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WEIGHTS AND MEASURES

Metric System

ACRONYMS AND ABBREVIATIONS

BEEPS	Business Environment and Enterprise Performance Survey	MFI	microfinance institution
CIT	corporate income tax	NSDI	National Spatial Data Infrastructure
CPF	Country Partnership Framework (World Bank Group)	OECD	Organisation for Economic Co-operation and Development
EU	European Union	PIT	personal income tax
FDI	foreign direct investment	RAE	Roma, Ashkali, and Egyptian
GDP	gross domestic product	SAA	Stabilization and Association Agreement (EU)
HBS	household budget survey	SCD	Systematic Country Diagnostic
ICT	information and communication technology	SEE	Southeastern Europe
IT	information technology	SFRY	Socialist Federal Republic of Yugoslavia
KRPP	Kosova e Re Power Project	SMEs	small and medium enterprises
LFS	labor force survey	UN	United Nations
		VAT	value added tax

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EXECUTIVE SUMMARY

Kosovo is one of the poorest countries in Europe. Its economic growth has been largely inclusive, averaging 3.9 percent a year among the bottom 40 percent of the consumption distribution in the population (the bottom 40), compared with 2.4 percent among the top 60. Nonetheless, as of 2011, about 30 percent of its people were still living below the national poverty line of €1.72 a day, and about 12 percent were living in extreme poverty, on less than €1.20 a day. More recent official poverty estimates are not yet available, but initial indications are that poverty continued to decline in 2012 and 2013. Poverty also varies considerably across Kosovo's regions and across ethnic and other vulnerable groups.

In historical terms, Kosovo is Europe's youngest country. After its experience as part of the former Yugoslavia, Kosovo became a separate territory under United Nations (UN) administration in 1999, and, in 2008, it declared independence. The country has since made considerable socioeconomic progress, benefiting from international support and its own considerable diaspora. With its policies directed to the overarching political objective of European integration, it aspires to become a member of the European Union (EU). However, because its international status has not yet been resolved, its economic development is confronted by unique difficulties in areas such as transport, telecommunications, agriculture, banking, and insurance. Causing further problems are smoldering domestic and regional tensions, only tentative application of the rule of law, and unstable politics.

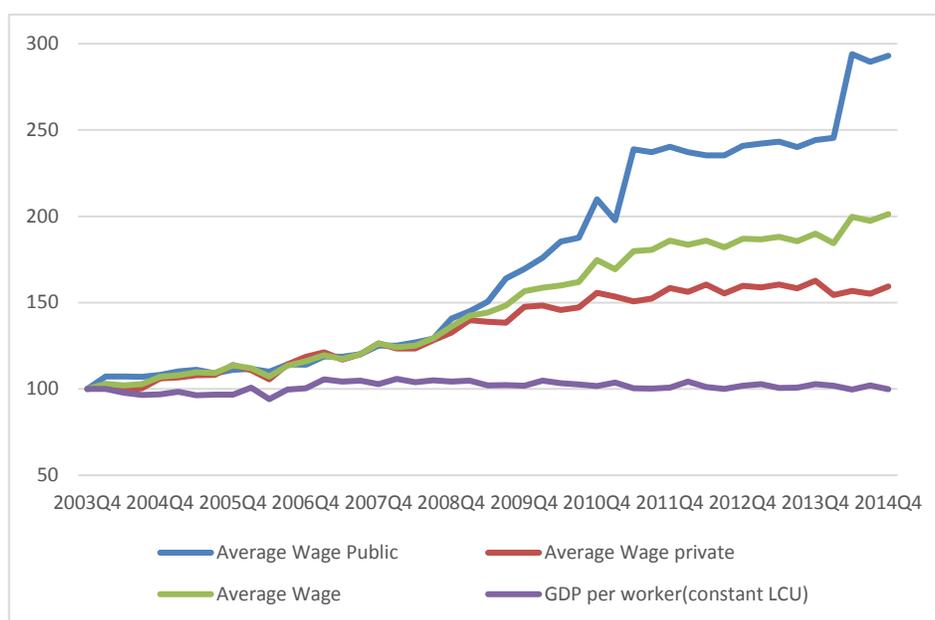
Demographically, Kosovo is also currently Europe's youngest country. Kosovo has a population of 1.8 million. The average age is about 26, and around 38 percent of the population is younger than 20. The population thus represents a resource for the country's future prosperity. Unlike most European countries, Kosovo is not confronted by the fiscal and economic pressures caused by an aging population, and a young, well-trained labor force could be a comparative advantage for boosting productivity, moving into modern economic sectors, and, ultimately, accelerating economic growth. However, so far, Kosovo's growth model has been unable to make much of a dent in the high rates of unemployment; provide formal jobs for more of its people, particularly women and youth; and reverse the trend of outward migration, which offers the principal opportunity for the young, the highly skilled, and the well-educated. Because the labor market outlook is unfavorable (employment is currently stuck at 25.2 percent; labor force participation is at 37.6 percent; and 31.4 percent of youth are not engaged in work, education, or training), job creation was a top priority during the general election campaign in 2014, and remains today. It was also a central factor in the 2014/15 winter of discontent that generated civil unrest and more emigration.

The juxtaposition of growth and poverty reduction with persistently low employment and low labor force participation is one of the many outcomes of Kosovo's structural characteristics such as small size, legacies of a troubled past, and dependence on massive foreign aid and remittances. Because domestic savings is negative, the current growth model relies heavily on remittances and aid. Although remittances reach some 20–25 percent of households and provide considerable income among poorer households, they have been mostly used for consumption. Because of the narrow, undiversified, and uncompetitive productive base (the agriculture and services sectors are large; manufacturing is small; and little is tradable), the steady consumption demand fueled by remittances has been met mainly by imports. The supply response has been limited to such nontradable areas as construction, real estate, and retail and other services, where Kosovo has seen considerable growth and dynamism. Understanding these factors is central to the effort to reduce poverty and share prosperity sustainably. Job creation is particularly important for inclusiveness

because employment earnings account for 50–60 percent of income across all income groups, while, among poorer households, they are the most important source of income growth.

The forces at play in Kosovo are the same as those that generate Dutch disease, and there are signs that Kosovo is losing competitiveness. Although the impact on relative prices and the real effective exchange rate has been muted (the economy is far from full employment; the evolution of the real effective exchange rate reflects mostly import prices; and food represents 35 percent of the consumer price index basket), there are clear signs that, from a unit labor cost perspective, competitiveness is being lost. While private sector wages have increased only moderately in real terms, the increase was substantial if scaled as a measure of productivity (figure ES.1). This is even more apparent if public sector wages, which have almost tripled since 2003, are brought into the picture. Factor accumulation is estimated to have contributed two-thirds to economic growth between 2008 and 2012, while productivity counted for the other third.

Figure ES.1. Wages and Productivity, Kosovo



Source: Ministry of Finance data.

Note: 100 = 4th quarter, 2003.

Manufacturing was the biggest contributor to the decline in labor productivity between 2010 and 2012.

Labor productivity dropped by 6 percent between 2010 and 2012 for all the firms in the Business Environment and Enterprise Performance Survey (BEEPS) sample.¹ The decline was driven by manufacturing, where labor productivity fell an average of 12 percent. Moreover, exporting firms saw labor productivity drop by about 8

¹ The dataset analyzed is a two-wave panel of firm data from 2010 and 2012. In the dataset are 202 firms in the 2012 survey and 262 firms in the 2010 survey. Of these, 10 were singled out for unreliable responses to some questions and were therefore not part of the sample for much of the analysis. The sample contains 69 manufacturers, 31 retailers, 26 wholesalers, 50 firms producing other services, and 12 construction firms; 4 firms are not categorized by sector. Of the firms analyzed, 30 export, and 162 produce nontraded goods or services. It is estimated that the firms are representative based on stratified sampling (three layers: firm size, sector, and region). However, they add up to just 0.5 percent of the total population in the economy, judging from information gathered through structural business statistics in Kosovo. The data are available at BEEPS (Business Environment and Enterprise Performance Survey) (database), European Bank for Reconstruction and Development and World Bank, London, <http://ebrd-beeps.com/data/>.

Kosovo's structural problems support the persistence of the current cycle. The current growth model has deep roots. The high unemployment and underemployment, low labor force participation, and emigration are all rooted in the period of the Socialist Federal Republic of Yugoslavia (SFRY), when Kosovo was the most backward and poorest area within the federation. It was also highly dependent then, as it is today, on transfers and remittances. The 1998–99 conflict and Kosovo's unresolved international status also support the persistence of the status quo. Considerable informality, corruption, and pressures to spend on pensions, benefits for veterans and former political prisoners, and public salaries weigh heavily not only on public finance, but also on the efficiency and effectiveness of public spending. Gaps in social infrastructure (for example, the rule of law, property rights, and the justice system), political impasses and disputes within the country and with neighbors, and tensions among ethnic groups are other reasons for the reluctance to update the economic model. Other major problems, such as the characteristics common to small states, are also evident, among them a narrow production base because of high input costs and the small internal market, government revenues that depend on tariffs and indirect revenues, state capture by vested interests, and minimal implementation capacity.

There are doubts whether the current model can sustainably support Kosovo's future development and ambitions. While, conceivably, a small economy such as Kosovo could continue to grow in the short and medium term, the marginal benefits of some growth drivers are expected to decline. Official development assistance (ODA) is already shrinking amid donor concerns about poverty, fragility, and security. The pace of public investment in physical infrastructure is slowing as damaged and obsolete infrastructure is replaced. The small size of the internal market is expected to suppress the growth and dynamism of nontradable services. Above all, the challenge of creating conditions for a more dynamic private sector will intensify, and social tensions may reemerge if demographic pressures are not absorbed by the labor market and emigration. The social and economic costs of protracted low job creation are amplified by the absence of an independent monetary policy and limited fiscal capacity for countercyclical responses to smooth the impact of shocks. To achieve its goal of successful and sustainable EU membership, Kosovo will require structural transformation and heightened productivity so that it can establish a market economy that can both cope with competitive market forces and provide income and job opportunities to reduce migration.

To break the self-perpetuating cycle, the central premise of this Systematic Country Diagnostic (SCD) is the need for a gradual rebalancing of growth to make growth much more reliant on higher productivity at home and greater competitiveness abroad. Refocusing Kosovo's growth agenda requires retaining several features of the economy as a foundation, while tapping into production factors—natural and human resources—that are either chronically underused or not used at all. This will help expand the opportunities for the poor sustainably to improve their welfare, reduce poverty, and promote shared prosperity. To broaden the economy's narrow production base, boost job creation, and reduce the heavy dependence on imports, Kosovo's current growth strategy needs to be amended across the board through new governance, macroeconomic, structural, and social policies.

That the reforms needed to boost socioeconomic development are congruent with those required for Kosovo to achieve the overarching priority of integration in the EU is helpful. Kosovo signed a Stabilization and Association Agreement (SAA) with the EU on October 27th, 2015, a significant milestone in the EU accession process. The SAA implementation started as of April 1st 2016. This first step toward EU integration opens a window of opportunity for a larger reform agenda supported by the EU. Seizing this opportunity would lead to more rapid gains in productivity and competitiveness and help unlock growth potential and convergence with EU economic, judicial, social, and environmental standards. However, the road to EU accession is long and difficult and will call for many structural reforms.

The EU approach to enlargement is based on the rule of law, economic governance, and public administration reform. The rule of law, such as judicial reform and the fight against organized crime and corruption, is at the heart of the enlargement process, and enlargement countries need to tackle these issues early in the accession negotiations to demonstrate a solid track record of sustainable results. The European Commission is cooperating with the enlargement countries to strengthen their economic governance, including through national economic reform programs, with a focus on fiscal stability and structural reforms for improved competitiveness and growth. Finally, emphasis has also been placed on the challenge of reforming public administration and strengthening democratic institutions, which remain weak, with limited administrative capacity, a high level of politicization, and a lack of transparency.

Not seizing the opportunity of EU accession will entail bringing unit labor costs back into line through a painful adjustment of internal devaluation to regain competitiveness. The process of realigning labor costs through productivity, however, requires the generation of productivity gains consistently more quickly than competitors do and may not be possible if the reservation wage rises in lockstep. Some adjustments in wages may still be necessary.

International experience and a consideration of Kosovo's specific challenges and opportunities reveal that four areas represent critical opportunities for achieving inclusive and sustainable economic growth anchored in broad participation in growth, higher investment, productivity, and external competitiveness. (The four areas are highlighted in boxes below.)

While preserving fiscal discipline, reprioritize public expenditures and reorient taxation to address critical development challenges.

Align the budget more closely with development needs and improve the allocation and efficiency of public spending. As the economy became euroized and given the benefits of structural reform and the changes in income policies, the scope for macroeconomic policy is limited by the availability of fiscal buffers and external financial support. Although Kosovo has managed to keep public finances healthy, protect the fiscal space for public investment, and defend against shocks, its future will depend on achieving the proper balance between stabilization and development objectives. While the fiscal rule reinforces the intention to maintain fiscal sustainability, Kosovo is sensitive to political business cycles and prone to election-related episodes of fiscal largesse. There has also been a tendency to overinvest in physical infrastructure, particularly roads. It is expected that, soon, the combination of these factors will either cause the deficit to surge or crowd out priority development-focused spending. Serious trade-offs will be needed, particularly if new power generation facilities require public resources. Regardless of the magnitude of public spending in the energy sector, reprioritizing expenditures across sectors would contribute more to addressing the poverty and unemployment challenges and would provide more value for money.

Shift to direct taxation and strengthen tax administration. The current tax structure reflects the import-heavy, low labor participation, transfer-dependent nature of the economy; it has proven to be revenue-effective mainly because the value added tax (VAT) system is well designed. However, meeting all fiscal needs will be more difficult if, as expected, border revenues, which make up over 70 percent of total revenues, slow down as EU integration and free trade agreements advance. A gradual shift to domestic revenue and direct taxation is necessary and feasible; indeed, there have recently been a number of changes in tax policy. This shift will also help improve how taxes affect families with less ability to pay. However, tax policy also needs to reflect the degree of compliance, the size of the shadow economy (which is estimated at 27–35 percent of gross domestic product [GDP]), and the capacity of the tax administration to adopt appropriate international best practice.

Enhance the environment for private investment and business expansion in tradable sectors and make a determined effort to reap the full benefits of European integration.

Capitalize on comparative advantages. Kosovo already has comparative advantages in several goods (garments, textiles, and food) and services (travel and communications). Manufacturing has the potential not only to spur income and exports, but also to generate employment among skilled and unskilled workers. Skilled manufacturing workers tend to be concentrated in the garment, nonmetallic mineral, and food processing subsectors, though nonmetallic mineral producers also employ relatively more unskilled workers. Given their direct impact on other sectors and on human capital formation, modern services, which are already a major source of income, have the potential to transform Kosovo's economy. However, manufacturing and modern services have been held back by large regulatory and infrastructure gaps. An unfavorable business environment, a deficit in quality infrastructure, and the poor access of firms, especially small and medium enterprises (SMEs), to technology and finance reduce growth prospects, profitability, and competitiveness, shifting the attractiveness of investments in favor of nontradable sectors.

Addressing regulatory gaps

Ensure good governance and reinforce the rule of law. Good governance, as demonstrated by the quality of institutions, the rule of law, property rights, the justice system, and the political culture, is an element of the soft infrastructure that is necessary for a well-functioning, competitive, and innovative market economy that has discarded the socialist legacy. While Kosovo's legislation, regulation, and institutions generally adhere to EU standards, the inadequate development and performance of governance institutions, particularly the shortcomings of the judicial system, are a major obstacle to business success. Because they raise the costs and risks associated with doing business, they encourage the offering, giving, receiving, and soliciting of bribes. Beyond economic considerations, addressing gaps in soft infrastructure would also help strengthen social cohesion because minorities and the bottom 40 are particularly disadvantaged in accessing justice.

Enhance the business environment. The establishment of an effective legal, regulatory, and administrative framework to govern trade and investment would help enhance the capacity of businesses to withstand competitive pressures and connect with global value chains, thereby generating jobs and spurring competition, innovation, and productivity increases. Some aspects of Kosovo's business climate have become much better, as evidenced in the consistent improvement in recent years in Kosovo's relative standing in the Doing Business Survey. However, a number of policies that support trade and investment need more work, including in strengthening property rights; reforming and streamlining licensing; reforming inspections; implementing customs and trade regulations; streamlining standardization, accreditation, and certification systems; enhancing foreign direct investment (FDI) and export promotion; clarifying competencies on competition; and tightening the arrangements for corporate governance, financial reporting, and auditing. Businesses consider the regulatory implementation gap to be a major problem.

Secure property rights, develop the land market, and coordinate the use of national geospatial data. Despite significant investment, less than 30 percent of cadastral zones in Kosovo have completed the cadastral reconstruction process, whereby the parcel boundary and legal information are updated, upgraded and managed in the digital cadastre. Land allocation, completion of formal registration, protection of land rights among those displaced during the war, and a well-functioning land market suffer from lack of access to historical cadastral

documentation, which was moved to Serbia in 1999 and is currently undergoing negotiations for their return, incomplete privatization and legalization programs, and issues with the sustainability of cadastral services. While the recent introduction of the National Spatial Data Infrastructure (NSDI) promises to benefit both private and public sector planning, decision making, and investment, significant work is still needed to ensure that the NSDI strategy is realized and complies with the EU INSPIRE Directive that regulates the collection, sharing, and use of geo-referenced information.

Maintaining financial stability and deepening financial intermediation. Broader financial intermediation will be critical to channeling savings, including remittances, through the formal financial system and into productive investment. Most Kosovar companies are SMEs; they cite the high cost of capital and the dearth of long-term financing as major impediments to expansion, creating jobs, and competing generally. Meanwhile, almost 50 percent of remittances arrive through informal channels, and the rest through banks, money transfer agencies and travel agencies. Channeling these flows to the regulated market would help increase financial access and inclusion. The banking sector is stable in Kosovo relative to neighboring countries. Thus, banks are highly liquid, profitable, and well-capitalized; credit growth is solid; and nonperforming loans are low and declining. Nonetheless, the financial sector suffers from weaknesses such as low levels of financial intermediation and a lack of sophisticated practices. The small financial sector is dominated by banks. High collateral requirements and debt collection difficulties are holding back the growth of commercial bank lending, especially in favor of SMEs.

Addressing the infrastructure gap

Ensure reliable and affordable energy. Energy insecurity has heavy costs for businesses and is the largest obstacle to attracting high-quality FDI to Kosovo. Kosovo's unreliable lignite-fired plants, overloaded and inefficient distribution system, lack of back-up generation capacity and financial constraints which do not allow for purchases of power imports, have resulted in suppressed demand (load shedding) affecting businesses and households. The decommissioning of the obsolete Kosovo A Power Station will create a supply gap and the requirements for new generation. Short-term energy deficit problems can be addressed partly by regional interconnectivity. In the long run, though, relying on external suppliers is not optimal from either a supply security or a cost perspective. Even taking into account the costs of managing environmental and social externalities, the best value-for-money option is an energy strategy that incorporates renewable energy, energy efficiency measures, and a new thermal power plant. Replacing the obsolete Kosovo A Power Station with a state-of-the-art, EU environmental standards-compliant plant and rehabilitating the Kosovo B Power Station would have immediate environmental, economic, and social benefits. One major problem related to the continued operations of the lignite mine and construction of the new power plant has been concern about its environmental and social impacts, which create public opposition and make the private sector reluctant to invest in operations that are not aligned with international standards. In particular, on the social side, the adequate identification and management (that is, proper planning, compensation, and so on) of the potential impacts on communities located in mining areas in line with international standards is a critical element to ensure the social license to operate for the sector. Additionally, the lignite mine will require substantial recapitalization for its continued operations and supply of the existing power plants, estimated at about €250-400 million over the next 3-5 years. Regardless of the extent of private participation, it is necessary to strike the proper fiscal sustainability balance by ensuring that tariffs fully reflect costs and service affordability, while also protecting the poor from tariff increases. Current energy costs may not remain low after large investments in energy efficiency, renewable energy, or a new power plant.

Increase connectivity. In a small and landlocked economy, connectivity is critical to successful integration with regional and global markets. Integration promises lower transaction costs, more trade, bigger markets, economies of scale, more competition, and more efficiency. Kosovo has invested heavily in new physical capital to compensate for damage because of war and years of neglect, but the investment in new highways risk squeezing out other public investments, particularly the maintenance of roads and railways. Also strategic for Kosovo's competitiveness is addressing infrastructure bottlenecks in broadband digital communications, which can pave the way for income growth and job creation. Not only does broadband contribute significantly to improving international competitiveness, it also contributes to the fight against poverty and unemployment, to social inclusion and territorial cohesion, and to stimulating infrastructure investments.

Foster greater inclusion by building human capital and ensuring equal opportunities.

More jobs and more productive workers are vital to building the critical human capital that is necessary to ensure that low-income households participate in and benefit from economic growth.

Unlike most European countries, Kosovo has a young population and a potentially large demographic dividend, which makes the jobs agenda all the more critical. A young and competent workforce will help attract investment to expand opportunities for employment and can lead to sustained income gains. Improving the quality and relevance of education at all levels and ensuring equitable access to educational opportunities at early ages is a first step that needs to be complemented by more opportunities to acquire the skills that private employers are seeking. The development of these skills opens up wage employment opportunities, but it may also stimulate greater self-employment and entrepreneurship in such areas as agribusiness, information and communication technology (ICT)-enabled jobs, and other emerging sectors. Education alone is not sufficient. Labor market policies and regulation are needed to tackle the extremely low labor force participation rate. Tax and benefit policies, improved job placement programs (aligned with market demand), active labor market programs, labor market information, and access to childcare for mothers are also important. Given Kosovo's extremely low labor force participation, improved opportunities are needed for women and minorities, especially the Roma, Ashkali, and Egyptian (RAE) populations, which are confronted by considerable discrimination.² A combination of policy and cultural changes to break the link among less schooling, early marriage, and entrenched family and community attitudes about the fulfillment of traditional roles would help reduce labor market disadvantages among women. It is also important to facilitate geographic and occupational mobility and the participation of minority groups generally.

For greater social inclusion and cohesion, policies are needed to enhance the opportunities of all wealth groups, ethnicities, and regions to access health care, education, and social protection equitably. A large share of the population is vulnerable to income shocks and falling back into poverty, and the social safety net has major gaps. Building up institutions, improving targeting, and making public spending more efficient in health care, education, employment services, and last-resort social assistance would promote equal opportunity and short-term protection so that the less well off, such as the RAE people, can accumulate assets, participate in economic growth, and improve their livelihoods. Given Kosovo's history, better targeting and coverage in social protection is paramount, and budgetary support should be directed to the poor rather

² The Kosovo Constitution recognizes the Roma, Ashkali, and Egyptian populations (RAE) as three distinct ethnic groups. The Roma are believed to have originated in India; they speak Romani. The Ashkali and Egyptians are reputedly from Syria and Egypt, respectively; they speak Albanian. Although the Ashkali and Egyptians distance themselves from Roma, the three groups are often viewed as one community by the Albanian majority.

than special interest groups. Shortcomings in the inclusion and participation of women at all levels of society are a major concern. While health indicators have improved, the efficiency of public spending and discrepancies between groups are still a problem. Health outcomes could be enhanced by shifting the focus from hospitals to primary care, water, and sanitation to meet basic needs. The planned mandatory health insurance scheme should enhance risk pooling and create opportunities to broaden efficiency by prioritizing spending on primary care and boosting the quality of care across the board. Particularly important is controlling the share of out-of-pocket payments in total health care spending because these payments add about 2 percentage points to the poverty headcount ratio. However, the impact of health insurance will critically depend on elevating the targeting of financial support on poor households.

Enhance the stewardship of the environment and natural resources for immediate social welfare advances and the long-term sustainability of inclusive growth.

Counter the effects of decades of neglect and war. Given the country's abundance of natural resources and its fertile land, greater productivity and sustainability in agriculture and mining—where Kosovo benefits from comparative advantages—are critical to exports and to import substitution because they can generate resources for development. Modernizing agriculture and mining, building up institutions and policies, and setting technical standards and regulations will be critical to addressing environmental and health risks and to aligning with EU norms. Consideration should also be given to the impact of trade agreements.

Increase productivity in agriculture. Agriculture accounts for about 11 percent of GDP and even larger as a share of total employment³, although much of the employment is informal. Agriculture also has a crucial social dimension: in Kosovo, it is a safety net. About 60 percent of the population own land for cultivation, and 30 percent own livestock. About 60 percent of the poor live in rural areas and, to a large degree, depend directly or indirectly on agriculture for their livelihoods. However, there are structural and interrelated challenges to agriculture's competitive and growth potential, including insufficient scale, financing, integration, and market links. Alignment with EU and international standards and technical regulations needs to be ensured. Accelerating growth and addressing rural poverty will require policies and reforms to shift agriculture from subsistence farming to farming that is intensive and more commercially oriented and that grows higher-value niche products. Policies are also needed to shift from underemployment in farming to full employment in processing and nonfarm rural activities. The prospects for eventual EU integration will largely drive the agriculture agenda, making agribusiness development central to accelerating growth, creating jobs, and raising agricultural competitiveness. Finally, the sector will need to adapt to the drought and flood threats of climate change, which will affect Kosovo's limited water resources.

Manage natural resources sustainably. Kosovo has been a major mining center since pre-Roman times. It has large reserves of lignite, lead, zinc, silver, nickel, cobalt, copper, iron, and bauxite, and high-quality construction minerals such as andesite, basalt, diabase, gabbro, granite, limestone, and marble. Mining, which was a mainstay of the economy of the former Yugoslavia, has the potential to generate exports, growth, and resources for development. However, chronic neglect since 1991, including little reinvestment in mining operations and the associated processing facilities, has diminished the industry's asset value and reduced

³ The 2014 LFS (KAS and World Bank 2015) estimates the agricultural share of employment at about 3 percent, but this uses a definition from Eurostat and International Labour Organization guidelines that systematically undercounts agricultural workers, especially the many small and informal farmers that dominate Kosovo's agricultural sector. It also does not include agroprocessing, which is categorized under industry. The European Commission estimates agriculture's share in total employment at approximately 35 percent (EC 2014c). The 2014 agricultural census estimates that 362,700 people worked in agriculture in 2014 (KAS 2015). Most of these are part-time or seasonal workers, who are still counted as 86,620 annual work units, which is similar to the concept of full-time equivalents.

production even as environmental and social legacy issues have escalated. Nonetheless, it is estimated that Kosovo's mineral endowment is sufficient to offset the start-up costs necessary for major upgrades. The principal challenge to relaunching Kosovo's mining industry is attracting private investment, considering that sectoral governance is weak and Kosovo's status is unresolved. The tension between privatization and a limited relaunch using the existing management structure is at the core of mining governance issues. Reforms to improve the rule of law and minimize discretionary decision making are necessary; but so, too, is addressing a legacy of unresolved labor, social, and environmental issues that affect workers and communities. Remedying environmental legacies related to mining will be vital to relieving health impacts, bringing degraded land back into productive use, and reducing public opposition to production. More accountability in the management of natural resource revenues is also critical for the equitable use of resources and to ensure that growth is inclusive.

The SCD analysis has identified numerous macro-fiscal, environmental, social, and political risks, but perhaps the greatest risk is that the authorities will miss the opportunity that the demographic dividend is offering. The challenge of keeping the economy stable given global uncertainties (especially in the euro area) is amplified by a narrow production base that prevents Kosovo from diversifying into a wide range of activities. Similarly, the country is prone to natural hazards, such as floods, landslides, droughts, earthquakes, and wildfires, that could do serious damage to the economy, the fiscal balances, and the well-being of vulnerable populations. These risks, as they relate to the requirements for fulfilling the EU environmental *acquis communautaire*, include the significant impact of industrial polluters; low air quality; inadequate waste, wastewater, and water infrastructure; and a large number of contaminated sites. The government needs to make dealing with the environment and climate issues a priority if it is to ensure EU accession. Finally, there is the question of the sustainability of reform: the reform agenda could lose momentum if the tangible benefits of reform do not become apparent to the public or if the costs of reform to narrow constituencies become too high. The limited institutional capacity for reform reflects the shortage of technical expertise, given the small pool of human resources in Kosovo.

As confirmed by consultations with stakeholders, the shortage of soft and hard infrastructure emerges from the diagnostic as the most pressing impediment to growth, poverty reduction, and sharing prosperity. Addressing the infrastructure bottleneck in energy and building up governance and the rule of law are top priority areas for creating the more attractive environment that is necessary to reaping the benefits of European integration fully, unleashing productivity gains, and creating quality jobs and inclusion. Other high priorities include improving the allocation and efficiency of public resources, addressing skills mismatches to increase employment and labor productivity, and ensuring the sustainable management of natural resources (figure ES.3).

Figure ES.3. Prioritization

Priority	Growth	Poverty and shared prosperity	Sustainability	Time horizon of impacts		
				Short	Medium	Long
Reducing energy bottlenecks	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Improving governance, the rule of law, and the business climate	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Improving the allocation and efficiency of public expenditure	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Increasing employment and labor productivity through education	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Ensuring the sustainable management of natural resources	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Strengthening tax policy and administration	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Increasing productivity in agriculture	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Raising employment and labor productivity through labor policies	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Reducing ICT bottlenecks	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Raising the quality and equality of opportunity through social protection	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Raising the quality and equality of opportunity through health care	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Maintaining financial stability and deepening financial intermediation	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Reducing transport bottlenecks	High priority	Medium priority	Low priority	Short term	Medium term	Long term

Color key	High priority	Medium priority	Low priority
	Short term	Medium term	Long term

This SCD draws on all reliable evidence. Some major knowledge gaps have already been identified, and steps to address them may be incorporated into the forthcoming World Bank Group Country Partnership Framework (CPF). More information is needed about many aspects of Kosovo’s informal economy, especially better estimates of the size of this economy, the extent to which informal activities are not captured by standard surveys, and the motivations of enterprises and individual workers in remaining informal. Information is also needed about the scale and scope of corruption and illegal economic activity. Because information on the informal economy is inherently scarce, filling this knowledge gap will require longer-term analytical and advisory support during the lifetime of the CPF. Further information is needed on why inactivity rates are so high, such as possible queuing for public jobs, elevated reservation wages because of remittance receipts, and the option to emigrate for better wages. More information is needed on the characteristics of Kosovo’s emigrants and on the amounts, frequency, and longevity of their remittances. Finally, most official data sources do not offer sufficient observations about minority groups to draw meaningful inferences. Oversampling these groups (booster samples) in some surveys could help close this information gap. Similarly, thorough analysis of trends in female employment, the gender constraints on labor market participation (childcare, regulations, lack of skills), and the role of women in the SME sector would shed light on how best to address this major challenge to inclusive growth in Kosovo. Additionally, quantification of the overall infrastructure gap under various growth scenarios would be useful.

I. INTRODUCTION

1.1. **Kosovo is Europe’s youngest country in terms of history and demographics.** Both characteristics are defining the country’s overarching development challenges.

- *For most of its history, Kosovo has been ruled by foreigners.* The country’s geographical position along major trade routes made its territory a pawn in the hands of powerful neighbors, from the Romans and the Ottoman Empire to Yugoslavia. The considerable amount of self-governance granted to Kosovo under the Yugoslav Constitution of 1974—as a province of Serbia, but not as a constituent republic of the federation—proved politically unsustainable, as temporary gains in self-rule were reversed by Belgrade during the Milošević era. The period after 1989 was characterized by increased repression and violence, culminating in war and population expulsion in 1998–99. During the immediate postconflict period, United Nations (UN) Security Council Resolution 1244 placed Kosovo under UN interim administration. In 2008, Kosovo declared independence. The transition period of supervised independence ended four and a half years later. International recognition has remained partial and has precluded Kosovo from joining the UN as a full member.⁴ In the wake of these developments, public institutions had to be established from scratch and earn the population’s acceptance and credibility as their own.
- *High population growth rates paired with strong emigration pressures are creating specific demographic challenges.* The average age of Kosovo’s 1.8 million inhabitants is 26 years, and about 38 percent of the population is under 19 years of age. Kosovo’s young population represents an enormous promise and resource for future prosperity or, if developments and perceptions of economic perspectives take a turn for the worse, a considerable risk of increasing social and political tensions and instability. At present, the labor force participation of the young is less than 50 percent, and the unemployment rate among the young is twice the national average.

1.2. **Since independence, the Kosovar economy has performed relatively better than any of its neighbors in the western Balkans.** The relatively good growth performance during 2008–15 partly reflected the support of the international community and the country’s sizable diaspora.⁵ Economic policies and reforms aimed at strengthening the legal and institutional framework and the public infrastructure of the country have been anchored in the overarching political objective of joining the European Union (EU). As a *potential candidate* for EU membership, Kosovo has made considerable progress in overcoming severe legacies from socialism, repression, and war. However, the temporary abandonment of the country’s socioeconomic development priorities caused by a succession of statehood-related political crises—not least those related to the EU-moderated negotiations with Serbia on the bilateral normalization of relations and the integration of the four municipalities of northern Kosovo into the country’s constitutional and legal architecture—has led to delays in the implementation of the corresponding reforms.

⁴ By mid-2015, 108 of 193 UN member states had recognized Kosovo, excluding two permanent members of the UN Security Council. In addition, the recognition by European Union (EU) member states has been nonunanimous; five member states have denied recognition. The nonunanimous recognition of Kosovo’s independence represents an economic development challenge, including in transport, telecommunications, agriculture, banking, mining, and insurance.

⁵ The deceleration of real growth to about 1.2 percent in 2014 was caused by specific factors reflecting the fallout from (a) the energy generation bottlenecks caused by an explosion at gasification plant near the Kosovo A Power Station in mid-year and (b) the protracted political and constitutional impasse after the June 2014 general elections. It however rebounded to about 4.1 percent in 2015.

1.3. **Economic growth in Kosovo has been largely inclusive because it helped reduce poverty and raise the incomes of the bottom 40 percent of the consumption distribution in the population** (the bottom 40). From 2006 to 2011, the most recent period on which comparable data are available, per capita consumption among the bottom 40 grew at a rate of 3.9 percent a year, compared with 2.4 percent among the top 60. Per capita consumption growth was strongest in the poorest quintile. The poverty rate at the national poverty line, having fluctuated between 35 percent and 45 percent before independence, had fallen to 30 percent by 2011. More recent official poverty estimates are not yet available, but initial indications are that poverty continued to decline in 2012 and 2013.

1.4. **The employment rate (25.2 percent) and the labor force participation rate (37.6 percent) have remained extremely low and stagnant.** Because of the narrow production base and the low, uncompetitive levels of domestic productivity, the implicit risk of continuing to rely on the current semi-successful growth model would mean the persistence of a cycle that has been characterized by the lack of a tangible decrease in the high rates of unemployment; the lack of the provision to wider segments of the population, particularly women and youth, of access to formal employment and income opportunities; and the lack of a reversal of the trend toward outward migration among youth and skilled workers.⁶ Since 2012, a rising number of young people from Kosovo have emigrated because of the lack of opportunities within Kosovo. Tens of thousands of Kosovars have emigrated in 2014 and 2015.

1.5. **Kosovo is one of the poorest countries in Europe, and several vulnerable groups are at a growing risk of social exclusion and poverty.**⁷ According to the Kosovo Agency of Statistics, 29.7 percent of the population was living below the national poverty line of €1.72 a day in 2011, while 10.2 percent were living below the national extreme poverty line of €1.20. Opportunities for social mobility are extremely scarce among marginalized groups such as the Serbs, as well as the Roma, Ashkali, and Egyptian (RAE) people, who continue to face major challenges in their socioeconomic circumstances, lacking education and facing discrimination from the general public.⁸ The prevalent geographical, political, and social segregation of minorities in Kosovo is a legacy of interethnic violence.

1.6. **The nonunanimous recognition of Kosovo's independence is adding specific challenges in economic development, including in transport, telecommunication, agriculture, banking, mining, and insurance.** Although Kosovo has been transformed from a fragile, postconflict, low-income country into a lower-middle-income economy with a partially functioning market economy, its unresolved status, smoldering tensions and bouts of violence, the weak implementation of the rule of law, and unstable politics are key obstacles to attaining political integration and socioeconomic development.

1.7. **The overarching political and economic objective—eventual EU membership—represents the anchor of the country's socioeconomic development strategy.** The EU Stabilization and Association Agreement (SAA), recently signed, represents the first formal step toward eventual EU membership. The SAA

⁶ Since autumn 2014, the pace of outward migration has accelerated substantially, raising considerable concerns in the EU of rising numbers of asylum seekers and undocumented migrants.

⁷ Though poor in a European context, Kosovo is much less poor than low-income countries in Sub-Saharan Africa or South Asia. For example, less than 1 percent of Kosovo's population is living below the international extreme poverty line of \$1.90 (2011 purchasing power parity U.S. dollars) associated with the World Bank Group's goal of eradicating extreme poverty.

⁸ The Kosovo Constitution recognizes the Roma, Ashkali, and Egyptian populations (RAE) as three distinct ethnic groups. The Roma are believed to have originated in India; they speak Romani. The Ashkali and Egyptians are reputedly from Syria and Egypt, respectively; they speak Albanian. Although the Ashkali and Egyptians distance themselves from Roma, the three groups are often viewed as one community by the Albanian majority.

implementation started on April 1st 2016 and will be done in phases. While Kosovo will be focusing on (a) negotiating and preparing for visa-free access to the 26-country Schengen Area, (b) implementing the obligations of the SAA, (c) continuing with the adjustments in the legal framework to approximate the EU's *acquis communautaire*, and (d) seeking to advance the EU-led negotiations with Serbia, the ultimate challenge is to ensure sufficient political support for the ratification of Kosovo's membership by all EU member states.

1.8. **Against this background, this Systematic Country Diagnostic (SCD) aims to identify the key constraints and opportunities for dynamic rates of sustainable and inclusive growth, a tangible reduction in poverty, and increased shared prosperity in Kosovo** (box I.1). The World Bank Group and the government will work toward a new Country Partnership Framework (CPF), the development of which will be informed by this SCD.

Box I.1: Systematic Country Diagnostic

The SCD is a diagnostic exercise upstream of the CPF. It aims at providing the analytical underpinnings for the CPF discussions on Kosovo with the government. It is conducted by the World Bank Group, in close consultation with national authorities and other stakeholders, including citizen engagement. SCDs are joint products of the World Bank Group.

Its objective is to address the question: *what are the most critical constraints (and opportunities) facing a country in accelerating progress toward the goals of ending extreme poverty and promoting shared prosperity in a sustainable manner?* This goal is interpreted in a particular country context. It may refer to the national notion of poverty and welfare of those at the bottom of the distribution, for example, the bottom two quintiles (the bottom 40). The SCD is expected to be a concise report based on the best possible analysis and drawing on all appropriate available evidence. It should not be limited at the outset to areas or sectors in which the World Bank Group is currently active or in which the World Bank Group expects government demands and interest.

1.9. **The remainder of this document is organized as follows.** Section II presents the country context, including political and economic conditions, and discusses factors behind recent trends in growth, shared prosperity, and poverty. It concludes with a proposed conceptual framework. Sections III–VI describe key drivers and the principal constraints to growth, shared prosperity, and poverty reduction. Section VII examines the priority areas for action.

II. COUNTRY CONTEXT

The Sociopolitical Context

2.1. **For most of its history, Kosovo has been under foreign rule.** Since 168 BC, there have been only a few years of self-rule and intermittent episodes of political autonomy (table 1). Otherwise, foreign powers and regional neighbors have ruled over the territory, which buttressed a mentality of and created incentives for parallel structures and economic informality, the reliance on extended family relationships, and a widespread skepticism toward government and the public sector. This behavioral legacy of two millennia of foreign rule is fading only gradually, thereby complicating and constraining socioeconomic policy making today. Even more pronounced than among any of its neighbors in the western Balkans, Kosovo have been unable historically to build its own public institutions—except during intermittent periods of limited self-governance—or to rely on a formal system of rules and laws.

2.2. **During the Yugoslavia era, Kosovo was disadvantaged both politically and economically.** After World War II, Kosovo remained an autonomous province of Serbia rather than a constituent republic within the multiethnic Socialist Federal Republic of Yugoslavia (SFRY, 1945–92).⁹ With the constitutional changes in SFRY in 1974, Kosovo gained political and economic autonomy within the Republic of Serbia and direct representation in the federal government of SFRY. At the same time, the institutional reforms fell short of providing Kosovo a constitutional status akin to the other republics within the federation. Economically, Kosovo was the most backward and poorest region within the SFRY, notwithstanding important mining and industrial sectors. In consequence, Kosovo continued to be highly dependent on federal development subsidies throughout the 1960s and 1970s. As a response to periodic demonstrations by Kosovars in the late 1970s and

Table 1 Summary of Kosovo's History

Time period	G*	On the Territory of Today's Kosovo
Since the 4th century BC	✓	Eastern part of Illyria (Dardanian Kingdom)
168 BC	✗	Conquered by Rome
441 and 447-49	✗	Hunnic invasions
527	✗	Reabsorption into Byzantine Empire
6th-7th century	✗	Slavic migrations
7th-11th century	✗	First Bulgarian Empire
11th-12th century	✗	Byzantine Empire
12th-14/15th century	✗	Second Bulgarian Empire and Serbia
1389 and 1448	—	First and Second Battles of Kosovo
Interbellum period	✗	Serbian principalities, as Ottoman vassals, and
	(✓)	Albanian resistance (Skenderbeg)
15-20th century	✗	Ottoman Empire
1912/13	—	First Balkan War
1912-13	✓	Albanian independence (incl. Kosovo territory)
1913	—	Treaty of London, recognizing Albania's independence, excluding Kosovo
1913	—	Second Balkan War and Treaty of Bucharest
1913-1941	✗	Kingdom of Serbia and Kingdom of Montenegro (Dukagjini), with increase in Serb settlements (colonization) and expulsion of Albanian population
1941-44	(✗)	Albanian under Italian occupation
1944-45	(✗)	Occupied by Germany
1946-63	✗	Autonomous Region of Serbia (SFRY)
1963-1974	✗	Autonomous Province of Serbia (SFRY)
1974-89	(✓)	Self-governance under SFRY constitution
1989-98	✗	Reversal of self-governance, repression,
	(✓)	violence, self-declared independence
1998-99	—	Kosovo war
1999-2008	(✓)	UN rule under UNSCR 1244
2008-present	✓	Republic of Kosovo

*G denotes Kosovars' ability (✓) or inability (✗) of self-governance.

⁹ The principal reason for Serbia's insistence that Kosovo was an autonomous province under UN administration, as defined by UN Security Council Resolution 1244 in 1999, stems from the fact that—unlike the other Yugoslav successor states, which had been constituent republics within the federation—Kosovo had a constitutional status akin to the status of Vojvodina, that is, an autonomous province of Serbia.

early 1980s, the Yugoslav government offered more economic aid, especially more investment for the development of Kosovo's lignite and other mineral assets.¹⁰ None of Kosovo's economic problems and none of the tensions between the autonomous province and the constituent republic could be resolved during the 1980s despite the large investments. For the Kosovars, the lack of progress toward economic convergence amplified their political dissatisfaction. For the Serbs, the challenge was to translate large and prolonged fiscal transfers into a productive, self-sustaining province. Meanwhile, large outflows of migrants toward Germany and Switzerland helped ease the social tensions and the pressure on the labor market.

2.3. The 1990s was a lost decade. The politically motivated hunger strike by Trepça miners in early 1989—triggering a decade-long struggle for political self-determination also in Kosovo—predated the fall of the Berlin Wall in 1989 and the monumental changes that followed in Eastern Europe. These proved most brutal in the SFRY's violent disintegration, the tail-end of which was the Kosovo War in 1998–99. Forced to pay for war and reconstruction efforts, the economy of the Federal Republic of Yugoslavia (1992–2003) and the successor Union of Serbia and Montenegro (2003–06) collapsed, as reflected in one of the most severe cases of hyperinflation in history. These factors were amplified by Socialist-era economic mismanagement and the effects of the UN trade sanctions that had been imposed against the Federal Republic of Yugoslavia during the war in Bosnia and Herzegovina. In the wake of these developments, the social situation deteriorated dramatically and produced large flows of refugees (over a million by some estimates) from the various Yugoslav republics. The overall result of the decade was (a) a sharp drop in output and trade; (b) the large-scale destruction of infrastructure and the severe deterioration in the enterprise, financial, and social sectors; and (c) worsened social indicators and increased poverty and inequality. In Kosovo, the decade saw an accelerating rate of economic neglect and destruction, the increasing discrimination against citizens of Albanian-ethnic origin (including in education), and an intensifying conflict that led to greater violence and—following the failed negotiations of Rambouillet—the Kosovo War of 1998–99 and the 78-day conflict between Serbia and the North Atlantic Treaty Organization in 1999.¹¹

2.4. The first decade of this century was characterized by the aftermath of the war and international rule. After the war, which came to a formal end through the adoption of UN Security Council Resolution 1244 of June 1999, Kosovo was placed under the administration of the UN Interim Administration Mission in Kosovo.¹² The war was a massive humanitarian crisis for such a small country. More than 13,000 lives were lost; an estimated 800,000 people were displaced; and a considerable portion of the country's physical

¹⁰ Pond, Elizabeth, 1981, "Why Turbulent Kosovo Has Marble Sidewalks but Troubled Industries," *Christian Science Monitor*, December 15, <http://www.csmonitor.com/1981/1215/121556.html>.

¹¹ The control of the education system by the Serb-dominated government was a major point of contention in the 1990s. Mass dismissals of ethnic Albanian teachers who refused to adhere to the central government curriculum and widespread boycotts of government schools by Albanian Kosovars led to the creation of informal Albanian-language schools. As a result, a large share of Kosovars currently in the 25–45 age-group have only had limited formal education. Aiming to stop the Kosovo conflict, the international community organized a peace conference in Rambouillet, France, in February 6–23, 1999. Talks ended without agreement. On March 15, 1999, Kosovo Albanian representatives agreed to accept the terms of the Rambouillet Accord, which did not grant independence to Kosovo, but allowed the alliance to move into the province to provide security. On March 19, 1999, the Kosovo peace talks failed: Serbia did not agree to the accord. Because of this failure, on March 24, the alliance began airstrikes against the military capacities of the former Federal Republic of Yugoslavia (consisting of Serbia and Montenegro). Airstrikes ended with the Kumanovo Accord of June 10, 1999 between the alliance and the Serbian military, which resulted in the withdrawal of all Serbian security forces from the territory of Kosovo on June 12, 1999.

¹² On June 10, 1999, the UN Security Council, with 14 votes and China's abstention, adopted UN Security Council Resolution 1244, which put the territory of Kosovo under the UN Interim Administration Mission in Kosovo, which was organized on four pillars: (a) police and justice (led by the UN), (b) civil administration (led by the UN), (c) democratization and institution building (led by the Organization for Security and Co-operation in Europe), and (d) reconstruction and economic development (led by the EU).

infrastructure was destroyed. The Kosovo Assembly declared independence from Serbia on February 17, 2008. As of September 2015, Kosovo had been recognized by 113 UN member states, including 23 of 28 EU member states. Serbia, however, continues to object to Kosovo's independence.¹³

2.5. At the moment, Kosovo is a potential candidate for EU membership. In 2013, the EU opened negotiations with Kosovo on an SAA after concluding that Kosovo had “met all the short-term priorities” identified in the Feasibility Study and “taken very significant steps toward visible and sustainable improvement in relations with Serbia.” The SAA with the EU, the first formal step toward eventual EU membership, was initialed by both parties in July 2014 and signed in October 2015. The SAA implementation started in April 2016. In parallel, talks are taking place on visa liberalization: Kosovo remains the only country in Southeastern Europe (SEE) of which the citizens require a visa to travel to the Schengen Area, representing a distinct comparative disadvantage relative to neighboring countries in the western Balkans.¹⁴

2.6. Kosovo's unresolved status remains an additional key obstacle to attaining the objectives of political integration and socioeconomic development. UN membership now seems a remote prospect, given that not all permanent members of the UN Security Council and less than the required two-thirds majority of UN member states represented in the General Assembly have accepted Kosovo's statehood. Similarly, there is strong opposition to Kosovo's independence in the four Serb-majority municipalities of northern Kosovo. The EU has led efforts to overcome these tensions by placing the normalization of bilateral relations with Serbia at the top of its foreign-policy agenda and linking the EU integration prospects of both countries to the outcome. An agreement between the prime ministers of the two countries was reached in Brussels on April 19, 2013, but not signed. The implementation of this Brussels Agreement remains an EU core focus.

2.7. The legacy of the past is a powerful barrier to sustainable socioeconomic opportunities among both the majority population in the internationally unrecognized country and the minority communities, many of which are not fully geographically, politically, and socially integrated. The government has undertaken efforts to improve the situation in this multiethnic country. Notwithstanding progress in the EU-moderated dialogue on the normalization of bilateral relations with Serbia, relatively strong undercurrents of hostility and mistrust continue to exist, at times resulting in ethnically motivated incidents.¹⁵ The divided municipality of Mitrovica is an ethnic hotspot and symbol of the frozen conflict within Kosovo that has prevented the establishment of a countrywide legal system and institutional infrastructure. Other war legacies have not been fully addressed either, including the challenges of displacement and the return of refugees that policy makers must face on the state and municipal levels. The Serb community, which constitutes the second-largest ethnic community, with about 5 percent of the total population, has experienced the highest

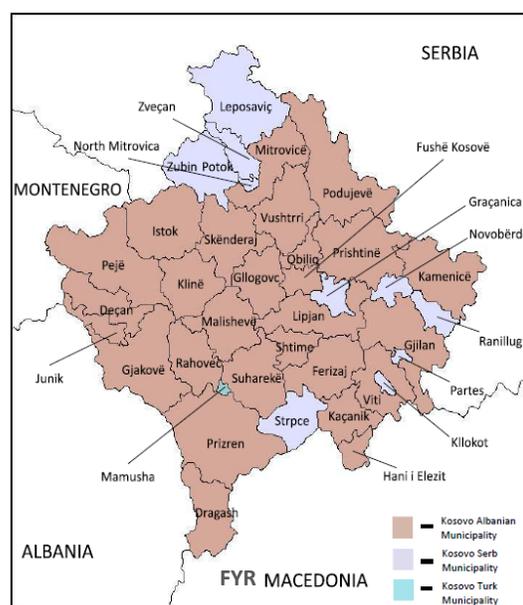
¹³ Full UN membership would require the support of one-half the Security Council members, without a veto from any of the permanent members, and two-thirds of the 193 UN General Assembly members.

¹⁴ The Schengen Area consists of all EU member countries except Bulgaria, Croatia, Cyprus, Ireland, Romania, and the United Kingdom. It also includes Iceland, Liechtenstein, Norway, Switzerland, and, de facto, Andorra, Monaco, San Marino, and the Vatican.

¹⁵ The 2011 population and housing census gave a first postwar indication of the distribution of ethnic groups in central Kosovo, that is, in all municipalities outside northern Kosovo. According to the census, the distribution was as follows: Albanians (92.9 percent), Serbs (1.5 percent), other ex-Yugoslav minorities (2.2 percent), RAE (2.0 percent), Turks (1.1 percent), and others (0.6 percent). The Constitution of the Republic of Kosovo, in effect since mid-2008, guarantees minority rights, including by (a) declaring as official languages Serbian (on the state level) and the Bosnian, Roma, and Turkish languages (on the municipal level); (b) guaranteeing a minority representation in Parliament (8.3 percent for Serbs and 8.3 percent for other ethnic minority groups); (c) requiring, for constitutional changes, a two-thirds majority of all deputies and the same majority among all deputies holding seats reserved and guaranteed for representatives of nonmajority communities; (d) establishing the permanent Committee on the Rights and Interests of Communities, two-thirds of which consists of minority deputies and which reviews and comments on all draft laws; and (e) requiring the prime minister to appoint at least one Serb and one other nonmajority minister to his cabinet.

relative levels of displacement from their places of origin.¹⁶ The hesitation to return reflects unresolved property disputes, low economic participation, and real or perceived security issues.¹⁷ The political self-exclusion of Kosovo Serb enclaves, particularly pronounced in the four Serb-majority municipalities in northern Kosovo, is still prevalent. However, the 2014 local elections—extended by the 2013 Brussels Agreement to the all of Kosovo—saw at least a 20 percent voter turnout in those municipalities that had previously boycotted Kosovo-led elections on principle. The RAE communities, representing about 2 percent of the total population, largely lives in informal settlements with particularly poor living conditions and high health-related risks, while experiencing exclusion from the health care system. By contrast, the Bosniak, Croatian, Gorani, and Turkish communities tend to be relatively well integrated into mainstream society.

Figure 1. Map of Kosovo



2.8. **The general elections of June 2014, although properly executed, revealed the intransigence of the political class and the ambiguity of the overarching constitutional framework.** As a result, the inconclusive parliamentary elections led to a protracted politico-constitutional crisis. The complete impasse and the grand coalition of the Democratic Party and the Democratic League, plus ethnic minority parties, that emerged from the crisis in December 2014 weakened the credibility of the entire political class. While the electoral campaigns of all parties and the government’s program and development strategy had focused on the creation of additional formal sector jobs, a series of politico-constitutional challenges—such as the creation of a war crimes tribunal—took attention away from the dominant issue of unemployment, a topic that has gained further urgency after the mass exodus of an estimated 5 percent of Kosovo’s population (mostly without the required visas) to the EU during the winter of discontent in 2014–15 (box II.1). The migration pressure, accompanied by antigovernment protests and labor strikes in the health care, education, and mining sectors, reflect the widespread pessimism about the rule of law and the economic prospects.

2.9. **The confidence in the state and the functioning of state institutions has been undermined among Kosovars by perceptions of widespread corruption, unresolved governance issues, and the fragile rule of law.** The declaration of independence in 2008 was meant to instill an appreciation of Kosovo’s statehood and overcome two millennia of behavioral patterns that had been rooted in deep suspicion of foreign governments, such as the reliance on parallel institutions and informal arrangements as well as narrowly defined clans and families. Changing this mentality and building trust in the state and its institutions—even more complicated in the context of an ethnically diverse population—are a great challenge in constructing a solid foundation onto which dynamic rates of sustainable and inclusive growth can be based (Box II.2).

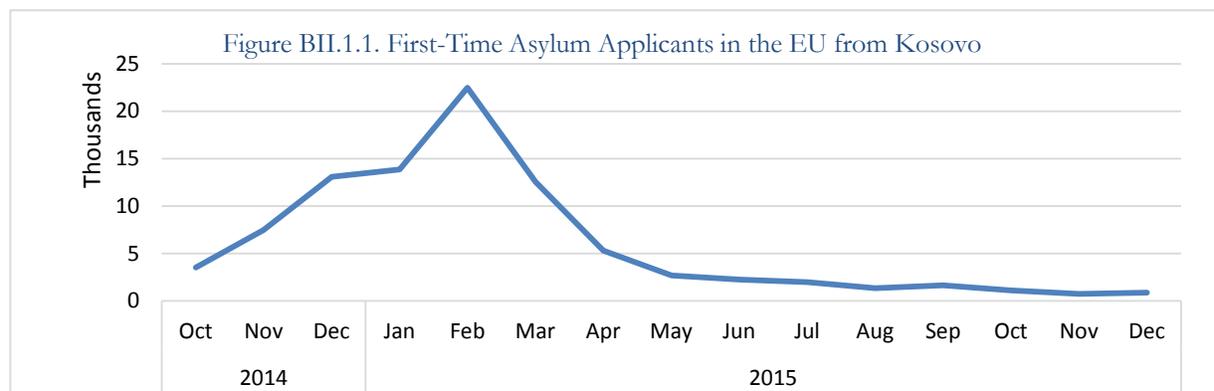
¹⁶ See OSCE (2012a); Wesli Turner and Nadine Walicki, 2014, “IDP Rights in Kosovo and Serbia Should Be a Key Consideration for EU Membership Talks,” blog post, February 24, Internal Displacement Monitoring Center, Geneva, <http://www.internal-displacement.org/blog/2014/idp-rights-in-kosovo-and-serbia-should-be-a-key-consideration-for-eu-membership-talks>.

¹⁷ Following the war, the Serb authorities took the civil and cadastral records with them, forcing central and municipal governments in Kosovo to recreate a corresponding database, with World Bank support, so as to be able to provide residents with land titles and proofs of property. See also OSCE (2010).

Box II.1. Recent EU Developments on Migration and the Expected Impact on Kosovo

Employment migration to other countries in Europe has been a prominent feature of Kosovo's economy since at least the 1960s. As of 2013, an estimated 381,000 people born in Kosovo were living outside the country, and an additional 300,000 or more were born outside Kosovo, but had at least one Kosovar parent. The large majority of emigrants from Kosovo go to Austria, Germany, and Switzerland, and their remittances are crucial for supporting family members who remain in Kosovo, as well as financing consumption that supports the growth of the economy.

Emigration from Kosovo spiked dramatically in 2014–15. The emigration surge has been attributed to several factors, the most important of which are as follows: (a) difficult economic and political conditions as well as poor employment prospects; and (b) an easing of travel restrictions in Serbia, providing a route to Hungary in the EU that had been widely expected to be closed off again in the near future. An exceptionally large number of the emigrants applied for asylum in the EU. Indeed, in October 2014–March 2015, more first-time EU asylum applications were submitted by Kosovo citizens than any other nationality, even Syrians. Most of Kosovo's asylum seekers could not demonstrate that they were fleeing war or persecution, and fewer than 2 percent of the applications were accepted, although some no doubt managed to remain in the EU unofficially or secure other authorizations to stay.



Source: Eurostat 2016.

The tightening of European border controls will likely inhibit migration from Kosovo. In addition to the lack of success with asylum applications, routine migration from Kosovo to the EU and Switzerland is likely to be affected as informal entry points are secured and new arrivals attract greater scrutiny from authorities. To date, there is nothing to suggest that Kosovars already resident in other countries would be repatriated or that those with formal employment offers would be denied entry. Nonetheless, in the current environment, migration to the EU from Kosovo is more difficult and is expected to diminish to levels below those observed before the surge in 2014.

Box II.2: Social Sustainability and Drivers of Fragility, Kosovo

Over the medium-term horizon, a number of drivers of fragility risk overshadowing the socioeconomic challenges faced by this new postconflict, posttransition country.

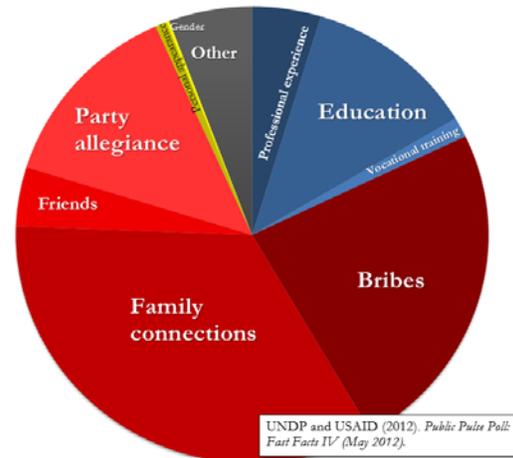
Orientation toward the common good. The legacy of centuries of foreign rule has contributed to the electorate's widespread suspicion of government and the legal framework. The government, in turn, often lacks internal ownership over development priorities and the ability to forge a national core consensus on key elements of an economic model, including the role the private sector should play, that would set the country on a track toward accelerated growth and rising per capita income. Lacking a national focus toward the common good, particular interests tend to dominate the political discourse, decision making, and initiatives.

Interethnic cohesion. Since declaring independence from Serbia in 2008, the country has faced significant postconflict challenges in (a) convincing Serbs, especially in the four municipalities north of the Ibër River, to view Kosovo as their state as well and (b) rebuilding strong interethnic cohesion especially with the Serb and RAE communities.^a Notwithstanding some progress among the Serb-majority municipalities in central Kosovo and in the context of the EU-moderated negotiations with Serbia, the war experience and long history of tensions between Kosovo's Albanian and Serb communities have kept Kosovo's ethnic divide unbridged (including for cars).^b Though interethnic reconciliation is viewed by both sides as a precondition for progress toward ultimate EU membership, there are few

representatives in either community who seek to build bridges of reconciliation to ensure the constitutional reality of a truly multiethnic state. Similarly, efforts to integrate the RAE communities into mainstream society are superficial and devoid of tangible steps toward integration and improved living conditions.

Meritocracy and social inclusion. A traditionally close network of family ties and loyalties dominates business relations, as has been the case for centuries. A recent survey confirmed that the same allegiances seem to have been carried over to decisions on public sector employment, implying that a job offer is considerably more likely to be the result of family connections, party allegiance, bribes, or friends (75.4 percent) than of professional experience, education, or vocational training (17.9 percent) (figure BII.2.1). This approach to doing business—to the detriment of developing a truly meritocratic system—has cemented the existing fragmentation within society, as reflected in the de facto exclusion of certain groups from full participation in the productive process. The procurement of goods and services that are unnecessarily expensive at a given quality or that are substandard in quality at a given price and the recruitment of someone without the best skills and most relevant experience represent costs in terms of forgone opportunities to generate income and equitable growth.^c

Figure BII.2.1. Perceptions of Factors Affecting Chances of Public Sector Employment



Youth unemployment. The youth unemployment rate of 57.7 percent in 2015 compared with 32.9 percent overall masks an even more serious challenge: only 8.5 percent of 15- to 24-year-olds are employed, while 31.4 percent are neither in employment nor in education or training.^d These figures reflect the risk of the emergence of a lost generation. The overarching challenge of economic policy making in Kosovo consists of ensuring that the country's large youth population—according to the 2011 census, 47.1 percent of Kosovo's population was younger than 25 years of age—will translate into the country's principal socioeconomic asset by overcoming the most pressing socioeconomic issues such as the lack of employment opportunities, an unfavorable climate for youth business development, and the idleness and general dissatisfaction with prospects.

