

A New Deal for Kosovo

Creating Sustainable Economic Growth

Position Paper published on the occasion of the 10th anniversary of ECIKS

Vienna, June 2013

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List of abbreviations

ATM	Autonomous Trade Measures
CSR	Corporate Social Responsibility
ECiKS	Economic Initiative for Kosovo
EU	European Union
EULEX	European Union Rule of Law Mission in Kosovo
FDI	Foreign Direct Investment
GoK	Government of Kosovo
GDP	Gross Domestic Product
ICT	Information and Communications Technology
IFI	International Financial Institution
IPA	Instrument for Pre-accession
KIDF	Kosovo Investment and Development Fund
KNDI	Kosovo New Deal Idea
LCD	Liquid Crystal Display
OECD	Organization for Economic Co-operation and Development
PSD	Private Sector Development
R&D	Research and Development
SAA	Stabilization and Association Agreement
SME	Small and Medium Enterprises
SOE	Socially Owned Enterprises
UNMIK	United Nations Mission in Kosovo
VAT	Value Added Tax

Foreword

It is common sense to take a method and try it.
If it fails, admit it frankly and try another.
But above all, try something.

Franklin D. Roosevelt

The Economic Initiative for Kosovo (EciKS) decided to mark its 10th anniversary of foundation with the publication of this position paper on the future of Kosovo's economy. Since 2003 EciKS is engaged in promoting the economic development of Kosovo through facilitating Foreign Direct Investments (FDIs) and supporting the Private Sector Development (PSD). Our humble experience does not mean that we hold the solution to Kosovo's challenges. The failure to predict the last financial and economic crisis has shown how inflated the term "expert" is and how big the need is for more modesty. Hence this paper is not an end-point. It is meant to encourage policymakers, academics, practitioners, politicians, managers, media people, and every person of good will, to discuss what we need to do for a sustained socioeconomic development, progress, and stability of Kosovo.

Kosovo people have a long history of adapting to change, be it economic or political. The country has suffered from wars, destruction, and exploitation and has even survived the most extreme forms of violence and repression. People of Kosovo have demonstrated that they love their country and they deserve a better life, no matter of ethnic and religious background or political orientation.

This is our common responsibility and we should not spare efforts to contribute to illuminating the challenges we face, their dimensions that have loomed large for many years, and pave the way forward. We can not lose hopes for the future and we ought to understand that there is no escaping from this responsibility. The earlier we deal with them, the better for us and our future generations.

1. Introduction

In the last fourteen years since liberation, Kosovo has achieved a notable progress in establishing the foundations of a democratic society and market-led economy. After nearly a decade of UN administration, the country has become independent in 2008. On its 5th independence anniversary, an EU-brokered accord has been reached aimed at normalizing Kosovo-Serbia relation. The deal is considered to be one of the final milestones in the country's political stabilization path.

The independence has proven to be a stabilizing factor, which is reflected in higher economic growth and higher inflows of Foreign Direct Investments (FDI). It made possible the membership to International Financial Institutions (IFIs), which is an important factor for the prospects of Kosovo's economy. Even during the global financial downturn, Kosovo's economic growth held well up and is gradually becoming driven by the private sector. The domestic inflation is relatively stable following mainly import prices for oil, commodities, and food. As result of a conservative fiscal policy of the past several years, but also because of the pre-independence inability to issue debt, country's sovereign debt remains low – 6.2 % of GDP in 2012.

The investment and business climate is gradually improving. A Tax Reform, which has halved the Corporate Income Tax and Personal Income Tax, has been applied since 2009 and has proven to be an important measure to boost the development of the private sector. Finally, after several years of slipping down in the World Bank's Doing Business rank, Kosovo has managed to reach the turning point and improve its position, although moderately.

Still, there are a number of challenges faced by the youngest democracy in Europe, which are mainly associated with an ongoing major structural adjustment process consisting of consolidation of statehood, the rule of law, transition to a market economy, and EU pre-accession reforms.

The country's socio-economic development has been overshadowed by the political concerns, such as status settlement and ongoing negotiations with Serbia, fragile governance and political structures. Consequently, the economy is characterized by structural problems like large trade imbalance, high unemployment rate, high informality, lack of transparency and accountability of public institutions, and significant levels of poverty. The current growth model, which is based on relatively unsustainable sources such as public spending, Diaspora remittances, and privatization, cannot be sustained over a long term. A reorientation towards more sustainable sources such as development of human capital and private sector, and utilization of natural resources is an imperative. In this relation, FDI would surely serve as a tool for the provision of finance, of managerial know-how, technology transfer, and for increasing the export base.

To reach the paradigm shift towards bringing the economic development on the top of Kosovo's agenda, a New Deal¹ in form of a widely accepted and supported National Economic Development Plan is essential. The Kosovo New Deal should refrain as much as possible from reflecting ideological views and rather stick to pragmatism and the practical needs of the economy.

¹ The term „New Deal” is made here with reference to the series of economic programs enacted in the United States in the period 1933-1936 during the first term of President Franklin D. Roosevelt in response to the Great Depression. The authors believe Kosovo needs a similar deal with a wide support from local and international decision makers in politics and economy, including circles in academia and civil society.

