KOSOVO

Institutions and Policies for Reconstruction and Growth

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The following symbols have been used throughout this paper:

. . . to indicate that data are not available;

— to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;

– between years or months (for example, 2000–01 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years (for example, 2000/01) to indicate a crop or fiscal (financial) year.

"Billion" means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

The term "country," as used in this paper, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

Preface

The authors are grateful for helpful comments and suggestions from a large number of IMF and World Bank colleagues, in particular Adrienne Cheasty, Robert Corker, Carlo Cottarelli, Shigeo Kashiwagi, Marina Wes, and Emmanuel Zervoudakis. The authors are also grateful to Gail Berre of the External Relations Department who edited the paper for publication and coordinated production. This report is primarily based on the work of an IMF team that visited Kosovo in September 2001, consisting of Dimitri G. Demekas, Johannes Herderschee, and Davina Jacobs, and assisted by the World Bank representative in Pristina, Giuseppe Zampaglione. The IMF team held a wide range of meetings, including with Mr. Hans Haekkerup, the Special Representantive of the UN Secretary-General at that time; senior officials of UNMIK; representatives of commercial banks, insurance companies, private enterprises, and the major donors; and the leaders of the major political parties and ethnic communities in Kosovo. The authors would like to thank without implicating these individuals for their time and cooperation.

The views expressed in this study are those of the authors and do not necessarily reflect those of the IMF or its Executive Directors.

Acronyms

BPK	Banking and Payments Authority of Kosovo
CFA	Central Fiscal Authority
KEK	Kosovo Electricity Company
KFOR	Kosovo Force
KTA	Kosovo Trust Agency
OSCE	Organization for Security and Cooperation in Europe
PISG	Provisional institutions of self-government
PTK	Posts and Telecommunications of Kosovo
UNSCR	UN Security Council Resolution
UNMIK	United Nations Interim Administration Mission in Kosovo

1

Overview

Kosovo is a province of Serbia in the Federal Republic of Yugoslavia. Following the end of the Kosovo war of March–June 1999, United Nations Security Council Resolution 1244 (UNSCR 1244) of June 10, 1999 placed Kosovo under temporary UN administration. While reaffirming the sovereignty of the Federal Republic of Yugoslavia over the territory of Kosovo, UNSCR 1244 authorized the UN Secretary-General to establish an interim administration that would provide "substantial autonomy and self-government" to the people of Kosovo.

Since Kosovo was placed under temporary UN administration, it has developed the instruments and institutions necessary to formulate and implement an independent economic policy. Kosovo's economy remains linked to the rest of the Federal Republic of Yugoslavia through trade, but the United Nations Interim Administration Mission in Kosovo (UNMIK) has severed virtually all links with the Federal Republic of Yugoslavia in the area of economic policy. Although a final political settlement for the province is still pending, its economic policy today is effectively independent. In the two-and-a-half years since the end of the conflict, Kosovo has been a laboratory of economic institution building from the ground up.

At the request of UNMIK, and together with the rest of the international community, the IMF has been assisting institution building and economic policy implementation in Kosovo.[1] The IMF Fiscal Affairs Department has focused on setting up the tax system, budgetary institutions, and the treasury. The IMF Monetary and Exchange Affairs Department has helped establish the Banking and Payments Authority of Kosovo, which has central banking and financial supervision functions; has appointed its first managing directors; and is working toward introducing a modern payments system. The IMF Statistics Department has provided assistance on a new statistical framework. Last but not least, IMF staff have provided macroeconomic policy advice to UNMIK on an ongoing basis. The IMF's work has been closely coordinated with the World Bank and other bilateral and multilateral donors, notably through participation in the High-Level Steering Group of the Group of Eight.

This paper gives an overview of institutional and economic developments in Kosovo to date and discusses the main economic policy challenges currently facing the province. Tackling these challenges will be a task not only for UNMIK but, increasingly, for the Kosovars themselves. Kosovo's recently promulgated constitutional framework created new institutions, including a Kosovar Assembly and a government, which are currently being formed following the first province-wide general elections in November 2001. These new institutions of self-government would take over from UNMIK a large share of its civil administration responsibilities, including in the area of economic and financial policy.

[1]UNSCR 1244 explicitly authorizes the UN Secretary-General to seek the assistance of "relevant international organizations" in establishing an international civil presence in Kosovo, and encourages "all Member States and international organizations to contribute to economic and social reconstruction" in the province. On this basis, in July 1999 the IMF Executive Board approved the provision of technical services to Kosovo.

2

Political and Institutional Developments Since the End of the Conflict

The immediate priorities of the international community after the end of the Kosovo conflict were to establish order and security and avert a humanitarian catastrophe. Despite the short duration of armed conflict between NATO and Yugoslav forces, which lasted 78 days, the Kosovo conflict caused significant human dislocation. At the peak of the conflict, nearly one million Kosovars—mainly ethnic Albanians—representing about 45 percent of the prewar population of the province fled their homes. Following the end of the conflict, some 210,000 Serbs and other non-Albanian minorities were displaced and remain so to this day. The conflict also caused extensive damage to property, especially to the housing stock and public infrastructure. After the end of the war, the NATO-led Kosovo Force (KFOR) and UNMIK inherited a precarious domestic security situation: widespread possession of arms, human rights abuses, violence, and the risk of generalized conflict between armed Albanian groups. KFOR and UNMIK's first major tasks were thus to establish a secure environment and provide emergency assistance to the population. During the first four months after the conflict, relief agencies distributed food rations to about 1.5 million people in Kosovo, and some 900,000 people—about half of the population—continued to receive food aid throughout the winter of 1999–2000. Construction materials were provided for home reconstruction, and emergency repairs were carried out on health facilities and on the road, energy, and water supply networks. The handling of the immediate postconflict crisis by the international community was a success: by the early summer of 2000, the humanitarian emergency was over.[2]

In parallel, UNMIK used its authority under UNSCR 1244 to establish a civilian administration in Kosovo. This resolution gave the Special Representative of the Secretary-General and UNMIK a very broad mandate, including the authority to perform civilian administrative functions, maintain law and order, develop provisional institutions for self-government, and support the reconstruction and economic development of the province. UNMIK was initially set up with four sections or "pillars," each run by an international agency: humanitarian affairs (the UN High Commissioner for Refugees); civil administration (UN); democracy building (Organization for Security and Cooperation in Europe); and reconstruction (European Union). These four pillars, as well as the 30 municipalities in Kosovo, were managed by international UNMIK staff. In addition, KFOR continued to guarantee security and order. In July 2000, after the humanitarian emergency was over, the humanitarian affairs pillar ceased to exist as a formal component of UNMIK, and the number of pillars was reduced to three.

UNMIK moved quickly to set up the structures and institutions necessary for an autonomous economic policy. A key early decision in this regard was

[2]United Nations, Security Council, *Report of the Secretary-General on the United Nations Interim Administration Mission in Kosovo* (New York, 2000); International Crisis Group, *Kosovo Report Card*, Balkan Report No. 100 (Brussels, 2000); and United Nations, Interim Administration Mission in Kosovo, *A Year and a Half in Kosovo* (Pristina, 2000).

to legalize the use of all foreign currencies for domestic transactions, including payment of taxes. Since the deutsche mark was already widely used in Kosovo before the conflict, it soon became the dominant currency. In addition, UNMIK took a number of important institution-building steps with extensive technical assistance from the international community, particularly the IMF.

- A Central Fiscal Authority (CFA) was created and put in charge of budget formulation and implementation, tax policy, and tax administration. In December 1999, the Authority prepared for 2000 the first Kosovo consolidated budget, covering the recurrent expenditures of the central government, municipalities, and public enterprises. There are no transfers between the Kosovo consolidated budget and the budget of the Federal Republic of Yugoslavia.
- The Department of Reconstruction was tasked with the coordination of donor assistance for reconstruction and the preparation of the public investment program.
- As the Yugoslav tax collection system had broken down in the province even before the conflict, a new tax system and tax administration were set up to provide the resources for the Kosovo consolidated budget and replace the parallel tax structures that had developed during the 1990s.
- The complex and distortionary trade regime that was inherited from the Federal Republic of Yugoslavia was replaced by a simple system, with no quantitative restrictions and a single 10 percent tariff rate, administered by a new Customs Department.
- The Banking and Payments Authority of Kosovo (BPK) was established in November 1999 to provide a system for domestic payments; to license and supervise domestic banks; and to ensure their liquidity, solvency, and effective functioning.
- The payments system was reformed with the initial introduction of a depository and cash facility at the BPK. More recently, as indigenous banks started to appear, the BPK started developing an interbank clearing and settlement system.

As a result of these measures, a new, autonomous institutional structure for economic policy has emerged in Kosovo. UNMIK took these institution-building steps on the basis of realities on the ground and the urgent need for a functioning administration in Kosovo. The result was an institutional structure that has gone further toward autonomy than originally envisaged. Under the Rambouillet Accords, the Federal Republic of Yugoslavia was expected to maintain responsibility for monetary policy, customs policy, and federal taxes in the territory of Kosovo. Although UNSCR 1244 referred to these Accords, it provided flexibility to UNMIK to respond to the needs of Kosovo. The outcome was economic policy structures and institutions that are, in effect, entirely independent.

Political institutions also evolved during the last two-and-a-half years. In order to share the administrative responsibility with the people of Kosovo, UNMIK set up in February 2000 the Joint Interim Administrative Structure. The functions of the administration were passed to the Structure's 20 departments and divided across the four pillars (which became three after July 2000 when the humanitarian affairs pillar was discontinued). Each department was co-headed by an expatriate and a Kosovar (Appendix I). Following the municipal elections of October 2000, the administration of municipalities was also handed over to locally elected representatives.

