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**MEMORANDUM OF THE PRESIDENT
OF THE
INTERNATIONAL DEVELOPMENT ASSOCIATION
TO THE
EXECUTIVE DIRECTORS
ON A
TRANSITIONAL SUPPORT STRATEGY
OF THE WORLD BANK GROUP
FOR
KOSOVO**

April 13, 2004

South East Europe Country Unit
ECC04
Europe and Central Asia Region

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ABBREVIATIONS AND ACRONYMS

AAA	Analytical and Advisory Assistance	MAFRD	Ministry of Agriculture, Forestry and Rural Development
BPK	Banking and Payments Authority of Kosovo	MLSW	Ministry of Labor and Social Welfare
CFAA	Country Financial Accountability Assessment	NATO	North Atlantic Treaty Organization
CSW	Center for Social Welfare	PCF	Post-Conflict Fund
DELTA	Development Enterprises Locally Through Action	PDK	Democratic Party of Kosovo
EAR	European Agency for Reconstruction	PISG	Provisional Institutions of Self-Government
EBRD	European Bank for Reconstruction and Development	POEs	Publicly-owned Enterprises
EC	European Commission	PRSP	Poverty Reduction Strategy Paper
FDI	Foreign Direct Investment	PSD	Private Sector Development
GDP	Gross Domestic Product	PSAG	Private Sector Advisory Group
GEF	Global Environment Fund	SAM	Serbia and Montenegro
GNI	Gross National Income	SAP	Stabilization and Association Agreement
HBS	Household Budget Survey	SCAAK	Society of Certified Accountants and Auditors of Kosovo
HCFS	Health Care Financing Structure	SEED	Southeast Europe Enterprise Development Facility
IBRD	International Bank for Reconstruction and Development	SEEREM	South East Europe Regional Energy Market
ICU	Internal Credit Unit	SFRY	Socialist Federal Republic of Yugoslavia
IDA	International Development Association	SMEs	Small and Medium-sized Enterprises
IFC	International Finance Corporation	SOEs	Socially-owned Enterprises
IMF	International Monetary Fund	SRSG	Special Representative of the UN Secretary General
IPC	International Project Consultant	TFK	Trust Fund for Kosovo
KCB	Kosovo Consolidated Budget	TSS	Transitional Support Strategy
KEK	Korporata Energjetike e Kosoves (The Power Company of Kosovo)	UN	United Nations
KFOR	Kosovo Force	UNDP	United Nations Development Programme
KTA	Kosovo Trust Agency	UNMIK	United Nations Mission in Kosovo
KOS	Kosovo Office of Statistics	UNICEF	United Nations Children Fund
LDK	Democratic League of Kosovo	UNSCR	United Nations Security Council adopted Resolution
LSMS	Living Standards Measurements Survey	USAID	US Agency for International Development
MEB	Micro Enterprise Bank	VAT	Value Added Tax
MIGA	Multilateral Investment Guarantee Agency		
MFE	Ministry of Finance and Economy		

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TABLE OF CONTENTS

EXECUTIVE SUMMARY	I
I. INTRODUCTION	1
II. BACKGROUND	1
POLITICAL CONTEXT	1
POVERTY AND THE SOCIAL SITUATION	4
ECONOMIC SITUATION AND CHALLENGES	6
KEY ECONOMIC CHALLENGES	8
III. THE WORLD BANK'S CURRENT PROGRAM	11
AID COORDINATION AND POLICY ADVICE	11
FINANCIAL ASSISTANCE.....	12
IV. WORLD BANK GROUP PROGRAM UNTIL JUNE 2005	14
PROMOTING BROAD-BASED ECONOMIC GROWTH AND EMPLOYMENT	15
RESTRUCTURING ENERGY AND MINING	18
BUILDING CAPACITY TO STRENGTHEN ECONOMIC AND PUBLIC EXPENDITURE MANAGEMENT	19
REGIONAL INTEGRATION	20
A POTENTIAL LONGER-TERM PROGRAM	21
V. RISKS	21

Boxes:

Box 1: Standards for Kosovo.....	3
Box 2: Poverty in Kosovo.....	5
Box 3: Kosovo's Business Environment.....	8
Box 4: The Legal Basis for Bank Assistance to Kosovo.....	13
Box 5: Bank Group Assistance to Support Private Sector Development in Kosovo.....	16

Annexes:

Annex I.....	Selected Economic and Social Data
Annex II.....	Indicative Assistant Program for Kosovo
Annex II.....	Grant Portfolio – Maturity By Objective
Annex IV.....	Grant Program for Kosovo (CY01-04), A Preliminary Assessment
Annex V.....	Donor Support for Reconstruction and Recovery in Kosovo

Map of Kosovo

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Transitional Support Strategy for Kosovo¹

EXECUTIVE SUMMARY

There has been continued, although uneven, progress toward self-government in Kosovo since the last TSS was presented to the Board in July 2002. Nevertheless, the political and security situation remains tense, and there is a risk that violent outbreaks may increase.

Following a largely successful reconstruction program, there has been further economic progress, although poverty remains widespread and growth is heavily dependent on generous, but declining, international assistance. There is hope internationally that the conditions may be in place by mid-2005 for officials from Belgrade and Pristina to begin a formal dialogue on Kosovo's final status, but the nature and timing of a resolution of these issues remains unclear.

While Kosovo's status remains unsettled, this TSS proposes the continuation of a separate grant program until mid-2005. Further support will be focused very selectively on (i) building economic policy and public expenditure management capacity among Kosovo institutions; and (ii) helping to build a business environment, including through restructuring of the critical energy and mining sectors, that will encourage broad-based growth and employment. Building the capacity of the relatively young Kosovo institutions will be a key cross-cutting theme through all interventions.

Management intends to make further commitments of \$15 million over the 18 month period from the beginning of 2004 to mid-2005². This is the same volume of assistance provided under the last TSS. Financial support will also be underpinned by a strong program of policy engagement and analytical work.

Management proposes to return to the Board in mid-2005 to assess progress toward final status issues and developments in Kosovo, as well as decisions that may be taken on the use of grants as part of the IDA-14 replenishment process.

Executive Directors may want to consider the following issues:

- (i) *Risks.* Are the inherent risks of operating in a volatile post-conflict environment properly reflected and appropriately managed?
- (ii) *IDA grants.* Are further IDA grants warranted for Kosovo until June 2005? In the absence of a political resolution, what scope might there be for further grants beyond mid-2005?
- (iii) *Selectivity.* Is the TSS appropriately focused on key priorities for Kosovo?

¹ Kosovo, Serbia and Montenegro, hereinafter Kosovo

² Funding includes \$12.5 million in IDA resources, plus about \$2.5 million in interest income earned by the Trust Fund for Kosovo since the end of 2001, which will revert to IDA and be made available for Kosovo.

Transitional Support Strategy for Kosovo³

I. INTRODUCTION

1. This is the third Transitional Support Strategy (TSS) for Kosovo since hostilities ended in late 1999. The first TSS, considered by the Board in October 1997, and a TSS update, considered in June 2000, provided the basis for initial Bank engagement in Kosovo, supported by grants totaling \$2 million from the Bank's Post-Conflict Fund (PCF), as well as by allocations from IBRD net income totaling \$60 million⁴. A second TSS, considered by the Board in July 2002, took stock of progress and outlined a strategy for the Bank to continue engagement with Kosovo until the conclusion of the four-year reconstruction and recovery program in December 2003. Consistent with the expanded scope for post-conflict grant assistance provided by IDA-13, the Board endorsed proposals in the July 2002 TSS to provide \$15 million in IDA grants to Kosovo over 18 months. This TSS proposes a similar level of funding, very tightly focused on key activities to strengthen governance and promote longer-term growth in Kosovo.

II. BACKGROUND

Political Context

2. *Kosovo is emerging from a post-conflict environment.* Conflict in the late 1990s resulted in total deaths of between 4,000 and 12,000 people. Following a significant displacement of ethnic Albanians in the early part of the conflict, many ethnic Serbs left their homes after NATO intervention. Between 100,000 and 200,000 people, mostly ethnic Serbs, remain displaced. The presence of a large NATO-led international force (KFOR) has ensured a reasonable degree of security. There has been some progress with reconciliation, but tensions remain and most areas of Kosovo remain divided along ethnic lines. Sporadic acts of violence continue against both ethnic Albanian and ethnic Serb communities. International officials, including from the World Bank, have occasionally been caught in violent outbursts.

3. *Kosovo's final status remains uncertain, and a UN interim administration continues to be the final authority.* On June 10, 1999, the United Nations Security Council adopted Resolution 1244 (UNSCR 1244), which provides the legal framework for Kosovo's current status. Until a political solution to the Kosovo crisis can be found, UNSCR 1244 affirmed the sovereignty and territorial integrity of Serbia and Montenegro (SAM) but also called for 'substantial autonomy' for Kosovo. UNSCR 1244 authorized the establishment of "an international civil presence in Kosovo in order to provide an interim administration" which has been implemented through the creation of the United Nations Mission in Kosovo (UNMIK).

³ Kosovo, Serbia and Montenegro, hereinafter Kosovo

⁴ Two contributions were made from net income: \$25 million in 1999 and \$35 million in 2000. In addition, \$2.8 million in interest income earned by the Trust Fund for Kosovo before the end of 2001 was committed for projects.

4. ***Progress toward self-government in Kosovo is continuing.*** The adoption of the Constitutional Framework in May 2001 signaled a key step in the transition to self-government. The Provisional Institutions of Self-Government (PISG) comprise the President of Kosovo; a 120 member Assembly; and an Executive branch that is headed by a Prime Minister and a Cabinet of 10 Ministers. PISG institutions are multi-ethnic, with the 120 member Assembly including 22 Kosovo Serb members and 10 members from other minorities; while the Cabinet includes both a Kosovo Serb and another non-Albanian Minister. Following elections in November 2001, Mr. Ibrahim Rugova, the leader of the Democratic League for Kosovo (LDK), became President. Mr. Bajram Rexhepi, from the Democratic Party of Kosovo (PDK), was appointed Prime Minister. Government formation took several months, as the three main Albanian parties, none of which won an outright majority, found it difficult to agree on a grand coalition. Eventually, a compromise was reached with the intermediation of the former Special Representative of the Secretary General (SRSG), who also played a pivotal role in securing Kosovo Serb participation in the Government. Municipal governments have also been established, following elections in October 2000 and November 2002.

5. ***The PISG has significant responsibility for governing Kosovo, although the UN retains final legal authority and certain reserve powers.*** Responsibilities transferred to the PISG include: economic and financial policy; fiscal and budgetary issues; administrative and operational customs activities; domestic and foreign trade, industry and investments; education, science and technology; youth and sport; culture; health; environmental protection; labor and social welfare; family, gender and minors; transport, post, telecommunications and information technologies; public administration services; agriculture, forestry and rural development; statistics; spatial planning; tourism; human rights and equal opportunity; and non-resident affairs. The final batch of responsibilities was formally transferred to the PISG on 30 December 2003. The transfer of responsibility should help gradually to ease tensions that have emerged between UNMIK and the PISG resulting from a fragmented structure for policy formulation and implementation. Until final status is determined, however, UNMIK retains final authority to determine whether decisions by the PISG are within the framework of UNSCR 1244. UNMIK also retains direct responsibility for reserve powers, many of which are central to development issues, including security, law and order, foreign relations, protection of minority rights, banking supervision, customs, and management of publicly-owned enterprises in the key sectors of energy and mining. In areas where UNMIK retains reserve powers, the establishment of 'counseling and consultative bodies' that include representatives from the Kosovo institutions is anticipated.

