



EVALUATION OF THE USAID/KOSOVO ECONOMIC RECONSTRUCTION PROJECT

Prepared for:
USAID/Kosovo

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EXECUTIVE SUMMARY

BACKGROUND

The USAID program of economic support for the reconstruction of Kosovo began almost immediately upon the cessation of hostilities in 1999. Extraordinary international financial flows and expatriate-staffed institutions of governance gave the economy a quick and significant boost as reconstruction got under way. However, USAID recognized quickly that the economic gains would be transitory unless a domestic economic dynamic developed to take the place of reconstruction-related activity as it began its inevitable eventual phase down.

Under UN leadership pursuant to Security Council Resolution 1244, it was determined that the Kosovo economy should be constructed to be compatible with the largely market-directed economies of the EU, under EU direction. Yet Kosovo had neither the legal framework nor the public institutions that are preconditions to the operation of such systems. USAID was the donor agency best able to mobilize quickly to begin the legal and institutional development effort required to fill the void. Thus the USAID program was launched under extraordinary circumstances that required that legal, financial and economic institutions commence operations even as they were being constructed. Technical assistance experts thus served in a number of cases not only as advisors but as *de facto* government officials.

The Economic Reconstruction Program was wisely designed to create a legal and institutional framework that would be visibly hospitable to private foreign and domestic investment. After years of neglect followed by wartime destruction, Kosovo's productive capacity was dramatically reduced. Nevertheless, in its capital-starved state, the potential returns on early investments in productive facilities could be extraordinarily attractive to investors under stable, transparent and reliable economic and political conditions. The attraction of private investment was, again, seen as the key to success and sustainability in the Kosovo economy.

The USAID program focused on four critical elements of the economic core, as reflected in four intermediate objectives of the Mission's 2001-2003 strategy: Fiscal Operations of the government, the Banking and Financial Sector including Pensions and Insurance Companies, Commercial Law and, finally, Privatization and Commercialization. Work in these areas was conducted under a series of four Task Orders (TO's), each of which built upon the accomplishments of its predecessor. Thus judging a particular TO successful implies satisfactory implementation of its predecessors. The work under the succession of four TO's in pursuit of the four IR's noted above is the subject of this evaluation.

FINDINGS

Progress

This evaluation concludes that the USAID strategy was plausible and appropriate. Moreover, the design of the institution-building program was meticulous and was tailored appropriately to the facts of the Kosovo situation as they were understood at the design stage, or as the design was altered in response to changes in conditions. The evaluation found close correspondence between the conceptual foundation of the program and the legal, regulatory, procedural and administrative documentation prescribing the form of the actual institutions and their operations.

In general, progress to date has been good, particularly considering that the program started just four years ago. In each of the four areas of concentration, the legislation required to establish the institutions and to initiate their operations has been passed. Some specific pieces of legislation have been held up (in the area property taxation, for example) but overall, the progress in establishing the legal framework has been noteworthy. The institutional development work has also recorded outstanding progress, especially in the Ministry of Finance and Economy (MOFE), the Banking and Payments Authority of Kosovo (BPK), the newly formed Pension system and the Insurance industry. Detailed implementation guidance has been included in each of the four TO's and their benchmarks. Some of the benchmarks in each area have not been reached. In some cases they proved to be unattainable due to changing conditions, and in others the benchmarks have been adjusted. An ongoing dialogue between USAID and others involved in implementation has served effectively to minimize serious problems associated with missed benchmarks and output targets.

While progress in establishing the institutions and legal environment has been strong and basically on track, in some areas implementation and sustainability have proved somewhat more problematic. The readiness of Kosovar executive-level managers and of professional technical experts to take control of the management of their functions does not appear to be as close at hand as might have been expected at this stage. Sustainability is a question in some areas as it is not clear that the general public fully understands and appreciates the conceptual foundations of the unfamiliar institutions and systems that have been built. This could weaken the resolve to defend them vigorously once the expatriate experts have left. More vigorous prosecution of public information and education campaigns in the future could be valuable in addressing this issue.

Constraints

Uncertainty about the final political status of Kosovo is almost certain to constrain many potential investors and other decision makers. In many, though certainly not all, areas sovereignty is a significant issue. Where it resides is not necessarily as important as that the issue be definitively resolved.

Across all four activity areas-government fiscal, financial, legal and privatization-progress has been constrained by a shortage of personnel with appropriate foundation educations. This has impaired efforts to provide training in specialized fields, as well as to move Kosovars into positions of executive management. The severity of this constraint may not have been fully evident or fully appreciated during program design.

The complexity of the politics of economic reconstruction has occasionally constrained progress. In some cases, the jurisdictional complexity has been a severe obstacle to implementation (especially in privatization, for example). In others it has merely resulted in a significantly greater lag between the identification of a needed action and its implementation. With the deep involvement of USAID, UNMIK, EU and the PISG as well as others in the identification, approval and implementation of appropriate actions, delays may be unavoidable. As economic reconstruction and political development proceed it is to be expected, and hoped, that fewer decision making points will be required.

A final significant constraint is the historical and cultural reality of Kosovo. There is not a tradition of free market economic practices, rules and procedures. Many of the strictures of a market economy may seem counter-intuitive and puzzling. Nor has education in free market economics been available. Thus while Kosovars can be trained to follow procedural manuals and perform routine institutional tasks, they do not fully appreciate the reasons for them, or the array of “off-manual” actions required in non-routine situations.

CONCLUSIONS

Program Strengths

The greatest overall strength of the program has been its design. It not only conforms to the requirements of a market-directed, transparent and stable economy, but within that paradigm was tailored appropriately to the specific situation of Kosovo. However the speed with which the resources were mobilized and the program was put in place, set an exceptionally high standard. Next in the order of strengths was that the program’s emphasis was primarily on establishing the environment for private economic activity rather than on trying to out-guess the markets. Finally, the four TO’s used to drive the program followed a logical and practical sequence, and were meticulously crafted.

Program Weaknesses

The principal weakness of the program has been its limited success to date in preparing Kosovars to take over the highest levels of management and the highly specialized professional-technical functions such as economic analysis. It has also been less successful than would be desired in informing and educating the public and government officialdom on the fundamentals of market-driven economic systems, to the extent that Kosovars appropriate confidence in and commitment to that kind of economic system. In the realm of taxation and public expenditures, in particular, it is to be anticipated that

after the departure of expatriate experts, intense special-interest lobbying will take place and will have the potential to corrupt the impressive market-friendly environment that USAID has been helping to create.

COORDINATION

Coordination among the donor agencies in which technical expertise primarily resides has been as good as a long-time foreign assistance observer can imagine. The IMF and the World Bank in particular have recognized the timeliness and appropriateness of the USAID program. While occasional disagreements among economic experts on particular routes to specific objectives is a certainty, there appears to be broad and deep agreement on the objectives and mutual respect for approach.

Coordination among the various public institutions being developed under the USAID program has also been excellent, particularly between the BPK and MOFE, where coordination is particularly important.

Coordination among the key political entities is more difficult if for no other reason, because of their sheer numbers. This appears to have been a serious obstacle to significant progress in privatization, even though the procedures and other elements of “literature” are largely in place. For the next stage of USAID assistance, it would be desirable for its program activities to be subject to fewer decision points.

RECOMMENDATIONS

The full evaluation report identifies priorities for future assistance in each specific area. The following is a brief overview of the most important recommendations detailed in the report.

1. **Banking and Finance.** Most of the remaining work is in Bank Supervision and Regulation, although a major, formal training effort is required. TA should continue for one year, with emphasis placed on preparing to turn all operations over to Kosovars.
2. **Fiscal Reform.** This effort has been exceptionally successful in getting the MOFE up, running and efficient. Nevertheless, it too is unready for operation by Kosovars. A final year of TA should address that problem, and develop a plan for dealing with issues raised in the evaluation report especially project evaluation in the budget function.
3. **Pensions.** The pension work has been highly, and quickly, successful. It is important not only as a potential vehicle for mobilization of savings, but for providing a much needed element of economic security for Kosovars. It should be seen through the next year of its development.
4. **Commercial Law.** The basic framework is in place. The EAU is involved and might be expected to produce replacement technical assistance, as required.

5. Privatization. This area could be considered a higher priority if logjams could be removed to allow it to proceed. If this happens it should be solidly supported.
6. Insurance. Some great successes have been realized. One technically expert observer considers it the most astounding success of the program, both because of its substantive significance and the fact that it was put in place without an internationally accepted template. Nevertheless, it is not clear that significant further USAID funding is required, and the industry itself should be considered a potential source of funding for deepening the sector's development.
7. Public Utilities. It appears that a decision has been made, or is about to be made, for USAID to remove activity in this sector from the current USAID program. That seems appropriate, with two caveats: (1) the Telephony sector is a good candidate for privatization and USAID might wish to support that; (2) although the power sector is not currently viable, it is such a huge economic sector that, should the opportunity arise for USAID to stimulate or undertake planning for a rational program of revitalization, it could be a worthwhile effort at modest cost.

MACROECONOMIC OVERVIEW

A massive international effort to rebuild the economy of Kosovo began almost immediately following the cessation of hostilities in 1999. The situation at that time was stark. Destruction of physical productive capacity during the war capped two decades of neglect and decay due to underinvestment and mismanagement under the previous political regime. The human capital base reportedly had also been depreciated by the systematic discrimination against Albanian Kosovars--- in terms of access to formal secondary and tertiary education and highly-skilled technical training, and advancement to supervisory, management and executive positions, especially in the 1990's.

In addition to reduced productive capacity of facilities and of people, Kosovo was left at the end of the hostilities with virtually none of the institutions, laws and regulatory systems required for an efficiently functioning economy.

Thus the initial challenge faced by USAID was not the traditional one of reforming and reshaping existing economic structures to enable them to perform more effectively. Rather it was to assist in the creation and initial operation of the legal and institutional structures that are at the core of an economic system. After that first step, the next was to begin making the legal and policy institutions user-friendly to the Kosovars who will ultimately have to oversee and operate them. This foundation was recognized as indispensable to the creation of an attractive and hospitable environment for private investment. It is investment alone that ultimately can ignite in Kosovo an economic surge onto a sustainable trajectory of economic efficiency, security and equity.

Under the authority of Resolution 1244 of the U.N. Security Council, the United Nations had the lead in the reconstruction of Kosovo. As Kosovo is a part of Europe it was deemed appropriate to have the EU take the lead in the economic dimension of reconstruction. This required legal and institutional structures that would be compatible with the mostly market-directed EU economies. This orientation has informed subsequent designs of assistance programs of USAID and of other bilateral and multi-lateral donors.

We turn now to a brief review of Kosovo's economic performance and prospects. The focus of the section is on the principal economic magnitudes that the program seeks to influence as well as some of the key obstacles to achieving strong and sustainable growth.

Recent Economic Performance and Prospects

In the first two years following the 1999 hostilities, the economic life of Kosovo took a sharp upward turn. Gross disposable national income is estimated to have reached DM 5.4 billion in 2000 and to have jumped another 20 percent to 6.5 billion in 2001. Real GDP growth reached an estimated 11 percent in 2001 and 7 percent in 2002. Per capita GDP is now estimated to be in the neighborhood of 850 Euros (US \$1,000.) Investment

outlays played a major role in this as reconstruction spending pushed investment to an extraordinary 54 percent of GDP in 2000 and 44 percent in 2001.

Employment data are very scarce and are imprecise. Nevertheless, there is little doubt that the burst of economic activity has created a significant number of jobs. Even so, estimates of unemployment continue to range between one-third and one-half or more of those seeking work. Moreover, of those who are employed over one-third are employed by the government. Since the government is still the beneficiary of substantial foreign assistance for reconstruction, and since such assistance is presumably transitory, employment may be transitorily inflated. (Offsetting this however, is the fact that much of Kosovo's economic activity occurs in the informal market, a factor which could make unemployment appear more severe than it is.)

Given the large proportion of the post-conflict economic surge that reflects reconstruction outlays financed largely by transfers from abroad the external sector is of extraordinary importance to recent economic performance. The significance of the inflows is underlined by spending estimates for all three of the principal domestic spending groups--households (consumption), businesses (investment) and government (both consumption and investment.) Consumption spending in 2001 was 20 percent greater than the total value of domestic production (GDP); imports alone were 75 percent of GDP and investment was over half the value of GDP. Government investment and consumption expenditures in the same year were 39 and 18 percent of GDP respectively. Clearly, domestic saving made no significant contribution to the financing of investment, and consumption spending was far above a long-term sustainable level in the current state of the domestic economy.

Along with the good news of elevated consumption levels (they do reflect increased welfare, at least temporarily) the GDP estimates show that the domestic economy alone cannot sustain recent income and growth performance. Foreign transfers have been necessary to fund investment in both the private and public sectors. The need to attract foreign savings will continue for the foreseeable future, as domestic savings cannot plausibly be expected to meet investment requirements.

In medium-term projections for Kosovo an IMF-World Bank team has estimated financing requirements for 2003-2005. This scenario is for annual real GDP growth of 4.5-5.5 percent. These estimates assume continued consumption in excess of GDP, investment ranging from one-third of GDP in 2003 to about one-fourth in 2004 and 2005 and large though declining foreign transfers as foreign assistance drifts downward. The required investment for the full three-year period is almost 2 billion euros, of which something close to one third (in the neighborhood of 600-700 million euros) will need to be private. A significant share of this latter amount will have to represent increased interest on the part of domestic and foreign private investors in investing in Kosovo.

Clearly, whether the outcomes can be realized, and whether good performance becomes self-sustaining will depend crucially on the success of the economic program in attracting domestic and foreign private savings and investment. Staying the course with respect to

market-friendly policy and administration is essential. Private investors are not afraid of risk when it is calculable. However they generally abhor the random and capricious surprises that are typical of policy and institutional environments that are ill-defined, that lack transparency and that are seen as lacking in integrity and efficiency. The 4.5 to 5.5 percent growth scenario is viable only to the extent that those conditions are effectively addressed by the Economic Reconstruction Program. Thus continued implementation of the program of legal, institutional and policy refinement supported by USAID is probably a necessary (though not sufficient) condition for achieving that outcome. The broad outlines of the requirements are set forth below.

Fiscal Reform

In the development of a robust, market-driven and self-sustaining economy the public sector will have to play a major role. Restoration of public infrastructure such as roads, provision of a social safety net and public safety and ongoing operation of the policy, legal, regulatory and judicial framework are all essential ingredients of a market-driven economic environment. In fulfilling its functions, the public sector undertakes a significant share of the investment that is required to propel economic activity. Thus the public sector must have the ability efficiently to plan, execute and monitor the expenditures associated with the provision of public goods and services. It must also be able to raise the revenue to pay for these activities primarily through an efficient tax system with minimal disincentive effects on aggregate production and distortions to the structure of production. And, perhaps most importantly, it must be seen to operate both the expenditure and revenue sides with integrity and fairness in order to win substantially voluntary compliance of the public with the “rules of the game.” These are the objectives of USAID assistance in the fiscal sector.