2. The Experienced Growth since Kosovo's Liberation

Developing a conceptual framework that emphasizes a broad based growth model for the next two decades is at the center of the Kosovo New Deal Idea (KNDI). The modeling of such framework necessitates a more practical and pragmatic approach that is somewhat different from stringent ideological views such as neo-liberalism and/or leftism. For this to happen, some light on factors must be shed that supported respectively impeded broad based economic growth in the last fourteen years:

1. Growth emerged during the reconstruction period (1999-2002) was rather short lived. Main engines of growth were remittances, humanitarian aid, reconstruction, and investments in the creation of a safe and secure environment. Whereas the international community provided substantial support to stabilize the country, no takeoff in economic terms was noticed not only because of the “inflated” nature of such growth but also due to the relatively fast (and expected) decline of foreign aid that has ultimately led to a period of economic stagnation (2003-2004).
2. Growth emerged during the post-reconstruction period (2005-current) was not based on technological change, innovations, and private sector development. The effects of the privatization of the Socially Owned Enterprises (SOEs) remained modest, with only a very limited number of success stories. The transformation of existing SOEs, in particular the structural changes in production, productivity, technology and internal organization of firms, were also limited. Currently, there is an impression that the private sector is expanding, but the challenges here remain high: productivity, access to finance, know-how – just to name a few.
3. In most cases economic institutions that would be necessary to support sustained growth did not develop sufficiently. First UNMIK and then EU and local institutions placed a larger accent on political developments and stability rather than on genuine reforms that would accelerate sustained growth. Despite some attempts, a strategy or a national economic development plan has never been fully developed. No institutions able to influence or implement major decisions were developed. For example, the development of new energy capacities, especially “Kosova e Re” project, is still pending. A proper broad based private-public dialogue was never genuinely established. Constructive criticism addressed to UNMIK and later on to the GoK about the lack of economic vision was disregarded and strongly discouraged. Financial development is not satisfactory due to legal uncertainty and limited number of lenders, although the banking sector remains stable.
4. The entire socio-economic development process is taking place simultaneously in a period of transition towards democratization and institutional development. As result, the experienced growth (~ 4% p.a.) was not broad based. It rather benefited to certain elites than fight of poverty and unemployment. It is not surprising that the improvements in living standard did not affect the entire society but only a minority. For example, empiric analysis show that entrepreneurs with political affiliations performed better since they enjoyed political protection. This includes illegal protection when it comes to public procurement or to “exclusive” rights on importing certain goods by creating illegal forms of cartels and monopolies. As result, entry barriers increased significantly, thus disabling new competitors to enter the market. Growth remains endangered by absence of contract enforcement and lack of rule of law.

When growth does not bring jobs, structural unemployment, lack of competitiveness and low productivity emerge. Consequently, life remains largely rural, and with expected 150,000 new entrants in the job market in the next five years, the unemployment remains a long-term challenge. Perhaps, more important, there continues to be little investment in human capital. As result a “creative destruction” that would trigger the change in Kosovo’s economy is becoming even more difficult. On this respect the state of educational system leaves a lot to be desired since politics is prevailing in this sector too.

3. Country’s Potentials to Generate Sustained Economic Growth

Kosovo is a land of paradoxes. It has a young, dynamic and hard-working population characterized by a very high entrepreneurial spirit, but still every second youngster is currently without a job. It has vast natural resources, but over 40 per cent of its population is still considered to be poor. It has access to a market of over 500 million people, but its exports remain rather modest. More than a half of its territory is arable land, but nearly all food is imported. The list can go on and on.

A long term sustained economic growth can be facilitated only if the vast potentials of the country are unlocked. The goal here should be to develop a competitive economy that will benefit all Kosovars by utilizing and combining potentials of i) human resources, ii) natural resources, and iii) private sector.

Human resources – Kosovo is blessed with young, multilingual and motivated individuals with a strong entrepreneurial spirit and a widespread knowledge of main European languages. With 70 percent of the population being under the age of 35, Kosovo is considered to have the youngest population in Europe. Although this represents a great development potential, it is at the same time a great challenge, since during the next five years over 150,000 youngsters are expected to enter the labor market while local absorption capacities are far from meeting this demand.

With an average monthly wage estimated at EUR 370, Kosovo’s workforce is the most competitive in the region. The labor market offer consists of basic skilled labor, with limited quantities of well skilled and highly educated jobseekers. According to the European Commission, Kosovo needs to further raise standards of education, reduce school drop-out levels, make its education system more inclusive, focus curricula on employability and concentrate on secondary vocational training, adult vocational training and life-long learning programs. The appropriateness of curricula has also been contested by the OECD, stating additionally that there are serious obstacles for human capital development making Kosovo to reach the second lowest score in the region.

Limited number of development programs, financing opportunities and relevant tools to induce business start-up among youngsters, remain further challenges towards unlocking the potential of creative and innovative business ideas. It is worth mentioning that Kosovo people have a long standing private initiative experience due to the limited access on public sector during the former Yugoslavia.

Natural resources – Kosovo is very rich in natural resources. It possesses the world’s fifth-largest reserves of lignite, which is fairly easily accessible and can be used to generate electric energy for at least the next 200 years. Base-metal mining has been a mainstay of Kosovo's economy since pre-

Roman times. Zinc, lead, silver, gold, cadmium and bismuth are found along Trepça's mineral belt. Proven chrome and bauxite reserves reach 100mn t. The country also possesses rich reserves of asbestos, chromium, limestone, marble and quartz. Rare minerals such as indium, germanium, thallium, and gallium, which are used for semiconductors, LCDs, infrared optics materials, electronics, biomedical applications, etc., are also existent but need to be further explored. Some rather conservative valuations of the proven natural resources of Kosovo estimate their value between EUR 13.5bn and 25bn.

Private sector – The private sector in Kosovo is dominated by SMEs which compose 95.5 percent of total number of registered companies in Kosovo. The SMEs are considered to be the backbone of Kosovo's economy, as it is the case in many European countries. While they contribute by 43 percent to the country's GDP and by 62 percent to employment, the private sector is still considered to be underperforming. The majority of SMEs are engaged in trade activities while production and service sector are developing at a low pace. The international competitiveness of the Kosovo companies remains low, explaining the huge trade imbalances. The quick market liberalization was intended to bring advantages in terms of maximization of outputs and market penetration. Due to the weak private sector development and limited resources to implement necessary adjustments and capacity building measures, the success was however limited. Kosovo exports remain still low in quantities and are undiversified.