Governance, voice, and accountability. In Transparency International's Corruption Perceptions Index 2016, Kosovo ranked 95 among the 1765 countries surveyed, that is, at or below the level of neighboring countries in the western Balkans.^e Personality-centered political parties, the de facto absence of a public forum on which national development priorities can be debated constructively across the political aisle, government institutions weakened by capacity constraints, unclear delineations of responsibilities, and a political focus on issues not directly linked to socioeconomic development have been detrimental to attempts to foster Kosovo's sociopolitical stability and the economic well-being of its citizens. Transparent, inclusive decision-making processes, good governance, and strong institutions are essential to Kosovo's socioeconomic development and politico-economic integration processes. Some positive steps have been made by the government, for example, in trying to improve the cooperation within civil society through approval of the Strategy for Cooperation with Civil Society 2014–17, but progress and the capacity for implementation have not been demonstrated. Local elections in northern Kosovo have provided space for local civil society organizations to participate in the monitoring process. Steps are under way to support legislative reform to promote transparency and improve service delivery, albeit with modest progress.

Notes:

- a. While receiving political and financial support from Belgrade, Serbs in northern Kosovo and the political parties that represent them—despite having agreed to join the government coalition in Pristina—consider themselves citizens of Serbia and object to Kosovo's independence and statehood.
- b. The barricades blocking the Mitrovica Bridge that connects both communities that were a symbol of the politico-ethnic and socioeconomic division of the communities have finally been removed in October 2016
- c. A World Bank (2013a) study reviews the international experience of social exclusion and proposes a range of domains across which inclusion is desirable for society. In Kosovo, ensuring growth that is sufficiently inclusive of different social and demographic groups is important, particularly those groups that are more vulnerable to social exclusion such as ethnic minorities, RAE, women, youth, and rural residents.
- d. KAS and World Bank (2015).
- e. Corruption Perceptions Index, Transparency International, London, <http://www.transparency.org/research/cpi/overview>.

2.10. **Thus, for historical and sociological reasons, the government must focus on strengthening the state’s credibility** so as to improve institutional capacity, reinforce the rule of law and the justice system, and curb corruption and the influence of vested interests. To accomplish this, it will have to allocate public resources in alignment with socioeconomic objectives. This presupposes that the authorities will strengthen their ability to act strategically, resist the temptation to accede to corruption and undue influence, and avoid politically motivated spending.¹⁸ Given the plethora of needs, the country cannot afford to forgo investments in areas central to the objective of increasing the economy’s potential growth, relieving social tensions, and countering the widespread perception of a deepening social divide between insiders and outsiders.

2.11. **Exceptionally high youth unemployment represents missed opportunities and is a source of social tension.** Kosovo’s large youth population is a potentially great socioeconomic asset. However, lack of employment opportunities, an unfavorable climate for youth business development, idleness, and general dissatisfaction with prospects, coupled with ethnic fragmentation, are rendering youth a potential threat to the country’s long-term stability and growth. The 2015 Kosovo labor force survey (LFS) indicates that nearly one-third of young Kosovars (31.4 percent) are neither in education or training and are not employed.¹⁹ Among young people 15 to 24 years old, the unemployment rate was 57.7 percent in 2015. Unemployment is also greater among young women, at 67.2 percent, compared with 54.2 percent among young men and youth. Minority communities, including RAE, typically face additional obstacles in accessing employment opportunities. Kosovo today aspires to an economic growth path that sustainably creates more economic opportunities and high-quality jobs for its growing, youthful population. However, achieving sustained political and economic stability requires smart approaches that integrate youth economic development interventions with efforts at social cohesion.

Economic Growth and Growth Incidence

2.12. **Kosovo’s economic growth has been steady and generally at rates** above those in neighboring countries. The structure of Kosovo’s economy—limited financial and trade links, remittances from migrants concentrated in Germany and Switzerland—has implied that, similar to the aftermath of the global crisis in 2008–09, spillovers from the euro area crisis have been less severe in Kosovo than in neighboring countries. Even so, both crises occurred when Kosovo was timidly recovering from more than a decade of conflict and political uncertainty as well as the transition from the planned economy to the market economy. After a deceleration of growth to 1.2 percent in 2014 driven by a combination of the recession in Europe, an energy crisis, a politico-constitutional crisis, and sluggish domestic credit, the



Source: Kosovo Statistics Agency and WB staff calculations

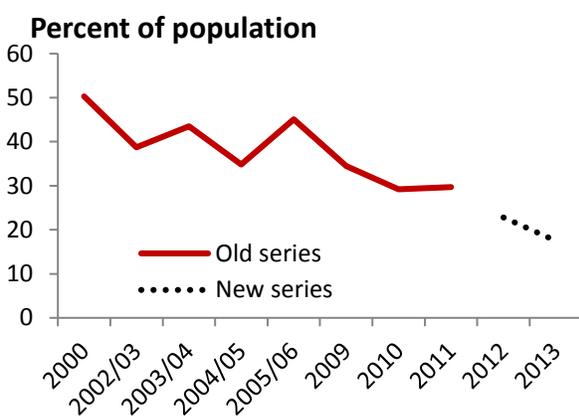
¹⁸ Current spending pressures stem largely from politically powerful lobbying groups centered on (a) pensions, (b) veterans benefits, (c) benefits for former political prisoners, (d) public salaries, and (e) low-value transport infrastructure.

¹⁹ KAS and World Bank (2015).

economic growth had picked up, to 4.1 percent, by the end of 2015, boosted by a sharp upturn in investment and the steady contribution of consumption. In 2014 and 2015, the private investments supported also by private consumption were the main driver of growth, whereas net export contributed negatively to growth due to larger expansion of imports than exports. The influx of remittances remained an important support for private consumption, growth, and inclusiveness.

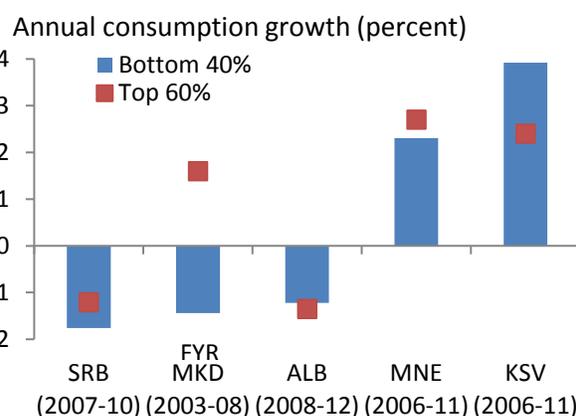
2.13. **Although growth has been largely inclusive, Kosovo is still one of the poorest countries in Europe, and GDP per capita is only about 11 percent of the EU average.** The World Bank’s (2001) first poverty assessment of Kosovo estimated that 50 percent of the population was living below the national poverty line in 2000; the share had fallen to 30 percent by 2011 (figure 3).²⁰ Although Kosovo weathered the economic crisis better than most countries in Europe, poverty reduction appears to have tapered off in 2010 and 2011. Preliminary results indicate that poverty fell significantly between 2012 and 2013, but these estimates should be treated with caution, especially because there may even be comparability problems between 2012 and 2013 (box II.3). Household income from remittances—relatively stable at around 15 percent of GDP—and the social safety net have been key components explaining the dichotomy between poverty reduction and the lack of employment generation.

Figure 3. Poverty Headcount, Kosovo, 2000–11



Source: World Bank analysis of Kosovo household budget surveys.

Figure 4. Shared Prosperity in South East Europe



Source: World Bank analysis of national household budget survey 2014.

²⁰The national poverty line was set in 2002/03 and has been updated for inflation using the consumer price index. It is now €1.72 per adult equivalent per day in 2011 prices. The specific poverty estimates from year to year are not strictly comparable because of frequent changes in survey methodology, but extensive sensitivity analysis confirms the falling trend in 2000–11 (box II.3). The years 2009 through 2011 offer the most robust comparisons and indicate a drop in poverty from 34 percent to 30 percent.

Box II.3. Data Availability and Data Quality

Accessible economic data are collected frequently on Kosovo relative to many countries in Europe and Central Asia and the western Balkans. A household budget survey (HBS) is conducted annually, and the LFS has been conducted annually except for an interruption in 2010 and 2011 because of insufficient budget. The World Bank enjoys privileged access to the survey data through its technical support of the Kosovo Agency of Statistics. Macroeconomic data are also available on a regular basis, and Kosovo has some of the most complete subnational budget execution data (Kosovo BOOST) in Europe and Central Asia. Important exceptions to the frequency of survey data collection are the enterprise survey, which was last conducted in 2009, the agricultural household survey, which was conducted in 2013 for the first time since 2008, and the agricultural census, which was completed in 2014 for the first time since 1960. However, there are also important data quality issues, particularly with respect to consistency and comparability. All surveys from 2000 to 2008, plus the 2009 LFS, were based on the sampling frame of the 1981 population census. Given the major upheavals surrounding the breakup of the former Yugoslavia and the 1998–99 war and its aftermath, it is highly doubtful that the 1981 census could provide a representative survey sample for Kosovo in the first decade of the new century. The sampling frame was updated in 2008 by way of a major relisting operation, which yielded more reliable samples until the 2011 population and housing census was completed. The 2011 census has served as the basis for the sampling in all surveys from 2012 to the present.

In addition to sampling issues, frequent changes in survey instruments and methodology have severely compromised the comparability of survey data over time. Many of the changes stem from efforts to bring Kosovo's statistical practices into line with international norms and, particularly, with Eurostat standards. The Kosovo Agency of Statistics is relatively understaffed in data collection personnel and management capacity. So, implementing these modernizations, while also maintaining comparability over time has proven challenging. The following are some of the concerns with respect to Kosovo's survey data.

Labor force survey

- Through 2009, the LFS was conducted during a few weeks in September and October. Because it failed to capture seasonal variations in employment, the resulting labor statistics had an inherent seasonal bias. After two years without an LFS because of insufficient budget, a new LFS was launched in 2012 with year-round data collection to eliminate the seasonal bias. This is an improvement, but confounds comparison with earlier surveys.
- The 2012 LFS also adopted International Labour Organization and Eurostat standards in defining labor market status. The biggest impact of the revised definitions was to reclassify 10–15 percent of the working-age population from unemployed to inactive because they did not meet the new criteria of actively seeking work and availability to work.
- Since 2012, efforts have been redoubled so that the LFS captures small activities and informal employment. Interviewers have been trained to probe respondents for any employment activity, including self-employment, during the reference week of the LFS. Surprisingly, the expected increase in the recorded employment rate has not emerged, leaving unresolved the issue of whether the new LFS might not be capturing these small activities or, if it is, these activities might be masking a decline in the true employment rate.
- Another gap in the LFS is the scant information on wages, which is only collected using 10 salary ranges.

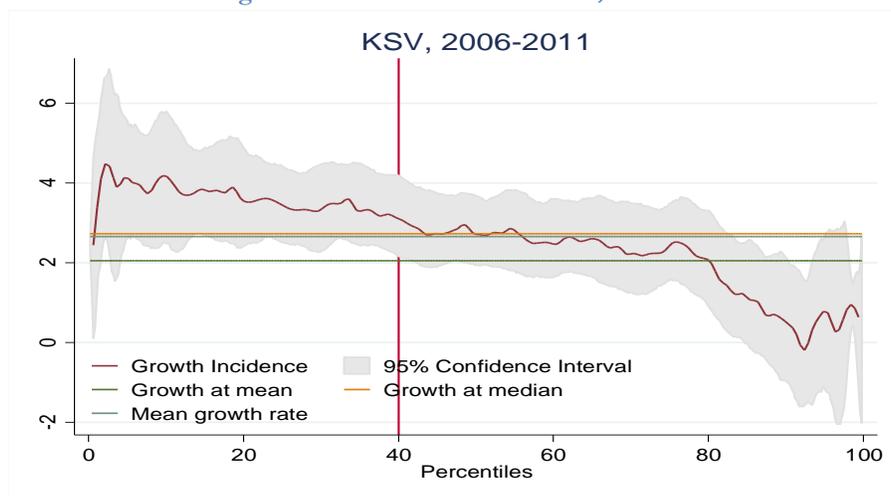
Household budget survey

- In 2012, the Kosovo Agency of Statistics made major changes to the reference periods for household expenditures without establishing an effective bridge to the previous methodology. The result of this change is a spurious and not credible spike in the level of consumption and a consequent sharp decline in measured poverty. These apparent improvements are not corroborated by any other data on well-being in Kosovo. Efforts by the World Bank to splice the HBS series before and after 2012 using survey-to-survey imputation methods have not yet been successful at establishing a fully consistent estimate of the true trends in poverty over this methodological break.
- The Kosovo Agency for Statistics and the World Bank are currently working on a poverty report covering the 2012–2015 HBS survey rounds. This will provide a new comparable series of poverty estimates for the 2012–2015 period, albeit the lack of comparability of these estimates with those from 2011 or earlier years remains.
- HBS data on subnational regions is likely to be biased because there is one HBS interviewer per region, and the interviewers do not rotate across regions. In particular, low recorded consumption may be a reflection of high poverty or low data quality (interviewer fixed effects).
- The HBS and LFS have similar weaknesses in informality and minor activities.
- For several topics, the HBS provides little detail or disaggregation. One notable example is social protection benefits, on which the questionnaire does not distinguish among different types of pensions or social transfers.

2.14. **There is only a relatively small divide between rural and urban poverty, although poverty is more prevalent in rural areas.** The poverty headcount ratio in rural areas in 2011 was 31.5 percent, compared with 26.7 percent in urban areas. The poverty gap, which measures the depth of poverty as well as the incidence of poverty, is only slightly lower in urban areas (7.1 percent) than in rural areas (7.8 percent). The small difference in rural and urban poverty is most likely attributable to the relatively small size of urban areas outside Pristina. For example, in 2011, the poverty rate in Pristina District was only 16 percent, considerably lower than the rate in the next poorest district (Gjakova, 22 percent) and much lower than the rate in Mitrovica District (44 percent) and Ferizaj District (50 percent).

2.15. **During 2006–11, consumption growth among the bottom 40 outpaced that of the top 60 in Kosovo.** Consumption per capita, as measured by the annual household budget survey (HBS), grew by nearly 4 percent a year among the bottom 40, compared with 2.4 percent among the top 60 (see figure 4). The downward-sloping growth incidence curve shows that consumption growth was strongest across the poorest segment of the consumption distribution (figure 5).²¹ The sources of growth in household consumption are a mix of increases in labor earnings and remittances. The inclusiveness of Kosovo’s growth also stands out relative to other countries in the SEE because the bottom 40 exhibited shrinking consumption in Albania, the former Yugoslav Republic of Macedonia (FYR Macedonia), and Serbia. Montenegro was the only other country among the SEE6 to experience positive growth among the bottom 40.²² The pro-poor pattern of growth in Kosovo is also reflected in the Gini index, which fell from 30.3 to 27.6 during the period.

Figure 5. Growth Incidence Curve, 2006–11



Source: World Bank Group staff calculations from HBS data

2.16. **Labor market indicators are among the worst in the region and the world.** Employment and labor force participation remain flat at exceptionally low levels. Despite economic growth, the private sector has been unable to provide sufficient high-quality jobs, particularly in the tradable sector. Steady consumer demand is being fueled by remittances, but the supply response by domestic producers has been limited primarily to services. Though there is great potential for exports, goods and services made in Kosovo are

²¹ Growth incidence curves provide a more granular view of the segments of the consumption distribution that benefit the most from growth. The curves depict the annual consumption growth rate for each (anonymous) percentile of the population. For Kosovo, they show that the growth rate in the poorest deciles exceeded 4 percent during this period.

²² SEE6 covers the western Balkans and consists of Albania, Bosnia and Herzegovina, Kosovo, the former Yugoslav Republic of Macedonia, Montenegro, and Serbia.

uncompetitive, and exports are stagnant. Table 2 shows how these features stack up against Kosovo’s regional peers in the SEE.

Table 2. Key Economic Indicators, South East Europe

Country	Growth, % of GDP, 2008–15	Exports, % of GDP, 2009–15	Personal remittances, % of GDP, 2009–15	Net official development assistance, % of GDP, 2009–12	Labor force participation, %, 2015	Employment rate, %, 2015	Unemployment rate, %, 2015
Kosovo	3.4	18.3	13.7	10.5	37.6	25.2	32.9
Albania	1.2	30.5	8.5	2.9	55.7	53.6	17.1
Bosnia and Herzegovina	1.2	33.9	8.6	3.0	44.1	31.6	27.7
FYR Macedonia	2.6	43.5	2.3	1.9	57.0	42.3	26.1
Montenegro	1.6	40.0	4.8	2.3	53.7	44.3	17.6
Serbia	-0.1	37.4	6.9	1.1	51.6	42.5	17.7

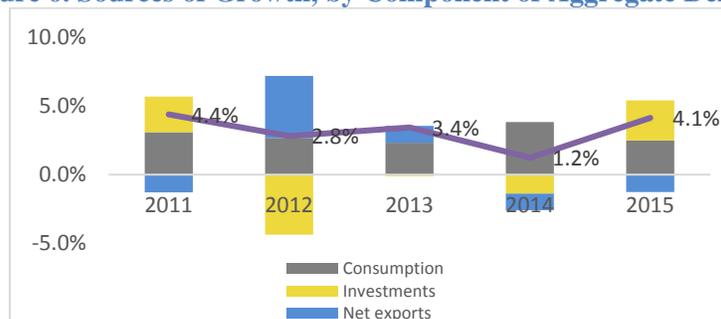
Sources: KAS and World Bank 2015; World DataBank, World Bank, Washington, DC, <http://databank.worldbank.org/data>.

2.17. The following subsections discuss the nature of economic growth—its composition, how it is financed, and how it is distributed—to shed light on the key constraints to achieving poverty reduction and shared prosperity in a sustainable manner.

The nature of economic growth

2.18. **The main drivers of economic growth have been consumption and investment.** Consumption is the largest component of aggregate demand and explains most of the recent economic growth (figure 6). Both subcomponents—households and government consumption—have been stable since independence. Investments, both public and private, have played a crucial role in boosting economic growth, but have been in a declining trend since 2008. Private investments experienced a real contraction from a peak of almost 20 percent of GDP in 2011. Public investments, after the increase between 2008 and 2010, have been stable and helped offset the contraction in private investment, but declined in 2014 mainly because of low execution rates as result of the absence of a government for six months. However, in 2015, private investment, fueled by recovery in the inflow of foreign direct investment (FDI), was the key driver of growth recovery. Only in the last few years have net exports contributed positively to growth (box 11.4). However, further decomposition between exports and imports reveals that the contribution to growth was largely explained by a larger decline in imports. The country remains highly reliant on imports, and its export base is small.

Figure 6. Sources of Growth, by Component of Aggregate Demand

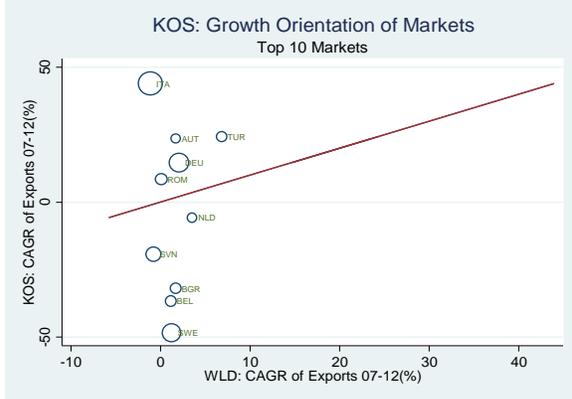


Source: Kosovo Agency of Statistics and World Bank calculations.

Box II.4. Export Growth and Orientation

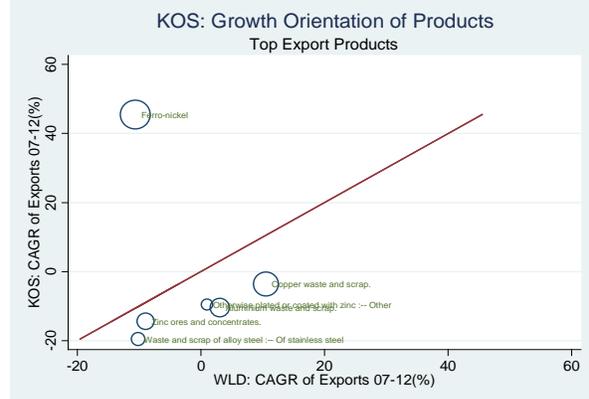
Kosovo's exports are relatively limited. They have been rather static, showing the restrained extent of the country's integration into the regional and global economy. While exports, as reported by trading partners, have increased by over 40 percent since 2008, export growth has been volatile, and it has decelerated since 2010. Kosovo's exports recently have lost their market share in EU countries such as Austria, Germany, and especially Italy, and increased their share in Serbia and FYR Macedonia. But these countries show relatively modest rates of growth in their demand for imports (figure BII.4.1). In terms of products, Kosovo has lost market share in all its most important export products with the exception of ferronickel (figure BII.4.2).

Figure BII.4.1. Growth Orientation of Markets



Source: World Bank calculations based on UN Comtrade.

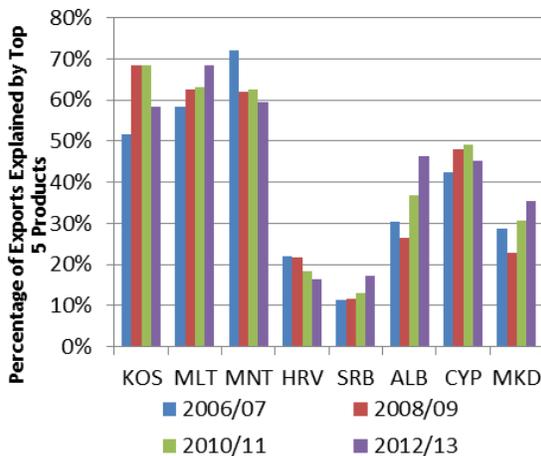
Figure BII.4.2. Growth Orientation of Products



Source: World Bank calculations based on UN Comtrade.

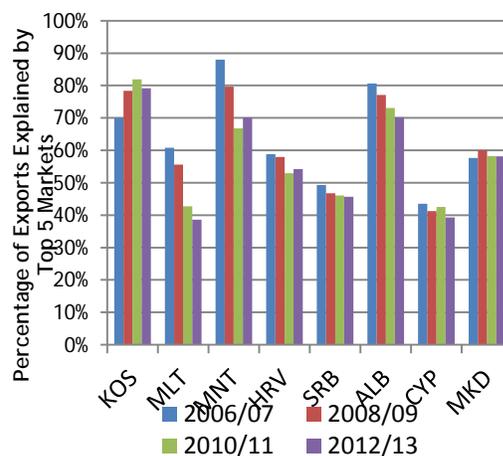
Export markets are not diversified. The top 5 export destinations account for almost 61 percent of Kosovo's exports of merchandise in 2014 (figure BII.4.4). In recent years, there have been some diversification and shifts to different markets (China and India) with high volatility. Product concentration is also high; only one product, ferronickel, accounts for almost 40 percent of total exports (figure BII.4.3). The Herfindahl Index, a measure of concentration, rose from 23 percent in 2008 to 30 percent in 2013, based on 21 export categories. The share of the top 5 export categories in total exports increased from 81 percent to 86 percent over the period. Including reexports, export product diversification is on a par with Malta and Montenegro, but less diversified than Albania or FYR Macedonia and much less than Croatia or Serbia. This suggests that Kosovar firms are not taking full advantage of the large EU export market at its doorstep to boost exports, particularly in areas other than raw materials. It also reflects the small production base.

Figure II.4.3. Share of Exports Explained by the Top 5 Products



Source: World Bank calculations based on UN Comtrade.

Figure II.4.4. Share of Exports Explained by the Top 5 Destinations

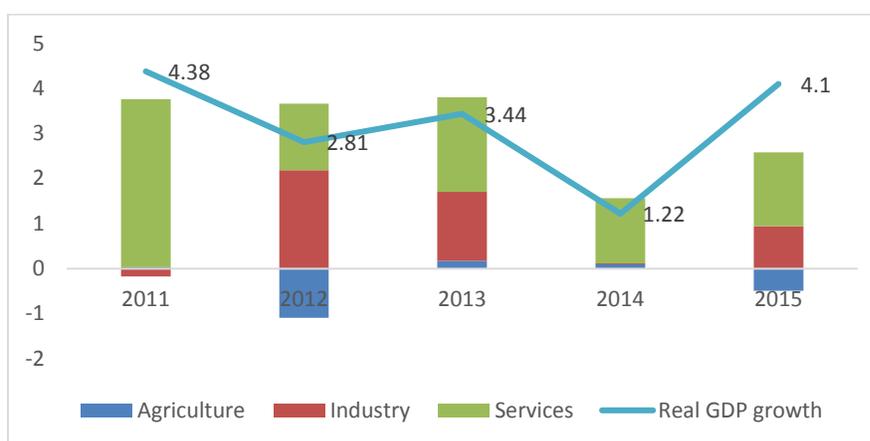


Source: World Bank calculations based on UN Comtrade.

Sectoral composition of economic growth

2.19. **With so little export-orientated manufacturing or services, the nontradable sectors dominate output and employment in Kosovo.** Services represent the largest sector in the economy, with a share of value added at 54.4 percent of GDP (figure 7). Agriculture remains large, at 11 percent of GDP, while manufacturing is relatively small, at 16.4 percent of GDP. A key role in services is played by construction services and real estate, at about 15.3 percent of GDP, followed by the wholesale and retail sector, with a 12.3 percent share. Services contributed to economic growth more than any other sector throughout the period. The contribution to growth in industry, including agroprocessing activities, peaked in 2012 at a time when imports were declining, suggesting some degree of import substitution. Agriculture, on the other hand, exhibited low growth and was affected by weather conditions and climate change. Recent reforms have helped increase the productivity and production in this sector but without positive contribution to growth.

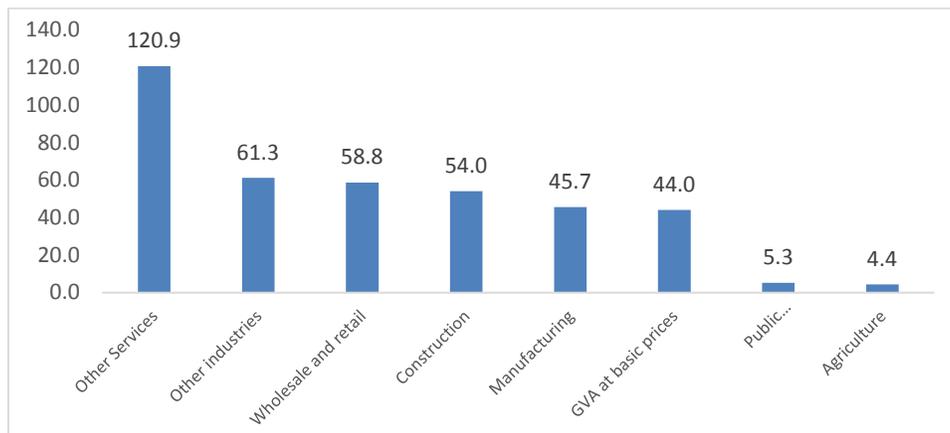
Figure 7 Contribution to Growth, by the Main Sectors of the Economy



Source: Kosovo Agency of Statistics and World Bank calculations.

2.20. **While the share of each sector has remained relatively unchanged since 2009, some components have shown large growth and dynamism.** Among those sectors with a large share in GDP, the wholesale and retail sector increased by 39.8 percent, and public administration and defense by 8.9 percent (figure 8). Other services, such as education, health care, transport, and administration, grew by over 60 percent, but from a low starting point. Construction, fueled by government capital investments in road infrastructure and public facilities (such as schools and health facilities) during period 2008-2012 and private investments during 2013-2015, rose by 48.9 percent between 2009 and 2015. The combined growth of construction and real estate was 31.7 percent because of lower growth in real estate activities.

Figure 8 Percentage Growth, by Subsectors, 2009–15



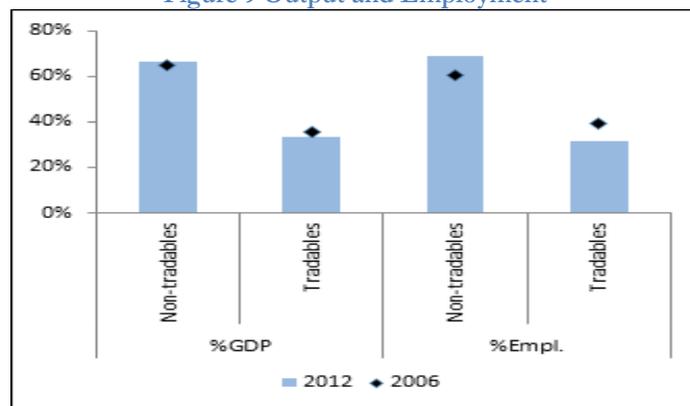
Source: Kosovo Agency of Statistics and World Bank calculations.

Note: GVA = gross value added. GVA + taxes on products – subsidies on products = GDP.

2.21. The composition of economic output and employment has shifted toward the nontradable sectors in recent years.

From 2007 to 2012, gross value added grew an average 8 percent a year. During the same period, the contribution of nontradable sectors grew from 64 percent to 66 percent of gross value added and from 61 to 68 percent of total employment (figure 9). This was mirrored by a reduction in the importance of the tradables sectors, which declined from 36 percent to 34 percent of total output and from 39 percent to 32 percent of employment. The public sector alone accounted for a quarter of the employed.

Figure 9 Output and Employment



Source: Kosovo Agency of Statistics and World Bank calculations.

The size of the public sector rose from 22 percent to 24 percent of gross value added over the period, while the largest increase was in other services, from 1.5 to 12 percent of gross value added. Some nontradable sectors also shrank as a share of gross value added. In particular, real estate and construction activities, which were hit by the crisis as the expatriate community slowed investment in this sector, fell from 16 percent to 11 percent and from 9 percent to 4 percent of gross value added, respectively.

2.22. Given Kosovo’s revealed comparative advantage in a number of sectors in manufacturing, manufacturing has the potential to generate income and exports if it can achieve export orientation similar to the Europe and Central Asia average.²³ However, the export base is small and static. A number of factors related to soft and physical infrastructure are impeding export growth and dynamism. The manufacturing subsectors that are most engaged in exporting are furniture, food, and garments (table 3). For example, 63 percent of furniture manufacturers in Kosovo export. Garments are also targeted at external

²³ Information based on World Bank enterprise surveys conducted for a range of countries in the region in 2013. See Enterprise Surveys (database), International Finance Corporation and World Bank, Washington, DC, <http://www.enterprisesurveys.org>.

markets, albeit to a lesser degree: 40 percent of garment producers export, and their exports account for 50 percent of total sales. Among furniture producers, by contrast, while 62 percent export, only 15 percent of their sales are from exports, and the remaining 85 percent are destined for domestic consumers.

Table 3. Export Intensity of Manufacturing Firms

Industry	Kosovo		Europe and Central Asia	
	Exporting firms among all firms, %	Exports in total sales, %	Exporting firms among all firms, %	Exports in total sales, %
Total	36.4	25.0	39.7	48.2
Fabricated metal products	27.3	16.0	47.1	46.7
Food	53.8	18.1	26.1	38.0
Furniture	62.5	15.0	38.8	43.4
Garments	40.0	50.0	42.3	63.6
Nonmetallic mineral products	30.0	17.0	25.7	35.6
Publishing	25.0	20.0	14.4	12.3
Wood products			53.7	53.2
Other manufacturing	27.3	29.7	52.2	48.1

Source: World Bank calculations based on 2013 data in Enterprise Surveys (database), International Finance Corporation and World Bank, Washington, DC, <http://www.enterprisesurveys.org>.

2.23. **In the manufacturing sector, exporting firms are larger than nonexporters and employ both more highly skilled and unskilled workers.** The proportion of skilled workers is markedly lower in Kosovo compared with the Europe and Central Asia average, but has risen significantly since 2009 (table 4). Based on measurements using wage levels as a proxy to compare job quality, exporters, on average, pay higher wages than nonexporters (exceptions are furniture and other manufacturing). Kosovo’s median manufacturing wages tend to be higher than the regional averages, although this likely masks important interindustry differences. Skilled manufacturing workers tend to be concentrated in the garment, nonmetallic mineral, and food processing subsectors. While garment manufacturing has a highly skilled worker ratio at 2.6, food and nonmetallic mineral producers employ relatively more unskilled workers; skill ratios average 0.6 and 0.7, respectively, which are lower than the regional averages.

Table 4. Size of Exporting vs. Nonexporting Manufacturing Firms, Number of Full-Time Employees

Year	Exporting status	Kosovo			Europe and Central Asia		
		Employees	Skilled employees	Unskilled employees	Employees	Skilled employees	Unskilled employees
2009	Nonexporter	19	6	13	48	26	25
	Exporter	35	10	28	244	92	77
2013	Nonexporter	30	14	17	33	23	15
	Exporter	50	25	25	110	63	44

Source: World Bank calculations based on 2009 and 2013 data in Enterprise Surveys (database), International Finance Corporation and World Bank, Washington, DC, <http://www.enterprisesurveys.org>.

2.24. **Kosovo’s exports are characterized by relatively high wages, high value added per worker, and low human and physical capital content.** Kosovo’s exports have a relatively high level of wages and value added content compared with Bosnia and Herzegovina, Bulgaria, Croatia, and Moldova. Kosovo compares less well in terms of skill content—both the share of skilled workers and years of schooling—and physical capital content. This suggests a relatively unsophisticated export basket, but with relatively high wages and value added. The latter could be a signal of higher product quality, but this result is also influenced by the predominance of ferronickel exports in Kosovo’s export basket.²⁴ The time trends of labor sophistication in comparator countries Bulgaria, Bosnia and Herzegovina, Croatia, Georgia, and Moldova are also relatively flat, implying regionwide constraints to expanding and diversifying exports in the EU market.

²⁴ The data used here do not allow a further exploration of these trends, but it could be possible to test the findings by examining unit values and quality ladders in future analysis, for example.

2.25. **Services are a major source of exports and have outperformed most regional peers.** Total services exports in Kosovo in 2014 represented 70 percent of total exports (figure 10). The service export composition is above all peer countries; Albania and Croatia are the nearest comparators in which service exports represent slightly over 60 percent and 50 percent of all exports, respectively (figure 11). Service exports continued to grow in Kosovo in 2015 by 3.9 percent to about 71 percent of overall exports and represent an important source of export diversification for the country.

Figure 10. Share of Services in Total Exports

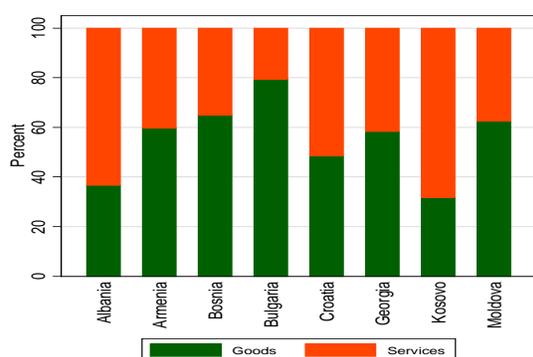
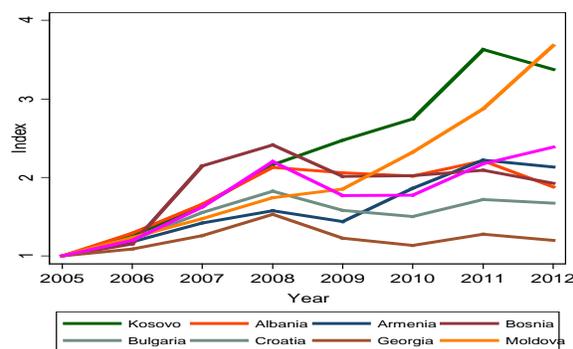


Figure 11. Service Export Growth



Source: World Bank calculations based on data of the World Development Indicators database, World Bank.

2.26. **Exports of travel services as well as communications, computer, and other services have driven Kosovo's commercial services export performance.** By 2011, export growth was more than 3.5 times greater than it had been in 2005, before declining in 2012. Travel services contributed significantly to this growth, while communications, computer, and other services were responsible for the decline in 2012. The revealed comparative advantage index suggests that Kosovo lost competitiveness in transport services and increased competitiveness in travel services between 2005 and 2012 (table 5).²⁵ Communication, computer, and other services also achieved strong growth, more than quintupling their value since 2005, from \$38 million to \$203 million.

Table 5. Revealed Comparative Advantage in Services, Kosovo

Category	2005			2012			CAGR, 2005–12	
	Value	Share	RCA	Value	Share	RCA		
Communications, computer, other	38.1	16.9	0.4	203.0	26.5	0.6	26.9	
Insurance and finance	11.6	5.1	0.9	33.3	4.4	0.6	16.2	
Transport	66.9	29.6	1.2	37.5	4.9	0.2	-7.9	
Travel	110.0		48.5	1.7	490.0	64.2	2.5	23.8

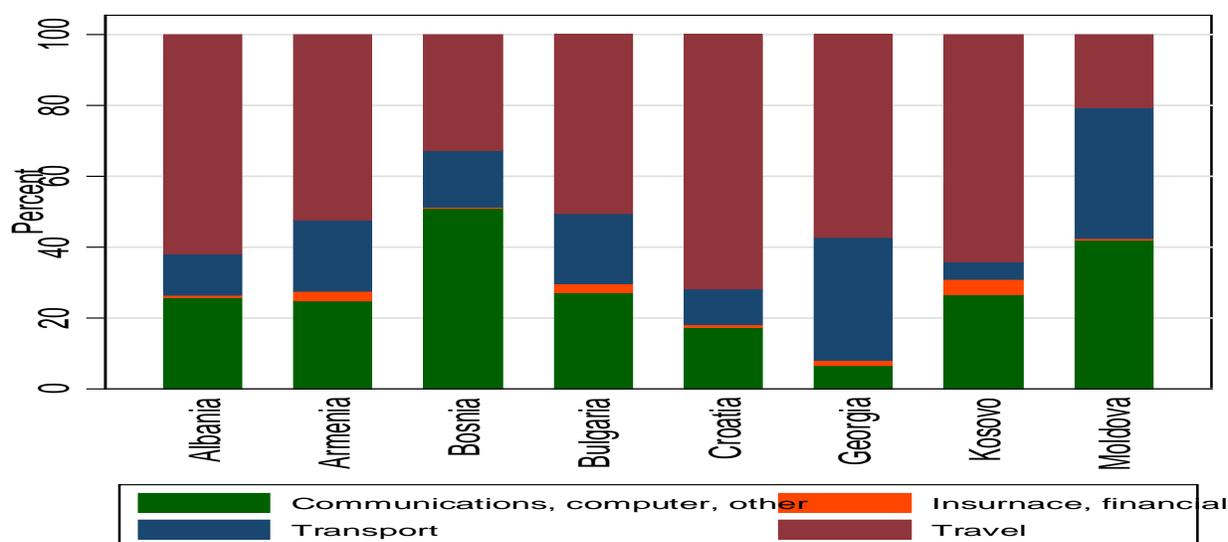
Source: World Bank calculations based on data of the World Development Indicators database.

Note: Values in current U.S. dollars, millions. RCA = revealed comparative advantage. CAGR = compound annual growth rate.

²⁵Transport services declined in value between 2005 and 2012, from \$67 million (30 percent of the export basket) to \$38 million (5 percent). Travel service exports achieved an average annual growth of 24 percent, increasing in value from \$110 million to \$490 million, or 49 percent to 64 percent of exports. The revealed comparative advantage index compares the share of sectoral exports of a country in world sectoral exports with the average share of exports of all countries in world exports in a particular service subsector. A revealed comparative advantage index above 1 therefore indicates that a country has a share of service exports in a particular service subsector that is higher than the global share of exports in that same service subsector and is considered to have a revealed comparative advantage in the subsector. The higher the ratio, the more competitive is the country in the given subsector.

2.27. **The growth in communications, computer and other services has shifted the concentration of Kosovo’s service exports from traditional to modern service activities, which have the potential to transform the economy, given their direct impact on other sectors and human capital formation** (figure 12). This is significant because communication services, along with other modern business services, are important in the process of promoting innovation and productivity in manufacturing, agriculture, and other sectors.²⁶ In contrast, travel services are likely to have fewer links to the rest of the economy, but are nonetheless important for the country’s service exports. The delivery of these services is less dependent on physical infrastructure and more dependent on telecommunications and power supply. At the same time, the local information technology (IT) industry possesses the basic preconditions for growth, including low-cost, highly skilled and multilingual labor; the high share of young people in the population, who tend to be more oriented toward information and communication technology (ICT) than other age-groups; an ideal location for outsourcing; nearshoring for EU clients; and improved broadband coverage in urban areas.

Figure 12. Composition of Services



Source: World Bank calculations based on data of World Development Indicators database.

2.28. **Although the country possesses several comparative advantages in growing an export-oriented IT industry, the IT market is small and underdeveloped because of the low level of digitalization and ICT usage in the economy.** The total value of the Kosovo IT market is expected to amount to €126 million in 2014, and the compound annual growth rate of the market is projected to reach 4 percent. In 2013, the IT industry accounted for 2.3 percent of GDP, and its contribution to GDP was estimated to be in the range of 8–11 percent in 2007–13.²⁷ There are no data on the sectoral value added. However, according to official data on the transport, telecommunications, and postal sector, which may be used as a proxy, the value added of the sector has been one of the lowest among all sectors. Based on 2011 data, the sector generated two times less value added at current prices than manufacturing, construction, or real estate and business services and three times less than agriculture and fishing or wholesale, retail, and trade.

²⁶ Official statistics on information and communication technology (ICT) are scarce on Kosovo or, where available, are merged with transport statistics. Therefore, an overview of the sector must rely on industry research conducted by other international donors. One of the reasons for the lack of statistics pertaining to ICT is that 41 percent of the information technology (IT) firms in Kosovo were founded between 2012 and 2014, unlike in other SEE6 countries. (See GIZ 2014.)

²⁷ MED (2013).

Box II.5. IT Industry

Official statistics show that there were 340 new and reregistered ICT enterprises in 2012 and 357 in 2013. Of these, around 120 firms were actively operating in the IT service and product market and employing approximately 3,000 professionals. (IT firms employ an average of 5–20 employees.) In addition, there were another 10 IT start-ups housed in the Innovation Center Kosovo. Few international IT companies are operating in Kosovo.

The majority of IT companies offer software products and software and IT services (42 percent). Hardware product and service firms lag far behind (9 percent and 7 percent, respectively). No company manufactures IT hardware or equipment. The main target industries of IT firms include the public sector, financial services, utilities, retail, health care, tourism, telecommunications, and education. In the public sector, the main target industry, the demand for health care and education IT applications is likely to increase substantially. The energy sector is regarded as a potential target market, too, especially in connection with innovative IT solutions (e-energy).

IT industry salaries may be considered competitive on a regional as well as international scale. The current salary scale may be adversely affected, however, by the growing shortage of university graduates specializing in computer science, management, human resources management, marketing and sales, project management, and product management. A shortage of necessary skills impedes the ability of local IT companies to grow and consolidate in the domestic market as well as to scout international clients for the export of IT products and services (see chapter VI).

Table BII.5.1. The Salary Scale in the IT Industry, by Field of Occupation, May 2013

<i>Field of occupation</i>	<i>Approximate salary per month, €</i>
Junior entry level developer	250–400
Junior software developer	400–500
Software developer with 3+ years experience	500–900
Business analyst, project manager	900–1,200
Senior software developer, software developer with 5+ years experience	1,200–1,600
Department manager	1,600

Source: Department of Post-Telecommunication and Information Technology, Ministry of Economic Development of Kosovo.

Among IT companies, 63 percent export their services and products, and most IT export revenues are derived from the sale of software and IT services (50 percent, 40 percent, and 42 percent in 2012, 2013, and projected 2014, respectively). This is followed by software products (29 percent, 43 percent, and 37 percent, respectively). Hardware product exports accounted for 16 percent, 14 percent, and 12 percent of all exports in 2012, 2013, and projected 2014. The main products and services exported include mobile solutions, web design, IT consulting, e-commerce applications, and custom software. The main export destinations include German-speaking countries (25 percent in 2012 and 29 percent in 2013), Scandinavian countries (22 percent and 13 percent), France and Benelux (14 percent and 5 percent), Central and Eastern Europe (10 percent and 12 percent), and North America (10 percent and 4 percent).

The biggest obstacles to export growth cited by IT market players include visa barriers, lack of government support, the shortage and poor quality of business contacts abroad and domestically, insufficient market information, and branding problems. Other major issues affecting sectoral exports and sectoral growth in the long term is the lack of a skilled workforce for mass production. The lack of government support is demonstrated through the absence of a strategy for the promotion of an IT industry, the lack of a systematic approach to promoting FDI in the sector, and the lack of special investment programs (particularly export financing schemes. According to the Kosovo Association of Information and Communication Technology, there are no support measures or incentives available for the industry, unlike in neighboring countries, where special industrial zones or incentive schemes have been established. Constrained access to finance is another impediment to the development of export-oriented IT firms. High interest rates and the need for substantial collateral make obtaining a loan from local commercial banks difficult. At the same time, venture capital is not available.

Sources: GIZ 2014; MED 2014.

2.29. In addition to its small size and comparative youth, the IT market is characterized by strong competition from imports. The low level of specialization and differentiation among Kosovar technology companies, in target industries (vertical specialization), and in functional areas (horizontal specialization) is a constraint on competition and growth (box II.5). After the peak reached in 2011, when the country exported ICT services worth over €96 million, the value of ICT service exports fell sharply between 2011 and 2013, but recovered partially in 2014, while ICT service imports started to show slow, but steady growth and doubled in 2014. The main push was in the second half of the year and the first half of 2015 and might have been driven by large out-migration during that period.²⁸

The role of the public sector

2.30. **Because the public sector is relatively small (28 percent of GDP) and the level of public investment high (2.5 times more than neighboring countries), efficiency and the prioritization of public spending are central to sustaining growth and promoting shared prosperity.** Capital expenditure averaged almost 40 percent of total public spending (or about 11 percent of GDP) between 2008 and 2013 (table 6). That share declined in 2014 to 28.2 percent of total public spending (or about 8 percent of GDP) and remained at that level in 2015 and declined to 26.6 percent in 2016. Capital spending has been heavily focused on transport projects to increase regional connections and access to markets, including through ports in Albania.²⁹ Transport projects have also contributed to the development of a nascent construction sector given that over half of the material inputs and 80 percent of the subcontractors for the highway to Albania are sourced locally. However, investments in critical priority areas have been postponed. Investment has also been high in the health sector, averaging 13 percent of total public health spending (or 0.3 percent of GDP), but mainly focused on improving medical equipment at the only tertiary health care facility.

Table 6. Expenditure, by Economic Category, 2008–14, % of GDP

	2008	2009	2010	2011	2012	2013	2014	2015
Total Expenditure	25.4	28.1	28.4	29.3	29.2	28.5	27.0	27.3
Current Expenditure	16.3	18.0	18.1	17.9	17.7	19.1	19.6	20.5
Wages	6.8	7.7	8.7	8.5	8.2	9.1	9.4	9.5
Goods and Services	4.1	3.5	4.1	3.7	3.8	4.0	3.7	3.8
Subsidies	5.4	6.8	5.2	5.7	5.7	5.9	6.5	7.3
Capital Expenditure	8.9	9.2	10.4	10.8	10.7	10.0	7.4	7.0
Other expenditure (net lending)	0.2	0.9	-0.1	0.6	0.8	-0.6	0.0	0.0

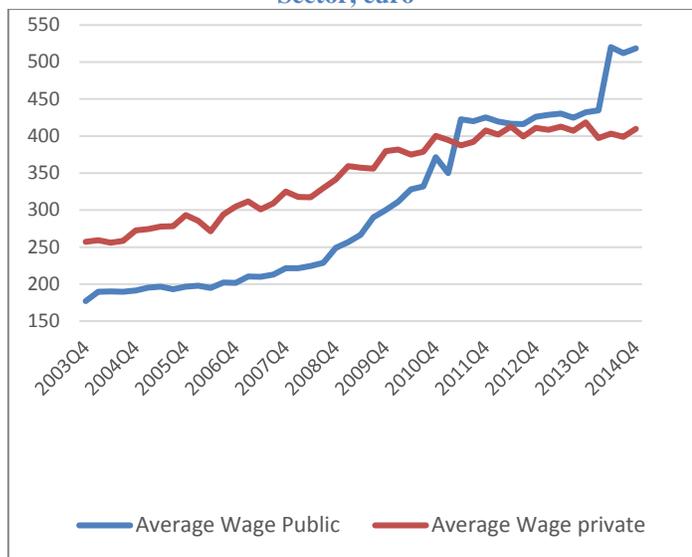
Source: Treasury Department of the Ministry of Finance and World Bank calculations.

²⁸ Based on data received on January 19, 2015, from the Department of Post-Telecommunication and Information Technology, Ministry of Economic Development of Kosovo. The 2014 data are based on trade in services published by the Central Bank of the Republic of Kosovo and covering the period up to June 2015.

²⁹ Between 2010 and 2013, 40 percent of budget investment went to a single project, the highway connecting Kosovo to the Albanian border (Route 7), which squeezed other capital investments, such as the rehabilitation and expansion of main roads connecting Pristina with Peja and Pristina with Mitrovica, two major towns. The road to Peja bears the heaviest traffic because it connects two main regions of Kosovo. A new highway to FYR Macedonia (Route 6) was introduced in the 2014 budget at a total cost of €750 million or 14.4 percent of GDP and is likely to crowd out other smaller public investments.

2.31. **Current government expenditure has grown substantially over the years, mainly driven by public payroll and pension increases in 2011 and 2014** (figure 13). The wage bill rose by 27 percent in 2011 and by 25 percent in 2014, driven by electoral promises.³⁰ Subsidies for publicly owned enterprises are largely directed to energy and mining.³¹ In contrast, the share of social transfers in total expenditure was only one-third to one-half the spending of other countries.³² Public health and education expenditure also increased, but is lower relative to other countries in the SEE and EU11 (newer, Eastern European members) and the small countries of the Commonwealth of Independent States (Armenia, Georgia, and Moldova). The largest share of this spending went to wages and salaries, particularly in education. The large pre-election increases in public wages have made full-time positions in the public sector the most desirable among job-seekers. A more conservative approach was followed during the FY 2015 and 2016.

Figure 13. Average Monthly Wage, Public Sector vs. Private Sector, euro



Source: Kosovo Agency of Statistics calculations.

2.32. **Wage and pension increases have created extra pressure on the budget and have crowded out priority investments and expenditures in 2015 and 2016.** Because of the recently passed fiscal rule that sets a ceiling on the general government deficit of 2 percent of GDP, fiscal space will depend on additional efforts to boost domestic revenues, especially in fighting relatively large tax evasion and in broadening the tax base by expanding direct tax coverage. Capital projects are exempt from the 2 percent ceiling only if they are financed from privatization receipts and the government bank balance exceeds a minimum threshold of 4.5 percent of GDP. The new Stand-By Arrangement with the International Monetary Fund approved on July 29, 2015, introduced changes in the fiscal rule through amendments to the Law on Public Financial Management and Accountability approved by Parliament in February 2016. The rule preserves the 2 percent deficit target and the 0.5 percent of GDP tolerance, introduces a limit of 30 percent of GDP on government debt and capital spending financed through privatization receipts, and excludes from the calculation of the deficit under the rule the capital spending financed by international financial institutions, bilateral donors, and the EU and its agencies. The Stand-By Arrangement, which covers the period up to the end of December 2017, projects that such spending will reach as much as 1.9 percent of GDP a year over the medium term. After completion of the Stand-By Arrangement, no such limitation (projection) is foreseen by the Law on Public Financial Management and Accountability, and it will be up to the authorities to preserve the limitation.

³⁰This triggered the termination of the Stand-By Arrangement of the International Monetary Fund in spring 2011. A wage freeze was applied in the following years.

³¹This involved mainly subsidies to support investments in Kosovo Electricity Corporation and subsidies to support important socially owned enterprises such as the Trepça mines.

³²This is because, after the war, Kosovo decided to abandon the former Yugoslavia pay-as-you-go pension system and introduced a second pillar pension system (defined contributions). It is associated with no unemployment benefits and only a small social assistance scheme.

2.33. **Addressing energy security will have a bearing on future fiscal sustainability in Kosovo.** Meeting future demand if the current aging power plant (the Kosovo A Power Station) is decommissioned is a particular concern in the effort to avert the looming energy crisis, particularly given that most neighboring countries are also in energy deficit. Closing the power gap requires building a new power station at an estimated cost of between €1 billion and €1.5 billion, or between 20 and 30 percent of GDP. The extent of any eventual private sector participation remains uncertain, and this represents the most important factor in determining the public spending in the sector over the medium term. Moreover, regardless of the extent of private sector participation, striking the proper balance between adjusting tariffs to reflect costs and affordability considerations is necessary. Cost-reflective energy tariffs will reduce the need for ad hoc subsidies to utility companies that, in the recent past, absorbed a significant share of the budget, but will also raise the fiscal costs of the necessary compensations going to poor and vulnerable consumers affected by the price adjustments. Energy efficiency measures across the building stock, especially in combination with renewable energy alternatives to replace electric heating, would help reduce the impacts of tariff increases.

The role of external sources of financing

2.34. **Because of negative gross domestic savings, the relevance of external financial factors (remittances, aid, and private capital) to finance Kosovo’s development is clear.** Since independence, remittances have averaged 17.1 percent of GDP, and aid has averaged 10.8 percent, bringing gross savings to a reasonable average of 20.8 percent (table 7). These factors explain the drop in private investment and bring to the forefront the importance of this investment in supporting consumption and growth, but also raise questions about sustainability. Official development assistance fell by almost 40 percent between 2009 and 2012 and continued to slightly decline as share of GDP in the following years.

Table 7. Savings

	2006	2007	2008	2009	2010	2011	2012	2013
Gross savings	18.3	16.6	17.2	22.3	20.8	18.7	21.5	
Gross domestic savings	-11.1	-11.3	-7.5	-3.7	-2.6	-3.3	-5.2	-4.0
Net ODA received	..	..	..	13.8	10.6	9.8	8.7	..
Personal remittances, received	19.7	19.6	18.3	18.7	17.1	16.8	16.3	15.9
Capital account balance (% of GDP)	7.2	10.3	16.2	9.7	13.2	15.4	7.5	
Foreign direct investment, net inflows	9.4	12.8	9.4	7.2	8.3	8.2	4.5	4.9
memo:								
Exports of goods and services	14.1	16.0	15.7	17.1	19.9	19.6	18.2	17.4
Total natural resources rents	0.3	1.7	2.0	1.8	3.1	2.9	2.4	..

Source: World DataBank, World Bank, Washington, DC, <http://databank.worldbank.org/data>.

2.35. **FDI in Kosovo has been decreasing and is among the lowest in the region. Some signs of recovery were noted in 2015 but latest data for 2016 suggest another drop.** FDI in Kosovo recorded a decline of about 40 percent between 2007 and 2013; the average annual decline was 9.5 percent (figure 14). Between 2011 and 2013, the decline was even sharper (31.5 percent), although some recovery was observed in 2013. On the regional FDI map, Kosovo was outperformed by several main competitors in 2013, such as Albania, FYR Macedonia, and Montenegro, although it was better positioned than Bosnia and Herzegovina, Serbia, and Slovenia. In terms of FDI per capita, Kosovo was behind Albania, Croatia, and Montenegro in 2004–13. FDI inflows in 2015 are estimated to have grown by a factor of 1.5 times (year-on-year) and reached about 5.3 percent of GDP; most FDI originates in the EU, representing a major shift in recent years.

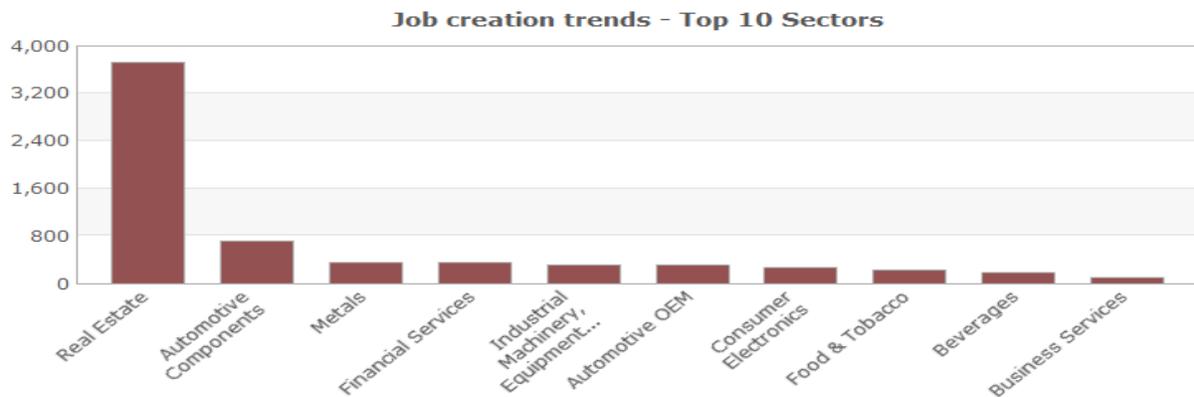
Figure 14. FDI Net Flows, 2007–13, U.S. Dollars, Millions



Source: World Bank data.

2.36. **The dominance of real estate, infrastructure investment, and construction have been key drivers in FDI trends.** The large majority of FDI flowing into Kosovo has been resource seeking and market seeking. Kosovo has attracted mainly companies involved in the financial and real estate sectors; almost half the FDI in 2012 and 2013 was directed toward real estate and construction, which are related to investment in housing by Kosovar diaspora and not in productive capacities (figure 15). As such they cannot be seen as sustainable as the housing demand from Kosovo diaspora will soon saturate. Therefore, export-oriented FDI has been scarce. Efficiency-seeking and greenfield investments are few and related to textiles, the automotive sector, and a handful of trade and business services. The mining sector has been disproportionately underperforming. Value added investment in the agriculture and processing industry, ICT, and business process outsourcing is limited. In addition, for three consecutive years, there was either zero or next to zero FDI in processing and agribusiness. Investment in internationally traded service industries has not been significant over the past few years.

Figure 15. FDI, by Sector, Capital Inflows, and Job Creation

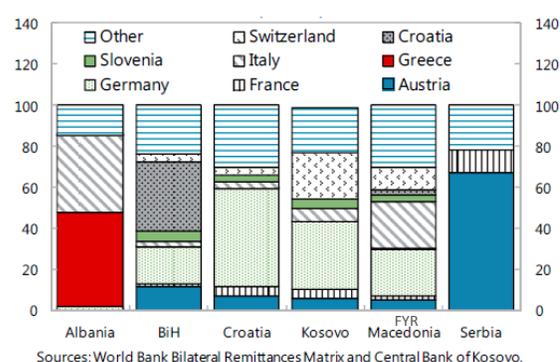


2.37. **While FDI in real estate and financial services has generated jobs, it has contributed little to the buildup in productive capacity in the tradables sector.** Considering the country’s advantageous characteristics (the small market, but with proximity and links to the EU and Central Asian markets, a relatively well-educated labor force and developed infrastructure, and rapidly improving business environment), global and regional FDI toward efficiency-seeking investment would help integrate Kosovo into global and regional value chains in manufacturing, including textile, food processing, and certain services. In addition, there is potential for direct forms of investment whereby foreign subsidiaries could serve as production and export agents, as well as for nonequity forms of investments whereby foreign and domestic investors enter into joint production contracts with a clear division of responsibilities within the value chain, such as contract manufacturing, contract farming, contract logistics, and business process service outsourcing.

2.38. **Remittances have represented a large and stable source of finance, supporting growth and inclusiveness over the years.** A legacy of the past has been the large migratory flows and the associated remittances from Kosovo’s diaspora, predominantly in the German-speaking countries of central Europe (figure 16).

The first wave of migration occurred in the 1960s and was followed by a second wave during the 1990s, the result of political pressure and then substantial unemployment and war in 1998–99. Since autumn 2014, emigration pressures have increased considerably. Consisting of 381,000 people born in Kosovo and now living abroad, together with people born abroad with at least one Kosovar parent, the total diaspora population is over 700,000 and constitutes both a potential market and potential business contacts.³³

Figure 16. Remittances, by Source Country



2.39. **Remittance incomes are closely tied to the economic health of the immigrant hosting country.** That personal remittances were less sensitive to the euro crisis in Kosovo than elsewhere in the SEE is a reflection of the fact that 60 percent of the remittances and other inflows of the diaspora derived from Germany and Switzerland, which were relatively less affected by the crisis. The euro value of remittances from Switzerland benefited from the appreciation of the Swiss franc. However, a negative shock in these host countries could lead to large welfare impacts in Kosovo given the dependence on remittances.