The new Constitutional Framework and the first elections for a Kosovo-wide assembly in November 2001 were further major steps toward self-government. In May 2001, the Special Representative of the Secretary-General promulgated a new Constitutional Framework for provisional self-government in Kosovo. This Constitutional Framework, together with UNSCR 1244, is now the fundamental document regulating the governance of Kosovo, pending a resolution of its final status. The Framework created a president, an assembly, and a government that would replace the joint interim administrative structure departments, collectively referred to as the provisional institutions of self-government (PISG). The framework also provided for the separation of executive, legislative, and judicial powers and institutions. The first Kosovo-wide elections under this Framework took place in November 2001 and, at the time of the writing of this report, these institutions were being formed. At the same time, the Framework circumscribed the authority of the PISG by reserving some key powers and responsibilities exclusively for the Special Representative of the Secretary-General. These include, inter alia, the authority to set the overall parameters of economic policy (see Box 1).

Box 1. The New Constitutional Framework

The new Constitutional Framework, promulgated by the Special Representative of the Secretary-General on May 15, 2001—supplemented by a regulation on the executive branch and passed in September—sets up a comprehensive legal framework for self-government in Kosovo. The main elements of the Framework are listed below.

Provisional institutions of self-government. After the elections of November 2001, the following institutions are being established:

- The assembly consists of 120 members elected for a three-year term. One hundred seats are filled by proportional vote, ten are allocated to Kosovo Serbs, and ten to other ethnic communities.
- The president is elected by the assembly with a two-thirds majority for a three-year term.
- The government, consisting of the prime minister and nine ministers, is approved by the assembly at the proposal of the president. Ministers do not have to be members of the assembly. At least one minister must be a Kosovo Serb, and one a member of another minority ethnic community.

Power sharing. The Special Representative of the Secretary-General continues to promulgate laws voted by the assembly, coordinate with KFOR on security issues, and have the authority to appoint and dismiss judges and prosecutors. In addition, a number of executive powers are reserved exclusively for the Special Representative. These reserved powers include:

- concluding agreements with states and international organizations
- controlling the police, correctional services, and the Kosovo Protection Corps
- setting the overall policy parameters for the budget, on the advice of the Economic and Fiscal Council
- controlling the UNMIK Customs Service
- administering state-owned and socially owned property, in cooperation with the provisional institutions of self-government
- exercising authority over railways, frequency management, and civil aviation
- appointing the members of the Economic and Fiscal Council; the members of the board of the Banking and Payment Authority; the chief executives of the Customs Service and Tax Inspectorate; and the auditor general.

The new Constitutional Framework has to be implemented under continuing uncertainty regarding Kosovo's final status and the ongoing segregation of the Serb and Albanian communities. The Framework has the support of the government of the Federal Republic of Yugoslavia, as indicated by the UNMIK-Federal Republic of Yugoslavia Common Document of November 5, 2001. However, it does not resolve the uncertainty regarding Kosovo's final political status. This uncertainty complicates the establishment of property rights and the process of economic policymaking. In addition, although inter-ethnic violence has abated, ethnic relations are far from harmonious. Serbs in Kosovo continue to live in enclaves protected by KFOR, and movement outside these enclaves in the rest of the province is a security risk. Finally, it is not clear how power sharing between UNMIK and the Kosovar government will work in practice. In the area of economic policy, in particular, tensions may arise between the power of the Special Representative of the Secretary-General to set the overall parameters of the budget on one hand, and the government's responsibility to implement it and discretion to allocate funds among various uses on the other. Furthermore, from an institutional point of view, frictions may arise between the new ministries and the administrative structures that the Special Representative of the Secretary-General will need to keep under his direct control in order to exercise his reserved powers, such as the CFA.

3

Recent Economic Trends and Policies

Production, Income, and Poverty

The productive capacity of Kosovo had been severely degraded during the 1980s and 1990s. Like the rest of Serbia, the province had suffered from the breakup of the former Socialist Federal Republic of Yugoslavia and the associated conflicts, as well as the economic mismanagement of the Federal Republic of Yugoslavia during the 1980s and 1990s (Table 1). Especially after 1989, when the autonomy of Kosovo within the Republic of Serbia was suspended, the province experienced massive disinvestment. Operations and maintenance in industry and infrastructure were neglected. As a result, estimates based on official data suggest that industry collapsed and real output contracted in the early 1990s.

The 1999 conflict caused additional destruction of economic infrastructure and severe loss of human capital. Two-thirds of the homes were severely damaged or destroyed; 40 percent of water sources were contaminated; bridges, roads, and other infrastructure suffered wartime damage; and large areas of the countryside were mined. Perhaps more importantly, the conflict and its aftermath caused a significant outflow of Kosovo's human capital. Before the war, most managerial and professional positions had been held by Serbs. The subsequent expulsion of a large number of Serbs left the province with a severe shortage of educated and skilled workers and professionals.

The dearth of economic statistics precludes an accurate assessment of the current economic situation. There are no official statistics on any macroeconomic aggregates, including national accounts, inflation, trade, and other financial flows with the rest of the world. The Statistical Office of Kosovo is building up its operations with technical assistance by donors, but its output is thus far limited to vital statistics for the population, a business registry for large firms, and monitoring of farmgate food prices. A living standards survey in cooperation with the World Bank and the first business survey are also being finalized. In the meantime, other sources of data are scarce and coverage is fragmentary. The exception is public finances, where accurate statistics are available for the central government.

Preliminary staff estimates suggest that GDP amounted to DM 2.75–3.25 billion (US$700–800 per capita) in 2000. National accounts estimates by IMF staff (Table 2) are little more than guesses based on fragmentary information and supplemented by anecdotal evidence. The GDP estimate is almost identical to that made earlier by staff for the same year,[3] but incorporates lower figures for private consumption,

TABLE 1
Sectoral Investment Flows
(In percent: 1971=100)

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

Source: *Riinvest* estimates, based on official data.

[3]R. Corker, D. Rehm, and K. Kostiel, *Kosovo: Macroeconomic Issues and Fiscal Sustainability* (Washington: International Monetary Fund, 2001).

Table 2
GDP and National Income
(In millions of deutsche mark, unless otherwise indicated)

	2000 Original	2000 Revised	2001 Estimate
Gross domestic product	3,000	3,052	3,807
Per capita (US$)	746	759	899
Gross national income	3,000	3,202	4,107
Gross national disposable income	5,540	5,446	6,545
Consumption	4,380	3,864	4,607
Private	4,077	3,450	3,912
Public	303	414	695
Investment	1,160	1,577	2,107
Private	405	531	688
Public/foreign financed	755	1,046	1,419
Exports	0	404	467
Merchandise	0	21	43
Services	0	383	424
Imports	–2,540	–2,793	–3,375
Merchandise	–2,540	–2,414	–2,871
Services	0	–380	–504
Net factor income from abroad	0	150	300
Net transfers from abroad	2,540	2,244	2,439

Sources: Central Fiscal Authority (CFA), Banking and Payments Authority of Kosovo (BPK), UNMIK departments; and IMF staff estimates.

based on a recent World Bank household consumption survey, and higher figures for private investment. Appendix II explains in detail these estimates and the source data.

All indicators show economic activity rebounding strongly in 2001, with real GDP growth well into the double digits. Reconstruction of buildings and infrastructure is evident everywhere; anecdotal evidence suggests that the 2001 harvest was perhaps 20–30 percent higher than in the previous year, as land was cultivated once again and agriculture recovered from a drought; the provision of public services is slowly improving; and there is a vibrant private service sector. Industrial production has yet to recover, but there are indications of light manufacturing activity—agricultural processing, machine parts, soft beverages—some of it associated with exports to the rest of the Federal Republic of Yugoslavia. Although domestic food prices remained fairly stable during the first part of 2001, reflecting increased supply, other prices have reportedly increased faster, and the GDP deflator is estimated by IMF staff to have risen by some 8 percent.[4] As a result, GDP in 2001 is estimated at DM 3.5–4 billion (US$850–950 per capita).

This level of activity, and the even higher level of disposable income and consumption, reflects the magnitude of foreign assistance. As Table 2 shows, the structure of GDP is very distorted. In 2001, gross national disposable income is estimated at about 172 percent of GDP, merchandise imports at about 75 percent of GDP, and consumption about 120 percent of GDP (or US$1,000–1,100 per capita). This was made possible by the extraordinary amount of foreign transfers from official sources, as well as from Kosovars abroad. Staff estimates show that official transfers amounted to DM 1.5 billion in 2000 and DM 1.6 billion in 2001, most of it for reconstruction (Table 3).

[4]This may indeed be an underestimate. A preliminary exercise by the CFA shows that consumer prices rose by 6.2 percent during the first half of 2001, and the 12-month inflation rate in June 2001 was 14.4 percent. These estimates would suggest that the increase in the GDP deflator could be in the range of 10–15 percent in 2001.

TABLE 3
Balance of Payments
(In millions of deutsche mark, unless otherwise indicated)

	2000		2001
	Original	Revised	Estimate
Trade balance	–2,540	–2,393	–2,828
Exports	0	21	43
Imports	–2,540	–2,414	–2,871
Nonfactor services	0	3	–80
Exports	0	383	424
Imports[1]	0	–380	–504
Net factor income from abroad	0	150	300
Factor income	0	150	300
Factor payments	0	0	0
Transfers	2,540	2,244	2,439
Private transfers	1,200	750	850
Official transfers	1,340	1,494	1,589
Humanitarian assistance	312	200	100
Donor grants for current spending	272	285	169
Reconstruction aid	756	1,009	1,320
Current account balance	0	5	–169
Current account balance as a share of GDP (percent)	0.0	0.2	–4.4
Capital account	0	100	150
Private foreign direct investment	0	100	150
Loans	0	0	0
Errors and omissions[2]	0	100	243
Overall balance	0	205	224
Net change in international reserves	0	–205	–224
Official reserves (–, increase)	0	–77	0
Net international reserves of the banking system (–, increase)	0	–128	–224

Sources: Central Fiscal Authority (CFA), Banking and Payments Authority of Kosovo (BPK), UNMIK departments; and IMF staff estimates.
[1]Excluding services provided by nonresidents living in Kosovo, which are paid by foreign donors.
[2]Including transfers effected earlier but deposited in the banking system during 2000 and 2001.

