

THE ECONOMIC POLICY TRENDS IN KOSOVO, CHALLENGES AND GROWTH

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Abstract

In the context of *slow economic growth in recent years and fiscal pressures*, Kosovo is faced with the complex challenge of unemployment, which still remains at a high level. The demand for labor is still very low and establishment of a favorable environment that would create sustainable jobs will be a challenging task that requires reforms in the economic policy. Hence, this paper addresses one of the deepest challenges of Kosovo that is domestic economic capacity to generate economic growth. By analyzing the economic factors affecting economic development, this paper identifies barriers and though discusses real opportunities for a better economic growth pattern to finally highlight the recommendations.

Keywords: labor market, economic growth, economic challenges, sustainable development.

JEL classification: M1, Q01, Q5

Introduction

Kosovo's economy has not remained unaffected by the crisis which is being faced by developed economies, especially those of the euro area. According to Central Bank of Kosovo, the Real GDP growth in 2012 reached 3.8 percent, while the main source of growth was the growth of public sector capital investments. However, the economic growth rate in Kosovo is expected to be lower compared to the previous years. The risks coming from the Eurozone crisis are being reflected mainly through the negative impact on the external demand for Kosovo's products (even though the level of exports is already low), the slight negative impact on remittances, and through a more pronounced impact on the foreign direct investments. This is not a model for sustainable growth and, moreover, it is not sufficient to create jobs for the roughly 45% unemployed and the 30,000 new entrants to the labor market each year. Lack of reliable energy, lack of an enabling business environment, poor infrastructure, and an unskilled workforce are among the major constraints facing Kosovo's economy. Kosovo has a highly import-dependent economy, with exports comprising less than 10% of GDP in 2012 – the lowest proportion of exports to GDP in any transition economy in Europe.

Kosovo's productivity in the agriculture sector has declined to the point where the country is not able to feed itself. Despite its history as an agricultural producer, Kosovo currently runs a trade deficit of over €144.6 million in agricultural products. A significant amount of arable land (34%) is in meadows and pastures or lies fallow. One-third of farmers do not cultivate all of their land. With an unemployment rate in rural areas running higher than the national average, the development of agriculture is a key priority for poverty reduction and economic growth.

Kosovo's economy continues to face structural problems, with the high level of imports relative to exports leading to a significantly negative trade balance. The high level of trade deficit continues to be the main contributing factor to the high level of current account deficit, which is partly mitigated by the current transfers. However, in the first half of 2012, remittances declined slightly compared to the previous year. A more significant drop was noticed in the Foreign Direct Investments (FDI), which fell down by 53.3 %, adversely affecting the financial account balance. Unlike

in 2011, the prices during the first half of 2012 grew more slowly. Inflation rate was 1.5 percent compared to 9.6 percent in the previous year.¹

Foreign investments are considered to have played a very important role in rebuilding the economies of the countries in transition from centrally planned economies to market economies. Of long was recognized that FDI brings benefits for these countries, FDIs are important because they include bringing new technologies and knowledge to domestic firms, increased competition, and further increasing access for exports abroad. The distribution of FDI among developing countries is irregular: some of them have more difficulties to attract foreign investment than others.²

General information of economy trends

It has not been easy to assess the role played by the SMEs in Kosovo's postwar development. Development of entrepreneurship hasn't been a dynamic process in Kosovo influenced considerably by changes in domestic business environment as well as the external influence, which is typical for a small country with open economy. Development of entrepreneurship through SMEs development formation has supported at a certain level economic development in Kosovo, the growth in employment and decrease in unemployment. SMEs contribute in GDP and serve as promoters of development. In Kosovo, micro, small and medium enterprises have had an impact on GDP growth, which are presented below.