The SMEs are product of the environment in which they operate. Current business environment in Kosovo is characterized by impeding structural factors such as the small size of the local market, limited export capabilities, relatively poor infrastructure, low entrepreneurial base, insufficient human and technical know-how and lack of access to finance. Prevailing policy factors include lack of determined measures against organized crime and corruption, weak economic governance and policy-making capacities and capabilities, insufficient data collection and evaluation mechanisms, limited ability to promote policies to attract FDI, weak legal structures to facilitate property rights and contracts, dispute resolution, etc.

A proper utilization of above mentioned resources combined with the creation of value chains in related industries, would give a remarkable boost to Kosovo's economy, generating large inflows of FDIs, increasing exports, budget income, the quality of life and disposal income of Kosovo's population. For example, the utilization of these capacities would suffice for the creation of at least 35,000 new jobs in the primary sector (mining and extraction of minerals), whereas the agriculture sector is supposed to have capacities for the creation of additional 150,000 new jobs.

4. Top Ten Priorities for Kosovo's Economic Development

Contrary to prevailing beliefs, Kosovo's economic potentials are vast. They can be unlocked, activated, and utilized for the benefit of a broad based growth only if led and accompanied by a set of smart measures and interventions from the economic governance point of view. The initiators of the Kosovo New Deal Idea believe that for this to happen, economic development should be made top priority of political agenda of GoK and of international institutions active in Kosovo. The following ten steps might be a good start in the right direction.

4.1 Strengthen rule of law

The rule of law is normally related to legal and political matters. In the meantime, the rule of law is being recognized as an important factor in the economic development too.

Rule of law is a declared priority of GoK, in order to reduce corruption and build up state institutions. In 2006 GoK has developed an "Anti Corruption Action Plan" as response to economic and social necessity in Kosovo. The call for "Zero tolerance against organized crime and corruption" remains a declared goal of every elected government in Kosovo by now. When independence was declared in 2008, Kosovo authorities invited and welcomed the presence of the EU-led rule of law mission (EULEX). Since then, executive responsibilities in investigating and prosecuting crime and corruption are shared between Kosovo institutions and EULEX.

Despite increased efforts, the results up to date leave much to be desired. Informality remains a key challenge, although the introduction of cash registers has provided some initial remedy in this process. A number of recent corruption scandals have shaken the trust of foreign investors in Kosovo's economy. There is a general opinion that impunity is largely in place. Some arbitrary actions of municipal authorities against foreign investors, although very limited in nature, send negative signals abroad concerning the business and investment environment, and as such must be suppressed. A particular challenge remains restoring the rule of law in the north, which despite the reached deal with Serbia to dismantle parallel structures and extend sovereignty of Kosovo institutions there, still needs determination and political will of local and international key players to implement its provisions. Less state in economy, does not necessarily mean privatizing at any cost. It rather means focusing at the provision of necessary legal and institutional protection of the economic system, eliminating monopolizing practices, improving circulation and reliability of information, maintaining competition and removing barriers for new entrants, taking care of macroeconomic stability, fiscal and monetary policy, income redistribution, reduction of external effects (e.g. pollution), etc.

Key Recommendations:

- Commitment to the **fight against crime and corruption** should go beyond rhetoric. The efforts of Kosovo executive and judiciary, along with legislative should be better harmonized and coordinated with EULEX and political influence, be it local or international, should be stopped. This will help restoring trust in institutions. The reform should be comprehensive

and led by professionals rather than politicians that often are in conflict of interest with the rule of law;

- **The court in northern part of Kosovo** as well as **customs points 1 and 31** should be fully functionalized;
- The **procurement process** should be reformed in accordance with EU practices and become more transparent. An **administrative court** to deal with procurement cases should be created;
- **Training and capacity development programs for Kosovo judges, prosecutors and lawyers** in dealing with economic and financial cases should be provided and specialization in these areas should be encouraged;
- **Court transparency** and public information should be increased through the introduction of online publication of court judgments;
- Private sector should be induced to **alternative dispute resolution** (Arbitration).

4.2 Strengthen economic governance

Economic policymaking has to take place based on reliable and sufficient macroeconomic data. Kosovo's policymaking efforts currently depend on a limited number of available economic indicators what imposes a certain trial-and-error effect on resulting policies. Furthermore, discrepancies in data coming from different sources are hampering unique planning based on the same underlying assumptions. More effective and detailed statistics focusing on the structure and evolution of the economy and providing a framework for numerically describing and analyzing economic interactions must therefore be put in place. Certainly, industrial policies will require continuous, reliable and detailed data from economic sectors and sub-sectors. Increasing the international competitiveness of tradable sectors inducing exports will require more qualitative data on manufactured exports, share of low, medium and high-tech products in manufactured exports, etc.

Sustainable economic development is reachable only through long-term planning and policymaking. In this regard, Kosovo will have to develop and stick to a coherent National Economic Development Plan. Ministerial strategies and activities are to be derived from such a plan and put in function of overall economic goals. A strengthened inter-ministerial co-ordination and co-operation is an imperative. Ad-hoc policy making will have to be avoided. While certain short-term positive effects might be reached, the impact of such policies in the long-run is highly uncertain in polarity. There were certain initiatives in the past for developing economic strategies in Kosovo, however there was either no institutional will to implement them or they were unrealistic, incomprehensive and costly. Subsequently, the National Economic Development Plan will have to include realistic and explicit targets and provide policy instruments to reach them. It must be implementable in budgetary terms and monitored and evaluated regularly. Such a plan must take into consideration the local socio-economic circumstances and possible effects on the national economy due to currency and monetary policy restrictions. It also should evaluate the use of existing financial resources (for example privatization revenues) for sustainable economic development purposes.

