Kosovo Growth Diagnostic:

Constraints Analysis

September 2012

Pristina, Kosovo

Kosovo Growth Diagnostic[1]

Executive Summary

Since declaring independence in 2008, Kosovo has continued to make progress in development, both in terms of its economic performance and as a young, multi-ethnic democracy. Although Kosovo was not affected by the first wave of the European crisis in 2008-2010, indications, such as the sharp decline of exports, from the first quarter of 2012 suggest that it may be increasingly vulnerable to a deepening recession in Europe. The economy has maintained a growth rate of 3-5% for about a decade, up to 2011. However, the pace of growth is not nearly enough to have a transformational effect on Kosovo. Unemployment continues to hover at around 45% of the labor force, while labor force participation is the lowest in the region, at about 40%. The large current account deficit (19% of GDP in 2011) is financed primarily through aid and remittances. Indeed, Kosovo is a top ten remittance-receiving country with about 13% of GDP in annual receipts. Both of these streams are highly vulnerable to a continuing economic crisis in Europe. Kosovo has largely had a stable budget performance, although the budget deficit in 2011 widened to 4% of GDP. Government expenditures have been increasing rapidly and are currently the major driving force behind growth in investment. Private investment has remained at around 20-22% of GDP for the past five years, while public investment has increased from 5% to 12% of GDP. Our analysis shows that to stimulate growth and employment, private sector investment needs to increase.

This paper examines the most binding constraints to private investment growth in Kosovo. We follow the Millennium Challenge Corporation Guidelines on Constraints Analysis, based on the growth diagnostic approach laid out in Hausmann, Rodrik, and Velasco (HRV) (2005). A growth and employment diagnostic for Kosovo was last produced in 2009, with data up to 2006 (Sen and Kirkpatrick, 2009). That study concluded that the major binding constraints to growth in Kosovo are the costs and access to finance; poor provision of public goods – electricity and transport; and weakness in the rule of law. We look at developments 2007-2011 and find that some of the same constraints continue to be binding, pointing to a lack of progress in fundamental reforms.

The conclusions are summarized below:

Growth and investment are not transformational: The International Monetary Fund estimates that Kosovo will need to grow at about 8% per year to halve unemployment within ten years. GDP has been growing at about half that rate, and private investment as percentage of GDP was essentially unchanged in 2011 from 2007 levels. Although remittances have continued to be high and stable thus far, only about 11% are used for investment, with the majority of funds used for current consumption. This in turn contributes to Kosovo's extremely high current account deficit, leaving the country vulnerable to external shocks. To strengthen its economic viability, Kosovo needs to increase private sector investment rapidly and reduce its dependence on aid and remittances.

[1] This report was prepared by a team of US and Kosovo economists to inform USAID/Kosovo strategic programming. The team included Mentor Mehmedi, Artan Mehmeti, Luan Gashi, Dardane Peja, and Theodora Dell.

Access to Credit is a binding constraint for private investment growth in Kosovo. The study notes that credit to the private sector in Kosovo is low compared with other countries. Kosovo has a level of domestic savings roughly in line with the peer countries but a much lower level of borrowing. It has limited access to international financial markets, however that was not shown to be a binding constraint as banks have substantial excess liquidity, i.e. deposits and other funds available for lending. More than 80% of companies do not borrow at all using only own funds or help from family and friends. Borrowing costs are high compared to other countries, due to higher operational and risk costs of Kosovo banks. Collateral and other conditions for loans are more restrictive than in the comparator countries. We argue that the primary cause for the high cost and limited access to capital is the lack of enforcement of judgments, decisions, and contracts. Banks are extremely cautious in lending as it is virtually impossible to collect a bad loan. Even though there is some improvement in the operation of courts, with a reduction in the backlog of cases in 2011, there is no such improvement in the backlog of decisions waiting to be enforced. The enforcement of decisions is fully in the public sector (no private bailiffs) and it remains underfunded, poorly organized, with unclear institutional mandate, and subject to significant corruption. Ultimately, this is a key binding constraint on economic growth.

Power is a binding constraint to private investment growth in Kosovo. Over the last ten years, enterprise surveys have consistently listed power as the most important constraint in Kosovo. Even with imports, the frequency and cost of power outages is much higher than the comparator countries (with the exception of Albania.) Until recently, inadequate generation was coupled with high transmission and collection losses to reduce the electricity delivered to enterprises even further and to pose a heavy burden on the budget. Since 2008, the performance of the Kosovo distribution company (KEDS) has improved steadily and losses have been reduced. 2011 was the first year without an energy subsidy. However, the central issue is that Kosovo's production capacity is inadequate to meet current needs, grossly inadequate for future needs even at 5% economic growth rate, and will continue to pose a heavy cost to the economy. Kosovo has one of the most significant deposits of lignite coal in Europe so theoretically it has the resource to power itself, albeit through thermo generation. But very little progress has been made in the past twelve years to bring new capacity on board. The latest estimates show that a new thermo power plant is unlikely to start generation before 2020, potentially keeping Kosovo on a low-growth trajectory until then.

Human Capital is a binding constraint to growth. With unemployment hovering at 45%, the prevailing view in the government and donor community is that the major problem in Kosovo is a lack of jobs, not a lack of workers. While job creation is low, the evidence suggests that the lack of skills is a constraint on growth, especially for sectors with high-growth potential such as services. Kosovo's labor force is poorly educated and poorly skilled, compared to other countries in the region and even Eurasia. This is combined with high labor costs and a high reservation wage, partly due to the level of remittances. Low-skilled workers are not competitive even with those in EU members like Bulgaria and Romania. Demand for low-skilled workers is low and the supply is high. Most unemployment occurs among workers with high school education or less. Demand for workers is high in the most highly qualified categories, where we find insufficient supply. Although data quality in Kosovo is problematic, several statistical sources point to high returns to education, indicating that human capital is a binding constraint on growth.

Corruption is an increasingly serious concern but evidence is insufficient to determine if it is a binding constraint to growth. The evidence from several enterprise and public opinion surveys is mixed. While three quarters of enterprises list corruption as a major constraint, the level of bribe-giving and the reported cost of bribes is significantly lower than in the peer countries. Nevertheless, there is a high public perception of growing corruption, indicating a growing crisis of confidence in the government. The perception is mostly for corruption in public procurement. If the current trend in rising public spending continues, corruption can become a major factor against growth.

We examined other potential constraints such as transport, water infrastructure, telecoms, macro risks, and other conditions for doing business. They were not found to be binding constraints.

Part 1. Introduction: Is Private Investment in Kosovo Too Low?

Since declaring independence in 2008, Kosovo has continued to make progress in development, both in terms of its economic performance and as a young, multi-ethnic democracy. Kosovo has maintained an annual growth rate of 3-5% of GDP for about a decade through 2011. Its economy was spared the worst effects of the global financial crisis of 2008-2010. Its government finances are stable, with very low public debt and a low budget deficit. Its banking system is considered to be one of the most stable in South East Europe. Kosovo has made progress in reforms, especially in tax administration and banking. Politically, Kosovo has also stabilized. Since declaring independence, it has held local and national elections, has engaged in a promising dialogue with Serbia aimed at normalizing relations, and has taken the first steps to becoming an European Union member candidate, with the Stability and Association Process (SAP) now in its initial stages. The period of "supervised independence" established in 2008 by the 25-country International Steering Group will end in September 2012.

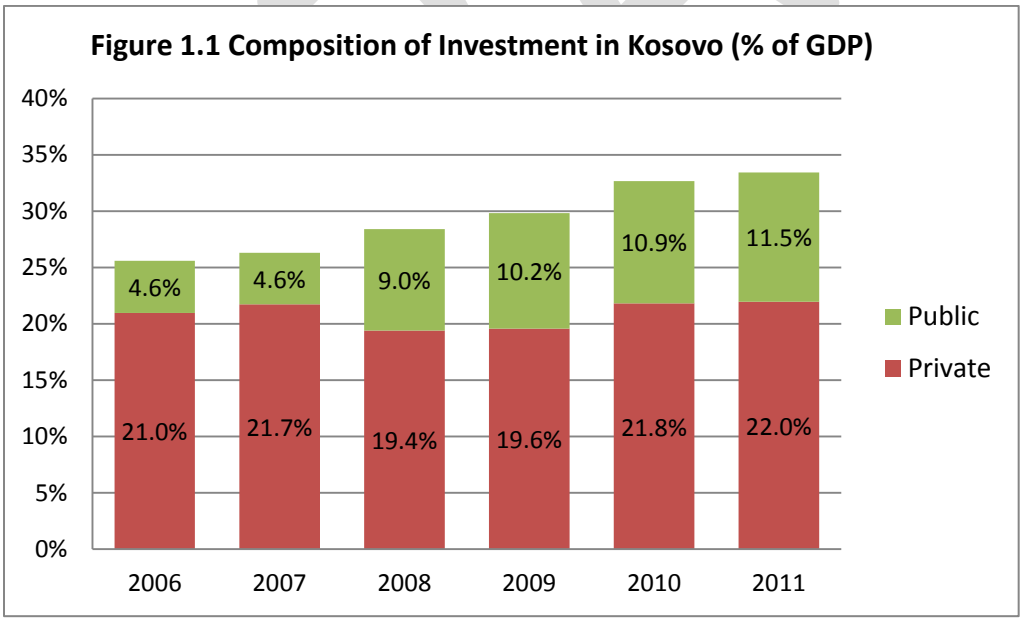
Despite this progress, Kosovo faces formidable political challenges related to the continued uncertainty over its status and the resulting inability to integrate fully in international, European and regional institutions. It has been recognized as a state by 87 countries but cannot become a member of the United Nations until Russia and China – two veto-holding members of the Security Council - drop their objections. Both continue to regard Kosovo as a part of Serbia. The situation in the Serb-dominated municipalities in the north of the country, which refuse to accept the authority of the Kosovo government, has become a de-facto frozen conflict. The recent elections in Serbia saw a hardline nationalist government come to power and thus make the prospect of a political solution to the Pristina-Belgrade problem unlikely in the near future.

Kosovo's economic performance has been uneven. Although it was mostly not affected by the first wave of the financial crisis, indications from the first quarter of 2012, such as the sharp decline of exports, suggest that it may be increasingly vulnerable to a continued economic weakness in Europe. The economy is growing but not enough to have a transformational effect. Unemployment continues to hover at around 45% of the labor force, while labor force participation is the lowest in the region, at about 50%. Kosovo remains the poorest country in Europe, with a GDP per capita of EUR 2,600 and a poverty rate of 34.5%. Youth, women, and

minorities are disproportionately affected by both poverty and unemployment. The unemployment rate among those aged 15-25 is 76% and for women it is 56%. Only 11% of working age women are employed, compared to 68% of men.

Kosovo unilaterally adopted the euro as a national currency and so must rely on sound fiscal policy to preserve macroeconomic stability. It has largely had a stable budget performance, with a budget deficit in 2011 of 1.8% of GDP. Expenditures have risen rapidly since 2009, and have mostly depleted the savings built up after several years of surpluses until then. In July 2010, the government entered into a Stand-by Agreement (SBA) with the IMF, which was suspended in 2011 after an unplanned increase in government sector salaries. The six-month Staff Monitoring Program concluded successfully and Kosovo has a new 20-month, Euro 107 million SBA concluded in May 2012. The budget deficit is expected to increase in 2012 and 2013, to 3.3% of GDP as a result of continued expenditures on highway construction, and to decline starting in 2014. Kosovo's major macroeconomic weakness is the large current account deficit (19% of GDP in 2011), financed primarily through aid and remittances. Kosovo is a top ten remittance-receiving country with about 13% of GDP in annual receipts – a figure that has remained stable through the European financial crisis thus far.

Overall investment has been increasing, with public investment, mostly transportation infrastructure, as the major driving force behind growth. Private investment has remained at around 20-22% of GDP for the past five years, while public investment has increased from 5% to 12% of GDP (Figure 1.1). Our analysis shows that to stimulate growth and employment, private sector investment needs to increase.

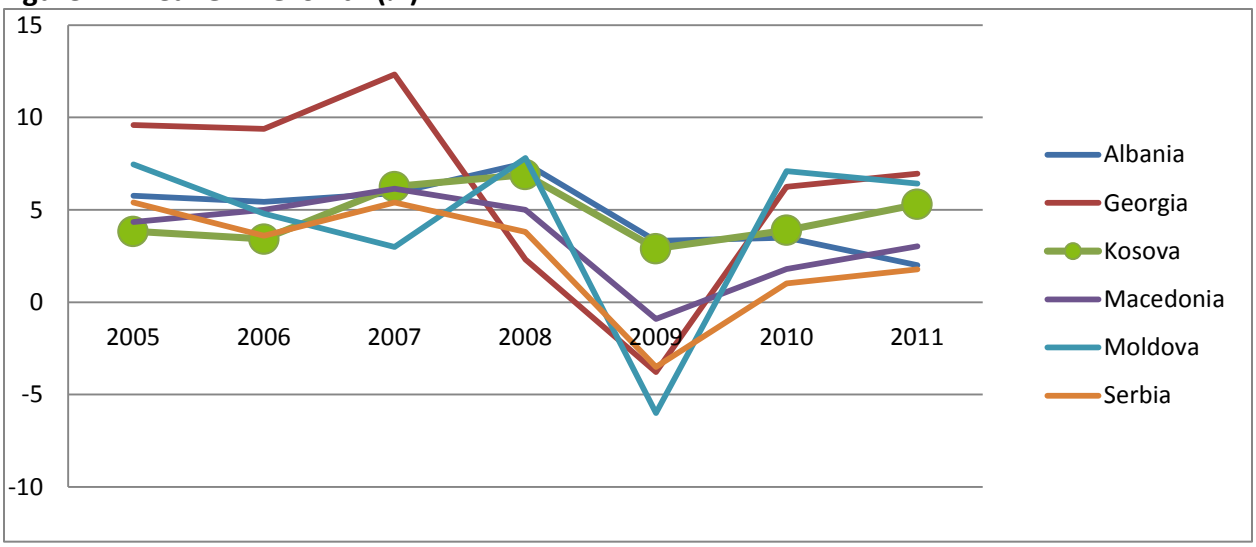


Source: Central Bank of Kosovo

Over the past ten years growth rates in Kosovo have averaged slightly less than 5% per annum (Fig. 1.2). In 2005, Kosovo had the lowest growth rate among the six comparator countries, the

other being Albania, Macedonia, Georgia, Serbia, and Moldova. But it was one of only two (Albania being the other) that did not experience an economic contraction as a result of the financial crisis in 2008-2010. However, as Figure 1.2 shows, since then since then growth in Georgia and Moldova has recovered and again exceeds Kosovo's.

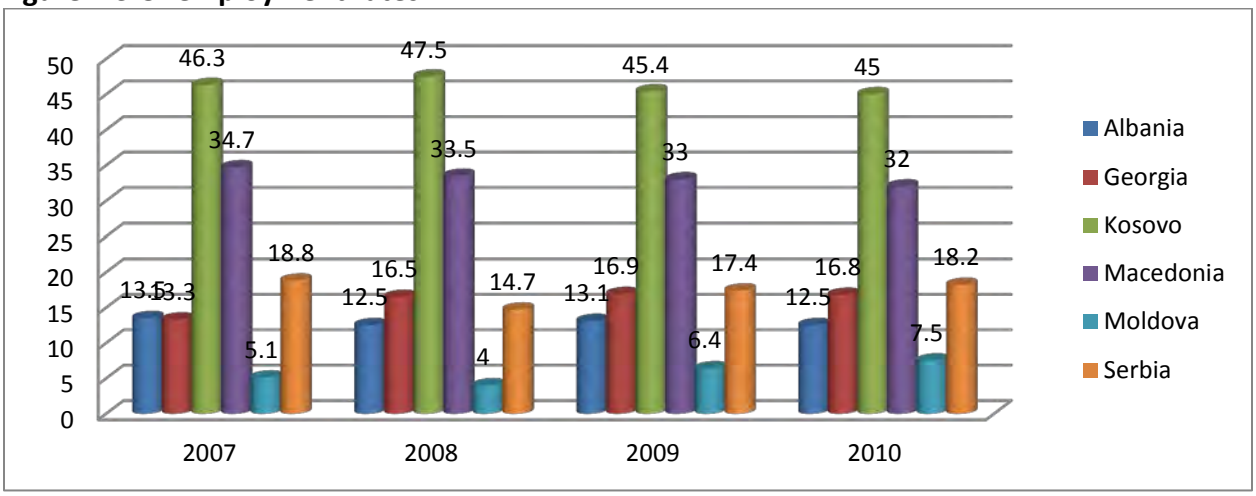
Figure 1.2 Real GDP Growth (%)



Source: IMF World Economic Outlook, 2012

Kosovo's economic growth has not contributed to a reduction in unemployment. Figure 1.3 shows that Kosovo has the highest unemployment rate among the comparators and has made virtually no progress in reducing it. Growth is too low to be transformational.

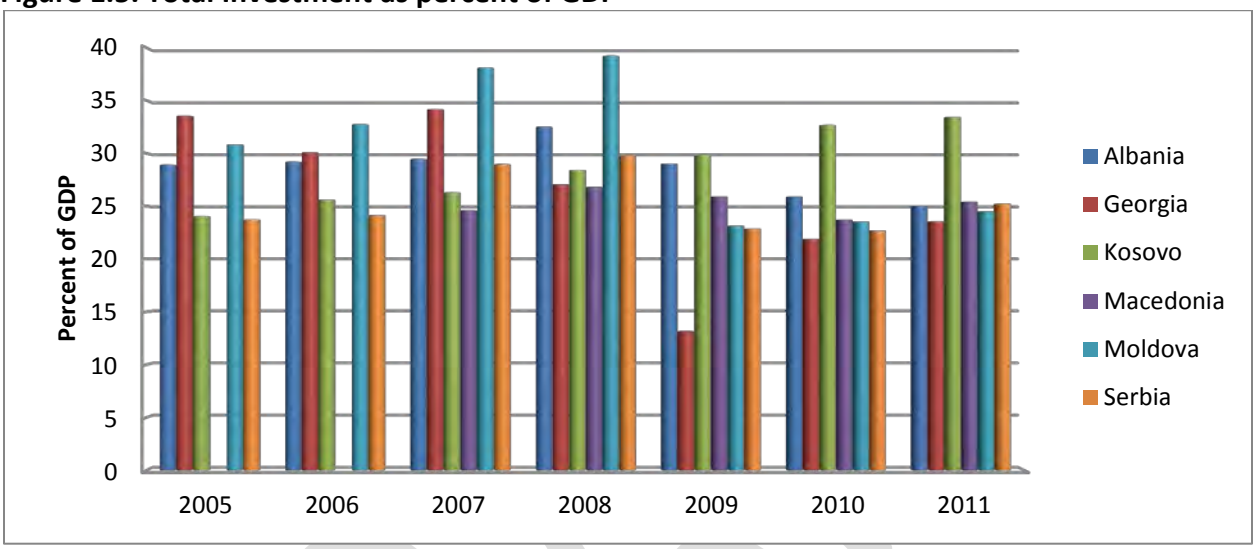
Figure 1.3 Unemployment rates



Source: World Bank, 2012

The total investment picture is mixed. Over the past three years, comparator countries have experienced a sharp contraction in investment as foreign direct investment in particular, withdrew as a result of the financial crisis (Fig. 1.5). Kosovo has remained insulated from the crisis as it is largely not integrated in the world financial system. Total investment in Kosovo actually grew after the crisis, although as we saw in Figure 1.1 above, the growth was due almost entirely to an increase in government expenditure.

