European Bank
for Reconstruction and Development

Kosovo country diagnostic:

Private investment challenges and opportunities 2022

Country diagnostics are a European Bank for Reconstruction and Development (EBRD) tool for identifying the main obstacles to entrepreneurship and private-sector development in the economies where it operates. They also help to shape the Bank's priorities and project selection in formulating new country strategies. Each diagnostic informs the EBRD's policy engagement with the authorities in that country.

Each diagnostic assesses national progress and challenges in developing a sustainable market economy. Private-sector development and entrepreneurship are at the heart of the Bank's mandate, but in all of the Bank's investee economies, the private sector faces a range of problems and obstacles. The country diagnostic highlights the key challenges facing private companies and shows where each economy stands relative to its peers on the Bank's six transition qualities – competitive, well governed, green, inclusive, resilient and integrated – highlighting the main deficiencies and gaps
in each.

The diagnostics draw on a range of methodologies and best practices for assessing how big certain obstacles are. Extensive use is made of the Bank's in-house expertise and surveys, such as the Business Environment and Enterprise Performance Survey (BEEPS) and the Life in Transition Survey (LiTS), as well as other cross-country surveys and reports from institutions such as the World Bank, the World Economic Forum and the Organisation for Economic Co-operation and Development (OECD). For some larger countries, the diagnostics also draw on specially commissioned studies of selected issues that are critical to private-sector development.

The EBRD's Country Economics, Strategy and Policy (CESP) team lead the diagnostics, drawing substantially on the expertise of sectoral, governance and political experts in the Policy Strategy and Delivery (PSD) Department and consulting widely with experts across the Bank in preparing the final product. The diagnostics are shared with the EBRD Board during the country strategy process and published during the public consultation period.

For more information, go to https://www.ebrd.com/publications/country-diagnostics.

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Contents

Executive summary

Kosovo is a small economy in the Western Balkans that has seen its transition heavily influenced by complex political realities and uncertainty. This has complicated its economic development, leaving Kosovo among the poorest economies in the region, with gross domestic product (GDP) per capita at about €4,250 as of 2021.[1] Some of the key weaknesses common to the Western Balkans – weak rule of law, low public administration capacity, complex inter-ethnic relations and a shaky culture of political dialogue and consensus building – have been amplified in Kosovo. Though landlocked, it benefits from its location on the crossroads of the Western Balkans and the rest of Europe. It also has natural and mineral resources, not insignificant by regional standards.

The economy of Kosovo is dominated by family-owned micro companies, present mostly in the services sector. Mining only accounts for a small share of GDP today due to underinvestment over the past three decades, while the manufacturing base is narrow. Due to high unemployment, a very young population (the youngest in Europe) and relatively high poverty rates, a large share of the 1.8 million-strong population lives and works abroad. The resulting, significant remittance inflows and services revenue cushion poverty and help to finance a sizable trade deficit. Following a Covid-19 pandemic-induced recession in 2020, the economy is recovering thanks to a supportive external sector.

The key issues constraining the private sector are:

- **Widespread informality:** The large informal economy present in many sectors reduces budget revenues and hinders investment and business development, constraining economic growth. In addition, informal firms create unfair competition. The government has attempted to tackle the issue and there are some positive initial signs of businesses being formalised in the aftermath of the pandemic, but more systemic solutions, including improvements in public governance, are needed.

- **Low external competitiveness:** Kosovo is weakly integrated into global value chains, with low goods exports comprising mostly low-value-added, unsophisticated products. While goods exports grew significantly in 2021, this growth remained limited to very few economic sectors. Foreign direct investment, which could enhance the competitiveness of the economy, has been limited to date and has mostly gone into non-tradeable sectors, primarily real estate.

- **A poorly functioning labour market:** The labour market is characterised by low participation and high unemployment rates due to several factors, including cultural and structural ones. Weak female and youth inclusion are also significant challenges. Weak labour-market outcomes contribute to continuously high emigration (at least one-third of the population is abroad) and remittance inflows. The latter in turn keeps reservation wages elevated, contributing to structural rigidities in the labour market.

- **Large public infrastructure gaps and the need to speed up the green transition:** Public infrastructure gaps in all areas (road, railways, air transport and energy) remain high, limiting the country's integration into European supply chains. Implementation capacity and the transparency of transport infrastructure projects remain poor. In the energy sector, outdated and highly polluting lignite-based power generation requires urgent replacement, while energy and distribution efficiency could be raised considerably. There is significant space to speed up the green transition.

- **Weak governance of state-owned enterprises (SOEs):** The financial performance of publicly owned enterprises is weak, while proper reporting and monitoring are not a given, contributing to fiscal risks and suboptimal service delivery. At the same time, SOE employees enjoy a high wage premium compared with the private sector. SOE governance needs to be improved and the speed of SOE resolution stepped up.

This diagnostic document consists of the following sections: 1) political economy; 2) economic background and outlook; 3) private sector and business environment; 4) key issues in the economy; and 5) qualities of a sustainable market economy.

[1] See IMF (2021b).

1. Political economy

Kosovo is a small economy in the Western Balkans that has seen its transition affected by its contentious legal status with regard to the former Yugoslavia and Serbia (which still does not recognise Kosovo as an independent country). It was seriously affected by the disintegration of the former Yugoslavia and Belgrade's rule in the 1990s (the period when most Western Balkans countries started their transition), the war of 1998-99, and the uncertainties of the post-war phase prior to its declaration of independence, which saw, among other things, governance by a UN interim mission.

All of these factors served to complicate Kosovo's economic development. It remains among the poorest countries in the region. They have also led to a situation whereby key weaknesses common to the Western Balkans – weak rule of law, low public administration capacity, widespread economic informality, complex inter-ethnic relations and a patchy culture of political dialogue and consensus building – have been amplified to some extent. These factors, alongside high unemployment, have left a large proportion of the population living abroad. Remittance inflows thus account for a significant share of Kosovo's GDP, even by regional standards.

In contrast, Kosovans' desire to overcome their difficult legacy, including historical isolation and discrimination, has provided a strong boost to entrepreneurship and seen the country open up enthusiastically to the outside world. Throughout the transition, in various regional sociological surveys, Kosovans have tended to be among the strongest believers in free markets and the benefits of Euro-Atlantic integration.

Kosovo proclaimed independence in 2008. The International Court of Justice (ICJ) considered the legality of this act on referral by the United Nations General Assembly. On 22 July 2010, the ICJ ruled that the declaration of independence did not violate any applicable rule of international law. Although this decision was an Advisory Opinion, which is not binding on any country, it was reinforced in September 2010 by a Resolution of the United Nations General Assembly, which "acknowledged the contents of the decision of the ICJ".[2] While many countries, including some of the EBRD's shareholders, do not recognise Kosovo – and this will remain a political matter for each member of the international community to decide – as of 2021, the number of bilateral recognitions exceeded 100. Continuing political controversy stemming from the differing positions of the wider international community on Kosovo's status affects assessments of the situation in Kosovo produced by various international actors.

Regionally, a significant international presence sets Kosovo apart. UN Security Council Resolution 1244 (UNSCR 1244), which in 1999 established the United Nations Interim Administration Mission in Kosovo (UNMIK), is still formally in force, though to all intents and purposes, its role is very limited. The European Union Rule of Law Mission in Kosovo (EULEX) was the largest civilian mission ever launched under the European Security and Defence Policy. Its initial aim, when established in 2008, was to assist and support the Kosovan authorities with the rule of law, specifically in the police, judiciary and customs. The current mandate of EULEX, whose executive functions have been progressively reduced (and the mission itself downsized), expires in June 2023. Kosovo also has a NATO-led foreign military presence – the Kosovo Force (KFOR) – which, in accordance with UNSCR 1244, has been leading a peace support operation in Kosovo since June 1999. Today, a significantly reduced KFOR presence (of about 5,000 troops) continues to help maintain a safe and secure environment and freedom of movement for all citizens.

