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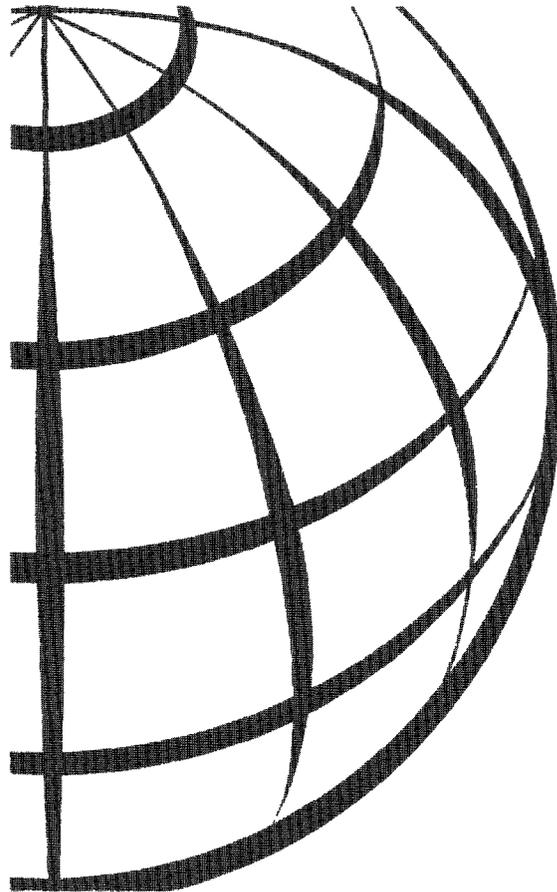
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*Economic and Social Reforms for Peace
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(List continues on the inside back cover)

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Economic and Social Reforms for Peace and Reconciliation

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CONTENTS

VOLUME I

ACKNOWLEDGMENTS	v
ABBREVIATIONS AND ACRONYMS.....	vi
INTRODUCTION.....	vii
CHAPTER 1: ECONOMIC BACKGROUND.....	1
CHAPTER 2: KEY CHALLENGES: THE POLITICAL ECONOMY.....	5
THE SHAPE OF THE EVENTUAL POLITICAL SETTLEMENT	5
LOCAL PARTICIPATION IN POLICIES AND DECISIONS	6
THE NOSTALGIA FOR 1989	8
INSTITUTIONS.....	9
CHAPTER 3: POLICY PRIORITIES AND UNMIK RESPONSE	11
BUDGET AND FISCAL STRUCTURES.....	12
TRADE REGIME AND CUSTOMS ADMINISTRATION	18
CURRENCY AND BANKING SYSTEM.....	22
CONDITIONS FOR PRIVATE MARKET GROWTH.....	28
EDUCATION.....	32
HEALTH.....	34
SOCIAL PROTECTION	38
SUMMARY OF RECOMMENDED SHORT-TERM ACTIONS (TO MID-2001).....	41
SUMMARY OF RECOMMENDED MEDIUM-TERM ACTIONS.....	42

VOLUME II

CHAPTER 1: BUDGET AND FISCAL STRUCTURES	43
FISCAL DEVELOPMENTS	44
BUDGETARY SYSTEMS.....	50
CHALLENGES TO FISCAL PERFORMANCE	51
FISCAL DEVOLUTION.....	56
CHAPTER 2: EXTERNAL TRADE AND CUSTOMS.....	58
INTRODUCTION	58
STRUCTURAL FEATURES OF THE TRADE REGIME	59
POLICY ASPECTS OF THE TRADE REGIME: COVERAGE AND TAXATION	60
IMPLICATIONS OF THE TRADE REGIME FOR NASCENT EXPORTS	63
IMPLEMENTATION	65
RECOMMENDATIONS	67
CHAPTER 3: THE BANKING SECTOR	70
BACKGROUND.....	70
A STRATEGY FOR BANKING SECTOR DEVELOPMENT	74
NEXT STEPS TO RESTORE FINANCIAL INTERMEDIATION: INSTITUTIONAL AND MARKET DEVELOPMENT.....	81
MEDIUM-TERM CHALLENGES DESPITE NEAR-TERM PROGRESS	86

REFORM OF THE PAYMENTS SYSTEM	88
CHAPTER 4: STIMULATING PRIVATE ENTERPRISE DEVELOPMENT	91
BACKGROUND	91
FACILITATING PRIVATE SECTOR DEVELOPMENT	95
CONVERTING PUBLIC ENTERPRISES TO PRIVATE OWNERSHIP	98
CHAPTER 5: EDUCATION.....	107
INTRODUCTION	107
KEY SECTOR PRIORITIES	111
BUDGET ANALYSIS 2000	117
CHAPTER 6: HEALTH.....	123
BACKGROUND	123
THE PRE-CONFLICT SITUATION	123
CURRENT SITUTAION	125
KEY POLICY ISSUES	127
RECOMMENDED SHORT-TERM ACTIONS (TO END-2000)	134
RECOMMENDED MEDIUM-TERM ACTIONS	135
CHAPTER 7: SOCIAL PROTECTION	136
INTRODUCTION	136
KEY POLICY ISSUES	140
SUMMARY OF RECOMMENDED SHORT-TERM ACTIONS (TO MID-2001).....	148
SUMMARY OF RECOMMENDED MEDIUM-TERM ACTIONS.....	149

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This report has been prepared on the basis of Bank missions to Pristina and a number of municipalities of Kosovo in the period June to November 2000. The missions are thankful to the staff of the United Nations Interim Mission in Kosovo (UNMIK) for the generous assistance accorded to its work, in particular to the staff of the reconstruction and development pillar of UNMIK headed initially by Joly Dixon and subsequently by Andy Bearpark.

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ABBREVIATIONS AND ACRONYMS

ATP	-	Autonomous Trade Preferences
BPK	-	Banking and Payments Authority
CA	-	Child Allowance
CFA	-	Central Fiscal Agency
DOR	-	Department for Reconstruction
EITS	-	Electronic Interbank Transfer System
FRY	-	Federal Republic of Yugoslavia
FYR Macedonia	-	Former Yugoslav Republic of Macedonia
HIF	-	Health Insurance Fund
IAC	-	Interim Administrative Council
IOM	-	International Organization for Migration
JIAS	-	Joint Interim Administrative Structure
KPA	-	Kosovo Privatization Agency
KTC	-	Kosovo Transition Council
MTS	-	Mother Theresa Society
NGO	-	Non-governmental Organizations
NTM	-	Non-Tariff Measures
OAC	-	Ownership Adjudication Council
OSCE	-	Organization for Security and Cooperation in Europe
PHC	-	Primary Health Care
PIP	-	Public Investment Program
QR	-	Quantitative Restrictions
SFRY	-	Socialist Federal Republic of Yugoslavia
SME	-	Small and Medium-Sized Enterprises
TCP	-	Tax Collection Points
TSA	-	Treasury Single Account
UNFPA	-	United Nations Population Fund
UNHCR	-	United Nations High Commission for Refugees
UNMIK	-	United Nations Interim Administration in Kosovo

INTRODUCTION

This report contains a discussion of the principal economic and social reform policy tasks facing Kosovo in the aftermath of a lost decade of civic exclusion of its majority ethnic population and of disinvestment and neglect of both physical and human capital – a period that culminated in the seventy-eight day conflict of spring 1999. It is intended to present ideas to the interim civil administration of Kosovo led by the United Nations (UNMIK), to the joint political and administrative structures, involving representatives of the local population, that are embedded within UNMIK and, perhaps most of all, to Kosovo society as a whole. The overall objective is taken to be the consolidation of peace, the fostering of social reconciliation between the peoples of Kosovo, and the initiation of sustainable, self-propelling growth in the economy of the province.

The key reform areas in the sphere of economic policy are considered to be:

- The formulation of a sustainable budget that is increasingly financed through local taxation and user fees and, therefore, with reduced reliance on external donor support as well as the development of fiscal institutions ensuring the efficiency and probity of public spending;
- The establishment of a liberal trade and customs regime that permits Kosovo to realize its potential for growth and exports in the context of its geographical location in the south-central Balkans as well as taking advantage of the enabling arrangements being fostered by the Stability Pact and the European Union;
- The use of a hard currency for internal transactions and savings together with the development of a sound banking system subject to strict supervision; and
- The creation of a reformed framework for encouraging the growth of private, small and medium enterprises and transferring viable existing public enterprises into private hands.

These reforms will enable Kosovo to create the conditions for durable growth under efficient market conditions. Fiscal discipline would be maintained through balanced budgets and the provision of essential public services, a low inflation environment safeguarded through the use of the deutsche mark, savings encouraged by a safe banking system, and the transition to a private market economy assisted through the incentives of trade, the forces of competition, and the adoption of a suitable legal and regulatory framework for enterprise formation. But three aspects of the social policy agenda deserve attention.

- Critical to addressing the denuding of human capital and loss of technical skills among the population is education policy and institutions. The basis for near-term prosperity can be laid only with a work force educated to standards not below those in competitor countries.

- Moreover, the neglect of health services and policies over the past decade and the need to catch up as well as address the effects of recent social traumas places health policy as a key agenda item in social reforms.
- Finally, Kosovo ought to develop a financeable, sustainable system of social protection for its vulnerable elements of the population to replace the *ad hoc* humanitarian interventions of the past decade.

These three areas of social policy reforms, discussed in the report, also constitute the major expenditure categories in the budget, accounting for nearly three-quarters of total spending.

The report is organized as follows: the first volume provides some economic background (with the absence of data over the last dozen years being a major limiting factor to analysis) and then proceeds to a discussion of the key aspects of the political economy. In particular, it analyses some of the critical factors and constraints bearing on the transition to a rapidly growing private market based economy: the political and constitutional uncertainties and their effect on policy making; the role of the local population in governance and the economy; the nostalgia for the Kosovo of the late-1980s and the need to renew ideas and approaches; and the weaknesses of existing institutions. The discussion of the political economy is concluded with some observations on the sustainability of economic developments and policies. The final chapter of this volume identifies the key economic and social policy priorities and the actions taken by UNMIK as the reforms necessary over the medium term. It provides a summary of the state of play, the essential priorities and suggested policy reforms in each of the economic and social sectors described above.

The second volume of the report contains a detailed elaboration of the current state of knowledge in each of these areas and a discussion of the policy reform agenda.

The report has been discussed with UNMIK and with civic organizations in Kosovo as well as with the staffs of the European Commission, the International Monetary Fund and of UNMIK. Nevertheless, the World Bank is solely responsible for the analysis and policy advice contained in this document.

CHAPTER 1:

ECONOMIC BACKGROUND

Pre-conflict economy. Kosovo has a rich mineral and natural resource base, and fertile agricultural land. From being predominantly an agricultural economy as a province of the republic of Serbia within the Socialist Federal Republic of Yugoslavia (SFRY) in the immediate post Second World War period, economic transformation wrought by central planning led to industrialization and development of mining. During the 1970s-80s, Kosovo's development became a priority for the SFRY government. The province received significant investment resources from a national investment fund. This financing largely benefited the capital intensive extractive industries and infrastructure. Thus, over the two decades, 1970-90, economic activity increasingly centered on mining and production of raw materials and semi-finished products (lead, coal, zinc and some textiles), but agriculture continued to be important. Over this period, the share of industry and mining in the output of the province rose from one-third to one-half, whilst that of agriculture fell from nearly one third to one fifth.

**Table 1: Structure of Output
(in percent)**

	1971	1988	1996
Industry	33.3	47.4	33.8
Agriculture	28.2	20.4	28.8
Other	38.5	32.2	37.4

Source: Riinvest Consultants, Pristina, based on official data.

By the mid-1990s, however, the latest year for which rough data are available, the structure of output had reverted to that a quarter of a century earlier. This phenomenon reflects, of course, the massive de-industrialization. Notably, growth in output slowed markedly over the industrialization period (Table 2), reflecting poor resource allocation decisions. This slowdown was exacerbated in the first half of the 1990s, when income per head fell by an annual average of an astonishing 13.4 percent as the industrial sector and other parts of the organized sectors contracted sharply and employment was reduced in tandem.

The policy and regulatory environment was based on SFRY-style state and social ownership: heavy industry was largely state and socially owned. Commercial criteria did not play the dominant role in decision-making; decisions on resource allocation and location of industry, for example, were based on regional factors or were politically inspired. More than 60 percent of the pre-conflict population lived in rural areas, and agriculture was nearly universally privately held. Despite its economic potential, Kosovo has traditionally been SFRY's poorest province: in 1988, output per head in Kosovo was 28 percent that of SFRY as a whole.

**Table 2: Growth Indicators
(annual average in percent)**

	1948-65	1966-70	1971-75	1976-80	1981-85	1986-90	1991-95
Output	5.7	6.0	7.5	3.6	1.8	-5.6	-11.6
Output per head	3.4	3.4	4.4	1.5	-0.4	-7.5	-13.4

Source: Riinvest Consultants, Pristina, based on official data.

In 1989, the autonomy of Kosovo within the republic of Serbia was suspended. Over the succeeding five years, GDP contracted by 50 percent, falling to less than US\$400 per head by 1995, according to official statistics, with a particularly severe contraction in industry and mining. In that year, industry and agriculture were each responsible for about one third of GDP, with trade and commercial activities accounting for the remainder. Over the past decade, industry, mining and infrastructure in Kosovo have been characterized by massive disinvestment in net terms (gross investment flows are shown in Table 3) and neglect of operations and maintenance.

**Table 3: Sectoral Investment Flows
(index: 1971=100)**

	1975	1980	1988	1990
Industry and mining	149	294	89	28
Agriculture	272	409	248	116
Public utilities and housing	230	291	196	188
Total investment	169	274	115	68

Source: Riinvest Consultants, Pristina, based on official data.

The fall in gross investment in the industrial and mining sector in the late 1980s is particularly striking: these sectors are overwhelmingly under state or social ownership. Data for the 1990s are not available, but, undoubtedly, investment stagnated during this period. The fall-off in investment in the agriculture and the public utility and housing categories was less pronounced owing to the large private ownership element in agriculture and housing. Overall gross investment in 1990 amounted to two-thirds of the flow twenty years earlier. Unemployment was already high before the recent conflict in reflection of the stagnation in the Federal Republic of Yugoslavia (FRY) economy.

Economic impact of the conflict. The economic consequences of the spring 1999 conflict were severe. Industrial output collapsed and agriculture production plummeted, with livestock herds lost or killed and the planting season missed. Actual conflict-related damage is concentrated on private housing – both urban and rural, in particular in the west of the province – agriculture, and

some infrastructure. The private homes that were used to provide parallel health and education services were also badly damaged.¹

Among the most significant impact of the recent conflict was the massive flight of people from their homes and the dislocation that this caused. Of the province's estimated pre-conflict population of 2.2 million (82-90 percent ethnic Albanian), it is estimated that over 800,000 Kosovar Albanians fled to neighboring Albania, Bosnia and Herzegovina, Former Yugoslav Republic of Macedonia (FYR Macedonia) and other parts of FRY, plus tens of thousands to other countries during the course of the conflict. More than half a million were internally displaced and over 6,000 killed. Over 100,000 ethnic Serbs had also fled Kosovo by the end of the hostilities.² With this exodus, many institutions lost their staffing and management. While by late August 1999, most Kosovar Albanian refugees had returned, the post-conflict period has seen a massive exodus of Serb Kosovars, with the consequent loss of vital technical and managerial skills in administration and public enterprises. It is estimated that the pre-conflict population of Kosovar Serbs has been reduced from nearly a quarter of a million to below 70,000, while that of gypsies³ from 150,000 to only 30,000. Unemployment remains extremely high. There are no official estimates of domestic product, but it is clear that Kosovo ranks amongst the poorest parts of Europe. Consumption is clearly much higher than domestic income, given reliance on a heavy flow of remittances from the ethnic Albanian diaspora.

The current economy. Through indigenous enterprise, assisted by donor support, the Kosovar economy appears to have made a strong start in recovering from the contraction in output per head seen over the past two decades and then the ravages of the spring 1999 conflict. No official statistics of output or investment exist, but the repair of housing, the tilling of farmland, burgeoning services in urban areas, and even the revival of some enterprises provide testament to the industry of the population and its determination to make up for lost time. These developments reflect not only the impact of donor assistance but also reliance on domestic savings and inflows of diaspora funds for investment as well as a sturdy belief in self-effort. Nevertheless, it is clear that conflict related damage, the poor state of infrastructure, inadequate energy supplies and denuded capital stock in enterprises are powerful factors constraining growth.

The table below, prepared by IMF staff⁴, provides a useful snapshot of the economy in 2000, with IMF estimates of both domestic product and domestic consumption. The Fund staff estimate GDP from estimates of public and private expenditures (based on a Riinvest household survey, public budget estimates, donor financing of investments and official import data). The estimate of domestic output is DM3 billion or about US\$750 per head; and of domestic consumption at DM4.5 billion or about US\$1,125 per head. Diaspora remittances account for the large difference between domestic output and consumption. All estimates of provincial accounts are subject to enormous margin of error; that said, it is believed that the snapshot presented below provides a guide as to the current state of the economy.

¹ Estimates of expenditures required to address conflict-related damage and the effects of prolonged neglect of maintenance of the capital stock and of infrastructure are contained in a joint EC-World Bank report, *Towards Stability and Prosperity: A Program for Reconstruction and Recovery in Kosovo* (www.seerecon.org).

² Based on UNHCR data as of June 1999.

³ Report by P. Polansky for Oxfam and Society for Threatened Peoples.

⁴ Kosovo – Macroeconomic Issues and Fiscal Sustainability (www.IMF.org)

Table 4. Output, Consumption and Balance of Payments Estimates for 2000

	DM million	Percent of GDP
GDP	3,000	
Consumption	4,380	146
Private	4,078	136
Public	303	10
Investment	1,161	39
Foreign	756	25
Domestic	405	13
Exports	0	...
Imports	2,540	85
Reconstruction	680	23
Energy	54	2
Humanitarian	312	10
Food and agriculture	155	5
Equipment	21	1
Emergency assistance	136	5
Households	104	3
Health	21	1
Education	10	0
Dutiable imports	1,496	50
Declared	823	27
Other	673	22
National income	4,512	150
GDP	3,000	100
Private remittances from abroad	1,200	40
Humanitarian assistance	312	10
Balance of payments		
Current account	-1,029	-34
Trade balance	-2,540	-85
Remittances	1,200	40
Humanitarian assistance	312	10
Financed by		
Budgetary assistance 1/	273	9
Reconstruction aid	756	25

1/ Includes off-budget financing and draw down of cash balances.

Sources: Kosovo – Macroeconomic Issues and Fiscal Sustainability (IMF Report) based on data from the Central Fiscal Authority, UNMIK Departments, and the Food and Agriculture Organization; and IMF staff estimates.

CHAPTER 2:

KEY CHALLENGES: THE POLITICAL ECONOMY

There is wide consensus within Kosovo society that the twin challenges faced by the economy are recovery from the long decades of lack of basic productive investment and even routine maintenance of infrastructure and services exacerbated by conflict-related damage to part of the capital stock, and the creation of incentives and institutions to make a rapid transition to a market economy. This vision is shared by the interim civil administration of Kosovo (UNMIK) and, indeed, by the donor community at large.

Transition in Kosovo has to take place against the background of not only the legacy of Yugoslav-style planning and social ownership but also the constitutional peculiarities and political uncertainties of the present. No representative institutions at the provincial level exist today; yet, transition requires local consent and, indeed, whole-hearted participation. Transition is also handicapped by the long period of exclusion from civic participation of the Albanian Kosovars and by the tradition of parallel institutions and informal, at times criminal, ways of operating, e.g., in revenue raising. It is, however, assisted by a strong wish to build a market economy and the demonstrated entrepreneurial spirit of the people. The key policies and associated institutional developments required for transition together with the political economy context of the post-conflict period are discussed below.

THE SHAPE OF THE EVENTUAL POLITICAL SETTLEMENT

Within the framework of UN Security Council Resolution 1244 that balances continued sovereignty of the Federal Republic of Yugoslavia with substantial autonomy and self-government for Kosovo,⁵ UNMIK has issued two general regulations (Regulations 1 and 24) clarifying that FRY laws applicable in Kosovo until the suspension of the autonomy of the province in 1989 continue to apply unless invalidated on human rights grounds or superseded by UNMIK regulations. Certain laws passed after 1989 will also be enforced on a case by case basis if considered to be consistent with standards of human rights and also if they are considered to be in the interests of the province.

More specifically, on economic policy matters, UNMIK has taken a pragmatic approach, balancing the considerations of sovereignty and autonomy. On the one hand, the trade and customs regimes that were inherited from the FRY were found to be severely distortionary with widespread exemptions from rules and a high degree of discretionary as opposed to rule-based authority. Clearly, such regimes were inimical to the interests of promoting efficient, private sector led growth, and were, therefore, radically re-shaped. A thoroughly revised tax system and a tax administration system were instituted to replace the unsatisfactory FRY system. The system of bank licensing and supervision was overhauled to modern standards of effective

⁵ Resolution 1244, paragraph 11.

surveillance and prudence. The payments system was reformed with the abolition of the FRY-style public monopoly over payments and the creation of a market-based system. Thus, modern, efficient policies and structures were put in place, but the accomplishment of the final results will, of course, take time.

These actions were essential to provide support for private sector growth and investment and to ensure rising local financing for expenditures. On the other hand, no independent currency is to be issued, nor a central bank established; rather, the use of the deutsche mark and other foreign currencies was legalized, whilst the FRY dinar continues to be the legal tender. Decisions on the degree to which substantial autonomy and self-government will be exercised in Kosovo remain to be taken in some sensitive economic areas, such as ownership of state and socially owned property, international commercial contracts and commercial laws.

Despite the clarifications or developments in policies and laws described above, there remains a considerable degree of uncertainty about the shape and timing of an eventual political settlement for Kosovo. The gulf between the parties to the discussions is wide and the dialogue on this question practically non-existent.⁶ The inception of a post-Milosevic democratic government of FRY has added a further dimension to the debate. The continuing uncertainty regarding the constitutional future of Kosovo is bound to damage investment, particularly foreign investment, and growth prospects. There is an obvious need to clarify constitutional arrangements prior to the hand over of substantive authority to a representative administration elected on a province-wide basis, expected to take place next year. While the Special Representative of the Secretary General of the UN will continue to exercise supreme authority under resolution 1244, the responsibilities of the representative administration and the extent of its autonomous powers will have to be established.

LOCAL PARTICIPATION IN POLICIES AND DECISIONS

Whilst there is acceptance of the need for a UN administration in Kosovo for a period, the populace is clearly anxious to see representative government formed. This reflects pent-up yearnings for civic participation in all walks of life after a decade of exclusion. Both the major local political parties see themselves as provincial governments in waiting, and have developed shadow ministries and town councils with their own budgets that provide some public services financed through diaspora funds or illegal local revenue raising. These structures, parallel to the UNMIK administration, were to have been totally dissolved in early 2000 as a part of the agreement with UNMIK that broadened local participation in Kosovo's administration (see paragraph 18 below); it appears that while some parallel institutions have been formally abolished, some significant parallel activities and budgets continue to exist.

The considerable local pressures for elections at both the provincial assembly and the municipal levels led UNMIK to hold municipal elections in October 2000. The first free political campaign in Kosovo for decades was conducted, on the whole, peacefully and with a keen sense of competition. Elections, supervised by the OSCE, saw a high turn-out by the Kosovar Albanians, but a total boycott by Kosovar Serbs. They resulted in a clear victory for the long-established

⁶ UNMIK is charged with facilitating a political process designed to determine Kosovo's future status, taking into account the Rambouillet accords (paragraph 11 of the resolution).

party led by Ibrahim Rugova with nearly 60 per cent of the vote and a second place for the political party associated with the liberation army led by Hashim Thaçi with nearly 30 per cent of the vote. Municipal councils are expected to take power by end-2000. These councils will continue to be supervised by UNMIK representatives. Although all parties have stated that they respect the election results, a major challenge is likely to be to induce incumbent councilors (often nominated by political or other interests) to give up effective power to those elected. A further challenge to the efficient functioning of municipalities is lack of clear structures or clear lines of authority and responsibility regarding permissible municipal functions and powers at the municipal level to raise revenues. These structural issues are still under design by UNMIK.

Box 1: Governance Arrangements in Kosovo

Current Legal Status and Interim Arrangements. The Security Council Resolution 1244 reaffirms the commitment to the sovereignty and territorial integrity of FRY (Preamble to the resolution), whilst promoting substantial autonomy and self-government in Kosovo (paragraph 11). The resolution establishes the UN Interim Administration in Kosovo (UNMIK) as the provisional administration. The powers vested in UNMIK- and its head, the Special Representative of the Secretary-General of the UN, include "all legislative and executive authority...including the administration of the judiciary". UNMIK has four "pillars" or areas of accountability: (1) humanitarian issues (led by UNHCR); (2) civil administration; (led by the UN); (3) democracy building and elections (led by the OSCE); and (4) reconstruction, recovery and economic development (led by the EU). Practically all economic matters fall within the remit of Pillars 2 and 4.

Plans for Transition to Self-Government. Resolution 1244 (paragraph 11) also provides that UNMIK is to organize and oversee the development of provisional institutions for democratic and autonomous self-government pending a political settlement, including the holding of elections, and transferring, as these institutions are established, its administrative responsibilities. In order to help prepare for this first phase of self-governance, a Kosovo Transitional Council (KTC) was established to include representatives from ethnic Albanian, Serb and other ethnic groups from the start. The Transitional Council is designed to be Kosovo's highest political consultative body, providing the main parties with a forum for direct input into the decisions of UNMIK.

Local participation in Kosovo's governing institutions was broadened in January 2000 with the establishment of a Joint Interim Administrative Structure (JIAS) with joint representation of UNMIK staff and Kosovar political leaders and experts responsible for the administration of the territory but under the KTC. Furthermore, 20 departments (akin to ministries) have been established with joint UNMIK staff and Kosovar expert presence for implementation. The co-heads of these departments constitute a Council of Ministers, a body formed in late 2000 to assist policy discussions and implementation. Although the KTC and the JIAS (together with the departments) will wield both policy making and implementation powers, the supreme authority in Kosovo will remain the Special Representative of the Secretary-General of the UN as provided for under Resolution 1244.

It is expected that provincial elections will be held in 2001 with a transfer of power rapidly thereafter to a provincial government that enjoyed the support of the elected assembly. As noted, the constitutional powers of such a government are still to be decided. For both the major political groupings, independence remains a cardinal objective, with little thought having been given to the limitations posed by Resolution 1244. Indeed, the constraints posed more widely by Kosovo's constitutional status as a province of FRY feature little in local political thinking.

From its inception as the interim government of Kosovo under Resolution 1244, UNMIK had established a forum for consultation with local opinion in the formulation of economic and other policies. Thus, the Kosovo Transitional Council (KTC) was formed with high level local

political representation (see Box 1). This initiative was deepened through formal advisory boards or joint consultative councils permitting Kosovars a formal role in the design of policies. UNMIK undertook to consult the Kosovo Transitional Council before any regulations were issued or important political decisions taken. Likewise, joint consultative groups were established in the administrative district levels and in some of the municipalities.

In economic institutions, such as the banking and payments agency (charged with supervising banks and operating the payments system), the central fiscal agency, customs administration, education and health policy making, provision was made for a significant role for Kosovars in providing advice to UNMIK. UNMIK declared that this advice would be given great weight before final decisions were taken. An Economic Policy Advisory Board with UNMIK and local representation was established. The role of Kosovars was envisaged to be substantial also in the implementation of policies, e.g., in the banking and payments institutions and in the central fiscal agency. Municipal councils, in the pre-election period, were formed to a standard approved by UNMIK with community representation; and these councils were given authority in essential public service delivery.

These early initiatives for local Kosovar participation in economic governance described above were greatly strengthened and formalized in January 2000 with the establishment of the Joint Interim Administrative Structure (JIAS). The JIAS permitted the continued functioning of the KTC as the highest level body (under the supreme authority of the Special Representative of the Secretary-General of the UN), but created an Interim Administrative Council (IAC) with policy making and law-proposing powers as well as with supervisory powers over all civilian affairs (with the exception of policing and other aspects of security) to report to the KTC. The IAC has four foreign members and four Kosovars – three ethnic Albanians and one ethnic Serb. Twenty administrative departments were created (akin to ministries), each with UNMIK and local Kosovar co-heads, to carry out the normal functions of a government. Each such department is headed jointly by UNMIK international and Kosovar staff, and each department has both international and Kosovar staff.

Following the municipal elections of October 2000, UNMIK announced a decision to reconstitute the membership of the KTC and the JIAS to reflect more closely the results of the election. It would also be advisable to use the opportunity of this reconstitution to simplify the administrative structure and, in particular, to grossly reduce the number of government departments. At the same time, UNMIK announced that a formal grouping of the 20 department co-heads would be constituted as a Council of Ministers, a body intended to discuss economic policies and their implementation.

THE NOSTALGIA FOR 1989

All major strands of Kosovo's local political leadership support the objective of a private market based economy with open trade and investment regimes and integration with the other economies of Europe. The articulation of a clear vision and the path of transition that Kosovo must follow in its economic and social development are tasks that the political leadership must now address. The economic institutions necessary to undertake such a transformation have also not been reflected upon. In the absence of such policy or institutional work or debate within society and even in the absence of a widely shared common vision and consensus on the

transition path, there is today an overwhelming nostalgia for 1989, the last year of autonomy under the SFRY constitution. Indeed, that year is seen as the last year of a golden epoch when public enterprises employed ethnic Albanians, civic institutions functioned satisfactorily, and standards of living rose steadily. This nostalgia is as strong today – one and a half years after the cessation of the conflict -- as it was in its immediate aftermath.

The view is widespread that government institutions, utilities, enterprises, ought to be restored to what they were in that year, with the guaranteed employment that went with it. Such factors as the fundamental unviability of many public sector economic activities that in 1989 were propped up by cheap credits or outright grants, captive markets, and other subsidies from the FRY development funds, as well as the rapidly changed world market conditions and technologies of today – all of which make industrial revival inadvisable – are still to enter public consciousness. Moreover, the necessity of nurturing a private sector based economy and contemporary standards of governance, as opposed to the corrupt ways of the FRY *nomenklatura*, make the reference point of 1989 fundamentally an unrealistic one. A major task for UNMIK and the international institutions will be to help develop viable transition strategies and institutions, and build public support for them.

INSTITUTIONS

The centralized administration of Kosovo in the decade to the conflict of spring 1999 and the exclusion of Kosovar Albanians from participation in government, civic institutions and in public enterprises were developments that led to a degree of erosion of skills amongst the majority ethnic group in Kosovo with an accompanying atrophy of the practices and traditions of representative politics, self-government, and administrative skills. The challenge now is to re-build governing institutions, at legislative and executive levels, with standards of governance and transparency, and to inculcate skills. The JIAS structure provides a framework for the establishment of ministries and other public agencies and to undertake public administration. In this task of skill formation and the development of a democratic, meritocratic culture, the experience accumulated from the years of operating the parallel systems in education and health would be helpful, but it should be noted that the standards and methods required for a formal government system to operate properly imply considerable re-learning and adaptations of civic and political behavior in the direction of a consensual framework for decision making.

One aspect of institutional development is the degree of power sharing between a central provincial authority and the municipalities. There is a clear trend towards decentralization. As a reaction to centralized rule from Belgrade and from unrepresentative institutions in Pristina over the past decade, strong preferences for fiscal and economic devolution are evident, with key powers envisaged for the municipalities. Whilst it is agreed that much revenue collection will have to be centralized, expenditures and service delivery are seen as municipal responsibilities, with choice at municipal levels being accorded much weight. In view of the post-conflict concentration of the Serb ethnic minority in a few municipalities, this appears the only way for providing discretion in allocating resources within sectors such as for education services.

* The challenge of sustainability. The political economy factors discussed above have a strong bearing on the sustainability of economic policies and economic institutions in Kosovo and on both internal and external sources of support that are required for the province to be self-

sustaining. In the absence of a clear vision for the final political and constitutional settlement for Kosovo and a firm trajectory for attaining that settlement, the parameters for achieving sustainability are hard to define. For example, what degree of external support – economic, financial, political, security – can be assumed over the medium term? Can sustainable political and civic institutions be built contemporaneously with external administration of the UNMIK kind? The development of responsible local administration, of representation, of accountability can best take place if supreme political and constitutional authority is defined in a permanent manner. Thus, civic and political sustainability depends on the definition of the future constitutional position of Kosovo, in particular, its relation with the rest of Serbia, with its neighbors and its authority and ability to exert a well-defined, well understood, and well-clarified degree of autonomy.

Moreover, economic viability clearly depends greatly on tailoring the aspirations of the populace to the resources available over the short and medium terms and ensuring that public expenditures and welfare programs fall within these constraints of resource availability. External donors have made clear the provision of approximately US\$2 billion of support over a three to four year period for reconstruction and investment activities plus sufficient support (approximately US\$150 million) ; (ii) pressures on expenditures from greater than budgeted outlays for public utility subsidies; (iii) the structure, types and levels of social assistance benefits that are designed more for the conditions of the prosperous countries in the EU rather than the straitened circumstances of Kosovo; and (iv) poor state of public management and weaknesses in the functioning of the administrative apparatus, partly for reasons of capacity, and partly for the political economy factors, including ethnic tension, discussed above. These challenges to economic viability are discussed in summary in the rest of this volume and in detail in the second volume of this report.

Some preliminary conclusions on sustainability may be noted. It is surely the case that as yet there is no light at the end of the tunnel – constitutional or economic. The current international effort of starting reconstruction, providing basic public services, and initiating the creation of essential institutions is necessary and appropriate as the immediate post-conflict response, but sustainable patterns of public spending and public institutions will only be determined when the constitutional and economic frameworks are clearly defined.

CHAPTER 3:

POLICY PRIORITIES AND UNMIK RESPONSE

Against the background of the lost decade of growth and the institutional and political challenges outlined above, policy priorities lie in stabilizing macroeconomic conditions, making provision for essential public services - administration, education, and health - and setting the stage for private sector led recovery and long-term growth. The policies being pursued by UNMIK as the interim civil administration are designed to these ends.

The fundamental conditions for macroeconomic stability have been laid by permitting the unfettered use of a hard currency, the deutsche mark ('Euro'), in all transactions without disturbing the legal status of the dinar. This policy will serve to shield Kosovo substantially from the inflation being experienced in the rest of FRY. The inflow of diaspora funds seen at present will provide resources for reconstruction and investment and will be a stabilizing factor. The local Kosovo budget that has been prepared by UNMIK will be financed fully through local taxation and donor budget support contributions: thus, the fiscal stance will also add to stability. A treasury with proper controls over expenditures has been established within UNMIK.

Box 2: Reforms Over the Medium Term

The structural reforms over the medium term will center on the transition to a market economy and effective, affordable social protection for the population. In parallel, reforms towards modern, cost-effective standards in education and health will be pursued. Together with local political leadership and with the assistance of local technical experts, UNMIK is devising a strategy for medium term reforms.

It is of crucial importance to assist the revival of the private sector. As experience elsewhere shows, the major source for new jobs will lie in the small and medium enterprise sector. The framework of laws, regulations and institutions for supporting small and medium-sized enterprises (SME) growth are being developed. Business advice to nascent and existing enterprises will be provided through TA. Credit lines are being planned (including one through the Bank's grant operation) in support of SME growth. With regard to existing enterprises and in particular large enterprises (mining, metal works, food processing, construction materials), it is of vital importance to clarify ownership status and to provide a functioning framework for private sector participation through concessions, leasing or ownership.

Kosovo faces the challenge over the medium term of providing for an extremely young population profile: education, technical training, and employment. Moreover, the needs of the vulnerable elements in the population that include those affected by the recent conflict and displaced minorities will have to be addressed. The social protection framework being devised within UNMIK will reflect these needs as well as deal with the creation of enduring and sustainably funded systems for pension and social insurance.

In the eighteen months since the end of the conflict, UNMIK has, understandably, focussed on the urgent tasks of providing basic public services, reviving the economy, establishing fiscal and bank supervision systems. It has, together with its donor partners, including the Bank, initiated work on the medium term policy priorities identified above. This medium term strategy will have strong local participation in its formulation and implementation. Indeed, a major challenge for the newly established joint administration will be to carry this strategy forward. The constraints posed by Resolution 1244 and the constitutional status of Kosovo will have to be borne in mind as medium term reforms are developed.

The major expenditure items in the budget relate to administration (civil service, judiciary, law and order), education, and health. Schools were re-opened in September 1999 and health centers and hospitals are functioning again. UNMIK has reconstituted a judiciary, established a self-defense force - the Kosovo Protection Corps – as well as a police force and a civil administration in the major spending sectors has been built up. Education, health and social assistance strategies this chapter contains a summary of the state of play, the essential priorities, and suggested policy reforms in each of the economic and social sectors covered by this report.

BUDGET AND FISCAL STRUCTURES

UNMIK is making progress towards establishing a public administrative structure intended to deliver adequate public services to the population of Kosovo, within the available budgetary resources complemented by donor support. As noted above, such progress includes the establishment of the Joint Interim Administrative Structure (JIAS) that provides for the participation of both Kosovars and international staff in administration. Within the JIAS can be found the Kosovo Transition Council – a 36 member body of politicians – that can be thought of as a rudimentary national assembly with consultative powers; a smaller deliberative body of 11 technocratic members, the Interim Administrative Council; as well as a Council of Ministers consisting of the two co-heads of each of the 20 departments (akin to ministries) -- an international and a Kosovar co-head. A notable institutional achievement was the establishment of the Central Fiscal Authority (CFA) and a budget management system that is able to provide resources in a timely manner and ensure that these resources are spent efficiently and transparently for the purposes intended. In addition, progress is being made to improve coordination in the reconstruction efforts, given substantial needs for capital investments and donor commitments and financial support to finance these needs.

The key institutional development at this stage in ensuring effective budget outcomes and effective service delivery over time relates to the link between the policy formulation process and planning and budgeting within a coherent budget strategy and expenditure framework. The link between policy, planning and budgeting becomes essential in the specific circumstances of Kosovo given a unique multinational administrative structure and substantial donor involvement in financing a considerable part of the recurrent budget needs and the entire capital investment needs. The present separation of the recurrent and capital budgets, with the former being financed partly through local taxation and partly through external donor assistance and the latter entirely from donor support, inhibits the formulation of a coherent budget strategy undermining the effective and efficient use of budgetary resources.

The Budget Balance for 2000 and Estimates for 2001⁷

In the year 2000, the financing gap is estimated to be DM 200 million. Underlying this estimate is a revenue performance of DM 18.6 million per month in 2000 as compared to DM 7.6 million per month in 1999 and expenditures of DM 35.3 million per month in 2000 as compared to DM 21.7 million per month in 1999. Thus, the self-financing of the budget was estimated to rise

⁷ Details on revenues and expenditure policies and outcomes can be found in Volume 2 of the economic report (referenced earlier).

strongly in 2000, with the financing gap as a proportion of expenditures falling from 65 percent in 1999 to 47 percent in 2000.

Developments in the first two months of 2000 showed an extremely weak revenue performance, with significant shortfalls in all categories of revenues, particularly excises. Though the causes of these developments are not fully understood, it is likely that the tax coverage gap related to the Montenegro boundary line led to large leakages. UNMIK has, as noted, now set up a tax post at the Montenegro boundary line and expects to meet its budgeted revenue estimates on the basis of the new taxes to be instituted and improved tax administration and coverage.

Following the poor performance of the first two months, revenue collections rose markedly. Excise taxes have shown strong increases due to the application of unified tax rates for heating oil and petroleum products. Hotel Food and Beverage Tax is now fully operational. Although its collections remain small, the experience gained through its administration was an ideal training ground for the staff and taxpayers for future inland taxes such as presumptive tax. Total revenues have shown significant improvements and are slightly above the pro-rata figures in the ten months ending October 2000.

The 2000 budget proposed a strong rise in overall expenditures (but at a rate less than the rise in tax and fee revenues) centering on education, health and social assistance. The key objectives of the education budget were to ensure full enrollment, initiate steps towards a unified curriculum, enhance pre-service teacher training, reform the Pristina university, and undertake comprehensive school mapping. The budget also funded the preschool sector. The major objectives for the health sector were strengthening primary care and building up the physical facilities for health care. The social assistance budget focused on assistance delivery to the most needy, particularly elderly over age 70, single parent families and families with a handicapped person.

Expenditure estimates for the 2000 budget rested on the assumption of DM 273 per month for the average public sector wage (a rise of nearly 50 percent in relation to those who received wages in 1999) and a fall in public employment (particularly in education and health sectors) of an estimated 10 percent. There was also the intention to develop retraining and counseling for redundant public sector employees and to establish a framework for unemployment insurance in future years.

The budget outturn for the ten months of 2000 as described above show that this limit of DM200 million in donor financing for the year as a whole is achievable, assuming that: (i) recent positive trends in revenue collections are maintained till the end of the fiscal year; and (ii) on the expenditure side there is partial catch-up in under-spending, with discipline on wage and subsidy spending being exerted in the rest of the year. On the other hand, any additional surpluses coming as a result of better than expected revenue performance should be used to ease up pressures on the next fiscal year by paying off arrears for the electricity imports as well as using some of the resources to support redundancies which otherwise must be financed out of the year 2001 budget. It is clear that additional donor budgetary support would not be required till the end of the year, opening the way for medium-term sustainability in the Kosovo local cost recurrent budget.

Table 4: Summary Budget Accounts
(in millions of deutsche marks)

	Sept-Dec 1999		2000 Budget	2000 Amended	2000 Projection	2001 Budget estimates
	Estimates	Outturn				
Total Revenues	47.7	30.5	223.2	210.0	212.6	344.0
Customs	9.3	9.0	38.0	35.0	51.8	44.5
Excises	14.7	1.6	21.0	18.0	39.7	83.4
Sales and VAT (from mid - 2001)	23.6	19.5	104.0	91.0	104.4	138.0
Payroll	-	-	15.0	15.0	-	-
Hotel, food, and beverage	-	-	-	-	2.7	4.0
Fees and user charges	-	-	26.7	32.0	11.0	40.1
Other	-	0.5	18.5	19.0	3.0	34.0
Total Expenditure	121.6	86.6	423.2	429.3	432.6	505.9
Education	44.0	32.4	116.2	116.2	...	118.0
Health	24.9	17.3	81.1	81.1	...	98.0
	-	-	-	-	-	-
Civil administration	13.4	13.6	49.7	53.8	...	109.1
Social Assistance	28.0	8.9	82.5	82.5	...	85.0
Other	11.3	14.4	93.7	95.7	...	95.8
Financing Gap (in US dollars, millions)	73.9 (41)	56.1 (31)	200.0 (103)	219.3 (113)	220.0 (100)	161.9 (74)
Donor contributions	73.9	85.3	200.0	200.0	220.0	161.9
Transfer to cash reserves	-	29.2	-	-19.2	-	-

Source: UNMIK.

Revenue projections for year 2001 assume improvements in both tax policy and tax administration and are expected to increase by 45 percent compare to 2000, to DM 344 million. Although such an increase is significant, it is necessary to ensure that Kosovo moves towards self-sufficiency and becomes less dependent on donor financing, especially for the recurrent expenditures. Increasing revenues in 2001 would be achieved by a broadening of the tax base and removal of the large distortions associated with the existing customs tariff structure. Measures are proposed towards the adoption of a modified VAT from mid-2001 and an extension of the tax base, therefore, to domestic production of goods and services. The abolition of the customs tariff from the time VAT is introduced, with the rate of the VAT being set to be revenue-neutral, will eliminate significant distortions in the current revenue raising system and help raise economic efficiency. Finally, the establishment of the legal framework for private sector development would open up opportunities for employment, growth and higher tax yields.