Figure 1.5. Total Investment as percent of GDP



Source: IMF International Financial Statistics, 2012

Private sector investment, which drives sustainable economic growth, is stagnant in Kosovo, and is at levels well below the pre-crisis levels of the comparator countries (approximately 25% of GDP.) This study will attempt to identify the determinants of low private sector investment and low economic growth in Kosovo.

The rest of the paper is organized as follows: Part 2 describes the Growth Diagnostic methodology. Part 3 examines the credit side of the growth diagnostic, i.e. the evidence that constrained access to finance is holding investment and growth back. Part 4 looks in turn at the returns to economic activity that may hinder investment opportunities (geography, infrastructure, human capital). Part 5 examines whether issues with the appropriability of returns discourage investment (market and policy failures, corruption). Part 6 summarizes the findings.

Part 2. Growth Diagnostic Methodology

This paper examines the most binding constraints to private investment growth in Kosovo. We follow the Millennium Challenge Corporation Guidelines on Constraints Analysis, based on the growth diagnostic approach laid out in Hausmann, Rodrik, and Velasco (HRV) (2005).

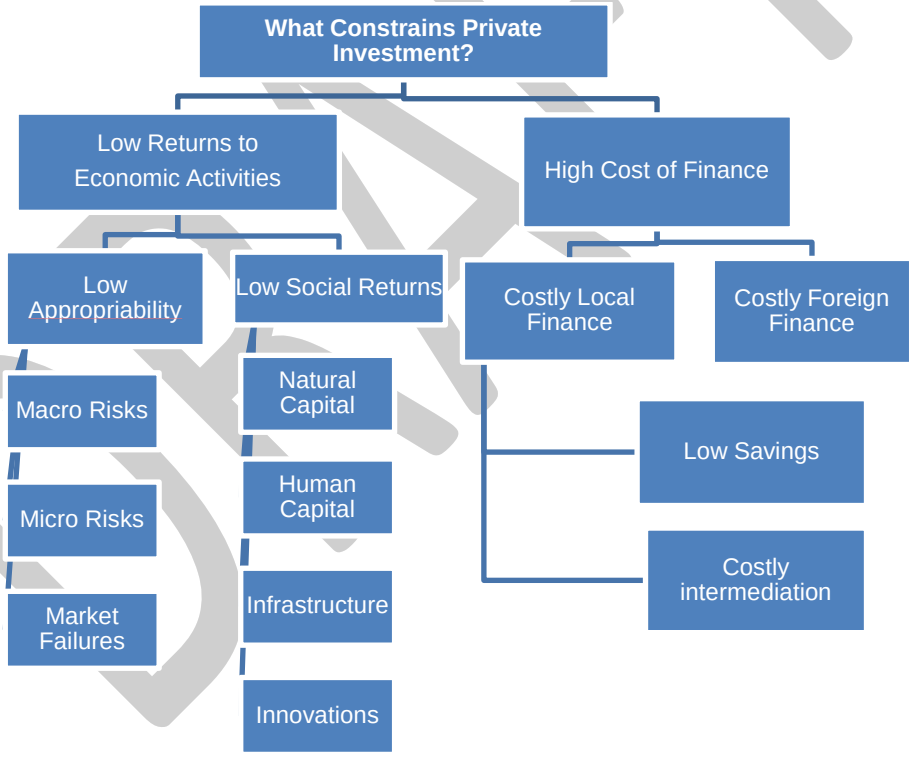
The purpose of the growth diagnostic (GD) is to identify the root causes that deter households and firms from making investments of their financial resources, time, and effort that would significantly increase their incomes. The GD is not intended to dictate specific projects to be

funded by USAID, but rather to provide a framework that will help focus the consultative process on appropriate programs that will ease those constraints and stimulate economic growth. A successful GD will constitute a solid foundation for development assistance that addresses country priorities and is consistent with USAID's policies and goals.

In essence, successfully undertaking a GD involves posing and answering a sequence of diagnostic questions that highlight the "root causes" that constrain investment. Answering those questions involves: (1) selecting and formulating the diagnostic questions in a sensible way for the country at hand; (2) researching and gathering key evidence and data that shed light on the questions; and (3) answering the questions given the balance of such evidence.

The GD builds on the premise that private investment, both domestic and foreign, represents the primary engine of economic growth. Countries seeking to accelerate growth, then, are faced with the fundamental question that lies at the center of the GD exercise: "What constrains private investments?" The framework for answering this question is presented in Figure 2.1.

Figure 2.1. The Growth Diagnostic Decision Tree



The GD is an exercise in considering these questions in turn and finding the most appropriate answer. Ultimately, it is about making a judgment call, backed by the evidence, as to where the most binding constraints are. The goal is to produce a ranking of a few fundamental constraints, rather than a long list of problems, on the theory that countries get the biggest bang for the buck in terms of growth if they focus on the most binding problem first. This does not imply that other issues are not important or no steps should be taken to resolve them. But it does mean that even if the non-binding constraints

were resolved, the economy will likely not experience a large improvement until the binding constraints are resolved. It also means that once a binding constraint is resolved, it is possible, even likely, that a new constraint becomes binding.

It is important to stress that the constraints identified in the GD should be fundamental causes rather than symptoms. For example, "inadequate access to finance" is frequently given as a constraint, but without digging in to what is really causing this – is it weakness in the banking system, low savings rate, lack of access to foreign financing, or lack of bankable projects in the economy.

We applied the four tests suggested by Hausmann, Klinger, and Wagner (2008) to test whether a constraint is binding or not:

- First, the shadow price of a binding constraint is high. For example, a high skills premium suggests that human capital is a binding constraint.
- Second, relaxing a binding constraint leads to observably faster growth.
- Third, there should be evidence of coping measures by economic actors: if unreliable power is a binding constraint, then firms will have stand-by generators.
- Fourth, the composition of the private sector should reflect the fact that economic agents that are affected by the constraint to growth will be a small or falling proportion of the overall economy. If energy is a binding constraint, then industry would be underdeveloped or will be falling as a proportion of GDP.

Comparator Countries:
In order to draw conclusions about Kosovo's economic performance and potential for growth, we compared outcomes to those in two groups of comparator countries. The first group of so-called "peer countries" includes Albania, Serbia, Macedonia, Georgia and Moldova. These are countries at a roughly similar level of economic and political development as Kosovo. All are small open economies transitioning from a socialist economy. All are aspiring to membership in the European Union – a key special circumstance that limits the pool of appropriate comparators. Three – Albania, Serbia, and Macedonia are Kosovo's immediate neighbors. Three – Serbia, Macedonia, and Moldova are landlocked. All have relatively high poverty rates and low per capita GDP. Moldova's per capita GDP is the closest to Kosovo, and its poverty rate is similarly close to the highest in Europe. Finally, all four countries face external or internal political challenges that impact their economies. Macedonia's path to European Union and NATO membership has been blocked for several years by an ongoing dispute with Greece over its name; Serbia's accession fortunes are closely linked to Kosovo's as well as to progress in resolving war crimes from the Balkan conflict in the 1990s; Albania has faced a major constitutional crisis and a lack of stable government until last year; and Moldova has a number of major issues, including a frozen conflict in its Russian-majority region of Transdinestria, and prolonged inability to form a stable government. Georgia has some similar issues with a powerful neighbor, in addition to a particularly difficult transition from socialist economy during the 1990s. In many respects, in the 2000s Georgia became a best practice country in terms of pro-business reforms. However, despite this, it still struggles with high unemployment and poverty.

The main challenge in conducting the diagnostic work in Kosovo was the severe limitations in data availability and quality. In 2011, Kosovo conducted its first census in more than two decades – the data is expected to be released by the end of the year. The quality of most micro-level data, such as the Household Budget Survey and the Labor Force survey is questionable. There are major gaps in

National Accounts data as well. GDP data using the production approach is not available, making an assessment of sectoral contributions to growth impossible.

Prior conclusions

A growth and employment diagnostic for Kosovo was last produced in 2009, with data up to 2006 (Sen and Kirkpatrick, 2009). That study concluded that the major binding constraints to growth in Kosovo are the cost and access to finance; poor provision of public goods – electricity and transport; and weakness in the rule of law. The cost and access to finance was judged to be the most highly binding constraint, and to be mostly due to the low efficiency of financial intermediation than to the low volume of intermediation. The most important source of the constraint was determined to be the high risk premium due in part to political uncertainty and in part to weak property rights in land.

The second binding constraint was associated with low social returns to investment due to the poor provision of public goods, especially transport and energy. Other factors, notably low human capital, were found not to be binding constraints.

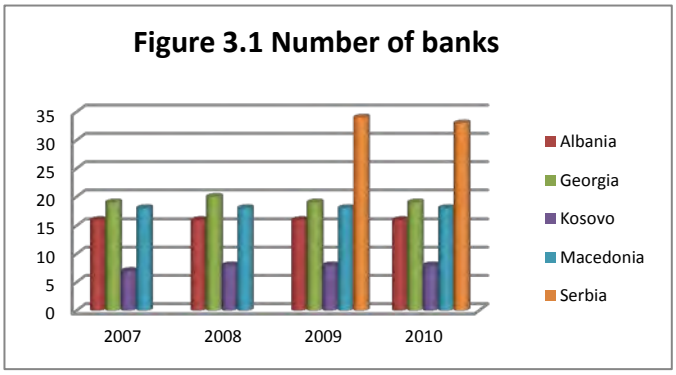
The third constraint was determined to be the weakness in the rule of law, particularly with respect to the establishment and enforcement of property rights. In particular, the deficiency was seen in municipal court operations and the lack of clarity in legal systems.

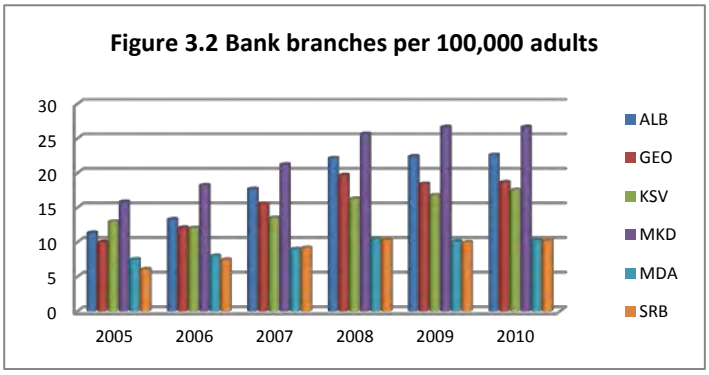
We look at developments 2007-2011 and find that some of the same constraints continue to be binding, pointing to a lack of progress in fundamental reforms. We also find that one constraint which was judged not to be binding then – human capital – is binding now.

Part 3. Cost and Access to Finance

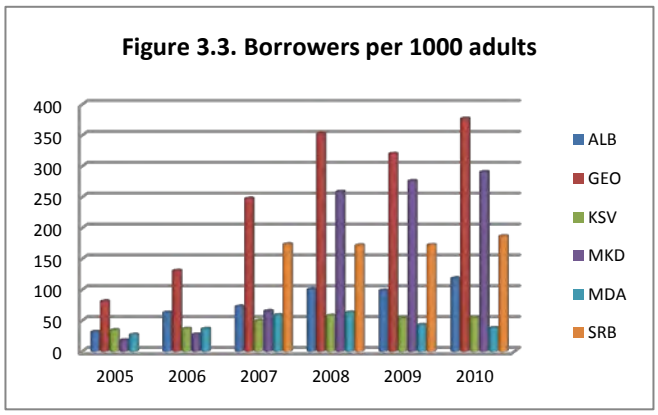
The financial sector in Kosovo is composed mainly of banks – the eight banks hold over 76% of the total assets of the financial sector, followed by insurance companies and micro financial institutions. Overall the banking sector in Kosovo has been a success story in terms of sector stability. Partly this is due to the poor integration in the international financial sector, but mostly it is a reflection of the prudential oversight by the Central Bank of Kosovo. Six banks in Kosovo are in the property of the foreign banks but they operate as separate entities and their liquidity during the period of financial crisis in Europe remained at high levels.

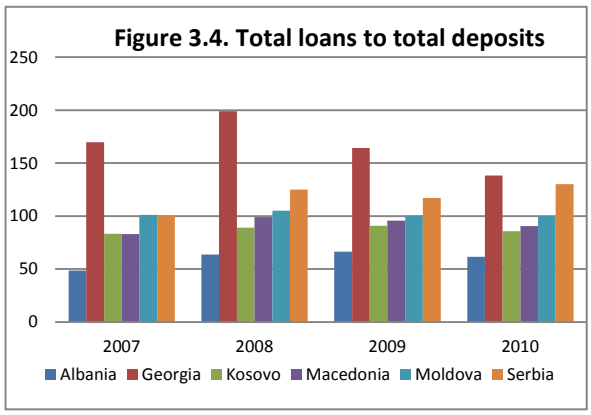
The banking system is also one of most profitable and stable sectors in the economy. Kosovo has a smaller number of banks than the comparator countries, as shown in Fig. 3.1.





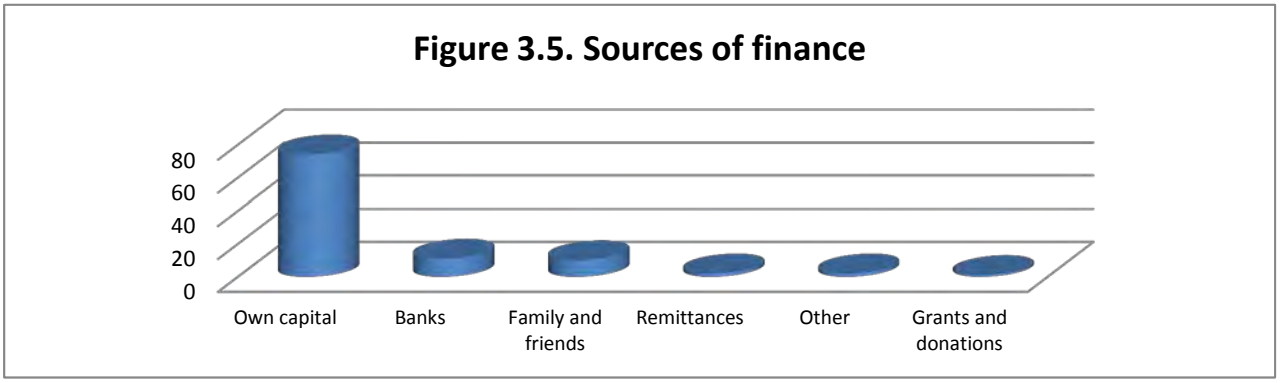
No new banks have been approved since 2008, although the Central Bank is reportedly considering two new applications. Despite that, bank branch coverage, has been growing and is comparable to the other countries in the sample (Fig 3.2). This indicates that the financial market in Kosovo provides sufficient coverage in terms of access to services.





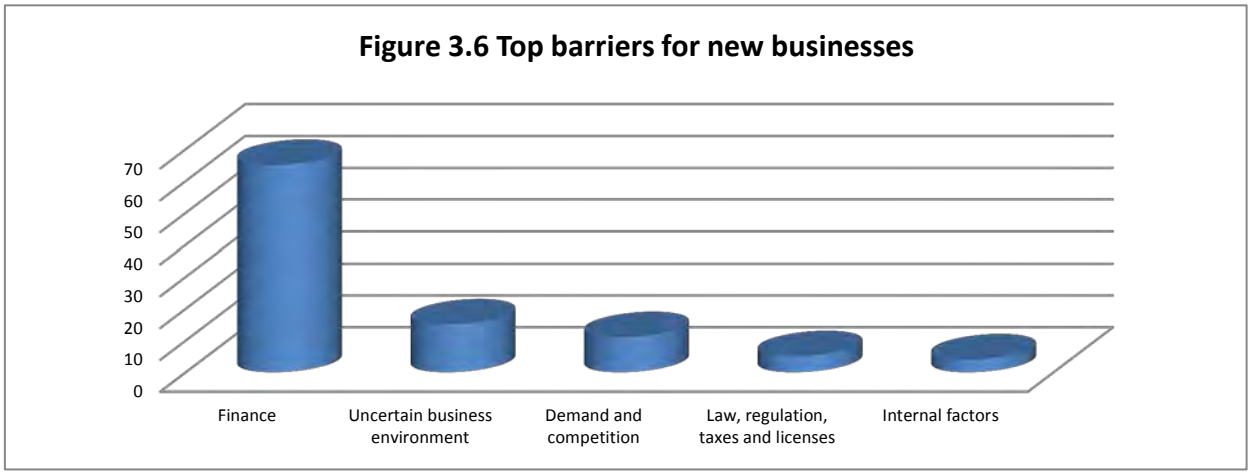
Kosovo banks, however, do not lend at levels comparable to the other countries. There is a small number of borrowers (Fig. 3.3) and a relatively low ratio of loans to deposits at 80% (Fig 3.4). The Central Bank estimates that bank have excess liquidity of about Euro 500M per year. At the same time, the Central Bank recommends that commercial banks do not exceed this ratio of 80%. Central Bank staff expressed to the team that they consider this semi-requirement an essential part of maintaining stability in the system. Even so, Central Bank staff estimate that there is sufficient liquidity to increase lending without accessing other sources of financing.

Most Kosovo firms finance investments through their own capital (Fig. 3.5) according to the Riinvest Enterprise Survey of 2011, 74% of firms use own capital and only 20% use banks as a source of investment capital.



