12
12.2	New Road Kline by-pass (2 lanes) from R104-R105	3.6	2022	5.664	0.8	-0.95	-0.17
12.3	New Road Kline by-pass (2 lanes) from R104-M9	3.6	2022	5.744	0.8	-0.95	-0.17
43.0	Paving R108 Deçan -border Montenegro (Manastir - Bogaj)	24.1	2017	17.39	1.9	-2.2	-0.13
17.1	Widening M9 to 3 lanes from Peje-border	24.6	2022	29.062	-1.6	-2.24	-0.08
13-14a	Widening Kline - Leshan - Peje	24.0	2017	56.707	5.3	-3.03	-0.05
39.0	New extension R113 to border Macedonia	40.0	2022	82.732	2.8	-4.81	-0.06
18.0	New section 7-1 Merdare (border) - Podujeve	6.7	2017	35.484	0.4	-6.37	-0.18
4.2a	New Route 6 4-lane, Doganaj - border (staged)	17.8	2017	376.273	6.5	-8.35	-0.02
15.1	New Peje by-pass (4 lanes) from M9 to R107	3.0	2017	1.950	0.4	-9.87	-5.06
15.2	New Peje by-pass (4 lanes) from R107 to M9	7.0	2017	4.570	0.4	-9.87	-2.16
11.0	New Motorway along M9, Kijevë-Klinë (part of 6-3)	12.5	2017	66.500	1.9	-11.58	-0.17
22a	New 2-lane alternative Suhareke-Prizren	17.3	2017	100.080	2.7	-12.58	-0.13
40.0	New extension R114 to border Macedonia	11.0	2022	22.7513	-5.1	-13.36	-0.59
23.1	New Section 7-8.1 Prizren North - South	5.7	2012	36.004	0.1	-16.57	-0.46
22.0	New section 7-7 Suhareke Prizren North	17.3	2017	153.319	1.1	-26.69	-0.17
23.2	New Section 7-8.2 Prizren South - Vermice (Border)	11.5	2012	86.410	1.1	-28.71	-0.33
4.2	New Route 6 4-lane, Doganaj - border (6-7a)	17.8	2017	492.473	5	-44.18	-0.09
21a	New 2-lane alternative Shtime-Suhareke	24.7	2017	352.060	1.3	-50.366	-0.14
16.1	New section 6-1b Leshan -Deçan - border Montenegro	39.6	2022	354.204	-5.3	-57.35	-0.16
21.0	New section 7-6 Shtime - Suhareke	24.7	2017	586.766	0	-104.266	-0.18

Source: MTC Investment Plan 2010-2029.

Analysis from: Egis BCEOM International & COWI *Kosovo – Multi-Modal Transport Strategy and Action Plan – Final Strategy and Action Plan* (Final version, May 2009) pp.42-43

[145] Note that the section cost estimates for Route 7 have changed since the economic analysis was done by Egis, BCEOM International and COWI. Even with the new cost estimates, the number of sections with a negative economic return are expected to be high.

Annex F: Energy Efficiency Measures

Efficient Lighting Initiative

Kosovo intends to follow the EU in its decision to phase out incandescent light bulbs and replace them by much more efficient lighting, notably so called compact fluorescent lights (CFL).[146] World-wide, about 19 percent of electricity demand is for lighting. Lighting typically accounts for about 13 percent of electricity consumption in the residential sector and for 20-60 percent in the commercial sector, but in Kosovo lighting appears to constitute about 23 percent of total household demand.[147] Conventional incandescent lights are highly inefficient with only 5-10 percent of the input energy being converted into light and the rest into waste heat. CFLs are 4-5 times more efficient than incandescent lights and last up to 10 times longer. CFLs for residential and commercial use and high-pressure sodium lamps for street lighting would result in significant energy savings, thus reducing the need for electricity imports and the cost of electricity use for consumers.