Total expenditures in the 2001 budget are estimated at DM 480 million or about DM 50 million over the expected outturn for 2000. These estimates represent a modest increase in the overall expenditures, mainly in civil administration and expenditures to support the new decentralized structure of municipalities; such expenditure tightness is clearly supportive of self-sustainability

of the budget over the medium term. There are no planned increases in wage levels. However, major risks will remain in the next year's budget and in the medium term, if the structural issues in year 2000 budget are not addressed. They include (i) bringing employment to a sustainable level for 2001, especially in health and education that have been running in excess of planned levels, even in year 2000; (ii) reduce transfers to the utilities by reducing employment and preparing an implementation plan for introducing cost recovery measures; (iii) preparing a fiscally sustainable redundancy policy and implementing employment reduction measures consistent with the policy; (iv) carefully implementing an adequate fiscal decentralization plan consistent with the local government capacities for taking over financial management responsibilities.

Consistent with the self-sustainability principle and tight fiscal scenario in the year 2001 budget, donor support is projected at DM 162 million. Donor support will, thus, fall not only in absolute terms as compared to 2000, but also sharply as a proportion of expenditures (51 percent in 2000; 32 percent in 2001). The rise in the self-financing of the budget is, of course, a necessary condition for an eventual successful "exit" by donors from providing budgetary support. Other conditions are being created for a successful exit: the infusion of new technologies and skills in fiscal and banking system management and supervision (to name but the two most important developments thus far) and the creation of institutions of governance and management. Keeping fiscal spending within the limits of medium-term sustainability as determined by the likely capacity to raise domestic revenues and obtaining external funding for investment will be critical. Instruments and institutions of economic management of this kind are being constructed to be durable whatever may be the eventual political settlement applied to Kosovo.

Budget Systems

Initial fiscal spending was organized in an *ad hoc fashion*, outside the context of a fiscal framework and budget planning process. It was directed to financing the stipends of some health employees and judges in an effort to quickly address urgent needs. In response to the existing situation the establishment of a Central Fiscal Authority with the functions of a finance ministry was identified as a first priority

The Central Fiscal Authority (CFA) was established by regulation 1999/16 at the end of 1999. After making an impressive start in December 1999 it is functioning admirably despite extremely difficult and complicated circumstances. Its main divisions for budget, treasury, tax policy and tax administration became operational within a very short period and are performing important functions including: (i) budget preparation and monitoring; (ii) execution of budgetary transactions through the Treasury Single Account (TSA) and their financial control; (iii) formulation of tax policy and the management of tax and customs revenues. In addition, the CFA has hired and trained many local staff who already performs several routine tasks in the budget and treasury divisions, as well as a large number of tax inspectors. These functions are being performed under a newly established legal and regulatory framework which includes regulations and procedures on the functioning of the divisions, procedures on expenditure authorization, accounting and reporting, regulations on procurement of goods and services as well as tax legislation and procedures on revenue collection and administration. Internal audit capability reporting to the highest level of UNMIK is also under preparation.

Despite this impressive progress challenges remain to complete the development of budget management institutions. The budget and treasury system should be extended beyond UNMIK's spending departments and the budgetary transactions should be carried out as appropriate by the spending units. This requires further developments in the treasury and payments system. It also requires significant strengthening of budget and financial management capacities to the spending units to ensure a transparent and accountable use of budgetary resources. This last link in the expenditure chain is being worked on by the CFA and UNMIK in cooperation with the Banking and Payments Authority. Although the 2000 budget was prepared in consultations with the spending departments, formal procedures need to be developed to guide the budget formulation process for 2001 and beyond. Moreover these procedures should include recurrent and investment expenditures in order to ensure an integrated approach to budget planning, the formulation of a coherent budget strategy, and better coordination of foreign donors that finance entirely investment expenditures.

Challenges to Fiscal Performance

The task of a finance ministry in the circumstances of today's Kosovo is an exceptionally difficult one. This applies to budget formulation as well as execution. The fiscal base is uncertain in view of the difficulties in projecting real rates of growth of the economy from a very low base under conditions of major institutional changes. Customs and tax administrations are being reinforced, but uncertainties surround their capacity, speed of strengthening, and willingness to apply the law fairly.

Closing the two major tax gaps, with the boundary line with the rest of FRY (Montenegro and the rest of Serbia) and FYR Macedonia effectively is important. A tax point was to have been established at the boundary point with Montenegro on January 1, 2000, but this was not done until March; the delay is estimated to have cost DM 20 million in revenues. The tax post will likely take some time to function effectively. There appears to be widespread evasion of excise taxes. With respect to FYR Macedonia, the budget assumed the repeal of the preferential trading arrangement, but steps to this end have not been taken. Delay in closing this gap is leading to revenues losses associated with both Macedonian goods and false certificates of origins on goods purporting to be of Macedonian origin.

Prompt institution of domestic coverage for sales and excise taxes and the payroll tax were planned for early 2000. It is now the intention to introduced a modified VAT in mid-2001 and therefore to extend the tax base to some domestic goods and services. The payroll tax was delayed by legal controversy over whether local staff of the UN system could be covered.

Adhering to the *public sector wage bill* as given in the budget. There are pressures to raise overall wages and to change relativities. A higher average wage is unsustainable over the medium term and would lead to an irresponsible budget. The budget estimates are based on a significant fall in *public employment*, particularly in education and health to eliminate ghost workers. Achieving this will be difficult given the strong sense of entitlement to a job and public opinion that calls for a mainstreaming of all parallel system workers. At best, it may take considerable time.

There are likely to be pressures for *subsidies to public enterprises* in order to re-start certain enterprises (regardless of their ultimate economic viability) or to greater-than-budgeted subsidies to the electric sector to make up for possible slow cost recovery and non-payment of charges. A significant reduction in the bloated labor force of the electricity company is essential; as a first step, a reduction of about 25 per cent is planned for 2001. It is essential to stick to budget limits for subsidies to public enterprises.

As implementation of capital investment projects progresses, there will be pressure on the Kosovo Consolidated Budget for higher proportions of operating expenses to go towards maintenance of the investments, particularly in the case of roads and other infrastructure. This could also be a significant issue in the utilities sector, although in principle that pressure should be contained within the operating costs and pricing structure of the utility providers.

Strengthening Capacities for Policy Formulation and Implementation

Although some progress has been made during the last few months, capacities for strategic policy formulation at the sector spending departments of UNMIK remain weak. A systematic process that defines main sector policy objectives and priorities and ways to implement them should be institutionalized as part of the overall budget formulation process. This would require strengthening capacities for:

- Setting overall objectives in the sector;
- Defining the appropriateness of public service provision in the sector consistent with these objectives and the overall economic program; and
- Defining strategic programs in the sector and identifying priorities for which budgetary resources (recurrent and investments) will be needed consistent with the overall resource framework.

The objective is to be able to have the right information and analytical work for the preparation of short strategy statements for each sector that can be used as an input into the preparation of a comprehensive budget strategy and expenditure framework and presented for discussions to a high level inter-sectoral decision making body and subsequently to the donor community.

Strengthening the Investment Planning Process

The establishment from UNMIK of the new Department for Reconstruction (DOR) has been a positive step in an effort to coordinate the donors and the reconstruction efforts in Kosovo. However, this department was created outside the CFA, with a mandate that goes well beyond just the coordination of the reconstruction efforts and into the formulation and implementation of a strategy for reconstruction. This organizational structure does not encourage an integrated planning and implementation process. While it is necessary to review, evaluate and coordinate external financed projects, there is a risk that such an exercise, usually reflected in the preparation of a donor-funded Public Investment Program (PIP) would be accorded undue priority. As a result, the investment planning process would focus primarily on the need for

donor coordination, thereby crowding out the vital need for the preparation of a comprehensive and integrated budget strategy that reflected the priorities of an overall program.

As a first step towards a more integrated process the mandate of the DOR should be revised to serve as a department for project coordination and evaluation (including maintaining formal contacts with the donor community) and ensure consistency between investment projects, policy priorities in the sector and overall program. It is vital that policy formulation and implementation should be left with the spending departments. DOR should, however, maintain responsibility for creating an information database and strengthening capacities for project evaluation, especially in the sectors where most of the donor financing is being directed.

Strengthening the Policy Choice Mechanisms

Linking the policy formulation process with planning and resources (budgeting) in a resource constrained environment such as the one in Kosovo, requires that difficult decisions are taken on inter-sectoral and intra-sectoral tradeoffs, consistent with the policy objectives within the sectors and consistent with UNMIK's overall program. These broad policy and program tradeoffs can be made by a decision making body at the center of the administration that has the right incentives to make the necessary tradeoffs and has adequate authority to enforce them. Such a body should be the forum to ensure that policy formulation and budget decisions are made in the right sequence and also serve as a mechanism for ensuring accountability during the implementation of sector strategies and priority programs and ensure that intended results are being achieved.

TRADE REGIME AND CUSTOMS ADMINISTRATION

The Structure of the Regime

The introduction of a simple, neutral trade regime was considered to be important in stimulating private sector led economic growth and reconstruction, and in creating the conditions for healthy exports. Moreover, in the absence of adequate administrative machinery to collect taxes on consumption and incomes, UNMIK saw the introduction of the customs/external trade regime as the major source of revenue for the local recurrent budget of Kosovo.

The key characteristics of the trade regime are: *First*, a uniform tariff structure of 10 percent was introduced. This tariff structure is commendable in its simplicity and the low rate involved. The principle of the uniform tariff rates was, however, compromised by the simultaneous introduction of duty exemptions on some agricultural and medical products. Also compromised were the major advantages of a regime of uniform tariff rates such as neutrality in protection afforded to various stages of production and the reduction in opportunities for rent seeking. *Second*, the foreign trade regime is devoid of non-tariff measures (NTMs) and quantitative restrictions (QRs). *Third*, a further advantage of the system is that its registration procedures of traders (exporters, importers and forwarding agents) and licensing are non-discriminatory and transparent. There is no state trading and foreign trade activity is open to all firms. There are no non-automatic licenses and the existing regime offers limited, if any at all, opportunity for bureaucratic micro-management of foreign trade.

Policy Aspects: Coverage and Taxation

Although the Kosovo foreign trade regime has the right institutional design, and low and almost uniform tariff rates, a number of policy concerns arise.

- *First*, an important weakness of the trade regime stems from the recognition of the preferential trade agreement between FRY and FYR Macedonia. Granting of preferential status to FYR Macedonia has distorted trade flows and led to revenue losses for two reasons: FYR Macedonia has been traditionally an important trading partner of Kosovo; and a considerable portion of total imports into Kosovo transit through FYR Macedonia. The latter has provided opportunity to falsify certificates of origin.
- *Second*, the lack of complete coverage through tax collection points (TCPs) at the boundary lines of Kosovo and the rest of FRY provide a strong incentive to traders to reroute shipments through Montenegro and points across the rest of Serbia and thus narrow the tax base.

The two policy concerns outlined above could be addressed by removing the customs tariff altogether. UNMIK has undertaken to abolish the customs tariff at the same time as the introduction of a value added tax (expected to be in mid-2001) with the VAT to be set at a rate to ensure revenue neutrality. This decision is a major step towards removing the significant distortion that arises from the FYR Macedonia preferential trade arrangement and the treatment of commerce from the rest of Serbia as well as from Montenegro. Such a step would broaden the tax base and lead to a reduction in the disparity of taxes levied. A unified VAT rate of, say, 20 per cent, would result in a reduction of around 6 percentage points in the customs cum sales tax on imports (other than from FYR Macedonia) and a rise of 5 percentage points in the sales tax on imports from Macedonia and commerce flowing in from the rest of Serbia and Montenegro. Excise taxes would continue to be levied on all excisable goods regardless of origin.

- *Third*, at present, sales and excise taxes on goods are applied to imported goods only. Since these taxes are levied only on imports, they constitute trade measures; they discriminate against imports. It is entirely understandable that under current conditions of weak local capacity and lack of an internal tax administration, there was no other tax base other than imported goods. The intention of UNMIK to widen the tax base to domestic products when VAT is introduced is welcome. The imposition of VAT on domestic goods will level the playing field vis-à-vis imports and diminish incentives for evasion.
- *Fourth*, while the 10 percent 'almost uniform' tariff rate is very low by the standards of least developed countries, the aggregate burden of border taxes is quite considerable. The sales tax of 15 percent is applied on the post-tariff value of imports. Thus, the actual 'tax burden' for non-food, non-medicine products amounts to 26.5 percent *ad valorem*. For products subject also to excise taxes with rates varying between 5 and 50 percent, total payment rises even further since excise is calculated on the basis of the value of imports post tariff tax.

Such tax burdens are not unusual; they prevail in many countries, developed or developing. However, several problems emerge: By recognizing the preferential trade agreement between FRY and FYR Macedonia signed on October 7, 1996 and the granting of preferential status to FYR Macedonia (Section 16 of the AD 1999/01), a potential source of evasion and consequent loss of revenues has been created. Imports originating in FYR Macedonia are not subject to custom duties, as noted above, but only to a 1 percent *ad valorem* customs fee. Thus, the fee lowers total tax on non-excise goods from 26.5 percent *ad valorem* to 16.2 percent that amount to the loss in revenue 10.3 percent of the value of imports from FYR Macedonia. On products subject to excise tax, the losses are higher ranging between 16 and 11 percent of the value of imports of these products.

- *Fifth*, a clear case can be made for a wider use of specific taxes (in a simple and transparent manner) in place of *ad valorem* taxes - with the exception of coffee, all excise taxes are in *ad valorem* terms (Table 2). Since Kosovo uses the deutsche mark as the main transaction currency, the 'inflation' argument against specific taxes does not apply.⁸ In the absence of sophisticated control techniques, the advantages of specific taxes are considerable: they are simpler and thus easier to implement and more difficult to evade; and they remove the incentive to under-invoicing, which is particularly strong in case of high excise rates.⁹

The Impact of the Regime on Emerging Exports

Of considerable concern is that in two aspects the trade regime presents a significant impediment to Kosovo's nascent exports. The first is legal or institutional in nature – the formal recognition by trading partners of Kosovo's trade regime and, in particular, trading arrangements in the context of the Stability Pact; the second, certain disincentives to exports arising from the trade and tax regimes.

The *de facto* establishment of a customs territory by UNMIK was neither accompanied nor followed by its *de jure* recognition. Its legal status as a foreign trade entity continues to remain vague and issues arising from this ambivalence tend to be addressed on *ad hoc* rather than systemic basis. As a consequence, Kosovo does not show up in Customs Codes of any country including that of its preferential trading partner—FYR Macedonia. Except for the EU (see below), Kosovo's trade and customs regime is treated as a part of the FRY trade and customs regime, despite the institution of its own trade regime by UNMIK, and its exports are subject to the same conditions of access as those faced by exporters from Serbia or Montenegro.

With the entry into force of the Council Regulation No. 2007/2000 (18 September 2000), the EU has formally recognized UNMIK as an autonomous customs territory "... in accordance with UNSC Resolution 1244 (10th and 11th preambular)" and linked to the EU's Stabilization and

⁸ This was the right choice because the inflation-prone FRY dinar was expected to be the only legal tender in Kosovo. With the acceptance of D-Mark as an officially recognized currency, concerns about inflation undercutting collected taxes lost their relevance.

⁹ For instance, a DM 100 underinvoicing of petroleum yields the 'saving' of DM 90 in terms of unpaid taxes. This is undoubtedly a strong incentive to underinvoice imports.

Association Process.¹⁰ The Regulation has extended trade preferences to Kosovo, which previously were limited to Croatia and Bosnia-Herzegovina.¹¹ It has also considerably widened trade preferences already applied by removing the remaining tariff ceilings for industrial products and by improving conditions in access to EU markets for agricultural products.¹² Once UNMIK-CS has effective procedural and organizational procedures harmonized with the EU for issuance certificates of origin, they would then be accepted by EU Customs provided that appropriate measures are taken.

But as long as the trade status of Kosovo is not clarified by other countries (especially its neighbors), preferential access to EU markets alone will not suffice to trigger export growth. Therefore, UNMIK, in cooperation and support of the EC, should obtain for products originating in Kosovo duty-free access to markets in at least Albania, Bulgaria and countries of the former Yugoslavia – Bosnia and Herzegovina, Croatia and Slovenia. One possibility would be to accomplish this goal through integration into the existing network of bilateral free trade agreements among Balkan countries. For instance, both Bulgaria and UNMIK customs territory have free trade agreements with FYR Macedonia. The immediate step should be for Bulgaria and Kosovo extending the same rules in their mutual trade as in their trade with FYR Macedonia. Similarly, UNMIK should accord free trade access to Albanian exporters in return for a similar treatment of Kosovar exports

The fiscal disincentive to exports arises from the fact that the trade regime does not provide for a scheme for rebate of tariffs and taxes on imported inputs used for exports, thereby unwittingly penalizing exports, in particular, inward processing activities. Typically, such activities are an important source of employment and growth in transition economies, especially in the initial phases.¹³ Moreover, by not introducing schemes that support exports specifically – duty drawbacks, rebates, in-bond manufacturing or temporary admission – the trade regime makes it less attractive, perhaps quite unattractive, for foreign firms to establish processing activities in Kosovo.

Implementation

The customs service remains understaffed. It came into being with hiring of 14 customs officers – previously with FRY Customs Administration – on August 3, 1999. By the end of August it employed 42 ex-FRY customs officers. With subsequent recruitment its staff rose to 90 customs officers by March 2000. While the Kosovo customs administration under the FRY regime was probably overstaffed (around 200 customs officers and administrative supporting staff), the

¹⁰ Note that the official title is “Council Regulation (EC) of 18 September 2000 introducing exceptional trade measure for countries and territories participating in or linked to the European Union’s Stabilization and Association process ...”

¹¹ Prior to the Regulation 2007/2000, the so-called autonomous trade preferences granted by the EU to Yugoslavia in the 1980 Cooperation Agreement applied only to Bosnia and Herzegovina and Croatia (see Trade Relations between the European Community and South Eastern Europe, Discussion Paper, Stability Pact: Meeting of the Economic Working Table, Brussels, 9 October 1999), but neither to FRY nor the UNMIK customs territory.

¹² Albania obtained the same preferences. It was reported that identical preferences the EU will grant to FYR Macedonia (Agence Europe, Brussels, 20 September 2000).

¹³ For instance, inward processing of textiles accounted for 20 percent of Bulgaria’s exports to the EU in 1997 and 23 percent in 1998. The cost of labor in Kosovo is much lower than in neighboring Bulgaria.

current level seems to be well below levels needed to cover all crossing points as well to open one or two inland customs processing stations. Estimate suggests that at least 30 more customs officers would be needed to perform these functions.

Despite an impressive record of implementing customs control, the customs service does not have adequate administrative capacity to process shipments efficiently in all CBPs and a TCP. Technical problems at the border augmented by the absence of in-land customs clearance facilities and warehouses have often created disorderly conditions at CBPs and further delayed their opening. While UNMIK has established the trade regime and customs administration with commendable speed, especially given the need to control borders and begin to raise local revenues, the deficiencies in design and practice noted above should be promptly addressed if distortions are to be minimized and fiscal revenue increased.

Summary of Recommendations

The preceding discussion suggests three major issue-areas that should be given consideration: the status of Kosovo in terms of international economic relations; external trade policies; and tax policy. The broad recommendations are: (i) that the Kosovo trade and customs regime should be recognized internationally as autonomous customs territory for foreign trade purposes; (ii) that the trade and customs regime should be modified as to make more friendly to exports and consequently imports; and (iii) that incentives for evasion of tariffs and duties should be minimized.

CURRENCY AND BANKING SYSTEM

Currency

On September 2, 1999, UNMIK issued a regulation permitting the use of foreign currencies for payments and contracts in Kosovo, thereby setting aside FRY restrictions on the use of foreign currencies for domestic transactions as well as FRY capital controls. Foreign currencies may now be freely and legally used for payments and contracts in Kosovo. The legal tender status of the FRY dinar under FRY law is unaffected: thus, all payments may be made and contracts discharged in dinars if the payer so wishes. No other currencies are to be given legal tender status. Deutsche marks or dinars may be used for tax and other official payments; the use of deutsche marks is encouraged with dinar use in such transactions being subject to an administrative fee to cover administrative and handling costs. No consideration is being given by UNMIK to the creation of a Kosovo currency.

As residents of Kosovo have long been conducting business in foreign currencies, overwhelmingly the deutsche mark, the UNMIK regulation acknowledges and legalizes current practice. The continued recognition of the dinar as the legal tender will maintain existing law. Granting legal tender status to any other currency requires the consent of the central bank issuing the currency in question and, in any case, appears unnecessary, it being sufficient to permit the circulation and use of that currency within Kosovo. It is also not necessary for Kosovo to issue its own currency; reliance upon a hard foreign currency will serve the purpose of a stable medium for transactions and for savings - two important pre-conditions for the revival of a

private market based economy. By mid-2000, the deutsche mark was being used overwhelmingly as the currency of Kosovo, with the dinar playing an extremely minor role.

The Banking System

The banking industry that was left at the end of the spring 1999 conflict was exceptionally weak, with little capital, technical ability, few deposits or performing assets, but with strong local interest in reviving banks or establishing new ones (the 1989 nostalgia being very evident). Of the local banks, Vojvodanska and Ekonomika banks had been operational in making limited payment transfers and some other limited activities, but were highly short of capital and liquidity. Two other local banks, Bankkos and Yugobanka, have not conducted banking operations for over one year now and their viability remains highly unlikely.

Banks suffer from an extreme lack of confidence on the part of the public in view of the effective confiscation of foreign currency deposits by the Belgrade authorities over the past decade and the weak management and capital positions of the banks themselves. In these respects, Kosovo is not different from some of the former republics of Yugoslavia. The revival of the banking industry will depend crucially on regaining public confidence. That, in turn, is closely related to the quality and probity of banks and bank management. The key policy steps consist of establishing firm banking supervision within the framework of a stringent banking law and, eventually, introducing limited deposit insurance. It appears likely that revived banking activity in Kosovo will originate from new entrants, whether foreign or domestic.

As of end 1999, there were no banks operating in Kosovo. One bank, the Micro-Enterprise Bank of Kosovo (MEB-Kosovo), with EBRD and IFC being equity participants, received approval to commence operations in January 2000. A second financial institution (technically a “non-bank”), the Grameen-Missione AMF, also obtained a license to operate as a micro-finance institution, although it was not active as of the second quarter of 2000. Preliminary licenses were approved by the licensing and supervisory authority in spring 2000 for three banks with a history of operations in Kosovo, but it is uncertain whether these banks would be able to qualify for permanent licenses.

In parallel to these developments there have been a number of donor-led initiatives that relate to or support credit activities. The most significant one is the creation of UNMIK’s Interim Credit Unit. This initiative is joint effort of the World Bank and European Agency for Reconstruction and it aims at channeling donors funds to small and medium enterprises. While still at an initial stage, the new ICU envisions to unload its activities and know-how into emerging private banks.

Immediate problems of the banking system include:

- The absence of banks that have been prepared to compete along commercial lines;
- The inadequacy or nonexistence of meaningful financial information and management systems in the banking (and enterprise) sector;

- The heretofore lack of adequate banking sector infrastructure (e.g., laws, judicial capacity, regulations, accounting/audit framework) to provide the needed guidelines and parameters for a well-managed and viable banking sector;
- The absence of financial intermediation (deposit-taking or lending) resulting from a lack of public confidence, past resource misallocation and politicization of bank lending, and the need for cash to finance trade and services in the largely informal Kosovo economy;
- The presence of only a small and costly range of banking services, namely transfers, which are provided more by travel companies or informally rather than through banks; and
- Allegations that fraud, money laundering and other illicit financial activity could occur if the supervision system proves not to be effective.

The Development of the Banking Sector

Success in banking reforms will depend on a number of factors: a sound legal and institutional framework to ensure incentives are in place for adequate resource mobilization; proper risk management guidelines and practices; and public confidence. There has been clear progress with respect to developing the regulatory framework for banking. The newly-instituted banking supervision agency within the Banking and Payments Authority (an umbrella body that also shelters the operation of the payments system) enforces a regulation system that prescribes conditions or responsibilities for:

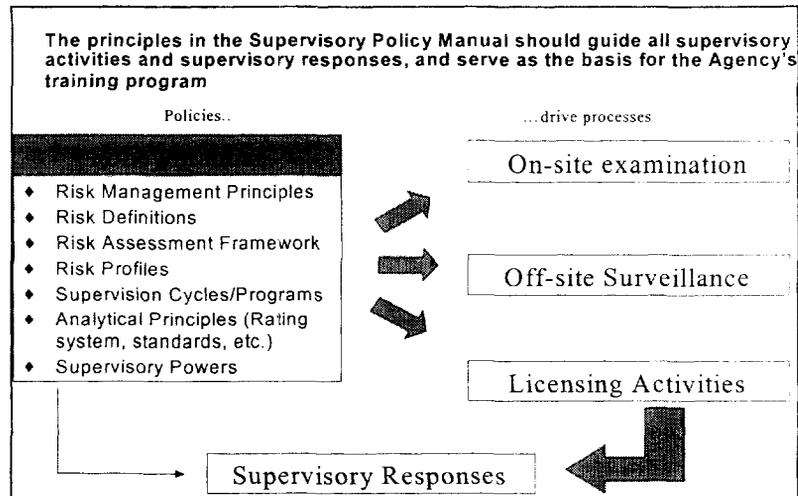
- Requirements to obtain and maintain a license;
- The right of foreign banks to operate, with associated cross-country supervisory requirements;
- The authority of the Banking and Payments Authority (BPK) of Kosovo to approve banks' governing boards, conduct on-site inspections, request any/all information as needed for supervisory oversight, require prompt corrective action when regulatory capital falls to two-thirds or less of requirements, and to appoint receivers and liquidate;
- Minimum capital of at least DM 1 million as a "narrow" bank,¹⁴ DM 3 million to provide basic banking services, and a higher minimum capital of DM 5 million to engage in non-DM currency futures trading, trust, investment/portfolio management, and securities underwriting and trading;
- Minimum capital adequacy requirements/ratios (to be specified);
- Exposure and concentration limits on large loans (to be specified);

¹⁴ This would require that assets be held in investment-grade EU securities. Lending would not be permitted.

- Restrictions on banks' equity holdings in non-financial companies to 15 percent of regulatory capital per investment, and no more than 100 percent of regulatory capital in aggregate;
- Liquidity practices and risk management functions regarding interest rate, exchange rate, maturity, and asset-liability risks/gaps;
- Ownership, management, and governance guidelines based on prudent internal controls, modern management information systems, internationally accepted standards and qualifications of board members and managers, and legal, operational, financial and administrative autonomy for banks;
- Autonomous internal audit functions;
- External audits based on IAS on both an individual and consolidated basis, including assessments of the (non)viability of internal audit standards, guidelines, practices and information systems;
- Reporting to supervisory authorities to maintain a banking license;
- Prohibition on certain activities and fines and sanctions for violations; and
- Receivership and liquidation.

The supervision agency is developing a basic policy framework utilizing a CAMEL-style evaluation system to guide supervisory decisions, and then extend the scope to include a broader array of assessment factors and techniques, such as risk management and risk profiling. The manual delineates UNMIK's expectations regarding the standards of financial condition and management practices for financial institutions, as well as evaluation methodology. The manual focuses on risk management principles and other non-financial areas, such as corporate governance, transactions with affiliates and insiders, internal controls, and issues related to regulatory compliance, etc. The manual itself will become a more comprehensive supervisory policy manual containing principles-based guidance for the assessment of risk in individual institutions and the sector. It also facilitates consistent policy application throughout the range of supervisory activities, including licensing activities/licensing, examination, and off-site surveillance. In addition, it enhances the ability of the agency to design and initiate risk-appropriate corrective actions.

The development of the policy manual also serves as the basis for continued development of the organizational structure, creation of supervision programs/cycles, on-site examinations, off-site surveillance and risk profiling activities. Additionally, the principles in the manual help guide decision-making with respect to licensing and problem bank management and resolution. It also provides the basis for periodic staff training as well as the foundation for a comprehensive training program. Lastly, the well-articulated policy structure, in conjunction with the legal and regulatory framework, provides a solid base on which the agency can sustain sound financial sector management after the withdrawal of UNMIK.



The success or failure of efforts to introduce lasting reform hinges on the efficiency of resource use, the ability to attract private direct investment into the banking and enterprise sectors and on interrelated programs for development of responsive civil institutions. Three key medium-term challenges in banking sector development are:

- *Expanding Institutional Capacity for Effective Implementation of Reforms.* Progress has been achieved with new banking regulations and rules. Commercial reform is also underway in support of an improved environment for contract enforcement, recognition of property rights, secured transactions and other features that will provide some comfort to lenders to take risk. The challenge now will be to develop institutional capacity in the judicial system, bank supervision, among accounting and audit professionals, and the bankers themselves.
- *Creating a Virtuous Circle to Restore Public Confidence.* Observance by bankers of the new prudential regulatory framework and sound governance and management practices will be needed to restore confidence and financial intermediation. Deviation from global standards may lead banks in Kosovo down the same path found in many other neighboring economies: poor asset management that undermines solvency and liquidity, triggering doubts about deposit safety. This, in turn, undermines the funding base, limits access to credit, and raises its cost through fees and higher interest rates. Sound management should reverse this process in which sound returns, which strengthen capital and liquidity, lead to a more stable funding foundation based on rising levels of depositor, shareholder, inter-bank, and regulatory confidence.
- *Utilizing Changing Incentives for Management Purposes.* There is a tendency on the part of older bankers in Kosovo to tolerate a return to the Yugoslav non-commercial orientation of the banking system, which relied on connected lending, excess concentration, distorted classifications, and a passive role whereby banks merely disbursed credits to their enterprise owners. The new owners and managers of banks

in Kosovo should ensure the new incentive structure works profitably for them. At a minimum, this will require more and better information for strategic planning, and the ability to monitor developments in a timely manner to ensure risks are adequately understood and controlled.

Payments System

Since the inception of UNMIK, the work of re-establishing a functioning payment system has passed through several stages. Of particular importance has been the establishment of the Banking and Payments Authority of Kosovo (BPK). As earlier noted, the BPK's main purpose is to foster the development of efficient and sound banking and payments in Kosovo. At its inauguration in May 1999, the BPK was able to provide teller window exchange of DM banknotes, services to UNMIK for payments of stipends and wages; and receipt of taxes, opening and maintaining of deposit accounts for banks and official entities and the acceptance of deposits and withdrawals from those accounts of DM; and receipt of payment orders (for non-cash payments) from authorized agents of depositors and their execution (clearing and settlement)¹⁵.

As the government's banker, the BPK can accept deposits from the CFA and other UNMIK agencies; it also makes payments from these accounts in accordance with the instructions of the CFA and other depositors. During the initial stage, all deposits with the BPK have been in cash since it is not yet prepared to accept non-cash deposits. As the bankers' bank, the BPK is responsible for clearing interbank payments in DM and settling them using bank deposits with the BPK.

The institutional development of the BPK and of its payment services has been delayed. The delay in developing the BPK's ability to offer deposit and payment services and the faster than expected establishment of banks with the ability to offer such services, necessitates a re-evaluation of the BPK's plans to use the temporary authority given to it in UNMIK Regulation No. 1999/20 to accept deposits from enterprises. A further implication of these developments is that the teller window services for government wage and salary payments and tax collections can be moved to banks more quickly than was originally envisaged.

With an increasing number of banks being licensed, the need to develop interbank clearing and settlement becomes more urgent. Since the payment system infrastructure is only in the embryonic stage of development, it has been recommended that their design from the beginning, should be based upon electronic media deposited directly with the BPK, and settled on a gross basis to ensure safe and reliable service to customers. Finally, it is recommended that an UNMIK regulation on payment transactions in foreign currencies be adopted in the near future. The objective of such legislation is to provide for a modern law establishing a firm foundation for an advanced market economy payment system to operate in Kosovo.

¹⁵ These depositors would be UNMIK agencies and banks. An Electronic Interbank Transfer System (EITS) for clearing and settling these payments will later be operational where depositors are expected to submit payment orders electronically.

CONDITIONS FOR PRIVATE MARKET GROWTH

The absence of a proper commercial law framework and the severe problems affecting the definition of property rights makes distinctions somewhat unclear, yet it can be argued that Kosovo's economy consists of three basic components: publicly owned enterprises; privately owned enterprises, and the parallel segment. Publicly owned enterprises formerly engaged in all sectors of the economy but predominately in the industrial sector, and generally in poor condition. The population of privately owned enterprises - much larger in number and collective output - engaged mostly in trade and services. The substantial parallel segment consists of gray market activities in trade and services on a small to medium scale. All exist today in institutionally and economically unfriendly conditions: no industrial production, no banking system, and no regulatory framework.

The sharp decline in the Kosovo GDP over the past decade can be attributed to a dramatic falloff in industrial output in a sector comprised almost entirely of publicly owned enterprises. Virtually all enterprises suffered heavy damage during this decade of disinvestment and neglect," leaving many in a severely deteriorated physical condition. Most enterprises now need significant restart capital to resume even minimal production. Enterprises also suffer from the far more serious problem of having lost their markets. This is because the rest of the Balkan region moved on economically after 1989, with FRY no longer a viable market for most products previously manufactured in Kosovo. As a result of the exclusion of the ethnic Albanians from management and skilled worker positions, the skills of the ethnic Albanian workforce are out of date.

Facilitating Private Market Development

The success of the program of economic development and reconstruction of Kosovo hinges to a large extent on the degree to which the private sector can be empowered quickly to generate growth. While the difficult political and legal issues in Kosovo are being addressed, the existing private sector will need to provide stimulus for economic growth. In addition to the rapidly growing retail and services areas, short-term growth can be expected to come largely from agriculture, agro-processing, construction, and the production of construction materials. Primary agriculture and construction, which are mostly private, should be encouraged to follow the lead of the impressive development of SMEs in the retail and services sector.

To develop the private sector, Kosovo will need to pursue three strategic paths concurrently. *First*, promote the growth and development of privately owned enterprises already in the formal economy. *Second*, embrace the parallel economy and bring it into the formal economy through a combination of incentives and requirements. And *third*, expand the private sector's composition by transferring the potentially viable public enterprises to private ownership.

To support private sector development, UNMIK must assign top priority to the introduction of a regulatory environment that makes the cost of operating illegally significantly greater than operating legally. The regulatory framework should be: (i) simple, understandable, and enforceable; (ii) facilitate compliance; (iii) allow as little discretionary authority as possible to minimize scope for corruption; (iv) eliminate any duplication of existing FRY regulations; and (v) remove all discriminatory aspects of the existing FRY system. The essential elements of the

framework are a business registration system, enterprise and contract laws, competition and foreign investment laws, and mechanisms for settling all kinds of disputes.

As taxation inside Kosovo is introduced, careful attention should be given to the overall tax burden on enterprises, especially given the high sales taxes levied at the border. In addition, the trade regime will need to be refined to with respect to taxes that could constrain private sector growth in Kosovo. For example, a rebate system needs to be introduced in the medium term to stimulate processing, subcontracting and consignment arrangements, which will be important to allow Kosovo to exploit its abundance of labor. Also, it is clearly not in the interest of Kosovo's economic development to tax imported capital goods - even in the short term.

The lack of short- and long-term credit for viable productive activity has been identified in a recent survey of Kosovo SMEs as their most serious constraint. This limits the private sector to activities that require minimal investment - mainly in the services and retail sectors. Establishing a credit program based on sound economic and financial principles will be critical.

The Bank and a number of other donors have either started or are still planning to provide credit lines for SMEs. In order to ensure coherence of purpose and approach and to foster the emergence of market-based credit, UNMIK has taken the lead in developing certain principles upon which such programs ought to be based.

- SME lending activities must be conducted within the newly established banking supervisory regime;
- Credit should be extended mainly for private enterprises only, based on sound credit analysis;
- Credit should be extended to enterprises in the parallel sector only after their conversion to the official economy (the lack of a functioning enterprise law or registry means that interim procedures will have to be adopted if the credit line is to be disbursed expeditiously);
- Borrowing terms extended to enterprises should not distort competition with commercial credit;
- Lending programs should be conducted so that it support the medium-term institution building needs for the banking sector;
- Donor-financed SME credit should be viewed only as a transitional measure until a healthy banking system is developed;
- Donor coordination must be maximized and overseen by UNMIK itself; and
- Similar principles should be applied to the extension of micro- and agricultural credit.

Selling Public Enterprises to Private Hands

Following a decade of neglect and enforced measures, many enterprises may not be viable, and thus will need to be liquidated. Therefore it should be recognized that keeping some of these entities running would only subtract value from the economy. While ownership transformation should be a key objective for the development of the private sector, it is no substitute for outright liquidation of non-viable entities. Under this premise, and in planning for privatization, Kosovo's socially-owned enterprises can be organized into the following categories: (i) large unique enterprises, such as the Trepca mining complex; (ii) utilities; (iii) enterprises of potential interest to foreign investors; (iv) other viable and potentially viable enterprises; and (v) non-viable enterprises.

Appropriate privatization methods may include: (i) asset sales/liquidation of the non-viable enterprises; (ii) public auctions or tenders for assets or shares for the majority of viable enterprises; and (iii) concessions or management contracts for special cases, such as Trepca. Asset sales would be the simplest to organize and the most attractive for potential investors.

Privatization progress requires resolution of several key issues, including UNMIK's mandate, ownership of social property, treatment of workers, and treatment of claims. These issues can be resolved quickly but will require detailed procedures for enterprise preparation and privatization transactions, in addition to public support.

The ownership issue has been considerably simplified by Regulation 1999/24. This defines the applicable laws as those in force as of March 22, 1989 - except when superseded by UNMIK regulations. It is generally considered that little or no privatization under the 1988 "Markovic" law had occurred by March 22, 1989. Although the majority of enterprises subsequently affected by "enforced measures" were wholly socially owned by March 22, 1989, there currently is no mechanism to establish this as a basis for further action. Recent policy statements by UNMIK propose the establishment of an adjudication panel to rule on the structure of ownership in each enterprise.

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It seems appropriate to equate social ownership with state ownership and for the privatization of such property to be administered by UNMIK. In the SFRY, social ownership conferred wide powers on workers to elect their management and otherwise determine how an enterprise would conduct its business; however, workers did not have a share in the capital of the enterprise. Moreover, in the former SFRY republics that recognized social ownership, the transformation of social capital was organized by the state, with the state receiving proceeds from the sale of transformed social capital.

In the interests of speed and efficiency, it is vital to limit restructuring of enterprises to the minimum necessary. It will be important that the only restructuring that takes place before privatization should be the separation of social assets (apartments) and public assets (power plants and irrigation systems) from the economic assets of an enterprise.

In recent months UNMIK has proposed the establishment of two public agencies: one for the adjudication of claims; the other for administering the adjudication decision, taking control of and managing enterprises until their privatization. It is important that the adjudication body is a small, efficient organization, with rules of procedure that permit rapid results. It is also proposed that once ownership is established, those businesses of which the majority of the stock is publicly owned will be brought under the control of a new Kosovo Enterprise Agency (KEA). The mandate of the KEA would be to incorporate the businesses and pay out any compensation according to the findings of the OAC, to take interim control of the enterprises until privatization, and to organize the privatization process, when that becomes appropriate. The KEA will be part of UNMIK, but it will report to an independent Steering Board representing all sections of Kosovar society. However, the proposal to establish the KEA flies in the face of experience with enterprise revival and privatization in transition economies. It is not advisable to have a government body being responsible for the control and operation of enterprises, even less to have such a body reporting to all sections of society, thereby permitting a conduit for pressures from workers, directors and others to press on with their vested interests. Inaction, deadlock and the preservation of enterprises are likely to result. It appears more efficient to appoint temporary management to such enterprises prior to their eventual sale or liquidation. Indeed, the privatization mandate should have clear and enforceable deadlines for preparation for sale and execution of the sale, with liquidation following on automatically should the enterprise prove to be insolvent or unsaleable.

Recent UNMIK proposals also contemplate that 10 percent of the capital of large enterprises, and 20 percent of small and medium sized be reserved for purchase by the workers. Preferential share sales to workers, however, should not be allowed to interfere with the ability of a strategic investor or dedicated management group to control an enterprise's operations and carry out necessary restructuring. Terms for preferential share sales should also be kept simple – e.g., cash purchases rather than installment purchases. It will also be necessary to define which workers (e.g., 1989 vs. 1999) are eligible for preferential share purchases.

As a first step towards privatization, UNMIK should assert its authority over potentially viable socially-owned enterprises by confirming or replacing current enterprise directors; establishing requirements and standards for regular financial reporting (including development of a current balance sheet) and preparations for privatization transactions; limiting the ability of enterprises to dispose of assets outside the ordinary course of business; and establishing director liability and penalties for non-compliance with UNMIK regulations.

Viable enterprises should be privatized through asset sales or – if there is a need to allow share sales to workers – through share sales. There are a very small number of socially owned enterprises in Kosovo, and the even smaller number of those that are potentially viable. Preliminary estimates suggest there may be fewer than 200 potentially viable socially owned enterprises of all sizes. Simple processes which focus on speed and transparency of the process,

rather than revenue generation, or even equity, should be the objective when considering what institutional arrangements are necessary to get the potentially productive assets back to work.

EDUCATION

The formal asserting of centralized control over education content from 1990 caused the Kosovar Albanians to develop a “parallel” education system financed by remittances from abroad and by informal tax revenues collected and managed at the municipality level. Despite the remarkable efforts during the past nine years – particularly among teachers – to maintain a functioning education system under extremely difficult conditions, the quality of education delivered in the classroom has inevitably suffered. Enrollment ratios, thought to be over 90 percent in primary prior to 1989, have almost certainly declined substantially over the past decade, particularly among girls. As a result of the recent conflict and a decade of inadequate maintenance, 30 to 50 percent of school facilities is in need of reconstruction, presenting a serious constraint to re-starting the education system. Since June 1999, Kosovar Albanians have taken it upon themselves to re-start the education system. Curricula and textbooks developed under the “parallel” system will be used in the first several years while new programs can be developed based on modern teaching and learning innovations.

Thus, in terms of provision of educational inputs (which say little about learning outcomes), the past nine years and the recent conflict have taken a serious negative toll. Few teachers, professors or administrators – with the important exception, perhaps, of those living abroad - have benefited from any organized professional skills upgrading. Even prior to 1989, pre-service teacher training lacked a methodological focus and education administrators were not exposed to modern public sector management skills. Basic textbooks for primary and general secondary education were reported to have been generally available to most students, financed through external contributions, but their pedagogical and physical quality is said by teachers to be lacking, and many of these books were destroyed or lost during the recent conflict.

Key Sector Priorities

Priorities in education can be expressed in two broad categories:

- The need to restore a minimally acceptable learning environment to children currently in schools, and
- The need to define a new education system and policies that will serve children in Kosovo for generations to come.

The education system in Kosovo needs to begin a transition that has been underway in many of its central and eastern European neighbors for the past seven to eight years. While comprehensive, locally driven strategy and policy development will take time to evolve, there are a number of key priorities and objectives that an eventual education strategy would be expected to address.

Education governance and financing. The key to establishing an efficient distribution of responsibilities and functions across levels in education is twofold: first, to allocate to the center

the authority for policy/strategy formulation and for ensuring equity of access (redistribution to disadvantaged areas) and the quality and consistency of educational programs; and, second, to ensure that lower levels are given the responsibility and authority (including budget and expenditure authority) to implement programs flexibly and creatively within established norms. A priority should be to continue a policy of decentralization to ensure the authority of municipal officials to manage the majority of resources for education. The design of a system of fiscal devolution for education in Kosovo would include two crucial elements:

- Once the relative priority for education has been determined at the center in competition with other sectors and priorities, the distribution of resources for education to the municipalities could be carried out in the form of block grants on the basis of a per student budget formula. Such a formula-approach to education funding – common in Western Europe and North America and recently adopted in Hungary, Poland and the Czech Republic -- would help ensure equity (all children would be entitled to equal funding) and provide a powerful incentive to municipal officials to manage education resources efficiently. The formula can be adapted to take into account existing disparities (separate urban and rural budgeting norms, for example), and to allow additional spending for programs in low performance areas. A centrally mandated public pay scale for teachers and other employees in education could also be maintained under such an arrangement. The introduction of per student funding would also contribute greatly to transparency in terms of allocation of resources across ethnic groups.
- Despite the tradition of local management and financing councils, priority would have to be given to supporting municipality governance structures to develop their public administration skills and for re-defining the role of local school boards and parent associations -- which are mandated without much description in informal Kosovar Albanian legislation. Local school boards, in particular, should be expected to play an important role in ensuring accountability in the definition of local priorities and the expenditure of funds to achieve those priorities.