6. ***Under the policy of "standards before status", discussion on Kosovo's final status will depend on progress toward a range of benchmarks.*** Detailed *Standards for Kosovo* were elaborated by the SRSG in December 2003 and have been endorsed by the UN Security Council. While Kosovo institutions have generally endorsed the standards as an appropriate framework, concerns regarding the implementation of the Standards have been raised by both ethnic Serb leaders in Kosovo and officials in Belgrade. Standards are intended to outline the minimum conditions for what the SRSG has described as a "normal society". Further details on the standards are set out in Box 1. A comprehensive review of

progress toward the Standards is expected in mid-2005, and decisions on how and when to begin discussions of final status are anticipated to follow this review.

7. *Political uncertainty and divisions in Kosovo have the potential to impact on progress toward the Standards and, ultimately, discussions on final status.* There has been considerable progress toward many of the standards, although much remains to be done. Given the very recent establishment of the PISG, the capacity of many Kosovo institutions is weak. In some cases, differences among the main political parties in Kosovo have also been reflected in a fragmented Government approach to issues. This was evident particularly in the divergent approaches taken to discussions with SAM officials held in Vienna in October 2003, which were ultimately attended only by the President and Assembly Speaker, both from the LDK, but boycotted by the other ethnic Albanian parties. UNMIK considers that the Parliament especially has also sought at times to go beyond the mandate of UNSCR 1244. New Presidential and Assembly elections are due for October 2004, and this is likely to add a level of uncertainty to the political climate in Kosovo.

Box 1: Standards for Kosovo

The self-described goal of the *Standards for Kosovo* is to set out the minimum requirements for “a Kosovo where all – regardless of ethnic background, race or religion – are free to live, work and travel without fear, hostility or danger and where there is tolerance, justice and peace for everyone”. The Standards set out minimum requirements under eight broad headings:

- (i) Functioning democratic institutions.
- (ii) Rule of law.
- (iii) Freedom of movement.
- (iv) Sustainable returns of displaced people and respect for the rights of all communities and their members.
- (v) A competitive market economy.
- (vi) Fair enforcement of clear property rights.
- (vii) Constructive and continuing dialogue between the PISG and Belgrade on technical issues.
- (viii) The transformation of the Kosovo Protection Corps into a civilian emergency operation that represents all communities in Kosovo.

A key theme throughout the Standards is the need for Kosovo to move toward European standards. Senior policy-makers in Pristina recognize that Kosovo’s future is likely to depend on greater European integration. Like the rest of the Western Balkans, European Union policy to Kosovo is anchored in the Stabilization and Association Process (SAP), with a joint technical working group including UNMIK, PISG and European Commission officials regularly tracking Kosovo’s progress under the SAP.

The Standards for Kosovo were prepared by UNMIK in close consultation with the PISG and all major political parties in Kosovo, including representatives of the Serb communities. Working Groups are anticipated to prepare work plans for the implementation of the Standards. Despite some initial caution from Belgrade and Kosovo Serb representatives, the first meetings of the Working Group on Energy and the Working Group on Missing Persons were held in Pristina in early March 2004, and meetings of other Working Groups are anticipated shortly.

8. *The formation of a new government in Belgrade, following parliamentary elections in December 2003, could also impact on the policy approach toward Kosovo and activities within Kosovo.* As well as broad policy discussions, Serbian involvement in Kosovo is most evident in parallel institutions supported through the Serbia Coordination Center for Kosovo, as well as additional salaries paid to Serb employees of UNMIK and the PISG. UNMIK regards such parallel structures as detrimental to inter-community relations and as undermining the efforts of legitimately elected municipal officials.

Poverty and the Social Situation

9. *The post-conflict reconstruction program has proceeded well, due to the initiative of the population and generous donor support.* By the end of 2003, donors had disbursed over \$2.2 billion in assistance for Kosovo (excluding UNMIK and KFOR costs). Assistance has helped considerably to rebuild Kosovo after the conflict. Close to 50,000 houses have been rebuilt or rehabilitated, providing homes to about 300,000 people. More than 1,400 km of roads have been rehabilitated, improving economic activity and access to markets for all Kosovars. Agricultural production has increased, with wheat production almost doubling since 1999 to now meet two thirds of domestic needs. There has also been a promising start in the delivery of social services. Urgent infrastructure needs have largely been met, including the reconstruction of 80 per cent of rural health clinics, a large number of schools, and extensive work on water distribution and sewerage infrastructure. Attention is now focusing on ensuring that appropriately trained teachers and health workers can provide quality services. Further information on donor flows to Kosovo and achievements is contained in Annex V.

10. *Despite initial progress in reconstruction and economic recovery, poverty remains widespread.* Average incomes rebounded strongly after the cessation of hostilities, but Kosovo remains the poorest area in Europe, and incomes are still well below pre-conflict levels. About 36 percent of the population lives below the poverty line. Poverty is especially concentrated among non-Albanian ethnic groups and there are large gender inequalities. Unemployment, which is a problem throughout the Western Balkans, is particularly acute in Kosovo. (Box 2).

11. *Ensuring equal opportunities for all citizens and overcoming ethnic divisions remains the key social challenge.* The Standards envisage the adoption of policies that favor the integration of all communities with respect to employment on the public sector, education, health, culture and language rights as well as full freedom of movement and the right of refugees and displaced people to return to their homes. Nevertheless, reconciliation remains a very significant challenge. Albanian and Serb communities remain largely separated, and up to 200,000 people – mostly ethnic Serbs - remain displaced. Although 2003 did see a net positive number of ethnic Serbs return to their homes, partly encouraged by Government support of \$10 million, recent violence is likely to result even greater numbers of displaced people. Greater efforts to encourage reconciliation will require a long-term commitment from leaders of all communities. The extreme poverty and lack of social integration of the Roma population also remains an issue, although the number of Roma is proportionately smaller than in SAM or Macedonia.

Box 2: Poverty in Kosovo

Four years after the end of the conflict, Kosovo remains the poorest area in Europe, with persistent and widespread poverty. In 2002, about 36 percent of the population of Kosovo was living below the poverty line of US\$1.65 per adult per day. Many of these people, however, have incomes that are not significantly below the poverty line, with estimates indicating that consumption levels for the average poor person are only about 10 percent below the poverty line. This also reflects a relatively flat distribution of consumption, with Kosovo having a Gini coefficient of only 30.

While less common, extreme poverty remains an important problem. About 15 percent of the population lives below the extreme (food) poverty line of 2100 calories per adult per day. There is a strong correlation between extreme poverty and those people who are landless, have little formal education, large numbers of children, or are disabled. Gender and ethnicity are also important correlates of extreme poverty, with a relatively high incidence of extreme poverty among female-headed households and among the non Albanian and Serb ethnic groups (especially the Roma, the Muslim Slav, and the Gorani). Extreme poverty has also a strong regional dimension, with high rates in Ferizaji, Mitrovica and Peja. Finally, extreme poverty appears more pronounced in secondary cities than in rural areas or in the Capital city.

Unemployment is a particular concern in Kosovo, and is closely linked to poverty. Official estimates indicate that over 50 percent of the workforce is not formally employed – although many of these people are engaged in subsistence farming or the informal economy and more detailed analysis suggests that the number of people looking for employment is between 20 per cent and 30 percent of the workforce. Many of these are long-term unemployed. Unemployment is also a particular problem among youth, with very large numbers of new job seekers entering the workforce each year.

Non-income poverty measures confirm that poverty is widespread in Kosovo. UNICEF estimates indicate that as many as 35 out of 1,000 children die before their fifth birthday – the highest rate of infant mortality in Europe. Social indicators also highlight significant gender disparities, especially in educational attainment. Gross primary enrolment rates in Kosovo are approximately 90 percent, and roughly equal for boys and girls. At the secondary level, however, just over half of all girls are enrolled in school, compared to almost three quarters of boys.

Further information on poverty in Kosovo is anticipated in the forthcoming 2004 Poverty Assessment based on figures from the Kosovo Office of Statistics (KOS) prepared with technical assistance from the World Bank. Figures are based on the 2002 Household Budget Survey (HBS). Previous poverty estimates based upon the 2000 Living Standard Measurement Survey (LSMS) are not strictly comparable to the HBS data, but suggest a reasonably similar picture. It is anticipated that future surveys will be more directly comparable to allow a better picture of changes in poverty over time.

12. ***Opportunities need to be provided for large numbers of young people, especially for girls.*** Kosovo has the highest youth unemployment rate in Southeastern Europe, with over one third of youth neither in school nor at work. Opportunities need to be provided for this group to participate in and benefit from economic growth if they are not to become vulnerable to exploitation by extremists. Lack of adequate secondary schooling and job training targeted to the needs of youth, particularly in rural areas, has created a gap that has been filled by religious non-formal education. Given disparities in educational attainment, there is a particular need to ensure that girls are able to receive the education necessary to participate in and benefit from broad-based economic growth.

Economic Situation and Challenges

13. ***Broad-based growth is critical to reduce poverty in Kosovo and to provide opportunities for all communities.*** As poverty in Kosovo is widespread but relatively shallow, broad-based growth is likely to provide the opportunities needed for a large proportion of the poor to escape poverty. Growth is also critical to provide opportunities for the very large number of people, especially youth, that are currently unemployed as well as for those entering the workforce. Similarly, broad-based growth will be an important element in the longer-term process of rebuilding a multi-ethnic Kosovo in which all communities can participate in and benefit from economic opportunities.

14. ***Macro-economic management has been sound.*** The adoption of the Deutsche Mark, and subsequently the Euro, as well as the maintenance of a liberal trade regime has resulted in a relatively high degree of macro-economic stability in Kosovo. Significant progress has also been made in building the domestic revenue base, although this remains narrowly based on a VAT introduced in 2001 and tariffs and excises collected at the border. Domestic revenues now cover expenditures under the Kosovo Consolidated Budget and an increasing proportion of the public investment program. Strong growth in revenues, together with much slower than anticipated capital spending, has resulted in the authorities having built an uncommitted “surplus” of approximately Euro 75 million, and having a cash balance of over Euro 300 million.

15. ***After significant economic declines in the late-1990s, growth bounced back immediately after the end of the conflict but is now starting to slow.*** As common in many post-conflict environments, Kosovo experienced robust, double-digit growth rates in 2000 and 2001. This has resulted in average GDP per capita doubling from less than \$400 in 2000 to about \$640 in 2002 and almost US\$790 in 2003⁵. Growth has, however, begun to slow. Very large increases in USD denominated GDP figures in 2003 are due predominantly to exchange rate movements rather than strong domestic growth. New estimates prepared during 2003 by the Kosovo Ministry of Finance and Economy (MFE) with assistance from the IMF indicate that, after the initial reconstruction boom, growth has slowed to approximately 4 to 5 percent per annum. Details of key macro-economic indicators are provided in Annex I.