2.40. **Similar to other financial inflows, there are risks in the impact of remittances on competitiveness.** In a small open economy with a small production base, large inflows have an impact on the quantity of imports and on the price of nontradables unless the inflows are channeled toward building productive capacity to generate a supply response. Recent studies indicate that remittances reached 20–25 percent of households and mainly financed consumption (UNDP 2010, 2011, 2012a).

Household-Level Evidence on Growth and Shared Prosperity

2.41. **Labor earnings, including remittances, have been the main driver of the inclusiveness in Kosovo’s growth.** In any country, there are several potential transmission paths that translate growth into

³³ Respectively, 35 percent and 23 percent live in Germany and Switzerland (KAS 2013).

reduced poverty and shared prosperity. The main channels open to poorer households to increase consumption or income are (a) expanding employment, (b) greater returns to employment, (c) higher private transfers such as remittances, and (d) increased public transfers. In the case of Kosovo, data on personal and household incomes are incomplete, but the available information indicates that growing returns to employment have been the biggest factor supporting income growth among lower-income households. Higher labor returns have come partly through changes in the sectoral composition of employment, as workers have moved from lower-paying to higher-paying sectors. Wage increases have also contributed to higher returns to employment, especially in the public sector.³⁴ The other three channels have been much smaller contributors in Kosovo. Employment levels have been stagnant: the employment rate and the average number of hours worked per worker have been essentially unchanged in recent years. Although remittances comprise a significant share of household incomes, they have also been relatively flat and have not been a major contributor to growth in recent years. Social transfers have increased at the margin since 2009, but program coverage is low; so, this source has only been a factor among a subset of the poorest households. Finally, low-income households are vulnerable because their real incomes risk erosion because of rising energy costs and out-of-pocket health care expenditures.

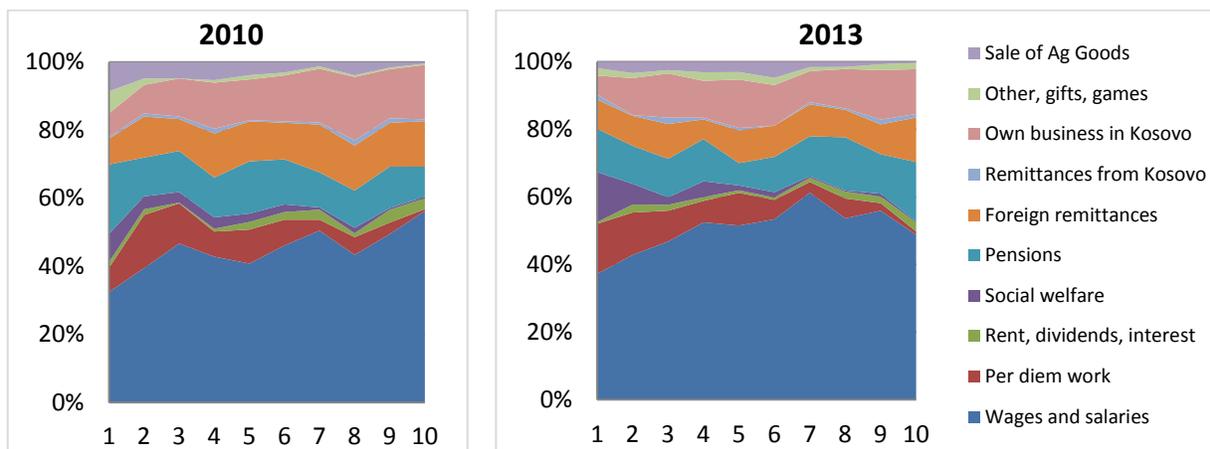
The role of employment

2.42. **Employment earnings account for 50–60 percent of income across all income groups.** Data on the shares of income from different sources by consumption deciles show that employment (either wage or casual day labor) accounts for approximately half of household income across all deciles and that casual daily work (per diem according to Kosovo surveys) are more significant among poorer households (figure 17). Between 2010 and 2013, the wage and per diem employment shares grew among most income groups, but especially among the poorest decile. Last resort social assistance represents a significant share of income only among the poorest decile, and this share rose between 2010 and 2013. Remittances from abroad account for about 10 percent of income, on average, across the deciles, but the average belies the large contribution remittances make among the 25 percent of households that receive them. The share of foreign remittances in incomes increased slightly among the first and third deciles, but declined among the others. The pension income share fell among poorer deciles and increased among richer deciles, an outcome of pension increases among certain categories of pensioners such as beneficiaries of war-related benefits.³⁵

³⁴ Although public sector wages are higher than average, a significant share of poor households in Kosovo depend on public sector wages; often, one public sector employee supports a large household and is the only employed household member.

³⁵ There are a large number of different categories among war-related beneficiaries, among which are war invalids, families of fallen Kosovo Liberation Army soldiers, families of civilian victims, and so on and a recently added category of war veterans (registered as fighters) who are not employed and not yet at the age of retirement.

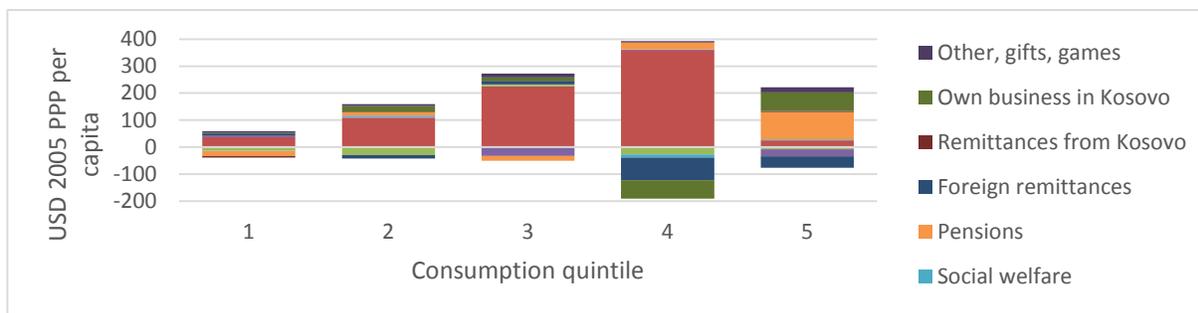
Figure 17. Income Shares, by Source and Consumption Decile, 2010 and 2013



Source: Household budget surveys.

2.43. Among the bottom 40, especially the second quintile, the income gains from wages and salaries were augmented by a modest increase in self-employment income (figure 18). Some of the increase in wages and salaries was offset by declines in casual (per diem) labor income. Other income components such as remittances, social assistance, and pensions contributed little to income gains among the bottom 40.

Figure 18. Change in Income, by Source and Consumption Quintile, 2009–13



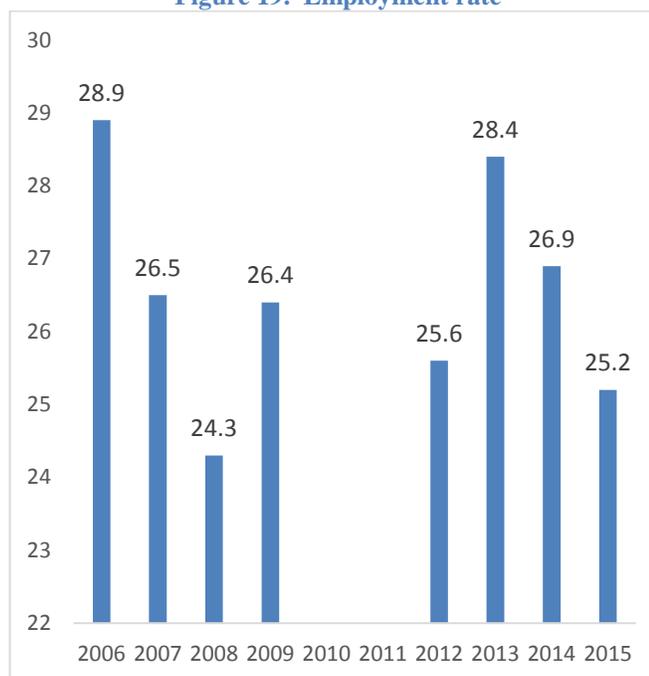
Source: Household budget surveys.

2.44. **Aggregate employment has generally been stable since 2006, keeping approximate pace with the growth in the working-age population.** The share of people ages 15–64 who are employed was in the 24–29 percent range from 2006 to 2015 (figure 19).³⁶ This suggests that increased domestic employment has not been an important contributor to welfare gains in Kosovo. While the employment rate has been more or less stable since 2006, there have also been no changes in the intensive margin because the share of full-time workers and the average number of hours worked by the employed were remarkably constant from 2008 through 2014. Based on HBS data changes in the employment rate from 2009 to 2011 were distributed evenly across the income (consumption) distribution. There was little change in the employment rate among the bottom 40, and only minor increases in the second and third deciles were offset by small declines in the first and fourth deciles. (The overall employment rates are higher in the HBS than in the LFS because of differences in the wording of the relevant questions.)

2.45. **The information on changes in the returns to employment is limited.** There are two main mechanisms for sustainably increasing the returns to employment, and both are associated with increased productivity. One is to increase returns within the same sector through increases in the capital employed, skills, or other productivity enhancements.³⁷ The second mechanism is to change the sectoral composition of employment so that workers move from sectors at low productivity and low pay to sectors at higher productivity and higher pay. Data on the first of these mechanisms are virtually nonexistent. The HBS records income, but not the time worked; so, it is not possible to separate changes in the amount of time worked from changes in returns per hour, day, or month. The LFS captures wages using broad ranges, but only since 2012, and does not record total household income, which is required to identify who is among the bottom 40.

2.46. **There is limited evidence suggesting a shift to employment in higher-productivity sectors** (figure 20). The annual HBS shows that, from 2010 to 2013, the bottom 40 tended to move out of agriculture and into construction, trade, and manufacturing (figure 21). The shift out of agriculture and into construction is most dramatic among the poorest quintile, where agriculture’s share of employment dropped from 35 percent to 20 percent, and the share of construction rose from 27 percent to 34 percent. Smaller, but significant increases among workers in the bottom 40 were observed in manufacturing (8 percent to 11 percent) and trade (13 percent to 19 percent).³⁸

Figure 19. Employment rate



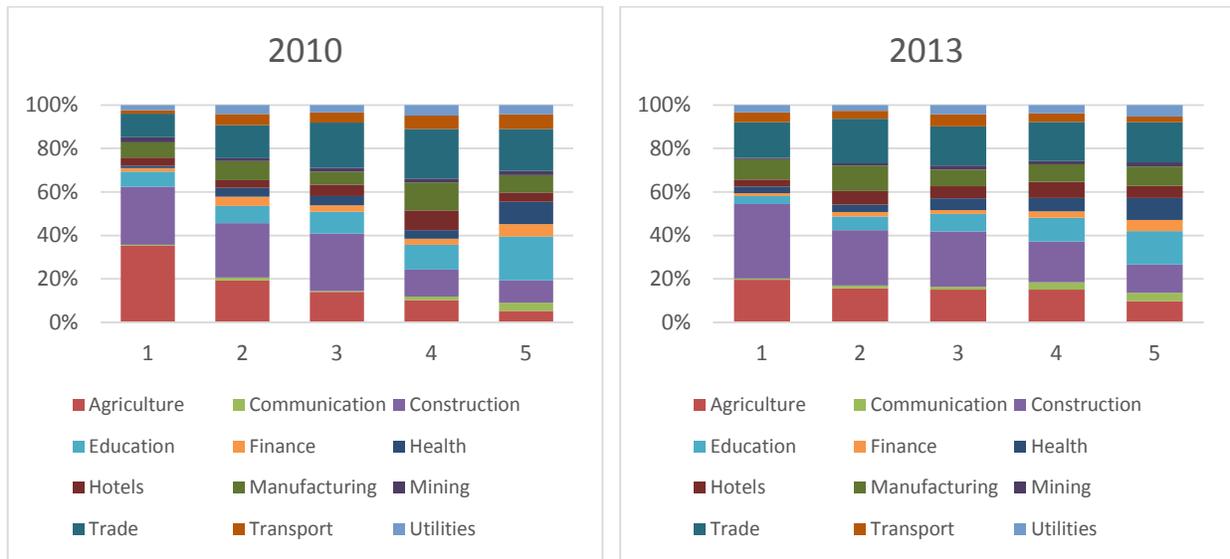
Source: Labor force surveys, various years.

³⁶ Comparisons of unemployment and participation rates in years prior to 2012 are more difficult because of changing definitions over time. There are no data for 2010 and 2011 because the Labor Force Survey was not conducted in Kosovo in those years.

³⁷ In Kosovo, there has been a series of wage increases in public sector employment, which are administrative actions with no clear link to productivity improvements.

³⁸ The HBS and LFS provide incomplete pictures of employment because both omit most informal employment, especially in

Figure 20. Employment by sector

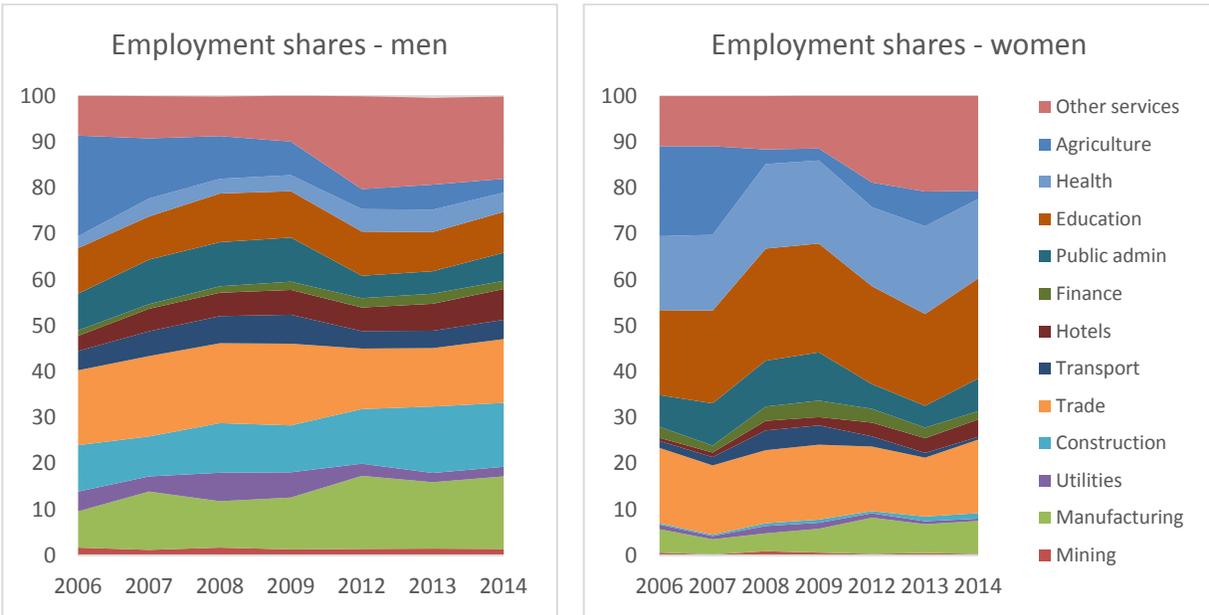


Source: Household budget surveys.

2.47. **There are major differences in men and women’s employment by sector.** The main sectors of employment among men are manufacturing, construction, and trade, all mostly in the private sector (figure 22). In contrast, women’s employment is dominated by education and health care, predominantly in the public sector. Women’s sectoral composition of employment has been relatively stable over time, aside from an apparent reduction in agricultural employment and an offsetting increase in other services. Sectoral shifts in men’s employment have been much more pronounced, showing large increases in manufacturing and construction employment, in addition to a shift from agriculture to other services. The prominence of public sector employment among women has important implications for efforts to increase women’s labor force participation and employment, which must increasingly be generated through the private sector.

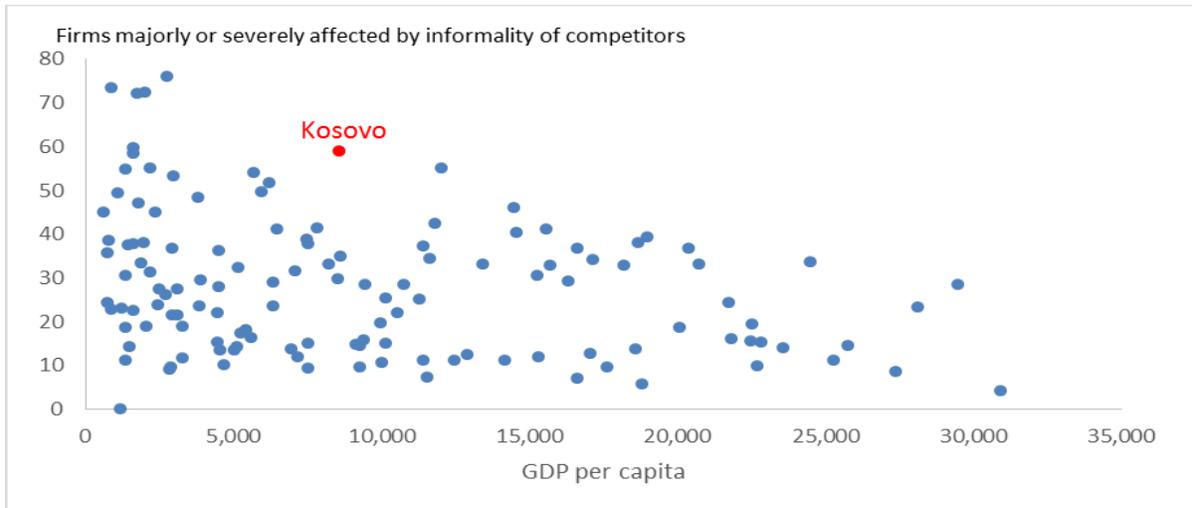
agriculture. Because they use different definitions, the HBS and LFS provide much smaller estimates of agricultural employment than the 2014 agriculture census (KAS 2015). Therefore, the sectoral employment shifts recorded by the HBS overstate the relative magnitude of the shifts (percentages of total employment in each sector), but the direction of the shifts should still be accurate. Although the 2014 agriculture census provides a more complete view of agricultural employment, it cannot be used to assess recent changes over time because it is a single cross-section given that no agriculture census was conducted between 1960 and 2014.

Figure 21. Sector of Employment, by Gender, 2006–14



2.48. **Informality is a significant problem in Kosovo.** Analysis of firm-level data reveals that the share of firms that are severely affected by the competition of informal firms is one of the largest in the world (figure 23). Moreover, the share is high even among countries at the same level of development. The share of firms that claim to be seriously harmed by the informality of competitors is significantly above the level predicted by Kosovo’s GDP. Furthermore, a comparison with other countries in the region reveals that this level is the highest in the region (figure 24).

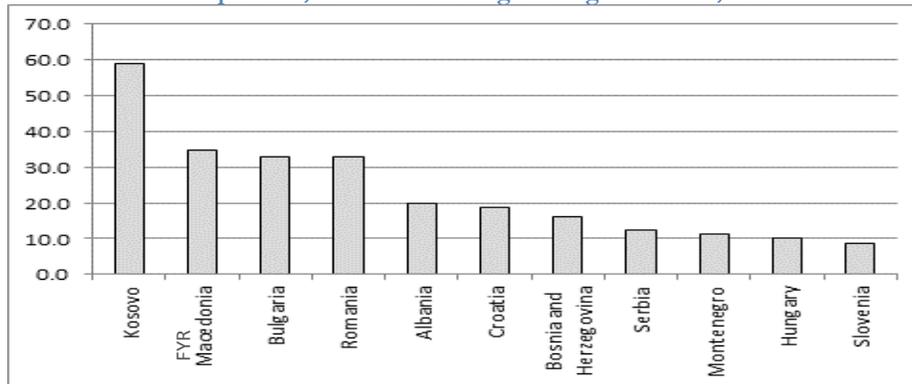
Figure 22. Percentage of Firms Majorly or Severely Affected by the Informality of Competitors, circa 2013



Source: Winkler, Ajwad, and Vasquez, forthcoming, based on BEEPS (Business Environment and Enterprise Performance Survey) (database), European Bank for Reconstruction and Development and World Bank, London, <http://ebrd-beeps.com/data/>, circa 2013, and World Development Indicators database.

Note: Per capita GDP in 2011 constant purchasing power parity international U.S. dollars.

Figure 23. Percentage of Firms Majorly or Severely Affected by the Informality of Competitors, Kosovo and Neighboring Countries, 2013



Source: Winkler, Ajwad, and Vasquez, forthcoming, based on data in BEEPS (Business Environment and Enterprise Performance Survey) (database), European Bank for Reconstruction and Development and World Bank, London, <http://ebrd-beeps.com/data/>.

2.49. **By one definition, approximately one-third of workers in Kosovo are engaged in informal employment.** Informal sector work has many definitions, but the size of the informal sector can be approximated by the share of workers in unproductive activities. Typically, these are workers in small firms, unpaid family workers, and self-employed people in either small firms or nonprofessional occupations. By this definition, about 35 percent of workers are in the informal sector in Kosovo; more than half of workers in the formal sector are public sector employees; and more than 40 percent work in large firms. Meanwhile, informal workers are more likely to be young men with low educational attainment and living in rural areas.

The role of remittances and transfers

2.50. **Remittance inflows are an important source of income among the bottom 40.** Most of the recent information on emigrants, remittances, and the benefits to households that receive remittances are derived from studies by the United Nations Development Programme (UNDP 2010, 2011, 2012a). It is estimated that 20 percent to 25 percent of households in Kosovo receive foreign remittances. Survey data show that remittance-receiving households tend to have higher mean incomes, excluding remittances, than nonrecipient households (table 8). However, this does not mean that lower-income households are not benefiting from remittances. These same data also show that the distribution of remittance-receiving households is almost uniform across preremittance income quintiles (figure 25). Moreover, cross-sectional analysis shows that households with characteristics associated with greater poverty (for example, larger households, households with lower educational attainment, woman-headed household, rural households, and households at higher unemployment) are more likely to receive remittances.³⁹ Official data on remittance inflows indicate that remittances have been steady over this period, and evidence on income sources suggests that remittance income has not been rising among the poorest households in recent years (see figure 17).

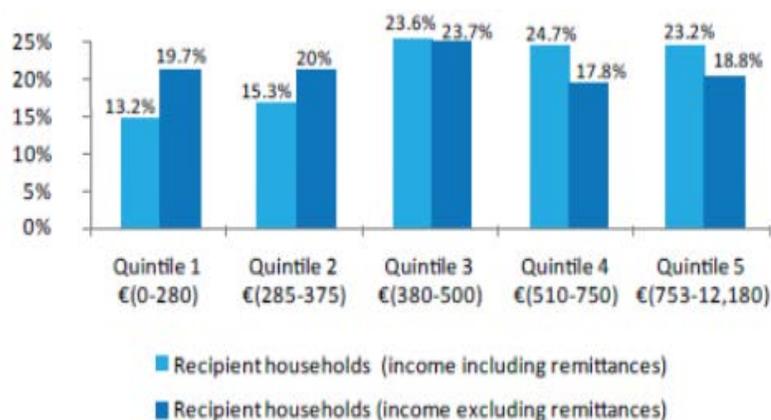
³⁹The causality could run both ways, such as members of remittance-receiving households earning higher reservation wages because of remittances.

Table 8. Mean Household Income of Remittance Recipients and Nonrecipients

Household category	Mean monthly household income (euros)	
	Excluding remittance income	Including remittance income
Households receiving remittances	580	694
Households not receiving remittances	536	536
All households	546	575

Source: UNDP 2012a.

Figure 24. Remittance-Recipient Households, by Income Quintile



Source: UNDP 2012a.

2.51. **Public sector pensions, the largest component of social protection spending, have not been an important source of income growth among poorer households.** Approximately 80 percent of social protection spending in Kosovo is devoted to four pension or retirement schemes. From 2008 through 2013, total social protection spending was at approximately 4 percent of GDP, but was declining as a share of total public expenditure. This occurred despite a one-off increase in pension spending in 2009 among those who had contributed to the former Yugoslav pay-as-you-go system and a 25 percent increase in pensions prior to the 2011 elections. Spending on public pensions rose in 2014 following an additional 25 percent increase among all categories of pensioners prior to the 2014 elections. Another increase was granted to former pension contributors by diversifying the scheme into four subcategories depending, for instance, on years of contribution or level of education. The share of social protection spending going to war-related benefits—such as payments to war veterans and the families of those who died in the war—has increased markedly since 2009. There is no hard evidence on the incidence of war-related benefits across income groups in Kosovo, but the recent *Public Finance Review* on Kosovo concluded that “anecdotal evidence and experience from other countries in the region suggest that, despite being part of the social protection budget, [war-related benefits] tend not to reach the poor” (World Bank 2014b, 101).

2.52. **The last resort social assistance program has also not contributed substantially to income growth among the bottom 40.** The program is well targeted, that is, there is little leakage to higher-income groups, and 71 percent of the program benefits go to the poorest quintile. However, two-thirds of households in the poorest quintile do not receive program benefits, in large part because of nonmonetary eligibility criteria. The program contribution to poverty reduction eroded from 2008 to 2012, as spending on the program declined 8.6 percent in real terms, reducing the program share in total social protection spending from 19 percent to 14 percent. Over this period, the size of the benefit rose marginally, but the number of beneficiaries was reduced because of tighter eligibility criteria (figure 26).

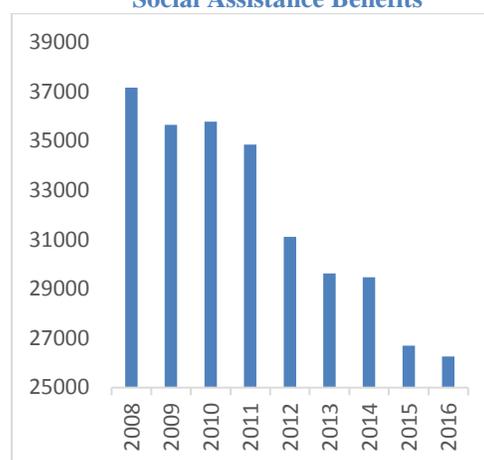
Conceptual Framework

2.53. The previous sections provide a snapshot of Kosovo's economy, growth, the drivers of growth, and how growth is shared across the income distribution. A number of traits have emerged that help identify key constraints to achieving poverty reduction and shared prosperity.

2.54. **Growth has been fueled by foreign aid and remittances, which have played a catalytic role by boosting aggregate demand.** Since 2008, growth in Kosovo has also been largely inclusive, reducing poverty and increasing the incomes of the bottom 40. However, because of a negative domestic savings rate, the current growth model is financed mostly by remittances and aid. Although remittances reach about 20–25 percent of households, the contribution to sustainable poverty reduction and shared prosperity have been limited because they have mostly been directed to increasing consumption. Moreover, FDI, mainly generated by the diaspora, has been mostly directed toward the nontradables sector (for example, real estate and services) and have contributed little to the buildup of productive capacity in the tradables sector.

2.55. **There are strong signs of a loss of competitiveness because of these large flows of aid and remittances.** The current impact on Kosovo's relative prices is unclear because trends in the real effective exchange rate reflect mostly import prices, while food represents 35 percent of the consumer price index basket. However, there is strong evidence of a loss in competitiveness from the perspective of unit labor costs. While private sector wages have risen moderately in real terms, the increase is substantial once it is scaled with a measure of productivity (figure 27). This is even more apparent if public wages, which have expanded almost threefold since 2003, are brought into the picture. Factor accumulation is estimated to have contributed two-thirds of overall economic growth between 2008 and 2012, while productivity accounts for the remaining third.⁴⁰

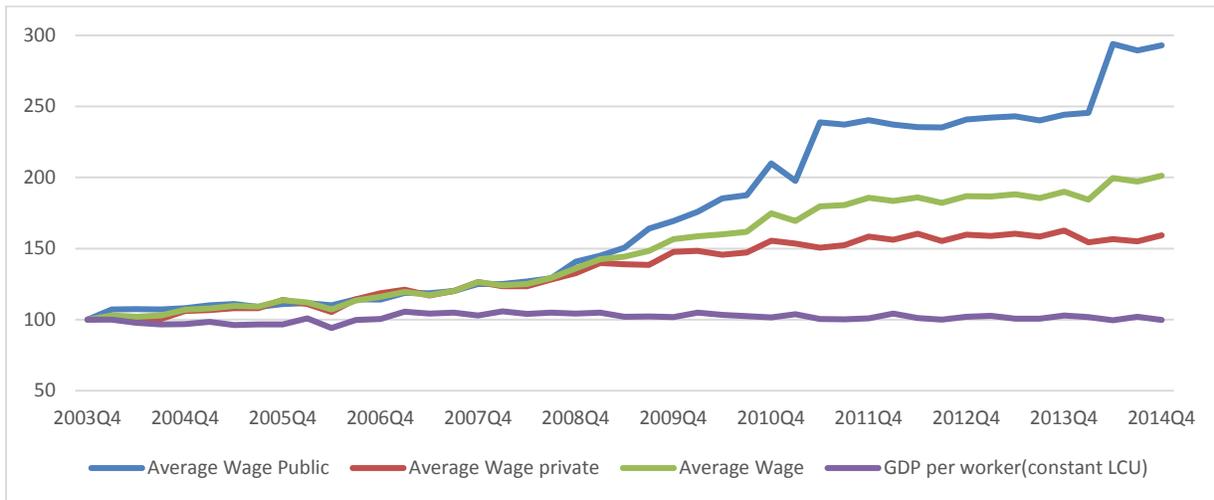
Figure 25 Number of Households Receiving Social Assistance Benefits



Source: Data of Kosovo Agency of Statistics and Ministry of Labor and Social Welfare.

⁴⁰Based on employment data and simplified assumptions (see annex C), labor contributed 40 percent of overall economic growth; capital contributed in the range of 18 percent to 25 percent; and total factor productivity explained the other 42 percent to 35 percent.

Figure 26. Wages and Productivity, Kosovo



Source: Ministry of Finance data.

Note: 100 = 4th quarter, 2003.

2.56. **The decline in labor productivity in manufacturing drove an overall decrease between 2010 and 2012.** Labor productivity declined by 6 percent between 2010 and 2012 among all firms in the sample of the Business Environment and Enterprise Performance Survey (BEEPS).⁴¹ The overall decline in labor productivity was driven by the manufacturing sector, which saw average labor productivity fall by 12 percent in 2010–12. In contrast, productivity in the retail sector increased by 7 percent. The overall decline in labor productivity is reflected across firms with most characteristics. Old and young firms (less than seven years) faced productivity declines during 2010–12, as did small and medium firms, sole proprietorships and publicly traded firms, and firms in all but two districts (Ferizaj and Gjilan). Moreover, exporting firms saw a decline in labor productivity of around 8 percent over 2010–12, compared with a drop of 6 percent among non-exporters, suggesting there was a more challenging environment for exporters than non-exporters (especially those producing nontradables).

2.57. **Low competitiveness and low domestic productivity have curtailed business expansion and investment opportunities in tradables.** Uncompetitive low levels of domestic productivity, reinforced by an unfavorable business environment, weak governance in the public and private sectors, and a deficit in infrastructure have constrained opportunities for private sector expansion and impeded diversification. FDI has not reached the level needed to affect domestic productivity and transform the economy. Despite some progress in recent years, the productive base in the economy remains narrow and undiversified. The agriculture and service sectors are large, and the manufacturing and tradable sectors are small. As a result, the quantity of imports is large, and exports have not reached the level required to support the economy. Kosovo has failed to

⁴¹ The dataset analyzed is a two-wave panel of firm data from 2010 and 2012. In the dataset are 202 firms in the 2012 survey and 262 firms in the 2009 survey. Of these, 10 were singled out for unreliable responses to some questions and were therefore not part of the sample for much of the analysis. The sample contains 69 manufacturers, 31 retailers, 26 wholesalers, 50 firms producing other services, and 12 construction firms; 4 firms are not categorized by sector. Of the firms analyzed, 30 export, and 162 produce nontraded goods or services. It is estimated that the firms are representative based on stratified sampling (three layers: firm size, sector, and region). However, they add up to just 0.5 percent of the total population in the economy, judging from information gathered through structural business statistics in Kosovo. The data are available at BEEPS (Business Environment and Enterprise Performance Survey) (database), European Bank for Reconstruction and Development and World Bank, London, <http://ebrd-beeps.com/data/>.

attract strong private sector participation; the public sector footprint is large and inefficient; and more than 98 percent of businesses are family-owned microenterprises and small and medium enterprises (SMEs).⁴² Additionally, unreliable electricity supply and frequent power cuts are among the top constraints cited in business surveys. As the aging plants are phased out and more reliable electricity supply is commissioned, the increased electricity tariffs would also impact firm competitiveness. Energy efficiency programs could help enhance competitiveness.

2.58. **Limited job creation.** Despite recent progress, the pace and type of growth have not provided the labor force, particularly the young, with sufficient opportunities for formal employment so as to reverse the trend in outward migration. Kosovo has one of the weakest employment records in Europe: a labor force participation rate of 37.6 percent, an employment rate at 25.2 percent, and an unemployment rate at 32.9 percent in 2015, and the situation is considerably worse among women and, especially, youth.⁴³ Youth unemployment is especially high, at over 57.7 percent. Every year, approximately 30,000 new job-seekers enter the labor market, while current economic growth generates only around 15,000 new jobs a year. As a result, only about 10 percent of the youth population is working; the rate falls to less than 5 percent among young women. Even though this is an underestimate because of incomplete survey coverage among small and family-run businesses, particularly in the agriculture sector, the employment prospects for new entrants to the labor market are extremely challenging. The large pre-election increases in public wages are adding more distortion into the job market by making full-time positions in the public sector the most desirable jobs for job-seekers.

2.59. **Employment growth is further constrained by an inadequate human capital base.** An inadequately educated and skilled workforce limits employment growth, especially among large and rapidly growing firms. The current education system has not yet succeeded in equipping students with the specific skills, including soft skills, necessary to thrive in the changing labor market. To benefit from the demographic dividend and generate more rapid and inclusive growth, the general education system needs to provide greater opportunities to acquire the skill sets demanded by employers. This is especially true for women, youth, and minorities, whose participation in the workforce has been marginalized. Public spending per student on education is low relative to comparator countries, and the quality of education is weak and inequitable. The quality and coverage of health services are similarly weak and characterized by inefficient public spending, high out-of-pocket costs, and significant discrepancies across income groups, ethnic groups, and regions.

2.60. **Job creation is particularly important for poverty reduction and inclusiveness because employment earnings account for 50–60 percent of income across all income groups.** Employment status and, if employed, the sector and type of employment are important in defining poverty. Households of which the main source of income is salary, particularly public sector salaries, are less likely to live in poverty than those that depend primarily on other sources of income, such as farmers. In a more dynamic sense, the limited available evidence indicates that labor earnings have been the most important source of income growth among poorer households. Despite economic growth, employment was fairly stable from 2004 to 2014, suggesting that the welfare gains of the bottom 40 percent of the population have not been derived from expanding employment. HBS statistics show some evidence of a shift in employment from agriculture to higher-productivity sectors (construction and other services) among poorer households, but changes in the LFS

⁴² Kosovo retains a state-owned telecommunications company, a state-owned electricity-generating monopoly, and other infrastructure companies (water, railways) (UNDP 2014a).

⁴³ The official employment data in Kosovo do not fully capture informal employment; so, the labor force participation rate and the employment rate may be considered lower bounds. This data weakness exists in all countries to a greater or lesser degree and does not explain the large difference between Kosovo and other countries.

do not allow conclusive assessments. The information on changes in returns to employment is extremely limited.

2.61. **The main traits and characteristics of the current growth model have deep roots in Kosovo's past.** High unemployment, high underemployment, low labor force participation, and migration may be traced back to the SFRY, when Kosovo was the most backward and poorest region in the federation. Kosovo was also highly dependent on transfers and remittances then as it is today. Agriculture, at 24 percent of GDP, and mining and energy were the main economic activities then as well.

2.62. **Kosovo also has the traits of a newly independent country emerging from a conflict.** These include large investment needs to replace obsolete or destroyed physical infrastructure especially in energy and mining, a low level of economic activity, a lack of trade integration with the global supply chain, substantial informality, high unemployment, and low labor force participation. There are large spending pressures because of pensions, veterans' benefits, benefits to former political prisoners, and public sector salaries. Kosovo is also characterized by implementation gaps in social and soft infrastructure, such as the rule of law, property rights, the justice system, and political culture; frequent political standoffs, disputes, and uncertainties within the country and with neighbors; and social tensions among ethnic groups. Organized crime, widespread informality, and corruption are significant challenges that hinder economic development.

2.63. **Kosovo's economy also displays the economic characteristics of a small state dependent on foreign aid and remittances.** Production is undiversified and narrow because of high input costs, including high transportation costs; narrow choices in energy generation; diseconomies of scale; and lack of competitiveness. The small internal market constrains the private sector, and, as a result, the public sector is large. Nonmarket practices, monopolies, and lack of competition deter innovation and productivity. Because of small production and domestic income generation, government revenues are dependent on indirect revenues mainly collected at the border, but less on domestically collected direct taxation.⁴⁴ State capture by narrow vested interests and thin implementation capacity are major obstacles in development.

2.64. **The combination of structural characteristics because of size and the legacies of the past are forces that support the perpetuation of the current cycle, generating unique outcomes** (figure 28). In a number of indicators, Kosovo is an outlier compared with other countries and small states.⁴⁵ For instance, the personal remittances to GDP ratio is high (16.3 percent in 2012) compared with small states (table 9). Similarly, the trade and export to GDP ratios are substantially lower (70.6 percent and 18.4 percent) relative to small states. This suggests that Kosovo's main export has been labor rather than goods and services, even by the yardstick of small states.

⁴⁴ About 75 percent of overall revenues are collected at the border (World Bank 2014b).

⁴⁵ Small states for this analysis are defined as sovereign states with populations below 2 million.

Figure 27 The Self-Perpetuating Negative Cycle

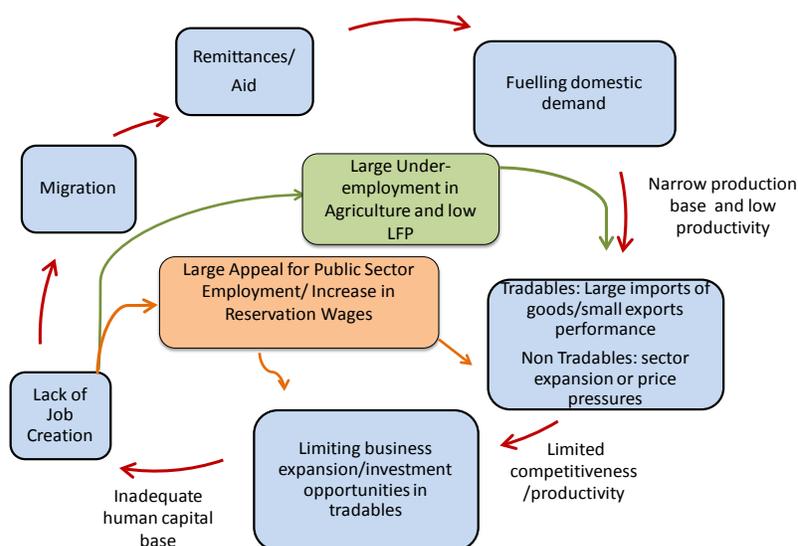


Table 9. Indicators of Integration

Concept	Trade to GDP ratio	Exports to GDP ratio	Remittances to GDP
Mean all	97.1	46.0	5.1
Mean small states	119.0	53.8	6.5
Kosovo	70.6	18.4	16.3
Median all	86.0	37.5	1.9
Median small states	106.1	46.4	4.5
Number of observations	170	170	159
Number of small states	37	37	39

Source: World DataBank, World Bank, Washington, DC, <http://databank.worldbank.org/data>.

Note: The data correspond to 2012. The sample corresponds to all countries and all small states on which data are available for 2012 in the World DataBank database.

2.65. **While it is conceivable for a small economy such as Kosovo to continue developing in the short to medium term, the marginal benefits of some of the drivers are expected to decline.** While remittances will continue to be an important source of financing, official development assistance is already shrinking as donor concerns about poverty, fragility, and security decline. Remittances and official development assistance in Kosovo depend on the health of European economies. The pace of public investments in physical infrastructure is expected to slow when damaged or obsolete infrastructure is replaced.⁴⁶ Growth and dynamism in nontradable services are expected to be constrained by the size of the internal market.

2.66. **The private sector has not reached the level required to transform the economy and provide sufficient high-quality jobs.** So far, the pressures on the labor market have been alleviated through migration. However, Kosovo has one of the youngest populations in Europe, and the working-age population is expected to grow rapidly in the near future. The challenge ahead is to create conditions for a more dynamic private sector

⁴⁶ According to the International Monetary Fund (IMF 2013a, 9), “fiscal stance is sustainable, provided capital spending—which has fluctuated considerably in recent years, reflecting in part ambitious infrastructure projects—converges to around 10 percent of GDP.”

that absorbs larger demographic pressures. Every year, approximately 30,000 new job-seekers enter the labor market, while current economic growth generates around 15,000 new jobs per year. As a result, only about 10 percent of the active youth population is working, and this falls to less than 5 percent among young women. Population growth can be a great opportunity, or, if high unemployment is sustained over prolonged periods, it can be a trigger of social tensions.

2.67. The social and economic costs of protracted low job creation are amplified because the government has not adopted an independent monetary policy, and there is limited fiscal space for growth and a countercyclical response. The capacity to generate fiscal space will be a challenge and depend on the ability to generate alternative revenues away from tariffs and custom duties, which are expected to decline when the SAA with the EU and a trade agreement with Turkey are fully implemented.

2.68. Despite the success in protecting public capital investments, resources have not always been allocated effectively to meet the challenges. With the recently passed fiscal rule, wage and pension increases have created extra pressure in the budget and risk crowding out capital investments and other priority expenditures. A better allocation of resources to break the bottlenecks in energy and education will be critical to supporting growth and business expansion. Addressing energy security is crucial for the future of Kosovo. However, meeting future energy demand would require investment in a new electric power plant costing between €1 billion and €1.5 billion, or between 20 and 30 percent of GDP.

2.69. To fulfill its ambition of EU membership, Kosovo will require a prolonged period of sustained growth to achieve real convergence toward European living standards. Poverty reduction and convergence with European incomes are occurring, but at a slow pace because Kosovo's production factors remain vastly underutilized. Accelerating growth and making it more inclusive will require complementing the externally financed sources of growth through the creation of more domestic opportunities for employment, as well as strengthening social service provision. However, structural transformation and increased productivity are necessary to establish a functioning market economy to cope with competition, market forces, and asymmetric shocks, as well as to provide income and job opportunities to reduce migration.

Building Blocks

2.70. The central premise of the proposed framework for accelerating growth, poverty reduction, and shared prosperity is a gradual rebalancing of growth toward greater reliance on increased productivity at home and improved competitiveness abroad. Unleashing growth potential would require tapping into production factors—natural and human resources—that are currently either unemployed or chronically underemployed. This would help support opportunities among an increasing share of the population and across a broader number of sectors, which are conditions for reducing poverty and promoting shared prosperity in a sustainable manner. Drawing on the lessons of international experience, including the Commission on Growth and Development (2008), and taking into account Kosovo-specific challenges and opportunities, four sets of building blocks have been identified for supporting this gradual rebalancing with the aim of achieving more rapid, sustainable, and equitable economic growth. The building blocks, listed hereafter, are the subject of chapters III–VI.

2.71. In the absence of a substantial adjustment in productivity, the alternative to a euroized economy is to engineer an internal devaluation to bring unit labor costs into line. This process may be

painful, but it has worked in Latvia and other euroized or dollarized countries. Moreover, the process of realigning unit labor costs through productivity gains, if feasible, requires the generation of productivity gains consistently more rapidly than competitors; the chance may vanish if the reservation wage rises in lockstep.

- **Reprioritizing public expenditures and reorienting taxation to address critical development challenges, while preserving fiscal discipline is key to a gradual rebalancing of growth toward greater reliance on increased productivity and improved competitiveness.** Kosovo has managed to maintain macrofiscal stability and weather the global financial crisis and the euro area crisis. However, fiscal policies have deteriorated since early 2014 because of political business cycles and election-related episodes of fiscal largesse. In a euroized economy, the capacity for maintaining healthy public finances by successfully implementing fiscal rules, avoiding spending pressures from nonpriority areas, and generating alternative revenues is vital to creating sufficient resources necessary for public investments to improve competitiveness and crowd in the private sector, while protecting the poor and vulnerable from unforeseen shocks. In this context, the key to breaking bottlenecks and generating productivity gains is knowing which public investments in which areas are needed to establish the proper balance between stabilization and development objectives.
- **Accelerating growth and fostering shared prosperity will require a more attractive environment for private sector investment and business expansion in tradable sectors and a determined effort to reap the benefits of European integration.** Manufacturing has the potential to generate quality jobs and raise incomes. Kosovo has comparative advantages in a number of manufacturing products (garments, textiles, and food). In services, the ICT industry is already a major source of employment and has the potential to transform Kosovo's economy, given the direct impact on other sectors and human capital formation. However, these sectors have been constrained. The current growth strategy needs to be amended through the implementation of a broad set of soft and hard infrastructure initiatives to provide an attractive business environment and enhance productivity and competitiveness in the tradables sector and, ultimately, create quality jobs and foster inclusion.
 - Applying good governance at all levels and strengthening the rule of law and the business climate are elements of the social and institutional infrastructure needed to establish an appropriate incentive system for a well-functioning competitive and innovative market economy, while removing the remaining socialist legacy and solidifying social cohesion.
 - Widening the bottlenecks in physical infrastructure by providing reliable and affordable energy and improving connectivity (roads and ICT) is also crucial for private sector expansion, competitiveness, and inclusion. Addressing energy needs is particularly challenging. The government will need to strike a balance between energy security and environmental considerations as well as between fiscal sustainability and affordability issues.
 - Secure, tradable land rights are fundamental to accessing land and credit for investments as well as protecting one of the main assets of the most vulnerable, that is, the land they use. Implementation of the National Spatial Data Infrastructure (NSDI) is needed to reap the benefits of geo-referenced information in public and private sector planning, decision making, and asset management. NSDI is, therefore, expected to boost private sector competitiveness, foster innovation and improve public sector service delivery.
 - The financial sector, while risk averse in its lending decisions, has remained well-provisioned, profitable, and liquid, with nonperforming loans and credit-to-deposit ratios much lower than in neighboring countries. However, deepening and widening financial intermediation are key to

channeling savings, including remittances, through the formal financial system and toward productive investments and job creation. This is particularly important because more than 98 percent of businesses are family-owned microenterprises and SMEs.

- **Greater inclusion is essential to tapping into human resources that are currently either unemployed or chronically underemployed and to cashing in on the demographic dividend of a young population.** Building skills and human capital is critical for attracting investment, but also for ensuring that a larger share of the population, including low-income households, participate in and benefit from economic growth. Over a third of young Kosovars are neither in education nor in employment, meaning there is a risk of creating a lost generation. Even among youth with higher educational attainment, the prospects appear gloomy; evidence suggests that rising numbers of youth with university degrees are unemployed. In 2012, 15.6 percent of degree-holders were unemployed or underemployed, possibly reflecting a mismatch between education and the labor market demand for skills. A large share of the population is still vulnerable to falling back into poverty from income shocks, including from loss of employment, rising energy costs, or high out-of-pocket health care expenditures. Strengthened social safety net institutions, improved targeting, and greater efficiency and quality in public service delivery in health care, education, employment services, and last resort social assistance would promote equal opportunity and short-term protection so that the less well off, including RAE people, can accumulate assets, participate in economic growth, and improve livelihoods. Policies to raise the quality and equality of opportunities across wealth groups, ethnic groups, and districts in health care, education, and social protection are important for greater social inclusion and cohesion.
- **Better stewardship of the environment and natural resources is a key to immediate social welfare improvements and the long-term sustainability of inclusive growth.** Decades of neglect and the war have destroyed the roots of the economy's strength. Given the abundance of natural resources and fertile land, greater productivity and sustainability in agriculture and mining, in which Kosovo displays strong comparative advantages, are crucial to better export performance and import substitution and to generating the resources for development. Modernizing these sectors, strengthening institutions and policies, and implementing smart technical standards, good practices, and regulations are necessary for exploring the potential of these sectors, while alleviating the risks associated with the environment, resettlement, and health and achieving compatibility with EU norms. This will also require actions to mitigate and adapt to climate change. Addressing governance issues and establishing a framework to distribute equitably the rents generated from natural resources are also essential for shared prosperity.

III. REPRIORITIZING PUBLIC EXPENDITURES AND REORIENTING TAXATION TO ADDRESS CRITICAL DEVELOPMENT CHALLENGES

3.1. **Reprioritizing public expenditures, implementing income policies, and reorienting taxation represent the first pillar of a strategy to rebalance growth gradually toward greater reliance on productivity and competitiveness, while preserving fiscal discipline.** In a euroized economy, the capacity for maintaining healthy public finances by successfully implementing fiscal rules, avoiding spending pressures, and generating alternative revenues besides declining border taxes is vital to the creation of the resources necessary for public investments that improve competitiveness and crowd in the private sector, while protecting the poor and vulnerable from unforeseen shocks.

Maintaining Fiscal Discipline and Aligning Budgets to Development Needs

3.2. **In a euroized economy, fiscal policy is the main tool for macroeconomic stability and economic growth.** Without independent monetary policy, the response to shocks or a loss in competitiveness involves adjustments in wages and prices rather than adjustments in the exchange rate. The challenge of maintaining macroeconomic stability in the face of the uncertain global environment is amplified by the narrow resource base in Kosovo, which prevents the country from diversifying into a wide range of activities. Given the large, potentially volatile external financial flows, maintaining prudent and countercyclical fiscal policy is key to rebalancing aggregate demand and supporting more sustainable growth.

3.3. **Kosovo has managed to maintain healthy public finances and protect the fiscal space that has supported growth and absorbed unforeseen shocks.** The government ran successive budget surpluses between 2000 and 2007, accumulating a cash buffer of over €420 million, 12.3 percent of GDP in 2007. This allowed fiscal policy to turn expansionary in 2008, when economic growth was at risk because of the effects of the global financial crisis. The accumulated cash buffer financed fiscal deficits between 2009 and 2011; debt financed the fiscal deficit in 2012; and debt and the cash buffer financed deficits in 2013 and 2014.

3.4. **From 2008 through 2014, public spending was heavily focused on capital expenditure, but capital spending was too narrowly focused on high-cost investments that may not have maximized the impact on growth and inclusion.** Government capital expenditure averaged about 40 percent of total public spending or 10 percent of GDP, over 2.5 times the amount allocated in neighboring countries over the period. Government capital spending was heavily focused on transport projects, mainly a new highway. Road improvements have helped increase regional connections and access to markets, including through ports in Albania. They have also contributed to the development of a nascent construction sector: over half of the material inputs and 80 percent of the subcontractors were sourced locally. Investment has also been high in the health care sector, averaging 13 percent of total public health spending between 2010 and 2012. However, health spending has been narrowly targeted: a large share went to improving medical equipment at the country's single tertiary health care facility.

3.5. **There has been a tendency to overinvest in roads.** Kosovo's efforts to maintain substantial investment to support economic growth and repair the damage associated with the breakup of Yugoslavia and the war are commendable. However, because of the young and growing population, long-term economic growth also depends on investing in human capital through education and health care. There has been a tendency to overinvest in new capital stock and underinvest in the maintenance of existing capital stock, a

particular issue in the case of roads, but many schools also require improvements, and some new health care facilities have been poorly constructed. The efficiency of public spending might also be enhanced. For example, health resources have been focused on a tertiary health care facility rather than primary care, and education funds have not been used to follow pupils to ensure that upper-secondary schools have the resources they need to cope with rising enrollment.⁴⁷ The only sector that has systematically lacked public support is ICT.

3.6. Despite the presence of an institutional framework to rein in fiscal policies, Kosovo has been sensitive to political business cycles and prone to election-related episodes of fiscal largesse. Driven by election promises, the wage bill increased by 27 percent in 2011 and by 25 percent in 2014.⁴⁸ Kosovo has adopted a tight constitutional and legal framework to safeguard fiscal sustainability from unsustainable fiscal deficits and policies. A fiscal rule has been put in place to maintain the general government deficit below 2 percent of GDP and consistent with the long-term objective of keeping gross public debt below 40 percent of GDP (box III.1). Capital projects are exempt from the ceiling provided (a) they are financed from privatization receipts and (b) the government bank balance exceeds a minimum threshold of 4.5 percent of GDP. A system of fiscal buffers has been adopted, especially for bank balances, valued at an estimated 3 percent of GDP.⁴⁹ The development of a framework for funding the resolution of systemically important banks and strengthening the emergency liquidity facility to complement the country's financial safety net.

3.7. Amendments have been introduced to protect and boost capital investment. The new Stand-By Arrangement with the International Monetary Fund approved on July 29, 2015, introduced changes to the fiscal rule through amendments to the Law on Public Financial Management and Accountability that were approved by Parliament in February 2016. The new rule preserves the 2 percent deficit target and the 0.5 percent of GDP tolerance, introduces a limit of 30 percent of GDP on government debt, and, besides capital spending financed through privatization receipts, excludes from the calculation of the deficit under the rule capital spending financed by international financial institutions, bilateral donors, and the EU and its agencies.

3.8. While Kosovo's public debt stock is low, and its fiscal deficit is among the lowest in the SEE, its fiscal rule regime will require the generation of alternative revenues to create future fiscal space.⁵⁰ The challenge of meeting the fiscal rule is expected to grow unless additional efforts are undertaken to boost domestic revenues, especially in fighting relatively large tax evasion and in broadening the tax base by expanding direct tax coverage, as domestic production increases and integration with the EU and free trade agreements advances.⁵¹

⁴⁷ To keep pace with rural-to-urban migration in Kosovo, the per capita funding of municipality spending on schools was rolled out in 2011. However, implementation has been uneven, and the funding formula has not always been applied correctly (World Bank 2014b).

⁴⁸ This triggered the termination of the Stand-By Arrangement with the International Monetary Fund in spring 2011. A wage freeze was applied in the following years.

⁴⁹ This had declined to less than 2 percent of GDP by the end of 2014.

⁵⁰ The end-2014 stock of public debt (excluding Paris Club and London Club debt), while gradually increasing, remained at a manageable level, at 10.8 percent of GDP.

⁵¹ Many recent studies, including one of the World Bank (2014c), have identified potential tax evasion at about 34 percent. A new measure to broaden the tax base might involve the introduction of a value-based property tax on agricultural land.

Box III.1. Public Financial Management and the Fiscal Rule

To safeguard fiscal sustainability, Kosovo has adopted a tight constitutional and legal framework to prevent unsustainable fiscal deficits and debt policies. Under the Constitution, all new external debt needs to be ratified by a two-thirds majority in Parliament. In addition, the Law on Public Financial Management and Accountability requires that supplementary budgets have to be deficit neutral. In 2013, Kosovo adopted a new fiscal rule, which was incorporated into the main fiscal law. The fiscal rule established policy restraints on the fiscal deficit, the public debt level, and other indicators to control macro-fiscal sustainability, as follows:

- Maintain the overall fiscal deficit at 2 percent of projected GDP in the current budget year: this deficit level applies to the consolidated central and municipal budget.
- The unspent part of appropriations from the previous year can be used in the new budget appropriations in capital expenditure and will not be considered for purposes of compliance with the fiscal deficit ceiling.
- Other revenue receipts additional to budgeted revenues from the previous year may be transferred to the following year for new budget appropriations in the category of capital expenditure and will not be considered for purposes of compliance with the fiscal deficit ceiling.
- Privatization proceeds and their spending will not be subject to the fiscal deficit ceiling. These revenues can be used only for capital investment projects if the level of usable government bank balance amounts to at least 4.5 percent of projected GDP.
- Any excess of the projected fiscal deficit of more than 0.5 percent of GDP should be eliminated within the next three fiscal years.

The fiscal rule also specifies situations when the rule may be temporarily suspended, such as the following:

- Economic recession, when nominal tax revenues are equal to or lower than the tax revenues collected during the same period of the prior fiscal year, excluding the impact of policies and one-off tax revenues
- An emergency such as a natural disaster
- In the event of a crisis in the banking system identified by both the minister of finance and the governor of the Central Bank of the Republic of Kosovo, on the proposal of the Central Bank
- A call on a state guarantee that will have to be paid by the government and that has an impact on overall expenditures of over 1.5 percent of projected GDP

Given that the fiscal rule has constrained much-needed productive investments in infrastructure and other development initiatives, an amendment to the fiscal rule was introduced and approved by Parliament to allow for such investments outside the budget deficit ceiling, as follows:

- For the purposes of compliance with the deficit ceiling, expenditures for capital projects financed externally from supranational financial institutions, the EU or its institutions, or foreign governments or their development agencies shall not be taken into account.
- Projects that have been contracted before enactment of the paragraph are excluded from capital projects mentioned in this paragraph.
- The exemption provided for in the paragraph shall not apply to the Law on Budget Appropriations of any fiscal year if the execution of the Law on Budget Appropriations or conclusion of a contract for any capital project has caused or is likely to cause general government debt to exceed 30 percent of projected GDP.
- The exemption provided for in the paragraph shall expire after 10 years from the date of entrance into force.

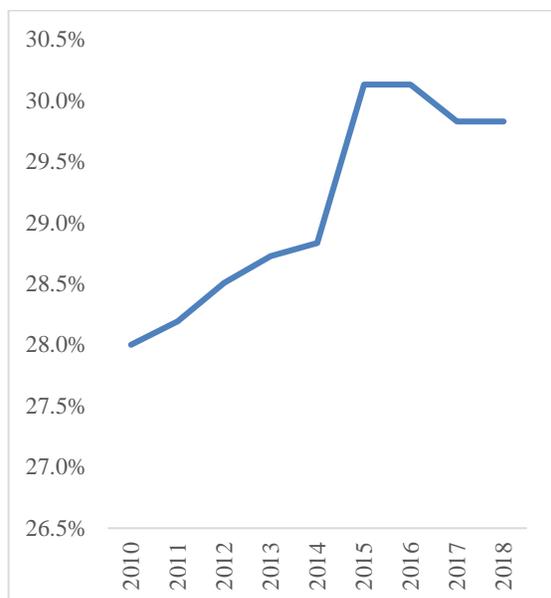
Sources: OPM 2013a; information of the Ministry of Finance, September 2015.

Improving the allocation and efficiency of public expenditure

3.9. **Without spending on restructuring, Kosovo's mix of declining revenue and increasing entitlements would result in either a rapid rise in the fiscal deficit or the crowding out of growth and development-focused spending.** Simulations undertaken in the 2014 Public Finance Review suggest that, without policy change, nongrant spending would increase from about 28.5 percent in 2013 to almost 30.0

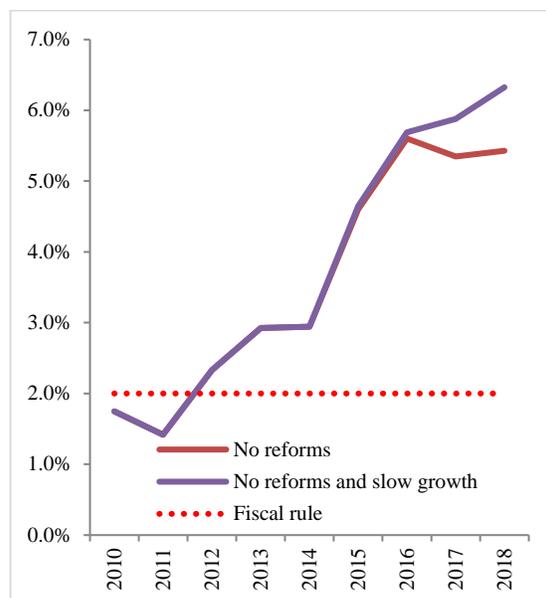
percent by 2018, driven by increases in veterans benefits and public service salaries (figure 29).⁵² Fiscal adjustment measures in 2015 and 2016 and a more conservative budget for 2017 have brought back short term stability in fiscal deficit and tend to reduce it below the limit set by fiscal rule. This newly established fiscal stability has however to be confirmed during the next electoral cycle. Additional fiscal pressure could arise from the need to meet future electricity demand when the current aging power plant is decommissioned.

Figure 28 Expenditures Excluding Grants, No Policy Change Scenario, % of GDP



Source: World Bank estimates.

Figure 29. Primary Deficits, Excluding Net Lending and Grants, No Policy Change Scenario, % of GDP



Source: World Bank estimates.

3.10. **Important trade-offs will need to be made.** Kosovo’s track record of budgetary discipline shows that the government is capable of taking the difficult decisions necessary to meet challenges, and it now has an opportunity to reorient spending toward areas that address these challenges. Aligning spending with the country’s needs will require more than ensuring that the headline fiscal numbers are sound, as the fiscal rule aims at ensuring. Although there are genuine needs in many areas, the limited resources should be reallocated toward areas that unlock economic growth potential and help reduce unemployment and poverty. In addition, improving public services will require efficiency improvements, notably in health care and education.