The central ministry's role in ensuring educational standards and consistency within a fiscally devolved system is discussed below in the curriculum and assessments section.

Higher Education Governance. The University of Kosovo operates as a loose association of faculties, academies, colleges and institutions, each with a legally autonomous status and management structure. This dispersal of authority in what should be a single institution has led to a redundancy of programs, personnel, and facilities across faculties which diverts resources from improving the quality of teaching and learning. The weakness of the university rectorate also hinders an effective prioritization of programs in the face of a changing economic and social environment and allows autonomous faculties to resist systemic reforms aimed at investing efficiency gains in improving the quality of programs. As the university is re-established and new legislation is drafted over the coming months/years, authorities in Kosovo should make the university compatible with European standards in university governance and management. The key will be not to allow direct investments in single faculties to re-enforce the inefficiency and redundancy of the current governance structures. Further, specific higher education programs, which respond to particular development needs or skills shortages – such as the development of programs for medical, business administration and public administration programs – should be a high priority.

Curriculum and Assessments. There is an awareness among leading professional educators that educational programs at all levels are characterized by a dense and ambitious body of knowledge to be learned, leaving little flexibility to focus on thinking and learning skills or to deal with children with varying capabilities. In order to make the education system responsive to changes in the skill needs of the labor market, reforms will be needed not only in what is learned in school but in how it is learned. The authority for developing and monitoring a curriculum framework and modern learning standards should be placed at the center. Agreement among all stakeholders on an institutional mechanism and process for beginning this fundamental effort should be a priority for the coming year.

Teaching. There is complete agreement among education authorities that top priority should be given to upgrading the teaching skills of nearly all the estimated 22,000 primary and secondary school teachers currently serving the system. Local authorities and donors should balance support between the need to re-define pre-service teacher training curriculum and re-structure delivery mechanisms for in-service training – reform initiatives which should start soon – with the need to provide at least some remedial training to existing teachers with a degree of urgency over the next year or two. Donors and NGOs should play a major role in helping to organize both medium term teacher training reform and offering urgent skills training to teachers in the short term.

Secondary and Vocational Education. As currently designed, the secondary system in Kosovo is out of alignment with the emerging market economy's need for broad-based skills, labor flexibility and continuous learning. It is crucially important for donors not to rush into the re-establishment of the current secondary system until local authorities have developed a strategy for secondary reform. Focus should then be put on the medium term objective of developing new broad-based programs and on an extensive re-training program for the existing secondary teaching force.

A reform of secondary technical/vocational education will also necessitate commensurate reforms in the field of adult training and two-year higher education technical/professional programs. The goals are to develop a network of training suppliers (public university, private-for-profit, semi-public, NGOs,), to bring social and private sector partners into the governance of adult training, to complement government funding with cost recovery, and to facilitate the availability of labor market information.

HEALTH

The health system in Kosovo has traditionally been financed by pay-roll and profit contributions to a health insurance fund (HIF), and service delivered through a tertiary hospital in Pristina, five other district hospitals, "health houses" (a form of polyclinic) and small primary health care (PHC) clinics. The prevailing model of medical practice is excessively specialized, yet out of line with modern clinical practice. Family medicine and nursing practice need a great deal of development.

After 1989, HIF management, and policy and regulation were centralized to Belgrade, with district office functions in Pristina and four other districts of Kosovo. Ethnic Albanians were dismissed from management and senior medical positions. The HIF covered only around half of

the ethnic Albanian population, many of whom ceased to pay contributions and lost HIF coverage. Ethnic Albanians set up a parallel system to provide PHC through the Mother Theresa Society (MTS); delivered parallel training of 700 doctors and 1200 nurses; and delivered services through private practice financed from user fees. Since June, the MTS system has largely collapsed, and there appears to be little desire to restore it. Many Albanian doctors have moved to the hospitals, claiming rights to restitution of previous employment, or to specialist training positions denied to them during the past 10 years. This migration has had an adverse effect on the operation of PHC facilities, particularly in rural areas.

Indicators of health status. Even before the crisis, Kosovo's health care statistics were among the poorest in Europe on virtually every health indicator. Preliminary results from a national survey conducted by the International Organization for Migration (IOM) and the UN Population Fund (UNFPA) confirm that Kosovo continues to have one of the highest infant mortality rates in Europe, with 25 deaths per 1,000 live births. According to the survey, undertaken from November 1999 to February 2000, 15 percent of pregnant women do not see a health-care worker and 20 percent of deliveries take place at home without professional help. Breakdowns in the immunization system have placed the population at even higher risk.

Health services. The effects of the conflict added to underlying problems in health services that arise from ten or more years of neglect, poor policy and weak management. There has been chronic under-investment in maintenance of physical infrastructure and equipment, and in staff development. Much of the equipment installed in the hospitals is obsolete, out of order due to poor maintenance, unused due to lack of consumables, or under-utilized due to lack of personnel.

As noted, many health professionals who worked in Mother Theresa Society clinics have now abandoned this system to seek employment and specialist training positions in hospitals. As a result, the means of providing health care for the poor and in rural areas is now in decline. Medical staff who graduated from the parallel system also claims a right to positions in hospitals that would enable them to complete an "intern year" of supervised practice, and then obtain registration. A further concern is the level of clinical skills among health professionals. Kosovar Albanians educated in the parallel system and those working in the Mother Theresa Society system or private sector have had little access to facilities for updating knowledge of changes in medical technology and evidence of effective practice for the past ten years.

The combined effect of these trends is that doctors have now moved from primary care to the hospitals, hoping to work or train as specialists, over-burdening the hospitals and the system of specialist clinical training, while primary health care facilities, particularly in remote areas, are deprived of staff. The distribution of health care facilities and of health professionals across Kosovo was already inefficient and inequitable, with a relative concentration in Pristina, alongside scarcity of primary health care facilities and doctors in many rural areas. Large segments of the population, especially the rural poor, have limited access to modern health services.

Health care financing and expenditures. The local cost, recurrent budget provides financing for health services. One large problem with the budgeting process in Kosovo is its reliance on donor funding which makes planning very difficult. For example, questions such as how many pharmaceuticals to order or whether to keep a specialist on staff in face of uncertain financing

commitment for that particular service (cancer for example) are real questions that must be answered. Moreover, until a personal income tax was in place and a tax base was defined, it would be difficult to introduce any contributory taxes.

The budget does not explicitly account for co-payments, though both the CFA and UNMIK Health and Social Welfare agree that the present recurrent budget will not be sufficient to operate at a minimally acceptable level. There is evidence that people are already paying a large amount of money for health care; some of this can be collected back into the system. This would have the added advantage of not only raising some revenue, but also reducing informal payments and restoring transparency to the system.

Key Policy Priorities

Four areas of policy development are crucial in the environment described above. Kosovo, as a “late starter” has the advantage of learning from other countries on what some of the strategies might be.

Identifying Sustainable Sources of Revenue for the Sector. The Interim Health Policy Guidelines already indicate a preference for Kosovo to restore a system of compulsory health insurance contributions. The examples of other countries in the region could help Kosovar health authorities to re-establish a health insurance system that preserves the main virtue of the pre-1990 system – widespread population coverage – while improving transparency and creating incentives for efficiency. In the short to medium term, however, Kosovo will be unable to move entirely to a social insurance system. Most of the financing for the health sector in the near future will have to come from the consolidated budget. A risk currently facing the sector is that a large portion of health spending will be paid out of pocket with limited risk pooling. There is already a growing prevalence of under the table payments to health care providers that according to experiences in other countries, will become more difficult to control over time.

Policies to govern the distribution of health revenue to different districts and health care providers across Kosovo, and the mechanisms for paying health care providers will need attention in the medium term. Initially, health providers will be reimbursed for the costs of inputs (salaries, pharmaceuticals, other supplies, and capital), based on approved plans for staff numbers, approved capital investment and so on. In the medium term, mechanisms should be developed to pay providers for defined outputs - i.e., number of patients registered with a primary health care clinic, numbers of hospital admissions for various conditions - subject to a global limit on their budgets. Ideally, providers also should be given incentives to improve service quality, efficiency, and effectiveness. The previous system for paying providers encouraged inefficiency - for example, by encouraging long hospital stays, with excessive doctor consultations - and should not be reinstated.

Prioritizing Spending. In the near term, prioritizing spending will entail rationing the limited budgetary resources for health - deciding where to spend public sector funds. The first priority should be given to services such as immunizations, which have clear public good aspects, as well as to the most essential and cost-effective clinical services. The tradeoff comes in deciding how many people to fully cover because of their inability to pay versus offering a bigger package for everyone. UNMIK may want to prioritize some of its health spending based on an income

means test, perhaps along with the issuance of social assistance benefits, to ensure that the poorest are not excluded. Even with additional revenue from co-payments, a significant cut in the health budget makes some sort of list inevitable.

Another component of the prioritization strategy that DHSW has already embraced is to build capacity in primary health care to deliver services that address the most common health problems - including Kosovo's specific post-conflict needs and problems arising from past lack of access to public services. There may be value in defining a basic set of services to be managed in primary health care. In the short term, WHO and a range of donor agencies and NGOs have begun to offer short-course training to provide orientation and basic training for doctors in primary health care/family medicine. The aim is to encourage a large share of the parallel system graduates and other returning medical school graduates to shift into primary health care.

Resource allocation tools and provider payment mechanisms need to be developed to support the strategy of treating more patients in primary health care, and at the district rather than central level. Financial incentives in the salary structure for doctors and nurses have already been put in place to encourage health workers to take up primary health care. These incentives will need to be refined to encourage providers to move from urban to rural areas (a problem in many countries) as well as between various specialties.

Reduction of Waste and Inefficiency. Two areas stand out in which there is substantial scope for reduction of waste and inefficiency: pharmaceuticals management and the organization and operation of health services, particularly hospitals. In Kosovo's 2000 budget, pharmaceuticals are estimated to be 57 percent of the budget; there is a danger that an uncontrolled private drug supply system could develop, pushing up the cost of drugs dramatically. Efficiency gains would be realized through the introduction of user co-payments (prescription charges) for drugs dispensed in public pharmacies and competition between public and private pharmacies.

Several organizational improvements can be made:

- Reducing the relatively high average length of stay (12.5 days) in hospitals, reflecting in part the under-performance of the primary care system. Most patients currently self refer to hospitals due to the collapse of the official referral system during the crises. Re-establishing referral systems and guidelines for referral will be required alongside the redevelopment of primary care.
- Pushing up a below normal occupancy rate (75 percent).
- Eliminating the excess of beds in specialties that require less or no in-patient care and under-provision in other areas (e.g., cancer services).

Community Control and Decentralization. Decentralization of public health services often is viewed as potentially the most important force for improving efficiency and responding to local health needs in former socialist economies. Success will come only when local government health agencies and providers develop a sound financial base, solid administrative capacity, incentives for improving efficiency, and accountability to patients and local citizens.

The functions of pooling financial risk and redistributing revenue from higher to lower income areas should be centralized at the provincial level. The average municipal population is too small to make efficient use of general hospital services or to pool financial risks (the risk that some of the population will require very high cost health care), or to distribute revenue fairly across high and low-income populations. Therefore, the health sector will be better served by a single health fund with five or six district branches than by a more decentralized approach to financing. Policy, planning and regulation functions for the health sector are also best carried out at the province-wide level. Municipal ownership of primary health care facilities creates fewer problems, though the benefits of local ownership (such as greater community support) need to be weighed against the benefits of common management for both primary health care and secondary health care (better co-ordination, stronger clinical and managerial support).

The recent decision to devolve responsibility for primary health care to municipalities in Kosovo could be problematic, depending on how actual responsibilities between the DHSW and the municipalities are defined. It currently appears that policy making as well as financial control will remain with the center while responsibility for the delivery of services will be handed over to the municipalities. It would be best to hold off on any further decisions regarding the financial responsibilities until decisions had been reached about the overall design of the new system.

SOCIAL PROTECTION

Between the mid-1970s and 1989, Kosovo operated its own social protection system under legislation of the autonomous provincial legislature. This was consistent with and under the general umbrella of Federal Yugoslav legislation. Cash transfers included contributory *pensions* and *unemployment benefit*, means-tested *child allowances* for contributors on low wages, and very tightly controlled *social help* for households with no resources. In 1989, Kosovar legislation was superceded and all entitlements and programs were incorporated directly into the Serbian social protection system and directed from Belgrade. New eligibility rules discriminated in several ways against ethnic Albanians. At the same time, many Albanian staff administering the various social protection programs were dismissed and replaced by Serbs. Those dismissed from their jobs in the public service also lost entitlement to unemployment benefit and child allowances and ceased to build up pension entitlements.

Between 1990 and 1999, therefore, basic social protection for many Albanian Kosovars was provided by the extended family network, by remittances from the large Albanian community outside Kosovo, and by help in kind from various humanitarian organizations. Particularly important among the latter was the Mother Teresa Society: an organized charity established in 1990 and funded by private donations from the diaspora and international organizations, with an extensive network of branch and local centers staffed by volunteers throughout Kosovo.

Current Situation

Following the conflict, large numbers of Kosovars lacked basic housing, furniture, clothing or cooking facilities. While self-help and donor assistance have eased the situation considerably, a significant number of households have lost the main breadwinner, and there remains significant levels of physical and psychological damage. When introduced in November 1999, the UNMIK

social assistance system was paying benefits to 54,000 households, rising to around 80,000 in April 2000. However, as the scope of the scheme was very tightly constrained, that this may not be a realistic measure of the total number in need.

In addition to the substantial help in-kind being provided by humanitarian organizations, there is an unknown flow of funds from family members outside Kosovo, and many households receive regular stipends paid to public sector workers (who totaled around 70,000 in 2000). In addition, informal economic activity is thriving. All of this suggests that the number of people without insufficient cash income will stabilize during 2001, but will remain high for some time to come. The planned withdrawal in the near future of WFP and other donors such as UNHCR also suggests that the most vulnerable are likely to face a significant welfare shock in the first half of 2001.

Given limited budgetary resources in 1999-2000, the UNMIK administration decided - quite appropriately - that the highest welfare impact was to focus social transfer resources on an interim social assistance program. The Emergency Financial Assistance Program was administered by UNMIK with help from CSW and NGOs between November 1999 and April 2000. From May 2000, a new social assistance scheme has been implemented in stages, administered by CSW under the overall supervision of JIAS, with support from local and international NGOs. The main social insurance programs - pensions, child allowance, and unemployment benefit - have not been reinstated. Conditions that would make a restart of any social insurance programs feasible are discussed below.

Key Policy Issues

The extent to which changes in the pre-1989 (or the current) structures (as described in the foregoing sections) are necessary or desirable.

- The benefit structure of the *pensions system* is generous by modern Western standards and that of many transition economies. It would be expected that any pension system that is might be introduced in the medium term would require a range of reforms which would bring it more into line with reformed transition systems throughout the region. This would include increased normal retirement ages, rationalizing early retirement entitlements in order to raise average retirement ages, and flattening - perhaps entirely in the interim - pension benefits.
- The inherited structure of *social help payments* has some unusual features by Western European standards, but the system has a track record of meeting need in a way which fits local customs and attitudes and which exercises tight control over the costs. There clearly is a need to update the skills of the Kosovars now running the system.

Much the same is true of *child allowances*. However, the feasibility of child allowances in the future needs to be assessed in light of the overall social safety net, fiscal constraints and administrative demands of multiple programs.

- The current structure and coverage of *unemployment benefit* are not sensible for a modern economy, and need to be considered afresh. This is very much a longer-term

issue, however, as it is hard to see any sensible function for a contributory unemployment benefit in Kosovo over the next two to three years.

The priority to be given to reintroducing the various benefits.

- Sensible criteria for deciding this in the immediate future might be operational feasibility (what is actually possible); targeting resources on greatest need; and cost and affordability. For the longer term, these might be supplemented by financial sustainability; the need to take account of past obligations and expectations; maintaining a sensible structure of incentives and relativities between those in and out of work; and the advantages of some form of comparability of arrangements with neighboring countries and trade partners;
- Resumption of pension payments. There is strong pressure from various groups within Kosovo for an early resumption of pension payments, at least to those with entitlement in February 1999, and certainly resumption would go some way to help alleviate very real need among potential beneficiaries. However, from a broader social protection and assistance perspective, there are powerful arguments for not according high priority to resumption of pensions;
- The practical issues of resuming a PAYG system prior to re-introduction of a payroll tax or a personal income tax are enormous.
- Payments would be badly targeted, reaching only a comparatively small proportion of those in the various vulnerable groups and without regard to immediate need;
- The operational difficulties in identifying and locating beneficiaries can not yet be predicted with any confidence, and could be substantial;
- It would raise very real questions of equity in relation to those ethnic Albanians who have lost pension entitlements because they have been prevented from working in the state sector over the past ten years;
- There is a complicated tangle of issues about the relative responsibilities of the Serbian and Kosovo Pension Funds – and a real possibility of disadvantaging numbers of people by too simplistic an approach to these questions; and

Social Assistance. In the present circumstances of Kosovo, it would be neither practical nor sensible to rely on cash payments to individuals as the prime instrument for meeting need. That function is better fulfilled by humanitarian aid in kind. It is imperative that the Mother Teresa network and the various international agencies should continue to function in Kosovo for this purpose.

In 1999, UNMIK ran an emergency social assistance scheme that was replaced in mid-2000 by a two tier approach that targeted households with no adult capable of work and some unemployed families – the total number of assisted families is expected to be 50-60,000. It is clear that there will remain significant needs for refining this system going forward, in particular on

implementation of the means test, and how it is integrated with asset tests and other targeting tools. This will need to be done with a close eye on fiscal sustainability. So long as social assistance is the only public transfer program, the issue is somewhat less acute, but the design of the longer run scheme will need to be assessed in light of developments on pensions.

Child Allowances. Cash payments related to household size could lead to large entitlements for those with large families – possibly larger than the amount they might earn at the bottom of the wage scale. This may result in a problem of incentives to work. This issue was addressed in the former system by child allowances (CA). While there may be a role for child allowances in the medium term in combating child poverty, for 2001, there is no separate CA in the budget. This seems appropriate given the absence of a robust poverty profile, and the need to take decisions on specific benefits within a coherent strategy for the whole social protection system.

Unemployment benefit. Given the likelihood of high formal sector unemployment, the absence of individual taxes, and the existence of a basic social assistance benefit, it appears that unemployment benefit payments would not be a priority over even the medium term.

Fiscal Devolution

There is no case for devolution of the financing or management of contributory benefit systems, which should be organized on a Kosovo-wide basis. The arguments are different in the case of social assistance schemes. Some discretion in the administration of such schemes is desirable to avoid too rigid and broad brush an approach to different household circumstances. The risk is that discretion will be exercised in ways that increase overall costs; this can be avoided only by imposing arbitrary local budgetary limits or by including a significant local element in the financing of the scheme.

SUMMARY OF RECOMMENDED SHORT-TERM ACTIONS (TO MID-2001)

- The existing social assistance system should continue as the priority cash transfer program, with joint work by UNMIK, the Institute for Social Policy, CSWs, and the World Bank/DFID-financed expert team on developing a fiscally sustainable and administratively feasible longer-term social assistance program, particularly with respect to targeting among current second tier beneficiaries;
- Work on a medium-term Social Protection Strategy should be completed as a priority, in order to help develop a coherent and sustainable structure of cash benefits and other services. This would include policy directions for reform of any inherited benefits that are likely to be restarted in the medium term, take close consideration of tax reform developments, and provide a framework for innovative public-private mixes in social welfare provision;
- Following local elections, consultation between UNMIK, local authorities, CSWs and the WB/DFID expert team would need to be initiated to consider the appropriate roles and responsibilities of different levels of government in social protection;

- Resumption of pension payments on a social insurance model should not be an early priority.
- Consistent with emerging recommendations of the Social Protection Strategy work, UNMIK should continue to assess possibilities for introduction of an elderly financial supplement, subject to resources being clearly identified;
- There is no case for reintroduction of a contributory unemployment benefit in the short to medium term;
- The reintroduction of child allowances is not an urgent priority;
- The new veterans' scheme should remain strictly cash limited, and eligibility criteria and administrative channels developed soonest. Payments should focus on those veterans most severely disabled and survivor families, with controls on the categorization process in order to minimize the risks of abuse seen in neighboring countries;
- The LSMS should be completed and analyzed. Data and main findings should be shared as widely as possible with key stakeholders in social protection, in particular for further improvements in social assistance; and
- UNMIK should consider further revisions to the draft Labor Law (see above) which place a stronger emphasis on labor market flexibility and facilitating formalization of the gray economy.

SUMMARY OF RECOMMENDED MEDIUM-TERM ACTIONS

- Based on the key recommendations of the Social Protection Strategy, work should begin on Social Protection Law which would act as a framework law for the sector;
- There should be a detailed study of the possible path to financial sustainability of the Pensions Fund over the longer term, including issues of dealing with claims of ethnic Albanians related to the 1990s. This should include a full examination of different options for the structure of the scheme, including the possibility of a phased increase in retirement age and benefit rules more in line with Western European practice;
- As it becomes possible to replace the payment of cash stipends by a proper wage and salary structure, every effort should be made to move away from the traditional approach in which salaries are denominated in terms of take-home pay and contributions are added in on top. Payments of contributory pensions should not resume without a change of this sort, even if the consequent contribution income is insufficient to match the cost of payments; and
- Further work is needed on developing approaches for ensuring that Kosovar Serb populations continue to have access to the social protection system, including assessing the implications for the CSW network.

VOLUME II

CHAPTER 1:

BUDGET AND FISCAL STRUCTURES

UNMIK is making progress towards establishing a public administrative structure able to deliver improved public services to the population of Kosovo, within the available budgetary resources complemented by donor support. Such progress includes the establishment of the new Joint Interim Administrative Structure (JIAS)¹ and the regulatory framework which defines the responsibilities and functions of its various departments, as well as the establishment of the Central Fiscal Authority (CFA) and a budget management system that is able to provide resources in a timely manner and ensure that these resources are spent efficiently and transparently for the purposes intended. In addition, progress is being made to improve coordination in the reconstruction efforts, given substantial needs for capital investments and substantial donor commitments and financial support to finance these needs.

Despite progress, serious challenges remain as regards the fiscal performance and medium term fiscal sustainability in the coming years. The budget data as of October 31, 2000 show considerable improvements in the revenue performance compared with the beginning of 2000. However, they also show expenditure shortfalls compare to pro-rata figures for the 10 months of 2000 and highlight important budget structural issues especially related to wage and employment as well as transfers to utilities. The data show a spending pattern with overspending trends on wages and subsidies and under-spending in non-wage categories raising concerns about the ongoing implementation of budget programs. More importantly, budget estimates for 2001 highlight additional pressures on expenditures coming from off budget items and expenditures financed from dedicated donor grants (DDG) (e.g. Kosovo Protection Corps) which should be included and financed from projected resources in the next year's budget.

To ensure effective budget outcomes and effective service delivery over time, the policy formulation process should be closely linked with planning and budgeting in a coherent budget strategy and expenditure framework. The link between policy, planning and budgeting becomes essential in the specific circumstances of Kosovo given a unique multinational administrative structure and substantial donor involvement in financing a considerable part of the recurrent budget needs and almost the entire capital investment needs. The present separation of the recurrent and capital budgets into two wholly distinct entities, with the former being financed partly through local taxation and partly through external donor assistance and the latter entirely from donor support, inhibits the formulation of a coherent budget strategy undermining the effective and efficient use of budgetary resources. A non-unified budget may be unavoidable in an immediate post-conflict environment, but is clearly undesirable over the medium run. The following sections intend to discuss fiscal policy and budget management issues in more details and present some of the challenges UNMIK faces in building financial management institutions.

¹ See Volume 1, Chapter 2 of this report for further details.

FISCAL DEVELOPMENTS

The Expected Outturn for the 2000 Budget and Estimates for the Year 2001

Fiscal policy in Kosovo can only take a rudimentary form, given Kosovo's present peculiar circumstances. In a cash-based deutsche mark economy with no domestic financial instruments, nor even domestic currency, there is scope for neither seignorage nor inflationary finance, and there is no other means for financing a domestic budget deficit. At present, there is no external debt service payable either, so this is neither a burden on the budget, nor does it require budgetary decisions.

In September 1999, UNMIK prepared estimates for the recurrent budget for the final four months of 1999 and a preliminary estimate for the year 2000 in consultation with World Bank and IMF fiscal teams. The estimates for 2000 were finalized and issued as a regulation by UNMIK at end-December 1999, thereby constituting the annual budget law for 2000 for Kosovo. With the creation of JIAS the budget regulation for 2000 was amended and approved in March to incorporate expenditures for the new administrative structure that includes local co-heads for all the departments of UNMIK (Table 1).

**Table 1: Summary Budget Account
(in millions of deutsche marks)**

	Sept-Dec 1999		2000	2000	2000	2001
	Estimates	Outturn	Budget	Amended	Projection	Budget estimates
Total Revenues	47.7	30.5	223.2	210.0	212.6	344.0
Customs	9.3	9.0	38.0	35.0	51.8	44.5
Excises	14.7	1.6	21.0	18.0	39.7	83.4
Sales and VAT (from mid-2001)	23.6	19.5	104.0	91.0	104.4	138.0
Payroll	-	-	15.0	15.0	-	-
Hotel, food, and beverage	-	-	-	-	2.7	4.0
Fees and user charges	-	-	26.7	32.0	11.0	40.1
Other	-	0.5	18.5	19.0	3.0	34.0
Total Expenditure	121.6	86.6	423.2	429.3	432.6	505.9
Education	44.0	32.4	116.2	116.2	...	118.0
Health	24.9	17.3	81.1	81.1	...	98.0
Civil administration	13.4	13.6	49.7	53.8	...	109.1
Social Assistance	28.0	8.9	82.5	82.5	...	85.0
Other	11.3	14.4	93.7	95.7	...	95.8
Financing Gap	73.9	56.1	200.0	219.3	220.0	161.9
(in US dollars, millions)	(41)	(31)	(103)	-	-	-
Donor contributions	73.9	85.3	200.0	200.0	220.0	161.9
Transfer to cash reserves	-	29.2	-	-19.2	-	-

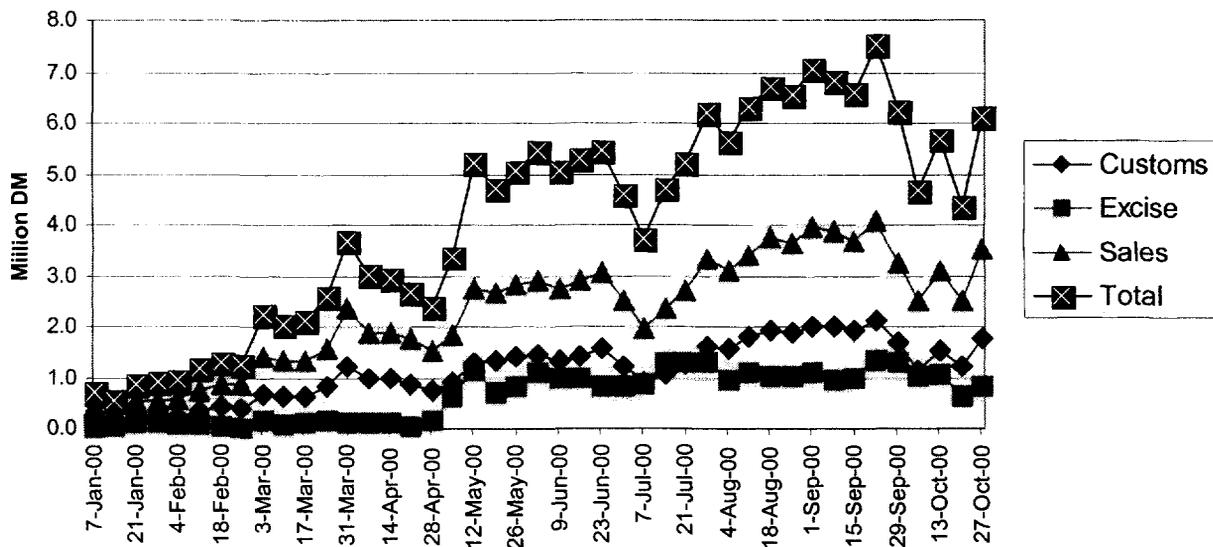
Source: UNMIK.

Revenues

The taxes being levied today are a customs tariff of 10 percent, excise taxes at varying *ad valorem* rates on tobacco, coffee, oil and oil products, alcohol and soft drinks and certain electronic goods, amounting to between 5 and 50 percent, and a sales tax of 15 percent on

imports. Taxes are today being collected at certain border points (the border points with Albania, Macedonia, and as of March also the boundary line with Montenegro); the coverage is to be gradually widened. A service tax, hotel food and beverage tax has also become effective at the end of February 2000. Excise taxes on domestic products, such as beer and cigarettes, sales taxes on domestic products in general, and certain municipal level taxes were to be phased in gradually in 2000 as tax administration capacity was built up. Other taxes that were proposed for implementation from 2000 were a wage withholding tax, a presumptive tax, and a profit tax, but so far as the yield of these new taxes is concerned, much depends on tax administration capability.

**Chart 1: Kosovo Consolidated Budget
Weekly Revenues by Tax Type as of October 28th**



Source: Data supplied by UNMIK.

Developments in the period since the customs and tax systems were put in place to end-1999 show that customs tariff and sales taxes were collected broadly satisfactorily, but there was disappointingly little collection of excise duties. Total revenues collected at the end of 1999 amounted to DM 30.5 million, in contrast to budget estimates of DM 47.7 million. The weakness in excise duty collection was, in significant part, related to incomplete coverage of entry points into Kosovo as well as weak tax administration capacity. Reports from the customs administration indicate that high value excisable items (beer, cigarettes, fuel oils) have entered in large quantities from Montenegro (a boundary crossing point where a tax post has only just been set up) and that some illegal "revenue" associated with these goods are being collected by "parallel organizations".

Tax and fee revenues were estimated at DM 200 million in 2000 – a substantial increase on revenues per month in relation to the final four months of 1999. Estimated growth of 23 percent of the real economy in 2000 is projected to boost the fiscal base. In addition, the extension of sales and excise taxes to domestic goods (not just imports), the institution of a wage withholding tax (the payroll tax), presumptive tax on businesses, a profits tax, Hotel Food and Beverage tax (HFB), and vehicle license and radio frequency user fees are new, significant sources of revenue. Some of these taxes, such as Hotel Food and Beverage tax, vehicle license fees and presumptive tax have been phased in already. Others were expected to be phased in during the course of 2000 as tax administration capacity allowed. However, at the time this report was being written no other taxes had been introduced. The institution of the wage tax – a highly important potential source of revenues – depends on authorization from UN New York headquarters to permit taxation of local staff employed by UNMIK. Without such authorization, the institution of the wage tax would be divisive and politically difficult, besides being based on a much narrower base. Additional customs officers have been recruited and tax administrators have been under training. Budget estimates for 2000 assumed that the Montenegro tax gap will be closed and the preferential trading agreement with Macedonia that provides for tariff free entry for Macedonian goods (but subject to a 1 percent fee) would be eliminated. However, they still remain outstanding issues constituting significant revenue losses for the Kosovo Consolidated Budget.

Developments in the first two months of 2000 showed an extremely weak revenue performance, with significant shortfalls in all categories of revenues, particularly excises. During the third month, however, revenues experienced significant improvements especially in customs and sales tax collections. Though the causes of these developments are not fully understood, it is likely that the tax coverage gap related to the Montenegro boundary line led to large leakages. UNMIK has, as noted, now set up a tax post at the Montenegro boundary line and expects to meet its budgeted revenue estimates on the basis of the new taxes to be instituted (as described above) and improved tax administration and coverage.

Following the poor performance of the first two months, revenue collections are now rising (see chart above). Excise taxes have shown strong increases due to the application of unified tax rates for heating oil and petroleum products. Hotel Food and Beverage Tax is now fully operational. Although its collections remain small, the experience gained through its administration was an ideal training ground for the staff and taxpayers for future inland taxes such as presumptive tax. Total revenues have shown significant improvements and are slightly above the pro-rata figures in the ten months ending October 2000, although they still rely largely on collections made at the Administrative Boundary Lines (ABL). Compliance activity is underway in both ABL and Inland Operations. ABL collections remain subject to seasonal factors, but continue to grow with increasing staff competence, a broadening tax base and increasing compliance/education activity. A review of ABL taxes will commence shortly to better integrate the tax portfolio through inland collections of excise and sales tax. Both the Customs and Taxation Administrations have plans to grow beyond current budgeted levels as inspections and enforcement activities expand.

Revenue projections for year 2001 assume improvements in both tax policy and tax administration and are expected to increase by 45 percent compare to 2000, to DM 330 million. (Table 1) Although such an increase is significant, it is necessary to ensure that Kosovo moves

towards self-sufficiency and becomes less dependent on donor financing, especially for the recurrent expenditures. Increasing revenues in 2001 would be achieved by a rapid broadening of the tax base and removal of the large distortions associated with the existing customs tariff structure. Measures must be taken to move towards a sales tax and eventually a Value Added Tax (VAT) system and change the existing tax structure in favor of taxes being raised domestically. In addition, a rapid establishment of the legal framework for private sector development would open up opportunities for employment, growth and higher tax yields.

Expenditures

The major categories of budgetary expenditures in both 1999 and 2000 estimates relate to education and health, transfers for social assistance, and the civil administration (including police and justice), with salaries constituting the largest single item. The budgets provided that social assistance would be extended to a core group of the neediest families at the minimum wage level; it was also decided that pension payments would not be made at this stage. The outturn for expenditures in the final four months of 1999 showed a very substantial shortfall from initial budgetary estimates, DM 86.6 million vs. DM 121.6 million. The highest underspending was in the items of social assistance, education and health. The principal cause of the expenditure shortfalls can be found in tardiness in establishing the administration structure, in setting up the payroll for education and health, in working out safe ways of delivering cash for expenditures and putting in place effective budget execution and monitoring systems. In social assistance, establishing the needy and implementing the proposed assistance has taken considerable time. As social assistance spending was originally estimated conservatively and is targeted to the vulnerable, the shortfall is of particular concern, and it is hoped that, with improving implementation capacity, planned social assistance programs would be adequately funded and implemented.

The 2000 budget proposed a strong rise in overall expenditures (but at a rate less than the rise in tax and fee revenues) centering on education, health and social assistance. The key objectives of the education budget were to ensure full enrollment, initiate steps towards a unified curriculum, enhance pre-service teacher training, reform the Pristina university, and undertake comprehensive school mapping. The budget also funded the preschool sector. The major objectives for the health sector were strengthening primary care and building up the physical facilities for health care. The budget included some incentives for shifting doctors to rural areas. The social assistance budget focused on assistance delivery to the most needy, particularly elderly over age 70, single parent families and families with a handicapped person. Policy work on a permanent system of social assistance will be funded in coordination with health, pension and social insurance funds.

Expenditure estimates for the 2000 budget rested on the assumption of DM 273 per month for the average public sector wage (a rise of nearly 50 percent in relation to those who received wages in 1999) and a fall in public employment (particularly in education and health sectors) of an estimated 10 percent. There was also the intention to develop retraining and counseling for redundant public sector employees and to establish a framework for unemployment insurance in future years.

The 2000 budget was amended in March to incorporate expenditures for the implementation of the Joint Interim Administrative Structure. As a result of these amendments, overall expenditures were increased by DM 6 million. However, the introduction of additional revenue generating measures to offset the increase in expenditures left the overall balance unaffected. Budget outturn for the ten months of 2000 shows that expenditures have picked up considerably amounting to a total of DM 260.1 million or 60.3 percent of the annual budget. However, they still remain below the pro-rata figures by DM 99 million. The majority of expenditures have occurred in education, social assistance and fuel and energy and most of them have been used to pay wages and social assistance compensations. Several issues become evident when analyzing actual expenditures for the first ten months of 2000:

- *Wages and Salaries.* They amount to 72 percent of the annual appropriations. While this number appears reasonable, three significant issues should be noted: (i) the total number of persons employed under the budget exceeds authorized numbers, particularly in the Department of Education and Science and the Department of Health and Social Welfare, which together comprise 76.9 percent of the wages budget. The number of employees for the two departments grew in the first few months of 2000 before stabilizing in April; (ii) staffing levels for other departments were initially below authorized levels, as departments experienced delays in the start-up phase of their activities. As a result they continued to hire additional personnel during the course of 2000; and (iii) there are still unpaid salary obligations for the month of October that are expected to be paid in November. When adjusted for this factor expenditure is slightly higher than pro rata.
- *Goods and Services.* They are 50 percent of the appropriated amount (DM 103.5 million), representing significant under-spending compared to spending levels that might be expected at this time of the year. Slow spending is caused by delays for startup of various programs, and for establishment of local spending and procurement mechanisms. Because of these delays, procurement of various goods and services will be pushed back in time, potentially resulting in a considerable portion of the spending that would have occurred at the end 2000 to occur in early 2001. Remedial action may be needed for a coordinated strategy for developing procurement and cash management competencies across a range of agencies to ensure real goods and services needs are met effectively and efficiently.
- *Public Utilities.* The level of actual spending during the ten months in the form of subsidies to the electricity company under-represents the actual transfers that have occurred, as some of the transfers -- about DM54.2 million -- have been paid off budget through Dedicated Donor Grants (DDG). The amount recorded in the budget figures represents 54 percent of the amount budgeted for year 2000. If this amount is adjusted for off budget transfers the actual spending exceeds the budgeted amount by about 58 percent. The number of employees for Kosovo Electricity Corporation (KEK) increased from January to May 2000 while achieving cost recovery required reduction in employment levels. Non-payment of electricity bills continues to be an issue and only recently has been pursued aggressively. Recent actions by the Public Utilities Department have been directed at bringing the utility entities' management to the point of fully understanding the situation, but overspending still seems likely. These facts show that electricity transfers remain a substantial risk for the fiscal balance considering that they would have to be sustained through the rest of the winter months for 2000. Moreover, unless the underlying structural issues in the sector are

addressed these spending patterns will remain a major risk for the year 2001 budget and beyond.

Total expenditures in the 2001 budget are estimated at DM 480 million or about DM 50 million over the expected outturn for 2000. These estimates assume a very modest increase in the overall expenditures, mainly in social transfers and expenditures to support the new decentralized structure of municipalities, aiming towards self-sustainability for the Kosovo Consolidated Budget. There are no planned increases in wage levels. However, major risks will remain in the next year's budget and in the medium term, if the structural issues in year 2000 budget are not addressed. They include (i) bringing employment to a sustainable level for 2001, especially in health and education that have been running in excess of planned levels, even in year 2000; (ii) reduce transfers to the utilities by reducing employment and preparing an implementation plan for introducing cost recovery measures; (iii) preparing a fiscally sustainable redundancy policy and implementing employment reduction measures consistent with the policy; (iv) carefully implementing an adequate fiscal decentralization plan consistent with the local government capacities for taking over financial management responsibilities.

Requirement For Donor Budget Support

Original budget estimates showed that the projected deficit for the last four months of 1999 would be DM 74 million or US\$41 million. In the event the financing gap amounted to DM 56.1 million or US\$31 million. Donor contributions, however, exceeded even the initial financing gap estimate and amounted to DM 85.3 million. This enabled the budget to close the year with a cash surplus of DM 29.2 million.

In the year 2000, the financing gap is estimated to be DM 200 million. Underlying this estimate is a revenue performance of DM 18.6 million per month in 2000 as compared to DM 7.6 million per month in 1999 and expenditures of DM 35.3 million per month in 2000 as compared to DM 21.7 million per month in 1999. Thus, the self-financing of the budget was expected to rise strongly in 2000, with the financing gap as a proportion of expenditures falling from 65 percent in 1999 to 47 percent in 2000.

The budget outturn for the ten months of 2000 as described above show that this limit of DM200 million in donor financing for the year as a whole is achievable, assuming that: (i) recent positive trends in revenue collections are maintained till the end of the fiscal year; and (ii) on the expenditure side there is partial catch-up in underspending, with discipline on wage and subsidy spending being exerted in the rest of the year. Were there to be pressures to spend beyond budgeted numbers, the external financing requirement would, of course, rise. On the other hand, any additional surpluses coming as a result of better than expected revenue performance should be used to ease up pressures on the next fiscal year by paying off arrears for the electricity imports as well as using some of the resources to support redundancies which otherwise must be financed out of the year 2001 budget. It appears that additional donor budgetary support would not be required till the end of the year, opening the way for medium-term sustainability in the Kosovo local cost recurrent budget.

Consistent with the self-sustainability principle and tight fiscal scenario in the year 2001 budget, donor support is projected at much lower levels of DM 150 million. The rise in the self-

financing of the budget is, of course, a necessary condition for an eventual successful “exit” by donors from providing budgetary support. Other conditions are being created for a successful exit: the infusion of new technologies and skills in fiscal and banking system management and supervision (to name but the two most important developments thus far) and the creation of institutions of governance and management. Keeping fiscal spending within the limits of medium-term sustainability as determined by the likely capacity to raise domestic revenues and obtaining external funding for investment will be critical. Instruments and institutions of economic management of this kind are being constructed to be durable whatever may be the eventual political settlement applied to Kosovo.

BUDGETARY SYSTEMS

Central Fiscal Authority

The removal of Kosovo's autonomy and the consequent centralization of financial management functions in Belgrade during the last ten years created an institutional vacuum for the public administration in Kosovo. Essential functions of any public administration system, such as the management of public resources, either did not exist or existed in a rudimentary form that did not ensure adequate effectiveness and transparency in the use of resources. A parallel budget system, financed by voluntary taxes and contributions of the Kosovar diaspora was established during these years. Its funds provided resources for basic operating costs of primary and secondary education and health care for the Kosovar Albanians. Under the new situation, however, this system could not serve as a substitute for formal budgeting, although it is known to have functioned quite effectively in the past. In addition, payments bureau (SDK) ceased to carry out some budget execution functions they performed before the war leaving almost no alternative for the execution of financial transactions.

The current situation required immediate action for establishing basic administrative and financial management functions in the territory of Kosovo in order to facilitate the effective and transparent deployment of revenues that were being collected, as well as donor funds that were expected to enter into Kosovo to provide basic public services to the population of Kosovo and finance investments and reconstruction efforts. Since the establishment of the UNMIK administration, spending has been gradually taking place. Initially such spending was organized in an *ad hoc* fashion, outside the context of an overall fiscal framework and budget planning process. It was directed to finance the salaries of some health employees and judges in an effort to quickly address some urgent requests for financing in the public sector.

Despite these initial *ad hoc* developments work progressed expeditiously to establish suitable and well organized financial management institutions, which would be able to address the management of the resource flow and spending in the short run and form the foundations for building a modern system in the long run. In response to the existing situation the establishment of a Central Fiscal Authority (CFA) with the functions of a finance ministry was identified as a first priority.