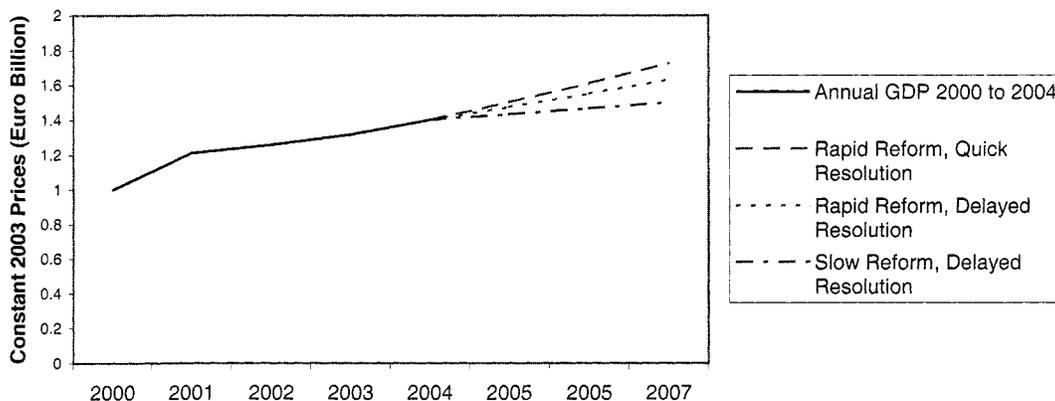
16. ***Growth remains narrowly based and dependent on donor flows.*** Growth has been driven especially by a large number of new small and medium enterprises (SMEs) concentrated in the construction, service and retailing sectors, especially catering to the international community in and around Pristina. Small scale agricultural production has also rebounded. While contributing approximately 20 percent of GDP, agriculture

⁵ All economic statistics in Kosovo are subject to a considerable degree of uncertainty. There has not been a reliable census in Kosovo for two decades. GNI figures are especially subject to a very high degree of uncertainty as they are based on assumptions and hypotheses regarding capital flows from seasonal workers temporarily residing abroad. Latest estimates are based on considerable work during 2003 by the Ministry of Finance and Economy, supported by the IMF and the Bank. Recent estimates suggests that the economy may not be as large as previously thought, but show a consistent pattern of strong growth immediately after the conflict, supported by generous donor flows, with growth now slowing. While data is slowly improving, all estimates must still be considered preliminary.

provides employment for the vast majority of the two-thirds of the population that live in rural areas. Growth has been dependent especially on generous donor assistance for reconstruction and remittances from the Kosovo diaspora. For the past four years, annual remittances and international assistance have together been equivalent to total annual GDP. Consistent with other post-conflict environments, total donor disbursements (excluding UNMIK and KFOR costs) have declined from a peak of about \$700 million in 2000 to just less than \$240 million in 2003. With declining assistance, UNMIK's costs have been larger than donor assistance to finance Kosovo's public investment program since 2002. While this level of donor assistance remains generous, declines are likely to particularly affect the large number of SMEs catering to the international community.

17. *While Kosovo has potential for longer-term growth, this will depend on significant reform.* Based on studies of other post-conflict and transition economies, simulations for the Kosovo Economic Memorandum suggest that – under an optimistic scenario - growth of approximately 7 percent per annum could potentially be achieved over the next four years as economic recovery continues, falling to about 5 percent thereafter. Significant reform will be required, however, if such rates of growth are to be achieved. In particular significant reform of the large publicly-owned enterprises (POEs) that dominate the mining and energy sectors – with agriculture, the traditional mainstays of the Kosovo economy – will be required if these sectors are to again become sources of growth. Continued privatization of socially-owned enterprises will be critical to encourage investment and growth. In addition, an early resolution of final status would also help to provide certainty for foreign investment, encourage greater integration with regional markets, and allow Kosovo institutions access to loan financing for important public investment activities. At the same time, however, too quick a move to final status, without having key Standards being achieved, also potentially poses longer-term risks. Even without clarification of final status, strong reform could potentially see short-term growth maintained at about 4 to 5 percent per annum. But with neither reform nor resolution of political issues, growth could potentially slow to not much more than 2 percent per annum – which would result in per capita incomes remaining essentially flat (Chart 1).

Chart 1. Projected GDP for Reform Scenarios



Key Economic Challenges

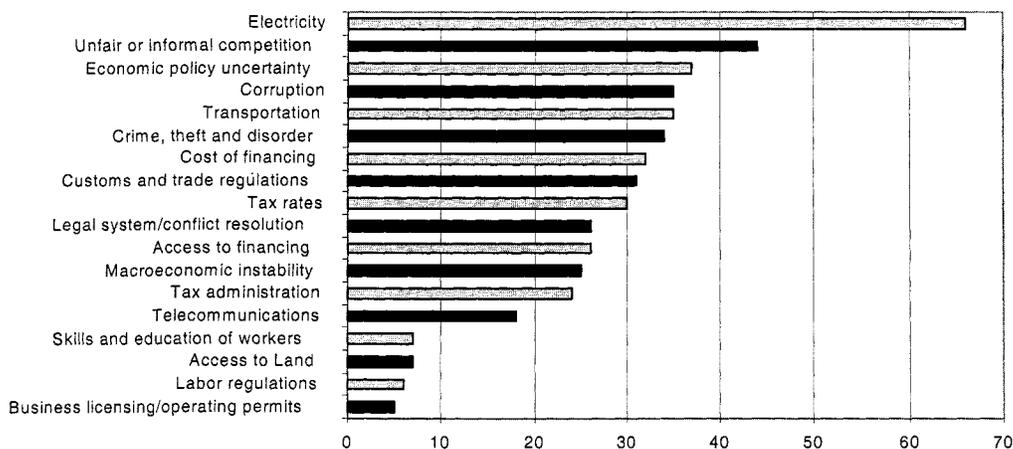
18. *In order to promote growth and generate employment, Kosovo faces two main challenges: to emerge from an economy based on post-conflict reconstruction; and to continue the transition to a market economy.* Meeting these challenges will require significant reform to further strengthen the business environment; continued restructuring of publicly-owned enterprises (POEs) and privatization of socially owned enterprises (SOEs); maintenance of macro-economic stability; and strengthening of the budgetary and expenditure systems to increase the proportion of public expenditure devoted to investment and the effectiveness of these activities.

Box 3: Kosovo's Business Environment

The business environment in Kosovo is better than many transition countries. Yet Kosovo still needs to overcome the legacy of conflict and continue the transition to a market economy. One of the most important obstacles to economic growth in Kosovo is the unresolved issue of sovereignty. A 2004 World Bank Kosovo Economic Memorandum concluded that resolution of final status will be critical to encourage the levels of foreign direct investment that will be required to restructure major industries such as energy and mining. Resolution of final status is also needed to provide greater certainty regarding the enforceability of legal contracts necessary for private investment, especially for significant FDI flows. Uncertainty on final status appears to be one of the main reasons for recent delays to the privatization program and the continuing process of economic transition.

A recently completed Investment Climate Survey found that domestic and foreign investors generally regard the business environment as positive. Most firms indicate satisfaction with macro-economic stability, labor regulations, skills of the workforce, and administration of business licenses and operating permits. The most significant constraints identified are operational in nature. Unreliable electricity supply is clearly seen as the main obstacle to growth. Firms report an average of 90 per year days with power outages and estimate that production and sales losses, and the purchase of alternative supplies, are equivalent to about 9 percent of an average firm's annual sales. Many firms in the formal economy identify competition with those operating informally as a concern. Corruption is also cited as a constraint. Problems are seen as being particularly acute in some municipalities.

Chart 2: Evaluation of General Constraints to Operations
(% of firms ranking constraint as "major" or "very")



19. ***The business environment is now better than in many transition economies, but major constraints at the operational level will need to be overcome to encourage broad-based growth.*** A relatively strong legislative foundation for a market economy is largely in place. At the same time, however, continuing uncertainty about final status continues to deter investment and is one reason for delays in the privatization program. Considerable impediments to private sector activity also persist despite the relatively sound legislative framework. Unreliable electricity supply is a key problem. Many businesses are concerned about uncertainty in economic policy and the operation in practice of the tariff and tax regime as well as non-tariff barriers. Poor enforcement of creditor rights in the court system, as in other parts of the region, acts as brake on lending to private firms. Corruption, while apparently less of a problem than in other parts of the region, remains an issue. (Box 3).

20. ***In the short-term, small and medium enterprises are likely to continue to be the main economic actors.*** The enterprise sector in Kosovo is comprised of about 30,000 formal businesses, with many more operating in the informal sector. Further growth in the SME sector, and particularly the capacity of the sector to take advantage of improving export opportunities, is likely to depend on improved product quality, reliability of supply, and larger scale production. As the overall environment in Kosovo changes, however, the SME sector will increasingly need to move away from activities, such as construction and retail services, which are heavily dependent on remittances and donor assistance. Currently very few firms are engaged in significant value-adding. Improving financial sector intermediation is likely to be an essential element in ensuring that SMEs are able to access investment financing. Lending to business has been growing strongly as the financial sector develops, but margins remain high and smaller firms face difficulties accessing credit outside informal systems. The weak enforcement of creditor rights is a particular issue constraining lending. The rebound in small scale agriculture suggests that this sector could particularly play a key role in Kosovo's economy. Agriculture will be critical to provide employment opportunities, with family farms currently providing employment for the overwhelming majority of the two thirds of the population that live in rural areas. There is also some potential for further growth in this sector, in particular for higher value-added processed and semi-processed products such as fruits, vegetables, livestock and niche seasonal markets.

21. ***Continued economic transition will be critical for Kosovo to continue to grow.*** Privatization of socially-owned enterprises (SOEs) is vital to improve economic efficiency, but has proved a particular challenge. Of more than 500 SOEs, there is scope for about 75 to 100 to be sold as on-going businesses. Liquidation of other enterprises is also needed to free up productive assets, and especially large land holdings which are not currently being put to any productive purposes. The privatization process in Kosovo has proved highly political. After almost three years of impasse, the Kosovo Trust Agency (KTA) was established in June 2002 and enacted regulations that will allow the sale or liquidation of SOEs, with proceeds to be held in trust to meet potential claims. While three rounds of privatization have been completed, covering some 30 SOEs, the process was suspended in October 2003. While there are indications that this process will resume shortly, it is likely to continue to prove a difficult political issue.

22. ***Restructuring of large publicly-owned companies (POE) that dominate the energy and mining sectors is vital for medium-term growth.*** Intermittent power supply is identified by businesses as the single largest constraint to growth in Kosovo, and reform of this sector will be crucial to encourage investment and further growth throughout the economy. While having the potential to become a major energy exporter, Kosovo currently has to import significant amount of electricity during winter months – which is a major drain on the budget. The sector is dominated by the Korporata Energjetike e Kosovo (KEK). Problems include dilapidated infrastructure, large technical and non-technical losses including pilferage of electricity, poor billing and collection, overstaffing and low productivity, and inefficient labor practices. Energy, which remains a reserve power under the control of UNMIK, is also highly political. KTA is in the process of engaging a management contractor, through a performance-linked and incentive-based contract to turn around KEK. Ultimately, very significant investments required to increase electricity production in Kosovo will depend on the success of this reform program and improvement in KEK's performance.

23. ***Restructuring of the mining industry will also be needed.*** Prior to the conflict, the mining industry was a key source of foreign currency and provided employment for more than 17,000 people. With little capital investment for a decade, however, infrastructure is dilapidated. There is some scope for possible privatization of ferro-nickel and other mining operations managed by SOEs. Nevertheless, there is a major need to also restructure operations at the main lead and zinc mines at Trepca, near Mitrovica, which were closed following the conflict in 1999. Approximately 15,000 miners at Trepca, both ethnic Albanians and ethnic Serbs, remain out of work with unresolved pension issues and few opportunities. In both the energy and mining sectors a significant environmental legacy remains to be addressed; Kosovo is one of the most polluted areas in Europe as a result of past environmental practices.

24. ***Careful management will be required to ensure continued macro-economic stability as international flows decline.*** Cautious management will be required to preserve Kosovo's current fiscal position as donor flows decline. Kosovo's external financial position has improved since 1999, but remain unsustainable. Low levels of exports, together with large import flows associated with the reconstruction program has led to a current account deficit before grants and remittances of over 75 percent of GDP. While external financing needs are currently met by remittances and donor flows, much stronger reform and export growth is likely to be needed to make up for projected declines in donor flows. While Kosovo is currently unable to borrow, one concern for both the fiscal and external position is the possibility of Kosovo inheriting, as part of any resolution of final status, a significant debt liability incurred by the Socialist Federal Republic of Yugoslavia (SFRY) for activities in Kosovo, which the Serbian Government has been servicing.