Banking and Financial Markets

Banks are the core institutions of the financial system of Kosovo. As in any economy, they have the potential to fill three key roles: providing a fast, reliable and efficient payments mechanism, attracting savings and intermediating in financial markets to achieve efficient resource allocation. To actually produce these potential boosts to efficiency, banks must earn the highest possible degree of confidence of the key economic agents, including the household, business, financial and foreign sectors. Failing that, depositors will not supply funds, borrowers will not trust banks and transactors will find other, less efficient, means of settling accounts. Integrity, transparency, efficiency and open competition are the keys to a sound banking system, and they are promoted by effective supervision and regulation by the public sector of entry into and performance of banking. Kosovo’s financial sector at present consists primarily of banks, micro enterprise finance companies, a newly established insurance industry and a fledgling pension system. Under the four TO's of the Economic Reconstruction project, each of these components has been led by USAID technical assistance.

While only banks provide the economy-wide payments system, the others are potentially important agents of financial intermediation. As income grows and domestic savings follow, the effectiveness and soundness of the financial institutions will play a determining role in the attractiveness of the domestic economy as a destination for both domestic and foreign private investment. The objectives set out in the USAID strategy for banking and finance are to promote the development of the financial sector's ability to play this facilitating role for economic growth and development.

Commercial Law and Property Rights

A market-directed economy can only produce its potential for efficiency and high performance if there exists a clear set of laws that set forth the "rules of the game" and that establish and define transparent property rights. Transactions of all kinds are discouraged if the things or rights conveyed can not be clearly defined and described and the agreements enforced. Moreover, markets are made efficient not only by the fact that they are private, but by free and open competition among their participants on both the buying and selling sides. Among the most important particular laws required in this domain are laws dealing with: contracts; companies; foreign investment; customs and excise; foreign exchange transactions; collateral; banking; protection of competition; registration of property and cadastre. USAID assistance to Kosovo has included each of the foregoing as important components.

Privatization and Enterprise Governance and Management

Kosovo still has almost 400 enterprises that are wholly or principally owned by the public sector. These are divided into two categories, "socially owned enterprises (SOE's)" and "publicly owned enterprises (POEs.)" It is primarily the former that are the subject of the privatization program. The latter include some entities, such as the electric utility company, that might be classified as "natural monopolies." If not deemed suitable for sale to private owners, these entities must be carefully administered and held accountable to the public.

A particularly important reason for privatizing state-owned enterprises is that they draw the attention and the scarce resources of the public sector away from the essential task of providing social goods and services. Many of the enterprises represent dormant resources that could be put to work doing the essential work of a public sector in a market-directed economic system. Their sale to the private sector could also offer some level of domestic outlets for investment, and could contribute to the revitalization of production and employment. Nevertheless it is important that the privatization or other form of commercialization of enterprises owned by the public sector be undertaken in a manner that is transparent and that benefits the community as a whole, and not just special interest groups. This objective is embraced in the USAID economic assistance program. While slow getting under way, and fraught with political as well as legal and economic obstacles, the privatization program has made some strong advances, and has had some setbacks in the past year.

The ultimate test of the success of the activities that are the subject of this evaluation, will be the economic outcomes that are achieved. Can Kosovo get onto a trajectory to 4.5 to 5.5 percent growth in the medium-term? It is possible, and indeed plausible as concluded earlier in this section. However there are some potential stumbling blocks, and these are identified in the body of this evaluation report. It is to the specific evaluation of the four intermediate results addressed in this evaluation that we turn next.

SCOPE OF THE EVALUATION

This evaluation covers the work under Task Order (TO) PCE-I-807-00-00014-00, and the three that preceded it, dating back to 1999. All four address the broad objective of creating a legal and institutional foundation for an economic system that is compatible with EU-style market-directed economies. On such a foundation private markets are expected to produce self-sustaining economic growth to move Kosovars steadily closer to the realization of their own economic objectives.

The current TO and its predecessors are wholly compatible with Strategic Objective (SO) 1.3 in the Mission's 2001-2003 Strategy Statement, "Establishment of an Economic Policy and Institutional Framework." Under the current TO (the logical successor to the previous three) the categories of work to be performed by the contractors correspond to the first four of five IR's under SO1.3: *A Sound Fiscal Policy and Administration Regime Developed; A Competitive and Well Regulated Financial Sector; A Commercial Law Regime Which Effectively Establishes and Protects Property, Contract and Investor Rights; and Privatization of State and Socially Owned Enterprises.*

The Task Orders provide guidance to the contractor by identifying specific tasks and benchmarks to track implementation. Nevertheless, the Task Orders explicitly recognize that the exceptional economic, social, political and bureaucratic circumstances in Kosovo can alter the relevance of any particular guidance from one day to the next. Accordingly departures from the benchmarks can represent appropriate responses to the changing environment. The evaluation team has found that USAID maintains a constructive ongoing dialogue with other key elements of the Kosovo reconstruction effort and that program benchmarks are adjusted, dropped or added to as circumstances demand.

We have adopted a correspondingly flexible interpretation of the task and benchmark guidance, in consultation with USAID. In sections of the evaluation focused on compliance with specific guidance, we have found it useful in this context to group the task and benchmark guidance under the following four categories:

Promulgation or Implementation of Legislation, Regulations or Policies

Institutional Development, Reinforcement or Strengthening

Specific Implementation Actions and/or Quantitative Output Targets

Public Information and Education

FISCAL REFORM

Fiscal Reform is concerned with the first Intermediate Result under SO 1.3: “a sound fiscal policy and administrative regime developed.” It focuses on the Ministry of Finance and Economy (MOFE) and covers nine areas: direct support to the Minister and Permanent Secretary; macroeconomic analysis and revenue forecasting; tax policy; tax administration, including the property tax; budgeting; intergovernmental fiscal relations, including fiscal decentralization and municipal budget preparation; treasury; internal audit; and procurement. Direct support to the Minister and Permanent Secretary is addressed in the Recommendations Section.

FINDINGS

Progress

Basic Findings on Progress

The objectives of the first three TO’s, as adjusted, were substantially achieved. Most of the original benchmarks (29 of 40) for TO 4 will have been met by March 2004. These current benchmarks are cumulative in their effects and are intended to be among the last steps in key sub-units of the MOFE, which has been a primary focus of all four Task Orders issued under this project. Broadly speaking, the current effort has made very significant progress. On the other hand, all benchmarks will be complete in only three of eight areas; tax policy, intergovernmental fiscal relations, and internal audit.

Promulgation or Implementation of Legislation, Regulations or Policies. The initial legal framework for the revenue structure is in place and, in fact, is in the process of being up-graded (e.g. the wage tax would be replaced by a comprehensive income tax under legislation proposed by the Ministry of Finance and Economy.) Tax administration and procurement are operating under UNMIK regulations and instructions; but legislation is currently being drafted for tax administration, and The Law on Public Procurement in Kosovo is in the final stages of approval. The property tax seems not yet to have a satisfactory legal base: two Administrative Instructions are still to be issued. The Law on Public Financial Management and Accountability provides the legal basis for the remaining areas. Thus it appears that, by March 2004, a comprehensive and satisfactory legal basis will be in place for all areas except, perhaps, the property tax.

Institutional Development, Reinforcement or Strengthening. Institutional development has advanced impressively, although the process will have been completed (as defined by the benchmarks) only in internal auditing and tax administration. In all other areas, at least one important element will be missing: (e.g. good data in macroeconomic analysis; a capable unit director in tax policy; a tested enforcement mechanism and a computerized information system in property tax; project evaluation capability in budget; an

organizational structure in intergovernmental fiscal relations; and a complete computerized accounting system in treasury and, for the future, a debt management unit.) Absence of these elements means that performance of the institutions could easily fall below standard following departure of expatriate experts.

The Municipal Budget Unit could be considered complete, but it imperfectly meets the needs for intergovernmental fiscal relations. In procurement, institutional development consistent with the new law has not begun, a significant shortcoming in terms of assuring procurement integrity. Moreover, the European Union has assumed responsibility for this work. Since the law has been drafted, the essential benchmark has been completed, and USAID work is complete. Finally, a public enterprise monitoring unit was to have been established in MOFE; but MOFE has determined that, until responsibility for public enterprises is transferred to the PISG, it would be inappropriate for MOFE to establish a monitoring unit. Therefore, no institution exists.

Specific Implementation Actions and/or Quantitative Output Targets. This area relates to the operation of developed institutions. The basic fact is that institutions are operating in each of the eight areas listed. Kosovo does have a functioning government. This is a huge accomplishment. However, as identified above, except in internal audit and tax administration, institutional development is not complete. In tax administration, operating weaknesses remain in tax auditing and appeals and will not meet the performance benchmarks. Internal auditing on the other hand is out-performing quantitative targets. Therefore, while operations are under way in the fiscal institutions, and have made extraordinary progress in only four years, only internal auditing is operating at the level of a mature and efficient institution.

USAID's strategy papers contemplate development of economic policy institutions that are not only fully developed in the law, in regulations and in procedural and operational standards, but that also can be managed, administered and operated from top to bottom by Kosovars. In the fiscal institutions, this degree of development has not been attained except in the internal audit function. Although the current benchmarks will be achieved in tax policy and intergovernmental fiscal relations, these areas appear to require the continued presence of expatriate heads to operate satisfactorily. All other areas have incomplete benchmarks. These conclusions are partially based on interviews with the Kosovar heads of all units. (For a fuller discussion of this point, see International Crisis Group Report, *Two to Tango*, pages 23 and 24.)

Public Information and Education. MOFE does have a Public Information Office, and the benchmarks do call for a comprehensive public education program for both expenditure and revenue components of Fiscal Reform. Nevertheless, the Office is providing only intermittent support to the Fiscal Reform components and on an ad hoc basis. It did, for example, launch a public campaign when the payroll tax rates were changed. Thus, the benchmark is only partially achieved. Fiscal Reform could benefit from a stronger, deliberate campaign to inform and educate the public, and to win the confidence and support of the public. Simply publicizing specific events is not sufficient.

Other Findings on Progress.

The Strategic Objective-“Establishment of an Economic Policy and Institutional Framework”- Will have been substantially achieved by March 2004. Nevertheless, the Process of Making These Institutions Fully Operational, without Expatriate Expertise, is Incomplete. The Intermediate Result for the period ending March 2004-“A Sound Fiscal Policy and Administration Regime Developed”-is to “develop” institutions. The corresponding Intermediate Result in the draft Strategic Plan for 2004-2008 is to “fully develop and institutionalize” the budget and tax systems. This might be expressed as assisting the relevant institutions to achieve maturity—a process that depends on operational experience, and hence one that cannot be rushed. (See Strategy for Kosovo 2001-2003, page 14 and Strategic Plan 2004-2008, page 22.)

In a formal textbook sense, a minimum of one and a maximum of three of a possible eight institutions will be completely “developed” by March 2004. Therefore, formally, the Intermediate Result might be considered to have been missed. However considering that the IR is a step toward the Strategic Objective, the degree of success over the past four years surely merits high praise and justifies the continuation of support needed to preserve the gains made to date.

To Date, the Overall Economic Impact of Fiscal Reform on Output and Growth Is Not Quantifiable but Is Almost Certainly Positive. USAID has been the primary international organization supporting fiscal reform. Substantial progress has been made in creating fiscal institutions. Therefore, the USAID program has had a major impact upon creating these fiscal institutions.

The significance of this development to economic output, employment and growth is that potential investors are deeply interested in the implications of taxes for the viability of potential investments. In addition, a fiscal reform program should be designed to: (1) foster a secure and predictable environment; (2) produce a tax structure that minimizes obstructions to private sector economic activity; and (3) fund public infrastructure that supports economic development. The implemented program does all three: (1) the new fiscal institutions add a degree of security and predictability that did not exist in 1999; (2) the tax structure uses relatively low rates and taxes that minimize distortion of economic activity, particularly the VAT, and generally are levied on those who can pay; and (3) the integrated budget includes a Public Investment Program that funds infrastructure projects that support economic development. Finally, it is hard to imagine circumstances under which efficiency and integrity of fiscal institutions would not have a positive overall economic impact.

Constraints

A Major Constraint upon Accomplishment in The 2004-2008 Period May Be the Educational Backgrounds of the Existing Generation of Analysts. A comparison of areas where institutionalization has progressed with areas in which institutionalization has not progressed, suggests the following.

- For jobs that are procedural and managerial in nature, it may be possible to train employed local staff satisfactorily. Local staff for operations and/or managerial positions seem to be progressing well in the Internal Audit, Tax Administration, Property Tax, and Treasury Units.
- For jobs that are deeply analytical in nature, satisfactory training of existing employees may not be possible. After four years there are no local employees that are satisfactorily trained for the senior analytical positions in the Macroeconomic, Budget, Tax Policy, or Intergovernmental Fiscal Relations Units, and there are no local employees who are professionally prepared to lead these operations.

In planning for the 2004-2008 period, USAID should consider the difficulty of staffing policy units with adequately prepared local staff, and should recognize that on-the-job training may not be an adequate vehicle for resolving this problem. The low compensation package is part of the problem, but long-term training (preferably in-country) is essential as well.

CONCLUSIONS

This section identifies strategic issues in the USAID program with the intention of offering considerations for planning the next phase of technical assistance. It focuses primarily on problems, as those are the areas in which corrections can be most productive. However, the problems do not in our view overshadow the high level of accomplishments. Our overall judgment remains that much has been accomplished, just not everything in an ambitious program.

Program Strengths

The Content of the USAID Program for Fiscal Reform Was Appropriate and Adapted to the Circumstances. The USAID program of fiscal reform was designed with care and precision. The program's appropriateness is underlined by the high regard expressed for it by the IMF, the World Bank and other informed observers.

The program implemented by USAID is characterized by simplicity of administration. The taxes are relatively flat, and the expenditure planning and management process, at least in design, imposes a discipline on Ministries that requires them to strive for cost control.

The Greatest Accomplishments in Achieving Benchmarks Appear to Be in Local Implementation of a Property Tax and in Central Tax Administration. The local property tax has been introduced into Kosovo. To date 27 of 30 municipalities have been certified as having financial systems strong enough to implement and operate a property

tax. Implementation is in its second year and fourteen municipalities are already collecting revenue. (The collection rate is low, only 11 of tax due after eight months.) Given the length of time that it usually takes to implement a property tax in developing countries, the progress in Kosovo is impressive.

Central tax administration is also an area of success. Eight of eleven final benchmarks will be completed by March 2004. It seems highly probable that the remaining three benchmarks would be achieved in the near or medium-term future.

Program Weaknesses

The Most Widely Internationally Accepted Institutional Development Procedure Has Not Been Followed Faithfully. This procedure contains five steps.: (1) create the institution using expatriate personnel; (2) operate the institution initially using expatriate personnel; (3) prepare local personnel to manage and operate the institution; (4) turn management and operation of the institution over to local personnel and place expatriate personnel in coaching roles; and (5) support local managers and operators with short-term assistance, as required.