Finally, policy making and policy implementation requires institutional competence which exists only to some extent in Kosovo. Capacity building and effectiveness increasing measures will have to be followed in apparatus of State to reach suitable levels of qualification and cut cost. The unjustifiable

growth of the public-sector employment and institutional expansion is here the phenomena to begin with. The call for more regulation should be understood in terms of inducing a healthy and fair market competition and avoiding of monopoly structures or barriers to competition.

Key Recommendations:

- GoK should guide a process of compiling a coherent **National Economic Development Plan** which is to be actively pursued to avoid principal-agent problems and ensure a broad-based sustainable economic development;
- Effective **platforms for inter-ministerial co-operation and co-ordination** should be strengthened to avoid double efforts and to streamline and increase the effectiveness of the economic development policies. GoK should **avoid** [politically motivated] **institutional and public employment** growth and rather concentrate on **increasing effectiveness and decreasing the cost of state apparatus**
- The capacities and capabilities of the Statistical Office of Kosovo should be increased and a **System of National Economic Accounts** should **be developed in accordance with EU practices**;
- **Detailed, reliable and continuous sector statistics** should be introduced for evaluating the development of the competitiveness of the private sector and monitoring policy implications;
- Donor support should be increasingly utilized to further **develop institutional capacities** in economic planning and policy making;
- **Macroeconomic stability** should be maintained by achieving and maintaining a prudent level of sovereign debt, providing reasonable degree of stability and predictability of tax system, by keeping budget deficit below 3 per cent of GDP, and inflation rates below 3 per cent.

4.3 Education

The education system in Kosovo currently consists of more than 500,000 young people (27% of total population) enrolled in primary and secondary schools as well as universities. The higher education system operates through three public and 22 private universities and other higher education institutions. Although the lately introduced accreditation process of high education institutions in Kosovo has brought improvements in the education sector, the quality and market orientation of the universities and colleges is still far from reaching a satisfactory level.

The investment in the education is currently approx. 4 percent of the country's GDP, which lies far beyond the EU average of 5.9 percent in 2012. The gap is even higher in nominal terms if the level of the national GDP and the beneficial demographical structures are taken into account. In order to ensure a long term development of the high-knowledge society out of the young population, investments in education will have to increase and be re-oriented towards a non-physical infrastructure. In the last decade a fairly large percentage of the investments were used for building new schools and physical infrastructure which corresponded to the reconstruction needs imposed by war destruction.

Furthermore, a diversification of the education offer through combining theory training in a vocational school and practical training in private companies is required to facilitate the

diversification of the labor and ensure practical skill development in different fields of economy. The introduction of an industrial code regulating different business fields would be a motivating factor for such education and as a result the overall quality and productivity of the private sector in Kosovo should increase.

Kosovo currently has approx. 260,000 registered jobseekers, out of which some 70% are unskilled or basic skilled. Investment in subsidizing vocational trainings and building capacities for implementing such training are furthermore required to qualify the jobseekers according to the market needs and broker them successfully to the private sector.

Key Recommendations:

- The Government of Kosovo should introduce a **dual education system**, similar to those in Austria, Germany and/or Switzerland, for enabling a more diversified and effective supply of labor;
- **Market orientation** should be embedded in the **curricula development process** of higher educational institutions through establishment of dialogue platforms with the private sector;
- Mechanisms for **inducing the R&D activities** of the private sector should concentrate on increasing the co-operation with educational institutions;
- Investment in physical (such as labs) and non-physical **educational infrastructure** should be increased to enable practical skill development and increase competence of the labor;
- For a successful reorientation and brokerage of unemployed into the economy, GoK should increase investment in **vocational trainings** as well as in establishing mechanisms for incentivizing participation;
- An **industrial code** regulating the entrance into selected business fields will be needed to support the development of the dual system in Kosovo and increase the overall competitiveness and productivity of the SMEs;
- As part of reforms in primary educations, mechanisms should be developed to **identify and support young talents** in science, sports, and culture.

4.4 Infrastructure

Infrastructure, as the stock capital that provides public goods and services, is a precondition for a sustainable economic growth. Although results may not come over night, better roads, railways, airports, hospitals, power and water supply and sanitation, are a precondition for an inclusive and sustained economic growth. An improved infrastructure benefits people across income levels and geographic areas; it improves quality of life for the poor and is likely to support alleviating poverty.

Kosovo has inherited a basic, relatively well developed infrastructure, which was, however, devastated due to the mismanagement during the Serbian rule in the nineties and also due to the war in 1998-99.

Numerous infrastructure development initiatives have been implemented in the meantime. The road infrastructure has improved significantly. The highway connecting Kosovo with Albania, which has

been opened in 2012, is considered to have a significant role for an improved regional economic cooperation, though still largely underused due to a lack of policy adjusting approach of both Kosovo and Albania governments that would enable boost of trade and cooperation. The Government of Kosovo will spend over 40 percent of its budget for 2013 on infrastructure projects, such as road infrastructure, education, and health care. Top priorities remain completion of the highway Merdare-Morin and the construction of the highway connecting Prishtina with Skopje. To ensure budget sustainability, these projects have been coordinated with the International Monetary Fund.

As the importance of existing rail network is increasingly being recognized for both freight and passenger transport, there is an emerging need to develop strategies and measures for its modernization. The combined length of Kosovo railways reaches 330 km, connecting both the south with the north and east with west parts of the country. The non-electrified network was originally part of the international railway network, but due to the occurrences in the nineties these lines are not utilized anymore.

Also the energy infrastructure, in particular supply, production, and transmission need improvement and the creation of new capacities based on fossil and renewable sources is an imperative. Kosovo needs to modernize and expand energy network and develop smart grids to save energy and better manage network. Additional investments are needed for an increased penetration of internet also in the rural areas and for an improvement of mobile network connections.