25. ***Weak budget systems and public expenditure management will need to be strengthened to ensure that investments and services are delivered effectively.*** Public expenditures equivalent to over 40 percent of GDP in Kosovo reflect the need for post-conflict reconstruction, but will not be sustainable in the longer-term. Within the overall envelope, greater priority will need to be given to investment activities that will provide a

foundation for longer-term growth. Strengthened strategic priority setting mechanisms and overall public expenditure planning and management especially will be needed. Ultimately the Kosovar authorities may need to consider moving toward the development of an inclusive priority setting process such as a Poverty Reduction Strategy Paper. Institution building and stronger public expenditure management systems will also be needed to ensure that public investments and services are provided effectively. While considerable strides have been made, local institutions are relatively young and this is reflected in weak delivery capacities. Overall financing for services such as education and health, while low in absolute terms, are not especially low as a proportion of the total budget – public spending on education and health, for instance, respectively make up 15 percent and 11 percent of the total Kosovo Consolidated Budget. The effectiveness of services is severely constrained, however, by a strong weighting to recurrent costs and difficulties in tendering and contracting for needed capital projects.

III. THE WORLD BANK GROUP'S CURRENT PROGRAM

26. *The Bank has been involved in Kosovo since the end of the conflict.* Given uncertainties surrounding the resolution of final status issues, a series of relatively short Transition Support Strategies have guided Bank engagement and allowed the program to be regularly tailored to meet changing needs. While financial support has not been insubstantial, constraints on lending mean that the Bank has not assumed the burden share it might have in other situations. Bank engagement has been characterized by the donor coordination role played in conjunction with the European Commission (EC) and by policy advice. Although further strengthening of the Bank's capacity to engage in detailed dialogue with the PISG will be required, strong analytical work has allowed the Bank to "punch above its weight" in policy dialogue with the PISG and UNMIK.

Aid Coordination and Policy Advice

27. *The Bank has worked closely with the EC to mobilize funds and encourage donor coordination.* In collaboration with the EC, the Bank co-chaired four donor conferences – most recently in November 2002 – and the High-Level and Working Level Steering Groups for Southeast Europe. The Bank worked closely with the EC and other donors to mobilize over \$2.2 billion in donor support in addition to the continuing costs of the UNMIK administration. Coordination between the Bank and the EC is most evident in the functioning of the joint office in Brussels. With the changing environment in Kosovo, however, the nature of donor coordination functions are likely to also be transformed over the next few years. In particular, as Kosovo emerges from the post-conflict phase and as donor flows decline, coordination is likely to require less of a focus on international donor conferences. Increasingly, main responsibility for coordination will continue to shift to Kosovo and to the PISG. Further technical coordination at the sectoral level is also likely to prove important, such as the groups that the European Agency for Reconstruction and USAID are currently discussing. Close collaboration in Kosovo is likely to prove especially important in the area of governance and economic planning and management, which is becoming a stronger focus for many donors while activities in other sectors

decline. Annex V describes in more depth the role of all donors in supporting the reconstruction and recovery program in Kosovo.

28. *Economic and policy advice to the PISG and UNMIK, in close collaboration with the IMF, has been an important component of the Bank's assistance to Kosovo.* The Bank has established a reputation as a reliable and impartial advisor and the Bank's support is valued highly. Consistent with its broad comparative advantages among donor institutions, the Bank provided support to UNMIK to establish the basic institutions for macro-economic management and, since the formation of the PISG, has worked actively to provide advice on issues ranging from preparation of the Kosovo Consolidated Budget, the design and implementation of the commercial framework, and appropriate tax and trade policies. As soon as the new Kosovo Government was formed, the Bank organized a round-table discussion with its members on key economic policy priorities, based on a set of policy notes prepared by Bank staff. Most recently, the preparation of a detailed Kosovo Economic Memorandum has helped to identify potential sources of growth and, together with an Investment Climate Assessment, has helped to provide an indication of the key constraints confronting investors.

Financial Assistance

29. *The Bank has responded flexibly to Kosovo's uncertain status, but this has limited the amount of financial support that the institution has been able to provide.* Given Kosovo's current inability to borrow, the Bank has had to be innovative in providing grant resources to Kosovo (see Box 4 for a more complete discussion of the requirements necessary for a lending program). Despite the constraints, the Bank has committed over \$80 million to Kosovo by the end of 2003. Bank assistance has also attracted about \$65 million in co-financing from other donors, including the European Commission, Canada, France, Germany, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom. Due to constraints, levels of assistance to Kosovo have necessarily been lower than the Bank's global share of development assistance might suggest: Bank grants in the initial post-conflict period were about 5 percent of total donor flows to Kosovo (excluding UNMIK costs). Bank assistance is also declining in line with other donor flows to Kosovo, but is anticipated to continue making up about 5 percent of all donor assistance. In total, Bank grants have comprised:

- (i) two allocations from net income to the Trust Fund for Kosovo, totaling \$60 million, as well as almost \$3 million in investment income from the Trust Fund;
- (ii) three grants from the post-conflict fund totaling \$4 million to support reconstruction and reconciliation activities; and
- (iii) IDA post-conflict grants of \$15 million over the 18 month period from the beginning of IDA-13 in July 2002.

30. *Reflecting the post-conflict environment, Bank assistance has been aimed at building institutions and providing a clear peace dividend.* Assistance has focused on: (i)

economic reform and institution building; (ii) promoting broad-based growth, job creation and income generating activities; and (iii) rehabilitating selected infrastructure and re-establishing service delivery.

Box 4: The Legal Basis for World Bank Assistance to Kosovo

Kosovo, which is a territory of a sovereign country, but which is under UN administration, is a special case when it comes to the provision of World Bank assistance.

The World Bank initially provided grant support to Kosovo financed through the post-conflict fund and net income. At that time, the Federal Republic of Yugoslavia – subsequently Serbia and Montenegro (SAM) - had not yet succeeded to the membership of the Socialist Federal Republic of Yugoslavia in the World Bank. Kosovo was thus not then a territory of a member country. In reaching its decision, based upon UN Security Council Resolution 1244, to endorse the first TSS for Kosovo and to establish a trust fund for Kosovo, the World Bank's Board of Executive Directors concluded that such assistance was for the benefit of the Bank's member states.

With the introduction of expanded post-conflict grants mechanisms under IDA-13, IDA subsequently provided grants to Kosovo. UNMIK is a subsidiary organ of a principal organ (the UN Security Council) of an international organization, and such grants fall within the ambit of Article V(2)(c) of IDA's Articles of Agreement, which allows for the provision of financing to a public international organization. IDA grants to UNMIK fall within the purposes of IDA, as such funding is intended to "promote economic development, increase productivity and thus raise standards of living" in Kosovo, which is a "less-developed area of the world included within the Association's membership" [Article I and Article V(1)(a)]. The IDA-13 report also explicitly noted that "in the post-conflict context, grants could be made available, in special cases, to territories within member countries that are under UN administration on an interim basis" [paragraph 85].

IDA lending to Kosovo is potentially feasible from the Bank's perspective, but does not appear practicable at this stage. The World Bank is aware that other international financial institutions have had preliminary discussions with the UN whether lending might be possible through a combination of an assurance by the UN Security Council that responsibility for any financing provided to the interim administration would be resolved as part of a resolution of Kosovo's final status; an assurance by the PISG that obligations binding any potential successor to the current Kosovo administration would be met; and a bilateral or multilateral guarantee from a third party. The Bank is following these development closely. At this stage, however, it appears unlikely that these minimum requirements for a lending program will be met without a resolution of final status. Any lending program would also need to consider the implications of new lending on Kosovo's credit-worthiness. Significant loans to the former SFRY for investments in Kosovo are currently being serviced by SAM.

As IFC investments in private sector entities do not require a sovereign guarantee and do not enjoy preferred creditor status, the unsettled status of Kosovo has not restricted IFC's ability to invest. Similarly, MIGA guarantees to private sector entities are possible. Finally, there appears to be a legal foundation for UNMIK to access GEF grants, provided UNMIK develops certain technical arrangements with the GEF authorities including on the applicability of relevant global environment conventions in Kosovo.

31. *A conscious effort has been made to ensure that assistance is able to benefit all communities in Kosovo.* Ten percent of funds provided under community development schemes, for instance, were for activities in Serb areas and to assist returnees and a further 10 percent was provided for other minority areas. Support included the rehabilitation of roads, cultural centers, water supply and sewerage. Similarly, education, health and agriculture activities have all provided benefits for all communities in Kosovo.

Nevertheless, security precautions, particularly around the northern town of Mitrovica, has at times limited the Bank's capacity to engage with communities in affected regions.

32. ***Despite the difficult post-conflict environment, Bank financial assistance has proved effective.*** Post-conflict reconstruction activities (water supply, sewerage, schools, health clinics) have directly benefited over 100,000 people among all ethnic communities. In the economic area, the Bank has helped the Kosovar authorities to improve economic and budget decision making; maintain responsible fiscal policy; establish a Banking and Payments Authority for Kosovo; improve the business environment and establish a streamlined business registration system (with almost 30,000 businesses registered). A recent Portfolio Review of the Kosovo program found that the performance of the program was strong despite the difficult environment and lack of capacity. Nineteen of twenty activities are expected to have a satisfactory development outcome. Nevertheless, sustainability issues will particularly need continued attention to ensure that the institutional achievements of the current program can be maintained in the longer-term. Details of the Bank's current program and achievements is provided in Annexes III and IV.

IV. WORLD BANK GROUP PROGRAM UNTIL JUNE 2005

33. ***This TSS outlines an 18 month strategy, which will allow the Bank to reconsider its position in mid-2005 in light of progress towards the Standards for Kosovo and the potential start of dialogue on final status, as well as taking into account deliberations on future Bank grant financing.*** There are growing indications that discussions on final status may be able to begin in mid-2005, but it remains difficult to predict how long this process may take. Ultimately, further grant assistance for Kosovo may need to be considered in 2005 if the Bank is to remain engaged until a political solution is reached. Nevertheless, this will depend on the future framework established for grant financing as part of the IDA-14 replenishment.

34. ***New activities will focus very selectively on key priorities for Kosovo in areas where the Bank has a broad comparative advantage among international donors.*** As Kosovo emerges from a post-conflict situation, a future program will focus on: (i) encouraging broad-based and sustainable economic growth and employment creation; (ii) restructuring key sectors of the economy as part of the transition process; and (iii) assisting the PISG to address key economic Standards necessary to begin discussion on final status. This focus reflects the Bank's broad comparative advantage as a source of advice and assistance for governments undertaking economic and structural reform. Given the newly established nature of many of the Kosovo institutions, capacity building will be a key cross-cutting focus throughout all new interventions.

35. ***While new activities will be strictly focused, efforts to promote reconciliation and to provide benefits directly to poor people will continue through existing activities.*** This will include support for community development programs, water supply, education, health and social protection. Additional support from the Post-Conflict Fund for girls education and education in Serb areas is being explored actively. Greater attention will

also be able to be paid to youth issues as part of the *Youth Voices* initiative, and efforts will be made to mainstream the particular needs of youth and ethnic minorities into activities. Nevertheless, new activities under this TSS are anticipated to be focused very selectively. Annex III provides further details of how new activities will fit with the current program.

36. *To support new activities, management intends to commit \$15 million of IDA resources to Kosovo on grant terms until June 2005.* This maintains the level of assistance provided by IDA over the past 18 months, and broadly maintains the burden share of total assistance initially accepted by the Bank after the conflict. Funding includes \$12.5 million in IDA resources, plus about \$2.5 million in interest income earned by the Trust Fund for Kosovo, which will revert to IDA and be made available for Kosovo.

37. *Focused analytical work will underpin the new program and ensure that the Bank is able to maintain an adequate knowledge base to scale-up assistance once a lending program is able to begin.* A Poverty Assessment being undertaken over the next 18 months will be especially important to gain a better understanding of poverty in Kosovo and the scope for interventions to be tailored to support broad-based growth and employment to reduce poverty. A Kosovo Economic Memorandum due for completion in April 2004 will strengthen understanding of potential sources for longer-term growth in Kosovo. A Public Expenditure Review to be undertaken in FY05 will be critical to underpin continuing engagement on economic policy and institutional issues. An Operational Procurement Review and a Financial Accountability Assessment, both anticipated for completion in early 2004, will also be important to identify weaknesses and advise as to how the program can build capacity in these areas as well as on fiduciary and procurement structures that will allow these risks to continue to be managed effectively. Further details on the analytical work that will be conducted is provided in Annex II.