Kosovo is landlocked. However, it benefits from its location on the crossroads of regional infrastructure corridors (existing and planned), which run through Kosovo from west to east and from north to south, connecting the Western Balkans to the rest of Europe. It has certain natural and mineral resources, not insignificant by regional standards, and a young population (the youngest in Europe). Except for Serbia to the north, Kosovo does not have any major issues in its relations with its immediate neighbours. Its further integration into the intensifying regional cooperation would make it part of a wider Western Balkans market with more than 20 million people.

Kosovo is progressing with the decentralisation of government, including the strengthening of local administration. The main remaining challenges include its relatively weak professional expertise at the local level, budgetary constraints and overall absorption capacity. Challenges of a different kind can be found in the specifics of the situation in northern Kosovo, predominantly populated by ethnic Serbs (a minority in most regions in the rest of Kosovo), which has remained volatile over the years.

Efforts towards European Union (EU) approximation remain the key external anchor for comprehensive reform. The EU has repeatedly stressed that Kosovo shares the European perspective of the rest of the Western Balkans. Kosovo signed a Stabilisation and Association Agreement with the EU in October 2015,

[2] See United Nations General Assembly (2010).

which was approved by the European Parliament on 21 January 2016 and formally entered into force on 1 April 2016. As of 2021, however, Kosovo remains the only Western Balkans country whose citizens do not benefit from visa-free travel to the Schengen area. Over the last decade, Kosovo has participated in an EU-led dialogue with Serbia, which, according to the EU, should conclude with a legally binding agreement on the normalisation of relations. Such an agreement is crucial so that both countries can advance on their respective European paths.

2. Economic background and outlook

Kosovo is rich in natural resources ... Kosovo has the second-largest lignite reserves in Europe and fifth-largest globally (estimated at 12.5 billion tonnes)[3] and an abundance of minerals, such as lead, zinc, silver, nickel, cobalt, copper, chrome, magnesium, iron and bauxite. [4] However, the decline of the mining sector in the 1990s and weak governance, coupled with Kosovo's unresolved status, have prevented the mining sector from playing a more important role in the country's economic development.

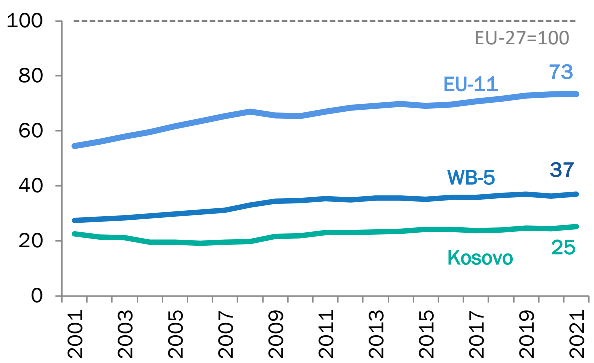
... but is still one of Europe's poorest and least developed countries. Kosovo was the most disadvantaged region of the former Yugoslavia and experienced an additional economic setback in the 1990s when Yugoslavia disintegrated and conflict ensued. Over the past two decades, the economy has been converging on EU income levels, albeit very slowly. Its real GDP per capita[5] is less than 30 per cent of the EU-28 average and less than 40 per cent of that of the new EU member states (EU-11). It is lagging other Western Balkans countries as well. On the positive side, poverty rates have declined in recent years. In 2017, 18 per cent of Kosovo's population lived below the poverty line (€1.85 per day)[6] and 15 per cent of employees were at risk of poverty (mainly self-employed and less educated individuals).[7] Both rates were 6-7 percentage points lower than in 2012.

The economy is dominated by services. As of 2021, services accounted for close to half of GDP, followed by industry and construction (19 per cent and 8 per cent, respectively). The structure of GDP remained largely unchanged from 2009 to 2021, except for agriculture. The sector's share of GDP halved over the decade, falling much more strongly than in other Western Balkans countries, to 7 per cent of GDP in 2021.

Agriculture is dominated by small plots of land, preventing economies of scale, and characterised by high levels of informality. In Q1 2021, the sector employed 3.4 per cent of the workforce, a level similar to that of the EU-28.[8] Services, in contrast, engaged close to 70 per cent of the workforce, while industry accounted for 17.4 per cent. The construction sector is a large employer, providing jobs for around 9.4 per cent of the labour force (down from 13 per cent in 2017), far more than in the rest of the Western Balkans or the EU-28 (below 7 per cent in both).

Figure 1: Living standards lag those of the EU

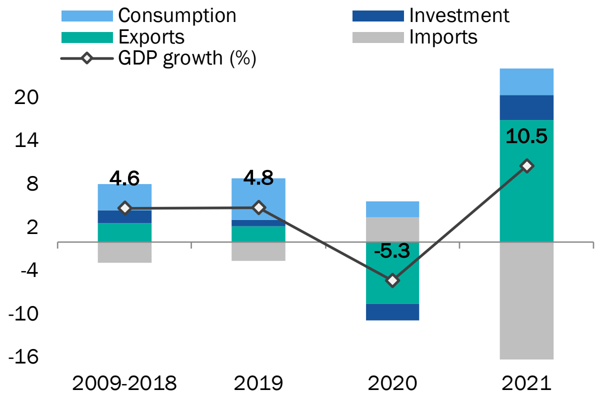
GDP per capita, US$ purchasing power parity (PPP)



Source: IMF (2022b), authors' calculations

Figure 2. GDP has been driven by private consumption

Contribution to GDP growth (pp), 2009-18 simple average



Source: Eurostat, Kosovo Agency of Statistics, authors' calculations

*2021 data are estimates based on initial quarterly figures.

[3] See Ministry of Economic Development (2017a).
[4] According to the Ministry of Economic Development, as of 28 February 2020.
[5] Per the IMF, international dollars, purchasing power parity.
[6] See World Bank and Kosovo Agency of Statistics (2019).
[7] See Haxhikadrija et al. (2019).
[8] According to the Kosovo Agency of Statistics (2022).

The manufacturing sector is concentrated in low-value-added industries. Accounting for 16 per cent of gross value added (GVA) in 2021, manufacturing in Kosovo is close to the Western Balkans-5 average,[9] but significantly smaller than that of the EU-11.[10] The sector is fairly undiversified, with a few prominent industries such as processed food and beverages and metals. In recent years, furniture production has emerged as a new driver of manufacturing output and exports. Wages in the manufacturing sector are among the lowest in the economy. In 2020, the average monthly gross wage in manufacturing was €335, higher only than wages in accommodation and food services (€218), agriculture, forestry and fishing (€249) and other services (€243).[11]

In the decade prior to the Covid-19 pandemic, economic growth was mostly consumption driven. As in other Western Balkans countries, GDP growth slowed after the financial crisis. From 2009 to 2021, annual growth averaged 3.6 per cent, down from close to 5 per cent in 2001-08. In the decade before the Covid-19 crisis, growth was primarily driven by domestic demand, especially consumption (which added around 4 percentage points annually to growth), while the investment contribution was significantly smaller (around 1.5 percentage point). Conversely, net exports acted as a drag on growth (slashing it by around 1 percentage point annually), mostly through rising imports. On the production side, growth was driven mainly by services (around 2 percentage points), primarily trade and tourism-related.