In order to reduce electricity imports and the need for corresponding subsidies, the Government should start a nationwide efficient lighting program as soon as possible, involving the free distribution of four CFLs per household consumer and six CFLs per commercial consumer (both must be up to date in their payments). This should be in exchange for an equal number of incandescent bulbs that should be promptly destroyed to prevent them from being re-circulated in the market. Distribution of the new lights (and destruction of the old ones) could be handled by a private firm. Through bulk purchase of high-quality CFLs their cost could be as low as €3.00 each. While the one-time cost to the Budget of this program, not including distribution and associated costs, would be about €5.0 million, the annual benefits would be €19 million.[148] Energy saved would be equivalent to 191 GWh or about 38 percent of the quantity of electricity imports in 2009. We assume that this program could be implemented during July 2010-June 2011, assuming that the Government will effectively ban the import of incandescent bulbs prior to that in order to avoid the creation of a secondary market in CFLs. Annual net benefits would be going up from about €5 million in 2010 to €19 million in 2012 and thereafter. *Over a five-year period the benefits would be €76 million compared to a cash investment of a mere €5 million*.[149] (How are benefits measured?)

Efficient Heating Initiative

Over 80 percent of households in Kosovo use firewood as a primary or secondary fuel for heating and cooking, as in many other countries in the Balkans. Over half of all schools use firewood as well for heating. In terms of electricity use, firewood and electricity are often

[146] As of September 2009, manufacturers and importers can no longer sell clear incandescent light bulbs of 100 watts or above in the EU. However, shops may continue to sell bulbs already in stock. The ban will be expanded in September 2011 and 2012 to include lower wattages of clear incandescent bulbs. Frosted bulbs and high-energy halogen lights are also being phased out.

[147] Source: *Status of Energy Efficiency in the Western Balkans*, Austrian Energy Agency, 2009

[148] Assuming a € 100/MWh price for imported electricity.

[149] This assumes a 5 year lifespan per CFL. However, usage patterns and voltage and frequency drops can significantly affect the lifespan of a CFL. After a few years the market for CFLs is expected to become self-sustainable without Government or KEK subsidies.

used together, with electricity supplementing the heat produced by wood burning stoves. This creates huge strains on the electricity networks during the winter peak period and causes voltage and frequency problems, while also requiring expensive electricity imports to meet peak demand. Making wood stoves more efficient is therefore very important for the electricity sector, while also having poverty reducing, health, and environmental benefits.

Efficient wood stoves. Firewood is expensive at about €40-50/m^3 (often smuggled in from Serbia and sold at exorbitant prices)..[150] Most of the wood burning stoves in use are poorly made and have efficiencies of only 15-20 percent, whereas efficient masonry and down-burning stoves have efficiencies of 50 percent or more. Using such stoves would reduce the cost of the firewood supply both in terms of quantity used as well as because overall demand would go down by about 60 percent. Efficient stoves would also greatly reduce indoor pollution as well as deforestation. Sustainable forestry would become a realistic proposition, especially if combined with reforestation and firewood drying, e.g. by using waste heat from power plants, which would further enhance the heating value of the wood and decrease demand. The unit cost of such stoves would be about €300 if procured in bulk. With annual firewood consumption now at 10 m^3 per household, the payback period would be less than 2 years. The Government should start a program to introduce efficient wood stoves on the market and target initially 100,000 of the poorest consumers, including all social cases. The reduction in electricity use for supplemental heating could be up to about 3,840 kWh/year per household, or 384 GWh in total.[151] The €30 million acquisition cost of the stoves would be less than the €38.4 million cost of avoided electricity imports in one year.

Liquefied Petroleum Gas (LPG) stoves. LPG is imported and used for cooking and for space heating, the latter mostly in non-residential buildings. The infrastructure for its transportation, storage and retailing is limited in Kosovo, but growing rapidly. LPG is efficient, clean and safe and can be utilized for space heating using a variety of appliances, ranging from light combustion stoves to central heating boilers. The latter can achieve efficiencies of about 90 percent when equipped with buffer tanks and instantaneous water heaters. For that reason LPG would be an even better solution than efficient wood stoves, but its market share is likely to remain small for years to come, in part because it is considered to be expensive. Natural gas is not an option in Kosovo since there is no natural gas system and introduction of such a system is likely to be a very long-term proposition. The Government should actively encourage further development of the LPG market as well as the wider usage of more efficient electric heating methods such as heat accumulators or modern heat pumps.