Transfers associated with the activities of KFOR are not included in these figures. Private transfers, on which there are no firm data, are estimated at an additional DM 750–850 million each year, and are used to finance private consumption or repairs of private homes. These transfers covered the large trade deficit. Finally, the sizable presence of expatriates in Kosovo also helped shore up demand for local goods and services and support private consumption. Although firm data are not available, there are currently about 10,000 UNMIK staff in Kosovo; an estimated 5,000–10,000 expatriates working for various other agencies and nongovernmental organizations; and perhaps 40,000 KFOR troops.

Poverty in Kosovo is widespread but relatively shallow. A World Bank assessment for 2000[5] suggests that about half the population of Kosovo had consumption levels below the poverty line. However, the size of the poverty gap indicates that the depth of poverty was small: the consumption levels of the poor needed to rise on average by less than 16 percent (or about DM 17 per month per person) for poverty to be eliminated. Moreover, the relatively flat distribution of income (an estimated Gini coefficient of 29 percent) makes the distinction between poor and nonpoor households in Kosovo very

[5]The World Bank, *Poverty Assessment, Kosovo, Federal Republic of Yugoslavia* (Washington: World Bank, 2001).

blurred. Extreme poverty was relatively limited: the share of people in this category was less than 12 percent. The assessment also found that donor assistance and, in particular, food aid in the postconflict period had been quite successful in mitigating poverty in Kosovo.

Public Finances

Although the CFA has established proper budgetary procedures, the management of the finances of the general government sector is fragmented, and reporting and accounting standards are uneven. The budgetary structure is presented in Box 2. The CFA has introduced a basic tax system, effective expenditure control mechanisms, and transparent accounting in the central government. However, reporting and accounting standards in the municipalities and public enterprises are much weaker. Also, the Kosovo consolidated budget so far covers mainly recurrent spending; the bulk of investment spending is financed by donors and managed separately by the Department of Reconstruction.

Given the low revenue base and UNMIK's inability to borrow, fiscal policy has very limited room for maneuver and depends heavily on foreign grants. Total revenue amounted to some 24 percent of estimated GDP in 2001, of which some 60 percent was collected at the border because, despite recent improvements, domestic compliance is very weak. The main revenue sources of the Kosovo consolidated budget have thus far been an excise tax on oil products, a 10 percent import duty, and a VAT that replaced a tax on business turnover in July 2001 (Table 4). There are no direct taxes, although there are plans to introduce taxes on wages and profits in 2002 (for details on the current tax system and plans, see Appendix III). Expenditures, on the other hand, including for reconstruction, amounted to just under 60 percent of estimated GDP in 2001.[6] The gap was covered by donor grants (Table 5).

Donor support for recurrent spending declined in 2001, but this was offset by improved domestic revenue performance. The 2001 budget envisaged about one-third of recurrent expenditure to be financed by donor grants (DM 162 million, primarily from the European Union), down from about one-half in 2000. In the event, revenue performance was much better than expected due to the rapid growth in activity and improvements in tax and customs administration. For the year as a whole, general budget revenue is estimated at DM 573 million, compared with an original budget target of DM 338 million. This enabled the CFA to revise its budget targets in November, allowing for an increase in current spending limits of DM 63 million and allocating the rest of the unanticipated revenue to building cash reserves.

The 2002 budget projects a further significant increase in revenue to DM 682 million on the basis of rapid growth in activity, further improvements in efficiency, and the introduction of taxes on wages and profits. On the financing side, the budget projects a fall in donor support for both recurrent and reconstruction spending: the former is expected to be limited to DM 50 million in 2002. This sets the envelope for expenditures. Within this envelope, the 2002 draft budget shifts priorities toward a number of one-off outlays associated with the new assembly and the expected decline in the number of UNMIK international staff, and includes an increased allocation for capital spending. Current spending is also projected to grow significantly, in part through higher transfers to municipalities, reflecting the devolution of responsibility to local governments for the provision of certain services. These services include primary health care, education, and the maintenance of restored

Box 2. Budgetary Structure

General Budget: Recurrent costs of government; administered by the CFA; financed by local revenue and foreign grants

Kosovo Consolidated Budget: General budget + municipalities + public enterprises; monitored by the CFA; financed by local revenue and foreign grants

Major Off-Budget Items:

- Reconstruction: capital spending; administered by the Department of Reconstruction; financed by foreign grants
- UNMIK: salaries of UNMIK staff; administered by the UN; financed by the UN and donors
- KFOR: administered and financed by donor countries

[6]This excluded the cost of maintaining UNMIK; the direct contributions to the administration of Kosovo made by the European Union, the UN, and other donors; and KFOR's contribution to security.

TABLE 4
Consolidated Budget
(In millions of deutsche mark)

	2000	2001		2002
	Preliminary	Budget[1]	Preliminary	Budget
General budget				
Revenue	248.9	486.1	572.8	681.6
Tax revenue	237.7	464.1	544.1	654.6
Customs	60.5	80.0	93.1	62.8
Excises	38.2	125.0	150.7	207.2
Sales and VAT	124.0	203.0	245.7	311.6
Presumptive business tax	9.2	50.0	52.4	43.0
Profit tax	0.0	0.0	0.0	20.0
Wage tax	0.0	0.0	0.0	10.0
Other	5.8	6.1	2.2	0.0
Nontax revenue	11.2	22.0	28.7	27.0
Expenditures	430.5	562.5	536.7	731.6
Recurrent expenditure	430.5	515.1	510.5	608.2
Salaries, goods and services	274.8	350.8	347.2	325.7
Of which: wages and salaries	167.0	201.9	196.1	154.9[2]
Of which: goods and services	107.8	148.9	151.1	170.8
Subsidies and transfers	155.7	164.3	163.3	282.6
To households	60.1	. . .	93.2	122.0
Of which: pensions	0.0	0.0	0.0	43.0
To municipalities and others	32.5	. . .	20.4	145.8[2]
To public enterprises	63.0	. . .	49.7	14.8
Interest payments	0.0	0.0	0.0	0.0
Capital expenditure and transfers	0.0	22.3	26.2	38.1
Reserves and contingency	0.0	25.1	0.0	85.2
Overall budget balance	–181.6	–76.4	36.1	–50.0
Overall budget balance (including grants)	48.9	85.5	165.2	0.0
Financing	181.6	76.4	–36.1	50.0
Undesignated donor grants	211.1	150.0	124.9	50.0
Designated donor grants	19.4	11.9	4.2	0.0
Domestic (change in bank balances) (residual)	–48.9	–85.5	–165.2	0.0
Local authorities				
Revenue	22.0	33.6	26.4	163.7
Of which: own revenue[3]	3.0	6.0	6.0	17.9
Expenditures (recurrent)	22.0	33.6	26.4	163.7
Balance	0.0	0.0	0.0	0.0
Public enterprises				
Revenue	276.7	196.8	377.2	644.8
Of which: own revenue	213.7	196.8	327.5	508.9
Expenditures[4]	117.4	188.6	321.5	485.3
Operating costs	62.9	148.6	281.5	485.3
Electricity imports	54.5	40.0	40.0	0.0
Balance	159.3	8.2	55.7	159.6
Donor grants for electricity imports	54.5	40.0	40.0	0.0
Change in bank balances	–213.8	–48.2	–95.7	–159.6
Kosovo consolidated budget				
Revenue	465.6	688.9	906.3	1,208.4
Expenditure	474.3	784.7	814.6	1,219.9
Balance	–8.8	–95.8	91.8	–11.6
Balance (including grants)	276.3	106.1	260.9	38.4
Financing	8.8	95.8	–91.8	11.6
Budgetary donor grants	230.5	161.9	129.1	50.0
Donor grants for electricity imports	54.5	40.0	40.0	0.0
Domestic (change in bank balances) (residual)	–276.3	–106.1	–260.9	–38.4

Sources: UNMIK; and IMF staff estimates.
[1]Budget as revised in November 2001.
[2]Due to a devolution of responsibility for education and health spending to municipalities, with a consequent increase in transfers from the consolidated budget.
[3]Own revenues include only revenue raised directly and paid over to the Kosovo Central Bank.
[4]Includes only current expenditure of public enterprises.