Source: Riinvest Enterprise Survey 2011

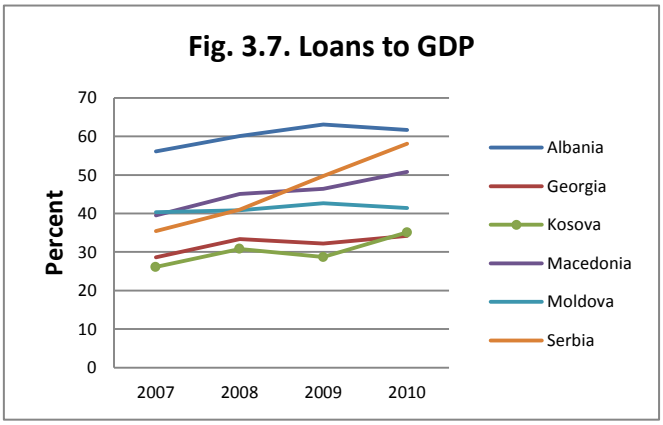
In that same survey, business representatives identify finance as the major barrier for new enterprises. For new businesses, access to finance might be a major constraint due to high collateral requirement and the (up to 300% of the loan value) and the cost of borrowing is even higher than the average. Many banks are reluctant to provide any financing for start ups.

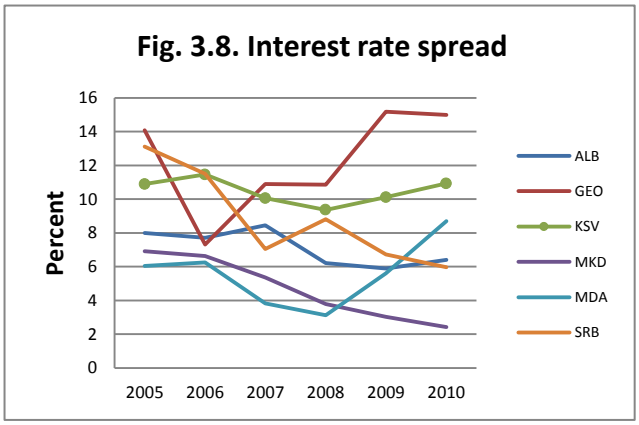


Source: Riinvest Enterprise Survey 2011

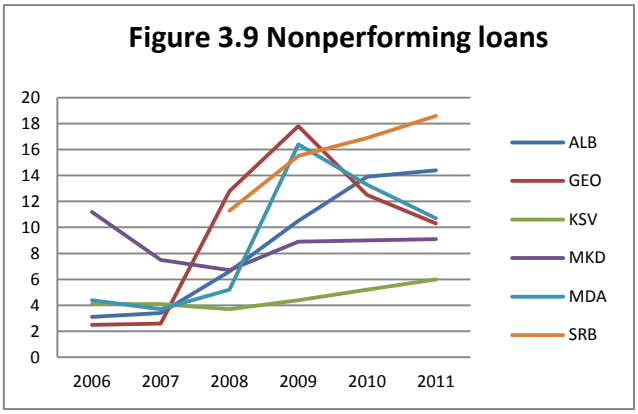
On the other hand, the Word Bank's Enterprise Survey 2009 indicates that only 2% of existing companies identified access to finance as the biggest obstacle to doing business. Existing firms find it easier to obtain financing especially if they build a relationship with banks. However, even they face costs that are higher than in the region, and frequently finance expansion only with their own capital, without any borrowing at all.

Loans have been growing as a percentage of GDP although the levels are still below those of comparator countries (Fig. 3.7). The interest rate spread in Kosovo is higher than the comparators, except for the recent spike in rates in Georgia (Fig 3.8). It is worth noting that real lending rates have been declining but are higher than in comparator countries.

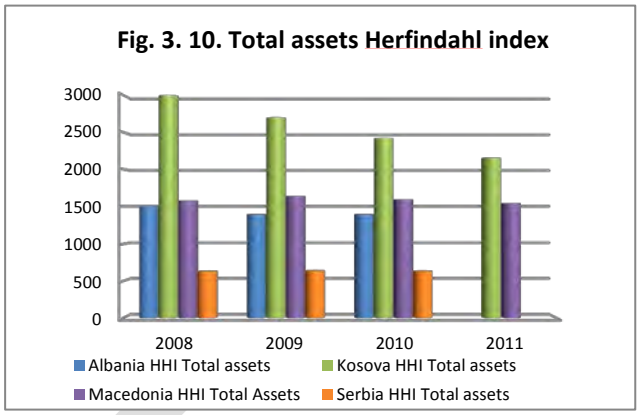




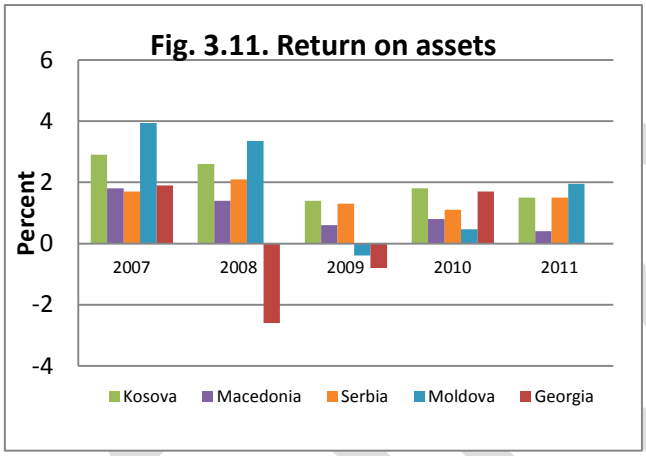
The high interest rate spread, as measured by the difference between lending and deposit rates, provides strong evidence that the cost of finance is high in Kosovo. Fig. 3.8 shows that the spread narrowed until 2008 and since then it has been increasing. The Kosovo interest rate spread is about 11.5%, twice as large as those in Albania and Serbia, and about four times larger than interest rate spread in Macedonia. Only Georgia, which was severely affected by both the war in South Ossetia in 2008 and the world financial crisis, currently has a higher interest rate spread, reflecting the continued high level of political risk there. Other countries have experienced a tightening of credit with the growth of non-performing loans, for example Moldova. In Kosovo interest rate spread remains very high despite that Kosovo has the lowest level of nonperforming loans. The nonperforming loans rate in Kosovo is about 6%, i.e. less than the half of the average of other countries (Figure 3.9) as revealed in the 2012 USAID study "Regional Comparison and Financial Sector Overview for 12 Countries in Southeast Asia and Eurasia". This low level of non-performing loans is partly due to the conservative lending practices in banks and partly due to the relatively low age of the loans in the system.

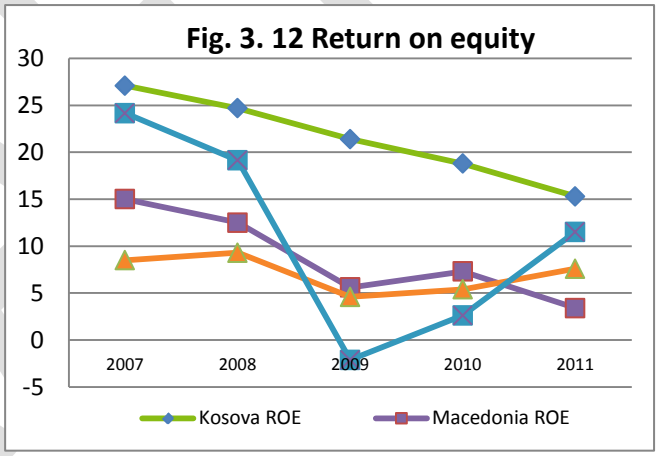


Overall, the evidence points to an efficient and highly profitable banking sector. There is however, evidence that the sector is not truly competitive. The sector is even more concentrated than the low number of banks suggests, with two banks holding more than 60% of total assets. The Herfindahl index of Kosovo's banking system, although declining, is still over 2200 – considered a high degree of concentration[2] (Fig. 3.10).



The high Herfindahl index and the high profitability of the sector shows that there is room for more banks to enter the market, meaning barriers to entry may be present. The profitability of Kosovo's banks both in terms of return on assets (Fig. 3.11) and return on equity (Fig. 3.12)





Another indicator that the demand for money is high is that the Central Bank of Kosovo highly recommends to Kosovo commercial banks not to surpass that 80% loan to deposit ratio, and the banking sector has remained at this level for several year. In order for banks to increase lending deposits need to increase or banks have to get credit from foreign financial institutions. Thus, this also reflects high cost of foreign financing.

In short, the cost of financing in Kosovo is high and businesses do not access financing sufficiently to fuel growth. The HRV methodology requires that the analyst dig deeper into this conclusion to unearth the true causes of high cost and insufficient access to finance.

[2] Herfindahl index below 1000 – indicated that market is not concentrated; 1000-1800 – market is moderately concentrated; above 1800 – market is highly concentrated.

We further examined in more detail the composition of the costs of lending, using data provided by the Central Bank of Kosovo. Table 3.1 below shows that Kosovo has higher intermediation costs than Macedonia, Albania, Croatia, or Serbia. Kosovo banks' funding costs have been increasing but are still lower than funding costs of banks in the other countries. This stems partly from the fact that Kosovo banks get funding mainly from deposits and from costlier foreign sources. Operating costs have been declining but are still twice the average of the region. High operating costs point to high inefficiencies in intermediation.

Table 3.1. A decomposition of the costs of finance for Kosovo and regional countries.

Description	Kosovo				Macedonia	Albania	Croatia	Serbia	Average fore region countries
	2006	2007	2008	2009	2009	2009	2009	2009	
Ex-post lending rate	**15.66**	**16.30**	**15.52**	**14.58**	**11.90**	**12.19**	**10.18**	**10.29**	**11.14**
Lending rate	13.32	13.30	13.09	12.59	10.74	9.70	9.04	8.49	9.49
Fees and commisions	2.35	3.00	2.43	1.99	1.16	2.49	1.14	1.80	1.65
Ex post Costs	**12.93**	**13.25**	**13.50**	**13.37**	**8.85**	**7.85**	**11.92**	**12.87**	**10.37**
Funding costs	2.30	2.52	2.93	3.36	4.10	2.93	5.17	6.17	4.59
Operational costs	5.64	5.37	5.28	4.48	3.99	2.00	1.89	0.42	2.07
Risk costs	4.22	4.54	4.37	5.08	0.38	2.55	4.30	6.26	3.37
Regulatory costs	0.77	0.81	0.92	0.45	0.39	0.36	0.57	0.01	0.33
o/w taxes	0.59	0.61	0.69	0.18	0.02	0.08	0.23	0.00	0.08
o/w reserves	0.19	0.20	0.23	0.27	0.36	0.29	0.33	0.01	0.25
Memorandum items									
Residual	**2.74**	**3.05**	**2.02**	**1.21**	**3.04**	**4.34**	**-1.74**	**-2.57**	**0.77**
o/w Profit	1.88	2.60	2.26	1.28	0.72	0.21	0.82	0.22	0.49

Source: Central Bank of Kosovo, Balance of Payment Report, 2011

The most important factor in determining intermediation costs in Kosovo is risk. Risk costs for Kosovo have been increasing and are the highest in the region, except for Serbia. According to banks surveyed by Central Bank risk costs in Kosovo are mainly associated with the inability of the banks to collect loans.

This was confirmed in interviews with several bankers, staff from Central Bank of Kosovo, and other staff from business/financial community. The major problem pointed out by all bankers, was the inability to enforce decisions even after the lengthy court process has been concluded. One banker estimated that less than 30% of collateral assets can be recovered after a default, leading straight to the biggest complaint of firms – collateral requirements exceeding 300% of the loan amount. The bankers gave numerous examples of inefficient and corrupt practices in the enforcement of judgments process, which remains fully in the public sector and outside of the court system. Enforcement clerks are state employees, not employees of the court, meaning that judges have little influence, and consequently little interest, in whether and how their decisions are carried out.

USAID works with the Kosovo Judicial Council and has collected data on the enforcement of judgments through the project Support for Enforcement of Agreements and Decisions (SEAD).

There were 80,792 civil judgments pending execution as of the end of 2011, more than the number at the end of 2010. The main obstacles to efficient enforcement SEAD identified include:

- **Process:** antiquated procedures that result in numerous delays and inefficiency. SEAD conducted an experiment to enforce simple judgments, mainly utility bills. It took a total of 28,000 attempts to enforce the 7,000 cases in the pilot project.
- **Resources:** there are only 74 enforcement clerks nationwide and no private enforcement is allowed (although that may change soon, with a new law on private bailiffs).
- **Incentives:** enforcement clerks do not report to judges and judges are not interested in enforcement; there are no consequences for poor performance or corruption; arbitrariness. Bankers also cited a frequent practice of delinquent borrowers is to pay the head enforcement clerk to put their case at the bottom of the enforcement pile.
- **No clear lines of authority:** the clerks are employed by the Ministry of Public Administration but work out of the courts. It is not clear who is in charge of the whole process. There is very little sense of urgency in the government about this issue.

The team conducted two focus groups with businesses operating in Pristina and Gjakova regarding obstacles to investment and growth. Most of them stated that they have never obtained loans and that they have no plans to do so, because bank conditions are too onerous. The focus groups revealed evidence of another complaint by bankers – that loan applications are poorly executed and do not contain sufficient documentation. Business owners stated several times that bankers "did not care about the businesses" but care only about business plans and documents. This suggests that there is a large scope for strengthening business owners' capacity to access finance effectively.

Conclusion:

The access to finance and the high cost of finance represent a binding constraint to private investment growth in Kosovo. Cost of capital remains too high and lending rates are too low to sustain economic growth. The evidence suggests that this is due more to lack of security in property rights than to poor intermediation. The root cause to the high cost of finance is the severe inefficiency of the court system in resolving and enforcing cases including property and commercial disputes. We found insufficient data to quantify the effect of the poor enforcement on borrowing and investment, but the evidence as exists, both quantitative and anecdotal suggests strongly a focus on improving enforcement, either through alternative dispute resolution methods or through a better functioning enforcement system will have a substantial impact on lending. There is also evidence that Kosovo is suffering from lack of access to financial markets. The Central Bank of Kosovo strongly recommends bank lend no more than 80% of their deposits, and banks face a very high cost of international borrowing, linked to country risk.

PART 4. Returns to Economic Activity

4.1. Infrastructure

4.1.1. Roads Network

The road network in Kosovo is classified into national (including motorway) and regional roads, under the administration of the Ministry of Infrastructure (MoInf), and local roads, including urban and rural roads, under the administration of municipalities. Table 4.1 shows the approximate total road lengths of the different types of roads.

Table 4.1 - Current Road Network in Kosovo (km)

	Paved	Unpaved	Total
MoInf	**1,810**	**111**	**1,921**
Motorway	38		38
National	599	4	603
Regional	1,173	107	1,280
Municipal*			**5,034**
Urban*			571
Rural*			4,463
Total			**6,955**

Source: MoInf Multimodal Transport Strategy, 2012 (* Estimated)

The recently developed Multimodal Transport Strategy[3] estimates that the state of national and regional roads (those maintained by MOINF) is overall acceptable, while the state of local roads, maintained by municipalities, is poor to critical. Regional and national roads meet or exceed the old Yugoslav standards of road design (road width of six meters), while local roads can be as narrow as three meters or less. Most unpaved roads are in the local road network but even the paved roads are frequently impassable.

Kosovo is lagging well behind the other Western Balkans countries on the transport infrastructure. The South Eastern Europe Transportation Observatory (SEETO) reports[4] that Kosovo road network constitutes only 5.4 percent of the regional network, whereas the rail network is only 3.1 percent of the total regional network. Roughly 80 percent of the road infrastructure is of medium quality, meaning roads needing rehabilitation. The Government of Kosovo has embarked on a large program of public investments aiming at modernizing the road infrastructure. Work is underway to link with the Albanian Durrës – Vërmicë highway, which gives Kosovo access to the sea. The highway starts at the city of Durrës in Albania and is planned to end at Merdare (border crossing between Kosovo and Serbia) by forming part of

[3] Kosovo Ministry of Infrastructure. Multimodal Transport Strategy for Kosovo. 2012
[4] South-East Europe Transit Observatory. SEETO Comprehensive Network Investment Report 2007- 2011. 2012

European route E851. Once the Kosovo part of the project is completed, the motorway will link the seaport of Durrës with the Pan-European corridor X in Serbia. The first segment of the road in Kosovo (some 36km) has been completed; the project should finish in 2013. Other road infrastructure projects link central Kosovo with the northern and northwestern part of Kosovo. Next year will see Kosovo embarking on another major infrastructure project, linking central Kosovo with the southern part of Kosovo and from there to the port of Thessaloniki, Kosovo's major import/export seaport.

4.1.2. Railways.[5]

The total length of Kosovo's railway network of Kosovo is 333 km of non-electrified standard gauge single tracks lines.

Road transport is currently the main transport mode used to carry freight in Kosovo, whether national or international freight. Railway transport accounts for a limited market share in freight services, although tonnage more than doubled between 2005 and 2009. Volume carried by rail in 2009 was about one million tons with revenues of 2.7 millions euros.

Kosovo Railways carried less than 1000 containers in 2009 via the Miradi terminal near the Pristina airport. The railways are used mostly for freight, with very limited passenger rail services nationally to Peja and internationally to Skopje, Macedonia.

The main line connects the northern border with Serbia to the border with Macedonia and passes through the central terminal Miradi, in Fushe Kosova, close to Pristina Airport. It is 141 km long and is part of the South Eastern Europe Transport Observatory agreement (SEETO) Core Railway Network Route 10. It connects via Skopje to SEETO Corridors VIII and X.

The other operational line connects Fushe Kosova to Peja. Several existing lines are not in operation, namely Kline-Prizren (Kline is located on the line between Fushe Kosova and Peja), and Fushe Kosova-Pristina-Podujevo.

There is no direct railway link between Kosovo and Montenegro and Kosovo and Albania.

Conclusion:

While the transport network is poorly developed, Kosovo's small size and short distance to seaports mean that this is likely not a binding constraint on growth currently. The government is investing heavily in road infrastructure which is expected to reduce freight costs. This will be felt especially after the most important trade route, through Macedonia to Thessaloniki port, is rehabilitated, starting in 2013. There are no comparable investments in rail infrastructure planned, meaning that this sector will likely stay underdeveloped and underused. Rail is a major low-cost freight option in the region. If a major tradeable sector emerges in Kosovo, the lack of rail infrastructure can become a constraint.

