

**KOSOVO/A CIVIL SOCIETY PROJECT**

**KOSOVO/A STANDING TECHNICAL  
WORKING GROUP: 5<sup>TH</sup> AND 6<sup>TH</sup> SESSION**

**ECONOMIC DEVELOPMENT  
AND RECONSTRUCTION**

Robert Curis and Camille Monteux

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## **I. Introduction**

The Standing Technical Working Group was established in March 2001 to address important issues of public policy in Kosovo/a at a technical level. It is composed of experts from Kosovo/a NGOs, from the parties and other civil society representatives. Its membership is fully interethnic and it prides itself on being able to conduct substantive debates about Kosovo/a in an interethnic way. In addition to reviewing technical aspects of policy, the group also formulates proposals and critical questions in relation to them. It then seeks to engage the international and Kosovo/a authorities on these issues. As the 5<sup>th</sup> and 6<sup>th</sup> session of the group were devoted to one common theme, it was found convenient to present the proceedings in one report.

## **II. Proceedings of the 5<sup>th</sup> Session of the Standing Technical Working Group**

At its 5<sup>th</sup> session of 27 October, the Standing Technical Working Group commenced its deliberations on economic issues. Given the complexities of this area, the Steering Committee of the Group had requested strong support through international and local experts for its deliberation and it was decided to devote two plenary sessions to this topic. Hence, the October meeting, attracting an attendance of around 40, including around 30 permanent members of the group and reflecting all ethnic communities in Kosovo/a, assumed a form that was somewhat different from the other sessions. There was a greater emphasis on presentations by local and international experts. A special focus was placed on small and medium enterprises – a topic of particular concern to participants. The meeting commenced with a presentation by Dana Eyre, Senior Policy Advisor, outlining UNMIK Pillar IV's policies for the promotion of small and medium enterprises. Ronald Ashkin of Kosovo Business Support also addressed practical issues of establishing and maintaining small business in the special environment of Kosovo/a. Iza Mustafa of Riinvest addressed tax policy and business development, followed by the issues of business registration addressed by Alexander Dardelli of the Department of Trade and Industry. Dr Muhamet of Sadiku then presented a paper on locating sources of finance for small and medium enterprise development. The following account summarizes these presentations and the responses thereto in an informal way. It has not been approved by participants.

## A. Business Planning

*Ron Ashkin, Chief of Party of the Kosovo Business Support, started the session with a presentation providing a global picture of the economic situation in Kosovo/a and different general issues relative to the implantation of SME.*

The emphasis of the presentation rested in the importance of planning in the development economy, which until now has been crucially lacking in Kosovo/a. It was emphasized that if Kosovo/a wants to develop its economy, it has to join the global free market which leads the world economy. However, Mr Ashkin underlined that if this is a basic requirement, it is not the only one. If Kosovo/a is to integrate with the global free market, there is still no guarantee that the economic situation will improve. In order to achieve success, there is a crucial need for the Kosovar community to be proactive and work towards its success. The community has to bend to the rules that govern the market, fixed by supply and demand, in order to achieve sustainable results.

The reasons for the adoption of the global free market lie in the situation of the Kosovo/a economy. Currently, the motor of the economy heavily relies on external factors. However, in the near future, the changes undergone by those motors will have a major impact on the economy. Already, some of those changes can be observed. Donors, who represent a high percentage of investors, will progressively withdraw, as their attention will be brought to different areas. In the same way, the Diaspora savings will slowly dry up. Mr Ashkin here again underlined that it was up to the Kosovars to react in accordance with those changes and take initiative to determine their own economic future, and minimize the exterior factors' impact on the local economy.

With this observation in mind, two lines of action can be adopted: either to join the global market and accept to follow its rules or resist them and remain an outsider, which, Mr Ashkin claimed, would be like leading Kosovo/a into a pariah status. In order to join this global market, certain issues would need to be addressed: the principles of integrity, transparency, arm's length transactions and rejection of corruption, hidden agendas, unreported transactions, multiple sets of accounting books, etc.

To achieve this goal, a need for change is urgent and should be acknowledged so that fundamental steps can be pursued. A need of urgency should be established, then a leadership team should be nominated and agree upon a vision before communicating this vision to all. It was agreed that this 'vision' should be a high level, mutual, shared and indigenous concept of the future, from which every person in Kosovo/a would benefit.

When the vision is determined, need for action is essential. A so-called casual link between the behavior and the desired result must be drawn. Mr Ashkin insisted that an excellent implementation of a mediocre plan is far better than a mediocre implementation of an excellent plan. However, it was agreed that to achieve this task, full responsibility and accountability should be assigned as much for the actions as for the results. Deadlines need to be set and respected as well as follow up mechanisms (audit, inspection).

In conclusion of this session, Mr Ashkin insisted on the idea that a plan is only good if implemented. Therefore, actions should be taken quickly as time was the enemy of the desired impact. The economic situation of Kosovo/a is changing rapidly and therefore all conditions must be put into place for the Kosovars to finally take their economic destiny in their hands.

## B. Tax policy and Business Development

*The second presentation aimed to introduce an essential aspect of the necessary environment for the development of SME.*

Iza Mustafa introduced his presentation on taxation policy through a comparison of tax reforms in states in transition. From this comparison, it appears that such states tend to be less conservative in their choice of reform. They concentrate their attention on VAT, personal income taxes and corporate income taxes.

According to Mr Mustafa, in order to enhance economic revitalization, certain elements need to be pursued such as a market economy, the development of SMEs, development of means to attract foreign investments, ownership transformation and the adoption of adequate fiscal, monetary and credit policy. In addition, basic fiscal principles such as efficiency, commitments, equality, stability, political and social reasons need to be observed and pursued.

He drew the attention of the participants to certain external economic transitional conditions common to each model of transition: a poor public sector, high financial needs, poor tax administration, and the need of harmonization with the European Union. In addition to heavy problems of macroeconomic stabilization there are additional factors, including price increases, regulation of fiscal imbalance which generates the problem of real income decrease, increase in subvention and transfer requests, decrease in employment and life standards, regulation of international debts and those of the budget itself.

Finally, he highlighted several important elements of the initial financial income of states in transition: lack of import taxes, which are not executed on importation of raw materials or, equipment for foreign investors in order to promote their implementation in the state; parallel to this, promotion of income tax exemptions for reinvested incomes and income realized in the first year of business; investment in agriculture and tourist economies in the underdeveloped regions and special economic zones.

The presentation then turned to the particular case of Kosovo/a. It soon appeared that a lack of a development strategy, in parallel with a lack of macroeconomic indicators, financial instruments, inadequacies in the custom system, and records of transactions (i.e.; hand to hand transactions) promote the inefficiency and inability to implement a sustainable tax system.

However, a number of elements do play a positive role in relation to the installation of an efficient tax system, such as the adoption of the DM/ EURO, ensuring monetary stability and sparing finances from a number of inconveniences such as exchange expenses and excessive inflation. In addition, the international institutions are putting into place a number of tax instruments, such as VAT, income and salary taxes (as from 1 January 2002), property taxes, etc. This will slowly enable the tax system to improve and achieve sustainability.

The debate on these issues was wide-ranging. Given the positive example of other states in transition and the general situation in Kosovo/a, a number of concerns were raised from different standpoints. From a business point of view, concerns were raised as to the implication of factors such as the lack of adequate laws to determine certain aspects of taxation and the uneven implementation. There is also the problem of unfair competition. In the same way, the lack of financial resources to implement those laws highlighted the vicious circle of the process. Finally, the tax system itself

was criticized and especially the linear character of the tax installed. Criticism then turned to issues related to the relation between the central and local government. There appeared to be a clear need for the clarification of competencies, the development at different levels of macroeconomic regulations as well as the need to reinforce fiscal instruments of the local governments.

The issue of fiscal evasion was then approached. A number of practices were denounced and condemned such as the preferential treatment of goods imported from the Former Yugoslav Republic of Macedonia in contrast to those transiting through that state. The abuse of unofficial border crossings was also pointed out, as well as the widespread practice of the use of forged tax and custom exemptions and the existence of administrative loopholes.