This model was not used in Kosovo. The exigency of starting from nothing pressured implementers to combine the first three steps and to execute all simultaneously. In doing so, they have discovered that they did not have sufficient resources to do an equally good job on all three steps. Faced with a choice, they have consistently (and necessarily, in our view) given priority to creating and operating a rudimentary institution and producing outputs. It is less clear that attempting to add the fourth (in some cases) was wise.

For planning purposes, it would not be unusual to assign a year to each of the first four steps. This timing would correspond reasonably well to the tenure of USAID technical assistance in Kosovo. Nevertheless, the situation in Kosovo was unique, and so would not have offered a perfect fit with the usual accepted sequence of institutionalization steps. That all desired results might not be achieved by the end of the strategic period seems acceptable, given the challenges of the environment.

USAID Underestimated Two Factors that Should Be Considered in Planning the Next Increment of Technical Assistance.

- 1) ***The requirements of institutional development were underestimated.*** For an institution to be created and then to operate effectively, eight items are required: policies; organization structure; staffing; budget; facilities, equipment, and supplies; data; systems and procedures; and technical assistance. If any of these items is not adequately provided, the institution will be defective.

It was not necessary for USAID to provide all of these items in every area. PSIG or other donors could provide many of them. But, for effective institutions to be planned, created, and operated, explicit consideration and provision of them is

necessary. It appears that explicit consideration and provision of each item in each area has not been consistent during implementation. Examples of deficiencies are data for the Macroeconomic Unit, staffing (leadership) for the Tax Policy Unit, training for the Budget Unit, and organization for the intergovernmental fiscal relations area. In planning the next phase of technical assistance, USAID should adopt a methodology that will ensure explicit and continuing consideration and provision of each of the eight items.

- 2) *The eventual complexity of the governing environment was not anticipated.* The difficulties of working in an environment composed of UNMIK, PISG, and the Economic and Fiscal Council are well known now, but were not anticipated when the USAID program was planned. In planning for the 2004-2008 phase, USAID should recognize the time-cost of this coordination in estimating time required for specific results.

The Greatest Failures in Achieving Benchmarks Appear to Be in the Priority Areas of Macroeconomic Planning and Management and Public Investment Planning. Two areas of high priority for USAID have been creation of a sound fiscal policy framework and management system, and development of sound public investment planning capability and systems. Yet, important benchmarks for these two have not been fully implemented, and key institutional elements will still be missing by March 2004. For macroeconomic analysis, timely and accurate data, absolutely critical to the successful operation, are not available. In addition qualified economic analysts and forecasters are not included on the local staff. For investment planning, cost/benefit training will not begin until February 2004. The training for Central Budget staff will consist of only one day and for municipal budget staff one-half day in four locations. Such training is not sufficient. Without cost/benefit analysis or other forms of formal project evaluation (e.g. analysis of internal rates of return) the Ministry has no rigorous way of discriminating among competing investment projects. Consequently, this element of the minimum program has not been implemented.

Coordination of Assistance

Strong Coordination Among Fiscal Experts in the Donor Community has Characterized this Work. Key international development institutions and officials in Kosovo, including International Monetary Fund (IMF) and World Bank representatives, report unusually good coordination of the fiscal reform program. Nevertheless, there have been some implementation problems and delays related to disputes between PISG and UNMIK over the locus of decision making authority. Whether this reflects deficient coordination or simply political/bureaucratic jurisdictional quarreling is not clear.

Issues and Sustainability

Given that Institutionalization Is Incomplete, Several Opportunities Exist for Continuing Technical Assistance. Technical assistance could continue to support the institutionalization effort in the following areas:

- Macroeconomic Unit. Ensure that data needed for macroeconomic analysis and projections are available. This should be relatively inexpensive for USAID since it is likely that another agency would finance the technical assistance needed to provide the data. This is a *sine qua non* of useable macroeconomic analysis.
- Central and Municipal Budget Offices. Implement formal project evaluation training for budget staff. It may be necessary to upgrade the preparation activity from training to education.
- Treasury Unit. Continue technical assistance to complete implementation of the Free Balance system, fiscal reporting, a debt management unit, and a training program to support all of the foregoing.
- Tax Administration Unit. Continue technical assistance to complete implementation of the auditing and appeals procedures and the training program to support them.
- Property Tax Unit. Continue technical assistance to strengthen the enforcement mechanism.
- Intergovernmental fiscal relations area. Continued technical assistance to create a unit capable of dealing with issues related to the assignment of revenue and expenditure responsibilities and development of formulae.

Opportunities Exist For Further Strengthening of the Ministry of Finance and Economy. In the course of interviews, two additional opportunities that go beyond the planned USAID program were identified.

- A unit for strategic management issues. Every government has issues that cut across the many and various ministries. Civil service reform and reform of the civil service pay scale are examples. The PSIG/MOFE does not have a unit that deals with such issues but would benefit from having one. Such a unit could be located appropriately in either the Prime Minister' Office or in the MOFE.
- Training for the MOFE Public Information Office. The unit already supports the outputs of the Ministry, but seems to do so on an ad hoc basis. The unit does not appear to be routinely notified of pending Ministry outputs in advance so that a strategic program aimed at developing public understanding can be developed. It would seem that an active and strategic program of public information could bring great benefits to the fiscal reform effort. USAID could consider funding a training program for the staff of the MOFE public information staff.

It Is Likely that Kosovar Financial Executives and Legislators Have an Incomplete Understanding of Their Tax Structure. The complexity of tax decision-making in any jurisdiction and the absence of what appears to be in-depth participation of local officials in tax decision-making in Kosovo, suggests that the tax structure has been approved with little understanding on the part of the people to whom it applies. In preparing for the next round of technical assistance, USAID should address the risk of corruptions of the tax structure that would undermine efficiency and/or equity objectives.

Lesson Learned: the Minister of Finance And Economy Will Draw Assigned Advisors into Political Disputes with UNMIK and SRSG. To the extent that such disputes are

based on interpretations of fiscal/economic realities, this may be a productive use of advisors. Nevertheless, USAID should seek to satisfy itself that technical expert advisors are used exclusively in areas of their technical expertise.

The Accomplishments in Internal Auditing Are Sustainable. Only the Internal Audit Unit is fully developed. Thus it appears that its state of development is fully sustainable. Nevertheless, it is our judgment that even the partial development of each of the fiscal system units can be sustained, but only if indispensable additional technical assistance is forthcoming. (For additional discussion of the preparedness of local staffs to assume the full burden of administration, see pages 23 and 24 of the International Crisis Group report: *Two to Tango*.)

RECOMMENDATIONS

1. ***Graduate Internal Auditing.*** The Internal Audit Unit can execute financial and compliance audits without continuing expatriate involvement. These audits provide assurance that policies and finances are being appropriately controlled. Therefore, by the end of March 2004, discontinue technical assistance.
2. ***Schedule Four MOFE Units for Completion of Institutionalization by Continuing Technical Assistance for up to One Year. The four are:***
 - The Budget Office;
 - The Treasury;
 - The Tax Administration Unit; and
 - The Property Tax Unit.

2.1 Retain Consultants as Coaches to Kosovar Managers for at least One Year. Responsibility for running the four above institutions should be turned completely over to Kosovar managers at the beginning of April 2004. Resident USAID expatriate counterpart advisors/coaches to these managers should continue in place for at least one year. Short-term advisors, if any, could suffice thereafter.

In the Budget Office, no advisor should be retained for municipal budgeting exclusively. One advisor to the local head of the central Budget Office should be sufficient. If municipal budgeting should need coaching, the advisor to the head of the central Budget office should be able to fill the need.

2.2 Require Each Kosovar Manager to Prepare an Institutional Development Plan, with Coaching from His or Her Advisors. When each manager assumes responsibility for his/her institution, he or she might be required to prepare a plan for developing his/her institution that ensures provision of each of the eight elements of institutional development. The counterpart coach of each local manager would coach on the preparation of the plans. The time schedule for executing the plans should permit unit operations and institutional development to proceed simultaneously.

2.3 Establish an Institutional Development Unit within the Ministry to Consolidate, Coordinate, and Manage Implementation of the Plans. A unit should be established to plan and supervise the continuing institutional development of the MOFE. As an institution, MOFE is not yet fully developed. In the first year, this unit should collect the institutional development plans from the four units scheduled for institutionalization (and the three policy units), and any other MOFE unit that develops one, and consolidate them into a Ministry-wide development plan. In following years, the unit should provide guidance to MOFE units to prepare plans and submit them to the unit for consolidation. The unit should supervise execution of the plans.

2.4 If These Plans Are to Be Funded, Rely upon Kosovar Money. The Consolidated Budget has accumulated a sizeable surplus. That money is available to fund development projects (but not recurring costs that result from development projects). Aside from expatriate coaches, the costs of MOFE institutional development should be funded from this surplus. The MOFE institutional development unit should ensure that money to fund the approved institutional development plans is included in the Consolidated Budget.

2.5 Let USAID Provide Short-Term Assistance, as Required. During the coaching period and perhaps through the 2004-2008 period, MOFE may require short-term technical assistance. This should be determined by each local manager in preparing his/her institutional development plan. To the extent that such assistance is required, continuity would suggest that it be provided through USAID. If USAID could require reimbursement from MOFE, it could discourage excessive use of this tool.

2.6 Provide an Advisor to the MOFE Institutional Development Unit, and Continue Him/Her for a Second Year. The MOFE Institutional Development Unit will require assistance to establish itself. An advisor should be assigned to provide that assistance. The advisor should spend the first year assisting the local head of the unit to establish the institution. S/he should spend a second year coaching the local head in the performance of his/her duties. During this second year, s/he should be the only advisor assigned to MOFE and should assist throughout the Ministry to the extent that s/he has time to do so. After the second year, USAID advisory assistance to MOFE should cease, except, perhaps, for the policy units.

3. Schedule Policy analysis Institutions for Long-Term Development. Development of the three policy analysis institutions---Macroeconomic Unit, Tax Policy Unit and Intergovernmental Fiscal Relations Unit--- is constrained by the lack of local policy analysts. Countering the lack of local policy analysts may not be something that can be accomplished in the short-term. USAID should ensure that each of these functions is headed by an expatriate advisor, and should advocate combining Macroeconomic and Policy Analysis. Currently, there is no expatriate leading Tax Policy or Intergovernmental Fiscal Relations.

- Require each expatriate leader to prepare an institutional development plan covering each of the eight elements of institutional development identified in

the Conclusion Section. The time schedules for executing the plans should recognize that unit operations and institutional development are proceeding simultaneously and that the complexities of the governing environment must be accommodated.

- Make the expatriate heads responsible for execution of the plans.
- USAID should undertake an effort to identify for recruitment local candidates with educational and experience backgrounds that are appropriate for serving as policy analysts. The effort could include an intensive advertising campaign within Kosovo and the Diaspora. Appropriate steps to provide adequate salaries must be included if the approach is to succeed.
- Support the educational foundation described on page 19 of the draft Strategic Plan 2004-2008.

4. ***Prepare a Development Plan for Strategic Ministry Management.*** MOFE as an institution does not appear to be fully developed at strategic levels. During the first year, the Permanent Secretary, with USAID technical assistance, should prepare a development plan that addresses strategic issues.

- The plan should provide a Ministry decision and control system that specifies clearly the different responsibilities of the Minister and Permanent Secretary, and the Principal International Officer.
- The plan should address issues identified by this evaluation. .
 - The new Institutional Development Unit should be accommodated
 - A unit for strategic management issues, as described in the Findings Section should be accommodated.
 - A central MOFE unit for applying rigorous cost/benefit analysis to investment projects should be considered. Cost/benefit analysts are scarce, and Kosovo may not have a large number of projects as donor funding declines. Placing the analysts in a central unit rather than in each ministry may be a more efficient use of a scarce resource, at least in the early years.
 - A procedure to use the MOFE Public Information Office strategically should be considered. USAID could consider providing training for the office if such a procedure were to be adopted.
 - Consideration should be given to creating a separate Intergovernmental Fiscal Relations unit.
 - Consideration should be given to removing the Municipal Budgeting Unit from the central Budget Office, combining it with the Property Tax Unit, and creating a unit to monitor municipal finances and to advise on improvement to municipal financial offices.

5. ***Prepare for Special Interest Attacks on the Tax Structure.*** Institutionalization will protect most reforms. Protection of the tax structure will require special effort. A training and education program for legislators (and the Minister) should be considered. However, the Assembly is still young, and identifying target legislators may be difficult. Including all legislators as targets may be an effective alternative.

6. ***Provide a Clear Statement to MOFE and the Advisors on the Role that They Are to Play in MOFE Disputes with UNMIK and SRSG.*** This would help to assure that the technical experts focus their efforts sharply in the areas of their technical expertise, and make it less difficult for them to resist being deployed on more political missions.
7. ***Establish the Following Priorities for Technical Assistance.***
 - 1) Prepare for special interest pressure for preferential tax treatment that would represent distortions of the tax structure. Successful attacks can be very expensive. The activities to defend against the attacks may not be very effective, but their costs are not high.
 - 2) Schedule the Macroeconomic Unit for long-term development. Success in this area could have a significant positive impact on economic development. The Tax Policy analysis function should be included as part of this unit, as the main expertise required is economic analysis. Policy analysis capability will be essential in warding off special interest corruptions of tax structure.
 - 3) Develop a sound public investment planning and evaluation capability and systems. This is one of USAID's highest priorities. It should be addressed in a broader context than just short-term cost/benefit training for budget analysts. A separate unit may be necessary.
 - 4) Schedule four MOFE units (Budget, Treasury, Tax Administration, Property Tax) for comprehensive institutionalization. All four offer a high probability of success and significant benefits if successful. In Treasury, do not provide assistance for cash management or debt management. Cash management is not an immediate concern, and debt management is usually treated as a separate technical assistance activity. Allow other donors to deal with debt management.
 - 5) Schedule Intergovernmental Fiscal Relations (IGFR) for long-term development. Acceptable work on intergovernmental fiscal relations has been done, so the benefits of success may not be high. Alternatively, IGFR could be one specialized focus of the Policy Analysis unit.
 - 6) Graduate The Ministry of Finance and Economy's Internal Auditing Unit. This would free some USAID resources, and it constitutes a success.
 - 7) Provide a clear statement to MOFE and the advisors on the role that the advisors are to play in MOFE disputes with UNMIK and the SRSG.
 - 8) Prepare a development plan for strategic MOFE management. A plan is needed, but it is not clear that this is a high priority for the Minister.

BANKING AND FINANCIAL SECTOR DEVELOPMENT

The current (fourth) task order builds on the foundation established in the first three. The project as a whole is the subject of this evaluation. The latest TOs objectives might be characterized as a continued strengthening of the financial sector's foundational institutions and policies. Had the first three TOs not been executed effectively, the actions called for in the current TO would have been different. Our judgment is that the first three were effectively implemented, and that those successes made it appropriate in the fourth to focus on earning the confidence of the community in the institutions' durability, efficiency and integrity. Without the work of the current TO the accomplishments of the first three would be in serious jeopardy. Accordingly, considerable emphasis is placed on the current TO.