Cogeneration of Heat

A feasibility study was prepared in 2005 regarding connection of the Pristina district heating system to Kosovo B to use that plant's waste heat. The design would require a heat transfer station at the power plant and at the DH system in Pristina plus about 2 x 10.5 km of pre-insulated heat transmission pipeline with a 450 mm diameter. The system would be used to meet base load heat demand and use the district heating company's (Termokos) existing

[150] Analysis of the Potential for Increased Firewood Production in Kosovo (SIDA). Consumption of firewood was estimated at 2.5 million m3 in the 2002/03 season, of which 2.0 million was used in rural areas where consumption per household is typically about 3 times as high (12 m3/year) as in urban areas. Firewood is used in some 83% of all households as primary or secondary fuel (Source: Heat Market Study)

[151] Assuming two 3 kW heaters per family that are used for 4 hours per day, 160 days per year.

heavy fuel oil-fired boilers for peaking. The investment costs were estimated at €25 million. If heat pumps are used the electric power output of Kosovo B might not decrease while installation of heat storage could further improve efficiency and reduce the need for Termokos' oil-fired boilers to cover peak heat demand. The idea for this project has been around for about 15 years and segments of pipe were laid over part of the distance to connect the plant to the district heating system. These pipes are now corroded, undersized for the current requirements and not pre-insulated, so they would have to be replaced. The feasibility study is currently being updated by KfW.

As a result of this proposed investment the variable heating costs would be much lower and the service level better, providing a 24 hour heat supply during the heating season. About 10,000 tons of heavy fuel oil, or €2.4 million at current prices[152], would be saved per year and local pollution levels would significantly decrease. Improved DH service should also reduce demand on the electric power network for supplementary heating by about 10 percent of heat demand, i.e., a 10 GWh or €1.0 million per year saving on electricity imports. Improved DH service should also help increase the collection levels of Termokos, as consumer satisfaction increases. In summary, the benefits of this investment would accrue to KEK and Termokos and, indirectly, to Government.

Building Codes

Kosovo needs an energy efficiency champion. The Government has submitted revised drafts of the three basic laws related to the energy sector, namely, the Energy Law, the Electricity Law, and the Law on Energy Sector Regulation. It has also submitted an Energy Efficiency Law to Parliament. However, financial constraints may block passage of the law. Without entering the debate on what specific institutions need to be created, we note that it is important to have a dedicated champion of energy efficiency within the administration to ensure that the agenda is pushed forward and to coordinate with other ministries and agencies. Creation of the "soft infrastructure" necessary for a successful and comprehensive energy efficiency program, including training of architects, contractors, energy auditors, etc., adopting codes and standards, and ensuring their enforcement, are amongst the many important tasks of this energy efficiency champion.

The building sector is the biggest energy consumer. Amongst the most important energy efficiency measures to be taken is that of designing and enforcing building codes and, in particular, their thermal efficiency standards. The buildings sector (residential and commercial) is the single largest energy user in most countries, accounting for 40 percent of the energy used in OECD countries. Energy is consumed by lighting, electric appliances and equipment, cooking, and heating, ventilation and air conditioning systems. While in most countries heating is provided by a variety of fuels that are far more energy efficient than electricity, in Kosovo electricity is being used on a large scale, either as the primary or secondary source of heating.

The building sector's energy savings potential is 30 percent or more. It is believed that about 33 percent of all electricity use in Kosovo is for heating buildings.[153] Using electricity

[152] Assuming an oil price of US$ 60/barrel or US$ 360 (€ 240)/ton.
[153] Source: Energy Efficiency in the Western Balkans , AEA, 2009

for heating is far less efficient than using direct heating by gas or district heating.[154] It also creates a huge strain on the electric power network during the peak winter period and, by itself, explains why Kosovo needs to import power. The IEA estimates that *the potential savings from improvements in the end-uses of heating, cooling, ventilation and hot water is at least 30 percent of the business-as-usual case by 2030 for the OECD* countries.[155] Given the generally poor construction of buildings in Kosovo, the absence of insulation and the low average temperatures in winter, the energy savings potential for heating in particular can be expected to be much larger.

