IMMEDIATE ATTENTION

SM/01/361

CONTAINS CONFIDENTIAL INFORMATION

December 7, 2001

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Kosovo—Progress in Institution-Building and the Economic Policy Challenges Ahead**

Attached for the information of Executive Directors is a paper on progress in institution-building and the economic policy challenges ahead in Kosovo. Concluding observations appear on pages 18 and 19.

It is intended that this paper will be published on the Fund's external website. If no objections are received by noon on Monday, December 17, 2001, the paper will be posted.

Questions may be referred to Mr. Demekas (ext. 36755), Mr. Herderschee (ext. 37091), and Ms. Jacobs (ext. 36391).

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

KOSOVO[1]

Progress in Institution-Building and the Economic Policy Challenges Ahead

Prepared by Dimitri G. Demekas and Johannes Herderschee (EU1) and Davina Jacobs (FAD)

Approved by the European I Department
(in consultation with other departments)

December 6, 2001

Contents

---

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

Figures

Tables

Appendices

ACRONYMS

BPK	Banking and Payments Authority of Kosovo
CFA	Central Fiscal Authority
IAC	Interim Administrative Council
JIAS	Joint Interim Administrative Structure
KEK	Kosovo Electricity Company
KCB	Kosovo Consolidated Budget
KFOR	Kosovo Force
KTA	Kosovo Trust Agency
MEB	Micro-Enterprise Bank
OSCE	Organization for Security and Cooperation in Europe
PISG	Provisional Institutions of Self-Government
PTK	Posts and Telecommunications of Kosovo
SRSG	Special Representative of the Secretary-General
SOK	Statistical Office of Kosovo
UNSCR	UN Security Council Resolution
UNHCR	UN High Commissioner for Refugees
UNMIK	United Nations Interim Administration Mission in Kosovo

I. Introduction

1. ***Since it was placed under temporary UN administration in June 1999, Kosovo has developed the instruments and institutions necessary for an independent economic policy.*** Kosovo's economy remains linked to the rest of the Federal Republic (FR) of Yugoslavia through trade, but the United Nations Interim Administration Mission in Kosovo (UNMIK) has severed all links with the FR Yugoslavia in the area of economic policy. Although a final political settlement for the province is still pending, Kosovo's economic policy today is effectively independent. Indeed in the two-and-a-half years since the end of the conflict, Kosovo has been a laboratory in economic institution-building from the ground up.

2. ***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.***[2] FAD has focused on setting up the tax system, budgetary institutions, and the treasury. MAE has helped establish the Banking and Payments Authority of Kosovo—which has central banking and financial supervision functions—and appointed its first two Managing Directors, and is working toward a modern payments system. STA has provided assistance on a new statistical framework. Finally, the staff has provided macroeconomic policy advice to UNMIK on an ongoing basis. The Fund'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 G8.

3. ***During September 12–21, 2001, a staff team[3] visited Pristina to review with UNMIK the current economic situation and prospects of Kosovo, as well as economic policies for 2002 and the medium term.*** The mission met Mr. Hans Haekkerup, Special Representative of the Secretary-General (SRSG) in Kosovo, head of UNMIK; Mr. Andy Bearpark, Deputy SRSG; other senior officials of UNMIK, including at the Central Fiscal Authority and the Banking and Payments Authority of Kosovo; and representatives of commercial banks, insurance companies, private enterprises, and the major donors. The mission also met Messrs. Rugova, Thaqi, and Haradinaj, the leaders of the three major Kosovar Albanian political parties, and Ms. Trajkovič, chairwoman of the Serb National Council.

---

[2] UNSCR 1244 explicitly authorizes the 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 Executive Board approved the provision of IMF technical services to Kosovo (EBD/99/80, 7/7/99).

[3] The team included Mr. Demekas (head, EU1), Mr. Herderschee (EU1), and Ms. Jacobs (FAD), and was assisted by Mr. Zampaglione, the World Bank Resident Representative in Kosovo.

4. ***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 henceforth 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 in the process of being formed following the first Kosovo-wide general elections of November 17, 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.

II. Political and Institutional Developments since the End of the Conflict

5. ***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 its short duration (the armed conflict between NATO and Yugoslav forces lasted 78 days), the Kosovo conflict caused significant human dislocation. At its peak, nearly one million Kosovars, mainly ethnic Albanians (about 45 percent of the pre-war 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 displaced 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: arms were ubiquitous, human rights abuses and violence were widespread, and there was a risk of 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 1½ million people in Kosovo, and some 900,000—almost 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 to health facilities and the road, energy, and water supply networks. The handling of the immediate post-conflict crisis by the international community was a success: by July 2000, the humanitarian emergency was over, and the Humanitarian Affairs section, managed by UNHCR, ceased to exist as a formal component of UNMIK.[4]

6. ***In parallel, UNMIK used its authority under UNSCR 1244 to establish a civilian administration in Kosovo.*** UNSCR 1244 gave the SRSG and UNMIK a very broad mandate, including 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 (UNHCR); Civil Administration (UN); Democracy-building (OSCE); and Reconstruction (EU). These four pillars, as well as the

---

[4] UN Security Council, *Report of the Secretary-General on the United Nations Interim Administration Mission in Kosovo*, United Nations, June 2000; International Crisis Group, *Kosovo Report Card*, Balkan Report No. 100, Brussels, August 2000; and UNMIK, *A Year and a Half in Kosovo,* December 2000.

30 municipalities in Kosovo, were managed by international UNMIK staff. In addition, KFOR continued to guarantee security and order.

7. ***UNMIK moved quickly to set up the structures and institutions necessary for an autonomous economic policy***. A key early decision in this regard was 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 administration. In December 1999, the CFA prepared the first Kosovo Consolidated Budget (KCB), covering the recurrent expenditures of the central government, municipalities, and public enterprises. There are no transfers between the KCB and the budget of the FR 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 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 KCB and replace the parallel tax structures that had developed during the 1990s.

- The complex and distortionary ***trade regime*** that was inherited from the FR 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, license and supervise domestic banks, and ensure their liquidity, solvency, and effective functioning.

- The ***payments system*** was reformed with the introduction, initially, 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.

8. ***As a result of these measures, the institutional structure for economic policy that has emerged in Kosovo is effectively autonomous***. 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 FR Yugoslavia was expected to remain responsible 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 is economic policy structures and institutions that are in effect entirely independent.

9. ***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 (JIAS). The functions of the administration were passed to 20 JIAS departments divided across the four pillars (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.

10. ***The new Constitutional Framework and the first elections for a Kosovo-wide Assembly of November 17, 2001 were further major steps toward self-government.*** On May 15, 2001, the SRSG 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 JIAS departments, collectively referred to as the Provisional Institutions of Self-Government (PISG); and provided for the separation of executive, legislative, and judicial powers and institutions. The first Kosovo-wide elections under this framework took place on November 17, 2001, and these institutions are currently being formed. At the same time, the Framework circumscribed the authority of the PISG by reserving some key powers and responsibilities exclusively for the SRSG. These include *inter alia* the authority to set the overall parameters of economic policy (for more details, see Box 1).