FINDINGS

With respect to the banking sector alone, the charge repeated in the successive TOs is to advance toward achievement of the IR primarily (though not exclusively) by deepening the institutional development of the Banking Supervision and Licensing Department in BPK. Other parts of the financial sector receive attention as well, but the emphasis for the past year has been (appropriately) on banking supervision and regulation. (Pension and Insurance Companies are the subject of separate sections of this report.) The current TO charges specifically: “---the bank supervision unit shall be further professionalized in a manner which will facilitate Kosovarization of top management positions of the unit; and which will ensure rigorous and transparent oversight of an expanding commercial banking system.”

Progress

Progress Pursuant to Specific Guidance in the Current TO

Promulgation or Implementation of Legislation, Regulations and Policy. The two actions called for in this category were:

- Implementation of a new anti-money laundering law; and
- Legal preparation for establishing a market for BPK securities.

The new anti-money laundering law has not been passed. Moreover when it is, its implementation and enforcement will be undertaken by the UNMIK's Pillar I organization (police.) This benchmark has therefore been overtaken by events. Nevertheless, BPK has issued regulations to the banks advising them of techniques for maintaining vigilance, and requiring immediate reporting when certain potential laundering situations present themselves.

The second item in this category was dropped by mutual agreement of BPK and USAID on the grounds that it is inappropriate at this stage of the financial system's development.

Institutional Development, Reinforcement or Strengthening. Building again on the previous TOs the fourth in the series called for outputs as follows:

- Strengthening the regulatory supervisory capacity of Bank Supervision and Licensing Department of BPK
- Overseeing installation and operation of BPK Accounting System
- Establishing a market and operational guidelines for BPK securities
- Further refinement of the interbank payments and clearance system in BPK
- Institutionalizing a formal training function in BPK
- Establishing BPK as a lender of last resort

Four of the six actions in this category relate to various elements of BPK operations, including Bank Supervision and Licensing, the BPK Accounting System, Interbank Payments and Claims, and Training. The first addressed both routine organization matters (e.g. position descriptions, training plans) and the fundamental issue of making the unit transferable to full Kosovar management and supervision. The routine matters were accomplished, but there is a serious question as to whether the transferability has been accomplished.

In the next three items, institution strengthening actions were called for through installation of a new electronic accounting system, quality control of the payments and claims system and the institutionalization in BPK of a formal training system. The first two of these was accomplished and the third was not, as resources to do so were not available. Nevertheless, several potential sources of financial and technical assistance for institutionalizing the training function are being explored at present.

The final two actions were to have prepared the rules, regulations and procedures for BPK to serve as a lender of last resort, and to establish the institutional architecture for a market in BPK securities. Both activities were dropped as it became evident that they were inappropriate at this stage of Kosovo's development or in the medium-term future.

Specific Implementation Actions or Quantitative Output Targets.

The two quantitative targets were to perform 12 on-site examinations of banks and 7 on-site examinations of micro-finance institutions. All but one of the bank examinations has taken place. It will be done before years end. Eleven micro-finance institutions have been examined so far, thereby surpassing the target. These targets accustom the local staff of BPK to a rigorous, timed schedule of examinations and give them the experience they need to gain confidence, judgment and effectiveness.

Public Information and Education. The current Task Order anticipated support for a major public information and education thrust by BPK. This suggested a major program aimed at bankers, public officials and the general public in the hope that they would gain a solid understanding of the changes occurring in the financial sector, and the improvements the changes could bring to economic efficiency and to the lives of the

members of the community. The BPK has hired a Public Information Officer, but no sharp and focused campaign has been launched.

Progress: The Broad View

The foregoing are valid categories into which to classify all of the actions that USAID has sponsored in the chain of four TOs supporting the overall economic reconstruction program. Thus while the current TO focuses sharply on developing BPK and its sub-units, it must be remembered that the program virtually created the banking and financial sector, institution by institution, law by law, rule by rule, task by task and policy by policy. A too-exclusive focus on the tasks and benchmarks of just one TO would obscure that most important broader vision.

The banking and financial sector program has been broadly successful. With two apparently sound international banks, five locally-owned banks and fifteen micro-finance institutions, all of which have been carefully screened and licensed, there is a developing competitiveness. However, the competitiveness of the system cannot be assured by the BPK and its policies alone. Anti-monopoly legislation is in process now. When promulgated, it will be implemented by the Pillar I (police) administration, not by USAID. Moreover as will be argued, too much competition can be as problematic as too little.

An evolving insurance industry and Kosovo pension funds are potential sources of longer-term finance for productive domestic investment. However, at this stage of Kosovo's reconstruction there does not appear to be a sizable menu of solid long-term productive investment projects seeking financing. Consequently a large proportion of financial resources owned in Kosovo are lodged in external accounts. This is inevitable in a new economy with significant economic, political and social uncertainty. On the positive side, the lodging of savings in safe, liquid international assets will help to rebuild confidence in savings instruments and associated institutions. This in turn should support the development of a culture of saving that will be indispensable as confidence in the longer-term future of Kosovo emerges. A more exhaustive treatment of the progress of the Pension and Insurance funds and companies is presented in separate sections of this report.

The banking and micro finance components of the financial sector appear to be "well regulated" by the Banking Supervision and Licensing Department of BPK. That unit has appropriate and well understood operating procedures, rules and regulations. Its examiners and supervisors have received good training in each of the major technical skill areas. Local employees now head examination teams conducting on-site examinations, as well as the less demanding off-site examinations. All banks and MFI's have been examined at least once in the past year, and all are subject to monthly off-site examinations. There have been no bank failures, and by year-end all banks will be capitalized at or above the internationally recognized Basel standard. Loan loss experience for the system as a whole and for most of its members is at a very low level.

Thus as of this writing, the system appears to be “well regulated” as well as reasonably competitive.

There are indirect indications as well that the banking system is gaining the confidence of the community. For example, it has attracted deposits of almost one-half billion euros. About half of these are time deposits, and so far the aggregate deposit level has remained quite stable. It is still too early to break out the confetti, but up to this point, this young system has progressed along a stable growth path. It is unlikely that there is an example in modern history of an infant banking system in a newly emerging economy that has progressed more rapidly or more soundly than this one in its first three years of life. This is not to say that there is no reason for exceptional vigilance. There is, and the reasons need careful attention to be sure that all that has been built up is not jeopardized. However there is no obvious failing of the USAID program to which concerns should be attributed. The concerns that do exist are discussed below under the “constraints” heading.

Progress: Final Statement

Kosovo has made remarkable progress in just four years, toward the establishment of a “competitive and well regulated financial sector,” (Intermediate Result 2 in USAID’s 2001-2003 Strategy.) This progress is especially noteworthy considering that in 1999 there was essentially no banking system at all, and there were few people with experience in the uses or operation of privately-owned banking or other financial institutions in a market-directed economy.

USAID’s strategy in this sector was right on the mark from the beginning. The initial economic restructuring Task Order correctly identified establishment of a basic banking system (including both commercial banks and a central bank-like entity to regulate and supervise the commercial banks and to anchor the payments mechanism) as the appropriate starting point. The three subsequent task orders added micro-finance institutions, insurance companies and two “tiers” of the three-tier pension system to the array of financial institutions under the supervisory purview of the Kosovo Banking and Payments Authority (BPK).

The importance of the banking and financial sector to broader economic performance cannot be exaggerated. It arises from its three principal functions: providing a fast, economical and reliable payments mechanism, attracting savings and allocating credit to its best uses. None of these can be performed effectively if the system does not enjoy the confidence of the economy’s principal agents in the integrity and transparency of its operations. While we identify some remaining gaps between the system as it is today and an attainable “ideal” system, we believe that the over-all financial sector accomplishments under this program are highly noteworthy and perhaps unique.

Constraints

As suggested above there are constraints that have prevented the program from being an unqualified success. Three particular manifestations of these constraints merit attention. First, while the institutions have been put in place, ready to support an efficient system of payments and of financial intermediation, the economic agents have not yet availed themselves fully of the available financial services. (The table is set, but many guests have not yet appeared.) Second, some observers believe the banks' relatively good scores on ratios usually used to judge portfolio quality may mask problems that could occur in the medium term. Seven banks, with five holding only a little over a quarter of all deposits, might render competition for a small share of all banking business excessive in a small jurisdiction such as Kosovo. Steady vigilance will be in order as the expatriate presence and extraordinary external financial support begin to dwindle. Finally, many senior commercial bankers, many BPK officials and many Kosovar bank regulators themselves doubt that Kosovars are fully ready to take over the management and executive functions of bank regulation and supervision.

The foregoing reflect constraints that get in the way of declaring the program unreservedly to have achieved all of its objectives. Each of them raises questions about the sustainability of the excellent systems that have been put in place. None of them, it should be observed, reflects a failure of USAID's program design, implementation or management. Nevertheless, they carry information that may be significant for the design of future USAID assistance. The main constraints are as follows:

A severe shortage of personnel in Kosovo with the combination of education, experience and background to make sound analytical, managerial and executive decisions without the benefit of all the "facts" that would make decisions easy.

A severe shortage of personnel, with the skills cited above, in the bank regulatory agency. This is due to the related conditions of high turnover and low compensation relative to the private banking sector, as well as a general shortage of such skilled personnel in Kosovo.

Historical-cultural factors related to the history of discriminatory treatment of Albanian-Kosovars with respect to formal education and training as well as to learning-by-experience opportunities in highly-skilled, managerial and executive positions. Historical-cultural factors also contribute to the reluctance of Kosovars to use banks either as custodians of funds or as guardians of the kind of information included in loan applications. Trust cannot be decreed but must be a natural response to sustained experience.

Weak demand by high quality borrowers for funding for long-term productive investment. In Kosovo's circumstances, there is much greater uncertainty than in other available investment environments, about the future political and economic conditions that can influence the expected value of long-term investments. The final status of

Kosovo is one of these uncertainties, but not the only one. This constraint undoubtedly contributes to the limited availability of attractive abodes for domestic or foreign savings in Kosovo.

Kosovo is still substantially a cash economy. Historical experience, concern for privacy, lack of confidence in impersonal institutions, fear of discovery of illegal transactions, and fear of the tax collector may all contribute to Kosovars' disdain for banks. Strong evidence suggests that the constraint is abating, but it is far from dead.

The expected eventual departure of the international community and its thousands of expatriates, and the phasing down of exceptional financial transfers from abroad contribute to uncertainty about the economic future of Kosovo. Will the domestic economy gain strength soon enough to compensate for this phase-down when it occurs? Does the economic boost from the international community include a positive influence that will remain after the expatriates leave? As the currently brisk economy slows or undergoes significant structural change, will all banks be capable of adjusting with sufficient speed and appropriate strategic adjustments? The answers of potential investors to these and other related questions can have a significant influence on pro forma estimates of the value of long-term investments. So far, a surge of private investor confidence in the future is not in evidence.

CONCLUSIONS

Program Strengths

In the view of the evaluation team the strengths of the program far outweigh the weaknesses that have turned up. The following lists the most significant strengths of the program itself (as opposed to its outcomes.)

The decision of USAID to focus its attention on the legal, policy and institutional foundation of a market-directed economy was wise from both a political and an economic perspective.

The meticulous design of the work to be carried out to create a working and workable central bank-like entity and to promote creation of a solid commercial banking presence was well considered. The importance of a regulatory authority and regulation and supervision of the conduct of banks in a private market-directed economy is not always appreciated. Fortunately, in this program it was.

Having given a high early priority to bank supervision and regulation, it was appropriate that the enabling legislation and regulations for the banking system were made highly compatible with free-market, competitive principles.

The program found, or came close to finding, an optimal mix of emphases on perfecting the institutions and their systems on one hand, and meeting the immediate need for a banking system to be up and running.

Program Weaknesses

Lack of capacity of local personnel to take over the managerial and executive level functions of BPK. The need for development of the kind of skills necessary to function at those levels in a market-type economy, may have been underestimated. (These executives need to be able to “get inside the heads” of private bank directors, for example, to anticipate the strategic direction in which they may be heading, and to analyze the implications for the future. In this fledgling economy, it is not sufficient to know what to do about a failed bank. It is essential to prevent each bank from getting into a situation in which the outcome is failure, most particularly in the system’s infancy.)

Lack of Kosovar appreciation of, and appropriation of, the conceptual foundation of the design of the systems, institutions and policies that have been put in place. These are the systems of mature, internationally competitive, market-directed economies. Many of their strictures are counter-intuitive (e.g. to strengthen the domestic banking system, welcome foreign competitors; welcome foreign investors and treat them as well as local investors.) Even in the mature industrial economies constant vigilance is necessary to prevent anti-free-market changes in laws and regulations in favor of particular interests. The risk of reversion to more self-interested policies, rules and regulations is greater because of unfamiliarity with and modest local "buy-in" to the private market system.

Coordination of Assistance

Coordination of assistance in Kosovo has had positive and negative elements. At the technical economic level, the expertise has been concentrated in USAID, the IMF and to a lesser extent the World Bank. Coordination among the three appears to have been exceptionally good. The IMF officials with responsibility for Kosovo both in Washington and in-country, and the World Bank’s Country Manager in the field have the highest praise for USAID’s work and for the collaborative and collegial posture USAID has maintained with others working in the sector. We believe this is because the three are experienced interlocutors who are deep in expertise (either in-house or through contractors), that they are in considerable agreement on the appropriate paradigm for Kosovo, and are skilled in getting the work of economic restructuring done.

Due to the unusual political situation in Kosovo coordination at a more political level is also important. In this realm it appears that the dialogue among the extraordinary variety of entities, and hence coordination, is somewhat less harmonious. It appears that the top two levels of authority over economic restructuring actions---the UN and the EU---are not the levels that are able to deliver promptly, the high-level of expertise required for economic institution building and for hands-on operation of the institutions. Moreover, since the election of a Kosovar government (PISG) (albeit with limited independent power) there is a third center of authority, which seems to have moments of tension with the UN/EU authorities. Under the circumstances, when there is a conflict of opinions, the receptivity of each group to the views of one or more of the others can be tepid or worse. The tension appears to have impeded the implementation of some components of the economic program, such as the comprehensive income tax and privatization.

Nevertheless, governance authority over the banking and financial sector remains unambiguously in the hands of the UN authorities at this time.

Issues and Sustainability

The mechanics of institutional development in the banking and financial sector have been well crafted for the present stage of Kosovo's economic development, and for some time into the future. Nevertheless, we are convinced that sustainability is the most important concern about the sector. Whether the framework that has been put in place can be sustained depends on the issues below.

Implications of the transition from an international donor-impelled economy to one that is dependent on its own mobilization of economic activity. The economy and many of its agents are relatively ebullient at present. Ideally the timing and pattern of withdrawal of extraordinary external inflows will match the ability of the domestic economy to replace them without major dislocations. There is no assurance however that the transition will be that smooth. If there is initially an economic downturn of significance, then the quality of loan portfolios that are excellent today can be poor tomorrow. Especially in banking supervision and regulation, it is essential for top executives to be able to anticipate such changes in direction and to devise strategies to deal with them.