¹ Financial Stability Report, December 2012

² Ghiassi, Spera, 2003, p.17

Contribution of enterprises in GDP

Size enterprise	Number of enterprises	Currency (€)	GDP(%)
Micro	14,968	656,885,164.33	16.79
Small	1,210	667,585,914.82	17.07
Medium	185	369,455,655.16	9.44
Large	58	528,558,359.84	13.51
Total	16,421	2,222,485,094.15	56.81

Source : Annual report of SME, 2011

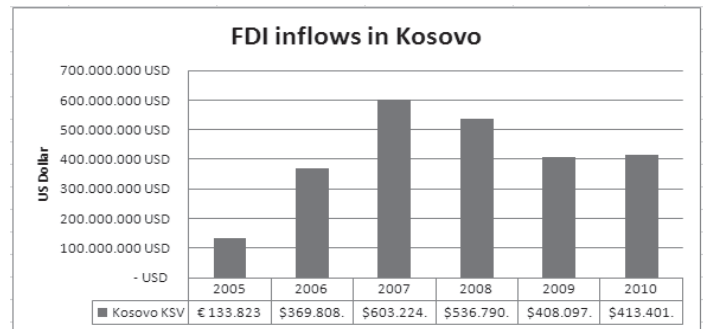
Presently, Kosovo's GDP stands at approximately 4.7 billion EUR. The per capita income is slightly more than 2,000 EUR (IMF 2011); half of that of Bosnia and Herzegovina, about a third of that of FYR of Macedonia and Albania and about a quarter of that of Serbia. The impact on the Kosovo economy of the global financial and economic crises of the late 2000s and early 2010s was relatively low, reflecting the limited level of integration into the larger regional, European and international economy. Nevertheless, Kosovo needs to significantly accelerate its growth if it is to reach regional income levels. According to World Bank estimates in 2010, Kosovo's economy would need to grow at 10percent annually for a decade to reach Albania's income level (assuming Albania's economy continues to grow by 5.5 percent annually during this period).¹

INVESTMENTS IN KOSOVO

There are several factors that affect the promotion of investments in Kosovo, however, the following are considered more important:²

- ❖ Natural and human resources
- ❖ Flexible working market and competitive working force
- ❖ Stimulating business environment
- ❖ Stable banking system
- ❖ New customs code – customs alleviations
- ❖ Low tax regime

Foreign Direct Investment flow to Kosovo has been declining from year to year given unfavorable business climate around the globe. Today, Kosovo is facing fierce regional competition in attracting more FDI. According to the World Bank statistics, there has been a 30% decrease in FDI flows from 2007 to 2011 in Kosovo, or from \$ 603,224,093 to \$ 413,401,759. This trend continued throughout last year, although the official statistics have not been published yet.³



Source: World Bank, 2012

The amount of FDI flows in Kosovo still remains one of the lowest in the region. Experience from transition economies shows that FDI is directly linked to the increase of exports and was the main contributor in the generation of new jobs, improvement of the overall economic and political stability. In order for FDI flows to increase, the investors need to gain the confidence that they can operate in an environment that is free of any undue political interference. The recent criticism of certain political figures from the local and central levels directed against a number of companies regarding compliance with environmental laws will have a negative impact not only on the protection of the environment. This is due to the fact that criticism in the form of political rhetoric that is not substantiated by facts neither improves the protection of the environment, nor helps Kosovo build an image of a country which is governed by the rule of law.

According to the Business Registry data there are over 2,000 companies of foreign and mixed ownership that have already used the opportunity to invest in Kosovo. The large amount of foreign companies operating in Kosovo is a living proof of the opportunities and benefits that the country offers, and also represents a base of quality products and a sufficient service-providing community.

POTENTIAL OF DIASPORA THROUGH REMITTANCES

The estimated figures show that migrants from Kosovo represent 20 to 25 % of total population. This suggests that around half a million Kosovars live abroad. With a relatively large share of migration which is mostly concentrated in developed countries.⁴ Kosovar emigrants appear to have a substantial earning power. Estimates indicate that the yearly earnings of Kosovar emigrants are over euro 4 billion. Based on estimates from several surveys (UNDP,

¹ UNDP Human Development Report, 2012

² Economic Initiative for Kosova: Top 10 reasons to invest in Kosova, 2011

³ American Chamber of Commerce, 2012

⁴ Around 90 % in European Union countries according to UNDP, 2010

2011 and Nexus, 2010), it may be suggested that savings and remittances comprise around 28% and 12% of total emigrant earnings, respectively.⁵