38. *The strategy envisages a coordinated Bank Group approach.* The Post-Conflict Fund, which was the source of the earliest grants to Kosovo immediately after the conflict, has been an extremely useful complement to other sources of grant financing, and potential exists for further support for reconciliation and reconstruction activities from the PCF. IDA supported activities to strengthen the business environment, as well as to restructure the mining and energy sectors, will take into account current IFC investments in the financial sector, as well as the potential for future IFC investments associated with the privatization process. IFC expertise will especially strengthen the Bank Group's capacity to assist in the mining sector, and will be drawn on in developing and implementing activities. Scope for MIGA guarantees to support private investments in Kosovo will be explored actively. Similarly, the potential for IDA supported activities, to be coordinated with possible additional support from the Global Environment Facility (GEF) to address the regional and global impacts of sustained environmental degradation in Kosovo will be considered closely.

Promoting Broad-Based Economic Growth and Employment

39. *A business environment and rural enterprise project* (\$7.0 million) will support further improvements in the investment climate. While substantial progress has been

made, Bank assistance will help to address key institutional and operational constraints that continue to confront firms. Assistance will build on the concerted effort the Bank Group has made already to help address some of the constraints to the development of the private sector (Box 5). Interventions are anticipated to focus on: strengthening access to finance and the financial sector more broadly, policy engagement as appropriate on privatization issues, fostering the competitiveness of the SME sector, and continued support for the agriculture sector which provides the bulk of employment in Kosovo

Box 5: Bank Group Assistance to Support Private Sector Development in Kosovo

Over the past four years, the Bank Group has made a concerted effort to address some of the constraints to private sector development through a set of interventions by the Bank, IFC, and the joint Bank/IFC Southeast Europe Enterprise Development Facility.

- (i) A series of economic assistance grants have supported the establishment of an adequate commercial legal framework to support the development of a market economy. Grants have supported the enactment of four key commercial regulations: the Regulation on Business Organizations, the Regulation on Contracts for Sale of Goods, the Regulation on Pledges, and the Regulation on Foreign Investment.
- (ii) A PSD Technical Assistance grant supported the establishment of a modern business registry, assisted judges of the Commercial and Supreme courts to deepen their understanding of and capabilities to adjudicate cases related to commercial laws, and worked with USAID to strengthen accountancy standards and practices.
- (iii) A pilot SME line of credit financed by the Bank and the European Agency for Reconstruction provided urgent start-up financing for a range of small businesses immediately after the conflict. The project was, however, less successful in meeting its sustainability objectives, particularly as the financial sector in Kosovo deepened, and the project's loan portfolio was sold to a commercial bank.
- (iv) The Micro Enterprise Bank (MEB) was the first bank in post-war Kosovo established in late 1999 as a joint initiative of EBRD, Internationale Project Consult (IPC) and IFC, which made an equity investment of \$1.1 million. MEB, which is based in Pristina and has 7 branches. MEB's performance has been excellent since its inception. The deposit base has reached \$280 million. The loan portfolio more than tripled in one year reaching US\$53 million by June 2003, and its quality is notable with arrears of only 0.32 percent. The deposit base remained stable at US\$280 million. MEB provides credits to over 10,000 micro and small businesses with an average loan size of US\$5,000 equivalent. MEB is profitable with half-year net income of US\$2.5 million.
- (v) A joint Bank/ IFC Southeast Europe Enterprise Development facility (SEED) has provided advisory services to a range of companies.
- (vi) An Emergency Farm Reconstruction Project supported the jumpstarting of agricultural production immediately after the conflict and the re-launching of the rural economy by investing in key assets and key agricultural services.
- (vii) The Bank Group and the Open Society Institute implemented a pilot program, Developing Enterprises Locally through Action and Alliance (DELTA) in 7 municipalities in Kosovo. This built the capacity of municipal teams (public and private sector) to prepare and implement their own local economic development strategies and action plans, especially addressing major concerns about unemployment. A second phase, funded by OSI, is due to start soon.

40. *The Bank will consider carefully the role that it might be able to play in encouraging the privatization process.* Privatization will be an important element in improving economic efficiency and promoting longer-term growth in Kosovo. Bank assistance is likely to be most productively focused on providing technical advice, underpinned by solid analytical work. There may also be some limited scope for technical assistance on specific issues, although this area already seems relatively well covered by the authorities, with the support of donors such as USAID. IFC and MIGA also intend to explore actively the scope to invest directly in privatized companies or to provide guarantees for companies considering making such investments.

41. *Assistance to improve enforcement of creditor rights is the main priority at this stage for improving access to credit.* Support for municipal courts to improve enforcement of creditor rights will help to overcome one of the key constraints to SME growth. Experience suggests strongly that a public-sector funded line of credit for SME financing is not needed. Rather, IFC and MIGA may be better placed to strengthen the financial sector: the IFC investment in the Micro-Enterprise Bank Kosovo (MEB) has already been successful. MIGA also has considerable experience in providing guarantees for investments in the financial sector in Bosnia and Herzegovina and SAM. In addition, MIGA is developing a Small Investment Program which is designed to provide guarantees of up to \$5 million for SMEs, which might prove a useful mechanism in Kosovo. The development of a land market, and an associated mortgage market, is likely to be needed to give SMEs secure title to access credit. This has been constrained by the absence of a property registry. While the Bank has been engaged in land registration in other countries in the region, other donors – particularly the Nordics – are engaged in this area in Kosovo. Although the regulatory and supervisory framework of the banking, insurance and pensions systems is in line with international standards, support will be needed to further strengthen the supervisory capacity of BPK, especially given the withdrawal of other donors from this area. In line with the Standards, and given the priority accorded internationally, assistance will be mobilized to ensure the implementation of an effective strategy to fight money laundering and terrorist financing.

42. *Support to foster the competitiveness of small scale commercial activities will encourage economic growth in the medium term.* Kosovo's enterprise sector is at a critical stage of transition. Having accumulated capital from service-oriented activities since the end of the conflict, small-scale commercial businesses now need to shift toward more value-added activities to sustain employment generation and incomes. This is a particular challenge for producers of primary and processed agricultural products. Assistance will encourage greater competitiveness of these small-scale commercial producers by improving their ability to produce high-value, high-quality products increasingly demanded by distributors, retailers and consumers in a regionalized marketplace. Competitiveness would be further enhanced by helping existing groups to build the organizational capacity necessary to successfully package, market and distribute the volumes of products demanded by local and regional wholesalers and retailers. Direct Bank support to foster the competitiveness of SMEs will be linked closely with efforts under a regional trade and transport facilitation program to reduce non-tariff barriers to exports, such as customs procedures and other regulatory issues. Support will also take

into account assistance from USAID in the SME area, which focuses on improving firms' competitiveness both in the domestic market and abroad.

43. *In supporting SMEs, a particular focus will be placed on rural enterprises.* This reflects the contribution of agriculture to employment in Kosovo. Building on the successful emergency farm reconstruction project, advice to the Ministry of Agriculture, Forestry and Rural Development (MAFRD) could also support the current decentralization of Government structures and provide services in a fiscally sustainable way and to ensure the effective functioning of the logistics chain from farm-gate to marketplace.

Restructuring Energy and Mining

44. *An energy and mining technical assistance grant III* (\$2.5 million) will address the specific needs associated with restructuring these sectors. Restructuring of energy especially will be critical to improve the performance of the Kosovo economy as a whole.

45. *In the energy sector, assistance will help the Kosovo authorities to meet their obligations outlined in the Athens Memorandum Framework in order to participate in the Southeast Europe Regional Electricity Market (SEEREM).* This will include the creation of an independent Transmission System Operator, the development of a Grid Code, and institutional strengthening to participate in the market. To protect the poor among the household sector from the possible tariff increase when large consumers shift to competitive suppliers and tariff rebalancing becomes inevitable, assistance will help the authorities to design a life-line tariff and a transparent and targeted system of subsidizing the electricity consumption of the poor. In addition, a study of inter-fuel substitution should help to explore options for providing households with alternative sources of space heating by shifting from electricity to environmentally clean fuels, as the prices of electricity go up. Assistance will prepare the way, in the medium-term, for competition in the supply of electricity throughout the region – which is likely to both provide opportunities for the export of electricity by Kosovo as well as encouraging continuing reform of KEK. Technical assistance will form a foundation for potential future Bank investments under a proposed SEEREM adaptable program loan that is anticipated to be presented to the Board in FY 2005.

46. *Bank support for the mining sector will focus on supporting the development of a mining strategy and policy, and encouraging the regional integration of the mining sector.* Assistance will include policy level engagement with the PISG and UNMIK regarding mining asset privatization and future lignite commercialization. Advice will be centered on a sustainable minerals development approach that recognizes the need for development to be economically viable, financially profitable, environmentally sensitive and socially responsible. Responding to a request from the Prime Minister, the Bank will work with the Government to provide advice on how an appropriate social protection package for Trepca miners might be structured to meet the needs of unemployed miners in a financially sustainable manner, recognizing that any initiative in the mining sector could form a precedent for labor restructuring that will also need to occur in other sectors. Work on mining sector issues will be coordinated closely with the IFC. Should privatization

proceed, IFC also anticipates exploring opportunities for investments in this sector. Given the considerable environmental legacy associated with both the mining and energy sectors, staff will also be exploring with the Global Environment Fund the scope for coordinated activities in Kosovo.

Building Capacity to Strengthen Economic and Public Expenditure Management

47. A multi-sector *economic and public expenditure capacity building project* (\$5.5 million) will assist in further institution building to strengthen economic policy and public expenditure management. Given Kosovo's relatively strong fiscal position, at least in the short-term, this will focus on capacity building rather than budget support, which has been an effective instrument in the past.

48. *Bank support will assist the authorities make progress toward key economic goals outlined in the Standards.* Key goals include: basic economic legislation in place and enforced; a tax regime is in place that can sustain the essential function of government, with tax revenue fully funding the recurrent budget and an increasing share of public investment; the budget process is functioning and meeting all legal requirements; relevant government institutions are functioning to provide services; and that economic statistics are available and regularly published.

49. *The central element will be to help the PISG to develop and implement appropriate economic policies and mechanisms that will allow Kosovo to make the best use of declining resources.* The Bank has previously been requested to assist the authorities through analytical work to define sustainable levels of fiscal expenditures over the medium term and their inter-sectoral allocation. This work helped the authorities to frame the 2003 budget. Further assistance will help core economic decision making bodies (such as the Office of the Prime Minister, the Ministry of Finance and Economy, and the Ministry of Trade and Industry) to consider appropriate tariff and trade policies and strengthen VAT administration in order to encourage growth while also sustaining essential government functions. On the expenditure side, the Bank will help PISG institutions to develop a well prioritized, medium-term public expenditure program and, ultimately, an appropriately phased development of an inclusive PRSP. Scope for civil service reform will be considered, given the relatively high proportion of expenditures taken up by public sector wages and salaries. A Public Expenditure and Institutional Review scheduled for early FY05 will underpin this work.