The solid economic growth of previous years gave way to a recession in 2020 as a result of the Covid-19 pandemic. GDP contracted by 5.3 per cent in 2020, primarily because of a sharp fall in service exports due to restrictions on international travel and domestic containment measures, as well as to a fall in investment, largely related to the construction sector. The government rolled out measures to support the population and the economy, as well as regulatory forbearance measures to ensure credit flows were maintained. The total mitigation and recovery measures are estimated at 4.3 per cent of GDP in 2020 and 5.6 per cent of GDP in 2021.[12]

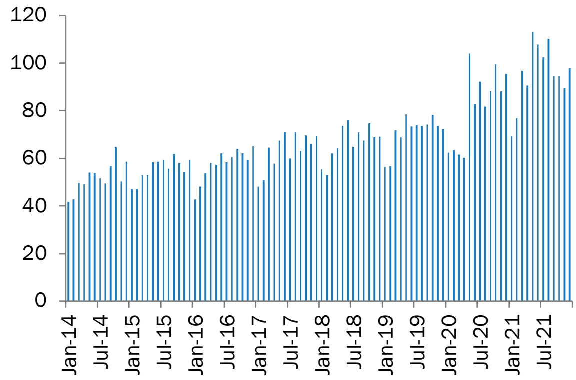
A strong rebound took place in 2021 thanks to a supportive external sector. According to initial estimates from the Kosovan Agency of Statistics, GDP grew 10.5 per cent in 2021. Strong support from the diaspora in the form of remittances, tourism, compensation of seasonal migrants and real-estate investment[13] gave a significant boost to economic activity. Household consumption was propped up by a burgeoning inflow of remittances, which grew 17 per cent year on year in 2021, in addition to credit growth. Exports of services nearly doubled in 2021 from 2020 on the back of diaspora visits. Still relatively small, at 9.6 per cent of GDP in 2021, albeit increasing (from 5.8 per cent of GDP in 2016), goods exports posted strongly positive annual growth rates of 24 per cent in 2020 and 58 per cent in 2021. Goods are also showing initial signs of diversification, both from a product and a market perspective. Given the strength of the rebound in 2021, the growth rate is likely to slow in 2022 and move closer to its long-term potential rate. While the first few months of 2022 were characterised by the continuation of strong credit growth and remittances, this was balanced against strong inflationary pressures, exacerbated by the economic impact of the war on Ukraine. The main risks to the outlook relate to growing geopolitical uncertainties, rising commodity prices, persistent weaknesses in the area of public investment management and potential weaknesses in the external sector.

The diaspora is a strong source of financial support through remittances, tourism and investment flows. Remittance inflows from abroad amounted to 14.6 per cent of GDP in 2021, supporting household incomes and consumption. These transfers remained positive throughout 2021, growing by 18 per cent on the year. While high remittances from the country's large diaspora help support consumption growth and finance the trade deficit, they also keep reservation wages high, thus contributing to low employment. Prior to the pandemic, service exports were more than four times goods exports thanks to travel-related inflows, which accounted for nearly 80 per cent of total services export receipts. After the easing of travel restrictions, both total services and travel-related receipts grew strongly and surpassed their respective 2019 levels. Foreign direct investment (FDI) into real estate, accounting for nearly half of all FDI to date, is largely driven by diaspora investment.

[9] Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia and Serbia.
[10] World Bank World Development Indicators, EU-11 figure excludes Bulgaria due to unavailable data.
[11] Other services are defined according to NACE codes as provided by the European Commission.
[12] See IMF (2022a).
[13] Ibid.

Figure 3: **Remittances are growing consistently**

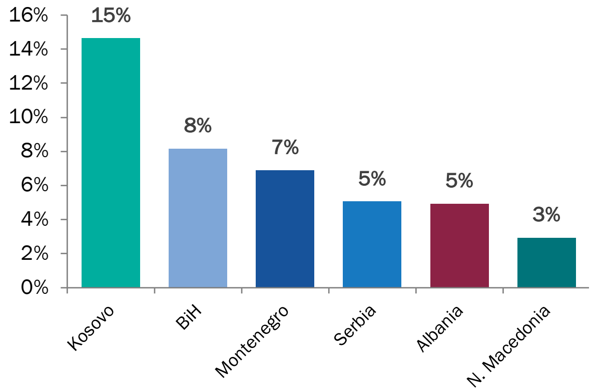
€, monthly, 2014-21



Source: Kosovo Central Bank

Figure 4. Remittances in the Western Balkans countries, 2021

Percentage of GDP



Source: National central banks and statistics offices, authors' calculations

While public debt is low, the structure of government expenditure is unfavourable and the economy has been posting large trade deficits. At 22 per cent of GDP at end 2021 (up 4 percentage points from 2019),[14] Kosovo has the lowest public debt figures in the Western Balkans region. This is in part due to Serbia maintaining and servicing Kosovo's previous debt after independence in 2008. Still, transfers and subsidies have increased rapidly in recent years, accounting for a significant share of government current expenditures (more than 40 per cent pre-pandemic). These increased to more than half of current expenditure during the pandemic as a consequence of the Economic Recovery Programme. Following a large fiscal deficit of nearly 8 per cent of GDP in 2020, the government budget declined significantly to an estimated 1.5 per cent of GDP in 2021, thanks to a strong recovery in fiscal revenues and low absorption of the investment budget, reflecting investment reprioritisation by the new government. Conducting sound fiscal policy while ensuring key infrastructure needs are met is especially important in the absence of monetary policy tools, as the country has unilaterally adopted the euro. The current-account deficit is persistently high, primarily because of a large trade deficit (the trade gap was on average four times the current-account deficit in 2016-21), largely reflecting the small size of the economy and its low competitiveness on external markets.

Kosovo's climate action momentum is affected by its unresolved status. There is currently no legal basis for drafting Nationally Determined Contributions, no targets have been set for 2030 and no regular reporting is undertaken, as Kosovo is not a signatory to the United Nations Framework Convention on Climate Change (UNFCCC). However, the country has developed a greenhouse gas (GHG) inventory and made efforts to align legislation and the policy framework to the EU climate acquis.

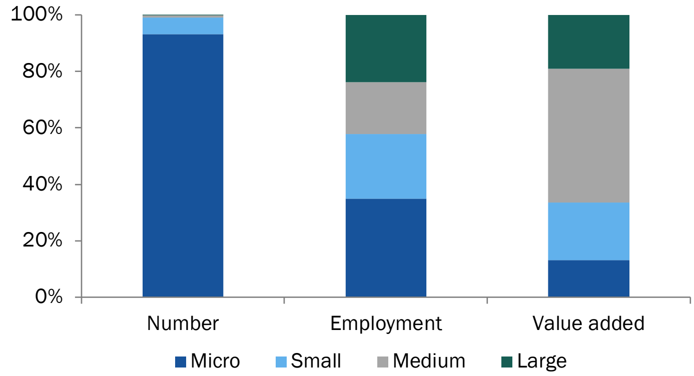
[14] See Ministry of Finance (2022).

3. Private-sector and business environment

The economy is dominated by SMEs, particularly micro enterprises, while most value is added by a small number of medium-sized companies. SMEs account for 99.9 per cent of businesses in Kosovo, 76 per cent of total business-sector employment and 81 per cent of value added.[15] The vast majority (93 per cent) of SMEs are family-owned micro-enterprises with fewer than 10 employees, which contribute only 13 per cent to value creation. The biggest contribution to value creation (48 per cent) comes from medium-sized enterprises, accounting for less than 1 per cent of the business population and less than one-fifth of the total business-sector employment. Large companies in Kosovo contribute significantly less to total value added (19 per cent) than large companies in any other Western Balkans country (37 per cent on average), despite a similar share of employment (around 25 per cent).[16]

Figure 5. Business demography indicators

As of 2016



Source: OECD (2019a)

Almost half of businesses are in the trade sector. In 2020, there were 40,056 active enterprises in Kosovo.[17] The largest share (42 per cent) of them operated in the trade sector, while 13 per cent were active in manufacturing. Manufacturing companies, however, are weakly integrated into global value chains.[18] The two sectors also account for the largest shares of employment (37 per cent and 18 per cent, respectively).

The private sector faces multiple challenges in the business environment. Governance challenges, including widespread informality and corruption, an inefficient judiciary, weak rule of law and insufficiently robust institutions are the key obstacles to doing business. According to the BEEPS VI survey,[19] when asked about the biggest obstacle to doing business, 25 per cent of respondents cited competition from the informal sector as the major constraint, while 15 per cent identified electricity as the biggest obstacle. The regulatory framework could be improved as well. Although business registration is simple and fast, with "one-stop shops" in place, businesses are burdened with a large number of licences and permits, cumbersome administrative procedures and frequent, uncoordinated and costly inspections. General inspections reform is ongoing, with a plan to decrease the number of (overlapping and parallel) inspections from 36 to 15. The new Law on Inspections was approved by the Kosovan assembly in December 2021.