Table 5
Overall Fiscal Position

	2000 Preliminary	2001 Budget[1]	2001 Preliminary	2002 Budget
	(In millions of deutsche mark)			
Kosovo consolidated budget				
Revenue	465.6	688.9	906.3	1,208.4
Expenditure	474.3	784.7	814.6	1,219.9
Balance	–8.8	–95.8	91.8	–11.6
Balance (including grants)	276.3	106.1	260.9	38.4
Financing	8.8	95.8	–91.8	11.6
Budgetary donor grants	230.5	161.9	129.1	50.0
Donor grants for electricity imports	54.5	40.0	40.0	0.0
Domestic (change in bank balances) (residual)	–276.3	–106.1	–260.9	–38.4
Capital expenditure[2]	1,046.0	1,393.1	1,393.1	881.0
Overall fiscal position				
Revenue	465.6	688.9	906.3	1,208.4
Expenditure	1,520.3	2,177.8	2,207.7	2,100.9
Balance	–1,054.8	–1,488.9	–1,301.3	–892.6
Balance (including grants)	239.6	32.7	187.5	–42.6
Financing	1,054.8	1,488.9	1,301.3	892.6
Grants to recurrent budget	285.0	201.9	169.1	50.0
Grants to reconstruction budget	1,009.3	1,319.7	1,319.7	800.0
Domestic (change in bank balances) (residual)	–239.6	–32.7	–187.5	42.6
	(In percent of GDP)			
Kosovo consolidated budget				
Revenue	15.3	15.0	23.8	26.1
Expenditure	15.5	17.1	21.4	26.3
Balance	–0.3	–2.1	2.4	–0.2
Balance (including grants)	9.1	2.3	6.9	0.8
Financing	0.3	2.1	–2.4	0.2
Budgetary donor grants	7.6	3.5	3.4	1.1
Donor grants for electricity imports	1.8	0.9	1.1	0.0
Domestic (change in bank balances) (residual)	–9.1	–2.3	–6.9	–0.8
Capital expenditure[2]	34.3	30.3	36.6	19.0
Overall fiscal position				
Revenue	15.3	15.0	23.8	26.1
Expenditure	49.8	47.4	58.0	45.4
Balance	–34.6	–32.4	–34.2	–19.3
Balance (including grants)	7.8	0.7	4.9	–0.9
Financing	34.6	32.4	34.2	19.3
Grants to recurrent budget	9.3	4.4	4.4	1.1
Grants to reconstruction budget	33.1	28.7	34.7	17.3
Domestic (change in bank balances) (residual)	–7.8	–0.7	–4.9	0.9

Sources: UNMIK; and IMF staff estimates.
[1]Budget as revised in November 2001.
[2]Kosovo reconstruction budget and capital expenditure by public enterprises.

roads. As a result, spending by the central government in these areas is projected to decline. UNMIK is planning a review of staffing and wages in its administration during 2002 to rationalize and increase the transparency of the system. Reconstruction spending projections show a marked decline in 2002, reflecting the expected decrease in donor transfers for investment projects. To facilitate better planning and coordination of the recurrent and reconstruction budgets, the CFA is currently working toward consolidating the two budgets, in line with earlier IMF and World Bank recommendations.

The performance and management of public enterprises is very uneven and raises questions about their governance. The main public enterprises are the electricity generation and distribution company; the posts and telecommunications company; Pristina airport; Kosovo railways; and a number of local water, waste, and heating companies.

- The Kosovo Electricity Company (KEK) has major engineering and management problems. Its two thermal generators are old and prone to failure. About one-third of total electricity generated by the company is lost due to technical problems or theft, and less than half of the remaining output is paid by the consumers. With about 10,000 employees, the company is overstaffed. As a result, KEK has been a drain on the budget. Emergency repairs and stricter oversight by UNMIK have improved performance somewhat. However, KEK is still not able to generate enough electricity to meet domestic needs, and blackouts are frequent.
- Posts and Telecommunications of Kosovo (PTK) is quite profitable as a result of its monopolistic position and a concession to a foreign company to operate a mobile telephone network. Indeed PTK appears to have been the single source of the sizable accumulation of deposits in the public enterprise sector during 2000–01 (Table 4). However, the company suffers from serious internal accounting problems: its financial operations are not transparent, oversight by UNMIK is weak, and reporting to the fiscal authorities is deficient.
- Although not a public utility, the Trepča mining complex is a drain on the budget. A vertically integrated conglomerate, including mining, smelting, processing, etc., Trepča has about 4,000 workers on its payroll, down from about 10,000 original employees, and currently operates at minimum capacity. UNMIK has estimated the immediate costs of revitalization at about DM 100 million, but it is unclear which parts of the company, if any, are viable in the long term. Also there is clearly a limit to the extent to which the budget can continue subsidizing the mining sector, and the fact that the company's activities are largely in the Serb enclaves makes this a politically sensitive issue.

A new social security system is slated for introduction in 2002. Kosovo so far has not had an indigenous social security system, and rights accumulated under the old Yugoslav system cover only a small part of the population. UNMIK designed a three-tier system, and the regulation was signed into law in late December 2001. The new system is designed to provide a minimum social safety net for the elderly population through a universal basic citizens' pension (first tier) and to create a mandatory, fully funded system for new contributors (second tier). The system also allows private pension funds to be created on a voluntary basis (third tier). The first tier will be funded through general budget revenues. Because of the phased introduction of the new system during 2002, the impact on the 2002 budget is expected to be DM 43 million.

The Financial Sector

The banking system is in a state of infancy. At the end of the conflict, financial intermediation in Kosovo was nonexistent and virtually all transactions were settled in cash. Although this is still largely the case, banking activity started in earnest in late 2001 and was spurred by the replacement of the deutsche mark by euros in 2002. There are currently 7 licensed banks and 15 microfinance institutions operating in Kosovo. Two of the banks and most of the microfinance institutions were created and financed by donors and, with one exception, are very small: the aggregate balance sheet of the commercial banks at end-December 2001 was DM 982 million. The exception is the Micro-Enterprise Bank, a foreign-owned bank partly capitalized by the European Bank for Reconstruction and Development and the International Finance Company, which accounts for more than half of the aggregate balance sheet of the banking system. Bank deposits amounted to DM 935 million (about one-quarter of estimated GDP), and bank loans to the private sector were just DM 48 million (Table 6), with the microfinance institutions providing an additional DM 29 million of loans, most of which were to finance trade and services. Most of the increase in deposits occurred in the last three months of the year as a result of preparations for conversion to the euro.

Bank supervision is strong. UNMIK regulations promulgated in November 1999 with IMF technical assistance established a framework for licensing, regulating, and supervising banks. The BPK has since built a small but strong supervisory team, staffed largely by international staff.

Although the BPK is operationally independent, it depends on the budget for financial support and suffers from internal accounting problems. Its

Table 6
Commercial Bank Balance Sheet
(In thousands of deutsche mark)

	2000	2001			
	December	March	June	September	December
Assets					
Cash	22,826	28,927	22,988	23,300	168,413
Balance with BPK	26,794	32,308	52,321	71,866	328,588
Non-interest-bearing current account with other banks	12,155	7,196	16,250	12,509	57,660
Loans to financial institutions (placement)	127,547	166,854	217,303	286,834	351,099
Securities	—	—	—	—	14,665
Net loans	6,157	9,230	20,239	27,907	47,660
Property and equipment (net of depreciation)	863	1,374	2,362	4,304	6,976
Interest receivable and other assets	5,038	3,810	3,124	3,642	7,108
Total assets	201,380	249,699	334,587	430,362	982,169
Liabilities					
Deposits	181,898	223,986	297,744	387,300	934,943
Borrowings	5,719	5,985	9,867	9,867	9,867
Interest payable and other liabilities	1,731	1,274	1,508	3,048	2,356
Subordinated debts	—	—	22	—	—
Shareholders' equity	12,032	18,454	25,463	30,148	35,003
Total liabilities and shareholders' equity	201,380	249,699	334,604	430,363	982,169
Off-balance-sheet commitments and contingencies	11,660	9,988	10,914	3,462	3,836

Source: Banking and Payments Authority of Kosovo, *Financial Statistics,* January 2002.

Box 3. Chronology of Developments in the Insurance Sector

November 1999. UNMIK decides to make third-party motor vehicle liability insurance mandatory and issues an administrative order setting the requirements for licensing insurance companies: DM 5 million of capital (could also be a commercial letter of credit), reinsurance arrangements, and adequate staff. No prudential standards are specified, and no supervisory agency is set up (UNMIK's Pillar II is responsible for licensing insurance companies, but without specialized staff). Five insurance companies are quickly set up.

April 2000. In the face of complaints about business practices, UNMIK issues a second administrative order specifying minimum premiums, commissions, and maximum discounts allowed for car insurance contracts. In response to this administrative price setting, illegal practices multiply, allegedly including extortion and criminal activity.

July 2000. The co-owner of an insurance company applies for a banking license, and the BPK discovers that he is not fit and proper for a financial institution. UNMIK begins to realize the extent of the problems in the insurance sector.

October/November 2000. UNMIK requests financial information from the insurance company, which the company refuses to provide. UNMIK's legal adviser confirms that, under the existing legal framework, the company is under no obligation to report financial information. UNMIK and the BPK decide to draft a new insurance regulation and ask for donor assistance. In the meantime, insurance companies continue to issue policies under the existing framework.

May 2001. With the new regulation still in the drafting stage, UNMIK renews the licenses of the existing insurance companies for three months, under the condition that they undergo an audit of their financial activity. By the end of July 2001, about 189,000 policies have been issued, yielding premium income of DM 67 million (about 1½ percent of estimated GDP).

September 2001. With the draft of the new regulation still under review, UNMIK again extends the licenses of the insurance companies, under the condition that they deposit 40 percent of unearned premiums with the BPK. At the same time, the BPK starts the process of evaluating the audits in order to assess the state of the existing insurance companies and to determine any necessary remedial measures.

October 2001. The new regulation is promulgated, and insurance supervision passes to the BPK.

dependence on budgetary transfers to finance its operations reflects the absence of seigniorage from the issuing of currency; a low level of capitalization; and high operating costs: the BPK maintains 29 branches partly due to the lack of commercial bank branches in many locations. Moreover, the BPK has been plagued by internal accounting weaknesses.

In the insurance sector, an inadequate legal framework, the absence of supervision, and UNMIK's slow response to a festering problem led to a crisis. In November 1999, UNMIK promulgated a legal framework for third-party motor vehicle liability insurance that did not set adequate prudential requirements and did not provide for supervision. Following this, five insurance companies quickly emerged. Their operations gradually raised concerns about their solvency and allegations of extortion and criminal activity. Only in October 2001, however, did UNMIK pass a new regulation and hand over the responsibilities for licensing and supervising the insurance industry to the BPK (Box 3), which is in line with international best practice.

