



**United States Agency for International
Development**

Economic Management for Stability and Growth

Annual Report

July 2009

Deloitte.

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Chief of Party

Contract Number

GEG-I-00-04-00004-00

CHIEF OF PARTY REPORT

It is again my pleasure to submit the annual report for the Economic Management for Stability and Growth (EMSG) project. This report covers the original contract and the new task order objectives for property tax, mining and tax administration.

As discussed in the first annual report, the first year of the EMSG project witnessed national elections, a change of government and a declaration of Independence. During the second year, the adoption of a Constitution triggered the need for a variety of legislative changes, mainly related to decentralization such as the rewrite of the Law on Public Financial Management and Accountability, the Law on Local Government Finances and the Law on Aviation. Notwithstanding these historical events, considerable progress in the development of core institutions and capacity building has been achieved and was recognized in the recent USAID independent evaluation of the project.

In the Central Bank of Kosovo (CBK) the evaluation determined that project deliverables have been met and subsequently, after approximately ten years of continued support, the CBK can stand alone and assistance has been withdrawn.

In the Ministry of Finance and Economy, the development of the macro-economic department continues to be a major success and a formal government decision to support their transfer to the government has now been taken and this is expected to occur no later than 1 October 2009.

Elsewhere in the Ministry, within the Treasury the focus is firmly on decentralization with substantial training of municipalities under way and a process in place to certify municipalities by the end of the calendar year for assuming all payments functions and associated retention of source documents.

In the Budget and Intergovernmental areas, development of the MFE analysts continues to yield results and further development of the budget process for 2010 is underway. A significant number of legislative changes were also made to municipality sources of financing and in establishing a credible Grants Commission process.

In Tax Administration, another Director has been appointed. However, early signs are very encouraging that the selected candidate will assist in further developing the Tax Administration to be a fair, responsible and respected organization. Considerable progress was also made in installing a professional audit selection model and in modernizing the information technology function and SIGTAS system.

The new Property Tax IT system has been rolled out and the first bills have been issued. A resurvey of all properties will be implemented later this calendar year. Following these initiatives, it is expected that the project will exit this area by the end of 2009 with deliverables again having been met.

Exceptional progress continues to occur in PPP with the promulgation of the PPP Law and establishment of a PPP Unit in the Ministry of Finance and Economy. The concession of the Pristina International Airport is tracking nicely towards finalization.

Legal training is meeting all objectives and considerable work continues to be done in reviewing pending legislation and on occasion writing new legislative acts.

Progress in energy has now accelerated with the Government taking formal decisions to privatize KEK Distribution and Supply and appoint a Transaction Advisor. Also instructions have been issued to the New Kosovo Transaction Advisor to finally accelerate this project forward.

In the new areas of mining, a new Mining Law has been presented to the Assembly with our focus now turning to pre-feasibility on a green-fields lignite mine.

A summary of the individual Result Areas follows.

CROSS-CUTTING THEMES

Anti-Corruption – Advisors involved in Airport, Energy and Disco transactions ensure Ministerial Board is aware of corruption issues and has opportunity to address perceptions through rules of procedure etc. Substantial training was offered to all POE Board members on their responsibilities/accountabilities.

Human Capacity Development– A week long training course on financial management has been completed with the assistance of the accounting body SKAAK and training will commence in September. Budget training to Budget Organizations and internal on-the-job training continues to be conducted across the supported institutions. Significant training of municipalities in decentralization certification is underway.

Gender – A project assessment is planned to measure progress prior to project completion.

REPORTS AGAINST RESULT AREAS

Objective 1: Strengthen the ability of three economic institutions, MFE, TAK, and CBAK

1.1.1 MFE as an institution is mature, professional and widely respected with all departments carrying out their functions at a high level of competence so that MFE operates proficiently, without the need for fulltime technical assistance.

The Ministry of Finance continues to hold a position of authority across Government. It is the focal point of contact for the major international financial institutions. As far as one can assess, the gap between MFE and the other line ministries continues to be substantial. This is noticeable in particular when the MTEF strategic spending priorities are being set and also at the time of the Budget. Typically, the good capacity of MFE Treasury, Budget

and Economic Policy staff is not matched by that in the line ministries.

The central functions; Treasury, Budget and Economic Policy are well established and as noted in last year's Report are now integral parts of the ministry, headed and staffed by competent people.

The Minister has established a small supporting Cabinet to help ensure that information is transmitted more efficiently through the Ministry. From the Project standpoint, the technical assistance provided currently focuses primarily providing support in the more technical areas and in particular, with policy recommendations.

An important example during this year concerns Kosovo's application for Membership of both the IMF and World Bank. A lot of Project Adviser support was provided through this long process. The outcome of this activity was highly successful with Kosovo now being able to take its place in this high level international policy forum. Indeed, acceptance of membership is the most important event for Kosovo post- independence.

1.1.3 MFE is well-organized by department with clear lines of authority and appropriate position descriptions for each position.

Undoubtedly, across the wide range of the more typical or generic day to day activities, MFE is well organized and staff know what is expected of them. In this domain, MFE functions well and justifiably can be regarded as a success story.

A concern is that over the past year and currently in the post-independence situation, the international community is placing more demands on the Ministry for policy responsibility, policy action and mandatory activities such as EU policy monitoring and surveillance. This is quite apart from the large and important number of political demands arising from Kosovo's rather special situation in the Balkans and which may have financial implications.

The combination of IMF Missions, EU Surveillance activities, regular procedures being put in place by the World Bank for the release of Budget support, together with oversight by the ICO, exert pressure on the thin resources available in the Ministry. Further, the majority of these activities are entirely new and have appeared on the scene in rapid succession. In addition, the Minister is now called upon to represent Kosovo in the international community. The provision of the support required, demands skill sets that in the Ministry, indeed in Kosovo as a whole, are in extremely short supply.

It is hoped that the Brain Fund initiative can be structured and implemented so as to identify and appoint new staff with the skills and capacity required to keep up with this flow of new activities and responsibilities.

1.1.4 MFE training department prepares and implements annual plans.

MFE Training Department demonstrated efforts to effectively assume its role in the preparation and implementation of comprehensive training program for the MFE personnel. Although some progress has recently been achieved the Department has not yet reached sufficient capacity to develop and manage self-sustaining structured training program for the whole institution.

During the reporting period the Department undertook basic assessment of MFE training needs based on requests reported by leaders of individual MFE Departments. The assessment underpinned the 2009 Training Program prepared with the focus on: (a) specific scope of necessary training; (b) number of staff to be trained; (c) approximate training budget. As of mid 2009, out of training program foreseen for around 260 individuals, often in multiple disciplines, the Department successfully completed training for 23 persons with many projects still in progress.

The project has been engaged with the Training Department to help facilitate MFE staff participation in the joint USAID-EMSG/MFE/ SCAAK initiative in Public Finance Management training for finance officers. It has also taken a lead in facilitating the new American University of Kosovo (AUK) masters program in Public Administration.

1.1.7 MFE has a macroeconomic policy strategy for Kosovo that takes account of fiscal adjustments and proposes feasible options to promote economic development over the medium to longer term.

The macroeconomic policy strategy of the Ministry is now incorporated in the annual MTEF exercise which has now become an integral part of MFE operations. Since it establishes the framework within which the broad public spending policy priorities are set, the most important purpose of the exercise is that it leads into the Budget process later in the year.

However, other more recent and important uses of the MTEF are that it: (a) provides a foundation for the now regularly scheduled EU fiscal surveillance meetings (b) serves as a benchmark for the IMF assessments of fiscal sustainability and (c) will provide a reference point for decisions related to the release of the donor support already pledged.

The technical quality of the exercise continues to be high and bears favorable comparison with similar exercises of this kind in the region and Central Europe more generally.

1.1.8 MEPD has strong analytic ability and is regularly consulted by the Minister of Finance and government.

All of the economic analysis in the Ministry is now undertaken by what is called currently, the Macroeconomic Policy Department. In fact, and as might be expected, an increasing amount of the work undertaken is becoming more of the sectoral and even micro kind e.g. topics such as assessments of the effects of tax policy changes, tariff and

duties analysis, detailed examinations of trade performance, the costing of laws and so on. This it would appear to be more appropriate that the facility be renamed simply the Economic Policy Department. The appointment of staff in the future should reflect this change in the balance of work.

Apart from the MTEF and Budget economic analysis, the MEPD provides all of the analysis and briefing required for visits by the IMF, the World Bank and the EU. Such visits which involve substantial data preparation, analysis and briefing are becoming much more important in the post- independence environment. The Minister, indeed, the Prime Minister and the whole Government is dependent upon the products produced and the service provided by the MEPD team.

The Concluding statement of the IMF following their recent visit reflects directly the analytic and data inputs of the Macro team. It is safe to say that in the absence of MEPD, the character of discussions between the Minister and the IFI's would be changed radically.

1.1.9 MEPD has strong analytical capacity for updating Kosovo's Medium Term Expenditure Framework.

This is the case today. What is noticed however, is that now that MEPD is about three years old and beginning to mature, staffing movements are beginning to occur. There is competition for good local staff from the IMF, World Bank and others. The future situation will depend on the success in attracting people of the right quality. The Group has lost one top performer in the last year; a replacement has been appointed but it is expected that competition for scarce skills in a thin market will continue.

In this respect, once again, the Brain Fund initiative, or whatever alternative scheme is devised, will be crucial in securing the long run viability of the facility. Should there be longer run difficulties in identifying and implementing a credible solution, then MFE will be placed in a vulnerable position. This particular issue together with possible alternative models is being addressed by the project at the present time.

Budget / Intergovernmental

1.1.2 Legislation relevant to MFE and its functions, including that required by the settlement document, is enacted; and¹

1.1.5 MFE has formulated new policies and procedures required by the settlement document, specifically in regard to fiscal decentralization.

Promulgation of the Law on Local Government Finances (LLGF) and the Law on Public Finance Management and Accountability (LPFMA) marked the beginning of the reporting period. Since then Project Advisors primarily focused on the assistance to the main MFE counterparts in the implementation of the new legislation. Particular efforts

¹ Due to similarity of Result areas they are addressed together

were directed at ensuring that the introduction of a new system of government transfers commenced during the 2009 Budget process and respected rules established in the LLGF.

During the second half of 2008 Project Advisors were engaged on the draft Law on the City of Pristina. Although not directly related to the Status Settlement, this specific legislation was viewed by the Government as a priority and an important part of legislative and financial\fiscal framework establishing the organization of local self-government. Project Advisors in close cooperation with USAID/EMI Project, worked towards ensuring that the draft Law would be in line with the general decentralization principles established in the Law on Local Self Government (LLSG) and LLGF.