3.11. **A reprioritization of expenditure across sectors would help address poverty and unemployment as well as provide higher value for money.** For instance, prolonging the completion of the highway between Pristina and FYR Macedonia—Route 6—would make it easier to free up resources to be invested in other, more urgent areas. Some of the funds could be invested in improving local and regional roads where evaluations show potential for high economic returns. Savings could also be used to improve the education system, notably, early childhood education, which is essential if Kosovo is to take advantage of the young population to generate future growth. Savings could also be used to expand and improve existing social protection mechanisms, which is especially important because of the introduction of obligatory health insurance.

⁵² See World Bank (2014b).

3.12. **The reorientation of public spending will help equip Kosovars, especially young Kosovars, to participate in and benefit from economic growth.** Because of its young and growing population, Kosovo has the opportunity to cash in on a demographic dividend that could help accelerate growth and reduce poverty. Improving and investing in education early and for all will be essential to the development of a more productive economy and may benefit poorer families more. Yet, relative to its neighbors and other countries at comparable income levels, Kosovo underinvests in the development of youth. Education spending is only 4.1 percent of GDP, and much of that is directed to wages, while limited resources are directed to other quality-related investments. As a result, primary and secondary education especially suffers from large disparities in quality across regions, and few children are enrolled in early development or preschool programs. Similarly, the children in poorer households do not reach their full potential because of poor health outcomes that compromise their ability to be productive workers. Health spending has emphasized central hospitals and equipment rather than primary and preventive care.

3.13. **The reprioritization of expenditure should go hand in hand with efforts to improve efficiency and reallocate resources within sectors.** Spending increases in health care and education, in particular, should be associated with improvements in the efficiency of spending to ensure that real improvements in services are delivered. For instance, some health services that poorer groups are more likely to use are especially underfunded. Likewise, the social protection budget has been progressively reoriented away from protecting the poor and toward special interest groups. Existing roads are in poor condition and need maintenance. At the same time, tighter controls over procurement could cut costs by reducing corruption.

3.14. **However, the extent of eventual private sector participation in building new power generation facilities represents the most important factor in shaping public spending in the sector over the medium term, crowding out other expenditures.** The sector is in urgent need of significant investment in new power generation initiatives. Closing the power gap requires building a new thermal power plant, which is estimated to cost between €1 billion and €1.5 billion, or between 20 and 30 percent of GDP. Phasing in the construction over time would be sufficient to close the power gap in the immediate future, but would most likely increase the cost per unit of capacity because of reduced economies of scale compared with a single-step construction process.

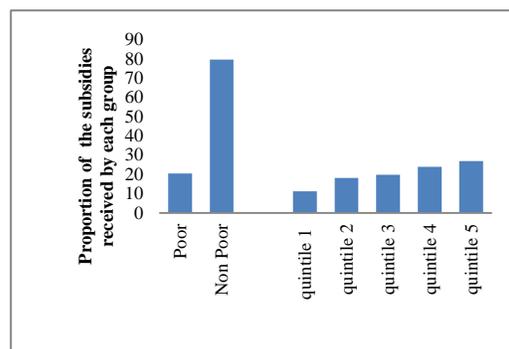
3.15. **Regardless of the extent of private sector participation, adjusting tariffs that fully reflect costs and affordability concerns would bear consideration.** Between 2008 and 2012, the debt owed by mostly state-owned companies in the energy sector increased 10-fold. By the end of 2012, the debt of energy companies had reached 5 percent of GDP or over three-quarters of the annual income of these companies. In addition, they depended on grants from donors and loans from the government for around 20 percent of their total income. Cost-reflective energy tariffs would reduce the need for ad hoc subsidies to utility companies, but would raise the fiscal costs of the compensations necessary to protect poor and vulnerable consumers from the price adjustments. Energy efficiency measures implemented in buildings, in parallel with the required rise in electricity tariffs, would help mitigate the impact on poor and vulnerable consumers.

Box III.2. Energy Subsidies and Costs

Although the subsidies are not part of the social protection budget, poor Kosovars benefit from explicit and implicit energy subsidies. These aim to protect poor groups from rising energy prices, to reduce energy poverty (spending more than 10 percent of household expenditure on energy), and ensure sufficient access to energy among poorer households.

Similar to the average monthly stipend of €63, social assistance beneficiaries received explicit annual energy subsidies in the range of €120–€130 per household between 2008 and 2012. These subsidies were distributed at a cost of around €4.5 million a year, or 0.1 percent of GDP. Although the bulk of these explicit subsidies went to the poorest households, most poor households did not receive them because of the low coverage of the social assistance program. In addition, the energy tariff structure was designed to provide implicit subsidies from large, presumably wealthier consumers to smaller consumers by charging lower prices per kilowatt hour among smaller consumers than among larger ones. These implicit cross-subsidies did little to help the poor. A recent analysis shows that this mechanism was regressive and that wealthier consumers received more (27 percent among the richest quintile) than poorer consumers in 2011 (only 11 percent) because of their consumption capacity (figure BIII.2.1).

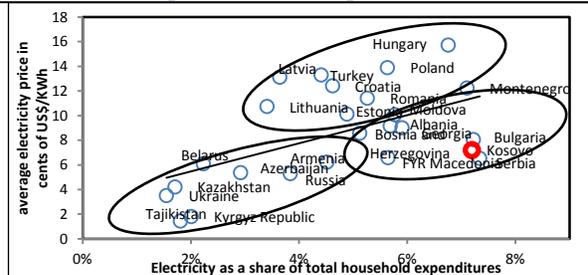
Figure BIII.2.1. Distribution of the Implicit Electricity Subsidy across the Population, Kosovo 2011



Source: HBS 2011.

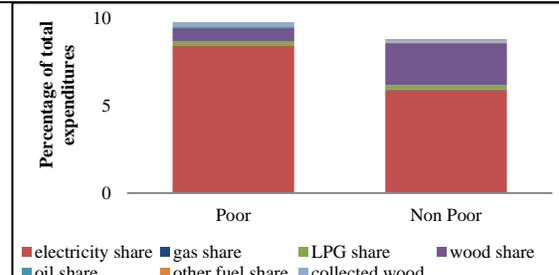
Electricity prices are low in Kosovo compared with other countries in the region, but electricity represents a larger share of spending in Kosovo than other countries, especially among the poor (figure BIII.2.2). In 2012, the average consumer tariff was €0.0688 per kilowatt hour after taxes, significantly below the regional average of €0.0797. Despite this, Kosovo's households spent a larger share of their expenditure on energy than households in almost any other country in Europe or Central Asia. Poor households spent an average of 8.4 percent of their expenditures on electricity in 2011, compared with 5.9 percent among nonpoor households (figure BIII.2.3).

Figure BIII.2.2. Electricity Price and Share of Total Household Expenditure, Europe and Central Asia



Source: World Bank 2013a, updated with Kosovo data of the HBS and Tariff Database, Energy Regulators Regional Association, Budapest, <http://erranet.org/Products/TariffDatabase>.

Figure BIII.2.3. Share of Energy Expenditure, by Quintile, Kosovo, 2011



Source: HBS 2011.

Future energy cost increases will be necessary, but will likely pose risks for poor or vulnerable households. Although there would likely be some behavioral adjustment, the projected large price rise would affect some households severely. Part of the solution lies in smoothing the cost increase to give households time to adjust. While there are already explicit subsidies given to recipients of social assistance and ineffective implicit subsidies, social protection may need to be expanded to help the poorest groups cope with the increases. The alternative would be more poverty and more widespread nonpayment of energy bills. Among households in the poorest quintile, 52 percent reported no spending on energy in 2011, compared with 6 percent among the top quintile; the situation would risk worsening without corrective social protection measures. Therefore, taking steps to identify the most vulnerable groups and, if needed, modifying social assistance criteria to ensure that the poorest and most vulnerable households are able to access energy is necessary. Additionally, energy efficiency measures that would help reduce the household demand for energy would also help mitigate the impact of higher electricity tariffs.

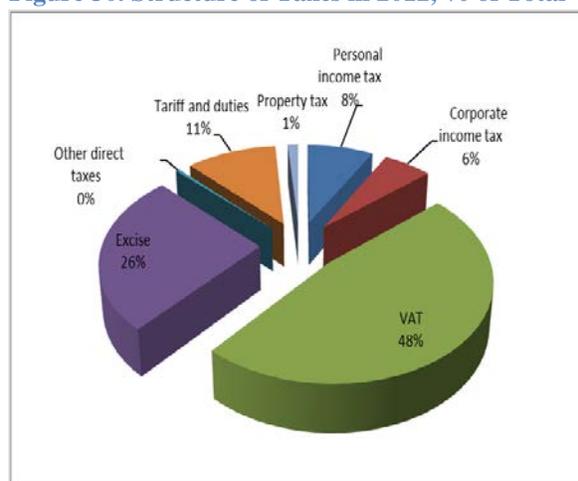
3.16. **More efficient public spending can promote growth and enhance the inclusiveness of growth through more job creation.** Labor supply measures such as improved education and health care that prepare the future workforce more effectively are not sufficient because the demand for labor also needs to be raised. Electricity supply in Kosovo is insufficient to meet present demand, and its unreliability imposes significant costs on both large and small businesses, which is a deterrent to investment and job creation. A private investor has submitted a bid to build a new power plant, and that bid has been accepted by the government, subject to the successful conclusion of ongoing contract negotiations. While the ultimate budgetary impact of bringing the new plant online and decommissioning the Kosovo A Power Station is still unknown, the transition presents an opportunity to shift public spending on energy away from broad subsidies toward more well targeted relief so low-income households are able to cope with the anticipated electricity tariff increases. In the transport sector, greater emphasis on local and feeder roads, as opposed to major highways, is also expected to foster investment and job growth.

3.17. **More efficient public spending will free up resources to improve the effectiveness of social safety nets to protect the vulnerable and those affected by economic shocks.** Because public spending has emphasized capital investments, the benefits of social safety nets to protect the poor and vulnerable have shrunk in real terms. There is also considerable scope for more efficient spending within the social protection system by directing more spending toward expanding the coverage of means-tested benefits such as the last resort social assistance program, which currently covers only one-third of households in the poorest decile, and less toward categorical transfers that primarily benefit special interest groups.

Strengthening tax administration and shifting toward direct taxation

3.18. **Meeting all fiscal needs will be challenging in an environment where the valued added tax (VAT) on imports, import duties, and excise taxes, which make up over 70 percent of total revenues, are expected to stagnate if not fall.** At about 22.6 percent, the tax-GDP ratio is relatively low, and the Ministry of Finance has estimated that the SAA with the EU will have a negative impact on revenues, gradually reaching about €60 million annually within five years, while the trade agreement with Turkey will reduce revenues by €20 million or 0.4 percent of GDP annually.⁵³

Figure 30. Structure of Taxes in 2012, % of Total



Source: Ministry of Finance

3.19. **The current tax structure is aligned with the import-heavy, transfer-dependent Kosovar economy, which is characterized by weak labor participation.** The tax structure has proven revenue effective, owing in large measure to Kosovo’s well-designed VAT system (figure 31). The tax regime in Kosovo

⁵³ October 28, 2013, marked the start of the negotiations for an SAA with the EU, and the agreement came into force in April 2016. A trade agreement with Turkey was signed in October 2013 and came into force in 2015.

has one of the lowest rates in the region. The corporate income tax (CIT) rate is 10 percent, and the VAT rate is 18 percent. The tax laws are simple and uncluttered, with few exemptions. Indirect tax revenues account for 84 percent of tax revenues and are mainly collected at the border through VAT, excise, and customs duties, which make tax revenue highly dependent on imports, but also less distortionary. The main direct taxes are a progressive personal income tax (PIT) and the CIT, which, together, accounted for about 16 percent of total tax revenue in 2013.⁵⁴

3.20. **After many years of strong revenue performance, Kosovo experienced a weak 2014, with a rebound in 2015.** Revenue performance was strong until 2011, but slowed thereafter (table 10). Approximately three-quarters of revenues were produced by indirect taxes in 2014. Taxes on goods and services grew by 33.6 percent over 2008–13, of which VAT growth was most rapid (53.2 percent), followed by excise taxes (20.0 percent). The growth of customs tariff revenue and other border revenue slowed during 2012 and declined in 2013, partially driven down by price effects and import substitution effects.⁵⁵ Although there was positive economic growth of 2.5 percent in 2014, and no tax policy changes, the tax administration of Kosovo collected fewer revenues than in the previous year for the first time since its establishment. Total revenues were short of the planned level by 9.6 percent in 2014; border taxes were short by 6.9 percent; and domestic taxes were short by 17.4 percent. Only less than complete execution of the capital budget helped the short-term fiscal balance remain within plan. However, a combination of both collection efforts and policy change (VAT rate) contributed to a rise in tax revenues in 2015.

Table 10. Revenue Performance, 2008–15

	2008	2009	2010	2011	2012	2013	2014	2015
Total revenue (including grants)	23.9	28.3	26.6	27.2	26.4	25.8	24.4	25.4
Tax Revenue	20.4	19.3	20.5	22.2	21.6	21.2	20.9	22.0
Value Added Tax (VAT)	8.7	9.0	9.9	10.8	10.3	10.0	10.1	10.6
Customs tariffs	2.4	2.3	2.4	2.5	2.3	2.3	2.3	2.3
Excise	5.2	4.9	5.3	6.0	6.0	5.8	5.7	6.1
Profit tax	3.0	2.2	1.9	1.7	1.8	1.9	1.8	1.8
Personal income tax (PIT)	1.1	0.9	1.0	1.2	1.2	1.3	1.2	1.3
Non-tax revenue	3.5	8.2	5.4	4.6	4.1	2.7	3.1	3.3
Non-tax central level revenue	2.4	7.0	4.2	3.5	3.2	1.6	2.3	2.7
o/w Dividend from PTK	0	4.9	2	1.3	0.9	0.8	0.3	0.3
Municipal Own source revenues	1.1	1.2	1.2	1.2	1.2	1.1	1.1	0.9
Grants for budget support	0.0	0.8	0.7	0.4	0.7	0.0	0.0	0.0

Source: Treasury Department, Ministry of Finance.

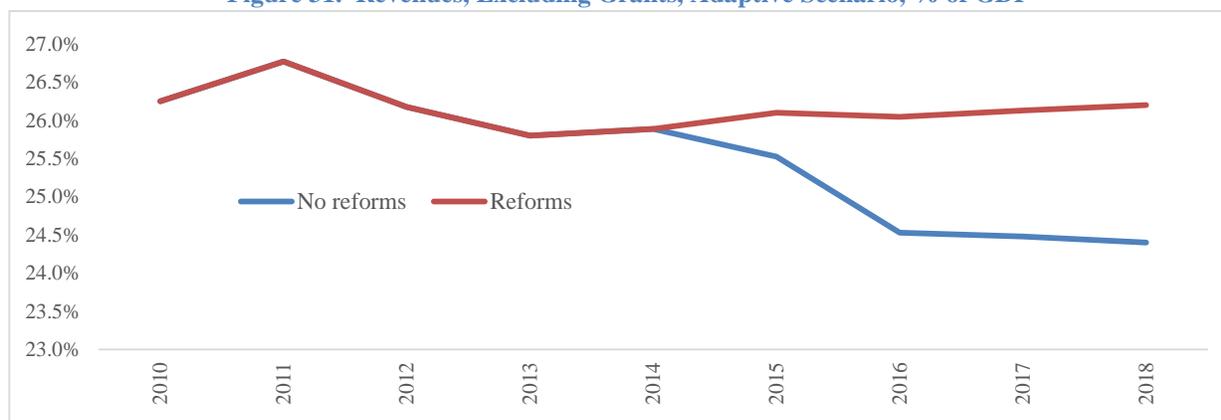
3.21. **Total revenues are projected to decline as a share of GDP over the medium term in the absence of measures to bolster domestic revenues to compensate for falling border revenues.** A gradual shift toward direct taxation would be necessary as domestic production increases and integration with the EU and free trade agreements advance. Given their relatively low level, in addition to the recent increase in VAT to 18 percent, an increase in the CIT to 15 percent from the current 10 percent could be considered. There also appears to be scope to raise PIT rates, especially among the higher-income brackets, from the current low 10 percent rate, perhaps to 15 percent, reflecting greater progressivity. There is also scope to raise property tax rates, which are low in Kosovo compared with most SEE countries. Additional enforcement efforts in the PIT, property taxes, and the domestic VAT would boost collections and raise compliance. Together, these reforms

⁵⁴ The PIT ranges from a low of 4 percent to the highest marginal rate of 10 percent.

⁵⁵ Kosovo Customs reported that 2013 revenues collected at the border missed the plan by 8.8 percent and were 1 percent lower relative to 2012.

may help raise revenues to above 26 percent in 2018, significantly higher than the approximately 24.5 percent projected without reform (figure 32).

Figure 31. Revenues, Excluding Grants, Adaptive Scenario, % of GDP



Source: World Bank estimates

3.22. Raising additional domestic revenue from income taxes is feasible. A tax-gap analysis shows that the revenue potential from the PIT is three times the amount currently collected. Kosovo has one of the lowest PIT-revenue productivity rates in the region. Bosnia and Herzegovina, Bulgaria, and FYR Macedonia, at similar tax rates, collect about twice as much PIT revenue as a share of GDP (table 11). Kosovo's outcome is a result of a combination of (a) PIT exemptions among several categories of income, which narrows the tax base; (b) weak tax administration; and (c) large shadow employment that is not adequately captured. While serious efforts have been made by the tax administration to improve performance, much more needs to be done.

Table 11. Regional Comparison of Income Tax Performance, Excluding Presumptive Taxes, 2011

	Statutory CIT rate, %	Top marginal PIT rate, %	CIT revenue, % GDP	PIT revenue, % GDP	CIT + PIT yield, % GDP	CIT productivity	PIT productivity
Kosovo	10	10	1.3	1.2	2.5	0.13	0.12
FYR Macedonia	10	10	0.8	2.1	2.9	0.08	0.21
Moldova	12	18	0.7	2.2	2.9	0.06	0.31
Bosnia and Herzegovina	10	10	0.8	2.3	3.1	0.08	0.23
Tajikistan	25	13	1.4	1.9	3.3	0.06	0.15
Albania	10	10	1.5	2.1	3.6	0.15	0.21
Bulgaria	10	10	1.9	2.9	4.8	0.19	0.29
Armenia	20	25	2.6	2.2	4.8	0.13	0.09
Montenegro	9	9	2	3.3	5.3	0.22	0.37
Turkey	20	35	1.9	3.6	5.5	0.1	0.1
Azerbaijan	20	30	4.3	1.4	5.7	0.22	0.05
Serbia	15	15	1.2	4.7	5.8	0.12	0.31
Croatia	20	40	2.4	3.5	5.9	0.12	0.09
Kyrgyz Republic	10	10	4.2	2	6.2	0.42	0.2
Belarus	24	12	3.1	3.2	6.3	0.13	0.27
Russian Federation	20	35	4.2	3.7	7.9	0.21	0.28
Georgia	15	20	2.8	5.9	8.7	0.19	0.3
Ukraine	25	17	4.1	4.7	8.8	0.16	0.31
Kazakhstan	20	10	8.2	1.4	9.6	0.41	0.14

Source: World Bank 2013b.

3.23. To this end, a number of changes in tax policy have recently been adopted. The government has approved a change in the VAT from a flat 16 percent to 8 percent for energy and basic items such as food and 18 percent for other products and services. A VAT exemption was adopted on imports of machinery to encourage direct investment and align the tax to the tax profile in neighboring countries. The Ministry of

Finance and Kosovo Electricity Corporation agreed to restructure the corporation's debts so they can be paid by the corporation.⁵⁶

3.24. **The tax policy framework should reflect the compliance environment, the size of the shadow economy, which is estimated at 27–35 percent of GDP, and the capacity of the tax administration based on international best practice adapted to the needs of the country.** It is critical to strengthen tax administration by enhancing the quality and quantity of tax inspectors and updating risk assessment modules, including by carrying out random audits to find areas for improvement. Efforts should also be made to fight tax evasion and encourage formality (box III.3). Anecdotal evidence suggests that, even in cases in which the tax administration attempts to pursue evaders, it faces obstacles in the judicial system.

Box III.3. Informality

A recent World Bank study on tax policies, revenues, and tax evasion revealed that there is a significant tax gap.^a The gap is composed of a VAT gap of about 34 percent that was attributed largely to low VAT collections from domestic suppliers; a PIT gap of about three times current collections; and a CIT gap estimated at about 17 percent of current collections. In addition, the size of the underground economy in 2004–11 was estimated at between 7.5 percent and 18.8 percent; this partly explains the tax gap, but also reinforces the need to bring a greater proportion of the economy into the formal sector to broaden tax revenues. The results of the perceptions of tax implementation survey conducted by the World Bank in June 2013 suggest there is a widespread belief among firms in Kosovo that other firms evade taxes. Respondents believe that around half of firms evade some of the legally owed VAT and CIT taxes. Many firms also reported that their competitors underreport the number of people they employ or their staff wages to reduce the amount of PIT they need to pay. Firms believe that political connections are key to escaping the penalties for tax evasion. Changes in methodology in the Kosovo LFS—persons working on small farms who do not sell their products, but produce only for self-consumption are no longer considered employed—caused the agricultural share of employment to drop by 14 percent. The European Commission estimates that the share of agriculture in total employment accounted for approximately 35 percent, including small and informal farmers, while the Kosovo LFS estimates 6 percent. Using a broader definition of agricultural employment, the 2014 agricultural census that was released at the end of 2015 counted 362,700 persons working in agriculture (86,620 full-time equivalents), more than the 2015 LFS estimate of 323,508 persons.

The informal economy was growing in the 1990s when local Albanians were distancing themselves from the Yugoslav state, and large numbers of Kosovars were left formally jobless.^b In the late 1990s, the economy consisted of small privately owned farms, about 200 socially owned enterprises (mostly inactive or in poor condition), and many privately owned microenterprises and small businesses. Currently, over 95 percent of the businesses in Kosovo are microenterprises or small firms (employing between one and nine workers). They are typically found in sectors with low entry barriers, such as trade or services. Family farms and medium and large enterprises represent the remaining businesses.^c

The survival of large-scale informal activities is fostered by the lack of appropriate enforcement of the regulatory framework, rather than the cost of formal economic activities. Indeed, business taxes, lowered to discourage tax evasion, are among the lowest among the SEE6 countries, at 10 percent for the CIT. Albania and Serbia have a CIT rate of 15 percent; Bosnia and Herzegovina and FYR Macedonia have the same rate as Kosovo; Montenegro has the lowest rate, at 9 percent. Kosovo also has the lowest VAT rate in the region, at 16 percent.^a Because the overall enforcement of laws is low in Kosovo, tax evasion is perceived to be widespread and linked to substantial corruption among politicians, the customs administration, and the tax administration.

The impact of informality goes beyond taxes; it affects competition. The single largest constraint on business most frequently cited among firms in Kosovo (26 percent) is the behavior of the informal sector, which creates a negative incentive for formal companies.^d

Notes:

- a. World Bank (2014c).
- b. Maliqi (1998).
- c. UNDP (2007).
- d. BEEPS survey data 2013.

⁵⁶ Other measures include the increase in the excise tax on tobacco and alcohol and the introduction of a new excise tax on cooking oil. Age limitations on the importation of cars were also removed.

IV. A MORE ATTRACTIVE ENVIRONMENT FOR PRIVATE SECTOR INVESTMENT AND BUSINESS EXPANSION IN TRADABLE SECTORS

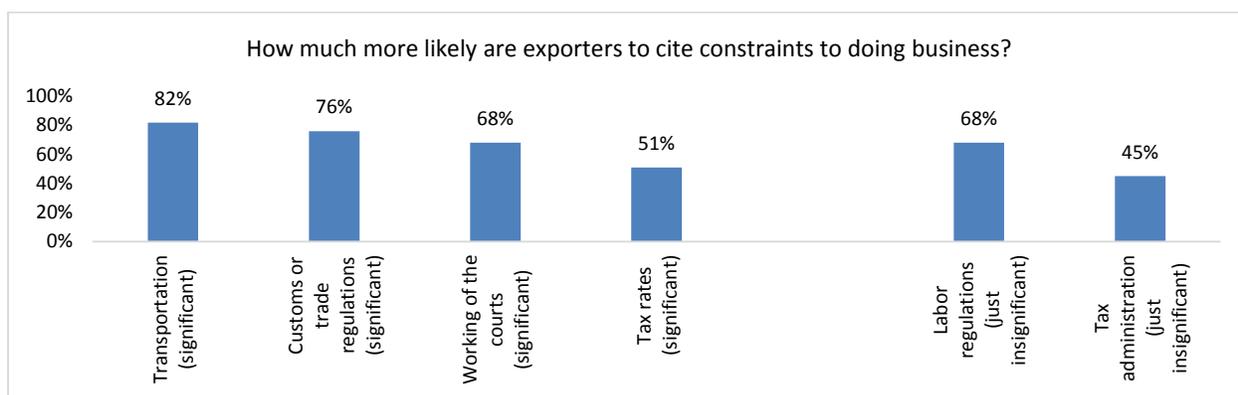
4.1. **Boosting growth and fostering shared prosperity will require a more attractive environment for private sector investment and business expansion in tradable sectors to reap the full benefits of European integration.** Kosovo already shows comparative advantages in a number of products (garments, textiles, and food) and services (travel and communications). Manufacturing not only has the potential to spur income and exports, but also to generate employment among unskilled workers and more highly skilled workers. Skilled manufacturing workers tend to be concentrated in the garment, and food processing subsectors, Modern services are also a major source of income and have the potential to transform the economy, given the direct impact on other sectors and human capital formation.

4.2. **However, these sectors have been constrained by the lack of the strong soft and hard infrastructure necessary to provide an attractive business environment and enhance competitiveness in the tradable sector, level the playing field relative to the nontradable sector, and, ultimately, create quality jobs and foster inclusion.** In the absence of a strong indigenous private sector equipped with sufficient capital resources, attracting international investment becomes important to the achievement of Kosovo's economic growth and diversification objectives. Migration from lower to higher value added jobs will depend on the ability of local companies to integrate into global production value chains. International investment is the pathway to such integration, the creation of jobs, infusions of capital and new technologies, and knowledge spillovers.

4.3. **Low competitiveness has led to a weak private sector and poor economic vitality among SMEs.** To date, the productive base in the economy has been narrow and undiversified. The service and agricultural sectors are large (54.4 percent and 11 percent of GDP, respectively). Manufacturing is limited (10.1 percent), and the tradables sector is small. More than 98 percent of businesses are family-owned microenterprises and SMEs. The challenges are reinforced by an unfavorable business environment, a deficit in quality infrastructure, and the poor access of firms, especially SMEs, to technology and finance, stifling their growth prospects.

4.4. **Exporting firms are considerably more likely than other firms to report they face constraints, suggesting that the constraints could be tackled to help boost exports.** The BEEPS survey data reveal that, even after one controls for other firm characteristics, exporters are 82 percent more likely than other firms to report that transportation is a constraint to doing business, 68 percent more likely to report that the workings of the courts are a constraint, and 76 percent more likely to report that customs or trade regulations are a constraint (figure 33). Relative to other firms, they also find tax rates more burdensome, perhaps because they have to face more competition.

Figure 32. Exporters Are Much More Likely Than Other Firms to Face Numerous Constraints



Source: BEEPS survey data and World Bank calculations.

Note: Estimates after controlling for other firm characteristics.

Good Governance and Strengthening the Rule of Law

4.5. **Good governance, including the quality of institutions, the rule of law, property rights, and the justice system are all elements of the soft infrastructure necessary for a well-functioning, competitive, and innovative market economy.** Effective implementation of the legal, regulatory, and administrative framework governing the economy would help remove the remaining socialist legacy and enhance firm competitiveness to withstand competitive pressures and to connect with global value chains, thereby generating jobs and spurring competition, innovation, and productivity increases. While composite governance indicators show improvements over 2003–13, a significant governance gap remains relative to the EU member states and regional neighbors (table 12). Moreover, improvements have been made only in the voice and accountability, rule of law, and government effectiveness indicators, while the values of other indicators have deteriorated or stagnated since 2008.

Table 12. World Governance Indicators, 2003–13

WGI composites	Year	Minimum governance, -2.5 to +2.5		Minimum percentile rank	
		SEE6	Kosovo	SEE6	Kosovo
Voice and accountability	2003	-0.06	-0.47	45.43	34.13
	2008	0.08	-0.32	51.12	37.5
	2013	0.01	-0.27	49.05	40.28
	2015	0.013	-0.18	48.52	41.38
Political stability and absence of violence/terrorism ^a	2003	-0.6	..	52	..
	2008	0.07	1.04	48.33	85.17
	2013	-0.21	-0.98	40.6	18.01
	2015	-0.04	-0.33	45	35.24
Government effectiveness ^a	2003	-0.58	..	31.71	..
	2008	-0.28	-0.5	45.55	37.38
	2013	-0.2	-0.41	47.77	40.67
	2015	-0.09	-0.42	50.8	39.42
Regulatory quality ^a	2003	-0.08	..	52.43	..
	2008	0.1	-0.01	56.6	53.88
	2013	0	-0.04	52.32	52.63
	2015	0.09	-0.30	55.61	42.79
Rule of law	2003	-0.75	-1.06	27.11	15.79
	2008	-0.44	-0.6	40.06	34.13
	2013	-0.31	-0.57	44.95	36.02
	2015	-0.23	-0.47	47.84	37.02
Control of corruption	2003	-0.59	-0.81	34.64	22.93
	2008	-0.36	-0.59	44.25	32.52
	2013	-0.35	-0.64	44.98	30.62
	2015	-0.30	-0.52	47.20	36.54

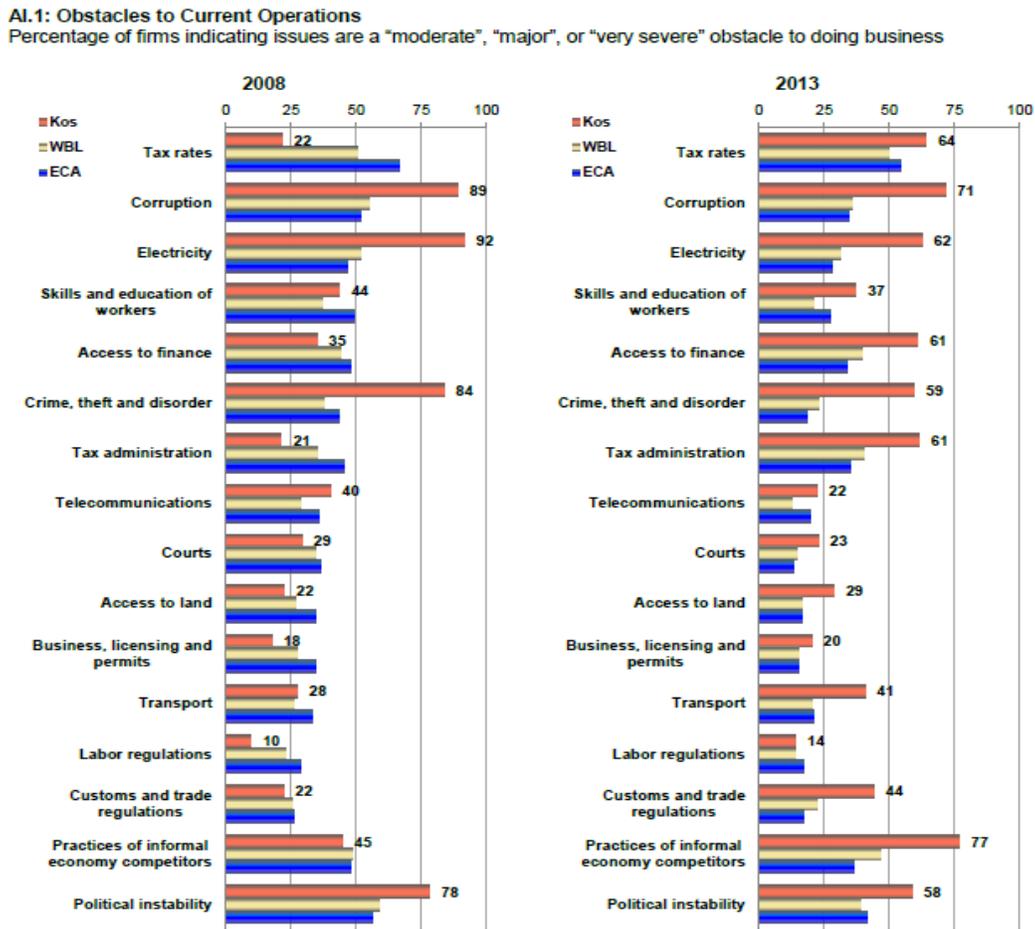
Source: Data of WGI (Worldwide Governance Indicators) (database), World Bank, Washington, DC, <http://info.worldbank.org/governance/wgi/index.aspx#home>.

Note: WGI = World Governance Indicators.

a. Four-country average.

4.6. **The inadequate sophistication and performance of governance institutions limit Kosovo's economic development.** Domestic companies face an uneven playing field in local and international markets. When asked about the single most important obstacle to their growth and operations, 25 percent of firms responding to the BEEPS survey pointed to the informal economy, which, they say, distorts the market and disadvantages businesses that comply with the law (figure 34). The second and third most often cited obstacles were access to finance, in which property rights over collateral is an important element (16 percent), and corruption (11 percent). Corruption and crime, theft, and disorder are still considered major obstacles to business success, although the share of firms reporting these concerns is declining (from 84 percent in 2008 to 51 percent in 2013 for corruption and from 66 percent to 47 percent for crime, theft, and disorder). Inadequate skills and educational attainment among the labor force is cited by 23 percent of firms as a major obstacle, although only 5 percent say it is the single biggest constraint.

Figure 33. Obstacles to Current Operations (% of firms)



4.7. **Addressing gaps in soft infrastructure would also help strengthen social cohesion.** Decisions on public expenditures also need to follow economic and social needs consistently, strengthen the ability of the government to act strategically, track policy implementation, and reduce the opportunities for corruption, the exercise of undue influence, and politically motivated spending decisions in nonurgent areas.⁵⁷ The last risks squeezing investments in critical areas to ensure sustained growth and poverty reduction, add to social tensions among ethnic groups and disadvantaged people, and increase the perception of the existence of a social divide between insiders and outsiders.

4.8. **The bottom 40 and minorities are particularly disadvantaged in accessing the justice system because there is no functioning legal aid network.** Legal aid is delivered through a small patchwork of legal aid centers. Eight of the 13 centers previously funded by the United Nations Development Programme have recently closed. The total number of legal aid recipients is unknown. Centers lack resources and coordination

⁵⁷ Spending pressures today stem largely from politically powerful lobbying groups focusing on (a) pensions, (b) veterans benefits, (c) benefits for former political prisoners, (d) public sector salaries, and (e) low-value transport infrastructure.

mechanisms to deliver basic services to those in need.⁵⁸ Vulnerable groups are at particular risk, despite legal protections.⁵⁹ The LGBT community is routinely subject to threats and attacks, as are journalists, particularly those reporting on allegations of corruption. Gender-based violence and human trafficking cases go largely unreported because there is little support available for victims pursuing claims.

4.9. **Significant progress has been made in establishing the legal framework and institutional structures necessary for a market-oriented economy, but there is a large regulatory gap that undermines the predictability needed by firms.** Most of the necessary commercial legislation has been enacted in line with EU standards, including laws on companies, bankruptcy, contracts, the registration of real property rights, foreign investment, accounting, and mortgages. However, weak institutional capacity, transparency, accountability, and regulatory enforcement undermine the implementation of many elements of the legislation and are a major obstacle to successful business operations.⁶⁰ Inconsistency in the application of regulations across institutions, as well as between the national and local levels, creates regulatory gaps that diminish predictability and limits transparency in decision making. Predictability and transparency in the institutional environment are critical components of a business climate conducive to growth. Firms report that institutional and governance obstacles negatively affect their sales and employment growth. Evidence from recent firm surveys, particularly BEEPS, together with anecdotal evidence, point up this inconsistency in the application of laws and regulations.

4.10. **Reported and perceived corruption reveals weaknesses in governance and the regulatory environment.** Corruption was identified as the single largest obstacle to entrepreneurship by 11 percent of the Kosovo businesses surveyed in the BEEPS 2013 survey. Limited progress over the years since independence has left Kosovo with a significant achievement gap relative to its neighbors and the EU in establishing an effective governance regime and controlling corruption. According to the 2015 Transparency International Corruption Perception Index, Kosovo was ranked 103th among 167 countries and was the worst performer among the SEE6. The Gallop World Poll shows an even more pronounced relative deterioration in the position of Kosovo in voice and accountability and in the control of corruption. In that poll, 84 percent of the local respondents reported that corruption is widespread in government, and 72 percent reported that it is widespread in business.

Table 13. Transparency International Corruption Perception Index, 177 Countries, 2013

<i>Country</i>	<i>Rank</i>	<i>Score</i>
Kosovo	103	33
Albania	88	36
Bosnia and Herzegovina	76	38
FYR Macedonia	66	42
Montenegro	61	44
Serbia	71	40
Bulgaria	69	41
Romania	58	46

Source: CPI (Corruption Perceptions Index) (database), Transparency International, London, <http://www.transparency.org/research/cpi/overview>.

⁵⁸ In 2012, it was estimated that, if the budget for the Legal Aid Commission were increased by 20 percent each year for three years, it would still be unable to meet the need for services. See Ohrid Free Legal Aid Initiative (2012).

⁵⁹ EC (2014a).

⁶⁰ EC (2014a).

Table 14. Business Survey: Widespread Corruption

Country	Yes, in business, %	Yes, in government, %
Kosovo	72	84
Albania	68	73
Bosnia and Herzegovina	86	81
FYR Macedonia	86	74
Montenegro	66	49
Serbia	82	71
Croatia	83	77

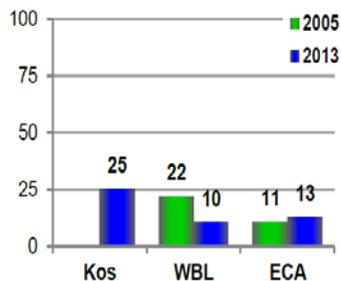
Source: Nyiri and Gravelle 2007.

4.11. **Inefficient regulations also constrain the private sector, raise the costs and risks associated with doing business, and present opportunities for corruption.** Administrative corruption in the government and civil service is a direct additional administrative and financial burden on firms and thus stifles firm growth and development. The number of reported incidents of administrative corruption is rising in Kosovo, although still relatively rare, compared, for example, with Albania. The perception of state capture is widespread, particularly affecting large procurement contracts, privatization, and concessions.⁶¹ Despite the progress in establishing the legal and institutional framework, including public procurement and asset disclosure among public officials, there is a significant gap in implementation.⁶² A quarter of firms believe that the practice of giving gifts and bribes to elected and appointed public and government officials at all levels to influence their legislative and regulatory decision has a major or decisive impact on their businesses. The composite graft index is rising in Kosovo and is more than double the averages among the SEE6 and in the Europe and Central Asia region (figure 35).

Figure 34. Private payments/gifts or other benefits to parliamentarians/officials to gain advantages

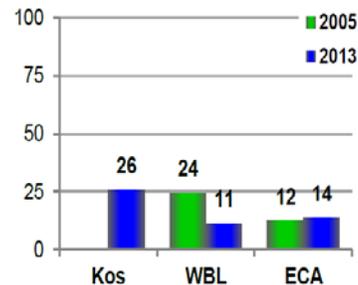
13.1b: Private payments/gifts or other benefits to parliamentarians to gain advantages

Percentage of respondents indicating gifts/payments have "moderate", "major", or "decisive" impact



13.2b: Private payments/gifts or other benefits to government officials to gain advantages

Percentage of respondents indicating gifts/payments have "moderate", "major", or "decisive" impact



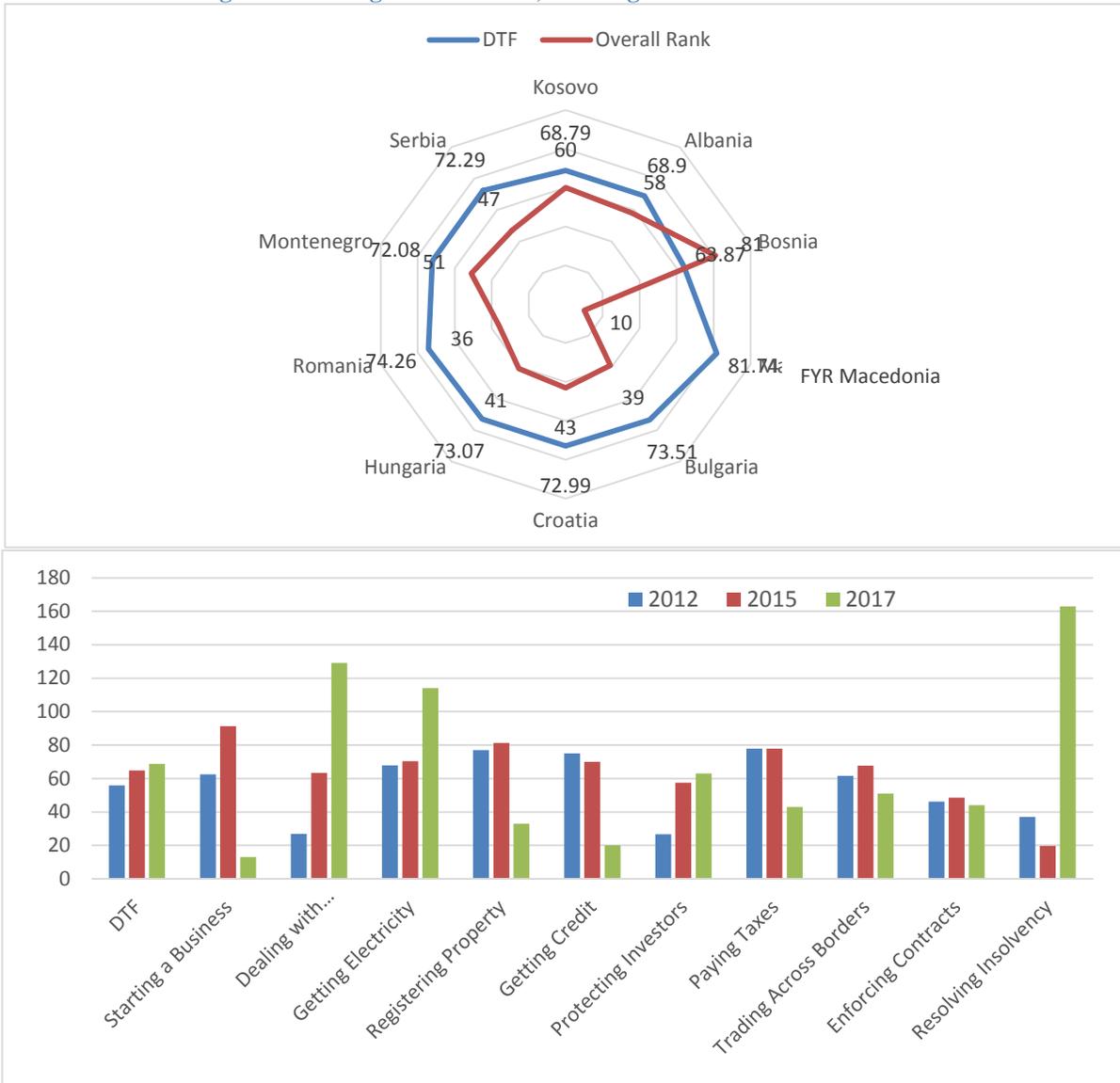
61 EC (2014a).

62 A new e-procurement system is under development and is expected to come online in 2016. The first government-wide centralized procurement of fuel has been finalized, and several other packages for centralized procurement are being prepared.

Strengthening the Business Climate

4.12. Some aspects of Kosovo’s business climate have improved considerably in recent years, but Kosovo continues to rank poorly in the Doing Business survey. Compared with the averages of relevant comparators, Kosovo fares well in some aspects, but other constraints constitute considerably higher hurdles for businesses (figure 36). Relative to the SEE6 countries, Kosovo firms of all sizes rate resolving insolvency (rank 163), enforcing contracts (rank 44), construction permits (rank 129), trading across borders (rank 51), and getting electricity (rank 114) as the most important impediments to doing business. Distance to the frontier is considered to be a better measure of the doing business environment, and, Kosovo, thanks to improvements in the last few years, Kosovo performs better than few of its neighbors.

Figure 35. Doing Business 2017, Ranking and Distance to the Frontier



Source: Doing Business (database), International Finance Corporation and World Bank, Washington, DC, <http://www.doingbusiness.org/data>.

4.13. **Violations of contracts are common, and weak contract enforcement dampens the business climate.** According to the *Doing Business Report 2017*, Kosovo is below the average in the Europe and Central Asia region for time, cost, and procedures to enforce contracts and is lowest among its regional neighbors and comparator small states.⁶³ According to the BEEPS 2013 survey, the share of firms reporting that the court system is able to enforce decisions fell from 55 percent in 2008—the average among the economies of the western Balkans and the Europe and Central Asia region—to 38 percent in 2013. Furthermore, 68 percent of the surveyed firms reported that the courts are not a problem for their operations, which is lower than the averages in the western Balkans and the region. Weak contract enforcement appears to impact the market in two ways: first, it has created concern among investors and companies in Kosovo and, second, it has contributed to high interest rates at commercial banks.

4.14. **Delays in court cases frustrate users and undermine trust in the rule of law.** The courts have been failing to resolve as many cases as they receive; so, backlogs have been growing each year. The share of firms reporting that the judicial system is quick has shrunk by more than half, from 39 percent in 2008 to 18 percent in 2013, and is lower than the averages in the western Balkan and the region. Despite the need for action, the courts have yet to implement the Kosovo Judicial Council's instruction on the prioritization of backlogged cases. Case backlogs are symptomatic of an inefficient case processing system, which is not centralized, is largely paper based, and routinely loses files, including criminal records. Such inefficiencies undermine public trust in the ability of the courts to regulate business, handle disputes, and curb corruption. These concerns may explain why, in 2013, Kosovo firms used the courts half as often as an average firm in the region or in the SEE (13 percent, 24 percent, and 28 percent, respectively).

4.15. **The perception of the judiciary's fairness, expeditiousness, and ability to enforce decisions has significantly deteriorated.** The share of firms perceiving the court system as fair, impartial, and uncorrupt fell by 23 percent, the third largest drop among the 29 countries surveyed in the Europe and Central Asia region. In 2008, Kosovar firms enjoyed the sixth highest relative perception of fairness of the court system among countries in the region and the highest relative perception among western Balkan comparators. By 2013, the relative ranking had gone down to 20th in the region and last among all countries in the western Balkans, except Serbia (23rd in 2013). According to the Public Pulse Project of the United Nations Development Programme, the share of the population that perceives corruption in the courts rose from 41.6 percent in 2011 to 56.4 percent in 2013 with a reduction to 42.3 percent in April 2016.⁶⁴ The same survey found that only approximately 18.4 percent of citizens were satisfied with the work of the judicial system. Although the legislative framework in Kosovo guarantees an independent judiciary, appointment procedures for judges and prosecutors are politicized, and disciplinary mechanisms are weak.

4.16. **Few corruption cases reach the courts.** The legislative framework against corruption has improved through new criminal and procedural codes in 2013, but few cases have proceeded through the courts. Implementation of the anticorruption strategy and action plan has yet to generate results because of weak political support. The strengthening of the Anti-Corruption Agency's oversight and preinvestigation functions would be a welcome step, as would enhanced coordination between the agency and the Office of the Prosecutor.

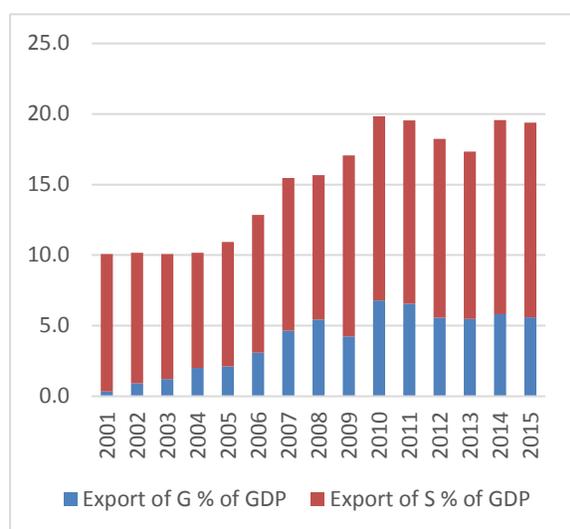
⁶³ World Bank (2015a).

⁶⁴ See "Public Pulse: Project Summary," United Nations Development Programme, Pristina, Kosovo, http://www.ks.undp.org/content/kosovo/en/home/operations/projects/democratic_governance/PublicPulse.html,

Increasing the integration into global value chains

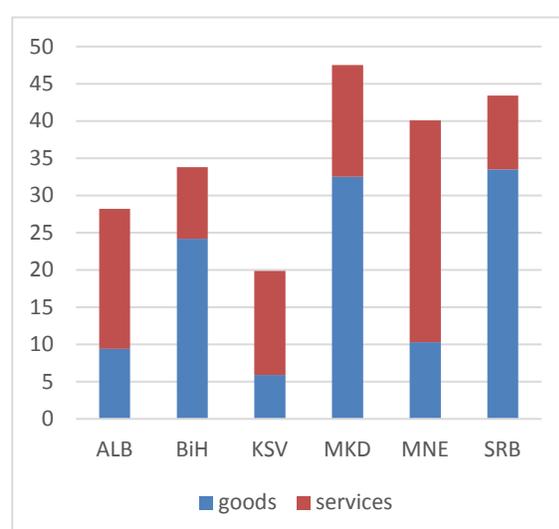
4.17. **Because of Kosovo’s small domestic market, integration will be essential for economic growth and employment.** Kosovo displays a highly negative external balance in goods and services, and the export volume is considerably smaller in Kosovo than in all other countries in the SEE (figures 37 and 38). Trade and export to GDP ratios are significantly lower (70.6 percent and 18.4 percent, respectively) compared with other small states, and the survival of exporters is low.⁶⁵ Kosovo’s exports are concentrated on low-value added items, such as raw materials (including metals such as ferronickel, which accounts for more than half of total exports, and minerals). According to a recent survey by the Kosovo SME Promotion Program, only about 5 percent of Kosovo’s SMEs are currently exporting.⁶⁶

Figure 36. Exports of Goods and Services as % of GDP, 2001–15



Source: Kosovo Agency of Statistics and World Bank calculations.

Figure 37. Goods and Services Export as % of GDP, Western Balkan Countries, 2001–14



Source: Kosovo Agency of Statistics and World Bank calculations.

⁶⁵ Data for 2013. The mean trade and export to GDP ratios for small states was 11.9 percent and 53.8 percent, respectively. (See World DataBank, World Bank, Washington, DC, <http://databank.worldbank.org/data>.) Less than 40 percent of export activities that are initiated in a given year remain active beyond the first year, and only 14 percent remain active beyond the fifth year.

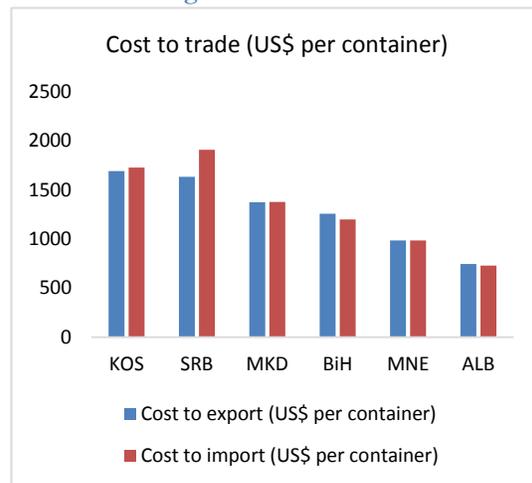
⁶⁶ See “KOSME: Kosovo Programme for Overall SME Promotion,” Ministry of Trade and Industry, Pristina, Kosovo, <http://www.mti-ks.org/en-us/-KOSME-Kosovo-Programme-for-overall-SME-Promotion->.

4.18. **Efforts are necessary to increase the integration of the private sector into global value chains by taking a holistic approach to trade and investment policy and anchoring supportive policies in a strategic framework.** Administrative barriers make it more difficult than necessary for Kosovo firms to take advantage of their proximity to the EU. Firms face higher export costs than in other SEE countries and the second highest import costs (figure 39). Jointly with Bosnia and Herzegovina, firms need more documents to export than in other country in the region. Kosovo’s business environment is unlikely to motivate significant investment, unless a number of policies are in place to address constraints and reduce costs. These policies are described below.

4.19. **Licensing: While important steps have been taken in reforming and streamlining licensing procedures for economic activity, transparency and compliance costs remain challenges for businesses.** In May 2014, the government approved the Better Regulation Strategy 2014–20, which introduced regulatory impact assessment and aims to reduce administrative costs and simplify the regulatory environment for businesses and, more generally, among the population. The strategy has three main objectives: (a) establishing a regulatory system, (b) sound implementation, (c) effective communication. Regulatory impact assessment is expected to be a useful mechanism for future policy making. The new Law on Permits and Licenses that entered into force in January 2014 represents a step toward improving licensing procedures for conducting economic activities in Kosovo. It establishes the main principles behind central level permits and licensing. The World Bank Kosovo Investment Climate Project is supporting the implementation of these initiatives. It has found that there are around 450 types of licenses and permits required for business operations at the central level and around 150 types at the local level. These permits are regulated by around 80 laws and many more regulations. In 2012, there were around 60,000 applications for different central level permits by businesses. The requirements for permits often overlap and create burdens and increase the costs of businesses. No regulatory-quality mechanism exists to ensure the ease of doing business.

4.20. **Inspections: The legal framework lacks a clear definition of the duties and mandates of inspectorates and the resources available to enforce the laws and bylaws that are under their purview.** A World Bank (2013c) analysis of the business environment in Kosovo found around 40 inspectorates at the central level and around 4-5 at the local level in 2012. These inspectorates are regulated by around 80–90 different laws and many more regulatory acts. Most laws offer no or few details on the rights and responsibilities of the inspectors and the businesses subject to inspection. Overall, this means the procedure of appeal is unclear and uncertain. In most cases, inspectorates do not know how much budget they have. Sometimes, this is because they function as entities within ministries. Even in cases when inspectorate bodies are organized as separate agencies, budgets are small and mostly dedicated to inspector salaries (approximately 70 percent of the budgets), a few operational activities, and overhead expenditures such as electricity, paper, and fuel. Overall, inspectorates lack scientific infrastructure such as laboratories and research centers. No study has been conducted on the amount of resources used, the resources needed, or how the available resources could be used more efficiently.

Figure 38. Cost to Trade



4.21. **Customs and trade regulations: 30 percent of Kosovo firms perceive customs and trade regulations as major or severe obstacle to firm operations and growth in 2013.** This is three times of the level in 2008 and more than three times the subregional and ECA averages for 2013. This combined with increased reported percentage of firms applying for an import license in Kosovo (from 11 percent in 2008 to 23 percent in 2013) and increased perception of bribery in dealing with customs and imports (from zero percent in 2008 to 6 percent in 2013) suggests that the government has to aggressively continue regulatory reforms in foreign trade. Protection for organized crime activities related to smuggling is also a likely source of grand corruption mentioned by EU and other reports.

4.22. **Quality infrastructure: The standardization, accreditation, and certification systems are weak and increase the cost of quality assurance for firms.** Accreditation services are not offered, so firms that need accreditation must go abroad, to FYR Macedonia and Albania, for example. There is also a lack of adequate domestic testing facilities, so certification bodies cannot offer internationally recognized certifications. Given the small size of the domestic market, establishing various specialized laboratories might not be cost-effective; however, establishing laboratories in key sectors, such as agriculture, livestock, and energy, and utilizing specialized laboratories in the region might be an option. Also, the lack of harmonization between inspectors on technical and customs regulations on the border further delays the process of obtaining relevant certification for imports and exports.

4.23. **FDI/export promotion: The Kosovo Investment and Enterprise Support Agency faces limited resources and capacity in supporting export and investment promotion.** Despite its multiple roles, the agency has no dedicated programs or activities that clearly target sectors or investors and exporters in a proactive manner. Its capacity should be improved to establish a well-designed activities program with concrete objectives and a targeted aftercare program for investors; an in-house research department should also be developed in collaboration with private sector stakeholders and municipalities.

4.24. **Competition policy: While Kosovo legislation was further aligned with the EU acquis in 2014, there is lack of clarity on competencies and responsibility over competition.** The Kosovo Competition Authority was reorganized and includes a decision-making body, the Competition Commission, and its Secretariat, the administrative and investigation body. The Competition Commission has not been operational during November 2013 to June 2016 because of delays in the appointment of four of five members whose mandate had come to an end. Capacity should be enhanced in internal control and market investigation to provide quality information to support management decision making and to ensure that information is classified, recorded, maintained and reported in compliance with legal requirements.^{67 68}

4.25. **Corporate governance, financial reporting and auditing arrangements: Sound and transparent governance and reporting practices are considered a major obstacle to the business climate.** The 2012 Accounting and Auditing ROSC has identified a number of actions that would help enhance firms' competitiveness and contribute to tackling the large informal sector.

67 EC (2014a).

68 Kosovo EC Progress Report 2016

Securing property rights and an efficient land market

4.26. **Despite impressive reform as demonstrated by Kosovo's ranking in the Doing Business report⁶⁹, concerns remain over the slow progress on securing property rights and developing a well-functioning land market, particularly given its implications on agriculture, finance, and households' assets.** Significant investments have been made to improve cadastral information and services through the Kosovo Cadastral Agency. The digital Kosovo Cadastral Land Information System is operational in all but the 3 Northern municipalities, a national building registration process has been undertaken and initial components for the NSDI are in place. However, significant challenges remain in land administration and management. Less than 30 percent of cadastral zones have completed the reconstruction process and are formally registered in the system, in part because of the lack of access to historical cadastral documentation.⁷⁰ Incomplete privatization and legalization/regularization programs as well as cases involving illegal occupation of land/buildings belonging to displaced owners mean that many properties cannot be formally registered. BEEPS data suggests that almost 1/3 of survey respondents (29 percent) considered access to land as least a moderate obstacle to their business operations and growth. This is an increase over the 22 percent in 2008. Adoption of a national land policy and completion of the cadastral reconstruction program are prerequisites to enhance investment, ensure equitable allocation of land assets and facilitate better land management.

4.27. **There has been some improvement in compliance with legal obligations related to post-conflict returns.** The Kosovo Property Agency (KPA) is responsible for resolving property claims resulting from the armed conflict. Of a total of 42,684 claims, 1,357 remain to be adjudicated by the Property Claims Commission. The number of implemented decisions stands at 29,871, although implementing some decisions is difficult, particularly if illegal construction has occurred. The KPA, as highlighted in a case before the Constitutional Court, needs to develop legal mechanisms and procedures for the solution of such cases. In addition, the ongoing negotiations for the return of cadastral documentation from Serbia, including the 2016 approval of the Law on Kosovo Property Comparison and Verification Agency which expands the role of KPA, the legal status these documents will have, and potential discrepancies with the post-1999 cadastral documentation maintained at the Municipal Cadastral Offices have the potential to increase and prolong the uncertainty over property rights. A careful balancing of priorities and scarce resources will be needed in the proposed review of the historical documentation by the agency and the support going to the Kosovo Cadastral Agency and Municipal Cadastral Offices, which manage current property rights information.⁷¹

4.28. **Better planning and management of infrastructure and natural resources can be achieved through development of the NSDI.** The new NSDI strategy and draft legal framework regulates the collection, use and sharing of geo-spatial information in line with the EU INSPIRE directive. The introduction of the national "geoportal" in late 2014 aims to facilitate direct interoperability and public availability of geospatial data such as the 2013 digital orthophoto (www.geoportal.rks-gov.net). The NSDI is managed by the Kosovo Cadastral Agency and currently includes several data sets provided by different institutions, including

⁶⁹ Kosovo was among the top-10 reformers in the Doing Business 2014 report and the best regional performer in Doing Business 2017. See Business (database), International Finance Corporation and World Bank, Washington, DC, <http://www.doingbusiness.org/data>.

⁷⁰ Kosovo's historical property archives were taken by Serbia in 1999. This has led to considerable confusion about property ownership and has required a process of cadastre reconstruction to determine the rightful property owners.

⁷¹ The Law on the Kosovo Property Comparison and Verification Agency was expected to help resolve any property disputes initiated by ethnic minority communities. In its current form, however, it authorizes the Kosovo Property Agency to verify and order the Kosovo Cadastral Agency to register ownership based on the pre-1999 records. This poses three significant risks: (a) reopening already completed property registrations, (b) the additional insecurity of property rights for an indeterminate and prolonged period of time, and (c) the risk of considerably higher demands on the government budget because of the establishment and operation of a new parallel agency.

the Kosovo Cadastral Agency, the Kosovo Agency of Statistics, and the utility agencies. The number of unique visitors is increasing rapidly: from 100 at the end of 2014 to 1,000 per day as of November 2016. Further support to harmonize and access additional key datasets through the geoportal, such as energy, transport and other infrastructure networks, natural resources, hydrology, territorial boundaries, and so on, would facilitate well informed planning and decision making in both the public and private sectors.