11. ***The new Constitutional Framework will have to be implemented under continuing uncertainty regarding Kosovo's final status and ongoing segregation of the Serb and Albanian communities.*** The Framework has the support of the government of FR Yugoslavia, as indicated by the UNMIK-FR 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 policy-making. 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 SRSG 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 on one hand and the administrative structures that the SRSG will need to keep under his direct control in order to exercise his reserved powers, such as the CFA, on the other.

Box 1. The New Constitutional Framework

The new Constitutional Framework, promulgated by the SRSG on May 15, 2001 and supplemented by a Regulation on the Executive Branch passed in September, sets up a comprehensive legal framework for self-government in Kosovo. The main elements of the Framework are the following.

Provisional Institutions of Self-Government (PISG). Following the elections of November 17, 2001, the following institutions are being established.

The ***Assembly*** consists of 120 members elected for a three-year term. 100 seats are filled by proportional vote, 10 are allocated to Kosovo Serbs, and 10 to other ethnic communities.

The ***President*** is elected by the Assembly with a two-thirds majority for a three-year term, and has largely symbolic powers.

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 is a Kosovo Serb, and one a member of another minority ethnic community.

Power-sharing. The SRSG 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 SRSG. 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- and socially-owned property, in cooperation with PISG.

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 BPK; the chief executives of the Customs Service and Tax Inspectorate; and the Auditor General.

III. Recent Economic Trends and Policies

A. Production, Income, and Poverty

12. ***The productive capacity of Kosovo had been severely degraded during the 1990s.*** Like the rest of Serbia, the province had suffered from the breakup of the former SFR Yugoslavia and the associated conflicts, as well as the economic mismanagement of the FR Yugoslavia during the 1980s and 1990s. Especially after 1989, when the autonomy of Kosovo within the republic of Serbia was suspended, the province experienced massive disinvestment. Operations and maintenance in

Sectoral Investment Flows (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.

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.

13. ***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.

14. ***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 (SOK) 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 farm-gate 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.

15. ***Preliminary staff estimates suggest that GDP amounted to DM 2¾–3¼ billion (US$700–750 per capita) in 2000.*** The staff national accounts estimates (Table 1) are little more than guesses based on fragmentary information and informed by anecdotal evidence. The GDP estimate is almost identical to that made earlier by staff for the same year,[5] but incorporates lower figures for private consumption (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.

16. ***All indicators show economic activity rebounding strongly in 2001, with real GDP growth well into double digits.*** Reconstruction of buildings and infrastructure is evident everywhere; anecdotal evidence suggests that the 2001 agricultural harvest was perhaps 20–30 percent higher than in the previous year; the provision of public services is improving; and there is a vibrant private service sector. Industrial production is 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 FR Yugoslavia. In addition, 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

---

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

estimated by the staff to have risen by some 8 percent.[6] As a result, GDP in 2001 is estimated at DM 3½–4 billion (US$850–950 per capita).

17. ***This level of activity, and the even higher level of disposable income and consumption, reflect the magnitude of foreign assistance.*** As Table 1 shows, the structure of GDP is very distorted. Gross National Disposable Income is estimated at about 175 percent of GDP, merchandise imports about 80 percent of GDP, and consumption about 120 percent of GDP in 2001 (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 (Table 2) show that official transfers amounted to DM 1.5 billion in 2000 and 1.6 billion in 2001 (a total of about US$2.1 billion), most of it for reconstruction. 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 finance private consumption or repairs of private homes. These transfers covered the large trade deficit. Finally, the sizeable 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 approximately 40,000 KFOR troops.

Official Transfers
(In DM million)

	2000	2001
Humanitarian assistance	200	100
Budgetary grants	285	202
Reconstruction	1,009	1,320
Total	1,494	1,622
(percent of estimated GDP)	51	44

Source: UNMIK; and IMF staff estimates.

18. ***Poverty in Kosovo is widespread but relatively shallow.*** A World Bank assessment for 2000[7] 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: on average, 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 non-poor households in Kosovo very 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 post-conflict period had been quite successful in mitigating poverty in Kosovo.

[6] 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.

[7] *Poverty Assessment, Kosovo, Federal Republic of Yugoslavia*, The World Bank.

B. Public Finances

19. ***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 Central Fiscal Authority (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 (KCB) so far covers mainly recurrent spending: the bulk of investment spending is donor-financed and managed separately by the Department of Reconstruction.

Box 2. Budgetary Structure

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

Kosovo Consolidated Budget (KCB): 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 Dept. 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.

20. ***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 15–20 percent of estimated GDP in 2000–01, of which some 80 percent was collected at the border because, despite recent improvements, domestic compliance is very weak. The main revenue sources of the KCB 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 on July 1, 2001 (Table 3). 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 over 55 percent of estimated GDP in 2000 and 2001.[8] The gap was covered by donor grants (Table 4).

21. ***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 being financed by donor grants (DM 162 million, primarily from the EU), 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 538 million, compared with a budget target of DM 338 million. This enabled the CFA to revise its budget targets in October, allowing some increase in current spending limits (by DM 63 million) and allocating the rest of the unanticipated revenue to building cash reserves.

---

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

22. ***The 2002 draft budget projects a continuing increase in tax revenue, but the expected further decline in donor grants limits the room for spending increases.*** 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 towards 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. Wages and salaries and current spending, on the other hand, are projected to grow only modestly. UNMIK is planning a review of staffing and pay in the administration during 2002, in order to rationalize and increase the transparency of the system. Reconstruction spending projections show a marked decline in 2002, reflecting the expected decline in donor transfers for investment projects. To facilitate better planning and coordination of the recurrent and reconstruction budgets, the CFA is currently working towards consolidating the two budgets, in line with earlier IMF and World Bank recommendations.

23. ***The performance and management of public enterprises is very uneven and raises questions about governance.*** The main public enterprises are the electricity generation and distribution company (KEK), posts & telecommunications (PTK), Pristina Airport, Kosovo Railways, and a number of local water, waste, and heating companies.

- 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 to technical losses or theft, and of the rest, less than half is paid by the consumers. With about 10,000 employees, KEK 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, it is still not able to generate enough electricity to fulfill domestic needs and blackouts are frequent.

- 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 sizeable accumulation of deposits in the public enterprise sector during 2000–01 (Table 3). However, PTK 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—if any—of the company are viable in the long term, and there is clearly a limit to the extent the budget can continue subsidizing the mining sector. The fact that the company's activities are largely in the Serb enclaves makes this a politically sensitive issue.

24. ***UNMIK plans to introduce a social security system in 2002.*** At present, there is no social security system in Kosovo. UNMIK has designed a three-tier system for introduction in 2002. Although the details of the system are still being finalized and its introduction is likely to be phased in gradually, the new system is designed to provide a minimum social safety net for the old through a universal Basic Citizens' pension (first tier), and 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. Depending on the way its introduction is phased in during 2002, the impact on the 2002 budget is expected to be DM 35–40 million.