In the field of Status Settlement implementation, Project Advisors assisted in the formulation of budget development procedures associated with the anticipated establishment of new municipal entities. Project Advisors designed the framework for budget development and procedures appropriate for the integration of future new municipalities into the 2009 Budget. Proposed arrangements gained the endorsement of the MFE, MLGA, and ICO, and were incorporated in the 2009 Appropriations Law. This secured funding necessary for further administrative decentralization as foreseen in the Status Settlement. A series of field visits to concerned communities ensured their agreement with proposed technical solutions.

Project activities at the beginning of 2009 were mainly focused on assisting MFE in the implementation of the Appropriations Law. In conjunction with the ICO, Project Advisors contributed to the development of Administrative Instructions on reporting by parent municipalities on budget expenditure earmarked for future new municipalities. They also provided consultation and advice to the OSCE on the development of performance monitoring mechanisms for municipal competencies in order to substitute for the former Fair Share Financing system.

Working jointly with MFE counterparts Project Advisors reviewed budget development procedures in order to reflect new arrangements, roles, and responsibilities of municipal authorities introduced by the LLSG and LPFMA. The first Municipal Budget Circular commencing the 2010-2012 Budget process incorporated the appropriate amendments.

Project Advisors assisted MFE in the preparation of a summary progress report on the implementation of IMF TA recommendations in the area of fiscal decentralization. Progress was marked with respect to the establishment of the necessary legislative framework. However, Government activities aiming at developing and monitoring of service standards for core municipal competencies (which would provide valuable input into grants system) experienced some delay.

1.1.6 Central grant transfer system complies with settlement document provisions and is well implemented.

The implementation of the grants system introduced under the LLGF commenced with the 2009 Municipal Budget. The aggregate amount of transfers and its horizontal

allocation to individual municipalities complied with rules and procedures established by this law. Grants parameters were determined and approved by the Grants Commission, and officially communicated to all municipalities through Budget Circulars. Building on experience of the previous year and with the assistance of Project Advisors, MFE assumed leadership in the application of the LLGF provisions during the 2010-2012 MTEF and Budget processes. The 2009 PEFA (Public Expenditure and Financial Accountability) assessment of public finance management practices reaffirmed MFE compliance with a transparent and rules based grants system.

The beginning of 2009 witnessed major improvements in the institutionalization of the Grants Commission: (a) open and transparent appointment of local government representatives in accordance with the LLGF requirements; (b) formal establishment of the Grants Commission Secretariat; (c) Grants Commission approval of municipal financing from government transfers underpinning the 2010-2012 MTEF.

Project Advisors provided assistance to the Grants Commission Secretariat in assuming its responsibilities, prioritizing activities, aligning its support to the Commission with the MTEF and Budget processes, and organizing information outreach to newly appointed members of the Commission.

1.1.10 The budget process is transparent, follows the law and meets legal deadlines; budgets are increasingly prepared using program budgeting and improved cost/benefit analysis.

The 2009-2011 Budget was prepared broadly in accordance with the law, being presented to the Assembly close to the end-October deadline, and approved before the end of 2008. Indeed this was earlier than in previous years and enabled budget execution to commence at the start of 2009.

Transparency of the Budget was improved with detailed supporting documentation, - equivalent to a full MTEF update and provided to the Assembly together with the draft Appropriation Law and schedules.

The 2009 Budget included for the first time a detailed set of capital projects to be financed in the Budget and a set of rules in the Appropriation Law for regulating transfers in funding between projects. All projects in the capital schedule were based on information and analysis in the Public Investment Program (PIP) system.

The 2009-2011 Budget incorporated detailed multi-year ceilings for both capital and recurrent elements. Further, preparation has commenced in full accordance with the timetable specified in the LPFMA. Of most critical importance is that the MTEF was completed by the end of April, which is earlier than previous years and provides a solid base for the rest of the process. The first Budget Circular has been issued with indicative ceilings for capital and recurrent elements and consistent with the MTEF.

1.1.11 Budget Department performs with strong analytical skills in assessing budget submissions.

Project Advisors worked towards further enhancing the capacity of Municipal Budget Department staff to undertake professional and analytical assessment of municipal budget documents.

A workshop for Budget Analysts, based on a real case study of Fushe Kosovo Municipality submission, was organized. This provided staff with: (a) a model framework for budget submission assessment, (b) guidance on the evaluation process, including compliance with MFE budget development instructions, consistency with approved structure of municipal financing from government grants, and professional communication with municipal authorities in the case of possible budget revisions.

Project Advisors prepared a Working Paper “The 2009-2011 Municipal Budget Process: Lessons Learned and Recommendations”, which was officially endorsed by the Department for implementation during the next budget development cycle.

Analysts in the Central Budget Department demonstrated capacity in undertaking detailed analysis of sector strategies submitted by Budget organizations and developing these for inclusion in the final published MTEF. Importantly, this analysis enabled the publication of a set of multi-year ceilings for individual sectors that are consistent with the overall macro-fiscal framework.

1.1.12 Budget Department proactively works with budget users to develop better budget submissions; and

1.1.13 Budget Department proactively works with budget users to develop well-conceived capital projects.

Project Advisors assisted the Municipal Budget Department in the implementation of a training program for municipal authorities engaged in municipal budget processes. Advisors provided coaching for the MFE staff and contributed to the development of training materials. However, MFE staff assumed full responsibility for the delivery of both the training and seminars.

Three regional Forums for Municipal Leaders, attracted 40-50 participants per regional event. In addition, a Workshop for members of Municipal Assemblies was organized in September 2009 in order to strengthen capacity of municipal legislative branch in understanding responsibilities with respect to municipal budget review and approval.

Advisors have engaged with the Ministry and the professional accounting body SCAAK to develop a curriculum on public financial management for a 5-day course that will be delivered to practitioners in Budget Organizations over the coming 12 months. “Budget preparation” is one of the 5 modules and is designed to assist in improving the quality of budget submissions.

1.1.22 New municipalities are certified and trained in financial management and in collection of property tax.

The establishment of new municipalities is still pending. Some progress in the formulation of Municipal Preparatory Teams (MPTs), as a first step foreseen in the Status Settlement, has taken place recently. Recruitment of the MPT for Municipality Klokot occurred in June. Subject to the Government decisions the Project stands ready to support newly established entities of local government in public finance management systems and processes. Annual Work Plans for the next reporting period will envisage appropriate assistance.

1.1.25 MFE processes are transparent and information is appropriately shared with the public and other government institutions.

Noticeable progress was achieved in the area of availability of main municipal budget process related documents to municipal stakeholders and general public. Municipal Budget Circulars, including budget instructions, the calendar, and the main budget parameters are now available on the MFE website promptly following their dissemination to municipal authorities. Grants Commission decisions, minutes, and Policy Papers are published and accessible from the MFE website in accordance with requirements established by the LLGF.

Municipal Budget Department, with the assistance from Project Advisors, worked towards establishing a standard format for municipal budget documents, including Municipal MTEF and Budget. Several Municipalities utilized these templates and posted the 2009 Municipal Budgets at their own municipal websites.

Treasury

1.1.14 Treasury Department understands purpose and function of each Treasury module and is able to manage the Treasury system in a sophisticated manner.

The KFMIS is currently used for budgeting, cash planning, recording obligations for payment, execution of expenditures, recording of revenues, recording of assets and financial reporting. Two upgrades are expected in the near future, the development of an automatic reconciliation module, and the use of crystal reports.

The Treasury Department has been using all the modules at a relatively sophisticated level. The Commitments and Obligations, Revenues and Assets modules have been devolved to budget organizations in the past years; however the Treasury staff continues to assist budget organizations staff in processing the above transactions. A project on delegating recording and approval of expenditures is underway, and the Treasury is expected to continue to play a monitoring role and to provide assistance and support until budget organizations become skilled in using these functions.

1.1.15 Treasury Department utilizes modern and sophisticated public accounting and cash management skills

The Treasury Department has issued an Accounting Manual and annually issues Administrative Instructions for preparation of financial statements for budget organizations. Through these documents Treasury has required the use of IPSAS for the preparation of government financial statements.

The Chart of Accounts in use is fully based on the IMF Government Financial Statistics. It is reviewed periodically to reflect the needs of its users, especially in terms of the economic categories. It is expected to be reviewed in 2009, in order to confirm its compliance with the GFS and its usefulness to Kosovo needs.

1.1.16 All new municipalities mandated by the settlement document are connected to the Treasury FMIS system and trained in its use

All Budget Organizations are presently connected to the Treasury FMIS, including all newly formed municipalities. There exists a system of communication with the budget organizations through Treasury Helpdesk function, and all requests for new connections and/or training are usually met on a relatively timely basis. As new budget organizations are formed, the Treasury organizes training on all KFMIS functions, including briefing on the Treasury rules and procedures.

Staff involved with the expenditure decentralization process will require further training on the functions of entering and approving expenditures and possibly providing new KFMIS connections to budget organizations.

1.1.17 Treasury Department reconciliations are produced in a timely manner

Current reconciliations are performed on a daily basis however the process is largely manual and prone to error. A reconciliations module is to be implemented in the near future that will provide automatic comparisons of information between the bank and KFMIS. This is expected to shorten the time for reconciliations and hence enable staff to focus more on the problematic unreconciled balances and produce more accurate data.

The automatic reconciliations, along with the delegation of expenditure functions will affect other processes within the Treasury. Treasury will no longer be able to rely on original documentation since the archived original payment documentation will also be decentralized to the budget organizations. This calls for an update of almost all internal Treasury processes and procedures.

1.1.18 Treasury Department external audits show zero (or near-zero) errors

The Treasury produces regular financial reports in compliance with the requirements of the LPFMA and the International Public Sector Accounting Standards (IPSAS) on “Financial Reporting under the Cash basis”. These reports are aggregated in KFMIS and

presented on a quarterly and annual basis. The financial statements have been audited by the Auditor General and have been found to comply with the LPFMA and IPSAS. They are however, qualified due to concerns about regular reconciliations between Free Balance System, accounting systems maintained by Ministries, Departments and Agencies and relevant bank accounts. Remedial action has now been taken by Treasury to address these issues, including the development of automatic bank reconciliation software in Free Balance.

The OAG has requested the Treasury to provide training on the KFMIS Free Balance system for selected external auditors, in order to enhance their knowledge and understanding of the computerized double-entry accounting system. Such training should go some way to eliminating misunderstandings between the OAG and Treasury when undertaking future year-end external audits.