Consequently, the potential of the Kosovar emigrants to invest in their home countries is substantial. However, the investments of the emigrants in home country are dependent on the relationship that the emigrants have with their families and relatives. Other social and economic factors play a role, however, most importantly, it is expected that the overall economic environment in the country is also equally important factor. With savings and remittances level at nearly 2 billion € per year, migrants are the main source for economic development in Kosovo. Moreover, with the FDI level of around 7-8 % of the GDP, around 30% is capital of emigrants from Kosovo who jointly invested with foreign companies.⁶

Based on a survey of UNDP, the distribution of remittances according to regions varies significantly. The share of remittance recipient households in Peja region is the highest (37%) compared to other regions, which exhibit a more balanced distribution of remittances.⁷ The government of Republic of Kosovo in cooperation with the “Eciks” initiative, based in Vienna and the Society “Südosteuropa Gesellschaft”, organized in March 2012 in Berlin the Conference “Investing in Kosovo”. This economic forum was assessed as a good opportunity to identify potential German speaking investors and promote investment possibilities and the expansion of opportunities for economic cooperation between Kosovo and Germany.⁸

BALANCE OF PAYMENT

Integration of the economy in terms of trade and investment integration is essential to staying competitive in the EU market, which Kosovo aspires to join. In the last decade, Kosovo's economy has been more liberal on imports, but it failed to export products and services and to attract foreign direct investments. Foreign trade statistics consistently show high trade deficit, exports of products and services are estimated to be 8.2% of imports during the last ten years.⁹

Year	Exports	Imports	Balance of payment	Export / Import
2001	10,559	684,5	-673,941	1.5%
2002	27,599	854,758	-827,159	3.2%
2003	35,621	973,265	-937,644	3.7%
2004	56,567	1,063,347	-1,006,780	5.3%
2005	56,283	1,157,492	-1,101,209	4.9%
2006	110,774	1,305,879	-1,195,105	8.5%
2007	165,112	1,576,136	-1,411,024	10.5%
2008	198,463	1,928,236	-1,729,773	10.3%
2009	165,328	1,935,541	-1,770,213	8.5%
2010	234,031	2,139,534	-1,845,503	13.7%
2011	313,106	2,479,611	-2,166,505	12.6%
2012	269,000*	2,489,000*	-2,220,000*	10.8%*

Source: Statistical Agency of Kosovo (2013)

*Uncompleted data; (f) Forecast; Source: CBK, KAS and IMF (2013)

Data of Foreign Trade in Kosovo show a trade deficit for month of January 2012 of €112.7 million compared with deficit of € 109.8 million in January 2011.

Exports in January 2012 were worth € 18.7 million, while imports were € 131.5 million, and this is decrease of for exports (17.9%), and by 0.9% for imports compared to January of 2011.¹⁰

UNEMPLOYMENT

Poverty and economic exclusion are prevalent throughout Kosovo, despite significant investment in infrastructure and enterprise by international partners – and despite the rising GDP. Poverty rates are controversial; estimates range between 34 and 48 percent for absolute poverty and from 12 to 18 percent for extreme poverty – those people unable to meet their critical survival needs.¹¹

⁵ Calculation is based on UNDP, 2010, Nexus, 2009 and Riinvest, 2007

⁶ Ministry of Trade and Industry, 2010

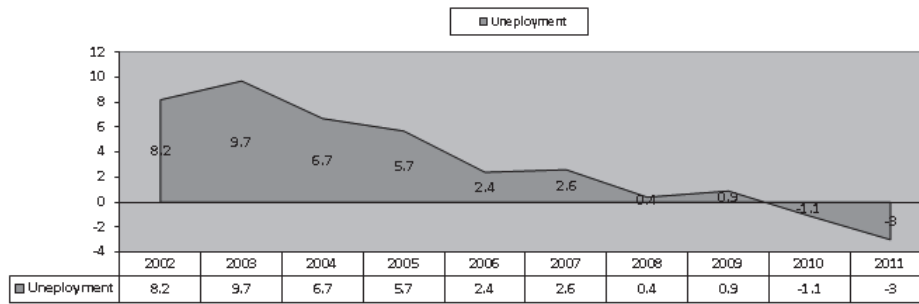
⁷ UNDP, Kosovo Remittance Survey, 2011

⁸ Conference investing in Kosovo, held in Berlin, 2012

⁹ Foreign Trade Statistics, Statistical Agency of Kosovo, 2012

¹⁰ Statistical Agency of Kosovo, 2012

¹¹ UNDP, Human Development Report, 2012.