[5] Ministry of Infrastructure. Multimodal Transport Strategy for Kosovo. 2012

4.1.3 Power.

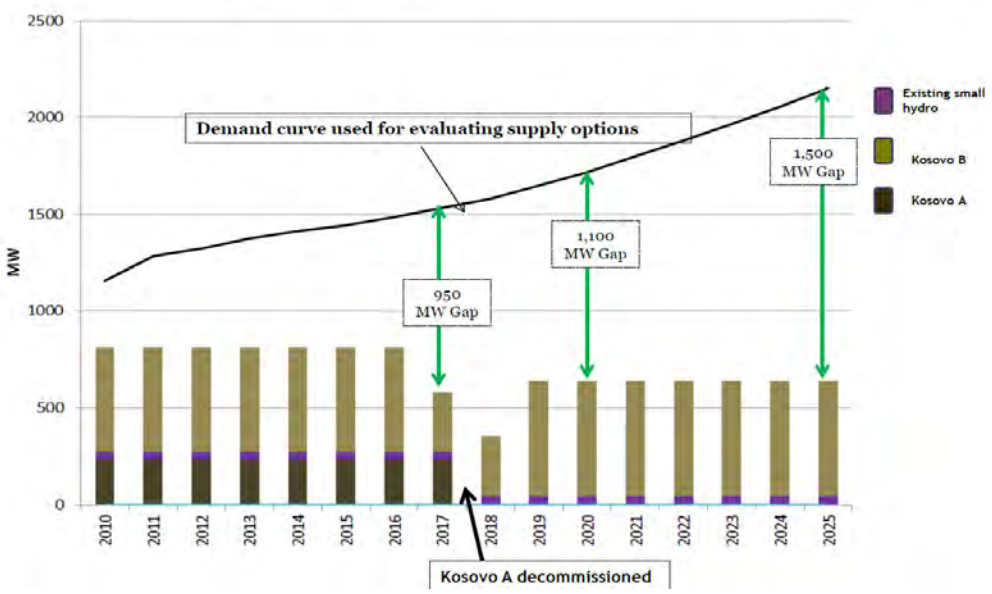
More than 97.5% of total consumed energy in Kosovo is generated from thermo power plants. Kosovo has one of the most important deposits of lignite coal in Europe[6] which serves to power Kosovo's two thermo power plants (TPP) in Obiliq, near the capital Pristina. Nevertheless, Kosovo's currently installed generation capacity of 846 MW per million-population[7] is inadequate to meet the demand of economic actors. Kosovo has not been able to cover its domestic needs for electricity since its de-facto split from Serbia in 1999 and has consistently relied on imports, funded in part by an annual government subsidy.

The World Bank Paper on the "Development and Evaluation of Power Supply Options for Kosovo" produced in 2011 pinpoints to the energy sector challenges and names shortages and unreliable electricity supply, peak capacity gap (~ 950 MW by 2017 on closure of Kosovo A), high technical and commmercial losses and poor billing and collection practices as big issues for the Kosovo's ecomoy.

The study forecasts that electricity consumption in Kosovo would grow by 4.6% per year and Kosovo's needs for new firm capacity are: 950 MW by 2017 (after Kosovo A has retired), 1200 MW in 2018 (when one Kosovo B unit is out of service), 1000 MW in 2019 and about 1500 MW in 2025 (see Figure 4.1.3.1). The study concludes that Kosovo needs a mix of renewables and thermal to meet its demand for peaking and base-load capacity.

Figure 4.1.3.1.

Generation Capacity Required To Meet Peak Demand (MW)



Source: Kosovo Energy Regulatory Office (ERO) 2011

[6] World Bank 2010
[7] KOSTT (2010)

Imports of electricity via regional interconnections have been important to Kosovo over the past decade. Net imports have ranged between 5 and 17 percent of total annual consumption since 2001. Imports account for about 10 % of electricity supply; Government subsidies peaked at 5% of government expenditure in 2008.[8]

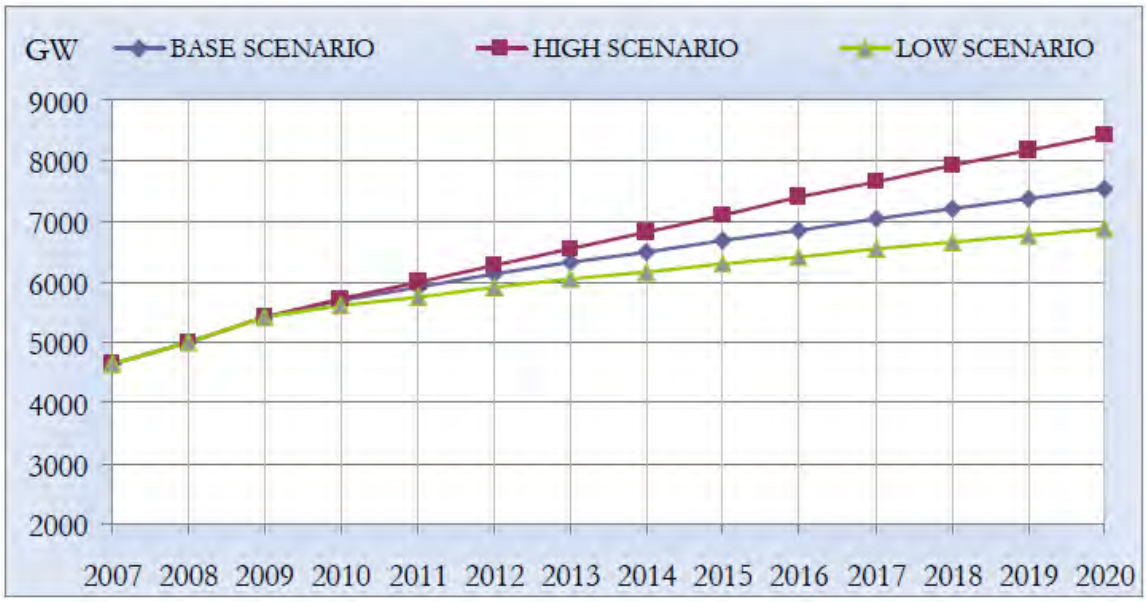
Until recently, inadequate generation was coupled with high technical losses in distribution and transmission and extremely high rates of theft and non-payment. These losses serve to reduce the electricity delivered to enterprises even further and pose a heavy burden on the budget. The performance of the Kosovo distribution company (KEDS) has improved steadily over the past few years and losses have been reduced. Commercial losses (as percent of energy available for sale) have fallen from 31% in 2006 to 18% in 2011. Technical losses (losses in distribution as percent of energy delivered for distribution) have fallen less dramatically - from 18.2% in 2006 to 16.8% in 2011. (KEDS, 2012).

Kosovo continues to lose out on the potential for energy revenues and not only due to the continuing high commercial and technical losses. The Serbian electrical power utility maintains an unlicensed branch in the north of Kosovo. This deprives the Kosovo Energy Corporation of revenue, particularly since power is deviated from the Gazivoda hydropower plant to supply the north. Further, Kosovo's electricity transmission system operator does not participate in regional mechanisms to plan and remunerate electricity transit, due to Serbia's obstructionism. The resulting lack of control imperils the stability of Kosovo's power system and Kosovo loses out on transit revenue.[9]

Registered energy consumption has grown since by more than 90% since 2000 to 5500 GWh in 2010. Demand is projected to reach 8400 GWh in 2020, assuming Kosovo grows at an average economic growth rate of only about 5% per year. Figure 4.1.3.2 shows the estimate of domestic demand by the Kosovo Transmission, Systems, and Market Operator (KOSTT 2011) under three growth scenarios: High – 5.29% GDP growth rate 2011-2015 and 5% 2015-2020; Average – 3.1% growth rate 2011-2020; and Low – 2.5 % growth rate 2011-2020. KOSTT estimates that without new generation capacity Kosovo will have to import as much electricity as it produces domestically until 2017 - and even more afterward.

[8] World Bank. Development and Evaluation of Power Supply Options for Kosovo. 2011
[9] European Commission. Kosovo 2011 Progress Report. Commission Staff Working Paper. 2011

Fig. 4.1.3.2: Projected Demand 2011-2020



Source: KOSTT 2010

No new generation capacity has been installed since 1984 when the TPP Kosovo B came online, with a lifetime until 2030.The other TPP - Kosovo A was installed in 1970-4 and has a lifetime until 2017, when Kosovo has agreed with the European Commission to have it decommissioned. Two hydro power plants (HPP), Ujmani and Lumbardhi, were installed in 1983 with a planned lifetime of up to 2030. However, the plants' life has been compromised through years of inconsistent and irregular maintenance, meaning that without overhaul decommissioning may have to take place as early as 2020.

Plans for a new TPP have been ongoing since the 1980s. The latest proposal calls for the TPP New Kosovo with capacity of 600MW to be built by 2017 and operated in a public-private partnership, with the investor also taking on the refurbishment and operation of Kosovo B. There has been scant investor interest which may push the potential date of new generation capacity coming on-line further, to 2020 or beyond. The government is reconsidering decoupling the refurbishment of Kosovo B from the New Kosova power plant package and putting forward a package involving only investment in new electricity generation capacity of 600 MW (2 x 300 MW) and a new lignite mine with an estimated cost of € 1.4 billion.

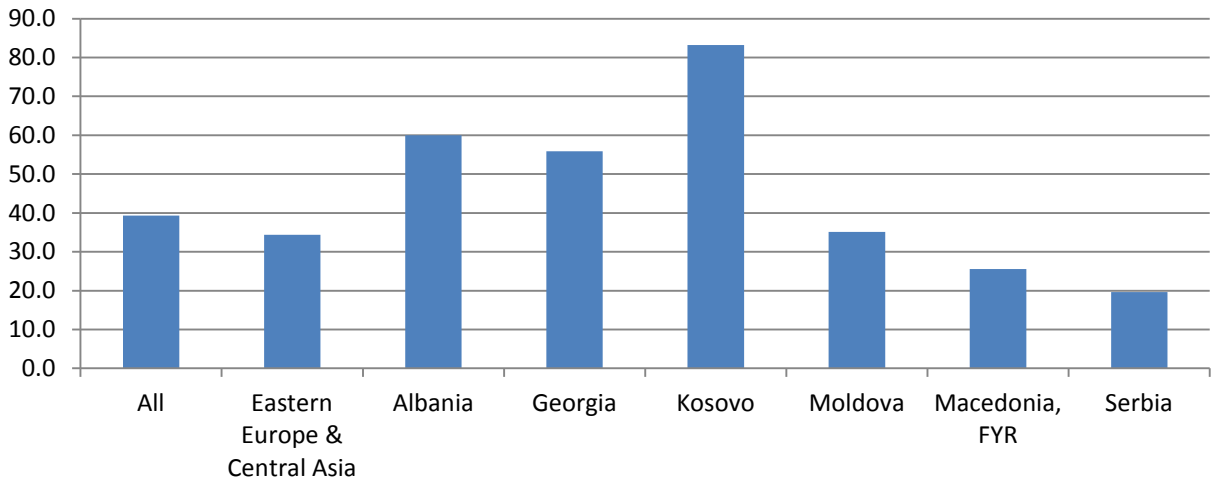
However, if there is no new generation capacity within five years and TPP Kosovo A is decommissioned on schedule, Kosovo could face a severe energy supply crisis again.

Another characteristic of the Kosovo energy sector is the low efficiency of use. Kosovo households, which consume the majority of power produced, use mostly electricity for heating, with firewood as a secondary source. Dwellings generally have poor insulation. According to

some estimates, more than 90% of current construction in Kosovo is illegal – i.e. without applicable permits. Building codes are antiquated and at any rate are not enforced. KOSTT estimates that improved energy efficiency, the reduction in technical losses in distribution and transmission, and the implementation of co-generation in Pristina will improve energy adequacy by 35%. In June 2011, Kosovo adopted a law on Energy Efficiency, which calls for increasing energy efficiency by 8% by 2018. Kosovo further adopted a Heating Strategy, which aims to reduce the use of electricity for space heating. Technical preparation for a cogeneration plant at the Kosovo B TPP, which would use waste heat to produce district heating, are in place but an actual investment is doubtful.[10]

Kosovo's enterprises have consistently listed power as the most important constraint in Kosovo in surveys conducted over the last ten years. Even with imports, the frequency and cost of power outages is much higher than the comparator countries (with the exception of Albania.) Figure 4.1.3.3 shows the proportion of enterprises in Kosovo who identify electricity as a major constraint in the World Bank's latest Enterprise Survey (2009) compared to other countries in the region and the world average.

Figure 4.1.3.3. Percent of firms identifying electricity as a major constraint



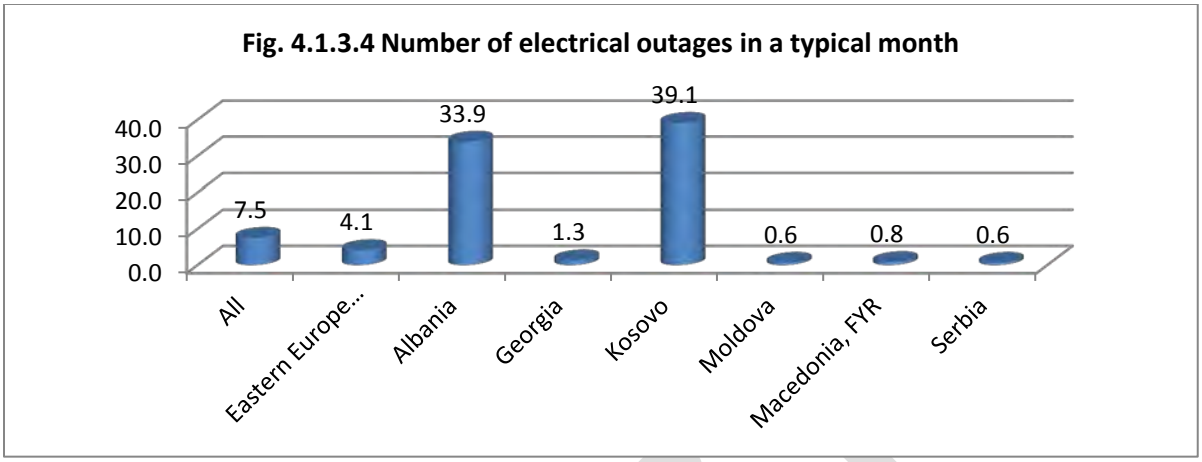
Source: World Bank Enterprise Survey 2009

Energy supply is the top constraint to firms in Kosovo, far higher than in countries with similar GDP and the average of Eastern Europe and Central Asia and the world. Energy has consistently been the top constraint listed in previous enterprise surveys conducted in Kosovo, such as the World Bank's and European Bank for Reconstruction and Development BEEPS (2006, 2008).

The frequency and cost of outages is also higher than comparable countries, the region, and the world. Figure 4.1.3.4 shows that Kosovo firms experience a much higher number of electrical

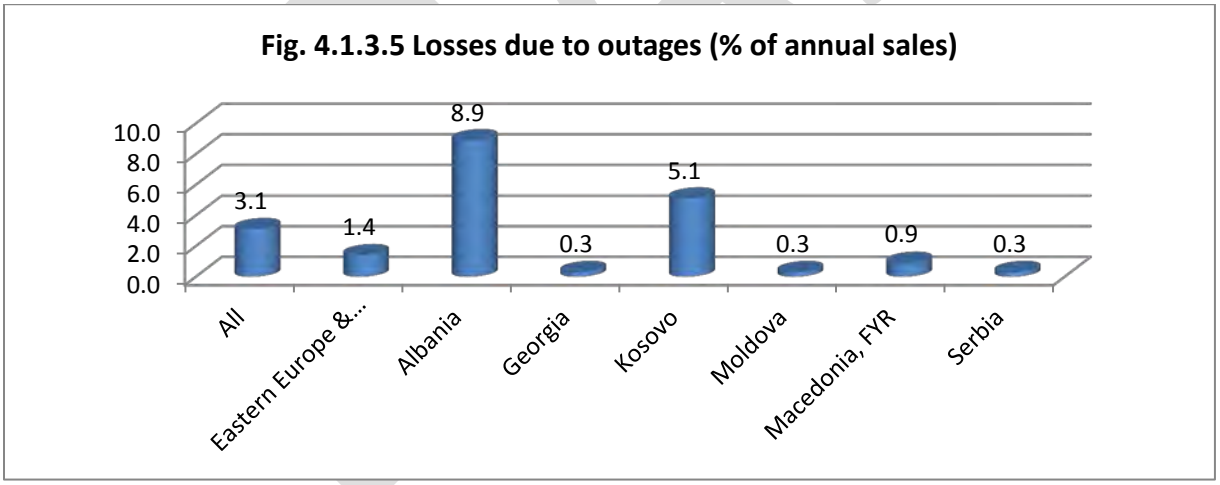
[10] European Commission. 2011

outages in a month, close to forty, than all of the comparator countries (except Albania).



Source: World Bank Enterprise Survey 2009

Outages cost firms an average of 5.1% of annual sales, even for firms that did not experience outages, as shown in Figure 4.1.3.5. This again exceeds significantly the comparable data from countries in the region and the world, with the exception of Albania, which faces severe energy constraints of its own.



Source: World Bank Enterprise Survey 2009

One of the chief difficulties in analyzing economic performance in Kosovo is the lack of data on sectoral contribution to GDP, as GDP is calculated only based on the expenditure approach, not the production approach. When calculating the cost of power outages to the economy this is an issue because the Enterprise Survey excludes firms the agriculture sector. While no definitive

data is available, it is estimated that agriculture contributes about 12%[11] to GDP. The public sector contributed a combined 15.8% to GDP. Multiplying the share of other firms – 72.2% by the average cost to firms implies that the cost to the economy of persistent outages is 3.7% at the least and likely significantly more, as this does not include many other costs, such as the cost of purchasing and operating generators, the cost to the agriculture sector firms, and the cost of additional wear and tear on equipment due to voltage spikes and other features of an irregular supply off the grid.

In addition, there is some evidence from the Statistical Agency of Kosovo (SAK) that industry is declining as a share of GDP, falling from 13.1% of GDP in 2005 to 11.2% of GDP in 2007[12]. Further, an estimated 150 MW in stand-by generator capacity has been installed in Kosovo – evidence of widespread use of coping mechanisms by enterprises[13]. Almost 90% of firms in Kosovo have a generator and obtain 15% of their electricity from it. All these factors point to energy as a major constraint to growth and investment – probably the biggest.

Conclusion:

Power is a binding constraint to private investment growth in Kosovo. Given the high cost to business in terms of losses and direct electricity costs, as well as the evidence that energy-dependent industries are in decline, we believe that the lack of reliable energy supply is the most binding constraint on growth. Despite progress in reducing technical and commercial losses in distribution, Kosovo has failed to tackle the central issue - its production capacity is inadequate to meet current needs, grossly inadequate for future needs even if the economy continues to grow at 5% per year, much less the recommended 8% per year necessary for a substantial reduction in unemployment. Insufficient energy will continue to pose a heavy cost to the economy until large new generation capacity is installed. Very little progress has been made in the past twelve years to bring new capacity on board. If Kosovo wants to achieve industrialization and transformational economic growth, energy supply must be tackled with the utmost urgency. Without reliable power, Kosovo risks being on a low-growth trajectory even with other needed reforms in place.