1.1.19 Treasury Department performs tasks at a sophisticated level, able to understand and analyse the purpose behind each “Freebalance” module and process.

With the introduction and operational use of the “Freebalance” system, Treasury and Budget Organizations have been trained in the use of the system. However, there is an essential need for financial officers both at Treasury and Budget Organization level to undertake a formal training course in basic accounting principles.

During the third quarter of 2009 onwards, SCAAK (the Society of Certified Accountants and Auditors of Kosovo) will present training workshops to selected Financial Officers at B.O. levels throughout Kosovo on Budgeting, KFMIS, Accounting and Financial Reporting/External Audit.

Property tax

1.1.20 Municipalities have increased capacity to use market valuations for assessing properties for property tax.

As noted in the 2008 annual report, the municipalities and the MEF Property Tax Department analyzes contract sale prices to determine average market values for each property class in each valuation zone before setting the next year’s municipal appraisals and tax rates. Municipal staff are trained to conduct tax impact analyses based on these average market values to understand shifts in the tax burden and the revenue yield of different tax rates.

This year, all records in the municipal property tax registers will be resurveyed to verify existing data and collect additional property characteristics, including GPS coordinates and external property characteristics. Real estate sales from the past 18 months will be matched to records in the fiscal cadastre to create a sample data set upon which mass appraisal models will be built for each municipality. It is anticipated that two or three municipalities will be ready to implement values generated through mass appraisal in 2010, with the remaining municipalities completing their resurvey in 2010 and building mass appraisal models for implementation in 2011.

1.1.21 Property tax collections increase yearly.

Property tax collections improved dramatically in 2008 due to administrative improvements implemented by USAID EMSG and enforcement measures taken by the new local governments. Of the €15.7 million property tax levy, nearly €2.7 million was collected for an overall collection rate of 81%.

In 2008, USAID EMSG led and managed the outsourcing of bill production and delivery to Post & Telecom Kosovo (PTK). PTK was able to print and deliver nearly 380,000 property tax bills at a cost of 0.247 euro per bill and complete the entire job in 3 weeks. This is approximately 60% cheaper than the municipalities doing it themselves. More importantly, PTK had a 98% success rate in delivering property tax bills. For the first time, nearly every taxpayer in Kosovo received their property tax bill in a timely fashion. This led to a substantial increase in voluntary compliance.

In addition to improving the bill production and delivery process, EMSG lobbied the new local administrations, elected in November 2007, to pursue more vigorous enforcement of the property tax in 2008. A political decision was made by most municipalities to deny services to non-compliant taxpayers and this too had a substantial impact. Table 1 below outlines property tax collections from 2005 to present.

Table 1: Total Annual Property Tax Revenue

	2005	2006	2007	2008	2009*
Annual Revenue	€6,682,728	€7,635,273	€8,289,247	€12,677,735	€14,580,000
% Increase	21%	14%	9%	53%	15%

* projected annual revenue

As of June 2009, Kosovo's municipalities are on track to collect approximately 15% more than 2008. This is no small achievement given last year's spike in collections. Continued revenue growth will come from ongoing improvements in property tax administration which includes automating many functions in a new IT solution that are currently done manually. The implementation of mass appraisal models will also add significant value to the tax rolls, leading to higher assessments for wealthier properties.

1.1.22 New municipalities are certified and trained in financial management and in collection of property tax.

The Pilot Municipal Units (PMUs) were fully operational and certified to administer the property tax during the second half of 2007 after personnel were appointed to the municipal property tax offices and training was completed. However, the PMUs had been collecting property tax revenue throughout the entire year since property tax bills in their jurisdiction were sent by the "mother" municipalities and the revenue was later apportioned to the PMUs. No additional municipalities were created in 2008-2009.

1.1.23 Property Tax Department proactively works with municipalities to improve collections.

The MEF Property Tax Department is seeking to ease the burden of property tax administration on the municipalities by automating key functions, including enforcement, in a new software solution. The new system will automatically generate reminder notices and final notices for non-compliant taxpayers.. Payments registration is automated and downloaded directly from Treasury for up-to-date information on outstanding debts. Municipalities can now verify property tax payments quickly through the system before administering other municipal services to the taxpayer.

In addition to these efforts on the technology front, the MEF Property Tax Department conducted two training sessions with each municipal property tax office on collections, enforcement, taxpayer education and public relations. Lists of non-compliant taxpayers were sent each quarter to every municipality. A brochure describing why the property tax is important for local communities was sent to each taxpayer with their property tax bill in March 2009.

1.1.24 Property tax assessors are trained in modern valuation techniques.

While municipal assessors are performing reasonably well in setting values per square meter for each property class in each valuation zone, they currently lack data on other property characteristics to make more accurate appraisals. This will be rectified with the resurvey, the recording of sales data in electronic format, and the implementation of mass appraisal models.

Objective 1.2 Strengthen the Capacity of TAK

Advisory work continued to increase capacities of the tax administration. Amendments to the Law on Tax Administration and Procedures were introduced into the Assembly in August. Advisers assisted in meetings with the Budget Committee of the Assembly to help ensure the law was approved.. These amendments which became effective in February, add significant capacity to the tax administration in terms of enforced collection capabilities that include a wide range of activities.. All of these improvements in the law will help TAK address many of the causes of non-compliance and improve revenue performance.

In the core areas, further progress was made toward achieving the goals of the TAK 2008 – 2010 Strategic Plan and addressing many of the issues arising from the IMF Technical Assistance Visit of April/May 2008. Included in that progress has been development of taxpayer registration procedures; implementation of procedures for non-filers/stop filers; further development and roll out of audit risk assessment; oversight of SIGTAS stabilization and upgrade; and preliminary work for the implementation of fiscal cash registers.

As of 1 January 2009, corporate and personal income tax rates were reduced from 20% to 10%. The VAT standard rate was increased from 15% to 16%. Corporate income revenues are expected to be decreased by the loss of the extra profit tax (approximately 26.474 Million Euros) being paid by one large taxpayer.

With respect to the USAID Performance Monitoring Plan, the target was set at 200.4 Million Euros for the period 1 July 2008 through 30 June 2009. As of mid-June, TAK revenue for the period beginning 1 July totaled €19.604 Million. It must be noted that the reduced rates only applied to half of this time period and there is approximately €13.2 Million in Extra Profit Tax included in this figure.

1.2.1 TAK is a well-functioning agency, able to competently carry out its responsibilities without full-time USG assistance:

EMSG Advisors have drafted a large number of procedural documents and advised on a wide variety of issues with the Director General and his Deputies. All of these will contribute to the ability of TAK to function effectively at the end of this contract.

The goals of the Strategic Plan for the years 2008 – 2010 will have been largely achieved. Actions during this reporting period toward this end include:

- Establishment of new taxpayer visit procedures.
- Establishment of a rulings function in the office of the Manager of Taxpayer Education which provide guidance to the public on application of tax laws.
- Establishment of a taxpayer advocate position and position descriptions for subordinate staff. This position has yet been filled..
- Development of procedures for cleaning up the TAK database to enable TAK to manage its taxpayer population more effectively.
- Development of procedures for non-filers and stop filers, which were implemented beginning in May 2009..
- Development of sub-legal act and procedures for taxpayer registration and issuance of fiscal numbers which is scheduled to begin 1 July 2009.
- Preparation of a sub-legal act for enforced collection implementation of new procedures and authorities provided under the amended Law on Tax Administration and Procedures.
- Development of sub-legal act for implementation and functional specification of fiscal cash registers.
- Oversight of and assistance in the contract to stabilize and upgrade SIGTAS. Collection and Audit assignments will be made through modules activated by the upgrade.
- Stabilization of the TAK network and implementing security measures that allows the rollout and implementation of audit risk assessment model as well as non-filer and stop filer monitoring.

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- Established Enforced Collection Manager reporting to Deputy Director (Operations) who is responsible for oversight of collection team leaders in regional offices.
 - Assisted TAK in successfully implementing a Government Decision for penalty relief if the taxpayer enters into an agreement for payment of tax and interest.
 - Assisted TAK develop procedures for addressing fictitious invoices and fictitious entities which are important for increasing both VAT and income tax revenue.
 - Began implementation of Audit Quality Measurement Program through selection of a Team Leader.
 - Barcoding of returns and payments was implemented in conjunction with UNIREF to assist in early identification to tax payments by tax type and to facilitate application of payments to taxpayer accounts.
 - Income taxpayers (Corporate and Individual) were given the opportunity to download forms from the TAK web-site that had identification data pre-printed, as well as a barcode.
 - Training in international tax issues conducted for selected audit personnel to enhance skills in dealing with more complex issues.
 - Further improvements in audit risk assessment system which currently is valid for legal entities (LLC and JSC). Additional development needed for individuals and partnerships. System has now been rolled out to all regions for selecting audit cases and planning audits.
 - New VAT Law drafted and introduced into the Assembly – law is fully in line with the EU VAT Directives.
 - New Corporate and Personal Income Tax laws drafted and introduced into the Assembly.
 - Assistance in introducing reduced rates for income taxes and increased rate for VAT – assisted in drafting public ruling for taxpayers on the change from 15% VAT to 16% VAT.

1.2.2 TAK collects taxes in a competent, professional and even-handed manner, with the result that taxpayers are increasingly compliant, having confidence that TAK is assessing taxes accurately.

The amended Law on Tax Administration and Procedures provided additional authority to TAK in collecting taxes. TAK can now more effectively address cases where taxpayers transfer assets to avoid payment of tax or use straw men to establish companies in their behalf. The sub-legal act will ensure that the procedures are implemented in the same manner throughout Kosovo and will significantly improve TAK's collection capability.

The Government issued a decision, effective 12 September 2008 through to 31 December for implementation of a penalty initiative through which taxpayers could pay, or enter into agreement to pay, all tax and interest and receive relief from all penalties assessed and accrued. Through this initiative, over €10 Million were collected.

The Audit Quality Measurement System that is being implemented measures 6 primary auditing standards. Each region will be measured against the same standards and will be tracked. Regional managers will be measured by the improvement made in the quality of audits completed in their region. The increased quality in audits will increase taxpayer confidence in TAK's capability as a revenue collection agency.

As part of the 2009 PEFA Action Plan for TAK, a requirement was established that all technical advice must be issued through a manager's office and over a manager's signature. This will avoid one region being advised in one direction and another region receiving conflicting advice.