The CFA was established by regulation 1999/16 at the end of 1999. After making an impressive start in December 1999 it is functioning admirably despite extremely difficult and complicated

circumstances. Its main divisions for budget, treasury, tax policy and tax administration became operational within a very short period and are performing important functions including: (i) budget preparation and monitoring; (ii) execution of budgetary transactions through the Treasury Single Account (TSA) and their financial control; (iii) formulation of tax policy and the management of tax and customs revenues. In addition, the CFA has hired and trained many local staff who already performs several routine tasks in the budget and treasury divisions, as well as a large number of tax inspectors. These functions are being performed under a newly established legal and regulatory framework which includes regulations and procedures on the functioning of the divisions, procedures on expenditure authorization, accounting and reporting, regulations on procurement of goods and services as well as tax legislation and procedures on revenue collection and administration. Internal audit capability reporting to the highest level of UNMIK is also under preparation.

Despite this impressive progress challenges remain to complete the development of budget management institutions. The budget and treasury system should be extended beyond UNMIK's spending departments and the budgetary transactions should be carried out as appropriate by the spending units. This requires further developments in the treasury and payments system. It also requires significant strengthening of budget and financial management capacities to the spending units to ensure a transparent and accountable use of budgetary resources. This last link in the expenditure chain is being worked on by the CFA and UNMIK in cooperation with the Banking and Payments Authority. Although the 2000 budget was prepared in consultations with the spending departments, formal procedures need to be developed to guide the budget formulation process for 2001 and beyond. Moreover these procedures should include recurrent and investment expenditures in order to ensure an integrated approach to budget planning, the formulation of a coherent budget strategy, and better coordination of foreign donors that finance entirely investment expenditures.

Remaining Challenges

Despite continuous progress in developing budget management institutions several challenges remain to ensure that the JIAS functions as a cohesive structure that is able to formulate and implement public policies and programs and take decisive actions to address the fiscal risks faced by the 2000 budget.

CHALLENGES TO FISCAL PERFORMANCE

The task of a finance ministry in the circumstances of today's Kosovo is an exceptionally difficult one. This applies to budget formulation as well as execution. The fiscal base is uncertain in view of the difficulties in projecting real rates of growth of the economy from a very low base under conditions of major institutional changes. Customs and tax administrations are being reinforced, but uncertainties surround their capacity, speed of strengthening, and willingness to apply the law fairly.

Closing the Two Major Tax Gap: Montenegro and FYR Macedonia. A tax point was to have been established at the boundary point with Montenegro on January 1, 2000 but this was not done until March; the delay is estimated to have cost DM 20 million in revenues. The tax post

took some time to be fully functional. There appears to be widespread evasion of excise taxes. With respect to FYR Macedonia, the budget assumes the repeal of the preferential trading arrangement, and it is hoped that UNMIK will soon take steps to this end as delay in closing this gap is leading to revenues losses associated with both Macedonian goods and false certificates of origins on goods purporting to be of Macedonian origin.

Delayed introduction and low compliance with hotel food and beverage tax. The later than expected introduction and low compliance with this tax has resulted in lower than expected revenues estimated for the 2000 budget. Actions would need to be taken to introduce more aggressive compliance measures to make up for some of the revenue loss, through training, education, and registration.

Prompt institution of *domestic coverage for sales and excise taxes* and the *payroll tax*. The delay in introducing the payroll tax has already caused loss of revenues for the budget. In addition, much will depend on tax administration capacity and the willingness of the populace to pay these taxes.

Adhering to the *public sector wage bill* as given in the budget. The major risks to an increase in the wage bill might come from two directions: (i) an increase in the average wage; and (ii) an increase in the number of budget employees. There are pressures to raise *overall wages* and to change relativities. Competition between several Spending Departments for qualified personnel is causing the salaries to raise, even while maintaining the current wage multiplier structure. This is being achieved by promoting persons to higher wage brackets in the wage structure and using supplementary benefits such as overtime and hazard pay, to effectively give salary increases. A higher average wage is unsustainable over the medium term and would lead to an irresponsible budget. The prompt implementation of the wage tax is vital. A decision is required from UN New York to authorize the implementation of this tax, covering, *inter alia*, local employees of UNMIK.

The budget estimates are based on a significant fall in *public employment*, particularly in education and health to eliminate ghost workers. Reducing employment numbers has proven difficult so far, while there has been new hiring in other departments that had experienced shortage of personnel. In addition, because of personnel hiring delays in the startup phase of the budget programs, the monthly personnel costs at the end of 2000 will be much larger than for the first few months, thus exceeding the average monthly cost for the year. As a result staffing patterns may be poised to put significant upward pressure on the wage bill for 2001. Therefore, maintaining the number of employment within the levels estimated in the 2000 budget makes indispensable elimination of overstaffing in education, health and public utilities. Achieving this will be difficult given the strong sense of entitlement to a job and public opinion that calls for a mainstreaming of all parallel system workers. At best, it may take considerable time.

There are likely to be pressures (within UNMIK itself) for *subsidies to public enterprises* in order to re-start certain enterprises (regardless of their ultimate economic viability). In addition greater-than-budgeted subsidies to the electric sector to make up for possible slow cost recovery and non-payment of charges as well as overstaffing pose a real threat to the overall spending levels for 2000. Public utilities have drawn 48 percent of their annual subsidy and a great danger remains for overspending these amounts until the end of the year. These pressures must be

resisted with determination and serious remedial actions should be taken from the KEK to pursue payments of electricity bills.

As implementation of capital investment projects progresses, there will be pressure on the Kosovo Consolidated Budget for higher proportions of operating expenses to go towards maintenance of the investments, particularly in the case of roads and other infrastructure. This could also be a significant issue in the utilities sector, although in principle that pressure should be contained within the operating costs and pricing structure of the utility providers.

Strengthening Capacities for Policy Formulation and Implementation

Although some progress has been made during the last few months, capacities for strategic policy formulation at the sector spending departments of UNMIK remain weak. A systematic process that defines main sector policy objectives and priorities and ways to implement them should be institutionalized as part of the overall budget formulation process. This would require strengthening capacities for:

- Setting overall objectives in the sector;
- Defining the appropriateness of public service provision in the sector consistent with these objectives and the overall economic program; and
- Defining strategic programs in the sector and identifying priorities for which budgetary resources (recurrent and investments) will be needed consistent with the overall resource framework.

The objective is to be able to have the right information and analytical work for the preparation of short strategy statements for each sector that can be used as an input into the preparation of a comprehensive budget strategy and expenditure framework and presented for discussions to a high level inter-sectoral decision making body and subsequently to the donor community. In this context, it should be noted that statistics services in Kosovo today are almost non-existent. Clearly, there is an urgent need to collect and process basic economic and social statistics; the strengthening of the statistical bureau must be a priority.

At present, and in particular for the preparation of the Kosovo 2001 budget, the preparation of sector strategy statements can benefit from the expertise and the analytical work that international organizations such as WB, EU, WHO, UNICEF and others have been providing in different sectors such as education, health, social protection, infrastructure, etc. However, given the involvement of so many donors sometimes even within one sector, it is imperative that capacities within the spending departments are created to ensure consistency with the overall policy objectives in the sector and timely implementation of budget and donor financed projects.

Integrating the Investment and Recurrent Budget Planning Process

Given the unique and somewhat fragmented administrative structure in Kosovo, as well as significant amounts of foreign aid to finance reconstruction efforts and capital investment projects, there is clearly a risk of creating a segregated policy formulation and subsequently a

dual budget process, undermining the formulation of a coherent budget strategy and expenditure framework. Experience from other countries in the region shows that such a segregated process has negative implications also for project and program implementation that are associated with delays in disbursement of funds from the donors and insufficient recurrent expenditures for operating and maintaining investment projects.

The establishment from UNMIK of the new Department for Reconstruction (DOR) has been a positive step in an effort to coordinate the donors and the reconstruction efforts in Kosovo, a process that earlier was taking place somewhat unsystematically by the individual spending departments of UMNIK. However, this department was created outside the CFA, with a mandate that goes well beyond just the coordination of the reconstruction efforts and into the formulation and implementation of a strategy for reconstruction. This organizational structure does not encourage an integrated planning and implementation process. While it is necessary to review, evaluate and coordinate external financed projects, there is a risk that such an exercise usually reflected in the preparation of a donor-funded Public Investment Program (PIP) would be accorded undue priority. As a result, the investment planning process would focus primarily on the need for donor coordination, thereby crowding out the vital need for the preparation of a comprehensive and integrated budget strategy that reflected the priorities of an overall program.

As a first step towards a more integrated process the mandate of the DOR should be revised to serve as a department for project coordination and evaluation (including maintaining formal contacts with the donor community) and ensure consistency between investment projects, policy priorities in the sector and overall program. It is vital that policy formulation and implementation should be left with the spending departments. DOR should, however, maintain responsibility for creating an information database and strengthening capacities for project evaluation, especially in the sectors where most of the donor financing is being directed. In the interim it should also take responsibility for coordinating the preparation of the KPIP. However, the preparation of the KPIP should be gradually subordinated to the broader task of preparing, from a very weak base, a comprehensive expenditure framework and be considered as a step in a process aimed at integrated sector expenditure programs within a comprehensive budget framework.

The benefits of an integrated process include, but are not limited to:

- Investment planning would not risk wasting resources by planning investments whose full costs, both investment and recurrent, are unlikely to fit within the overall financing resources of Kosovo;
- Investment projects can be assured that adequate resources, both investment and recurrent, will be available to allow their being both completed and subsequently maintained and operated as planned;
- Budget decisions can realistically address the recurrent cost requirements of investments at a point in the decision-making process that allows rational tradeoffs;
- Strategic decisions requiring tradeoffs between broad policy areas or sectors can occur at a point in the policy formulation process that allows rational tradeoffs;

- Overall fiscal policy decisions can occur at a point in the policy-making process that allows them to impose fiscally sound, realistic and binding budget constraints on the decisions affecting each of the individual components of the budget, both investment and recurrent; and
- Deliberate and carefully considered decisions, rather than donor preferences, can determine strategic priorities and budget allocations, both investment and recurrent.

There is wide latitude of organizational arrangements for achieving those benefits, but it is important that clear and enforceable rules are established to guide the interactions of different stakeholders.

Improve the Decision Making Mechanisms at the Center of the Administration

Linking the policy formulation process with planning and resources (budgeting) in a resource constrained environment such as the one in Kosovo, requires that difficult decisions are taken on inter-sectoral and intra-sectoral tradeoffs, consistent with the policy objectives within the sectors and consistent with UNMIK's overall program. These broad policy and program tradeoffs can be made by a decision making body at the center of the administration that has the right incentives to make the necessary tradeoffs and has adequate authority to enforce them. Such a body should be the forum to ensure that policy formulation and budget decisions are made in the right sequence and also serve as a mechanism for ensuring accountability during the implementation of sector strategies and priority programs and ensure that intended results are being achieved.

Positive steps have been taken in Kosovo to establish such decision-making mechanisms. The Interim Administrative Committee (IAC) of JIAS, which includes the SRSG and his deputies as well as the highest representatives of Kosovar major political groupings serves currently as the highest level decision making body in the administration. However, there is a gap between IAC and individual Department Co-Heads which should be filled by a mid-level decision making body such as an Economic Policy Board that can be formed with Co-Heads of the Departments most concerned with economic policy and development issues. An Economic Policy Board would constitute a better exchange of information, views and ideas between the different departments of UNMIK, a more transparent and consultative decision making process and it will help the IAC take better informed decisions in their policy deliberations. It will also ensure consistency between sector policies and strategies and better implementation of their programs. This forum should replace the idea of the Investment Board which is associated with the DOR, which as discussed in the above section, would undermine an integrated policy formulation and budget process.

An Economic Policy Board as a decision making body would also ensure an appropriate sequence in the policy and budget formulation process. Major stages in such a process would include: (i) the approval of the macroeconomic framework which defines the resources and provides the context against which major budget issues are discussed (e.g., wage policy); (ii) the development of sector strategies and sector priority programs; and (iii) the preparation of expenditure plans to finance these priority programs. Maintaining this sequence is essential to ensure the link between the policy formulation and the budget process and at the same time

ensure that policy and expenditure priorities are being defined consistent with the overall program and resource constraints.

FISCAL DEVOLUTION

Design of the structure of municipal finance in Kosovo presents a significant dilemma. Kosovo has a provincial government and 29 municipalities. The desire for devolution is strong and widespread, but the design of a devolved structure is complicated by large variations in the size, economic potential, income per head and capabilities of the municipalities. In view of the traditions of strong local government and the experience of locally financed and administered service provision in the operation of the parallel system, it appears inevitable that a significant role for local government will be a feature of any future long term system of government in Kosovo.

In view of the heritage of informal and in part illegal operations of the parallel institutions, especially in revenue generation, there is an urgent need to establish a transparent and legitimate framework for government institutions at local level. In particular, this must include clear and comprehensive assignment of revenue and expenditure functions and a transparent framework for financing of local government, embracing both transfers from the provincial government and external financing. Absence of clarity in all these features of the framework for local government will lead to continuing prevalence of informal operations, tending to subvert accountability of public sector institutions more generally and building up substantial long-term governance problems for future public administration in Kosovo.

While the urgency of establishing a clear framework for local government institutions is undeniable, the absence of representative institutions at any level as yet in Kosovo poses serious difficulties for establishing such a framework in the near future. The task for design of municipal finance is therefore the difficult one of identifying arrangements which give maximum transparency, accountability and efficiency in the near term while leaving open the possibility of radical restructuring in due course, following the development of representative institutions and an extensive process of consultation on long term goals for devolution within the province.

Expenditure Assignment. The approach to fiscal devolution in the social sectors, as described separately in the chapters on education, health and social protection, generally advocates that a substantial proportion of expenditure in these sectors will be delegated to municipal level. However, the volume of such expenditure in each sector will be determined by criteria set at the center, rather than assigned as local responsibilities within a fully devolved budget. Service delivery will be delegated, but the municipalities will not at this stage have the option to switch resources between sectors. In education, it is proposed that services at municipality level would be financed as block grants on a per student basis. For health, financing will be handled through the health insurance fund managed at the level of the province. On social protection expenditure, central administration is recommended for contributory benefit schemes in due course, as operation of the pension system resumes. For social assistance, some discretion in the administration of such schemes would be desirable, constrained by imposing local budgetary limits or by including a local element in the financing of the scheme.

For other areas of expenditure at municipal level it is assumed that financing would continue to be covered by block grant from the center on a simple formula basis, supplemented in due course with local revenue, including cost recovery measures where appropriate. These areas will include municipal administration, and other local services such as waste management, district heating and fire services.

On the criterion of proportion of delegated expenditure within general Government expenditure, the net impact of the approach summarized above would be a relatively decentralized structure. Aggregation of all categories of expenditure assumed delegated to municipal level would amount to approximately 26 percent of general Government expenditure. Allowing for some delegated expenditure in infrastructure maintenance and some role of municipalities in direction of social assistance spending, the proportion might be somewhat higher. This compares with recent data for other countries in the region of around 20 percent for Albania and 12.5 percent for Croatia.

Measured on other dimensions, the degree of decentralization is relatively cautious. Own revenue at local level will take time to develop and is not in any case expected to cover a large proportion of local expenditure. In the approach described above, the municipalities will have relatively little discretion to switch funds between major programs. However, by ensuring that management of service delivery is generally maintained as far as possible at local level, building on existing capacity, the overall system remains poised for a program of fuller decentralization should political will be so expressed at a later stage.

Financing. The general revenue grant to municipal government as included in the FY 2000 budget should be retained as the main mechanism for financing core functions, including a fixed lump sum payment for each municipality and a per capita grant based on total population in each municipality. The population-based element of the grant is a proxy for basic needs of municipalities and widely used for defining intergovernmental transfer payments throughout the world. As a robust, simple and broadly equitable mechanism, this arrangement should be retained in this form at least for the period prior to any comprehensive review of local government institutions. Application of the formula should make use of more accurate population data as soon as possible, while recognizing that this will give rise to transitional difficulties for municipalities which currently benefit from grants based on excessive estimates of population and will probably require a limited period during which rates are gradually adjusted towards the new levels.

Municipalities also benefit from external financing, a substantial proportion of which remains outside the budget. It is as important at the municipal level as for the center that such financing is integrated within the budget, not least in order to permit a realistic assessment of fiscal sustainability at municipal level.

Financial Management. While the long-term architecture of local government may need to await a broader political settlement, development of financial management capacity at municipal level may be one of the most important contributions that can be made now for accountable local government in the long term. An important contribution will be the development by the Department of Local Administration of the framework for municipal accounting consistent with system adopted in the CFA and training of municipal officials in budget management.

CHAPTER 2:

EXTERNAL TRADE AND CUSTOMS

INTRODUCTION

As a province of Serbia and, therefore, a part of the Federal Republic of Yugoslavia (FRY), Kosovo was subject to the FRY trade regime and customs administration until the end of the hostilities in mid-1999. Customs administration ceased to exist with the withdrawal of FRY military and civilian forces. Between June 10, 1999, when UN Security Council Resolution 1244 established UNMIK, and September 3, 1999, there were no customs checking points at borders of Kosovo. KFOR carried out random checks on incoming trucks and automobiles for arms and hazardous materials. Goods flowing into Kosovo were not subject to tariff or non-tariff barriers (NTBs). By setting customs border controls in Kosovo on September 3, 1999, UNMIK introduced *de facto* an external trade regime and customs administration.

While this was not a free trade regime, it represented a radical transformation from the highly distorted FRY trade regime. By the same token, UNMIK has established a *de facto*, if not *de jure*, customs territory, albeit in a rudimentary form. The initial reach of the customs territory was limited to external boundaries of Kosovo – i.e., borders with Albania and FYR Macedonia. Concerns that the establishment of customs controls at boundary lines with the rest of FRY might be construed as bestowing upon Kosovo the status of a sovereignty thus overstepping the delicate bounds set in UN Resolution 1244 appear to have prevented UNMIK from formally declaring Kosovo a separate tax and customs territory from the rest of FRY.

The introduction of a simple, neutral trade regime was considered to be important in stimulating private sector led economic growth and reconstruction, and in creating the conditions for healthy exports. However, in the absence of adequate administrative machinery to collect taxes on consumption and incomes, UNMIK saw the introduction of the customs/external trade regime as the major source of revenue for the local recurrent budget of Kosovo. The design of the regime successfully avoided typical pitfalls associated with the use of the tariff structure primarily to maximize revenue usually occurring against the backdrop of distortions in production and consumption patterns. The introduced tariff structure is relatively uniform with two rates (0 and 10 percent *ad valorem*), thereby assuring a high degree of neutrality. In consequence, the regime is transparent, relatively easy to administer and has rather neutral impact on allocation of resources in the economy. In addition to the standard task of collecting duties and excise taxes, the Customs Administration (UNMIK-CS) has also been charged with collecting sales taxes. These are not levied on domestic sales as yet.

STRUCTURAL FEATURES OF THE TRADE REGIME

As noted, in early September 1999, UNMIK concluded that the trade regime of the FRY was too distorted to offer a basis for efficient growth in Kosovo. Therefore, it promulgated a new regime that represents the best international practice in foreign trade policy design (albeit with some important caveats) in three respects. *First*, a uniform tariff structure of 10 percent was introduced. This tariff structure is commendable in its simplicity and the low rate involved. The principle of the uniform tariff rates was, however, compromised by the simultaneous introduction of duty exemptions on some agricultural and medical products. Also compromised were the major advantages of the uniform tariff rate such as neutrality in protection afforded to various stages of production and the reduction in opportunities for rent seeking.¹

Table 1: Goods Exempt from Customs Duties and Sales Tax

Pharmaceuticals
Medical and surgical instruments and apparatus
Milk
Cooking oil and fats
Vegetables
Fruits
Stamps and valuable papers
Goods imported by UNMIK, UNHCR, Red Cross and Red Crescent Societies, NGOs registered with the UN
Goods imported by foreign diplomatic missions for their official use

Source: Annexes I and II to UNMIK Administrative Direction No. 1999/01, 30 August 1999.

Consider the case of agriculture – an important sector of the Kosovo economy. In view of widespread effective subsidization of agricultural exports by partner countries, the 10 percent tariff and sales taxes that apply to certain agricultural products have the effect of assisting local Kosovar producers by giving them a 27 percent level of nominal protection. But for those agricultural goods that are exempt from tariffs (and sales taxes) – listed in Table 1 – matters are very different: local producers suffer a handicap. This negative incentive to local production is not likely to be a desirable outcome for an economy where agriculture accounts for around one-fifth of the total output with even a larger share of population employed in this sector.

¹ There are strong arguments for tariff uniformity. First, because of its administrative transparency and simplicity, it reduces the scope for arbitrary actions by Customs officials. Second, the political economy of trade policy formation suggests that a credible commitment to a uniform tariff keeps potential lobbyists at bay. To be effective, the commitment has to be credible. Third, a uniform tariff rate is neutral and minimizes the net welfare cost. Uniform tariff structure equates the marginal distortion cost of protection in production across all sectors. For an extensive discussion, see V. Thomas, J. Nash and Associates, 1991. *Best Practices in Trade Policy Reform*, A World Bank Publication, Oxford University Press, Oxford, pp. 163-169.

Second, the foreign trade regime is devoid of non-tariff measures (NTMs) and quantitative restrictions (QRs). Commitment to keeping the trade regime free of NTMs and QRs is somewhat eroded by the caveat that these only remain "...suspended until further notice". (Section 2 of REG 1999/3). While so far NTMs and QRs have not been reintroduced, this unnecessarily opens the possibility for lobbying to implement these measures in the future.

Third, a further advantage of the system is that its registration procedures of traders (exporters, importers and forwarding agents) and licensing are non-discriminatory and transparent. There is no state trading and foreign trade activity is open to all firms. There are no non-automatic licenses and the existing regime offers limited, if any at all, opportunity for bureaucratic micromanagement of foreign trade.

POLICY ASPECTS OF THE TRADE REGIME: COVERAGE AND TAXATION

Although the Kosovo foreign trade regime has the right institutional design and low and almost uniform tariff rates, some of the policy measures raise concerns. *First*, the foreign trade regime is yet to be extended to cover all boundaries of Kosovo. There are no TCPs (Tax Collection Points) at the boundary with the rest of Serbia. This has two implications: it narrows the tax base leading to a significant loss of tariff revenue; and deprives the UNMIK Customs Administration of control over products entering its customs territory. According to a conservative estimate of the UNMIK-CS (Customs Service), the lost tax revenue amounts to around DM 50,000—100,000 per day.

Second, an important weakness of the trade regime stems from the recognition of the preferential trade agreement between FRY and FYR Macedonia. Granting of preferential status to FYR Macedonia has distorted trade flows and led to revenue losses for two reasons: FYR Macedonia has been traditionally an important trading partner of Kosovo; and a considerable portion of total imports into Kosovo transit through FYR Macedonia. The latter has provided opportunity to falsify certificates of origin. It also raised technical problems, as the implementation of preferential trade agreements regime requires enforcing rules of origin, which is complicated in itself and prone to fraud and corruption. The preferential trade agreement with FYR Macedonia imposes on the UNMIK-CS the responsibility to control imports on a discriminatory basis through the use of the rules of origin to determine the nationality of a product. The procedures to identify the origins of products are rather complex and subject to the WTO Agreement on the Rules of Origin. Their implementation requires considerable skills among customs officers and prolongs customs clearance at border.

UNMIK has undertaken to abolish the customs tariff at the same time as the introduction of a value added tax (expected to be in mid-2001) with the VAT to be set at a rate to ensure revenue neutrality. This decision is a major step towards removing the significant distortion that arises from the FYR Macedonia preferential trade arrangement and the treatment of commerce from the rest of Serbia as well as from Montenegro. Such a step would broaden the tax base and lead to a reduction in the disparity of taxes levied. A unified VAT rate of, say, 20 per cent, would result in a reduction of around 6 percentage points in the customs cum sales tax on imports (other than from FYR Macedonia) and a

rise of 5 percentage points in the sales tax on imports from Macedonia and commerce flowing in from the rest of Serbia and Montenegro. Excise taxes would continue to be levied on all excisable goods regardless of origin.

Third, at present, sales and excise taxes on goods are applied to imported goods only. Since these taxes are levied only on imports, they constitute trade measures; they discriminate against imports. It is entirely understandable that under current conditions of weak local capacity and lack of an internal tax administration, there was no tax base other than imported goods. The intention of UNMIK to widen the tax base to domestic products when VAT is introduced is welcome.² The imposition of such taxes on domestic goods will level the playing field vis-à-vis imports and diminish incentives for evasion.

Fourth, while the 10 percent 'almost uniform' tariff rate is very low by the standards of developing countries, the aggregate burden of border taxes is in fact quite considerable. The sales tax of 15 percent is applied on the post-tariff value of imports. Thus, the actual 'tax burden' for non-food, non-medicine products (i.e., those not listed in Table 1) amounts to 26.5 percent *ad valorem* (see the last row of Table 2). For products subject also to excise taxes with rates varying between 5 and 50 percent, total payment rises even further since excise is calculated on the basis of the value of imports post tariff tax. Thus, products subject to excise taxes bear the 'tax burden' amounting to between 33 percent (wines) and 90 percent (diesel, gasoline, strong alcoholic beverages) of the value of these products prior to customs.

Such tax burdens are not unusual; they prevail in many countries, developed or developing. However, several problems emerge. The preferential trade agreement between FRY and FYR Macedonia has created a potential source of evasion and consequent loss of revenues. Imports originating in FYR Macedonia are not subject to custom duties, as noted above, but only to a 1 percent *ad valorem* customs fee. Thus, the fee lowers total tax on non-excise goods from 26.5 percent *ad valorem* to 16.2 percent that amounts to the loss in revenue 10.3 percent of the value of imports from FYR Macedonia (duty and sales tax combined – see the last row of column 4 in Table 2). On products subject to excise tax, the losses are higher ranging between 16 and 11 percent of the value of imports of these products (Column 4 in Table 2).

Fifth, a clear case can be made for a wider use of specific taxes, provided that this is done in a simple and transparent manner, in place of *ad valorem* taxes - with the exception of coffee, all excise taxes are in *ad valorem* terms (Table 2). Since Kosovo uses the deutsche mark (or more broadly Euro) as the main transaction currency, the 'inflation'

² There is a proposal to extend the base of sales tax first to larger domestic firms and subsequently to all firms with Customs Administration in charge of collection. While an effort by UNMIK to widen the tax base is commendable, this proposal suffers from two major weaknesses: sales tax should not be collected in the production source; and customs administration should focus on movements of goods and services across borders or boundaries.

argument against specific taxes does not apply.³ But there are other arguments as well. In the absence of sophisticated control techniques, the advantages of specific taxes are considerable: they are simpler and thus easier to implement and more difficult to evade; and they remove the incentive to under-invoicing, which is particularly strong in case of high excise rates.⁴ While it would be tempting to recommend a wider use of excise tax, the decision should take into account broader context of taxation reform in

Table 2: Aggregate Border Tax *Ad Valorem* Burdens on Products from Non-Preferential Partners, FYR Macedonia, and the Rest of FRY (in percent)

Product Groups	Rate	Non-preferential partners		FYROM			Montenegro and Serbia		
		Excise tax and tariff rate (10%)	sales tax (15%) on column 1	excise tax and customs duty (1%)	sales tax (15%) on column 4	<i>differenc e between columns 2 and 4</i>	excise tax and customs duty (0%)	sales tax (15%) on column 6	<i>differenc e between columns 2 and 7</i>
		1	2	3	4	5	6	7	8
Gasoline	Ad valorem 50%	65.0	89.8	51.5	74.2	15.5	50.0	72.5	17.3
Diesel	Ad valorem 50%	65.0	89.8	51.5	74.2	15.5	50.0	72.5	17.3
Strong drinks	Ad valorem 50%	65.0	89.8	51.5	74.2	15.5	50.0	72.5	17.3
Cigarettes	Ad valorem 25%	37.5	58.1	26.3	45.2	12.9	25.0	43.8	14.4
Beer	Ad valorem 15%	26.5	45.5	16.2	33.6	11.9	15.0	32.3	13.2
Alcohol/ethanol	Ad valorem 15%	26.5	45.5	16.2	33.6	11.9	15.0	32.3	13.2
Mobile phones	Ad valorem 15%	26.5	45.5	16.2	33.6	11.9	15.0	32.3	13.2
Satellite dishes	Ad valorem 15%	26.5	45.5	16.2	33.6	11.9	15.0	32.3	13.2
TV sets	Ad valorem 15%	26.5	45.5	16.2	33.6	11.9	15.0	32.3	13.2
VCR	Ad valorem 15%	26.5	45.5	16.2	33.6	11.9	15.0	32.3	13.2
Cigars and cigarillos	Ad valorem 10%	21.0	39.2	11.1	27.8	11.4	10.0	26.5	12.7
Other manufactured tobacco	Ad valorem 10%	21.0	39.2	11.1	27.8	11.4	10.0	26.5	12.7
Soft drinks	Ad valorem 10%	21.0	39.2	11.1	27.8	11.4	10.0	26.5	12.7
Wines	Ad valorem 5%	15.5	32.8	6.1	22.0	10.9	5.0	20.8	12.1
Coffee	Specific DM 3 kg.	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Non-excise products	0	0.0	26.5	0.0	16.2	10.4	0.0	15.0	11.5

Source: See Table 2.

³ This was the right choice because the inflation-prone Yugoslav dinar was expected to be the only legal tender in Kosovo. With the acceptance of D-Mark (Euro) as an officially recognized currency, concerns about inflation undercutting collected taxes lost their relevance.

⁴ For instance, a DM 100 underinvoicing of petroleum yields the 'saving' of DM 90 in terms of unpaid taxes. This is undoubtedly a strong incentive to underinvoice imports.

Sixth, imports by Non Governmental Organizations with Public Benefit Status—registered with UNMIK—are exempt from duties. Considering a very large number of NGOs providing assistance in Kosovo, the potential for abuse and the use of fraudulent exemption forms is quite significant. According to the UNMIK-CS, an apparent increase in the number of NGO-destined shipments crossing Kosovo’s boundaries in comparison to the situation in 1999 seems to indicate that some of them may be diverted for commercial purposes.⁵ One may thus consider levying appropriate charges at the border subject to refund upon presentation of detailed information.

IMPLICATIONS OF THE TRADE REGIME FOR NASCENT EXPORTS

The trade regime is clearly supportive of exports: it is liberal; transparent and open; and it relies upon the use of a convertible currency, the deutsche mark. If an institutional environment favorable to private business environment complements the current regime, then clearly conditions for sustainable economic growth ought to be created.

In two aspects, though, the trade regime presents a significant impediment to Kosovo’s nascent exports. The first is legal or institutional in nature – the formal recognition by trading partners of Kosovo’s trade regime and, in particular, trading arrangements in the context of the Stability Pact; the second, certain disincentives to exports arising from the trade and tax regimes.

The *de facto* establishment of a customs territory by UNMIK was neither accompanied nor followed by its *de jure* recognition. Its legal status as a foreign trade entity continues to remain vague and issues arising from this ambivalence tend to be addressed on *ad hoc* rather than systemic basis. As a consequence, Kosovo does not show up in Customs Codes of any country including that of its preferential trading partner—FYR Macedonia. Except for the EU (see below), Kosovo’s trade and customs regime is treated as a part of the FRY trade and customs regime, and its exports are subject to the same conditions of access as those faced by exporters from the rest of Serbia or Montenegro.

With the entry into force of the Council Regulation No. 2007/2000 (18 September 2000), the EU has formally recognized Kosovo as an autonomous customs territory “in accordance with UNSC Resolution 1244 (10th and 11th preambular)” and linked to the EU’s Stabilisation and Association Process.⁶ The Regulation extended trade preferences to Kosovo, which previously were limited to Croatia and Bosnia-Herzegovina.⁷ It has

⁵ According to the estimate of the UNMIK-CS, the average number of trucks crossing the Kosovo boundaries increased from 120 trucks in September—October 1999 to around 230 in September—October 2000.

⁶ Note that the official title is “Council Regulation (EC) of 18 September 2000 introducing exceptional trade measure for countries and territories participating in or linked to the European Union’s Stabilisation and Association process ...”

⁷ Prior to the Regulation 2007/2000, the so-called autonomous trade preferences granted by the EU to Yugoslavia in the 1980 Cooperation Agreement applied only to Bosnia and Herzegovina and Croatia (see *Trade Relations between the European Community and South Eastern Europe*, Discussion Paper,

also considerably widened trade preferences already applied by removing the remaining tariff ceilings for industrial products and by improving conditions in access to EU markets for agricultural products.⁸ Goods subject to preferential treatment include also such sensitive products as steel and textiles. In consequence, the percentage of duty-free tariff lines will increase to 95 percent (from 80 percent under autonomous preferences). Once the Kosovo customs has effective procedural and organizational procedures harmonized with the EU for issuance certificates of origin, they would then be accepted by EU Customs.

Clearly, Kosovo will have to look not only to EU countries but also to its neighbors as potential clients for its exports. For it to be able to export successfully, a number of questions regarding its trade status will have to be clarified: these questions arise from the fact that, though a province of Serbia and a part of FRY, it enjoys a distinct trade and customs regime. For example, how will Kosovo's commerce (particularly the sale of goods and services) to Montenegro and the rest of Serbia be treated, when Kosovo would be importing goods and service under a different regime to that of Montenegro and the rest of Serbia? Moreover, will exports of Kosovo to its trading partners be subject to MFN treatment accorded automatically among WTO members? Or will such exports be subject to often higher tariff rates levied on non-WTO members with no special trade agreements with a given partner? How will Kosovo link into trade networks designed under the aegis of the Stability Pact?

These issues have constitutional and political dimensions that UNMIK will have to address. From a purely economic standpoint and one that seeks to maximize the growth prospects of Kosovo, it would appear important that UNMIK, in cooperation and support of the EC, should obtain duty-free access for Kosovo products to Albania, Bulgaria, Bosnia and Herzegovina, Croatia and Slovenia. One possibility would be to accomplish this goal through integration into the existing network of bilateral free trade agreements among Balkan countries. If regional cooperation could be extended to the setting up of a free trade area at least among countries that are part of the EU process of stabilization and association for Western Balkan countries and customs territories, then Kosovo would clearly benefit.

The trade status of Kosovo should encompass the issuance of certificates of origin in conformity with the definition of the concept of "originating products" provided for EEC Regulation No 2454/93 by UNMIK. The acceptance of these certificates should not be negotiated on a country-by-country basis, but rather solved 'wholesale' through such an institutional device as, for instance, OECD, the EU and other signatories of Pan-European Cumulation Agreement (28 European countries including EFTA, EU and its associate candidate countries). Whatever the mechanism selected - in addition to

Stability Pact: Meeting of the Economic Working Table, Brussels, 9 October 1999), but neither to FRY nor the UNMIK customs territory.

⁸ Albania obtained the same preferences. It was reported that identical preferences the EU will grant to FYR Macedonia (Agence Europe, Brussels, 20 September 2000).

countries covered by the above arrangements - it must also include Albania, Bosnia and Herzegovina, Croatia and FYR Macedonia.

The fiscal disincentive to exports arises from the fact that the trade regime does not provide for a scheme for rebate of tariffs and taxes on imported inputs used for exports, thereby unwittingly penalizing exports, in particular, inward processing activities. Typically, such activities are an important source of employment and growth in transition economies, especially in the initial phases.⁹ Moreover, by not introducing schemes that support exports specifically – duty drawbacks, rebates, in-bond manufacturing or temporary admission – the trade regime makes it less attractive, perhaps quite unattractive, for foreign firms to establish processing activities in Kosovo.

IMPLEMENTATION

Given weak local capacity, AD 1999/01 envisaged gradualism in establishing customs border points (CBPs) by the UNMIK-CA. The customs controls were established first at one crossing point with FYR Macedonia, then Albania. Several other border-crossing points remain to be covered. EU Customs Assistance Mission in Kosovo (CAM-K) has played crucial role in this process but its resources remain limited and declining. With the current staff of seven customs officers and the prospect of opening two TCPs at the boundary with Serbia, CAM-K can hardly provide badly needed technical assistance and supervision of CAM-CS. Without CAM-K customs border controls would not have been established, and without their continued and expanded support the quality of customs control will dramatically deteriorate.

The CAM-CS was (and remains) understaffed. It came into being with hiring of 14 customs officers – previously with FRY Customs Administration – on August 3, 1999. By the end of August it employed 42 ex-FRY customs officers. With subsequent recruitment, its staff has risen to over 100 officers. Considering, however, that UNMIK-CS should cover not only external borders of FRY but also boundary lines with Montenegro and the rest of Serbia, the current level seems to be well below levels needed to cover all crossing points as well to open one or two inland customs processing stations. Estimate suggests that at least 90 more customs officers would be needed to perform these functions.

Despite an impressive record of implementing customs control, the CAM-CS does not have adequate administrative capacity to process shipments efficiently in all CBPs and a TCP. Technical problems at the border augmented by the absence of in-land customs clearance facilities and warehouses have often created disorderly conditions at CBPs and further delayed their opening. For instance, although Section 5 of the Administrative Direction No. 1999/1 set the date for the opening of Globocice/Globocica BCP for September 13, 1999, this CBP remained closed almost six months later and long delays have occurred frequently at various CBPs (especially in Hani i Elezit/Gjeneral Jankovic.

⁹ For instance, inward processing of textiles accounted for 20 percent of Bulgaria's exports to the EU in 1997 and 23 percent in 1998. The cost of labor in Kosovo is much lower than in neighboring Bulgaria.

Box 1: Tax Collection Point (TCP) in Pec at the Boundary Line with Montenegro

Faced with diversion of trade routes to entry points not covered by customs border controls, UNMIK opened a TCP in Pec at the boundary in Montenegro on February 14, 2000. The TCP was physically set in Kula - high in the mountains on a narrow twisty road leading to Montenegro not far from the Italian KFOR checkpoint.

But the opening got to a rocky start, as truck drivers - apparently taken by surprise - blocked the passage and refused to surrender to customs procedures. Citing security reasons the KFOR requested moving the TCP to another location. The TCP was moved to Pec. The Pec TCP has the staff of 24 customs officers and a TCP Head—4 of them worked for the FRY Customs Administration including Head of the TCP.

Since its present location would allow truck drivers to easily by-pass the TCP, it has been split into two parts separately located and performing different functions. Customs officers located in the first site perform initial assessment of papers, conduct initial examination of freight to determine any possible discrepancies between freight and documents. All relevant data about the shipment, its driver, trucks, and importers are duly recorded in a registration book. If a document is missing or a shipment is not for an NGO registered with UNMIK, or there is discrepancy between the import declaration and freight content, drivers' documents (passport, drivers license, etc.) are deposited with UNMIK customs officers and sent through a courier to Site 2. Both sites are open 24 hours and three customs officers are assigned to it.

Customs officers in Site 2 are responsible for conducting all relevant customs procedures. Customs officers there first check the papers. If they accept the import declaration, then they calculate the customs revenue due and physically examine each cargo. If everything is OK, they release the cargo after the receipt of a payment in cash. The whole procedure then takes around 10 minutes.

While customs officers, dressed in clean UNMIK uniforms, seem to be competent and professional, the existing physical arrangements have several weaknesses:

- The two-site layout and the location of the first site are not right. Dirt roads before the Site 1 offer opportunity to enter the UNMIK territory without customs clearance towards Mitrovice, Calican village or Istogu. Once traders master them fully, customs revenues will decline. It seems that all customs procedures should be performed in one site and the site should be located before the intersection. In the meantime, KFOR would seem to be in good position to limit access to these roads.
- Working conditions are very difficult and dangerous especially to customs officers in Site 1. The "office" in Site 1 is a van with a small table inside. A marked police SUV with two policemen parked on the other side of the road provides security. This may not be inadequate if two or more traders collude to avoid customs. The office in Site 2 is in sort of a mobile home. It is not equipped with amenities and space is limited – if there are more than 2 patrons, one of them has to be outside.

Two sites should be combined and moved to a location closer to the Montenegrin boundary. According to an estimate of the UNMIK-CS, loss in customs revenue due to trucks bypassing the ill-located TCP amount to DM 150,000. Security arrangements and work conditions should be addressed as soon as possible.

Pec/TCP at the boundary with Montenegro – whose opening marks an important step to tighten customs controls – brings to fore organizational and technical problems faced by UNMIK-CS. As noted in Box 1, its facilities are provisional at best; the location was changed twice and still has not tightened border controls; its physical layout gives customs officers a considerable discretion in sending a shipment for a final customs clearance; and working conditions are extremely difficult.

Addressing these key issues in implementation will require a continued and increased presence of CAM-K. Consider the following: UNMIK considers the introduction of temporary importation, duty-drawback mechanism or warehousing. This will increase pressure on UNMIK-CS, already rather strained administrative capacity. UNMIK plans to complete soon the process of establishing a separate tax and customs territory. This will involve opening and establishing additional TCPs and BCPs covering all major

entries into Kosovo. More personnel will have to be hired and trained. UNMIK-CS does not have this capacity. Furthermore, with drastically reduced possibilities to tax-free entry into Kosovo, there will be growing pressures to corrupt UNMIK-CS customs officers. Only CAM-K can provide external monitoring until UNMIK-CS develops intelligence, surveillance and anti-smuggling capacities.

RECOMMENDATIONS

Sustainable economic growth is one of the main challenges in Kosovo. The preceding discussion suggests that without triggering exports, this challenge will be difficult, if not impossible, to achieve. Given the small size of businesses operating in Kosovo and the absence of marketing know how as well as established commercial contacts with remote international markets, access to regional, neighboring markets is crucial. But without the recognition of locally issued certificates of origin, Kosovar firms will not be able to sell their products. Without obtaining at least the same conditions in market access as those accorded to preferential partners of Balkan countries—and all of them have signed preferential with several trading partners including the EU—they stand little chance to compete successfully. Similarly, the capacity of Kosovar firms to market products depends on the cost of imports.

Hence, four major issue-areas should be given special consideration: access to regional markets; the status of Kosovo in terms of international economic relations; external trade policies; and tax policy. The broad recommendations are: (i) implementation of UNMIK's decision to abolish duties on all imports when VAT is introduced; (ii) that the issue of Kosovo's trade status be given urgent attention; (iii) that the trade and customs regime should be modified as to make it more friendly to exports and consequently imports; and (iv) that incentives for evasion of tariffs and duties should be minimized through measures aimed at broadening the tax base.

Promoting Regional Cooperation

The Council Regulation No. 2007/2000 (18 September 2000) offers Western Balkan countries and territories an unique opportunity to benefit from expansion in trade with the EU. The challenge is to exploit this opportunity. Their ability to take advantage of improved access to EU markets hinges critically upon establishing environment conducive to the development of regional trade unhindered by tariffs or prohibitive customs procedures. This involves not only vigorous implementation of liberal structural reforms but also the removal of barriers to regional trade.

In this context, UNMIK's decision to abolish duties on all imports, as noted above, and to work closely with the EC on liberalizing regional trade is welcome. The emergence of a free trade area encompassing Balkan countries and territories and the EU would remove one of the obstacles (too small markets) to high quality Foreign Direct Investment.

Kosovo's Trade Status

Kosovo's external trade-related status remains nebulous; this adversely affects access to foreign markets by firms operating in Kosovo. The decision of the EU to grant autonomous status to the Kosovo as well as to offer preferential treatment to exports originating there is encouraging.

It is suggested that the following policy proposals be given consideration and discussions take place with the EC and other interested international partners:

- OECD countries (excluding the EU and its Central European associates that are OECD members—Czech Republic, Hungary and Poland) should accord Kosovo similar recognition to that given by the EU and should grant at least GSP status to Kosovar exports.
- With the inclusion of Kosovo into the trade provisions of the EU Stabilization and Association process, UNMIK, in cooperation and support of the EC, should secure duty-free access for products originating in its territory to markets in the Western Balkan countries (Albania, Bosnia and Herzegovina, and Croatia), those in other countries of the former Yugoslavia, i.e., FYR Macedonia and Slovenia as well as in Bulgaria and Romania.
- As a first step designed to foster effective regional cooperation recommended by the Council Regulation on Exceptional Trade Measures, UNMIK's decision to abolish tariffs on imports when VAT is introduced (expected to be in mid-2001) is notable. Using the support of the EC, Kosovo should seek clarification of its trade status and obtain duty-free access for products originating in Kosovo.