4

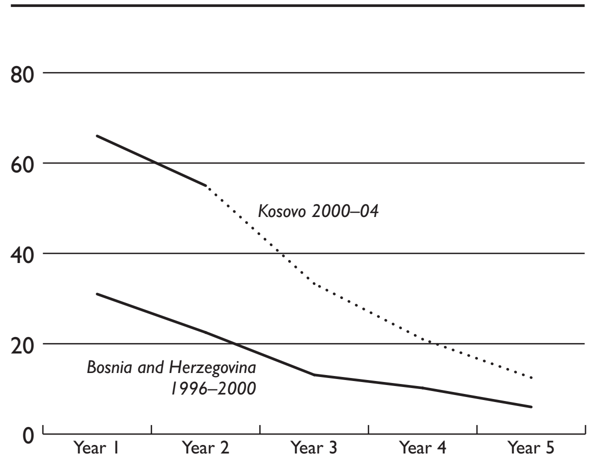
Policy Priorities for the Near Term

Despite the signs of vigorous private economic activity, Kosovo's long-term economic prospects are clouded by considerable uncertainty. Revitalizing the province's infrastructure and capital base after years of degradation and wartime damage would require significant up-front investments. One of Kosovo's greatest assets, its young population,[7] would also require sizable investments in education to realize its full potential. Donor assistance has been critical in averting a humanitarian tragedy and getting Kosovo's economy back on its feet, but it cannot be relied upon fully to finance these necessary long-term investments. At the same time, domestic and especially foreign private investors are unlikely to undertake major projects in Kosovo as long as uncertainty about the province's final status persists.

In addition, regardless of the timing of the final political settlement, in the more immediate future Kosovo is facing the prospect of a rapid decline in foreign transfers (Figure 1). Humanitarian assistance has already started declining and is expected to drop to very low levels by 2003. In the same year, donor grants for recurrent budgetary spending are expected to end. Grants for reconstruction are likely to decline to DM 300–400 million by 2004 from DM 1.3 billion in 2001. While the current magnitude and medium-term outlook for private transfers are uncertain, these are unlikely to persist at their present level. In all, foreign transfers are expected to fall to 15–20 percent of estimated GDP by 2004 from 67 percent in 2001. This pattern is similar to that of Bosnia and Herzegovina after the war. Indeed, the experience of the latter suggests that the decline of foreign transfers to Kosovo might, if anything, be even steeper over the medium term. The presence of international staff in Kosovo is also likely to be reduced.

The near-term economic policy goal should thus be to develop the domestic productive capacity and further the integration of Kosovo's economy into that of the region and the rest of Europe. This would mitigate the impact of the decline in foreign assistance. Moreover, given the longer-term uncertainties, it would maximize the chances of building a sustainable economy. To achieve this goal, UNMIK

Figure 1.
Kosovo and Bosnia and Herzegovina: Unrequited Transfers
(In percent of GDP)[1]



Source: IMF staff estimates and projections.
[1]Data are subject to considerable uncertainty.

[7]With over half the population under 25 years of age, Kosovo has one of the youngest populations in Europe.

and the provisional institutions of self-government should focus on four broad policy priorities: fiscal sustainability, financial sector deepening, private sector development, and good governance. Each of these is discussed in turn below.

Fiscal Sustainability

The main fiscal challenge for 2002 and the medium term will be to keep spending growth in line with that of available resources. Despite better-than-expected revenue collection in 2001, local revenue growth will be unable to compensate for the drop in donor grants in the short to medium term. Spending needs, however, will remain high, even after reconstruction is over. Resolving the tension between resources and needs in a rational manner will require transparency, a medium-term vision, and the political courage on the part of UNMIK and the provisional institutions of self-government to make tough decisions.

Tax policy should aim at simplicity, low and uniform tax rates, and as broad a tax base as possible. Tax collection is likely to continue to grow rapidly as the economy expands, major new taxes are introduced (on wages and profits in 2002 and on all incomes in 2003), and tax compliance is improved. However, the capacity and human resources of the tax administration are likely to remain strained. The following measures would help maximize the contribution of the tax system to economic growth while, at the same time, keeping it manageable and equitable.

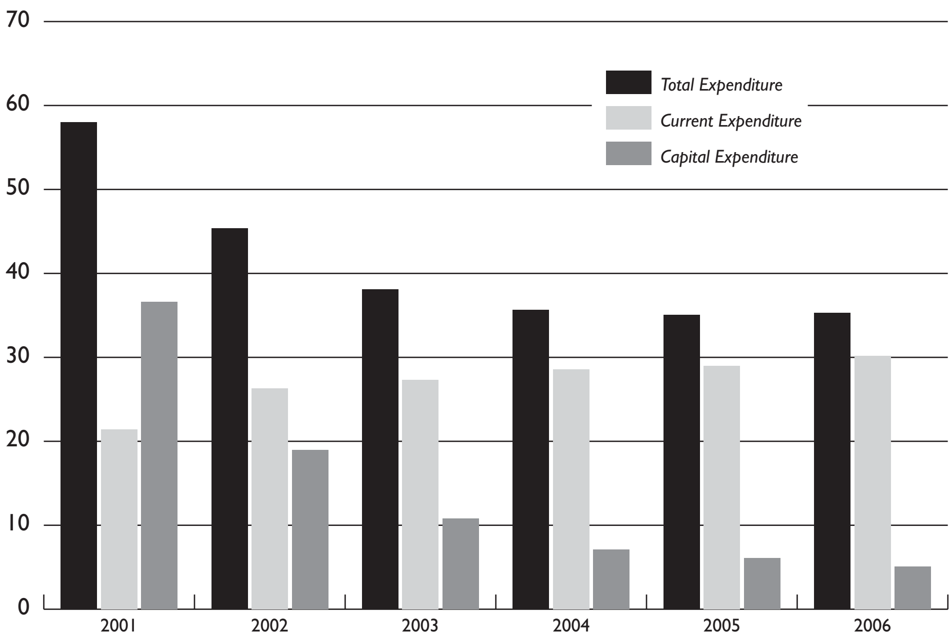
- The planned wage tax should apply to all wage earners, including Kosovars employed by UNMIK.
- The future income tax should be levied on all sources of personal income, including that from labor, interest, rents, pensions, and social transfers.
- The import tariff rate should be reduced or, preferably, abolished altogether in order to eliminate the associated trade distortions. However, this step should only be taken if the associated revenue loss can be fully offset by other means, such as lowering the VAT threshold and improving domestic revenue collection.
- Strengthening the tax and customs administration should continue to be a priority, and care should be exercised in creating customs warehouses.
- UNMIK should resist the temptation to grant tax exemptions to certain categories of goods, regions, or groups of taxpayers. International experience has shown that such exemptions do not generate permanent benefits for the economy as a whole, but reduce the transparency of the tax system, hamper the efficiency of tax administration, and open the door to corruption.

On the basis of this tax policy, and without the possibility of borrowing, staff projections of revenue and the outlook for donor grants provide a tentative estimate of the envelope for public expenditures over the medium term. These projections suggest that the resources available to finance public spending will decline (Figure 2). Since reconstruction needs will naturally fall, however, the room for current spending within this overall envelope will actually increase over the medium term. The share of current spending to GDP in Kosovo—excluding interest and pensions, which have so far been zero—is broadly in line with that of other countries in the region, as well as that of a representative sample of low- and middle-income countries (Figure 3 and Table 7). This suggests that the medium-term expenditure envelope in Figure 2 is adequate for the needs of Kosovo without additional support by donors for current spending. It also underscores the need for UNMIK and the provisional institutions of self-government to put the emphasis on allocating the existing resources efficiently.

Deciding on public resource allocation in an efficient manner will be a challenge. First, although reconstruction spending will naturally fall in the near future, the need for capital spending will continue to be high, especially in the energy sector. Second, social spending, such as education and health, together with the recent introduction of a pension system will require an increasing portion of budgetary resources. Third, new spending needs will arise, such as the possible burden from Kosovo's share of former Yugoslav debt and several off-budget expenditures currently financed directly by donors. The special circumstances of ethnic minorities are also likely to generate expenditure pressures.

Against this background, it will be critical to set expenditure priorities over a medium-term horizon, rather than from one annual budget to the next, and to control current spending, especially the public

Figure 2.
Medium-Term Projections of Expenditure
(In percent of GDP)



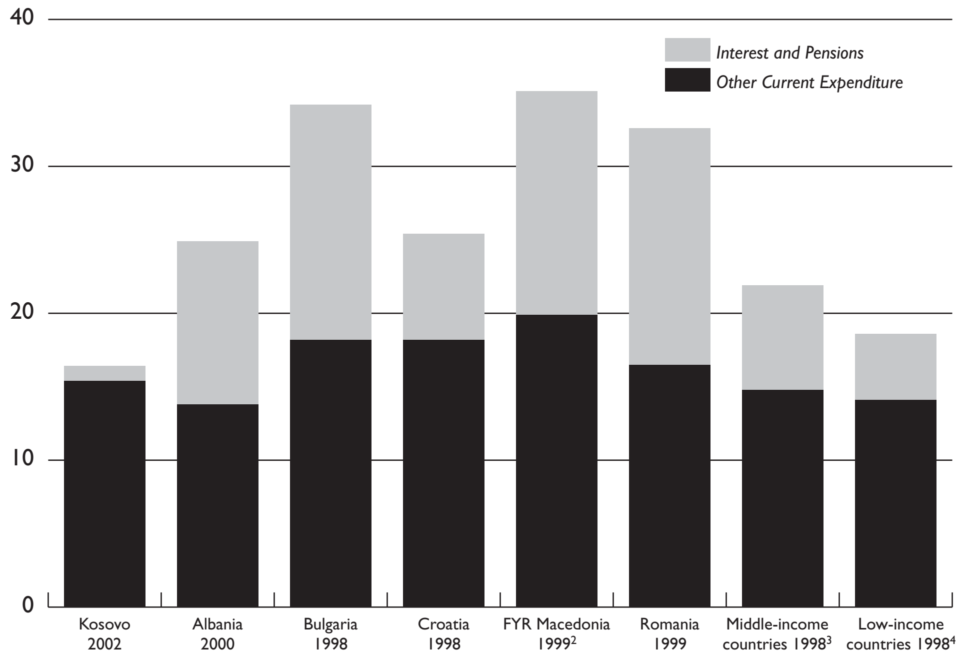
Sources: UNMIK; and IMF staff estimates.

wage bill. The wage bill already absorbs the bulk of the consolidated budget. UNMIK has not been able thus far to tackle widely acknowledged overstaffing in the public sector, notably among administrative staff in the health sector and in the Kosovo Protection Corps, relying instead on wage compression to keep the wage bill manageable. This policy deprives the public sector of qualified personnel. The review of medium-term staffing needs and pay, currently planned in the context of the 2002 budget, is a timely initiative. It should be accompanied by a plan to reduce and rationalize public sector employment starting in 2002, with the savings partly used to increase wage differentiation.