4.1.4. Water Infrastructure

The European Commission points out in its 2011 Progress Report for Kosovo that water quality remains a challenging issue and the investment in the water sector in general has been insufficient[14].

[11] Statistical Agency of Kosovo estimate, 2008
[12] Statistical Agency of Kosovo estimate, 2008. 2007 is the last year for which SAK produced an estimate of sectoral contribution to GDP.
[13] World Bank 2010
[14] EC Progress Report on Kosovo 2011

Kosovo has abundant natural water resources. The supply of water for drinking is split between surface water, which accounts for about 55% of the water supplied, and underground water sources with 45%. Kosovo has four main river basins; Drini i Bardhë, Iber, Morava e Binqës and Lepenc. The head waters of all river basins are within Kosovo, with the exception of Iber basin which is in Montenegro.

Five large impounding reservoirs: Batllava, Badovc, Radoniqi, Gazivoda, and Perilepnica provide half of the half the water supplied in Kosovo and another 31% comes from Karst natural springs, the latter providing a major source of high quality raw water.[15]

The independent economic regulator for water and solid waste services in Kosovo is the Water and Waste Regulatory Office ("WWRO"). Its mandate is to ensure non-discrimination and provision of qualitative, efficient, and reliable services at a fair and reasonable price for customers with respect for environment and public health.

Water services in Kosovo are provided by seven licensed Regional Water Companies (RWC). The drinking water supply system remains poorly developed and a significant part of the population is still not connected. The RWCs supply water to 60% of the population. Out of the 40% that do not receive water from any of the seven RWC, an estimated 7% have access to piped running water system and the remaining 33% rely on wells or springs. The figures suggest that connection rates are generally low except in Pristina, and physical losses are still substantial.

One of the hydrological features of Kosovo is the unequal water distribution among different areas of the country. While water is plentiful in the western and southern part of the country, the central/northern part which covers about half of Kosovo's territory is short of water featuring only a few minor rivers and brooks. Most rivers and wells are polluted, or at serious risk.[16]

Water supply in Kosovo is generally subject to supply/demand balance constraints that often limit supply to less than 24 hours/day service. The Water and Waste Regulatory Office reports on the service reliability offered by the seven RWCs in its Annual Performance Report. The majority of the RWC provide service less than 18 hours per day.[17]

Since Kosovo's water resources originate with the borders of the country, this means that the quality of raw water sources remain within the mandate of Kosovo's institutions. Due to the lack of the proper and functional sewage treatment systems in Kosovo, once river water descends from upland/mountainous areas and passes into lower urban and semi-urban areas, the quality of raw water deteriorates considerably.

Water quality test results for 2009 and 2010 carried out by the Waste and Water Regulator suggests that the average pass rates for all RWC is above 90%. However, this rate falls well below internationally accepted norms where pass rates are in excess of 99%. A pass rate of 90% (especially for bacteriological tests) in Kosovo suggests that an unacceptable level of risk of

[15] Feasibility Study on Drinking Water Quality in Kosovo, Volume 1, Final Feasibility Report, 2009

[16] World Bank Water Security for Central Kosovo – Water Resources, Water Demands, Water Balance Assessment, and programme of measures, 2011

[17] Water and Waste Regulatory Office- Annual Performance Report for the Water and Waste Companies in Kosovo 2010

customers suffering illness from their water supply system is existent. Yet, there is no water quality monitoring program.

Kosovo currently has only two waste water treatment plants, with another one being in the process of completion. The Ministry of Environment and Spatial Planning estimates that only about 50% of Kosovo population has access to public sewerage systems. This represents a problem since wastewater discharges represent the main source of pollution of natural waters.[18] Vulnerable zones and protected areas have not yet been designated either.

Conclusion:

Inadequate water resources have the potential to become one of the more important constraints to growth if Kosovo pursues a development strategy based on agricultural exports and/or industrial development. At present, other factors, such as energy supply, constrain production. As they are removed, water has the potential to rise to the top as an impediment to growth, without significant investments in the protection, preservation and development of water resources is very important and remains a great challenge for the Kosovo's authorities.

4.2 Geography[19]

Kosovo is a landlocked country and the evidence shows that landlocked countries trade less, lag in terms of development, and account smaller economic growth rates relative to maritime countries (see Arvis et al., 2010). In addition, landlocked developing countries are less technologically advanced and have lower levels of accumulated human capital (see Chowdhury and Erdenebileg, 2006, for a survey).

Being a landlocked country adds to the long list of political, economic, and social constraints Kosovo is facing. This section draws largely on the methodology developed by Faye et al. (2004) on the challenges facing landlocked developing countries in the world, to outline, in turn, challenges facing Kosovo in accessing world markets. This involves considering trade costs and per-capita exports levels to demonstrate the differences in the performance of Kosovo and the other landlocked countries in the South Eastern Europe (SEE)[20], relative to their maritime neighbors.

The main effect of the landlockedness is in increasing trade costs. Table 4.2.1 shows marked differences in the trade costs between landlocked WB countries and their maritime neighbors. These are reflected in the World Bank's *Doing Business* indicator for Trading across Borders.[21,22] On average cost to exporting a 20-foot container for maritime countries is almost 40 percent lower than for landlocked countries, with the highest cost by far in Kosovo. Importing is

[18] The State of Water in Kosovo Report 2010, Kosovo Environmental Protection Agency, Ministry of Environment and Spatial Planning 2010

[19] This section draws on a report prepared by USAID's Business Enabling Environment Project

[20] We include also Moldova in the analysis, and treat it as the part of the WB region throughout.

21 To this end, one can use the World Bank's Logistics Performance Index, but Kosovo is not included in the analysis.

22 See also World Bank (2008) *Doing Business in Landlocked Economies 2009* for more details.

even costlier for landlocked countries; the cost difference is 43 percent, or roughly $750. In terms of the time required to export or import, on average landlocked courtiers require an additional day to export whereas three additional days to import goods relative to maritime neighbors. Even the procedural requirements are slightly more complicated in landlocked countries, which also indicate a lag in the reform process in landlocked countries. The latter is reflected in the documents required to export.

Table 4.2.1 Trading Across Borders Doing Business Indicators in 2012

Indicator	ALB	BiH	CRO	KS	MAC	MOL	MON	SER	Average maritime	Average landlocked
Trading Across Borders Rank	75	71	98	130	66	134	34	74	69.5	101
Documents to Export	7	5	7	8	6	6	6	6	6.3	6.5
Time to export (days)	19	16	20	17	12	32	14	12	17.3	18.3
Cost to export (US$ per container)	725	1,240	1,281	2,230	1,376	1,545	775	1,398	1,005	1,637
Documents to import	9	7	8	8	6	7	6	6	7.5	6.8
Time to import (days)	18	16	16	16	11	35	14	14	16	19
Cost to import (US$ per container)	710	1,200	1,141	2,280	1,380	1,740	890	1,559	985	1,740

Source: World Bank (2011). http://www.doingbusiness.org

Costs to exporting and importing in Kosovo are the highest in the region (over 40 percent above the regional average for both imports and exports), whereas the number of days required for import and export transactions are the highest in Moldova (on average around 55 percent more than the regional average for export transactions; the difference for import transactions is around 50 percent). On the other hand, the data show that Macedonia and Serbia are overcoming the drawback of landlockedness through the ease of regulatory burden and mitigation of other impediments to international transactions.

Exports

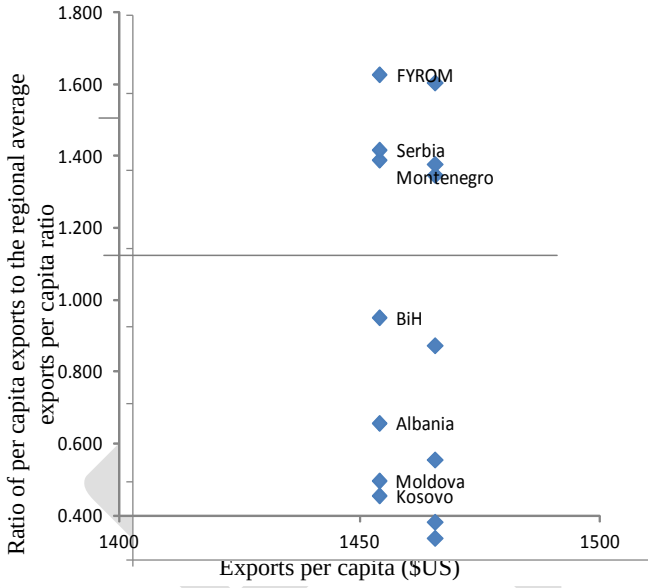
Kosovo's exports are the lowest in the region on a per capita basis, although it is unclear if this is the result of landlockedness. (see Table 4.2.2; the same trends are indicative in Figure 4.2.1, which plots the ratio of country's export per-capita to the regional average). Taken as a group, maritime countries export more on average than their landlocked neighbors. However, taken individually we see countries like Macedonia and Serbia exporting more on per-capita basis than some of their maritime neighbors, particularly Albania and Bosnia and Herzegovina.

Table 3. Exports per capita (2010, current $)

	Exports per capita
Slovenia	14,978
Croatia	5,278
Bulgaria	3,661
Montenegro	2,313
FYROM	2,111
Serbia	1,839
Romania	1,771
Bosnia and Herzegovina	1,584
Albania	1,095
Moldova	646
Kosovo	592
Average total	3,261
Average over maritime	4,383
Average over landlocked	1,297
Average WB	1,454
Average WB maritime	1,664
Average WB landlocked	1,297

Source: World Development Indicators (2012). Accessed at: http://data.worldbank.org/data-catalog/world-development-indicators

Figure 2. Ratio of country's exports per capita to the regional average



Source: World Development Indicators (2012). Accessed at: http://data.worldbank.org/data-catalog/world-development-indicators

Kosovo has been unable to increase its export capacities due to a many persisting problems, such as: poor institutional quality; low inflow of foreign direct investments; inefficient privatization; poor quality infrastructure; high cost of finance; lack of access regional initiatives; low level of productivity, and others. As a result, for over a decade Kosovo has experienced a very large negative trade balance. Exports of goods and services while growing, have reached at most $1 billion (2010). Imports have been much higher, around $3.4 billion in 2010, or 62 percent of GDP[23].

Dimensions of landlockedness

Following Faye et al. (2004) we examines the avenues through which landlockedness affects economic performance: 1. distance to seaports; 2. dependence on transit infrastructure; 3. dependence on political relations with neighbors; and, 4. dependence on administrative processes in transit.

1. Distance to seaports

[23] World Bank. World Development Indicators, 2012

The average distance for the landlocked countries in our analysis is 291 km. The greatest identified distance is from Belgrade (the capital of Serbia) to the seaport of Bar in Montenegro). Kosovo transits goods through four regional ports (see Map 2 below). Although, Kosovo's businesses are becoming increasingly dependent on the Albanian seaports, especially since the new and modern road infrastructure has been build, Thessaloniki still remains the major entry and exit point. There are a number of reasons why Thessaloniki may remain an important entry point for goods destined for Kosovo. First, it has a greater cargo processing capacity compared to the other seaports in the region. The second point is related to the greater administrative efficiency of the seaport. Finally, the high quality of the road infrastructure gives an edge to Thessaloniki relative to other seaports in the region (roughly 40 percent of the distance is modern motorways). As a result of the latter factor, goods reach Thessaloniki seaport faster relative to

Map 2. Distance from Prishtina to the regional seaports

Route:	Prishtina - Durrës, AL	Route:	Prishtina - Shëngjin, AL
Time:	5h13	Time:	4h10
Distance:	310km	Distance:	251km
			
Route:	Prishtina - Bar, MN	Route:	Prishtina - Thessaloniki, GR
Time:	4h56	Time:	4h21
Distance:	321km	Distance:	316km
			

Source: www.viamichelin.com (accessed on: July 6, 2012)

the distance than any other regional port.

The other two ports, Bar in Montenegro and Shëngjin in Albania are relatively unimportant as transit seaports. In the case of the latter the port capacity is very low (the seaport has a piers and cargo processing capacity up to 3,000 tons). However, if the required investments are in place, Shëngjin may become the main seaport for Kosovo exports and imports following the agreement of October 2009 between the respective government of Kosovo and Albania on granting the seaport of Shëngjin to the Kosovo Customs authorities.[24]

[24] For the potential of the Shëngjin seaport see *Kosovo's Multimodal Transport Strategy (2012-2021) and Action Plan (2012-2016)* (2012), commissioned by the European Community.

2. *Infrastructure in transit countries*

Weak infrastructure in the transit countries imposes direct costs on trade, thus limiting the ability of transit countries to compete in the world stage. In addition, the weak transit infrastructure limits the return on investments on landlocked countries' domestic infrastructure, since it constraints market opportunities. In turn, lack of market opportunities hampers the specialization in production and the efficient utilization of labor and other resources.

In the last decade, the Western Balkans (WB) countries have invested heavily in the transport infrastructure. These investments were channeled mainly through the South East Europe Transport Observatory (SEETO), a regional transport organization established by the Memorandum of Understanding for the development of the Core Regional Transport Network.[25]

In the 2012 Network Development Plan, SEETO reports that the total value of implemented infrastructure projects between 2005 and 2010 amounted €5.698 billion, out of which 81 percent went to the road infrastructure, 14 percent on the rail networks, and 5 percent went on the airports and other transport modes.

Kosovo's greatest challenge is not the quality of the infrastructure of transit countries, but the inability to access the least cost route towards the markets of the European Union, through Serbia. Serbia has blocked exports and transit from Kosovo on several occasions, most recently from September 2011 to July 2012.

3. *Political relations and stability in the transit countries*

From the perspective of Kosovo, there is little resolution in political relations and stability, with its biggest neighbor, Serbia. Since 2000 numerous international undertakings have been initiated aiming at reconciling ethnic divisions in the region. The establishment of the Stability Pact for the SEE region, an EU initiative, was an important step aiming at bridging these divisions. Forty signatory countries and international organizations undertook to support the strengthening of the SEE countries "in their efforts to foster peace, democracy, respect for human rights and economic prosperity in order to achieve stability in the whole region", as it is stated in the official declaration.

Another attempt to contain regional tensions is the introduction by EU of the Europe Agreements for countries of the SEE region, however in the form of Stabilization and Association Process (SAP). One of the major building blocks of the SAP is, *inter alia*, the promotion of regional cooperation. The basic premise of the regional cooperation within SAP was the conditioning of the process of joining the EU with integration and free trade between countries in the SEE region. EU had made it clear that the "rapprochement with the EU will go hand in hand with the process of developing regional cooperation". As a result, under the sponsorship of the EU, the WB countries have signed a regional agreement, the Central European Free Trade Agreement (CEFTA).

[25] The Memorandum of Understanding has been signed in June 2004. The Memorandum has been signed by the Governments of Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro and Serbia, UNMIK on behalf of Kosovo, and the European Commission.

Despite these efforts, more than a decade on, the relations between former adversaries are still strained. The key to regional stability remains the resolution of Kosovo issue, which declared independence in February 2008, but has struggled to capitalize on that in the face of Serbia's obstructionism, both economic and political. To further complicate the trade environment, the northern part of Kosovo, populated mainly by the Serb minority, does not accept the jurisdiction of the central government, generating continuous tensions.

4. Administrative burden in transit countries

Landlocked countries are subject of various administrative burdens associated with border crossings and transiting through the foreign territory. In some cases there are direct transit and customs charges, often adding to the shipping costs. In addition, international transit requires burdensome paperwork and costly bureaucratic procedures on shippers. Finally, border crossings can cause long delays, frequently hindering the ability of businesses to meet contractual obligations without large inventory stocks (see Faye et al., 2004).

While progress has been made in the region, through initiatives such as the World Bank Trade and Transport Facilitation Program for Southeast Europe, Kosovo has not benefited fully from this integration. This is especially true on the border with Serbia, but occasional ad-hoc administrative requirements and extra costs also occur at the borders with Macedonia and Albania.

Two current initiatives can improve Kosovo's access to markets. The first one concerns SEETO's development of a coordinated transport policy for Western Balkans. Some of the main building blocks of this policy are the so-called 'soft' transport facilitating measures. These soft measures are primarily directed at alleviation of regulatory and institutional deficiencies of the national transport systems. Second is the introduction of the so-called Integrated Border Management policy for WB countries. This mechanism is aimed at, *inter alia*, facilitating the mobility of people and unhampered movement of goods and services across the borders, including between Kosovo and Serbia.

Conclusion.

In conclusion, while landlockedness is no doubt a contributing factor to Kosovo's slow export growth, there are internal factors that likely play a more important role. The evidence from the region is inconclusive regarding the costs of landlockedness, with some landlocked countries such as Macedonia and Serbia performing better in terms of trade costs and outcomes than maritime countries. We conclude that Kosovo's geographic position is not a binding constraint on growth. However, a deterioration in Kosovo's political relationship with its neighbor to the North, Serbia, through which an important trade route passes, can hamper efforts to increase trade with the European Union and potentially impact growth.

4.3. Human Capital

Kosovo has the youngest population in Europe, with 70 percent of the population under the age of 35 and 50 percent below the age of 25.[26] The World Bank estimates that roughly 200,000 young people will reach working age by 2015, while the number of people reaching retirement age will be approximately 60,000[27]. This presents a particular challenge for Kosovo which has been struggling with unemployment rates in excess of 45% since its de facto separation from Serbia. Long spells of inactivity during youth can have long-term costs, and high youth unemployment tends to be associated with increasing crime and social tensions.

Kosovo's Education Statistics for 2010 – 2011 reveal that the number of children, pupils and students enrolled in public and private education totaled 472,226, roughly 26 percent of the total population. Of these 472,226, 52.1 percent were male and 47.9 percent female.[28] Kosovo's adult literacy rate for 2007, defined as those being 15 and over who can read and write, is at 91.9 percent with the literacy rate for men at 96.6 percent and women at 87.5 percent. [29] UNICEF data shows that Kosovo has an almost universal primary school enrolment for the Kosovo Albanian and Kosovo Serb communities (97.5 percent and 99 percent respectively). Enrolment of minority communities and those with special needs remain comparatively low. Kosovo possessed an extensive primary school network that provided access to students from even the most remote communities. However, there is a drop in participation in lower secondary and at the higher secondary school level.[30]

Education is a top priority of the Government of Kosovo, with development of human capital one of the five strategic objectives in Kosovo's Economic Development Vision Action Plan 2012-2014. Nevertheless, Kosovo faces major challenges in human capital development. In the latest UNDP Human Development Index (HDI), Kosovo ranks 87th in the world, behind all other countries in the region[31].