50. *Support will also help to improve public financial management and accountability.* Bank assistance can help the PISG to strengthen budget execution, project management and public procurement to improve service delivery and strengthen accountability across the public service. This is particularly needed given chronic under-expenditure on capital projects. This could also include assistance to promote public-sector transparency and assist local communities to monitor performance of service delivery. A Financial Accountability Assessment and Operational Procurement Review currently under preparation will guide key interventions. Support will need to be provided flexibly to central decision-making bodies, bolstered by assistance to key line Ministries

and municipal authorities. Bank support will be able to assist key Ministries to improve policy formulation and medium-term strategy development; strengthen the budget allocation process; encourage greater transparency and accountability in service delivery; and monitor and evaluate the success of programs. Engagement with particular Ministries will be determined based on: the potential of that sector to contribute to longer-term economic growth in Kosovo; where the Bank is already engaged and will need to maintain a knowledge base for potential future lending operations; and the adequacy of Bank or donor programs to meet the needs of individual sectors. In particular, support for the Ministries of Transport and Communication, and Health may be warranted. Previous Bank assistance in the transport sector has concluded and other donors are also withdrawing, but significant benefits could potentially be achieved from further assistance to strengthen economic prioritization of projects, greater attention to maintenance compared to new investments and the development of an appropriate road user charge. Similarly, there is little donor engagement in the health sector which is also one of the largest in terms of overall public expenditure and which faces many of the same issues confronted by other service delivery Ministries.

51. *Such a program will be developed in close collaboration with other donors.* A wide range of donors are increasing engagement with the PISG on broad governance and public expenditure management issues. The EC is proposing to strengthen assistance for governance activities, with a particular focus on improving the economic policy capacity of the Kosovo institutions, as well as strengthening the development of the public investment program and budget management. The United States has been integrally involved in governance activities, including the provision of technical support for the Ministry of Finance and Economy, as well as other Ministries and the judiciary, and this is likely to continue. UNDP and the United Kingdom are increasingly providing support to improve planning at the central level. The IMF is active in providing macro-economic policy advice. Yet while an increasingly crowded field, there are particular gaps in terms of supporting overall strategic prioritization mechanisms, public expenditure management, and service delivery in particular ministries and municipalities. On the other hand, some areas, such as the development of better national accounts, appear relatively well covered by Nordic and other bilateral donors. The Bank has a strong knowledge base on economic issues in Kosovo from previous engagement and a relative advantage in providing support. Other donors have welcomed Bank engagement in these areas, but close coordination will be crucial. Translating close support at the policy level between the EC and the Bank into integrated interventions particularly appears to offer significant scope to provide coordinated advice as Kosovo moves toward a longer-term future in Europe.

Regional Integration

52. *Given Kosovo's likely long-term future in Europe, interventions will be designed to encourage Kosovo's integration with the region and to ensure that Kosovo moves toward European standards.* Strengthened engagement by Kosovo in regional dialogue, as well as discussions with Belgrade on technical issues such as energy, transport and communications, are also an integral part of the Standards for Kosovo. Bank assistance will help particularly to ensure that Kosovo is able to participate, to the extent allowed by

UNSCR 1244, in the development of the Southeast Europe Regional Energy Market under the Athens Memorandum Framework. A Memorandum of Understanding establishing a Southeast Europe Core Regional Transport Network, which will include Kosovo, was signed in March 2004 and will become operational in September. Support for customs and tariff administration are also integral component of the regional trade and transport facilitation initiative being supported by the Bank in South Eastern Europe, which is also working to ensure the compatibility of technical standards and regulations and facilitating border crossing procedures. The Bank has initiated preparation of a second phase of the trade and transport facilitation program for Southeastern Europe and Kosovo is likely to be included in this program. This will run parallel to the bilateral free trade agreements being developed between Kosovo and several neighboring countries. Scope for GEF financing to support regional environmental issues, including climate change mitigation, land degradation, and pollution of international waters, will also be explored actively.

A Potential Longer-Term Program

53. *The nature of a program beyond June 2005 will depend critically on progress toward final status.* A future lending program is likely to depend on resolution of final status. The size of any possible lending will depend critically on performance by the authorities. In the longer-term, potential IBRD lending to Kosovo will be subject to credit-worthiness considerations. Given the large amounts of SFRY debt current being serviced by Belgrade, Kosovo could well face the same issues as the “gap” countries in the region. Reflecting Kosovo’s development needs, and the Bank’s comparative advantages, a possible future lending program could potentially have a strong focus on investments in: (i) education, which will be critical to give Kosovo’s young population the skills to participate in and benefit from a growing economy; (ii) infrastructure development, which will be important to promote broad-based growth, is an area in which other donors are withdrawing, and will be linked to Kosovo’s efforts to join regional trade, transport and electricity markets; and (iii) continued support in the economic area and for capacity building. Nevertheless, even should discussions on a political resolution be able to begin in 2005, the timetable and outcome of such a process remains uncertain. It could be several years before the Bank will be able to move to a lending program. Any potential grant program beyond 2005 is likely to require continuing very strict selectivity in the interventions the Bank is able to make.

V. RISKS

54. *Critical risks identified in the previous TSS remain, particularly the scope for a resurgence of ethnic tension, limited progress on final status issues and weak institutional capacity and fragmentation among Kosovo institutions.* In general, the overall political and security environment in the region has improved significantly. The democratic transition in SAM and the increased intra-regional cooperation in the framework of the Stability Pact represent clear improvements. At the same time, however, recent violence in Kosovo clearly demonstrates the potential for the security situation to deteriorate significantly and very quickly. There is a particular risk that tensions will

become more evident in the lead up to elections in late 2004. The new Standards for Kosovo provide a renewed impetus to undertake the reform and institutional strengthening that will be needed to move toward a resolution of final status issues. Similarly, the coalition government has proved relatively resilient, although fragmented decision making between different interests within the Government is evident. Nevertheless, tensions between UNMIK and the PISG persist despite the continuing transfer of responsibility. Overall, the possibility of renewed ethnic tensions, the economic uncertainty created by a prolonged impasse on final status issues, declining donor resource flows to Kosovo, and the potential for reform to slow during the forthcoming election period, pose considerable risks to the fragile economic and social gains that have been made.

55. ***To manage risks, Bank assistance will focus strongly on building institutional capacity and will be sequenced to ensure that there is appropriate ownership of the program by the Kosovo Government.*** Building institutional capacity will continue to be a central theme, and strengthened efforts will particularly be made to ensure the sustainability of the current program. To manage political uncertainty in the lead up to elections in late 2004, the main interventions outlined in the TSS will be phased so as to allow full discussion with any potential new Government that may emerge following elections before activities commence. In a charged political environment, the Bank will also continue to make every effort to ensure that the activities benefit all communities in Kosovo and to build support for Bank engagement across all parts of society.

56. ***While the existing program has performed strongly, the greater focus outlined in the current TSS on inherently sensitive issues, such as economic reform, privatization, and reform of the mining and energy sectors, represent a high risk/ high reward approach.*** The Bank's global knowledge base gives it a comparative advantage in engaging complex and sensitive areas, but this will require a greater tolerance of risk as well as the careful development of interventions in order to manage risk.

57. ***Fiduciary risks will be managed by "ring-fencing" Bank activities, as well as by efforts to build capacity.*** Current Bank activities in Kosovo have been implemented by separate management units that have ensured high fiduciary standards, and this is intended to continue for the immediate future. Efforts to build fiduciary and procurement capacity among the PISG will continue, informed by an Operational Procurement Review and a Financial Accountability Assessment. In the longer-term, fiduciary safeguards will need to be strengthened sufficiently across the board to ensure that systems are in place for Bank projects to be implemented in the same way as domestically financed activities. This process will, however, need to be appropriately phased in order to manage financial risks.

James D. Wolfensohn
President

By Shengman Zhang
Managing Director

Washington, D.C.
March 18, 2004

Kosovo
Selected Economic and Social Data

Area	11 000 square kilometers
Population	1.892 million (estimate)
Life expectancy at birth	71 years (males); 76 years (females)
Total fertility rate	2.6 births
Poverty:	
• Population in extreme poverty, under food poverty line (2100 calories)	14.9%
• Population living under full poverty rate (US\$ 1.65 per day)	36.3%

National Accounts and Balance of Payments Data

	2000	2001	2002	2003*
<u>Key Economic Indicators</u>				
GDP (US\$ million) ¹	688	1,032	1,203	1,486
Real GDP growth rate (% in local currency) ²	-	21.2	3.9	4.7
GDP per capita (US\$)	380	560	640	790
GDP per capita (local currency – Euro)	410	630	680	700
Inflation (in %)	-	11.7	3.6	0.0
Investment (in % of GDP)	66.9	57.7	48.3	39.8
Private investment (in % of GDP)	33.4	38.2	37.4	30.2
Consumption (in % of GDP)	298.6	214.7	199.4	185.2
Private consumption (in % of GDP)	181.2	132.8	125.8	121.0
<u>Balance of Payments</u>				
Exports of goods and services (in % of GDP)	0.5	3.0	7.4	8.2
Imports of goods and services (in % of GDP)	207.4	130.1	115.4	105.5
Trade balance (in % of GDP)	-206.9	-127.2	-108.0	-97.4
Net transfers from abroad (in % of GDP)	226.2	143.0	105.9	87.1
<i>Of which</i> Private Transfers	73.7	52.0	42.9	43.2
Foreign Assistance	152.5	91.0	63.0	44.0
Current account balance (before grants, % GDP)	-174.6	-110.2	-96.5	-76.9
<u>Consolidated Government Operations</u>				
Kosovo general budget revenue (in % of GDP)	17.2	28.0	38.9	44.8
Kosovo general budget expenditure (in % GDP)	31.5	24.4	33.5	43.4
Kosovo capital expenditure (budget, in % GDP)	2.3	1.8	3.3	7.4

Sources: IMF, CFA/MOFE, Staff estimates

* 2003 figures are preliminary estimates

¹ IMF/World Bank staff estimates, based on population of 1.9 million, excluding displaced persons or refugees living outside Kosovo. Calculations are based on current prices and exchange rates.

² Annual real GDP growth rates are calculated in local currency (Euro) adjusted for inflation. These calculations exclude exchange rate movements evident when GDP figures are converted to USD.

**Indicative Assistance Program for Kosovo
January 2004 to June 2005**

Grant Financing

Quarter 3 FY05

Business Environment and Rural Enterprise Project	\$7.0 million
Energy and Mining Technical Assistance Grant III	\$2.5 million
Economic Policy and Public Expenditure Management Project	\$5.5 million
TOTAL	\$15 million

Analytical Work

Kosovo Economic Memorandum: Source of Growth (expected completion April 2004)

Kosovo Operational Procurement Review (expected completion May 2004)

Kosovo Operational Financial Accountability Assessment (expected completion June 2004)

Kosovo Poverty Assessment (expected completion of first phase in June 2004, and second phase in June 2005)

Kosovo Public Expenditure Review (expected completion quarter 1 2005)

Grant Program to Kosovo: A Preliminary Assessment of Performance

Grant Program for Kosovo (CY01-04) A Preliminary Assessment

This Annex summarizes achievements of Bank-financed projects in Kosovo during the two and a half years since the inception of the program. The operations, many of which are still under implementation, have supported three main objectives: (i) economic reform and institution building; (ii) encouraging broad-based growth, job creation and income generation; and (iii) rehabilitation of infrastructure and service delivery.

I. Economic Reform and Institution Building

Budget Support Grant (US\$ 1.0 million. Approved in CY99. Closed)

Objective: To support the restart of education and health services through financing the employment of teachers and health workers.

Achievements:

1. The grant was instrumental in helping the prompt restart of key social services.
2. It also supported the kick-start of the budget preparation process following the conflict.

Economic Assistance Grant I (US\$ 5.0 million. Approved in CY00. Closed)

Objectives: To support the creation of a fully functioning and effective (i) budget management system; and (ii) bank licensing and supervision capability.

Achievements:

1. The newly-created Central Fiscal Authority (CFA) made good progress in designing and implementing the Kosovo budget. The CFA has been in charge of: (i) budget preparation and monitoring; (ii) execution of budgetary transactions and their financial control; and (iii) formulation of tax policy, and management of tax and customs revenues.
2. The Banking and Payments Authority of Kosovo (BPK) was established at the end of 1999, and legislation for bank licensing, regulation and supervision then followed. As of March 2002, BPK had issued 7 licenses to newly established banks.