According to Labour Force Surveys (LFS) conducted by the Kosovo Agency of Statistics (KAS) and the Annual Reports on Labour and Employment produced by the Ministry of Labour and Social Welfare (MLSW). The data suggest that Kosovo's unemployment rate for men and women in the recent years has fluctuated around an alarming 40-50 percent. This is many times higher than any conceivable figure in a developed economy, but also substantially higher than those in the transition economies of south-east Europe (SEE).

Despite the conditions of the labour market, Kosovo's population is growing fast, with an estimated 25-35 thousand young people entering the labour market each year.¹ If Kosovo wishes to increase participation, access and equity in the labour force and marketplace then the pressures on its existing market will only grow. With an already large and inefficient public sector, new entries in the labour market will have to be absorbed by the private sector. The private sector is thereby at the centre of the effort to stimulate growth-ready sources of decent work that promote both sustainable livelihoods and dignity.

CAPITAL MARKET

The Treasury bond market of the Government of Kosovo, which commenced in January 2012, represents the single component within the capital market in Kosovo. During Q4 2012, 3 auctions were held, which had offers of euro 10 million with a maturity of 91 days (Figure 16). Out of these amounts, 10 percent of the total bids were not competitive, while the rest were competitive bids. The bids of the primary stakeholders in each round exceeded the amount offered by the treasury by an average of 2.1 times. The interest rate in the auctions was continuously characterized by a steady decline, reaching at 1.08 % in December, thus marking the lowest level during the whole year. Overcoming of the Treasury offer from the primary stakeholders by 2.1 times on one hand, and the continuous decline of the interest rate at every auction on the other, may be considered as an important reflection on the situation of the financial, fiscal and real sector of the economy.

Barriers and challenges to growth

In June 2011, research institute Riinvest with a mission to promote modern economic development in Kosovo based on a philosophy of entrepreneurship conducted a survey of

600 respondents to obtain a general picture of critical barriers to private sector development. Among these, a number of serious problems, which have been inadequately addressed, as of today continue to constrain growth and job creation. In terms of business environment, the World Bank (2011) ranks Kosovo as 119th out of 183 countries, a level that is unfavourable and represents an impediment for local businesses and discourages foreign investors. Low levels of job creation and lack of opportunities widen the income gap between the rich and the poor, and unemployment levels are high, especially among the youth, compared to the levels in the region. Though broadly stable, reported unemployment in Kosovo remains at an exceptionally high level (according to Labour Force Survey (LFS) 2009 an estimated 45.4 % in 2009, down marginally from 45 % in 2006, with youth unemployment at 73%).

While actual employment is likely to be higher than official records (due to Kosovo's large informal economy), these figures are still alarmingly high. In general, a major concern for the economy of Kosovo remains reliance on unsustainable sources of growth.

Besides, foreign development aid, importation of goods to sell to a large and wealthy expatriate aid community, the major concern of Kosovo's economy continues to be reliance on unsustainable sources of growth, remittances from abroad and governance expenditure. Black market enterprise also plays a role in generating income in Kosovo – although there is little data on its proportionate impact. There has been, to date, over-emphasis on exploiting natural resources (such as mineral reserves) and international trade opportunities, and insufficient emphasis on developing human capital and human capacities to build a balanced, socially-integrated private sector.

INFRASTRUCTURAL BARRIERS / POWER SUPPLY

Over the last decade, electricity has always been perceived and ranked amongst the top barriers, and even today it remains strongly near the top. Increased costs of production and manufacturing due to frequent interruptions in the electricity supply are still causing competitive constraints to firms across Kosovo. This driver has resulted in many such firms choosing to invest in alternative sources of electricity supply, with the majority investing in large costly electricity generators. Today, despite new reforms in the energy sector, the electricity supply in Kosovo remains generally insecure. Kosovo is primarily reliant on two power plants, both of which are old, and one of which is 50 years old and on the verge of collapse.