Finding the optimal number and size of banks. The present banking structure features two relatively large international banks and five small local banks. In the present circumstances the system as a whole appears adequately capitalized and loan-loss experience is good. What happens when the explosive expansion of the past four years is over? One possibility is that the current size structure will be found unsustainable. Planning for such a plausible eventuality should already be underway, but there is no evidence that it is. This is highly specialized work that falls under the heading of "bank market structure and competition." USAID has experience in this specialty. It could be the subject of significant assistance to BPK.

Final status. Many aspects of international banking and finance involve issues of sovereignty, including settlements among central banks, sovereign debt and credit card operations. An early determination of Kosovo's status would remove a significant element of uncertainty to potential investors.

RECOMMENDATIONS

1. Provide for One Year of Continued Expatriate Guidance and Direction for the Banking Supervision and Licensing Department of BPK. This department is the single most important institutional component for imposing rigorous prudential management of the banks' lending practices. It has been brought close to the stage of readiness for full managerial and executive control by the senior Kosovo officials, but is not quite there yet. An additional year of expatriate expertise, if supplemented by appropriate preparation of the relevant Kosovar executives to manage, can probably suffice. It seems

plausible that a single individual could serve the same purpose for both banking and insurance, and possibly for the Tier Two and Three pension funds. Significant additional institution building activities---aside from senior managerial level and analytical training and data gathering and analysis--- are no longer high priorities for scarce donor funds. While there is room for improvements in BPK, most of them are within the reach of Kosovars to identify and implement.

2. Identify a Means of Providing Training for High-Level Financial Officers to Acquire the Analytical Decision Making Capacity to Become Effective Managers; Examine Means of Establishing Premium Compensation and Reducing Turnover. BPK is not the only local institution in need of such training. However, it might help BPK to add to its prestige, and might add to the prestige of the training, to institutionalize the training in something like The BPK Financial Officers Academy. Association with the academy might also be an appropriate part of the assignment of an expatriate expert in the Banking Supervision and Licensing Department, as that Department's management devolves increasingly to Kosovars. The Ministry of Finance and Economy and various other elements of both the government and the private sector should be rich sources of candidates for such high level training. A premium pay scheme for graduates should be explored as a means of attracting exceptional personnel and reducing turnover in their ranks.

3. Develop an Elite Statistical Gathering and Analysis Institutional Capability in BPK. A severe lack of quality data is a major problem in Kosovo. BPK should be one of the principal users of the output of such an institution. While BPK is not necessarily the only rational location for such a unit the current lack of a large volume of high quality statistics adversely affects all institutions concerned with micro and macro economic analysis. BPK would be a logical locus for a high-level economic analysis function.

4. Focus Future Training (i.e., for the Next Five Years) in the Banking Supervision and Regulation Area, on Banking Systems in Jurisdictions with Maximum Comparability to Kosovo. As one observer has put it, "there's nothing to be gained by sending bank examiners to New York to learn about derivatives." Of course that is an extreme example, but is a useful caricature of the kind of training not needed in the near future in Kosovo. The real challenge in Kosovo is valuing exceptionally simple financial instruments. The data are not available to rely exclusively on objective "facts" so subjective judgements play a major role along with careful and skilled analysis.

PENSION REFORM

FINDINGS

The overall impact of USAID technical assistance to the pension reform in Kosovo has been profound and very positive. The Kosovo pension system is essentially a USAID creation. It is well designed, draws on a “best practices” model that is appropriate for the current economic environment in Kosovo, has a well-developed legal and regulatory framework, and has thus far been implemented satisfactorily in a very short time. The simplicity of the tier one basic pension and the tier two contribution rules increases the likelihood that Kosovo will be able to maintain and sustain the system. Nevertheless, implementation and operation of the pension system makes demands on the human capacities of Kosovo that are currently beyond its ability to meet. For this reason, expert advisory assistance will be required for an additional period in the future, and training should be enhanced for local personnel at all levels. It is also important to increase efforts to educate the public about responsibilities and opportunities provided by the new pension system.

Progress

The design and implementation of a comprehensive, modern pension system for Kosovo is an outstanding achievement of the USAID technical assistance program. From 1999 through 2001 there was no pension system for Kosovar Albanians. UNMIK faced strong political and economic pressure to establish a pension system. Reintroduction of the old FRY system was not a viable solution for both administrative and equity reasons. Records from the previous system were incomplete, many having been lost or destroyed. Through the 1990’s, most Albanian Kosovars did not have jobs covered by the pension system and did not qualify for adequate pensions.

USAID technical assistance advisors adopted a model with widely accepted features that had been supported elsewhere by USAID and other international donors. A three-tier system was designed. The first tier is a modest, indexed, flat benefit (for 2003, 35 euros, the estimated cost of a basic food basket for one person) payable to every registered resident age 65 or older. The benefit is financed from general government revenues. The second tier is a mandatory defined contribution that funds an individual account, the proceeds of which will be used to purchase an annuity at age 65 or will be available to the contributor’s dependents if he/she dies before age 65. The third tier establishes a legal and regulatory framework for voluntary supplementary employer or individually provided pensions.

A comprehensive pension law (Regulation No. 2001/35, “On Pensions in Kosovo”) was drafted and promulgated in December 2001. Payment of the first tier basic benefit began in July 2002. The basic benefit system is administered by the Pension Administration of the Ministry of Labor and Social Welfare. A USAID advisor to the Ministry played a substantial role in the establishment and implementation of the system. Payment is made through commercial banks. Everyone registering for the basic pension is given a bank

account. Coverage is close to 100 percent. In October 2003, of about 109,000 persons registered, about 107,000 pensions were paid. All ethnic groups participate in the system and registration of minority groups has been widespread. (In October 2003 Serbs, Roma, and other non-Albanian Kosovars represented almost 18 percent of active registered pensioners, a greater proportion than in the population as a whole. This reflects the age structure of the Serbian and minority populations of Kosovo.)

Tier two is being implemented in two stages. In the first stage, collection of mandatory payroll tax contributions from government agencies and Socially Owned Enterprises (SOEs) began in August 2002. A contribution of five percent of the worker's gross wage is paid monthly by the employer, and five percent is paid by the employee, withheld by the employer. Aggregate contributions are deposited in a commercial bank, which transfers them to the Pension Trust account at the BPK. After some start-up delays and confusion, compliance was reported to be high. The second stage, which began in August 2003, requires all employees and the self-employed to contribute – five percent each for the employee and the employer and ten percent for the self-employed. Information on compliance in the second was not available in October 2003.

The Kosovo Pension Savings Trust (KPST) was established as an independent not-for-profit organization to set up and maintain contribution accounts, process contribution and account information, and supervise investment of the funds collected. KPST was essentially established by USAID advisors. During the period after the pension law was promulgated, USAID advisors developed a staffing plan, hired staff, made presentations to the public explaining the new system, and set up the collection mechanisms. A USAID advisor served as acting director until the Director was hired in March 2003. The KPST has a staff of 21, plus two USAID advisors. A Board of Governors of the KPST sets investment policy, hired two international investment management firms, and hired the Director. The Board is currently comprised of four international experts and two local representatives of workers and employers, respectively, and an *ex officio* member, who is an expatriate.

The Pension Trust had collected about 26 million Euros through August 2003. Except for small balances held in the BPK, almost the entire amount is held in a short-term money market fund administered by ABM AMRO, a Netherlands financial services firm.

The tier three legal and regulatory framework for voluntary employer and individual pension plans is implemented through the Department of Pension Supervision at the BPK. The Department has a Director and staff of two. It has licensed six pension plans, four in Socially Owned Enterprises (SOEs), and one each for the Micro Enterprise Bank and the BPK.

Several have attempted to provide pensions to their workers and retirees, similar to those provided under the former system, without adequate funding. These pensions are often arbitrary, uneven, and unsustainable. The third tier regulations require that these pensions meet the new standards for funding and eligibility.

Constraints

Delays in reconciling tier two contribution data and sending statements. KPST and the Tax Administration have had problems and delays in reconciling pension contribution information. Delay resulted because the Tax Administration relies on voluntary filing of a form by workers, many of which have not been filed. Furthermore, the IT system contracted for by KPST in August 2002, to be delivered in March 2003, was not operational in October 2003. As a result, statements to contributors could not have been sent even if they had been reconciled. The expectation is that the statements will be sent nine months after end of the contribution period to be reported. (The current law calls for statements to be sent 45 days after the end of the reporting period. This is generally acknowledged to be unrealistic.) It is vital that contributors have confidence in the new pension system, which is not well understood by the public. Support of contributors is crucial for the long-run maintenance of independence of the KPST. Receipt of a statement verifying that the contributor has an account with funds that belong to him or her is considered to be key to building confidence and support. The Pension Supervision Department at BPK and the Board of Governors of KPST have expressed concern about the delay.

An overarching constraint is the weakness of the IT and data processing capabilities of KPST. The IT system is new and may become more robust as staff gain experience in its use. However, it may be difficult to retain good IT staff because of limitations on the compensation they are offered in public and quasi-public agencies, relative to that of the private sector.

Limited capability of the pension supervision staff of BPK. The staff of the Pension Supervision Department has a director and staff of only two. This compares with a staff of 13 in the Insurance Supervision Department. It is not obvious that the responsibilities of the two departments differ to that degree. The evaluation team was told that staff personnel have little knowledge of pensions operations, investments, accounting, or management. The BPK pension department provides little oversight or assistance to KPST.

CONCLUSIONS

The pension reform program can be judged a major success. Appropriate laws and regulations have been developed, promulgated by the SRSG, and endorsed by the Parliament. The required first tier benefit payment institutions and second tier contribution collection and investment management institutions have been established. Starting from scratch, all three tiers began operations within eight months of promulgation of the basic regulation. A Director and staff of the KPST have been hired and are being trained. A qualified Board of Governors of KPST has been appointed and has developed investment management policies and hired management firms. The benchmarks on the whole have been met.

Program Strengths

A major strength is that the USAID advisors involved in the pension design, legal development, and implementation at both the KPST and the Ministry of Labor and Social Welfare appear to have been capable, providing expertise encompassing policy, law, organization, and information technology. The international experts on the KPST Board of Governors are highly qualified. The investment policy is well considered.

Tier one and tier two appear to be working well, with the exception of the tier two reconciliation process. Use of the commercial banking system for tier one benefit payment and for tier two collections is reported to be working well. This widespread use of the commercial banking system by both employers and pension benefit recipients, many of whom did not previously have bank accounts, should serve to increase confidence in and use of the banking system.

A key strength of the pension system is its simplicity. Both tier one and tier two require a minimal administrative apparatus, especially at the local level where administrative capability is weakest. By paying a flat, universal benefit through the banking system, the tier one basic pension avoided the necessity of developing mechanisms and offices to determine eligibility and deliver benefit payments. The tax administration collects payroll tax contributions through the banking system, piggybacking on the wage tax, requiring no additional collection and enforcement system (although the KPST does have an employer relations department that has some enforcement functions).

Program Weaknesses

Information technology and reconciliation problems have delayed delivery of contribution account statements to participants in the tier two defined contribution system. Statements may be delivered nine months after the end of the March 2003 reporting period. The KPST IT system was not operational as of October 2003, but testing was scheduled to begin at that time. It is important for participants to receive statements in a timely fashion, especially during the first years of the new system.

Limited capacity of the pension regulatory department of the BPK. The capacity of the pension department appears to be limited to checking eligibility of individual beneficiaries of the existing tier three pension plans and relatively straightforward violations of rules. Financial, accounting, and investment assessment capabilities appear to be very limited. The BPK regulatory office does not play an important role in assisting the KPST at this time.

Coordination of Assistance

No other donors are actively involved in pension reform in Kosovo. Consequently, there has been little or no coordination of assistance. Resources are limited and the USAID budget is becoming increasingly constrained. The mission and the Kosovo counterparts

may wish to consider seeking additional assistance from other sources, especially in the areas of training and public education.

Issues and Sustainability

Human capacity. A major issue concerning sustainability is the capacity of local personnel to operate and maintain the systems that are being created. Information technology, organization, and management requirements are considerable and may exceed the human capacity that currently exists. It appears that KPST will require two full time international advisors for at least one more year, particularly to oversee the expansion of the contribution collection universe to include all employers and the self-employed, and to test and implement the information and data processing system. KPST appears to be developing capable staff that will sustain the organization, after an additional period of training and experience. This will require more formal and informal training.

The personnel at the BPK pension department also lack the capacities to fully supervise and advise the pension plans they have licensed and the KPST. The USAID mission and BPK management may want to examine the needs of the pension department, both for more local staff and for additional advisory assistance. More formal training of local staff will be required.

Public education. Public understanding and support is vital for the successful operation of the pension system and its sustainability. Public education regarding both the tier one basic pension and the tier two mandatory contribution pension should be expanded. A comprehensive public education and public relations campaign should be developed.

Political sustainability. Perhaps the greatest vulnerability of the new pension system in the long-run is the political sustainability of its basic design and features, in particular the independence of the KPST from the government and the independence and prudence standards of its investment policies. It has been reported to the evaluation team that most Kosovar politicians believe that the KPST should be under the control of the Kosovo government and that the assets of the pension trust should be invested in Kosovo. Both the Minister of Economy and Finance and the Minister of Labor and Social Welfare expressed these views to the evaluation team. Ultimately, full control of Kosovar institutions, including the KPST, will be transferred to Kosovar hands. If the KPST is to remain independent of political influence on its policies, and if the assets are to continue to be invested prudently and exclusively for the benefit of the contributors, it must foster strong political support for its independence from the participants – contributors who own the assets entrusted to the pension trust. For this reason, timely and clear reporting, as well as comprehensive public education are vital. It is also vital, for this reason, for the fund assets to show a positive return during the early years of its existence.

RECOMMENDATIONS

1. Attention should be focused on implementation and improvement of the information technology capabilities of the KPST and the information flow and reconciliation between the Tax Administration, the Central Processing Center, and the KPST.
2. Clear and understandable account statements should be delivered to contributors to the tier two pension fund in a timely manner.
3. Public education concerning both tier one basic pension and tier two pension accounts should be increased
4. Training of KPST and BPK pension department staff should be increased. Both formal and informal training at all staff levels should be increased. The mission may wish to investigate the many training resources and opportunities available from other donors and sources, including the World Bank, pension plan advisory firms in advanced market economies, and financial services firms in advanced economies.
5. Continue two permanent full-time advisors for an additional year, while stage two of the tier two plan is being implemented and the IT system is being brought on line. The mission should investigate the appropriate type and level of advisory support required to enhance the capabilities of the pension supervisory staff at BPK. Merger of the Pension and Insurance units should be considered.
6. Senior mission personnel and the Director of the KPST should take every opportunity to communicate to the public and especially to KPST officialdom, and to political leaders, the philosophy, purposes and economics of the pension system, in particular the need for independence of the KPST and prudent management of the assets of the trust for the benefit of the contributors
7. The mission, and others in the donor community, should support planning for the eventual facilitation of prudent investment of part of the assets of the KPST in Kosovo. Investment of part of the assets of the trust in Kosovo may alleviate political pressure for more government control of KPST and could provide much needed capital for sound local investment. (One approach might be to explore qualified IFIs the possibility of supporting establishment of a Kosovo development bank whose securities could be guaranteed by an international financial institution and whose investments could benefit from the technical assistance and oversight that could be provided by the guarantor institution.)