A key recommendation of IMF and a primary goal of the TAK strategic plan has been to improve taxpayer registration. A significant effort has been made to develop and implement a process whereby TAK will register taxpayers and issue fiscal numbers. This is scheduled to begin on 1 July 2009; will give TAK full control over its taxpayer database, allow identification of active businesses and those that are inactive. Improved attention to non-filers and stop filers will result. Procedures were developed and implemented in May 2009 for addressing the non-filer and stop filer cases.

1.2.3 TAK Headquarters managers (director, deputy directors and department heads) have strong management skills, asserting appropriate oversight of regional offices so that taxes are collected in a consistent manner across Kosovo.

Significant amounts of support have been provided to the Director General of TAK, who had been appointed on a temporary basis in April 2008. The Director General was never given a permanent contract and continued on a series of temporary contracts. This negatively impacted his ability to deal with certain issues. At this time, it appears that TAK will have another new Director General sometime in July or August 2009, which will require more significant support. The EMSG advisor participates in all Director staff meetings, advising in preparation of the agenda, and accompanies the Director in most meetings with the Minister of Economy and Finance, helping the Director prepare for those meetings.

EMSG advisors have assisted in the development of the role of an 'enforced collection manager' to be assigned to the Deputy to the Director General for Operations to assist in oversight and management of the field enforced collection activity. At the time of implementation, TAK have decided to leave direct supervision of the enforced collection activity to the regional managers and make the new position more of an advisor and program analyst for the Deputy.

Significant time has been spent with the Deputy to the Director General for Compliance in assisting with drafting of legal documents and procedural guidance. Through this assistance, the Deputy has developed a very good technical knowledge of the VAT Law and its principles. In addition, he has been the leader of a number of working groups, including the working group for fiscal cash registers.

Similarly, significant time has been spent with the Deputy to the Director General for IT in developing his managerial skills and assisting him in revamping his organizational chart. In addition, assistance has been provided in preparation of strategic plans for the IT Department and budgetary planning.

Assistance has been provided to the Deputy to the Director General for Gambling in his role as responsible person for implementation of taxpayer registration. Assistance has also been provided in his role as TAK EU Liaison and contact person for such activities as PEFA, STM, IPA, and other donor activities. While EMSG advisors were named for participation in a working group to draft a new gambling law, this activity was not in the project workplan and only minimal assistance could be provided.

1.2.4 Secondary legislation and manuals exist for interpreting tax laws.

With the passage of the amendments to the Law on Tax Administration and Procedures, a number of sub-legal acts are required in order to implement many of those provisions. As examples, EMSG advisors have assisted in drafting sub-legal acts for fiscal cash registers, the issuance of fiscal numbers, enforced collection, implementation of new penalty regime. In addition, EMSG advisors have assisted in drafting procedural documents for dealing with a number of other activities.

Assistance has been provided in preparation of public rulings, among them a public ruling for KEK related to its VAT liabilities to assist in its privatization effort; a public ruling related to the KEK re-organization, also for its privatization effort; and public rulings related to the rate changes for VAT, corporate and personal income taxes.

1.2.5 Tax legislation is amended, as needed, to comply with settlement document.

Primary work on legislation required for the settlement document was completed in the prior reporting period. As has been noted, laws to revise tax rates were passed, which at the same time converted UNMIK Regulations into laws.

1.2.6 TAK procedures, including selection of taxpayers for audit, are transparent and objective so that opportunities for political or other influence are minimal.

EMSG advisors are assisting in the development of an automated audit risk selection system. With recent improvements in the TAK IT network, the system has now been rolled out to the regions. A goal has been established for 30% of all audit cases to be centrally selected from headquarters to eliminate local influence in case selection. The goal is for all cases to be centrally selected by the end of 2010. Unlike most audit risk assessment systems, the system developed is an on-line, dynamic system which measures risk on current data and automatically changes as new, more current information becomes available. The system is valid for selecting cases for audit related to VAT as well as income tax cases. It is currently valid only for legal entities but will be enhanced for individual and partnership case selection in the coming report period.

1.2.7 VAT refunds are made in a timely manner.

Further work has been done to improve VAT refund processing. However, the prevalence of fictitious invoices is causing TAK to conduct audits of most refund claims. The EMSG advisor has assisted TAK in developing procedures for identifying fictitious invoices and entities using the audit risk model. In addition, the advisor is assisting TAK in drafting further revisions to the VAT refund processing guidelines. This will allow TAK to reject claims that do not include the required invoice copies and other required data. There are currently no standards that a claim must meet in order to be considered by TAK. TAK has improved its record of issuing VAT refunds increasing the number of claims submitted from 23 claims in 2005 with €1.25 Million in refunds approved to 153 claims in 2008, with €23.3 Million in refunds approved. Refund approval has slowed somewhat in 2009 due to concerns over issuance of invalid refunds.

1.2.8 Procedures for VAT refunds are based on best practice, effectively utilizing risk-based audits.

VAT refunds are processed in accordance with many best practices. However, a systematic risk assessment capability is not expected to be in place before the end of 2009. Because of the fictitious invoice issue, it has been necessary for TAK to audit most claims. With the pending revision of the VAT processing guide noted above, further best practices will be introduced, including the establishment of standards for a valid claim.

1.2.9 TAK is able to properly interpret tax laws.

In drafting the VAT Law now pending before the Assembly, the EMSG advisor conducted a series of seminars for the working group on the EU VAT Directive and its principles. The EU 2006 VAT Directive was translated into Albanian (the first time that TAK employees had actually been able to read the directive). [During a recent Balkan meeting on VAT in which TAK officials participated, the moderator of the panel noted the significant improvement in the knowledge of TAK officials with respect to VAT in comparison to his experience from a earlier visit to Kosovo]. TAK officials actively participated in the drafting of new personal and corporate income tax laws and thus will now be able to educate the public in their content. Similarly, when the Law on Tax Administration and Procedures was approved by the Assembly, TAK officials appeared on various live television programs to explain its provisions and implications.

With respect to tax law interpretation, the EU Tax Directives leave minimal room for interpretation. It is more a matter of understanding the laws and applying them properly. EU Tax Directives are treated as an obligation to be implemented by the EU Member States and other countries which committed to move to EU standards.

1.2.10 The LTU effectively and transparently manages its taxpayers.

The Deputy Manager of LTU was promoted to Manager of the LTU and a new Deputy Manager was appointed. The new manager is stronger technically than the previous

manager and is able to communicate effectively with taxpayers and staff. The new manager was a participant in the managerial training provided to TAK employees in 2008. The LTU has been using the audit risk selection system for selecting audit cases for some time. At the present time, the LTU accounts for slightly over 70% of all TAK revenues. That percentage may decline a little in 2009 and the next few years due to the expiration of the extra profit tax and reduction in corporate income tax rates.

1.2.11 Audit departments (particularly LTU) implement risk based, objective audits.

As has been previously noted, TAK has targeted to centrally select at least 30% of audits to be conducted by the end of 2009. The decision has been made to utilize the audit risk assessment model to select taxpayers for audit in headquarters, rather than selecting the cases at the regional level. Cases will be selected based on the risks identified by the audit risk model. Regional offices will be given some flexibility in selecting a certain number of cases in order to account for local knowledge and observations.

1.2.12 Taxpayers have clear, understandable tax guides.

When tax rates were changed at the beginning of 2009, public guidance was prepared and published, giving taxpayers clear guidance on new rates.. The new VAT Law will require a significant amount of guidance to be prepared as there are a large number of changes with major impact on the application of the law. Similarly, the new corporate and personal income tax laws will require new guidance to be prepared and provided.

1.2.13 Management Information Systems are effectively used to guide management in assessing and improving performance.

The tax administration is funding an upgrade to the current data processing system (SIGTAS). When fully implemented, this upgrade will activate modules for controlling audit and collection cases. It will provide management reports on case status, aging of cases, caseloads of individual employees, and other data normally associated with a credible MIS. It is also expected that the audit quality measurement system will develop baselines of quality on which improvement expectations can be established. TAK management currently has access to information on non-filers and stop filers, collection cases with a pending statute expiration, refund activity, audit activity, enforced collection activity, and budget performance.

1.2.14 Increased compliance is shown by improved rates of collection, with direct taxes (personal and corporate income taxes) showing an increasing proportion of all tax revenue.

TAK has continually increased its revenue collection during the life of this contract: 2007 revenue – 189.5 Million; 2008 – 224 Million; 2009 (through May) – 85.7 Million. The percentage of direct to indirect taxes has continued to increase: 2007 – 67.7%; 2008 – 72.2%; and 2009 (through May) 71.5%. With the change in rates (increase in VAT from 15% to 16% and decrease in income tax rates from 20% to 10%) effective 1 January

2009, it is expected that the percentage of direct to indirect taxes will decrease in 2009 and in the near term. The implementation of fiscal numbers for TAK will greatly increase TAK's ability to manage its taxpayer base and deal more effectively with non-filers and stop filers.

Pending a Government Decision, Kosovo will be implementing a requirement that businesses use fiscal cash registers that are capable of communicating with a server at the tax administration. It is expected that this implementation, planned to begin later in 2009 will have a positive impact on compliance levels and both VAT and income tax revenues.

1.2.15 TAK processes are transparent and information is appropriately shared with public and other government institutions.

The Director's Advisory group (consisting of representatives of business associations) continued to be active in the early part of this reporting period. However, due to uncertainty in appointment of a new Director, there have been no press conferences since early March, when the TAK February results were discussed.

An MOU has been established with the Ministry of Social Welfare and Labor for joint compliance visits relative to employment – for TAK the issue is whether all employees are being properly reported. Business Registration information exchange has been further improved such that TAK now is able to obtain daily updates on business registration.

In January 2009, TAK hosted a multi-lateral meeting of Balkan countries (attended by Bulgaria, Turkey, Albania, and Macedonia – other countries were invited but unable to attend). This successful conference discussed the potential for further exchanges of experience and information.

In introducing new tax rates and new procedures resulting from the amendments to the Law on Tax Administration and Procedures, the tax administration held numerous public meetings and several appearances in the media to ensure full publicity for these changes. In addition, TAK developed publicity campaigns and television spots encouraging taxpayer compliance, with examples of the benefit of paying taxes.

REVISED TASK ORDER

Provide technical oversight and ensure quality control for the SIGTAS improvement project performed by the TAK-funded contractor:

The stabilization and upgrade of the core TAK IT system, SIGTAS, has been underway since mid-February. TAK ESMG Project Advisors, including the Resident IT Advisor, have been heavily involved throughout as TAK counterparts have maintained difficulty in delivery consensus on key procedural and technical issues.