Recent surveys indicate that access to finance is an important issue for SMEs in Kosovo. According to the BEEPS VI survey,[20] accessing finance is most difficult in Kosovo out of all the Western Balkans countries, with around one in two Kosovan firms perceiving it as a major constraint on doing business. The survey on the access to finance of enterprises (SAFE), conducted annually by the European Central Bank (ECB), in 2021 identified access to finance as a significant issue, more prominent in Kosovo than in the rest of the Western Balkans or EU-11, although it was cited by a smaller share of Kosovan firms as the most important problem (8 per cent) in the same survey. The issue might be related to the perceived high cost of

[15] See OECD (2019a). The data refer to 2016 (latest available).
[16] See OECD, ETF, EU and EBRD (2019).
[17] See Kosovo Agency of Statistics (2021a). This number excludes enterprises in agriculture, forestry, fishing, finance, education, health, household activities and public administration.
[18] See European Commission (2019c).
[19] EBRD, World Bank and EIB (2018). The Enterprise Surveys implemented in European and Central Asian countries are also known as Business Environment and Enterprise Performance Surveys (BEEPS) and are jointly conducted by the EBRD, the World Bank Group and the European Investment Bank.
[20] See EBRD, World Bank and EIB (2018).

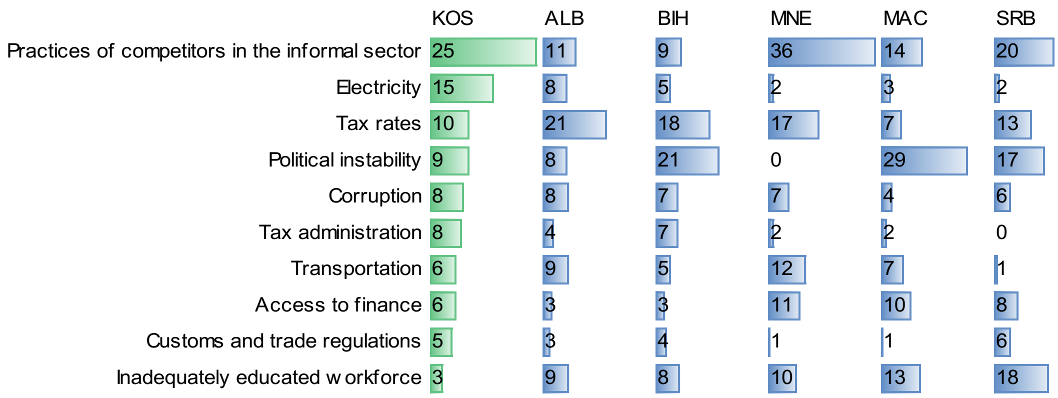
loans, as suggested by the SAFE survey, and high collateral requirements, particularly since the pandemic.[21] Also, the availability of finance differs according to the size of the company. For example, the BEEPS VI survey showed 8 per cent of small firms highlighting access to finance as their biggest obstacle while only 2 per cent of medium and large companies felt the same.[22] Difficult access to finance might be a reason why Kosovan firms rely relatively more on bank overdrafts as a form of credit.[23]

Private-sector development is also constrained by Kosovo's relatively low entrepreneurial capacity and financial literacy ... Given Kosovo's still nascent development of an entrepreneurial culture, it is no surprise that entrepreneurial intentions and early-stage entrepreneurial activity are deemed weak compared with regional and global averages. [24] Similarly, research shows that SMEs in Kosovo are rather risk-averse and tend not to be proactive, innovative or customer oriented.[25] In addition, levels of financial literacy and inclusion are low.[26] While a lack of data hinders the assessment of financial inclusion, estimates from the International Monetary Fund (IMF) show that the use of electronic payments and cards is not prevalent and mobile payments are very low, despite progress on the legal framework.[27]

... as well as by skills mismatches and companies' limited ability to compete in export markets. The small internal market makes it necessary for firms to find export opportunities. However, Kosovan companies are often less competitive in foreign markets due to problems they face in developing new products and certifying the quality of existing ones, as well as insufficient knowledge of marketing and sales.[28] Furthermore, companies complain of not being able to find skilled workers. The latter, combined with weak foreign market penetration and poor access to technology and finance, keeps productivity low and limits growth prospects.

Figure 6. Top 10 major constraints to doing business

Per cent of firms identifying it as such



Source: BEEPS VI[29]

[21] Ibid. The BEEPS VI survey shows that 90 per cent of loans in Kosovo require collateral (compared with 67 per cent in the Western Balkans-5) and that the value of the collateral is significantly above the Western Balkans-5 average (270 per cent of the loan value compared with 175 per cent). See EBRD, World Bank and EIB (2018).
[22] See EBRD, World Bank and EIB (2018).
[23] According to the SAFE survey, close to half of Kosovan firms used credit lines, bank overdrafts or credit-card overdrafts in the six months prior to the survey, compared with a third in the Western Balkans-5 and less than a third in the EU-11. See ECB (2021).
[24] See Global Entrepreneurship Research Association (n.d.).
[25] See Sadiku-Dush, Dana and Ramadani (2019).
[26] See World Bank (2017a).
[27] See IMF (2020).
[28] See Cojocaru (2017).
[29] See EBRD, World Bank and EIB (2018).

4. Key issues in the economy

4.1. Widespread informality

The informal economy in Kosovo accounts for up to 40 per cent of GDP. Informal activities show up in different forms: unregistered businesses, undeclared revenue, work without a contract or work without social security coverage, undeclared or under-declared work, unregistered barter trade, smuggling of prohibited goods, and illegal activities such as drugs, arms or women trafficking. Informality is present in all economies to some degree, but is especially pervasive in less developed ones. The available estimates on the size of informal economy in Kosovo range from 30 to 40 per cent of GDP.[30] According to a recent EU-funded study,[31] the grey economy (that is, undeclared but legal economic activity) accounted for 23.5 per cent of GDP in 2017, while the black economy (that is, illegal economic activity) totalled 8.2 per cent of GDP.

Informality is present in many sectors. According to the Kosovan government,[32] the informal economy is largely made up of services (primarily the hospitality sector, trade and transportation) and the construction sector. Studies also mention other sectors, such as agriculture, manufacturing, forestry, human health and social work.[33] Undeclared work is especially prevalent in agriculture. This could be a consequence of seasonal fluctuations and the more frequent labour turnover in the sector, but also of a small number of agricultural businesses operating formally. Although a large part of population lives in rural areas, agricultural holdings are very small[34] (making it hard to achieve economies of scale) and mostly semi-subsistent. Poor and elderly people are especially dependant on farming. When it comes to firms, research shows that smaller and older firms and firms owned by men are more likely to underreport sales.[35]

Institutional and governance weaknesses are contributing to informality … According to the European Commission's latest report on Kosovo, the country is "at an early stage/has some level of preparation" in areas pertaining to public governance, such as public administration reform, developing a well-functioning judicial system and the fight against corruption.[36] Kosovan citizens seem to lack trust in the state and perceive the quality of public services received in exchange for taxes (such as healthcare and education) to be low. This is confirmed by the country's score on government effectiveness (-0.32 on a scale from -2.5 to 2.5).[37] Also, perceptions of corruption in the public sector are high, as shown by the country's ranking in the Corruption Perceptions Index (87th out of 180 countries in 2021)[38] or its score for the control of corruption (-0.5 on a scale from -2.5 to 2.5).[39] A large share of the population (between 57 and 70 per cent) thinks political parties, parliament, healthcare providers, judiciary, customs and education are corrupt.[40] Other issues that contribute to the perceived unfairness of the system include selective inspections, discretionary/unfair penalties by inspectors, potential conflicts of interest where government officials owning businesses, tax inspectors owning accounting firms, an overlap between local and central inspection authority supervision and a dearth of complaint mechanisms against enforcement authorities.[41] The establishment of commercial courts, as approved by parliament in July 2021, if well planned and effectively implemented, could help reduce the length and increase the efficiency of commercial disputes.