INSURANCE SECTOR DEVELOPMENT

FINDINGS

Progress

Considerable progress has been made in promoting the development of a private insurance sector in Kosovo. There were no insurance companies in 2000 and no legal or regulatory basis for an insurance sector. Institution building concentrated on establishment of a legal and regulatory framework for private insurance companies, development of regulatory institutions, strengthening the private insurance sector, and establishment of an insurance industry association.

Promulgation and Implementation of Legislation, Regulations, Rules and Policies. A legal framework, developed with significant input from a USAID advisor, was adopted in October 2001 (Regulation No. 2001/25, “On Licensing, Supervision and Regulation of Insurance Companies and Insurance Intermediaries”). Implementing rules were promulgated by the Banking and Payments Authority of Kosovo (BPK) in March and April 2002. Rules have been reviewed, amended, and augmented in 2002 and 2003.

Institutional Development, Reinforcement or Strengthening. The insurance regulation mandates the BPK to license and regulate insurance companies. A Department of Insurance Supervision and Licensing was established at BPK. The department currently has a Kosovar director and staff of 13. It actively conducts on-site examinations and audits and off-site analysis of existing Kosovo insurance companies. One company has been put in receivership.

Currently eight insurance companies are licensed to write automobile third party liability (TPL) insurance, which is mandatory in Kosovo. Two of the companies are Kosovo branches of Serbian companies, which primarily write automobile liability insurance in Serbian enclave areas. In 2001 about 180,000 TPL policies were sold (by four companies), and in 2002 about 175,000 policies were sold (by seven companies). Premiums in 2001 were about 31 million Euros, and in 2002 premiums were about 27 million Euros. Through August 2003, 136,200 policies had been sold, of which 98 percent were TPL or TPL Plus policies.

An Insurance Association of Kosovo (IAK) has been established and began operating effectively in March 2003. It has the active participation of all Kosovo companies, including the Serbian-owned companies. The active participation of the Serbian companies in the Kosovo association is considered a major achievement. The association has expanded to form a regional association with insurance companies in Albania. Under the auspices of the IAK an Insurance Institute has been organized, which is developing and conducting training programs for members’ employees. Members also participate in programs offered by the Malta International Banking and Insurance Center. The IAK also carries out programs of public education concerning insurance and has established a complaint system for policyholders and an arbitration panel for claims disputes.

Capacity Building. Diversification of products. BPK rules require licensed insurance companies to diversify the classes of insurance they offer by specifying that no more than 75 percent of premium revenue of any company be from any single class of insurance. BPK is moving to enforce this rule in 2003. Six additional classes of insurance other than automobile TPL have been licensed for three companies, and four of the six classes for three other companies. (Task order benchmarks call for 11 new classes by September 2003.) Through August 2003 only two percent of premiums and 4.5 percent of total premium revenue were from classes other than TPL. Two applications for life insurance have been submitted to BPK, but no life insurance provider has been licensed. Development of life insurance is important for the pension reform as well as insurance reform. The pension law requires that all distributions from the tier two mandatory accounts be done in the form of annuities sold by a life insurance company licensed by the BPK. (It will be about nine years before significant numbers of retirement benefits are paid from the tier two funds.)

Training. BPK, with USAID assistance, provides numerous training programs and opportunities for the director and staff of the Insurance Supervision and Licensing Department, concerning insurance principles, rules and regulations, compliance, audit and inspections, accounting, claims activity, and other aspects of insurance. The regional Insurance Institute sponsors training programs provided by the Malta International Banking and Insurance Training Center and the Financial Volunteer Services Corporation.

Other initiatives. A Kosovo Reinsurance company has been approved by the BPK. A Guarantee Fund to protect the Kosovo population against uninsured motorists has been established by the BPK. A common administrative system and an on-line communication platform, linking private insurance companies branch offices, BPK, the IAK, police departments, vehicle registration centers, the Ministry of Public Services, the Department of Justice, the Ministry of Transportation and Communication, and the Center for Technical Services, are being developed. The on-line communication platform will help reduce a significant problem of fraud in sales of automobile liability policies. BPK has established Memoranda of Understanding (MOU) with Albania and with Macedonia to provide automobile liability border insurance, which permits motorists to drive between Kosovo and these two countries without needing to purchase additional insurance for each country. Discussions are ongoing with Serbia and Montenegro, Bosnia, Croatia, Bulgaria, and Turkey to establish similar MOU.

Constraints

Limited capability of the insurance supervision staff of BPK. Before 2002, Kosovo offered no educational programs or formal training in insurance or actuarial science, and very little training in accounting, business management, finance, or other skills required to develop and supervise insurance products. There was no experience or familiarity with insurance. Albanian-Kosovars had little management experience in government or business during the decade before 1999. There is limited expertise in information

technology. The University of Pristina has begun to offer a course in the economics of insurance, and the new American University offers basic business courses. It will take time to convey these important and complex skills and, perhaps more importantly, for people to gain experience and judgment in how to apply them.

Limited and rudimentary financial markets and institutions. The very limited financial instruments available in Kosovo severely limit the ability of Kosovo insurance companies to invest domestically. There are no domestic government or corporate bonds and no publicly traded stocks. Insurance companies are permitted to hold 100 percent of their investments in the BPK, but no more than 10 percent in any single commercial bank, and no more than 30 percent in all commercial banks. Companies may hold 100 percent of their assets in approved non-Kosovo government bonds.

CONCLUSIONS

Achievements

The USAID insurance sector technical assistance has been appropriate and successful. About 80 percent of the task order benchmarks have been completed as of October 2003. Major achievements are development of an adequate legal and regulatory framework and set of institutions, licensing of eight insurance companies, including two Serbian companies, development of an active market for one class of insurance, establishment of an insurance industry association, and provision of training courses to the regulatory staff and to insurance industry participants through the industry association. All required legal and regulatory mechanisms for a viable insurance industry are in place. Local, private sector participants, including Serbian companies, were reported to be participating enthusiastically in the association and in development of insurance market institutions. Significant capacity, particularly human capacity, remains to be developed.

Program Strengths

The USAID advisors are highly professional, experienced both in insurance institutions and regulation and in providing technical assistance and are pro-active. They appear to work well with their Kosovar counterparts. Good communication, coordination and cooperation among advisors in numerous areas (e.g. insurance, pensions, BPK examiners) that must interact with one another has facilitated the development of mutually beneficial working relationships and cooperation.

A sound legal and regulatory framework has been established. Establishment of the Insurance Supervision and Licensing Department within the BPK is likely to enhance the ability to maintain its independence. The BPK is a reserved power and has considerable independence at present.

Program Weaknesses

The greatest constraint to the successful development of a viable insurance sector in Kosovo is the lack of human capacity to operate, regulate, and enhance the insurance sector without the active participation of international advisors. Training programs and on-the-job experience address this need. It was reported to the evaluation team that there is a lack of training materials and books on topics related to insurance. There is no insurance library at the BPK. It is unlikely that there is a sufficiently complete range of books and material concerning insurance in the Albanian language. There is considerable literature and material available in Serbo-Croatian and in English. At relatively low cost, such materials could be provided to BPK and to the Insurance Association of Kosovo and made available to the public. It would not be unreasonable to expect the private insurance association to bear the cost.

Coordination of Assistance

No other donors are actively involved in insurance reform in Kosovo. The World Bank has shown some interest, releasing a Technical Assistance Identification Paper in March 2003, but has provided very little input of resources or technical assistance. Consequently, there has been little or no coordination of assistance specifically to the insurance industry.

Issues and Sustainability

Political and Insurance Sector Support. It was reported to the evaluation team that there is considerable political support and support from insurance companies for the reforms and institutions created. It is recognized that the objective of the reforms is to enhance the marketability of insurance and the viability of the insurance sector. Companies are reported to be willing to maintain and finance the insurance association and institutions being created.

RECOMMENDATIONS

1. Provide One Additional Year (in multiple short-term visits possibly) of Expatriate Guidance for the Insurance Supervision and Licensing Department of BPK. Impressive progress has been made in development of the insurance sector and the Insurance Supervision and Licensing Department of BPK in the two years since Regulation 2001/25 was promulgated. Nevertheless, it is clear that a significant advisory presence will be required for an additional year. The director of the Insurance Supervision and Licensing Department has been in office only since April 2003. While six new classes of insurance have been approved, the number of policies sold in the first eight months of 2003 is relatively small. USAID should set as a goal preparing the insurance sector and the staff of the BPK Insurance Supervision and Licensing Department to operate with limited advisory input after CY2004. Merger of the pension and insurance units of BPK should be given support by USAID. It would not be unreasonable for the industry itself to take over responsibility for financing such assistance after the end of the work of the current TO.

2. Continue to provide intensive formal training and on-the-job training. Training and experience are key to the sustainability of the Kosovo insurance sector. USAID and BPK should continue to avail themselves of all training opportunities, including training offered by the resident advisor, programs provided by the Malta International Banking and Insurance Training Center and the Financial Volunteer Services Corporation, and training provided by other local and international experts. An insurance library at the BPK and at the IAK should be established and provided with adequate books and materials provided with insurance industry funding.

3. USAID should consider sending a qualified individual for actuarial training (abroad if necessary). The objective of the training should be a level of proficiency equivalent to an Associate of the Society of Actuaries (ASA). This level of competence would ordinarily require about two years of full-time study for an individual with a bachelors degree in mathematics. The individual should be committed to remain in (or return to) Kosovo to establish and head a government actuarial department and to train other Kosovar actuaries. Skills in actuarial science will be required to establish and evaluate viable life insurance products, as well as other insurance products, defined benefit pension schemes, and annuities. The government actuarial department would serve the needs of several agencies other than the Insurance Supervision and Licensing Department, including the BPK Department of Pension Supervision, the Kosovo Pension Savings Trust, and private insurance companies. The BPK would be an appropriate place for the government actuarial department to be located, but this would not be necessary. The actuarial department should maintain international standards and be protected from political or other outside influence.

COMMERCIAL LAW

USAID assistance in Commercial Law seeks to develop and implement the legal regime required to support a market-oriented economy.

FINDINGS

The Commercial Law activity, which includes drafting of commercial legislation, provides assistance to the Office of Legal Services Support (OLSS) in the Office of the Prime Minister and support to the Assembly to facilitate enactment of commercial legislation.

Progress

Impressive achievements have been made in the development of a commercial legal regime that effectively establishes and protects property, contract, and investor rights. The following discussion focuses on the implementation and institutionalization of the legal regime.

Promulgation or Implementation of Legislation, Regulations or Policies-Commercial Law Framework. The main categories of laws addressed are: property rights registry law, the law on mortgages, bankruptcy law, law against restraints on competition, the external trade law, law on administrative procedures, law on geology and mining, copyright and trademark law, and procurement law. Establishment of a pledge filing office and the transformation of the right to use socially owned immovable property were the subject of legislation and regulation, respectively, and are also addressed.

The property rights registry law was promulgated by SRSG and supplemented by additional legislation addressing minority rights. A final draft of administrative guidelines for implementing the law is complete and has been submitted to the Government for approval. It contains instructions on how to establish the immovable property rights registry in all municipal cadastre offices. The Kosovo Cadastre Agency will carry out implementation, and the Commercial Law Team (CLT) will help with training.

An implementation plan for the new property rights registry has been developed; a pilot program will be established in two municipalities in December 2003. This system will serve as the mechanism for the registration of mortgages and the transfer of land ownership. It will also be linked to the already established and functioning property tax database. The implementation of the program in all 23 municipalities might be delayed due to concerns about the supplemental legislation required by SRSG.

The Law on Mortgages was drafted by the CLT and promulgated by SRSG. Its foreclosure process provides for extra-judicial enforcement, which was deemed appropriate, taking into account the current court system in Kosovo.

A comprehensive Bankruptcy Law was adopted by the Assembly in March and promulgated by SRSG without change in April. Implementation instructions were adopted in June. The CLT is currently preparing five modules to provide training support for the effective implementation of the new law by judges, trustees, and lawyers.

The Law against Restraints on Competition has been drafted by CLT and, after review by the Ministry of Trade and Industry, will be approved by the Government and transmitted to the Assembly. The law and the implementing instructions and procedures define and limit the market intervention role of the Government and disallow exclusive licensing, except under limited circumstances. The competition law facilitates the entry of firms, existing or potential, into existing markets. It promotes the creation of a competitive environment through enforcement actions to reduce the abuse of market power by dominant (or noncompetitive) firms. It provides for the establishment of the Kosovo Competition Commission to ensure that dominant enterprises do not abuse their positions.

The External Trade Law was also drafted by CLT. The draft was EU-consistent and ensured that administrative measures directed at regulating cross-border trade in goods would not be discriminatory or unduly restrictive. The Assembly adopted an amended version, and the new law was promulgated by SRSG in May. This law is consistent with international best practices and the requirements of WTO and EU. It sets out rules and regulations affecting trade and commerce between Kosovo and other areas. The law contemplates detailed implementing instructions in a broad range of areas, including export and import licenses and lists, sanitary requirements, product standards, antidumping duties, countervailing duties, and protection of intellectual property. CLT expects that the administrative instruction on sanitary measures will be adopted by the Government before March 2004.

Legislation on Administrative Procedures is in the drafting process. In order for the legislation to be EU compatible, USAID advisors in OLSS will take the lead in developing a Law on Sub-Normative Acts that will regulate the process of rule-making; and EAR advisors will take the lead on drafting the law on administrative adjudication.

A Law on Geology and Mining has been drafted and is under review at the Ministry of Trade and Industry. The CLT is working with UNMIK and the PISG to ensure that the draft law promotes transparency, competition, and compliance with EU legislation.

The first draft of the Copyright Law is near completion and is expected to be submitted to Government by 31 October. The Trademark Law is under development and is expected to be submitted to the Government by 30 November.

Laws for a securities market were correctly considered premature, given the current stage of economic development in Kosovo, and were deleted from the present benchmarks.

The CTL has worked on other laws that were not included in the original benchmarks but were later determined to be priorities by USAID, i.e., laws on public management and

accountability, the property tax, the comprehensive personal income tax, and tax administration and procedures.

A comprehensive Procurement Law was passed by the Assembly and is currently before SRSG. The CTL is working together with the Kosovo Institute for Public Administration to provide training to a core group of procurement experts.

The Pledge Filing Office is fully institutionalized as a separate and self-sustainable administrative unit. There are several thousand pledges filed with the office. The Municipal Court of Pristina has more than 20 claims on pledges filed with it.

The Regulation on the Transformation of the Right to Use Socially Owned Immovable Property was developed jointly by USAID consultants and UNMIK with input by PISG. This regulation transforms into a leasehold any right to use property registered in the name of a socially-owned enterprise. Implementing procedures have been adopted.