The Prishtina International Airport is with over one and a half million passengers per year, one of the most frequented airports of the region. Creation of new capacities in air transportation would, however increase competition, reduce travel cost, and benefit Kosovo's population and Diaspora.

As far as water supply and sanitation is concerned, significant part of international aid was concentrated on refurbishing and improving these capacities. Assessments show that nearly a quarter of Kosovo's population is currently not yet covered with operational water supply systems; whereas only approximately the half of Kosovo's rural population has access to sanitary sewer system.

Key Recommendations:

- **Highway construction** between Merdare-Morin and Prishtina-Skopje should be finalized as planned and in accordance with budgetary capacities of GoK; this will improve the geostrategic position of Kosovo between Western Europe and Middle East and North Africa (MENA) countries and make the country more attractive for business and FDI;
- In a next step, to increase mobility of people and goods, GoK should embark on the **modernization of railways**. Particular attention should be paid to linkages in international networks, i.e. by constructing a railway line to Albania, which can be further extended to Montenegro, by modernizing the existing connection to Macedonia and by re-activating and modernizing the connection to Serbia;
- The **Gjakova Airport**, which is currently used for military purposes, should be opened for civil transportation to increase competition, reduce travel cost, and increase benefits for Kosovo's population and Diaspora;

- **Public transportation** in the cities should be improved by modernizing public transportation companies through private-public partnerships; for example Prishtina is in need and can afford the construction of tram lines and, in cooperation with central authorities, the construction of a railway line linking the city center with the Prishtina International Airport;
- The GoK should speed up procedures for the **construction of new coal fired power plants** (Kosova e Re) and attract serious investors, who will invest by respecting internationally recognized environmental protection standards and CSR criteria;
- GoK should attract further investment in **renewable energies** and in cooperation with IFIs facilitate access to finance for such projects;
- GoK and Government of Albania should complete the **construction of the 400kV transmission line** by 2016, enabling both countries to make use of their complementary opportunity to exchange energy throughout the year;
- GoK should support the development of necessary infrastructure to facilitate **full internet penetration** in schools, institutions and households particularly in rural areas by 2017;
- GoK should introduce new **3G and/or LTE licenses** for mobile telephony by 2015;
- GoK should utilize international aid and increase investment to ensure maximum coverage of population with operational **water supply and sanitary sewer system** by 2017.

4.5 Utilize natural resources

As indicated in Section 3 of this paper, Kosovo possesses a large quantity of natural resources, which represent one of the three pillars of KNDI for a sustainable and broad based economic growth of the country. A proper utilization of these resources can lead to the reactivation of large industrial potentials and to the emergence of completely new industries and value chains. First and foremost, Kosovo should utilize its energetic capacities for the benefit of economic development and sustained growth. Although energy generation resources remain vast, Kosovo still needs to import electricity. At the same time, the existing generation capacities, the two coal-fired power plants Kosova A and B, are far from meeting international environmental standards. New investments in utilizing energy resources should be paired with efforts in pursuing an active R&D component of developing know-how and capacities in energy generation and environmental protection, with particular attention to renewable resources. By combining its unique natural and human resources with scientific efforts, Kosovo can become an internationally recognized area for R&D in energy and environment protection.

On the other hand, the revival of mining industry has the potential to lead to the development of metallurgy, metal processing, and a set of further related industries which emerge up the value chain ladder. By utilizing deposits of rare minerals, Kosovo can even set up and develop completely new high end industries such as electronic components, semiconductors, LCDs, optics materials, etc.

Utilizing the vast agricultural potentials will not only help substituting large amounts of food imports, which are often of doubtful quality, but it will also help the emergence of a completely new food processing industry and would absorb a large number of currently unemployed people.

The resolved political status of Kosovo, has *de jure* clarified the politics surrounding ownership, management, and control of country's natural resources. When using and transforming these

resources now, capital stocks will be created, which add to the wealth of present and future generations. These resources need to be used in accordance with principles of *a) efficiently* – using them in a sustainable manner while minimizing impacts on the environment, and of *b) sustainable development* – which means that the needs of present generations should not jeopardize the ability of future generations to meet their own needs.

These principles need to be not only integrated in policies and legal provisions of Kosovo, but they need to be streamlined in political and economic decisions and pursued by the society in general.

Finally, to develop and utilize these capacities, Kosovo will need to attract increased inflows of FDI, which will bring the necessary know-how and market linkages – a pre-condition for the success.

Key Recommendations:

- GoK should conduct a **detailed investigation of Kosovo’s natural resources** using most advanced methods and technologies, introduce a resource valuation tool, create an online database to communicate the value and condition of the available resources, and help policy-makers to integrate this information in Kosovo’s social and economic indicators;
- Policymakers should encourage further research and analysis to identify additional tools for the financial, regulatory and legislative frameworks, needed to create contextual realities for a **better utilization of natural resources**; particular attention should be paid to preventing the practices of “trade” with exploration licenses.
- GoK should encourage further studies and research about establishing industries and clusters that can **develop value chains** for further processing of raw materials and natural resources;
- Principles of **efficiency and sustainable development** of natural resources should be integrated into mainstream economic planning, development, and regulatory frameworks;
- GoK has to take advantage of increased interest of foreign investors for natural resources in Kosovo and **facilitate a fair competition** with maximum benefit for the local population;
- Investigate the feasibility of establishing new market mechanisms whereby private investors and individuals could invest in established mining companies as minority shareholders (**widespread shareholding**); this would give the population the chance to directly gain from the utilization of natural resources and would also mobilize large Diaspora investments;
- Under any circumstances, GoK should not negotiate the issue of **ownership and control of country’s natural resources**. Giving up the control over natural resources (e.g. water resources in the north) would severely undermine Kosovo’s chances for a sustainable socio-economic development;
- GoK should create a “**national royalty fund**” or a “**national wealth fund**”, which will be filled through income from licenses, royalties, fees, etc. and will be used predominantly for investment in education, healthcare, and infrastructure;
- GoK should establish a **University Program for Energy Studies** with a Center of Excellence for Energy and Renewable Energy Research.