Maintaining financial stability and deepening financial intermediation

4.29. **Deepening and widening financial intermediation would be critical to channel savings, including remittances, through the formal financial system toward productive investments.** Almost 50 percent of remittances (about 8 percent of GDP) are sent through informal channels, and the rest through banks and travel agencies. Some research has been carried out into the sector, which indicates that some 35 percent of remittances are sent via money transfer operators. Channeling those flows and other savings to the regulated market, would help increase the level of financial access and inclusion. However, Kosovo's financial markets are still at an early stage of development to provide such intermediation.

4.30. **Banks remain highly liquid, profitable and well capitalized.** Liquid assets recorded an annual increase to 43.5 percent in November 2015 from 38.5 percent year-on-year at the end of 2014. ROE improved to 20 percent from 9.4 percent in December 2013 while ROA improved to 1.9 percent from 0.9 percent during the same period. Capital adequacy of the system reached an average of 17.8 percent, exceeding the 12 percent minimum regulatory requirement.

4.31. **Credit growth has accelerated during the last year, achieving the highest levels after the crisis, at 8.3 percent year-on-year in November 2015.** Overall, this growth is attributed to an easing of lending terms and conditions to enterprises and households applied by financial institutions as well as increased demand for financing. The loan-to-deposit ratio stood at 76.7 percent, a slight decrease from an average of 80 percent for the last two years. In November 2015, Kosovars entrusted the banks with about €2.6 billion in deposits, 5 percent more than a year earlier, and households contributed more than two-thirds to the corresponding liability positions of the banks.

4.32. **Nonperforming loans (NPLs) have been decreasing and remain lower than in neighboring countries.** NPLs stood at 6.5 percent of total loans in November 2015 (down from 8.3 percent at the end of 2014) remaining significantly lower than in neighboring countries, with loan-loss provisions to NPLs remaining high. A newly introduced private bailiff system has been supporting enforcement of collateral recovery contributing to the decrease of the share of NPLs.

4.33. **The Central Bank of the Republic of Kosovo has maintained a strong focus on preserving banking sector stability.** Having adopted the euro as sole legal tender, Kosovo does not have access to independent monetary policy instruments. But the monetary and fiscal authorities have pursued an important structural reform agenda whereby (a) €46 million in treasury deposits are earmarked for a fund for emergency liquidity assistance, (b) a deposit insurance fund was established, (c) a new Law on Banking, Microfinance, and Nonbank Financial Institutions was approved by Parliament, and (d) a safe and efficient payment system is being promoted because of Kosovo's membership in and the receipt of a user-assigned code from the Society

for Worldwide Interbank Financial Telecommunication (SWIFT). In mid-2014, Kosovo was able to introduce international bank account numbers (IBANs). Using IBAN format for accounts held in Kosovo starting on 1 February 2015 will complement the SWIFT system functionality associated with international payments, enabling foreign bank clear identification of the beneficiary bank account in Kosovo and complementary control of the accuracy of this account. Important further work lies ahead in enhancing the bank resolution framework, especially regarding the resolution of systemic banks, for which the current legal and regulatory framework is not fully appropriate.

4.34. **However, several weaknesses remain in the existing financial stability framework.** The use of the euro as domestic currency limits the exchange rate risk, but also limits flexibility in terms of monetary policy and the lender of last resort function. The institutional capacity of the banking supervision function is improving, but lags behind neighboring countries. Cross-border supervision is a particular challenge for Kosovo because of the country's political status, and the small size of the banking subsidiaries in the foreign groups. The deposit insurance system, launched in 2011, has not yet built up sufficient funds and has relied on donor programs for backup sources of financing. The framework for resolving failed banks needs to be enhanced. The overall financial stability framework is constrained as the government does not have the financial means to support the banking system in the event of a crisis, although some steps have been undertaken to improve the framework. Moreover, credit growth is significantly influenced by developments abroad as the three largest banks are foreign owned. In 2013, the share of euro area based banks in loans' stock issued to corporate clients amounted to 71 percent while domestic banks contributed just 12 percent to the total loan volume. Risks of deleveraging and withdrawal of banks (such as Raiffeisen and NLB) due regulatory pressures and adapted business models risk pressuring the domestic banking system and add to the feeling of uncertainty in the sector as well as among the population.

4.35. **Moreover, Kosovo's financial markets are still at an early stage of development, with low levels of financial intermediation.** The depth of the financial sector stands at a relatively low level relative to countries with similar income per capita. Private sector credit in GDP accounts for roughly 35 percent. High concentration (the three largest banks account for 67 percent of assets) and weak intermediation which adversely affects domestic real savings and investment gives rise to competition and inefficiency concerns. At around 10 percent, the interest rate spread is the highest in the region and increased further as interest rates on deposits fell from 3.7 percent (December 2012) to 2.4 percent (December 2013) and 0.9 percent (June 2014) and 1 percent (December 2015) given rise to competition concerns. Also, uncertain business environment and limited economies of scale contribute to high rates. In particular, it is difficult to enforce contracts and realize the value of collateral because of weaknesses in property rights and a nonexistent secondary market. Also, the costs associated with originating loans (informality of revenues) are high. In addition, asymmetrical information and risk aversion contribute to the high interest rate spread. Besides the increase of the lending volume and reducing costs, the diversification of financial sector products, including housing finance, is necessary to enable better access to finance for less credited sectors of the economy which could have an important role in economic development of the country.

4.36. **Kosovo's financial sector is small and dominated by banks.** At end of November 2015, the financial system included 10 private commercial banks, 15 insurance companies, 2 pension funds, and 18 microfinance institutions (MFIs). The assets of 15 insurance companies amounted to €157.7 million. It is the smallest insurance markets in Europe limiting availability of insurance products for households and small businesses.

Table 15. Key Financial Indicators

	2008	2014
Number of banks	8	10
Foreign ownership, % of total assets	90	90.4
Banking sector assets, % of total assets	80	70.3
Deposits/GDP	34	48.5
Credit/GDP	32	36
Three-bank asset concentration, %	82	67

4.37. **The microfinance sector is relatively strong relative to the situation in other countries, but its business is limited to lending activities and its current regulatory framework for MFIs needs to be adjusted to procure for the growth and development of the sector.**⁷² MFIs are licensed to provide lending services with specific definitions in the type of clients they serve, as well limits on the size of loans they can provide to individuals and corporates. MFIs are authorized to operate and open branches, but only to provide customer service. Apart from lending services, the other permitted services do not allow general payment services provision (except in relation to the loan), nor taking of deposits. The recent Law on Banks, Microfinance Institutions, and Nonbank Financial Institutions approved in April 2012, developed a framework to strengthen the regulation and supervision of MFIs. However, the issue of asset transformation from nongovernmental organizations into business entities (JSC or LLC) has still not be resolved. Following a decision of the Constitutional Court to suspend several articles of the Law on Banks, Microfinance Institutions, and Nonbank Financial Institutions related to MFI reform, the Central Bank of the Republic of Kosovo prepared a draft Law on Microfinance Institutions and Nonbank Financial Institutions, which is now awaiting the approval of the Kosovo Assembly.

4.38. **Deepening and widening financial intermediation is necessary to increase the level of financial access and inclusion.** The large majority of companies, which are small to medium-sized companies,⁷³ face constraints the high cost of capital and lack of long term finance as a major impediment to expand, add jobs grow, and compete. According to BEEPS, 45 percent of firms identified access to finance as a single biggest constraint⁷⁴. While more than 97 percent of firms have a checking or savings account, 67 percent of surveyed enterprises have a loan from a bank comparing well to regional peers. Although on a declining trend, at around 7 percent, the interest rate spread remains the highest in the region given rise to competition concerns. The Small and Medium Enterprises Support Agency considers that SMEs in Kosovo are experiencing several barriers to accessing finance. The Ministry of Trade and Industry together with various donors are in the process of establishing an SME credit guarantee scheme as a tool to improve access to finance. In December 2015, the Kosovo Assembly approved the draft Law on the establishment of the Kosovo Credit Guarantee Fund. The law provides a legal basis for the fund as one more component in the framework to address the problem of limited access to finance among microenterprises and SMEs in Kosovo.

⁷² There are 18 MFIs, and these account for around 3 percent of total financial sector assets. MFIs have been licensed, regulated, and supervised by the Central Bank of the Republic of Kosovo since the launch of the sector. The majority of MFIs are registered as nongovernmental nondeposit entities; only two have been registered as joint stock companies. The total assets amounted to €112.9 million, of which 92.4 percent represent foreign-owned capital.

⁷³ Data of the United Nations Development Programme.

⁷⁴ The most recent study, conducted by Riinvest in 2014 among 1,000 Kosovar companies, reveals that access to finance and the cost of financing are two major obstacles faced by businesses in Kosovo; see Riinvest Institute (2014).

4.39. **Despite its significant contribution to the country’s GDP and employment, the Kosovar agricultural sector is underserved by financial institutions.** Although the Ministry of Agriculture over the last two years have improved significantly the access to finance for the agricultural sector, agricultural loans account for only 4.5 percent of total gross loan portfolio. There is a specific need to meet the demand for long-term loans for this segment including the development of models and methodologies for rural finance intermediation. There is a need in strengthening the legislative and regulatory foundations of agricultural finance and insurance and improving finance infrastructure and access to finance in agriculture.

Table 16. General Indicators of Access to Finance

	Kosovo	Albania	FYR Macedonia	Bosnia and Herzegovina	Montenegro
General access indicators					
Adults with a bank account, %	48.0	38.0	72.0	53.0	60.0
Branches per 100,000 adults, number	19.8	21.9	24.3	31.0	42.5
ATMs per 100,000 adults, number	33.2	33.0	53.1	42.6	71.7
Access to credit and other sources of financing					
Firms with a loan or line of credit, %	66.8	28.2	45.4	66.3	54.9
Firms identifying access to finance as a major constraint, %	44.9	6.5	19.3	14.1	7.6
Firms using banks to finance investments, %	30.9	11.2	20.9	38.0	29.6
Firms using banks to finance working capital, %	56.1	23.1	38.4	46.7	43.9

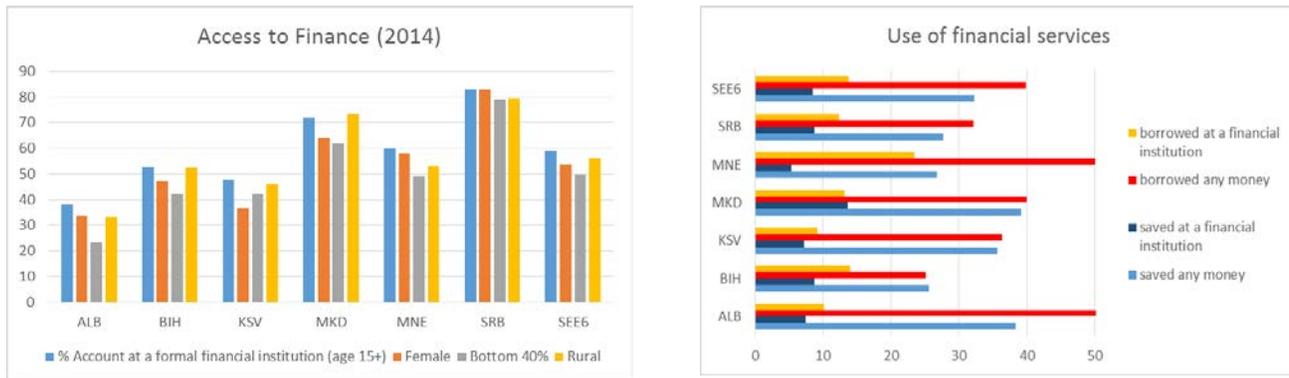
Sources: BEEPS survey; 2013 data of FAS (Financial Access Survey) (database), International Monetary Fund, Washington, DC, <http://fas.imf.org/>; Global Financial Inclusion (Global Findex) Database, World Bank, Washington, DC, <http://www.worldbank.org/globalfindex>.

4.40. **High collateral requirements and difficulties with debt collection are holding back the growth of commercial bank lending, especially among SMEs.** These obstacles include (a) the inability to enforce contracts (b) inability to realize the value of collateral because of weaknesses in property rights (both the availability and reliability of documents/maps) and a nonexistent secondary market, and (c) the costs associated with originating loans because of high informality and transaction costs. The informality and lack of financial transparency related to both individual earnings and small business revenue, as well as the low quality of financial reporting (especially with the micro and SME segment) has resulted in highly collateralized lending, rather than cash-flow based analysis, although cash flow is prepared and analyzed for any loan to companies. Banks lend almost exclusively against immovable collateral. Collateral requirements range from 160 percent to 230 percent of the value of the loan.

4.41. **Some aspects of household access to financial services are still are limited by regional standards.** With 48 percent of adults having access to a bank account, access to finance remains low relative to some other countries in the region (figure 40). In particular, only 42 percent of low-income households and 36 percent of women have access to a bank account. Based on Findex data for 2014, 13.4 percent of account holders use their account to receive their wages, while 4.4 percent use them to receive government payments.⁷⁵ At the same time, the use of lending and savings services are limited by regional standards. While 35.6 percent of adults reported saving money in the previous year, only 7.2 percent did so at a formal financial institution.

⁷⁵ Global Financial Inclusion (Global Findex) Database, World Bank, Washington, DC, <http://www.worldbank.org/globalfindex>.

Figure 39. Access to Basic Financial Services



Source: 2014 data of Global Financial Inclusion (Global Findex) Database, World Bank, Washington, DC, <http://www.worldbank.org/globalfindex>.

4.42. **Use of electronic payment services is limited because of high informality and constraints on physical infrastructure and delivery channels.** Only 57 percent of remittances are done through the formal financial system. ATM and branch penetration is relatively low. The country lags the region in terms of electronic payment systems: only 15 percent of households have a debit card and 18 percent have a credit card.

4.43. **While credit bureaus do not exist in Kosovo, the highly functional credit registry ensures that credit exposure of legal entities as well as individuals is captured.** Regular updating of the registry is mandatory for all registered formal sector providers. As in the cases of similar public registries, data from retailers and utility companies are not included. Additionally, credit scores are not offered as a value added service to help banks and financial institutions assess the creditworthiness of borrowers.

4.44. **Going forward, a number of constraints will need to be address to maintain financial sector stability as well as enhance financial intermediation.** Policy measures to address these constraints are: (a) further strengthening the financial safety net, (c) addressing obstacles to competition and development of the MFI sector, (d) enhancing availability of a wider range of financing instruments that meet the varying needs of households and enterprises, (e) addressing weaknesses in the contract enforcement regime, (f) enhancing financial transparency related to both individual earnings and small business revenue as well as improving the quality of financial reporting and (g) conducting an assessment of the current stock and flow of NPLs.

Reducing the infrastructure gap

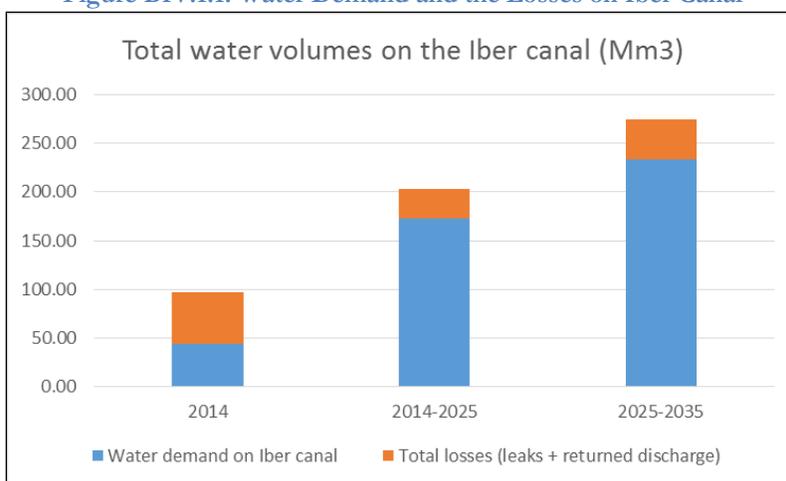
4.45. **Reducing infrastructure bottlenecks would be crucial for private sector participation, competitiveness, macro-financial sustainability, and shared prosperity.** Energy security is particularly at risk. Kosovo's unreliable lignite-fired plants, overloaded and inefficient distribution system, lack of back-up generation capacity and financial constraints which do not allow for purchases of power imports, have resulted in suppressed demand (load shedding) affecting businesses and households. The decommissioning of the obsolete Kosovo A Power Station will create a supply gap and the requirements for new generation. Similarly, improving transport connectivity— by adequately balancing new investments and good quality maintenance of

existing assets—is also important for future growth given the state of Kosovo’s road and communication network. In addition, measures for the water sector are necessary to address the challenge of quality water and security (box IV.1).

Box IV.1. Water Resources

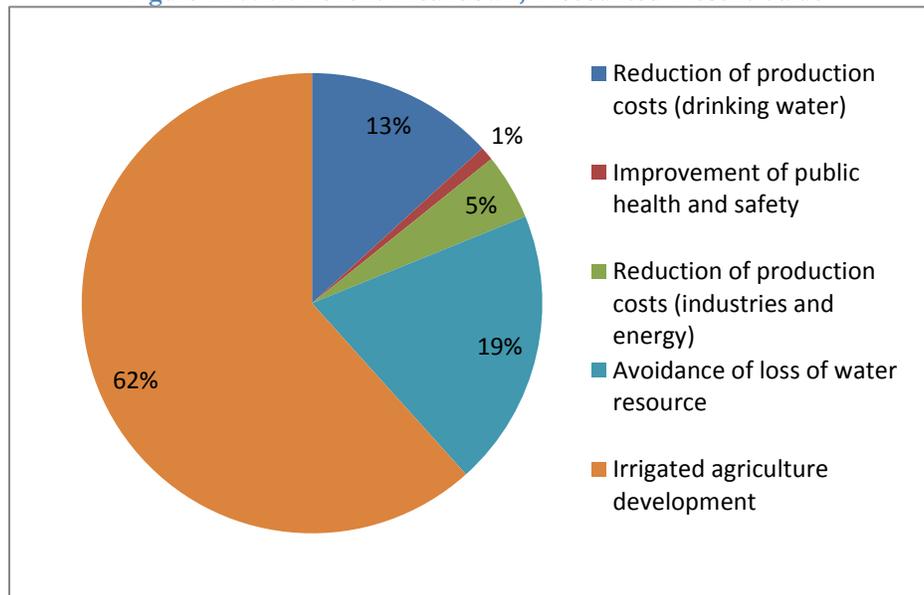
Kosovo has limited water resources and its distribution remains largely unequal throughout the country. While the mountainous western and southern fringes are plentiful in water, the central/northern high-lying plateau that covers about half of the country’s territory, has limited water resources. It is precisely this region that holds the country’s largest development potential as most of the mining, agricultural and industrial activities are located here, including the Durrës–Pristina–Belgrade industrial belt. This region has the highest population of the country and is regarded as the commercial and administrative center of Kosovo. However, the region depends almost entirely on the Ibër-Lepenc canal, which is a multipurpose water conveyance system, supplying water for energy production, mining, industrial, agricultural and household uses. There are limited (in some cases none) secondary sources of water for the canal users so that an interruption of service would have a significant impact on the overall economy of Kosovo. It is the single source of drinking water supply to the populations of central Kosovo. The cooling water for the thermal power plants, Kosovo A and B, are drawn from the canal (Kosovo A is only partially dependent on the canal, mostly during summer months). Irrigation in central Kosovo is also dependent upon the water supplied by the canal, although only about 2,000 ha out of the originally planned (equipped) 20,000 ha (15,000 ha) are currently irrigated, primarily because of low demand among farmers for several reasons, mostly market-related, but also including water-related reasons.

Figure BIV.1.1. Water Demand and the Losses on Ibër Canal



Supporting structural and nonstructural measures for the water sector is necessary to broadly achieve its socioeconomic development objectives linked to availability of adequate and quality water. The canal currently faces reduced conveyance capacity (particularly downstream of the node # DO2 where water demands would soon increase) because of seepage and leaks, operational losses, sedimentation and increased roughness, and unplanned drainage inflows. The study, “Water Security for Central Kosovo” (2012) concluded that, out of several alternatives, the set of measures to improve water security in the Ibër-Lepenc Canal basin proved to be economically, institutionally and technically the most preferable. The benefits of this operation would include: (a) reduction of drinking water production costs, (b) water loss prevention because of extreme natural events, (c) reduction of industrial production costs, (d) increase of hydroelectricity production, and (e) irrigation benefits. The base case economic rate of return (ERR) is estimated at 19.31 percent. The base case net present value of the Project’s net benefit stream, discounted at 10 percent, is €16.4 million in economic terms. The financial analyses shows that, as the project will improve services to end users, the Iber-canal utility would be able to raise relatively end user tariffs, thereby the financial internal rate of return (FRR) would be 3 percent. This compares favorably with the regional norms of 3 percent to 5 percent bearing in mind that the project focuses mainly on system rehabilitation and not system development.

Figure BIV.1.2. Benefit Breakdown, Discounted Present Value



4.46. **Urbanization is an important element that will shape infrastructure needs and bottlenecks in the medium to longer term.** With 39 percent, Kosovo and Bosnia and Herzegovina have the lowest urbanization rates among its peers in the western Balkans. All other countries that have emerged from the former SFRY have an urban population between 50 (Slovenia) to 64 (Montenegro) percent. Most of these countries experienced only small changes – up or down – to their share of urban population, with the exception of Montenegro which share has steadily increased from 59 percent in 2000 to 64 percent in 2013. Also Albania’s share of urban population increased from 42 percent in 2000 to 55 percent in 2013. Trend data is not available for Kosovo, therefore preventing further understanding of migration patterns within the country.

4.47. **Only slightly more than 10 percent of Kosovars reside in the capital Pristina.** With the expected decline of agriculture and the increase of manufacturing and services – urbanization is projected to increase as goods and services are produced more efficiently in densely populated areas to take advantages of agglomeration economies (including supply chains, skilled labor, infrastructure, and so on). A critical question for Kosovo is whether that transition to a new economic state is requiring support to unlock agglomeration economies.

4.48. **The patterns of urban development, efficiency in land allocation, and policies around land use may have important consequences on poverty patterns, agglomeration economies and sustainability of urban services in the medium to longer term.** A look at high-resolution satellite images of the built-up urban areas in Kosovo at intervals of roughly 10 years starting in 1975 shows that the change seems significant, and visual observations indicate that new development is mainly low rise and spread out.⁷⁶ The cost of sprawl is well documented internationally, difficult or impossible to reverse once in place, and a fiscal burden on the public sector. Satellite imagery is in line with the steady growth of construction and real estate as the key sectors

76 GHSL (Global Human Settlement Layer) (database), Joint Research Centre, European Commission, Brussels, <http://ghslsys.jrc.ec.europa.eu/>.

absorbing remittances beyond consumption and services. Looking at the medium and longer term, the pattern of spatial development and its effects and externalities is a concern- higher commuting times, cost of truck infrastructure, climate change related costs of a more energy-intensive development and so forth, and the efficiency of public spending. This also leads to inefficiencies in the allocation of land, land use and space (density) which may have important consequences on agglomeration economies (reducing them). In the short to medium term, rural development, including employment in agriculture, will remain an important dimension.

4.49. **Higher levels of commitment to infrastructure may be a need given that service level deficiencies will likely become a bottleneck for Kosovo's aspirations to join the EU and reduce urban and rural poverty.** Service providers are not financially viable and have entered a vicious circle of bad service, low fee collections, and increasing debt and arrears, leading to lack of funds for maintenance and capital investment. Moreover, experience from other preaccession and accession countries is that when investing in infrastructure, insufficient emphasis is given to operating expenditure requirements.

Reliable and Affordable Energy

4.50. **Reliable and affordable energy is central to growth and poverty reduction.** The Kosovo power system was designed in different circumstances, when power system elements (power plants, transmission and distribution elements) were considered as a part of larger Yugoslavian power system. Therefore sustainability (ability to fully cover local demand, to regulate output in accordance with demand, to provide self-sufficient ancillary services) of that subsystem was not considered a relevant criteria in its initial design. Kosovo has not built new generation facilities as planned, and needs to establish new sources of electricity before it can decommission the aging and inefficient Kosovo A Power Station. Additionally, the poor rely heavily on firewood as a source of energy (see box).

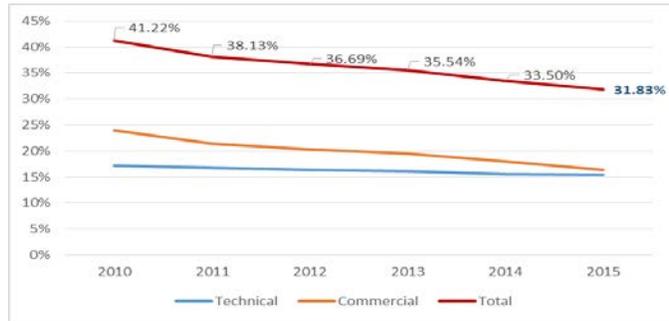
4.51. **Kosovo's unreliable lignite-fired plants, overloaded and inefficient distribution system, lack of back-up generation capacity and financial constraints which do not allow for purchases of power imports, have resulted in suppressed demand (load shedding).** The 50-year old Kosovo A (about 230MW) and 30-year old Kosovo B (about 520MW) lignite-fired power plants meet more than 95 percent of electricity consumption, while small hydropower provides the remaining 5 percent. High distribution losses result in about a third of electricity consumed being lost, either through technical deficiencies of the distribution system or theft (commercial losses). The large proportion of household electric heating adds further constraints to the system, with year-round baseload demand standing at about 700MW while electric heating creates a peak electricity demand at close to 1,200MW in winter. The requirement for electricity imports, and the impact of suppressed demand (load shedding) are therefore higher in the winter. Load shedding has constrained consumers, although it has reduced from about 8.7 percent in 2011 to about 2 percent in 2013-2015.

Figure 40. Suppressed Demand as a Percentage of Gross Electricity Consumption



Source: Kosovo Energy Regulatory Office Annual Reports.

Figure 41. Distribution Losses



Source: Kosovo Energy Regulatory Office Annual Reports.

4.52. **The decommissioning of Kosovo A will create a supply gap and the requirement for a new fossil-fuel plant.** A minimum of 230MW (Kosovo A current capacity) new additional baseload capacity would be required to meet year-round baseload requirement (the latter was about 700MW in 2016, and largely met from the existing Kosovo A and Kosovo B lignite-fired plants). Further measures would be required to address peak demand, in particular during the winter months. These could include switching from electric heating to more efficient, affordable and less polluting District Heating.

Figure 42. Historical Consumption (Gigawatt-Hours) and Peak Demand (Megawatt)

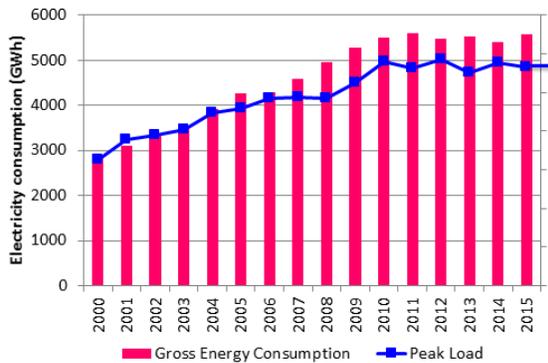
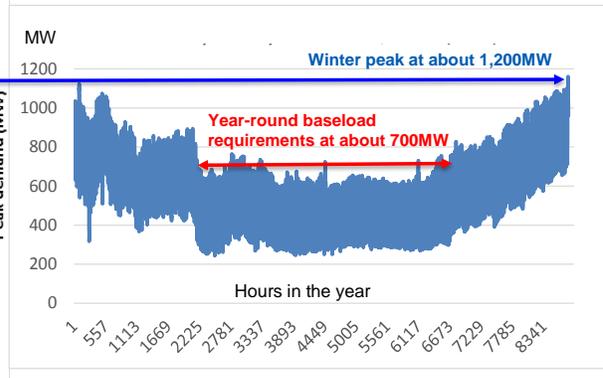


Figure 43. Electricity Hourly Load Curve, 2016 (Megawatt)



4.53. **The looming energy crisis is a major concern, particularly given that most neighboring countries are also in energy deficit.** The lack of energy security—notwithstanding €284 million in net electricity imports (2008–13)—causes large costs to business and represents the single largest obstacle to attracting high-quality FDI to Kosovo. A recent study of the U.S. Agency for International Development shows that, when all costs (real and opportunistic) and losses (real and productive) are considered, Kosovo businesses realize €359 million in additional annual costs and losses because of unreliable power supply, and that SMEs were the most affected.⁷⁷ The fiscal burden of unreliable supply is higher for microenterprises (44.5 percent of average annual turnover) and small businesses (21 percent of average annual turnover) relative to medium

⁷⁷ USAID (U.S. Agency for International Development), “The Effect of Unreliable Power Supply and Quality on Kosovar Businesses,” Presentation, December, 2012, USAID, Pristina, Kosovo.

enterprises (3.9 percent) and large businesses (1.8 percent). Furthermore, the study found that production firms are most impacted. Frequent power cuts are a major obstacle to day-to-day operations and a constraint both to investment in new equipment and business expansion, in turn affecting job and employment creation and investments.

4.54. **Consequently, Kosovar firms perceive unreliable electricity supply as the second major obstacle to doing business**, according to the most recent BEEPS survey. In 2013, 81 percent of Kosovar firms experienced an average of 13.6 power outages per month, the worst performance in SEE.⁷⁸

Box IV.2. Poverty, Energy Demand, and Firewood Dependence

The most recent data on forest resources in Kosovo, including public and private forestland, are the data from the National Forest Inventory (FAO 2003). This report indicates a total of 464,800 hectares of forestland in Kosovo, accounting for 42.3 percent of total area.

The national forest inventory estimated that 278,880 ha are public forestlands, under the control of the Kosovo Forest Agency (KFA), and 185,920 ha are privately owned. The total standing volume on public forestlands is estimated as 33.5 million m³ and on private forests is 19.5 million m³. The inventory estimated the annual allowable cut at around 900,000 m³ gross, corresponding to 77 percent of the calculated increment on areas surveyed. About 700,000 m³ will be harvested in high forest, and about 200,000 m³ in low forest. The inventory suggested that 400,000 m³ of this volume is technical wood and 500,000 m³ is firewood.

Supply and demand data highlight a serious imbalance, and suggest that as much as 1,000,000 m³ of firewood may be used from imported or illegally felled sources in 2008. This imbalance is certainly a contributory factor in the high price for firewood. This price could mean that as much as 15 percent of family income in poor households is spent on firewood for space heating and cooking, mainly with highly inefficient devices (stoves).

These data clearly indicate that the more efficient use of this biomass resource would be welcome in the context of low family incomes. A number of studies and initiatives that could lead to a more efficient use of biomass in Kosovo are underway. (See section VI.)

4.55. **Replacing the obsolete Kosovo A Power Station with a state-of-the-art, EU environmental standards-compliant power plant and rehabilitating the Kosovo B Power Station would also have immediate environmental, economic and social benefits.** The health costs from air pollution were estimated at 2.3 percent of GDP in 2010, almost as much as the entire public health budget.⁷⁹ Although air pollution is mostly due to wood and lignite use for household heating, the existing lignite power plants also remain a significant source of pollution.^{80 81} Rehabilitating the Kosovo B Power Station would also increase its net output capacity from the current 550 megawatts to 600 megawatts, while improving pollution controls to meet the relevant EU environmental directives.

4.56. **Without reliable energy supply, long-term investments in other sectors may fail to materialize.** Although demand forecasts for energy consumption vary, it is expected to increase over the next decade. The

78 See “Kosovo,” Business Environment and Enterprise Performance Survey (BEEPS) V Country Profile, European Bank for Reconstruction and Development and World Bank, London, <http://ebrd-beeps.com/wp-content/uploads/2015/04/kosovo.pdf>.

79 World Bank (2013d).

80 In 2013, Kosovo Electricity Corporation completed installation of electrostatic precipitators (dust filters) in all working units of the Kosovo A Power Station (units A3, A4, and A5). In addition, the corporation has installed wet ash transport, replacing an old belt conveyor system.

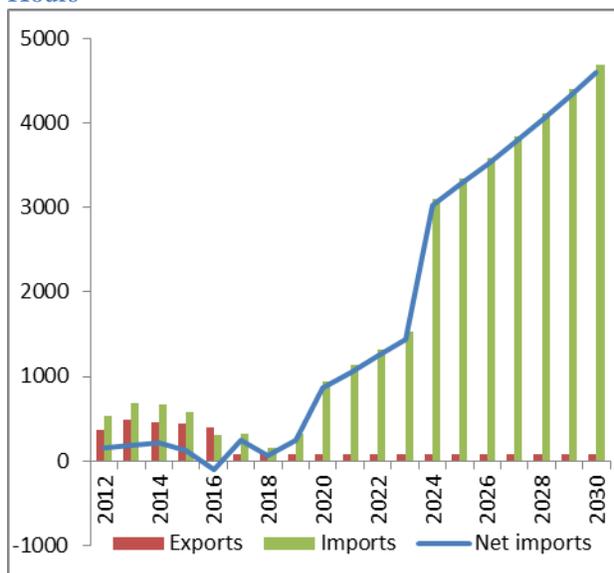
81 The KRPP will be compliant with the EU directive 2001/80/EC on the limitation of emissions of certain pollutants into the air from large combustion plants, EU directive 2008/1/EC concerning integrated pollution prevention and control, and EU directive 2010/75/EC on industrial emissions (which came into force in 2012), as well as the associated sector-specific Best Available Techniques Reference documents; the latest of which was published in 2006.

aging power plants will not be able to meet the growing demand and need to be decommissioned (Kosovo A) and rehabilitated (Kosovo B). This gap would require a growing amount of imports that would need to be paid for through increased costs or subsidies. An energy strategy based on a mix of regional interconnectivity, supporting renewable energy sources, considering different options for local or regional balancing and ancillary capacities as well as investment in electricity demand management (reduction of electricity losses or increasing energy efficiency) and new thermal power generation would ensure that demand growth and its seasonal/daily variations can be safely met.

4.57. **In the short-term, energy deficit challenges can be addressed partly by regional interconnectivity.** Currently, Kosovo is linked to the regional system through 400 kV interconnections with Serbia, FYR Macedonia, and Montenegro, and a 220 kV line to Albania. However, the existing transmission capacity is already utilized, and Kosovo constitutes a transit corridor with large net electricity inflows from Serbia, and outflows to FYR Macedonia and Montenegro. In June 2016, transmission operators from Kosovo and Albania completed the construction of the 400kV line with Albania to facilitate power exchanges between the countries’ complementary power systems While it is expected that the additional line will contribute to providing some energy toward peak demand in Kosovo, the new line is not currently energized, and Kosovo’s import potential will be constrained by the growing electricity supply deficit in the region over the longer term.

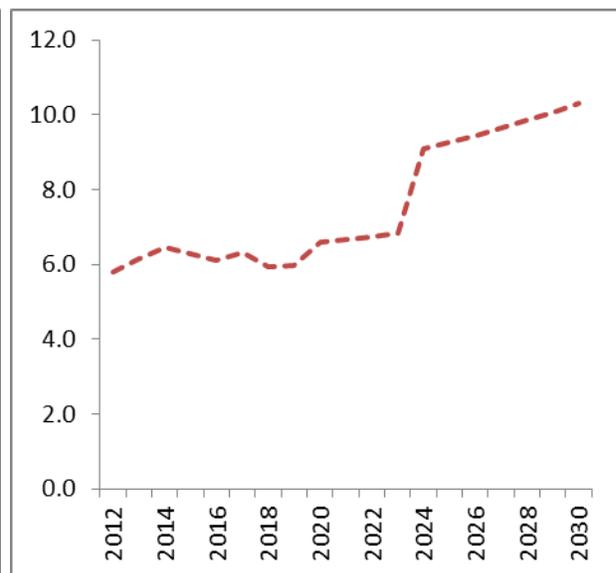
4.58. **Additionally, in the long run, relying on external supply will not be optimal from both a supply and a cost perspective.** Import availability would rely on uncertain relations with neighboring countries, unknown future generation capacity in the region, and weather conditions, which affect both demand and supply in the region, as well as available transmission capacities in neighboring. A large proportion of power in the region (98 percent in Albania, around 40 percent in Bosnia and Herzegovina and around 35 percent in Serbia for example) is produced by hydropower stations, whose generation is affected by hydrology and seasonality, and which will likely become more volatile as the impact of climate change is felt. Even if a large volume of imports were possible, the costs would be high, and alternative sources need to be included in the energy equation.

Figure 44. Estimated Imports and Exports, Gigawatt Hours



Source: Kosovo Energy Sector Impact Tool.

Figure 45. Estimated Cost, € cents per Kilowatt Hour



Source: Kosovo Energy Sector Impact Tool.

4.59. **Ensuring that demand growth can be met in the long run would require a mix of transformational changes, implying a number of critical challenges to:**

- Increase electrical generation capacity through rehabilitating the Kosovo B Power Station to meet the requirements of the Industrial Emissions Directive, and constructing a new thermal plant to replace the Kosovo A Power Station.
- Achieve renewable energy and energy efficiency targets, according to the commitments made toward the Energy Community, that is, 25 percent renewable energy sources in gross final energy consumption by 2020 (with identified baseline in 2009 of 18.9 percent) and 9 percent energy savings by 2018.
- Implement the market reforms defined by the Energy Community which, together with increasing capacity in all three power system components (generation, transmission and distribution), will lead to significant change in power system operation for all stakeholders.
- Enhance the transmission network and improve the recently privatized distribution system to reduce losses (investment required estimated at €300 million for the distribution system).

Box IV.3. Renewable Sources of Energy and Energy Efficiency

Kosovo's energy intensities are about 2.5 times higher than the average in European countries. The residential sector represents the largest portion of energy consumption (38 percent). Promoting energy efficiency in the public, residential, and commercial sectors could help save money, reduce energy demand, and narrow the electricity deficit. Energy efficiency can help address issues related to energy security (current account deficits and the availability of imports), while reducing public expenditures on energy and the environmental impacts of energy use. Energy efficiency investments are win-win investments, providing energy bill savings for end users, reduced investments and imports for the government, and reduced environmental impacts. If energy efficiency measures were implemented in the building sector, a total of 240 kilotons of oil equivalent energy savings, or a third of the projected electricity imports in 2014 (729.87 kilotons of oil equivalent), could result in €198 million in total energy savings per year from reduced consumption.^a This does not include the monetary value of the reduced imports. There may also be cost savings in the public purse.^b Ways to accomplish this include the following:

- **Continuing to promote energy efficiency in the public, residential, and private sectors to reduce energy use and generate fiscal savings.** Energy use in public buildings could be reduced by over 40 percent without loss of comfort because of the current large energy wastage. Investments of €79 million in energy savings measures in municipal and central public buildings could save close to €19 million per year from the public sector energy bill. The government has requested the authority to make such investments.^c Although the residential sector represents the bulk of energy consumption in the buildings sector and therefore holds the most potential, energy savings in the residential sector would be more difficult to unlock, possibly requiring subsidized energy efficiency measures.
- **Reforms would be complemented efficiently by promoting the growth of sustainable and renewable solutions for space and water heating.** Because of the rising costs and challenges involved in meeting the demand for electricity, ratepayers that use electricity for space and water heating must be incentivized and informed to switch to more affordable and sustainable heating solutions such as district heating, sustainable biomass (for example, wood pellets), heat pumps, and solar water heating. Central and local governments need to promote an enabling environment that would make sustainable heating solutions available for households that use electricity for heating.

The cost of renewable energy will add to the overall cost of supply and will require integration into a sustainable tariff path. In November 2013, the government adopted the National Renewable Energy Action Plan for 2011–20, committing the country to a 25 percent renewable energy target by 2020 (as a share of final energy consumption) and a voluntary target of slightly more than 29 percent. In the electricity sector, the action plan foresees increased renewable energy generation from an additional 240 megawatts of small hydro, 305 megawatts of large hydro, 150 megawatts of wind power, 14 megawatts from biomass, and 10 megawatts from photovoltaic solar. To encourage investment in renewables, the Energy Regulatory Office has set the feed-in tariff for wind generators at €85 per megawatt hour, while, for small hydro plants, the regulatory office has set a feed-in tariff of €63.3 per megawatt hour. A feed-in tariff of €71.3 per megawatt hour has been set for biomass and biogas, and €136 per megawatt hour for photovoltaic solar has been set as the feed-in tariff. For all technologies except photovoltaic, the subsidy period is 10

years; for photovoltaic, it is 12 years. Renewable energy will not be able to meet the full growth in demand and, in particular, will not be able to meet seasonal variation and peak demand (because it is not a dependable capacity). Rationalization of energy prices will be fundamental to the sector because, if prices are low, they make renewable energy options wholly uncompetitive.

The complex application process for renewable energy sources needs to be streamlined to increase the supply of renewable energy. Only 15 percent of the applications for hydropower capacity have been approved, and all new applications face slow progress through the regulatory approval process. This means Kosovo could be missing a chance to attract renewable energy sources that would increase energy independence and slow the growing gap between supply and demand. To attract private sector financing for renewable energy, the regulatory office needs to continue to pursue the development of a robust regulatory framework, including the streamlining of the licensing process.

Administrative bottlenecks are delaying the use of renewable sources of energy. In October 2012, Kosovo set an ambitious renewable energy target of 25.6 percent of total electricity consumption, 10.0 percent of renewable energy in the final consumption of energy in transport, and 45.7 percent of renewable energy in gross final consumption for heating and cooling by 2020. Private sector interest in Kosovo's renewable energy sector has increased substantially. By the end of 2013, the Energy Regulatory Office had received 26 license applications for hydropower and wind projects, totaling over 350 megawatts of generation capacity. Administrative bottlenecks represent a key reason behind the delays in the use of renewable energy in Kosovo. There is a significant potential to incorporate renewable energy applications in space and water heating, given that current practices rely on lignite, oil, electricity, and unsustainable biomass. Water heating, for instance, represents 15 percent of heating demand, for which purpose inefficient electricity is used. The use of sustainable biomass (for example, wood pellets) could be a policy option.

a. Eptisa (2013).

b. The government is implementing the National Energy Efficiency Action Plan for 2010–18. The plan calls for a cumulative energy savings of 9 percent over three periods of three years each.

c. The World Bank is supporting the government in implementing energy efficiency measures in public buildings through a \$31 million project, the Kosovo Energy Efficiency and Renewable Energy Project.

4.60. **An energy development scenario which includes renewable energy, energy efficiency measures, and a new thermal power plant presents the lowest cost option even when including the costs of adequately managing environmental and social externalities.** To meet the energy gap created by growing demand and closure of Kosovo A, the authorities aim to meet the National Renewable Energy Action Plan targets and construct a new lignite power plant, Kosova e Re Power Project (KRPP), which is to be fully financed by private sector investors.⁸² Because the KRPP will more than fully meet short-term demand, this would also be the ideal time to refurbish the Kosovo B Power Station, the production of which will therefore decline in the short term. Feed-in tariffs for renewable energy and the costs of investing in energy efficiency, combined with the cost of building the KRPP, are expected to increase energy costs before these subsequently decline as distribution losses are reduced. The resulting increase in electricity tariffs could create significant risks to the poorer households and would require corresponding remedial measures.

4.61. **A bid was received on December 19, 2014, from the energy company Contour Global, representing a major milestone for the KRPP project's realization.** Contract negotiations are currently under way between the government and Contour Global to determine the details concerning financing, timeline, and other aspects of the project.⁸³

⁸² A World Bank (2011) options study examined several alternatives for closing the power gap, including renewables, imports, a new natural gas power plant, and a new thermal power plant.

⁸³ While the bid process moves forward, the government would also need to (a) ensure adequate funding of the required mine expansion, (b) guarantee full adherence to the resettlement framework for future mine development, (c) prepare steps to adjust tariffs accordingly (most likely in conjunction with complementary social policies), (d) maintain the focus on the development of renewable energy and energy efficiency, (e) take the necessary steps to create a trade company that will act as offtake purchaser for the power purchase

4.62. **A critical challenge in the energy and mining sectors is the substantial environmental and social concerns and legacies, which create public opposition and reluctance from the private sector to invest in operations not in line with international standards.**⁸⁴ In addition to applying Best Available Techniques, in line with EU legislation for new investments, remediation of the historic environmental legacies related to mining will be required to remove the health impact of these legacies, bring dilapidated and degraded land back into productive use and reducing public opposition against continuing/increasing production. The areas of the depleted and dilapidated Bardh and Mirash lignite mines are about 10 km² of which large areas could be made available for agricultural production and other land uses to the communities in the municipality of Obiliq/Obilic once rehabilitated. For the Trepça complex, the main sources of nonproduction related pollution are as follows: (a) mine tailing ponds and dams/heaps which cause dust, erosion, contaminated runoff water and seepage water and groundwater contamination; both dust and discharges contain heavy metals; (b) site contamination and onsite storage of waste at the two smelter sites- dust, contaminated run-off water and seepage water, and groundwater contamination, also containing heavy metals; (c) acid mine drainage – mine water discharge, often with high acidity and containing heavy metals; and (d) soil contamination from dust and other emission deposits- deposits of particulate matter containing heavy metals causing soil and groundwater contamination and uptake in crops and plants for grazing.⁸⁵ On the social side, the adequate identification and management (that is, proper planning, compensation, and so on) of the potential impacts on communities located in mining areas in line with international standards is a critical element to ensure the social license to operate for the sector. Additionally, the lignite mine will require substantial recapitalization for its continued operations and supply of the existing power plants, estimated at about €250-400 million over the next 3-5 years.

4.63. **Further, to ensure private sector participation, another particular challenge consists of ensuring that energy tariffs fully reflect costs.** As the government has planned a significant role for the private sector in the development of the Kosovo energy sector, it is crucial that investors benefit from a predictable and fair market environment. Investors need confidence that investments can be fully recovered through cost reflective tariffs. In addition, investors need to be persuaded that the Energy Regulatory Office will independently regulate the energy market without favoring particular market participants, including public sector companies. Cost reflective energy tariffs will also reduce the need for the public sector to provide ad hoc subsidies that currently absorb a significant share of the budget.

4.64. **Regardless of the extent of private sector participation, striking the right balance between fiscal sustainability and service affordability considerations is necessary.** The energy sector has received large—but declining—subsidies to protect consumers from high import prices. While the import subsidies have fallen from €69 million in 2009 to €18 million in 2012, the government provided the public power utility Kosovo Electricity Corporation over the years with considerable credit and grant funds for capital repairs and improvements, thereby taking off the pressure for cost reflective tariff increases⁸⁶. These subsidies, loans and grants have kept energy prices artificially low. Despite the large distribution losses, there are few countries in Europe whose consumers pay cheaper electricity prices than Kosovo. Such low tariffs in Kosovo arise partly because Kosovo A and B were able to generate power at wholesale prices of less than €0.025 per kilowatt hour thanks to the generous grants and unrepaid loans to fund capital repairs and improvements.

agreement, and (f) complete negotiations with the bidder.

⁸⁴ The energy sector is the main source of air, water, and soil pollution in Kosovo. Environmental and climate standards are not mainstreamed into other policies, particularly energy, transport, forestry, agriculture, or industry.

⁸⁵ World Bank (2013d).

⁸⁶ The capital investments are counted in the tariff as depreciation costs.

4.65. **Current low energy costs cannot be maintained after large investments in energy efficiency, renewable energy or a new power plant.** Maintaining 2013 prices following large-scale investments of any kind would require significant government subsidies to the sector. With nonsmoothed costs, these subsidies are estimated to peak around 2020, and could create difficulties from a fiscal perspective. If all costs are passed through to consumers, the increase could have economic and social consequences as households and firms see bills rise. Particular attention should be paid to the poor and vulnerable, such as those receiving the last-resort social assistance. A middle path could be found by raising costs gradually and by compensating poor and vulnerable consumers for the real income losses arising from tariff increases through an adequate social protection mechanism. Compensating low-income households via income transfers is more economically efficient than direct energy subsidies, which distort relative prices and encourage overconsumption of energy. The current mechanism for subsidizing electricity costs to recipients of last resort social assistance would be inadequate, as the majority of poor households do not receive last resort social assistance because of nonincome eligibility criteria. Instead a new, more comprehensive means-tested transfer would have to be established to ensure adequate protection to low-income households from the real income loss of sharply increased electricity tariffs.

Increasing Connectivity

4.66. **As a small and landlocked economy, connectivity plays a critical role for a successful integration to regional and global markets.** Integration promises lower transaction costs, more trade, bigger markets, economies of scale, and more competition and efficiency. However, despite its proximity to important markets, Kosovo can be marginalized because of the lack of direct access to the sea and dependence on transit through other countries. The expansion of the communication network is also a key to Kosovo economic prospects.

Transport

4.67. **Kosovo's main modes of transport— roads and rail – were in poor condition at independence because of the effects of war and the years of low investment and neglect.** Many of its stations, bridges, tunnels and viaducts were destroyed. Overall, Kosovo's road transport infrastructure is comparable with other Eastern European countries.⁸⁷ Among a group of 10 comparator countries in Eastern Europe, Kosovo ranks high on measures of road transport density, but average on measures of road network length per population.⁸⁸ With 330 kilometers of railway, Kosovo's railway network is small compared with most SEE countries. The combined freight tonnage per kilometer and passenger kilometers of travel per kilometer of track (railway intensity) is the second lowest in the SEE and is only 7 percent of the average of the railways in the EU. However, given Kosovo's small geographical area, most transport distances are too short for rail transport to be a viable alternative to roads.

⁸⁷ Roads are the main mode of transport in Kosovo, comprising more than 90 percent of transport infrastructure by length and 98 percent by service delivery (tons or passengers per kilometer).

⁸⁸ Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Moldova, Montenegro, Romania, Serbia, and Slovenia.

Table 17. Transport Infrastructure Road Density Comparison

Country	Kilometers per								
	Population, 1,000s			Square km, 1,000s			GDP, U.S. dollars		
	Paved	Unpaved	Total	Paved	Unpaved	Total	Paved	Unpaved	Total
Albania	2.0	3.1	5.1	244	382	626	559	875	1,434
Bosnia and Herzegovina	5.3	0.5	5.8	413	35	448	1,219	104	1,323
Bulgaria	5.2	0.1	5.3	358	5	363	777	12	789
Croatia	5.9	0.6	6.5	471	48	519	471	49	520
Kosovo	2.9	2.1	5.0	461	327	788	780	553	1,333
Moldova	1.8	0.3	2.1	238	38	276	1,111	177	1,288
Montenegro	8.4	3.8	12.2	381	171	552	1,250	559	1,809
Romania	2.4	1.9	4.3	195	151	346	275	211	486
Serbia	3.5	2.1	5.6	300	174	474	688	400	1,088
Slovenia	19.0	0.0	19.0	1,920	0	1,920	857	0	857
Average	5.5	1.6	7.1	476	155	631	762	331	1,093
Kosovo average, %	27	215	70	51	352	125	54	278	122
Kosovo rank	6	3	6	2	2	2	5	3	3

Source: World Bank estimates using data of the CIA, World Factbook, 2012.

4.68. **Kosovo has invested heavily in new physical capital to repair the damage associated with the breakup of Yugoslavia and the war.** During 2008–10, a large proportion of investments were directed in rehabilitation and expansion of main roads of Pristina-Peja and Pristina-Mitrovica that enable internal road connection of Kosovo. While the majority of high-level main roads has been developed and upgraded – several sections to motorway standards—many national, regional and local roads did not receive much attention. During this period there has been some expansion in construction of local roads, but the construction of Route 7 brought other road construction projects to a halt. Similarly, Kosovo’s average investment in maintenance and rehabilitation has dropped significantly in the past few years. By 2012, the road rehabilitation budget was just a quarter of its 2009 (pre-highway construction) levels. This stems from a road maintenance budget that is less than half of neighboring Serbia or Bosnia and Herzegovina on a per kilometer basis. A recent study identified a need for 39 local road improvements with economic rates of return of up to 81 percent. While there are significant caveats to this comparison, the results indicate an underfunding of maintenance in Kosovo.⁸⁹ However, the costs are measured. Rail investment has also been low and dependent on support from the budget.

4.69. **The new highways risks squeezing other public investments, including the maintained of existing road network and railways.** The recently approved Route 6 Highway between Pristina and FYR Macedonia is estimated to cost approximately €750 million or 14.4 percent of GDP.⁹⁰ While this will contribute toward improving trade corridors, it would likely crowd out the investments in maintenance (as did Route 7 investments) and other transport infrastructure needed by exporters such as railways that could support mining exports. Given that transport investments use scarce budget resources, investments in human capital energy

89 Each national authority and international institution uses unique definitions of road maintenance and includes different types of roads. For example, in the comparison presented in this chapter, the national roads in Kosovo are the only roads included. However, in other countries, maintenance may include only routine maintenance or may include, in addition, the reconstruction of paved roads. Activities may also be funded in different ways so that they are included or excluded from estimates of maintenance expenditures. Thus, if reconstruction is funded by international financial institutions, the cost might be lost in the budget line on loan amortization. Comparisons that include all roads and varied expenditures might give a different indication.

90 This new highway (Route 6) was approved at an interministerial steering committee on January 10, 2014, and the contract was awarded to the United States–Turkish consortium Bechtel-ENKA, which also built Route 7. The cost is €600 million for the project, plus an estimated €150 million to finance expropriations.

generation capacities could also be crowded out. Like its past investments, Kosovo's future investment plans do not appear to be calibrated to meet the country's needs.

Information and Communication Technology

4.70. **Addressing infrastructure bottlenecks in broadband electronic communications is strategic for Kosovo's competitiveness, paving the way for income growth and job creation.** The European Commission argues that increased availability of high speed broadband could significantly accelerate socioeconomic impact, for example, 2.5 times higher input-output benefit, 3 times higher number of jobs created, and considerable increase in consumer surplus.⁹¹ In terms of FDI, first, the sector itself is attractive for FDI. In 2013, ICT was the largest sector for FDI in Europe, up from third place in 2012, representing 18.08 percent of the total capital investment in the region.⁹² The development of broadband in the context of a competitive and open market is identified as a key factor to increasing the impact of GDP on growth (Farid Badran, 2011). It has also been proven that availability of reliable and reasonably priced high speed broadband is a key determining factor for attracting FDI.

4.71. **Not only does broadband contribute significantly to the increase in countries' international competitiveness, it also contributes to the fight against poverty and unemployment, promotion of social inclusion and territorial cohesion, and stimulation of infrastructure investments.** As discussed earlier, ICT not only provides income to high-skilled and lower-skilled labor, but also supports economic growth through creation of direct, indirect, and induced jobs.⁹³ The underdeveloped telecommunications infrastructure hinders individual and firm productivity, poses a constraint to FDI and the country's integration in the regional economy, and presents a major obstacle to ensuring universal public service delivery. After the campaign of the North Atlantic Treaty Organization in 1999, a significant share of the country's fixed infrastructure was damaged, and its regional networks were disrupted. Since then, ICT development has been hampered by patchy telecommunications infrastructure, which presently leaves 42.96 percent of the rural households unconnected to the broadband Internet infrastructure (62 percent of the Kosovo population is rural). A third of these households are unlikely to be connected to the network in the near future.⁹⁴ The municipalities, which are considerably underserved or simply unserved in terms of Internet access, contain a higher concentration of bottom 40 households.⁹⁵ Moreover, access barriers to existing telecommunications infrastructure are rather high: since 2010 local household expenditures for communication have been steadily increasing and present an impediment to the uptake of ICTs, particularly for the bottom 40.⁹⁶ As with other infrastructures, the level of access to ICTs of the bottom 40 may determine their ability to accumulate other assets.⁹⁷

⁹¹ Input-output analysis is based on the premise that investment in one sector of the economy causes growth in another sector through the multiplier effect.

⁹² The capital spent on ICT and Internet infrastructure in 2013 was the highest recorded since fDi Markets began tracking and was supported by a 66.5 percent rise in project numbers to 328 (fDi Intelligence 2014).

⁹³ ICT as a sector includes telecommunications and the IT industry.

⁹⁴ Department of Post-Telecommunication and Information Technology, Ministry of Economic Development of Kosovo.

⁹⁵ The municipalities (and the districts of which they are a part), are as follows: Junik (Gjakova), Decan (Gjakova), Dragash (Prizren), Novoberde (District of Pristina), Hani i Elezit (Ferizaj), Kacanik (Ferizaj), Gracanica (District of Pristina), Ranilug (Gjilan), Skenderaj (Mitrovica), Klina (Peć), Mamusha (Prizren), and Drenas (Glogovac). The majority of the districts represented have a high distribution of the bottom 40.

⁹⁶ Postal services, cell phone services and calls, other phone and fax services, Internet, and so on.

⁹⁷ Bussolo and López-Calva (2014).

4.72. **Investment into Kosovo’s electronic communications has been following a declining trend.**⁹⁸

Demand for broadband services alone cannot compensate for the investments required to extend broadband connectivity to rural areas. The amount of investments as percentage of revenues in Kosovo’s electronic communications sector remained lower than, for example, Serbia or Bosnia and Herzegovina, but somewhat higher than that of Montenegro, Albania, and FYR Macedonia. One of the reasons for it is low interest of the private sector to invest in the infrastructure rollout and upgrade in the low population density and mountainous areas, which are considered to be commercially unattractive. . In the case of rural households of Kosovo, the correlation between their broadband penetration and demand indicators is nonexistent. In such a situation, it is highly unlikely that the private sector will attend to the investments needs of rural Kosovo; it is equally unlikely that demand stimulation programs (for example, ICT literacy, and so on) would be effective without parallel support for infrastructure roll-out. Kosovo is thus likely to face a difficulty in meeting the national broadband coverage and speed targets if fixed Internet infrastructure is not rolled out outside of the urban areas.⁹⁹ Although recognizing the issue, the government of Kosovo has not yet been able to launch any public program to stimulate geographically consistent broadband rollout and ensure high quality of broadband service in the economically unattractive areas.

Figure 46. Fixed and Mobile Broadband Penetrations, 2013

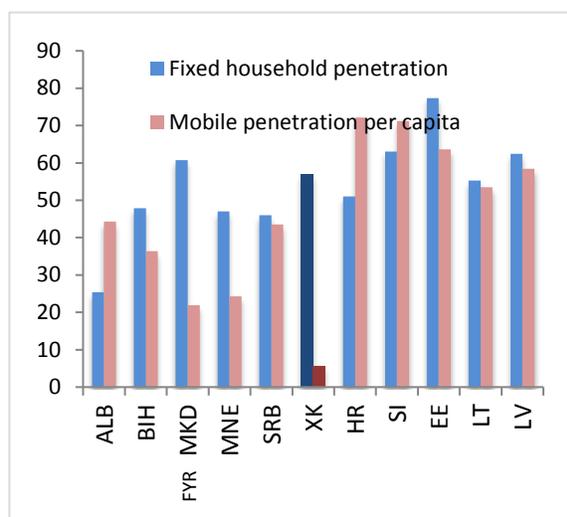
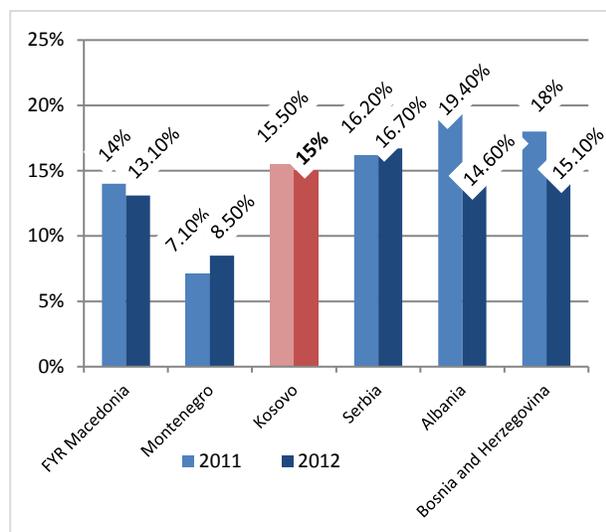


Figure 47. Investments as a Percentage of Revenues, Electronic Communications Sector



Sources: EC 2014b; GlobalComms Database, TeleGeography, Washington, DC, <https://www.telegeography.com/research-services/globalcomms-database-service/index.html>.

Note: Higher value for the fixed broadband household penetration in Kosovo is attributed to the high number of inhabitants per household (~6); fixed broadband penetration per capita is among the lowest in the region.

⁹⁸ In the particular case of Kosovo, there was a decrease in investment in fixed voice telephony in both 2011 and 2012 because of the government’s decision to freeze most of the capital and investment projects at the incumbent operator because of the privatization process.

⁹⁹ The digital communication sector policy establishes: the following goals: (a) by 2016, 70 percent of Kosovo residents have access to the Internet at a speed of 30 Mbps, and, by 2020, all residents of the country have such access; (b) upgrade the Internet access infrastructure in libraries so that, by 2020, all libraries are equipped with public Internet access points at 10 Mbps or higher; and (c) upgrade the Internet access infrastructure of schools so that, by 2020, all schools are connected to the Internet at a speed of 10 Mbps or higher (MED 2013).