Economic Assistance Grant II (US\$ 5.0 million. Approved in CY01. Closed)

Objectives: To support (i) the formulation of a sustainable 2001 budget increasingly financed by local taxation; and (ii) the establishment of a liberal trade and customs regime.

Achievements:

1. A basic tax system relying on tax collection at the border was introduced.
2. The share of donor funding in total revenues was reduced from 48% in 2000 to 21% in 2001.
3. A liberal trade and customs regime was maintained. However, the full elimination of tariffs at the time of the introduction of the VAT did not take place because of revenue considerations.

Economic Assistance Grant III (US\$ 5.0 million. Approved in CY01. Closed)

Objective: To support the development of the private sector through the introduction of the first package of commercial regulations.

Achievements:

Assistance was provided in the drafting and discussion of the following key regulations, which were then approved by UNMIK:

1. Regulation on Contract for Sale of Goods;
2. Regulation on Foreign Investment;
3. Regulation on Pledges;
4. Regulation on Business Organizations.

Economic Assistance Grant IV (US\$ 5.0 million. Approved in CY03.)

Objectives: To assist Kosovo in the implementation of a structural reform agenda aimed at enhancing medium-term macro-fiscal sustainability, sustaining adequate public service delivery in the face of declining donor support, and promoting private-sector driven growth.

Achievements:

The project became effective on November 20, 2003. All the tranche conditions have been met prior to Board approval.

1. The 2004-2006 macro and revenue framework were agreed by the SRSB and used in the development of 2004 budget. The SRSB promulgated a regulation to establish the Audit office and an Auditor-general has been recruited.
2. A review of the pay, employment and civil service structure is underway and due to be completed by the end of the year. Local counterparts have been recruited and are working alongside the international contractors.
3. Roll-out to Treasury system to Municipalities has begun. External audits for 2000, 2001 have been completed.
4. The Law on Public Procurement was passed by the Assembly.
5. The Assembly passed the laws on mortgages, bankruptcy, and property rights registration.
6. The Private Sector Advisory group (PSAG) has been established and the business registry is operational and arrangements are in place for regular sharing of data with the Tax Administration.

II. Broad-Based Growth, Job-Creation and Income Generation

Pilot Line of Credit for SMEs (US\$ 5.0 million, and co-financing of US\$ 5.0 million from the European Agency for Reconstruction – EAR. Approved in CY00.)

Objectives: To support (i) the jump-starting of production through a line of credit for small and medium size enterprises (SMEs); and (ii) capacity building in the financial sector.

Achievements:

1. The Interim Credit Unit disbursed more than 60 loans for a total value of about Euro 7.6 million.
2. About 1200 new jobs were created directly in various sectors (e.g. building materials industry, food processing, production of furniture, textiles, and PVC materials) with significant economic impact.
3. The project also helped establish basic credit management capacity and loan administration skills in newly emerging banks by providing training and technical assistance for credit analysts and bankers.
4. The team implemented a successful exit strategy for the IDA-funded credit line. Through a competitive auction open to all the commercial banks licensed in Kosovo, ICU sold the IDA-funded portion of the outstanding loan portfolio to a reputable bank and at a very fair price as it represents 30.8% of the total outstanding portfolio or 89.4% of the performing loans. Total proceeds accruing to the Kosovo Consolidated Budget from the Project amount to about Euro 3.6 million representing 77% of the total amount of the funds disbursed under the Grant.

Private Sector Development TA (US\$ 3.0 million. Approved in CY01.)

Objectives: (i) to support the establishment and operation of a modern business registry system; (ii) to strengthen the capacity of the Commercial and Supreme Courts and improve the quality of legal services; (iii) to assist in the development of basic accounting standards, provide training for local accountants, and assist the establishment of an association of accountants.

Achievements:

1. The re-registration of businesses at the New Business Registry is still under way. As of mid-November 2003 about 15,000 businesses have been registered or re-registered in compliance with the relevant Administrative Instruction 2002/22.
2. A CD containing the complete database for legal entities is updated on a weekly basis and made available to the Fiscal Administration.
3. In the period between April 2002 and November 2003, a total of 850 persons have received training in accounting.
4. On November 13, 2003, SCAAK (Society of Certified Accountants and Auditors of Kosovo) became an associate member of the International Federation of Accountants.
5. All the judges at the Supreme and Commercial Court levels have been receiving training on commercial legislation such as Property Registration Law, Bankruptcy Law, Business Organization Law. The training is still underway.

Energy Sector TA (US\$ 2.5 million. Approved in CY01.)

Objectives: To support long-term strategic energy decisions, by preparing, disseminating and discussing a comprehensive study on future energy demand and supply. The study analyzes available energy options and assesses future physical investment needs in the energy sub-sectors. It also examines the internal organizational structure and operations of the energy companies and makes recommendations to improve efficiency.

Achievements:

1. First drafts of all thirteen modules have been prepared and are under review.
2. During preparation of the report, the Kosovo Electric Company (KEK) has been closely associated with the work of the consultants, and its staff has received hands-on training on the use of state of the art techniques and software instruments.

Energy Sector TA 2(US\$ 1.5 million. Approved in CY03)

Objectives: To assist Kosovo in (i) developing capacity for a commercially sustainable exchange of power with the regional system, and optimizing utilization of existing generation capacity through economic dispatch; and (ii) developing a framework for attracting private sector investment in the energy sector.

Achievements: Implementation Progress

The project has three components:

1. A feasibility study for a 400 kV transmission inter-connection between Albania and Kosovo. Consultations among Albania, Kosovo, and the potential lenders of the transmission line, have been concluded in November 2003, and scope of work of the consultants finalized. Request for Proposals will be issued to the short-listed bidders soon.
2. A detailed feasibility study for establishing a dispatch center in Kosovo.
3. Developing a framework for attracting private sector investments in the energy sector. Request for Proposals will be issued to the short-listed bidders soon. For the other two components, proposals have been received from the consultants and evaluation reports received by the Bank for its no objection.

III. Rehabilitating Selected Infrastructure and Improving Service Delivery

Education and Health Project (US\$ 4.4 million. Approved in CY00)

Objectives: To rebuild and restructure the governance, finance and administration of Kosovo's education and health systems.

Achievements - Education component:

The project has supported, inter alia:

1. An education funding system based on a per student funding formula and devolution of ear-marked block grants for education to Kosovo's 30 municipalities which has been adopted as a method for the preparation and justification of the annual budget of the Ministry of Education.
2. The formulation of the new Higher Education Law and the new university statute which has been adopted by the new assembly and has been signed by UNMIK.
3. The development of adequate capacities for setting and monitoring education standards and adequate dissemination of the results.
4. The formulation of a new General Education law which has been adopted by the Assembly and ratified by the UN Special Representative of the Secretary General. The Ministry of Education has issued several instructions on the role of the municipalities, the status, selection and role of school directors, as well as the structure and role of school boards.

Achievements - Health component:

The Project has supported the Department of Health and Social Welfare and its successor authority, the Ministry of Health in the development of an interim sustainable and affordable model for the financing of health care. To this end, the project has supported the:

1. Development and evaluation of an interim health care financing strategy.
2. Development of a model for planning and securing health sector funds.
3. Designing and monitoring of the implementation of a co-payment system.
4. Identification of priorities for public financing of health care.
5. Design of cost effective resource allocation and provider payment mechanisms.
6. Development of the organization and governance structures.
7. Training and capacity building of the staff of the Health Care Financing Structure (HCFS).
8. Development and implementation of public information and communication activities.
9. Development of options for private financing and private provision of health care in relation to the public sector
10. Development of a health and finance information strategy.

Community Development Fund (US\$ 5.0 million, and co-financing of US\$ 6.0 million from the Netherlands, and US\$ 1.2 million from Switzerland. Pilot phase, financed from a Post-conflict grant and some donor resources, approved in CY99; the scaled-up operation approved in CY00.)

Objectives: To support (i) small-scale infrastructure and social services projects in communities with a high incidence of conflict-related damage and poverty; and (ii) institutional capacity building at the community and municipal level in order to improve the sustainability of service delivery and increase civic participation.

Achievements:

1. The project has targeted poor communities in all regions of Kosovo responding to community priority needs through the 182 community infrastructure works including road reconstruction, cultural centers water supply, sewerage, school rehabilitation and social services; 76 social services and 11 technical assistance projects.
2. In-cash contributions from communities as of end October, 2003 totaled 2,7 million Euro. An estimated 170,000 Euro was contributed by the communities in the form of labor. A total of 93 contractors participated in the projects and the completed works projects generated a total of 99, 620 job days.
3. 175 community meetings were organized, with approximately 1,750 members attending. On average, communities have contributed 19% of total project costs (above the prescribed 15%). 10% of the portfolio is in mixed/minority communities.
4. With regard to communities, capacity building activities focused on training project committee members in preparing project proposals, developing business plans, as well as contractors in monitoring and supervising project activities: 5 special training programs were carried out in operations and maintenance which benefited the communities of 12 villages in water supply projects, 5 villages in sewerage projects and 12 villages in road projects.

Emergency Farm Reconstruction Project (US\$ 14.7 million, and co-financing of US\$ 1.8 million from the Netherlands, US\$ 1.4 million from Italy, and US\$ 1.0 million from Sweden. The preparation grant and the first operation were approved in CY00. Supplemental Bank financing was approved in CY01.

Objectives: To support the re-launching of the rural economy through (i) investing in key farm assets (distribution of cattle, and farm mechanization) in conflict affected areas, supporting vulnerable groups; (ii) providing key agricultural services; and (iii) building institutional capacity for effective policy making.

Achievements:

1. 4,400 pregnant heifers and 92 bulls were distributed to selected beneficiaries in 5 municipalities as well as minority areas. In value terms, the resulting milk production increased the family income of beneficiaries by an estimated US\$90 per month. As 70% of the milk is consumed in the households, the increased availability of milk to the vulnerable families (one selection criteria relates to the number of children under the age of 8 in the family) assures adequate nutrition for children. The milk sales contributed to family income.
2. More than 2,400 tractors were repaired in 13 municipalities, and 202 new tractors with implements were distributed in 5 municipalities and minority areas, serving about 6,000 beneficiaries (one distributed tractor serves 30 beneficiary families). Beneficiary selection was based on full community participation.
3. Equipment and drugs, as well as training were provided to 106 veterinarians. The number of free visits by veterinarians, as a cost recovery mechanism, amount to around 10, 000.
4. Capacity building support was provided to the Ministry of Agriculture, forestry and Rural Development on key rural development issues. A strong participation and training of local staff was achieved. The capacity support resulted in the drafting of the 'Green Book' – the Ministry's strategic document for rural development

Pilot Water Supply Project (US\$ 4.6 million. Approved in CY00.)

Objectives: To support the reform of the Radoniqui water system, by (i) financing urgent repairs to infrastructure; (ii) demonstrating the viability of private sector participation in the provision of water supply services; and (iii) developing a model for integrated water resources management for Kosovo.

Achievements:

1. Consistency of improvements of the water service quality, technical, commercial and financial management of the company.
2. The private operator has surpassed all the targets, such as collection ratio, customers metered, customers billed, computerized financial and billing management system and others during all 4 contract semesters.
3. The Radoniqui water company is creating sustainability of the water services quality to the customers, and of the financial operational efficiency of the company.
4. Eliminated the need for continuing central budget financing for the operations and maintenance costs of the water company, and demonstrated the improvements possible in water supply through private sector participation.

Social Protection (US\$ 4.2 million, and co-financing of US\$ 2.570 million from the UK. Approved in CY01.)

Objectives: To support (i) the design of a basic safety net for the immediate future; (ii) the design of a sustainable social welfare system for the medium term; and (iii) the development of an adequate administrative capacity for delivery of pensions, and veterans' and invalidity benefits.