The core TAK IT system is restored to a stable and maintainable configuration:

Initial stabilization of the existing system completed in late April. This technically-oriented effort resolved several long outstanding issues, including:

1. Core payment and interest calculations on Corporate Income Tax (CIT);
2. Instability of transaction data due to structural limits on the underlying database schema;
3. Inaccurate and poorly utilized core lookup tables, including re-keying of related relational data; and
4. Required updates to payment, interest, and penalty calculations to support changes in legislation.

Additionally, the Resident IT Advisor provided assistance with migration of the existing system to modern hardware, resulting in significant performance gains and the capability to support an increased user-base. Since completion of these activities, the TAK has experienced no major failures due to technical malfunction or improper calculation of accounts.

Confidence in TAK system data is restored:

While the stabilization effort has improved the confidence that TAK personnel have in core system functionality, there remain concerns over the quality of existing data. Tax rolls have tens of thousands of inactive/invalid taxpayers and many others poorly registered. The majority of taxpayer information has never been updated after initial registration.

The TAK has (in concurrence with ESMG Advisors and the International Community) decided to begin implementation of new Fiscal Numbers for all taxpayers in Kosovo starting in July. To support the initiative, the stabilization phase of the SIGTAS improvement project included enhancement of Tax Roll functionality required to issue the new numbers. Prior to upgrade to the new version of SIGTAS, it is anticipated that at least 90% of taxpayers will be visited, de-registered, or placed in inactive status. Only valid taxpayers will be carried forward to the new system, much increasing the value of MIS reporting and allowing the TAK to properly manage tax accounts.

The functionality of the TAK system is expanded to include priority modules:

Upgrade of the system remains an open project and is one of the high-priority efforts now underway in the TAK. The system vendor, CRC Sogema, has completed two missions to support development of functional requirements necessary for technical implementation of the upgraded system. It is anticipated the process will finalize prior to the end of July. Subsequently, in the October - November timeframe, the upgraded system will be implemented for testing purposes, with full rollout scheduled for early January, 2010.

The upgraded system will include many new modules core to the operation of a modern Tax Administration including Audit, Collections, Objections (Appeals), and MIS

reporting. Despite some budget restrictions on the TAK-funded effort, counterparts have proposed a significant amount of functionality for the new modules that will be included.

Regional Access to the core TAK system is made possible:

To support issuance of new Fiscal Numbers, the Resident IT Advisor, has assisted in implementation of remote access (Terminal) services for the existing version of SIGTAS. These services effectively allow the majority of the TAK to access the core system from regional centers. While this technical solution will support immediate needs, it is not ideal due to technical inefficiencies and the stress placed on the TAK network infrastructure. The upgraded version of SIGTAS will natively support remote-based access with far reduced resource requirements.

Lay the groundwork for introduction of electronic filing:

The Resident IT Advisor has assisted TAK in the development of technical and conceptual requirements for an Electronic-Filing system. In late-March a basic pilot was delivered to the TAK IT staff. This pilot contained all of the functionality required to build up a full featured system over time. Unfortunately, TAK IT staff has not yet acquired the skills necessary to continue forward with the pilot. Given the timeline established in the TAK strategic plan for delivery of the system, the decision has been made to contract out the bulk of development. The Resident IT Advisor has assisted with the process. A tender is expected to be published in July.

In addition to conceptual work and the pilot, the Resident IT Advisor has delivered technical specifications describing the protocol for transfer of payment data from the TAK E-Filing system to Commercial Bank electronic payment (E-Payment) systems. These specifications are required to facilitate full paper-less E-Filing for tax declarations and associated payments. The specifications, along with programming (code) samples, have been delivered to the Central Bank of Kosovo (CBK) for review. Upon approval, they will be released to the Kosovo Banking Advisory Committee (BAC) for feedback.

Establish a system of prioritizing tax debts so that collections efforts are better focused:

No dedicated system for debt collection has yet been developed. It is anticipated that transfer of active taxpayers (leaving behind those determined to be inactive) into the upgraded SIGTAS system will allow the TAK to effectively utilize built-in MIS reports for debt collection. The exception to this is a limitation of the core SIGTAS system architecture, which attaches debt to a specific tax-period, not an assessment. As such, SIGTAS, even after upgrade, will have difficulty properly aging debts. The Resident IT Advisor intends to work closely with the system vendor to devise the required work-around, one of which may be a unique system built on the TAK SharePoint portal.

Develop automatic generation of taxpayer assessment notices:

The upgraded version of SIGTAS will include the functionality to automatically generate assessment notices with basic pre-printed information. These will be localized and printable in batch – automatically defaulting to the identified taxpayer language. After printing, the desired notices will be forwarded to PTK for packaging and delivery to the taxpayer.

Additionally, the Resident IT Advisor has assisted the TAK in implementation of ‘E-Declarations’ on the TAK web site. This functionality allows a taxpayer to enter his or her identification number, select a tax period, and receive a pre-printed declaration with basic information already included on the document (name, contact information, etc...). The functionality was heavily used by CIT and PIT taxpayers in February.

Refine the system of automatic selection of taxpayers for audit, replacing the subjectivity screening currently in use:

The initial Risk Analysis/Audit Selection system piloted in 2008 has been refined and completed for joint-stock and LLC taxpayers. Risk scores for audit selection are now updated on a daily basis. The required hardware (servers) has been procured and is now dedicated for the existing system. Rollout has been achieved to all regional locations. Thus far, usage has been steady. It is anticipated that the system will become a key tool and permanent fixture in the TAK IT portfolio.

In addition to the Risk Selection system, the Resident IT Advisor has assisted in the development of a modern Stop/Non-Filer program. This program has been deployed on the same Microsoft SharePoint system that hosts Risk Analysis. The program allows TAK personnel a high-level view of the filing process for core documents. It also presents metrics in the form of filing compliance for each regional tax center.

Working in close collaboration with a similar USAID-funded activity in Albania, assist the TAK in development of a pilot electronic filing project:

The TAK has taken the decision not to utilize the USAID-funded E-Filing system being developed in Albania. This decision is primarily due to perceived contractual restrictions in-place on the effort. ESMG Advisors, after visiting the Albanian administration, advise that the TAK is far ahead of its neighbor in terms of IT capability and concur with TAK decision to attempt to procure and develop an E-Filing system locally.

Provide day-to-day expert IT advice on IT issues relating to data processing and payments:

The Resident IT Advisor has provided expert advice on all manner of IT functions within the TAK. To support future growth, progressive IT architecture schematics have been developed and agreed upon by relevant leadership. These schematics provide the

framework by which the TAK will invest new money in IT and, ultimately, provide the capability required of a modern institution.

Discussions on long-term IT objectives confirm the limitations of existing IT staff. Timelines to train existing staff will be long and the TAK will likely contract out the vast majority of new work. Projects scheduled to commence during the current year include:

- *Electronic Filing:* TAK has taken the strategic decision to implement web-based Electronic-Filing services for taxpayers eventually this will serve as the primary interface through which the majority of taxpayer declarations and other documents are submitted to TAK. Taxpayers that utilize E-Filing services are expected to be capable of full paper-less tax filing and the net gain to taxpayers, the Government of Kosovo, and Commercial Banks from implementation is anticipated to be high.
- *Fiscal Data Management:* In response to a government decision, the Kosovo Ministry of Economy and Finance (MEF) and TAK have initiated the process to implement Fiscal Electronic Devices (FEDs) nationally in Kosovo. These devices are expected to be utilized for all retail and specified wholesale transactions. TAK requires that all core administration processes be facilitated by a secure and web-accessible Fiscal Device Management System (FDMS). Upon implementation, the FDMS will be the primary interface through which MEF/TAK officials, authorized FED distributors, and authorized FED maintenance technicians will coordinate and manage FEDs in Kosovo. The TAK intends to publish a tender internationally for development and maintenance of the system. In respect of data management and functional use of the data of FEDs, TAK intends to introduce all data received from FEDs into the audit – risk assessment module.
- *Client Modernization:* TAK maintains an IT infrastructure that supports approximately 600 users at 10 different physical locations throughout Kosovo. A major effort underway for over a year to centralize the majority of IT resources within the TAK headquarters is in the final stages of completion. All external network traffic (including Internet) has been re-routed from TAK regional centers through the TAK headquarters for security review. However, years of neglect have left PCs in an uncertain state, particularly at regional centers. TAK intends to award a contract locally to re-install all PCs with pre-configured management and security tools.
- *Back-End Modernization:* To support a major increase in direct-to-taxpayer IT services, TAK is required to significantly enhance its capability to host critical IT services. Presently, TAK supports IT for approximately 600 users internally. With the introduction of Electronic Filing and Fiscal Cash Registers, it is anticipated that TAK will be required to extend IT services for a minimum of 20,000 taxpayers. To facilitate the increase, TAK must take the steps necessary to establish a modern data hosting environment. TAK intends to award a contract locally to enhance the existing IT infrastructure but there will still be a need to provide for long-term IT hosting facilities over the next two to three years.
- *Integration Services:* TAK presently maintains a data processing system, SIGTAS, which facilitates the majority of core processes in the organization. Best practice dictates that SIGTAS not be directly integrated with any other system. Instead, TAK requires that robust integration services be introduced. These services are designed to

automatically extract, transform, and load data to and from disconnected systems. They will facilitate movement of data for SIGTAS, E-Filing, Fiscal Registers, Data Matching, distribution of automated reports, and publication of searchable data on the TAK web site. TAK intends to award a contract locally to perform the required services and training for IT personnel.

Central Bank of Kosovo

1.3.1 CBK's supervision departments exercise strong, competent oversight and regulation of the commercial banks, insurance companies, Kosovo Pension Savings Trust and private pension companies.

The bank supervision department has the tools and basic legal framework to fulfill their regulatory responsibilities. Supervision strategies are prepared for all banks. Full-scope examinations are conducted on an annual basis with follow-up target inspections to supplement the CBK's oversight, when needed. The bank supervision department currently uses a rules-based supervision approach; however, efforts are underway to develop and adopt a risk-based supervision approach.

The off-site supervision department is currently using an excel-based regulatory reporting system to perform its monthly monitoring of the banks' financial condition. Included in the World Bank are funds to purchase and implement a more advanced regulatory reporting system that could also be used by the insurance and pension supervisors. While the supervision of the banking industry has advanced significantly, the insurance and pension supervision has not received the same amount of attention. (See section)

1.3.2 Public confidence in the commercial banking sector is shown by an increasing level of deposits.

The public's confidence in the banking sector is evidenced by the strong deposit growth and by not being influenced by inaccurate negative newspaper reports. During 2008, aggregate banking deposits grew 27.9% and totaled €1.44 billion at December 31st. During 2009, commercial banks have reported that deposits continue to grow, but at a slower pace probably due to the international financial crisis.