Moving Towards an Export-Friendly Trade Regime

The current trade regime in Kosovo likely discourages both exports (especially as these involve imported inputs) and inward processing activity in Kosovo and consequently FDI inflows. The inward processing has been an important source of employment and hard currency earnings in all transition economies especially during the initial phases of moving to market-economy. With the planned introduction by the EC of separate textile quotas for Kosovo, UNMIK should contemplate establishing arrangements friendly towards inward processing as soon as possible.

- Consideration should be given to introducing a scheme (temporary admission, duty drawback, rebates, etc.) that would provide incentive to foreign firm to establish production activity, to outward processing in Kosovo and to domestic firms to become involved in exports.

Notes: (1) Without a clarified trade status for Kosovo, the benefits of a scheme will be marginal at best; (2) Operationalization of a scheme would require substantial assistance by CAM-K. Therefore, assistance capacities of the CAM-K should be considerably

expanded in order to assure a smooth introduction of an import regime allowing for the development of inward processing activity.

Although committed to the principle of uniform tariff rate, the UNMIK foreign trade regulations exempt several product categories including important agricultural products, which results in discriminating against the agricultural sector and may undermine its recovery.

- In order to assure neutrality in incentives, one should confine exemptions to tariffs to such products as pharmaceutical and medical instruments and goods imported by UNMIK, diplomatic missions, international organizations and NGOs registered with UNMIK. Thus, it seems that milk, cooking oils and fats, and fruit should be removed from the list of products exempt from custom duties and sales tax.

In order to lessen the burden on UNMIK-CS and remove the source of distortion in supplying routes to Kosovo, no preferential trade agreements should be a component of the UNMIK foreign trade regime.

Note: The planned elimination of tariffs in mid-2001 upon the introduction of a VAT scheme would of course make the FTA with FYR Macedonia immaterial.

Reducing Incentives to Smuggling and Underinvoicing

Broadening of the tax base would significantly moderate the existing incentives to smuggling and underinvoicing. The most effective way of broadening the tax base and removing distortions is to suspend the customs tariff and make countervailing adjustments in the sales tax (as discussed earlier); this will occur once VAT is introduced. Tax base can be significantly broadened also by additional ancillary measures: (i) setting TCPs in all crossing points (including those with the rest of Serbia) to Kosovo (ii) tightening boundary controls in existing TCPs (e.g., closing the possibility of by-passing controls in TCP/Pec by importers); (iii) tightening controls over imports by NGOs by, for instance, introducing the refund scheme; (iv) reducing the level and dispersion in excise tax rates; and (v) moving from *ad valorem* excise taxes to specific taxes for at least some products.

Successful broadening of the tax base would significantly increase tax revenue and would offset the fall in revenue due to the abolition of tariffs and possible cuts in excise tax rates on some products.

The dispersion in excise rates on similar products creates opportunities for corruption and therefore should be reduced.

- The excise rate should be uniform for at least the following sets of products: cigarettes, cigars, and cigarillos; beer and wines; gasoline, diesel and heating oil (the excise should be imposed on the latter at the same rate as on gasoline and diesel) .

CHAPTER 3:

THE BANKING SECTOR

BACKGROUND

Kosovo's banking sector is underdeveloped by modern standards. Causes include weak resource mobilization, virtually no lending and few formal sector transactions. Banking sector weaknesses partly reflect the traditionally poor status of Kosovo (based on formal economic measures). Kosovo had the lowest per capita income in the former Yugoslavia,¹ reported to be US\$700 in 1988, in contrast to Serbia's at US\$2,285, and the Yugoslav average of US\$2,520. Confidence in the banking system steadily eroded in the late eighties and into the 1990s following the revocation of autonomous provincial status, the freezing of foreign currency deposits, and attempts to dismantle the local banking system.

Throughout the 1990s, most banks transferred hard currency to Serbia or to some of the socially-owned/State-owned² industries in Kosovo. Then Albanians and other non-Serb managers and workers were dismissed from these industries to facilitate the hiring of ethnic Serbs. As these companies began to physically deteriorate and resource transfers to Serbia became less frequent, the remaining banks left the Kosovo market. This pattern in the banking sector - along with the attempted legal liquidation of Bank Kos³ - became the financial counterpart of the de-industrialization of Kosovo following the revocation of its status as an autonomous province.

Prior to the 1999 conflict, Kosovo had five major banks and reportedly 54 branches of Serbian banks.⁴ However, assets, loans, deposits, capital, and other generally standard bank balance sheet data however were not reported - except for the "indigenous" Ekonomik Bank, a successor to the closed Bank Kos. If gauged by reporting standards found in other dinar-denominated economic areas, these data would have been

¹ Figures in 1989 are gross material product per capita.

² The issue of ownership is a source of heated debate and perpetual contention. Before 1989 and into the 1990s, most of the industrial enterprises in Kosovo were considered "socially owned." In 1995, as part of Serbia's privatization program of ownership transformation, many of these industries were apparently converted to "State ownership" to provide a legal basis for the right of the state to "privatize" these companies. In either case, ethnic Albanians were generally expelled from these enterprises from 1990 on in favor of ethnic Serb managers and workers.

³ While Bank Kos stopped operations in 1990, it could not be liquidated according to Serbian/Yugoslav law because it retained a balance sheet with positive net worth based on prevailing prudential norms.

⁴ See "Economic Activities and Democratic Development of Kosova," Riinvest, 1998.

meaningless even if reported.⁵ This is because assets and loans did not reflect loss provisioning or write-offs as is customary in international practice. Deposits would have reflected frozen foreign exchange deposits of about US\$1 billion (transferred to Belgrade in 1990). On the other hand, capital would not have been adjusted for negative earnings retained over the years. Also, the downward impact of market-based valuations of fixed assets and their impact on net worth would not have appeared. Without these adjustments, balance sheet reporting would have overvalued the asset base, active funding sources, and banking system capital - even prior to the conflict.

Of the four major banks operating prior to hostilities, three were reported to be operating until late 1998/early 1999, though only on a limited basis:

- *Bank Kos*, which was deactivated in 1990, but served the larger industrial enterprises and *agro-kombinats* from 1961 to its deactivation - similar to the role played by the older Privredna Bank in former Yugoslavia in today's Bosnia-Herzegovina and Croatia.
- *Beobanka*
- *Ekonomik Bank*, which replaced Bank Kos in Kosovo in terms of general target clientele, and still has basic operational infrastructure. Persistent asset stripping, equipment cannibalization, transfers of funds, and dismissals of ethnic Albanians from industrial enterprises - all rendered the bank's activities progressively less important throughout the 1990s. By late 1999, Ekonomik Bank reportedly had only about Dinar 7 to 8 million in deposits (about DM 500,000, or less than US\$300,000).
- *Yugobanka*, which operated throughout Yugoslavia prior to its break-up, and still operates in Serbia, though it is now defunct in Kosovo.
- *Vojvidanska Bank*, which, like Ekonomik Bank, possesses some infrastructure for basic payment operations, but is now closed.

As in the rest of the country, under the model of "social ownership," these banks traditionally served as captive finance companies. They loaned money to their socially owned enterprise owners and provided numerous services to their respective employees. These included accepting deposits, paying pensions, and providing other basic financial stewardship functions. Private sector accounts and shareholders were added in the 1990s, although their role was not significant because of the informalization of the economy. In general, the role of these banks diminished in the 1990s, as industries in Kosovo became increasingly run down, and ethnic Albanians and others found employment in the trade and service sectors (mostly in the gray economy). Bank branches from Serbia that

⁵ Even if reported, figures would have shown poor performance. In Yugoslavia in mid-1998, total liabilities of the enterprise sector exceeded US\$2 billion, and banks were weak and reporting losses. Thus, in Kosovo, financial figures would have reflected the poor state of the economy even without adjustments. See "Transition," April 1999.

operated in the market in the 1990s functioned more as unit banks, i.e., no or few branches. Their main objective was to transfer hard currency from Kosovo to the vaults in Belgrade or into accounts abroad. Most of these banks had closed and returned to Serbia by early 1999.

Traditional Structural Weaknesses in the Banking System

Almost no financial analysis was done to assess risk. Before the early 1990s, if enterprises needed additional funds, they would obtain them from the bank(s) they owned. This became more difficult in the 1990s after the imposition of sanctions. Industries then began to cannibalize machinery and equipment, running down their industrial assets. Political criteria became more important than commercial value in obtaining funds during periods of tight liquidity. Principal due was frequently rolled over without evidence of the debtor's ability to repay. Interest was frequently capitalized. Banks also took out mortgages and liens on their borrowers' assets to secure loans. These collateral values were dubious because of problems of "perfection" and the inability to assume ownership of properties used as collateral. Moreover, the judicial structure of the former system was not set up to enforce contracts or to resolve disputes in favor of creditors.

All of these factors contributed to a passive banking system, in which banks neither lent according to commercial criteria nor monitored for risk once loans were made. In cases where loans were granted to Albanian-owned enterprises, in the 1990s they were frequently not repaid (with the consent of bank management) based on the belief among ethnic Albanians in Kosovo that Serbia had already expropriated deposits and other funds from them (i.e., to finance wars and to ease the effect of sanctions in Serbia). Thus, principal repayments could potentially be subject to the same confiscatory practices in the future.

On the liability and cost side, banks provided safekeeping services for enterprises and households. However, as in the rest of Yugoslavia, foreign currency deposits were physically transferred to the vaults of the former National Bank in Belgrade in exchange for local currency. Hyperinflation from the late 1980s into the 1990s promptly erased Dinar values - and with it the savings and confidence of the public.⁶ Meanwhile, the conflicts in Croatia, Bosnia and Herzegovina and other parts of the former Yugoslavia in 1992 prompted the imposition of sanctions against the reconstituted Yugoslavia⁷ by official creditors. This manifested itself in the curtailment of international lending flows to Kosovo, a loss of liquidity in the banking system, and a virtual halt to banking operations. Moreover, in the 1990s because of prejudicial practices directed against ethnic Albanians (and other non-Serbs) in the industrial sector, a significant portion of the majority population in Kosovo engaged in private sector activity in the "gray" and

⁶ The National Bank of Yugoslavia (NBY) extended equivalent amounts of credits in Yugoslav Dinars to domestic banks which had placed foreign currency deposits with NBY, and used foreign exchange proceeds to repay FRY's foreign debts and to finance imports by enterprises. Most of these Dinar credits were not repaid to NBY.

⁷ Serbia (including Kosovo and Vojvodina) and Montenegro.

“black” economy. Thus, the incentive structure prevailing in the 1990s constrained formal savings mobilization and prompted full-scale financial disintermediation. This led to the virtual disappearance of the banking sector in Kosovo.

Profile of the Current Banking Sector⁸

As of end 1999, there were no banks operating in Kosovo. One bank, the Micro-Enterprise Bank of Kosovo (MEB-Kosovo), with EBRD and IFC being equity participants, received approval to commence operations in January 2000. A second financial institution (technically a “non-bank”), the Grameen-Missione AMF, also obtained a license to operate as a micro-finance institution, although it was not active as of the second quarter of 2000. Preliminary licenses were approved by the licensing and supervisory authority in spring 2000 for four banks with a history of operations in Kosovo, but it is uncertain whether these banks would be able to qualify for permanent licenses.

By early 2000, deposit mobilization and lending were virtually nonexistent in the banking sector apart from the 2,000 or so accounts that had been opened with MEB-Kosovo.⁹ Basic transfers through the banks had been virtually stopped so the payment system could be reorganized. (These services are now beginning to be provided by the Banking and Payments Authority in Kosovo. However, in the absence of a functioning banking system, these services have generally been provided by travel companies at a 5 to 7 percent charge per transfer.) In late 1999-early 2000, the banks were characterized by:

- lack of meaningful monetary capital;
- real estate as the major asset on the balance sheet, but frequently damaged physically and overvalued in financially;
- a desire to re-create pre-1990 conditions and practices;
- a comparatively untrained labor force for modern banking;
- the intention to re-start operations as “large” banks; and
- virtual stoppage of operations.

Immediate problems include:

- The absence of banks that have been prepared to compete along commercial lines;
- The inadequacy or nonexistence of meaningful financial information and management systems in the banking (and enterprise) sector;

⁸ Most of this section is based on findings from a brief diagnostic assessment of the banks during the economic mission of the World Bank in August-September, 1999, and confirmed in a subsequent mission in October, 1999 and February 2000.

⁹ This should be viewed as a positive step towards development of the banking sector. MEB-Kosovo had established about 1,600 accounts as of February 2000, only a few weeks after opening its operation. However, even if this number grew several times, the total financial balance would be relatively small compared to the overall intermediation needs of the economy.

- The absence of financial intermediation (deposit-taking or lending) resulting from a lack of public confidence, past resource misallocation and politicization of bank lending, and the need for cash to finance trade and services in the largely informal Kosovo economy;
- The presence of only a small and costly range of banking services, namely transfers, which are provided more by travel companies or informally rather than through banks; and

A particularly severe problem – the lack of public confidence in banks – was revealed by a survey. It indicated that the population would refuse to place their significant informal savings in any institution except a foreign commercial bank.¹⁰ While the survey did not elucidate the meaning of “foreign commercial bank,” it did note an absence of confidence in foreign banks from Albania, FYR Macedonia, and Yugoslavia. (The survey was conducted prior to the opening of MEB-Kosovo).

There has been, perhaps unsurprisingly, little interest shown to date from international banks in investing in Kosovo. This could change over time once pilots are tested and successes are demonstrated. One such pilot is the Bank and EC supported line of credit for small and medium enterprises that has recently become operational (details can be found in a later section of this chapter). However, for the foreseeable future, efforts to establish a firm foundation for formal financial intermediation will be undermined by the widespread lack of public confidence. The revival of the banking industry will depend largely on regaining public confidence. This is closely linked to the quality and probity of banks and bank management, as well as the presence of an adequate banking supervision authority.

A STRATEGY FOR BANKING SECTOR DEVELOPMENT

Banks in Kosovo lack modern management systems and personnel experienced in commercial banking consistent with international standards and market-based norms. Meanwhile, financially, the banks that operated before are insolvent because of the prevalence of bad (and immobile) assets and damaged real estate on their books. Consequently, they cannot obtain new licenses until they are in a position to comply with new licensing and regulatory requirements, introduced at the end of 1999. These requirements specify both managerial and financial restoration as prerequisites. Compliance with new regulations will almost certainly require new banks to enter the market. This would be either in the form of “greenfield” investment, or from a strategic investor reviving one or more “old” banks. Bank Kos had dozens of correspondent relationships, including several with major international banks. On the other hand, given the political risk and small size of the market, these and other prime-rated banks probably will not have an interest in investing in the Kosovo market any time soon. This has led to the need for a comprehensive strategy to develop the Kosovo banking system based on a sustainable and comprehensive incentive structure.

¹⁰ See International Rescue Committee, 1999.

Strategic Goals and Objectives. Strategic goals and objectives for banking sector development depend on support for a wide range of structural reforms. As elsewhere, success in developing a viable banking sector depends on a number of factors. They include a sound legal and institutional framework to ensure incentives are in place for adequate resource mobilization; proper risk management guidelines and practices; and public confidence. To rebuild the banking system in Kosovo the following will need to be achieved:

- *Focus on Restoring Sustainable Financial Intermediation.* This will mean restoring confidence in a banking system so that meaningful resource mobilization and financial intermediation can occur.
- *Rebuild the Banking System Based on Emerging Global Standards.* This will depend on establishing a modern banking system and economy for Kosovo based on a suitable regulatory and institutional framework for market-based competition and incentives for sound management and governance - from foreign as well as local sources.
- *Design Donor-Supported Projects to Be Consistent With Market-Based Principles.* Donor assistance in providing needed intermediation and related services (through loan funds, technical assistance, and training) will achieve better results if project design is harmonized, and if commercial fundamentals are applied by enterprises and banks in concert with prevailing prudential regulations. Such an approach would also contribute to a meaningful and well-coordinated rejuvenation of the *formal* Kosovo economy, which would support the long-term goal of developing a viable and competitive private sector in a well-managed and increasingly diversified economy.
- *Include Explicit Exit Strategies in Donor-Supported Projects.* Donor assistance in helping to rebuild the banking system should consider the current weakness of the formal financial sector as an aberration. There is no guarantee that private banks, domestic or foreign, will invest soon and play their proper role in restoring financial intermediation. Nevertheless, attracting legitimate private investment and professional management in this sector should be the main objective, with donor programs serving as a bridge. Consequently, donor projects in the banking sector should be designed with an exit strategy. This strategy could be revised if adequate levels of investment and professionalization fail to materialize.
- *Development of Human Capital.* The well-known weaknesses of the Yugoslav banking system, the low level of banking activities in Kosovo over a decade and the exclusion of the majority ethnic population in the formal banking industry have resulted in a massive denuding of human capital in this sector. Training in modern standards of efficient and sound banking is urgently required. This will need to be provided through intensive, hands-on technical assistance to bankers and bank supervisors over a period of some years. Experience suggests that such investment in training have a high pay-off;

indeed, however fine regulations, rules and manuals may be, critical to effectiveness is human skill, motivation and honesty. The entry of foreign banks will greatly contribute to human capital formation, but management contracts and twinning arrangements with nascent local banks should also be considered.

Progress in the Banking Sector: Regulations and Rules. Several years will be needed to reverse the problems facing Kosovo. This is because of the political divisions of the region, and the associated political risks that could unfavorably impact developments in the economy and banking sector. Key challenges for banking sector modernization include improving prospects for foreign investment, professionalizing the management of formal financial sector institutions and resources, and developing accountable and credible civil institutions that inspire confidence and are fiscally sustainable. All three are interdependent, and combined represent the necessary conditions to place the banking sector on the path of long-term commercial viability. Moreover, as deposits are mobilized and the banking system begins to make loans, interest rates will emerge and should be determined in as a market process. Building blocks for development of a stable banking sector include the following:

- Introducing incentives in the banking system to “formalize” the economy so as to increase savings mobilization and prudently managed lending;
- Developing standards for better information and disclosure, including improved accounting standards, strengthened internal audit functions, and adequate management information systems;
- Providing legal incentives for banks to take prudent financial risk by providing a better framework for secured transactions, contract enforcement, out-of-court arbitration, and timely dispute resolution based on clear, straightforward, transparent guidelines;
- Strengthening the role of banking supervision according to market-based and risk-based models;
- Developing banks’ general capacity for risk management, portfolio management, and asset-liability management - all of which are directly linked to improved governance and internal oversight;
- Adapting banking practices to international standards that address connected (related-party) lending, loan concentration and exposure, and new loan classification standards (both in the aggregate, and on a loan-by-loan basis);
- Introducing timely loan-loss provisioning (factored on a pre-tax basis) and write-offs accompanied by suspension/reversal of accrued interest income;

- Improving loan monitoring and administration, including better credit files and documentation for systematic follow-up; and
- Developing a fully functioning payments system.

Much has been accomplished in some of these areas, principally the establishment of an effective supervision system supported by modern laws and regulations and progress is underway in some of the other areas. The introduction of three key regulations¹¹ that establish new guidelines for market-based banking, unify the payments system, and call for basic banking supervision capacity represents a start. Time, experience, and investment will be required to meet the long-term challenge of constructing a viable institutional framework and a conducive environment for market-based banking.

To date, the regulations alluded to above, provide guidelines and parameters for bank governance, management, and operations. Work is also under way to draft new rules that touch on issues of commercial law—corporate/business organization, contract enforcement, property rights, privatization, dispute resolution, collateral, mortgages, bankruptcy and insolvency. This is expected to reinforce progress in reconstituting the formal banking sector. It should also ultimately help provide banks with incentives to lend in a manner that is risk-taking yet prudent. In addition to the introduction of sound banking legislation, the development of risk management capacity at the banks, and the evolution of effective supervision, other preconditions for public confidence and deposit safety are now being put in place.

Key features to the banking regulations include:

- Requirements to obtain and maintain a license;
- The right of foreign banks to operate, with associated cross-country supervisory requirements;
- The authority of the Banking and Payments Authority of Kosovo (BPK) to approve banks' governing boards, conduct on-site inspections, request any/all information as needed for supervisory oversight, require prompt corrective action when regulatory capital falls to two-thirds or less of requirements, and to appoint receivers and liquidate;
- Minimum capital of at least DM 1 million as a "narrow" bank,¹² DM 3 million to provide basic banking services, and a higher minimum capital of DM 5 million to engage in non-DM currency futures trading, trust, investment/portfolio management, and securities underwriting and trading;

¹¹ These are technically called Regulations in Kosovo. However, they have the effect of laws. One addresses monetary and payment issues. The second addresses bank licensing, supervision and regulation.

¹² This would require that assets be held in investment-grade EU securities. Lending would not be permitted.

- Minimum capital adequacy requirements/ratios,
- Exposure and concentration limits on large loans;
- Restrictions on banks' equity holdings in non-financial companies to 15 percent of regulatory capital per investment, and no more than 100 percent of regulatory capital in aggregate;
- Liquidity practices and risk management functions regarding interest rate, exchange rate, maturity, and asset-liability risks/gaps;
- Ownership, management, and governance guidelines based on prudent internal controls, modern management information systems, internationally accepted standards and qualifications of board members and managers, and legal, operational, financial and administrative autonomy for banks;
- Autonomous internal audit functions;
- External audits based on IAS on both an individual and consolidated basis, including assessments of the (non)viability of internal audit standards, guidelines, practices and information systems;
- Reporting to supervisory authorities to maintain a banking license;
- Prohibition on certain activities and fines and sanctions for violations; and
- Receivership and liquidation.

New licenses would be issued to newly established banks based on their demonstrated ability to meet minimum conditions specified in the new Regulation on Bank Licensing, Supervision and Regulation and accompanying requirements, as well as to comply with these on an ongoing basis.

Creation of a Banking Supervision Agency within the Banking and Payments Agency

As noted, the banks suffer from an extreme lack of public confidence in view of the effective confiscation of foreign currency deposits by the Belgrade authorities over the past decade and the weak management and capital positions of the banks themselves. The revival of the banking industry will depend crucially on regaining public confidence. This, in turn, depends on the quality and integrity of banks and bank management. Key policy steps consist of establishing effective banking supervision within the framework of a stringent banking law and, eventually, introducing limited deposit insurance. It appears likely that revived banking activity in Kosovo will originate from new entrants, whether foreign or domestic.

A new banking supervision department has been set up within the umbrella of the Banking and Payments Agency, which is also charged with operating the payments

system. The supervision department has responsibility for: (i) licensing new banks; (ii) permitting banks to engage in new activities or offer new products; (iii) permitting mergers and consolidations of banks; (iv) providing guidance to banks on what the supervisor deems to be unsafe or unsound; (v) assessing the condition of individual banks and of the banking system; and (vi) initiating, pursuing and following up on corrective actions.

Policies and procedures related to direct supervisory activities are disclosed to banks and to the general public. Disclosure enables the public to gain a better understanding of the supervisor's role. More importantly, informing banks of the supervisor's expectations and of the consequences for failure to meet them is an effective supervisory technique to encourage voluntary compliance. This aspect of public interaction is managed in a manner that suggests UNMIK is promoting the stability and strength of the banking and financial sectors.

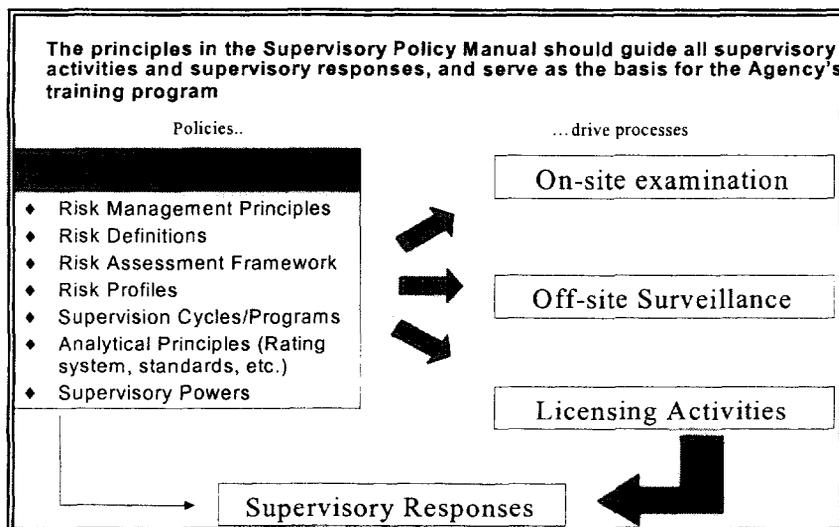
The supervision department is developing a basic policy framework utilizing a CAMEL¹³-style evaluation system to guide supervisory decisions, and then to extend the scope to include a broader array of assessment factors and techniques, such as risk management and risk profiling. The manual delineates expectations regarding the standards of financial condition and management practices for financial institutions, as well as evaluation methodology. The manual focuses on risk management principles and other non-financial areas, such as corporate governance, transactions with affiliates and insiders, internal controls, and issues related to regulatory compliance, etc. The manual itself will become a more comprehensive supervisory policy manual containing principles-based guidance for the assessment of risk in individual institutions and the sector. It also facilitates consistent policy application throughout the range of supervisory activities, including licensing activities and procedures, on-site examinations, and off-site surveillance. In addition, it enhances the ability of the agency to design and initiate risk-appropriate corrective actions.

The framework of the manual allows the application of the appropriate principles and concepts to any institution—regardless of structural or operational differences. The manual details on- and off-balance sheet activities, management practices, related policies and regulations. The manual also describes a set of risk assessment principles and evaluation factors applicable to each area. Expectations for minimum risk management policies and practices are given. The advisory team assists in the implementation of these principles as part of its supervision of commercial banks. The advisors routinely test the policies during examinations to better tailor the policy and improve its practical application.

The development of the policy manual also serves as the basis for continued development of the organizational structure, creation of supervision programs/cycles, on-site examinations, off-site surveillance and risk profiling activities. Additionally, the principles in the manual help to guide decision-making with respect to licensing and problem bank management and resolution. It also provides the basis for periodic staff

¹³ Capital, Assets, Management, Earnings, and Liquidity.

training as well as the foundation for a comprehensive training program. Lastly, the well-articulated policy structure, in conjunction with the legal and regulatory framework, provides a solid base on which the department can sustain sound financial sector management after the withdrawal of UNMIK.



BPK, as the licensing authority has the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base. In addition, UNMIK has the legal authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties. This review process is subject to policies that promote a competitive, market-based banking system.

With the legal and regulatory basis for licensing activities in place, the department now is focusing on the process of licensing, including the decisional framework, policies, tools and work products. The goal is to ensure that licensing activities are guided by the risk-based policies outlined in the policy manual, and decisions are consistent with market-based supervisory philosophies.

The supervision department has also developed an array of supervisory responses that allows it to respond to institutional and sector issues in a risk-appropriate manner. The policy framework includes an outline of possible actions or consequences that may be applied to an individual, an institution, or financial group, under specific conditions, practices or situations. This includes risk-appropriate measures for dealing with "problem banks," and procedures to liquidate insolvent institutions.

The issue of problem banks is of critical importance to the Kosovo financial sector, as banking weaknesses, unpaid frozen deposits, apparent fraud and other factors have

eroded consumer confidence and inhibited the mobilization of savings for investment. While banks continue to report high capital ratios under FRY accounting rules, it is clear that when loan losses are recognized, banking institutions will experience dramatic declines in capital ratios, and bank failures and liquidations can be expected to increase.

**NEXT STEPS TO RESTORE FINANCIAL INTERMEDIATION:
INSTITUTIONAL AND MARKET DEVELOPMENT**

Progress in creating a viable legal and regulatory framework will need to occur in tandem with the development of the banking supervision authority. A workable payments system, drafting of new accounting and audit standards, and commercial bank training are required to support the new banking system. In the process, risk management practices need to be introduced by the banks themselves. An important step towards restoration of financial intermediation is the institution of Bank/EC and donor-supported credit lines for SMEs from autumn 2000.

From a portfolio management standpoint, initially focus should be on asset-liability management, credit quality (including off-balance sheet exposure), and liquidity management. From a systems standpoint, focus would be on the introduction of an autonomous internal audit function, the installation of modern management information systems, and the implementation of regular reporting to BPK and within bank organizations themselves. Meanwhile, investment from donors in one or more new banking organizations is expected to establish fundamental competitive norms. Such institutions, as well as micro-finance institutions also supported by/with donor funds, would be expected to comply with the prudential regulatory norms drafted for the banking sector. Key components are expected to include:

- *Lines of Credit.* The introduction of donor-financed lines of credit should help to provide some lending capacity to the private sector. Most project designs to date have focused on micro-finance market. In fact, there is a gap in financing for small- and medium-sized enterprises with credit needs in the DM 50,000 to DM 500,000 range. Filling this gap will depend on a number of conditions, including the ability of these enterprises to demonstrate good management, personal financial risk, accountability, and commercial prospects for success. Larger enterprises probably will require different sources of financing - but only after restructuring strategies have been developed and legal claims/disputes have been resolved.

Successful project implementation will require the training of lenders to assess risk based on commercial terms and incentives. In the absence of a buoyant private banking market, technical assistance and training should play a key role in developing credit management skills. These would pertain to initial contact and assessment of firms through analysis of business plans, loan approvals, loan disbursements, monitoring the use of loan proceeds, maintenance of proper credit files and systems, and loan collection. When banks eventually become licensed, technical assistance and training would be needed to develop portfolio management capacity regarding prudential regulations, the avoidance of excess

concentrations, asset-liability management, and other informational requirements for management and governance in a market-based system.

- *Business Advisory Services.* As part of the formalization of financial intermediation, many of the businesses seeking loans will need financial, operational, and managerial assistance. There is little doubt about entrepreneurial capacity in Kosovo. However, there are differences in the needs of firms operating in the formal economy, compared with those that have operated informally for 10 or more years. In a similar vein, larger corporations have needs that differ from owner-operated businesses and sole proprietorships in more transparent market-based economies. Business advisory services would provide some businesses with needed planning expertise--particularly after the last decade, when many businesses had little incentive to operate in the open. Establishment of a viable network of business advisory firms in Kosovo would go a long way toward helping firms to develop viable product and market strategies, and to maintain appropriate capital structures and liquidity management practices. These developments, in turn, would strengthen credit worthiness and enhance financial intermediation prospects for both businesses and banks.
- *Out-of-Court Arbitration.* More expedient out-of-court measures may need to be introduced to compensate for weakness in judicial capacity and differences between the emerging business sector framework in Kosovo and Yugoslav law. This approach would accelerate dispute resolution, in lieu of tying up claims in time-consuming court procedures. This might also alleviate some of the doubts creditors have regarding secured loans and collateral backing (along with contract enforcement measures). Clear guidelines would be needed to ensure rapid resolution. The guidelines would be developed as a precursor to creating the requisite judicial capacity to execute rules and regulations governing secured transactions.
- *Accounting/Audit Standards and Professionalization.* The introduction of accounting standards according to international norms is mandatory. This will require development of a new profession, with specific specialization needed for financial institutions based on a new accounting framework. This framework should be developed in concert with new banking regulations. The purpose would be to: generate more meaningful financial data for a market-based economy; facilitate bank supervision; and enhance financial disclosure for shareholders, depositors, lenders and regulators. At a minimum, technical assistance and training will be needed to introduce IAS for accounting along with ISA for the audit profession.
- *Internal Audit/MIS/Risk Management.* The importance of timely and accurate financial information for managerial purposes is a starting point for modern strategic planning in banking. Basle Committee guidelines on the importance of autonomous internal audit functions in banks will need to be introduced. They should be accompanied by comprehensive MIS for bank management to

map out strategies for funds mobilization, asset management, and the level of risk to be assumed in portfolios and operations. The best method for introducing modern risk management practices is to have prime-rated institutions invest in the local market and expose their balance sheets to risk. More often than not, this represents a two-staged process in the Balkans. First, prime-rated institutions establish operations but focus on fee-oriented services with little risk involved. This is then followed by lending and other risk-taking activities when they feel comfortable with companies and the market. In the case of Kosovo, it is expected to be some time before any prime-rated institutions invest and take risk. Thus, technical assistance and training will be needed to shore up these practices, with particular emphasis on coordination with regulatory authorities to contain any potential for systemic risk.

- *Overall Governance/Management.* As banking in Kosovo moves toward a more commercial orientation, governance and management requirements will change. The new banking regulations and rules have mapped out key requirements for board members, major shareholders and bank managers to enable those banks to obtain a license to operate. In particular, there will be strong focus on internal audit, credit management, and asset-liability management. In the absence of direct investment from prime-rated institutions, technical assistance and training may be needed to strengthen the ability of bank boards and managers to exercise “fit and proper” standards of governance and management that are consistent with internationally recognized “best practices.” Internal controls and crosschecks will be needed as well. For the foreseeable future, pressure will be on BPK to monitor developments in these areas through the use of full-scope and targeted inspections, in addition to ongoing off-site surveillance.

Risks to Restoring Financial Intermediation

There are numerous risks to establishing the kind of environment and framework required for stable banking and sufficient levels of financial intermediation in Kosovo. Key among them are political risks and the potential market size. Others relate to lack of public confidence in formal banking institutions, and the amount of time required to build a new and comprehensive incentive structure for *competitive* market-based finance. These and other issues are highlighted below:

- *Political Risk.* Political risk represents one of the major impediments to financial intermediation. Internally, problems persist in reconciling the various communities. These problems are not expected to abate until outstanding issues are resolved. Such disputes are rooted in political and legal issues that touch on property claims, presumed rights to compensation, and even national sovereignty. Meaningful levels of formal private investment are not likely to materialize at least until some of these obstacles are removed. Political risk guarantees may facilitate larger investments, and a gradual restoration of confidence may lead to smaller investments. However, until the political risk

rating of Kosovo improves, political risk will be an impediment to overall stability. This, in turn, will reduce direct investment from local and foreign sources. Prospects for financial intermediation may not be strong until the investment climate improves. This will require an improvement in the political landscape.

- *Market Size.* The size of the Kosovo market remains relatively small. The population is less than two million, and per capita income has traditionally been lower in Kosovo than virtually everywhere else in Europe. While remittances, informal savings, and strong family ties translate into more financial protection than indicated by economic statistics alone, the market is still small. This will cause investment prospects to appear less attractive and weaken prospects for financial intermediation.
- *Public Confidence.* Restoring confidence in civil institutions is a slow process, particularly after a long period of alienation. During the last decade informal parallel structures emerged. While these meet many immediate needs--and in some ways are more responsive on a personal and community level--in the long run, they do not meet the needs of a modern economy. At a minimum, these structures are clearly insufficient for banking and financial intermediation. For public confidence to be restored, prime-rated foreign investment will be needed. Here, political risk and market size are paramount. With no resolution of political risk and no signs of market growth - in the form of rising incomes, more purchasing power, and greater investment flows - it is unlikely that prime-rated banks from OECD countries will have any incentive to invest in Kosovo soon. Even with investment, it is doubtful that banks would expose themselves to risk for some time. Instead, they would probably rely on guarantees for balance sheet exposure, and focus on fee income-generating services in the form of transfers and remittances, trade finance, investment counseling, and foreign exchange trading for others' accounts. This would do little for intermediation, as there would be little commitment, if any, to building retail deposit franchise.
- *Ability of Banks to Mobilize Funds.* Funding for and from banks is expected to be minimal for the foreseeable future. First, funding sources would be limited because of the unwillingness of banks to establish a retail-banking network needed for deposit mobilization in Kosovo. This would involve high cost and be risky, given the general distrust of banks and consequent unwillingness to deposit funds for safekeeping. Second, there are no bond markets or secondary financing markets. Third, there is understandable concern on the part of BPK about licensing banks if they cannot meet regulatory requirements.¹⁴ Thus, it is conceivable that investment groups with capital resources - and possibly the

¹⁴ It should be noted that this effort is part of a global effort to promote safe, sound and stable banking in general, as well as to contain money laundering, fraud, and other financial crimes. These are considered essential ingredients to international financial stability as cross-border financing increases in volume, value and speed.

greatest interest in opening up banks - may not qualify for a bank license because of concerns about how those groups may have generated their capital. Fourth, prime-rated foreign banks to date have shown little interest in investing in the banking market in Kosovo.

- *Willingness of Banks to Take Risk.* Banks in general are unlikely to lend in any great volume soon for several reasons. First, their funding base will be limited. Second, the regulatory regime will be stricter in terms of the management and quality of assets than during the Yugoslav period. Third, judicial weakness in the commercial framework undermines the use of collateral for secured lending. Fourth, profit opportunities may abound for banks able to render needed services without the banks themselves subjecting their balance sheets to undue risk. Without donor assistance, this scenario is unlikely to change until there is competition. And competition probably will not materialize until political conditions have stabilized, risks have abated, some measure of public confidence is restored, and at least two or three professionally managed banks are licensed and operating in common segments, such as consumer banking, small business lending, and the like.
- *Time Required to Build New Incentive Structures.* The restoration of financial intermediation to support sustainable long-term economic growth will require a transformation of incentives and institutions. Even with the adoption of new regulations, it will take time for these changes to be implemented. Much training will be required, new principles and guidelines tested and adapted, and new standards of information dissemination introduced. Also, an appeals process will need to be institutionalized throughout the judicial and political system. In the banking sector, personnel need training in market-based commercial principles; regulations must be understandable, information systems should be used for strategic planning and monitoring; new standards of accountability and disclosure must be established; and management and governance practices need to be completely revamped to conform to emerging global standards.
- *Donor Coordination.* There are a number of potential issues that could weaken prospects for the development of *sustainable* financial intermediation. First, in an environment where human tragedy has occurred, there is a tendency to provide soft loans and grants for humanitarian purposes. This is almost always justifiable and sometimes appropriate. However, in other cases, this has led to aid features that distort market development through subsidized pricing, free loans, and agency arrangements instead of risk-assuming principal positions for institutions. While immediate relief can be provided, such features ultimately can undermine the foundation for sustainable medium-term finance and institutional development. Second, there is the risk of donor as well as recipient fatigue: aid recipients become frustrated with slow progress or donors' reluctance to release funds without any accountability requirements on the part of the recipients. Donors may become frustrated with political division, corruption, or simply slow progress with the reform and implementation

process. If this happens, there is a risk that donor coordination issues could undermine efforts to help Kosovo build a viable banking sector with adequate intermediation capacity.

MEDIUM-TERM CHALLENGES DESPITE NEAR-TERM PROGRESS

Several medium-term challenges will persist based on the needs and risks identified in this chapter. The success or failure of efforts to introduce lasting reforms hinges on the effectiveness of donor coordination, efficiency of resource use, and ability to attract private direct investment into the banking and enterprise sectors. Progress also depends on an interrelated program for development of responsive civil institutions. Key medium-term challenges in banking sector development include the following:

- *Expanding Institutional Capacity for Effective Implementation of Reforms.* Progress has been achieved with new banking regulations and rules. Commercial reform is also underway in support of an improved environment for contract enforcement, recognition of property rights, secured transactions and other features that will provide some comfort to lenders to take risk. The challenge now will be to develop institutional capacity in the judicial system, in banking supervision, among accounting and audit professionals, and among the bankers themselves.
- *Unifying the Payments System.* The traditional payments system in Yugoslavia was organized outside the banking system to provide fiscal authorities with greater control over money flows. This undermines implementation of monetary policy, slows movement toward a viable inter-bank market to meet overnight and short-term liquidity needs, and reduces bank deposits. Kosovo is in the process of creating a payments system that will run through the banks. A critical concern of BPK is monitoring progress in this area. Meanwhile, bankers in Kosovo ultimately will need to adjust to new sources of funding, liquidity management techniques, and reporting requirements.
- *Creating a Virtuous Circle to Restore Public Confidence.* Observance by bankers of the new prudential regulatory framework and sound governance and management practices will be needed to restore confidence and financial intermediation. Deviation from global standards may lead banks in Kosovo down the same path found in many other neighboring economies: poor asset management that undermines solvency and liquidity, triggering doubts about deposit safety. This, in turn, undermines the funding base, limits access to credit, and raises its cost through fees and higher interest rates. Sound management should reverse this process in which sound returns, which strengthen capital and liquidity, lead to a more stable funding foundation based on rising levels of depositor, shareholder, inter-bank, and regulatory confidence.
- *Utilizing Changing Incentives for Management Purposes.* There is a tendency on the part of older bankers in Kosovo, whose activity was curtailed in the

1990s, to return to practices of the 1980s, when enterprises owned the banks. This spawned a non-commercial orientation of the banking system, which relied on connected lending, excess concentration, distorted classifications, and a passive role whereby banks merely disbursed credits to their enterprise owners. Elsewhere in the former Yugoslavia, this lowered the quality of bank loan portfolios and technical insolvency of the banks themselves. The new owners and managers of banks in Kosovo should ensure the new incentive structure works profitably for them. At a minimum, this will require more and better information for strategic planning, and the ability to monitor developments in a timely manner to ensure risks are adequately understood and controlled. In an open and competitive environment, these challenges will be far more demanding than previously experienced in the former Yugoslavia.

- *Strengthening Credit and Overall Asset Management.* In the former Yugoslavia, banks were traditionally passive institutions lending to their borrower shareholders without evaluating project or market risk. When principal payments fell due they were commonly rolled over. When interest payments came due they were frequently capitalized and rolled back into principal. Loan classification standards were not measured based on performance, and/or loan loss provisioning was insufficient to cover non-performing loans. The result was an overstated balance sheet and assets that were of lower quality than reflected in available financial information. Further, the subordinated role of banks in this relationship meant that there was little follow-up on loans. Bankers will need to adapt to new practices to better manage credit and overall asset-based risk. This should include a better understanding of underlying credit risk (including off-balance sheet exposures), as well as maturity, interest rate, exchange rate, and other risks attached to assets, where imprudent exposures can lead to massive and destabilizing losses.
- *Developing Modern Asset-Liability Management Capacity.* A sustainable commercial banking system means that banks will need to develop their asset-liability management systems for underlying financial sector stability. Over time, bankers will have to learn to structure and manage diversified portfolios (loans, securities, properties, etc.) under market conditions, and to ensure that these assets are matched with liabilities to ensure prudent management of risk exposures. As market conditions may lead to frequent changes in these values, banks will have to employ adequate systems and controls to be certain that they are monitoring these risks and exposures in a way that does not jeopardize their financial status. For major banks (when they emerge), these issues will be of greater importance in light of systemic issues and the risks of mismanagement after public confidence is restored.
- *Clarifying the Role of Non-Bank Financial Institutions.* Apart from the issue of micro-finance institutions, there is currently no strategy for non-bank financial institutions in Kosovo. At some juncture, a framework must be developed for insurance, leasing, factoring, venture capital, capital markets and other “non-bank” activities. With the growing influence of universal banking around the

globe, establishing a stable banking system should be a high priority. At the same time, if adequate protective structures are in place, part of the attraction of banks in markets is the ability to diversify into these “non-bank” activities. Developing non-bank financial institutions will require an open environment for capital investment, regardless of origin. Medium-term objectives should include establishing a regulatory framework for private insurance, pension funds, and institutional investors, and building up the institutional infrastructure needed for information disclosure and market analysis. However, these efforts should be partly delayed until there is evidence that a stable monetary and banking system is evolving. Alternatively, if there is movement in the non-bank sector, such efforts should be introduced cautiously to prevent undue financial risk from slowing down progress in banking sector development.