¹ Evaluation of Active Labour Market Programme for Youth in Kosovo, June 2008.

Together, both plants fail to supply half of the electricity needs of Kosovo during the winter and cold periods, leaving Kosovo reliant on importing electricity during these periods. This solution is both costly and, with a lack of funds, often therefore unattainable. In 2012, due to lack of budgetary subventions for energy supply (driven by financial constraints and high budgetary deficits at the level of the Kosovo Government), an increase in electricity costs in the region of 25 percent is expected. This, in turn, will affect operational costs for businesses across Kosovo and across sectors. While new power plants (with approximate capacities of 600 MW) are being planned, no other solution, apart from importing electricity, is provided.²

BUSINESS ENVIRONMENT

Unfair, unsafe and unpredictable business environments undermine trust in the body politic and in the equity of governance. In a climate where special interests are seen to dominate, people are forced back on traditional allegiances to family, clan or ethnicity – rather than urged towards inter-cooperation. Unequal business practices and enforcement are perceived – often rightly – as an effort to redistribute public revenues towards preferred members of society. In Kosovo's case, this frequently comes down to issues of unsystematic and weak enforcement rather than unfair laws per se.³

The business environment in Kosovo continues to demonstrate a lack of progress. The private sector in Kosovo continues to suffer from the lack of rule of law, poor infrastructure and limited access to finance. Only 3% of Kosovo businesses have addressed the courts in the last year.⁴ This fact indicates the presence of a difficult judicial environment and a lack of trust in the system by businesses. Irregular power supply continues to obstruct local producers from carrying on with a steady process of production. Infrastructure and public services continue to be inferior given the needs of the Kosovo businesses.

REGULATORY BARRIERS / TAXES

Based on the survey conducted by Riinvest in 2011, the primary criticism of taxation in Kosovo is oriented towards an inefficient tax administration, with special reference to Value Added Tax (VAT). As is the case with many transition economies, taxes are often unduly high because of inefficiencies in service delivery, poor tax collection capacity and a narrow tax base due to the existence of a large informal sector. Interviews with business associations exposed several needs for reducing the tax burden from VAT collection, particularly the VAT rates in specific industries (most notably agriculture). Business associations have also complained about arbitrary interpretation of obscure tax regulations, selective enforcement and associated extortion by the tax administration. These practices were increasingly highlighted in recent years as the Government has felt pressure to fulfil income forecasts due to heavy involvement in capital investments. As such,

an inefficient tax administration - a characteristic of poor governance - contributes to both costs and risks faced by firms and may also affect investment decisions. According to business associations, tax administration is a synonym for bureaucratic harassment through disruptive and costly tax inspections.

Policy implications / recommendations

Kosovo's economy is growing in pockets. Favoured parts of society, with the right connections, are more likely to thrive, in a largely informal climate where rules and regulations are not systematically enforced. Inclusive growth, however, is not happening. Inclusive growth means, in essence, a pattern of growth that opens opportunities to the poor and the marginalized, that opens the door of mainstream markets to women, the young and ethnic minorities, that allows companies to compete openly based on performance and merit, and that – in short – increases dignity, social cohesion, income and life-enhancing choices across the entire reach of society.

The reason for the lack of inclusive growth in Kosovo is captured in the primary barriers facing private sector development: unfair business practice married with poor enforcement. However, these barriers present opportunity as well as constraint. Kosovo has the potential to translate its uneven enterprise culture into a pattern of growth with wide ranging rather than narrow benefits. Kosovo has the potential to translate its uneven enterprise culture into a pattern of growth with wide ranging rather than narrow benefits. If this potential is to be realized, some profound changes will be required, and below are included a number of important policy recommendations to work towards the realisation of this potential:

INADEQUATE GROWTH MODEL

Kosovo continues to have low economic development and as a result the population of this country remains one of the poorest in Europe. World Bank finds that the economic growth of the past years was focused on external sources, or from donors and remittances - both these sources, which have shown that they are not able to bring a sustainable economic growth in the future. Sustainable growth must be based on the assets and resources of the country, which are natural resources and labor. According to the World Bank, the higher investments are made by the public sector and that of real estate, which do not support long term growth. Therefore, it is highly recommended that Kosovo change its model for economic growth and instead use a pattern that would be based primarily in the exploitation of natural resources, young labor force, as well as better utilization of agricultural land.