In conclusion to the session, Mr Mustafa attempted to summarize the discussion through the elaboration of a list of tax policy objectives that Kosovo/a needs to focus on. In this list the highest priority again came from the pressing need for the harmonization of the business community. Once that has been achieved, it would be possible to establish policies to address urgent issues such as development needs, need for the encouragement of large investments, for the enhancement of fiscal discipline, for fiscal and market equality and finally the need to widen the tax base.

### C. Business registration and business development

*The next presentation focussed on the legislative aspect surrounding SME development, providing information regarding the state of legislation in the field, the needs to be covered and finally presented the institutions set in place for the practical implementation of the legislation. As was made clear through the development of this presentation, legislation is vital to the development of the economy, due to its essential role of confidence building in the economy.*

Mr Aleksander Dardelli from the Department of Trade and Industry started with a presentation of the legislation attached to the development of the market economy. He pointed out that the rewriting of legislation regarding that field was essential for the transition to a market economy. The leading principle driving the drafters should be to apply the best practice of other countries' legislation in an adequate manner in order to include issues such as the local business culture and needs. He emphasized

the importance of the legislation in areas such as trade, where it influences transactions, and where it makes them foreseeable and turns actual processes such as hand to hand transactions into long term market exchanges.

However, it was pointed out that the legislative aspect of the market did not only include legislation regulating practices but also regulations to enable the set up of implementing mechanisms such as regulations concerning market associations (e.g., UNMIK regulation 6/2001). This regulation lays down the different nature of acceptable market associations to set out the different needs of the economy in different form all regulated by law.

Another sector of economic activities where the development of legal structure is needed is the sector of mortgages. In this specific case, the legislation defines ways in which the mortgage on property is created and executed, as well as questions relative to the application to third persons. In addition, UNMIK regulation 5/2001 regulates the creation of institutions to implement those laws through the establishment of a mortgage register which enables people in Kosovo/a to use all forms of non-real estate property as a mean of loan guarantee.

However, there remains a real need in the field for additional action around mortgages such as loan insurance where a draft regulation has been waiting to be adopted for some time.

The discussion that followed upon this presentation focused not only on specific elements of legislation, but also the time-consuming process of generating it. It was regretted that draft laws regarding pressing issues were still to be adopted, waiting for the technocratic paper work to be completed.

#### D. Financing small and medium enterprises

*The final session aimed to introduce participants to notions of SME sources of finances in order to enable them to understand policy mechanisms that lie behind SMEs development.*

Dr Muhamet Sadiku introduced his presentation with an overview of the role of SMEs in the economic development of Kosovo/a. From the available statistics, it appears that, for the past two years, micro and small enterprises form the essential backbone of Kosovo/a's economic activity. This phenomenon appears at different

levels, from the number of enterprises created to its contribution on the employment market and percentage of the GDP. However, there seems to be also an imbalance as half of those enterprises are concentrated in the field of trade while only one third are dedicated to industry and production. This element explains the present massive external trade imbalance.

Regarding the environment in which SME develop, a number of characteristics arise such as the government's and donors' effort to facilitate this development through the drafting of a commercial law framework, promotion of institutional development and direct business and financial support to this emerging sector of activity. However, a number of set-backs must also be noted, including the absence of a vision/strategy for the development of SME, the failure to adopt the proper legislation, the inability to restrain unfair competition and above all, the lack of access to external finances which represent a heavy barrier for those small and micro enterprises.

Following the presentation, Mr Sadiku went on with the analysis of key elements to the development of SME such as the origin of investments, generally issuing from private sources. Here again, a heavy unbalance appears between the favoured trade sector to that of production. This imbalance is further reflected in other key indicators, such as in the credit demand and supply, which reflects a dysfunction in the activities sectors. Other characteristics can be gleaned from the credit supply. Although the increase of supply is encouraging, a huge gap remains between the supply and demand for credit, slowing down the normal trend of development. In addition the major and growing role of non-bank financial institutions in comparison with banks is noteworthy, despite the fact that similar conditions apply placing a heavy burden on developing SME (high loan rates, short repayment periods, etc.). Along the same lines, it was proposed that further financial instruments be developed such as leasing, credit guaranty funds, a stock exchange, etc.

The discussion then turned to SME capacity constraints. The first element to be denounced was the lack of capacity and skills of SME managers. This reflects heavily in the poor quality of business planning that was observed all along the day. The second element concerned the actual mechanisms of information and distribution of business support programmes which appear to benefit only a small percentage of enterprises.

Issues relating to legislation and regulation were also considered, being the cornerstone of the institutional framework to the development of SME. This framework

develops along a number of key issues relevant to SME such as collateral and mortgage laws and registries, bankruptcy, property, regulations over banks and financial institutions and accounting. However, a number of areas were raised concerning mortgage regulation and registration as well as bankruptcy and accounting regulations, where legislation has not yet been approved and set in place. Moreover, concerns regarding enforcement procedures were expressed, including the length of court procedures, which represent a barrier to the pursuit of abuses. Issues such as land title and ownership still need to be resolved.

Finally, in order to close this presentation and discussion, Dr Sadiku pointed out the increase in the financial institution sector of Kosovo/a, where the creation of institutions such as the Kosova Credit Information Services or the Kosova Bankers Association play an important support role in the development of SME.

#### E. Evaluation of the Event and Further Steps

The impressions of the facilitators about the organization of the event were positive. In organizing this session, the facilitators feared the negative effects of the political climate, given the imminent elections. However, attendance was good, both from political party representatives and from the different NGOs. All ethnic groups were fully represented.

The training element itself was greatly appreciated. Regarding the lecturers, the facilitators were pleased to be able to involve international as well as local lecturers which were able to provide the participants an expert local outlook on the economic situation in Kosovo/a. In the future, the facilitators are looking forward to developing this method, through involving minority local experts. In addition, in order to respond to the positive response of the participants towards the lecturers, the facilitators are attempting to develop on-going contacts between the participants and the lecturers and have re-invited them to participate in further debates in future sessions of the STWG.

In order to expand upon the benefits of this training, and to continue to involve the participants in issues of economic development and reconstruction, ECMI, has promoted the participation of members of the Standing Technical Working Group in other activities of specialist NGOs. Members of the group were invited to participate in the Women's economic weekly working group, and in the Kosovo Business Support general meeting, etc. Moreover, as is indicated below, the economics

Steering Committee of the Standing Technical Working Group expended considerable energy in building upon the success of this initial meeting at the 6<sup>th</sup> Session.

### **III. 6<sup>th</sup> Session: The Initial Plenary Debate**

#### **A. Preliminary Issues**

On 8 December 2001 the sixth session of the Standing Technical Working Group was held in UNHQ, Pristina. The session continued the preliminary work on the issue of Economic Development held on 27 October. Since that meeting, the Agenda for the December session had been developed by an expert steering committee which met three times in preparation for the full STWG meeting on 8 December. The event brought together over thirty participants representing all sections of Kosovo/a society, including political party representatives, representatives of minority groups and specialist NGOs as well as local and international experts in the field of economics.

The conclusions drawn at the 27 October working session of the STWG provided a point of departure for the Economic Expert Steering Committee. In a series of three preparatory meetings the Steering Committee debated on what they determined to be the key issues for discussion at the session. They also began compiling a list of experts, both local and international, that they felt would best compliment their discussion of these issues. There was also consensus among the expert committee members that the session would provide the invited international experts an important and rare opportunity for feedback. The steering committee also benefited from a background paper examining the economic future of Kosovo/a which had been compiled by Dr Vladimir Gligorov of the Vienna Institute for International Economic Studies. In the final two meetings of the Steering Committee before the session, an agenda was decided, a 'wish list' of Kosovo/a based experts was drawn up, and several key objectives were identified. These objectives were:

- To have a frank discussion with expert economists on the current condition and current potential of the economy in Kosovo/a.
- To critically engage the local and international experts/policymakers in the pressing need for movement to occur in privatization of Kosovo/a's State and socially owned enterprises.
- To hammer out specific strategies for production which would compliment Kosovo/a's comparative advantages.

Because the first session of the newly elected Kosovo/a assembly was scheduled for 10 December, and this assembly would be meeting in the Pristina Government Building. – former HQ and KTC venue, ECMI lost its normal meeting place. The venue for the workshop was changed by the UNMIK hosts only two days before the

conference. This put extra strain on the regional office logistics coordination to ensure full participation. Given the logistics of operating in Kosovo/a, this meant that several members and even one expert were unable to attend the event.