Building codes and standards introduced and enforced by Government are critical in achieving the energy savings potential of the sector. The most important measure Government can take is to set and enforce mandatory energy efficiency standards through building codes for both new as well as older buildings, the latter when they undergo substantial renovation. These codes should be regularly revised (in consultation with the industry and architects) and strengthened to take advantage of technological developments. They should require optimum insulation, windows and doors for the climate based on life-cycle costs.[156] One issue that good building codes also resolve (to some extent) is the split incentive problem between builders/buyers and owners/ tenants, since it removes the option of not constructing an energy-efficient building in order to save costs. Later on, of course, the split incentive problem can re-emerge as more efficient technologies come on the market.

Lack of action will have long-lasting negative effects. From the energy efficiency perspective the problem with buildings is that they last long, typically from 50 years (commercial/service buildings) to up to 100 years (residential buildings). The annual turnover of the building stock is therefore only 1-2 percent of the total per annum, much lower than the turnover in other sectors, e.g., industry (15-20 years) and transport (10 years). Thus it can take a very long time to incorporate energy efficiency measures in buildings, and the latest energy saving technologies will be incorporated in only a relatively small percentage of buildings during any given year.

The Government should set and enforce building codes and standards and encourage homeowners to retrofit existing buildings with energy saving materials. While extremely important, and from an energy sector point of view very urgent, these measures will have long lead times and the effects will not be felt until several years from now. Therefore we do not assume a noticeable impact until after 2015.

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[154] At Kosovo's aging power plants, some 70 percent of the energy is lost as waste heat. Another 16 percent is lost in the network before the electricity even reaches the consumer's home.

[155] IEA Energy Efficiency Policy Recommendations to the G8 2007 Summit

[156] Proper insulation and ventilation is the first and most important energy saving measure. It can reduce heating needs to one-third or even one tenth of what the current average house would need.

Annex G: KEK – Energy Accounting Data

Note: Column for 2010 has been deleted.

	2006	2007	2008	2009
Direct Consumers (220/110 kV lines)	80.1	199.1	473.4	519.4
Energy delivered to Distribution	3923.5	4134.0	4255.4	4409.2
Total energy flows into KEK	4003.7	4333.1	4728.9	4928.7
Less: Technical Losses (Distribution)	693.7	702.3	704.8	771.3
Less: Internal Consumption	72.7	74.7	107.1	98.7
Less: Energy to Minority Areas	229.2	326.0	427.0	323.7
Energy Available for Sale (A)	3008.1	3230.1	3489.9	3734.9
Less: Energy Billed (B)	2080.4	2258.1	2780.0	2977.7
Equals: Unaccounted for Energy (Theft)	927.7	972.0	709.9	757.2
Energy Billed/Energy Available (B/A)	0.69	0.70	0.80	0.80
Energy Billed (€ Mln)	129.7	144.7	178.4	191.3
Energy Collected (€ Mln)	96.2	110.8	134.6	155.4
Energy Collected/Billed	0.74	0.77	0.75	0.81
Energy Not Collected (GWh)	537.1	529.3	682.9	559.8
COMMERCIAL LOSSES:				
Unaccounted for Energy (Theft) (GWh)	927.7	972.0	709.9	757.2
Energy to Minority Areas (GWh)	229.2	326.0	427.0	323.7
Energy Not Collected (GWh)	537.1	529.3	682.9	559.8
TOTAL	1693.9	1827.3	1819.8	1640.7
As percent of Energy Available for Sale (%)				
Excluding Minority Areas	49%	46%	40%	35%
Including Minority Areas	56%	57%	52%	44%
TECHNICAL LOSSES	17%	16%	15%	16%