… while the role of the taxation regime and procedures is rather unclear. On the one hand, Kosovo has a simple tax system and relatively low tax rates,[42] which reduces the cost of doing businesses formally. The tax burden appears to be among the lightest in the region, with personal and corporate income tax rates of 10 per cent and a value-added tax (VAT) rate of 18 per cent, or a reduced rate of 8 per cent for certain goods and services.[43] In 2016, the country introduced an online system for filing and paying VAT and social security contributions, which reduced requirements for face-to-face contact with tax officials. Also, Kosovan

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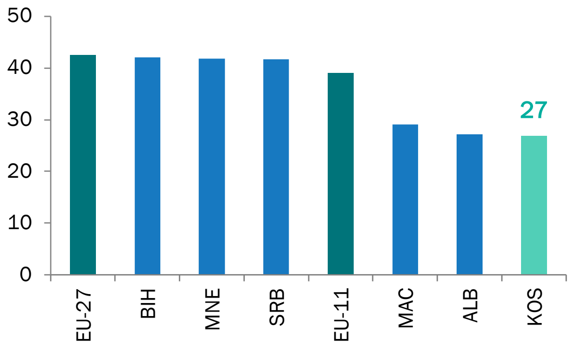
[30] See, for example, European Commission (2019b): 31.7 per cent of GDP in 2017; Kelmanson et al. (2019): 38.8 per cent of GDP in 2016; and Putnins and Sauka, (2020): 39.5 per cent of GDP in 2018.
[31] See B&S Europe (2017).
[32] See Ministry of Finance (2019).
[33] See, for example, Riinvest Institute (2013); Gashi and Williams (2018); Krasniqi and Topxhiu (2012); and Cojocaru (2017).
[34] The average land holding per family is about 3.2 hectares (ha), of which on average 1.6 ha are arable land, typically fragmented into six to eight plots. Less than 1 per cent of holdings are above 10 ha. See European Commission (2019d).
[35] See Williams and Krasniqi (2018).
[36] See European Commission (2021).
[37] See World Bank Worldwide Governance Indicators. Government effectiveness reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. The data refer to 2020.
[38] See Transparency International Corruption Perception Index. Data are for 2021.
[39] See World Bank Worldwide Governance Indicators. Data are for 2020.
[40] See RCC (2021).
[41] For more detail, see Gashi and Williams (2018).
[42] See Hernandez et al. (2019).
[43] See Tax Administration of Kosovo (n.d.).

Figure 7. General government revenue is relatively low

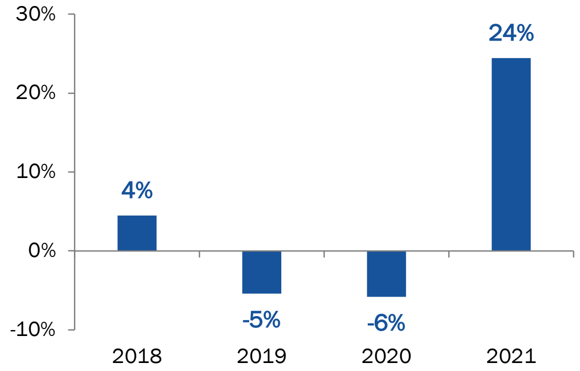
Percentage of GDP, average 2016-21



Source: IMF (2022b), authors' calculations

Figure 8. Tax revenues are on an upward trend

Annual percentage year-on-year change in tax revenue



Source: Ministry of Finance, authors' calculations

citizens perceive the tax administration to be less corrupt than in other countries in the Western Balkans.[44] On the other hand, about 4 in 10 firms identified tax rates and the tax administration as a major obstacle to doing business in the recent BEEPS VI.[45] Moreover, the percentage of firms perceiving these to be the biggest obstacles has increased between the last two rounds of the survey. Tax rates appear to be an issue, particularly for small firms with fewer than 20 employees.

Informal firms create unfair competition for the formal ones. According to BEEPS VI, one in four firms identified the practices of competitors in the informal sector as the biggest obstacle to doing business in Kosovo, while more than 60 per cent of firms reported it as a major constraint on doing business.[46] The latter is the highest of all 29 countries covered by BEEPS VI and significantly above the average (24 per cent). Competition from informal activity seems to be a bigger issue for medium-sized businesses (20-99 employees), with 44 per cent of medium-sized firms choosing it as the main business environment constraint. The large amount of informal activity also restricts access to finance, something that every second Kosovan firm deems a major obstacle to doing business.

Budget revenues in Kosovo are among the lowest in Europe. Widespread informality results in a narrow tax base, leading to limited tax revenues and, consequently, a low level of overall government revenues. In 2016-21, government revenues in Kosovo stood at an average 27 per cent of GDP annually, significantly below the EU and other Western Balkans country average (almost 43 per cent and around 36 per cent of GDP, respectively). Naturally, the level of revenue constrains government expenditure, limiting the scope and quality of public services, enhancing the perception of an inefficient public sector. This, in turn, holds back private-sector activity.

Widespread informality negatively affects economic growth and competitiveness. Although informality brings some short-term benefits to businesses, such as savings on taxes, in the long term, it carries opportunity costs due to foregone growth. In addition to inhibiting private-sector activity due to insufficient, low-quality public goods and services (for example, education, healthcare and transport infrastructure) caused by constrained government spending, there are other channels through which informality acts as a drag on growth. Informal firms generally have low levels of human and physical capital and difficulties in accessing finance, and they tend to focus on the short term, which keeps them in a vicious circle of low investment and low productivity. In other words, they are likely to remain non-competitive and small. They also use resources for unproductive purposes, such as hiding informal activities, while the government has to spend more on enforcing compliance. This means an economy-wide waste of (scarce) resources.

The Kosovan government has taken some measures to combat informality. The authorities see tackling informality as a priority and a cost-effective means of boosting government revenue. The labour inspectorate and tax administration regularly organise awareness-raising campaigns. A general inspections reform is ongoing, with a plan to decrease the number of (overlapping and parallel) inspections from 36 to

[44] The wider region includes the Western Balkans countries, Bulgaria, Croatia and Turkey. For more detail, see SELDI (2016).
[45] See EBRD, World Bank and EIB (2018).
[46] Ibid.

15, while a new law on inspections has already been adopted. In May 2019, the government passed a revised strategy and action plan for fighting informality in 2019-23, the fourth strategic document in this area since 2008. The measures include improving the exchange of information between relevant government institutions, reducing the cost of transactions for electronic payments to reduce cash transaction, and facilitating the provision of bank loans based on financial statements submitted to the tax administration. The strategy also includes qualitative and quantitative indicators to enhance the monitoring process. However, the fight against informality has often been oriented towards detection rather than prevention and supportive measures for formalisation.[47] Also, the process could be helped by abandoning departmental 'silos', whereby the relevant ministries largely work separately of each other.

There are encouraging signals that formalisation has increased during the pandemic. Covid-19 has disproportionally affected informal firms, entrepreneurs and workers, as most of them do not benefit from traditional social protection systems and were not reached by emergency support measures, which largely targeted the formal sector. Sectors that traditionally have high levels of informality, such as services, were also among those hardest hit by the lockdown measures. However, this may have incentivised businesses to formalise faster than they otherwise would. In 2021, tax revenues increased 24 per cent from the same period the previous year and by 17 per cent compared with two years ago. Given how disproportionate this growth rate is to economic activity, it might be indicative of the increasing formalisation of businesses. The EU also notes an increase in the number of registered workers in the construction sector.[48]

4.2. Low external competitiveness of the economy

Kosovo is a small, open economy, with potential for further opening. Total trade in goods and services was equivalent to 86 per cent of GDP in 2019, 23 percentage points lower that the Western Balkans-5 average. This declined by 10 percentage points in 2020 due to a contraction in services exports. Given Kosovo's relatively small size and narrow production base, the trade of goods is highly imbalanced, with imports six times larger than exports in 2021 (down from eight times in 2019),[49] resulting in a trade deficit of more than 30 per cent of GDP. While goods exports are rather limited (at €753 million, or around 10 per cent of GDP, in 2021), exports of services play a more pivotal role (nearly €2 billion, or 25 per cent of GDP in 2021, up from €1 billion, or 15 per cent of GDP in 2020), largely due to the country's vast diaspora and their visits to the country.