C. The Financial Sector

25. ***The banking system is in a state of infancy but bank supervision is strong.*** 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 recent months. There are currently seven licensed banks and fifteen micro-finance institutions operating in Kosovo. Two of the banks and most of the micro-finance institutions are created and financed by donors and, with one exception, are very small: the aggregate balance sheet of the commercial banks at end-August was just over DM 400 million. The exception is the Micro-Enterprise Bank (MEB), a foreign-owned bank partly capitalized by the EBRD and the IFC, which accounts for more than half of the aggregate balance sheet of the banking system. Bank deposits amounted to DM 364 million (less than 10 percent of estimated GDP) and bank loans to the private sector were just DM 27 million (with an additional DM 29 million of loans extended by micro-finance institutions), most of them to finance trade and services (Table 5). As regards bank supervision, 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.

26. ***Although the BPK is operationally independent, it depends on the budget for financial support and suffers from internal accounting problems.*** The BPK's dependence on budgetary transfers to finance its operations reflects the absence of seignorage from the issuance of currency, 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.

27. ***In the insurance sector, a deficient legal framework, the absence of supervision, and UNMIK's slow response to a festering problem led to a crisis.*** After UNMIK promulgated in November 1999 a legal framework for third-party motor vehicle liability insurance that did not set adequate prudential requirements and did not provide for supervision, five insurance companies quickly emerged. Their operations gradually raised concerns about their solvency and allegations of extortion and criminal activity. However, only in October 2001 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.

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 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 competitive 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 criminality.

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 starts realizing 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 at 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 premia 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 any necessary remedial measures.

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

IV. Toward Sustainable Economic Development: Policy Priorities for the Near Term

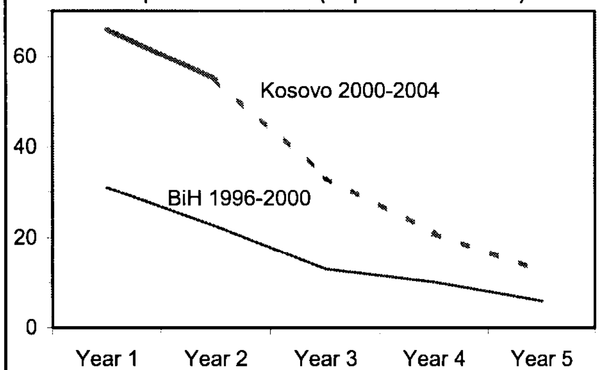
28. ***Despite the signs of vigorous private economic activity, Kosovo's long-term economic prospects are clouded by considerable uncertainty***. Revitalizing the province's infrastructure and capital base after years of degradation and wartime damage would require significant upfront investments. One of Kosovo's greatest assets, its young population,[9] would also need sizeable 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 cannot be relied upon fully to finance these necessary long-term investments. At the same time,

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

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.

29. ***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.*** Humanitarian assistance has already started declining, and is expected to drop to very low levels by 2003. At the same year, donor grants for recurrent budgetary spending are expected to end. Grants for reconstruction are likely to decline from DM 1.3 billion in 2001 to DM 300–400 million by 2004. While the current magnitude and medium-term outlook for private transfers is uncertain, they are unlikely to persist at their present level. In all, foreign transfers are expected to fall from 67 percent of estimated GDP in 2001 to 15–20 percent by 2004. 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.

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.

30. ***The near-term economic policy goal should thus be to develop the domestic productive capacity and deepen the integration of Kosovo's economy to 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 will maximize the chances of building a sustainable economy. To achieve this goal, UNMIK and the PISG should focus on four broad policy priorities: fiscal sustainability, financial sector deepening, private sector development, and good governance. The rest of this paper discusses each of these in turn.

A. Fiscal Sustainability

31. ***The main fiscal challenge for 2002 and the medium term will be to keep the growth of spending in line with that of available resources.*** Despite better-than-expected collection this year, local revenue growth will be unable to compensate for the drop in donor grants in the short to medium term. Spending needs, on the other hand, will continue to stay 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 by UNMIK and the PISG to make tough decisions.

32. ***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 planned to be 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 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 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 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.

33. ***On the basis of this tax policy, and absent 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 1). Within this overall envelope, however, since reconstruction needs will naturally fall, the room for current spending may actually increase somewhat over the medium term. The share of current spending to GDP in Kosovo (excluding interest and pensions, which have so far been zero) is already higher than other countries in the region and a representative sample of low- and middle-income countries (Figure 2 and Table 6). This suggests that the medium-term expenditure envelope in Figure 1 should be adequate for the needs of the administration in Kosovo without additional budgetary support by donors. It also underscores the need for UNMIK and the PISG to put the emphasis on allocating the existing resources efficiently.

34. ***Expenditure management in the medium term will be a challenge***. First, although reconstruction spending will naturally fall in the near future, the need for capital spending will nonetheless continue to be high, especially in the energy sector. Secondly, social spending, such as education and health, together with the recent introduction of a pension system, will demand an increasing portion of budgetary resources. Thirdly, new spending needs will arise, such as the possible burden from Kosovo's share of former Yugoslav debt and the need to take over several off-budget expenditures that are currently directly financed by donors. The special circumstances of ethnic minorities are also likely to generate expenditure pressures.

35. ***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 keep control over***

current spending, especially the public wage bill. The wage bill already absorbs the bulk of the General Budget. UNMIK has not thus far been able 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.

36. ***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. PTK must be brought under the Public Utilities Department and its transactions and, 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. A new and professional management is needed in KEK to reduce overstaffing, streamline operations, and improve service provision to the public.

37. ***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 draft pension regulation, the Assembly is responsible for setting the benefit level, but taxation remains in the reserved powers of the SRSG. A mechanism is thus needed in order to ensure that the benefit level set by the Assembly is low and consistent with available resources, and is adjusted in a transparent, de-politicized way. A relatively low Basic Pension would also strengthen the fully funded second and third pillars, which would thus become the main components of the system. Furthermore, since the Basic Citizen's Pension is essentially a social safety net for the old, it should be means-tested by being subject to the future income tax. 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.

B. Financial Sector Deepening

38. ***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, thus bringing the "shadow economy" into the light. However, Kosovo's financial sector is stunted by lack of confidence in banks; lack of trained and experienced managers and supervisors; weak legal framework for private business; and political uncertainty, which deters potential foreign investors.

39. ***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. Structural reforms in other areas, such as passage of bankruptcy legislation, introduction of a property registry, and payment of public employees and suppliers through direct 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.

40. ***On the other hand, developments in the insurance sector 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 while no one was held accountable. The resulting crisis was inevitable. The new insurance regulation, under which the BPK took over the supervision of insurance companies is a welcome step in the right direction. However, the magnitude of the problem and the possible costs arising from undercapitalized insurance companies are yet to be fully assessed.