REFORM OF THE PAYMENTS SYSTEM¹⁵

Since the inception of UNMIK, the work of re-establishing a functioning payment system has passed through several stages. Of particular importance has been the establishment of BPK. As earlier noted, the BPK’s main purpose is to foster the development of efficient and sound banking and payments in Kosovo. More specifically, the BPK is responsible for providing: (i) an appropriate inventory of clean DM banknotes in the needed denominations; (ii) clearing and settlement services to banks in DM; and (iii) a full range of banking and payment services to the government. On a temporary and emergency basis, the BPK was also authorized to provide deposit and payment services to enterprises and to the general public until banks were able to do so.

At its inauguration in May 1999, the BPK was able to provide the following services: (i) teller window exchange of DM banknotes for clean notes and coins of desired denomination; (ii) universal teller window cash payments of UNMIK stipends and wages; (iii) receipt and deposit (at vault or teller window) of taxes and other payments to UNMIK; (iv) opening and maintaining of deposit accounts for banks and official entities and the acceptance of deposits and withdrawals from those accounts of DM; (v) receipt of payment orders (for non-cash payments) from authorized agents of depositors and their execution (clearing and settlement);¹⁶ and (vi) receipt of sealed bags or chests from enterprises for safekeeping.

As the government’s banker, the BPK can accept deposits from the CFA and other UNMIK agencies; it also makes payments from these accounts in accordance with the instructions of the CFA and other depositors. During the initial stage, all deposits with the BPK have been in cash since it is not yet prepared to accept non-cash deposits. The largest amount of payments from the UNMIK accounts has been for stipend and wage payments. Until the BPK has fully organized the transportation of cash from its Pristina vaults to its branches and sub-branches, it will not completely assume the responsibility

¹⁵ This section is based on a contribution from IMF staff.

¹⁶ These depositors would be UNMIK agencies and banks. An Electronic Interbank Transfer System (EITS) for clearing and settling these payments will later be operational where depositors are expected to submit payment orders electronically.

for these payments, which have been made directly by UNMIK using BPK staff and facilities.

The BPK is also the bankers' bank, and as such is responsible for clearing interbank payments in DM and settling them using bank deposits with the BPK. New PC-based computer equipment and banking software are now in place and provide a modern basis for the universal teller window services and for the subsequent interface with the interbank clearing and settlement system. Furthermore, a contract has been accepted for the provision of cash transportation services both within Kosovo and between Pristina and a foreign bank. The first bank was licensed in January 2000 and started operations in April. However, other commercial banks are not expected to be in operation in 2000. Due to these delays, the timetable for developing clearing and settlement rules and facilities as well as for adopting a liquidity requirement for banks to hold balances with the BPK is being moved down. By late 2000, the banking system still remains in an early stage of development, requiring considerable further attention in the future.

Problem Areas and Recommendations

The institutional development of the BPK and of its payment services has been delayed by several factors. Admittedly, the original timetable was deliberately ambitious. The key management positions that were to be filled at end-1999 took place only at the beginning of April 2000. Furthermore, the out-of-date SDK computers and software could not be used as initially planned and having to work with the inherited staff of the SDK and the NBK slowed the development of new skills and procedures.

The delay in developing the BPK's ability to offer deposit and payment services and the faster than expected establishment of banks with the ability to offer such services, necessitates a re-evaluation of the BPK's plans to use the temporary authority given to it in UNMIK Regulation No. 1999/20 to accept deposits from enterprises. The IMF, which has provided advice to BPK, recommended that BPK offices should not provide services that compete with banks. Accordingly, the BPK should not open any deposit accounts for enterprises, which in the relatively near future will have two or three banks to choose from for the provision of deposit and payment services. A possible exception could be made for the state-owned utility companies if the BPK determines, on a case-by-case basis, that such a service would be useful for the public.

A further implication of these developments is that the teller window services for government wage and salary payments and tax collections can be moved to banks more quickly than was originally envisaged. The exact timing and geographical spread of bank branches capable of providing these teller window services remains, however, somewhat uncertain and, thus, the BPK will need to be able to provide their services in some locations for a number of months, possibly for as long as a year.

Moreover, it is recommended that the BPK should take the initiative of entering into agency agreements with its core customers - the CFA and other UNMIK agencies. These should include service contracts, formalizing responsibilities and expectations, as well as determining the financial compensation.

The BPK should also complete arrangements for shipping and processing coins and for the repatriation and replacement of old and damaged banknotes. Each of these services must be priced and its fee schedule properly posted. In addition, discussions with the Bundesbank for banknote maintenance and certain other cash-handling services are in the process of being concluded.

With an increasing number of banks being licensed, the need to develop interbank clearing and settlement becomes more urgent. Since the payment system infrastructure is only in the embryonic stage of development, it has been recommended that their design from the beginning, should be based upon electronic media deposited directly with the BPK, and settled on a gross basis to ensure safe and reliable service to customers. The infrastructure for this Electronic Interbank Transfer System would require secure leased telecommunication lines to allow banks to have reliable connectivity with the BPK.

Finally, it is recommended that an UNMIK regulation on payment transactions in foreign currencies be adopted in the near future. The objective of such legislation is to provide for a modern law establishing a firm foundation for an advanced market economy payment system to operate in Kosovo. It covers domestic payments in foreign currency - it does not apply to payments in the Yugoslav dinar, which are governed by existing FRY legislation and the National Bank of Yugoslavia - and covers large-value payments processed individually as well as payments processed in bulk. Above all, such a regulation provides for payment transaction participants' rights and remedies, in case of both in-house and interbank payment transactions.

On balance, considering the difficult initial conditions, the outlook for reform of the Kosovo payment system is bright, although the development of the internal capabilities of the BPK (i.e., modernization of its hardware, software, and selection and training of staff) has been delayed and the licensing of banks has not proceeded as rapidly as was hoped. When a few more institutions have been licensed as banks and when bank services come on stream, the BPK will need to sharply refocus attention on its primary mission to serve banks and the Central Fiscal Agency.

CHAPTER 4:

STIMULATING PRIVATE ENTERPRISE DEVELOPMENT

BACKGROUND

Kosovo benefits from a rich natural resource base and fertile agricultural land. For the last 20 years, economic activity centered on extractive industries, production of raw materials, and semi-finished products (lead, coal, zinc and textiles), as well as agriculture. The economic policy and regulatory environment was shaped by Yugoslav-style socialism. Heavy industry was largely publicly owned.¹⁷ In contrast, agriculture was almost totally privately held. Significantly, more than 60 percent of the pre-conflict population lived in rural areas.

Kosovo's economy consists of three basic components: publicly owned enterprises; privately owned enterprises, and the parallel segment. Publicly owned enterprises formerly engaged in all sectors of the economy but predominately in the industrial sector, and generally in poor condition. The population of privately owned enterprises - much larger in number and collective output - engaged mostly in trade and services. The substantial parallel segment consists of gray market activities in trade and services on a small to medium scale. Nevertheless, it should be noted that the dividing line between the formal and informal sector is an obscure one, given the absence of a legal and regulatory framework, the incompleteness of registration of companies, and the strong incentives over the pre-conflict decade on the part of ethnic Albanians to divorce their activities from the formal sector. All sectors exist today in institutionally and economically unfriendly conditions: no industrial production, no banking system, and no regulatory framework.

The sharp decline in the Kosovo GDP over the past decade can be attributed to a dramatic falloff in industrial output in a sector comprised almost entirely of publicly owned enterprises. Virtually all enterprises suffered heavy damage during this decade of disinvestment and neglect," leaving many in a severely deteriorated physical condition. Most enterprises now need significant restart capital to resume even minimal production. Enterprises also suffer from the far more serious problem of having lost their markets. This is because the rest of the Balkan region moved on economically after 1989, with

¹⁷ Unless otherwise indicated, the terms "public enterprise" and "publicly-owned" are used throughout this report to mean socially-owned enterprises as well as other forms of state ownership, such as enterprises wholly-owned by the state and joint stock companies majority owned by public shareholders.

FRY no longer a viable market for most products previously manufactured in Kosovo. As a result of the exclusion of the ethnic Albanians from management and skilled worker positions, the skills of the ethnic Albanian workforce are out of date.

Throughout the decade, the private sector was the major pillar of the formal economy. This was unusual relative to other non-Balkan, Eastern European countries, but resembled the contribution of the private sector in the rest of the SFRY – a legacy of the Markovic era. In fact, the output levels of the privately owned sector have remained more or less stable since 1987. As of 1996, privately owned enterprises contributed 47 percent of the total GDP, and in 1998, the contribution of the private sector to the overall economy rose to 80 percent. In the meantime, the publicly owned sector became stagnant just before the conflict.

As the formal economy collapsed, ethnic Albanians were dismissed from their positions at public companies. While the official unemployment rate over the decade was significant - some pre-war estimates running as high as 70 percent - this was ameliorated by ethnic Albanians participation in the gray (legal) and black (illegal) economy. The program imposed by Belgrade created a new segment of the economy, namely, ethnic Albanians, who lost their jobs and were forced underground by the subsequent legal regime.

- *No industrial production.* Kosovo's emerging private sector does not include any significant ongoing industrial production or processing activities. Under the SFRY's policy and regulatory regime, production primarily was limited to extracting resources. Most processing was conducted in other SRFY regions. The publicly owned industry that existed before the bombing was subject to the "enforced measures." The few private productive enterprises that survived the war suffer from many of the same problems resulting from loss of markets and inadequate financial resources. The investment needs required to (re-)start most productive enterprises appear prohibitive.
- *No banking system.* The Micro Enterprise Bank Kosovo (MEB Kosovo) is the only bank now operating in Kosovo - although five other banks have received preliminary licensing approval. There is no formal payment system outside of the limited services offered by MEB Kosovo. Lack of payment and banking services combine to restrict private sector activity to areas requiring relatively modest up-front investment. In addition, businesses do not benefit from more advanced cash management or the use of alternative payment methods, such as checks or credit/debit cards. This is almost exclusively a cash economy, with all the inherent limitations and dangers. The near-total absence of financial intermediation is a severely constraining factor to private sector growth.
- *No regulatory framework.* In theory, the FRY's legal and regulatory regime applies today to publicly- and privately owned enterprises as well as to the parallel economic segment. With the repeal of Regulation 1, Section 3, and the adoption of Regulation 24, UNMIK has adopted the SFRY commercial legal framework of March 22, 1989, modified and expanded by other UNMIK regulations. In practice few if any of these

laws are enforceable, nor are they suited to the type of market-oriented economy UNMIK wants to establish.

With the exception of the new customs, sales, and excise tax regime, introduced by UNMIK September 3, 1999¹⁸, plus the Banking Law (Regulation 1999/21), there are currently no other elements of a regulatory framework or for the registration of private businesses. The benefits of this extremely liberal regime are clearly reflected in the robustness of private sector activity. Unfortunately, this is accompanied by troubling reports about the increase in organized crime. In the Bank's view, the rapid introduction of an appropriately liberal system of business registration and regulation would constitute an important part of a strategy to stem this trend, and move the emerging private sector into the formal economy. While progress has been made in recent months towards the preparation of an adequate legal framework for the private sector, UNMIK should concentrate its efforts in the completion and final approval of a basic package of commercial law dealing with business registration, contracts and enterprise law, competition and foreign investment, and setting laws and mechanisms for settling all kinds of disputes.

The Public Enterprise Sector

Ownership. There are reportedly 437 publicly owned enterprises in Kosovo, out of which some 140 medium-sized, and 66 large. These include both industrial enterprises (including agro-industry) and public utilities. Although virtually all these enterprises were under "social ownership" prior to 1989 - the effective date adopted by regulation 24 - there were many changes in the intervening decade that have caused conflicting ownership claims - in addition to the customary claim that social ownership is equivalent to employee ownership. In many cases, enforced measures resulted in Serbian claims to ownership in the form of shareholding or through complete integration of the Kosovar enterprise into a Serbian one (as was the case for Yugobanka). In other cases, the situation is further complicated by commercial contracts or concession arrangements with foreign companies. Generally speaking, the larger the enterprise the higher the degree of complexity in determining ownership. Medium sized companies, such as brick factories and slaughterhouses, are essentially local ventures, while the huge Trepca mining complex presents much more difficult ownership issues. The introduction of Regulation 24 may simplify the situation, as any ownership changes since 1989 would appear to be valid only if they were done pursuant to non-discriminatory laws. There is a sentiment among Kosovar Albanians that all such transactions, in fact, were done under discriminatory laws, or laws applied in a discriminatory manner.

Political Perceptions. The situation described above creates a huge political problem for ethnic Albanians and for UNMIK. Enterprise workers, having been dismissed from their jobs in the early 1990s and forced to take find employment in the parallel system, have returned to enterprises destroyed by years of neglect, war damage, asset stripping, and vandalism. The immediate psychological reaction to this "discovery" is a strong desire to

¹⁸ UNMIK Regulation No. 1999/3 and Administrative Directive No. 1999/01.

bring the enterprises back to their state during the “golden age” before 1989. In discussions with Kosovars on these issues, there is a very strong sense of entitlement to compensation, and an almost complete denial that many of these enterprises would not have been viable - even if they were in the best possible physical condition. Dialogue with community leaders and specialists on enterprise issues among the local populace should be encouraged, as well as through public education campaigns. Unfortunately, the scope was limited for this type of dialogue between UNMIK and local counterparts during the winter of 1999/2000. Extensive and fundamental discussion about structural reform and enterprise privatization remains an urgent priority.

Social Problems. The social problems associated with the restart of these enterprises are somewhat less severe than in most transition economies. Although many workers have not been employed in these enterprises for 10 years, they managed to survive in the private sector or parallel economy, and through remittances from family members abroad. It would therefore be false to assume that significant social problems will arise if enterprises were not to start up soon. This distinction from the experience in other Balkan countries is important: a careful public education campaign aimed at modifying unrealistic expectations should lead to fewer problems associated with vested interests in dealing with enterprise issues. There is a high premium on honesty in the debate about the viability of these enterprises, as it is important that the Kosovars accept that many of enterprises face overwhelming obstacles in ever operating on a sustainable basis again. Non-viable enterprises will need to be liquidated or abandoned, even though this will create the difficult political problem that some former employees of socially owned enterprises may become re-employed while other will not. The local community will need to acknowledge that even for those enterprises that are potentially viable, a condition for their being so may be that only a small percentage of the previous workforce will be re-employed.

Larger Enterprises—Limited Potential for Contribution. The large enterprises need investment, competent modern management, and access to new markets to be viable again. This can be achieved only by attracting foreign capital for enterprises that depend on exports markets and need sophisticated and expensive capital goods. The lack of clarity in Kosovo’s legal framework and the issues related to ownership will make it nearly impossible to achieve this quickly. This means that few large public enterprises in Kosovo will contribute to economic growth in the short term.

Smaller Public Enterprises—Good Opportunities for the Domestic Market. There is strong potential for growth in provision of services (especially to the very large international community present in Kosovo), as well as in agriculture and agroprocessing and construction. While the service and construction sectors are already overwhelmingly private, this is not the case for agroprocessing and the production of construction materials. Most enterprises in these two sub-sectors appear only slightly better off than the large enterprises, but their services appear to be much in demand. They generally are technologically simple operations of relatively modest size, and are likely to be easy to re-start drawing on domestic resources. These types of enterprises appear to be essentially local operations, with a much smaller degree of complexity in their ownership structure.

Privately Owned Enterprises

Promise of Retail and Service Sector. The rapid return of refugees in June and July of 1999 was immediately followed by a remarkable level of activity in the private sector. New shops, restaurants, and small trading “companies” began operating literally within days of the arrival of KFOR and the rest of the large international community in Kosovo. Very quickly, these operations became more sophisticated, as goods began to flow into Kosovo and owners responded to a rapidly increasing demand for services. In early September, most major towns had a strong retail and services sector offering a remarkably diverse supply of goods and services. Even during the difficult winter months, this sector continued to expand.

Given the nature of the parallel market, its current size and characteristics are difficult to ascertain. But the parallel economy could give a tremendous boost to the official economy if it sheds its gray status - with the growth push likely occurring in the trade and services sectors. This will not occur without the effort by UNMIK to develop policies designed to encourage this sector and provide incentives for it to move into the official economy.

FACILITATING PRIVATE SECTOR DEVELOPMENT

Opportunities for Short-Term Growth. The success of the program of economic development and reconstruction of Kosovo hinges to a large extent on the degree to which the private sector can be empowered quickly to generate growth. While the difficult political and legal issues in Kosovo are being addressed, the existing private sector will need to provide stimulus for economic growth. In addition to the rapidly growing retail and services areas, short-term growth can be expected to come largely from agriculture, agro-processing, construction, and the production of construction materials. Primary agriculture and construction, which are mostly private, should be encouraged to follow the lead of the impressive development of small and medium-sized enterprises (SMEs) in the retail and services sector.

To develop the private sector, Kosovo will need to pursue three strategic paths concurrently. *First*, promote the growth and development of privately owned enterprises already in the formal economy. *Second*, embrace the parallel economy and bring it into the formal economy through a combination of incentives and requirements. And *third*, expand the private sector’s composition by transferring the potentially viable public enterprises to private ownership or divest productive assets from public enterprises to private hands.

Legal and Regulatory Framework. To support private sector development, UNMIK must assign top priority to the introduction of a regulatory environment that makes the cost of operating illegally significantly greater than operating legally. In addition, the legal framework needs to provide and promote the availability of credit by protecting private property rights and permitting collateral to secure loans. Further, the framework needs to be flexible enough to promote financing mechanisms for private productive activity, such as venture capital.

The current regulatory framework in Kosovo is ambiguous and incomplete. On the one hand, UNMIK has issued few regulations in this area; on the other, UNMIK Regulation 24/99 states that, unless otherwise provided by UNMIK, pre-1989 laws are still in effect. This creates a situation of considerable ambiguity, in which there is only one logical response for the emerging private sector: *remain underground*. This creates a breeding ground for organized crime. UNMIK will need to establish a minimal structure to deal with the limited number of potentially viable enterprises quickly, and which least involves the privatization institution in protracted administration.

The regulatory framework should be: (i) simple, understandable, and enforceable; (ii) facilitate compliance; (iii) allow as little discretionary authority as possible to minimize scope for corruption; (iv) eliminate any duplication of existing FRY regulations; and (v) remove all discriminatory aspects of the existing FRY system.

The framework also should include the following elements:

- An effective and simple business registration system;
- An enterprise regulation;
- An appropriate property rights legal framework, including collateral and bankruptcy legislation;
- Basic business law and contractual rights legal framework supportive of private business formation and operation;
- A practical legal mechanism for resolving property disputes;
- A competition law framework that severely limits the scope for public intervention in industries that are not natural monopolies;
- A law for the privatization of socially- and state-owned property;
- A law covering concessions of state owned real property and natural resources;
- A law on labor relations and workplace rights and obligations;
- A foreign investment law which enshrines the basic principles of any sound foreign investment climate: protection of investors' rights, non-discriminatory treatment for foreigners and locals, and access to fair arbitration; and
- A comprehensive accounting legal and regulatory framework that promotes the application of International Accounting Standards for financial and tax accounting purposes.

It will take time to complete this framework and even longer to create the institutional capacity to implement it. Thus, it will be crucial to set priorities according to a critical

path analysis that focuses on removing the biggest obstacles first. Drafts of an enterprise regulation, bankruptcy regulation, contract regulation, foreign investment regulation, pledges and a concession regulation have been completed and await confirmation. A regulation on ownership of non-residential ownership has also been drafted, yet it is still subject to the completion of a better defined and comprehensive enterprise development strategy.¹⁹ The other essential basic regulations are also being drafted.

Trade Regime Linkages. Careful attention should be given to the cumulative effect of the various fees and taxes on private business as the recently introduced trade and taxation regime is refined. Currently, customs fees, sales, and excise taxes are being charged at only about half the border checkpoints of Kosovo. As taxation inside Kosovo is introduced, careful attention should be given to the overall tax burden on enterprises, especially given the high sales taxes levied at the border. In addition, the trade regime will need to be refined with respect to taxes that could constrain private sector growth in Kosovo. For example, a rebate system needs to be introduced in the medium term to stimulate processing, subcontracting and consignment arrangements, which will be important to allow Kosovo to exploit its abundance of labor. Also, it is clearly not in the interest of Kosovo's economic development to tax imported capital goods - even in the short term.

Credit for Private Enterprises. The lack of short and long term credit for viable productive activity has been identified in a recent survey of Kosovo SMEs as a major constraint to growth. Lack of credit limits the private sector to activities that require minimal investment - mainly in the services and retail sectors. Establishing a credit program based on sound economic and financial principles will be critical. Currently, a number of donors are trying to support the private sector by providing grants to small businesses but without any form of financial intermediation. Anecdotal evidence suggests that these grant programs are not being coordinated, leading to the same enterprises receiving support from different donors. UNMIK should tackle this problem by setting up a donor coordination forum for enterprise support.

SME Credit Program. UNMIK has agreed with the Bank and other donors that the following basic principles would be followed for an SME credit program for Kosovo:²⁰

- SME lending activities must be conducted within the newly established banking supervisory regime;
- Credit should be extended through the Program for private enterprises only, based on sound credit analysis;

¹⁹ In recent months UNMIK Pillar 4 drafted a White Paper entitled "Enterprise Development Strategy" (May 24, 2000) that addressed issues of property rights, developing the private sector legal framework, privatizing enterprises and building a social consensus. While this paper was not formally adopted as UNMIK policy, it was used as a preliminary framework of discussion on these issues.

²⁰ The World Bank and the European Agency for Reconstruction have developed a credit line scheme along these principles. Four bilateral donors have expressed an interest in cofinancing this line of credit.

- Credit should be extended to enterprises in the parallel sector only after their conversion to the official economy (the lack of a functioning enterprise law or registry means that interim procedures will have to be adopted if the credit line is to be disbursed expeditiously);
- Borrowing terms extended to enterprises should not distort competition with commercial credit;
- The Program should be conducted so that it supports the medium-term institution building needs for the banking sector;
- Donor financed SME credit should be viewed only as a transitional measure until a healthy banking system is developed;
- Donor coordination must be maximized and perhaps overseen by UNMIK itself; and
- Similar principles should be applied to the extension of micro- and agricultural credit.

In conclusion, it is worth reiterating that the development and enforcement of a legal and regulatory environment of the kind described above remains vital if private enterprise growth is to be encouraged. This emphasis on establishing a conducive business environment is of the first importance – far more germane than plans to concession or privatize public enterprises. A number of such enabling laws have been drafted (enterprise law, law on secured transactions, bankruptcy laws) with regulations to support the registration of companies, but none of these laws have yet been issued in the form of regulations. Delays in promulgating these regulations will be costly as opportunities will be lost for a rapid stimulation of private sector led growth.

CONVERTING PUBLIC ENTERPRISES TO PRIVATE OWNERSHIP

Revitalizing the Socially Owned Enterprise Sector. In planning for privatization, Kosovo's socially-owned enterprises can be organized into the following categories: (i) large enterprises, such as the Trepca mining complex; (ii) utilities; (iii) enterprises of potential interest to foreign investors; (iv) other viable and potentially viable enterprises; and (v) non-viable enterprises. Following a decade of neglect and enforced measures, many enterprises may not be viable, and thus will need to be liquidated.

Appropriate privatization methods may include: (i) asset sales/liquidation of the non-viable enterprises; (ii) public auctions or tenders for assets or shares for the majority of viable enterprises; and (iii) concessions or management contracts for special cases, such as Trepca. Asset sales would be the simplest to organize and the most attractive for potential investors.

Progress on privatization requires resolution of several key issues, including ownership of social property, treatment of workers, and treatment of claims. These issues can be

resolved quickly but will require detailed procedures for enterprise preparation and privatization transactions, in addition to public support. As noted, earlier this year UNMIK prepared a policy paper and conducted an extensive policy dialogue with local as well foreign parties on this set of issues; this section contains a summary of the main UNMIK proposals and an assessment of them.

Ownership of Social Property. Regulation 1999/24 defines the applicable laws as those in force as of March 22, 1989 - except when superseded by UNMIK regulations. It is generally considered that little or no privatization under the 1988 "Markovic" law had occurred by March 22, 1989. Although the majority of enterprises subsequently affected by "enforced measures" were wholly socially owned by March 22, 1989, there currently is no mechanism to establish this as a basis for further action. Recent policy statements by UNMIK propose the establishment of an adjudication panel to rule on the structure of ownership in each enterprise. In the absence of an expropriation mechanism, or the existence of provable claims that could support bankruptcy proceedings, UNMIK cannot otherwise take control of these enterprises unless and until it is determined that an enterprise is majority socially owned. As expropriation is unlikely to be politically acceptable, and there are few records or any bankruptcy structure or institutions, an independent board will need to be established to rule on ownership issues as soon as possible. Otherwise, the process of privatization and revitalization of any of the socially owned enterprises cannot proceed as planned.

It seems appropriate to equate social ownership with state ownership and for the privatization of such property to be administered by UNMIK. In the SFRY, social ownership conferred wide powers on workers to elect their management and otherwise determine how an enterprise would conduct its business; however, workers did not have a share in the capital of the enterprise. Moreover, in the former SFRY republics that recognized social ownership, the transformation of social capital was organized by the state, with the state receiving proceeds from the sale of transformed social capital.

In the interests of speed and efficiency, it is vital to limit restructuring of enterprises to the minimum necessary. It will be important that the only restructuring that takes place before privatization should be the separation of social assets (apartments) and public assets (power plants and irrigation systems) from the economic assets of an enterprise. Allocation of assets and (particularly) workers and liabilities will be difficult and contentious, and inevitably accusations of prejudice and favoritism may arise, especially when some of the new units have to be liquidated. Experience in other countries suggests that the private sector is better able to restructure a business to achieve profitability than is the government. In this sense, the transfer of potentially viable businesses to the private sector will be a more important objective for UNMIK than receiving the maximum price for the assets or net assets.

Institutional Framework for Adjudicating Ownership. As it has been proposed by UNMIK, launching this process will require setting up a new institution, the Ownership Adjudication Commission (OAC), and the clarification of the effects of the applicable law for the purposes of the ownership adjudication process. The relevant legislation is

proposed to be passed soon with the by the end of May, with the OAC established in the summer. The proposed features of each are given below.

The OAC would be empowered to adjudicate ownership of non-residential assets. Any interested party, including UNMIK itself, could request adjudication. In many cases UNMIK intends to initiate adjudication to establish unambiguously that certain businesses are publicly owned. UNMIK would then decide whether to privatize it or to retain it temporarily as part of the public sector and establish firmer control over its management. However, there are few economic grounds to justify UNMIK becoming involved in the rejuvenation of socially owned enterprises prior to their transfer to the public sector; it has neither the specific mandate, nor the necessary skills. Nor would it seem to be required.

The OAC will exist outside the local court system. The issues involved in the adjudication are complex and may involve determining whether the law in force between 1989 and 1999 was discriminatory or applied in a discriminatory manner. A significant number of enterprises are publicly or socially-owned. Since UNMIK has assumed responsibility for administration of public property, it will be directly involved in such adjudication. Moreover, the FRY may have claims to such public property. Progress is being made to re-establish the courts and to build a judiciary capable of dealing with civil and commercial claims but there is still a long way to go. To ensure that ownership questions which need to be resolved urgently are dealt with rapidly and fairly, creation of an ad hoc independent body appears to be the best solution. It is vital that the OAC be set up as a small, technical, efficient body with rules of proceedings that ensure rapid adjudication results.

It is also proposed that once ownership is established, those businesses of which the majority of the stock is publicly owned will be brought under the control of a new Kosovo Enterprise Agency (KEA). The mandate of the KEA would be to incorporate the businesses and pay out any compensation according to the findings of the OAC, to take interim control of the enterprises until privatization, and to organize the privatization process, when that becomes appropriate. The KEA will be part of UNMIK, but it will report to an independent Steering Board representing all sections of Kosovar society.

The proposal to establish the KEA with the functions described above flies in the face of experience with enterprise revival and privatization in transition economies. It is not advisable to have a government body being responsible for the control and operation of enterprises, even less to have such a body reporting to all sections of society, thereby permitting a conduit for pressures from workers, directors and others to press on with their vested interests. Inaction, deadlock and the preservation of enterprises is likely to result. It appears more efficient to appoint temporary management to such enterprises prior to their eventual sale or liquidation. Indeed, the privatization mandate should have clear and enforceable deadlines for preparation for sale and execution of the sale, with liquidation following on automatically should the enterprise prove to be insolvent or unsaleable.

A new regulation would confirm the applicable law as defined in Regulation 1999/24. It will make clear that if an ownership interest is declared invalid as a result of the adjudication, the owner shall be the next preceding owner who can establish ownership of the property in 1989. The adjudicating body will be required to substantiate its determinations with detailed findings of fact and conclusions of law. Any relevant precedents would be applied. Efforts would be made to contact owners whose rights are declared invalid so they can be present for the determination of compensation to be paid. In addition, the regulation will include mechanisms for payment of compensation. Rules would be established on how payments should be made; if payments are not made as agreed, ownership determinations could be revoked. Also sale, lease or assignment of property can be done subject to compensation rights once ownership has been established.

Treatment of Workers. Notwithstanding the general right of the state to transform and dispose of social property, workers typically believe they have an inherent “interest” in their enterprises. Other ex-SFRY republics have allowed workers to purchase some portion of shares in enterprises on preferential terms. Recent policy discussions have contemplated that some 10 percent of the capital of large enterprises, and 20 percent of small and medium sized be reserved for purchase by the workers. Preferential share sales to workers, however, should not be allowed to interfere with the ability of a strategic investor or dedicated management group to control an enterprise’s operations and carry out necessary restructuring. Terms for preferential share sales should also be kept simple – e.g., cash purchases rather than installment purchases. It will also be necessary to define which workers (e.g., 1989 vs. 1999) are eligible for preferential share purchases.

It is important that consultation with former “workers” should be carefully thought through to ensure that UNMIK does not inadvertently create unrealistic (non-economic) expectations. Under the best of circumstances, it is unlikely that more than half the number of former workers in socially owned enterprises can be re-employed in those enterprises. A labor law which clearly sets out, among other things, the status and rights (if any) of “former workers” must be a high priority for UNMIK in managing expectations as the transformation process moves forward.

Purchasers also should be free to hire the number of employees they want, rather than having a potential obligation to take on a historic number of employees which bears no relationship to the current environment which the business faces.

Treatment of Claims. Claims may include both ownership interests - such as Markovic privatization transactions during the period of enforced measures and concessions granted to foreigners - as well as enterprise liabilities, such as credits from Yugoslav banks. The Ownership Adjudication Commission proposed by UNMIK is a practical, although potentially time consuming, method of resolving ownership interest. However, the question of how minority ownership interests will be recognized will remain. The choices are to recognize a legitimate interest as ongoing minority ownership interests in the newly privatized enterprise, or to compensate the minority shareholders for, in essence, their expropriated interests. Whichever method is chosen, compensation or restitution should be done on the basis of current rather than historic value of the assets or

net assets, and that the process of establishing that value be transparent. In practice, this means a simple, clear, and open way of selling assets. Part of the proceeds should be reserved to pay legitimate ownership and creditor claims.

The concept of interim administration by public bodies or local municipalities in consultation with workers, should emphatically not be pursued for several reasons. In fact, it should be noted that many socially owned enterprises are not viable, or may only be viable if historic levels of employment are dramatically reduced. The involvement of local interests very likely will obscure the focus on viability, and shift to an emphasis on re-employment. Interim administration (other than through management contracts and leases) of a loss-making activity where the administrator has no resources to fund losses also poses many potential hazards for UNMIK. For these reasons UNMIK should not consider funding losses from the proceeds of privatization. The potential costs of such a policy clearly far outweigh any possible benefits.

Enterprise Preparation. UNMIK should assert its authority over potentially viable socially-owned enterprises by confirming or replacing current enterprise directors; establishing requirements and standards for regular financial reporting (including development of a current balance sheet) and preparations for privatization transactions; limiting the ability of enterprises to dispose of assets outside the ordinary course of business; and establishing director liability and penalties for non-compliance with UNMIK regulations. As noted, the only restructuring that takes place before privatization should be the separation of social assets (apartments) and public assets (power plants and irrigation systems) from the economic assets of an enterprise.

Viable enterprises should be privatized through asset sales or – if there is a need to allow share sales to workers – through share sales. In cases where there is both worker interest and one or more potential investors concerned about unknown liabilities, consideration should be given to conveying an enterprise's assets and known liabilities to a new company (NewCo) and privatizing the NewCo through sales of existing shares to workers and sale of new shares to a strategic investor/management group in a recapitalization transaction.

Taking direct control of these enterprises before privatization raises the risk that employment issues - rather than viability issues - will constitute the focus of discussion with the local community. Almost by definition, the socially owned enterprises are loss making. These will have to be financed by someone. If UNMIK directly controls them, the expectation could easily arise that UNMIK would assume responsibility for payroll, etc. This is not feasible; the risk and complications are even bigger for smaller, community-based enterprises. The idea of "interim administration" by local administrations, with input from the workers, should be strongly discouraged. The risks to UNMIK far outweigh the possible benefits. A preferable strategy would be to sell the assets of such enterprises as soon as possible, in order to curtail any debate on the desirability or purpose of "interim administration" for minor enterprises.

An essential part of limiting the resources needed to complete the transformation process would be an early and concerted attempt to identify and liquidate non-viable enterprises.

This can be started during the public awareness campaign - even while the transformation institutions are being set up. Non-viable enterprises should be disposed of through asset sales. UNMIK's involvement after majority socially ownership has been established should be limited to a rapid confirmation of the potential viability or lack thereof, followed by placing the enterprise into liquidation when required.

Privatization Transactions. There are a very small number of socially owned enterprises in Kosovo, and the even smaller number of those that are potentially viable. Preliminary estimates suggest there may be fewer than 200 potentially viable socially owned enterprises of all sizes. Simple processes which focus on speed and transparency of the process, rather than revenue generation, or even equity, should be the objective when considering what institutional arrangements are necessary to get the potentially productive assets back to work.

UNMIK will need to develop detailed regulations on the conduct of public auctions of assets and share auctions or tenders; for unique enterprises, like the Trepca mines, and perhaps for utilities, concessions and management contracts should be used. In general, privatization processes should be as open, transparent, simple, and rapid as possible - e.g., auctions instead of tenders; cash payment instead of installment payments; and outright sales instead of concessions or management contracts. UNMIK also may need to regulate protections and rights for employee shareholders, including maintenance of share registries.

UNMIK's overriding goal should be to revitalize viable enterprises and re-deploy the assets of non-viable enterprises through "clean" privatization transactions, unencumbered by questionable ownership claims or liabilities. While UNMIK needs to provide some satisfaction of legitimate ownership/creditor claims, this goal is distinctly secondary to the revitalization of viable enterprises. A tentative timetable would be for UNMIK to target completion of enterprise privatization within two years of setting up the necessary structure and institutions.

In contrast to what has recently been discussed, , the assets should be sold for cash only. Potential purchasers should not be required to submit an investment or development plan. To attempt to evaluate promises will expose the privatization authority to accusations of lack of transparency, as well as requiring KEA to monitor the promised plan, and even attempt to recover the assets if the promises are not fulfilled. Thus the privatization authority should focus on procedures that allow it to complete its mandate in the shortest possible time.

Development of Public Support. While UNMIK is developing the authority to manage and dispose of socially owned enterprises, it nonetheless needs to elicit public support for a sensible enterprise privatization program. It is important that Kosovar opinion-makers, workers, and the public develop an appreciation of the realistic prospects for socially owned enterprises and the lessons which can be learned from the ex-SFRY republics during their transformation experiences.

It is important that public discussion and a public education program on enterprise privatization begin as soon as possible after a privatization initiative has been authorized. The public education program needs to cover both the rationale for UNMIK's privatization program, as well as detailed information to enable potential investors and claimants to participate. Public education efforts should convey the message that Kosovo's economic future lies not in re-creating the Kosovo of 1989, but in building a new Kosovo based on current economic realities and opportunities. The implications for workers expectations need to be taken into account and explained. For example, the public awareness campaign should also emphasize that the market will decide which enterprises will be rejuvenated, once in the private sector, and that the new owners will determine how many employees will be re-employed.

Suggested Priorities for a PSD Strategy for Kosovo

UNMIK DEVELOPMENT STRATEGIES		
Highest Priority: Target 1-3 months		
Promote growth of existing Private Sector	Embrace the Parallel Economy	Privatize potentially viable enterprises
Put in place key Enabling Environment Laws a) develop active input cooperation form local counterparts at drafting stage b) draft critical laws/ regulations Enterprise law Property Rights Contracts law Collateral law Registry system for enterprises Concessions law	Strengthen customs regime	Begin inventory of socially owned enterprises Begin debate with local counterparts of design features of a privatization law (see separate paper for key design considerations). Key issues include what is being sold (assets or net assets) a claims identification and adjudication mechanism workers rights
Establish financing facilities for SMEs MEB and UNMIK's ICU (already done) Commercial small scale agricultural financing Micro credit		
Technical Assistance (TA) for SMEs; business plans, loan applications New lending institutions: governance, management, lending, IT Strengthen regulatory framework		
Coordination with donors re plans for grant and financing facilities		

UNMIK DEVELOPMENT STRATEGIES		
2nd Priority ; Target 4-6 months		
Promote Growth Of Existing Private Sector	Embrace The Parallel Economy	Privatize Potentially Viable Enterprises
Put in place the next set of enabling environment laws <ul style="list-style-type: none"> ▪ Accounting law and regulatory framework for tax accounting ▪ Establish commercial court structure ▪ Law on Bankruptcy ▪ Competition law 	Draft key laws and regulations to encompass parallel economy <ul style="list-style-type: none"> ▪ Vehicle registration (done) ▪ Vendor registration ▪ Taxing statutes ▪ Development of enforcement capacity 	Resolve ownership issue/ Establish claim resolution mechanism for socially owned and state owned enterprises Identify "most viable" enterprises/ identify least viable enterprises Draft a privatization law which encompasses agreements/ compromises reached in the consultation stage (above). TA necessary Begin liquidation of nonviable enterprises
3rd priority; Target 6-12 months		
Enabling environment laws <ul style="list-style-type: none"> ▪ Foreign Investment Law 		Establish institutional framework for transformation. TA necessary for setting up Privatization Agency Conduct public awareness campaign for privatization (possible TA contribution) Begin to offer "most viable" enterprises for sale (TA necessary) Concession and management agreements for a few large enterprises
4th Priority: Target : beyond 12 months		
Promote Growth Of Existing Private Sector	Embrace The Parallel Economy	Privatize Potentially Viable Enterprises
		Identify viable large enterprises; offer potentially viable enterprises on a tender basis, case by case (TA necessary)

CHAPTER 5:

EDUCATION

INTRODUCTION

Beginning with its creation in 1946, the Federal Republic of Yugoslavia was a positive force for Kosovar Albanians in terms of access to Albanian language education. Prior to the second world war, education in the province of Kosovo was conducted almost exclusively in Serbian, and at the time of the creation of FRY nearly three-quarters of adult Kosovar Albanians were estimated to be illiterate. Albanian language enrollments rose steadily under FRY, with a dramatic increase in the ten years beginning in 1968 when the proportion of Kosovar Albanians in the region's education system rose from 38 to 72 percent.¹ The University of Pristina (formerly a branch of the University of Belgrade) was created in 1969 and enrollments in Albanian language higher education programs experienced a similarly dramatic increase. Illiteracy among the adult population is said to have decreased to well under 10 percent, but may have begun to increase again during the past decade.

Although access was increasing dramatically, local influence and control over education content was not. The federalist 1974 constitutional reforms gave the mixed ethnic population of Kosovo theoretical control over nearly all education governance and content matters, and Kosovar Albanians were empowered and emboldened to promote their own culture and history through education. As a backlash against the outcome of these federalist reforms – which led to serious university student demonstrations in 1981 – authorities in Belgrade moved to re-centralize control over education content during the 1980s. All authority for education content was finally transferred back to Belgrade with the abolition of Kosovo's formal autonomy and the adoption of the 1990 Serbian constitution – events which led to creation of the “parallel” system in education. It is important to note that while control over curriculum content, particularly in history and cultural subjects, is a central element of the ethnic conflict in Kosovo, a strong system of decentralized management and financing of the education system was in place in FRY. The Kosovar Albanians did participate in this fiscally devolved system and, to some extent, controlled the management and financing of general education in many majority Kosovar municipalities prior to 1989.

In 1991-92, the majority of Kosovar Albanian students left the formal Yugoslav-supported education system. Although formal, government-supported salaries were discontinued, the education of Kosovar Albanians, representing about 90 percent of overall enrollments in general education, continued in the roughly half of school facilities that they controlled. This situation resulted in serious over-crowding of facilities, and alternatively, the use of non-school buildings and private homes to conduct education. A

¹ Noel Malcolm, *Kosovo: A Short History*, Macmillan (1998), page 326

“parallel” governance structure was gradually established including simple regulations and arrangements for financing the system from within and from external remittances. Consistent and reliable data on the “parallel” system were not kept, but estimates are that about 20,000 teachers, professors and non-teaching staff supported over 300,000 pupils in roughly 400 primary schools, over 50,000 students in 65 secondary schools and over 10,000 students in 20 university faculties. Enrollment is reported to have declined, particularly at lower levels, throughout the decade due to outward migration and dropouts.

Following the 1991-92 school year, during which little funding was made available to the education system, the informal governance system reportedly succeeded in paying only a nominal DM 20 per month stipend to most teachers and other education employees in 1992-93. Between 1994-98, the informal system attempted to pay salaries at minimum rates of between DM 120 to 160 per month, depending on level and qualification. Although some higher income municipalities reportedly were able to exceed these minimum payments on occasion, nearly all salary payments were made irregularly. As hostilities in Kosovo increased over the past 12 to 18 months, salaries were paid with increasing irregularity. Some teachers were reported not to have been paid for up to 18 months. With the exception of some textbooks, which were predominantly funded from abroad, non-salary recurrent expenditures – to the extent any were made – were covered by informal direct parent contributions to schools in cash or in kind.

Informal municipality-level tax collection (between 3 to 5 percent) is said to have provided for about 60 to 70 percent of education salary expenditure. Contributions collected from abroad accounted for the remainder of education spending and acted as an equalization fund for municipalities that could not meet the minimum salary payments from local revenue. External funding could not, however, ensure complete equalization, and allocations of external funding were said to be, to some extent, politically motivated. Internally generated municipality revenues, assigned to education by a municipality financing council, were managed by the municipality education director in cooperation with school directors, as was external funding once it arrived at the municipality level. The cost of supporting the “parallel” education system is estimated at about DM 3 million per month, although available financing was frequently less.

Current Performance and Status

Despite the remarkable efforts during the past nine years – particularly among teachers – to maintain a functioning education system under extremely difficult conditions, it is inevitable that the quality of education delivered in the classroom has suffered. However, because of the lack of consistent student performance information with which to make comparisons (a problem even with the pre-1989 system), it is not possible to be definitive about the cost of the past nine years in terms of learning outcomes. Enrollment ratios, thought to be over 90 percent in primary prior to 1989, have almost certainly declined substantially over the past decade, particularly among girls. But, due to internal migration and re-settlement, precise figures remain unavailable.

In terms of provision of educational inputs (which say little about learning outcomes), the past nine years and the recent conflict have taken a serious negative toll. As mentioned

above, education financing was available during the "parallel" system at only 10 to 20 percent of pre-1989 financing levels. Few teachers, professors or administrators - with the important exception, perhaps, of those living abroad - have benefited from any organized professional skills upgrading. Even prior to 1989, pre-service teacher training lacked a methodological focus and education administrators were not exposed to modern public sector management skills. In addition, the system as a whole has been isolated for a decade from recent trends and advancements in pedagogy, methodology and education administration and management. Basic textbooks for primary and general secondary education were reported to have been generally available to most students, financed through external contributions, but their pedagogical and physical quality is said by teachers to be lacking, and many of these books were destroyed or lost during the recent conflict.

Level	Students	Teachers	Admin Staff
Primary	289,567	16,541	3,600
Secondary	75,169	5,049	915
Higher	18,000	1,300	N/A

Source: UNMIK.