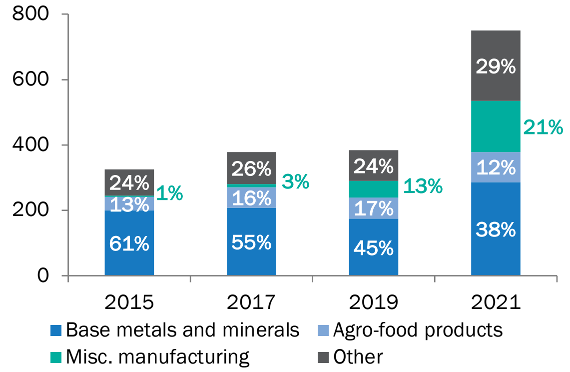
The EU is Kosovo's main trading partner, while trade with Central European Free Trade Agreement (CEFTA) countries dipped in 2020 due to a tariff increase. Goods imports from the EU accounted for around 60 per cent of imports in 2021, up from 46 per cent in 2020. Other important import partners were the Central European Free Trade Agreement (CEFTA) countries (more than 25 per cent of total goods imports in 2021), Turkey (18 per cent) and China (14 per cent). On the export side, the largest share of goods exports in 2021 went to CEFTA countries (37 per cent, down from 44 per cent in 2020), primarily Albania, and the EU countries (around 35 per cent). The United States of America is emerging as a significant export partner, too, as the destination for 16 per cent of exports in 2021, a big increase from just 5 per cent in 2020. In November 2018, Kosovo imposed a 100 per cent tariff on imports from Serbia and Bosnia and Herzegovina, violating the CEFTA and going against the spirit of the Stabilisation and Association Agreement (SAA) with the EU. Before the imposition of tariffs, Serbia was among Kosovo's main trading partners, with goods from Serbia accounting for close to 15 per cent of all Kosovan imports and Kosovan goods to Serbia accounting for around 10 per cent of all Kosovan exports. After the imposition of tariffs, imports from Serbia fell dramatically to 0.2 per cent of total imports in 2019. Exports to Serbia also decreased, but more moderately, to 7 per cent of total exports in 2019, possibly due to already present non-tariff barriers.[50] Despite an increase in imports from Albania and North Macedonia, overall trade with CEFTA countries fell from €1 billion in 2018 to around €825 million in 2020. The tariff was lifted in June 2020. Both imports from and exports to Serbia and Bosnia grew rapidly thereafter, but remain below pre-tariff levels. The successful implementation of a Western Balkans regional economic area, aimed at fostering economic integration in the areas of trade, investment and mobility throughout the region, remains a challenge in the current circumstances.

Kosovo was the last country in the Western Balkans to sign an SAA with the EU. The agreement entered into force in April 2016. The SAA foresees an upgrade in trade relations through the gradual establishment of a free trade area over a period of at most 10 years. As a result of the agreement, the EU has abolished all customs duties with Kosovo, except for those on beef, sugar and wine, which are subject to quantitative restrictions. Overall, 99.7 per cent of Kosovar products were part of the agreement. Kosovo has abolished

[47] For more detail, see Gashi and Williams (2018).
[48] See European Commission (2021).
[49] Measured in euro terms.
[50] For more on non-tariff barriers, see, for example, Huruglica et al. (2019).

Figure 9. Kosovo's changing export basket

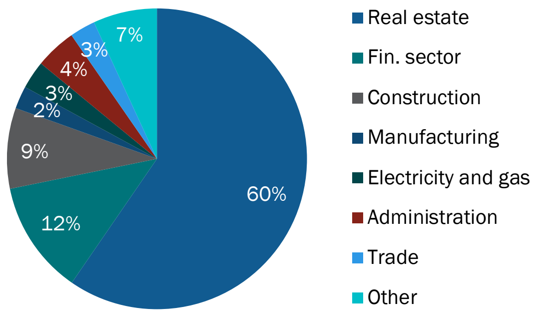
Export size in €million, percentage industry share



Source: Kosovo Agency of Statistics

Figure 10. Foreign direct investment by industry

2011-21 average, per cent



Source: Kosovo Central Bank

customs duties on EU imports on a number of products and envisages reductions on the rest of products over the transitional period of up to 10 years. While goods exports to the EU have nearly doubled since 2014, Kosovo's trade deficit with the EU has increased as well (by some 40 per cent in the same period to around €1.3 billion in 2021). An analysis shows that, when it comes to exports of agricultural and fisheries products to the EU, it is more supply-side constraints – such as poor-quality infrastructure, a lack of sanitary and phytosanitary standards, a lack of proper testing and certification, poor processing facilities, unconsolidated land and general limitations of the business environment – that are impeding Kosovo's exports.[51] This probably extends to other products.

Kosovo mostly exports low-value-added products. Kosovo primarily exports metals such as lead, zinc, silver, ferronickel (accounting for 32 per cent of the entire export basket in 2021, down from 37 per cent in 2020), agro-food products (12 per cent) and plastics (11 per cent). Some product diversification has been observed over the years. Exports of mineral products have been volatile in absolute value terms, but their value relative to the entire export basket declined from a peak of 21 per cent in 2016 to 6 per cent in 2021. In contrast, exports of miscellaneous manufactured items grew from an average of less than 4 per cent in 2016-19 to 10 per cent in 2020 and reached 21 per cent of total exports in 2021. This comes largely on the back of the fast-growing furniture sector, which largely exports to developed markets, in particular, the United States. The country mainly imports industrial supplies, food and consumer goods.

Upgrading the manufacturing sector could play a key role in global value-chain integration. According to the OECD, the products that could help to diversify and increase Kosovo's economic complexity are linked to the products it already exports, including base metals, chemicals, machinery and electrical equipment, with some space for agro-food products.[52] An analysis of the capabilities embodied in the country's export basket reveals considerable long-term potential for growth in the automotive industry (vehicle and engine parts), as well as in other machinery and metal products.[53] Accelerating growth in manufacturing would require addressing gaps in infrastructure, customs and logistics, the availability of skills and weaknesses in the business environment.

FDI, which could enhance the competitiveness of the economy, has been limited. At around US$ 2,800 in 2020, the FDI stock per capita in Kosovo was significantly below the Western Balkans-5 average (of around US$ 5,650). Despite the OECD FDI Regulatory Restrictiveness Index showing Kosovo as the least restrictive country (in 2017), net FDI has been just 3 per cent of GDP annually. In 2017, Kosovo adopted a law on strategic investments, identifying several sectors as strategic (energy and mining, transport and telecommunications, tourism, processing, agriculture and food, health, industrial and technological parks, wastewater and waste management), but there has been no significant increase in investment since then. According to a survey reported in the research paper 'Obstacles Encountered by Foreign Investors in Kosovo',[54] some of the obstacles to greater engagement of foreign investors are weak law enforcement and judiciary, corruption, failure to integrate into the EU, poor infrastructure, a lack of financial incentives, the weak business climate, poverty and frequent legal changes. Enhancing inter-institutional coordination

[51] See Nixha (2019).
[52] See OECD (2019b).
[53] See OECD (2021), Competitiveness in South East Europe 2021.
[54] See Kida (2016).

in attracting and supporting FDI, as well as the capacity of the Kosovo Investment and Enterprise Support Agency (KIESA), could help to attract more FDO, a key factor in facilitating more exports.[55]

In recent years, FDI has gone predominantly into non-tradeable sectors, primarily real estate. In 2011-21, real-estate accounted for some 60 per cent of total FDI inflows, with another 12 per cent going into financial and insurance activities. Investment in core production sectors, such as mining and agriculture, has been negligible and very low in other tradable sectors. Over half of all FDI during the period came from four countries with a large Kosovan diaspora (Germany, Switzerland, Austria and the United States), suggesting that the diaspora may be primarily investing in real estate. Despite low labour costs and the existence of three special economic zones and several industrial and business parks, Kosovo has not managed to attract FDI to its manufacturing sector (unlike neighbouring North Macedonia or Serbia). Over the past 10 years, investments in manufacturing accounted for only 2 per cent of FDI inflows. According to the European Commission,[56] financial support for the economic zones and industrial parks has been provided "without a clear plan or a transparent impact or gap analysis, raising concerns on state aid compatibility". As of 2021, decision-making on the establishment of economic zones remained based on unclear criteria and lacked economic analysis.[57]