## B. Introduction to the First Plenary Session

The session was co-chaired by two members of the Expert Steering Committee, Ilir Salihu and Ymer Shatri. In the morning session Dana Eyre, senior policy advisor to the DSRSG of EU led pillar IV kicked off the event by reviewing work completed by the plenary in the October session as well as issuing a challenge to the group to be as productive and concrete as possible during the day; Dr Validimir Gligorov provided a summation of his working paper; the ‘local’ experts invited to take part in the discussion both to improve the debate and also to receive concrete local feedback were Ron Ashkin, USAID, Chief of Party Kosovo Business Support; Aleksander Dardelli-USAID-Commercial Law Advisor-Department of Trade and Industry; Khwaja Sultan-KPMG/Barents-Director Tax Policy-Central Fiscal Authority; Giuseppe Zampaglione, World Bank Representative in Kosovo/a.

The session was introduced by Graham Holliday, ECMI Balkans Project Coordinator. He outlined the aims and future plans for ECMI’s Kosovo/a project as well as the specific aims for the day’s session. The floor was then turned over to Dana Eyre, advisor to the DSRSG of EU led pillar IV, who provided framework for the deliberations:

- A healthy approach for long term sustainable social and economic development must be based upon the development of this interdependent three way triangular relationship: free market economy – democratic political system – civil society
- Based upon this triangular relationship the central question is: What legal/policy frameworks need to be put in place to achieve this?
- The efforts of the STWG complement the efforts of the international administration’s attempts to shape policy to serve the needs of Kosovo/a’s citizens.

As with all reports of the Standing Technical Working Group, the summary of the debate which follows has not been reviewed by participants and only aims to provide a rough guide to the proceedings. However, the conclusions listed below were adopted by consensus.

### C. Analysis of the Kosovo/a Economy

The substantive work of the session began with an analysis of Kosovo/a's economy by Dr Gligorov. Despite the general problem of data collection there were certain specific recommendations/conclusions from this background paper.

- Kosovo/a and the competent international organs (DTI/Pillar IV) need to determine a road map based upon policies that will lead toward sustainable growth.
- Determination of the markets (both external and internal) that Kosovo/a will be able to participate.
- Fiscal sustainability fosters democracy – states need to be able to pay their bills and businesses/citizens need to be willing to pay taxes.
- Privatization is an important step towards promoting long term sustainable growth, but it is not a panacea for Kosovo/a's economy.
- Clearly the overriding challenge to the economy is the lack of operating market forces in Kosovo/a. As a protectorate with an international administration that has limited resources and limited long term interest in Kosovo/a, the challenge for Kosovo/a is to achieve a stable legal and competitive environment from within which the policies charted by the international administration can flourish. Without a stable legal and competitive environment for businesses any policy will be fruitless. And likewise, the international administration needs to be engaged in finding Kosovo/a solutions for Kosovo/a's problems.

There was brief discussion among the STWG participants affirming Gligorov's basic principals. There was no disagreement as to the present state of the economy and which prescriptions/principles should be applied by policymakers. However, Ron Ashkin followed this agreement by challenging the choice by the expert steering committee to focus on privatization. He stated that his choices for the STWG would have been employment and investment generation. Ashkin also made a prediction for a near term scenario when donor funds would drift elsewhere and Diaspora remittances would dry up. The invited experts commented with frank disappointment as to why the expert steering committee decided to focus on privatization despite the warnings to the contrary. One of the experts used an analogy stating that the patient does not go to the doctor to tell the doctor what is wrong. The patient needs the

doctor to determine the malady. A lively discussion amongst the participants ensued focusing on Gligorov's conclusions and recommendations. The following bullets highlight the discussion of the STWG members and experts:

- There was general consensus that there had been a degree of economic recovery but even this recovery could be improved by implementation of all laws that have thus far been drafted.
- There was a call for greater transparency from the international administration to help achieve a more stable legal framework. And indeed greater transparency would mean better more accurate information which would raise the business community's awareness.
- There was strong agreement on the need to develop better links within the region and thus greater integration. This included improving the ability of businessmen to travel within the region.
- Dr Gligorov's point for better data collection was seconded. There was an active call that the international administration together with local experts should expand their efforts collecting existing data and undertaking viability studies to improve future data collection.
- A well-reasoned point highlighting the failures of the Department of Trade and Industry's current policy of commercialization. The local expert argued that the lack of clear success in commercialising state/socially owned enterprises coupled with the high unemployment and lack of political stability in the region should be enough for the international administration to see through the apparent legal mire that is hindering moves toward privatization.
- Kosovo/a's citizens do not expect that large multinational firms will be burning a path toward this region to invest. Nevertheless there are investors who are more comfortable with the risk and uncertainty of Kosovo/a's market: the Diaspora. The privatization process will be successful once the legal barriers are removed and market forces can be unleashed.
- The situation of minority communities was raised: disproportionate number live in abject poverty. UNMIK criticized the neglect of these communities – and recommended that a process of education and training target such groups.

- Studies of Slovenia’s model for privatization recommended as a model of good practice.
- The very fact that 1244 does not provide for a clear mechanism for privatization to take place. The SRSB and DTI have latitude in pushing for specific policy prescriptions, however, the final decision to move forward on privatization will come out of the Security Council. Most participants in the room and on the panel agreed that the issue had become too politicized.

After these points were made, the international expert panel responded. Ron Ashkin mentioned several factors as arguments against seeing privatization as a ‘cure all’ and he also stated that the Slovenian model was not applicable to Kosovo/a. He stated that certain questions needed to be answered – what he called his: “mantra of sustainability” for a developing economy.

- **Viability:** can the economy sustain itself in absence of subsidies or donor funds?
- **Competitiveness:** Are others doing what we are doing, and if so, can we do it better?
- **Market Drive:** Is what we are doing going to add value to our customers?

Mr Ashkin offered the following privatization formula for Kosovo/a: Satisfaction equals results plus expectations. (Satisfaction = Results + Expectations)

He argued that it is a foregone conclusion that the results are will be poor (based upon his research and frequent contacts with the business and economic experts in Kosovo/a). Similarly since the people of Kosovo/a and even many members of the STWG have high expectations for the privatization process, even with some measured success it will be perceived as a failure.

To substantiate his argument he stated that in the first place privatization is a change of ownership rather than a creation of value rendering much of the privatization process to a legal argument versus a productive and fundamental economic change. Furthermore, with privatization comes bankruptcy and liquidation: firms with positive economic value will continue whereas firms with negative economic value will go bankrupt. This would mean closure of firms and immediate loss of jobs. Finally, based upon real case studies of neighbouring states in central and Eastern Europe, if there is too much corruption any real efforts toward privatization will fail. There is no room for corruption.

Dr Gligorov responded to all the participants by advocating a simple solution – sell what you can, sell it at a high price and sell it as soon as possible. Unlike Ashkin he did not fear the pitfalls of unemployment. He stated that it was true that privatization will increase unemployment. What he argued therefore was for the international and local administration to institute a parallel process of training and employment generation which could reduce the effects of privatising.

Gligorov's final point was that from a fiscal point of view it was not strong long-term policy planning for Kosovo/a to rely on tariffs to protect its markets. Arguing against protectionism or import substitution industrialization he stated that market protection is simply not viable long-term economic policy. If privatization were to occur, there were also additional considerations that must be taken into account: the social aspects in legal mechanisms – without the proper legislation or regulation, unemployment effects will be exacerbated.

The STWG and Expert Committee members were charged to focus on private sector development, employment generation and investment. If these three sectors were prioritized, then real measurable perceived success could be achieved. Perhaps the most controversial proposal was put forward by Dr Gligorov, and seconded by both Aleksander Dardelli (DTI Commercial Law Expert) and Ron Ashkin. Gligorov argued that in the former Yugoslavia the owners of socially owned enterprises were the workers in those enterprises. He argued that this was not a liberal interpretation of the law but an exact one. If this was the case he stated, then the current workers of these enterprises should go and 'privatize' or 'capitalize' these SOEs themselves. (In fact there is a precedent for doing so: Grand Hotel and Peja Brewery are two successful examples of former SOEs that have continued working under the auspices of UNMIK and 1244).

