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Program Information Document (PID)

Concept Stage | Date Prepared/Updated: 27-May-2019| Report No: PIDC26893

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Kosovo	P170113	Kosovo Public Finances and Growth DPF (P170113)	
Region	**Estimated Board Date**	**Practice Area (Lead)**	**Financing Instrument**
EUROPE AND CENTRAL ASIA	Oct 23, 2019	Macroeconomics, Trade and Investment	Development Policy Financing
Borrower(s)	**Implementing Agency**		
Kosovo Ministry of Finance	Ministry of Labor and Social Welfare, Ministry of Trade and Industry		

Proposed Development Objective(s)

The operation supports reforms in two main pillars: (i) managing fiscal risks through evidence-based decision making and fiscal transparency, (ii) improving the regulatory environment to foster private sector development.

Financing (in US$, Millions)

SUMMARY

Total Financing	40.00

DETAILS

Total World Bank Group Financing	40.00
World Bank Lending	40.00

Decision

The review did authorize the preparation to continue

B. Introduction and Context

Kosovo is a small, landlocked, and open economy in the Western Balkans with a GDP per capita of approximately at US$ 4,100 in 2018, and a population of 1.8 million. The country has maintained a comparatively strong economic growth over the last decade averaging 3.6 percent between 2008-2018 resulting in reduced poverty and increased shared prosperity. However, Kosovo's GDP per capita is at about 12 percent of EU's average GDP per capita and one of the lowest in Europe. Despite the sustained reduction in poverty over the last decade, poverty is also high estimated at 18 percent of people living under the national poverty line of 1.85 euro/day.[1] Catching up with average per capita income of the EU

[1] Kosovo Poverty Assessment, forthcoming, World Bank June 2019.

countries and reduction in poverty would require high and sustained growth rates over a long period of time.

Kosovo is one of the youngest countries in Europe based on its new statehood and demographics, with an average age of 30.2 years.[2] Kosovo has taken significant steps in building new institutions and overcoming legacies of the past. The country remains fragile, with weak institutional capacity and poor inter-institutional cooperation, and limited international recognition.

Kosovo has a good track record of maintaining macroeconomic and financial sustainability, but more is needed to achieve long-term development goals. Improving the efficiency of spending and commensurate investments in human capital and physical capital are crucial. The composition of fiscal spending has deteriorated since 2008, due to proliferation of untargeted social protection benefits, which not only translated into higher costs but likely led to disincentives for labor market participation, crowding out of essential social spending, including the poverty targeted social assistance scheme, and lower potential growth.

Kosovo is struggling with severe labor market challenges. Less than one third of the adult population holds a job, almost nine out of ten women are not working, and over half of active youth are unemployed. Kosovo's private sector has not managed to create enough jobs to absorb its young population, despite recent improvements in its business climate, as measured by the Doing Business indicators. Overall, Kosovo's unfavorable business environment is reflected in low levels of productivity and limited growth of firms due to high regulatory burden on firms. Advancing structural reforms to shift the drivers of growth to more export-oriented growth and higher value-added sectors is needed. In addition, foreign direct investment (FDI) is too low to be transformational and mostly concentrated in non-tradable sectors. Thus, building and maintaining an environment that is conducive to private sector development is of utmost importance.

The proposed Development Policy Financing (DPF) operation supports Republic of Kosovo's efforts to improve fiscal risk management in the short and medium term, and to cultivate an environment that is conducive to private sector development**.** There are substantial risks to the implementation of this operation. Political and governance, stakeholder, and macroeconomic risks are substantial and stem from politically difficult reforms in an institutionally weak and fragile context. The remaining risks are considered to be moderate.