4.3. Labour-market challenges

Kosovo has one of the youngest populations in Europe and one of the least economically active. The population of around 1.8 million people has an average age of 30.2 years (more than 30 per cent are between 10 and 24 years of age). The population predominantly lives in rural areas (61 per cent), but the capital, Pristina, accounts for 51 per cent of all employment. While the share of the working-age population (aged 15 to 64) is 68 per cent, only around 40 per cent is economically active (the proportion of country's working-age population that is actively engaged in the labour market either by working or looking for a job).[58, 59] The low labour-force participation rate is partly explained by the youth of the population; however, it still suggests structural problems, such as undeclared work and misalignment between educational outcomes and labour-market needs.[60]

Indicators of unemployment and vulnerable employment are high, despite improvements over the last decade. As of April 2021, around 26 per cent of the active labour force was registered as unemployed and around two-thirds of the unemployed reported being out of work for more than 12 months. Around 14 per cent of employed people were engaged in vulnerable employment (self-employment without employees or working without pay in a family business) and were less likely to have a formal work agreement than other workers.[61]

- *Weak female labour-market participation*

Almost 80 per cent of women in Kosovo are economically inactive … In 2020, only 20.8 per cent of the female working-age population was active in the labour market, compared with 56 per cent of the male population. No country in Europe has so few women in the formal labour market. Women's participation in entrepreneurship and formal business ownership is extremely low by regional standards. According to BEEPS VI, only 7 per cent of the surveyed companies had women among their owners, while women were majority owners in just 5 per cent of firms. Similarly, only 3 per cent of firms had female top managers.[62] These figures are among the lowest in the regions where the EBRD operates.

… and those who are economically active are less likely than men to be employed. The employment rate is significantly lower for women than for men (14 per cent compared with 43 per cent in 2020).[63] There seems to be discrimination when it comes to employing women, which could be tied to regulations on maternity leave, which make women costlier to hire than men. In addition, women who work do not reach leadership positions to the same extent as men, mostly remaining at administrative level.[64]

Young women face an even more pronounced disadvantage. Employment of young women is extremely low. Around 6 per cent of 15-24 year-old women worked in 2020, compared with 16 per cent of their male counterparts. Similarly, the young female unemployment rate is very high (57 per cent in 2020).[63]

55 See OECD (2021).
56 See European Commission (2019a).
57 See European Commission (2021).
58 See Riinvest (2021).
59 See Kosovo Agency of Statistics (2021b).
60 See European Commission (2020).
61 Data for Q1 2021. See Kosovo Agency of Statistics (2021b).
62 See EBRD, World Bank and EIB (2018).
63 See Kosovo Agency of Statistics (2020a).
64 See Färnsveden, Qosaj-Mustafa and Farnsworth (2014).

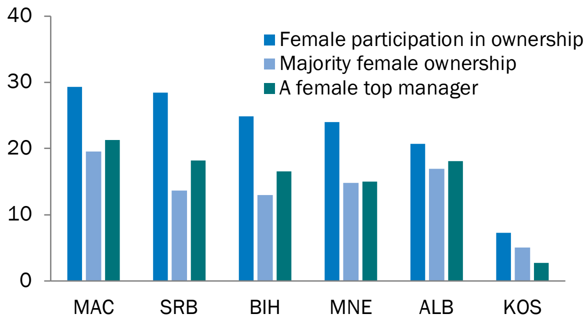
There are multiple causes of the low female labour participation rate. The most commonly cited reason is the patriarchal model prevalent in society.[65] In addition, a limited parental leave system, a lack of childcare facilities and practically non-existent institutions for the care of the elderly put women under great pressure to take up care obligations, keeping them out of the labour market. The level of school attainment is another key determinant of female activity. Women with incomplete secondary education or less are much more likely to be inactive due to family responsibilities than women with upper secondary education or above.

- *High levels of emigration*

In light of Kosovo's high unemployment and social fragility, outmigration continues. Another salient feature of the Kosovan labour market is the persistently high unemployment rate. The average unemployment rate in 2012-20 was close to 30 per cent, while the youth jobless rate was close to 55 per cent. Dissatisfaction with socioeconomic conditions, weak employment opportunities and political instability seem to be the main factors driving migration.[66] For example, the latest Life in Transition Survey revealed that only 8 and 20 per cent of respondents, respectively, believed that the political and economic situations in Kosovo were better in 2016 than they were four years prior to the survey.[67] Furthermore, a survey by Gallup conducted in 2015-17 showed that 46 per cent of adults in Kosovo wanted to emigrate and that Kosovo ranked in the top 10 of 152 countries in terms of how much the total population and the population of highly educated residents would shrink if all who wished to emigrate were able to do so.[68]

Figure 11. Poor representation of women in business

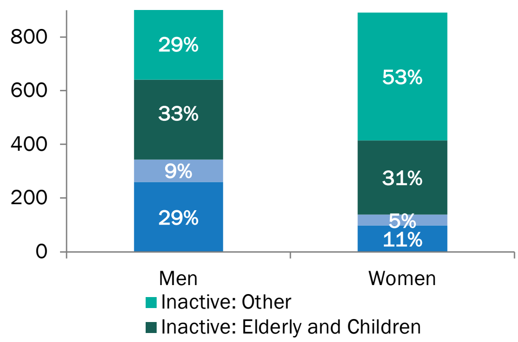
Per cent of firms



Source: BEEPS VI[69]

Figure 12. Inactivity due to youth or old age explains just a portion of Kosovo's inactive population

'000 people, percentage of male/female population



Source: Kosovo Agency of Statistics

At least one-third of the Kosovan population has emigrated. According to the 2011 population census, close to 30 per cent of Kosovo's population lived outside of the country. Given the perception of no tangible improvement in the socioeconomic situation since, the percentage is probably now higher. Current estimates tend to suggest 700,000 to 800,000 people living abroad.[70] Almost half of Kosovo's citizens are thought to have family members abroad, which is another strong motive for further migration (for family reunification reasons).[71] Similarly to people from other Western Balkans countries, Kosovans most often choose Germany and Switzerland as their destinations.

Strong remittance inflows reduce incentives to work. Besides depriving the country of its productive workforce, international migration has an additional negative impact on the labour market. Remittances sent to families in Kosovo are an important source of income (the second largest for remittance-receiving households, estimated at 20 per cent of total monthly income). They help to reduce poverty and cushion the impact of unemployment, but at the same time, make members of households receiving remittances

[65] For more detail, see, for example, Democracy for Development Institute (2017), Cojocaru (2017) and Farnsworth et al. (2018).
[66] See Cojocaru (2017).
[67] For more detail, see EBRD (2016).
[68] See Esipova, Pugliese and Ray (2018).
[69] See EBRD, World Bank and EIB (2018).
[70] See Hazer et al. (2021).
[71] See Cojocaru (2017).

less likely to register as unemployed and more likely to have a higher reservation wage (a wage level at which a person is willing to accept a job).[72]

- *Skills mismatches*

Demand for skilled labour is outgrowing supply. A recent skills gap analysis[73] shows that private-sector employers in Kosovo encounter significant difficulties in finding skilled and qualified labour, despite the high unemployment rate and the large number of people enrolling in higher education (double the EU average). The country is facing structural challenges in preparing its skilled labour force to meet private-sector needs and demand. According to the study's findings, both higher and vocational education suffer from lack of quality standards and a lack of alignment of study programmes with the needs of the labour market.

The education system does not respond sufficiently to the private sector's needs. Despite some educational reforms, OECD Programme for International Student Assessment (PISA) scores remain low and unemployment among tertiary education graduates is still high.[74] This points to the inadequate quality and relevance of education. In 2015, the European Commission recommended a rationalisation of the vocational education and training (VET) school network in line with labour-market needs and a revision of the provision of VET programmes. And yet, the conclusion of the European Commission's 2021 country report is that the VET reform remains at an early stage, with a lack of practical and applied courses, a lack of teaching materials and textbooks, a dearth of cooperation between schools and businesses, and insufficient professional development opportunities for teachers.[75] Improving the quality of education is even more important given the fact that Kosovo is the youngest nation in Europe.