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

42. ***In order to perform its functions properly, the BPK should have not only operational autonomy but also financial independence.*** 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. Resolution by the BPK of its internal accounting problems and rationalization of its operations (notably the reduction of the number of branches to two, as recommended by MAE) are thus key priorities, as well as prerequisites for recapitalization.

43. ***The conversion of deutsche marks to euros in 2002 will be a challenge and an opportunity***. Kosovo's cash-based economy may face some short-term disruption until an adequate amount of euro notes and coins is available. At the same time, the conversion process will provide an opportunity to accelerate financial deepening, since it will force most holders of DMs (many of them for the first time) to make transactions with commercial banks. The BPK's plan for the conversion envisages parallel circulation of DMs and euros for two months (through end-February 2002). Given the uncertainties regarding the amount of DMs in circulation in Kosovo, the amount of collateral that can be mobilized to cover frontloading of euros before January 1, 2002, and the pace of conversion, the BPK should stand ready to extend the conversion period beyond the planned two months.

C. Private Sector Development

44. ***Private activity in Kosovo today is vibrant but remains mostly limited to informal services.*** It thus 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.

45. ***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 of pledging of mobile assets. This package now needs to be supplemented by legislation on bankruptcy, protection of competition, and mortgages, as well as a functioning cadastre and property registry. Equally important is strengthening of the judiciary so that the new laws can be properly administered.

46. ***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, a quarter to half are unlikely to be viable as going concerns (although they might still own potentially valuable assets), while a small number (20–40) have competent management, working capital, and an established market, and could attract outside investors. In between, there is a large number of enterprises that might be viable in some form, but are unlikely to attract investment. Box 4 outlines a proposal for a three-part approach to privatization that the Reconstruction pillar of UNMIK developed in early 2001. However, this plan has raised a number of legal and political issues. UN legal services have interpreted UNSCR 1244 as preventing UNMIK from making any change to the ownership status of socially owned enterprises in Kosovo that would prejudice the rights of former owners or claimants. Potential old Serbian claims or concession agreements with foreign companies could thus stop the sale of socially owned companies in Kosovo. Although the proposal is designed to overcome these legal snags, UN legal services are yet to decide whether and how to proceed.

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 to enterprises that are able to meet minimum capital requirements but 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), governed by a Board of Governors appointed by the SRSG, and in charge of promoting restructuring and privatization of the enterprises in which it holds shares.

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

47. ***Privatization of state- and socially-owned enterprises is an important component of the transition to a market economy and should start as soon as possible.*** Some argue that in the case of Kosovo, privatization would have limited benefits, since many, perhaps most, of these enterprises are today unviable. The importance of privatization, however, should not be underestimated: *first*, it would unlock the potential of valuable assets that many of these enterprises hold, notably land; *second*, it would eliminate a source of quasi-fiscal liabilities; *third*, it would restore a level-playing field between them and potential private sector competitors and reduce corruption; and *fourth*, 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.

D. Good Governance

48. ***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 lacunae in law 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.

49. ***UNMIK has recently started focusing particularly on economic crime***. In November 2001, UNMIK 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 would be important to ensure this strategy cover anti-money laundering legislation and infrastructure, and to utilize the already considerable capacities and expertise of the Customs Administration in this area.

50. ***Good governance goes beyond law and order, and 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 take months of legal review, or budget decisions are not implemented by spending agencies due to differences in policy priorities or interpretation within UNMIK. These incidents have real economic costs for donors and Kosovars alike. Steps should be taken to shorten review procedures, strengthen inter-departmental coordination, and enhance accountability.

- ***Institutional structure of public finances***. Under the new Constitutional Framework, the authority for fiscal policy in Kosovo will be split between the SRSG and the government that will emerge after the elections. This split risks weakening budgetary discipline, and therefore needs to be carefully planned and implemented. In addition to setting overall financial and policy parameters for the budget and maintaining authority over certain areas of public spending, as stipulated in the Constitutional Framework, the SRSG should also retain responsibility for tax policy and administration. Furthermore, 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 KCB 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 KCB all public spending and all sources of financing in order to increase transparency and rationalize resource allocation.

51. ***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 in national accounts and external trade statistics, and providing adequate resources to the Statistics Office.

V. Concluding Observations

52. ***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 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 re-starting 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.

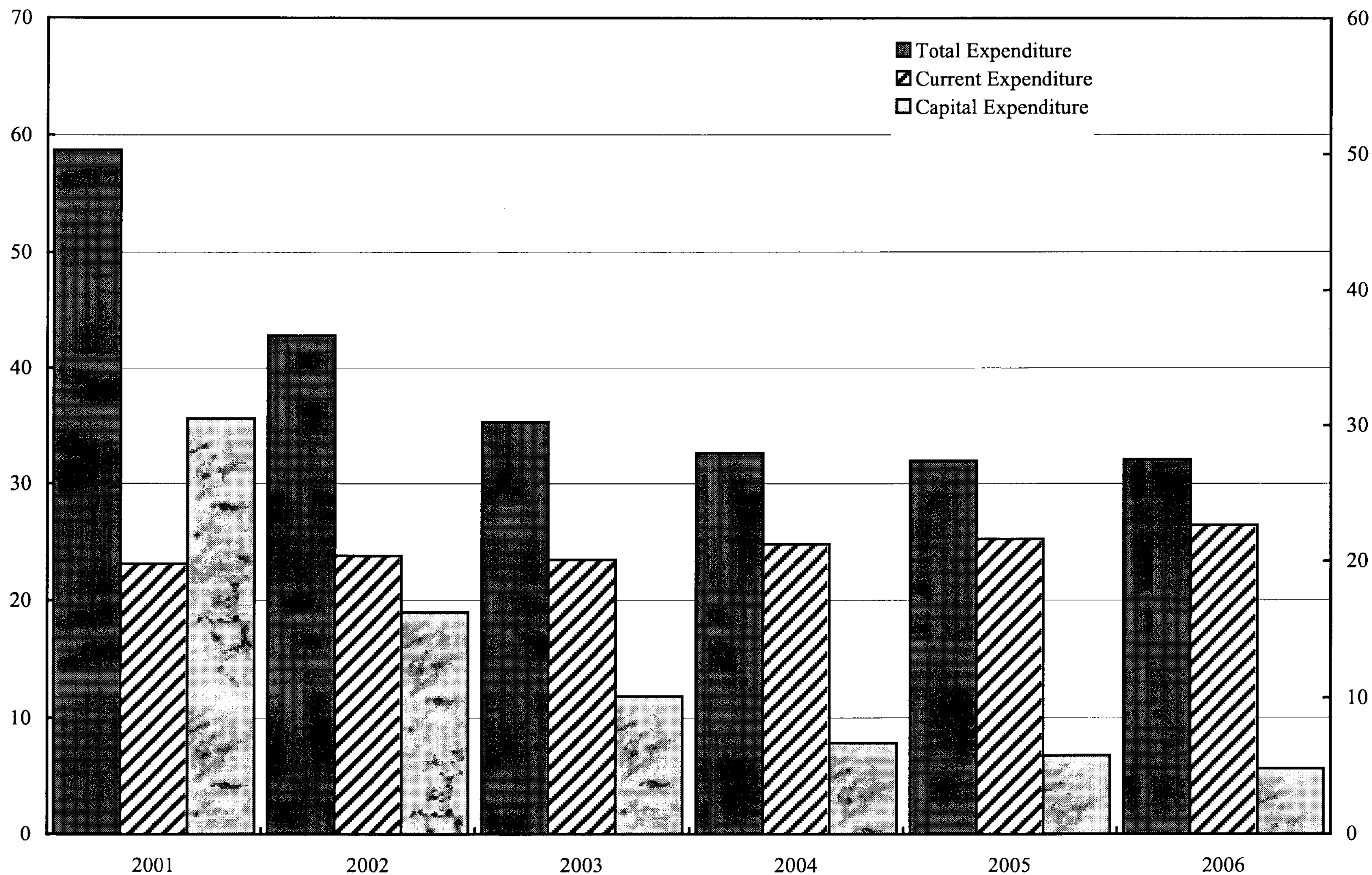
53. ***Nevertheless, the economic challenges ahead are still daunting.*** The economy needs prodigious amounts of investment in physical capital and human resources. Poverty is widespread. With the possible exception of mining, the natural resources of Kosovo's small, landlocked territory are relatively limited and communications with neighboring regions 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 are still high, and the risk of a throwback into violence and anarchy, though greatly diminished, has not entirely disappeared.