Kosovo's Macroeconomic Policy Framework

Growth remains strong at an estimated 4.2 percent in 2018 and is primarily supported by domestic demand. Consumption supported by remittances, higher public wages, and consumer lending was the main driver of growth between 2008 and 2017. More recently, the main driver of growth has been the increased public infrastructure spending. In 2018, growth was driven mainly by public investment as it increased by 13.4 percent in nominal terms, mostly on road infrastructure financed by privatization proceeds. In 2018, consumption also contributed to growth, drawing on higher public wages, consumer lending, and remittances. However, net exports subtracted from growth as import growth outpaced exports. From the production side, contribution of agriculture to growth has been minimal, while the services were the main engine of growth.

Kosovo's headline fiscal policy has been sustainable thanks to the strict adherence to a set of fiscal rules. Kosovo follows rule based fiscal policy (which evolved over time) that supported a sustainable headline macro fiscal framework. The current primary fiscal rules in place are the deficit ceiling of 2 percent of GDP and the general government public and publicly guaranteed (PPG) debt-to-GDP ceiling of 40 percent of GDP. The PPG debt-to-GDP ratio is low at 16.8 percent of

[2] Kosovo Agency of Statistics (KAS), *http://ask.rks-gov.net/media/4582/women-and-man-2016-2017.pdf*

GDP but is rising due to higher primary deficits. In 2018, the overall budget deficit reached 2.8 percent of GDP, while the fiscal rule definition of the budget deficit was at 1.2 percent of GDP, excluding the capital spending financed by privatization proceeds, in line with the fiscal rule on the deficit ceiling of 2 percent of GDP. Kosovo managed to increase revenue collection from 24.3 percent in 2008 to 26.2 percent in 2018, thanks to the growth in the tax base.[3] However, tax revenue base is still narrow at 22.1 percent of GDP in 2018 and relies heavily on border taxes. While the overall macroeconomic policy has been supported by rules-based fiscal policy, and has been sustainable, fiscal risks are on the rise. The key pressures stem from proliferation of social protection benefits, which increased from 3.2 percent of GDP in 2008 to 6.3 percent in 2018. PPG debt was low at 16.8 percent of GDP but is increasing, driven by higher primary deficits. The Current account deficit (CAD) widened in 2018 to 8.5 percent of GDP, up from 6 percent of GDP in 2017 due higher domestic demand. Kosovo's financial sector is well-capitalized and sound, and non-performing loans as a percentage of total loans is the lowest in the region.

Kosovo's macroeconomic outlook is positive with a projected average growth rate of 4.3 percent over 2019-2022, primarily driven by public investment financed through the investment clause and privatization proceeds. Several large public investment projects, planned to commence in 2019, are expected to be the main driver of growth. Higher public wages and consumer lending is projected to contribute to increased consumption. Service exports will be strong; however, net exports are expected to subtract from growth driven by higher domestic demand due to higher capital imports for capital projects. CAD is projected to rise to 9.7 percent of GDP due to higher domestic absorption with public infrastructure projects financed by IFIs. Though, this would be safely financed through donor grants or external borrowing from multilateral institutions. Growth in remittances are expected to remain strong as in the previous years, assuming the EU area growth remains solid.[4]

The Bank projected medium-term fiscal deficit, is expected to increase in 2019 reaching 3.4 percent of GDP, up from 2.8 percent of GDP, driven by public infrastructure spending. With the implementation of the envisaged freeze in untargeted social protection spending, the freeze in the wage coefficient and existing budgeted vacant positions through the 2020 budget, the government is expected to mitigate the fiscal risks that might arise from the law on public wages and potential further proliferation of social protection benefits and stay within the fiscal rules.[5] Under the baseline scenario, broadly based on the current State Debt Program, Kosovo's debt-to-GDP ratio is expected to increase and reach 25.5 percent by end 2022 driven by the primary deficits and the investment clause.

Kosovo's macroeconomic policy framework is sustainable and adequate for the proposed operation. The debt-to-GDP ratio was at 16.8 percent of GDP at end-2018 and is sustainable under the baseline scenario and the potential macroeconomic shocks. The debt-to-GDP ratio is projected within the debt ceiling of 40 percent of GDP as well as the debt limit of 30 percent of GDP for the execution of the investment clause by end-2022. On the external front, slower-than projected growth in the EU and potential geopolitical and trade disputes could weigh down on Kosovo's growth through lower remittances and exports. On the internal front, rising fiscal risks due to potential further proliferation of social protection benefits and law on public salaries could narrow fiscal space. In addition, slower than projected implementation

[3] Kosovo has a simple tax system and relatively low tax rates, Kosovo PFR 2014.