#### **IV. 6<sup>th</sup> Session: Further Plenary Deliberations**

##### **A. Tax Structure**

The afternoon plenary session began with an overview of Kosovo/a's current and future tax structure given by Khwaja Sultan, Director of Tax Policy in the Central Fiscal Authority. The highlights were:

- The overall health of revenue collection in Kosovo/a is excellent. It was noted that Kosovo/a's revenue base was minimal so tax experts are optimistic but reservedly so.
- Currently Kosovo/a is one of the lowest taxed economies in Europe.
- The low tax burden does provide Kosovo/a with one specific advantage over its neighbours.
- Over time the tax burden will increase as Kosovo/a tax level should increase from 8 per cent of GDP to 18 per cent of GDP.

The participants (local and international) were eager to learn from the Director of tax policy. There were several sector specific comments and questions. One of the experts questioned what type of tax policy existed in Kosovo/a. But in general the discussion and comments affirmed the success of the efforts to set up an efficient revenue generating mechanisms through the newly introduced Value Added Tax (July 2000) and customs collection points at Kosovo/a's Administrative Boundary.

There were issues raised suggesting that perhaps this fiscal mechanism could be used in some way to stimulate sectors deemed worthy. Members of the STWG did argue repeatedly against the unfair trade advantage that exists between Kosovo/a (and the FRY) and FYR of Macedonia. The argument was mostly an attempt to raise an issue so that momentum could be generated within the international administration examining whether a trade distortion is hurting Kosovo/a competitiveness.

##### **B. Privatization Strategies and Adoption Measures to Enhance Production Output**

In the second working session the topics chosen by the expert steering committee, Privatization and Strategies for Production, were addressed in more detail. After three preparatory sessions, the expert steering committee members were well placed to generate thought provoking suggestions and concrete proposals for the entire plenary. Below are bulleted points related to privatization developed by the entire group:

- There is a strong need for a top down (ministerial level) employment strategy – especially since previous experiences of privatizations involved selling assets to highest bidder and this inevitably creates disincentives for employment.
- Need to initiate legal regulation which would complement any privatization process to safeguard against negative effects; urgent need to initiate legislation on bankruptcy and liquidation.
- Explore publicity campaigns both within Kosovo/a and in the region to heighten chances of investment. (E.g. establish trade/information offices abroad.)
- Examine models of other transition and post-conflict countries – possibility of establishing a twinning programme.
- Greater transparency in privatization process will be an incentive for investment.
- Urgent need to clarify and resolve ownership issues of enterprises – perhaps through pursuing a policy of trusteeship to manage assets in the interim or the establishment of a caretaker agency.
- Need for three pronged approach to privatization: clarify policy priorities, develop a coherent short and long-term strategy and explore best practices/models of similar societal change.

The group then addressed specific strategies aiming to increase production in Kosovo/a:

- To determine competitive advantages – need to explore local AND regional strategies.
- Feasibility studies exploring sectoral advantages need to be undertaken and widely distributed (publicized). Sectors worth exploring: agro-business and construction.
- Moreover, there is a need to explore sectoral clusters and establish comparative advantage on a regional level.
- Need to prioritize training in managerial skills.
- The role of UNMIK should be non-interventionist with the sole aim of creating an economic environment conducive to growth.

- Priority should go to exercising pressure for reforms on mortgage and loans.

The absence in Kosovo/a of operating market forces (i.e. the absence of movement in the large medium size business sector) make many of these production strategies solid recommendations to the UNMIK international administrators currently working in DTI or the department of reconstruction. Moreover the STWG plenary and invited experts developed a solid wish list of proposals. If these proposals were enacted individually or as a modified package positive steps would be taken toward enabling long-term sustainable economic growth.

## **V. Engagement with Representatives of Implementing Organizations**

In the day's final session Dana Eyre, Senior Policy Advisor to the DSRSG of EU Pillar IV and Giuseppe Zampaglione, World Bank Representative in Kosovo/a, actively engaged the plenary by examining its cumulative recommendations. Both that the group treaded into risky waters when adopting a highest bidder strategy. Even though they understood the natural tendency to pursue such a strategy, they warned of negative trade offs. There was general agreement on the need to avoid employment quotas, although the World Bank representative did remind the group of the social downsides to privatization. The group was told that despite their best efforts or even parliamentary legislation, the competencies for privatization would remain firmly in the SRSR's sphere. There was broad agreement that transparency on all levels and from all sides with needed. The Pillar IV representative weighed in strongly on this point stating that the international community's lack of transparency on issues of strategies for privatization has only added to heightened frustration. There was also agreement on the need to address questions of freedom of movement of capital, goods and people. The internationals both felt that this important issue was also in many respects ultimately a question of security and this is something Kosovars could best address themselves.

Perhaps one contentious area was the discussion around the inevitable connection between resolving property and ownership issues and final status. There was general consensus among locals and internationals that privatization measures should be acted upon immediately, however, in Kosovo/a's case, decision on final status disrupts and paralyzes all actors. The World Bank representative stated the need to move on privatization but bemoaned the lack of consensus on how to go about doing it. Several STWG members responded that tying economic development to politics would prevent any movement. They did not see the connection between trying to jump-start their decaying economic enterprises and the role of Belgrade in this process.

A less contentious point was the need for the assembly to immediately establish bankruptcy and liquidation. Also the World Bank representative complemented the people of Kosovo/a on their track record in repaying loans. He felt that thus far they have used money well and their repayments have been excellent – not the case in Bosnia or FYR Macedonia.

The session closed with an expression of gratitude to the facilitators, implementation agencies and participants. The STWG was reminded and encouraged about the resumption of activities in 2002 with a proposal to reconvene in early March (2 March) to assess the overall nature of the STWG and possible modifications to its method and aims in 2002-2003. The steering committee on economics was asked to reconvene after the holiday season (early January) to try and come up with a work plan to possibly transform STWG recommendations into policy.

## **VI. 5<sup>th</sup> and 6<sup>th</sup> Sessions: Recommendations**

The Group as a whole concluded the day by adopting the following recommendations, on the basis of the work done by the Expert Committees.

### *Privatization*

- action items need to be as specific as possible;
- preference for highest bidders;
- better marketing of privatization, use of Internet for marketing;
- involve more local experts in Kosovo/a's privatization agencies;
- promote transparency in the privatization process;
- apply greater pressure on UNMIK and neighbouring states to secure freedom of movement;
- aim to generate an integrated economy throughout all territories of Kosovo/a;
- measures to resolve issues of ownership must be undertaken at first opportunity
- pressure for correct and unbiased description of the current standing of the enterprises to be privatized;
- urge new assembly to move forward on liquidation and bankruptcy framework;
- recommendations against (# of employees ) and employment guarantees;
- continue efforts attempting to improve Kosovo/a's statistical infrastructure;
- establish a quality framework of achieving sustainability;

### *Production Strategies*

- apply pressure on internationals and assembly to consider establishing an exemption of capital equipment from import duties;
- pressure on establishment of a governmental body for certifying local products to international standards;
- demand lower interest rates from banks;
- focus on compliance and enforcement for all businesses;
- pressure for a mortgage law;

## VII. ANNEXES

### Annex A: Programme of Events

*5<sup>th</sup> session: The Economic Development of Kosovo/a (Saturday, 27 October 2001)*

TIME	ACTIVITY
9.30-10.00	<b>Introductory remarks</b> <ul style="list-style-type: none"> <li>○ ECMI: objectives of the session</li> <li>○ UNMIK Pillar IV: International policies for the promotion of SMEs – Dana Eyre</li> </ul>
10.00-11.15	<b>First Session:</b> <ul style="list-style-type: none"> <li>○ Turning an Idea into a Business Plan – Ronald Ashkin (Kosovo Business Support)</li> </ul>
11.15-11.30	Coffee break
11.30-13.00	<b>Second Session:</b> <ul style="list-style-type: none"> <li>○ Tax Policy and Business Development – Iza Mustafa (Riinvest)</li> </ul>
13.00-14.30	Lunch break
14.30-16.00	<b>Third Session:</b> <ul style="list-style-type: none"> <li>○ Business Registration and Business Development – Alexander Dardelli (Department of Trade and Industry)</li> </ul>
16.00-16.30	Coffee break
16.30-18.00	<b>Fourth Session:</b> <ul style="list-style-type: none"> <li>○ Locating Sources of Finance for Small and Medium Enterprise Development - Dr Muhamet Sadiku, (Riinvest)</li> </ul>
18.00–18.30	<b>Concluding Remarks</b> <ul style="list-style-type: none"> <li>○ Review of Activities</li> <li>○ Wrap-up and Follow-On</li> </ul>