In the last few months, the public's confidence in the banking sector was challenged when an article in a local newspaper inaccurately reported problems in a foreign-owned local bank and irresponsibly recommended that the public withdraw their funds from the bank immediately. While the article was widely circulated and discussed, no bank, including the foreign-owned bank mentioned in the article, reported an increase in deposit withdrawals or any other business disruption. This event further illustrates the public's confidence in the banking system.

1.3.3 Core Basle Principles scores for CBK show annual improvement.

During the first quarter of 2008, the IMF and World Bank conducted a joint Basle Core Principles assessment and significant improvement was noted in the CBK's compliance with the international standards. The CBK was rated either as 'compliant' or 'largely compliant' with the majority of the 25 Core Principles. Six Core Principles were considered 'materially non-compliant'. During the previous assessment in May 2006, 14 principles were considered 'materially non-compliant'.

While the CBK is working to be fully compliant with all Core Principles, most of the principles rated as 'materially non-compliant' are not considered a primary concern or serious impediment to the CBK in carrying out its regulatory responsibilities of the banking system.

1. 3.4 Supervision Department competently performs Basle Core Principles self-assessment and drafts Action Plan for remedying deficiencies.

An Action Plan has been developed to address the weaknesses and recommendations noted in the BCP Assessment. The Action Plan identifies the tasks that need to be performed, the person(s) responsible for the task and a target completion date. The plan has been approved by CBK management and is being implemented. During 2008, the Supervision Department developed, approved and promulgated an internal control regulation and liquidity guidelines, addressing two weaknesses noted in the BCP assessment.

1. 3.5 Bank inspectors are knowledgeable about new banking products and changing commercial practices.

With several larger international banks entering the local market, there have been new products and service introduced. The Bank Inspectors work to remain up-to-date on new banking products, services and innovations within commercial banking.

Virtually all of the bank supervision management and staff have their professional accounting certificate from SCAAK (the Kosovar professional accounting association) or are working towards the certificate. In addition, several staff members are working towards their ACCA certificate on accounting. Recently, numerous staff members have enrolled in the Global Association of Risk Professionals (GARP) to obtain an International Certificate in Banking Risk and Regulation. Following the projects promotion, most management and staff are enrolled in the BIS' Financial Stability Institute's online courses for bank supervision, focusing on Basel II Capital Standards, credit risk and market risk.

Finally, the CBK actively pursues and promotes overseas training opportunities for its management and staff. CBK bank supervision staff has participated in courses with numerous international organizations, including: the International Monetary Fund; the Joint Vienna Institute; The US Federal Reserve System; and, the Toronto Center on Leadership in Financial Supervision. As a result of these efforts, the Bank Supervision

Department has a knowledgeable and deep talent pool on new banking products and changing commercial practices.

1.3.6 Supervisory profiles of all licensed banks are established.

Supervisory profiles/strategies have been established and updated on an annual basis for all licensed bank.

1.3.7 For both on-site and off-site examinations, bank examiners are knowledgeable, analytical and appropriately proactive in supervising banks, able to detect problems early, devise action plans and enforce appropriate corrective actions.

Due to the training and support from various donor agencies, the examination staff has strong analytical skills and there has been noted improvement in their abilities to identify issues and emerging problems and recommend the appropriate action. In response to the world financial crisis, the Bank Supervision Department has increased its on-site and off-site monitoring of the banks activities. Off-site supervisors monitor deposit levels and remittances on a daily basis. The on-site supervisors are performing target examinations and are following up on potential weaknesses noted in several bank examinations.

1.3.8 Bank examiners perform meaningful analysis of commercial bank reports and update CAMEL ratings for commercial banks.

The bank examiners conduct annual full-scope examinations on all of the banks and issue a report of examination and CAMEL rating at the conclusion of the examination. Target examinations are performed during the year at banks where significant issues were identified during the full-scope examination.

While the Bank Supervision is using the rule-based CAMEL system, they are migrating toward a risk-based supervision system to conduct their examinations and other activities. Currently, at the conclusion of the examination, the examination team issues a CAMEL rating and a risk-based matrix rating. There is an on-going debate and discussion as to whether the CBK should abandon the CAMEL rating system or continue with the dual rating system. The CBK is meeting with and studying regional supervision authorities, especially the authorities in Austria and Slovenia, to help determine what is most appropriate for the banking system in Kosovo.

1.3.9 Bank licensing manual is updated and procedures are significantly improved.

The bank licensing manual has been updated and procedures improved. Specifically, bio data, financial reports and ‘fit and proper’ guidelines have been added for commercial bank officers and owners. Once the new banking law before parliament is approved, the bank licensing manual and procedures will need additional updating. Part of the World Bank grant is dedicated to bringing in a short-term advisor to work on this issue. The CBK is waiting for parliament’s approval before engaging the advisor with the World Bank monies.

1.3.10 CBK vigorously implements bank-licensing requirements.

The CBK has implemented the licensing requirements under UNMIK Regulation 1999/21 Section VII, including requiring business plans, by-laws, bio and financial data on significant shareholders and an annual report. As noted earlier, updates and changes will be needed once the parliament has approved the new banking law. The World Bank, under its US\$2 million grant, will provide short-term advisors to work on this issue.

1.3.11 Bank inspectors rigorously enforce Anti-Money Laundering laws.

A review of a bank's AML policies and procedures is part of the annual examination cycle. There are two bank examiners specializing in AML who have had extensive training and continue to participate in conferences and training opportunities domestically and internationally. The examination staff also receives AML training on a regular basis. For example, during the second quarter of 2009, two bank inspectors. Finally, the Bank Supervision Department is working with the local Police Department to ensure the banks adhere to proper AML policies and procedures

1.3.12 Bank inspectors effectively audit internal controls of commercial banks.

In the last year, the CBK has developed, approved and promulgated the rule On Internal Control Systems that adequately addresses the banks' requirements for an functional internal control system. The CBK has also developed interpretive guidelines on the Rule for the banks. Finally, the Bank Supervision Department has conducted target examinations in the last year on internal controls at all of the commercial banks operating in Kosovo. In conclusion, the bank inspectors effectively inspect audit internal controls of commercial banks.

1.3.13 Insurance and pension supervisors competently supervise insurance companies and pension plans.

The insurance and pension supervisors have not received the same level of attention and their development is lagging, significantly. During 2009, the World Bank, under their US\$2 million grant, will provide short-term advisors to work on a variety of insurance related issues, including: TPL tariff liberalization; legal framework; procedural manuals; and, off-site regulatory reporting systems.

While the short-term advisors will provide needed assistance, further long-term technical support is also needed to ensure that the laws, regulations and manuals are properly interpreted and implemented. A long-term advisor is needed to work directly with the insurance and pension supervisors to participate on inspections and off-site reviews.

Objective 2: Stimulate Trade and Investment through Modern and Well-Implemented Commercial Laws

Consistent with Objective 2, the project's Legal Team provided advice and assistance on the development of a number of new laws, including (1) a comprehensive new draft Law on Mines and Minerals (submitted to the Assembly in June 2008) which will replace two existing UNMIK regulations and bring the mining legal regime into better compliance with best practices in the EU, (2) a new Law on Expropriation of Immovable Property (promulgated in April 2009) that provides better procedural and substantive protection of immovable property rights in line with the ECHR, including fundamental principles on the method of determining compensation, (3) a Law on Leasing (adopted by the Assembly in June 2008) regulating the financial leasing of movable property; and (4) a new draft law on Anti-Dumping and Countervailing Duties (currently in the Assembly).

The Legal Team also provided advice and assistance on the development of two new laws that will replace two existing UNMIK regulations and, in conjunction with the new Law on Mines and Minerals, will create a legislative framework that will enable the prompt resolution of the impasse over Trepca. The first is a new draft Law on the Special Chamber which will regulate the operation of the Special Chamber in a manner that is more consistent with the new Privatization Law, the Status Settlement and the ECHR. The second is a new draft Law on SOE Reorganization. Both the ICO and EULEX had taken a serious interest in the new Law on the Special Chamber but, by May 2009, international political concerns arose that required a delaying of the progress of that draft. It is now believed that those concerns have been allayed and the Government intends on submitting the draft law to the Assembly by September 2009.

As for the new Law on SOE Reorganization, which is critical to resolving the Trepca impasse, the Legal Team in cooperation with a highly experienced bankruptcy judge – has now brought that draft law to a near final state. As before, the three principal aims of the new law are to: (i) enable Trepca management to serve as the administrator of Trepca during its reorganization, (ii) give the Government a seat on the Creditors Committee, and (iii) bring more clarity and logic to the progression of the reorganization process.

The Legal Team also participated in the development of amendments to the Law on Public Procurement, the Law on Public Financial Management, and the Law on Tax Administration. The Legal Team assisted CBAK with the development of a draft law on Deposit Insurance; however, work on that draft law was suspended at the end of 2008. Finally, on-going assistance was provided to MEF and PAK on understanding and implementing the new POE Law and the new PAK law. In addition, the Legal Team provided legal support to the Office of the President through end 2008.

2.0.1 Practical material and training plans on new commercial laws have been developed.

During the second year of the EMSG, the Legal Team (i) continued delivering training methodology – one that requires the use of case studies, interactive discussions, and exercises – to KJI instructors, which is now being used as their primary method to conduct all training courses; (ii) prepared and delivered to judges handling commercial law cases three more legal training courses as required by the workplan; with each course

covering a separate commercial legal subject area (the courses delivered during the second year covered Bankruptcy, Copyrights and Competition); and (iii) prepared and disseminated at each of those courses detailed practical explanatory materials and implementation guides for the concerned commercial legal subject area.

The Legal Team also took substantial steps to schedule the re-delivery of the courses on Trademarks, Arbitration and Business Organizations to the Chamber of Advocates in the Fall of 2008. The Legal Team also began to prepare the four courses and related materials that the workplan requires to be delivered/disseminated during the third year (covering Property/Secure Transactions, Obligations, Foreign Trade and Corporate Governance). Over the course of the project, the complete commercial law training program will cover a total of 11 core commercial law topics.

2.0.2 Judges who hear commercial cases and commercial law attorneys understand policies and concepts underpinning the laws - how and why enforcement of these laws will support a market economy.