The public enterprise sector urgently needs better management, and greater transparency and accountability. It makes little sense to rely on donors for financing recurrent expenditures while, at the same time, public enterprises are accumulating large cash balances. Posts and Telecommunications of Kosovo must be brought under the Public Utilities Department, and its transactions—in particular its cash balances, which derive from its status as a state monopoly—must be accounted for with complete transparency. The telecommunications sector needs to be opened up to private sector competition as soon as possible. Kosovo Electricity Company requires new and professional management to reduce overstaffing, streamline operations, and improve service to the public.

The new pension system addresses an important need, but care should be exercised to ensure its financial viability. The main risk for the proposed system is setting the basic citizen's pension at a level that is not fiscally responsible. This risk is considerable because, under the pension regulation, the assembly is responsible for setting the benefit level while taxation remains in the reserved powers of the Special Representative of the Secretary-General. A mechanism is thus required to ensure that the benefit level set by the assembly is low enough to be consistent with available resources and adjusted in a transparent, nonpolitical way. A relatively low basic pension would also strengthen the fully funded second and third pillars, which would then become the main components of the system. Furthermore, because the basic citizen's pension is essentially a social safety net for the elderly, it should be subject to

Figure 3.
International Comparison of Current Expenditure[1]
(In percent of GDP)[1]



Sources: IMF, *Government Finance Statistics Yearbook* (Washington, various years); and IMF staff estimates.
[1]Estimated outcome for Kosovo consolidated budget, excluding budgets of the public enterprises. Subsidies and transfers include unallocated contingency reserves.
[2]Former Yugoslav Republic of Macedonia.
[3]Barbados, Botswana, Chile, Colombia, Costa Rica, Cyprus, Dominican Republic, Egypt, El Salvador, Fiji, Hungary, Islamic Republic of Iran, Jordan, Malta, Mauritius, Morocco, Panama, Paraguay, Peru, Romania, Swaziland, Thailand, Tunisia, Turkey, Uruguay, and Zimbabwe.
[4]Burkina Faso, Cameroon, Democratic Republic of Congo, Ghana, Kenya, Lesotho, Malawi, Mali, Sierra Leone, Sri Lanka, and Zambia.

the future income tax, which would provide a method of means testing. Finally, pension funds should be managed for the benefit of their contributors, strictly supervised, and required to invest in low-risk instruments, which are unlikely to be available in Kosovo in the near future.

Financial Sector Deepening

Financial sector development in Kosovo is facing formidable obstacles. Financial intermediaries have a critical role to play in evaluating and pricing risk, allocating savings, financing investment, and enforcing good accounting and management practices, thereby bringing the "shadow economy" into the light. However, Kosovo's financial sector is stunted by lack of confidence in banks; lack of trained, experienced managers and supervisors; and a weak legal framework for private business. In addition, political uncertainty deters potential foreign investors.

Despite these obstacles, significant, albeit uneven, progress is being made. Kosovo's nascent banking system is growing rapidly, as deposits and a small but healthy loan portfolio are rising. The early introduction of a sound regulatory framework and the work of the BPK in establishing and enforcing high supervisory standards have contributed to this development, as has the process of the introduction of the euro. Structural reforms in other areas, such as passage of bankruptcy legislation, introduction of a property registry, and payment of public employees and suppliers through di-

Table 7
International Comparison of Government Expenditures
(Average as percent of GDP)

	Kosovo[1] 2001	Albania 2000	Bulgaria 1998	Croatia 1998	FYR Macedonia 1999	Romania 1999	Middle-Income[2] 1998	Low-Income[3] 1998
Expenditures by economic type (including net lending)	17.3	31.4	36.8	31.0	37.7	35.6	27.7	25.6
Current expenditures	16.4	24.9	34.2	25.4	35.1	32.6	21.9	18.6
Goods and services	11.3	12.4	16.5	16.6	12.4	11.7	11.5	12.6
Wages[4]	5.8	6.5	8.7	9.6	9.3	5.0	7.9	6.7
Other goods and services	5.4	5.9	7.8	7.0	3.1	6.7	3.6	5.9
Interest	0.0	5.7	4.4	1.4	1.6	5.5	2.5	3.2
Subsidies and transfers	5.1	6.8	13.3	7.4	21.1	15.4	7.9	2.8
Of which: pensions	1.0	5.4	11.6	5.8	13.6	10.6	4.6	1.3
Capital expenditures	0.9	6.5	4.0	4.8	2.6	2.9	4.7	6.0
Net lending[5]	0.0	0.0	–1.4	0.8	. . .	0.1	1.1	1.0
Expenditures by function[6]	17.3	31.4	41.5	29.9	37.6	35.6	26.7	26.3
Military and civil defense	2.5	1.2	2.7	5.3	2.4	3.6	3.4	3.0
Education	3.8	3.2	3.8	3.4	4.0	3.3	3.8	3.9
Health	3.0	2.3	3.6	0.6	6.1	3.0	2.0	1.7
Social security and welfare	2.7	8.4	11.6	5.8	13.6	10.6	4.6	1.3
Housing	0.4	1.3	1.7	1.9	0.0	1.7	1.1	0.7
Economic services	2.5	1.2	1.0	. . .	2.0	0.5	5.7	6.4
Other government services[7]	2.4	8.1	12.7	. . .	7.9	7.4	3.6	6.1
Interest	0.0	5.7	4.4	1.4	1.6	5.5	2.5	3.2
Number of countries							26	11

Sources: IMF, *Government Finance Statistics Yearbook* (Washington, various years); and IMF staff estimates.
[1]Estimated outcome for Kosovo consolidated and reconstruction budgets, excluding the budgets of the public enterprises. Subsidies and transfers include unallocated contingency reserves.
[2]Barbados, Botswana, Chile, Colombia, Costa Rica, Cyprus, Dominican Republic, Egypt, El Salvador, Fiji, Hungary, Islamic Republic of Iran, Jordan, Malta, Mauritius, Morocco, Panama, Paraguay, Peru, Romania, Swaziland, Thailand, Tunisia, Turkey, Uruguay, and Zimbabwe.
[3]Burkina Faso, Cameroon, Democratic Republic of Congo, Ghana, Kenya, Lesotho, Malawi, Mali, Sierra Leone, Sri Lanka, and Zambia.
[4]Military wages included in other goods and services for Bosnia and Herzegovina in 1999.
[5]Data unavailable for the former Yugoslav Republic of Macedonia.
[6]Does not include lending minus repayments.
[7]Services provided by Ministries of Agriculture, City Planning and Construction, Development, Economy, and Information; the Bureau of Statistics; and other agencies.

rect bank deposit, would help accelerate banking system growth. Above all, however, the BPK should continue to exercise close oversight, as new banks with inexperienced management trying to acquire market share often take excessive risks if not properly supervised. Moreover, as the banking system develops it will be important to ensure adequate rules on loan-loss classification, provisioning, and connected lending.

Developments in the insurance sector, however, were a serious setback for the industry, as well as for UNMIK. The original regulation was hastily prepared by inexperienced staff; supervision was nonexistent; and once problems were identified, corrective action was delayed and there was no accountability. The resulting crisis was predictable, and could have been prevented with more timely action by UNMIK. The new insurance regulation, which assigned the BPK a supervisory role over insurance companies, is a welcome—albeit much delayed—step in the right direction. The magnitude of the problem and the possible costs arising from undercapitalized insurance companies, however, are yet to be fully assessed.

There are good arguments for extending the BPK's supervisory role over new financial intermediaries. In the future, new financial intermediaries will be created, starting with the pension funds. It would normally be unusual for a quasi-central bank to supervise pension funds. But in the circumstances of Kosovo, given that the BPK has already amassed significant expertise in financial oversight, it would make sense to charge it with the supervision of these intermediaries, provided it has adequate resources to do so.

In order to perform its functions properly, the BPK should have not only operational autonomy but financial independence as well. UNMIK should consider a plan for the gradual capitalization of the BPK. Independence, however, ought to go hand-in-hand with good governance and accountability. The BPK's resolution of its internal accounting problems and rationalization of its operations—notably the reduction of the number of its branches to two—are thus key priorities, as well as prerequisites for recapitalization.

Private Sector Development

Private activity in Kosovo today is vibrant but remains mostly limited to informal services. Therefore, it remains small scale, outside the official tax net, and vulnerable to crime. While this activity bears testimony to the entrepreneurial spirit of the Kosovars, it is unlikely to be sufficient as the basis for sustainable development.

The key to transforming the existing activities into a modern business sector is an appropriate legal framework and the institutional apparatus to enforce it. UNMIK has made significant progress in promulgating a basic package of laws, including a contract law, a company law, a foreign investment law, a customs and excise law, a foreign exchange law, a banking law, and a law for the pledging of mobile assets. This package now must be supplemented by legislation on bankruptcy, protection of competition, and mortgages, as well as a functioning cadastre and property registry. Equally important is the strengthening of the judiciary so that the new laws can be properly administered.