*6<sup>th</sup> Session: Economic Management: Strategies for Economic Development and Reconstruction (Saturday, 8 December 2001)*

TIME	ACTIVITY
9:00-9:30	<b>Introduction</b> <ul style="list-style-type: none"> <li>○ ECMI: Welcome and Outline of Workshop</li> <li>○ UNMIK Pillar IV: Aims and Strategies of International Economic Policy in Kosovo/a – Dana Eyre</li> </ul>
9.30–11.00	<b>First Plenary Session 1:</b> <ul style="list-style-type: none"> <li>○ <i>Presentation of Background Paper: “The Economic Future of Kosovo”</i> – Dr Vladimir Gligorov (Vienna Institute for International Economic Studies)</li> <li>○ <i>Presentation: “Limits of Privatization”</i> – Ron Ashkin, (Kosovo Business Support)</li> </ul>

	<ul style="list-style-type: none"> <li>○ <i>Plenary Discussion</i>: Strategies for Privatization <ul style="list-style-type: none"> <li>- Is comprehensive privatization feasible in Kosovo/a?</li> <li>- What vision would support this?</li> <li>- Developing strategies for privatization and implementation</li> </ul> </li> </ul>
11.00–11.30	Coffee Break
11.30–13.00	<b>Secondary Plenary Session:</b> <ul style="list-style-type: none"> <li>○ <i>Plenary Discussion</i>: Developing Strategies for Production <ul style="list-style-type: none"> <li>- Identifying aims</li> <li>- Developing an operational strategy</li> <li>- Need for tools for implementation: regulations, potential legislation and taxation.</li> </ul> </li> </ul>
13:00-14:00	Lunch
14:00-16:30	<b>Working Groups: Drafting Recommendations</b> <ul style="list-style-type: none"> <li>• Group 1: Strategies for Privatization</li> <li>• Group 2: Strategies for Production</li> <li>•</li> </ul>
16:15–16:30	Coffee Break
16:30–18:00	<b>Dialogue with Pillar IV and World Bank</b>
18:00–18:30	<b>Concluding Remarks</b>

## Annex B: Members Participating

### *Political Parties*

Name	Affiliation	Ethnicity
Adem Limani	AAK	Albanian
Besnik Osmani	LDK	Albanian
Dragan Velic	Member of the Serbian National Council	Serb
Fahri Beqa	PDK	Albanian
Feti Grabci	PRK	Albanian
Gani Toska	SH Rom. K	Rom
Ibrahim Makolli	KMDLNJ	Albanian
Iilir Salihu	LDK	Albanian
Hysni Bajrami	PDK	Albanian
Mehmed Ćeman	BSDAK	Bosniak
Mevludin Krasniqi	PDK	Albanian
Nebahat Doğan	KTHP	Turk
Ruzdija Krijestorac	SDA	Bosniak
Şerafettin Ömer	TDB Vice-president	Turk
Slavisa Kolašinac	Mayor of Upper Rahovec	Serb
Ruzhdi Hamza	PDK	Albanian
Valon Murati	LKÇK	Albanian

### *NGO representatives*

Fahredin Tahiri	ZAMAN- Bosniak	Bosniak
Fatmire Lutolli	Jehona NGO	Albanian
Petar Jeknic	Independent Media Group, Pristina	Serb
Radmila Djordjevic	MARAS, Leposavic	Serb
Skendo Kandic	NGO Bosniak	Bosniak
Suzana Arni	KCSF	Albanian
Ymer Shatri	Handikos	Albanian

### *Local experts*

Boban Nikic	Economist	Serb
Mirjana Rajovic	Economist	Serb
Mujo Dacic	Economist	Bosniak
Myrvete Pantina	Economist	Albanian
Sebahate Grajqevci	AAK Economist	Albanian
Xhafer Xhaferi	LDK (Observer)	Albanian
Xhevdet Neziri	Economist	Egyptian

### **Annex C: International Experts**

<b>Name</b>	<b>Affiliation</b>	<b>Area of specialist knowledge:</b>
Ronald Ashkin	Kosovo Business Support	SME
Vladimir Gligorov	Vienna Institute for International Economic Studies	Balkan Economy
Aleksander Dardelli	Department of Trade and Industry	Commercial Law
Dana Eyre	UNMIK Pillar IV	Economic Policy
Iza Mustafa	Riinvest	Tax Policy
Muhamet Sadiku	Riinvest	SME
Khwadja Sultan	Central Fiscal Authority	Fiscal Policy
Guisepe Zampaglione	World Bank	Development

## **Annex D: Background Paper Presented by Dr Gligorov**

### The Economic Future of Kosovo

*By Vladimir Gligorov, Vienna Institute of International Economic Studies*

#### **I. INTRODUCTION**

Politically and socially Kosovo is in a rather unique situation. *De facto* it is a protectorate, while *de jure* it is not. Its final political status cannot be expected to be determined for quite some time, though the political process that should unfold seems to have been already chosen and determined. It should lead to ever increasing self-government, which logically implies independence, though the politics of that is yet to be worked out. Kosovo society is also divided, although the minorities are and will probably remain to be just a tiny and diminishing fraction of the population. But the complexity of social exclusion and inclusion is not smaller or negligible for that reason. In addition, the social structures among the majority Albanian population are not really simple and homogenous, though this is not an altogether well researched topic.

These background facts have and will have significant influence on economic developments in Kosovo. At the moment, and for the foreseeable future, Kosovo will depend very much on foreign aid for reconstruction and recurrent fiscal needs. In addition, the unofficial economy will continue to play a very significant role. Finally, modern economic institutions will develop only very gradually. Thus, reconstruction and development in Kosovo will proceed along non-standard paths.

This process cannot be influenced in the usual way because of the lack of standard instruments of economic policy. Kosovo does not have and will not have its own currency, so monetary policy, in its usual sense, will remain unavailable. Fiscal policy will face significant challenges as both the revenues will come from diverse and not completely transparent sources and the expenditures will have to target a wide range of needs, mostly above the levels that could be sustained by the actual level of economic activity.

One major challenge for the Kosovo economy is its regional and wider integration. Domestic markets can hardly support rapid and balanced economic growth, so access to foreign markets becomes crucial. The regional integration of Kosovo is proceeding very slowly, essentially for security and political reasons. It is doubtful that the integration with the European and overseas markets can advance without regional integration – if for no other reason than because Kosovo is landlocked and needs the region for transit purposes. However, integration with Serbia and Macedonia are going to be very difficult, while integration with Albania will require significant investments in the development of infrastructure.

This is a part of the picture from which the economic future of Kosovo has to be read. In this paper, I will first review the current economic situation in Kosovo, then I will discuss the constitutional and political developments and how they could impinge upon the economy of Kosovo and, finally, I will discuss some of the policies that could support some kind of a sustainable development in Kosovo.

## II. CURRENT ECONOMIC SITUATION

The information on the present economic situation in Kosovo is largely fragmentary. As the responsibility for macroeconomic management and for reconstruction has been taken over by international actors, they are also the major sources of information. Local statistical information is largely unavailable and local research is still quite scarce.

A recent paper by the IMF<sup>1</sup> is probably the major source of macroeconomic data. The following table gives the main indicators that are available:

Table 1

<b>Kosovo: economic indicators 2000</b>		
	<b>DM mn</b>	<b>% of GDP</b>
GDP	3000	
National income	4512	150
Private remittances from abroad	1200	40
Humanitarian assistance	312	10
Exports	0	0

<sup>1</sup> See IMF (2001).

Imports	2540	85
Current account	-1029	-34
Trade balance	-2540	-85
Budgetary assistance	272	9
Reconstruction aid	756	25

Source: IMF

The first thing to notice is that national income is 50 per cent larger than GDP. This is because transfers from abroad, both remittances and humanitarian assistance, are not included in the GDP. Thus, Kosovo is very dependent on outside financial support. Another striking fact is that exports have to be taken to be zero. This is mainly because, on the one hand, exports to Serbia do not exist because of the collapse of the economic relations and, on the other hand, because the firms that exported to other parts of the world, mainly in extraction and in electricity, do not work. Whatever other exports exist, they are obviously not recorded. Imports, on the other hand, are quite high. Budgetary assistance is significant as is reconstruction aid.