All legal training courses and materials prepared and delivered/disseminated by the Legal Team have been designed in accordance with the USAID task order to ensure that judges and lawyers attending the courses will acquire an in-depth understanding of both the substantive provisions of each concerned piece of new commercial law legislation and the policy rationale underpinning those provisions. The courses place a particular emphasis on how each such piece of legislation supports the functioning of a market economy, economic growth and private sector development. The courses also emphasize the critical role that the judiciary must play if these laws are to have the intended positive effect on economic development; i.e. that investor confidence is in large part conditioned.

2.0.3 Judges who hear commercial cases and commercial law attorneys understand and enforce Kosovo's new commercial laws.

The Legal Team received highly positive feedback on the quality of both the training and the materials from the judges who attended the six courses delivered thus far. They clearly indicated that their overall understanding of the six covered legal subject areas has been very substantially advanced, an achievement that clearly promotes the ultimate achievement of the referenced objective.

2.0.4 Commercial law training is institutionalized, including a certification process; this may be in Kosovo Judicial Institute or some other organization identified by the Contractor in consultation with USAID.

The six courses delivered thus far to judges in the first and second year were delivered by local lawyers at the Kosovo Judicial Institute (KJI); and the Legal Team has received a commitment from the KJI to serve as the venue for the remaining five courses to be delivered in the next year. The Legal Team also actively worked with the KJI to institutionalize not only the courses delivered so far, but also the Project's training methodology. Consequently the Legal Team assisted the KJI in initiating a train-the-

trainers program that has been ongoing for the last two years. This training was aimed at teaching local law trainers to utilize the Project’s methodology to prepare and deliver training courses and materials in other areas of law.

The Legal Team also initiated discussions with the KJI on the introduction of a continuing legal education requirement and certification process. The Legal Team expects to begin similar discussions with the Kosovo Chamber of Advocates in the Fall of 2009.

2.0.5 Legal community enforces commercial laws to the extent that business community, including foreign investors, is assured that rights will be protected.

In the training courses and materials delivered/disseminated to judges at the KJI during the first two years, the Legal Team made a concerted effort to help the participants understand the extraordinary importance of the rule of law to investor confidence and economic growth, and how judges and other members of the legal community have an obligation to actively promote the proper and routine enforcement of the entire legislative framework, including – but not limited to - the specific commercial law being covered by the course. Ultimately, over the life of the project, training courses/materials on eleven different commercial law areas will be delivered/disseminated to a broad range of participants from the legal community: including judges, advocates, other commercial lawyers, law students, and interested members of the business community; and increasing the understanding of the participants of the linkage between the rule of law and economic growth will continue to be a core objective.

Objective 3: Privatize or Commercialize POEs

Public Private Partnerships / Airport Concession

3.0.2 PIA is operating under a concession

During the second year of project execution, significant advancements were made towards consolidating Kosovo’s nascent Public-Private-Partnership program. A comprehensive new law on “*Public-Private-Partnerships and Concessions in the Delivery of Public Infrastructure and Services*” was adopted by Parliament. The new legislation is fully compliant with international best practices and creates an effective legal framework for Kosovo’s multi-sector PPP initiative.

Significant progress was also made towards consolidating the institutional framework for PPP. The centralized PPP Unit in the Ministry of Finance and Economy became fully operational during the second year of project execution, with all key competency positions being staffed. Although it legally acts as an advisor to the Public-Private-Partnership Inter-Ministerial Steering Committee (PPP-ISC), the PPP Unit has now been fully integrated into the MFE organizational structure. Sustainable financing measures were also put into place to ensure that salaries will be adequate to recruit and retain skilled professionals in key PPP Unit positions.

Working through the centralized PPP Unit, progress has likewise been made towards building a consolidated and coordinated national PPP program. Now branded as “*Partnerships Kosovo*”, the national PPP program has made headway both within Kosovo, as well on an international level.

On the national level, PPP outreach efforts continued throughout Kosovo, with a particular focus on multi-sector capacity building and training. Likewise, targeted technical assistance was provided to line ministries and municipal governments to assist them in preparing projects for PPP. Additionally, documentation and marketing materials, such as a new PPP website, PPP brochures, presentations and leaflets, have been produced to promote and explain Kosovo’s PPP program to the public-at-large.

Internationally, efforts to market *Partnerships Kosovo* and specific PPP opportunities in Kosovo began. As a national priority of the Government of Kosovo, information regarding *Partnerships Kosovo* and potential projects was published in respected international journals, such as the Economist, Financial Times, etc. Presentations to potential investors also continued during the second year of the project.

Important steps were also taken towards the standardization of PPP processes and the development of best practices. During the second year of the project, standardized content was prepared for many PPP-related documents, including tender dossiers, project management units, etc.

Some preliminary advancement was also made with regard to the development of a pipeline of potential PPP projects. New projects proposed by line ministries and municipalities are being analyzed as possible PPP candidates. A number of feasibility studies are currently underway, as are efforts to identify funding sources for future studies. In some instances, project-implementation support is likewise being provided.

Significant progress was made with regard to the Pristina International Airport (PIA) concession, which is serving as a pilot project for *Partnerships Kosovo*. Since the creation of the Project Steering Committee (PSC) via Government Decision 14/24 (June 12, 2008), a number of important milestones were achieved, including the following:

- Designation of the PPP Unit as the Project Implementation Unit;
- Successful implementation of an international tender to hire an experienced transaction advisor to analyze PPP options and prepare an investment grade feasibility study and Value-for-Money Analysis;
- Successful completion of Phase I of the Project, on the basis of which the Project Steering Committee formally approved proceeding to a concession of PIA;
- Formal authorization via Government Decision 05/68 (June 12, 2009), to initiate the public international tender for a 20-year Design-Build-Finance-Operate-Transfer contract for PIA; and
- Formal approval by PSC of minimum qualifications for Prospective Bidders.

In an effort to utilize this experience as a learning tool (Learn-through-Doing), the Pristina International Airport PPP project is currently being managed by the PPP Unit, with intensive project management support by USAID. As currently envisioned, the international tender procedure for the Airport PPP should be successfully completed by December 2009. The Airport PPP project is likewise serving as a basis for the development of best practices for future PPP projects.

3.0.3 Relevant legislation relating to the transfer of POE's and civil aviation pursuant to the settlement document is enacted

With regard to the post-independence transfer of civil aviation responsibilities to Kosovar institutions, with extensive support from USAID, on January 01, 2009, full competencies were transferred to the newly formed Civil Aviation Authority, as required by the Civil Aviation Law. Substantial technical support is still being provided to line ministries and the Civil Aviation Authority to facilitate the execution of these new responsibilities.

3.0.4 Government has policies and strategies for POEs.

The Government has clear policies for the privatization/concession of the Pristina International Airport, all aspects of the energy POEs and the telecommunication carrier, PTK. Other POE's are less defined and while some assistance has been afforded to the POE Unit in the past year, more substantive resident expertise will be joining the project to ensure this aspect is in place by project end.

Objective 4: Assist Kosovo's Energy Sector to Become More Efficient, Transparent, and Modern

3.0.1 KEK's distribution functions (Network and Supply) are privatized.

The advisors supported the Privatization Committee (PC) to plan and prepare for the unbundling and privatization of the Distribution and Supply Functions of KEK (DistCo) with a strong strategic investor.

The advisors prepared the detailed, comprehensive, week by week, privatization plan and the draft cabinet paper which resulted in the Government Decisions approving the unbundling and privatization of DistCo, the establishment of the PC, and the hiring of a Transaction Advisor (TA) to prepare and implement the privatization tender. Based on the Government Decisions and in consultation with the PC, the advisors prepared the draft tender dossier for the hiring of the TA. The PC finalized the tender dossier and the procurement office of the MFE (PC Chair) opened the tender. There were seven bidding consortia that submitted proposals. The PC appointed an evaluation committee consisting of representatives from the five ministries of the PC. After evaluation and award notice, the tender was annulled due to concerns over possible procedural irregularities. The tender was re-launched and a new evaluation committee was appointed. In this round, there were six bidding consortia that submitted proposals. Of the six, three firms qualified to enter the financial round, and after opening the financial

proposals, an award was announced. A protest was filed requiring the review of the procurement review board. It is expected that the protest will be resolved and the winner announced and contracted by July/August 2009.

At the request of the MFE, the tender dossiers were drafted for the staff of the Project Implementation Unit (PIU) for the DistCo privatization. The procurement office launched the tenders. It is expected that the staff for the PIU will be engaged by August 2009.

The MFE requested that the advisors compile a comprehensive portfolio of documents, analyses, decisions, etc., for submission to the Kosovo Assembly for Assembly endorsement of the DistCo privatization. The Minister of MFE gave a presentation to the industry and energy committee of the Assembly. The committee approved in principle the DistCo privatization and the hiring of the TA. Their requirements for the final approval of privatization were: 1) financial and legal unbundling of DistCo from KEK and 2) a detailed, comprehensive and updated plan for the privatization by the TA.

The advisors worked with KEK, the advisors to KEK and the POE Unit to assist in the financial and legal unbundling of DistCo. This included drafting clauses in the TORs for the auditor of KEK to include fully unbundled accounts for each division of KEK in the 2008 and first quarter 2009 audits. The 2008 audit with integrated and unbundled accounts has been completed and the audit report is expected by July 2009. Because of the delay in the legal unbundling of DistCo and establishment of the DistCo joint stock company (JSC), it was decided that the auditor would provide a first half 2009 audit instead of a first quarter 2009 audit, also with unbundled accounts. These audits and the financial unbundling are critical to Assembly approval of privatization, the tender documentation, and the future tariff filings which require unbundled accounts.

All of the documentation for legally unbundling DistCo from KEK and creating the new DistCo JSC has been prepared by KEK and its advisors and the POE Unit has been briefed on the requirements. The advisors have been facilitating this process. The final steps are for the Government to appoint the Board of Directors for DistCo and submit the documentation to the business register to establish the new company. Then the steps will be taken by KEK to transfer appropriate staff, assets, liabilities, contracts, licenses, permits, etc., from KEK to DistCo JSC. It is currently planned that the TA will launch activities by August/September 2009 and the transaction will be closed by May/June 2010.