[4] Euro Area growth was at 1.8 percent in 2018 and is expected to be at 1.3 and 1.4 in 2019 and 2020. World Bank Global Economic Prospects June 2020.

[5] Authorities expect higher real GDP growth rates than the World Bank projections as they assume a faster execution of capital projects financed by the IFIs under the investment clause and privatization proceeds. The MTEF 2019-2022 assumes strict adherence to the fiscal rules, namely the wage rule, the deficit ceiling rule, the cash balance requirement, debt ceiling. However, the overall budget balance projections are projected to reach 6 percent of GDP in 2019, and gradually decrease to 5.4 percent and 4.7 percent in 2020 and 2021, as the fiscal rule definition excludes capital projects financed by IFIs under the investment clause and privatization proceeds. There are, however, significant fiscal risks due to several new social initiatives and the risks posed by the implementation of the law on public wages that could add up to 206 million euros, or 3 percent of GDP.

of the investment clause projects could lead to lower growth.

Relationship to CPF

The proposed operation is fully aligned with the Country Partnership Framework for FY17-21. The proposed DPO is expected to play an important role in two of the three focus areas, namely Focus Area I - Enhancing Conditions for Accelerated Private Sector Growth and Employment and Focus Area II - Strengthening Public Service Delivery and Macro-Fiscal Management. The proposed DPO would address the key priorities identified in the 2017 Systematic Country Diagnostic, namely: (i) improving the allocation and efficiency of public services, (ii) improving the governance, rule of law, and business climate, (iii) increasing quality and equality of opportunity through labor policies, and (iv) increasing quality and equality of opportunity through social protection. The proposed DPO is also consistent with the World Bank's Group twin goals of eliminating extreme poverty and promoting shared prosperity of the bottom 40 percent of population. The program aims to safeguard macroeconomic and fiscal sustainability, which are key preconditions for sustained poverty reduction. Actions related to an improved business climate are expected to promote higher growth in the medium to long term that would also support faster poverty reduction. Better targeting of social assistance programs and improved evidence base for social protection policies are expected to promote faster poverty reduction and shared prosperity through better protection of the poor.

C. Proposed Development Objective(s)

The operation supports reforms in two main pillars: (i) managing fiscal risks through evidence-based decision making and fiscal transparency, (ii) improving the regulatory environment to foster private sector development.

The DPO through its first pillar supports the government in strengthening the evidence-base and transparency in fiscal policy making for better management of fiscal risks. Fiscal pressures stem from the recently adopted law on public salaries and untargeted social protection spending. Therefore, the first pillar focuses on lowering key fiscal pressures in Kosovo by improving the debt management practices, providing a transparent and comprehensive framework for restraining the growth of the public wage bill, clearly defining competency and the method of costing of proposing new social protection schemes and improving the targeting of the social assistance scheme. The DPO through its second pillar aims to improve the regulatory environment to foster private sector development through improved coordination of inspections, reducing administrative burden through simplification, merging, and repealing of licenses and permits, through setting up a mechanism for investor grievances, and improved labor regulations. The DPO would also support the business environment by reducing energy consumption through energy efficiency measures to help relax energy supply constraints.

The two pillars complement each other. Improvements in fiscal sustainability, through reduction in fiscal risks, in the medium term would provide a conducive environment for private sector development. Similarly, private sector reforms through enhancing the growth potential of the Kosovar economy would contribute to higher revenue generation, lower informality, and support fiscal sustainability in the medium term.