Current estimates by UNMIK show a student to teacher ratio of 17.5/1 for primary education (within a range of 15/1 to 18/1 across the five UNMIK-created administrative regions), a student to teacher ratio of 15/1 for secondary education, and 14/1 for higher education. These ratios would suggest that Kosovo is supporting student to teacher ratios which are lower than the Western European average, particularly for primary education, leading to significantly higher personnel costs. Likewise, the ratios of teaching to non-teaching staff (just over 4/1 in primary and 5/1 in secondary) are slightly lower than the European average. These broad averages could also be hiding serious over-crowding of facilities balanced by under-utilization of other facilities across or even within municipalities. At the same time that teachers are in relative surplus, shortages of teachers with certain skills, particularly language and computers, will inevitably be a major issue. UNMIK estimates that Serb children remaining in Kosovo account for only 4.5 percent of total primary pupils, with all other ethnic groups (Turks, Bosniacs, Roma, other) accounting for another 3 percent combined. Serbs are estimated to be about 7 percent of total secondary students, with other groups accounting for only 2 percent of the secondary cohort. Nearly all Serbs and, to the extent their numbers are large enough, other ethnic groups, are educated in separate schooling facilities. Few if any Serbs attend the University of Pristina, and numbers for other ethnic groups are unavailable.

In terms of what is currently being taught in the system, Kosovar Albanian authorities and UNMIK decided to use the existing curriculum that was in use under the "parallel" system for the 1999-2000 and 2000-2001 school years, although there is consensus that this curriculum needs to be replaced as soon as possible with a more up-to-date framework of subjects and performance standards. Progress in adapting a new curriculum has been delayed by the slowness of institutional development. It is likely

that updates and improvements will come predominately on an *ad hoc* basis, driven mostly by donor efforts, until the new Department of Education can be properly staffed and a viable curriculum change process can be elaborated. The Serb community is continuing to use the pre-existing Serb curriculum. Cooperative program development between Kosovars and Serbs is not possible in the short term.

A decision was made to re-print existing textbooks, at least for core primary and secondary subjects, for use during the 1999-2000 and 2000-2001 school years, pending a curriculum and textbook review, which is subject to the same institutional constraints cited above for curriculum development. Special donor funding has already been mobilized for this initiative, and textbooks are available for most core subjects and levels during the 2000-2001 school year.

The physical condition of schools in Kosovo presents a serious constraint to re-starting the education system. According to EC/IMG estimates, which continue to be updated, slightly more than half of the approximately 1,000 primary school buildings are in need of repair. Roughly 30 to 40 percent of primary schools require light to medium repairs, while roughly 10 percent are seriously damaged. The EC's initial estimate for the costs of repairing/re-building primary schools is about DM 36 million (20 million Euro). The EC monetary estimate does not include the cost of furnishing/re-equipping schools. The percentage of damage to schools is thought to be about the same for Kosovo's 66 secondary schools. Although the unit cost of secondary reconstruction is higher, the smaller number of secondary schools should mean that secondary re-construction needs would be less than half that of primary. University facilities have not sustained serious damage, but are reported to be in need of re-furnishing and re-equipping. No monetary estimate for higher education re-construction has been forthcoming from the donors, although university authorities estimate their repair/re-equipping needs at DM 8.8 million. While about 10 percent of all school facilities were largely or completely destroyed during the recent conflict, the lack of maintenance during the past decade and the age of many schools (about 25 percent of school buildings are over 40 years old) are an equal if not greater cause of physical deterioration in most schools.

Institutional Development

In the latter half of 1999, the institutional situation in education was marked by competing claims to authority and responsibility for creating a Ministry of Education between the former government in exile and the KLA-backed provisional government. In response, a Joint Civil Committee for Education (JCCE) was created under UNMIK's Education Department made up of four representatives from the Albanian language system, two from the Serb language system and representatives from UNESCO, KFOR and UNICEF. However, the JCCE preformed a consultative function only and was not a successful mechanism for decision making in education.

Earlier efforts to coordinate and manage education activities at a central level in Kosovo have been superseded by the formation of an Interim Administration in which UNMIK authorities will share power with locally nominated officials. Co-Heads of the Department of Education and Science have been appointed and they are in the process of establishing a department which is expected eventually to evolve into the principal

education authority for a future Kosovo administration. To date, establishment of the Department of Education and Science has been hindered by inadequate staffing, both expatriate and local, and tenuous communications and cooperation with local authorities and school level officials. The initial focus has been on contracting teachers and other education employees, which has proven problematic in terms of determining real staffing needs. The contracting of university professors and employees has also dominated the dialogue between the University of Pristina Faculties and the new Department of Education and Science.

Leadership responsibility and lines of authority for education between the center, the five regional authorities and the 30 municipalities continue to evolve in Kosovo. Expatriate regional education officers are currently coordinating education finance and administration efforts with local education officers in the municipalities. The formalization of responsibilities and accountabilities between these levels is a crucial undertaking for UNMIK and for the future of education in Kosovo (see discussion of alternatives in the education governance and finance sections below). The formation or continuation of parallel institutions between Serb and Kosovar Albanian municipal officials continues to present a serious problem for which the immediate solution - as in parts of the Federation of Bosnia and Herzegovina - may be to accept parallel structures in the short term in order to ensure provision of education services, while providing incentives for cooperation in the medium-to-long term - for example, in terms of co-managing funding and working together on highly technical issues.

Within this context, UNMIK's Education Department has launched an initiative (DESK – Developing Education in Kosovo) under which *transitional working groups* have been created to address development issues in primary, secondary and higher education, as well as overall systemic and strategic issues. Each group is composed of various local stakeholders (public/private, unions, administrators, pedagogues, academics, etc.) and international representatives. With support from external technical assistance, these groups will study and report on various innovations and issues (including finance and governance, system performance, quality assurance, early childhood development, etc.) and would be expected to serve as a focal point for debate, knowledge accumulation and participatory consensus building in the sector. A presentation of this proposal is included in UNMIK's concept paper, *Developing the Education System in Kosovo* (October 17, 1999).

KEY SECTOR PRIORITIES

Priorities in education can be expressed in two broad categories:

- The need to restore a minimally acceptable learning environment to children currently in schools, and
- The need to define a new education system and policies that will serve children in Kosovo for generations to come.

There is a natural tendency to put reconstruction needs ahead of systemic issues on the priority list, and this is well justified when it comes to allocating investment

programming. Ninety percent or more of investment funding should be devoted to emergency restoration of schooling facilities. However, it would be a serious mistake - which would entail increasing costs in years to come - to allow the focus on emergency reconstruction to crowd out the equally urgent need for strategy and policy development in the short term. The education system in Kosovo needs to begin a transition that has been underway in many of its central and eastern European neighbors for the past seven to eight years. Education and political authorities in Kosovo and the donor community should not lose sight in the short term of the unique opportunity that is being presented to build a modern and responsive educational system that is compatible with a new economic environment and with European legislation, policies, governance and institutions, as well as content and performance standards.

In view of the highly uncertain political and institutional situation and the long time isolation of Kosovo's professional educators from external advancements in their profession, it is not realistic to expect authorities in Kosovo to develop a detailed, realistic and appropriate education strategy or policies in the short term. The development of a locally-prepared education strategy, which addresses the sector across its component parts (levels, inputs, performance, etc) and in its economic and social context, should, in fact, be seen as a medium term (two to three years) objective. While comprehensive, locally driven strategy and policy development will take time to evolve, there are a number of key priorities and objectives that an eventual education strategy for Kosovo would be expected to address.

Education Governance and Financing

The current unsettled situation in education presents an important opportunity to establish modern mechanisms and incentives that will serve to enhance quality, efficiency, and equity in the system. As a general western trend, the key to establishing an efficient distribution of responsibilities and functions across levels in education is twofold: first, to allocate to the center the authority for policy/strategy formulation and for ensuring equity of access (redistribution to disadvantaged areas) and the quality and consistency of educational programs; and, second, to ensure that lower levels are given the responsibility and authority (including budget and expenditure authority) to implement programs flexibly and creatively within established norms. In fact, the education system in the former Yugoslavia, in contrast to its central and eastern European neighbors, was an early and interesting example of just such a division of authority and responsibility in education. This tradition of decentralization in education was continued by the Kosovar Albanians in the operation of their "parallel" education system over the past nine years as municipality education authorities were given significant discretion for managing both locally-generated and centrally-provided resources for education. This authority entailed mainly assigning and re-allocating personnel (salary levels were centrally established), but also involved managing informal cash and in-kind contributions from parents.

Given western trends and local traditions for decentralized control over education inputs, a priority for authorities in Kosovo and the donor community should be to continue a policy of decentralization to ensure the authority of municipal officials to manage the majority of resources for education. This approach does not preclude, and is in fact complementary with, allocating authority for standard setting and quality assurance to

central authorities. However, unlike in FYR, where locally generated revenue was kept at the municipal level to fund education, authorities in Kosovo should consider various alternatives including a system of fiscal devolution for education funding in which central revenue is devolved to local education authorities on an equitable, per student basis. The design of a system of fiscal devolution for education in Kosovo would include two crucial elements:

1. Once the relative priority for education has been determined at the center in competition with other sectors and priorities, the distribution of resources for education to the municipalities could be carried out in the form of block grants on the basis of a per student budget formula. Such a formula-approach to education funding – common in Western Europe and North America and recently adopted in Hungary, Poland and the Czech Republic - would help ensure equity (all children in Kosovo would be entitled to an equal level of funding) and provide a powerful incentive for municipality officials to manage education resources more efficiently. The formula can be adapted to take into account existing disparities (separate urban and rural budgeting norms, for example), and to allow additional spending for programs in low performance areas. A centrally mandated public pay scale for teachers and other employees in education could also be maintained under such an arrangement. The introduction of per student funding would also contribute greatly to transparency in terms of allocation of resources across ethnic groups.
2. Despite the tradition of local management and financing councils, priority would have to be given to supporting municipality governance structures to develop their public administration skills and for re-defining the role of local school boards and parent associations - which are mandated without much description in informal Kosovar Albanian legislation. Local school boards, in particular, should be expected to play an important role in ensuring accountability in the definition of local priorities and the expenditure of funds to achieve those priorities.

The central ministry's role in ensuring educational standards and consistency within a fiscally devolved system is discussed below in the curriculum and assessments section.

As a last point on general education governance, a high priority should be given to helping authorities at all levels ensure the availability of reliable administrative, financial and performance information, as a pre-requisite for beginning a productive dialogue on education reform and for facilitating strategy and policy development. In the short term, the need for reliable school mapping information (currently supported by UNESCO) will be an increasingly urgent priority in order to promote efficiency, as reconstruction resources decline and reconstruction/investment decisions become more difficult. In addition, the development of per student formulas and a focus on measuring learning outcomes will go a long way toward helping to measure inputs and outcomes in the system. Helping to create capacity for producing and using management information at the central, municipality and school levels should be a priority for the governance reform strategy.

Higher Education Governance and Finance

Unlike integrated universities in Western Europe and North America, the University of Pristina operates as a loose association of faculties each with a legally autonomous status and management structure. This dispersal of authority in what should be a single institution has led to a redundancy of programs, personnel, and facilities across faculties which diverts resources from improving the quality of teaching and learning. The weakness of the university rectorate also hinders an effective prioritization of programs in the face of a changing economic and social environment and allows autonomous faculties to resist systemic reforms aimed at investing efficiency gains in improving the quality of programs. As the university is re-established and new legislation is drafted over the coming months/years, authorities in Kosovo should not miss the opportunity to make their university compatible with European standards in university governance and management. Along with new legislation, there is a need for a strategy aimed at developing academic and institutional accreditation within Europe in the medium term.

Per student funding formulas for various programs should also be developed for higher education as a way to instill transparency of funding and provide incentives for increased efficiency. The potential for a gradual institution of fee charges for various high demand programs should also be closely examined as a way to focus more resources on qualitative improvement, in combination with the development of student loan schemes and fellowships targeted on need. Cost recovery should be re-instituted as soon as possible - nominal fees of around DM 70 per student were collected during the “parallel” system - in terms of requiring increased student contributions to previously subsidized dormitories, food and transport costs.

Because governance and finance issues in higher education are fundamentally important to ensuring the long term pay-off of investments in the university, major investment in the university should be aimed at supporting governance and finance reforms prior to, or at least concurrent with, committing direct investments to improving the quality of programs in individual faculties. The key will be not to allow direct investments in single faculties to re-enforce the inefficiency and redundancy of the current governance structures. Apart from support for university restructuring, specific higher education programs, which respond to particular development needs or skills shortages – such as the development of programs for medical, business administration and public administration programs – should be a first priority in terms of program development support.

Curriculum and Assessments

There is an awareness among leading professional educators in Kosovo that educational programs at all levels are characterized by a dense and ambitious body of knowledge to be learned, leaving little flexibility to focus on thinking and learning skills or to deal with children with varying capabilities. In order to make the education system responsive to changes in the skill needs of the labor market, reforms will be needed not only in what is learned in school but also in how it is learned. Rather than focusing on a traditional redefinition of precise curriculum content and syllabi, course by course and level by level, local authorities should take time to review recent innovations in western European

education systems which focus on defining learning objectives and performance standards in the context of a coherent curriculum framework. Closely tied to this focus on performance standards is the need to develop a capacity, currently non-existent in Kosovo, to measure student performance in a standardized manner. The availability of student performance information helps ensure the accountability of education authorities to the public they serve, and is key to allowing education authorities at all levels – school, municipality, center – to identify problem areas and focus programs and resources on improving student and school performance.

In keeping with past tradition in Yugoslavia and recent western trends in education, the authority for developing and monitoring a curriculum framework and modern learning standards should be placed at the center. Agreement among all stakeholders on an institutional mechanism and process for beginning this fundamental effort should be a priority for the coming year. Every effort should be made to expose leading stakeholders throughout the system to technical and process innovations in neighboring countries and in Western Europe. It will obviously be important to ensure maximum flexibility in any curriculum framework to accommodate the desire on the part of minority ethnic groups to define and control their learning process at decentralized levels. As is the hope in neighboring Bosnia and Herzegovina, part of the answer to ensuring standards in the context of a non-cooperative environment across ethnic groups could be a focus on developing a student assessment capacity, which could be carried out on an independent, professional basis. It is too early to pre-judge the appropriate institutional arrangement for assessments, but developing such a capacity, to cover all children in Kosovo, should be a priority for local authorities and for donor investment.

Textbooks

The eventual development of a modern curriculum framework for Kosovo, together with changes in information technology, will determine the number and types of textbooks and other educational materials that will be needed in the medium term. The hundreds of textbooks currently prescribed for the system will no longer be justified or sustainable once the structure and orientation of programs have been reformed. The decision to use existing curricula and re-print existing books for the beginning of the coming school year takes the pressure off the need to develop new books that may or may not be appropriate for curriculum changes in the future. Given the myriad priorities and urgent reform needs in education, decisions on privatizing textbook production and re-organizing textbook selection and financing can be delayed until curriculum reform efforts are underway.

Teaching and Learning

Most teachers in Kosovo have been isolated from professional innovations and professional skills upgrading over the past nine years. A further constraint in the system is that pre-service teacher training faculties and academies in Kosovo and the former Yugoslavia did not traditionally emphasize child-centered or inter-active teaching methodologies, nor the need to use learning evaluation techniques to improve their effectiveness. There is, therefore, complete agreement among education authorities in

Kosovo that top priority should be given to upgrading the teaching skills of nearly all the estimated 22,000 primary and secondary school teachers currently serving the system. Local authorities and donors should balance support between the need to re-define pre-service teacher training curriculum and re-structure delivery mechanisms for in-service training – reform initiatives which should start soon – with the need to provide at least some remedial training to existing teachers with a degree of urgency over the next year or two. Donors and NGOs should play a major role in helping to organize both medium term teacher training reform and offering urgent skills training to teachers in the short term. A number of interesting and successful pilot or experimental schools projects are ongoing throughout the region (particularly in Albania, Bosnia and Herzegovina, and FYR Macedonia), and these interventions could offer a starting point for authorities in Kosovo to learn about innovations and opportunities.

Secondary Technical/Vocational Education and Adult Training

Approximately 70 percent of secondary students are estimated to be enrolled in specialized technical and vocational programs throughout Kosovo. Degree courses are offered for such specialties as waiters, cooks, shop assistants, nurses and tailors. However, due to the constraints of the “parallel” system and the recent destruction of facilities and equipment and loss of books and materials, many specialized schools will undoubtedly succeed in organizing only general core subjects and theory-based courses in the coming school year. When operating normally, specialized technical and vocational programs are often expensive to operate – due to low student/teacher ratios and equipment needs – and externally inefficient – graduates are trained in narrow, occupational specialization for which there is currently questionable labor market demand.

As currently designed, the secondary system in Kosovo is out of alignment with the emerging market economy’s need for broad-based skills, labor flexibility and continuous learning. It is crucially important for donors not to rush into the re-establishment of the current secondary system until local authorities have developed a strategy for secondary reform. Focus should then be put on the medium term objective of developing new broad-based programs and on an extensive re-training program for the existing secondary teaching force.

A reform of secondary technical/vocational education will also necessitate commensurate reforms in the field of adult training and two-year higher education technical/professional programs. The goals are to develop a network of training suppliers (public university, private-for-profit, semi-public, NGOs, etc.), to bring social and private sector partners into the governance of adult training, to complement government funding with cost recovery, and to facilitate the availability of labor market information. In this context, there is an urgent need to provide remedial training for specific skills such as business/enterprise management and various technical and engineering skills needed to ensure an effective operation of public sector resources and utilities.

BUDGET ANALYSIS 2000

The UNMIK Education Department has prepared a recurrent budget (see Table 6) for 2000 which will be funded through the Kosovo Consolidated Budget. The most important decisions were the establishment of initial salaries and a non-salary spending contribution adequate to keep teachers in the schools and allow minimal school operating expenditure, while being sustainable in terms of expectations of donor contributions in the short term and reasonable revenue generation prospects in the medium term.

Table 1: Recurrent Budget Summary (DM)

	Staff	Wages and salaries	Goods and services	Transfers	Reserve	Total
Educational administration	120	367,200	137,994	-	-	505,194
Preschool	180	505,440	-	-	-	505,440
Special needs education	365	1,048,500	229,133	-	-	1,277,633
Pre-primary	665	1,764,000	320,015	-	-	2,084,015
Primary	18,515	59,277,600	12,037,998	-	5,000,000	76,315,598
Secondary	5,249	17,955,864	4,638,607	-	-	22,594,471
University	2,534	9,860,580	2,465,912	-	-	12,326,492
Dormitory and facilities	107	259,200	54,713	-	-	313,913
National university library	81	223,560	54,860	-	-	278,420
Total	27,816	91,261,944	19,939,232	-	5,000,000	116,201,176

Source: UNMIK.

With a share of 28 percent, education is by far the largest expenditure category in the overall Kosovo consolidated recurrent budget, followed by health and social protection each with a 20 percent share. Total recurrent spending on education is estimated to be about US\$62 million in 2000, or just over US\$5 million per month. Primary education accounts for 65 percent of the education budget, with secondary and higher education accounting for 19 percent and 11 percent, respectively. These relative shares are close to regional averages, with the exception of slightly lower spending on secondary education, reflecting an extremely low differentiation between primary and secondary teacher salaries (see below). Personnel expenditure accounts for 80 percent of the primary budget and 75 percent of the secondary and higher education budgets. Education administration accounts for only 0.4 percent of the education budget, a share that will increase several fold as a new education administration is established over time.

Personnel Costs

Following nine years of hardship, teachers in Kosovo have expectations of returning immediately to pre-1989 salary rates. However, it is clear from GDP estimates that the Kosovo economy will not support relative pre-1989 wage rates in the short to medium term. Initial salary rates for 2000 have, therefore, been calculated to provide some improvement in salary rates over what was paid irregularly in the "parallel" system, while

attempting to ensure that salaries are sustainable once donor contributions to recurrent financing are discontinued. Net salaries currently set by UNMIK – DM 265 average for primary teachers, 285 average for secondary teachers and 325 average for university professors - are, in fact, only slightly lower than current wage rates in Macedonia and both entities of Bosnia and Herzegovina. Although a 20 percent income tax is being considered, net pay rates are expected to be at least maintained throughout 2000 and 2001. Donor experience in Bosnia and Herzegovina has shown that wage rates have recovered in terms of regional norms within three years.

Non-Salary Expenditure

As mentioned above, non-salary spending needs have been estimated at 20 percent for primary education and 25 percent for secondary and higher education, which translates into non-salary per student spending of about DM 30 per student in primary, DM 50 per student in secondary and DM 90 per student in higher education. A typical eight-room primary school of approximately 320 students would be entitled to about DM 10,000 in expenditure for goods and services. Expenditure categories are limited to pedagogic materials (books, paper, and other learning materials), heat and other utility costs, replacement furniture and light equipment, maintenance costs (cleaning supplies, winterization, and small works), and administration costs (record books, office supplies). Salary supplements and major civil works are not permitted, and school furniture and equipment such as computers and photocopiers are approved by UNMIK only on an exceptional basis. Student transfers or subsidies are not allowed except through prior authorization by UNMIK. UNMIK is expected to organize auditing of selected municipalities/schools to ensure compliance, and the auditing function should be announced publicly in advance.

The recurrent budget for education in Kosovo was generated almost exclusively as a function of teachers and wages. UNMIK education and budget authorities are well aware that this traditional perspective on education financing provides a significant incentive to increase employment in education and a significant disincentive to maximizing the efficient use of personnel and facilities, the two most costly educational inputs. The current surplus of teachers being paid under the consolidated budget (as indicated by the low student-teacher ratios) will not be sustainable as teacher salaries begin to recover to regional norms. In order to avoid the phenomenon – common in many developing education systems - in which personnel costs crowd out spending on improving education quality, UNMIK's highest priority in education finance is to define and establish a system in which the main unit of education spending is the student. In addition to providing an efficiency incentive, a per student allocation would serve to ensure equity across the municipalities and schools, as well as ethnic groups, and provide a premium to overcrowded facilities (those with high student-teacher ratios). A summary description of such a system is provided below.

Capital Budgets

School reconstruction, re-equipment and re-furnishing needs are expected to be covered in their entirety by donors. UNMIK has proposed a DM 76 million investment program for 2000 which is appropriately focused on school reconstruction and re-equipping. Once

simple works and emergency needs are met, the pace of implementation will undoubtedly slow as works become larger (wholly re-built schools) and investment decisions require more analysis. To the extent that urgent needs are not being covered in an urgent time frame, minor winterization and furnishing costs have been and will continue to be eligible expenditures for schools under their goods and services budgets, as was the case in late 1999 when UNMIK financed invoices for schools and the university on a capitation basis by municipality.

A first priority of the UNMIK Education Department should be to guide and track capital expenditure on the part of the donors and provide up to date information on implementation and achievement against reconstruction goals. Facilities standards will have to be defined and issued, and simple criteria for investment programming based on efficient utilization of existing facilities should be shared with donors. As mentioned in the respective sections on secondary and higher education above, the highest priority for UNIMK in terms of guiding donor investments will be to ensure that decisions on investments in individual secondary schools, university faculties and boarding facilities are made in the context of an overall reform agenda for these levels of education – necessitating that some investment in these areas may have to be re-directed to other priorities until an adequate strategy has been agreed. For example, boarding facilities should not be refurbished by donors without a strong commitment to reduce subsidies and institute cost recovery; and vocational schools should not be re-equipped without some evidence of the priority of re-establishing occupational training for secondary students.

As mentioned above, existing textbooks are in the process of being re-printed as an interim measure with donor financing already obtained. These books are expected to last for several years and some minimum additional funding will be required to provide supplemental materials during this period. Decisions on financing a second wave of textbooks should be made on the basis of relevance to new curriculum programs and the acceptance of minimum cost recovery for some books and levels.

Per Student Block Grant Funding for Education

In education, the budget request process is traditionally based on the number of teaching and non-teaching staff required to meet predicted class rolls, and a series of norms established for wages (salary scale) and for other expenditures such as educational materials, utilities, maintenance, administration, etc. In the interest of ensuring equity in public educational funding entitlements within a small system, this process of establishing norms is normally decided at the central level, and it is strongly recommended that this be the case in Kosovo.

Once budgets have been approved at the center, in competition with other public spending priorities (health, infrastructure, social benefits, pensions, etc.), there are various methods for allocating budgeted funds to the service provider – the school. In traditional centralized systems, funding is allocated as credits against various budget categories and lower levels or institutions have little discretion in terms of shifting the mix of expenditures to meet their own local priorities. However, many countries in Western Europe and North America, as well as several Eastern and Central European

countries (Hungary, Poland, and the Czech Republic) decentralize the responsibility for defining local spending priorities, within broad limits, by devolving funds in the form of block grants to lower administrative levels or to the schools themselves. In this scenario, local governance structures (or directors in the case of schools, in consultation with local school councils) are responsible for allocating funding according to their own local priorities and needs in education. A single pay scale and minimum salaries can continue to be mandated from the center. In an environment of severe revenue constraints and under-funded budgets (i.e. ideal norms cannot be met for all schools), this mechanism has the added advantage of allowing available non-salary funding to be allocated on an equitable basis and pushing down decisions to local officials over what spending trade-offs most meet their needs. Given the tradition in Kosovo for decentralized management of education at the municipality level under FRY and in the “parallel” system, it is recommended that such a system be considered and potentially piloted in Kosovo.

Block grants require some unit cost calculation for distributing funds and in education that unit is the ultimate beneficiary of the system, the student. Lump sum grants to municipalities would be determined on the basis of a per student funding which would include adjustments for varying circumstances of municipalities and individual schools. For example, typically rural schools would be entitled to a higher per student allocation to take into account the higher cost that may be associated with their isolation or with lower student-teacher ratios. Schools with similar circumstances and the same number of students will be entitled to the same level of funding.

In almost all such systems, capital costs (mainly civil works, equipment and furniture) are excluded from the funding formula due to disparities in the physical status and age of schools and the need to target scarce capital spending on the neediest areas. The amount of support coming from donors to cover capital spending in the short term makes this a non-critical issue. However, capital costs will eventually have to be budgeted through a detailed investment program, which should be established on the basis of detailed criteria for prioritizing investments. Before such an investment plan can be effectively established, consistent information will have to be collected and categorized on the status of schools and the efficiency with which facilities are being used. Donor assessments of schools should provide a base line for developing a centrally maintained school mapping database.

Allocating block grants on the base of a per student funding formula presents a number of advantages and constraints that should be taken into account in deciding whether or not such a mechanism is appropriate for Kosovo.

Advantages

- Allocating funding on the number of students provides a powerful incentive for the municipality to use its scarce public education funding more efficiently, particularly the two most costly elements in education, teachers and school facilities. Low student-teacher ratios and under-utilization of facilities will become extremely important issues to local officials who would have an incentive to address the problem locally rather than simply requesting more resources from the center. In the opposite situation, schools with high student-teacher ratios and over-utilized facilities

can at least expect a higher relative amount of funding to address these problems based on their higher relative number of students.

- Allocating block grants to municipalities is in keeping with the traditionally decentralized governance structure for education both in FYR and in the “parallel” system. Allowing local officials to determine their own needs and priorities in education, within broad norms, is generally thought to be a strength in modern education governance in that local authorities are more attuned to local needs than central administrators.
- Formula funding will bring about a more equitable distribution of resources – across all constituent groups - because it is based on the actual beneficiary of the education system and not on historical funding patterns. The formula can be modified over time to target public resources on disadvantaged groups or areas which are not performing up to established standards.
- The formula would be publicly available and serve to establish transparency of public funding for the education sector.

Constraints

- Providing education funds in block grants to municipalities to be used exclusively for education limits the authority of municipalities to determine their own optimal mix of spending priorities across sectors, as was the practice in FYR. The goal of ensuring an equitable allocation of public resources for education across Kosovo and the need to ensure minimum spending standards for all children may outweigh this constraint. Municipalities would, of course, be able to make additional contributions to education with any revenues assigned to them or through private contributions.
- There would be little direct central control over education spending, except for certain broad norms including the central salary scale. In this context, municipalities may attempt to divert education funding to activities other than education. Both a central auditing function and the re-enforcing of accountability systems within the municipalities would be necessary, as in any decentralized system, to guard against corruption and ensure that norms are respected.
- There could be some diseconomies of scale in terms of items that could best be procured centrally. Although many education systems are tending to push the responsibility for choosing textbooks to lower administrative levels or even to the schools, textbooks might, at least initially, be an item that is better funded outside the formula and distributed from the center.
- Microanalysis of school expenditure would not be immediately available in the system. New accounting/information systems would have to be developed to ensure consistent reporting which would be used to monitor the adequacy of the per student allocation and to make adjustments where necessary at the central level.

The introduction of block grants to municipalities through a per student funding formula would require an assessment of municipality capacity to implement such a system, as well as an assessment of existing or recommended accountability procedures designed to ensure that funding is used in the best interest of students and teachers, that centrally-established norms are respected (salary scales, maximum student-teacher ratios, for example), and that corruption in the system is reduced or eliminated. Because the introduction of new decentralized governance and financing systems is commonly an experience in which much is learned in the initial stages of implementation, it is recommended that donor financing be made available to organize a pilot exercise in one or more municipalities beginning with the 2000-2001 school year. In the meantime, much can be learned about capacity to manage such a decentralized governance system at both the central and municipality levels, through the process of funding the non-salary costs of the 1999 and 2000 education budgets.

Lastly, the full benefit of such a decentralized block grant system can only be realized if authorities in Kosovo have the capacity to measure the performance of its students and schools in some standardized way so as to allow comparisons and to re-allocate central funding to address problem areas. The need to develop a capacity for standardized student assessment is discussed above and should be considered by donors together with the proposal for a decentralized governance and financing system.

CHAPTER 6:

HEALTH

BACKGROUND

Even before the crisis, Kosovo's health care statistics were among the poorest in Europe on virtually every indicator. Results from a national survey conducted by the International Organization for Migration (IOM) and the UN Population Fund (UNFPA) confirm that Kosovo continues to have one of the highest infant mortality rates in Europe, with 25 deaths per 1,000 live births. According to the survey, undertaken from November 1999 to February 2000, 15 percent of pregnant women do not see a health-care worker and 20 percent of deliveries take place at home without professional help. Failures in the immunization system have placed the population at even higher risk. A recent outbreak of tularemia, a bacterial disease transmitted from wild animal hosts to humans, confirms the dangers of the breakdown in sanitation and waste management.

However alarming these statistics may seem, the central issue confronting the sector in Kosovo, as in other parts of FRY or, more generally, Central and Eastern Europe, is how to maintain these standards at a time of economic collapse and sharp reductions in public sector spending on health. For most countries, this has required significant reforms in how the sector is organized and financed, moving from an overspecialized, inefficient system that provided all health care services free of charge towards a leaner public system financed from both public and private sources and based on the principles of primary health care. New incentives such as paying providers by their outputs (patients treated) rather than their inputs (number of beds) and requiring patients to contribute to the cost of their care (co-payments, co-insurance) have been introduced to limit unnecessary utilization of health care services and control cost escalation.

Kosovo, in addition to facing these typical challenges of the health reform transition, must also deal with the special circumstances of its history and its current reality. These include a more insecure revenue source than most countries, given that the Kosovo recurrent budget (that finances health expenditures) enjoys a high degree of donor funding, a cadre of health sector providers that was trained under a parallel system, excluded from practicing in specialized facilities, and who now wish to return there; and more than 250 NGOs and donors working in the sector, often providing services without consideration of their longer term fiscal sustainability.

THE PRE-CONFLICT SITUATION

Prior to 1989, the Kosovar health system was financed through a health insurance fund (HIF) organized as a "self-managing community of interest" (SIZ) at the central level of the province, and through 29 "elementary units" (OZs), which were municipal branches

of the SIZ at the community level. This health insurance system provided insurance for health care and a range of cash benefits (for sick leave, disability, funeral benefits, eyeglasses, orthopedic devices, etc.) to those who paid insurance contributions and to their families. Health insurance revenues were derived from compulsory contributions from employers and their employees, calculated at 9 percent of gross salary. This accounted for 80 percent of the HIF's revenue. The pension fund contributed 14 percent of pension income for pensioners and other social funds also contributed. Farmers and small businesses were expected to contribute 20 percent of farm income while in reality, collection was far below this level. Many Kosovars worked abroad, contributing nearly US\$7 million from foreign health insurance funds to cover family members in Kosovo. In addition, 8.5 percent of health care revenue (US\$5.8 million in 1989) came from a federal Solidarity Fund.

The financing and provider payment system did not create incentives for efficiency. The OZs paid providers using a modified-fee-for-service "point" system. This system encouraged higher numbers of hospital bed days and hence longer than average length of stays. Relative prices were derived from norms regarding number of beds, equipment, staff ratios, and building size while absolute prices were not based on any true estimate of costs. Instead, they were adjusted according to the available funds. Under these circumstances, as the real payments for services declined, informal co-payments for services emerged as a supplementary source of finance. By 1989, the health system was already in financial deficit, with expenditures (US\$89.8 million) exceeding revenues (US\$68.9 million) by 24.5 percent. Average expenditure per capita in 1989 was about US\$55 in Kosovo, or between 4 and 4.6 percent of Kosovo's estimated GDP.

Between 1990-92, responsibility for financing and management of health care was moved from Pristina to Belgrade as the system became more centralized. The central Health Insurance Fund in Belgrade assumed responsibility for health finance in Kosovo. Kosovo's five regional offices (Pristina, Prizren, Gjilan, Pec/Peja, and Mitrovica) were responsible for collecting contributions, 70 percent of which they could retain and the remainder to be sent to the Solidarity/Equalization Fund in Belgrade. However, local perceptions were that nearly all revenue went to Belgrade, and redistribution to the regions was unpredictable and untransparent.

During this time, most Kosovar Albanians were dismissed from management and senior positions in the health system, as in other public services. Many Kosovar Albanians had limited access to coverage under the centralized health insurance system. More than 50 percent of Albanians lacked a social insurance card needed for health insurance coverage. A parallel charitable primary health care system was organized through the Mother Theresa Society to provide basic health services free of charge to those unable to afford private medical care and who had no social insurance card. The Mother Theresa Society established 96 clinics throughout Kosovo, many in remote villages with predominantly Kosovar Albanian populations. Staff worked as volunteers. Additional resources were financed by a parallel tax system. Kosovar Albanians also organized a system of parallel medical education, as they were no longer able to obtain medical education in their own language in this period. Over 700 doctors and 1,200 nurses graduated from this system.

CURRENT SITUATION

Responsibility for organizing and delivering health services has been given to UNMIK's Department of Health and Social Welfare, which operates with the advice and assistance of the World Health Organization (WHO). The Department has a Kosovar co-head and a number of Kosovar senior staff. The Department's health policy is guided by the UNMIK Interim Health Policy Guidelines (commonly referred to as The Blue Book) that was drafted by an UNMIK/WHO/local professional policy group and published in October 1999. The Department was subsequently given the authority to issue administrative decrees and regulations necessary to implement the new health policies.

In April 2000, a Working Group on Health Policy and Planning was set up by the Department of Health and Social Welfare with the objectives being to: (a) improve the capacity in health planning and policy in Kosovo; (b) review the interim health policy guidelines and update as necessary; (c) produce an action plan for the health sector through the year 2000; and (d) form study groups on key areas of policy to prepare future policy options for decision-makers. The membership of the group reflects the professional and geographic diversity of Kosovar stakeholders involved in health policy, and is an attempt to consult with a wider group of stakeholders in the development of health policy and planning for the future governing structure of Kosovo. In August, a revised version of the policy guidelines was circulated.

Health status indicators, while of concern, have not deteriorated as significantly as many experts had expected. The country is currently experiencing a transition where rates of infectious diseases are still high but chronic, non-communicable diseases pose the greatest burden on the health system.

During the conflict, the hospitals and most health houses remained intact. Damage occurred mainly in remote dispensaries and small clinics, particularly the Mother Theresa Society (MTS) facilities. An estimated 10 to 15 percent MTS facilities continue to operate, mainly in the cities. The building in Pristina used jointly by the Health Insurance Fund, the Social Welfare Agency, and the Pension Fund was also damaged. However, the effects of the conflict highlighted the underlying problems caused by over 10 years of neglect and weak management. Among these are chronic under-investment in maintenance of physical infrastructure and equipment and staff development. Much of the equipment installed in hospitals is either obsolete, will not work because of poor maintenance, is unused due to lack of consumables, or is underutilized for lack of personnel. Since the conflict ended, considerable work has been done on assessing the condition of health care facilities in Kosovo. UNMIK's Department of Health and Social Welfare (DHSW) has identified the reconstruction needs and damaged equipment in primary health care facilities as a priority for capital investment. Equally important, essential repairs such as heating, electricity, water supply and sanitation, must be undertaken in the district hospitals.

Many health professionals who worked in the Mother Theresa Society clinics have now left to seek employment and specialist training positions at the hospitals. Kosovar Albanians who were expelled from their positions in 1989 returned to the hospitals to

reclaim their old jobs as the Kosovar Serbs left. Medical staff who graduated from the parallel system also claimed a right to positions in hospitals so they could complete an "intern year" of supervised practice, and then obtain certification. The combined effect of these trends is that doctors have now moved from primary care to the hospitals, hoping to work or train as specialists. This has overburdening the hospitals and the system of specialist clinical training, while primary health care facilities, particularly in remote areas, are deprived of staff.

UNMIK's Central Fiscal Authority has assumed responsibility for financing health services from the Kosovo Consolidated Budget. The budgets for the last quarter of 1999 as well as 2000 were prepared with the assistance of the Department of Health and Social Welfare, the World Health Organization, and the World Bank. The budgets for the health sector were based on norms in surrounding countries and projected revenues.

The budget for the final four months of 1999 was under-spent as expenditure systems for paying salaries and procuring goods and services were not fully in place. The 2000 recurrent budget for health is DM 81 million (see table below). The proposed capital budget is DM 83.6 million in 2000 and DM 35.3 million in 2001. The 2000 budget will see over-spending on salaries as it has proven difficult to shed surplus staff in the sector, but substantial under-spending in goods and services as pharmaceutical stocks, benefiting from donor replenishments, proved to be adequate. The capital budget is expected to be entirely financed by donors.

Table 1: Department of Health and Social Welfare, 2000 Budget Summary (DM)

	Staff	Wages and salaries	Goods and services	Transfers	Reserve	Total
Hospitals	5,245	16,410,960	29,698,490	-	-	46,109,450
Primary care	4,980	15,990,600	17,559,874	-	-	33,550,474
Other health	357	1,046,880	435,499	-	-	1,482,379
Total	10,582	33,448,440	47,693,863	-	-	81,142,303

The 2000 budget is based on a combination of donor pledges and tax revenues. There is now a discussion focused on whether to implement a payroll tax earmarked for health, as was done in the past. For now, UNMIK has decided against introducing the wage tax because current rules would make UN employees exempt and it was felt that this would be inequitable and place an unfair burden on government employees and the private sector. Therefore, UNMIK's short-term policy is to finance the health sector from general revenues raised from other taxes and to review health sector financing options over the coming year as part of the World Bank financed project.

Recently the Department of Health and Social Welfare introduced a system of co-payments. While the budget did not explicitly account for co-payments, introducing a system was considered to be a priority to not only fill a financing gap but also to attempt

to control some demand and restore transparency to a system that was rapidly moving towards increasing informal payments. Evidence suggested that people were already paying a significant amount of money for health care. The Kosovar Albanian Health Survey Report (September 1999)¹ found 55 percent of patients had spent money on health the previous two weeks. Of those households that spent money, the largest expenditure by far was for medication – the mean expenditure being 73 percent of total expenditures (DM 41.4). The next largest expenditure was on transportation (17 percent). Extrapolating to the total population of 1.5 million ethnic Albanian Kosovars, and assuming health expenditures remain relatively constant, the report estimated that private health care expenditures totaled DM 150 million a year or approximately DM 100 per capita. This is nearly twice the size of the entire UNMIK recurrent budget for health in 2000.²

KEY POLICY ISSUES

Identifying Sustainable Sources of Revenue for the Sector

One of the main issues Kosovo will face is how to finance health care services. Currently the sector is reliant on donor funding, which is a major problem for all of the social services in Kosovo, not just health. The uncertainty of donor funds makes planning extremely difficult.

The Interim Health Policy Guidelines already indicate a preference for Kosovo to restore a system of compulsory health insurance contributions. The examples of other countries in the region could help Kosovar health authorities to re-establish a health insurance system that preserves the main virtue of the pre-1990 system – widespread population coverage – while improving transparency and creating incentives for efficiency. Nearly every Central European country finances health care through compulsory payroll tax contributions to health insurance funds, often supplemented by revenue from the general government budget.

In the short to medium term, however, Kosovo will be unable to move entirely to a social insurance system. The most immediate problem is the issue of the personal income tax; until this is resolved it will be difficult to plan for any contributory tax for health. Most of the financing for the health sector in the near future will have to come from the consolidated budget. A risk currently facing the sector is that a large portion of health spending will be paid out of pocket with limited risk pooling. There is already a growing prevalence of under the table payments to health care providers that according to experiences in other countries, will become more difficult to control over time.

¹ International Rescue Committee, Institute for Public Health, Kosovo, WHO, and US Centers for Disease Control. 1197 households in 25 of the 29 municipalities in Kosovo. The four municipalities with a majority Serbian population were not surveyed because of security concerns.

² The survey used a crude instrument to collect baseline data on a variety of health status and health behaviors. For this reason it probably underestimated the amount of private payments as no reference was made to informal payments to health care providers. Also, the amounts for inpatient and outpatient services seem unreasonable given the use rate of 5.6 OPD visits per person per year.

Priority will have to be given to tax collection, doing everything possible to strengthen the overall capacity to raise general taxes, continue to press for an exemption for the income tax exemption of UN employees, and consider other possible taxes for the health sector. Given the past history of voluntary contributions to the parallel system to finance health care services, it may be possible to raise additional revenue in a similar manner. The highest priority should be given to decreasing the proportion of total health spending that is paid directly out of pocket.

Policies to govern the distribution of health revenue to different districts and health care providers across Kosovo, and the mechanisms for paying health care providers will need attention in the medium term. Initially, health providers will be reimbursed for the costs of inputs (salaries, pharmaceuticals, other supplies, and capital), based on approved plans for staff numbers, approved capital investment and so on. In the medium term, mechanisms should be developed to pay providers for defined outputs - i.e., number of patients registered with a primary health care clinic, numbers of hospital admissions for various conditions - subject to a global limit on their budgets. Ideally, providers also should be given incentives to improve service quality, efficiency, and effectiveness. The previous system for paying providers encouraged inefficiency - for example, by encouraging long hospital stays, with excessive doctor consultations - and should not be reinstated.

The main component of the recently approved World Bank health project aims to develop local capacity for health sector revenue collection and provider payment. What type of system will best suit Kosovo, given its projected revenue outlook and unique circumstances, will be considered. Also, no assumption is being made a priori that a rapid return to restoring the health insurance fund is the most desirable option. Given the revenue outlook, as well as lessons learned from other countries in the region, it seems advisable to move slowly, and gradually develop and hand over functions to an HIF-like agency.

Prioritizing Public Sector Spending

In the near term, prioritizing spending will entail rationing the limited budgetary resources for health - deciding where to spend public sector funds. While there are numerous ways to think about this, and various levels of consultation that can be undertaken before reaching a final decision, most agree that the first priority should be given to services such as immunizations, which have clear public good aspects, as well as to the most essential and cost-effective clinical services. The tradeoff comes in deciding how many people to fully cover because of their inability to pay versus offering a bigger package for everyone. The 2000 budget of DM 81 million budget already represents a significant decline in real spending on health care services for Kosovars. UNMIK may want to prioritize some of its health spending based on an income means test, perhaps along with the issuance of social assistance benefits, to ensure that the poorest are not excluded. Even with additional revenue from co-payments, a significant cut in the health budget makes some sort of list inevitable. In the medium term, as part of the Bank project, a more systematic approach to prioritizing should be introduced.