Looking into the GDP in some detail, one gets the following figures for consumption and investments, which together with the trade balance, which in this case is highly negative, gives the GDP. It can be noticed that it is yet to be determined where the production of this GDP comes from:

Table 2

<b>Kosovo: GDP structure, 2000</b>		
	<b>DM mn</b>	<b>% of GDP</b>
Consumption	4380	146
Private	4078	136
Public	303	10
Investment	1161	39
Foreign	756	25
Domestic	405	13

Source: IMF

To finish the description, the structure of the imports should be added, which can be found in the following table:

Table 3

<b>Kosovo: imports 2000</b>		
	<b>DM mn</b>	<b>% of GDP</b>
Structure of imports, total	2540	85
Reconstruction	680	23
Energy	54	2

	Humanitarian	312	10
	Food and agriculture	155	5
	Equipment	21	1
	Emergency assistance	136	5
	Households	104	3
	Health	21	1
	Education	10	0
	Dutiable imports	1406	50
	Declared	823	27
	Other	673	22

Source: IMF

Summarising the information in these three tables, it is obvious that the local economy is not contributing too much to the overall reconstruction effort and to the everyday subsistence of the population. The IMF estimates that agriculture has recovered to about three-fourths of its pre-war level, which is not precisely known anyway. Also, there is a boom in the construction sector and also in trade and services (restaurants, cafés, hotels). However, the IMF notes, that “industry remains depressed”, or in other words, it is hardly recovering from the level of close to zero.

The picture of the Kosovo economy that emerges from this is simple. Aid and reconstruction money together with remittances account for most of what is spent on consumption and investments. Most of that money covers the imports while the local economy supplies agricultural goods, labour and some material for construction and labour, and some facilities for services mainly consumed by the internationals or those who work for the internationals.

This is not unlike the picture that the economy of Bosnia and Herzegovina paints (in principle, but not necessarily in details). At this moment, in Kosovo, unlike in Bosnia and Herzegovina, there is not much concern or discussion about corruption and criminal activities, but it is to be assumed that those activities are as high, if not higher, in Kosovo. Thus, it is to be expected that here, as in every other case when large aid and reconstruction effort was undertaken in unclear political and institutional circumstances, this will be one of the major themes in the coming years.

Looking at the macroeconomic policies, these can be summarized simply. Kosovo is using the German Mark (DM), i.e. the Euro, as its currency of choice. The Yugoslav dinar plays a role in the Serbian enclaves, but a very marginal one even there. There

are no intentions to create a Kosovo central bank or to introduce its own local currency as the legal tender. Thus, there is no monetary policy to worry about. Of course, with this shock of foreign spending, the price level in Kosovo is presumably significantly higher than in Serbia and probably than in neighbouring Macedonia too. However, there is no information on the price level in Kosovo at this moment.

The major macroeconomic concern for the internationals has been the budget. To minimize budget support, an attempt has been made to collect as much budget revenues as possible in Kosovo. The following table gives the fiscal picture of Kosovo:

Table 4

<b>Kosovo: 2000 and 2001 budget summary, DM millions</b>				
	<b>2000 budget</b>	<b>2000 budget amended March</b>	<b>Provisional estimate</b>	<b>2001 Budget</b>
Revenues	223	210	242	338
from imports	163	144	222	236
Expenditures	423	429	431	500
for wages	166	172	163	182
Balance	200	219	189	162
Financed by				
Donor grants	170	189	199	162

Source: IMF.

Expenditures are almost equally covered from revenues, mainly from import tariffs and taxes related to imports, and from donations. Expenditures amount to less than 25 per cent of GDP and less than 10 per cent of the national income. So, they are not a major source of consumption and employment. Revenues collected are significantly smaller than expenditures and come mostly from import tariffs and other taxes levied mostly on imports, which means that nobody pays income taxes in Kosovo. Thus, it could be said that there is no fiscal policy in Kosovo at the moment. To the extent that revenues are collected they come from where they are the easiest to collect, though in this case this is irrelevant because the incidence of the tariffs collected is, in one way or another, related to those who pay for reconstruction and aid, at least to a very large extent.

Apart from monetary and fiscal policy, which are more or less non-existent, regulation could play a role, but there is as yet no legal authority in Kosovo. This

presents especially tough problems when it comes to privatization, which is a difficult task as it is, and is next to impossible in the rudimentary legal statues that Kosovo finds itself at the moment. In any case, it can be concluded that there are hardly any possibilities for macroeconomic governance in today's Kosovo. This should change after the November elections with the establishment of the government, of which more below.

### **III. PRIVATIZATION, CORRUPTION AND PRIVATE GOVERNANCE**

Kosovo has inherited the system of social ownership and of self-management that existed in the former Yugoslavia and has not really been reformed in the last ten years or so. The reform of this system is not necessarily more difficult than that of a Soviet style of socialism, but it is different. There is some experience with that, both good and bad.

What is this system? Social ownership essentially means that firms are not owned by individuals or institutions but belong to the public, which entrusts their management to those who are employed in these firms. This is different from state ownership because the state is not entitled to the profits of the firms and cannot sell them. Indeed, this kind of ownership gives the rights to the residual, i.e. the profits, to the employees of the firm. They make the decision to reinvest or to distribute the profits to the employees. As a consequence, the employees have the sense that they are *de facto* owners of the enterprises they work in. This sense is reinforced by the system of self-management, which entitles the employees to manage the firms they work in and also to appoint the management. Thus, in all, except in law, the employees are owners and managers of the firms in which they are employed. However, they do not have shares or any other titles to the assets in these firms.

As a rule, employees in self-managed firms resist nationalization as well as privatization. This does not mean that they resist the idea that they can privatize their firms. Indeed, the experience with the privatization of such firms shows that the schemes that meet with the least resistance are those that respect the *de facto* employee ownership of the firms. The best example of this is Slovenia, where the self-managed firms were mainly privatized with the idea to transform the *de facto*

employee ownership into *de jure* ownership. In a different way, something like this happened in Macedonia too. In both cases, the firms were given over to the insiders almost for free. This is basically in recognition of their informal ownership of these firms. In the cases in which these firms were nationalized, for instance in Croatia and in Republika Srpska in Bosnia and Herzegovina, the results were worse both in terms of legitimacy and in terms of efficiency. There is, of course, no doubt that insider ownership is not a very efficient one, but it does conform to the prevailing sense of who is entitled to what.

The major problem with the self-managed firms that have gone through employee or management buy-outs, with or without money, is that the employees tend to behave as if the firm is not privately owned but socially owned. Thus, they expect the society to help them in what they do, i.e. they expect state subsidies or privileges to continue. Therefore, the crucial step is the next one when these firms are exposed to hard budget constraints, which pressures the employees to either sell their shares or to declare bankruptcy, or both. Once that happens, privatization can be said to be over.

It has been argued that this is too long a process and that privatization can proceed directly. In Slovenia, the large companies that were destined for bankruptcy or even liquidation were not subject to internal privatization. This has met with another set of problems, as it has in Macedonia too, but may be one way to deal with this problem. In the case of Kosovo, it will be the big loss-making companies that will be in this category anyway. The same goes for utilities, which can be nationalized because they never were felt to be in social ownership in the same way as firms in industry or services. Thus, privatization of utilities should not present any special problems because of social ownership or self-management.

The real problem in Kosovo is not the legacy of self-management but the state of lawlessness. Spontaneous privatization in these circumstances is equal to theft, and nationalization by international agencies is bound to be regarded with suspicion. Thus, the key issue is to have some kind of legality in Kosovo.

Corruption is a tough issue in Kosovo. As already mentioned, it is not currently at the top of the list of priorities. It is even not clear how widespread it is. This is because

corruption is an illegal activity and there can be very little illegality in a lawless state. For instance, if nobody pays taxes there is no point in paying bribes not to pay taxes. Tariffs are a different story, and clearly trade across borders must be a major source of corruption. Also, as it is the authority that is to be corrupted, the obvious targets of corruption must be the international agencies and organizations that are running Kosovo. At this moment there is not very much information on that type of corruption.