Key Results

Actions supported by the proposed operation are expected to: (1) improve the transparency and the oversight of debt management operations, (2) improve the transparency of public employment management and compensation and managing fiscal risks, (3) improve the evidence-base for decision making on and coordination of social protection spending initiatives, (4) sustain the level of social spending to manage fiscal risks, (5) improve the targeting and the coverage of the social assistance scheme, (6) reduce the number of inspectorates to improve the coordination and efficiency of business inspections, (7) reduce and simplify the business licenses and permits at the central level, (8) create a mechanism for investor dispute resolution, (9) improve the employment outcomes of vulnerable groups, (10) relax the energy supply constraints.

D. Concept Description

The first pillar - managing fiscal risks through evidence-based decision making and fiscal transparency would focus on improvements in debt management operations through aligning the Debt Law to international best practice and harmonizing within the existing legislation, a more comprehensive and transparent way of managing public employment through the secondary legislation on the Laws on Public Wages and Public Employment, containment of the the immediate fiscal risks through restraining the value of the wage coefficient and the number of vacant and budgeted positions, improvements in the the costing and responsibility of social protection initiatives, and improvements in the coverage and targeting of the social assistance program to maximize its impact on poverty reduction. The freezing of the new untargeted social protection initiatives would also supports managing fiscal risks through the 2020 budget.

The second pillar - improving the regulatory environment to foster private sector development will focus on reducing administrative burden on private sector by consolidating, and simplifying licenses and permits at the central level, by better coordinating inspections through the new inspections law, by promoting equitable job creation through promoting anti-discrimination at work and providing more flexible forms of employment. The second pillar also supports the business environment through Energy Efficiency measures to relax the energy supply constraints.

E. Poverty and Social Impacts and Environmental Aspects

Poverty and Social Impacts

The proposed DPO would support actions that are expected to have largely neutral or positive effects on poverty reduction and income distribution in the short-term, and overall positive effects over the medium- and long-term. Annex 4 summarizes the expected effects of the reforms supported under the operation. The poverty and distribution effects are likely to differ across actions. The DPO addresses issues such as fiscal risk management that is critical for sustainable poverty reduction and shared prosperity in the medium term. The reform of the social assistance scheme to improve targeting will have positive direct social impact on the poor. The reform of the Labor Law will improve the employment situation of vulnerable groups, especially women. The actions related to the administrative burden reduction and increased energy efficiency are expected to promote growth and job creation in the medium to long term and has the potential to contribute to poverty reduction. The expected poverty and social impacts are summarized in Annex 4, and during the course of preparation of the operation, the team will deepen the PSIA analysis building on existing household income and consumption survey data. The operation is expected to have positive gender impact through removing disincentives and administrative restrictions to labor market participation of women that are embedded in the current design of the social assistance scheme, and the positive impact expected from a reform of the Labor Law, including creating equal opportunities and criteria to both male and female applicants in the hiring process, prohibition to inquire about pregnancy during interview, and equal pay. The PSIA analysis will further analyze the gender impact of the proposed reform program.

Environmental Impacts

Policies supported by this operation are not expected to have adverse effect on Kosovo’s environment or natural resources. The operation is expected to bring positive environmental impacts, including climate co-benefits. Prior Action 6 is expected to have positive effects in environment, as the Law on Inspections will regulate the business inspections, including inspections related to environmental inspections under Ministry of Environment and Spatial Planning and Ministry of Agriculture. The Law is expected to improve the coordination of inspections to reduce the regulatory burden on firms but would also improve the effectiveness of inspections through better coordination including environmental, water, nature, nature, spatial planning inspections. Reduced number of inspections will reduce the energy consumption and will improve quality of environmental inspections. In addition, Prior Action 7 is expected to generate climate change mitigation/adaption co-benefits, since simplification of licensing and permits through merging, repealing and reduction of document requirements will reduce energy consumption as well as paper consumption. Prior Action 10 on Energy Efficiency is expected to generate climate co-benefits through reduced energy consumption. The environmental aspects of the proposed prior actions will be further elaborated during the course of the preparation.

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APPROVAL

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