Another component of the prioritization strategy that DHSW has already embraced is to build capacity in primary health care to deliver services that address the most common health problems - including Kosovo's specific post-conflict needs and problems arising from past lack of access to public services. There may be value in defining a basic set of services to be managed in primary health care. In addition to the need for mental health interventions for conflict victims, primary health care should be equipped to manage serious mental illness, given the lack of psychiatric services in Kosovo, as well as the return of a number of Kosovar patients from long-term psychiatric facilities in Serbia.

In the short term, WHO and a range of donor agencies and NGOs have begun to offer short-course training to provide orientation and basic training for doctors in primary health care/family medicine. The aim is to encourage a large share of the parallel system graduates and other returning medical school graduates to shift into primary health care. This type of training will need to be supplemented by a more medium-term approach to provide a good quality primary health care system, and to raise the status of family medicine in a credible way.

Resource allocation tools and provider payment mechanisms need to be developed to support the strategy of treating more patients in primary health care, and at the district rather than central level. Financial incentives in the salary structure for doctors and nurses have already been put in place to encourage health workers to take up primary health care. These incentives will need to be refined to encourage providers to move from urban to rural areas (a problem in many countries) as well as between various specialties.

Reducing Existing Waste and Inefficiency in the System

The Eastern Bloc countries are dealing with problems related to excess capacity in both physical infrastructure and human resources. This was caused by outdated clinical practices as well as financial incentives based on the number of inputs instead of outputs. Interestingly, in Kosovo the number of physicians and the number of beds per capita are both relatively low. For example, there are 4,769 beds in acute care hospitals – equivalent to an average of 264 per 100,000 population. In Europe, only Turkey and the UK have lower ratios; however, these numbers are misleading. First, Europe and the other OECD countries have too many beds and hospitals and are trying to reduce their number in response to changes in clinical practice and pressure to lower health care expenditures. Kosovo's low bed ratio is not an indication of high efficiency. Second, by looking only at the number of beds, other potential efficiency gains from reorganizing service delivery may be overlooked.

In Kosovo, there are several indications that efficiency improvements can be made, including:

- A relatively high average length of stay (11.5 days) in hospitals, reflecting in part the under-performance of the primary care system. Most patients currently self-refer to hospitals because of the collapse of the official referral system during the crises. Re-

establishing referral systems and guidelines for referral will be required along with the redevelopment of primary care;

- An occupancy rate of only 70 percent; which is higher than most countries in the region, but low by OECD standards;
- An excess of beds in specialties, which modern practices suggest requires less or no in-patient care: ENT, dermatology, ophthalmology and infectious diseases; and under-provision in areas such as cancer services, which were provided in Belgrade. Re-organization of bed use will be needed to achieve more effective care within the financial constraints.

One example of how to improve the existing system is provided by Gjakove hospital, where a master plan was completed by its international management team and the Norwegian Aid Committee. The plan calls for taking one of the hospital's six buildings, adding a new wing, and merging nearly all of the services into the single building. The plan would reduce the number of beds by almost 30 percent, put an end to duplication of services, make better use of specialist staff and equipment, and lead to savings in salaries and overhead. There are similar proposals for consolidating the small dispensaries into larger primary health care practices.

On the human resources side, counting the number of staff has been an ongoing exercise related to paying the stipends and preparing the 2000 budget. The numbers vary from 11,270 (November 1999) to 13,610 (March 2000). Either number shows Kosovo at the bottom in terms of doctors and nurses per 100,000. With somewhere between 2,100 and 2,500 physicians, the average would be approximately 13 per 10,000, compared to the EU average of 35. The main issue is therefore not the number of health sector personnel, but their distribution both by specialty and region. In secondary care, the most urgent shortages are in anesthesiology and radiology; in primary care fully trained family health care doctors and nurses are needed.

A human resources strategy is under preparation that will take into account issues of standards of care as well as the impact on the Kosovo economy and population. Efficiencies can be expected as staff are reassigned to match the change in the clinical profile of the system occurring as primary health care is introduced and hospital services are restructured. Emphasis should be put on assessing the current skill level of staff (and verifying their existence) in preparation for the development of the human resources plan before any organizational restructuring is done.

Pharmaceuticals is another area where there is potential for significant savings. In Eastern European countries, pharmaceuticals typically account for 15 to 30 percent of public health spending, and a large share of private out-of-pocket spending. In Kosovo's 2000 budget, pharmaceuticals are estimated to be 57 percent of the total. The recent study of private spending confirmed that pharmaceuticals are the largest out-of-pocket expense for the population. In addition, UNMIK and donors are keen to not allow an uncontrolled private drug supply system to develop that could push up the cost of drugs

dramatically. This happened in many countries in Eastern Europe. Macedonian drugs, for example, cost five times more than international prices.

As the emergency situation subsides, responsibility for pharmaceutical management is shifting from humanitarian agencies to UNMIK, which agencies are in turn preparing for a Kosovo-owned system. A number of positive steps have been taken over the last six months that should lead to significant savings and improvements in the safety and efficacy of treatment. These include:

- Formation of the Co-operative of Kosovo Pharmacists (KKK) that brought together the former state pharmacies and linked them to the current distributor of drugs (PSF) to facilitate a transition from an externally-run to a Kosovar-run system;³
- Establishment of a Kosovo Drugs Regulatory Office (KDRO), which will be responsible for the regulation of import, manufacture, export, wholesale and retail and supply of pharmaceuticals. Regulations, tools, and procedures are currently being developed with advice from WHO;
- Adoption of an essentials drug list for procurement;
- Completion of a survey of prescribing practices that will be used to retrain clinical staff on updated and more cost-efficient practices;
- Launch of an international tender for supply of hospital drugs; and
- Dissemination of guidelines for drug donations to mitigate risks of expired or therapeutically useless drug donations.

Other issues under discussion include the introduction of user co-payments (prescription charges) for drugs dispensed in public pharmacies and competition between public and private pharmacies. The competition between public and private pharmacies is part of a larger debate that Kosovo will need to have regarding the mix of public and private provision of all health services. However, in the short to medium term, it would seem advisable to concentrate scarce resources on the smaller number of pharmacies that are part of the KKK, thereby benefiting from bulk purchases.

Upgrading Skills and Licensing Parallel Medical School Graduates

In the years 1992/93, it became increasingly difficult for Kosovar Albanian physicians to work in the health care system in Kosovo. In particular it was almost impossible for them to be accepted as medical students in Pristina University Medical Faculty. For these and other political reasons, a "parallel university" was established. Teaching was carried out in private homes and clinics both by academic staff who had lost their formal university positions and also by some of those who had managed to retain them. The

³ The intent is that the KKK would supervise a central procurement unit for pharmaceuticals and be responsible for procuring, storing, and distributing drugs. Patients would go to a network of state pharmacists to get their prescriptions filled.

latter worked in both systems. Through this mechanism it appears that quite a high standard of theoretical knowledge was acquired by the students. The major problem concerned clinical training, as access to patients in hospitals was very difficult to achieve. Considerable ingenuity was used to overcome the obstacles. In part experience was gained in the ambulances. Also some staff in the university hospital used great ingenuity (and took some risk) to enable students to make ward rounds and see cases first-hand. In some instances, courses were concluded by examinations and degrees and certificates were awarded for satisfactory completion of training - but not in all situations. A number of students completed their training in universities of neighboring countries outside Kosovo and were awarded degrees there.

An estimated 710 students graduated with degrees in General Medicine and 140 in Dentistry from the parallel years. Some of those students had begun their training in academic institutions and hospitals, so their deficiencies are less than later students who were denied that opportunity. Since June 1999, teaching has recommenced in the university and students of the "parallel era" have either returned to formal academic studies or are practicing medicine and dentistry in hospitals and clinics under the supervision of more senior clinicians. However, the social demand for formal proof of education, examinations, and clinical expertise has increased with the return of peace and normalization of everyday life. The students who studied in the parallel system are increasingly concerned that they should not be denied career opportunities given the risks and sacrifices made during exceptionally difficult times.

The only rational way to resolve this issue is through the creation of a single accrediting body responsible for the registration of all diplomas and documents that formally certify the satisfactory completion of training. The registration and licensing body would have the following functions:

- Consider formal evidence of completion of medical education and qualifications in medicine submitted to it, and, on the basis of the evidence submitted;
- Issue licenses to practice medicine in the Administrative area of Kosovo to those who possess the necessary basic medical qualifications;
- Receive and where appropriate register accredited certificates of completion of specialist training and other recognized qualifications;
- Consider, and when appropriate, approve and register certificates of completion of newly developed specialist and other formal postgraduate medical training;
- Maintain and regularly update a Register of those persons licensed to practice medicine in Kosovo; and
- Consider evidence of non-Kosovar/FRY qualifications submitted for the purpose of licensing for practice in Kosovo.

Many of these steps above are underway. At a later stage, without unreasonable delay, responsibilities should be extended as follows:

- Establish and publish a code of medical ethics;
- Issue guidelines on acceptable standards of medical practice, and promote the professional obligation to participate in continuing medical education and professional development;
- Consider and where appropriate approve newly developed specialist training and other formal evidence of further medical training; and
- To establish a mechanism to regulate the observance of the above standards for practice in all areas of medical practice, including private practice.

Deciding the Degree to Which the Organization and Financing of the New System Should be Decentralized

The appropriate degree of fiscal and administrative decentralization will need to be considered when developing local institutions to manage and oversee the health financing and service delivery system in Kosovo. Decentralization of public health services often is viewed as potentially the most important force for improving efficiency and responding to local health needs in former socialist economies. Success will come only when local government health agencies and providers develop a sound financial base, solid administrative capacity, incentives for improving efficiency, and accountability to patients and local citizens. Hasty decentralization, or decentralization at too small a governmental unit can lead to inefficiencies.

The functions of pooling financial risk and redistributing revenue from higher to lower income areas should be centralized at the provincial level. The average municipal population is too small to make efficient use of general hospital services or to pool financial risks (the risk that some of the population will require very high cost health care), or to distribute revenue fairly across high and low-income populations. Therefore, the health sector will be better served by a single health fund with five or six district branches than by a more decentralized approach to financing. Policy, planning and regulation functions for the health sector are also best carried out at the province-wide level.

There is room for debate about whether there are benefits from more decentralized ownership of health care facilities. Municipal ownership of primary health care facilities creates fewer problems, though the benefits of local ownership (such as greater community support) need to be weighed against the benefits of common management for both primary health care and secondary health care (better co-ordination, stronger clinical and managerial support).

The recent decision to devolve responsibility for primary health care to municipalities in Kosovo could be problematic, depending on how actual responsibilities between the

DHSW and the municipalities are defined. It currently appears that policy making as well as financial control will remain with the center while responsibility for the delivery of services will be handed over to the municipalities. It would be best to hold off on any further decisions regarding the financial responsibilities until decisions had been reached about the overall design of the new system.

Ensuring Access to Health Services for Minorities

UNMIK is now pursuing a health policy of “co-existence” rather than “multi-ethnicity.” This means “parallel” facilities can be set up if relationships between ethnic communities exclude any group from access to health care. WHO has been instrumental in encouraging Serbian doctors to return to serve Serb villages. As a result, many minority enclaves now have access to primary health care services provided by staff of their own ethnicity. Where this is not possible, humanitarian organizations serve patients using mobile clinics. However, secure transportation for those living in more isolated areas or between enclaves and regional hospitals are problematic. UNHCR set up KFOR-protected bus services in some districts; in others there are local arrangements with KFOR.

Coordinating the Large Number of Donors and NGOs to Ensure a Consistent and Rational Health Policy

With numerous donors and NGOs operating in Kosovo, one of the biggest difficulties is coordination. While individual donors will want to operate their own project implementation arrangements, stronger coordination will be needed to mitigate risks that emerged in the post-conflict environment in Bosnia and Herzegovina, including inappropriate and unsustainable investments. Examples of this can already be found in Kosovo. For example, in Gjakove, where the district hospital developed a master plan that reduced the bed capacity by 30 and merged 6 buildings into 1, an Austrian NGO was simultaneously signing a contract with the municipality to invest DM 7 million in a new building for mine injured children on the hospital grounds. This was done without the knowledge of the hospital board, the DHSW, or the municipality’s director of health. It not only conflicted with the master plan that was developed to rationalize the hospital’s already extensive buildings, but the services to be offered by the Austrian hospital also duplicated many of the activities already carried out by another NGO at a different site.

These mistakes are much less likely to happen now that the Department of Health and Social Welfare has been granted the authority to issue an administrative instruction that requires registration and approval of all NGO projects. The Department also has taken the initiative to convene a weekly tripartite meeting of the DHSW and representatives of donors and the NGO council.

RECOMMENDED SHORT-TERM ACTIONS (TO END-2000)

- Prioritize tax collection, doing everything possible to strengthen the overall capacity to raise general revenue, some of which in the short term will be needed to finance

health care, continuing to press for an exception for the income tax exemption of UN employees.

- Begin to monitor the financial flows and impact of the recently introduced co-payment system.
- Decide on the main principles of rationing health services and implement them as soon as possible.
- Develop integrated health care restructuring plans, with participation and commitment of donors, health care providers, and communities, to begin to introduce key changes to remove existing inefficiencies and waste. Use purchase of equipment and refurbishments, particularly at hospitals, to leverage some of these changes.
- Initiate and sustain training in family medicine.
- Create a Registration and Licensing Body for Medical Graduates with the aim of re-training (as necessary) and integrating the parallel medical graduates

RECOMMENDED MEDIUM-TERM ACTIONS

- Design future financing system (i.e., considering such issues as whether to proceed with a health insurance fund, how to pay providers, which services to offer, and governance structures) and begin implementation. (To be supported by Bank-financed project.)
- Upgrade a rationalized network of health centers and dispensaries to provide modern primary health care/family medicine.
- Gain commitment of health care providers and the population for the reform of the health care system through strong communication programs.

CHAPTER 7:

SOCIAL PROTECTION

INTRODUCTION

The social protection system of Kosovo faces many challenges in the coming years, as it simultaneously confronts the social aftermath of conflict, economic restructuring, the need to adjust programs and expenditures to fiscally sustainable levels, and uncertain timing of tax policy developments. This takes place in an environment where local administrative capacity requires substantial strengthening, the roles of different levels of government in social protection remain unelaborated, and local and international administrators strive to find an effective balance between the roles of the public and non-government sectors in social welfare provision.

Between the mid-1970s and 1989, Kosovo operated its own social protection system under legislation of the Kosovar autonomous provincial legislature. This was consistent with and under the general umbrella of Federal Yugoslav legislation. Cash transfers included contributory *pensions* and *unemployment benefit*, means-tested *child allowances* for contributors on low wages, and very tightly controlled *social help* for households with no resources. In 1989, Kosovar legislation was superceded and all entitlements and programs were incorporated directly into the Serbian social protection system and directed from Belgrade. New eligibility rules discriminated in several ways against ethnic Albanians. At the same time, many Albanian staff administering the various social protection programs were dismissed and replaced by Serbs. Those dismissed from their jobs in the public service also lost entitlement to unemployment benefit and child allowances and ceased to build up pension entitlements.

Between 1990 and 1999, therefore, basic social protection for many Albanian Kosovars was provided by the extended family network, by remittances from the large Albanian community outside Kosovo, and by help in kind from various humanitarian organizations. Particularly important among the latter was the Mother Teresa Society: an organized charity established in 1990 and funded by private donations from the diaspora and international organizations, with an extensive network of branch and local centers staffed by volunteers throughout Kosovo.

The Pre-Conflict Social Protection Structure¹

The benefit structure that existed in 1999 was therefore similar to that of most SFYR, though with specific features that effectively excluded the majority of the population.

¹ For a more detailed discussion, see Structure of the Social Protection System in Kosovo (Whippman, consultant report, 1999).

Exclusionary features of the entitlement rules were exacerbated by labor market exclusion which decreased the participation of Kosovar Albanians in social insurance programs in which they would otherwise have been entitled to participate. The major benefits were:

- The *pension scheme*, which included age pensions (with a number of early retirement provisions), invalidity and survivor pensions, and disability allowances. In practice, only a comparatively small proportion of the population was in the scheme, almost all of them employed in the state sector. Perhaps a quarter or less of those over retirement age actually received a pension, with only 32,511 receiving an age pension as of the last payment in February 1999.² This was in part a reflection of the former Yugoslav pension system, which is purely a social insurance program, and for which participation for farmers was initiated only in the 1970s. It also reflected labor market exclusion of Kosovar Albanians, who failed to build up contribution histories in many cases after 1989. Kosovar experts also note that the system had the largest arrears of any part of the former Yugoslavia at the time of cessation of payments. The system was administered by a network of regional pension fund offices.;
- *Unemployment benefit*, which was both based on a contribution record and means tested. The program was administered by the Employment Service through a regional network, which also ran a range of active labor market programs;
- *Child allowances* were payable on a means-tested basis to people in work on low incomes. During the 1990s, eligibility rules discriminated against ethnic Albanians in two ways. First, only households with children in Serbian language schools were entitled to child allowances, effectively excluding many of the Kosovar Albanians even where parents continued to work in the formal sector. Second, limits on the number of children that could be counted for means-testing purposes worked against ethnic Albanian households, due to larger family sizes;
- Cash payments of *social help* were clearly seen as a last resort, carrying a high degree of stigma. These were given both on a regular basis and as one-time help for those experiencing temporary difficulties. Payments were targeted according to means and categorically, with the emphasis on those unable to work. These benefits and other social services were administered through a regional network of Centers for Social Work (CSW) similar to those found throughout former Yugoslavia. No social help payments were made for the two years prior to the conflict - when payments were last made, they went to only 39,000 people; and
- A range of social services administered by CSW, including placement of children in care; custody assessments; services for the handicapped, etc.

² In addition, there were 27,403 invalidity pension beneficiaries, 27,664 survivor pensions, and 10,550 disability pensions. It also estimated by UNMIK that 6-10,000 additional people would have become entitled to old age pensions between early 1999 and the end of 2000.

Financing of all aspects of the system was by contributions paid by employers and employees. In practice, the latter were largely notional. All salaries were set in terms of net take home pay. The various contributions were calculated as a percentage of this net pay, which itself remained unaffected by changes in a contribution rate. In addition, social protection was subsidized from the budget to some extent, including funds from the Fund for Undeveloped Regions, a Yugoslavia-wide fund which distributed resources from richer to poorer regions, and of which Kosovo was a major beneficiary.

Table 1 below gives estimates of *staff* engaged in the social protection system as of early 1999. The figures are a combination of estimates for staff actually in post, pre-1997 figures and normative values under Yugoslav legislation. For the CSW, the normative values in place previously were 1 social worker per 20,000 people; 1 lawyer and 1 educationalist per 50,000, and 1 sociologist and 1 psychologist per 100,000. However, it is important to note that most ethnic Albanian staff working in the SP system as of 1989 had been replaced during the 1990s. Many former CSW staff and central social fund management had returned to their offices to assume their former positions in 1999, though the JIAS has since carried out a more structured hiring of CSW directors and staff (see below on current system).

Table 1: Staff Engaged in Social Protection - early 1999

	Staff numbers			
	<i>Professional/directors</i>	<i>Middle band</i>	<i>Support</i>	<i>Total</i>
Pension Centers ³	18	290	25	333
Family Allowance Centers	7	115	10	132
Centers for Social Work ⁴	385	100	40	525
Special Institutions	60	120	60	240
Employment Service	35	245	120	400
Total	505	870	255	1,630

Source: Bank calculations

Current Situation

Following the conflict, large numbers of Kosovars lacked basic housing, furniture, clothing or cooking facilities. While self-help and donor assistance have eased the situation considerably, a significant number of households have lost the main breadwinner, and there remains significant levels of physical and psychological damage. The best indication of the overall level of need in the immediate post conflict period was probably the number of people receiving some form of help from the Mother Teresa

³ Including Pension Fund headquarters staff.

⁴ Including Children and Social Welfare Fund headquarters staff and the Institute for Social Policy.

Society: some 850,000 in September 1999 or nearly half the population. Large as this figure may seem, it was half the figure of July. When introduced in November 1999, the UNMIK social assistance system was paying benefits to 54,000 households, rising to around 80,000 in April 2000 (see below). However, as the scope of the scheme was very tightly constrained, that this may not be a realistic measure of the total number in need.

In addition to the substantial help in-kind being provided by humanitarian organizations, there is an unknown flow of funds from family members outside Kosovo, and many households receive regular stipends paid to public sector workers (who totaled around 70,000 in 2000). In addition, informal economic activity is thriving. All of this suggests that the number of people without insufficient cash income will stabilize during 2001, but will remain high for some time to come. The planned withdrawal in the near future of WFP and other donors such as UNHCR also suggests that the most vulnerable are likely to face a significant welfare shock in the first half of 2001.

Given limited budgetary resources in 1999-2000, the UNMIK administration decided - quite appropriately - that the highest welfare impact was to focus social transfer resources on an interim social assistance program. The Emergency Financial Assistance Program was administered by UNMIK with help from CSW and NGOs between November 1999 and April 2000. From May 2000, a new social assistance scheme has been implemented in stages, administered by CSW under the overall supervision of JIAS, with support from local and international NGOs (see below). The main social insurance programs - pensions, child allowance, and unemployment benefit - have not been reinstated. Conditions that would make a restart of any social insurance programs feasible are discussed below.

The social protection function within UNMIK has core staff in place in Pristina and 5 regional centers. They work closely with CSWs throughout Kosovo, and with the Social Policy Institute. Establishing staffing levels in the local social protection system with precision remains difficult. In the 2000 budget, stipends for a total of 779 staff in the sector were provided for, of which 165 were from the Employment Service and 614 from other Social Welfare activities, the bulk of them CSW staff.⁵ A more detailed breakdown within social welfare activities was not available, but staff in pensions and child allowance centers has not been viewed as priorities, in light of the unlikely resumption of these programs in the short term. One area that is unclear, but which is of obvious importance is budgeting for staff in specialist institutions (e.g., handicapped and elderly homes; orphanages). These institutions are receiving direct donor and NGO support in several cases, but it is important that they do not "fall between the cracks" of social protection, education and health sectors.

⁵ A three-band staffing structure was assumed in budget preparation: Band 1: professionals (social workers, psychologists, sociologists, lawyers, educationalists); directors of local units such as a CSW or pensions center; chief accountants/finance directors; the top management team at headquarters; Band 2: qualified clerical or administrative staff; and Band 3: unqualified support staff (cleaners, drivers).

The 2000 budget also allows for limited non-salary costs of just over DM 465,000 for the year. This will be an important item to monitor in budget execution, as administrative costs such as cash handling have historically been a significant budget item. As of the last quarter of 2000, the BPK was not charging for payments functions to JIAS, but this will need to be monitored as the situation evolves. Another critical item in rural areas is the recurrent costs of operating vehicles so that CSW staff can visit clients in outlying - particularly mountainous - areas. This is an essential function for many clients, who are unable to visit CSW due to either physical immobility or travel costs. The need for vehicles has been met to date largely through NGO donations, but operating costs are an issue, and some CSWs have already had donated vehicles stolen.

An additional issue about which there is mainly anecdotal information is the ongoing relation between the Serbian social protection system and the Kosovar Serb population. UNMIK reports that pensions have been paid since the second half of 1999 in Serb enclaves, although contributions to the Belgrade fund do not appear to have been made since the conflict. This has been done at the previous dinar rate, so that the real value of pensions is low, at around 20-30 DM equivalent per month.. It appears that none of the other payments under the Serbian system have been made, though social assistance payments within the UNMIK system have been initiated as elsewhere in Kosovo.

KEY POLICY ISSUES

The Extent to which Changes in the Inherited Structures are Necessary or Desirable

Most transition economies, including those in former Yugoslav republics, have confronted the need to reform inherited social protection systems. Given the likely economic situation of Kosovo in the medium to long term, it can be expected that the need for reforms in social protection will be substantial. The implications for different programs are discussed in turn below. It is stressed that the issues are in some cases medium term, in light of the delayed resumption of social insurance programs. However, broad directions need to be examined more immediately in development of a coherent Social Protection Strategy, work on which has been initiated under UNMIK with support from the World Bank and UK DFID. It will be necessary to include local experts and authorities as widely as possible in this process, in particular as new local administrations assume their responsibilities. Those same local experts see an overarching legal framework for social protection as a priority.

- The benefit structure of the *pensions system* is generous by Western standards, and that of many transition economies. It would be expected that any pension system that might be introduced in the medium term would require a range of reforms which would bring it more into line with reformed transition systems throughout the region. This would include increased normal retirement ages (typically by at least 5 years for both men and women), rationalizing early retirement entitlements in order to raise average retirement ages, and flattening - perhaps entirely in the interim - pension benefits. An additional issue would be examining what are sustainable replacement rates on benefits in the medium term. Local specialists also note the important labor

market role that a pension system could play in creating incentives for skilled workers to stay in Kosovo and in the formal sector;

- The inherited structure of *social help payments* has some unusual features by Western European standards, but the system has a track record of meeting need in a way which fits local customs and attitudes and which exercises tight control over costs. There is only limited expertise and experience in this area among the Kosovars now administering the system, and there are inevitable needs for updating of technical skills, and training in management skills that were not a feature of the previous system. Ongoing initiatives by bilaterals and NGOs (e.g., DFID, ADRA; CARE) aim to strengthen existing capacity, through improved systems and training. The social protection component of the recent Bank-financed social services project aims to build on these efforts;
- Much the same is true of *child allowances*. However, the feasibility of CAs in the future needs to be assessed in light of the overall social safety net, fiscal constraints, and administrative demands of multiple programs. A key strategic issue is whether any child allowance program should be focused only on those making contributions in the formal sector - as was the case previously - or made more broadly accessible, in both cases on a targeted basis; and
- The current structure and coverage of *unemployment benefit* are not sensible for a modern economy, and need to be considered afresh. This is a longer-term issue, however, as it is hard to see any sensible function for a contributory unemployment benefit in Kosovo over the next two to three years. The 2000 budget includes stipends for a limited number of Employment Service staff, though this is intended for active labor initiatives rather than restarting unemployment benefit payments. These efforts are supported by ILO and bilaterals. The draft 2001 budget also anticipates no unemployment benefit payments.

The Priority to be Given to Reintroducing Various Benefits

Sensible criteria for deciding the priority to be given the different programs in the immediate future include: operational feasibility; targeting resources on those in greatest need; and cost and affordability. For the longer term, these could be supplemented by financial sustainability; the need to take account of past obligations and expectations; maintaining a sensible structure of incentives and relativities between those in and out of work; and the advantages of some form of comparability of arrangements with neighboring countries and trade partners. Given the tendency for systems of cash payments to introduce perverse incentives or to distort the normal behavioral patterns of a society, it is also important that any desire for early action should be balanced by a degree of caution about longer-term consequences.

With respect to specific benefits, there is a range of considerations in prioritizing their reintroduction. As the social protection budget will be cash limited for the foreseeable

future, it will be critical to communicate to the population that gains for certain groups of beneficiaries can only be achieved at the expense of others⁶. They are as follows:

Pension Payments. There is strong pressure from various groups within Kosovo for an early resumption of pension payments, at least to those with entitlement in February 1999, and certainly resumption would go some way to help alleviate real need among potential beneficiaries. However, from a broader social protection perspective, there are powerful arguments in the circumstances immediately post-conflict for not according high priority to resumption of pensions. They include:

- The practical issues of resuming a PAYG system prior to re-introduction of a payroll tax or personal income tax are enormous;
- Payments would be badly targeted, reaching only a comparatively small proportion of those in the various vulnerable groups and without regard to immediate need. Targeting is not of course the primary objective of the pension system, but the consideration is relevant in such a constrained budgetary environment;
- The operational difficulties in identifying and locating beneficiaries can not be predicted with any confidence, and could be substantial, particularly among Serb beneficiaries;
- It would raise large equity issues with respect to ethnic Albanians who lost pension entitlements because they have been prevented from working in the formal sector during the 1990s. Working out a system which gives notional entitlements for the period of exclusion from work would probably be politically necessary, but is complicated by a range of factors, including proof of work history prior to 1989, unfunded obligations for the public pension system etc; and
- There is a complicated tangle of issues about the relative responsibilities of the Serbian and Kosovo Pension Funds – and a real possibility of disadvantaging numbers of people by too simplistic an approach to these questions.

Nonetheless, Kosovars are strongly committed to resumption of pension payments in the short term – including proposals from local experts on new financing sources - though it remains unclear to what extent this relates to all pensioners under the previous scheme, or mainly the elderly. UNMIK has been assessing options for addressing such concerns. However, the various constraints outlined above have resulted in preliminary discussions focused more on the concept of a financial supplement for the elderly, rather than payments which can be characterized as a pension *strictu sensu*.

Given the practical difficulties in verifying prior claims on the pension system, UNMIK is analyzing options for payments to the elderly of some form. These include: (i) paying pensions to those - or sub-sets of those - with existing entitlements, either in relation to their previous pensions or at a flat rate. This would be subject to most of the difficulties

⁶ The overall allocation in the draft 2001 budget for social protection (including veterans' payments) is DM 81 million, or around 19 percent of total expenditures.

outlined above, though a flat rate scheme would avoid some problems; (ii) paying some form of flat rate "citizens pension" to all those over a certain age, irrespective of prior contributions. If such an approach were taken, it would be administratively simple and avoid many of the issues outlined above. The major risk of this approach is fiscal, with such a model potentially very costly, given increased coverage.

Social Assistance. In the present circumstances of Kosovo and with the present state of public finances, it cannot be expected that cash payments to individuals will be the prime instrument for meeting need. That function is being fulfilled by humanitarian aid in kind, support from extended families within and outside Kosovo, informal economic activity, and wage payments from public sector and international organizations. In this context, there will remain an important role for the Mother Teresa network and the declining number of international agencies which will continue to function in Kosovo beyond the emergency phase. They will also participate in other services for CSW clients, though these direct services will continue to be a primary function of the public system. Nevertheless, a public social assistance scheme has been viewed as an important priority, both as a complement to humanitarian efforts, and as an indication of the continued role of the state in social protection.

The Emergency Financial Assistance Program categorically targeted those perceived to be in greatest need. The program was given high priority by UNMIK, which allocated DM 80 million for cash payments in the 2000 budget - or over 14 percent of total expenditures. The maximum monthly payment per family was DM100. The targeted social categories were: (i) the elderly over 70 years of age, who were entitled to DM 25 per month; (ii) single parent families; and (iii) families with a handicapped person. By the end of the scheme, over 80,000 payments had been made, at a total costs of DM 30 mln., of which DM 25 mln. came from the consolidated budget. Without a reliable poverty profile, it is difficult to know whether these groups are the worst off, but poverty data from neighboring countries suggests that these were reasonable choices. The most notable gap if one looks at poverty data from Albania and Macedonia is households with large numbers of children, who are significantly poorer than average in both countries. However, the fiscal burden of wide coverage among this group in Kosovo would be enormous.

The 1999 emergency program was always intended to be an interim one. As of May 2000, a new scheme has been introduced. This takes a two tier approach. The first beneficiary category is households where there is no adult capable of work, which includes those over 65 who are not expected to look for work. The second tier will include some unemployed families, though how narrowly defined within this potentially large group is still to be worked out. The maximum benefit is DM 120 a month. The UNMIK estimated budget for 2001 for the program is DM 73 mln., with an assumption of a cash limited scheme where second category payments are likely to be quite restricted. The total caseload assumption for social assistance in 2001 is 50-60,000 families. It is clear that there will remain significant needs for refining this system going forward, in particular with respect to targeting among the second category beneficiaries. This will need to be done with a close eye on fiscal sustainability. So long as social assistance is the only public transfer program and is cash limited, the issue is somewhat

less acute, but the design of the longer run scheme will need to be assessed in light of developments on pensions. If any form of additional elderly financial supplement is introduced, there would also be implications for elderly who are categorically covered under the current social assistance scheme, more so if some form of citizens' pension was the preferred model.

Child Allowances. Social assistance payments related to household size could lead to large entitlements for those with large families – possibly larger than the amount they might earn at the bottom of the wage scale. In principle, this may result in a problem of incentives to work. This issue was addressed in the former system by child allowances. However, in the foreseeable future, it is suggested that the level of social assistance payments which will be fiscally supportable is not such as to make work disincentive problems a major issue. This is increased by the inherited stigma attached to social assistance beneficiaries. While there may be a role for child allowances in the medium term in combating child poverty, for 2001, there is no separate CA in the budget. This seems appropriate given the absence of a robust poverty profile, and the need to take decisions on specific benefits within a coherent strategy for the whole social protection system. When an individual tax system is introduced, it will be important to weigh up the competing needs for the beneficial labor incentive impact of CAs against the need to keep taxes on labor affordable, and safety net programs administratively simple and fiscally sustainable.

Unemployment Benefits. Given the likelihood of high formal sector unemployment, the absence of individual taxes, and the existence of a basic social assistance benefit, it appears that unemployment benefit payments would not be a priority over even the medium term⁷. The experience of neighboring countries suggests that with ongoing high unemployment and limited scope for high labor taxes when introduced, there needs to be serious consideration of whether unemployment benefit is a feasible part of the future social protection system. There are of course efficiency arguments for such a program when the major issue is frictional unemployment, but it is suggested that the larger need is to stimulate growth and employment creation, and that the additional tax burden (previously up to 1.75 percent of payroll) of unemployment insurance would be difficult to justify in the circumstances.

Veterans benefits. Since the end of the Kosovo conflict, there has been considerable pressure for a veterans' cash benefit scheme of some form, including survivor payments for those who lost their breadwinner. UNMIK have included such a scheme within the 2001 budget, on the understanding that it will be restricted in coverage, and is financed within the overall social protection ceiling, rather than being incremental. Like the social assistance program, it would therefore be cash limited. The estimated allocation for 2001 is DM 6 mln., which suggests that eligibility and benefit levels will need to be tightly controlled. The experience of neighboring countries such as Bosnia-Herzegovina and

⁷ UNMIK.ILO estimated unemployment as of the last quarter of 2000 at around 60 percent.

Croatia provides abundant evidence of the potential for such schemes to overwhelm social spending, and be subject to major abuses in beneficiary categorization⁸

Poverty and Living Standards Data

Over time, it would be desirable to develop a more robust profile of poverty. In order to do this, there is a strong need for reliable household level data on consumption and income, and the proportion and characteristics of households falling below various poverty thresholds. To this end, there have been estimates by NGOs and donors of a minimum consumption basket, and FAO, amongst others, has taken a lead in this area. UNMIK have also established a Working Group to review and develop poverty alleviation strategies, including household surveys and work on a poverty line⁹. The World Bank is planning a Poverty Assessment for Kosovo which should contribute to this process.¹⁰

Generating representative and comprehensive household survey data is a priority. There have been several initiatives already, including surveys by UNFPA, IMG and KFOR. These have provided useful insights into living standards, though understandably have typically had a food security focus required for design and monitoring of humanitarian programs. To date, the most commonly used sampling frame has been the 1991 census of Kosovo. This has two major shortcomings. First, it does not reflect migration during the 1990s, and subsequent major movements of people since 1999. Second, for the ethnic Albanian population, it is based on an extrapolation of 1981 census results, due to widespread non-participation in the 1991 census.

Nonetheless, an expert assessment in April 2000 found that the basis for a representative sample of rural households existed already, and an equivalent base for urban households was constructed based on the election registration process undertaken by OSCE. This has allowed a statistically representative sampling frame to be developed. An LSMS-type survey has been designed in close consultation with a wide range of stakeholders. Pilot testing has been completed, and field work was started in early fall of 2000. The results from such a survey - which could be expected in the first half of 2001 - would provide the most comprehensive and rigorously representative overview of living standards in Kosovo to date. However, given the lead time on such an exercise, the ongoing efforts of donors and NGOs to field more focused surveys are vital.

Fiscal Devolution

There is no case for devolution of the financing or management of social insurance systems whenever they are reintroduced, which should be organized on a Kosovo-wide

⁸ A good outline of problems in BiH is in Gregson, Veterans' Programs in BiH (mimeo, World Bank, 2000).

⁹ Any work on a poverty line needs to be done with caution, as it is not feasible in the foreseeable future that social assistance benefits will be affordable which could have a major effect on lifting households out of poverty.

¹⁰ This would build on a Social Assessment carried out during 2000 using qualitative methods.

basis in the interests of creating the largest possible risk pool. The arguments are different in the case of social assistance schemes. As a longer-term system is developed, some discretion in the administration of such schemes would be desirable to avoid too rigid and broad brush an approach to different household circumstances. While there is a risk is that discretion will be exercised in ways that increase overall costs, this can be minimized by imposing local budgetary limits or by including a local element in the financing of the scheme. The role of NGOs as a tool for promoting local level accountability should also not be under-estimated. However, the lessons of neighboring countries such as Bosnia and Herzegovina need to be taken on board. In that case, complete devolution of financing and administration of social assistance has resulted in a system with high regional variations, with the poorest areas least able to provide basic benefits. Current framework regulations in Kosovo on municipal authority roles make provision for local authorities to have some responsibilities in social welfare, but the details have been left to be spelt out in regulations which will be developed after the October 2000 municipal elections. It is critical that delineation of the central and local roles take close account of the revenue base at different levels.

Kosovar Serb Issues

As noted above, the situation with Kosovar Serb population is not known in detail. While clearly local Serbs should be entitled to social assistance payments and participation in other transfer programs when they are restarted, there are a range of practical issues for the medium term about how to promote inclusion of Kosovar Serbs in the system, most particularly in areas where the local CSW is in an ethnic Albanian area. The same applies in reverse for ethnic Albanians in areas where the CSW for the municipality is located within a Serbian enclave. UNMIK have managed to address these issues to date in clearly defined enclaves. The more challenging task is where there is a dispersed minority population, and this will need to be handled in collaboration with local authorities. Again experience from Bosnia and Herzegovina is important, as the emergence of parallel delivery channels (e.g., ethnically based CSW in so-called "split cantons" in FBiH) has been a source of inefficiency and fragmentation in the social protection system. Whatever interim arrangements are made to ensure delivery of benefits to both ethnic groups must explicitly be made temporary, with a more sustainable mechanism developed as part of the overall SP Strategy.

Defining the Public-Private Mix in Social Services

While humanitarian aid and NGO involvement can be expected to reduce in the coming period, there is likely to remain a significant NGO presence relative to other ECA countries for the medium term in Kosovo. On the other hand, the capacity of CSW and the public system will take considerable time to strengthen. These factors, together with the continuing role of the Mother Teresa Society, suggests that developing a coherent policy on public-private complementarities in social welfare delivery will be unusually important. There are possibilities for contracting-out and direct provision of services that are being piloted in other countries that may have important lessons for Kosovo. NGOs

can also play an important role in ensuring accountability at the local level as municipalities take a stronger role in the operations of CSW.

Labor Market Framework

Generation of productive employment opportunities will continue to be the major pillar of household welfare. In recognition of the importance of these issues, UNMIK have drafted a core Labor Law for Kosovo, which various stakeholders have been able to review. The draft focuses on incorporation of core ILO labor standards in Kosovo, including such key areas as non-discrimination, prohibitions on child labor etc. Given the need for rapid development of a labor relations framework, many other areas which would typically be found in other laws or regulations are also covered, including collective bargaining, collective dispute settlement, minimum wage fixing, health and safety regulations, labor inspectors and unemployment agencies.

The draft as it stands represents a significant improvement on Yugoslav labor legislation, while retaining some of the key protections of that legislation. Nonetheless, there remain several concerns on the draft which will be important to address if the new law is to facilitate job generation more effectively. It is hoped that some of these concerns – which from consultations with various stakeholders seem to be shared by local businesses, local and international NGOs, and donors – can be addressed in the approved version of the law¹¹. Overall, promotion of small scale private sector participation in the formal economy should be a key goal of any labor legislation, and there are concerns that the current draft will either create new barriers to entry into the formal sector, or be so widely ignored as to undermine respect for labor legislation. The key areas of concern with the draft law are:

- *Hiring and firing provisions.* There are a number of examples where the current draft is unnecessarily restrictive. These include restrictions on circumstances in which fixed term contracts can be concluded (a point of unusual importance given the prevalence and uncertain time horizons of NGOs and donors); and restrictions on the circumstances in which lay-offs for economic, technological or structural reasons can take place;
- *Unreasonable reporting obligations on the employer.* Particularly with respect to recruitment and dismissals;
- *Wide room for unclarity, labor disputes and burdening of an inefficient court system.* There are a number of key areas where the guidance given by the draft is inadequate for the practical issues confronting employers and employees. These include provisions on collective bargaining, severance pay, collective dispute settlement, powers of labor inspectors, and health and safety in the workplace. While such issues are often addressed in implementing regulations, the likely timeframe for development of these in Kosovo suggests that the core law may need greater precision; and

¹¹ A Working Group of NGOs and donors has been formed to review and provide feedback to UNMIK/ILO on the draft law.

- *The minimum wage provision.* Given the economic uncertainties, unclear situation on relativities to social transfers, and underdeveloped wage bargaining institutional framework, this provision is probably, at present, best left out altogether.

SUMMARY OF RECOMMENDED SHORT-TERM ACTIONS (TO MID-2001)

- The existing social assistance system should continue as the priority cash transfer program, with joint work by UNMIK, the Institute for Social Policy, CSWs, and the World Bank/DFID-financed expert team on developing a fiscally sustainable and administratively feasible longer-term social assistance program, particularly with respect to targeting among current second tier beneficiaries;
- Work on a medium-term Social Protection Strategy should be completed as a priority, in order to help develop a coherent and sustainable structure of cash benefits and other services. This would include policy directions for reform of any inherited benefits that are likely to be restarted in the medium term, take close consideration of tax reform developments, and provide a framework for innovative public-private mixes in social welfare provision;
- Following local elections, consultation between UNMIK, local authorities, CSWs and the WB/DFID expert team would need to be initiated to consider the appropriate roles and responsibilities of different levels of government in social protection;
- Resumption of pension payments on a social insurance model should not be an early priority.
- Consistent with emerging recommendations of the Social Protection Strategy work, UNMIK should continue to assess possibilities for introduction of an elderly financial supplement, subject to resources being clearly identified;
- There is no case for reintroduction of a contributory unemployment benefit in the short to medium term;
- The reintroduction of child allowances is not an urgent priority;
- The new veterans' scheme should remain strictly cash limited, and eligibility criteria and administrative channels developed soonest. Payments should focus on those veterans most severely disabled and survivor families, with controls on the categorization process in order to minimize the risks of abuse seen in neighboring countries;
- The LSMS should be completed and analyzed. Data and main findings should be shared as widely as possible with key stakeholders in social protection, in particular for further improvements in social assistance; and

- UNMIK should consider further revisions to the draft Labor Law (see above) which place a stronger emphasis on labor market flexibility and facilitating formalization of the gray economy.

SUMMARY OF RECOMMENDED MEDIUM-TERM ACTIONS

- Based on the key recommendations of the Social Protection Strategy, work should begin on Social Protection Law which would act as a framework law for the sector;
- There should be a detailed study of the possible path to financial sustainability of the Pensions Fund over the longer term, including issues of dealing with claims of ethnic Albanians related to the 1990s. This should include a full examination of different options for the structure of the scheme, including the possibility of a phased increase in retirement age and benefit rules more in line with Western European practice;
- As it becomes possible to replace the payment of cash stipends by a proper wage and salary structure, every effort should be made to move away from the traditional approach in which salaries are denominated in terms of take-home pay and contributions are added in on top. Payments of contributory pensions should not resume without a change of this sort, even if the consequent contribution income is insufficient to match the cost of payments; and
- Further work is needed on developing approaches for ensuring that Kosovar Serb populations continue to have access to the social protection system, including assessing the implications for the CSW network.

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