Achievements:

1. Over the past 6 months the Ministry of Labor and Social Welfare has completed the transfer of responsibilities from UNMIK international staff to the local Ministry staff.
2. Nearly all major contracts under the project have been signed (38 contracts have been signed and of those 23 are fully completed).
3. Technical assistance is in place to assist the MLSW with institutional capacity and policy development and another technical assistance contract is in place for the training of current and future social workers.
4. Sixteen Centers for Social Welfare have been renovated to serve the population and equipment has been provided for all CSWs and equipment for mobile teams to serve populations that cannot reach CSWs.
5. Information technology support has been installed in the Ministry of Labor and Social Welfare to set up a monitoring system for social assistance provision and social services.
6. The project has provided support to the design of a new pension system for Kosovo, based on citizen's pension and advance funded scheme, and it is now supporting the implementation of the plan. An invalidity system is now being developed

Urgent Road Project (US\$ 5.0 million, and co-financing of US\$ 28.0 million from the EAR, US\$ 7.2 million from Germany, US\$ 7.0 million from the Netherlands under Bank management, and US\$ 0.9 million from France. Approved in CY00.)

Objectives: To support: (i) the re-establishment of a road management capacity; (ii) emergency road maintenance activities on the main network; and (iii) restoration of a local contracting capacity for road/bridge rehabilitation and maintenance.

Achievements:

1. Core road administration was re-established with a Road Infrastructure Division (9 staff), and a Directorate of Roads (45 staff), and training was provided. The Road Infrastructure Department has prepared a new strategy to further strengthen the capacity of the Road Administration. Implementation of this strategy is underway.
2. 570 km of road maintenance have been executed as well as two bridges (under the Bank/Dutch funding of \$12 million).
3. Several contracts financed through the Grant were awarded to local contractors and were successfully implemented, although local contractor capacity is still limited. All fund (\$7 million under the Dutch TF and \$5 million of the Bank Grant) are exhausted.
4. The project has functioned as an efficient coordination mechanism among donors.
5. Significant progress has been made but sustainability remains however an issue, especially because donors are phasing out their support.

Education (US\$ 4.6 million. Approved in CY03.)

Objectives: To improve educational attainment at primary and secondary education levels and to enhance access of vulnerable groups to education.

Achievements:

1. As a result of the project, dropout, survival and attendance rates will improve in the targeted groups. In addition, schools will also be able to plan, manage and monitor school based initiatives. Municipalities and the Ministry would also have capacity to monitor access to education.

Donor Support for Reconstruction and Recovery in Kosovo

Donor assistance to Kosovo from 1999 until the end of 2003 has been provided under the broad framework of a reconstruction and recovery program presented to donors by the European Commission and the World Bank in November 1999. The strategy outlined had three main objectives: (i) developing a thriving open and transparent market economy; (ii) restarting public administration and establishing transparent, effective and sustainable institutions; and (iii) mitigating the impact of the conflict and addressing the legacy of the 1990s¹.

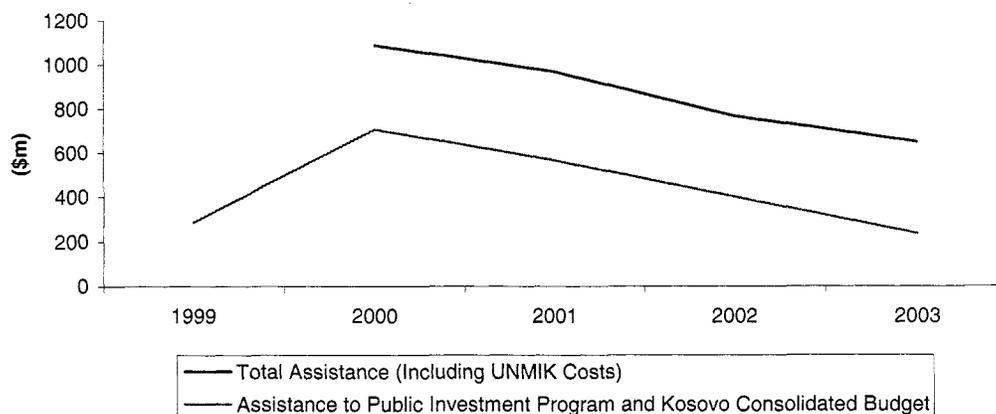
The cost of the reconstruction and recovery program was estimated at approximately \$2.3 to \$2.4 billion for the period until the end of 2003, with significant capital-intensive investments, particularly for housing, energy, water and solid waste. The program also placed a strong emphasis on private sector development and the rehabilitation of agriculture. Donor meetings were jointly chaired by the European Commission and the World Bank in July and November 1999, February 2001 and November 2002 to take stock of progress, encourage coordination, and to share information on assistance priorities and future needs.

Donors responded generously to promote the reconstruction and recovery program in Kosovo. In total, donors have disbursed over \$3.5 billion to the end of 2003 to support reconstruction and recovery (excluding KFOR costs, but including UNMIK). Direct contributions to the budget and to the public investment program (excluding UNMIK costs) have amounted to over \$2.2 billion. The immediate reconstruction and recovery needs have been financed. Overall, the emergency recovery and rehabilitation phase in Kosovo has essentially finished, with considerable achievements. Close to 50,000 houses have been rebuilt or rehabilitated, providing homes to about 300,000 people. More than 1,400 km of roads have been rehabilitated, improving economic activity and access to markets for all Kosovars. Agricultural production has increased, with wheat production almost doubling since 1999 to now meet two thirds of domestic needs. There has also been a promising start in the delivery of social services. Urgent infrastructure needs have largely been met, including the reconstruction of 80% of rural health clinics, a large number of schools, and extensive work on water distribution and sewerage infrastructure. Attention is now focusing on ensuring that appropriately trained teachers and health workers can provide quality services.

Reflecting the success of the immediate recovery phase, as well as other international priorities, donor assistance to Kosovo is now beginning to slow. After reaching a peak of about \$700 million in 2000, disbursements in 2003 (excluding UNMIK) have fallen to a still very substantial \$240 million. As the post-conflict transition continues, disbursements in 2004 are anticipated to amount to approximately \$200 million (see chart 1). This pattern of disbursements is similar to other post conflict environments. Nevertheless, in order to consolidate the significant gains that have been achieved over the past four years, it will be important that Kosovo's outstanding needs be reflected in continuing future donor allocations for Kosovo.

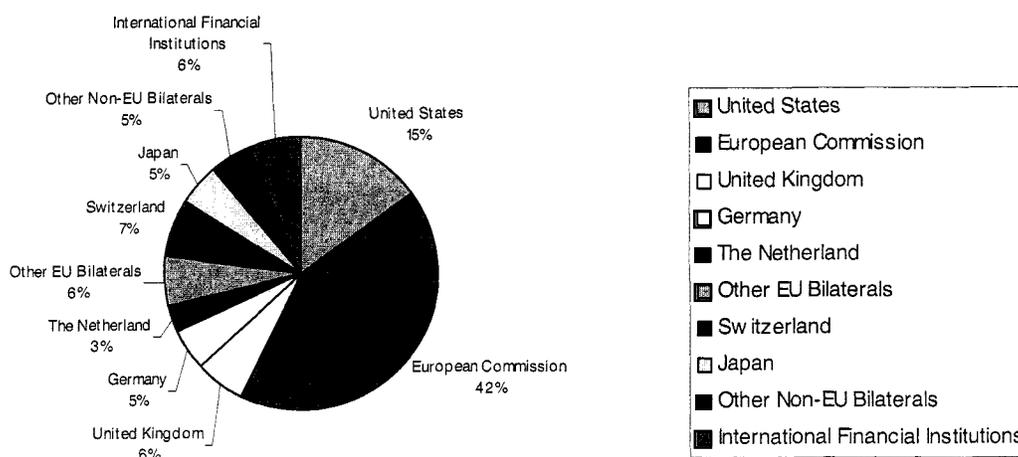
¹ *Towards Stability and Prosperity: A Program for Reconstruction and Recovery in Kosovo*, November 3, 1999. While this program has provided the overall framework, annual Public Investment Plans have been developed by the authorities as part of the budget preparation process. Further details on this program, as well as the outcomes of Donor Conferences, and financial flows to Kosovo is made available by the Joint EC - World Bank Office and can be found at www.seerecon.org.

Chart 1. Donor Disbursements to Kosovo



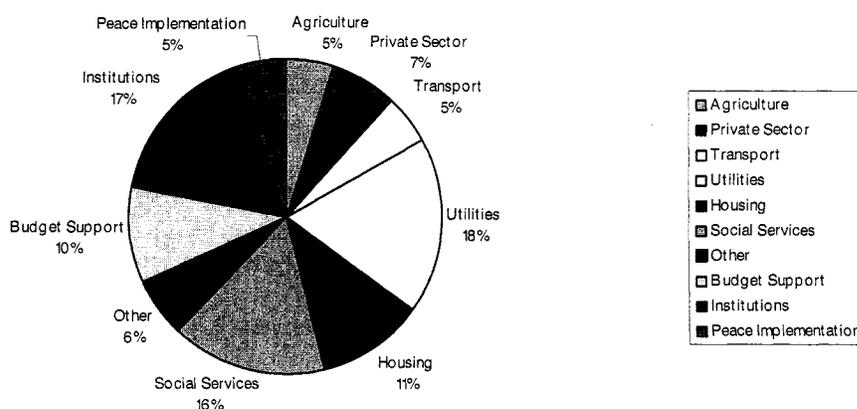
Over 30 donor governments and international agencies have been involved in the reconstruction effort. The single largest source of funds has been the European Commission and EU member states, which collectively have provided approximately two thirds of all assistance to Kosovo. EC support alone accounts for about 40 percent of total assistance. The US has been the second largest single donor, contributing about 15 percent of total funds, while non-EU bilaterals – especially Japan and Switzerland – have also contributed substantially to the reconstruction effort. With declining disbursements, the pattern of donor engagement is starting to change – and the United States is particular starting to assume a relatively more prominent role in donor flows. Reflecting Kosovo’s inability at this stage to borrow, the contribution from the international financial institutions, while significant, has been proportionately less than might otherwise have been anticipated.

Chart 2. Donor Contributions to Kosovo



The vast bulk of donor commitments have been allocated to improving public utilities, especially electricity, and to strengthening Kosovar institutions. Social services (including education, health and water supply), housing reconstruction, agriculture, transport and private sector development have also been key features of the donor reconstruction effort (see chart 3).

Chart 3. Donor Support by Sector



The structure of donor support is changing as a result of the transition from the reconstruction phase progresses, as donor flows decline, and as many of these responsibilities are assumed by the Kosovar authorities and financed through the budget. While elements of the reconstruction and reconciliation process remain, donor support housing and peace building initiatives will continue to decline. Similarly, while energy and appropriate infrastructure remain significant issues for Kosovo's longer-term development, these aspects of Kosovo's development program will be increasingly financed through the budget.

Support for institution building is likely to take up an increasingly large proportion of donor resources. This is consistent with the strong emphasis placed in the Standards for Kosovo on strengthening local institutions and on improved economic and budget management as well as service delivery. The EC especially is proposing to strengthen assistance for governance activities, with a particular focus on improving the economic policy capacity of the Kosovo institutions, as well as strengthening the development of the public investment program and budget management. The United States has been strongly involved in governance activities, including the provision of technical support for the Ministry of Finance and Economy, as well as other Ministries and the judiciary, and this is likely to continue. Nordic donors have been supporting the Kosovo Statistics Office. UNDP and the United Kingdom, through DFID, are increasingly providing support to improve planning at the central level. And the IMF is active in providing macro-economic policy advice. Given the significant needs in Kosovo, and the Bank's comparative advantages, there continues to be room for continued Bank support for strengthening economic planning, budget prioritization and public expenditure management – although the emphasis will shift from policy dialogue associated with budget support to technical assistance and institution building. Close collaboration with other donors as well as the Kosovar authorities will, however, be even more critical in developing appropriate interventions in future.

MAP SECTION