54. ***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 developing without significant assistance from the rest of the world. Last but not least, considerable financial 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.

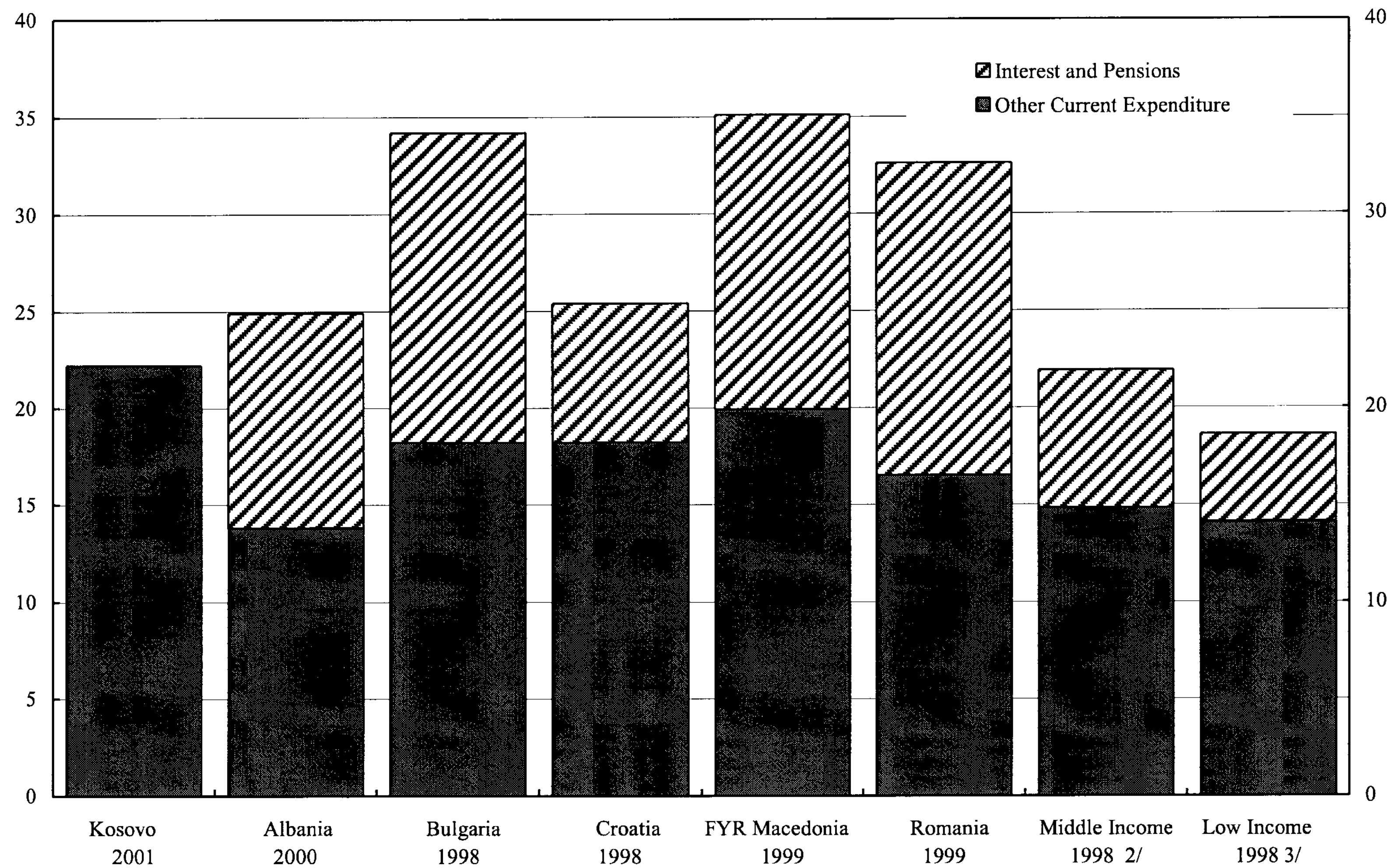
55. However, the presence of the international community in Kosovo, while crucial, will not by itself be enough to achieve any of these goals. The ubiquitous presence of expatriates in Kosovo today, occupying virtually every position of authority, conveys a misleading impression. The fate of Kosovo is ultimately in the hands of the Kosovars themselves. The new, democratic institutions of self-government, however provisional, have already given them 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.

Figure 1. Kosovo: Medium-Term Projections of Expenditure, 2001-2006
(In percent of GDP)



Sources: UNMIK and IMF staff estimates.

Figure 2. International Comparisons of Current Expenditure, 1/
(In percent of GDP)



Sources: IMF, *Government Finance Statistics Yearbook* (Washington, various years); and IMF staff estimates.

1/ Estimated outcome for Kosovo Consolidated and Recurrent Budgets, excluding the budget of the local governments. 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, Ghana, Kenya, Lesotho, Malawi, Mali, Sierra Leone, Sri Lanka, former Zaïre, and Zambia.