4.73. **Kosovo's wireless market is also underdeveloped with a penetration rate per capita of only 89.1 percent in end-2013, in contrast to the average of 157 percent for the western Balkan region.** Inefficient spectrum management (for example, freeing up and issuance of additional frequency bands) is considered to be the major bottleneck for the mobile broadband roll out. The underdeveloped wireless market in turn holds back arrival of high-speed mobile broadband offerings, which are of particular importance to the mountainous and less densely populated rural and isolated areas of the country, where the deployment of fixed broadband networks is not commercially viable. As a result, only 5.74 percent of Kosovo population are mobile broadband service users, which is almost seven times lower than the regional average. Similarly, the number of the dedicated data cards/wireless modems per 100 population in Kosovo stands at only 2.78 percent, whereas the SEE6 average is 4.5 percent and EU-27 average is 9 percent. Kosovo is one of the last countries in Europe to launch commercial 3G services.

4.74. **With over 60 percent of rural population, regional development is key to shared prosperity.** Its young and technologically savvy population means that Kosovo could build its position in the digital economy for a sustainable and more prosperous future. Extension of broadband infrastructure to rural areas is strategic for Kosovo as it may address number of development bottlenecks through job creation, attraction of FDIs and positive impact on other sectors, such as agriculture and tourism. This approach is also seen as an efficient measure in EU (box IV.5). For that to happen Kosovo needs to put in place public financial stimulus program to advance geographically consistent broadband development in the economically unattractive areas and introduce greater efficiency in the area of spectrum management to enable further development of mobile broadband market. The unprecedented spread of the Internet globally and improvements in ICT access in Kosovo mean that businesses and people can access economic, knowledge, and social networks globally, opening opportunities for employment (for example, through growth of IT-based businesses, online work, and trade in services). Yet, this also means that the skills base will need to be developed, and young people should have the capacity to find and do work in the digital era. The potential for digital jobs goes beyond the vertical ICT industry, as trends suggest that jobs across sectors are becoming digital; absent appropriate skills, young people will find themselves either out of work or stuck in low-wage jobs (especially in nontradable service sectors). It may be essential thus to bridge the existing gaps between education and employment, to increase the size of the local talent pool and expand digital job opportunities.

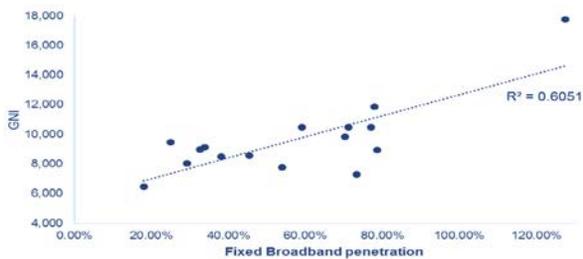
Box IV.4. The correlation between demand indicators and broadband penetration in the case of urban and rural households in Kosovo

The World Bank is currently providing a technical assistance to the government of Kosovo in development of a rural broadband program that aims to identify and prepare the feasibility studies for bridging infrastructure gaps between the urban and rural areas. In this context, interdependencies between the broadband penetration and sociodemographic parameters that are having the greatest impact on the broadband adoption, that is, demand indicators, have been analyzed at the municipality level. These indicators include the level of income (measured by GNI), level of education (measured by years of education), and population age (measured by average age). This exercise is part of the assignment to forecast the potential demand for broadband services.

While analyzing the interdependencies between the demand indicators and broadband penetration in the case of rural municipalities of Kosovo, no strong correlation between the two variables was observed. However, in the case of urban municipalities, a correlation between the level of broadband penetration and level of income was observed. There was no observed correlation between the level of education or age in the case of both urban and rural households. The broadband penetration and number of urban households per municipality demonstrated (and anticipated) a strong correlation, proving the fact that most of the broadband connections are concentrated in urban areas. The correlation

test using mobile broadband penetration was not performed because currently the mobile broadband services are only available in urban areas. Some of the results of the analysis are presented in below figures.

Figure BIV.4.1. Correlation between the fixed broadband penetration and (a) number of urban households per municipality or (b) level of income



Source: 2015 Deloitte analysis for the World Bank.

Box IV.5. Why Does the EU Cofinance Broadband Infrastructure in Rural Areas?

There is a wide consensus across the EU that by bringing the broadband connectivity to rural areas member states encourage the take-up and diffusion of ICTs that are essential for economic diversification of rural areas as well as for their local social development, provision of public services and promotion of e-inclusion, for instance:

- Improving the *competitiveness of the sector* through the adoption of e-Commerce and e-Business and innovative practices in the design, production, marketing and delivery of products and services (for example, e-Tourism) thereby sizing the opportunities offered by the internal and international markets.
- *Reducing the natural handicaps in remote, rural and mountainous areas* thereby contributing to a sustainable, environmentally friendly development through the delivery of affordable ICT broadband services and infrastructure.
- *Improving the quality of life* in rural areas with more efficient e-public services to citizens and enterprises (e-government, e-Health).
- *Enhancing training, skills acquisition* and dissemination of knowledge and expertise through e-learning and networking services.
- *Improving governance* with a better design, management, and implementation of rural development policy through online networking of stakeholders and better monitoring and evaluation tools.

Some more examples of ICT contribution to sectors of economy in the rural areas include the following:

- On the EU level, the *agrifood sector*, as a whole, has been identified as lagging behind in the take-up of ICT. This is particularly the case for smaller businesses. Adoption of e-business applications is still at a low level outside of large multinationals and their larger suppliers. The rural development structural funds are complementing different initiatives across the EU in the fields of e-business (particularly in relation to SMEs), e-skills and e-learning.
- Wide adoption of ICTs is encouraging the *development of tourism*. Tourism is a major growth sector in many rural areas and can build on existing cultural and natural heritage. Increased use of ICT in tourism for bookings, promotion, marketing, service design and recreational activities can help improve visitor numbers and lengths of stays, particularly where ICT provides links to smaller facilities and encourages agritourism.

Source: Adopted from the Council Decision on Community strategic guidelines for rural development (programming period 2007 to 2013), 2006/144/EC, 20 February 2006, at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:055:0020:0029:EN:PDF>; Commission Staff Working Document, Annex to the: Proposal for a Council Decision on Community strategic guidelines for Rural Development, Update to Impact Assessment Report [SEC(2004) 931]{COM(2005) 304 final}, at: http://ec.europa.eu/agriculture/rurdev/publi/strategic-guidelines/impact_en.pdf.

V. GREATER INCLUSION BY BUILDING HUMAN CAPITAL AND PROVIDING EQUAL OPPORTUNITIES

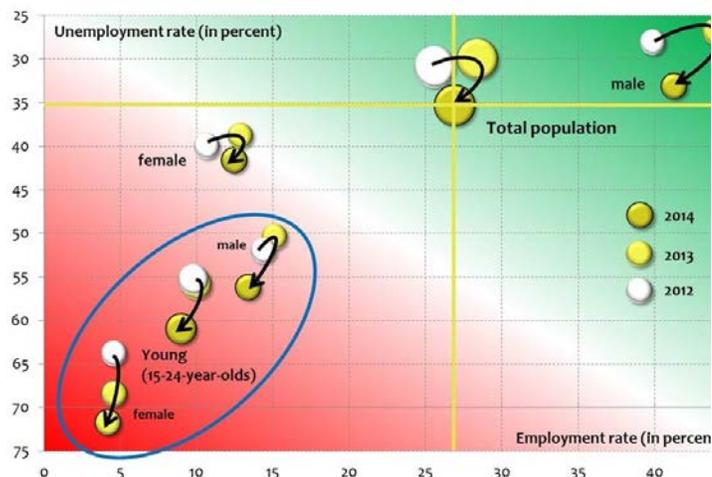
5.1. To attract private sector investments and foster business expansion and fully reap the benefits of European integration, the workforce needs to be equipped with both the specific skills and the soft skills that private sector employers are seeking. Cashing in on the demographic dividend of a young population and promoting economic inclusion will require that the general education system be complemented with greater opportunities for acquiring these skill sets as well as improving opportunities for women, youth and minorities, which do not participate and benefit from economic growth. Paying greater attention to the quality of public services and equality of opportunities, across wealth groups, ethnic lines, and regions in health, education, and social protection, is also important for greater social and economic inclusion and cohesion.

Increasing skills, employment and labor productivity

5.2. Increasing employment and labor productivity are vital for ensuring that low-income households participate in and benefit from economic growth. Kosovo is a young country, with 38 percent of the population under the age of 19. Unlike most European countries¹⁰⁰ Kosovo has a young population and is sitting on a potentially large demographic dividend, which provides an opportunity to build a large, educated workforce with few of the fiscal and economic pressures that burden countries with aging populations. In addition to the business environment improvements noted earlier, the existence of a large, young and competent workforce will also help attract investment and increase employment opportunities and sustained income gains. However, the jobs agenda is all the more pivotal: if Kosovo does not take advantage of its youthful population, the demographic dividend may become a demographic curse. This particular demographic distribution brings serious risks of accelerated rate of outward migration and brain drain, if there is failure to provide youthful population with an economic perspective.

5.3. Kosovo has one of the weakest employment records in Europe. Kosovo's 37.6 percent labor force participation rate in 2015 is substantially below the 70 percent regional average. Similarly, the employment rate stood at an estimated 25.2 percent end unemployment rate at 32.9 percent (and considerably worse for women and, especially, youth).

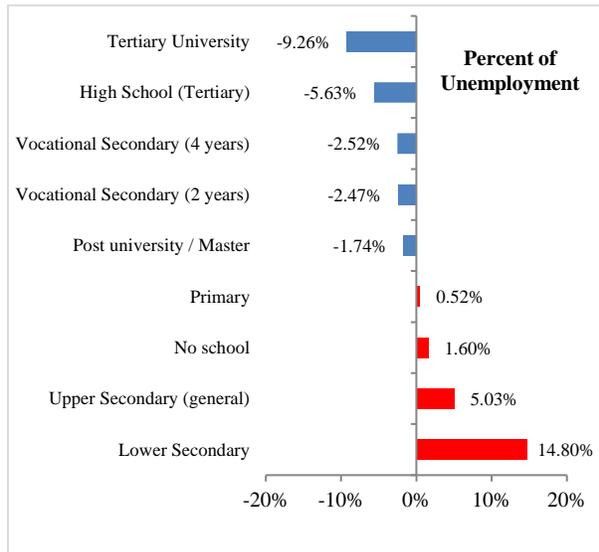
Figure 48. Changes in Kosovo's Labour Market, 2012–14



100 Albania (33 percent), Bosnia and Herzegovina (25 percent), Montenegro (27 percent), Serbia (23 percent), Slovenia (19 percent).

Figure 49 Factors behind Employment

5.4. **Education is the first essential step as part of Kosovo’s efforts to increase productivity, build the critical human capital and reduce the unacceptably high rates of unemployment.** The current education system has not yet provided students with the skills necessary to succeed in the (changing) labor market. In Kosovo, an inadequately educated and skilled workforce remains a binding constraint for, especially, large and fast-growing firms—thereby dampening growth and causing important social costs in terms of foregone employment.



Source: Kosovo LFS 2012 and World Bank calculations.

5.5. **Public spending on education is low and squeezed by public investment.** Following wide-ranging reforms, public expenditures in education have grown in recent years and are catching up with the rest of SEE.¹⁰¹ Yet, because of its youthful demographic structure Kosovo spends much less per pupil—only 13 percent of per capita income per student in primary and secondary education. This is considerably less than upper-middle income countries (16.2 and 17.8 percent, respectively primary and secondary education), average EU15+3 countries (19.5 and 22.0 percent) or other EU member states such as Poland (23.5 and 24.6 percent) or Slovenia (26.9 percent for both primary and secondary education).¹⁰²

5.6. **Moreover, expenditures on teacher wages have driven the increases, crowding out other spending.** Spending on wages under the education budget increased by over 25 percent in real terms between 2009 and 2012, taking wages from 85 percent of total spending on basic education (grades 0-9) in 2009 to 92 percent by 2012.¹⁰³ At the same time, spending on all other items fell. Capital spending fell by over 60 percent in real terms, declining from 8 to 3 percent of the total. Secondary education suffered from a similar budget squeeze. Spending on nonsalary recurrent items was low in 2012 relative to countries in the Organisation for Economic Co-operation and Development (OECD) or in the region. On average, OECD countries spent 22 percent of education budget on nonsalary recurrent items, and about 8.7 percent on capital expenditures.¹⁰⁴ In Europe, Slovenia spent 19 percent of total expenditures on nonsalary items and 8 percent on capital expenses,

¹⁰¹ Improved access to preprimary and upper-secondary education, with 2012 enrollment rates at 72 percent (age 5) and 91.8 percent, respectively. Upper-secondary enrollments rose by 50 percent during 2004–12 and remained at high levels in basic education, between 97 and 100 percent. Public spending on education grew steadily, from 3.3 percent of GDP in 2007 to 4.1 percent in 2012, more than Albania (3.3 percent) and FYR Macedonia (3.5 percent), but less than Croatia (4.4 percent) and Serbia (4.7 percent).

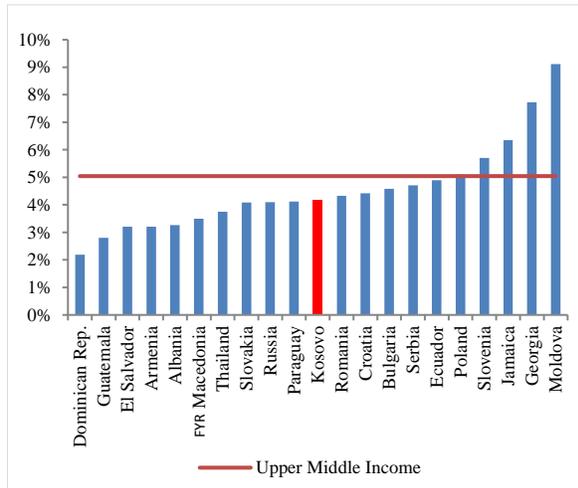
¹⁰² Austria, Belgium, Denmark, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

¹⁰³ As a share of recurrent budgets, the figures are 94 percent and 92 percent for primary and secondary education, respectively.

¹⁰⁴ OECD (2012).

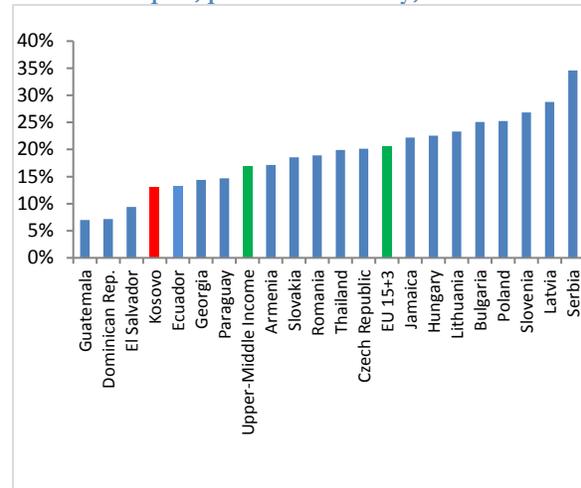
while Bulgaria and Romania spent 26 percent on nonsalary items, and 6 and 4 percent on capital expenditures, respectively.¹⁰⁵

Figure 50. Public Expenditure in Education, % of GDP



Sources: Kosovo BOOST; EdStats: Education Statistics (database), World Bank, Washington, DC, <http://datatopics.worldbank.org/education/>.

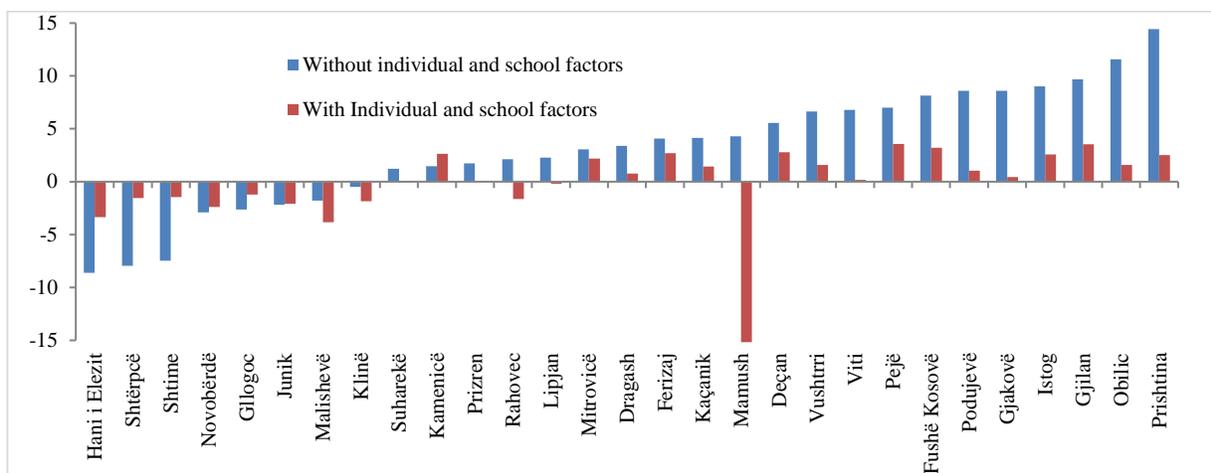
Figure 51. Public Expenditures Per Pupil as a % of GDP Per Capita, prior to University, 2011 or Latest



Sources: Kosovo BOOST; 2013 data in EdStats: Education Statistics (database), World Bank, Washington, DC, <http://datatopics.worldbank.org/education/>.

5.7. **Moreover, the quality of education remains weak and inequitable.** Overall results show significant municipal disparities (with and without controlling for socioeconomic variables), calling for action in order to alleviate and mitigate these differences. While the low passing rate and achievement levels of students at the national Matura appear to indicate a need for considerable improvements, the initial results of Grade 5 sample-based test—undertaken in 2010 as a precursor to Kosovo’s entry in the 2015 wave of the Programme for International Student Assessment—suggest large differences between girls and boys (especially in language tests) and rural and urban students.

Figure 52. Fifth Grade Reading Scores, by Municipality



Source: World Bank calculations based on the results of grade 5 examinations; EdStats: Education Statistics (database), World Bank, Washington, DC, <http://datatopics.worldbank.org/education/>.

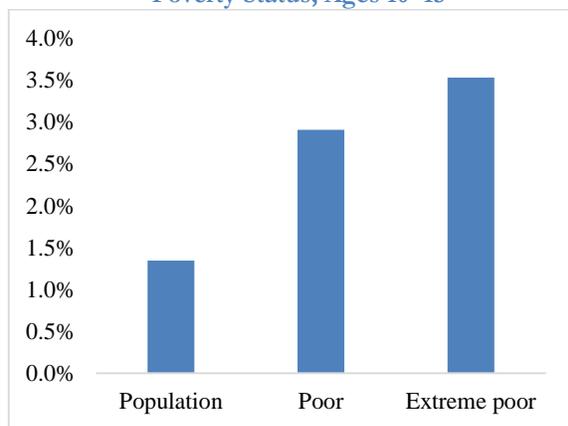
Note: Results reported are the regression coefficients of reading scores and municipality fixed effects, with and without individual controls on socioeconomic background and learning conditions.

105 EdStats: Education Statistics (database), World Bank, Washington, DC, <http://datatopics.worldbank.org/education/>.

5.8. **Kosovo has reached full gender parity in basic education, but needs to increase female enrollment in upper secondary.** In recent years, gross enrollment ratios have been virtually identical and almost universal for boys and girls in basic education, ranging from 97 to 101 percent. However, enrollments in upper secondary are neither universal nor gender-balanced, although there have been recent improvements. The gross enrollment ratio among girls in grades 10–12 increased from 81 percent to 84 percent between 2010 and 2014, while, among boys, it grew from 88 percent to 89 percent. Girls’ rates of transition from one grade to the next drop significantly in the 10th grade. While the transition rate for girls has increased from 84.9 percent in 2012 to 91 percent in 2014, it is still behind the transition rate of boys 98 percent in 2014.¹⁰⁶ MICS 2013/14 data suggest that only about 66 percent of children from the poorest quintile attend upper-secondary education compared with 97 percent from the richest. Furthermore, transition rates to upper secondary are only 81 percent for the poorest compared with 97 percent for the richest.

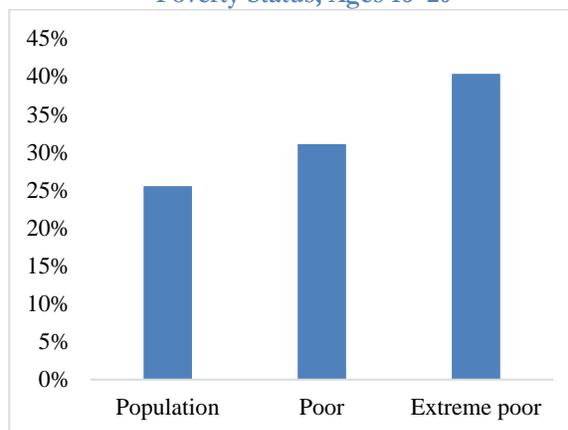
5.9. **Children in poor and extremely poor households are less likely to be enrolled in education.** Nonenrollment of children aged 10 to 15 years (who are expected to be in basic education) in households defined as poor, according to the national poverty line, is 2.9 percent, and rises to 3.5 percent for children in extremely poor households (figures 52 and 53). Differences are even larger for higher levels of education. While around a quarter of all 16 to 20 year olds are not enrolled in higher education this increased to over 30 percent for children from poor households and 40 percent for children from extremely poor households. Insufficient access to education is most pronounced for the RAE communities. According to the Multiple Indicator Cluster Survey (MICS) 2013–14, only 68.1 percent (54.1 percent in the poorest quintile) of RAE children of primary school entry age enter primary school, compared with 91.6 percent (91.5 percent of the poorest quintile) among the rest of the population.¹⁰⁷ Furthermore, children from the RAE community fall further behind in terms of attendance to lower secondary and upper secondary education, especially those from the poorest quintile.¹⁰⁸ This suggests that efforts to increase enrollment would benefit from targeting to offer children from poorer households a way to break out of the cycle of poverty.

Figure 53. Nonenrollment Rates, by Household Poverty Status, Ages 10–15



Sources: 2011 HBS; World Bank calculations.

Figure 54. Nonenrollment Rates, by Household Poverty Status, Ages 16–20



Sources: 2011 HBS; World Bank calculations.

¹⁰⁶ MEST. 2014. “Statistical report with education indicators: 2012/13 and 2013/14.”

¹⁰⁷ KAS (2014).

¹⁰⁸ According to MICS 2013–14, only 65 percent of RAE children attend lower-secondary education, compared with 96 percent among the general population. Furthermore, only 30 percent of RAE children attend upper-secondary education, compared with 82 percent among the general population. Only about 8 percent of children from the poorest RAE quintile attend upper-secondary education, compared with 66 percent among the general population.

5.10. **Moreover, enrollment rates for Early Childhood Education are particularly low.** According to the MICS, the percentage of children aged 36–59 months attending an organized early childhood education program is 14 percent, with a notable difference between children in urban (23 percent) and rural (9 percent) areas. Notable differences are seen between the attendance of children from the poorest quintile (7 percent) relative to the richest quintile (37 percent). Among the RAE community, about 16 percent of children attend ECD programs. These figures show that most children in Kosovo do not have the opportunity to gain a set of emotional, behavioral and cognitive skills that lead to better school preparedness. The social and economic returns for investing in early childhood education are highest at young ages. In addition, investment in early childhood education is particularly beneficial for children from poorer families because they are less likely to receive sufficient support in the home with respect to social, communication, and cognitive development. Expanding early childhood education and preprimary education would lead to society-wide benefits in the medium to long term in terms of higher employment and worker productivity and would contribute to a positive fiscal dynamic.

5.11. **Evaluating the core skills of pupils will enable the government to focus on developing and implementing policies to raise educational and skill standards.** The participation in the Programme for International Student Assessment will allow to extend the results obtained in the 2010 national 5th grade assessment (which followed the same assessment methodology) to a more comprehensive analysis of the quality and equity of the system throughout differences between municipalities, ethnic groups, gender disparities, or types of schools. The other main contribution of the assessment will be to compare Kosovo’s education system performance internationally, identifying the strengths and weaknesses of the system and pointing toward potential areas of improvement.

5.12. **Going forward, education could benefit from both more resource and improved efficiency of existing resources.** Demographic changes – resulting from both a lower birth rate and migration – are partly responsible for future savings and required future spending increases. Resources should be used to increase enrollment in preprimary education and early childhood education, which has high economic and social rates of return, and to ensure sufficient resources in upper-secondary education to cope with demographic changes. Other savings and spending adjustments can be made by adjusting policy and the rationalization of the school network – especially in rural areas with small classrooms – and by taking measures to improve the school financing formula such as simplifying it and providing sufficient training to school-level financial managers. Finally, increase teacher training opportunities and depoliticize wage increases so that they are based partly on training and performance.

5.13. **Education alone is not sufficient.** Improving the general education system—especially primary and secondary—is a first step, which needs to be complemented greater opportunities for acquiring both the specific skills and the soft skills that private sector employers are seeking.¹⁰⁹ Developing these skills not only increases wage employment opportunities, but may also stimulate greater self-employment and entrepreneurship, including agribusiness, ICT-enabled jobs, and other emerging sectors. Measures to improve the supply of skills, labor market matching, and incentives to work have an important bearing on growth and employment. Low labor force participation and high unemployment also affect incentives to work, labor market

109 Detailed information about the supply of and demand for worker skills is expected from the World Bank STEP survey of households and firms. See “The STEP Skills Measurement Program,” World Bank, Washington, DC, <http://microdata.worldbank.org/index.php/catalog/step/about>.

matching, and the nature of labor demand by firms. However, evidence from BEEPS suggests that regulations in labor markets are not a binding constraint on employment.

5.14. **Labor market policies and regulations are needed to tackle the extremely low labor force participation rate.** Public employment centers and self-employment programs do exist, but the efficiency of these programs must be improved. Establishing quality certification, such as adopting international certificates, might improve trust level among employers about potential employees outside their networks. A more regular, consistent, and strategic consultations with the private sector would help (a) develop business and management know how, and (b) facilitate a more significant transfer of skills and information, research, and development. On the supply side, tax policies, improve job placement program (alignment with market demand), active labor market programs, labor market information and intermediation, access to child care for mothers, and other legislations are also important aspect to consider.

Box V.1. Labor Market Programs and Policies

Kosovo is not a member state of the International Labour Organization and has not ratified any of the conventions specified. However, Kosovo is a signatory (either in its own right or as part of its legacy) to most International Labour Organization regulations and has aligned its regulations with international standards.^a The labor law generally balances the need to provide flexibility to workers at entry and exit to the labor market while at the same time protecting workers from exploitation. Labor market rigidities in terms of hiring and firing of workers are low. However, the maternity leave (now 12 months) may be imposing a cost on employers and may lead employers to avoid hiring women, which would contribute to the low female employment rates (less than 10 percent of working age women were employed compared with 40 percent of men in 2012). The government is in the process of revising the labor law, including the maternity leave provision, but the revised law has not been submitted to Parliament.

Kosovo does not have unemployment benefit insurance. The last resort social assistance program combines elements of minimum-income support schemes; unemployment benefit and child allowance schemes, and is the single instrument for poverty and unemployment risk mitigation. Employment services for the registered unemployed who are willing to work are provided through the public employment offices (PES).

The Labor Law provides flexibility at entry and exit to the labor market. Labor market rigidities in terms of hiring and firing of workers are low, among the lowest in all transition economies. The BEEPS 2013 survey results show that only 2.2 percent of firms in Kosovo find labor regulations to be a problem for doing business, lower relative to the SEE average (4.6 percent). There is little direct state intervention in the labor market. Moreover, the tax wedge on labor is among the lowest in the region since Kosovo only applies a (low) pension contribution, in addition to the (low) PIT.

a. The employment protection framework provides for basic protection through the Law on Labor No. 03/L 212 (published on December 1, 2010), the Labor Inspectorate Law (2002), and the Occupational Safety, Health and Working Environment Law (2003). However, enforcement is spotty, and there is a lack of appropriate incentives.

5.15. **Kosovo will benefit greatly from regional mobility and the benefits may well be mutual.**¹¹⁰ Kosovo remains the last territory in the western Balkans whose citizens must get a visa in order to travel to countries in the Schengen Area. This is also the case when they travel on Serbian passports (although the Serbs themselves can now travel visa-free). When it comes to incoming migrants, the Kosovo authorities have made considerable efforts to follow up and include most of the relevant migration acquis, where feasible, in the Law on Foreigners and respective bylaws, in particular directive 2011/98 on a single application procedure for a single permit, the EU directive 2003/86/EC on the right to family reunification, the directive 2004/114/EC on the conditions of admission of third-country nationals for studies and training, the directive 2003/109/EC

¹¹⁰ RCC and IOM (2015).

on admitting third-country nationals for research (directive 2005/71/EC) as well as the directive 2003/109/EC on long term residents.

5.16. It is also important to facilitate geographic and occupational mobility of labor and tackle low labor force participation of specific groups to better enable the bottom quintiles and disadvantaged people such as women, RAE, and youth to access and benefit from income generating opportunities.

One salient characteristic of the bottom 40 is the low percentage of adults who are working or looking for work. Most prominent is the low labor force participation of women and youth.¹¹¹ Cashing in on the demographic dividend and promoting economic inclusion will also require improving opportunities for minorities, especially the RAE populations, which face considerable discrimination in public services and employment. These opportunities include not only wage employment in the modern sector but also self-employment, agriculture, and labor mobility and occupational mobility. Agriculture and rural development have been important for employment and welfare dynamics of the poor and bottom 40, and will probably continue to be at least in the short term.

5.17. The authorities recognize the importance of female participation in education, especially secondary education, but this has not translated into parity in labor force participation or employment.

While gross enrollment ratios have been almost identical and almost universal for boys and girls in basic education in recent years (ranging from 97 to 101 percent), enrollments in upper secondary are neither universal nor gender-balanced, although there have been recent improvements.¹¹² Productivity losses because of gender disparities in labor force participation and entrepreneurship shows that, in 2012, Kosovo had the highest income loss in the western Balkans (at 28.2 percent). A gender equality strategy and an action plan 2008–13 were adopted. However, implementation has been limited, and the effects of these initiatives have thus also been inadequate so far.

5.18. A combination of lower schooling, early marriage, and entrenched attitudes among family and community about the fulfillment of traditional roles help explain women labor market disadvantage.

For women who work, the relatively low gender wage gap masks gender disparities as men receive higher labor market returns to their characteristics than women. Women have lower educational attainment than men. (62 percent of women have only basic education up to nine years of schooling), compared with 37 percent of men, and 6 percent of women have a university degree, compared with 12 percent of men (2009). Labor force participation in Kosovo is extremely low for women, standing at 18.1 percent for women in 2015 against 56.7 percent for men (Kosovo Agency for Statistics, 2016). Moreover, trends in female employment and unemployment relative to men appear to have stagnated or become worse over time. In 2015, only 11.5 percent of working-age women were employed, compared with 12.9 percent in 2012 and compared with 38.7 percent of working-age men in 2015. Unemployment rates are also higher for women at 36.6 percent (31.8 percent for

¹¹¹ Productivity losses because of gender disparities in labor force participation and entrepreneurship show that, in 2012, Kosovo had the highest income loss in the western Balkans, at 28.2 percent.

¹¹² The gross enrollment ratio among girls in grades 10–12 increased from 81 percent to 88 percent between 2010 and 2012, while, among boys, it rose from 88 percent to 92 percent. The transition rates among girls dropped significantly in 10th grade, where the transition rate was 84.9 percent among girls and 96.8 percent among boys in 2012. However, survival rates once in upper-secondary education are higher among girls than boys (the share of girls in upper-secondary school has averaged 44.5 percent in 10th grade in recent years, but 46.5 percent in 11th grade), which implies a selection of the best and most favored girls to carry on their studies in secondary schools.

men in 2015), a ratio of 1.15. The ratio of female to male youth unemployment is 1.24 (2015). Women's participation in entrepreneurship and formal business ownership in Kosovo is also extremely low.¹¹³

Paying attention to the quality and equality of opportunities

5.19. **Implementing policies to enhance the quality and equality of opportunities, across wealth groups, ethnic lines, and regions in health, education, and social protection, would be important for greater social inclusion and cohesion.** A large portion of the population is still vulnerable to falling back into poverty with income shocks and poverty is still widespread. Strengthening institutions for quality service delivery in health, education, and poverty targeted programs and transfers, and associated safety net would promote equal opportunity and short-term protection so that the less well-off, including the RAE populations, can accumulate assets, participate in economic growth, and improve their livelihoods. Regarding gender equality the inclusion and participation of women at all levels of society remains a key challenge. While health indicators have improved, efficiency of public spending, discrepancies across groups, and high out of pocket health spending remain problems. Efficiency within sector is also key in health, where outcomes could be improved by focusing on primary care, water and sanitation to meet basic needs¹¹⁴ rather than hospitals. The planned introduction of mandatory health insurance should improve risk pooling and creates opportunities to improve risk protection and the efficiency by prioritizing spending on primary care and improving quality of care across the board. However, its impact will depend on improvements in poverty targeting.

Social Protection

5.20. **The main elements of the social protection system were set up in the first half of the 2000s.** Compared with most countries in Europe, including the western Balkans, the social protection system in Kosovo has a narrower scope and is predominantly tax-financed, including pensions which combine contributory with noncontributory schemes. The main building blocks and pillars of social protection include the following. *Pensions* include a universal tax-financed basic pension or old-age pension payable to all those over the age of 65, with a supplement for those who can prove that they contributed at least 15 years to the old Yugoslav pension system; a defined contribution pension established in 2002, which is fully funded and consists of mandatory contributions by employers and employees; and early retirement benefits for a small number of beneficiaries.¹¹⁵ *War-related benefits* include a plethora of benefits for civilians and soldiers who became disabled during the 1998–99 military conflict; and protection of surviving relatives of fallen soldiers and civilians, as well as for families of those missing. The *social assistance scheme* is a tax-financed last-resort income support program, but which provides assistance only to a limited set of beneficiaries. *Other transfers* include a noncontributory disability pension; and benefits for children with disabilities. In addition to these, the social protection budget also finances other services including *social care services* provided by decentralized centers for social work and focused mostly on child protection services and *employment services* for those registered as unemployed but willing to work. Finally, though not part of the social protection budget, there are *energy subsidies* for recipients of the

¹¹³ Women account for 9 percent of individual entrepreneurs (self-employed) and participate in ownership in only 14 percent of formal businesses. The share of firms with a woman top manager increased from 0.3 percent in 2009 to 9.5 percent in 2013.

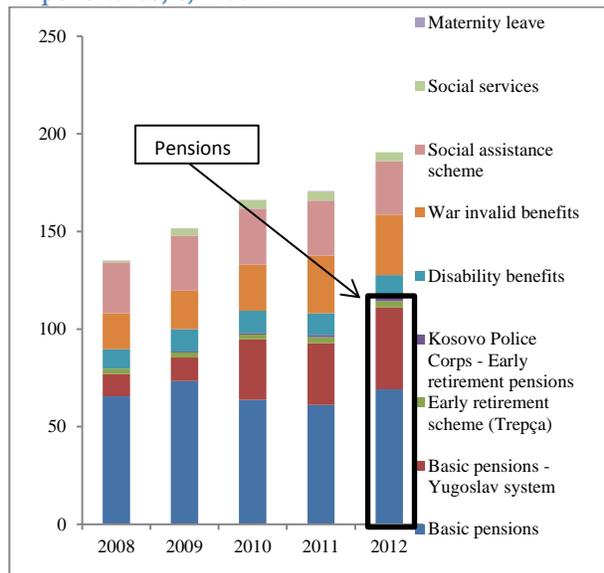
¹¹⁴ There are insufficient capacities for waste management, and a significant share of households still do not possess direct access to drinking water.

¹¹⁵ This is for former Trepča mine employees and former Kosovo Protection Corps members who lost their jobs after the transformation of the corps to the Kosovo Security Force in 2008.

social assistance scheme and energy costs, which are designed to provide implicit subsidies from wealthier to poorer consumers through energy tariff differentiation.

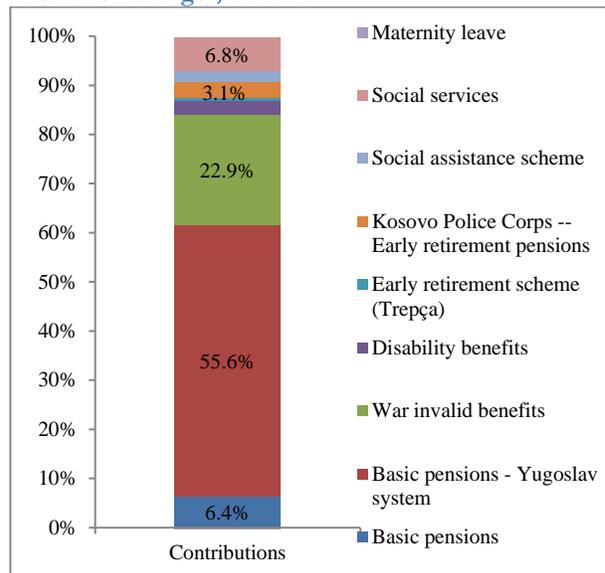
5.21. **Policy choices, rather than demographics or the economic cycle, have driven social protection spending.** The introduction and expansion of payments to contributors to the ex-Yugoslav pension system has driven over half of the increase in social protection spending between 2008 and 2012, when pensions reached over 80 percent of all social protection spending in 2012. The largest policy-driven increase in nonpension social security spending between 2008 and 2012 came from the war-related benefits, some of which were paid regardless of the beneficiaries' age or ability to work, though some are determined by level of disability. Increases in the war-related benefits have been responsible for nearly a quarter of the total increase in the social protection bill, and almost all nonpension increases, over this period. Social protection spending has remained relatively stable as a percent of GDP until recently, when pensions were increased a further 25 percent for all categories of pensioners during the preelection period in 2014.¹¹⁶

Figure 55. Composition of Social Protection Expenditures, €, 2008–12



Source: BOOST and World Bank calculations.

Figure 56. Increase in Contributions in Social Protection Budget, 2008–12



Source: BOOST and World Bank calculations.

5.22. **Moreover, there are significant gaps in social protection coverage, which focuses on categorical benefits rather than on benefits targeted toward the poor.** The last-resort social assistance program is not available to all of the poor, even in the bottom quintile, as it limits eligibility to households who fall under limited categories, such as those with children under the age 6. The scope of active labor market programs is limited mostly to public works, which are meant to target the unemployed and poor, but not exclusively. Social care services are targeted mostly to vulnerable children. Expanding the social protection programs targeted toward the bottom quintiles is hampered both by fiscal constraints and the vocal demands for expansion of nontargeted benefits. Since the basic pension is already sufficient to bring pensioners to the

116 The government provides four categories of benefits: (a) benefits for people over the age of 65 with 15 years of contribution history in the former Yugoslavia, (b) benefits for people over the age of 65 without 15 years of contribution history, (c) benefits for the disabled, and (d) benefits for the unemployed at the Trepça mines.

poverty threshold and war-related benefits are, in many cases generous, these steps would do little to combat poverty.

5.23. **Furthermore, attention should be paid to the impacts of energy and health reforms on the social protection system.** The large investments required in the energy sector will increase energy costs. At the same time, the introduction of health insurance will likely have benefits for poorer households but will also add to the monthly bills of households that are not exempt from premium payments. For both health and energy, identifying vulnerable households and exempting them from payment (in the case of health insurance) or protecting them against energy price rises will be important. Without careful identification and indemnification of the poor, the (necessary) energy and health modernizations risk having a negative impact on the poor and vulnerable.

5.24. **Going forward policy considerations should focus on better aligning social protection spending with Kosovo's needs.** Any increases in social protection should be sustainable and targeted toward areas of need rather than special interest groups. The recent increase in benefits to protect those who are not able to work, such as pensioners and the war-disabled, could also bite in the longer-term as the current favorable demographics change. Therefore, going forward, social protection should focus on the remaining challenges: (a) protecting the poor and vulnerable and enabling them to climb out of poverty; and (b) mitigating the impact of modernization in energy and health. Social protection should be calibrated to encourage rather than minimize labor market participation and should therefore attempt to avoid leakages to wealthier groups who are able to work.

5.25. **To combat the impact on the poor of both energy tariffs and out-of-pocket health costs, as well as to improve coverage of Last Resort Social Assistance, a better effort to identify the poor will be required.** Expanding coverage for poor and vulnerable households, while preventing leakage to wealthy households should be a priority to both tackle poverty and mitigate the negative shocks. This can only be achieved with a better targeting mechanism. This will also be important for health insurance, which will require better identification of the poor than currently exists to ensure that they are exempted from health insurance premiums. Identifying the poor would be the first step to tackle poverty and mitigate the risks associated with necessary modernizations in energy and health. This, combined with a willingness to expand the social assistance scheme to meet these challenges, should be the policy priority in social protection.

Pensions

5.26. **Pensions represent the largest component of social protection spending in Kosovo.** In 2013, 116,512 individuals benefited from the *basic pension* (pillar 1 pensions). They received €60 per month, financed directly from the state budget. Another 35,830 beneficiaries received a supplement of €52 per month in 2013 (making the total pension received €112 per month). This supplement was introduced in January 2008 for those who could prove over 15 years of contributions to the old Yugoslav pay-as-you-go system. A fully funded, contributory system (pillar 2 pensions) became mandatory for all formal sector employees who were under the age of 55 in 2002, when the system began. Contributions are paid by the employer and employee (5 percent of earnings each, paid through the taxation system). Pensions are also paid to disabled persons, and early retirement schemes exist for the Trepča miners and for those individuals who were downsized when the Kosovo Protection Corps was transformed into the Kosovo Security Force. In 2013, 18,891 individuals received disability pensions, down from 21,200 in 2011, and around 3,800 former Trepča miners received early

retirement benefits in 2013, down from 4,130 in 2011. Finally, 798 persons received early retirement benefits from the corps in 2013, reduced from around 1,600 in 2011.

5.27. **Kosovo provides pensions for all those aged 65 or older, with benefit levels just above the poverty line.**¹¹⁷ It also provides a fully sustainable savings system that is mandatory for workers in the formal sector.¹¹⁸ Benefit levels which were already above the poverty line, were increased a further 25 percent for all categories of pensioners during the preelection period in 2014. While the individual benefit from the first category is more than sufficient to raise the individual pensioner above the poverty line, the elderly often reside within larger households and the benefit is not sufficiently large to raise the whole household out of poverty. The Kosovo Pension Savings Trust began providing benefits in recent years. However, the benefit coming from the savings system is only provided until the balance of the account is positive, which is usually short period as not much was able to be accumulated, and not for the duration of the pensioner's life.

5.28. **The pension system is relatively low cost and governance appears to be functioning well.** While pressures are not likely to be a challenge for Kosovo's pension scheme over the medium term, there are both longer-term demographic challenges and policy risks. In the longer term, as the currently youthful population ages, pressures on pension spending will grow. The number of working-age adults to support each pensioner will decrease from ten today to just four by 2050. Moreover, pressures to grant pensions increases have recently pushed pension spending onto a higher trajectory. Although legislated to increase with inflation, benefits have been increased much more during election cycles, raising the fiscal costs to the government. In the run-up to elections, a recurrent theme is providing pensions to additional categories, like war veterans and political prisoners, and police. Increasing numbers of pensioners have been petitioning for inclusion in the ex-Yugoslav contributors' supplement.¹¹⁹ Many argue that they would have achieved the requisite 15 years of contributions if they had not lost their employment during years of latent or overt conflict. All of these measures will serve to raise the cost of the budget financed pension system in Kosovo.

5.29. **A mechanism for providing annuities or scheduled withdrawals needs to be put in place in the near future as people will begin retiring with almost 15 years of contributions in the savings system.** . If the ex-Yugoslav supplement continues to expand, as is anticipated in 2016, more pensioners will shift away from the basic pension of €50 per month and toward a pension of €112 per month¹²⁰, paid directly from the budget. If all pensioners shift begin to receive €112 per month (the €60 basic plus the €52 supplement), spending on pensions would jump to 3.2 percent of GDP by 2015, up from 2.3 percent in 2012.

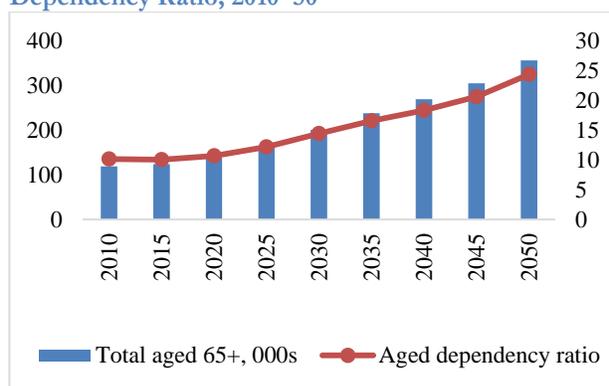
117 The definition of the poverty line in this case is the food poverty line. It does not cover health expenditures or utility costs. If these expenses are factored in to cost of living, then the basic pension is not sufficient to raise old-age pensioners above the poverty line.

118 Kosovo Pension Savings Trust, a defined contribution pillar 2 pension system.

119 The inclusion was approved in spring 2014, although the costs are not yet known.

120 This was before the 25 percent increase in pensions in April 2014 that was driven by election promises.

Figure 57. Pensioner Population and Aged Dependency Ratio, 2010–50



Source: World Bank Population Projections.

Figure 58. Annual Cost, Pensions, % of GDP



Source: World Bank Population Projections and estimates.

War-related benefits

5.30. **A plethora of war-related benefits cover those who were injured during the 1998-99 war and the families of those killed or missing.** War-related benefits were introduced in 2000 by the UN Interim Administration Mission in Kosovo and additional categories were added in 2011. They covered around 11,000 people in 2013, in six main categories: (a) soldiers who became disabled; (b) families of soldiers who died; (c) families of soldiers who are missing; (d) civilians who became disabled; (e) families of civilians who died; and (f) families of missing civilians. In addition to these main categories, there are also benefits for caregivers to the disabled who are more than 80 percent disabled and payments made to the widows of those who were disabled and subsequently died. The total benefits received by households depend on how many dead or missing there are in a particular family and on the degree of disability for the injured.

5.31. **Benefits to each of the categories of war-related benefits have increased steadily since 2009.** Nearly a quarter of the increase in social protection spending over this period went toward these benefits, which have increased sharply in value over this short period. New war-related benefits included in the 2014 budget risk increasing the social protection budget while failing to address the current or upcoming challenges facing the country. The authorities are considering expanding and introducing new categorical benefits rather than focusing on benefits that target the poorest. Potential new war-related benefits include war veterans' benefits and one-off payment for political prisoners.

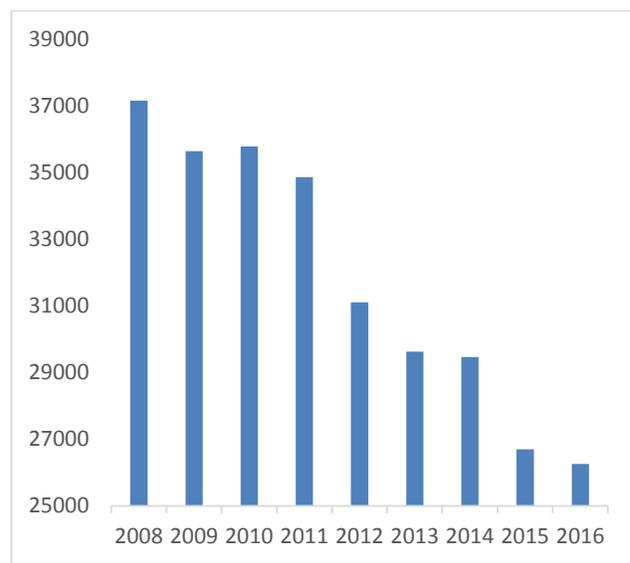
5.32. **War veterans benefits could prove extremely harmful for fiscal sustainability, have negative labor market consequences, crowd out more urgent spending, and not designed to cover the poor.** The process that will allow war veterans to receive benefits is already advanced and close to 67,000 people applied to receive the veteran status. By June 2016 about 46,000 were certified, and cca 29,000 were in beneficiary lists. The 2016 budget projected 25 million in benefits but after complete verification of veterans the amount needed exceeded 50 million. The 2017 budget projects 38 million which is again not sufficient to cover the cost of benefits unless policy changes are done such as decreasing number of beneficiaries or amount of benefit. However, the total costs could be much larger. The proposed minimum cash benefit is equal to the minimum wage but employed veterans would not be eligible. This could have negative labor market consequences as potential beneficiaries move into the informal sector to receive the benefits. 70 percent of these benefits could also be bequeathed to family members. Additional benefits for war veterans are also included in the draft law

including those linked to health, education, housing, transport, and undefined business subsidies and tax and customs benefits.

Social safety net programs

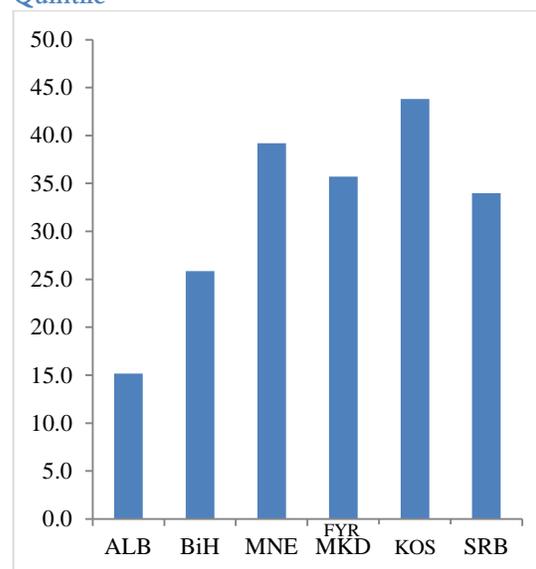
5.33. **There is only one social assistance program, in the form of a single targeted cash transfer (Asistenca Sociale).** Around 35,000 households benefited from the last-resort social assistance scheme in 2011 though this declined to 26,261 by end 2015. Beneficiaries fall into two categories identified through filters supposed to test poverty. Category 1 beneficiaries need to live in a household in which every adult is disabled, dependent or a caregiver for these beneficiaries. Category 2 beneficiaries need to be registered as unemployed and the household must have a minimum of one child under the age of six or an orphan less than 15 years old (starting in 2013, there may be a maximum of one able-bodied person in the household). Between 2008 and 2012, spending on the last-resort social assistance scheme fell by 8.6 percent in real terms, taking it from 19 percent of total social protection spending to 14 percent or from 0.7 to 0.6 percent of GDP. During this period, the government tightened the eligibility criteria while making small increases in the benefit. At the same time, almost all other social protection benefits – including those not targeted toward the poor – have increased. This reflected policy choices and priorities, which focused social protection on more politically vocal groups – such as war veterans and select groups of pensioners – rather than the poor. While the change of eligibility reduced the number of beneficiaries, it kept costs stable in nominal terms.

Figure 59. Number of Households Receiving Social Assistance Benefits



Sources: Kosovo Agency of Statistics, "Social Welfare in Kosovo" and MoLSW.

Figure 60. Income from Social Assistance as percent of Household Consumption in Poorest Quintile



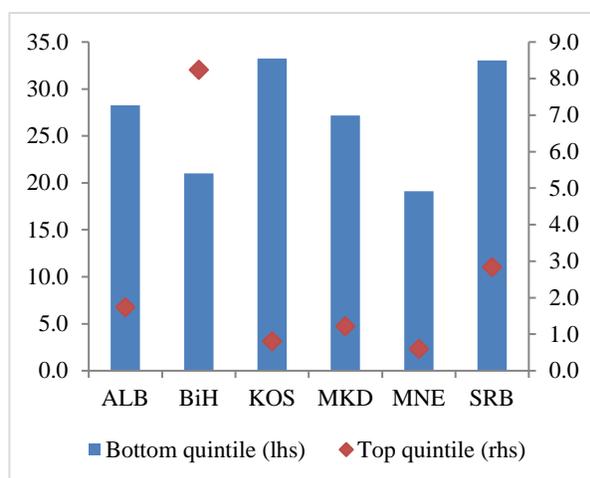
Source: National authorities and Europe and Central Asia Social Protection expenditures and evaluation Database, World Bank.

Note: Data are from the following years ALB: 2008; BiH: 2007; KOS: 2009; MKD: 2010; MNE: 2011; SRB: 2010.

5.34. **Coverage of Asistenca Sociale is limited but its targeting accuracy measured as share of the benefit budget going to the poorest quintile is high.** Close to 80 percent of benefits are transferred to the extreme poor and 90 percent of benefits go to the poorest 40 percent. This is among the highest targeting accuracy for similar programs across the countries in the Europe and Central Asia region. The leakage to the

rich is among the lowest compared with similar programs in the region, with less than 1 percent of all benefits going to the richest quintile. It also helped to ensure that social assistance was high as a percentage of the total consumption of beneficiaries. Indeed, at 44 percent, social security represented a higher share of consumption for beneficiaries in the poorest quintile in Kosovo than in other SEE countries. However, this is partly caused by low consumption among the poorest groups in Kosovo; indeed, average individual receipts were worth just 7.2 percent of the minimum wage in 2011.¹²¹ In addition, the strict eligibility criteria have ensured that the social assistance scheme is one of the best targeted in the region. Because of restrictive eligibility criteria, a significant share of poor and vulnerable remain however uncovered or undercovered.¹²² Coverage with old-age and disability pensions which are largely noncontributory and by design not overlapping with social assistance, adds around 38 percent to the coverage in each of the two poorest quintiles. In 2016 the government plans to increase the amount of the Asistenca Sociale benefit by €20 per household beneficiary. This is expected to be revenue-neutral, with the additional benefits coming from savings realized by cleaning the beneficiary list of those not eligible. As a result the generosity of benefits will improve and the targeting may improve, but the coverage will remain low and unchanged. The rest of the programs are rights-based and with less accurate targeting.

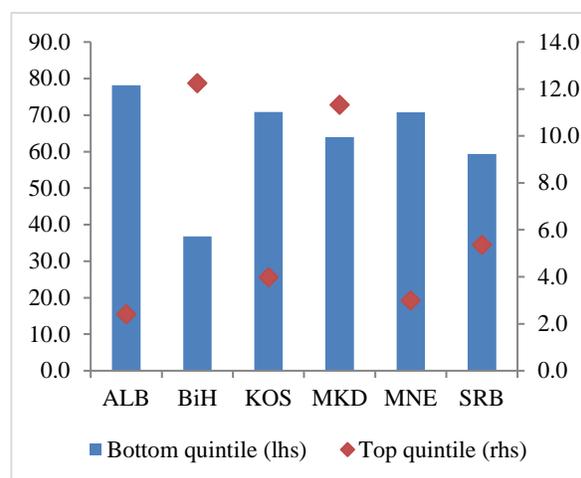
Figure 61. Coverage: Percent of Households in Top and Bottom Quintiles Receiving Asistenca Sociale



Sources: Data of national authorities and Europe and Central Asia SPEED Database (Social Protection Expenditures and Evaluation Database), World Bank.

Note: Data are from the following years ALB: 2008; BiH: 2007; KOS: 2009; MKD: 2010; MNE: 2011; SRB: 2010.

Figure 62. Targeting: Percent of Asistenca Sociale Benefits Going to Households in Top and Bottom Quintiles



Sources: Data of national authorities and Europe and Central Asia SPEED Database (Social Protection Expenditures and Evaluation Database), World Bank.

Note: Data are from the following years ALB: 2008; BiH: 2007; KOS: 2009; MKD: 2010; MNE: 2011; SRB: 2010.

Health

5.35. Health outcomes in Kosovo have improved over time but remain poor, with RAE populations experiencing worse health outcomes. Life expectancy at birth in Kosovo has, for instance, increased over time from 69 years in 2007 to 70.5 years in 2012, but remains the lowest in SEE and is 10 years lower than the

121 World Bank (2013e).

122 Eligible households are identified through a means test. In addition, only a maximum of one household member is allowed to be working if he or she is registered as unemployed and if the family has at least one child who is 5 years old or younger.

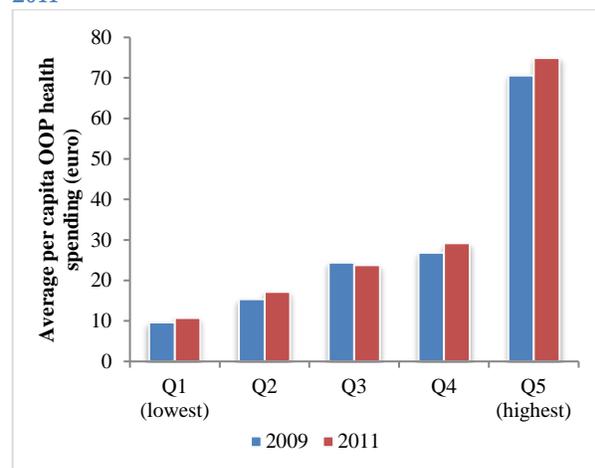
EU average (80.5 years). Circulatory diseases are the primary cause of death in Kosovo, followed by cancers, perinatal conditions and respiratory diseases. Maternal and child mortality rates are an important concern. The infant mortality rate at 17.1 per 1,000 as well as the maternal mortality ratio at 7.2¹²³ per 100,000 live births (both in 2011) are still high relative to the EU averages of 4.1 per 1,000 and 5.8 per 100,000 in 2011.

5.36. **Health financing arrangements in Kosovo fail to meet the World Health Organization’s macrocriterion for financial protection: The share of out-of-pocket payments in total health spending is almost twice as high as the recommended upper limit of 15-20 percent.** Private health expenditure, almost entirely in the form of out-of-pocket payments at the point of service, contributes an estimated 40 percent of total spending in the sector, with drugs accounting for 85 percent of all health out-of-pocket spending. This proportion of private expenditure is on par with the average in SEE countries, but high in comparison with the EU average: the average share of household out-of-pocket payments in total health spending was 16.2 percent in the EU in 2011.

5.37. **Health expenditures are impoverishing a number of households.**

In 2011, 29.7 percent of the population was below the poverty line compared with 34.5 percent in 2009. However, if health expenditures are considered as essential and the poverty threshold is adjusted accordingly, poverty increases to 31.3 percent in 2011 and 37.7 percent in 2009. This indicates that about 2 percent of the population in 2011 is not counted as living in poverty but would actually be considered poor if health payments were taken into account. This represents a 7 percent increase in the poverty headcount for 2011. Both in 2009 and 2011, the estimated poverty gap increased by about 10 percent when health payments were taken into account. When health payments were deducted from nonfood expenditures, the normalized mean poverty gap increased by about 1 percent – from 32.6 percent to 32.9 percent in 2009, and by 2.8 percent in 2011 – from 25.1 percent to 25.9 percent in 2011 (Table 6.5). This suggests that the widening poverty gap is caused mainly by more households falling into poverty and not to a deepening of the poverty of the already poor

Figure 63. Average Annual Per Capita Out-of-Pocket Health Spending, by Consumption Quintile, 2009 and 2011



Source: Kosovo HBS 2009 and 2011.

123 According to public health facility and registrar records, the maternal mortality ratio was as high as 43.3 deaths per 100,000 live births in 2009. The small number of deliveries each year makes such estimates highly volatile and difficult to assess. More recent survey data suggest that the infant mortality rate has dropped to 12 per 1,000 (MICS 2013–14).

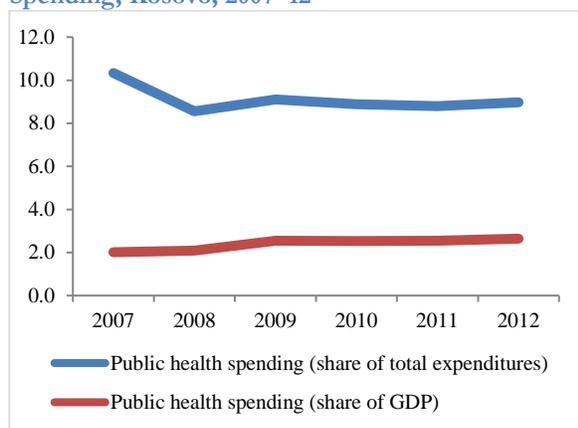
Table 18. Poverty Impact of Out-Of-Pocket Health Expenditures, 2009 And 2011

	Gross of health payments	Net of health payments	Change	Change (percent)
2009 Poverty headcount	34.5	37.7	3.1	8.9
Poverty gap	50.8	55.8	5.0	9.9
Normalized poverty gap	11.3	12.4	1.1	9.9
Normalized mean positive poverty gap	32.6	32.9	0.3	0.9
2011 Poverty headcount	29.7	31.3	2.1	7.0
Poverty gap	46.2	50.9	4.6	10.1
Normalized poverty gap	7.4	8.1	0.7	10.1
Normalized mean positive poverty gap	25.1	25.9	0.7	2.8

Source: Estimates based on data of HBS 2009 and 2011 data.