Institutional Development, Reinforcement or Strengthening-Training. USAID has provided assistance to the Prime Minister's Office through a commercial law unit, the CLT, since March 2002. The unit has become a vital part of the Office of Legal Support Services (OLSS), the Government lawyers responsible for the final drafts of all Government laws. Technical assistance has been provided to the Assembly of Kosovo, through a commercial law unit since May 2002. This unit has provided legislative assistance to the chairpersons, members, and staff of the four Committees in the Assembly (Budget Committee, Committee on Trade and Industry, Committee on Finance and Economy, and Committee on Transport and Telecommunications).

USAID identified a need to provide general, background training on corporations, contracts, property, investments, and trade before providing training about the new laws regulating these areas. Follow-on law-related training programs, designed to provide lawyers and judges with an understanding of the rationale behind and the content of the new commercial law framework, were then given.

Explanations of (commentaries) and teaching materials on the following regulations and laws have been developed and used in training for judges, attorneys, bankers, students and others: the Regulation on Business Organization, the Regulation on the Sales of Goods, the Pledge Regulation, the Foreign Investment Regulation, and the Mortgage Law. The commentary on External Trade Law is under preparation.

To provide the training, seminars were held in the main cities of Kosovo. At least nine seminars were given: five seminars on business organizations and the business registry and four seminars on the regulation of the sale of goods. Over 200 judges, lawyers, bankers, and business people received training.

In addition to the seminars, a course on foreign investment regulation was presented to attendees of the University of Pristina summer school in 2002 and to law and business students from February to May 2003. Based on a Memorandum of Understanding

between USAID and the University of Pristina, commercial law-related programs in the Law and Business Faculties have become a permanent and official component of the educational curricula.

The following items are still being prepared:

- The Law on Sub-Normative Acts (a part of the legal regime for the administrative process);
- The Copyright Law and Trademark Law (near completion);
- Implementing instructions for the External Trade Law; and
- Training materials in the area of bankruptcy.

Constraints

As discussed above, great progress has been made in the enactment of a commercial law regime. However, implementation and enforcement of this regime are critical for realizing economic growth. There are, as explained below, a number of constraints upon implementation and enforcement.

The Role of Government Agencies in Implementation of Law. Government agencies will play an important role in implementation and enforcement. The new laws in administrative procedures will ensure that public authorities (ministries and agencies) are required to exercise their authority in a manner that is increasingly transparent, nondiscriminatory, and narrowly consistent with the legislation.

Insufficient Knowledge of Business Practices and Concepts. Judges lack an adequate understanding of such matters as finance and valuation principles. They will not be able to apply legal standards to factual circumstances of the cases before them if they lack an understanding of relevant business practices and concepts. The World Bank is currently providing training to judges in this area.

Insufficient Knowledge of Laws. Judges, lawyers, and business persons lack knowledge and understanding of the legal regime. There is a need for materials and training that will supply required levels of knowledge and understanding of the new laws.

Public Access to Justice. A large gap exists between institutional reform and public access to justice. An overarching theme that emerges from this assessment is that the public needs to be aware of and benefit from the new legislation.

Unclear Division between UNMIK and PISG. Division between UNMIK and PISG under the Constitutional Framework lacks clarity in some areas, and this has been a detriment to the CLT's efforts. Final authority in interpreting the Framework rests with SRSG. Chapter 5 and 8 of the Framework deal with reserved and transferred powers. OLA interpretations suggest that any area that is not specifically transferred is reserved. Differences are gradually being resolved; continuing good faith will be required to resolve outstanding issues and to expedite the passing of new legislation.

The Risk of Corruption. Judges we met do not believe that corruption within the judiciary is a major problem. Nevertheless, existing conditions, such as low salaries and limited judicial administration, leave the possibility open. Corrupt practices, if allowed to develop, would threaten Kosovo's economic growth.

CONCLUSIONS

Strengths

Assistance to the Assembly. The Assembly operates with transparency and openness. Assembly members have been trained to develop, analyze, and review laws as well as to research laws and related areas.

Capacity Building. USAID advisors have worked closely with their counterparts at the PM's Office and the Assembly to train lawyers on how to review and amend the laws. It has been a hands-on approach by actively involving the locals in the work and showing step by step how laws are drafted. Members of the Assembly have been trained to analyze, research, and review laws.

Establishment of a Commercial Law Regime. USAID advisors have drafted over 30 laws and regulations to assist in establishing a commercial law regime that effectively establishes and protects property, contract, and investor rights.

Weaknesses

Implementation. A gap between legality and reality characterizes much of Kosovo's legal framework. Hundreds of new laws and regulations have been promulgated, but implementation and compliance are still poor. In some cases, the judges do not have copies of the new laws and regulations that have been passed.

Drafting of Legislation. At present, the Assembly does not write legislation (except the law "On Gender Inequalities"). Ministries prepare the draft laws; and they tend to present the views of the Minister, raising the concern that Ministries may tend to over-regulate and oppress economic growth.

Limited Local Role. The role played by UNMIK and the international community in drafting the legal framework has meant that Kosovars have had little say. Local impact of the new laws and regulations is as yet undetermined. In future work, it will be very important to take the time to include local personnel in the substance and the process of development of the framework of commercial law.

Coordination

Donor coordination is always important but is especially important now in the legal area in Kosovo in order to leverage the resources from each donor. There is good coordination between USAID and other donors in the commercial law area.

On development of legislation in the executive branch, the CLT works closely and cooperates with the Office of Legal Support Services (OLSS) and with the EAR/GTZ advisors at the Prime Minister's Office. The advisors of OLSS hold biweekly meetings to coordinate all OLSS activity, to review progress, and to make the most use of the expertise of various legal advisors.

The Assembly Support Initiative group holds biweekly meetings with stakeholders in the legislative process to review progress and coordinate support to the Assembly.

Outreaching coordination is necessary between USAID experts and UNMIK to clarify in advance issues related to reserved powers. As an example of failed coordination, a law on the trade of petroleum was drafted by USAID advisors; but UNMIK reversed its earlier decision and determined that SRSG retains the authority to legislate in this area.

Issues and Sustainability

Justice Sector. Practically all aspects of development, management, and oversight of the justice sector are reserved powers (Pillar I). Although UNMIK's retained control of the sector promotes gradual development of judicial institutions, retained control has consequences for sustainability because there is limited local involvement.

Checks and Balances. While the legislative work of the Assembly has increased, it still does not operate as an efficient check on the executive branch. Oversight and control of the Government is still limited. As UNMIK transfers more powers to Kosovars, it will be crucial that a sound legal framework that ensures checks and balances exists. Furthermore, ministers need to appear before the Assembly, and MPs need to know their own rights and responsibilities.

Judicial Training. Judicial training represents a priority need and is difficult to address. Training is needed in practically all substantive areas of law and judicial skills, especially in legal drafting. These problems exist in Pristina and are, perhaps, more severe outside Pristina. Long-term sustainability of judicial training requires two key conditions: competent trainers and funding from donors. Coordinating with other donors, USAID could consider fulfilling the need for training in select areas. The World Bank, for example, is providing training to judges.

Information. Judges and Assembly members interviewed spoke of the need for copies of laws and commentaries on the laws. UNMIK has promulgated approximately 188 regulations and 105 administrative directions since 1999, with numerous amendments. Thus, there is much information to be distributed and absorbed by the legal community.

Furthermore, the new laws introduce a market economy, and judges need commentaries to familiarize themselves with these new concepts. The lack of information poses a problem for all legal professionals.

RECOMMENDATIONS

1. Continue with Completion and Refinement of the Legal Framework.

- 1) A comprehensive Company Law is under development by EAR. USAID advisors will need to comment on the draft.
- 2) Basic Property Law is under development by EAR. USAID advisors will need to comment on the draft.
- 3) A Finance Leasing Law may be needed. PISG has not yet demonstrated interest in legislation governing financing leases. However, assistance may be appropriate if particular products likely to be provided under finance leasing are identified. SME activity may create a demand for additional legislation in this area, including provision of the statutory framework for financing leases.
- 4) Coordinate with UNMIK and EAR to respond to needs for new economic laws or for amendments to existing laws.

2. Assist Government Agencies with the Implementation Process. The Sub-Normative Act under development will put in place procedures that will ensure transparency and non-discrimination. As mentioned above, this is a priority for the CLT. EAR and USAID advisors should work to develop two laws on administrative procedures.

3. Assist the Assembly to Draft Legislation. Continued support to the Assembly is necessary to improve its capacity to debate and act on draft legislation. Such assistance will be even more important if the Assembly starts to draft its own bills. Therefore, legal drafting assistance should continue. Other areas where continued assistance would be helpful are monitoring the progress of legislation and assisting committee members to review and amend laws. Another helpful assist would be to introduce the right of interpolation to assembly committees, so that Ministers and other senior civil servants cannot refuse to testify. (This should be costless.)

4. Assist the Assembly to Conduct Oversight over the Executive Branch. A great need exists for increased oversight of the Executive by the Assembly. During the short period of time that the Assembly has been in existence, it has been so occupied enacting new laws that it has not had sufficient time or accumulated the experience required to conduct oversight of the executive branch. However, if the laws are not implemented and enforced, parliament should know why and take action to remedy the situation.

5. Assist in Building Public Awareness, Especially in the Business Community. The public, and businesses in particular, needs to understand commercial laws, including the rights and obligations that they impose. Public outreach efforts to businesses regarding reforms should contain practical and specific information regarding commercial laws and emphasize expected benefits to business from the reforms.

6. Address the Implementation Gap and Training. More than good laws are needed to stimulate economic growth. The important activities lying ahead are implementation and training. Training for lawyers on commercial laws and related procedures is critical. The commentaries on several laws seem to have helped judges and legal professionals to understand the laws and obtain guidance regarding their application. It will be advisable to continue support for the preparation, publication, and distribution of commentaries.

PRIVATIZATION AND COMMERCIALIZATION

FINDINGS

Progress

Promulgation or Implementation of Legislation, Regulations or Policies--Privatization Framework: The Kosovo Trust Agency (KTA) is fully operational, and the requisite administrative and tendering policies and procedures are substantially in place. A notable exception is the liquidation procedure, which is before the KTA Board. Additionally, finalization of the liquidation mechanism for real property awaits a Land Use Regulation amendment now being drafted by the SRSG's Office of the Legal Advisor (OLA). USAID is considering deletion of TO 4 benchmarks relating to liquidation and insolvency proceedings.

Procedures for evaluating ownership claims are still being refined with judges. Governance guidelines for privatized "newcos" have been established, but the comprehensive governance handbook has not been completed. No work has been done in the areas of securities law and securities market development, and deletion of these benchmarks is also being considered by USAID. A substantial database has been created, but no summary valuations of SOE's have been done, nor has the valuation unit been established. Deletion of valuation benchmarks has been proposed and is being considered by USAID.

Except in the case of a limited number of "special" spin-offs (perhaps 6 of 350) bidders need not have demonstrable expertise in the sector in which they are seeking to participate, and no commitments are required in terms of employment or investment levels. In the case of the one special spin-off reviewed in this Evaluation, KTA requires a business plan from each bidder and sets minimum employment and investment conditions. An option whereby KTA can retake the SOE in the event of noncompliance with the business plan supports the employment and investment conditions, although the conditions represent a significant departure from the free-market approach ostensibly being pursued in the Economic Reconstruction program of USAID. All prospective investors are subject to a background check through the local police, who reportedly have some ability to conduct liaison with Interpol.

Promulgation or Implementation of Legislation, Regulations or Policies-- Utility Commercialization Framework: In the telecommunications sector, a liberalized comprehensive regulatory framework is largely in place, including plans for private sector participation. The Ministry of Transport and Communications (MTC) plans to hire an independent specialist to work on tariffs. Telecommunications Regulatory Authority (TRA) is expected to be operational by mid-November. In the water/wastewater/solid waste sectors, an Administrative Directive establishing Water and Waste Regulatory Office within Central Regulatory Unit (CRU) is before SRSG, and some work appears to have been done in the accounting, reporting and licensing areas. However, the Project's progress in these sectors is very difficult to assess due to the complex overlap of

responsibilities between CRU and KTA, and between USAID technical experts and EU secondees. Progress of the Project in the electricity sector is even harder to identify. The Legal Affairs Office of UNMIK apparently has not approved development of a regulatory framework for the sector. A Project technical expert reportedly acted for a time as Secretary of KEK's Supervisory Board, providing liaison with KTA. Although a full regulatory framework is called for in TO 4 for the air/rail transport sectors this Evaluation has uncovered no Project work toward that end.

Institutional Development, Reinforcement or Strengthening--Training: Training of KTA staff primarily in the procedural aspects of privatization, and also in its general objectives, is complete. Some training has been provided at MTC, but much more will be required of specialized TRA staff when it is formally established. While core financial and operational oversight training is required by TO 4 in the water/wastewater/solid waste sectors, little training has been done due to funding limitations.

Specific Implementation Actions and/or Quantitative Output Targets--Privatization Execution: The first two waves of SOE tenders are complete, and 18 winners have been selected. Some E22 million in advance payment of full purchase price has been received by KTA. Its distribution is pending finalization and implementation of recipient identification procedures, as well as completion of contracts of sale and KTA Board ratification. The winning bids have ranged in amount from E310,000 to E2,875,000, and the bids for most SOE's have reportedly clustered fairly closely together. These executions are significantly short of the TO 4 benchmarks, due to legal delays in commencement of the program.

The 18 winning bidders comprise mostly local investors, some of whom may be generally characterized as strategic, including management buyouts. A few foreigners from the Albanian Kosovar *diaspora* have also won tenders, as has at least one local-*diaspora* consortium. Approximately 160 SOE's are in the transaction pipeline, representing a potentially wider range of pricing.

Public Information and Education: Seminars on the privatization process have been held for 1,500 SOE and union personnel, and debriefings have been done before high-level PISG officials.

Constraints

Final Status: Uncertainty regarding the final status of Kosovo remains one of the principal constraints on the use of privatization and commercialization to promote economic expansion. The status issue, and the related indeterminacy of Kosovo's equitable share of the former FRY sovereign debt, have prevented IFI lending for major capital projects. While risk-tolerant foreign equity investors might come to Kosovo shopping for perceived bargains, international commercial banks and other foreign private sector lenders are unlikely to lend significant amounts on a long-term basis into a territory with an unclear political, economic and social future. This could effectively preclude large transactions of the type that usually require substantial debt-capital.

Economic Conditions: The privatization and commercialization programs are being pursued amidst especially trying local economic circumstances detailed elsewhere in this Evaluation Report. One important such circumstance is the limited size of the local, and even cross-border Albanian-speaking market. In addition, the recent and current periods are rife with uncertainty for international investment most everywhere. It is likely that these factors have limited, and may continue to limit investor, and especially foreign non-*diaspora* investor interest, in pursuing opportunities in Kosovo.

Historical Factors: The unique Yugoslav communitarian model of property rights that has resulted in the existence of the SOE's, and the history of multiple expropriations, have combined to make privatization in Kosovo a more significant challenge than in many other jurisdictions. To begin with, the lack of identifiable owners was deemed to require the complex trust structure of KTA, involving a great deal of legal work. Further attention is required for the case-by-case SOE determination needed prior to tender. In addition, a lengthy publicity campaign was required to explain the process and anticipated results to the probable stakeholders. All told, the lag between USAID's TA advice in favor of privatization, and the receipt (and more importantly, release) of proceeds, has been longer than anticipated.