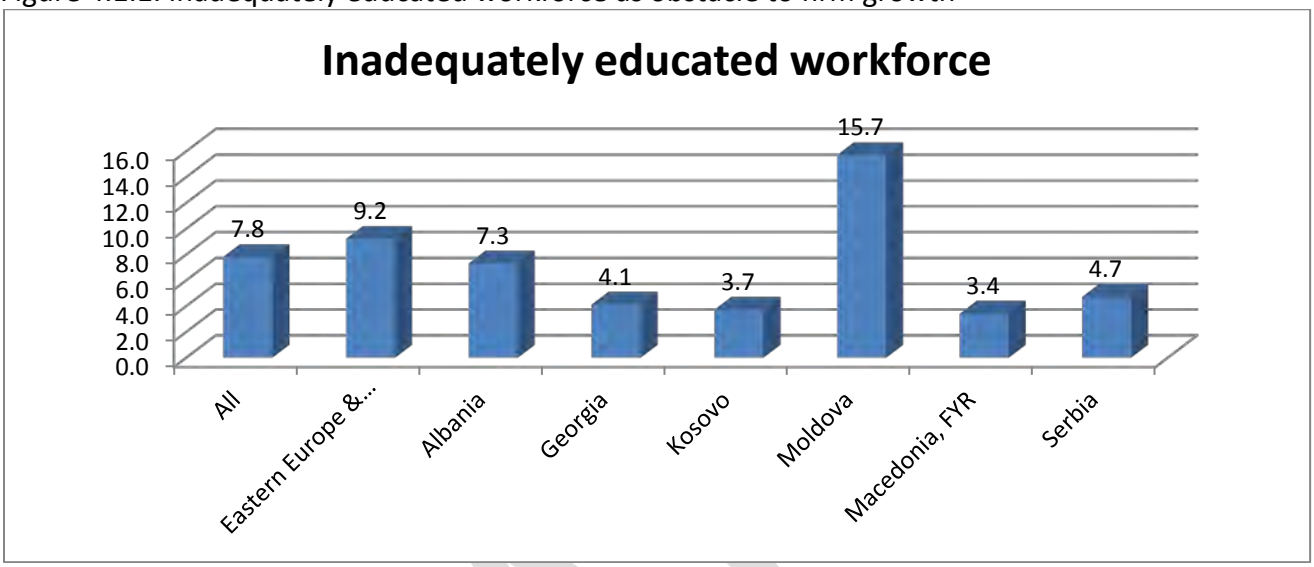
To look at the effect of human capital formation on investment and growth, we considered several sources. We first looked at the results of several firm-level surveys, namely the World Bank Enterprise Survey 2009 and the World Bank Foreign Investors Perception Survey 2010, to see what is the perception of employers about the costs imposed on their firms. We then considered available statistical evidence to gauge the extent of a skills premium in Kosovo. A high skills premium in wages would indicate that there is high unmet demand for skilled workers, and so a constraint on growth.

The evidence from firm level surveys paints a mixed picture. The World Bank Enterprise Survey 2009 indicates that firms in Kosovo do not see skills and education as an obstacle to growth, with only 3.7% percent of firms finding inadequately educated workforce as the biggest obstacle,

[26] IPAK
[27] World Bank: KOSOVO Unlocking Growth Potential: Strategies, Policies, Actions; A Country Economic Memorandum 2010
[28] Statistical Agency of Kosovo, The Education Statistics for 2010 – 2011
[29] CIA Fact-book, Kosovo
[30] UNICEF in Kosovo, http://www.unicef.org/kosovo/children_3474.html
[31] UNDP Kosovo Human Development Report 2012 – Private Sector and Employment

roughly in line with the comparator countries, except Moldova, but substantially lower than the rest of Eastern Europe. The figure suggests that very few Kosovo firms see skills and education as a constraint to their operations relative to other comparative countries.

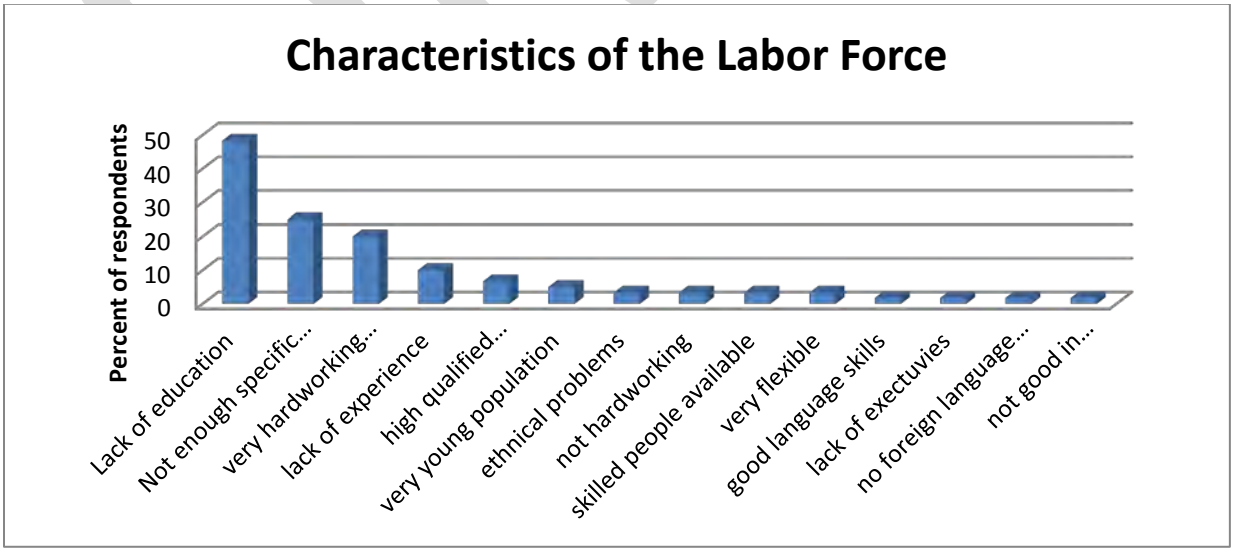
Figure 4.1.1. Inadequately educated workforce as obstacle to firm growth



Source: WB Enterprise Survey 2009

On the other hand, foreign investors see the lack of adequate skills as a major characteristic of the labor force in Kosovo. As shown in Fig. 4.3.2. almost 70 percent of respondents to the Foreign Investors Perception Survey conducted in 2010 identified the lack of education or the lack of skills as the most important feature of Kosovo workers.

Figure 4.3.2. Foreign Investors Perception of Kosovo Labor Force

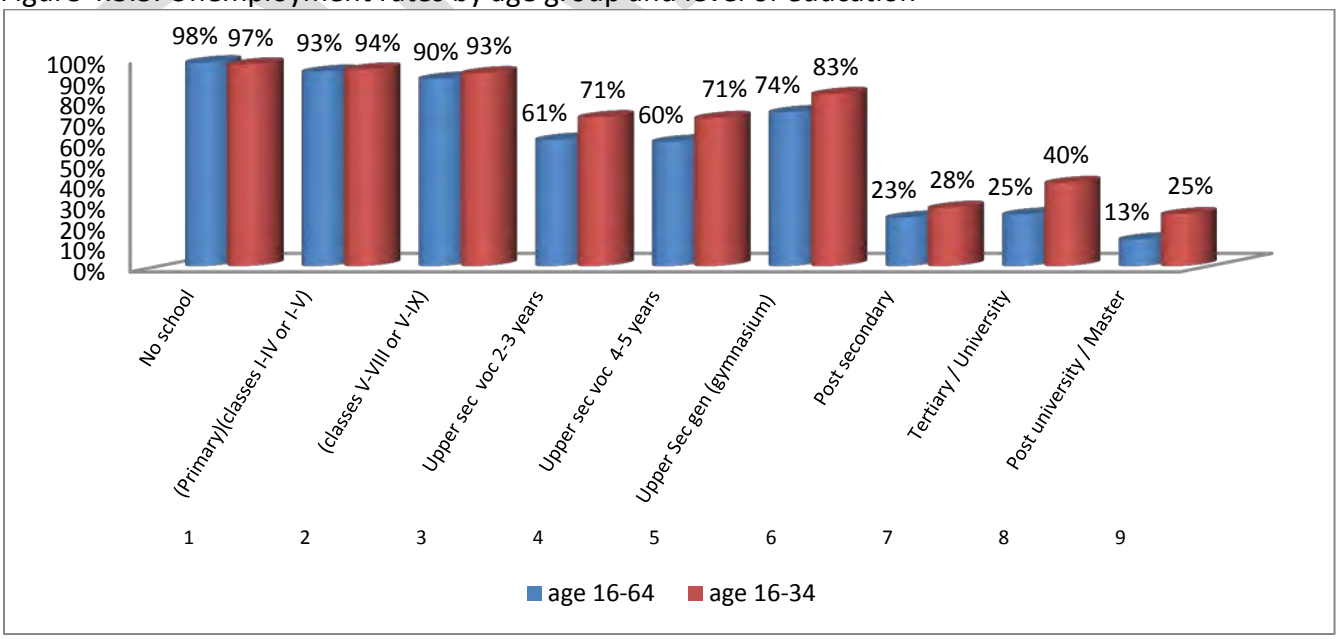


Source: WB Foreign Investors Perception Survey 2010

If the lack of human capital were a binding constraint for investment, we would expect to see a lot of competition among firms for talent. This would in turn be reflected in markedly lower unemployment rates for skilled workers, as well as in the "so called" skills premium – a rapid rise in wages with the attainment of more skills and education. On the surface, with an unemployment rate of 45% and 200,000 new labor market entrants per year, Kosovo appears to have a surplus of workers. However, it is possible that these workers are not the right kind of workers. It is possible to have both excess of human capital and a shortage, which would then present a binding constraint to growth.

The Kosovo Labor Force Survey 2009 shows the relationship between unemployment by age groups and level of education. We focused specifically on two groups – 16 to 64 years old representing the population of working age, and 16-34 years old, representing young workers. We are interested in outcomes for young workers, because they are more likely to have the right kind of education and training for what the economy demands right now. The data show that a drop in unemployment rates is highly correlated with education levels in Kosovo (Fig. 4.3.3), suggesting that there is a high demand for highly skilled workers. The unemployment rate among people with post university/masters degree is 13 percent for age group 16-65 and 25 percent for age group 16-34 versus rates exceeding 60 percent for workers with secondary education and below. The data show a higher unemployment rate among younger, more recently educated holders of higher degrees across all levels of education attainment. One reasons for this might be the lack of experience of the age group 16-34 compared to the other group. It may also be the result of a poor match between the kind of education provided by Kosovo's institutions of learning and the skills demanded in the economy. It is especially concerning that university graduates under age 34 report a still very high rate of unemployment of 40 percent. The experience of growth diagnostic studies shows that in countries where the education system reform leads to more responsiveness to business demand, younger workers can have lower unemployment rates than older workers.

Figure 4.3.3. Unemployment rates by age group and level of education



Source: Own calculations from Kosovo Labor Force Survey 2009

We estimated returns to schooling via a linear regression model using data from the Kosovo Household Survey 2010. The results are in Table 4.3.1.We estimated the influence on income levels of several variables: age, gender, marital status and levels of education: primary, secondary, professional secondary, vocational, university. We measured their effect as compared to a person with no education. We show an adjusted R-squared of 0.2081, indicating that about 21% percent of the variation in the dependent variable, the income level, is explained by the independent variables. At 95% confidence interval, all the coefficients are statistically significant.

Table 4.3.1. Income linear regression

Variables	Log of monthly income	Standard error
Gender omitted female		
Male	.149	.022
Age	.024	.006
Age squared	-.0002	.000
Marital status omitted married		
Single	-.062	.027
Education level omitted no education		
Primary education	.372	.082
Secondary education	.521	.081
Secondary professional	.563	.082
Vocational education	.699	.087
University or higher	.935	.083
Adjusted R squared	**0.2081**	

Source: Own calculation from Kosovo Household Survey 2010

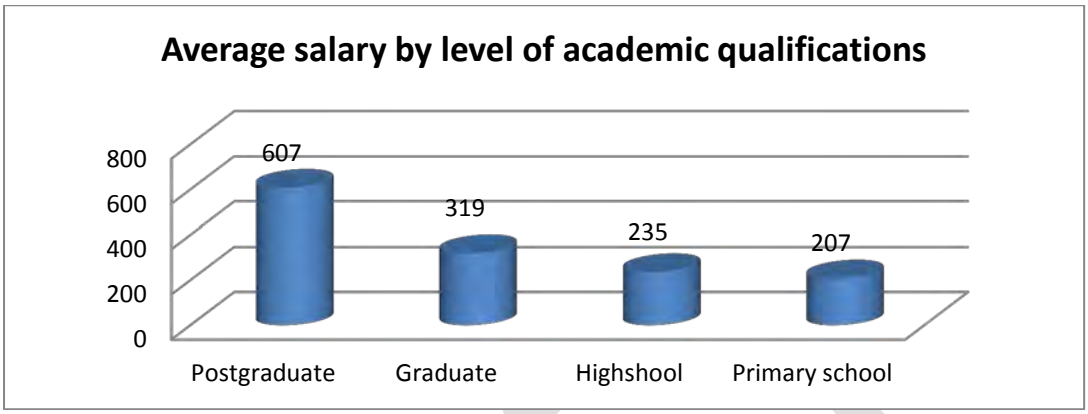
Our model indicates that on average, keeping other variables constant, a male can expect to earn 15% more than a woman in Kosovo, a single person can expect to earn about 6% less than those who are married. A person with primary education can earn 37% more than a person with no schooling, a person with high school education earns 69% more than a person with no school, and a person with university or higher education earns 94% more than those with no schooling. This is highly suggestive of a strong skills premium.

As was noted earlier both of these datasets – the Labor Force Survey and the Household Budget Survey have substantial issues in terms of representativeness of the data. So these results should not be taken as definitive. However, it is worth noting that both of them point in the same direction – there are high returns to education, and consequently a likelihood that lack of adequate human capital is holding investment back.

At least one firm-level survey supports that - the Riinvest Enterprise Barriers Survey 2011 reveals an even higher skills premium. Firms reported that the average salary of their

postgraduate degree holder workers is almost double that of university educated workers. On average, a worker with a postgraduate degree earns €607 per month compared to a worker with a university degree who earns about €319.

Figure 4.3.4



Source: Riinvest Enterprise Barriers Survey 2011

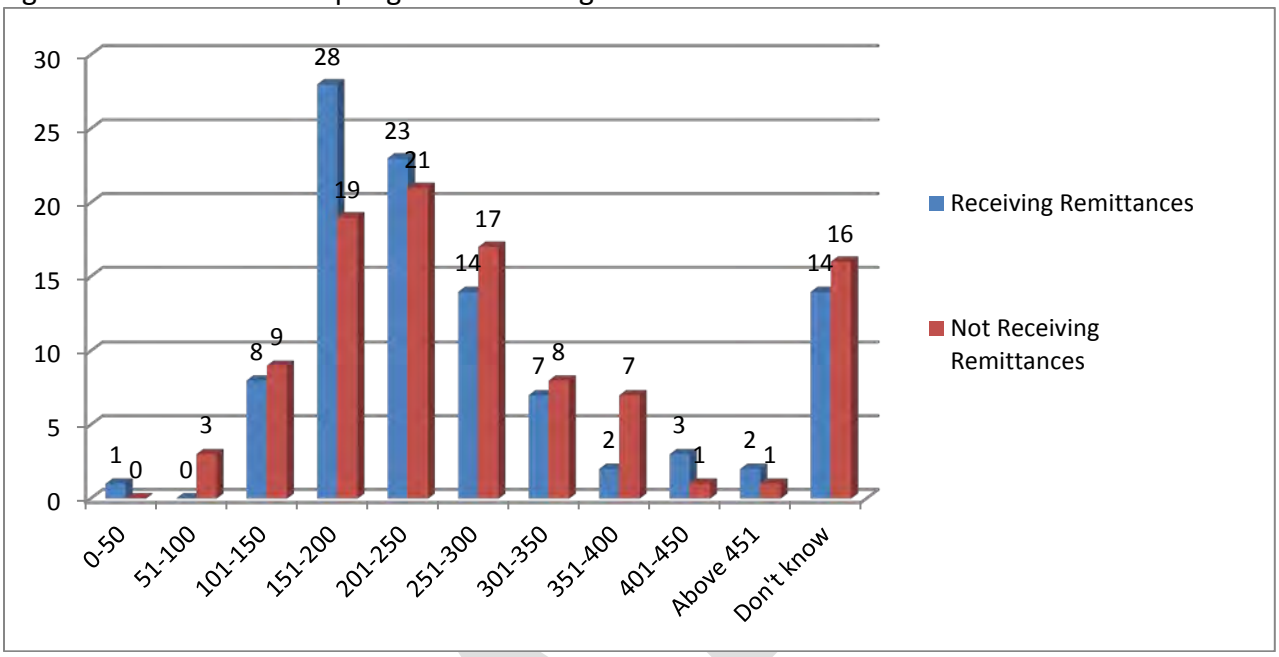
We believe there is enough evidence to suggest that there is an increasing demand for skilled workers which is not being fully met by supply, either because of lack of supply or inadequate supply of skilled labor. In conclusion, Kosovo is suffering from a both low human capital formation and a shortage of skills, hence human capital is a binding constraint to growth.

Given the oversupply of labor at the low-skilled end of the scale, it is important to explore why the private sector does not develop in industries that can exploit this seeming advantage. Numerous studies (UNDP, IMF, World Bank) suggest that Kosovo is not competitive in low-skill industries, such as textiles, because of the high reservation wage and high low-skill wages in general, compared to competitors in the region. This can lead to the paradoxical co-existence of both a high unemployment level and a labor shortage. The reservation wage is defined as the level of pay that an unemployed worker will accept to begin employment. 25 percent of households in Kosovo receive remittances based on the 2012 Kosovo Remittance Study. The average amount of remittances per household received in a month in 2011 almost matched the average monthly salary in Kosovo. The Migration Survey 2009 suggests that the national average of reported household remittances is €320 per month and the amount does not vary greatly between urban and rural areas.[32]

The 2012 Kosovo Remittance Study includes data on the minimum wage accepted to work, by presence of remittances. Figure 4.3.5 shows that households receiving remittances usually demand a higher minimum wage compared to households that do not receive remittances.