Table 1. Kosovo: GDP and National Income, 2000-2001
(DM million, unless otherwise indicated)

	2000		2001
	Original	Revised	Projections
Gross Domestic Product (GDP)	3,000	2,956	3,708
GDP per capita (US$)	746	735	880
Nominal GDP growth rate (percent)	...	...	25
Real GDP growth rate (percent)	...	...	16
Gross National Income (GNI)	3,000	3,106	4,008
Gross National Disposable Income (GNDI)	5,540	5,350	6,480
GNDI, excluding budget and reconstruction aid	4,512	4,056	4,958
Consumption	4,380	3,769	4,510
Private	4,077	3,450	3,912
Public	303	319	598
Investment	1,160	1,575	2,102
Private	405	529	686
Public/foreign financed	755	1,046	1,415
Exports	0	404	467
Merchandise	0	21	43
Services	0	383	424
Imports	-2,540	-2,792	-3,371
Merchandise	-2,540	-2,414	-2,869
Services	0	-379	-502
Net factor income from abroad	0	150	300
Net transfers from abroad	2,540	2,244	2,472

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

Table 2. Kosovo: Balance of Payments, 2000-2001
(DM million, unless otherwise indicated)

	2000 Original	2000 Revised	2001 Projections
Trade balance	-2,540	-2,393	-2,826
Exports	0	21	43
Imports	-2,540	-2,414	-2,869
Non-factor services	0	4	-78
Exports	0	383	424
Imports 1/	0	-379	-502
Net factor income from abroad	0	150	300
Factor income	0	150	300
Factor payments	0	0	0
Transfers	2,540	2,244	2,472
Private transfers	1,200	750	850
Official transfers	1,340	1,494	1,622
Humanitarian assistance	312	200	100
Donor grants for current spending	272	285	202
Reconstruction aid	756	1,009	1,320
Current account balance	0	6	-132
Current account balance as a share of GDP (per cent)	0.0	0.2	-3.6
Capital account	0	100	150
PFDI	0	100	150
Loans	0	0	0
Errors and omissions 2/	0	99	212
Overall balance	0	205	230
Net change in international reserves	0	-205	-230
Official reserves (-, increase)	0	-77	-50
NIR of the banking system (-, increase)	0	-128	-180

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

1/ Excluding services delivered by non-residents living in Kosovo, which are paid by foreign donors.
2/ Including transfers that had taken place earlier but are deposited in the banking system during 2000 and 2001.

Table 3. Kosovo: Consolidated Budget, 2000-2002
(In millions of DM)

	2000	2001				2002
	Prel.	Budget	Actual Jan.-Sep.	Rev. Budget	Est.	Budget
General Budget						
Revenue	248.9	338.1	376.2	486.1	538.1	681.6
Tax revenue	237.7	303.9	355.2	464.1	516.1	654.6
Customs	60.5	44.5	62.5	80.0	83.1	62.8
Excises	38.2	83.4	97.2	125.0	150.9	207.2
Salesand VAT	124.0	138.0	156.8	203.0	230.5	311.6
Presumptive business tax	9.2	28.0	37.0	50.0	50.0	43.0
Profit tax	0.0	0.0	0.0	0.0	0.0	20.0
Wage tax	0.0	0.0	0.0	0.0	0.0	10.0
Other	5.8	10.0	1.8	6.1	1.6	0.0
Nontax revenue	11.2	34.2	20.9	22.0	22.0	27.0
Expenditures	430.5	500.0	320.1	562.5	562.5	719.0
Recurrent expenditure	428.5	461.0	311.1	515.1	515.1	619.0
Salaries, goods & services	272.8	309.4	220.9	350.8	350.8	445.8
Of which: Wages and salaries	167.0	181.7	144.7	201.9	201.9	214.4
Of which: Goods and services	105.8	127.7	76.2	148.9	148.9	231.4
Subsidies and transfers	155.7	151.6	90.2	164.3	164.3	173.2
To households	60.1	94.9	...	...	...	43.0
Of which: Pensions	0.0	0.0	0.0	0.0	0.0	37.0
To municipalities and others	32.5	27.7	...	...	...	23.0
To public enterprises	63.0	29.0	...	...	...	70.2
Interest payments	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure and transfers	0.0	18.2	9.0	22.3	22.3	40.0
Reserves and contingency	2.0	20.8	...	25.1	25.1	60.0
Overall Budget Balance	-181.6	-161.9	56.1	-76.4	-24.4	-37.4
Overall Budget Balance (incl. Grants)	*48.9*	*0.0*	*184.9*	*85.5*	*137.5*	*12.6*
Financing	181.6	161.9	-56.1	76.4	24.4	37.4
Undesignated donor grants	211.1	150.0	125.0	150.0	150.0	50.0
Designated donor grants	19.4	11.9	3.9	11.9	11.9	0.0
Domestic (change in bank balances) (residual)	-48.9	0.0	-184.9	-85.5	-137.5	-12.6
Local authorities 2/						
Revenue	22.0	33.6	16.5	33.6	33.6	89.1
Of which: Own revenue 1/	3.0	6.0	...	6.0	6.0	38.5
Expenditures (recurrent)	22.0	33.6	16.5	33.6	33.6	89.1
Balance	0.0	0.0	0.0	0.0	0.0	0.0
Public enterprises 2/						
Revenue	276.7	225.8	98.4	196.8	196.8	287.3
Of which: Own revenue	213.7	196.8	98.4	196.8	196.8	217.1
Expenditures	154.1	262.0	74.3	262.0	262.0	289.0
Operating costs	62.9	148.6	28.1	148.6	148.6	163.9
Electricity imports	54.5	40.0	9.5	40.0	40.0	10.0
Capital	36.7	73.4	36.7	73.4	73.4	81.0
Balance	122.7	-36.2	24.1	-65.2	-65.2	-71.9
Donor grants for electricity imports	54.5	40.0	9.5	40.0	40.0	10.0
Change in bank balances	-177.2	-3.8	-33.6	25.2	25.2	61.9
Kosovo Consolidated Budget						
Revenue	465.6	540.9	474.6	688.9	740.9	937.2
Expenditure	511.0	738.9	410.8	858.1	858.1	1003.9
Balance	-45.4	-198.0	63.7	-169.2	*-117.2*	*-66.7*
Balance (incl. Grants)	*239.6*	*3.9*	*202.0*	*32.7*	84.7	-6.7
Financing	45.4	198.0	-63.7	169.2	117.2	66.7
Budgetary donor grants	230.5	161.9	128.8	161.9	161.9	50.0
Donor grants for electricity imports	54.5	40.0	9.5	40.0	40.0	10.0
Domestic (change in bank balances) (residual)	-239.6	-3.9	-202.0	-32.7	-84.7	6.7

Sources: UNMIK; and IMF staff estimates.

1/ Own revenues only include revenue raised directly and paid over to the KCB.

2/ Staff estimates for 2002.