THE RELATIONSHIP BETWEEN THE PUBLIC AND PRIVATE SECTORS

Most of the critical barriers identified by business owners had to do with the interplay between enterprise culture and governance – issues of fairness, equity, transparency and accountability. The barriers identified as the most critical are far less related to the macro-economic issues of trade barriers, visa issues and foreign direct investment that tend

² UNDP, Kosovo Human Development Report, Private sector and employment, 2012

³ Progress Report for Kosovo, 2011

⁴ World Bank 2011

to dominate dialogue over Kosovo's private sector regeneration. Kosovo's decision makers need to focus inward, to explore the dynamics that make businesses distrustful of each other and of administrative fairness from regulatory authorities. A more open, fluent dialogue on issues is required, across all sectors of the economy, including with businesses currently outside the formal economy. Translation of Kosovo's informal economy into the mainstream marketplace would do a great deal to foster equity, improve options for decent work and spur the expansion of growth ready sectors.

GOVERNANCE ACCOUNTABILITY ACROSS THE PUBLIC AND PRIVATE SECTORS

Barriers to inclusive growth are linked very strongly to Kosovo's broader human development barriers – lack of accountability, weak social protections and a sense of being “unsheltered” by authorities. These factors act to throw business owners and workers back on their own resources, tighten their reliance on ethnic loyalties and lead to unwillingness to cooperate for the public good. Over the coming years, Kosovo needs a concerted focus on the accountable implementation of its policies in both the public and private spheres. Accountability in the private sector sense includes timeliness; business is fast moving, and slow implementation of, for example, contract dispute resolution through the courts, is no better (if not worse) than no implementation at all - costing the public purse without providing any viable growth benefit. Accountability strengthens the relationship between individuals and governance, and builds public trust. Accountability also implies consultation and visibility, including at the local level, where business owners could benefit from a closer and more systematic relationship with municipal authorities during development planning cycles. This is particularly true for under-developed sectors that remain highly informal – such as agriculture.

PROMOTION OF BELIEF FOR SOCIAL BENEFITS

Lack of social cohesion in Kosovo is reflected in its business relationships, where individuals do not feel comfortable waiving immediate private advantage for longer-term social benefits. Where their peers in other countries wish to contest such strategies as tax evasion or corruption, business owners in Kosovo feel insufficiently supported to do so. There needs to be a far more rigorous system supporting a public-spirited approach to business,

educating owners on the value of their contribution to public revenues, particularly focussed on demonstrating the value these public revenues create in the local communities where the vast majority of Kosovo's SMEs source their revenue streams.

THE SPIRIT OF ENTREPRENEURSHIP

The priorities and perceptions of business owners may differ from those they employ. However, employees are rarely able to find fora to express their views and concerns. Their potential is also undervalued in the marketplace, where there is very limited demand for higher skills, knowledge and capabilities, despite the fact that the linkage between a more educated workforce and higher levels of fairness and compliance is well documented. Both business owners and workers need more information on the opportunities available to them and their responsibilities to each other. Given the high level of individual business ownership and the large numbers of unemployed youth in Kosovo, education on the social context of entrepreneurship should start in schools.

Conclusion

Based on what was argued and analysed above, it could be concluded that private growth is interconnected in a complex manner with social context of Kosovo. Macroeconomic stability is threatened more and more by economic and fiscal policies. Instead, it must be built by a broader base environment than it is currently, that would free up the true potential of the Kosovo market. Undertaking this challenge is not only the responsibility of the government, or private businesses. This is a high priority linked to those in power, those in the market and those who are currently excluded from it. Dialogue and transparency appears as a central instrument to solve some major issues of growth. In 2012, Kosovo has achieved a real GDP growth in a rate of around 4%, however, such economic growth trend is considered to be insufficient to ensure a sustainable economic development. Hence, the message of the paper is that the growth model presented in this paper should be highly recommended to be reviewed by policy makers in forthcoming years. Government institutions should take steps to reform the business environment in the country, so that the next report of the World Bank not find Kosovo in the same or regression punch, as has happened in the last couple of years.

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