4.6 Develop private sector and SME

There is a widely shared consent among practitioners and academia about the potentials and constraints on private sector development in Kosovo. As also indicated in Section 3, the factors impeding private sector development are interrelated to some key characteristics of economy, such as unsustainable sources of economic growth, lack of exporting capacities, the ongoing transition, etc. On the other hand, there are constraints in the business environment, which are a result of weak private sector development governance, such as evasion, informality, electricity, contract violations, administrative red tape, etc. Such factors combined with lack of trust and cooperation not only between public and private sector, but also within the private sector itself, discourage investment in capital and human resources, creation of long term cooperation among private sector players, formation of business clusters, and encourage business informality and tax evasion.

The SMEs in Kosovo are considered to be seriously underperforming relative to their potential with access to finance remaining as the main constraint. Financial institutions are being criticized for offering too little credit to the private sector, while also demanding high interest rates and excessive collateral requirements. On the other hand, over EUR 600mn of accumulated privatization funds and over EUR 500mn from the Kosovo Pension Fund are invested in the international capital market, representing a capital exodus of over 23 per cent of the GDP.

The above perceptions do however not necessarily mean that there is no institutional willingness to improve private sector development governance in Kosovo. Decision makers and government officials seem to increasingly recognize that private sector development is a vital element of sustained growth, that the latent force of SMEs can help maintaining a competitive edge during transition and overcoming challenges in domestic and international market, that SMEs are engines of job creation and poverty reduction, a significant contributor to industrial production, national income, exports and GDP. SMEs, furthermore, reflect individual initiatives and skills, have great operational flexibility, enable low cost production, have high potentials for R&D, utilize local human, material and natural resources, etc.

The Ministry of Trade and Industry of Kosovo has drafted the “Private Sector Development Strategy 2013 – 2017” which mainly focuses in the development of SMEs, investment promotion, enhancing the internal market, free movement of goods, as well as improvement of the trade policies. The purpose of this strategy is to address challenges in industry and private sector development which represent the change in legal, institutional and policy framework. Furthermore, an SME Development Strategy for Kosovo 2012-2016, with the mission of improving business environment, entrepreneurship culture and rapid growth of sustainable SMEs is in place and is being implemented.

Key Recommendations:

- In cooperation with industry associations and educational institutions GoK should engage on **increasing capacity building programs for SMEs** that facilitate know-how, technology transfer and skills development, promote linkages with larger enterprises, and support SME competitiveness;

- Develop programs and mechanisms **to induce reporting culture, encourage compliance** with tax regulations and **promote formalization**;
- Develop comprehensive **policies for human resources development** for labor, technical training, and increased funding for R&D expenditure;
- GoK should establish the **Kosovo Investment and Development Fund (KIDF)**, financed by the accumulated privatization fund, to encourage and accelerate private sector development, with particular emphasis on SME development. Credit guarantees, incentives for exports and employment, effective corporate governance, formalization, value chain development, R&D etc., should be main activities to be covered by KIDF.
- An **SME Development Bank**, as a derivative institution of KIDF, should be established to provide increased access to finance to SMEs, in particular in sectors that boost job creation and exports, such as agriculture, food processing, manufacture, ICT, wood processing, metal processing, etc.;
- Main attention should be paid to established SMEs, which have the market potential to develop further; **supporting their growth**, means supporting job creation, import substitution and poverty reduction;
- The **VAT system should be reformed** in line with European Standards, by improving VAT reimbursement, increasing VAT prolongation period from 6 to 24 months for sectors of specific interest (agriculture, manufacturing, etc.), reducing VAT threshold from EUR 50,000 to EUR 20,000 to support formalization, introducing lower VAT levels for basic food products, and by gradually replacing VAT border payment with payments when invoice is due.

4.7 Foreign Direct Investments (FDI)

Compared to its regional competitors Kosovo is a relatively new destination for FDI. Foreign direct investment has been recognized as a tool to reach national economic goals already in 2005 when the law on foreign investment was adopted and the Investment Promotion Agency of Kosovo subsequently established. Owing to beneficial local factors like the availability of young and cost-efficient workforce, natural resources, free trade agreements and Euro as official currency, the country has mostly had a positive FDI growth trend in the last decade. In 2012, however, FDI inflows decreased by 40% mainly due to the negative economic performance in the Eurozone which is the main source of FDIs for Kosovo.

Although progress is underway, the FDI inflows are still insufficient to reach the desired technological and know-how transfer and significantly contribute to local employment. The country is still facing an image problem which is hampering foreign investment initiatives. Studies on investor perceptions however indicate that Kosovo is better than its image. In this regard, the government efforts to improve the business and investment climate are foremost appreciated, but will have to be accompanied by far reaching and effective image building campaigns. For the image building activities to be efficient they will have to build upon locally perceived advantages that are and will be commonly shared between country's citizens.

Kosovo furthermore needs to move forward from factor driven towards the more technologically sophisticated business activities. In order to do so, incentivizing investment and increasing the qualification and skills of the human capital will be required. Financial incentives have budgetary

implications but could be restricted in amount and provided on first come first served basis. Investments in education should be guided from a perspective of aspiring a regional pioneer role in a certain sector (for example ICT). In addition, increasing FDI-inflows will require a more targeted promotion, better services for foreign investors, appropriate investment promotion staffing, and a better utilization of Kosovo diplomatic missions (economic diplomacy).