[32] World Bank: KOSOVO Unlocking Growth Potential: Strategies, Policies, Actions; A Country Economic Memorandum 2010

Figure 4.3.5. Percent accepting minimum wage levels to work



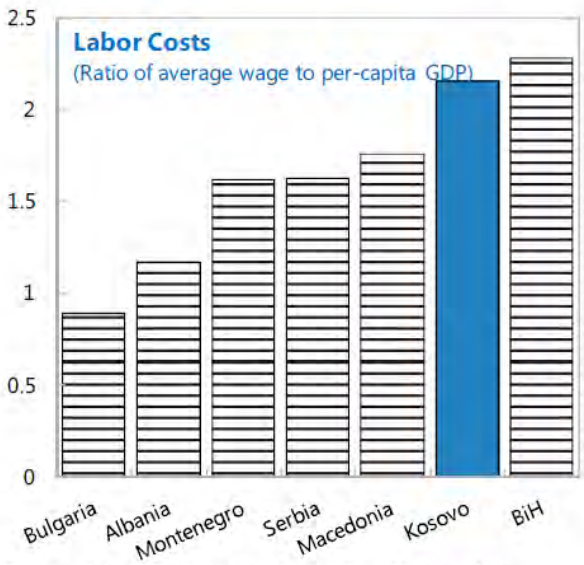
Source: Kosovo Remittance Study 2010

The percentage of households that receive remittances and demand a minimum wage ranging from €151- €200 is considerable higher than the percentage of households that do not receive remittances. The same is true for the minimum wage accepted to work which ranges from €151-€200.

Most of the remittances are used for basic consumption. In 2011, 90.6 percent of remittances were used to food, clothing, housing, durable goods, and education and healthcare services.[33] Only a small share goes to business investments.

Remittances can be a double edged sword. On the one hand, they have a substantial poverty reduction impact. Although the unemployment rate in Kosovo is high compared to our comparator countries, the high presence of remittances suggests that a large proportion of the population earns income close to the subsistence level.

On the other hand, they likely make Kosovo's products less competitive. The IMF (see box to the side) notes that large remittances and FDI



Sources: World Bank; national statistics offices and tax administration.

[33] UNDP. Kosovo Remittance Study 2012

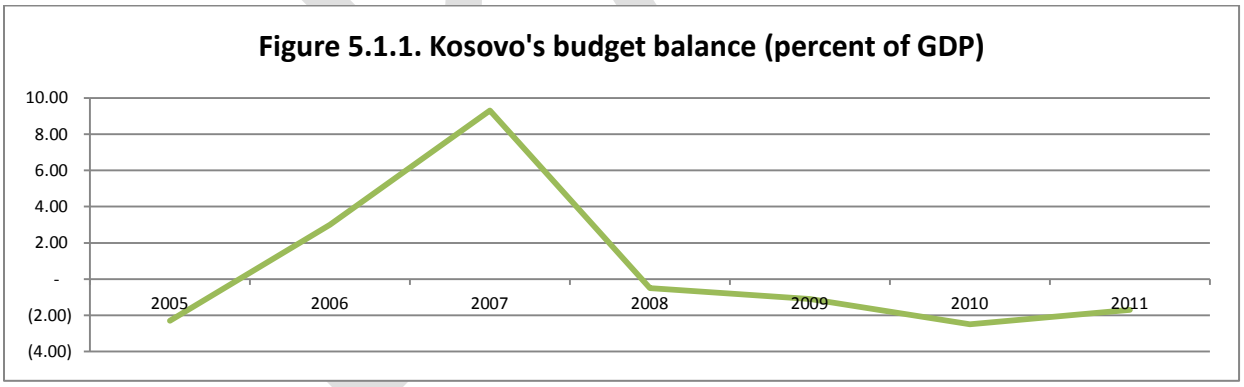
from the Kosovar diaspora not only pay for the consumption but also drive up wages, impeding the development of a tradable sector. Kosovo's ratio of average wage to per-capita GDP is the second highest in the region. The ratio of average wage to per-capital GDP for Kosovo is close to 2.3, much higher than the ratio for Bulgaria, Albania, Montenegro, Serbia, and Macedonia. [34]

In conclusion, it seems clear that Kosovo's private sector is focusing growth in industries where the high reservation wage and high low-skill wage rate poses less of a competitive disadvantage. The private sector demands more highly skilled workers which Kosovo currently lacks. Thus we reach the conclusion that inadequate human capital is a binding constraint to investment and growth, despite unemployment rates exceeding 45%. The Government of Kosovo is rightly committed to investments in education. What seems to be most urgent is that investments are made in education reform, so that the country's institutions of learning supply their graduates with the types of skills employers demand and in a quantity sufficient to meet the needs of a growing economy.

Part 5. Market and policy failures

5.1. Macroeconomic risks

Kosovo has unilaterally adopted the euro as a legal tender. This creates a measure of monetary stability, as evidenced by Kosovo's stable inflation performance. However, it removes monetary policy as a tool to maintain macroeconomic stability. The onus is fully on prudent fiscal policy. By and large, Kosovo has performed well. For the past eight years Kosovo has had a sound fiscal management running a budget surplus in 2006-2007, followed by a small and manageable deficit, from 2008 to 2011, as shown below.

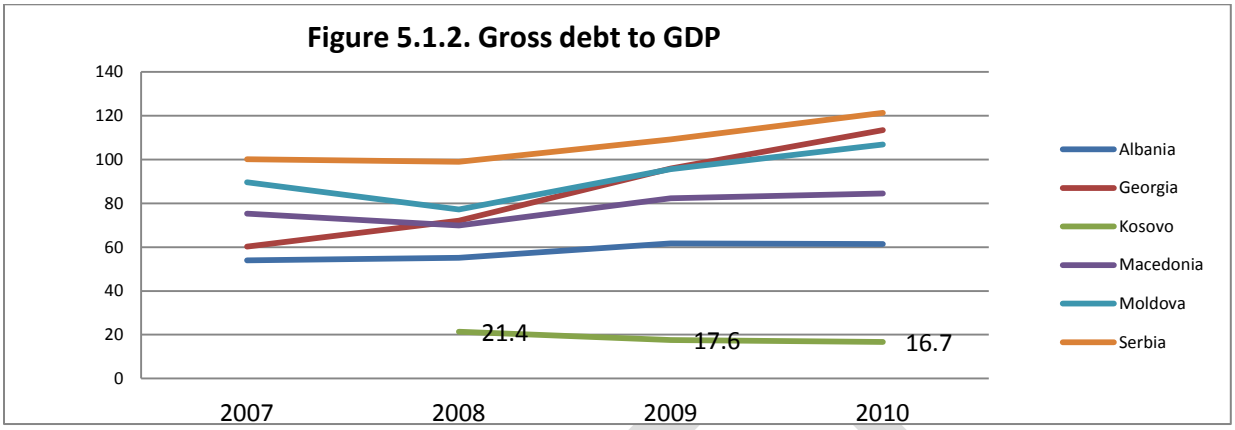


Source: Macroeconomic department, Ministry of Finance

Kosovo has very low levels of external debt, mostly inherited from the dissolution of Yugoslavia. Kosovo's debt to GDP ratio is less than 17 percent and is the lowest among the comparator countries. During 2012 Kosovo government began to issue government debt that by the end of 2012 is estimated to reach about 70 million Euros. Kosovo has a Stand By Agreement with the IMF and has agreed to continue to maintain low level of deficit and borrowing for next

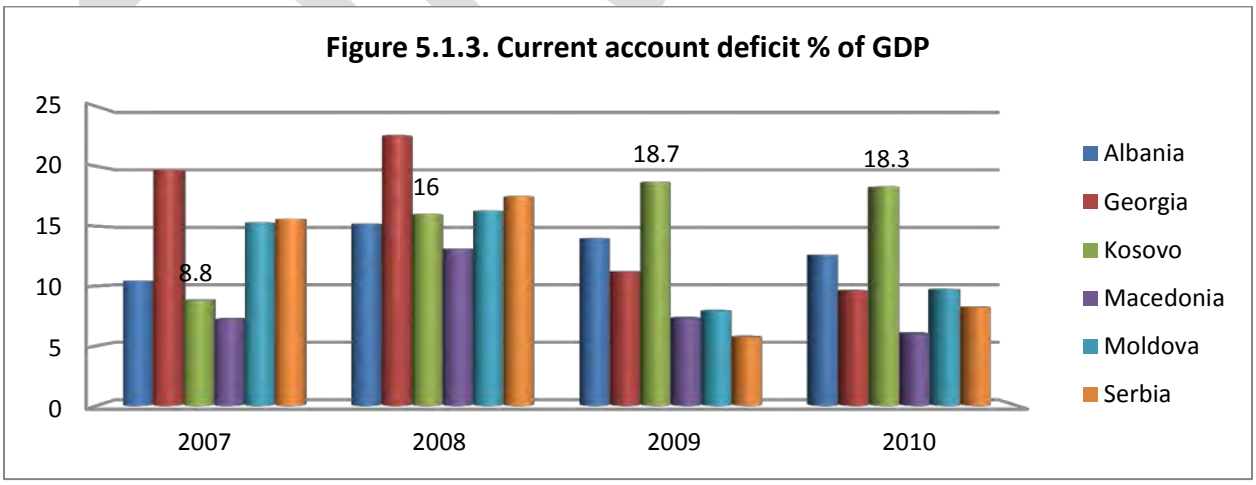
[34] IMF Country Report No. 12/180, July 2012

2 years. Therefore, the levels of debt and budget deficit are not considered to contribute to macroeconomic risk at present.



Source: IMF World Economic Indicators, 2012

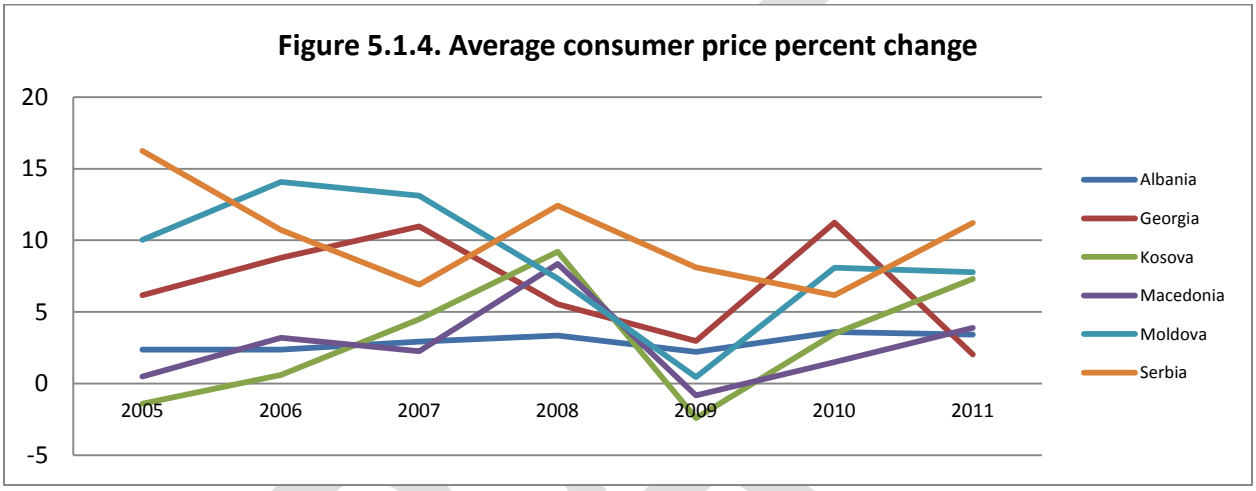
However, Kosovo does face significant medium term macro risks stemming from the extremely high current account deficit and some recent inflation trends. Kosovo's current account deficit has been growing during the last decade reaching a level of above 20% of GDP in 2011[35] (Fig. 5.1.3). It is financed mainly by remittances, transfers, and donor assistance in Kosovo. The financial crisis has had a muted affect on Kosovo's remittances, mainly because the majority of Kosovo's emigrants work in Germany, Austria and Switzerland, countries where employment levels remained high. The Central Bank of Kosovo reports an increase in remittances of 4 percent on an annual basis up to September 2011, to Euro 393.3 million[36]. A sharp decline in either remittances or donor support could threaten macroeconomic stability in the presence of continuing high current account deficits.



Source: IMF WEO Database

[35] Central Bank of Kosovo and Macroeconomic Department, MF
[36] Central Bank of Kosovo. Balance of Payment Report No. 11. July 2012. (p. 14)

Price stability is a major component of macroeconomic stability. Considering the large trade deficit, import prices are a significant factor for price formation in Kosovo. In addition, as Kosovo has no mechanism to maintain price stability (it is dependent on actions by the European Central Bank), it remains vulnerable to price fluctuations which affects the expectations of businesses and increase the uncertainty of doing business in Kosovo. Figure 5.1.4 shows that prices in Kosovo and Moldova are the most volatile compared to other countries. The volatility of prices in Kosovo stems from volatile oil and food prices, which may become even more volatile in the future. Therefore, both the sustainability of the current account deficit and price stability are considered to be medium-term risks to macroeconomic stability.



Source: IMF WEO database, 2012.

Conclusion

Kosovo has demonstrated sound fiscal management and has a very low level of debt compared to other countries, but has a high current account deficit that might be affected by the Eurozone debt crisis. Its dependence on imports also leaves the country exposed to import price shocks. Kosovo faces moderate macroeconomic risks that are not a binding constraint to private investment and economic growth.

5.2. Microeconomic risks - conditions for doing business

Kosovo has some of the poorest conditions for doing business in Europe, as measured by the World Bank's Doing Business Survey, and they have deteriorated in the past couple of years. The regulatory system is often used as a de facto tax system, funding the government rather than support public policy goals related to issues such as health or safety.

Table 5.2.1. shows Kosovo's standings in the 2012 report, along with our comparator countries. In overall Ease of Doing Business, Kosovo ranks 117 out of 183 countries. Within each indicator, Kosovo's relative position has worsened compared to the previous year. Kosovo ranks

low specifically in indicators such as starting a business, dealing with construction permits, getting electricity, protecting investors and trading across borders. It takes 58 days, 10 procedures, and 26.7% of income per capita in costs before you can open a business. In order to get a construction permit in Kosovo, the cost is 775.8% of income per capita and about 301 days, the highest cost and longest time compared to our comparator countries.

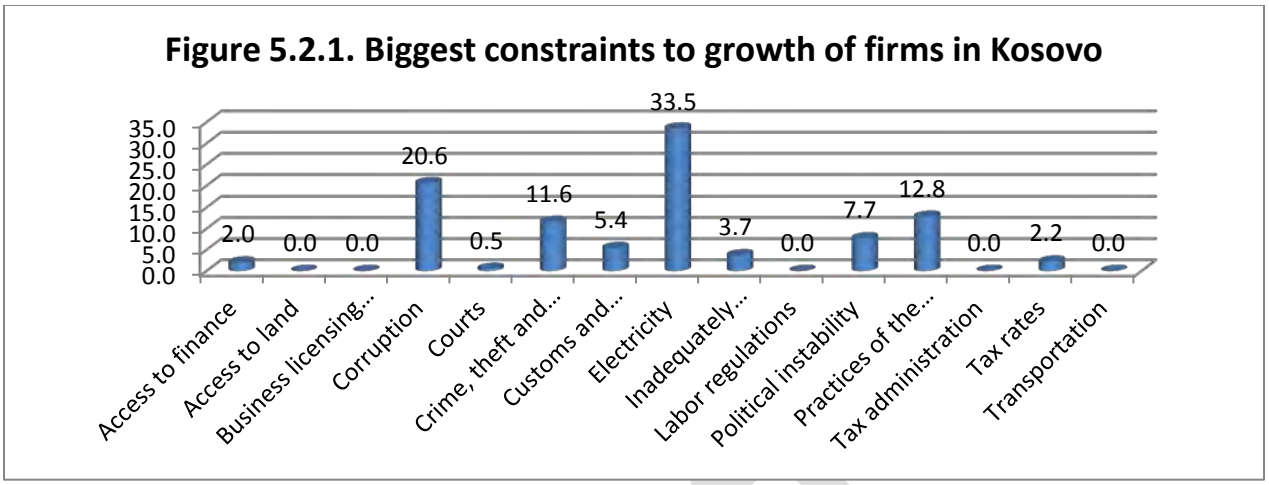
Table 5.2.1. Kosovo's rank across Doing Business Indicators, 2012 (out of 183 countries)

Economy	Ease of Doing Business Rank	Starting a Business	Dealing with Construction Permits	Getting Electricity	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Resolving Insolvency
Albania	82	61	183	154	118	24	16	152	76	85	64
Georgia	16	7	4	89	1	8	17	42	54	41	109
Kosovo	117	168	171	124	73	24	174	46	131	157	31
Macedonia, FYR	22	6	61	121	49	24	17	26	67	60	55
Moldova	81	88	164	160	18	40	111	83	134	26	91
Serbia	92	92	175	79	39	24	79	143	79	104	113

Source: Doing Business Indicators, 2012

The government of Kosovo has recently focused on its performance in terms of business enabling environment. The government has committed to a goal of reaching Top 40 rank in World Bank Doing Business Report by 2014 as part of its Economic Development Vision Action Plan. Improvements in Doing Business rankings with regard to starting a business, investor protection, construction permits, and property registration are being implemented and results achieved are expected to be shown in the WB Doing Business 2013.