CONCLUSIONS

Strengths

Cash Inflow from Privatization: Perhaps the most significant accomplishment of the privatization program to date is the successful tender of the first two waves of SOE's, raising almost E22 million, including some international funds. It can reasonably be expected that when the aggregate purchase price for the first two waves of privatization is distributed, especially the approximately E4 million earmarked for the workers, a portion will be spent, and a portion invested, in the local economy. If the results of the rest of the tenders reflect this experience, there should be a positive impact on the Kosovar economy.

Privatization Program Implications: Another strength is the completion of most of the critical institutional and legal framework for the projected 500 privatizations and liquidations. Fairly close clustering of the first sets of bids could reflect a desirably transparent process both on paper and in practice. Potentially, the privatization process in Kosovo could inculcate a sense of property rights and could contribute to the development of an entrepreneurial spirit. This could be one positive consequence of the planned distribution to an enterprise's workers of 20% of KTA sale proceeds, a scheme with little to recommend it on general equity grounds. There already appears to be a trading culture in Kosovo, but many current commercial ventures likely are responses to the higher-income expatriate presence, slated for reduction over time. Empowering large numbers of people with a small sum of investable capital in this way could conceivably motivate them to seek out market *niches*.

Telecom: The Project's only success on the utility commercialization side appears to be in the telecommunications sector, where a comprehensive independent regulatory framework is largely in place to promote new private sector entrants. While analytical questions are raised below about the transactional process, the mobile tender may have a good chance of success. Due to the relatively large number of modest sized firms typically found in this sub-sector, it could represent a significant opportunity for attracting some foreign direct investment.

Weaknesses

Timing of Activities: Some of the project activities originally planned have proved to be premature for Kosovo's needs now or in the immediate future. For example, the USAID project provides for significant work in drafting laws and procedures regarding corporate governance, securities issuance, and securities market regulation. Yet the facts on the ground suggest that most of the firms to be privatized (and those already in the private sector) are likely to have very simple capital structures, and will have no need for raising funds in a securities market. Moreover, it seems unlikely that an equities market would attract significant funds at this early stage.

Another example is in the telecommunications sector. The law drafted by the Project and promulgated by SRSB not only provides for regulation of a sector in which private participation is encouraged, but actually "embeds" three international tenders. The rationale for this provision is not obvious, and appears contrary to what might be suggested by a free-market approach.

Private Investment Conditionality: The special spin-off procedure is not economically optimal. The employment requirements should be expected to deter potential bidders. Moreover, it simply perpetuates the anti-market habits of the past by using productive economic entities to pursue social goals. Further, the required investment commitment effectively precludes receipt of precisely the market information that is normally desired in a competitive tender for sale. In practice, investors are being asked to bid on a KTA deal or an expatriate consultant deal, not an investor deal. Thus, the transaction looks less like a privatization sale and more like a concession in which the private sector is being asked to bid on the opportunity to undertake operations and investments determined in pursuit of non-commercial ends.

Skills Transfer: It appears that just as the local professional staff of KTA are being trained extensively on the tender process, their work is largely limited to procedural matters. The strategic analysis involved in privatization, such as the prioritization of the firms to be tendered and selection of special spin-offs, seems to be done primarily by expatriate consultants. In addition, since valuations are generally not done by KTA, local staff are not in a position to learn this valuable skill through on the job training. Some local staff do interact extensively with the SOE's, and some financial work is done, but it appears to be more in the nature of fact-gathering than analysis

Labor Sector Support: BSPK's President, a KTA Director, has proposed that special spin-off procedures be required for all SOE's with more than 50 employees. His proposal would require the investor in a privatized firm to retain 80% of its employees for the first two years, and permit 20% reductions every two years thereafter. It is hoped that this could be accomplished through attrition. The President estimates some 65% of the SOE's would meet this threshold, many multiples of the number of entities for which the KTA Privatization Department is planning special spin-offs.

The KTA Board does not support this proposal, believing it could deter potential investors. The general view at KTA is that the current employment in the SOE sector is sufficiently small that privatization will not dislocate an excessive portion of the Kosovar workforce. This view is supported by LLA's August 2002 finding "that well under 20,000 people, of a population of some 1.9 million, draw a regular income from an SOE." KTA also argues that the 20% payout should allay worker concerns. However, a dismissal of the views of a significant labor leader without care and diplomacy could weaken political support for privatization.

Issues and Sustainability

Immunity: As USAID is already aware, EU-seconded KTA Directors and counsel have raised concerns about KTA's legal mandate for mass SOE privatization and, accordingly, as to their potential personal liability for any related claims against KTA. As these directors may not have immunity from lawsuits arising from privatization transactions, the Deputy SRSG-Reconstruction, *ex officio* Chairman of KTA, has halted the privatization program. The recommendations below that relate to SOE privatization and liquidation obviously presupposes that this hurdle is overcome and the program is resumed. It should be noted, in addition, that since this matter is already in the public domain, a significant delay could damage privatization prospects even if resumption is later attempted, and that spillover effects on confidence in other aspects of market reform are possible.

Economic Impact: USAID's SO 1.3 seeks "recovery and *expansion* of the private-sector led economy." It is not likely that privatization of all SOE's will in and of itself lead to significant economic growth in Kosovo, perhaps not even enough to offset the negative impact of the anticipated phased withdrawal of the international presence. Privatization can enhance growth prospects through two major channels: by causing *systemic* improvements in enterprise efficiency, and by attracting productive investment. The results of the first two waves of SOE tenders, while admittedly not representative of the overall pool, suggest that SOE investors are likely to consist largely of local and *diaspora* investors.

It may well be that liquidations, apparently not being pursued due to legal and political issues, would have a greater economic impact than the planned going concern spin-offs. Putting land currently unused or unproductively used back into the economy could be a source of job creation. Further, if it is determined that SOE creditors had and have no claim against its land, sale proceeds could be used in a variety of socially and

economically desirable ways (such as in retraining or other dislocation coverage) not contemplated under KTA's current trust structure. Of the 500 or so SOE's, there is some uncertainty as to how many should, as an economic matter, be considered insolvent and formally liquidated, and how many sold at least initially as going concerns.

Coordination of Assistance

US/Kosovo: The cooperation between USAID's technical assistance program, especially in privatization, and Kosovar Albanians at all levels has been quite good. This population has very high regard for the United States, possibly even to an extent beyond that consistent with USG policy favoring Kosovo's full integration into Europe. KTA's public outreach campaign appears to have achieved major public buy-in to SOE privatization. As implied above, whether this support will last if significant layoffs occur is impossible to predict.

Kosovars in PISG and POE management have the highest regard for the talents and result-orientation USAID's technical experts. While, for example, MTC is very appreciative of the Project's educational efforts, an independent judgement is that there may be excessive reliance on the consultants for policy decisions as opposed to advice, a sustainability concern. The depth of local gratitude for specifically American assistance may also imply relatively uncritical Kosovar evaluations of its relative importance in any given area. This in turn hinders the interpretation of their evaluations as this evaluation team attempts to assist USAID in prioritizing future TA needs.

US/EU: Generally, EU officials in Kosovo respect the skill set USAID has mobilized, and is largely in agreement with USG's market-oriented agenda. However, the relationship between EU secondees in management positions in Pillar IV and those implementing the USAID TA program has not always been smooth.

Privatization is not, of course, hard science, and there is always a degree of subjectivity in professional perceptions of the proper approach in particular circumstances. Thus, for example, the foregoing concerns may only reflect the dichotomous views of two "camps" of privatization experts. Oversimplifying for illustrative purposes, one view holds that transactions should proceed quickly, with the market determining the critical economic values, while the other favors more painstaking analyses, evaluations, assessments and often restructurings, before any transactions take place. The search for the right balance of the two approaches has often been contentious in international experience.

The respective roles of KEK's donors have not been clear. Both TA and capital projects appear to have been undertaken with little coordination among various donors. Complicated by high turnover among expatriate experts and seconded management, the lack of coordinated donor planning has limited the effectiveness of KEK's turnaround efforts.

To the extent any lessons can be extracted from the singular experience of Kosovo, it should at least be contemplated whether the impacts of USAID's TA would have been greater had it been politically feasible to have had its own, more narrowly focused pillar.

US/UNMIK: While UNMIK, through Pillar IV, supports in principle the market-oriented reform program being assisted by USAID, practical difficulties in obtaining UNMIK approvals, especially in the legal area, have substantially delayed necessary implementation steps. For example, OLA is still working on the Land Use Regulation, which is preventing execution of liquidation transactions. Also, a recent EUMIK change in organizational structure reportedly led OLA to turn aside a significant amount of Project regulatory work in the energy sector. Whatever is the reason, it does appear that OLA-related delays have significantly hampered achievement some of Pillar IV's and USAID's objectives.

RECOMMENDATIONS

1. *Liquidations Should be Pursued More Vigorously.* As discussed above, the liquidations could be more economically significant than the spin-offs. In addition, the principle of market entry and exit is important to the further development of the private sector-led economy. Thus, rather than simply awaiting action by UNMIK/OLA, it would be justifiable to expend further resources in both political and legal aspects of moving liquidation forward. Of particular importance is to include outreach at the municipal level where the real environment for land acquisition is determined, as well as coordination with PISG and the labor sector.

2. *The Spin Off Privatization Program Should Be Completed if Pillar IV Permits.* Despite its probably limited economic impact, privatization of SOE's may be a key factor in developing a sense of private property rights in Kosovo, and could also further development of a viable entrepreneurial culture. The curious notion of "social property" is inconsistent with the development of a functioning market economy.

3. *Eliminating Work on Governance and Securities Would Be Justified.* As noted above, none of corporate governance, securities laws or public securities markets is on the critical path of the SOE privatizations and other transactions likely to occur in Kosovo over the intermediate term.

4. *TA for the Telecom Sector Should Continue, but with Better Skills Transfer.* Since the mobile telephony tender is perhaps Kosovo's best chance for attracting some foreign direct investment in the short term, TA would be very useful in implementation of the regulatory framework under which the new entrants will operate. However, MTC and prospective TRA officials must be given sufficient training so that they will be self-reliant once the initial transaction(s) close. Continued MTC and TRA dependence on expatriate consultants for policy advice in either regulating the market or suggesting new tenders may be required for the immediate future, but planning for its phase out should be completed at the earliest possible time. This is necessary to avoid a serious sustainability concern.

SUMMARY AND CONCLUSIONS

The design and initial implementation of this four year old program was of exceptionally high quality. Its accomplishments are at this stage beyond what might have been expected. There are, nevertheless, concerns about the sustainability of the accomplishments that are not negative reflections on the programs conception or management. Rather they reflect the unique political, social and economic circumstances of Kosovo. This evaluation report has sought to keep those circumstances in perspective, and to identify areas that require further attention going forward, and to suggest some forms that attention might take.

Program Strengths

The greatest overall strength of the program has been its design. It not only conforms to the requirements of a market-directed, transparent and stable economy, but within that paradigm was tailored appropriately the specific situation of Kosovo. However the speed with which the resources were mobilized and the program was put in place, set an exceptionally high standard. Next in the order of strengths was that the program's emphasis was primarily on establishing the environment for private economic activity rather than on trying to out-guess the markets. Finally, the four TO's used to drive the program followed a logical and practical sequence, and were meticulously crafted.

Program Weaknesses

The principal weakness of the program has been its limited success to date in preparing Kosovars to take over the highest levels of management and the highly specialized professional-technical functions such as economic analysis. It has also been less successful than would be desired in informing and educating the public and government officialdom on the fundamentals of market-driven economic systems, to the extent that Kosovars appropriate the confidence in and commitment to that kind of economic system. In the realm of taxation and public expenditures, in particular, it is to be anticipated that after the departure of expatriate experts, intense special-interest lobbying will take place and will have the potential to corrupt the impressive market-friendly environment that USAID has been helping to create.

COORDINATION

Coordination among the donor agencies in which technical expertise primarily resides has been as good as a long-time foreign assistance observers can imagine. The IMF and the World Bank in particular have recognized the timeliness and appropriateness of the USAID program. While occasional disagreements among economic experts on particular routes to specific objectives is a certainty, there appears to be broad and deep agreement on the objectives and mutual respect for approach.

Coordination among the various public institutions being developed under the USAID program has also been excellent, particularly between the BPK and MOFE, where coordination is particularly important.

Coordination among the key political entities is more difficult if for no other reason, because of their sheer numbers. This appears to have been a serious obstacle to significant progress in privatization, even though the procedures and other elements of “literature are largely in place.” For the next stage of USAID assistance, it would be desirable for its program activities to be subject to fewer decision points.

RECOMMENDATIONS

The full evaluation report identifies priorities for future assistance in each specific area. The following is a brief overview of the most important recommendations, in order of priority, detailed in the report.

1. **Banking and Finance.** Most of the remaining work is in Bank Supervision and Regulation, although a major, formal training effort is required. TA should continue for one year, with emphasis placed on preparing to turn all operations over to Kosovars.
2. **Fiscal Reform.** This effort has been exceptionally successful in getting the MOFE up, running and efficient. Nevertheless, it too is unready for operation by Kosovars. A final year of TA should address that problem, and develop a plan for dealing with issues raised in the evaluation report especially project evaluation in the budget function.
3. **Pensions.** The pension work has been highly, and quickly, successful. It is important not only as a potential vehicle for mobilization of savings, but for providing a much needed element of economic security for Kosovars. It should be seen through the next year of its development.
4. **Commercial Law.** The basic framework is in place. The EAU is involved and might be expected to produce replacement technical assistance, as required.
5. **Privatization.** This area could be considered a higher priority if logjams could be removed to allow it to proceed. If this happens it should be solidly supported.
6. **Insurance.** Some great successes have been realized. One technically expert observer considers it the most astounding success of the program, both because of its substantive significance and the fact that it was put in place without an internationally accepted template. Nevertheless, it is not clear that significant further USAID funding is required, and the industry itself should be considered a potential source of funding for deepening the sector’s development.
7. **Public Utilities.** It appears that a decision has been made, or is about to be made, for USAID to remove activity in this sector from the current USAID program. That seems appropriate, with two caveats: (1) the Telephony sector is a good candidate for privatization and USAID might wish to support that; (2) although the power sector is not currently viable, it is such a huge economic sector that,

should the opportunity arise for USAID to stimulate or undertake planning for a rational program of revitalization, it could be a worthwhile effort at modest cost.

ANNEX I: PERSONS INTERVIEWED

USAID: Washington

Sarah W. Farnsworth, Chief, Balkans Division, Bureau for Europe and Eurasia
John Chihfield, Economist and Financial Sector Advisor G/EGAD/EM
Jean R. Lange, Senior Financial Sector Advisor, Bureau for Europe and Eurasia

USAID: Kosovo

Dale Pfeiffer, Director
David Leong, Deputy Director
Judith Schumacher, Program Officer
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