Key Recommendations:

- GoK should develop an agenda for **attracting annual FDI flows of €1bn**;
- GoK should increase its efforts for reaching the promised **top 40 ranking** in the World Bank Doing Business Report;
- A far reaching and efficient **image building campaign** should be undertaken for awareness raising purposes and countering negative media coverage on Kosovo;
- In order to cope with regional competition, GoK should **introduce financial and nonfinancial FDI incentives**;
- A **more effective FDI promotion and facilitation** will require a more integrated approach within the governmental institutions avoiding double efforts and channeling the activities through a single specialized institution;
- **Recruiting and staffing decisions** for FDI promotion institutions will need to take into account job requirements related to FDI promotion work to a greater extent than previously;
- Through an appropriate package of developing curricula and investing in human capital a **pioneer role with a component or a vision for being regional leader** in for example the ICT sector, should be aspired;
- GoK should organize an annual **“beauty contest”** to attract investment in particular sectors by offering special incentive packages. This concept should be used as an cost-effective marketing activity to also put Kosovo on the radar screen of potential investors;
- **Data collection mechanisms** on FDI inflows and **investor perceptions** should be introduced for a more structured approach in FDI promotion and facilitation;
- **Diversification of the FDI source countries** should be pursued in order to reduce major dependencies on single economic areas;
- Effective **after-care programs** for foreign investors should be established to lower the risk of FDI drain from the country;
- To attract **more FDI from Diaspora**, a **support program** should be established from GoK, as part of KIDF, to provide grants and business consultancy to Diaspora entrepreneurs willing to invest in the private sector in Kosovo.

4.8 Social Security and Health care

The social protection system in Kosovo consists of a three tier pension system and social assistance scheme. Governmental spending on social protection is fairly modest amounting to approx. 4 percent of the GDP. Upon the exclusion from the Yugoslav pay as you go pension scheme, Kosovo has introduced basic pensions in 2002 for all old people (65 years and above) amounting up to 119 Euro. This means that every Kosovo retiree has a daily budget of approximately 4 Euro only. There has been a slight pension increase in the last years; however, due to the absence of indexation, the effects on purchasing power have been minimal. A partial relief to the situation is expected due to the decision of the International Court of Labor in Strasbourg, by which Serbia will have to pay for pensions that have been suspended 14 years before. The follow-up on this decision should therefore be a top priority of the Kosovo government. As far as the second tier mandatory pension savings scheme is concerned, measures to increase formality and widen contributor base are required. If a low coverage rate persists in the long term, a large number of elderly people can be expected to have to rely solely on the basic pension in the future.

In absence of a health insurance fund financed from employee contributions, Kosovo's public health care is relying on the governmental budget. Public health care spending is estimated at 2.7 percent of the GDP and amounts for 60 percent of the total spending on health care. The remaining part comes from out-of-the-pocket payments by private individuals. Regional comparison shows that Kosovo's public spending on health care is the lowest in Balkans and as a result significant further investment will be needed to improve the quality of health care and enhance health indicators like life expectancy, maternal death rates, infant and child mortality, etc., to the regional level. The high percentage of private spending on health care puts furthermore a significant burden on the households' budget. An introduction of a risk-pooling mechanism through health insurance is an imperative in this regard. Ensuring sufficient contributors base will need more pronounced measures for promoting formalization as well as an increase of human and institutional capacities for effective implementation of such an insurance scheme. A wider geographical and professional coverage of health care services might in addition require an introduction of a system of contracted medical service providers.

Kosovo's health system can not currently provide adequate services for more advanced interventions like in oncology, and cardiac treatment etc. According to World Bank some 80 Million Euro annually are spent by private individuals on such interventions in foreign countries. This deficiency in the health system represents an existential threat for Kosovar households due to the levels of available income. Public fund raising campaigns for supporting children in need represent for many households the only way out of the situation.

Key Recommendations:

- GoK should accelerate its efforts in **introducing a health care insurance** for enabling risk pooling mechanisms to prevail and reducing the financial burden on households;
- A system of **contracted medical service providers** will be required in order to widen the geographical coverage of qualitative medical services especially in the areas inhabited by the poor;

- **Increasing the base of contributors in the mandatory pension's scheme** by implementing concrete measures for promoting formalization should be pursued to prevent elderly poverty in the long run;
- GoK should **induce investment in those health care fields** for which Kosovo households are forced to buy services in foreign countries. Co-operation with local and foreign educational institutions and international donors should provide a platform for developing the needed human capital for such field development;
- GoK negotiations with Serbia should concentrate on accelerating the process of **paying the pensions** that were discontinued in 1999;
- A proper and continuous **indexation mechanism** should be introduced in the basic pension scheme to avoid decrease in the purchasing power of elderly and fight the prevailing poverty among old people.

4.9 EU-Integration and regional cooperation

Since the Thessaloniki Summit in 2003, Kosovo is part of the framework of the Stabilization and Association Process, which is designed to support Western Balkan Countries to prepare potential candidates membership. Negotiations for EU membership will only start once Kosovo has signed the Stabilization and Association Agreement (SAA) with the EU. The fact that Kosovo is still not recognized by five EU member countries does not pose a legal obstacle for signing the SAA. In October 2012 the European Commission conditioned the date for starting the SAA negotiations with further progress on Rule of law, Public administration, Protection of minorities, and Trade. An eleven points to-do-list has been agreed with the EU-Commission and is in the process of implementation. On April 2013, the European Council has decided to open negotiations on SAA with Kosovo, which are expected to start on the 10th anniversary of the Thessaloniki Summit (end of June 2013). The general impression that Kosovo has become more isolated from the EU since 2008 is now slowly changing and the European perspective is becoming much realistic. The still pending visa liberalization makes however Kosovo citizens as one of most isolated nations worldwide and is largely hampering the economic and trade cooperation between Kosovo and EU.