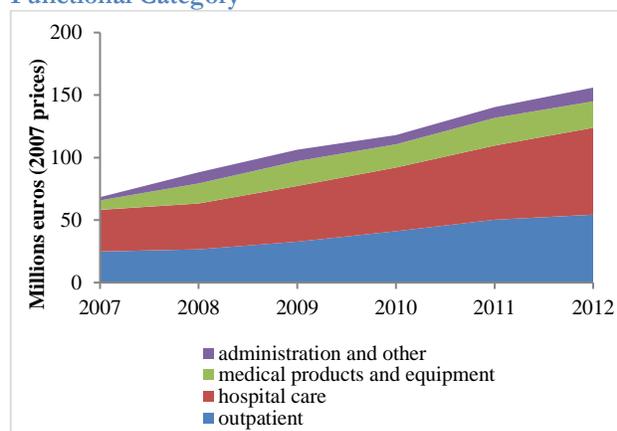
5.38. **Public spending on health is low, and is heavily focused on capital investment and hospital care which leaves room for improvements in efficiency of spending and quality of care.** At 2.6 percent in 2012, spending on health care – a critical expenditure necessary for sustainable development – is lower, as a percent of GDP, than in other countries in SEE as well as in the small countries of the Commonwealth of Independent States (Armenia, Georgia, and Moldova). The government of Kosovo spent a comparatively large share of the public health budget on capital expenditures in 2007-2012 (11.8 percent), compared with the OECD average of 4-5 percent. Hospital spending accounted for 44.6 percent of total public sector spending in 2012 (relative to the EU and OECD averages, which were around 30 percent in 2011). There has been a shift in the composition of both primary care and hospital expenditures between 2007 and 2012, with a decrease in the share of resources spent on goods and services (particularly medical supplies), and increases in the shares of spending on wages and salaries and capital. The government spent 21.2 percent of total primary health care spending and 33.8 percent of hospital spending on goods and services in 2007. By 2012, these proportions had shrunk to 13.2 and 17.6 percent, respectively.¹²⁴

Figure 64. Evolution of Government Public Health Spending, Kosovo, 2007–12



Source: Kosovo BOOST v1.0 based on Ministry of Finance data.

Figure 65. Evolution of Public Sector Spending, by Functional Category

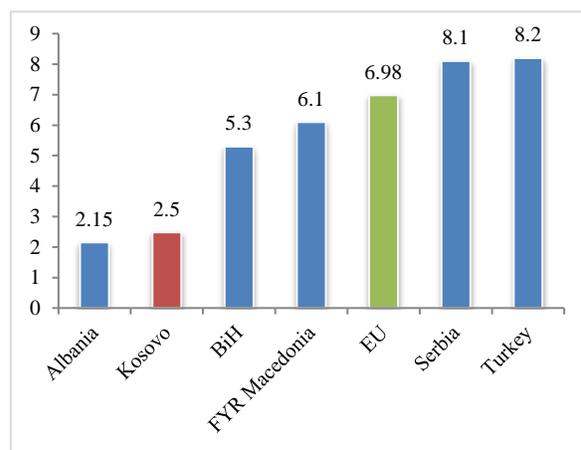


124 The outpatient spending category includes spending on primary care and public health as well as spending classified as outpatient expenditures within the Ministry of Finance treasury system; hospital care includes secondary care expenditures.

5.39. **Public spending on drugs is limited and reforms are needed to deliver better value.** Public spending on pharmaceuticals and equipment made up 13.6 percent of total public health spending in 2012 and 15.5 percent of total public health spending on average over 2007–12. Such levels of spending are on par with the OECD average, which is of the order of 15 percent. However, in absolute per capita terms, the \$16 that Kosovo spent is low. Shortages of medicines are reported to be widespread at both primary care facilities and hospitals.¹²⁵ At the same time, surveys and sector reviews have highlighted the need to deliver better value for money from drug spending through reforms that increase transparent and evidence-based prioritization of which drugs to purchase with public funds, modernize procurement systems for drugs and medical supplies.¹²⁶ In the absence of a mature and functional health information system, the ability of authorities is limited in monitoring transactions sufficiently closely (prescription practices and dispensing at pharmacies) to intervene to curb overuse of medicines or the avoidance of the generic substitution policy.

5.40. **Public sector service utilization rates are low.** Primary health care facility utilization rates are low. There were on average 2.4 visits per capita and 18.2 visits per physician per day in 2012. In comparison, among SEE countries, only Albania reports lower visit rates (2.2 visits per capita in 2011). The EU average is 7 visits per capita and Turkey's is 8.2 visits per capita. Utilization of inpatient services is also low. The average daily bed occupancy rate in Kosovo's regional hospitals was 54 percent in 2012; UCCK's occupancy rate was higher at 65.2 percent. While low hospital use rates can be a reflection of a well-functioning primary care system, this does not appear to be the case in Kosovo given the low utilization rates for primary care services.

Figure 66. Primary Health Care Visits Per Capita, 2011



Source: HFA database (World Health Organization), Kosovo Agency of Statistics
 Note: Serbia 2010 data.

5.41. **Incentives to improve quality of care and coverage of cost-effective primary care services are weak.**

Financing for primary care and hospital services is currently fragmented and does not adequately incentivize improvements in quality and efficiency. The Ministry of Health is responsible for public sector hospital services and hospitals, while municipalities are responsible for primary health care and receive a capitation-based grant for service delivery from the Ministry of Finance. Provider payments from Municipalities to primary care facilities are based on line item budgets, and do not offer strong incentives to improve quality of care or to expand cost-effective preventive services that could lower hospital costs.

5.42. **The planned introduction of mandatory health insurance and other ongoing health financing reforms could address many of these concerns.**

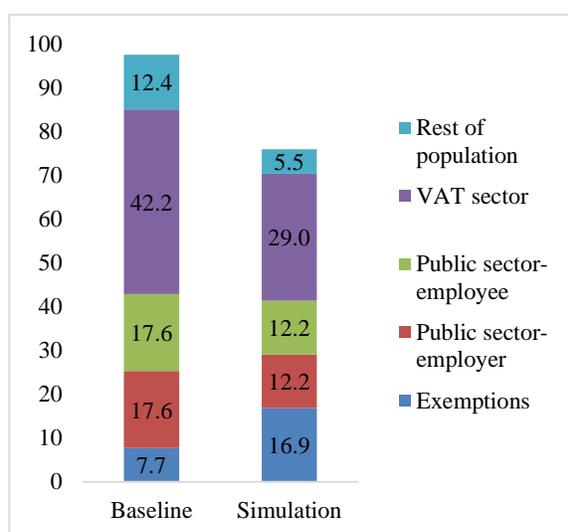
The scheme is expected to raise additional revenues for the health sector and increase financial protection (particularly of the most vulnerable) through risk pooling. It would be financed through a combination of payroll tax revenues and flat-rate citizen premiums. Estimates suggest that mandatory health insurance revenues could raise public health expenditures in Kosovo from 2.4 percent to 4 percent of GDP, bringing it closer to the SEE and EU average of 5 percent. The Health Insurance

125 UNICEF (2013).
 126 World Bank (2014b).

Law exempts the poor from insurance premiums and any cost-sharing to reduce financial barriers to access. The additional expected revenues create opportunities for the future Health Insurance Fund to purchase improvements in quality and coverage strategically for hospital and primary care services.¹²⁷

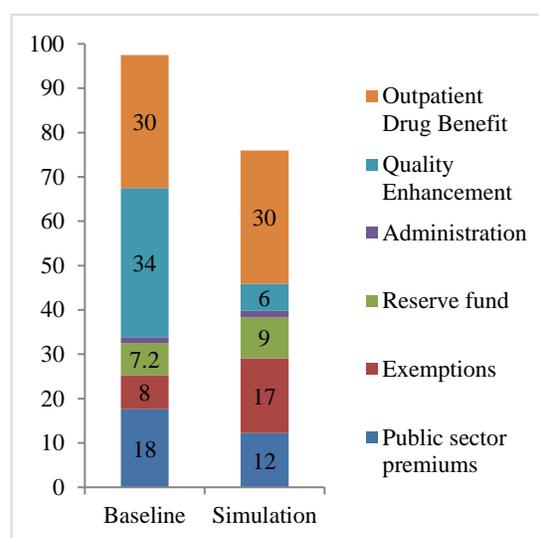
5.43. **Reducing household out of pocket spending on drugs should be a priority for mandatory health insurance revenues.** As shown earlier, out-of-pocket expenses can be large – and sometimes catastrophic – for households and drugs account for 85 percent of this. Poor households underspend on medication, with both individual and social costs. The mandatory health insurance scheme should therefore prioritize spending on drugs, both to reduce out of pocket spending and improve quality of care. The planned mandatory insurance scheme intends to introduce an outpatient drug benefit to reduce household spending on outpatient drugs as one of its flagship benefits. This is believed to be administratively achievable in a short time period as well as highly visible and pro-poor.

Figure 67. First Year Revenue Scenarios, € Mil.



Source: World Bank calculations.

Figure 68. First Year Spending Implications, € Mil.



Source: World Bank calculations.

5.44. **The poverty impact of mandatory health insurance will depend critically on improvements to poverty targeting.** The poorest quintile of households needs to be exempted from paying insurance premiums and cost sharing to maximize the poverty impact of health insurance.¹²⁸ This will require improvements to poverty targeting mechanisms in Kosovo which currently reach only 36.5 percent of the poorest quintile of households.¹²⁹ If coverage of the poor with exemptions is not improved, household survey data simulations indicate that the incidence of catastrophic health spending increases for all households and the incidence, depth and intensity of poverty worsens.

127 The recent policy decision to allocate the budget for hospital services directly—80 percent of the health care budget—to a newly created monopoly provider of public hospitals, the Kosovo University Clinical and Hospital Services, could undermine the potential to use payment incentives to drive improvements in the quality of care.

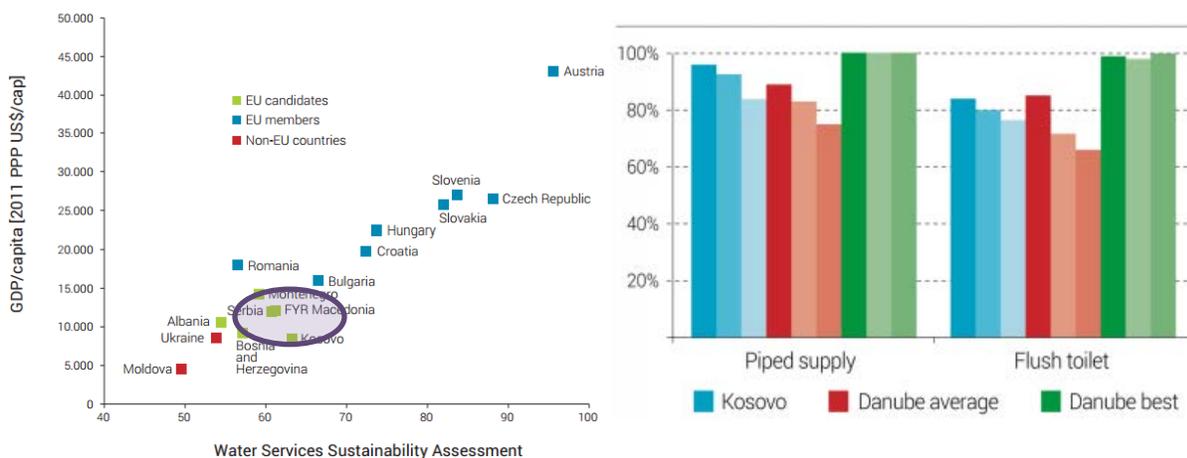
128 World Bank (2015b).

129 The last resort social assistance scheme, the only poverty targeting mechanism in Kosovo, uses strict eligibility criteria to identify the poor. Although there is little leakage of benefits to nonpoor households as a consequence, it covers only 36.5 percent of the poorest quintile of households, indicating that a large share of the poorest households are not identified as poor.

5.45. **Delivering visible benefits from health insurance will be critical to encourage enrollment.** Experience from countries with large informal sectors shows that achieving high insurance participation rates is challenging but crucial to the success of mandatory health insurance. Using and being seen to use insurance revenues to deliver early and visible benefits to participating households will be essential to encourage insurance enrollment. A well-administered outpatient drug benefit scheme could be a promising strategy in this respect. The additional premium revenues can also finance improvements in health services through purchasing mechanisms that incentivize improvements in quality of care and service delivery. In the interim, the public budget for health will need to accommodate expenditures to prepare for the future implementation of mandatory health insurance.

5.46. **Waste management, together with improved access, quality, and affordability of water and sanitation have important impact on health outcomes and poverty.** Kosovo's Water and Wastewater Services Providers can play an important role in improving health and environmental outcomes in an equitable manner. Kosovo went through a significant reform of water services provision in the early 2000's, resulting in the creation of seven regional companies overseen by an independent economic regulator. As a result of those reforms and significant investments by the donor community, Kosovo's water services sector stands ahead of many of its neighbors in terms of its ability to deliver sustainable services for all. The overall access to, and equity of access to piped water and flush toilets, is generally higher than the regional average. However, in order to deliver on the necessary health and environmental outcomes, significant progress must be made to improve wastewater collection (54 percent) and treatment (1 percent), particularly in rural areas. Achieving EU standards in those areas will require important investments, as well as much more efficient services providers and higher water and wastewater tariffs.¹³⁰

Figure 69. Water Services: (a) Sustainability (b) access of the bottom 40 and the poor



5.47. **Solid waste management (SWM) system in Kosovo has also made considerable progress.** Reform initiatives have been driven by the policy framework for municipal waste management in the EU. As a candidate for accession, Kosovo has initiated progressive harmonization of its legislation with that of the EU. It has issued a Law on Waste (2012), a National Strategy on Waste Management and a Five-Year Plan on Waste Management (2013-2017) with actions based on the Strategy. Kosovo has established a regionalized waste

130 World Bank (2015c).

collection and disposal system. Most recently, it has initiated changes to the system of billing and collection that are intended to improve the financial performance of the sector.

5.48. **Despite progress made, SWM in Kosovo continues to experience difficulties.** service coverage and quality both for collection and disposal remains poor, environmental measures and compliance are weak, costs exceed available financing, bill collection percentage is low, the legal and institutional frameworks miss important elements, staff capacity at all levels is insufficient, and there is nearly a total lack of public participation in SWM. The waste management sector has accumulated significant bad debt, tariffs are reasonably high relative to countries in the region, but too high from affordability benchmark point of view (close to 6 percent for vulnerable groups, compared with a recommended 1.5 percent of disposable income), that productivity is low and costs per unit are unjustified for the quality of service offered.

5.49. **The financial viability of service providers goes beyond waste management.** A number of utilities and municipalities are not financially viable and have entered a vicious circle of bad service-low fee collection-increasing debt and arrears, lack of funds for maintenance and capital investment. The higher level comment here is that the infrastructure and service level deficiency will become a bottleneck for Kosovo given country's aspirations to join the EU.

5.50. **Going forward, key priorities for the sector include:** (a) increase the population served by a formal waste management system which is now only 57 percent; (b) improve the disposal conditions at landfills by upgrading environmental control measures in landfills and expanding their lifetime, and reduce the number of illegal dumps through closure and prevention; (c) improve the financial sustainability of the system by increasing the number of waste generators (households, enterprises, institutions) that regularly pay for service; introduce a tariff level to sustain a professional system that takes into consideration the affordability for the population; and reduce inefficiencies and optimize costs, and (d) create an adequate waste information system that will help the monitoring and planning of waste management activities in all administrative levels.

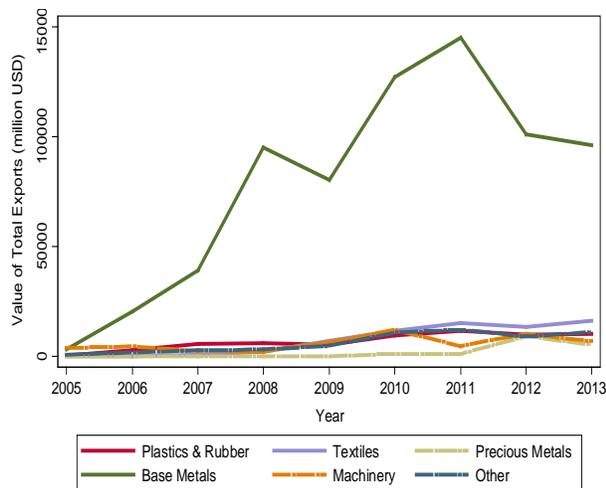
VI. BETTER STEWARDSHIP OF KOSOVO'S NATURAL RESOURCES

6.1. **Better stewardship of Kosovo's environment and natural resources is key for immediate social welfare improvements and long term sustainability of inclusive growth.** Given its abundance of natural resources and fertile land, greater productivity and environmental sustainability in agriculture and mining would be critical for export performance and growth, and for generating resources for development and achieve twin goals. Today, both sectors are held back by the legacy from the past such disputes over the status of the four municipalities in northern, land titles and cadastral maps. They also lack means, both financial, human, and technological, to reestablish and modernize production. They also lack integration and market links, standards and technical regulations to achieve compatibility with EU and international standards. Given the potential environmental, resettlement and health impact, strengthening key institutions and policies would be critical so that Kosovo taps its significant natural resources in a sustainable manner.¹³¹ In this context, mitigation and adaptation measures to offset climate change and build resilience to the associated impacts from climate change in Kosovo are paramount. Addressing governance issues and setting in place a framework to distribute equitably the rents generated from natural resources will also be crucial for shared prosperity.

6.2. **Given its size and lack of sea access, Kosovo's economic prospects are directly linked to its capacity to integrate successfully in the regional and global marketplace.** Kosovo's exports have been dynamic, although from extremely low starting values. Growth has been volatile, and a deceleration is observed after 2010. Exports are highly concentrated in less dynamic markets, with the EU27 absorbs over 85 percent of Kosovo's exports. Half of Kosovo's exports are directed to Italy, a market in which demand for foreign goods has been contracting. Exports are also concentrated along the product dimension, with a single product, ferro-nickels, accounting for 50 percent of exports. Despite this concentration, Kosovo's export product span is on par with that in FYR Macedonia and substantially greater than that in Malta or Montenegro.

6.3. **Kosovo shows clearly defined revealed comparative advantages in metals, hides and skins, textiles and mildly in foodstuffs.** During this period, the analysis reveals that Kosovo is losing its comparative advantage in vegetables, footwear and machinery and equipment. Less than 40 percent of export activities that are initiated in a given year remain active beyond the first year, and 14 percent remain active beyond the fifth year. Foodstuffs, metals, minerals, and stone and glass related export flows show higher chances of survival, while machinery and equipment, and textiles show substantially lower chances of remaining active past the first

Figure 70. Sectoral Composition of Exports



Source: UN Comtrade data, World Bank calculations

131 For instance, a study on heavy industry concluded that the uncertain operating environment (for example, transparency in levying royalty fees for natural resources and the legal and policy framework to encourage the reuse of industrial waste) is the major reason a local steel plant imports zinc, though zinc is available locally, and the necessary electrolysis equipment (STRAS 2012).

year. Scaling up of existing firms, rather than establishing new ones, is key to increase the number of jobs in the private sector. In the past 18 months (June 2012 to December 2014), 24,178 firms have been created. Therefore, efforts focusing on firm survival/growth should be prioritized for job creation.

Table 19. Kosovo's revealed comparative advantage (2004-2013)

Type	Exports 04/05	Share 04/05 (percent)	RCA 04/05	Exports 12/13	Share 12/13 (percent)	RCA12/13	CAGR
01-05 Animal				286,671	0.1	0.08	
06-15 Vegetable	2,066,223	16.3	6.2	4,288,187	2.2	0.69	10
16-24 Foodstuffs	1,187,525	9.4	3.29	7,853,506	4.0	1.27	27
25-27 Minerals	2,378	0.0	0	14,672,860	7.4	0.35	198
28-38 Chemicals	182,529	1.4	0.16	1,013,434	0.5	0.05	24
39-40 Plastic / Rubber	316,692	2.5	0.58	8,761,371	4.4	1.01	51
41-43 Hides, Skins	841,850	6.6	9.47	10,244,176	5.2	8.65	37
44-49 Wood	106,434	0.8	0.26	2,384,848	1.2	0.53	48
50-63 Textiles, Clothing	106,555	0.8	0.17	15,505,625	7.9	2.02	86
64-67 Footwear	264,767	2.1	2.51	408,992	0.2	0.26	6
68-71 Stone / Glass	72,867	0.6	0.19	10,270,141	5.2	1.48	86
72-83 Metals	3,144,575	24.8	3.3	100,737,540	51.0	7.35	54
84-85 Mach/Elec	3,886,224	30.6	1.09	13,610,007	6.9	0.29	17
86-89 Transportation	294,656	2.3	0.22	3,819,403	1.9	0.21	38
90-97 Miscellaneous	206,300	1.6	0.27	3,236,025	1.6	0.29	41
98-99 Special				250,122	0.1		

Source: Calculations based on UN Comtrade.

Note: RCA = revealed comparative advantage. CAGR = compound annual growth rate.

6.4. To foster trade creation and avoid trade diversion, consideration should be given about impact of the trade provisions in the future SAA and trade agreements. Kosovo currently benefits from unilateral trade concessions allowing it almost unlimited duty free access to the EU market. The application of efficient trade dispute mechanisms would also help to encourage trade.

Box VII.1. Trade Agreements^a

In September 2013 Kosovo has signed a free trade agreement with Turkey and it is in the negotiation process with other countries. Kosovo is part of the Central European Free Trade Agreement together with seven other countries in the SEE. The agreement was signed by the UN Interim Administration Mission in Kosovo in December 2006, and, while the government of Kosovo implements the agreement, Kosovar exports are facing obstacles because some of the parties to the agreement do not recognize Kosovo's institutions. In August 2014, Kosovo blocked the imports of food of animal origin from Bosnia and Herzegovina.^b Six integrated border management facilities between Kosovo and Serbia have been operational since 2013. The time and costs of transporting goods have been reduced thereby facilitating trade between the two countries. Kosovo also takes part in the Regional Cooperation Council and is invited to participate in meetings of the South-East European Cooperation Process. In October 2013, Kosovo started negotiations for the Stability and Association Assessment (SAA) with the EU, which was subsequently signed in October 2015 and started to be applied in April 2016.. This marked the first contractual relationship with the EU that is meant to bring Kosovo closer to EU integration. Trade relationships are a key part of the SAA.

The Ministry of Trade and Industry has gradually progressed toward implementing the strategy on the free movement of goods adopted in February 2013. Kosovo has continued the internal restructuring of the ministry, which is in charge of horizontal coordination. The bodies responsible for metrology, accreditation, standardization, and market surveillance have been transformed into agencies. The division for quality infrastructure in the ministry provides policy guidance and support to align Kosovo legislation with the EU acquis. Staffing is to be increased in all agencies.

As regards standardization, 1,575 European standards have been adopted as Kosovo standards, bringing the total number to 6,520. Standards are normally adapted from the recognized National Standards Body of Albania through the cover page method. Kosovo is not a member of either the International Organization for Standardization or the European Committees for Standardization–European Committee for Electrotechnical Standardization. Awareness raising in the private sector on the use and importance of standards needs to be improved.

Regarding conformity assessment, Kosovo has adopted regulations in the area of toy safety, machinery, conformity marking and household electrical appliances. In the area of general product safety, regulations on the rapid information exchange system to products posing a risk to the health and safety of consumers were adopted in November. A regulation on technical approvals for construction products was adopted in November and basic requirements for construction works were approved in May. The notification procedure, regulation on exchange information and notification of technical regulations, conformity assessment procedures and standards have been adopted and are in use as of April.

With regard to accreditation, the Kosovo General Accreditation Directorate has been transformed into an agency. The assessment of the former directorate carried out by the European Co-operation for Accreditation in 2012 identified a number of nonconformity issues that have now been addressed. There has not yet been a full evaluation of the new agency. Four inspection bodies, 22 testing laboratories, and one calibration laboratory had been accredited by the former directorate. One accreditation was withdrawn in the reporting period because of nonconformity. Fees for accreditation go into the general budget and are not directly channeled into the new agency's budget.

On metrology, the laboratories on mass, flow and volume, electrical measurement, precious metals, and thermometry are operational. The Agency of Metrology has improved its capacity to fulfill its supervision functions. The laboratories on time and frequency, as well as length and force, are only partially operational. In general, the level of operational capacity of laboratories needs to be raised to meet the necessary qualitative standards. In relation to market surveillance, two administrative instructions have been adopted, and a significant number of inspections have been undertaken by market inspectorates. Several thousand goods, including toys, electrical and mechanical equipment, and sports equipment have been seized

a. In 2014, the government declared three new free economic zones (Pristina, Mitrovica, Gjakova and Prizren). However, the institutional setup to screen, approve and monitor existing and planned state aid schemes has not yet been established.

b. Recent examples of escalated trade disputes—such as those with FYR Macedonia and Bosnia and Herzegovina—have demonstrated the dangers of ignoring already established trade-dispute mechanisms. In case of future trade disputes with the neighboring countries, Kosovo has at its disposal the mechanisms of the Central European Free Trade Agreement.

Greater Productivity in Agriculture

6.5. **Agriculture plays a significant role in Kosovo's economy.** It is an important contributor to GDP, accounting for about 11 percent of GDP in 2015. The sector is the largest private employer, accounting for about 18-20 percent of total employment, although primarily on an informal basis.¹³² About 90 percent of the population has land for cultivation and 55 percent own livestock. Beyond economic considerations, Kosovo's reliance on agriculture also has a crucial social dimension: agricultural activity is pervasive in Kosovo as a safety net for much of the population. Approximately 60 percent of the country's poor live in rural areas and depends, directly or indirectly, on the agricultural sector for their livelihoods.

6.6. **Despite growth, the overall balance of trade in agricultural products is substantially negative.** In 2011, the value of agricultural exports was €26.2 million, while the value of imports was approximately

¹³² The 2014 LFS (KAS and World Bank 2015) estimates the agricultural share of employment at about 3 percent, but this uses a definition from Eurostat and International Labour Organization guidelines that systematically undercounts agricultural workers, especially the many small and informal farmers that dominate Kosovo's agricultural sector. It also does not include agroprocessing, which is categorized under industry. The European Commission estimates agriculture's share in total employment at approximately 35 percent (EC 2014c). The 2014 agricultural census estimates that 362,700 people worked in agriculture in 2014 (KAS 2015). Most of these are part-time or seasonal workers, who are still counted as 86,620 annual work units, which is similar to the concept of full-time equivalents.

€561.4 million. Exports of agricultural products thus generated revenues to pay for only 4.6 percent of the cost of importing such products. Kosovo is the largest importer of food per capita in Europe despite its large potential because of fertile agricultural land and good climate. Agricultural products account for about 10 percent of all imports; of this 30 percent comprises food products.

6.7. **The agricultural sector can potentially be a source of growth and poverty reduction over the short- to medium-term.** By exploiting the competitive potential it enjoys, particularly in horticulture and livestock, the country can achieve the objective of (a) increasing import substitution of food products; and (b) promoting exports in niche or high-value products. The development of these subsectors would not only contribute to transforming agriculture into a dynamic and vibrant sector but also serve as an effective path out of poverty for a significant segment of the rural population by providing both long-term and seasonal employment as well as improving wages/incomes. Poverty among the agrorural population is high and about 40 percent of the rural population is unemployed. Most of the labor force is unskilled or semiskilled and the lack of perspective of jobs is putting a strain on social cohesion and encouraging out-migration (as well as emigration). In most cases, agriculture forms only part of rural household incomes; most families depend on remittances from abroad to supplement their farming incomes. It is estimated that in rural areas, an average of 48 percent of a household budget is used for consumption of food and nonalcoholic beverages, leaving little for other necessities and leisure.

Box VII.2. Priority Sectors in Agriculture

Horticulture is a high priority subsector in Kosovo. While the country is still a large importer of fruits, vegetables and decorative plants, the subsector is growing rapidly. This is primarily because of the underutilized or unutilized labor, good agroclimatic conditions that favor the production of high quality fruits and vegetables as well as the long tradition of producing fruits and vegetables. Also, there is a high preference/demand for traditional and local products by the Kosovar population.

The subsector has benefited substantially from several donor support programs – both technical and financial. Currently, there is a growing trend toward surplus production of fruits and vegetables and consequently increasing agroprocessing activities. Value chains are developing and maturing and contractual arrangements between producers and processors/traders are growing in number. Over the last five years, 100 - 150 ha of new orchards have been established annually. Similarly, the area under vegetable production has increased steadily and most of the produce is grown for commercial purposes. Only 25 percent of the produce is consumed at the farm level and the rest sold in local markets or to agroprocessors. Vegetables are increasingly grown in greenhouses (the number of greenhouses has tripled since 1999), which has helped to improve productivity and quality as well as allowed the produce to be sold a few days earlier than open field production (usually two weeks, rising to two months in the case of heated greenhouses). Processors are benefiting from the installation of modern equipment and technologies for collection, sorting, grading, processing, packing, and so on. Most agroprocessors are increasing their knowledge and technical skills through study visits and field trips to EU candidate and member states and benefiting from their knowledge and experiences.

Horticultural products with high potential for import substitution and exports are fruits (apples, plums, grapes, pears and sour cherries), vegetables (peppers, tomatoes, onions, cabbages and watermelons). For instance, Kosovo's agroclimatic conditions are highly suitable for the development of vineyards, especially for early varieties. Kosovo produces wine using only domestically produced wine grapes. Dominant export market for Kosovo wine is Croatia. Before 2008, most of the wine was exported to Serbia; this was resumed in 2012 after the trade blockade was lifted. Other export markets include Germany, FYR Macedonia, Romania, and Slovenia. Fresh table grapes are however imported throughout the year. There is a high demand for table grapes and the potential for the existing vineyards to cultivate and market table grapes is high. Additionally, there is a long tradition in the collection of wild medicinal and aromatic plants and wild mushrooms which offers an excellent potential for exports. Those involved in the collection of berries, mushrooms, and herbs regained most of their European markets in recent years. This subsector provides good opportunities for employment and income generation among populations residing in remote rural and mountainous areas. New agricultural products with high export potential (such as asparagus, raspberries, and so on) are

introduced in Kosovo lately, mainly supported by donor programs. Also fields producing strawberries for domestic consumption have expanded significantly in the last two years.

Livestock is a significant component of the agricultural sector, especially in the mountainous areas with pastures that cover a considerable portion of the country. Livestock products constitute a major food source for most Kosovars and a high share of production still serves subsistence purposes. With donor assistance, the subsector is becoming productive and efficient. On the processing side, modern equipment and reliable contractual agreements with producers has increased the efficiency of dairy processing which has significantly substituted imports of dairy products in the recent years. Overall livestock numbers are low and most slaughter houses do not operate to full capacity because of a small livestock population and a preference among livestock farmers to use their herds for milk production. Kosovo therefore imports a high percentage of meat and meat products for domestic consumption. There is also an increasing demand for good quality milk and dairy products as well as livestock products in Kosovo and although problems persist in the subsector (for example, lack of minimum food safety standards: only 35 percent of the milk processing capacity and only one livestock product processing company have been certified by the Hazard Analyses and Critical Control Point), with the targeted support, this subsector has a high potential to improve production and processing and become competitive in regional markets.

There are good opportunities for generating employment and additional household incomes in the rural sector through economic diversification – both onfarm and off-farm. Such activities also have the potential for curbing out migration of rural populations to urban areas in search of jobs and a better quality of life. There is a high demand for such products in local markets as the Kosovo population has a preference for local products. Such farm diversification also has an important social dimension, for example, in women's empowerment. Onfarm nontypical agricultural production, beekeeping can be especially lucrative in rural areas of Kosovo.^a Off-farm diversification activities include production of renewable energy from biomass and biogas (including manure) or wood residues (for example, wood pellets for heating), development of artisanal products and crafts (carpenters, leatherworkers, dyers, spinners, knitters, and so on), provision of agricultural services (machinery and other equipment, storage facilities), and so on.

a. Common applications include beekeeping, aquaculture, mushroom production and cultivation, and the collection of wild products (for example, forest fruits, medicinal and aromatic plants, herbs), flowers, tree nurseries, seed production for vegetables planted in greenhouses.

6.8. **However, a number of structural and interrelated challenges will need to be addressed to harness agriculture's competitive and growth potential.** Before the 1990s, Kosovo was largely food self-sufficient with large quantities of agricultural products exported to the region and livestock production contributing about half of total agricultural revenue. However, after the war, this trend was reversed so that traditional markets were lost, livestock numbers plummeted, agricultural land area dropped drastically and the availability of previously subsidized inputs (fertilizers and irrigation waters) reduced dramatically. The sector is now characterized by poor agricultural productivity primarily because of the following:¹³³

- Fragmented land holdings averaging 1.5 ha (often spread across an average of seven smaller plots, further exacerbating economies of scale).
- Outdated farm technologies and modern agricultural knowledge/skills among farmers and agroprocessors, lack of investments in irrigation, limited processing facilities, including lack of storage, packaging and transport facilities; limited implementation of food safety and hygiene standards.
- Lack of diversification of agricultural products, limited market access, poor integration, both horizontally (collaboration among farmers) and vertically (weak contractual arrangements between producers, agroprocessors, and traders), a rudimentary rural advisory system, and limited market information.
- Limited access to credit and investment capital (high interest rates) also because of the high costs associated with originating loans given the substantial informality and the inability to realize the value of collateral deriving from the weaknesses in property rights (both the availability and reliability of land title documents and maps).

133 UNDP (2102b).

- High production and export subsidies of many of Kosovo's trading partners (many of these countries allocate between one-third and two-third of their agricultural spending to such subsidies. Agricultural subsidies in these countries facilitate the entrance of better quality products at lower prices into the Kosovar market).
- Lack of an adequate policy and regulatory framework, including weak enforcement where legislation does exist) and low capacity of institutional structures (municipal offices, Managing Authority, Paying Agency, which are understaffed with limited technical skills); weak tax administration so that an informal economy continues to persist.

6.9. **While the government has taken several significant and strategic initiatives to address these challenges, a vast unfinished agenda remains.** The overall development agenda in Kosovo's agricultural sector is largely driven by prospects for eventual EU integration. In 2015, the government substantially increased its budgetary support to the sector, although the total allocation still remains considerably insufficient to tackle the myriad challenges facing the sector. However, as public investments are scaled up, there is a need to ensure that the appropriate policies are put in place to harness the sector's productive potential and promote, more broadly, a thriving rural economy. The agriculture chapter is one of the most demanding and onerous chapters of the EU *acquis communautaire*. This places additional demands on an already challenged sector. However, moving toward compliance with EU Common Agricultural Policy (CAP) provides Kosovo an opportunity to benefit from technical expertise (twinning projects with EU member states) as well as financial assistance (IPARD funds) (in addition to assistance from other donors) that can help put in place the right mix of policies and investments for the establishment and maintenance of a competitive agricultural sector

6.10. **Accelerating growth and addressing rural poverty, will require a three-pronged approach:** (a) improving productivity and competitiveness in the agricultural sector; (b) promoting economic diversification – both onfarm and off-farm; and (c) facilitating the movement of labor from the agricultural sector to more remunerative nonfarm activities. This approach means that the government will need to put in place policies and reforms to shift the agricultural sector from subsistence farming to one that is intensive and more commercially oriented, with a focus on niche, higher value products as well as shifting from underemployment in farming to less employment in farming and greater employment in processing and nonfarm rural activities. Creating the conditions for a competitive sector means that opportunities need to be created to boost the yield of existing farms, leading to increased food availability at the household level and larger marketable surpluses that generate higher incomes as well as promote agribusiness development.

6.11. **Creating such opportunities for economically viable, commercially oriented farmers and agribusinesses implies that the less productive farm holders would need to find other employment.** Some would remain in agricultural production as direct laborers or contract farmers for commercialized farms, but this is likely to be a small proportion of the current agricultural labor force. While this would remove the dead weight from the sector and make it more efficient and competitive, it would create a cadre of unemployed rural persons. This means that conditions also need to be created to strengthen economic opportunities outside farming and remove entry barriers to nonfarm employment. Nonfarm rural employment and income opportunities would also encourage farmers in disadvantaged or depressed regions where farm operations are not inherently viable or those with weak access to markets and infrastructure, to withdraw from the sector. Such off-farm rural diversification would be critical to provide jobs and incomes and prevent out-migration.

6.12. **As a considerable number of farmers derive only part of their income from agriculture, opportunities need to be created for onfarm and off-farm economic diversification for this segment of**

the rural population to assist in providing additional/supplementary jobs and incomes. In fact, as agricultural productivity increases and there is a concomitant decreases in farm employment, there is a need for a wide range of economic opportunities in the rural sector - rural diversification, both onfarm and off-farm – that would be critical to generating rural jobs, improving livelihoods, preventing out-migration and addressing the high level of poverty prevailing in the agrorural sector.

6.13. Agribusiness development is one of the key components for accelerating growth, creating jobs and building a competitive agricultural sector. Constraints to agribusiness development will need to be addressed through a mix of short-, medium and long-term policy actions on several fronts including, *inter alia*:

- *Land consolidation.* This is critical for economies of scale and competitiveness. Current farm production is inefficient because most farmers have small and scattered landholdings. On the marketing side,, processors have to deal with many small farmers at low levels of productivity whose supply is limited resulting in high collection costs which does not allow the processing industry to be competitive. While this may be a longer-term undertaking, in the meantime, incentives need to be provided to spur farmers to consolidate their land and production. Such consolidation will require clear registration of ownership rights and a geo-spatial infrastructure to maximize benefits
- *Development of strong value chains:* The forward and backward links for production, processing and marketing. Currently, processors do not have a reliable source of suppliers of raw materials nor adequate market information. Contractual arrangements remain weak.
- *Access to finance, availability of financial products more in line with the agricultural cycle* (longer maturities) and affordable collateral. The interest rates for agricultural loans varies between 8 percent and 48 percent a year, depending on the loan amount and repayment period. Collateral can range from 100 percent to 388 percent of the loan amount. One way to address this could be the establishment of a Guarantee Fund that would encourage banks to issue loans at a lower interest rate and require smaller collateral. Policies are therefore needed to make lending easier for the development of agriculture and agribusinesses.
- *Reduction of import barriers and custom duties* for importing modern, innovative equipment and technologies to improve quality and quantity of production/processing.
- *Provision of irrigation and establishment of Water Users Associations.* This is especially critical for higher value horticultural crops in which the sector is known to have a competitive potential.
- *Establishment of appropriate rural infrastructure,* such as rural roads for transportation and access to local markets.
- *Establishment of food safety and quality standards.* This will require policies for a food safety management system in line with the International Organization for Standardization 22000 family of international food management standards, including the Hazard Analyses and Critical Control Point. This is critical in order to increase exports and capture EU markets. The Ministry of Agriculture, Forestry and Rural Development, the Food and Veterinary Agency of Kosovo, and the Ministry of Health will need to work together to achieve this, and the Food and Veterinary Agency of Kosovo will need to become internationally accredited. *The agrifood sector,* as a whole, is lagging in the take-up of ICT technologies.
- *Agricultural risk management* to provide insurance products to protect from extreme weather events (which should also lower interest rates).
- *Improvement in the knowledge and skills* of commercially oriented farmers and agroprocessors to, among other things, stimulate development of sound business plans and introduction and application of innovative technologies. For this, the Ministry of Agriculture, Forestry and Rural Development, together with the Ministry of Education, Science and Technology will need to develop policies to strengthen capacity of local municipal advisors as well establish and equip vocational schools to introduce state of the art teaching methods on relevant agricultural topics. This will also have the added benefit of motivating educated young people to become active in agriculture.

6.14. **As the agricultural sector begins to become competitive and sheds the nonproductive labor force, it will be imperative that rural policies are put in place to provide alternative areas of employment and incomes to the rural population now out of agriculture.** While some of those moving out of agriculture will no doubt move to urban areas to seek employment, new opportunities for rural economic diversification will also be critical to invigorate the nonagricultural economy and promote local and regional economic growth. There will be a need to integrate various sectoral policies into a comprehensive and coordinated national rural policy addressing the five key dimensions: social, economic, environment, migration and governance. The national policy should contain a broad approach that allows line ministries (such as Education, Science and Technology; Environment and Spatial Planning) to play a distinct role in rural development in accordance with their unique competencies while at the same time also contain a narrow (regionally sensitive) approach given Kosovo's diverse geography and the presence of remote rural regions. Municipal governments should be provided the appropriate mandate and budgets to promote local and regional growth.

6.15. **To create jobs and provide/increase incomes of the nonfarming and marginal rural population as well as of those engaged in agriculture part time, government policies should encourage:**

- *Small-scale processing and marketing of traditional and local products* – there is already a tradition in rural areas of Kosovo in processing of selected horticultural products into juices, pickles, jams, rakia , and so on, processing sheep and goat milk in mountain areas, production of native Shari mountain cheese, honey production, ham and sausage , and so on. There is a high demand for such products in local markets as the Kosovo population has a preference for local products, which presents opportunity for adding additional value through packaging, branding and promotion at local and regional level. Such farm diversification also has an important social dimension, viz. women empowerment. Processing fruits and vegetables provides opportunities for women to be gainfully employed and contribute to family incomes and thereby increasing their sense of independence and self-confidence.
- *Rural tourism, including agrotourism and ecotourism.* An integrated approach of combining farming with tourism has the potential for improving the livelihoods of rural populations. Several rural families are converting their traditional/historical farm buildings into "authentic" accommodations for tourists and processing their farm products (into yogurt, cheese, and so on) for catering purposes, all of which are creating jobs as well as generating or supplementing incomes. Tourism is also an opportunity for direct marketing and promotion of agriculture and food products.
- *Off-farm diversification activities,* including production of renewable energy from biomass and biogas (including manure) or wood residues (for example, wood pellets for heating), development of artisanal products and crafts (carpenters, leatherworkers, dyers, spinners, knitters, and so on), provision of agricultural services (machinery and other equipment, storage facilities), and so on.

6.16. **For rural economic diversification to be successful, there will be a need for, *inter alia*, human capital and skills development, targeted vocational training as well as access to finance (low interest loans and grants) for startup capital.** These would be necessary for creating opportunities for rural populations to establish alternative businesses or avail of other employment opportunities. This would be especially important for the rural population on social welfare (about 28,000 people) that has few/no economic opportunities and are seeking to migrate to other countries in the region in search of better prospects. Assistance to this segment of the population in the form of grants/subsidies is a priority of the Ministry of Agriculture, Forestry and Rural Development and corresponding policies/actions need to be put in place urgently.

6.17. **Increasing droughts and floods from climate change will likely will threaten Kosovo's already limited water resources.** This will make it difficult to orient the agricultural sector sustainably and to be more competitive, without a focused consideration on how to make this sector resilient to climate change. The government of Kosovo recently completed its National Adaptation Strategy (NAS), and together they form the Climate Change Strategy for Kosovo, which identifies water resources, agriculture, forestry and land use planning, as particularly vulnerable to climate change. It also defines a project implementation schedule for the next 15 years for each of the 38 priority adaptation and resilience-building actions identified in the NAS, totaling €276 million.

Sustainable Management of Natural Resources

6.18. **Kosovo is rich in natural resources and has been an important mining center since pre-Roman times.** Kosovo possesses large reserves of lignite, lead, zinc, silver, nickel, cobalt, copper, iron and bauxite. Kosovo is also rich in high quality construction minerals, such as andesite, basalt, diabase, gabbro, granite, limestone and marble. Kosovo's minerals sector was the mainstay of the economy of the former Yugoslavia, providing direct employment to more than 17,000 miners in Kosovo.

6.19. **However, the period from 1991 to 1999 saw chronic neglect with little reinvestment in mining operations and associated processing facilities** – resulting in an industry having diminished asset value, reduced production while environmental and social legacy issues escalated. The 1999 conflict served to accelerate sector decline, damaging key production assets at several operations. Most importantly, from 2000 to 2013 an unprecedented commodity super-cycle led to hundreds of billions of dollars in new sector investments globally, during which Kosovo's metal and industrial mineral mining industry lay largely idle. Interestingly, other post conflict states fared equal to other emerging economies in their ability to attract and retain new mining investments.

6.20. **As such, a core impediment to the private sector reengaging in the mining sector has been weak sector governance combined with the unresolved status of Kosovo.** Mining investors require surety-of-tenure of license holding, stability of policy, and a transparent, nondiscretionary regulatory process backed by a sovereign government. Kosovo is a demonstration of a jurisdiction for which resource exploration and production is not commensurate with the excellent underlying resource potential. Absent these conditions in Kosovo, a domino of exacerbating issues has occurred:

- Interim recovery strategies implemented at several metal mining operations could not be sustained on government support alone.
- Unemployed and underemployed workers have become increasingly agitated and represent a material social barrier to investment without a clear policy and programmatic approach to labor reskilling, labor redundancy, and labor redeployment.
- Severe environmental legacy issues relating to mine contaminants cannot be addressed in a meaningful way without an operating industry partnering with the public sector, leveraging some resource rents from new production toward costly cleanup projects.

- While Kosovo has enacted a European style mining law, the government has sought to implement strategies that would grant itself the power to shape and develop the mining sector, making the independent Regulatory Agency vulnerable to external influence.

Box VII.3. Natural Resources in Kosovo

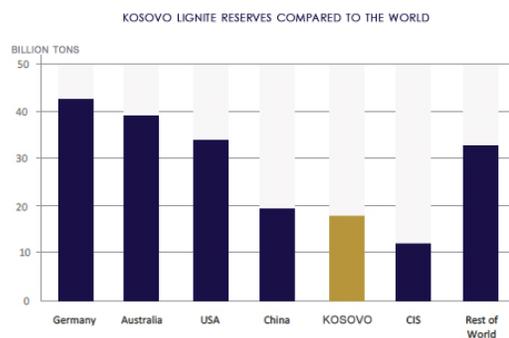
Lignite: Kosovo possesses the world's fifth-largest proven reserves of high quality lignite (estimate to be around 11 billion tons), which would allow Kosovo ambitious power generation. Lignite already contributes 97 percent of the total electricity generation and the cost of lignite-fueled electricity in Kosovo is the lowest in the region. The lignite is distributed across the Kosovo, Dukagjin and Drenica Basins, although mining has so far been restricted to the Kosovo Basin. Further development of lignite mining in the medium term is expected to continue with the exploitation of the Sibovc mining field in the northern part of the Kosovo Basin.

Lead zinc-silver: Base-metal mining has been conducted extensively in the region throughout its history. These activities have been based on a series of nine mines, of which five comprise today's Trepça complex. Current estimates for combined mineable reserves for the five mines have been undertaken, but all of the deposits are open at depth and their strike lengths are uncertain, owing to a lack of systematic exploration and definition drilling. Importantly, the global exploration industry continues to view Kosovo as having excellent potential for larger copper deposits at geological depth, associated with the Trepça deposits.

Nickel: Ferronikeli company (mine and smelter) now is the main exporter in Kosovo. Ferronikeli has three open pit mines: the Dushkaja mine with estimated reserves of 6.2 million tons; the Suka mine - 0.8 million tons and the Gllavica with 6.8 million tones. Laterite mineable reserves have been estimated at 13.2 million tons. Ferronikeli ore mining and metallurgical complex was set up in 1984 to produce ferro-nickel for exports. It produced and exported 6,800 tons of nickel a year, in ferro-nickel ingots, before the 1990s but from 1998 until its privatization in 2004 it has been idle. After privatization and significant investments from the new owner, Ferronikeli became fully operational and employs over 1,000 employees. While considered globally a second-tier investment opportunity, the potential for additional nickel deposits remains favorable and investor interest is good.

Bauxite and magnesite: Kosovo's bauxite deposits are hosted in karst limestone and have been exploited in a series of pits that comprise the Grebrik mine. Mining began in 1966 and ceased in 1990, owing to the deteriorating political climate in Kosovo. Total production was 2.85 Mt. Kosovo also possesses two magnesite mines at Golesh and Strezovc. Both originally worked as quarries and both moved to underground operations prior to their closure in 1999. Before 1990, the Golesh operation produced 110,000 tons of magnesite, 22,000 tons of sintered magnesia and 10,000 tons of caustic calcite magnesia per annum. Again, while considered globally a second-tier investment opportunity, the potential for additional bauxite deposits remains favorable and investor interest is good.

Figure BVI.3.1. Lignite reserves



6.21. **Despite these deficiencies the underlying mineral endowment for mid-sized known deposits (that is, those previously discovered and in production) remains good, while the potential for larger world-class deposits at geologic depth is excellent.** After more than a decade of chronic neglect, the mining sector is beginning to revive slowly. A number of mines have restarted operations, including lignite mines at Kosovo Electricity Corporation, lead and zinc at Trepça, nickel at Ferronikeli, and marlstone at Sharrcem, and the supply of materials is reaching the booming construction industry. Based on the Statement of the Economic Potential of the Mining Sector in Kosovo, the mining sector can sustain around 16,000 jobs (including direct jobs for 8,200 people and about 8,200 indirect jobs in maintenance and support services).

6.22. **The mining sector has the potential to generate needed resources for development and likely to benefit lower income households.** As mining is capital-intensive the direct impact on employment and income growth of the bottom 40 is expected to be modest, but the indirect impacts are potentially much broader. In a small country such as Kosovo, the 16,000 potential long-term jobs (direct plus indirect) represent a major opportunity for reducing unemployment and increasing incomes. Most of the mining sector jobs are relatively unskilled and can be filled by those whose employment prospects are otherwise quite limited. Employment from mining, even indirect employment in supporting industries, is heavily concentrated in the geographic area of the mines, areas that became disproportionately during the years of the decline of mining. Moreover, natural resource rents of 2.4 percent of GDP in 2012 seem small relative to other resource rich small states, which average about 27 percent. While natural resources rent is a function of a number of variables including the quantity and quality of reserves and production costs, the fact that Kosovo ranks fifth in proven reserves of high quality lignite show the potential of the sector. The potential fiscal benefits from mining sector should not be underestimated given the potential scale of the mining industry relative to Kosovo's economy and population.

6.23. **The principal challenge to restarting Kosovo's mining industry is to strengthen sector governance to attract private sector investments.** There is growing recognition globally that public sector governance may well be the key determinant of the extent to which extractives projects are economically, politically, socially or environmentally positive or negative; and the extent to which they are a source of major costs to various stakeholders or a significant source of benefits.

6.24. **The challenge and risk of getting sector governance wrong impacts Kosovo's ability to attract quality investments.** Within the global experience, undesirable outcomes of extractive industry ventures have included losses because of political interference and corruption, weak social and environmental policies and enforcement, inadequate benefits sharing, contract default, expropriation/nationalization, license cancellation, protests/strikes, regulatory changes and inconsistencies in taxation or revenue-sharing arrangements. Indeed, nontechnical risks that undermine the stability and predictability of the investment climate, now are widely recognized as major sources of risk for extractive industry investors. A World Bank survey of mining sector firms has found that, historically, among their top six key criteria for investment decisions, only one category, geological potential, was not directly related to the scope and efficacy of governance of extractive industries.¹³⁴

6.25. **As such necessary reforms to improve the rule of law, and remove discretionary decision-making powers are necessary; but so too are actions to address a legacy of unresolved labor, social, and environmental issues that have impacted workers and communities alike.** In Kosovo, unresolved legacy issues around land acquisition (Sibovc SW) and environmental and social issues at Trepça and other operations; combined with previous instability regarding the independence of the regulator has resulted in heightened investment uncertainty. Good governance in Kosovo starts with clarity regarding: what are the basic rules that guide Kosovo's mining sector development; how these rules are implemented, monitored, and enforced; and who determines the rules and how this authority is conferred and employed.

6.26. **While the industry needs major upgrades, the mineral reserves should be sufficient to offset the start-up costs.** A reactivated Trepça would provide much needed jobs and increase Kosovo's foreign

¹³⁴ See Enterprise Surveys (database), International Finance Corporation and World Bank, Washington, DC, <http://www.enterprisesurveys.org>.

exchange. Moreover, the international exploration industry has expressed much interest in Trepça's vast land holdings, given the geologic potential for significant resource potential at greater depths than have been explored and exploited until now. However, Trepça management have sought to protect the integrity of its land holdings from foreign investment, largely to preserve asset value in a bid to restart operations using an international mining contractor. The Law on Trepça was approved in October 2016, which should enable new investments, especially from the private sector.

6.27. The resulting tension between privatization and a more limited restart using the existing management structure speaks to the core of mining governance issues:

- What are the basic rules that will guide future mining sector development given the historic role of mining and need for job creation for youths?
- How will these rules be implemented, monitored, and enforced given a checkered history regarding independence of the mining regulator and past allegations of political interference?
- Who determines the rules and how this authority is conferred and employed when idle workers and their families have their futures invested in a resumption of mining? Moreover, the division between North Kosovo and Kosovo makes achieving voice and accountability to hold decisions-makers to account for their conduct more complex.

6.28. Other significant risks are associated with skills shortage include impact to production, project delays, and increasing labor costs. Identifying, attracting and retaining critical operational and construction skills remain a top priority for the mining and metal sector. In this context, there is likely to be a shift toward younger skilled workers or those entering the labor force given the technological demands of modern mining. This again introduces a political economy dimension if social protection of existing workers is not adequately addressed.

6.29. Given the environmental impact from potential and mining, strengthening key institutions and policies is also critical so that Kosovo taps its significant natural resources in a sustainable manner¹³⁵ and in line with international standards For instance, a study on heavy industry concluded that the uncertain operating environment (for example, transparency in levying royalty fees for natural resources and legal and policy framework to encourage the reuse of industrial waste) is the major reason a local steel plant imports zinc, though zinc is readily available locally, along with the necessary electrolysis equipment.

6.30. Remedies of the historic environmental legacies related to mining will be required to remove the health impact of these legacies, bringing dilapidated and degraded land back into productive use and reducing public opposition against continuing/increasing production. The areas of the depleted and dilapidated Bardh and Mirash lignite mines are about 10 km² out of which large areas could be made available for agricultural production and other land uses to the communities in the municipality of Obiliq/Obilic once rehabilitated. For the Trepça complex, the main sources of nonproduction related pollution are as follows: (a) mine tailing ponds and dams or heaps that cause dust, erosion, contaminated runoff water, and seepage water and groundwater contamination.¹³⁶ Both dust and discharges contain heavy metals; (b) site contamination and onsite storage of waste at the two smelter sites- dust, contaminated run-off water and seepage water, and groundwater contamination, also containing heavy metals; (c) acid mine drainage – mine water discharge, often with high acidity and containing heavy metals; and (d) soil contamination from dust and other emission

135 STRAS (2012).

136 World Bank (2013d).

deposits- deposits of particulate matter containing heavy metals causing soil and groundwater contamination and uptake in crops and plants for grazing.

6.31. **Priority actions for Kosovo’s mining sector relate to strengthening sector governance, addressing uncertainties and ambiguity regarding the overarching policy for the sector.** Appreciating that the international investment community has long signaled interest in the resource potential but has till now been indifferent to investing, the list of priority actions includes (a) improving sector policy, (b) further strengthening the mining law and regulations, (c) implementing a long-range plan to address remaining environmental and social legacy issues, (d) ensuring the taxation and fiscal package is modernized and aligned with international standards, and (e) increase the capacity of government institutions, especially independent regulatory agencies, for effective transparent, nondiscretionary administration of the sector, (f) building the NSDI as the platform for collection and use of geo-spatial information for informed decision making and planning related to natural resource management, infrastructure investments, urban planning environment/climate change/disaster risk management, agricultural sector development¹³⁷.

6.32. **Importantly, voice and accountability will ensure inclusive growth.** The global experience offers much insight to Kosovo’s mining policy makers -- when extractives projects are not perceived as adequately benefitting host societies or when they are seen as major sources of social and environmental harm, these situations have the potential to translate into negative outcomes for governments and investors alike. And the fewer mechanisms to hold governments and investors accountable for conduct and impacts of extractives projects, the greater the possibility of conflict escalation and volatility.

6.33. **Addressing directly the issue of how to manage revenues from natural resources is critical.** The role of taxation in the exploitation of natural resources, and the distributional implications of mining sector development are key produce direct or indirect benefits for the population at large. There is a lot of international experience to draw on – from the radical approach of Bolivia’s taxation of hydrocarbons to finance programs which by design benefit the most vulnerable (early childhood development) or the experience of Botswana which has put to good use its mineral wealth, or to the establishment of some form of “wealth fund”.

¹³⁷ Significant resources are currently being wasted on the nonstandardized and uncoordinated collection, use, and sharing of geospatial information. The NSDI is also an EU accession requirement under the INSPIRE directive.

VII. RISKS TO SUSTAINABLE SHARED PROSPERITY AND POVERTY REDUCTION

7.1 A number of risks have emerged from the analysis of previous chapters, principally related to macrofiscal risks, potential environmental risks, and social and political risks, which need to be managed carefully:

7.2 **Macrofinancial sustainability:** Because of the size of its economy, growth strategies in Kosovo must rely on foreign markets and its fortunes are fundamentally linked to a favorable external environment. Kosovo is however exposed to external shocks. The government has limited tools to cope with external economic uncertainties. With rigid fiscal rules (although mitigated somewhat recently with the introduction of the donor-financed investment clause) and euroized economy, the scope for macroeconomic policy responses to absorb unforeseen shocks would be limited to the availability of fiscal buffers and additional external financial support as well as structural and income policies.¹³⁸ The challenge of maintaining macroeconomic stability in the face of uncertain global developments, especially in the euro area, is amplified by its narrow resource base, which prevents Kosovo from diversifying into a wide range of activities. When one dominant activity declines, it has an impact throughout the economy, exposing the population to income volatility which can create additional hardships as the poorest are less able to weather shocks to their incomes. Government revenues are also volatile because they narrowly target specific industries and rely heavily on taxing imports as a source of revenue. As tariffs are reduced, so is the government's income. The landlocked status makes it also difficult and costly to access markets to compensate for its small domestic market — a situation that increases the cost of intermediated inputs and imports and prevents efficiency and innovation. Domestic competition is also limited, which hampers successful development. In a euroized economy, the absence of a significant adjustment by realigning unit labor costs through productivity gains, the risk is a painful adjustment through an “internal devaluation” to regain competitiveness.

7.3 **Environmental sustainability:** Kosovo is prone to a wide variety of natural hazards—including floods, landslides, droughts, earthquakes, and wildfires—that could pose serious damages to the economy, fiscal balances and well-being of vulnerable populations. Many of these climatic related hazards are expected to magnify with future climate change. These climate and disaster risks can seriously impact productive sectors of the economy, such as agriculture, infrastructure, energy, water resources, and communities and households. Natural disasters and climate change can also hamper reforms and add pressure on the fiscal position, exacerbate existing expenditure pressures, redirecting public resources away from long-run development plans and limiting a country's ability to build cushions for development programs and future needs. They can also divert scarce government administrative capacity toward emergency operations.

¹³⁸ These have recently declined to low levels. The bank balance had declined to below 2 percent of GDP by the end of 2014, and the overall fiscal deficit was set at 2 percent of GDP by the fiscal rule mandated by law.

Box VIII.1. Vulnerability to Disasters and Climate Change

Kosovo is exposed to earthquakes, floods and forest fires. In addition to these hazards, considerable risk is also posed by landslides, drought, heavy snowfall and water reservoir dam bursts.

Kosovo is located in a seismically active area of the world, with seismic fault lines running along the Adriatic littoral and the Vardar Valley making it susceptible to earthquakes. Since the end of the conflict in 1999, Kosovo has experienced an unprecedented construction boom and growth of urban areas. However, authorities do not always adequately control this, even though there is an understanding that illegal constructions pose higher risks to the population, especially with regards to floods. For example, in 1973, the city of Ferizaj-Urosevac was struck by a severe flood that affected the southern part of the city, but houses are still being constructed within flood-prone areas.

Exposure of production capacity to earthquakes can be significant. More than 20 percent of the economy would be exposed to a 100-year earthquake and about 44 percent of the country's GDP would be somehow affected by a 250 years return period earthquake. If an event of this magnitude occurs, the total (public and private) damage and losses could correspond to 18 percent or more of the country's investment (gross fixed capital formation) in a year. This amount would be equivalent to more than 2 months of investments in the country and the potential government revenue losses and the public damage and losses could amount to approximately 9 percent of total general government revenues.

Given Kosovo exposure to earthquakes, the government liability associated to a 250 years return period earthquake could be higher than \$100 million, which represents about 1.9 percent of the country's GDP. The government revenues lost because of business interruptions or tax exemptions could be equivalent to almost 2 percent of the total government revenues in a year, also hindering the country's response capacity. Within this context, fiscal stress could result from a 250-year earthquake in Kosovo. The budgetary reallocations could not be enough and issuing new debt, as well as requesting support from the international community, could be necessary to ensure recovery and reconstruction.

In terms of floods, a 100-year flood could affect 2.9 percent or more of the country's GDP of the country. In Kosovo, the government liability associated to a 100-year flood could amount to \$77 million or more, which corresponds to about 1.3 percent of the country's GDP. Exposure to climate hazards such as floods and droughts will become greater with climate change and increase socioeconomic impacts on human well-being and environmental conditions. The expected temperature increase and anticipated decreases in rainfall patterns, for example, will be directly reflected in river flow regimes, groundwater levels and recharge, as well as the soil evaporation.