**/ Source: KEK. The data for 2009 and 2010 are estimates*

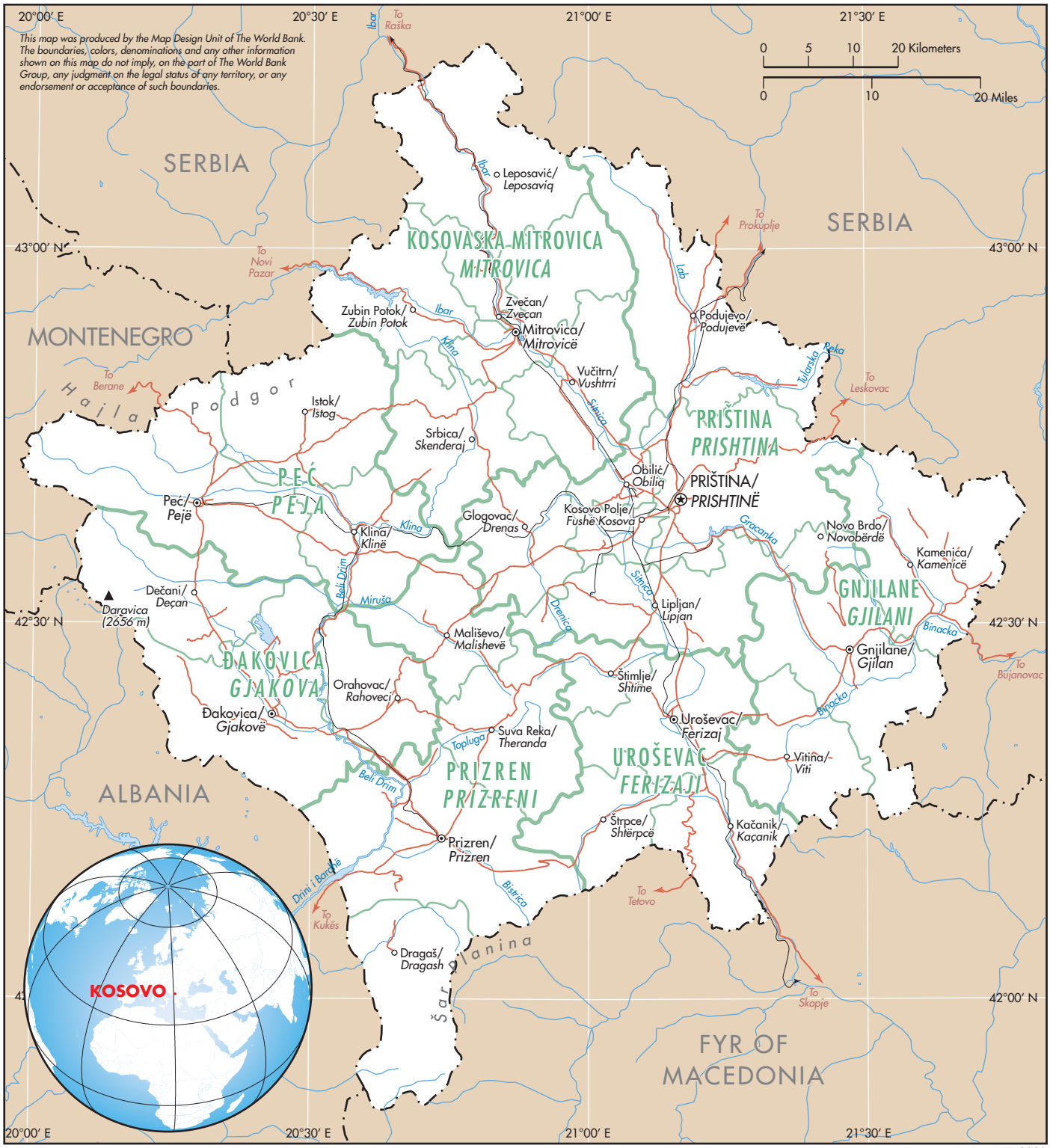
Import Data				
Electricity Imports (GWh)	393	540	458	500
Electricity Imports (€ Mln)	21	45	52	49
Price per MWh (€)	54.11	83.66	112.52	98.00

IBRD 37048

KOSOVO

- OPŠTINA/*KOMUNA* CAPITALS*
- OKRUG/*RRETH* CAPITALS**
- NATIONAL CAPITAL
- RIVERS
- MAIN ROADS
- RAILROADS
- OPŠTINA/*KOMUNA BOUNDARIES*
- OKRUG/*RRETH* BOUNDARIES
- INTERNATIONAL BOUNDARIES

* *The first name is in Serbian and the second one is in Albanian.*
** *Names of the Okrug/Rreth are the same than their capitals.*



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