UNMIK has prepared a proposal for privatization, but legal and political obstacles have stalled implementation. There are currently some 300–350 socially owned enterprises in Kosovo. According to tentative UNMIK estimates, one-quarter to one-half are unlikely to be viable as going concerns—although they might still own potentially valuable assets. A small number (i.e., 20–40) are estimated to have competent management, working capital, and an established market that could attract outside investors. In between, there is a large number of enterprises that may be viable in some form, but are unlikely to attract investment. Box 4 outlines a proposal for a three-pronged approach to privatization that the reconstruction pillar of UNMIK developed in early 2001. This plan, however, has raised a number of legal and political issues. UN legal services have interpreted UNSCR 1244 as not allowing UNMIK to make any change to the ownership status of socially owned enterprises in Kosovo that would prejudice the rights of former owners or claimants. Potentially, old Serbian claims or concession agreements with foreign companies could stop the sale of such companies in Kosovo. Although the proposal is designed to overcome these legal snags, UN legal services have yet to decide how and whether to proceed.

Privatization of state-owned and socially owned enterprises is an important component of the transition to a market economy and should start as soon as possible, either in the proposed form or under another scheme. Some argue that, in the case of Kosovo, privatization would have limited benefits because many or most of these enterprises are not viable. The importance of privatization, however, should not be underestimated.

- It would unlock the potential of valuable assets that many of these enterprises hold, notably land.

Box 4. The Proposed Privatization Plan

The proposal developed by the reconstruction pillar of UNMIK envisages three channels for privatization.

Spin-offs: Assets of enterprises that could attract new investment would be transferred to a new company, fully owned by the old enterprise. The latter would retain all liabilities. The old enterprise would then be liquidated (voluntarily or through bankruptcy) or transformed (see below), while the new company could seek new investors.

Transformation: Shares of enterprises that are able to meet minimum capital requirements but are unlikely to attract strategic investors would be distributed to employees (60 percent) and the rest to a newly created Kosovo Trust Agency (KTA). The KTA would be a public agency separate from UNMIK, thus shielding UNMIK from potential liabilities. The Agency would be governed by a board of governors appointed by the Special Representative of the Secretary-General, and would be in charge of promoting the restructuring and privatization of the enterprises in which it holds shares.

Liquidation: Nonviable companies would be liquidated or reorganized through bankruptcy.

- It would eliminate a source of quasi-fiscal liabilities.
- It would restore a level playing field between these enterprises and potential private sector competitors and reduce corruption.
- It would send a powerful signal to domestic economic agents, as well as to the rest of the world, about the kind of economy Kosovo wants to build.

Good Governance

Governance is a major weakness. UNMIK and KFOR have been very successful in improving the security situation and reducing violent crime. However, the process of building new state institutions in an area devastated by war has inevitably created gaps in laws and law enforcement, some of which still persist. As a result, Kosovo is vulnerable to corruption, tax evasion, and other economic crime. An even bigger threat is international organized crime, which concentrates on the weakest links in international law enforcement. Establishing and enforcing the rule of law should thus remain one of the highest priorities in order to promote sustainable economic development and prevent Kosovo from becoming a pariah in the international community.

UNMIK has recently started focusing on economic crime. In November 2001, it initiated work on an anti-economic-crime strategy, which includes the creation of an Economic Crime Unit. The strategy will be aimed at establishing priorities, building institutions, and mobilizing resources in fighting economic crime. It will be important to ensure that this strategy cover anti-money-laundering legislation and infrastructure, and that it utilize the already considerable capacities and expertise of the customs administration in this area.

Good governance goes beyond law and order; it encompasses transparency and accountability in government decision making and in managing public resources. Key measures to improve governance and facilitate the implementation of power sharing under the new constitutional framework are the following:

- Coordination and accountability in decision making. In a number of cases, notably insurance and privatization, important regulations took months of legal review, and budget decisions were not always implemented by spending agencies due to differences in policy priorities or interpretation within UNMIK. These delays have real economic costs for donors and Kosovars alike. Steps need to be taken to shorten review procedures, strengthen interdepartmental coordination, and enhance accountability.
- Institutional structure of public finances. Under the new constitutional framework, the authority for fiscal policy in Kosovo is to be split between the Special Representative of the Secretary-General and the government that will emerge from the elections. This split responsibility risks weakening budgetary discipline and therefore needs to be carefully planned and implemented. In addition, accounting and reporting standards, and treasury operations should remain unified for both parts of government spending, as well as for local authorities.
- Coverage of the Kosovo consolidated budget. The budget today covers only part of public expenditure: investment spending remains outside, as do many other donor-financed–off-budget activities. It is imperative to incorporate into the budget all public spending and all sources of financing in order to increase transparency and rationalize resource allocation.

Improving the statistical infrastructure is also an important step toward transparency and better policies. The lack of statistics—with the notable exception of public finances and the recently published monetary statistics—precludes the accurate assessment of the economic situation and hampers policy design. The importance of statistics has recently been fully recognized by UNMIK. It will be critical to continue efforts in this area, placing priority on national accounts and external trade statistics, and providing adequate resources to the Statistical Office of Kosovo.

5

Concluding Observations

Kosovo is a successful case study in economic institution building. The province's economy emerged from a decade of neglect and a short but destructive conflict with its human capital and physical capital severely diminished. Economic institutions were virtually nonexistent, and the vacuum was in some cases filled by parallel structures of dubious legality. The financial system was obliterated, and the economy had reverted to cash-based transactions. Against this background, the work of reconstruction and institution building undertaken by the international community since the end of the conflict is impressive. Today, Kosovo's economy has a recognizable face: private business is thriving, financial intermediation is restarting in a supervised manner, and there is a government providing public services partly financed through taxation. There are, of course, severe shortcomings and distortions in almost every part of this economy, but the nuts-and-bolts are there.

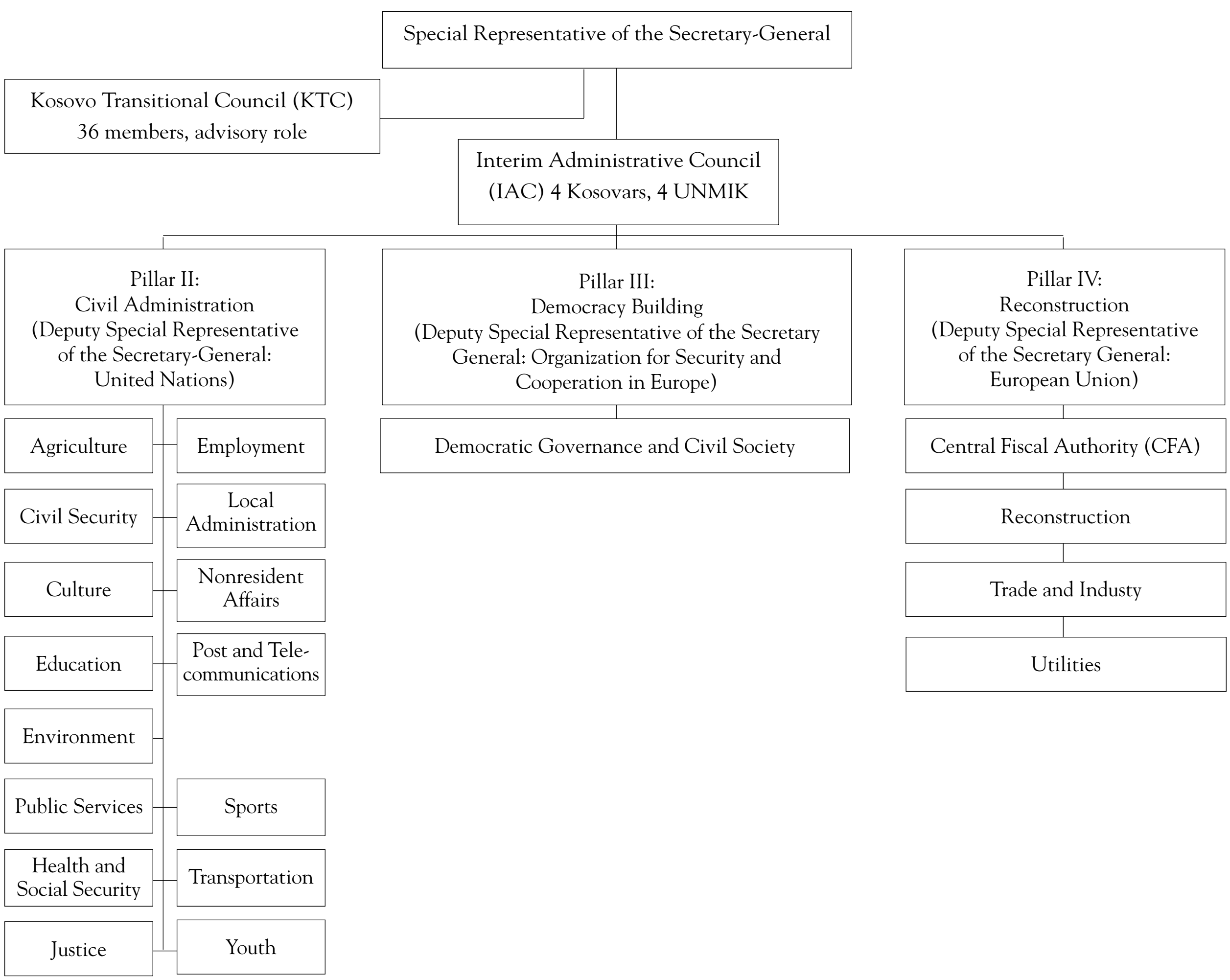
Nevertheless, the economic challenges ahead remain daunting. The economy needs prodigious amounts of investment in physical capital and human resources. Poverty is widespread. With the possible exception of mining, the natural resources of Kosovo's small, landlocked territory are relatively limited, and communications with neighboring regions are hampered by geography and inadequate infrastructure. The existing institutions are yet to develop deep roots and, as a result, Kosovo is vulnerable to criminality, both domestic and international. More importantly, ethnic and political tensions still run high, and the risk of a lapse into violence and anarchy, though greatly diminished, has not entirely disappeared.