If there is not that much corruption, in the strict sense of that term, that means that there must be quite a lot of economic activities that are criminal or would be criminal in a legal state. That includes smuggling, other trafficking of illegal goods and predatory behaviour. That also involves offering protection services and the concomitant spread of mafia-type economic activities. This creates quite an unfavourable environment for the start-up of firms and enterprises, which may account for the fact that there are not all that many of them especially in sectors that require higher start-up costs, as is generally the case in industry.

A special type of business that must also be quite developed is loan-sharking. The banking system in Kosovo is very rudimentary and offers very few opportunities for raising loans to do business of one kind or another. Thus, it must be the case, as it used to be before, that loans are offered by private individuals who charge quite high interest or extract other types of benefits. There is no information on this at the moment, but anecdotal evidence and past history point in this direction. Again, these practices create the whole structure of a mafia-type economy.

In this set up, private governance cannot be very efficient and well organized. The local population is quite entrepreneurial, but the circumstances are not favourable for setting up prosperous businesses that have the prospect to grow. A similar situation in Albania has made it very difficult to develop a reliable and competent business community.

#### **IV. THE NEW CONSTITUTION**

The ‘Constitutional Framework for Provisional Self-Government’ (The Constitutional Framework), i.e. the provisional constitution of Kosovo, has very little to say on the economy or on matters pertinent to economics. This basically means that this whole area will be regulated by laws that will be adopted by the new Assembly. The powers, however, are divided between the self-governing bodies and the Special Representative of the Secretary-General (SRSG). The latter has control over monetary policy and over the budget. Except for this and other divisions of power between the domestic and the international authorities, everything is pretty much left open when it comes to the economic regime and economic policy.

Still, from omissions in the Constitutional Framework it can be concluded that Kosovo will not have its own central bank, though monetary policy is entrusted to the SRSG. The principles of the fiscal policy are not to be found in the Constitutional Framework, though it could be inferred that not only the central government but also the municipalities will have fiscal rights and responsibilities. Indeed, the Constitutional Framework says nothing on the issue of territorial decentralization, so it should be inferred that the current local communities will remain pretty much as they are.

Nothing is said about foreign economic relations. It is stated that Kosovo will have a market and open economy, but the trade regime and the issues of economic integration are not dealt with. It is also mentioned that tariffs will be collected, but that is pretty much all. The same goes for internal trade as well as for the system of ownership. Nothing is said about privatization and the related transitional and developmental issues.

This leaves a lot of room for discretion. As there are quite a number of centres of discretion, this constitutional arrangement, by itself, will not mean too much for the economy. Thus, it will be extremely important to have a clear policy framework for future economic development in Kosovo.

## V. SELECTED PROBLEMS

Most of the strategy papers written by The World Bank or by the IMF deal with the transition from aid-dependency to self-reliance. For obvious reasons, the fiscal system gets most of the attention. As public revenues cannot be collected only from taxing consumption, the conditions for a sustainable supply recovery are also often treated. These are connected with privatization and with financing, i.e. with the banking and payments system. These are clearly important topics, but probably the most important one is that of markets and that means also of foreign markets.

### *Foreign trade and tariffs*

How important is foreign trade and what should be done to increase exports? Kosovo is perhaps an extreme case of what otherwise is not uncommon in the Balkans. Most Balkan economies do not export a lot, at least when it comes to merchandise goods. Some export services, i.e. tourism and transport, while a number of countries depend on transfers from abroad. In the latter category, apart from Kosovo, one finds Albania, Serbia, Macedonia, Bosnia and Herzegovina, and even Croatia. All of these countries do not rely very much on foreign markets for exports and rather use them for imports. Thus, trade balances in merchandise goods are deeply in the red while the positive balance of income partly compensates for that. Therefore, in many cases, the production can grow only as much as the residual domestic market expends.

An additional constraint exists in cases where, for this or that reason, there is restricted access to the neighbouring markets. In the Balkans, Kosovo is not an exceptional case, though, again, it is an extreme one. Especially at this point in time when the processes of integration have started in Southeast Europe. Kosovo has normal relations only with Albania, though there the lack of good infrastructure presents problems. With its other neighbours, Serbia, Montenegro and Macedonia, Kosovo has had political and economic problems and in some cases the relations are worsening. After the war in 1999, Macedonia emerged as the most important economic partner in the region, but the current conflicts have led to political and economic disintegration. Similar developments are possible in the case of

Montenegro, while the economic relations with Serbia are limited for any number of reasons and will probably remain so for the foreseeable future.

It is difficult to know the potential importance of this regional disintegration of Kosovo, but one indication could be the structure of foreign trade in the former Yugoslavia and the significance of that market for Kosovo.

Table 5

<b>Deliveries to the local market, as % of GDP</b>				
	<b>1970</b>	<b>1976</b>	<b>1983</b>	<b>1987</b>
Kosovo	57,6	56,8	58,2	64,6
<b>Deliveries to other regions, as % of GDP</b>				
	<b>1970</b>	<b>1976</b>	<b>1983</b>	<b>1987</b>
Kosovo	34,7	25,7	19,2	24,0
<b>Exports, as % of GDP</b>				
	<b>1970</b>	<b>1976</b>	<b>1983</b>	<b>1987</b>
Kosovo	7,7	17,5	22,6	11,4

The local market was always important for Kosovo, but the market of the former Yugoslavia was much more important than the then foreign markets (indeed more than twice as much). About a quarter of Kosovo production went to the markets of the former Yugoslavia, and Serbia and Macedonia must have had a significant share in that. Given the current GDP of Kosovo, estimated at DM 3 billion in 2000, that would mean about DM 750 million in exports to these markets. This is probably quite unrealistic, but even half that much would be a very significant boost to the Kosovo economy.

Alternative markets are not really easy to find. Some capacities could be developed in order to supply the European Union market, but these would involve mainly outward processing trade. It is not clear how competitive the producers from Kosovo can be, given the high transportation costs. Other investments may be looking to reach the market in the region, but that would require Kosovo to have an open economy.

Thus, the key economic issue in Kosovo is liberalization of foreign trade and of foreign economic relations in general.

It could be argued that the best foreign trade regime for the whole of the Balkans is that of currency union with the EU. This could present some problems in some cases

but not in Kosovo. Apart from the regional market and the market of the EU, no other market is important or can be expected to be important for Kosovo. That regime would run against the current high reliance on import duties as sources of public revenues. If the figures for imports and import duties of one or another kind are at all accurate, it would appear that the effective tariff rate was over 15 per cent in 2000. Obviously, the removal of tariffs would have significant budgetary effects.

It can be observed, however, that these high tariffs play no other role but that of fiscal. No production for exports is being protected, as exports are practically non-existent (smuggling and other illegal activities are not included, but they are not protected by the tariffs anyway). Also, as imports are close to 100 per cent as a share of GDP, it is clear that these tariffs, at this level at least, are not protecting the production for domestic markets. Thus, tariffs are purely a fiscal instrument in Kosovo.

Thus, the development of the fiscal system will make reliance on tariffs for fiscal purposes unnecessary and a rather liberal regime of foreign trade could be introduced.

### *Fiscal dependence*

Kosovo depends on foreign aid and support to a very significant extent. The current projections see this dependency continuing for the foreseeable future. The strategy is to make Kosovo self-reliant after a rather prolonged period of time. It is arguable whether this is the course that should in fact be taken. Looking around the region, there is no doubt that this aid-dependency is both unnecessary and it is often dysfunctional.

This is a complex subject and I can only make some comments on it here. The first issue is whether a political entity like Kosovo could be self-reliant when it comes to public expenditures. Currently, the budget spends below 15 per cent of GDP. It pays somewhat more than a half of that from the revenues that it collects. The gap is, then, about 6 per cent or so of GDP or about 15 per cent or so of the remittances from abroad. Thus, it does not look as if this deficit could not be covered from domestic sources.

Public investments are a different story. However, once reconstruction is declared to have been completed, there is no reason why other investments could not be financed from credits or in other commercial ways. Kosovo is not indebted and even if the outstanding debts inherited from the time of former Yugoslavia are identified, those could be written off. In that way, Kosovo could become self-reliant.