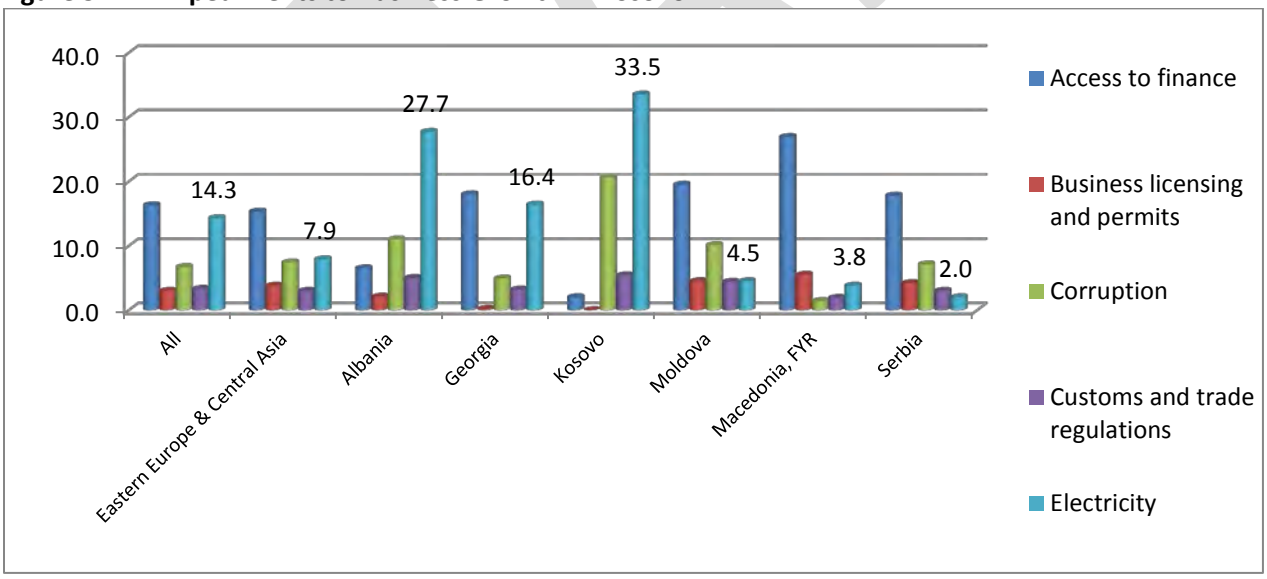
High microeconomic risks such as high taxes, heavy regulatory burden on the businesses, red and corruption increase the costs of doing business while reducing the appropriability of returns and weakening the incentives of businesses to invest. Despite Kosovo's poor performance in these indicators, firms by and large do not consider regulations to be a major impediment to their growth prospects.



Source:WB Enterprise Survey 2009

Business licensing, customs, trade regulations and labor regulations are the regulatory apparatus that mostly affects business operations. The Enterprise survey 2009 shows that Kosovo firms rank business licensing and labor regulations relatively low in terms of the constraint to growth they pose (Fig. 5.2.1). Indeed, the proportion of firms that see business licensing and permits as a major obstacle to growth is the lowest among all the constraints considered and the lowest compared to the benchmarked countries (Fig. 5.2.2). The same is true for labor regulations.

Figure 5.2.2. Impediments to Business Growth in Kosovo



Source: WB Enterprise Survey 2009

However, customs and trade regulation is reported as being a major constraint to business growth for firms in Kosovo with 5.4% of them reporting it as a constraint, the highest proportion compared to our benchmarked countries. The courts are not seen as being a major impediment to business operations. The proportion of Kosovo's firms reporting courts as a major constraint, together with Albanian firms, is the lowest among the comparator countries. Taxation policy is

not present as a major constraint to growth. There is a low tax burden in Kosovo and the tax system is fairly simple.

However, the Foreign Investors Perception survey shows that these enterprises see the cost of doing business in Kosovo as high. Only 11.1% of foreign investors responded believe that the general cost of doing business in Kosovo is low.

Figure 5.2.3 Barriers to Enterprise Growth, Riinvest 2011

The Riinvest Enterprise Barriers Survey from 2011, businesses listed the main barriers that affect their work and rated each barrier in terms of intensity with the scores for each barrier ranging from a minimum 20 to a maximum of 100. Kosovo enterprises listed unfair competition (invasion and informality) as the biggest barrier with the score of 76. Anti-competitive practices, street crime and theft, electricity, corruption were also listed as major barriers. Business licensing and permits and labor regulations do not seem to be a big barrier to the Kosovo's enterprises, with the score of only 40. Customs and trade regulations and tax administration score around 50, and do not make the top ten constraints.

In conclusion, the conditions for doing business in Kosovo, while generally poor, do not rise to the level of a binding constraint to private investment, primarily because other fundamental issues, such as the unreliable energy supply, are binding at present. However, micro risks can become a binding constraint to growth in Kosovo in the near future if government does not ease the regulatory burden on businesses and does not improve the business and investment environment in Kosovo.

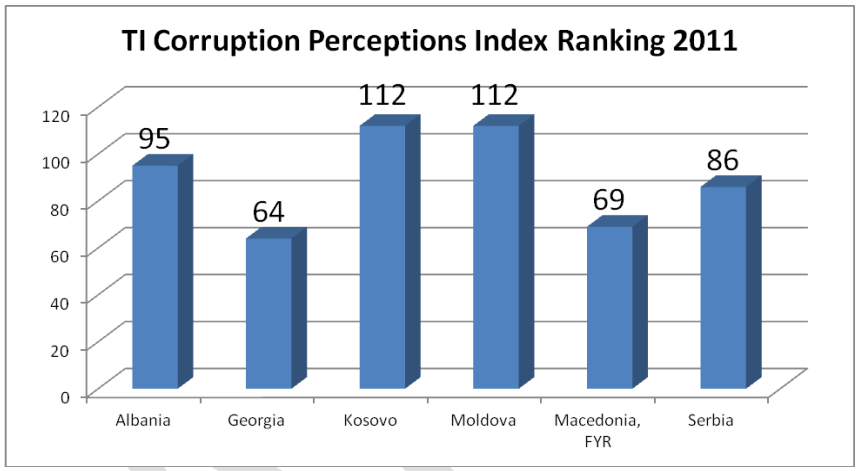
5.3. Corruption

Corruption hinders economic development by encouraging the emergence of a market system which allocates resources inefficiently – i.e. allocates talent, technology and capital away from the most productive uses socially (Murphy, Shleifer and Vishny, 1991, 1993). The presence of the corruption in the economic system opens the door to rent-seeking, increases risk and uncertainty, and distorts incentives.

Faced with corruption, firms in Kosovo may devote resources to obtaining licenses and permits as well as preferential market access, while focusing less on ways to increase productivity. In presence of widespread corruption and heavy regulatory burden, other firms may opt to operate in the informal economy.

Corrpution is one of the biggest challenges that Kosovo faces, a challenge it has in common with the other countries in South Eastern Europe. Numerous sources point to the perception of corruption as one of the most serious problems facing Kosovo, in the opinion of its citizens. Fig. 5.3.1 shows the rankings worldwide of Kosovo and the comparator countries in Transparency International's 2011 Corruption Perceptions Index (CPI), which is a measure of the public opinion of domestic, public sector corruption, Kosovo ranks 112 out of 182 countries, lower than any other comparator country except Moldova. Kosovo has an index of 2.9 - considered significantly corrupt.

Figure 5.3.1. TI Corruption Perceptions Ranking 2011



Source: Transparency International, 2011

This perceptions evidence is supported by numerous other sources, such as the World Bank's governance indicators for 2010. Kosovo scores low on government effectiveness, regulatory quality, and rule of law, while on control of corruption and government effectiveness Kosovo scores even lower (Table 5.3.1.). In percentile rank higher values indicate better governance ratings – they represent the percentage of countries worldwide that rate below the selected country. For Kosovo, the control of corruption indicator is 31.6 – lower than it was in 2005. In the rule of law, Kosovo's percentile rank is at 30.8 which is lower than the comparator countries. The only improvement is in voice and accountability, where Kosovo now ranks 42.2, better than in 2005 but still in the bottom half of the world.

Table 5.3.1. Kosovo Governance Indicators in 2005 and 2010

Governance Indicator	Year	Percentile Rank (0-100)
Voice and Accountability	2010	42.2
	2005	33.7
Political Stability / Absence of Violence	2010	14.2
	2005	N/A
Government Effectiveness	2010	32.5
	2005	N/A
Regulatory Quality	2010	52.2
	2005	N/A
Rule of Law	2010	30.8
	2005	17.2
Control of Corruption	2010	31.6

	2005	34.1

Source: World Bank Governance Indicators 2010

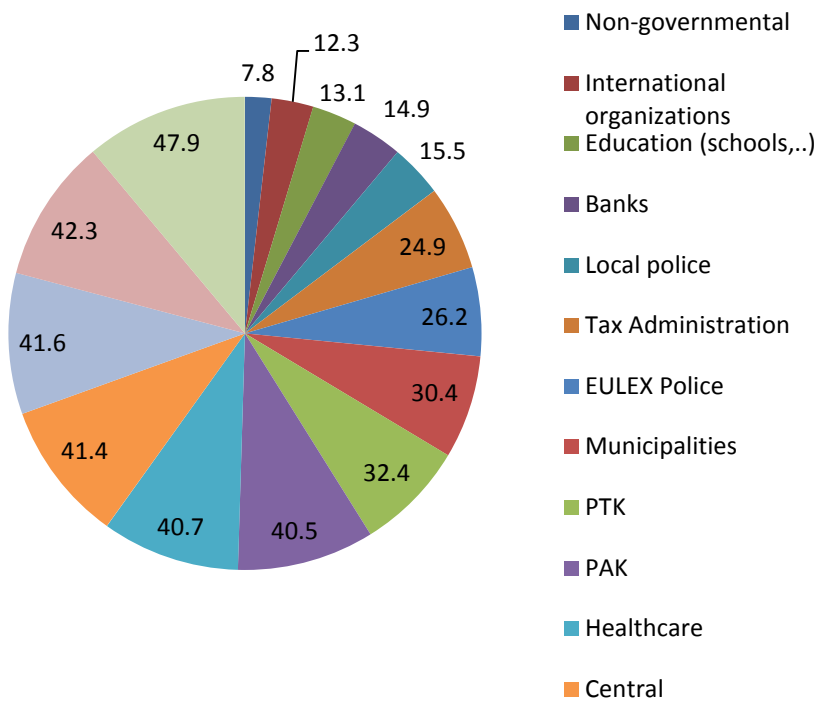
The Global Integrity Report 2011 assesses the existence, effectiveness, and citizen access to key governance and anti-corruption mechanisms through 320 actionable indicators. Fig. 5.3.2 shows the scores for several major anti-corruption mechanisms, with only judicial independence perceived as not weak (a score below 62 is weak).

Source: Global Integrity Report 2011

The report pinpoints problems in political financing transparency, the conflict of interest within the executive branch, business registration and licensing and the judicial independence to name a few. The low score on business registration and licenses indicator of the Global Integrity Scorecard for Kosovo, points to the presence of complex regulations, inefficient administration and possible corruption.

Yet another source with virtually identical results is the USAID and United Nations Development Program (UNDP) Public Pulse Report 2 of September 2011. The Public Pulse measures public perceptions and shows that corruption is ranked as the third most important problem facing Kosovo after unemployment and poverty. The electrical utility KEK and Kosovo Customs are ranked top in the list of institutions where there large-scale corruption is perceived to exist, followed by the public telecom PTK, the central government, and the courts (Fig.5.3.3)

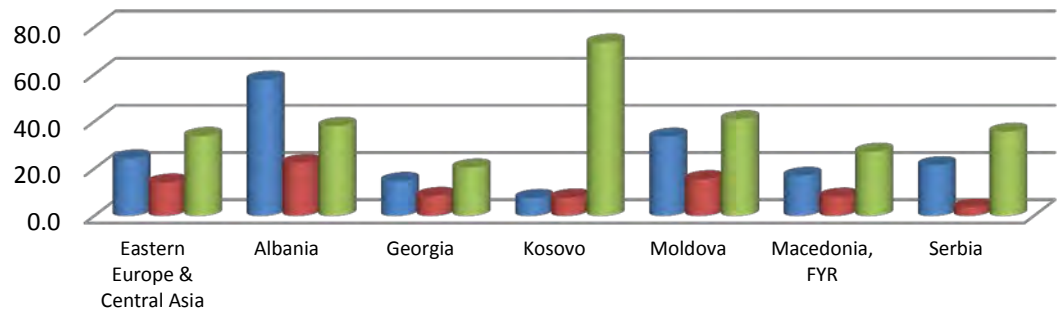
Figure 5.3.3. Perception of large scale corruption



Source: USAID & UNDP Public Pulse Report, June 2012

The World Bank Enterprise Survey 2009 shows that similarly to the public at large, firms also consider corruption to be a major problem (Figure 5.3.4). 73.4 percent of enterprises identified corruption as a major constraint to Kosovo, much higher than the comparator countries. The overall perception of corruption as a major constraint for the comparators is from 30-50 percent lower than for Kosovo.

Figure 5.3.4 . Corruption perception among enterprises in Kosovo and comparators



The rest of the data, however, presents a mixed picture. Only 7.5 percent of surveyed Kosovar firms reported that they are expected to give gifts to public officials to get things done and 7.7 percent reported that they are expected to give gifts in meetings with tax officials. In contrast, 24.3 percent of firms in Eastern Europe & Central Asia and 57.7 percent of firms in Albania respond that they give gifts to public officials to get things done.

A recent survey conducted by USAID to gauge business conditions at the sub-national levels has similar results. The Municipal Competitiveness Index results from 2011 & 2012 provide an assessment on corruption while measuring informal charges and corruption occurring, their predictability, and whether they lead to better services. The response rates to these questions in the MCI survey in 2011 was low across almost all municipalities (Tables 5.3.2. and 5.3.3). Some of the responses "don't know/refuse to answer" can be 'false responses', where a respondent knowingly gives a false answer due to the sensitivity of the question and fear of being linked to a response.

Table 5.3.2. Sub-national corruption as experienced by Kosovo businesses

Indicator	Year	% of Firms Responding Yes	% of Firms Responding No	% of Firms Not Responding (don't know/refuse to respond)
Firms pay some irregular unofficial payments	2011	12	57	31
	2012	11	61	28

Source: USAID/BEEP Municipal Competitiveness Index 2011, 2012

Half of the respondents agree that firms make no unofficial payments. Only a small proportion of firms report that they experience unofficial payments. Similarly, most firms respond that the cost of unofficial payments is low (Table 5.3.3), with about three quarters giving the cost as less than 5% of firm income, and more than 50% responding that there is no cost to firms.

Table 5.3.3. Cost of sub-national corruption to Kosovo businesses

Indicator	Year	% of Firms Responding 0%	% of Firms Responding Less than 5%
% of income firms pay in unofficial payments to public officials	2011	51	71
	2012	59	82

Source: USAID/BEEP Municipal Competitiveness Index 2011, 2012

Conclusion: The disconnect in perception and experience merits further research and more data. The presence of such wide diversion in outcomes means that it is impossible to give an accurate assessment of the true cost of corruption to businesses. The current evidence seems to show that the cost of corruption on normal business operations is not very high. But perceptions are undoubtedly extremely high. Perception alone can have a deterrent effect on investment decisions, even if it does not accurately reflect reality. Therefore we are not able to determine if corruption presents a binding constraint on investment or not.

More and deeper research on the root causes of corruption and ways that is manifesting itself will have to be conducted in order to shed more light on the cost of corruption in Kosovo.

Part 6. Conclusion

Growth and investment are not transformational: The International Monetary Fund estimates that Kosovo will need to grow at about 8% per year to halve unemployment within ten years. GDP has been growing at about half that rate, and private investment as percentage of GDP was essentially unchanged in 2011 from 2007 levels. Although remittances have continued to be high and stable thus far, only about 10% are used for investment, with the majority of funds used for basic consumption. This in turn contributes to Kosovo's extremely high current account deficit, leaving the country vulnerable to external shocks. To strengthen its economic viability, Kosovo needs to increase private sector investment rapidly and reduce its dependence on aid and remittances.

Given the data constraints in Kosovo, a precise estimation of the shadow price of the binding constraints we identified was not possible. Partly based on the quality of the evidence we had we are here attempting a ranking of magnitude of the three major binding constraints.

1. **Lack of reliable power is the most binding constraint to private investment growth in Kosovo**. Over the last ten years, enterprise surveys have consistently listed power as the most important constraint in Kosovo. Even with imports, the frequency and cost of power outages is much higher than the comparator countries (with the exception of Albania.) Until recently, inadequate generation was coupled with high transmission and collection losses to reduce the electricity delivered to enterprises even further and to pose a heavy burden on the budget. Since 2008, the performance of the Kosovo distribution company (KEDS) has improved steadily and losses have been reduced. 2011 was the first year without an energy subsidy. However, the central issue is that Kosovo's production capacity is inadequate to meet current needs, grossly inadequate for future needs even at 5% economic growth rate, and will continue to pose a heavy cost to the economy. Kosovo has one of the most significant deposits of lignite coal in Europe so theoretically it has the resource to power itself, albeit through thermo generation. But very little progress has been made in the past twelve years to bring new capacity on board. The latest estimates show that a new thermo power plant is unlikely to start generation before 2020, potentially keeping Kosovo on a low-growth trajectory until then.

2. **Lack of qualified human capital is the next most binding constraint to growth.** While job creation is low, the evidence is strong that the lack of skills is a constraint on growth, especially for sectors with high-growth potential such as services. Kosovo's labor force is poorly educated and poorly skilled, compared to other countries in the region and even Eurasia. This is combined with high labor costs and a high reservation wage, partly due to the level of remittances. Low-skilled workers are not competitive even with those in EU members like Bulgaria and Romania. Demand for low-skilled workers is low and the supply is high. Most unemployment occurs among workers with high school education or less. Demand for workers is high in the most highly qualified categories, where we find insufficient supply. Although data quality in Kosovo is problematic, several statistical sources point to high returns to education, indicating that human capital is a binding constraint on growth.

3. **Cost and Access to Credit is the third binding constraint for private investment growth in Kosovo**. The evidence suggests that the real binding constraint behind the high cost and lack of access to credit is the poor enforcement of judgments, contracts and decisions, more than the inefficient operation of the financial system. The study notes that credit to the private sector in Kosovo is low compared with other countries. Kosovo has a level of domestic savings roughly in line with the peer countries but a much lower level of borrowing. Banks have substantial excess liquidity, i.e. deposits and other funds available for lending. More than 80% of companies do not borrow at all using only own funds or help from family and friends. Borrowing costs are high compared to other countries, due to higher operational and risk costs of Kosovo banks. Collateral and other conditions for loans are more restrictive than in the comparator countries. We argue that the primary cause for the high cost and limited access to capital is the lack of enforcement of judgments, decisions, and contracts. Banks are extremely cautious in lending as it is virtually impossible to collect a bad loan. Even though there is some improvement in the operation of courts, with a reduction in the backlog of cases in 2011, there is no such improvement in the backlog of decisions waiting to be enforced. The enforcement of decisions is fully in the public sector (no private bailiffs) and it remains underfunded, poorly organized, with unclear institutional mandate, and subject to significant corruption. Ultimately, poor enforcement causes real damage to Kosovo's economy.

A note on corruption: corruption is an increasingly serious concern but evidence is insufficient to determine if it is a binding constraint to growth. The evidence from several enterprise and public opinion surveys is mixed. While three quarters of enterprises list corruption as a major constraint, the level of bribe-giving and the reported cost of bribes is significantly lower than in the peer countries. Nevertheless, there is a high public perception of growing corruption, indicating a growing crisis of confidence in the government. The perception is mostly for corruption in public procurement. If the current trend in rising public spending continues, corruption can become a major factor against growth.

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