In this context, the international community continues to have a key responsibility in Kosovo. Continued engagement is necessary at all levels. First and foremost, under the current arrangements the initiative to resolve Kosovo's constitutional status cannot be taken by anyone but the international community which, through the United Nations, is collectively responsible for the administration of the province. Moreover, regardless of the shape of the final political settlement, Kosovo's political and economic institutions cannot continue to develop without significant assistance from the rest of the world. Last, but not least, considerable resources and technical expertise are required for the significant capital investment needed to lift Kosovo's economy from poverty and place it onto a sustainable growth path. These resources cannot materialize without donor support. The international community's "exit strategy" from Kosovo should be a very gradual process.

However, the presence of the international community in Kosovo, while crucial, will not by itself be enough to achieve any of these goals. The ubiquitous presence of expatriates in Kosovo today, occupying virtually every position of authority, conveys a misleading impression. The fate of Kosovo is ultimately in the hands of the Kosovars themselves. The new democratic institutions of self-government, however provisional, have already given Kosovars considerable influence in shaping events in Kosovo, and this influence is bound to increase with time. They now have to make the choice to build a peaceful, well-governed society and a strong market economy.

Appendix I. The Joint Interim Administrative Structure (JIAS)

JIAS Institutions[1]



Source: United Nations.

[1]Pillar I (Humanitarian Affairs), run by the United Nations High Commisioner for Refugees, ceased to exist as a formal component within UNMIK in July 2000.

Appendix II. Estimates of GDP and Balance of Payments

Estimates of GDP and the balance of payments use earlier IMF staff work for 2000,[8] as well as newly available information, and are extended into 2001. Given the scarcity of data, these GDP estimates are compiled using the expenditure approach, based on partial information and some educated guesswork. The main data sources and assumptions underlying the estimates are as follows:

- The estimate of private consumption in 2000 is based on a household survey conducted by the World Bank.[9] The survey yields a private consumption estimate of DM 3 billion. As the study acknowledges, consumption is underestimated for two reasons: certain items are not included (particularly consumption of housing services); and survey data are systematically lower than consumption estimates for national accounts purposes. To take these factors into account, the World Bank estimate for 2000 is adjusted upward by 15 percent. For 2001, the consumption deflator was estimated to be 8 percent and real consumption growth was estimated to be 5 percent. This conservative assumption reflects the hypothesis that the main source of GDP growth in 2000 and especially in 2001 was investment, and it may well be an underestimate of private consumption.
- Estimates of public consumption for 2000 and 2001 are based on data from the Kosovo consolidated budget and, as such, are relatively reliable.
- Public investment includes all donor-financed projects managed by UNMIK's Department of Reconstruction, as well as a small amount of capital spending (estimated at 5 percent of the total) from the Kosovo consolidated budget.
- The significant construction efforts observed in Pristina and elsewhere in Kosovo suggest that there is substantial private investment. However, there are no reliable estimates of the value of total private investment. IMF staff estimates are based on the assumption that private investment was equivalent to about 40 percent of public investment. For 2000, this amount is augmented by DM 110 million and for 2001 by DM 120 million, which is approximately two-and-a-half times the amount of bank lending in Kosovo.
- Merchandise exports consist of cross-border exports and sales to the expatriate nonresident community. Cross-border exports are estimated on the basis of discussions with the Customs Department and information on the activities of selected companies made available by the CFA. On this basis, cross-border exports are estimated at DM 9.5 million in 2000 and DM 25 million in 2001. Sales to the nonresident expatriate community are estimated at DM 300 per civilian and DM 100 per military staff in 2000 and DM 500 per civilian and DM 200 per military staff in 2001.
- As regards services exports, it is assumed that the average expatriate civilian spent some

[8] Corker, Rehm, and Kostiel, *Macroeconomic Issues and Fiscal Sustainability*.

[9] World Bank, *Poverty Assessment, Kosovo*.

DM 12,000 on housing, plus some DM 3,000 in 2000 and DM 8,000 in 2001 on other locally produced services. The average expatriate military staff is assumed to have purchased local services of some DM 200 in 2000 and DM 600 in 2001.

- Merchandise import estimates are based on data for energy imports, humanitarian assistance, and the public investment program, as well as actual customs data for 2000 and January–June 2001. It is assumed that in 2000, 50 percent of public investments consisted of imports, a figure that declined to 45 percent in 2001. For 2001, the customs data are adjusted upwards by 22 percent. This adjustment reflects imports from Serbia across the administrative boundary line, which are not recorded in customs statistics, and is based on the share of Serbian imports to total sales tax receipts. In addition, import figures are increased by an arbitrary factor to capture the extent of smuggling, as well as the magnitude on imports by KFOR and nongovernmental organizations, which are not reported. This factor is assumed to be 60 percent in 2000 and 45 percent in 2001, the latter reflecting improvements in compliance. Finally, import projections for the second half of 2001 assume a nominal growth of some 45 percent compared to the first half of the year to take account of the rapid GDP growth and the expanded coverage of customs statistics. On the basis of these estimates, import growth in 2001 was 19 percent.
- Services imports are assumed to be equivalent to 15 percent of private investment and 25 percent of public investment, as well as 1 percent of private consumption.
- The estimates of factor income, private transfers, and direct investment from abroad are based on the assumption that in 2000 a total of some 200,000 Kosovars living abroad transferred an average of some DM 5,000 back to Kosovo. This assumption is based on anecdotal information provided by UNMIK staff and is slightly lower than World Bank estimates. Of this amount, it is assumed that three-quarters was private unrequited transfers and the rest remittances (DM 150 million) and foreign direct investment (DM 100 million). In 2001, private transfers were projected to increase by DM 100 million, factor income by DM 150 million, and foreign investment by DM 50 million.

On this basis, the current account shows a small surplus of some DM 5 million in 2000. BPK data provide some information on net foreign assets of the banking system, on the basis of which it is estimated that net bank reserves increased by DM 205 million, roughly half of which were financed by surpluses on the current and capital accounts. This leaves a residual DM 100 million of errors and omissions in 2000. For 2001, a similar calculation yields an increase in net bank reserves of DM 224 million and errors and omissions equivalent to DM 243 million. The large amount of errors and omissions largely reflect deutsche mark that were previously held in cash and are progressively being deposited in the banking system.

Appendix III. The Tax System and Future Plans

Current Tax System and Performance

Kosovo has made considerable progress in building a sound tax system and tax administration. The latter, in particular, had to be rebuilt from scratch because staff, records, and infrastructure had been dispersed, looted, or destroyed. Today, Kosovo has a basic functioning tax system that collects revenue mainly from imports and some domestic sources. The main sources of tax revenue are the following:

- Imports are subject to a 10 percent uniform *customs tariff*, with the exception of agricultural and medical products and humanitarian goods.[10]
- Since July 1, 2001, a *value-added tax* at 15 percent replaced the sales tax previously paid by importers. The VAT also applies to domestic taxpayers, but the high turnover threshold (DM 200,000 annually) and widespread tax evasion limit its efficacy.
- *Excise taxes* were mostly levied on an ad valorem basis. The rates varied between 10 percent on soft drinks, 20–50 percent on alcoholic beverages, and 25 percent on tobacco. In October 2000, ad valorem rates on several categories of excisable goods (alcohol, tobacco, and fuel) were switched to specific rates. An increase in the excise tax rate for fuel of 5 pfennig each quarter was introduced on January 1, 2001.
- A *presumptive tax on businesses* is levied at a rate of 3 percent of gross receipts in excess of DM 15,000 per quarter.

Custom duties, excise and sales taxes, and a large share of VAT are collected only at the borders. This reliance on border taxes makes revenue collection in Kosovo vulnerable to border disturbances, as illustrated by incidents involving the setting of a boundary line with Serbia and the temporary closure of the border with the former Yugoslav Republic of Macedonia in 2001.

In addition to these sources of tax revenue, the budget also collects vehicle registration fees and a few other small amounts in the form of charges and user fees.

Overall, revenue performance in Kosovo improved significantly in 2001, largely owing to rapid growth but also because of improved tax collection at the borders. The introduction of the VAT in July has proved successful, and the removal of certain exemptions on food has also contributed to higher performance. The quarterly increase of 5 pfennig per liter in petrol excise taxes boosted tax revenue even further.

Compliance with existing domestic taxes is currently very low. Recent estimates by the CFA have shown that the level of compliance is around 35–50 percent. There are also very strong indications that many products, notably fuel and cigarettes, are smuggled into Kosovo. After the full range of new taxes is implemented, it will be possible to shift resources from implementation to compliance.

[10]Customs tariffs are not levied on goods originating in the Federal Republic of Yugoslavia, because it is not a foreign country. Also, imports from the former Yugoslav Republic of Macedonia, with which the Federal Republic of Yugoslavia has a free trade agreement, are subject only to the 1 percent administrative fee levied on all imports.

Future Tax Policy and Administration Reforms

The following tax reforms are in the pipeline, subject to approval of the necessary regulations:

- the *wage withholding tax*, to be implemented in 2002 at the following proposed monthly rates:
  - DM 1–100: zero
  - DM 101–500: 5 percent
  - DM 501 and higher: 10 percent
- a *profit tax* at a rate of 20 percent on business profits, to be implemented at the start of 2002, that will replace the current presumptive tax for the larger enterprises
- an *income tax*, to be introduced in 2003, that would be levied on all sources of personal income, which includes income from labor, interest, rents, pensions, and social transfers
- *a lowering of the VAT threshold* to DM 100,000 in July 2002 from DM 200,000
- *a reduction in the customs tariff* in July 2002.

Proposals for several other taxes are under consideration, such as lottery or gambling taxes and a motor vehicle property tax.