Table 4. Kosovo: Overall Fiscal Position, 2000-2002
(In millions of DM)

	2000	2001				2002
	Prel.	Budget	Actual Jan.-Sep.	Rev. Budget	Est.	Budget
Kosovo Consolidated Budget						
Revenue	465.6	540.9	474.6	688.9	740.9	937.2
Expenditure	511.0	738.9	410.8	858.1	858.1	1,003.9
Balance	-45.4	-198.0	63.7	-169.2	-117.2	-66.7
Balance (incl. Grants)	*239.6*	*3.9*	*202.0*	*32.7*	*84.7*	*-6.7*
Financing	45.4	198.0	-63.7	169.2	117.2	66.7
Budgetary donor grants	230.5	161.9	128.8	161.9	161.9	50.0
Donor grants for electricity imports	54.5	40.0	9.5	40.0	40.0	10.0
Domestic (change in bank balances) (residual)	-239.6	-3.9	-202.0	-32.7	-84.7	6.7
Kosovo Reconstruction Budget (capital exp.)	1,009.3	1,346.5	412.0	1,319.7	1319.7	800.0
Kosovo Consolidated and Reconstruction Budget						
Revenue	465.6	540.9	474.6	688.9	740.9	937.2
Expenditure	1,520.3	2,085.4	822.8	2,177.8	2,177.8	1,803.9
Balance	-1,054.7	-1,544.5	-348.3	-1,488.9	*-1436.9*	*-866.7*
Balance (incl. Grants)	*239.6*	*3.9*	*202.0*	*32.7*	*84.7*	*-6.7*
Financing	1,054.7	1,544.5	348.3	1,488.9	1,436.9	866.7
Grants to Recurrent Budget	285.0	201.9	138.3	201.9	201.9	60.0
Grants to Reconstruction Budget	1,009.3	1,346.5	412.0	1,319.7	1319.7	800.0
Domestic (change in bank balances) (residual)	-239.6	-3.9	-202.0	-32.7	-84.7	6.7
			(As percentage of GDP)			
Kosovo Consolidated Budget						
Revenue	15.7	11.8	13.8	15.0	20.0	22.2
Expenditure	17.3	16.1	11.9	18.7	23.1	23.8
Balance	-1.5	-4.3	1.8	-3.7	-3.2	-1.6
Balance (incl. Grants)	*8.1*	*0.1*	*5.9*	*0.7*	*2.3*	*-0.2*
Financing	1.5	4.3	-1.8	3.7	3.2	1.6
Budgetary donor grants	7.8	3.5	3.7	3.5	4.4	1.2
Donor grants for electricity imports	1.8	0.9	0.3	0.9	1.1	0.2
Domestic (change in bank balances) (residual)	-8.1	-0.1	-5.9	-0.7	-2.3	0.2
Kosovo Reconstruction Budget (capital exp.)	34.1	29.3	12.0	28.7	35.6	19.0
Kosovo Consolidated and Reconstruction Budget						
Revenue	15.7	11.8	13.8	15.0	20.0	22.2
Expenditure	51.4	45.4	23.9	47.4	58.7	42.8
Balance	*-35.7*	*-33.6*	*-10.1*	*-32.4*	*-38.8*	*-20.6*
Balance (incl. Grants)	8.1	0.1	5.9	0.7	2.3	-0.2
Financing	35.7	33.6	10.1	32.4	38.8	20.6
Grants to Recurrent Budget	9.6	4.4	4.0	4.4	5.4	1.4
Grants to Reconstruction Budget	34.1	29.3	12.0	28.7	35.6	19.0
Domestic (change in bank balances) (residual)	-8.1	-0.1	-5.9	-0.7	-2.3	0.2

Sources: UNMIK; and IMF staff estimates.

Table 5. Kosovo: Commercial Bank Balance Sheet, 2000-2001
(In thousand DM)

	2000	2001			
	Dec.	March	June	July	Aug.
ASSETS					
Cash	22,826	28,927	22,988	32,893	31,615
Balance with BPK	26,794	32,308	52,321	53,729	57,944
Non-interest-bearing current account with other banks	12,155	7,196	16,250	10,106	8,170
Loans to financial institutions (placement)	127,547	166,854	217,303	244,648	271,706
Net loans	6,157	9,230	20,239	24,200	26,069
Property and equipment, net of depreciation	863	1,374	2,362	2,636	3,301
Interest receivable and other assets	5,038	3,810	3,124	4,494	6,044
Total assets	201,380	249,699	334,604	372,706	404,849
LIABILITIES					
Deposits	181,898	223,986	297,744	332,634	364,513
Borrowings	5,719	5,985	9,867	9,867	9,867
Interest payable and other liabilities	1,731	1,274	1,508	3,061	1,615
Subordinated debts	...	...	22	11	...
Shareholders' equity	12,032	18,454	25,463	27,133	28,854
Total liabilities and shareholders' equity	201,380	249,699	334,604	372,706	404,849
Off-balance sheet commitments and contingencies	11,660	9,988	10,914	11,750	3,462

Source: Banking and Payments Authority of Kosovo, Financial Statistics, September 2001.

Table 6. International Comparisons of Government Expenditures
(Average as percent of GDP)

	Kosovo 1/ 2001	Albania 2000	Bulgaria 1998	Croatia 1998	Macedonia 1999	Romania 1999	Middle Income 2/ 1998	Low Income 3/ 1998
Expenditures by economic type: (including net lending)	57.8	31.4	36.8	31.0	37.7	35.6	27.7	25.6
Current expenditures	22.2	24.9	34.2	25.4	35.1	32.6	21.9	18.6
Goods and services	13.7	12.4	16.5	16.6	12.4	11.7	11.5	12.6
Wages 4/	8.3	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	8.5	6.8	13.3	7.4	21.1	15.4	7.9	2.8
Of which: Pensions	0.0	5.4	11.6	5.8	13.6	10.6	4.6	1.3
Capital expenditures	35.6	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	0.0	0.1	1.1	1.0
Expenditures by function: 6/	57.8	31.4	41.5	29.9	37.6	35.6	26.7	26.3
Military and civil defense	7.2	1.2	2.7	5.3	2.4	3.6	3.4	3.0
Education	14.9	3.2	3.8	3.4	4.0	3.3	3.8	3.9
Health	9.2	2.3	3.6	0.6	6.1	3.0	2.0	1.7
Social security and welfare	8.8	8.4	11.6	5.8	13.6	10.6	4.6	1.3
Housing	2.4	1.3	1.7	1.9	0.0	1.7	1.1	0.7
Economic services	10.4	1.2	1.0	...	2.0	0.5	5.7	6.4
Other government services 7/	4.8	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 Recurrent Budgets, excluding the budget of the local governments. 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, Ghana, Kenya, Lesotho, Malawi, Mali, Sierra Leone, Sri Lanka, former Zaïre, and Zambia.

4/ Military wages included in other goods and services for Bosnia and Herzegovina in 1999.