The advisors also supported and participated in the USAID/USEA Privatization Workshop. Additional activities included advising on energy legislation, administrative instructions, and secondary legislation, building capacity in the legal department of MEM relating to EC Directives on energy and energy efficiency, building capacity on meeting obligations under the Energy Community, including preparing a submission to the Energy Efficiency Task Force of the Energy Community, significant input and comments on the Energy Strategy, coordination with the advisor to the Energy Regulatory Office (ERO), coordination with the EU advisors to the ERO, KOSTT and MEM, providing

input to the MTEF and 2009 Budget Book, providing input to the Energy Paper for the IMF, participating in the USG energy briefing to the ICO, drafting a new Law on Natural Gas, review of issues relating to MEM regulation of biofuels, extensive analysis and review, in conjunction with the advisor to the ERO on implications of the New Kosovo and DistCo transactions on tariffs (etc.), participating in the USAID energy briefings to the US Department of State, the US Department of the Treasury, and the IMF.

4.0.1 LPTAP has proceeded transparently and in a timely manner so that foreign investors have confidence in the process.

The advisors continued to support MEM, the LPTAP Project Office (PO), the Project Steering Committee (PSC) and USAID/USG on the New Kosovo transaction.

This assistance included comprehensive review and analysis of the various iterations of the Working Framework Document (WFD) and TA/LA presentations, development of a new comprehensive WFD that met all of the Kosovo Government and USG requirements for interim power, removing KEK from the Kosovo Consolidated Budget, developing the lignite mines, building new generation, meeting EC Directives including on competition, market opening and environment, preparing briefing papers for USAID and the USG, analyzing the impacts on tariffs of increasing the lignite royalty/fee, analyzing more real costing of coal supply costs, and analyzing and developing projections for load growth and implications for economic development, and provided input into analyses of the impacts on the KCB and GDP of various New Kosovo scenarios.

The New Kosovo project has experienced significant delays, and has not progressed sufficiently since the original EOI and investor shortlisting. As of June 2009, key decisions required for the preparation of the RFP have not been taken. Intensive PSC meetings are scheduled in July with the purpose of making such decisions and providing instructions to the TA/LA for preparation of the draft RFP for release to the bidders by September 2009. There remains considerable risk that the draft RFP will not be released by this date and/or won't be sufficiently robust for the tender to have maximum benefit to Kosovo.

Energy Regulatory Office

4.0.3 ERO is a strong and independent regulator, efficiently and accountably implementing its rules and monitoring responsibilities, giving confidence to international investors in the energy sector.

With assistance of the USAID resident regulatory advisor, the ERO continues evolving into a fully functional regulator capable of and desiring to do, its assigned responsibilities. As an independent body, and despite fierce political opposition to any price increases, for the third consecutive year, ERO has successfully completed its review of KEK retail tariffs and KOSTT transmission tariffs, using transparent processes, public proceedings, open review and comment on proposed changes, and implemented a

decision granting an increase (this year, of 2.5%, after two previous increases of 5% each) in electricity tariffs.

In the last year, the Government has nominated and the Assembly approved, two new Board members, filling the full five member Board. The project has continued to advise the MEM on a series of proposed potential changes to the regulatory and energy laws of Kosovo; this advice has assisted ERO to avoid changes detrimental to its independence.

In support of the potential KEK privatization, and separately of the KNPP transaction, the project developed and delivered to the ERO, special spreadsheet models which can analyze many possible scenarios of each transaction, presenting results simultaneously from the viewpoint of a potential investor, and from the viewpoint of the regulator. We completed development of an analytical model of the operation of the potential wholesale electricity market of South East Europe. The project delivered these three models to the ERO and presented seminars on their operation, for members of the ERO Board and staff.

The project assisted ERO to design and develop presentations for a series of meetings with their counterpart US regulator, the Illinois Commerce Commission. The project assisted ERO tariff staff to develop and adopt tariffs for renewable energy (for hydro, and for wind power), thus assisting to build self-confidence. On request of the ERO, the project developed simplified spreadsheet models for doing cost-allocation to customer classes -- a significant part of developing tariffs; ERO expects to continue developing those sheets for eventual issue of a revised, easier to use, "model" of tariff computations.

Ministry of Energy and Mines (MEM)

In support of the Trepca Revitalization

While much has changed concerning Trepca revitalization, the GOK has yet to fully commit to resolving the issues. Efforts have been in advising key new players in the intricacies of the current situation and options for resolving this in an internationally legitimate manner. Replacement laws have been developed for mining, reorganization and the special chamber that will enable a debtor led restructuring program.

The new mine management at Trepca is increasingly supporting this approach, and is pushing the PMs Office for resolution. Furthermore, the Project mining strategy and action plan supplied to the MEM outlines a detailed plan for moving forward with the Trepca reorganization. A risk is that the 'do nothing approach' favors the status quo as being the least problematic in the eyes of the political elite of GOK. There may well be significant change upon appointment of the Special Chamber judges for reorganization: It seems inevitable that with only one case in the court, and that case having been in moratorium for 3 years, that a special chamber decision concerning administration will occur. This will have major political repercussions and should be avoided if possible. It is notable that there were issues with garnering the support of MEM over the requirement to ensure an independent regulator, and this difference of opinion had slowed the

progress of the adoption of the mining law. This is now resolved and the law has been adopted using the approach recommended by advisers.

Key progress over the year have been the development of the mining law to international best practice which has now been adopted, the development of a reorganization plan for Trepcia which is slowly developing consensus, and, the development of a mining strategy that would have a positive impact on GDP impact once adopted. This strategy is currently under discussion again at the ministry, and it is believed will form a major element of the final strategy which is being presented in the forthcoming weeks.

Work with the ICMM to promote private sector investment

The ICMM mineral areas of special interest were the subject of a breakfast seminar at the London Mines and Money conference attended by over 100 international mining professionals. Advisers prepared briefing materials, developed the presentation with counterparts and contributed to the Ministers introductory speech. Despite the downturn in mineral commodity prices, this conference created a great deal of interest from the international mining community, and several exploration companies have visited Kosovo for initial assessments of the conditions. However, until the adoption of the law, it is not possible legally to run tenders for these special interest areas and hence progress has been slow.

Often with a new government the prevention of major backsliding is a success in itself. The minister of MEM who regarded privatization as a danger now uses the term with increasing regularity in speeches etc such that the strategy of the ministry is to encourage private sector participation where possible. It is also notable that advisers prevented what, in the face of plummeting commodity prices, could have been a catastrophic increase in royalties at the eleventh hour. The adoption of these royalties would have inevitably led to the closure of Ferronickeli; would have had a serious negative effect on exports and probably eliminated interest in private sector exploration.

1. PROBLEMS ENCOUNTERED, STATUS AND PROPOSED SOLUTIONS

Objective	Problem/Issue	Mitigation Plan	Status
1.1 MFE Organization	Minister Office is not fully organized and there is a lack of devolution within the Ministry	Arrange for a comprehensive 'day away' with the Minister and his senior staff to examine all aspects of the Ministry and make recommendations on improvements	Day away concept agreed and timing to be September 2009
1.1 Budget	Coordination and cooperation between the Budget departments is lacking and hampering a whole of government perspective.	Amalgamation of the Budget and Intergovernmental Departments under one Director.	Minister and Deputy supports concept but timing is dependent on formal appointments to positions.
1.1 Economic Policy	Government needs to strengthen its policy development process	Establish a Fiscal and Budget Committee of Government	Minister has proposal.
1.1 Economic Policy	Current capacity in macro economics and PPP supported by EMSG project	Macro Economic and PPP staff to be transferred to the Ministries payroll	Government decision has been taken, administrative issues to be resolved.
1.1 PPP	PPP is proving to be highly successful and could be in danger of being politicized		
1.2 Tax Admin.	TAK staffing has remained at 654 since 2004 and is inadequate for Kosovo's population	An optimum solution would be to make TAK an independent agency governed by a Board so that it has more flexibility in hiring personnel and more flexibility in the salary offered. As an independent agency governed by a Board, it would be less susceptible to political pressures and could possibly attract and retain a highly-qualified Chief Executive Officer. Short of that solution, TAK needs to be given authority to increase staffing by a minimum of 100 staff over the next	If consensus, take to MFE planning day in September for Ministerial support.

		18 months. The additional staff would still be necessary under the independent agency concept.	
1.2 Tax Admin.	The TAK IT staff has been provided training in the tools, systems, and services required to meet TAK objectives. With a few exceptions, staff is either reluctant to or incapable of utilizing and operating new modern technology at the required level. As the TAK IT 'footprint' expands without an increase in capacity, the risk of failure and protracted development of new IT systems becomes a serious concern.	EMSG advisors are assisting the TAK IT Deputy develop contracting proposals for new development which will include continuing maintenance after delivery. Additionally, the TAK has allocated 12 of the requested 100 new staff for IT. The majority of new staff will be tasked with administration and operations, not new development.	The 2009 Mid Year review has added more IT staff. The recruitment process will be important to ensure quality.

2. SUCCESS STORIES

Public Expenditure Financial Accountability (PEFA) Self-Assessment. First self-assessment of public finance management practices was undertaken by the Kosovo authorities and conducted by the MFE Secretariat, with guidance from Project Advisors, DFID, and World Bank.

Grants Commission. Establishment of the Grants Commission membership in accordance with the LLGF requirements and selection of local government representatives in an open and transparent manner marks a major step towards improved implementation of recently promulgated legal framework. Appointment of the Grants Commission Secretariat within MFE represents a milestone development towards institutionalization of technical and analytical support to the Grants Commission advocated by the Project during the last two years.

Property Tax. New IT solution for property tax administration went live in March 2009. Core system fully rolled out to all municipalities in June 2009.

3. MAJOR UPCOMING ACTIVITIES

Objective	Upcoming Activity	Counterpart(s)	Planned Dates
1.1 Economy	Semi-annual economic bulletin	Macro Economic	30 August 2009
	EU Fiscal Surveillance	Ministry of Economy and Finance	October 2009

	exercise		
1.1 Budget	Municipality approved budget submission due to MFE	Municipality Assembly / Intergovernmental budget MFE	31 September 2009
	2010 Budget due to the Assembly	Minister, Budget, Intergovernmental	31 October 2010
	Grants Commission members to be appointed for 2010	Prime Minister / Minister of Finance / Intergovernmental Budget MFE	December 2009
1.1 PPP	PPP Law comes into force	Government of Kosovo / PPP Unit	August 10
1.1 Property Tax	Start of Property Resurvey	Director of Prop Tax Dept, Municipalities	September 2009
1.2 Tax Administration	Director General Goal Setting for TAK	Tax Administration	10 August 2009
	Law on VAT- expected time of Assembly approval	Tax Administration	By September 2009
3.1 Airport Concession	Release of bidding documents	Ministerial committee/ PPP unit	10 August 2010
4.0 Mining	Mines and Money conference	Minister of Energy, Minister of Finance	Dec 2009