7.4 Environmental risks and requirements for fulfillment of the environmental *acquis* include the significant impact of industrial polluters, low air quality, absence of waste, wastewater and water infrastructure as well as large amount of contaminated sites, which places a high environmental and health burden on the population and causes large areas of degraded land to be out of productive use. Kosovo has not progressed beyond the initial stages of harmonization with the *acquis* in these areas. There has been little progress on implementing the transposed environmental legislation. However, the initial steps for creation of the NSDI under the INSPIRE directive, the EU's requirement for standardized data collection, use and sharing for environmental management, have been made and need to be augmented. Environment and climate need to become government priorities as one of the conditions of EU accession for Kosovo.¹³⁹

139 EC (2014a).

Box VIII.2. Environmental Risks

Air pollution is a significant problem in Kosovo's urban areas and a moderate problem for the country as a whole. Urban ambient air quality is poor particularly in Pristina, the Obiliq area, the Drenas area, and in Mitrovica. The principal sources of pollution include (a) the burning of wood and lignite for household/building heating purposes, and, to a lesser extent, energy and mining production activities; (b) smoke and emissions from large industrial complexes; (c) landfills of urban and industrial waste which tend to have more specific local impacts; and (d) vehicular emissions. Key health impacts from air pollution are related to the high levels of particulate matter (PM), also known as fine particles or dust.

Water Quality. Data from the Institute of Public Health on the quality of drinking water show that the pollution of drinking water is generally associated with bacterial rather than chemical contamination. Much of this bacterial (fecal) contamination occurs in the water supply systems of small cities and rural areas where a large proportion of wells and springs are thought to be contaminated, although no firm numbers exist. There is also a lack of operating wastewater treatment plants in Kosovo.

Untreated Hazardous and Municipal Waste. Historical and current industrial waste has remained—for long periods of time—in production sites, storage areas, and industrial hot spots. In addition to mining and industry activities which generate about 1.3 million tons per year of waste (commercial, hazardous and nonhazardous), an estimated 382,000 tons of municipal solid waste is generated yearly. At present, there is a near-total lack of proper waste management in Kosovo for all waste types—domestic, industrial, health care, and hazardous waste—as well as for legacy pollution from historical contamination. Current waste management practice, if left unchanged, will lead to high levels of pollution of groundwater and air (for example, through methane or landfill gas), but also dioxins and fine particles when burned. In line with the municipal waste management policy,

Forest resources are under pressure since 1990 with a majority of illegally harvested timber used for firewood and occurrence of heavy harvesting for rebuilding houses after the war. In addition, lack of financial resources for proper silviculture treatment, especially precommercial thinning in the young stage of forest development is required to bring the forests back into the desired management and growth.

7.5 **Social sustainability and political risks:** Sustainability of reforms might pose a challenge. Recent national elections opened a window of opportunity for pushing structural reform forward. Reform is associated with nonnegligible political economy risks. This reflects the fact that many of these reforms will have redistributive effects, meaning that they sometimes eliminate the rents and privileges of vested interests. The government may face difficulty in overcoming these vested interests or reach a minimum level of consensus. As a result, the reform agenda could lose momentum, especially if the tangible benefits of reform do not become apparent to the population or if the cost of reform to narrow constituencies is too high. Kosovo's unresolved status remains a key obstacle to attaining the objectives of political integration and socioeconomic development. Fragility drivers may emerge if tangible benefits are not shared with a wider range of the population. These are largely prominent around interethnic cohesion; social inclusion; persistent unemployment particularly among Kosovo's youth; poor governance and unstable political institutions; along with weak platforms for voice and accountability. It must also be noted that there are significant social risks associated to energy production and mining, particularly in relation to the weak institutional framework and capacity to identify and mitigate the adverse social impacts, and enhance the positive ones. One such risk is related to the impact of energy tariffs on the population and the other, significant risks, is associated to the management of involuntary resettlement of population associated to lignite mining needed for energy production. Annex A provides detailed analysis on social vulnerability and sustainability.

7.6 **Implementation capacity risks:** Limited institutional capacity for implementing reforms reflects absence of technical expertise in some areas given the small pool of human resources in this small country. The

tendency to overinvest in physical infrastructure without corresponding reforms in regulatory environment and bylaws or secondary legislation is also related to limited implementation capacity, increasing the risk of effectiveness and absorption. The multifaceted reform agenda also raises the risk that government capacity is stretched thin and implementation is delayed. Capacity varies across different ministries and is generally weak at the municipal level, thus preventing the proper implementation of decentralized services, in particular in education, social services and health care. Several of the reforms may require the government to hire personnel with specific skills (for example, purchasing power parity transaction specialists), and there is a risk that the government will not be able to fully operationalize some of these reforms. Likewise, limited fiscal resources could hinder the full execution and roll out of strategies. Statistical capacity and accuracy of data also limits the ability to monitor progress and timely and effective course adjustments.

VIII. PRIORITIZATION OF AREAS FOR ACTION

8.1 This SCD has identified the ingredients necessary for accelerating growth, poverty reduction, and shared prosperity in Kosovo by gradually rebalancing the sources of growth toward a greater reliance on increased productivity at home and improved competitiveness abroad. Unleashing growth potential would require tapping into production factors—natural and human resources—that are currently either unemployed or chronically underemployed. This in turn will help support opportunities to an increasing share of the population and across a broader number of sectors, which are conditions needed to reduce poverty and share prosperity in a sustainable manner. To broaden the economy’s narrow production base, boost job creation and reduce its high import dependency, Kosovo’s current growth strategy would need to be amended with a broad set of governance, macroeconomic, structural and social policies to unleash productivity gains. In the absence of a significant adjustment in productivity to bring unit labor costs back into line, the risk is a painful adjustment through an “internal devaluation.”

8.2 A number of priority areas for accelerating growth, reducing poverty and boosting shared prosperity emerged from the review of the evidence, team discussions and contributions, and engagement and consultations with local stakeholders. The impact on twin goals, its time horizon and possible complementarity considerations have been used for the prioritization process. The most important lens to assess whether a particular constraint needs to be a priority area was its expected impacts on sustainable increase in welfare of the poor and less well-off. The team has taken into account the time horizon of expected impacts since certain actions yield immediate results while other key constraints to achieving the development goals need addressing now to yield fruits in the future. The team has also identified whether important complementary effects would generate benefits across multiple different dimensions of inclusion, growth, or sustainability.

Figure 70. Prioritization

	<i>Growth</i>	<i>Poverty and shared prosperity</i>	<i>Sustainability</i>	<i>Time horizon of impacts</i>		
				<i>Short</i>	<i>Medium</i>	<i>Long</i>
Reducing energy bottlenecks	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Improving governance, the rule of law, and the business climate	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Improving the allocation and efficiency of public expenditure	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Increasing employment and labor productivity through education	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Ensuring the sustainable management of natural resources	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Strengthening tax policy and administration	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Increasing productivity in agriculture	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Increasing employment and labor productivity through labor policies	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Reducing ICT bottlenecks	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Increasing quality and equality of opportunities through social protection	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Increasing the quality and equality of opportunities through health	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Maintaining financial stability and deepening financial intermediation	High priority	Medium priority	Low priority	Short term	Medium term	Long term
Reducing transport bottlenecks	High priority	Medium priority	Low priority	Short term	Medium term	Long term

Color key	High priority	Medium priority	Low priority
	Short term	Medium term	Long term

8.3 **The discussions and consultations with stakeholders around the diagnostic of Kosovo’s key development challenges have confirmed that soft and hard infrastructure is considered to be the most pressing impediment to growth, poverty reduction and sharing prosperity.** To unleash productivity gains and create quality jobs and inclusion, good governance, the rule of law, and reliable and affordable energy were consistently mentioned as the top priorities. The dialogue with the authorities, donor community, academic community, and private sector businesses has also underscored the importance of improving the allocation and efficiency of public expenditure, addressing the skills mismatch to increase employment and productivity, and ensuring the sustainable management of natural resources. These discussions within the country were enhanced by a similarly inclusive process of gathering evidence and feedback within the World Bank and an internal review mechanism.

8.4 **The SCD analysis has underscored the need to reprioritize public expenditures, implement income policies and reorient taxation in order to support inclusive and sustainable growth, while preserving fiscal discipline.** Given the recent increase of wages and pensions and the adoption of the fiscal rules, a considerable compression in the budget can be expected, and the crowding out of pro-poor and pro-growth spending needs to be avoided. This SCD has identified the following priority areas going forward:

- **Improving the allocation and efficiency of public expenditure:** (a) continue to maintain sustainable fiscal deficits and debt levels by adhering to the recently passed fiscal rule; (b) align spending with the country’s real needs by a reprioritization of expenditure across sectors, including the delaying the completion of Route 6, savings from which could be invested in local and regional roads, education, social protection systems, health care, and the new power plant; and (c) depoliticize public servant wage increases and improve the efficiency of public services, notably in health and education.
- **Shifting toward direct taxation and strengthening tax administration and:** (a) consider raising the CIT while strengthening enforcement; (b) consider streamlining the rate structure for PIT to make it more progressive and equitable; (c) introduce a health insurance scheme that expands the tax base; and (d) increase efforts to expand tax collection, abandoning some tax exemptions, pursuing evaders through the legal system, and considering raising some tax rates.

8.5 **The SCD underscores the central role of soft and hard infrastructure to level the playing field between formal and informal sectors and between tradable and nontradable sectors.** Strengthening soft and hard infrastructure is necessary to provide an attractive business environment and enhance competitiveness in the tradable sector. This will ultimately unleash productivity gains and spur the creation of quality jobs, increasing employment and incomes and fostering greater economic and social inclusion. Good governance at all levels, strengthening the rule of law and business climate, is needed to establish the right incentives system for a well-functioning competitive and innovative market economy, removing the remaining socialist legacy, rewarding merit instead of political connections, and strengthening social cohesion. Reducing infrastructure bottlenecks by providing reliable and affordable energy and improving connectivity (roads and ICT), would also be crucial for private sector expansion and competitiveness, and reducing the marginalization of the poor and disadvantaged. Another critical area identified by the SCD is the need to deepen and widen financial intermediation not only to spur growth but also to increase the level of financial access and inclusion, as the large majority of companies, which are family-owned SMEs, face constraints because of the high cost of capital and lack of long term finance. This SCD has identified the following priority areas:

- **Governance:** (a) Improve the predictability of rules, contract enforcement and transparency of institutional environment; (b) strengthen the judicial system’s speed and ability to enforce decisions; (c) tackle administrative corruption; (d) improve compliance with property rights; (e) streamline and reduce the costs of licensing of economic activity; (f) clarify competencies of the inspection bodies and provide resources to enforce the laws and bylaws; (g) continue regulatory reforms in customs and trade regulations; (h) improve protection against organized crime; (i) strengthen standardization, accreditation, and certification systems; (j) provide resources to and strengthen the capacity of the Kosovo Investment and Enterprise Support Agency; (k) clarify competencies and responsibility over competition policy; and (xii) improve corporate governance, financial reporting and auditing arrangements.
- **Energy:** (a) Ensure energy demand is met, through a combination of energy efficiency, renewable energy and a new thermal power plant construction, even if public resources need to be found by delaying other investments; (b) ensure that tariffs reflect costs over time and provide further incentive to reduce losses and encourage private sector participation, and (c) guarantee social protection mechanisms that sufficiently protect the poor and vulnerable from tariff increases.
- **Transport:** (a) Consider a delay in the construction of Route 6 and divert those resources to other priority areas; (b) improve the maintenance of existing roads and improve or upgrade rural and regional roads; and (c) increase road user charges and vehicle registration fees to ensure sufficient funds for road maintenance in the long term.
- **ICT:** (a) Advance broadband development in the economically unattractive areas; (b) introduce greater efficiency in the area of spectrum management to enable further development of mobile broadband market; and (c) bridge the existing gaps between education and employment, to increase the size of the local talent pool and expand digital job opportunities.
- **Deepening and widening financial intermediation:** (a) Further strengthen the financial safety net; (b) address obstacles to competition and development of the MFI sector; (c) enhance the availability of a wider range of financing instruments that meet the varying needs of households and enterprises; (d) address weaknesses in the contract enforcement regime; (e) enhance financial transparency related to both individual earnings and small business revenue; (f) conduct an assessment of the current stock and flow of NPLs; and (g) develop models and methodologies for rural finance intermediation.

8.6 **The evidence that has emerged from this SCD is that building skills and human capital would not only be crucial for attracting investment but also for ensuring that a larger part of the population, including low-income households, participate in and benefit from economic growth and reducing poverty.** Strengthened institutions, improved coverage and targeting, and increased efficiency of public spending for quality service delivery in health, education, employment services and last-resort social assistance would promote equal opportunity and short-term protection. This will enable the less well-off—including both ethnic minorities and Albanian Kosovars—to accumulate assets, contribute to economic growth, improve their livelihoods, and ultimately support greater social inclusion and cohesion. This SCD has identified the following priority areas:

- **Education:** (a) Use prioritized budgetary resources to increase enrollment in preprimary education, which has high economic and social rates of return, and ensure sufficient resources to upper-secondary education to cope with demographic changes; (b) increase resource efficiency by identifying savings that could be achieved through school network rationalization—especially in rural areas with small classrooms—and by taking measures to improve the school financing formula such as simplifying it and providing sufficient

training to school-level financial managers; and (c) increase teacher training opportunities and depoliticize wage increases so that they are based on indicators such as training and performance.

- **Labor market policies:** (a) Develop business and management know-how; (b) facilitate a more significant transfer of skills and information, research, and development; (c) improve tax policies; (d) improve the labor market information systems and intermediation services to better match job seekers with employers; (e) pilot, evaluate, and scale up when appropriate Active Labor Market Programs that can increase employment rates of target populations, particularly women, youth, and minorities; and (f) consider piloting, evaluating, and scaling up, if appropriate, access to child care for mothers who are interested in participating in the labor market.
- **Social protection:** (a) Use the social assistance budget to protect the poor rather than provide benefits for special interest groups; (b) expand the Last Resort Social Assistance program to increase the coverage of the poor and vulnerable, and generosity of the payments, including protecting poorer families from the effects of increased energy prices; and (c) maintain the current pension system, which is already sustainable and brings pensioners' income up to the poverty threshold, and refrain from unsustainable increases.
- **Health:** (a) Expand health coverage to poorer groups by refocusing spending on primary health care and improving maintenance of existing facilities; (b) improve the procurement system for pharmaceutical products to achieve better value-for-money and expand their provision, particularly for poorer households that are underserved; (c) improve the targeting systems for social benefits, such as development of more robust means testing for benefit eligibility; and (d) introduce a contributory health insurance scheme with robust poverty targeting to raise additional resources for the health sector and help to raise additional domestic revenue while protecting the poor and expanding the tax base.

8.7 **Given its abundance of natural resources and fertile land, agriculture and mining can help boost export performance and growth, potentially generating resources for development and boosting incomes.** However, held back by the legacy from the past and recent neglect, both sectors lack the means—financial, human, and technological—to reestablish and modernize production. They also lack integration and market links, standards and technical regulations to achieve compatibility with EU and international standards. Modernizing the sectors, strengthening institutions and policies, and implementing technical standards and regulations would be critical for immediate social welfare improvements and long term sustainability of inclusive growth. This SCD has identified the following priority areas:

- **Greater productivity in agriculture:** (a) Land consolidation; (b) development of forward and backward links for production, processing and marketing; (c) access to finance, availability of financial products more in line with the agricultural cycle (longer maturities) and agricultural risk management; (d) reduction of import barriers and custom duties for importing of capital goods and technologies; (e) establishment of appropriate rural infrastructure and irrigation; and (f) establish food safety and quality standards and improve knowledge and skills of commercially oriented farmers.
- **Sustainable management of natural resources** (a) Address sector governance and policy, including developing policies, laws and regulations that are adequate in coverage and appropriate in detail to manage Kosovo's mining sector; (b) improve social inclusion, including setting up a voice and accountability framework for resource making decisions, particularly around the allocation and management of resources, transparency of contracts and revenues, and revenues management; (c) remove environmental and social legacy issues that are FDI barriers to leverage new resources that provide the funds to address long-term past liabilities; (d) increase core institutional capacity to monitor and report on extractive industry activities in a transparent, nondiscretionary decision making process; (e) implement technical standards and regulations to both address environmental, health and social risks and achieve compatibility with EU

practices; and (f) restore Bardh/Mirash mines, resettlement planning and public infrastructure provision, and possibly remediation of high priority mining legacies from Trepča to reduce pollution.

8.8 The SCD has drawn on all reliable existing evidence. Some of the more important knowledge gaps have already been identified. Some of these require longer term efforts that should be considered as part of the World Bank program to be developed in the upcoming CPF.

- **Informality:** More information is needed the motivations for enterprises (including family farms and all sizes of nonfarm enterprises) and individual workers to remain informal. Additional information is also needed on the scale and scope of corruption and illegal economic activities. As information on the informal economy is inherently scarce, filling in this knowledge gap will require a longer term effort.
- **Labor markets:** In addition to the questions concerning labor informality, further information is needed on why inactivity rates are so high, including the possibilities of queuing for public sector jobs and elevated reservation wages because of remittance receipts and the potential to emigrate for better wages. Better data on wages are also needed. More complete information on both the supply of and demand for workers' skills is anticipated from the STEP survey, which will be implemented in 2015.
- **Migration:** More comprehensive information is also needed on the characteristics of Kosovo's out-migrants, as well as the levels, frequency, and longevity of their remittances to Kosovo. More in-depth information about the economic activities of returned migrants would also be beneficial. To our knowledge there is little systematic information on this topic, the CPF should consider ways to close this knowledge gap.
- **Minorities:** Most of the official data sources do not include enough observations on minority groups (RAE, ethnic Serbs, persons with disabilities, sexual minorities, and so on) to draw meaningful inferences. Other countries in the ECA region often contend with similar issues by oversampling minority groups (creating booster samples) in standard surveys or designing separate data collection approaches. This is beyond the time horizon of the SCD, but is a potential topic for discussion with the government of Kosovo and, particularly, the Kosovo Agency of Statistics.
- **Gender:** An in-depth analysis of trends in female employment, gender constraints to labor market participation (childcare, regulatory, skills), and the role of females in the SME sector would shed light on how best to address what is a key challenge to inclusive growth.
- **Robust political economy analysis:** More in-depth analysis is needed on the political economy of decision making in Kosovo, particularly the role and influence of various interest groups.

ANNEX A. SOCIAL INCLUSION

Kosovo remains the poorest country in the region with several vulnerable groups at risk of social exclusion and poverty. Lack of income opportunities and limited social protection schemes make women, young people, children, the elderly, minority groups, disabled and internally displaced peoples particularly vulnerable to poverty. According to Kosovo Agency of Statistics, in 2011, 29.7 percent of the population lived in poverty while 10.2 percent were extremely poor. Since 2012, an increasing number of young people from Kosovo have emigrated because of a lack of opportunities at home.¹⁴⁰ The young that stay in Kosovo experience wide-spread unemployment (70 percent) and related risks of poverty and social exclusion. Finding opportunities for social mobility is almost nonexistent among marginalized groups such as the RAE, who continue to face major challenges in socioeconomic circumstances, lacking education and prevalent discrimination from the general public. The legacy of interethnic violence is a prevalent segregation of Serb community in Kosovo. Bosniak, Croatian, Gorani, Montenegrin and Turkish communities also reside in Kosovo in smaller numbers.

Vulnerable groups

***People with disabilities:* The majority of people with disabilities in Kosovo live in poverty and have no social mobility prospects.** There are around 200,000 disabled persons in Kosovo, which represents roughly 9 percent of the population.¹⁴¹ They suffer stigma in their daily lives and pervasive exclusion from the labor market, the educational system, and political and public life. According to the EC, despite the government's explicit commitment to inclusive education, people with disabilities do not enjoy the same access to quality education as the general public.¹⁴² A study of the United Nations Children's Fund found that only 24 percent of disabled children interviewed were attending school.¹⁴³ People with disabilities experience multiple barriers to labor market participation, low educational attainment, a lack of means of mobility, physical access restrictions, and discrimination. A 2011 survey of 950 disabled persons in Kosovo found that only 5 percent of the respondents had full-time jobs, while 43 percent were interested in pursuing employment opportunities.¹⁴⁴ Approximately half the disabled population lives in rural areas, where access to health care, social, and other services is particularly low. Because of the multiple disadvantages among people with disabilities, about 80 percent of them are living in poverty.¹⁴⁵ The situation is slowly improving in areas of disabled rights legislation and planning for the inclusion of people with disabilities in society.¹⁴⁶ However, the commitment to implementation and the sustainability of initiatives aimed at improving inclusion and eliminating discrimination among people with disabilities is slow, especially in education and employment.¹⁴⁷ Kosovo should leverage the existing National Disability Council, the Kosovo Disability Forum and nongovernmental disability organizations representing diverse disability groups to establish mechanisms for the implementation of inclusive laws and strategies for people with disabilities and accountability mechanisms.

***Refugees and internally displaced persons:* Displacement is a widespread problem in Kosovo and minorities are less likely to return.** Some of the 245,000 Kosovo Serbs and RAE that fled their homes during the 1999 Kosovo crisis have returned, but many still remain displaced outside and inside of Kosovo. The

140 In 2012, 86 percent of the people planning to migrate were doing so for economic reasons (UNDP 2014b).

141 IFES and NDI (2014).

142 EC (2014a).

143 UNICEF (2009).

144 OPM (2011).

145 NESsT, Varga, and Villanyi (2011).

146 In 2013, the government adopted a program on the provision of sign. A law in favor of paraplegics and tetraplegics is being drafted. See OPM (2013b).

147 The Law on Vocational Ability, Rehabilitation, and Employment of Persons with Disabilities, approved in 2008, obliges employers to hire one disabled person for every 50 employees. According to NESsT (2011), government offices do not comply with the quota and have no mechanisms for monitoring noncompliance among private sector employers.

number of internally displaced people (IDP) in Kosovo is about 17.300 - 50 percent of which are Serbs, 40 percent Kosovo Albanians and 5 percent RAE.¹⁴⁸ There are around 37 poorly serviced and poorly maintained collective centers in the Republic of Kosovo that host around 750 IDPs. The RAE IDPs that live in informal settlements in Kosovo have particularly poor living conditions. There is no systemic monitoring of returnees, but IDPs have reportedly been reintegrated in both mixed and single-ethnicity villages. Many Serb returnees, however, have experienced secondary displacement, and there are signs of easier reintegration in some municipalities managed by minorities.¹⁴⁹ Significant differences among the major groups of Kosovo IDPs can be found in areas of employment, access to social services and preferred durable solutions. Albanian IDPs have lower unemployment rates (41.8 percent) than Serbian and RAE IDPs (69.5 percent and 78.8 percent respectively).¹⁵⁰ Of the three IDP groups, Serbians are least likely to seek social services which attests to their social exclusion from the majority Kosovo Albanian society. Serbian IDPs were also least likely to favor “return” as a durable solution to their displacement while the majority of Albanian IDPs preferred to return to their place of origin. In the last years, Kosovo government has made efforts to improve the situation of IDPs through the initiation of a legislative framework for IDPs, adoption of a new Strategy for Communities and Return (2014–18) and signing an amnesty to improve inclusion of Kosovo Serbs. To facilitate sustainable solutions for returnees, the government should support local government funding for housing and reintegration programs and improve existing mechanisms for property disputes.

Gender: women remain disadvantaged in the political, economic and social sphere in Kosovo. Women are underrepresented in the public administration where one job in five is occupied by women. At the local level, women hold about a fourth of the seats, and, in 2010, there were no woman mayors in Kosovo. Women’s representation is particularly low in minority municipalities, especially in senior positions. Advances to increase political participation of women have yielded some positive results in the central government, where a third of the presidential advisers and a third of Members of Parliament are women.¹⁵¹ Unemployment among women is 27 percent higher than among the male population (41.6 percent vs. 33.1 percent)¹⁵² Barriers that women typically face in entering the workforce are lack of assets for accessing finances and traditionally led societal rules that tie her to the family.¹⁵³ Only 16 percent of Kosovar women own land or property.¹⁵⁴ Gender based socioeconomic exclusion is particularly prevalent among RAE women that are married early and women living in rural areas of Kosovo.¹⁵⁵ In fact, 14 percent of rural Kosovar women are illiterate. Overall education obtainment is lower among women than man in Kosovo. About 62 percent of women only finish primary school vs. 37 percent of men, and 50 percent fewer women graduate from university relative to men (6 percent and 12 percent, respectively).¹⁵⁶

Gender inequality is perpetuated by women’s economic dependence on men. About 46 percent of women headed households have a family member living abroad and are somewhat more likely to receive remittances from abroad than men headed households (73 percent vs. 68 percent). Remittances are associated with lower economic activity among women (7 percent higher than among non–remittance-receiving women). Greater responsibility for family members (children and elderly) is a probable explanation for the lack of labor force participation among female remittance recipients. Women’s access to inherited property needs to be better enforced and made more socially accepted to enhance women’s protection and independence from men.

148 See “Summary: Kosovo Internal Displacement in Brief,” Internal Displacement Monitoring Center, Geneva, December 31, 2013, <http://www.internal-displacement.org/europe-the-caucasus-and-central-asia/kosovo/summary>.

149 However, the return of Albanians to Serb majority areas in northern Kosovo has fueled ethnic tensions. See Derks-Normandin (2014); EC (2014d).

150 DRC (2009).

151 UNKT (2011).

152 Results of the 2014 LFS (KAS and World Bank 2015).

153 UNDP (2012b).

¹⁵⁴ FAO and World Bank (2014).

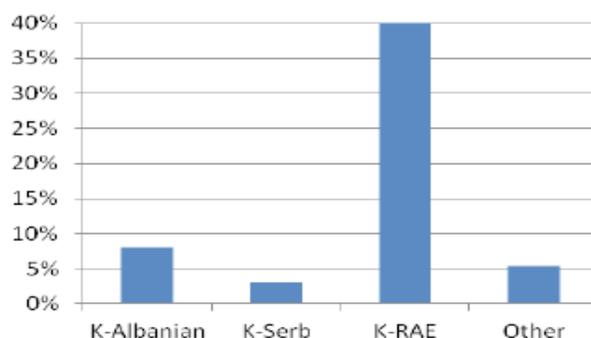
155 ECMI Kosovo and RROGRAEK (2013).

156 World Bank (2012).

Enforcement of maternity leave provisions in the Labor Law need to be strengthened to ensure gender equity at the workplace and in the private sphere.

Roma: Many RAE in Kosovo are not captured in the official records and live in deep poverty. The Kosovo government recognizes the RAE populations as three distinct ethnic groups. According to the 2011 population census, a total of 35,784 persons from RAE communities were recorded, about 2 percent of the total population. However, the RAE are believed to be underrepresented in the census results. The mission in Kosovo of the European Center for Minority Issues and the Organization for Security and Co-operation in Europe estimates there were, in the same year, between 21,300-27,000 Romani and 15,436 Ashkali persons living in Kosovo (for Egyptians the data were inconclusive).¹⁵⁷ Up to a third of RAE are not registered at birth and are unable to exercise their rights and freedoms in Kosovo because of a lack of civil registration. RAE communities particularly struggle with complicated and expensive civil registration procedures with the occasional requirement of property ownership.¹⁵⁸ According to the UN Kosovo Team (UNKT), RAE communities have the highest rates of exclusion among all the ethnic groups in Kosovo. More than 40 percent do not have access to any factor market –assets, arable land, object to rent, businesses and a family member participating in the labor market. In contrast, only 8 percent of Kosovo Albanians are excluded from all factor markets. Extreme poverty is prevalent among RAE households in Kosovo. There are some perceptions among the Kosovo Albanians that some Kosovo Romani sided with the Serbs during the conflict which may be another factor adding to their exclusion.

Figure A.1. Factor Market Exclusion per Community



Source: Kosovo Human Development Report 2010 in UNKT (2011)

- **Whereas labor market conditions in Kosovo are difficult for the entire population, the employment status is particularly dire for RAE communities.** According to a 2012 report of the United Nations Development Programme, the unemployment rate for RAE was between 60-80 percent vs. 47 percent among Kosovo Albanians at the same time. Lack of education, no professional training and endemic discrimination make RAE the least employable communities in Kosovo. Furthermore, RAE youth and women have the weakest employment record in Kosovo. While the many Kosovars turn to their diaspora relatives for financial support (27 percent of household benefit from remittances), the remittance inflow among RAE and Serb households are significantly lower (11 percent and 7 percent respectively). While remittances are helping mitigate the risk of poverty among the general population, there is a high probability that the remittances are not reaching the poorest minority Kosovars.
- **The education system is a missed opportunity for reversing marginalization of RAE children in Kosovo.** RAE children are the most excluded from Kosovo's education system. One RAE child in four never completes the first year of education, while only one in three finish secondary school. Only one RAE adolescent in 70 finishes high school, and the numbers are even lower among RAE university graduates.

157 ECMI (2012).

158 Demanding the payment of the property tax for the issuance of civil documents is illegal in Kosovo, but the lack of capacity at the local level results in the occasional unlawful practice of requiring such payment (OSCE 2012b).

Low participation rates and education performance hampers the RAE children's employment opportunities later in life. Mediators are engaged to reduce dropouts among RAE children, but there is little progress on adapting the school environment to RAE children's needs (for example, removing discrimination, raising awareness among RAE parents, subsidizing textbook, and so on).

- **Hazardous living environments exacerbates the RAE communities' health hazards.** Living conditions of RAE communities in Kosovo are characterized by tenure insecurity, segregation from employment opportunities, lacking connectivity to urban infrastructure and poor transport accessibility. There are about 100 informal settlements in Kosovo mainly inhabited by RAE.¹⁵⁹ Lack of garbage collection and sanitation infrastructure create unhygienic living conditions in the informal settlements. Instances of lead contaminations have raised concerns about the health conditions in RAE settlements and led to targeted interventions by affected municipalities.¹⁶⁰ However, the RAE communities remain a high-risk population because of weak health and exclusion from the health care system. Securing land tenure and accessibility to nonpolluted land is a prerequisite for successful integration of the RAE living in informal settlements.

Kosovo Serbs: Kosovo Serbs lack full geographic, political, and social integration. According to the mission in Kosovo of the European Center for Minority Issues and the Organization for Security and Co-operation in Europe, the 2011 Serb population was estimated to be around 140,000 –8 percent of the total population. The 2011 census, which however excluded the Serb-dominated northern Kosovo, estimated the Serb population at 25,532. Kosovo Serbs constitute the second largest ethnic community in Kosovo after Kosovo Albanians. The Serb community in Kosovo by high levels of displacement from places of origin and low levels of returns because of property disputes, , low economic participation and real/perceived security issues stemming from tensions with the majority Kosovo Albanian society.¹⁶¹ The planned return of cadastre/land ownership documents (scans of the originals) from the cadastral archives that were removed from Kosovo to Belgrade in 1999 could help clarify rights if the review process is properly designed. Political self-exclusion of Kosovo Serb enclaves is still prevalent although the 2014 local elections witnessed a slight mobilization of Kosovo Serbs (20 percent voter turnout) who previously boycotted elections completely.¹⁶² The Kosovo Serb community lives predominantly off agriculture and social welfare assistance from Serbia. Sustainable economic opportunities in the mainstream Kosovo labor market are limited. UNPD 2011 employment statistics for Kosovo indicate that youth employment among Kosovo Serbs is 6 percent lower than among Kosovo Albanians.¹⁶³ However, the Kosovo Serb community at large has more favorable employment figures than the majority Kosovo Albanians. To strengthen the position of an independent Kosovo state, the international community has been supporting the withdrawal of Serbian government institutions in Kosovo.¹⁶⁴ As ethnically motivated incidents targeting the minorities occasionally still occur, Kosovo institutions need to strengthen their ability to protect minority rights and ensure the well-being of minorities in a majority-Albanian Kosovo.

159 OSCE (2014).

160 OSCE (2012a).

161 OSCE (2010).

162 Wesli Turner and Nadine Walicki, 2014, "IDP Rights in Kosovo and Serbia Should Be a Key Consideration for EU Membership Talks," blog post, February 24, Internal Displacement Monitoring Center, Geneva, <http://www.internal-displacement.org/blog/2014/idp-rights-in-kosovo-and-serbia-should-be-a-key-consideration-for-eu-membership-talks>.

163 Serbian children in Serb-majority communities are educated according to Serbia's education curriculum. This is creating a language barrier for employment and a communication divide with the rest of Kosovo society. See EC (2010).

164 A recent example is the ongoing dismantling of Serbian institutional structures in law enforcement and the judicial system (EC 2014a).

ANNEX B. PROFILE OF POVERTY AND THE BOTTOM 40 PERCENT

As roughly 30 percent of Kosovo’s population live below the national poverty line, there is considerable overlap in the goals of eliminating poverty and promoting the income growth of the poorest 40 percent. Thus constraints and policy opportunities that work toward one goal generally work toward the other as well. This section describes the characteristics of the poor and the bottom 40. Rather than providing separate profiles for each of the two overlapping groups, the two are presented together, taking advantage of existing analysis as much as possible.

There are three respects in which the twin goals do not perfectly coincide in Kosovo that bear noting. First and most obvious is the place of the fourth consumption quintile, which is above the poverty line but part of the bottom 40. Even so, as these households remain vulnerable to falling below the poverty line, policies for poverty reduction are still relevant to them. Second, as in all countries, this overlap of the target subpopulations for the twin goals will diminish as poverty is reduced. Third, the main indicators of the twin goals emphasize, or place greater weight, on different parts of the distribution *within* the poorest 30 or 40 percent. By construction, it is the consumption growth of the richest households in the bottom 40 that receives the most weight when calculating the consumption growth of the bottom 40 (as illustrated by the growth incidence curve. For the poverty reduction goal the poverty headcount measure similarly emphasizes the least poor, as they are best positioned to move above the poverty line. Other poverty measures such as the poverty gap and squared poverty gap are therefore important because they capture progress toward the poverty reduction goals among those who remain below the poverty line (that is, become less poor).

Table B.1. Poverty Rates, Confidence Intervals and Distribution of the Bottom 40, by Region, 2011

	Poverty headcount ratio	95% confidence interval		Employment to working-age population ratio, 2013	Distribution of the bottom 40, %	Distribution of the population, %
		Lower bound	Upper bound			
Kosovo	29.7	26.9	32.7	28.4	100.0	100.0
<i>Regions</i>						
Gjilan	37.9	30.4	45.9	22.7	8.8	11.3
Gjakova	21.9	14.7	31.2	23.6	12.1	10.3
Mitrovica	44.2	37.0	51.6	28.0	20.8	14.8
Peja	29.8	23.1	37.6	23.0	10.2	9.9
Prizren	26.0	18.8	34.8	27.4	17.0	17.1
Pristina	15.6	11.2	21.3	33.3	14.3	26.0
Ferizaj	50.5	40.6	60.3	33.8	16.9	10.6
<i>Source:</i> Household budget survey 2011.						

Poorer households tend to live in rural areas, but urban areas are also afflicted with deep poverty. In recent years the poverty headcount rate in rural areas has exceeded that in urban areas by two to five percentage points. In 2011 the rural and urban poverty headcounts were 31.5 percent and 26.7 percent, respectively. As approximately 62 percent of Kosovo’s population lives in rural areas, this implies that two-thirds of poor households are rural dwellers, a proportion that is observed for the bottom 40 as well. Among poor households, urban households tend to be slightly further from the poverty line, with mean consumption that is only 73 percent of the poverty line, compared with 75 percent for rural households.¹⁶⁵

¹⁶⁵ The poverty gap measures the depth of poverty, reflecting both the proportion of the population living below the poverty line and the average distance of the poor to the poverty line. The extreme poverty line also illustrates the depth of urban poverty because both the extreme poverty headcount and the gap measures have been almost equal in rural and urban areas in recent years.

Table B.2. Poverty and Extreme Poverty, by Rural and Urban Areas

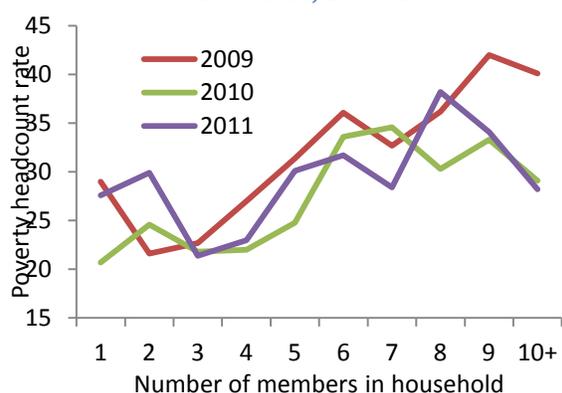
	2000	2002/03	2003/04	2004/05	2005/06	2009	2010	2011
Poverty headcount								
National	50.3	38.7	43.5	34.8	45.1	34.5	29.2	29.7
Rural	52.0	34.4	44.2	37.2	49.2	35.3	30.7	31.5
Urban	47.5	46.6	42.1	30.3	37.4	33.1	26.7	26.7
Poverty gap								
National	15.7		11.9		13.3	9.6	7.3	7.5
Rural	16.1				14.3	9.5	7.5	7.8
Urban	15.1				11.3	9.8	6.9	7.1
Extreme poverty headcount								
National	11.9		13.6		16.7	12.1	13.0	11.6
Rural	11.6		12.5		18.1	11.6	8.5	10.7
Urban	12.5		15.6		14.0	13.0	7.8	9.4
Extreme poverty gap								
National	2.5				4.4	2.8	1.9	2.1
Rural	2.7				4.6	2.7	1.8	2.1
Urban	2.4				3.9	3.0	1.9	2.1

Source: household budget surveys.

Poverty and social exclusion are particularly acute for several vulnerable groups. Women, youth, the elderly, minority groups, disabled and internally displaced peoples are particularly vulnerable to poverty. Since 2012, an increasing number of young people from Kosovo have emigrated because of a lack of opportunities at home. The young that stay in Kosovo experience high unemployment (61 percent) and related risks of poverty and social exclusion. Social mobility is almost nonexistent among marginalized groups such as the RAE, who continue to face major challenges in socioeconomic circumstances, lacking education and facing discrimination from the general public.

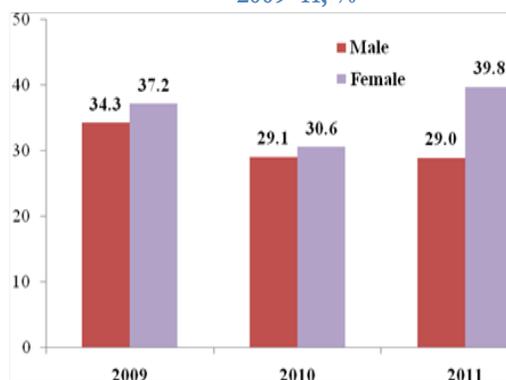
Large households tend to be poorer, and account for a large proportion of the poor population. The pattern from year to year is slightly erratic because of small sample sizes, but the overall positive correlation is readily apparent. Households in Kosovo tend to be larger than those in other European countries, averaging six people per household. As of 2011, approximately 20 percent of poor people in Kosovo live in households with ten or more members.

Figure B.1. Poverty Headcount Ratio, by Size of Household, 2009–11



Source: HBS 2009–11.

Figure 71. Poverty, by Sex of Household Head, 2009–11, %

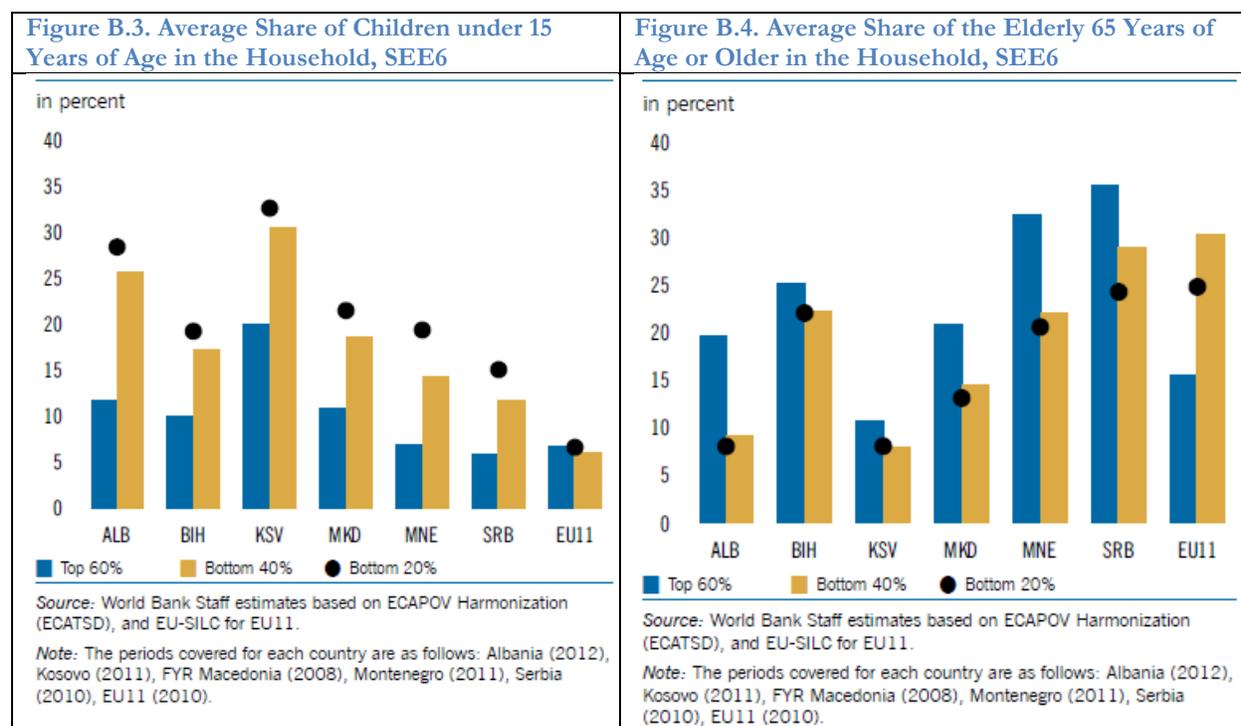


Source: HBS 2009–11.

Poverty is slightly higher among female-headed households. The difference in the poverty rates between male- and female-headed households is only 1.5 to 2.9 percentage points and not statistically significant in 2009 and 2010, but large (10.8 percentage points) and marginally significant in 2011. Less than ten percent of

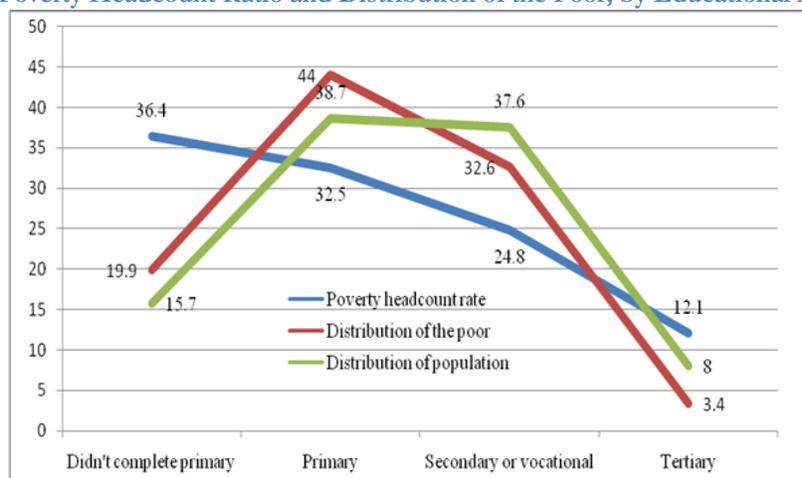
households in Kosovo are female-headed, which explains some of the volatility of the estimates over time for female-headed households. Contrary to common expectations, most female-headed households are not widows living alone, but are typically heads of households comprising four to seven members in total.

One reason for lower living standards in the bottom 40 is the high proportion of child dependents in Kosovar households. In the bottom 40 in Kosovo, one household member in three is a child under 15 years old, compared with one in five among the top 60. These child dependency rates are considerably higher than those found in other SEE6 countries; only the bottom 40 in Albania come close to the child dependency rates of the bottom 40 in Kosovo. The pattern between the bottom 40 and the top 60—and the pattern across SEE6 countries—is inverted when one examines elder dependency. In all SEE6 countries, the bottom 40 has lower average rates of elder dependency than the top 60, and Kosovo has the lowest rates in the SEE6.



As in most countries, less educated individuals tend to be poorer than those with more education. As of 2011 more than one-third of people age 15 or older who did not complete primary education were poor, with the poverty rate falling for each successive level of education completed, reaching a 12 percent poverty rate among individuals with university degrees. In the overall population slightly less than one-half (48 percent) of those age 15 or older have completed less than secondary education, but among the poor that proportion is 64 percent. Employment status and returns to employment are heavily influenced by a person's educational level, as those with higher levels of education are typically more likely to find employment and to have access to higher paying jobs.

Figure B.5. Poverty Headcount Ratio and Distribution of the Poor, by Educational Attainment, %



Source: HBS 2011

Access, quality, and affordability of public services have also an important impact on poverty. Health spending pulls more households into poverty, and nonpoor households are increasingly vulnerable to impoverishment from health spending. At close to 40 percent of total health spending, household out-of-pocket health care spending is high. The high payments create financial barriers for service among the already-poor, where the negative effects tend not to be manifested monetarily, but in poorer health outcomes as they self-ration and underconsume health care. High out-of-pocket spending contributes to impoverishment in Kosovo with an estimated 7 percent increase in the poverty headcount associated with out-of-pocket health care payments, mostly on medicines. For instance, overall waste collection coverage is only 57 percent and lower in rural areas. Sanitation have similar coverage. Moreover, quality is poor and de facto environmental compliance with transposed EU legislation is weak.

Consumption poverty is closely related to the economic activities of a household, especially employment status and, if employed, the sector and type of employment. Salaried workers are less likely to live in poverty than farmers, per diem workers and those without paid employment such as pensioners and housewives. The highest poverty rates are generally found among the unemployed and per diem workers. Subsistence farmers, housekeepers and those who are retired or disabled also show above-average rates of poverty. The table also shows that a salary or status as an employer is not a guarantee that one will avoid poverty. Because of large household sizes and high dependency ratios incomes from employment are spread thin. For example, just over one-quarter (27.2 percent) of households in the HBS 2011 were dependent on a single income earner.

Table B.3. Poverty Headcount, by Economic Status of Individuals Ages 15 or Older, 2009–11

	2009	2010	2011
Employer	6.9	7.6	8.5
Employed with salary	20.5	17.0	17.3
Subsistence farmer	33.0	31.5	29.4
Per diem worker	50.1	40.4	29.3
Other self-employed	20.1	15.6	21.9
Unpaid family member	15.9	22.7	20.1
Pupil/student	32.3	28.9	29.4
Retired or disabled	32.3	28.1	29.6
Unemployed	39.0	33.9	36.0
Housekeeper	35.8	31.4	29.5
Other	32.8	66.4	64.4

Source: HBS 2009–11.

Households whose main source of income is public sector wages and salaries are less likely to be poor than those that depend primarily on other sources of income. Poverty rates are highest among households that depend on social assistance as their main source of income, followed by those who depend on pensions. Poverty rates are lowest among households that depend primarily on public sector wage employment, household businesses (self-employment), private sector wages, and remittances from abroad.

Table B.4. Poverty Headcount, by Main Source of Household Income, 2009–11)

	Poverty headcount ratio			Percentage of households (2011)
	2009	2010	2011	
Public sector wages and salaries	23.6	19.7	19.8	24.6
Private sector wages and salaries	36.4	28.5	26.2	23.8
Farming	36.3	38.5	36.2	7.8
Per diem work	55.2	43.5	33.7	9.7
Other household business	20.6	16.1	20.6	14.1
Pensions	43.4	43.6	44.1	5.5
Remittances from abroad	21.9	24.2	30.1	7.3
Other remittances	32.9	38.3	51.1	0.15
Social Assistance	83.1	73.0	79.0	5.5
Other	34.5	46.8	35.0	1.6

Source: HBS 2009-2011

ANNEX C. TOTAL FACTOR PRODUCTIVITY AND DECOMPOSITION OF ECONOMIC GROWTH

Factor accumulation is estimated to have contributed two-thirds of the overall economic growth between 2008 and 2012, with productivity counting for the remaining one third. Based on employment data and simplified assumptions labor contributed 40 percent of overall economic growth; capital contributed in the range 18 to 25 percent and total factor productivity explained the remaining 42 to 35 percent.

The rate of growth of the GDP at constant prices between 2008 and 2012 was 14.6 percent. Assuming that the share of labor in GDP is 60 percent the contribution of increases in employment to growth was 0.60×0.098 , that is, 5.9 percent.

The contribution of capital is equal to 0.40 times the rate of growth of the capital stock. To calculate the capital stock this section starts with the average investment share of GDP for 2008-2011, that is, 19.3 percent. Second, to complete the calculation it uses a range of capital to GDP ratio between 2 and 3 and a depreciation rate between 4 and 6 percent. The following table present a grid of possible contributions of the capital stock to growth:

Table C.1. Contribution of the Capital Stock to Economic Growth

De \ (GDP/K Ratio	GDP/K=0.5	GDP/K=0.4	GDP/K=0.33
De= 0.04	0.057	0.037	0.024
De = 0.05	0.047	0.027	0.014
De = 0.06	0.037	0.017	0.004

Source: World Bank estimates.

Under these assumptions the contribution of TFP to economic growth is in the range 3.4-7.4 percent. $TFP = 0.14.6 - 0.059 - x$; where $0.017 < x < 0.057$

Taken as the base for estimation a GDP/K ratio of 0.4 and depreciation rate of 4 to 5 percent total factor productivity (TFP) was in the range of 5 to 6 percent ($5.0 < TFP < 6.0$), that is, it explains between a third and forty percent of the rate of growth of the GDP.

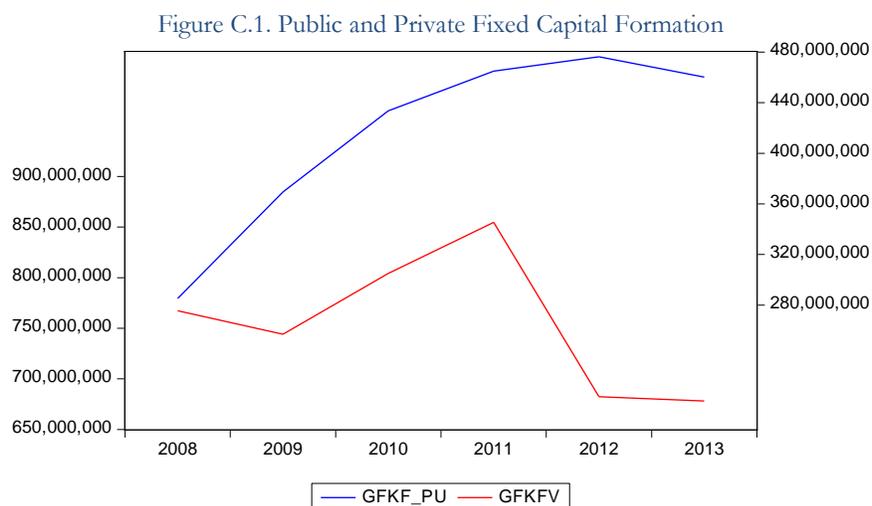


Table C.2. Key Economic Indicators, 2009–16 (December 2016)

Kosovo

Selected Indicators	2009	2010	2011	2012	2013	2014	2015	2016E	2017F	2018F	2019F	2020F	2021F
Income and economic growth													
GDP growth (annual %)	3.6	3.3	4.4	2.8	3.4	1.2	4.1	3.6	3.9	4.2	4.4	4.4	4.4
GDP per capita growth (annual %)	2.5	3.5	1.9	2.4	1.4	5.3	2.8	3.1	3.4	3.6	3.6	3.6	3.1
GDP per capita (US\$)	3210	3283	3739	3601	3877	4054	3559	3642	3731	3834	3947	4061	4181
Private Consumption growth (annual %)	2.3	3.5	3.6	2.7	2.0	4.8	4.0	5.8	2.2	3.3	2.2	2.3	2.4
Gross Investment (% of GDP)	27.8	29.6	30.6	26.0	24.8	23.1	24.8	25.8	27.1	28.1	29.3	29.6	30.1
Gross Investment - Public (% of GDP)	9.2	10.4	10.8	10.7	10.0	7.4	7.0	7.4	8.6	9.4	10.1	10.4	10.7
Gross Investment - Private (% of GDP)	18.6	19.2	19.8	15.3	14.8	15.7	17.8	18.4	18.5	18.7	19.2	19.3	19.4
Money and Prices													
Inflation, consumer prices (annual %, end of period)	0.1	6.6	3.6	3.7	0.5	-0.4	-0.1	1.3	0.9	1.4	1.8	2.0	2.0
Inflation, consumer prices (annual %, period average)	-2.4	3.5	7.3	2.5	1.8	0.4	-0.5	0.3	0.7	1.2	1.7	1.9	2.0
Fiscal													
Revenue (% of GDP)	28.3	27.1	27.2	25.9	25.2	24.0	26.3	26.8	27.2	27.7	28.4	28.6	28.8
Expenditure (% of GDP)	29.0	29.5	28.8	28.5	28.1	26.6	27.3	28.1	29.8	30.6	31.3	31.4	31.6
Current (% of GDP)	19.8	19.1	18.0	17.8	18.1	19.2	20.3	20.7	21.2	21.2	21.2	21.0	20.9
Capital (% of GDP)		10.4	10.8	10.7	10.0	7.4	7.0	7.4	8.6	9.4	10.1	10.4	10.7
Overall Fiscal Balance (% of GDP) /1	-0.7	-2.4	-1.6	-2.6	-2.9	-2.6	-1.0	-1.3	-2.6	-2.9	-2.9	-2.8	-2.8
Primary Fiscal Balance (% of GDP) /1	2.5	-1.1	-2.2	-2.9	-3.0	-2.3	-0.7	-0.9	-2.1	-2.4	-2.4	-2.4	-2.4
Total Public and Publicly guaranteed Debt (% of GDP)	6.1	6.3	5.9	8.1	10.1	11.6	14.0	15.4	18.4	21.2	23.0	24.1	25.1
Total Public Debt (% of GDP)	6.1	6.3	5.9	8.1	8.9	10.4	12.7	14.2	17.2	20.1	21.9	23.1	24.1
External Public Debt (% of GDP)	6.1	6.3	5.9	6.7	6.1	5.8	6.2	6.2	7.5	8.8	9.2	9.3	9.2
External Accounts													
Export growth, f.o.b (nominal US\$, % yoy)	8.3	20.0	13.1	-9.4	3.4	17.8	-14.1	3.0	4.2	4.6	8.3	10.0	9.4
Import growth, c.i.f (nominal US\$, % yoy)	-4.8	10.0	17.6	-10.4	1.7	7.8	-14.6	5.8	4.2	3.9	2.8	3.3	3.3
Remittances (% of GDP)	14.5	13.8	12.2	11.5	11.0	10.9	10.8	11.5	11.8	12.1	12.5	12.8	13.3
Current account balance (BoP, % of GDP)	-9.2	-11.7	-13.7	-7.5	-6.4	-7.9	-9.1	-11.4	-12.7	-13.7	-13.4	-12.9	-12.4
Foreign Direct Investment (net, % of GDP)	6.8	7.5	7.9	4.2	4.7	2.2	4.7	3.4	3.8	4.0	5.1	5.9	6.3
Foreign Direct Investment (inflows, % of GDP)	7.1	8.4	8.0	4.5	5.3	2.7	5.4	4.0	4.4	4.6	5.7	6.5	6.8
External debt, total (% of GDP)	29.3	31.2	29.7	30.0	30.2	31.2	33.5	33.5	35.3	37.0	37.7	38.2	38.5
Multilateral debt (% of total external debt)	20.9	19.0	17.7	22.2	20.2	17.9	16.8	15.9	18.2	20.7	21.0	20.6	20.1
Debt service ratio (% exports goods and nfs)	19.2	1.2	1.3	1.2	1.5	1.0	1.1	1.5	1.5	1.5	1.4	1.4	1.3
Population, Employment and Poverty													
Population, total (millions)	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.9	1.9	1.9
Unemployment Rate	..	..	..	30.9	30.0	35.3	32.9	..	..	..	..	..	..
Poverty headcount ratio at national poverty line (% of population)	34.5	29.2	29.7	..	..	..	..	..	..	..	..	..	..
Poverty headcount ratio at US\$1.25 a day (PPP) (% of population)	12.5	8.2	10.2	..	..	..	..	..	..	..	..	..	..
Population Growth (annual %)	0.8	0.8	0.8	0.8	1.0	-0.1	-1.1	0.8	0.8	0.8	0.8	0.8	0.8
Other													
GDP (current LCU, billions)	4.1	4.4	4.8	5.1	5.3	5.6	5.8	6.0	6.1	6.4	6.6	6.9	7.1
GDP (current US\$, billions)	5.7	5.8	6.7	6.5	7.1	7.4	6.4	6.7	6.8	7.1	7.3	7.6	7.9
GDP per capita LCU (real)	2283.5	2339.9	2422.9	2469.9	2528.4	2562.5	2697.1	2772.1	2858.2	2956.0	3061.3	3171.2	3284.4
CPIA (overall rating)	3.4	3.4	3.5	3.5	3.6	3.6	3.5	3.6	..	..	..	..	..

Notes: ".." indicates not available. E = estimate, F = forecast.

1/ Fiscal balance includes both the regular fiscal deficit within the 2 percent fiscal rule (which is always lower than 2% in projection here) and the deficit due to investment clause

Sources: Ministry of Finance, Central Bank of Republic of Kosovo, Agency of Statistics of Kosovo, WB staff calculations

ANNEX D. LESSONS FROM THE GROWTH COMMISSION

Since 1950, only 13 economies have grown at an average rate of 7 percent a year or more for 25 years or longer. The Growth Commission (2008) identified a number of the distinctive characteristics of high-growth economies and offers a framework to help policy makers create growth strategies to emulate these successful cases:

- Maintaining macroeconomic stability
- Mustering high rates of saving and investment
- Exploiting the external demand
- Allowing markets allocate resources
- Having committed, credible, and capable governments for growth and inclusion

To sustain high growth rate for more than a generation, the Growth Commission recognized the need for growth to be broad-based across sectors to expand and diversify sources of growth, and inclusive to an increasing share of the labor force in the growth process in an efficient way.

The Growth Commission also recognized small states' specific challenges because of their small size both on the demand side (small internal market) and on supply side (small production factor and diseconomy of scale), which leaves them with little scope for diversification and highly vulnerable to economic shocks. To succeed in their development, the Growth Commission conclusion is that they have little choice but to turn outward, especially if the country enjoys close proximity to world markets and a privileged geographical location (for example, Singapore). Advances in ICT creates new opportunities for small states as it make new range of services become tradable. The report finally notes that most small states are young states and good governance is an important foundation on which integration can be built on.

The Growth Commission also discusses how resource-rich countries can use natural endowments as a source of wealth and not a curse for the economy (Dutch disease) or the population (waste or resources diversion). Allocation of the rights for exploration and development and how to tax the earnings of the concession are critical to determine the flow of rents to the country and how those rents adjust to changing global prices. The distribution of rents flow is important` to avoid loss of competitive or a source of waste and corruption. To get the most out of the money, the Growth Commission recommend governments to pick the right investment projects for the right reasons. The remainder should flow into a savings/ endowment fund whose earnings to serve needs of future generations and the benefit of current citizens.

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ANNEX F. PERSONS MET DURING SCD CONSULTATIONS, MARCH 2015

Table F.1. Persons Met during SCD Consultations, March 2015

Ministry of Finance	H.E. Dr. Avdullah Hoti, Minister Macro team
Ministry of Economic Development	H.E. Blerand Stavileci, Minister Mr. Agim Kukaj, Director of Post-Telecommunication and Information Technology
Ministry of Environment and Spatial Planning	H.E. Ferid Agani, Minister
Ministry of Labor and Social Welfare	H.E. Arban Abrashi, Minister
Ministry of Agriculture, Forestry, and Rural Development	H.E. Memli Krasniqi, Minister
Central Bank of Kosovo	Mr. Bedri Hamza, Governor
Kosovo Investment and Enterprise Support Agency, Ministry of Trade and Industry	Mr. Agon Dula, Director of Private Sector Development Directorate
Energy Regulatory Office	Mr. Krenar Bujupi, Member of Governing Board
Kosovo Agency of Statistics	Mr. Ilir T. Berisha, Director, National Account Statistics Mr. Bashkim Bellaqa, Director, Social Statistics
European Union Office	Ms. Radica Nusdorfer
U.S. Agency for International Development	Ms. Victoria Mitchell Director, Program and Policy Office
Pristina RAE nongovernmental organization	Mr. Ahmet Jetullahu, Director
Kosovo Chamber of Commerce	Mr. Safet Gerxhaliu, Director
Private sector firms	Representatives of Bylmeti, Pestova, Haxhijaha, Frutomania, Lesna
UBO Consulting	Ms. Valmira Rexhebeqaj, Director
Riinvest Institute	Mr. Lumir Abdixhiku, Executive Director Mr. Alban Hashani, Research Director
GAP	Mr. Agron Demi
German Chamber of Commerce	Mr. Azem Rexhaj, Executive Director
Expert on Mining	Mr. Lorik Haxhiu
European Bank for Reconstruction and Development	Mr. Anton Kobakov, Director
International Monetary Fund	Mr. Frank Lakwijk, International Monetary Fund Resident Representative; Mr. Selim Thaqi, Economist