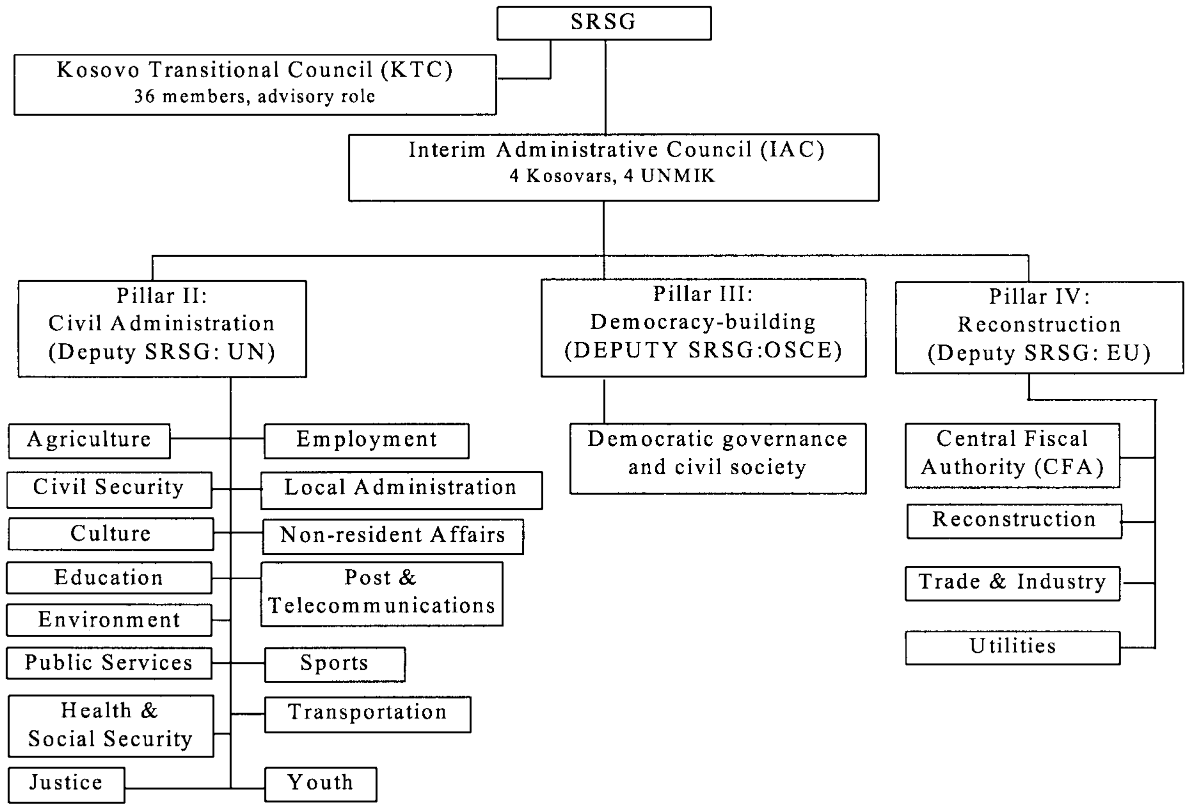
5/ Data unavailable for the former Yugoslav Republic of Macedonia.

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 nonclassified expenditures.

The Joint Interim Administrative Structure (JIAS)

JIAS Institutions[1]



Source: United Nations

1/ Pillar I (Humanitarian Affairs), run by UNHCR, ceased to exist as a formal component within UNMIK in July 2000.

Kosovo: The Staff's GDP and Balance of Payments Estimates

1. Estimates of GDP and the balance of payments utilize earlier staff work for 2000 (Corker *et al* (2001)) 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.[1] The survey yields a private consumption estimate of DM 3 billion. As the study acknowledges, this survey underestimates consumption for two reasons: first, because certain items are not included (particularly consumption of housing services); and second, because survey data are systematically lower than consumption estimates for national accounts purposes. To take these factors into account, the World Bank estimate is adjusted upwards by 15 percent. For 2001, the consumption deflator was estimated to be 8 percent and real growth was estimated to be 5 percent. This conservative assumption reflects the hypothesis that the main source of GDP growth in 2000 and—especially—2001 was investment, and may well be an underestimate of private consumption.

- Estimates of public consumption for 2000 and 2001 are based on data on the execution of 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 that can be 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. Staff estimates are based on the assumption that private investment was equivalent to about 40 percent of public investment. For 2001, this is augmented by DM 120 million, which is approximately triple the amount of bank lending in Kosovo.

- Merchandise exports consist of cross-border exports and sales to the expatriate non-resident 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 non-resident 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.

---

[1] *Poverty Assessment, Kosovo, Federal Republic of Yugoslavia*, The World Bank.

- As regards services exports, it is assumed that the average expatriate civilian spends some 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 purchase local services of some DM 200 in 2000 and DM600 per head 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 consist of imports, a figure that declines 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 imports from Serbia 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 NGOs, which are not reported. This factor is assumed to be 60 percent in 2000 and 45 percent in 2001, reflecting improvements in compliance. Finally, import projections for the second half of 2001 assume nominal growth of some 45 percent compared to the first half of the year to take account of the rapid GDP growth and the coverage expansion of customs statistics. Overall 2000–2001 import growth is 19 percent and the share of merchandise imports in GDP declines from 82 to 77 percent.

- Services imports are assumed to be equivalent to 15 percent of private investment and 25 percent of public investment, as well as one percent of private consumption.

- The estimates of factor income, private transfers, and direct investment from abroad is based on the assumption that in 2000 a total of some 200,000 Kosovars living abroad transferred on average some DM 5000 per year 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 are projected to increase by DM 100 million, factor income by DM 150 million, and foreign investment by DM 50 million.

2. On this basis, the current account shows a small surplus of some DM 6 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 99 million of errors and omissions in 2000. For 2001, a similar calculation yields an increase in net bank reserves of DM 230 million and errors and omissions equivalent to DM 212 million. The large amount of errors and omissions largely reflect DM that was previously held in cash and is progressively deposited in the banking system.

Kosovo: Tax System and Future Plans

Current Tax System and Performance

1. Kosovo has made considerable progress in building a sound tax system and tax administration. The latter, in particular, had to be rebuilt from scratch, as staff, records, and infrastructure had been dispersed, looted, or destroyed. Currently, Kosovo has a basic, functioning tax system that collects revenues 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).[1]

- Since July 1, 2001, a *VAT* 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 to 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. A quarterly increase (of 5 pfennig each) in excise tax rate for fuel 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.

2. Presently, custom duties, excise and sales tax (and now 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 recent incidents of difficulties in setting the boundary line with Serbia, and the temporary closure of the border with FYR Macedonia.

3. 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.

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

---

[1] Customs tariffs are not levied on goods originating in the FR Yugoslavia, which is not a foreign country. Also, imports from the FYR Macedonia, with which the FR Yugoslavia has a free trade agreement, are subject only to a 1 percent administrative fee.

5. 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, are smuggled into Kosovo. After the full range of new taxes is implemented, it will be possible to shift resources from implementation to compliance.

Future tax policy and administration reforms

6. The following tax reforms are in the pipeline. These reforms are still at the design stage, and details and timing may be changed.

- The *Wage Withholding Tax*, to be implemented in 2002 at the following proposed rates:
    - DM 1–100 per month: zero
    - DM 101–500: 5 percent
    - DM 501 and higher: 10 percent
- A *Profit Tax* at a rate of 20 percent on business profits is to be implemented at the start of 2002 and will replace (for the larger enterprises) the current presumptive tax.
- An *Income Tax*, to be introduced in 2003, which would be levied on all sources of personal income, includes income from labor, interest, rents, pensions, and social transfers.
- *Lowering of the VAT threshold* over the medium term.

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