There is no point in going into details about how important that would in fact be. In normal circumstances, fiscal transparency is supportive of efficient allocation of resources, of proper strategy of development and of market economy and democracy. In the cases in which the state is yet to be build, it is vitally important because it rationalizes the discussion about the kind of state that is being built and about the political preferences the public is ready to settle for. For instance, it constrains the size of the public sector which tends to grow very quickly in new and small states.

Thus, Kosovo's fiscal dependency could be diminished rather rapidly and indeed discontinued in no more than a couple of years.

*Supply side recovery*

The structure of production in Kosovo is rather under-developed and not really diversified. The long-term GDP structure looks as follows:

Table 6

<b>Kosovo: structure of GSP</b>		
	<b>1971</b>	<b>1988</b>
Industry and mining	33.3	47.4
Agriculture	28.2	20.4
Construction	13.6	5.7
Transport and communication	4.7	4.0
Trade and tourism	2.9	2.7
Handicrafts	1.1	3.3

Source: Riinvest.

From the available data the following structure of industrial production of Kosovo in the former Yugoslavia can be seen.

Table 7

<b>Kosovo: industrial structure in 1988, % of total</b>	
Energy	26.0
Non ferrous metals	17.9
Non metals and construction material	4.2
Metal processing	10.0
Chemical industry	3.8
Wood and paper industry	3.7
Textile, leather, shoes, rubber	16.0
Food processing	10.0
Graphic industry	1.0

Source: Riinvest.

Once the energy sector and the extraction of non-ferrous metals recover, the industrial structure will look pretty much as it looked ten or twenty years ago. The production in general will resemble that of Albania with the large role played by construction and by trade and other services. The difference will be in the share of agricultural production, which takes up a much larger share in Albania (though the figures have been disputed). In any case, the development of Kosovo will have to be sustained by a more diversified and more advanced industrial and services structure. As already said, this will crucially depend on the openness of the Kosovo economy, i.e. of the availability of markets, and also on the commitment to a market economy and the rule of law in Kosovo. The rule of law, in turn, should be supported by the development of other institutions, and all that will take time – in the current internal and international political set-up, probably quite a lot of time. However, without the rule of law, the costs of investments will be high and that will sap the development of those businesses that require long-term commitment and significant start-up costs.

### *Sustainable growth and development*

As can be seen from other cases of aid-dependent economies, the issue of sustainability of the economic growth and development pretty soon become crucial. Given the reliance on private transfers from abroad, consumption will probably always be sustainable. The same applies to the trade deficit, which can be taken as a long-term fact. As already argued, public expenditures can be covered by public revenues, assuming low public employment and especially low expenditures on security. Thus, the issue of sustainable growth boils down to investments. Those are

important also because the employment and unemployment picture, from all that we know, is rather bleak. The data that are available are summarized in the following table:

Table 8

<b>Kosovo: labour statistics</b>					
<b>Year</b>	<b>Labour force</b>	<b>Active</b>	<b>Active in</b>	<b>Active outside</b>	<b>Unemployed</b>
			<b>Agriculture</b>	<b>Agriculture</b>	
1981	838000	378827	86929	221898	459173
1991	1163000	592389	104617	487772	570611
1997	1330000	469000	106333	362667	861000

Source: Riinvest

Even if these figures are not altogether accurate, the picture would still be shocking.<sup>2</sup> There were almost twice as many unemployed as active persons. Even if the relation is, more realistically, one to one, it is still quite disturbing. There is clearly a need to conduct a good and thorough labour force survey in order to determine the real situation, but it can safely be concluded that it will point to a difficult situation in the labour markets. It will also imply a high level of dependency and a significant burden for those employed and for the budget.

Looking at the growth potential, the figures from the former Yugoslavia period may be helpful. The figures from the following table show that the growth potential is not all that impressive:

Table 9

<b>Kosovo: growth rates</b>		
<b>Period</b>	<b>GSP</b>	<b>GSP per capita</b>
1948-1965	5.7	3.4
1966-1970	6.0	3.4
1971-1975	7.5	4.4
1976-1980	3.6	1.5
1981-1985	1.8	--0.4
1986-1988	1.1	-1.3

Source: National statistics

The difference between the growth of GDP and that of GDP per capita is the consequence of high population growth as can be seen from the following table.

<sup>2</sup> OECD (1992) puts the unemployment rate in Kosovo at less than 40% in 1989.

Table 10

<b>Kosovo population and annual growth rates</b>			
<b>Year</b>	<b>Population</b>	<b>Period</b>	<b>Growth rate</b>
1948	733820	1948-1953	1.9%
1951	808141	1954-1961	2.2%
1961	963988	1962-1971	2.5%
9171	1243693	1972-1981	2.4%
1981	1584440	1982-1991	2.1%
1991	1956196		

Source: National statistics and Gjonca (1999)

This situation cannot be improved without significant investments. Those cannot and should not come as donations, so the key problem is to secure a steady inflow of financial resources that would be invested in Kosovo. Given the availability of markets this will not be easy to achieve. In addition, there are quite a number of other barriers to investments. These refer to institutional deficiencies primarily. But there are also problems connected with the competitiveness, which are not all that well understood. As consumption is higher by about 50 per cent than GDP, the price level has to be quite high too. As monetary policy is not available, only high productivity can substitute for high costs. That, however, means that low wages cannot be the basis for Kosovo's comparative advantage. Indeed, in this situation, only competitive wages of high-skilled employees could help. It can be assumed, though the data is lacking, that those are in short supply in Kosovo.

In a sense it could be argued that the existence of significant foreign transfers, both private and public, and of significant non-resident consumption in Kosovo create some sort of a Dutch disease as they sustain a high price level which constrains the inflow of necessary investments. Still, if one were to order the barriers by importance, that of lack of access to markets would still be the dominant one.

Thus, long-term and efficient policy to encourage investments in productive capacities, especially in labour-intensive industries, probably mainly in small- and medium-sized enterprises, should be designed and implemented.

## *Nation-building*

The economic consequences of public preferences have always been taken to be very important in development – especially if the process of development is connected with that of nation-building. In post-conflict societies, nation-building is often dominated by political and security concerns rather than the economic ones. This has disadvantages in the context of the current developments in Europe. Without going into details here, there is no doubt that development will be helped if economic costs constrain political aims. This transformation is yet to happen in Kosovo and it is not altogether clear whether the current process of state-building is going to contribute to that in a decisive way.

In any case, it has to be emphasized that modern nation-building is more about economics than anything else.

## **VI. PROSPECTS**

The development of Kosovo in the future will depend very much on three things: state building, self-reliance and integration.

The recently released document of The World Bank on the prospects of the Kosovo economy underlines these conditions for sustainable development. All the three processes will take longer than is envisaged in that document.

The process of state-building will get a positive kick with the parliamentary elections that are schedule for November 2001. Once there is a local government, it will have a chance to start building the rule of law and running the country. This process will be under severe pressure because of the unresolved issue of the territory of Kosovo and because of the difficult security situation in this political entity itself.

Achieving self-reliance will be a major challenge. This is because Kosovo has never been self-reliant and because the aid and reconstruction effort currently under way has already created enormous distortions and also quite significant aid dependency. It will take a serious effort and a lot of time (though unnecessarily as argued in this

paper) for Kosovo to start paying for its own public expenditures, but that may not be the main problem. The key problem is the distorted economic structure that is developing in Kosovo. It is difficult to see how economic activity is to break out of the current reliance on agriculture, services and remittances from abroad. Industrial investments will be an inferior alternative as long as there are no sharp turns in the sources of income and in the business risks.

Finally, there is the problem of integration. Kosovo depends on the region for its development more than any other Balkan state or political entity. It is landlocked and its neighbours are not rich. Still, in terms of infrastructure and markets, Serbia and Macedonia will continue to play a major role for the Kosovo economy. Indeed, already the economic link with Macedonia, though currently broken, is vital. But, the Serbian markets are potentially even more important. However, it does not look as if this economic integration will progress any time soon.

In the short run, economic prospects for Kosovo are quite good. Reconstruction will proceed and the inflow of money from abroad will continue, though it is intended to diminish over time. However, once Kosovo will have a government of its own, it will have to come up with a strategy for development and it is not at all clear that it will be capable of dealing with the challenges that it will face both on the side of its political preferences and on the side of the economic preconditions for sustainable growth.<sup>3</sup>

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<sup>3</sup> More on this can be found in Gligorov (2000).

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