The Kosovo EU relations are multidimensional. The EU is Kosovo's main trading partner, main source of FDI and of remittances. In addition, in 2002 Kosovo has adopted the Euro in cooperation with the European Central Bank and several national banks in the Eurozone. While it is unlikely that Kosovo will be forced to withdraw the euro from circulation, this remains an important issue to be resolved during the negotiation process. The road towards officially joining the Eurozone will obviously be longer than the EU accession process, especially when having in mind the strict convergence criteria and the lessons learned from the financial crisis. While the Euro gives Kosovo a considerable advantage over its competitors in the region by making the country more attractive to foreign investment, due to low transaction costs and the elimination of currency and exchange rate risk, it also poses a challenge due to the absence of traditional monetary policy instruments. As result, Kosovo for example cannot print money, or devalue its currency to boost competitiveness and exports.

A further example on the multidimensionality of Kosovo-EU relations is the help provided to ensure stability and rule of law through the EULEX rule of law mission. Institution building remains at large

one of most important outcomes of the pre-accession phase, since it helps improving legal framework and addressing inter alia weak private sector governance through the introduction of reforms in line with “acquis communautaire.”

Moreover, EU has extended the Autonomous Trade Measures (ATMs) to Kosovo, which is expected to be replaced by the SAA, enabling Kosovar products to be exported without import duties and other limitation to the EU countries.

While local policymakers and broad public are absolutely in favor of Kosovo joining the EU, there are some issues, such as trade liberalization, which will impact the state of Kosovo’s economy throughout the pre-accession period. While trade liberalization with the EU will bring additional social benefits to the population of Kosovo due to cheaper products and services unburdened with import duties and will improve prospects for increased FDI inflows, it will also put pressure to the private sector, which will be facing even more competitive firms from the EU and will need even more support and capacity building measures from the government and the donors.

In a nutshell, EU integration remains the most important mechanism to motivate countries of the Western Balkan region, including Kosovo, to carry out reforms in state building, rule of law, market economy, and regional cooperation. With this, the EU process is also a long-term mechanism supporting peace, stability, reconciliation and prosperity in the Western Balkans.

Key Recommendations:

- Despite the fact that few EU countries are not recognizing Kosovo yet, EU should remain committed to assist country’s economic and political development through a **clear European perspective** in the scope of establishing contractual relations;
- EU should pursue the policy of establishing a **transparent and credible SAA negotiation process** with Kosovo, containing specific, achievable and measurable short-term goals that will enable clear and objective measurement of progress achieved and will help avoiding blaming the one side or the other for the lack of progress;
- GoK should undertake every necessary measure to complete SAA negotiations, implement required reforms, and **sign the SAA by June 2014**. GoK should in particular **increase overall capacities to negotiate** and implement provisions of SAA and of the trade agreement;
- The EU should increase its financial aid, provision of know-how and technical assistance to the GoK, through the utilization of IPA funds and other initiatives, **to facilitate the SAA negotiation process** and to help introducing and implementing **an integration agenda for the north**, which is inclusive and long-term and consists of measures in strengthening rule of law, socio-economic development, safety and stabilization;
- GoK should develop and implement a strategy that identifies measures and tools to **offset adjustment costs of trade liberalization with EU**, particularly when it comes to revenue loss, increased competitive pressure for local SMEs, in particular in the agriculture, and develops tailor-made initiatives that help the reallocation process towards sectors that benefit from liberalization;
- The **IPA cross-border cooperation** component for Kosovo has to be increased and cooperation with all neighboring countries under this umbrella needs to be facilitated.

4.10 Create a broad-based coalition to utilize potentials based on the National Economic Development Plan

A broad based coalition with a common interest to work towards a goal of inclusive and sustainable economic development is a prerequisite for utilization of Kosovo's economic potentials. The country is not unique in terms of its development challenges and possible solutions paths are predominantly existent. It is just the depth of the economic problems that makes the list of required interventions long. Nevertheless, key stakeholders must jointly engage in establishing a priority list through constructive delivering and absorption of criticism. The economic views of government, political parties and academia members might differ, however their overall goal – increasing the welfare of Kosovo citizens – remains the same.

In this regards the coalition members will have to share the common vision of increasing the overall welfare and commit to work together on a KND initiative. The goal here is that political and electoral agendas remain dominated from approaches and views on how the KND can be better implemented and not if it should be implemented at all. This will finally increase the responsibility towards the communities political parties represent. In addition, there must be a political will from decision makers in politics to initiate the coalition building process – a **coalition for a sustained economic growth for Kosovo**. The KND-Initiative should be viewed as a mean to increase transparency and accountability of the government as it sets clear development paths which can be measured in quantitative and qualitative terms.

The utilization of Kosovo potentials for a broad based and sustainable economic development might be hampered by scarce financial resources. The dilemma to be faced in this regard involves investment in growth versus redistribution of equity through social expenditures. Therefore, successful policies that promote growth and create sources of income for the government are required. The success of policies will depend on the inclusiveness of economic actors in their planning and therefore policymaking dialogue through the means of a coalition is an imperative.

Key Recommendations:

- Economic Development is an issue of all Kosovo citizens, therefore an **inclusive approach of coalitioning** should be pursued to bring greater commitment and support for development as it is mainly sponsored by the community itself;
- **A broad-based coalition should be formalized** and operate as an organization with clear structures and responsibilities among the participants;
- The process of developing the **National Economic Development Plan** should be initiated and led by the Prime Minister's Office to ensure full stakeholder participation;
- Accelerated access to **structural assistance of EU** should be pursued. By securing additional financing sources for economic development purposes, social expenditures directly supporting the improvement of the living standards of the Kosovo citizens will continue to increase.

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