4.4. Public infrastructure gaps and the need to speed up green transition

Kosovo faces large public infrastructure gaps. Despite the improvements of recent years, Kosovo continues to lag the EU significantly when it comes to transport infrastructure, installed capacity for power generation and telecommunications networks (especially fixed broadband subscriptions). That potentially deters foreign investors and limits the country's integration into European supply chains. Existing public infrastructure and associated services will come under further stress as a result of climate change impacts (for example, reduced hydropower potential).[76]

- **Roads**: Roads are the main means of transport in Kosovo (95 per cent modal share), but motorway density is very low compared with southern and eastern European peers. The length of the road network is approximately 8,600 km. According to the IMF,[77] in 2015, Kosovo had 20 km fewer of highway per 1,000 km^2 than the average EU Member State – the largest gap among the Western Balkans countries. Currently, there are two highways in Kosovo (Routes 6 and 7). The older and longer one (Route 7), connecting Pristina with the Albanian border and giving Kosovo access to the sea port in Durres, was the largest infrastructure project after Kosovo proclaimed independence. It was also the country's most expensive public project, costing 20 per cent of GDP. While the highway meets international standards of quality, it has been underused so far (less than one-third of its capacity). Route 6, connecting Pristina with the North Macedonian border, was completed in 2019. Cross-border transport infrastructure should be enhanced with a view to rehabilitating and improving major cross-border routes.
- **Railways**: Kosovo's railway sector is fairly underdeveloped. Currently, there are rail routes to Serbia and North Macedonia, while direct routes to Montenegro and Albania are lacking. The latter would allow Kosovo to improve its trade capacity, as the country would gain easier access to the sea ports of Durres (Albania) and Bar (Montenegro). These connections have been a priority for the government for a number of years, but no major progress has been made. According to the IMF,[78] Kosovo's railway density gap (measured against the EU average) was the second highest in the Western Balkans region in 2015, at around 30 km per 1,000 km^2. At the same time, the existing railway network stock requires renovation, as much of the network comprises just a single track and is only partially electrified. Kosovo is relatively advanced in terms of the regulatory structure of the railway sector, but challenges remain in ensuring that these regulations are implemented effectively and in a commercial way. The

[72] See Krasteva et al. (2018) and Loxha (2017).
[73] See American Chamber of Commerce in Kosovo (2018).
[74] See European Commission (2020).
[75] See European Commission (2015; 2020).
[76] See USAID (2017).
[77] See IMF (2018).
[78] Ibid.

sector is overseen by an independent regulator and is open to competition for train services, but there is currently only one small private freight-train operator. Track access charges are partly subsidised by the government, as are rail infrastructure rehabilitation and maintenance.

- **Airports**: Kosovo's air transport gap is also sizeable, though on a par with the other Western Balkans countries, as estimated by the IMF.[79] Kosovo has one international airport (Pristina International Airport), which, until recently, was not served by any public transport. One of the government's recent successes, fulfilling part of the country's infrastructure strategy, was the establishment of a bus line connecting the airport to the city. Due to the country's dispute with Serbia over independence, flights from and to Kosovo cannot pass through Serbian airspace, but have to go through North Macedonia or Montenegro, which increases flight duration and cost.
- **Energy**: At around 1.1 kW per capita, Kosovo's gap (measured against the EU average) in installed capacity for power generation was the second highest in the Western Balkans region in 2014.[80] Total energy supply per capita was below the world average and only a half the EU average in 2019.[81] Almost all electricity in the country is generated by two old and unreliable coal power plants, whose production capacity cannot meet demand. The outdated infrastructure has significant negative environmental implications.

Transport and other infrastructure require significant investment. In 2008, Kosovo had a rundown road network that had largely been built in the 1960s. There has been a persistent lack of funds to maintain existing infrastructure, as most resources are allocated to new road construction. In 2009-19, total public investment amounted to between 7 and 11 per cent of GDP annually. In 2020, public investment declined by nearly 30 per cent from the year before as spending was refocused on pandemic-related priorities. Overall, the impact of Kosovo's public investment is limited, according to the IMF.[82] Public debt remains relatively low compared with the rest of the region, despite a significant increase in 2020 (from around 18 per cent of GDP in 2019 to 24 per cent of GDP in 2020) amid economic contraction and sizeable economic support measures, but it is constrained by low capacity and weaknesses in the public investment management framework. The fiscal rule, which was suspended to accommodate pandemic-related support for 2020-22, contains an "investment clause", which allows international financial institutional funding and bilaterally financed capital investments to be excluded from the budget deficit limit of 2 per cent of GDP, provided that overall public debt is below 30 per cent of GDP (lower than the legal ceiling of 40 per cent of GDP). There is a possibility that Kosovo will hit that debt ceiling prior to 2025. In 2015, the government adopted the national transport strategy and action plan for 2015-25, aiming to improve its transport infrastructure and to address traffic quality and safety.

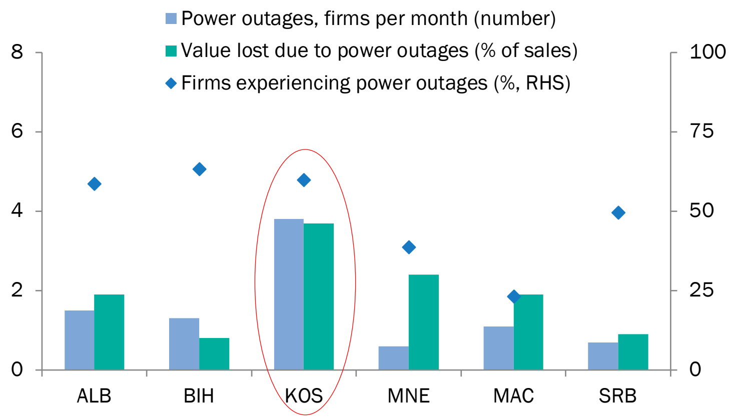
The development of transport infrastructure is slowed by delays in project implementation, in particular, public procurement. The delays are the consequence of deficiencies in project design, the expropriation process, public procurement and contract management.[83] Often, annexes need to be added to contracts for additional unplanned works. For example, almost all contracts between the Ministry of Infrastructure and road construction companies on two national roads[84] have required concluding annexes. At the same time, litigation risks were noted, whereby contracting companies planned to sue the government for unreasonable deadlines and additional labour costs incurred. The Ministry does not keep a detailed list of public contracts and is, therefore, unable to track delays and hold contractors accountable. Due to delays in the tendering process, many regional and national roads have been without maintenance for some time.[85]

Low level of transparency and unclear economic rationale for large transport projects are of concern. Project details and public documents and information are often not available to interested groups.[86] Contracts are occasionally awarded without the publication of a tender, contrary to the country's Public Procurement Law.[87] A lack of transparency and accusations of corruption were observed in two highway projects.[88] The contract for Route 7 was never published, for instance, and the price of the highway was more than €11 million per kilometre, the second-highest price (after Austria) in the observed sample of countries and notably higher than in comparable countries in Central Europe. Similarly, a feasibility study

[79] Ibid.
[80] Ibid.
[81] See IEA (n.d.).
[82] See IMF (2022a).
[83] For more detail, see, for example, KDI (2019a) and NAO (2017).
[84] The Pristina–Peja road (N9) and Pristina–Mitrovica road (N2).
[85] See KDI (2019b).
[86] See KDI (2019a).
[87] See, for example, NAO (2017).
[88] For more detail, see, Riinvest Institute (2015b) and Brunwasser (2015), for example.

for Route 6 was conducted, but never made public or discussed with a broader audience. According to the World Bank, “the rates of economic return on highways are comparatively low and call into question the choice to prioritize this spending over investments in energy, education and health as well as maintenance of existing roads”.[89]

Figure 13. High share of companies experiencing power outages



Source: BEEPS VI[90]

Energy infrastructure is largely outdated, inefficient and coal dependent. Kosovo produces 97 per cent of its electricity in two thermal power plants (TPP), Kosovo A and Kosovo B.[91] The rest is produced by hydro power plants (HPP) and a single 32 MW wind power plant (WPP), or imported. Kosovo is not connected to any natural gas system. No new major capacities have been constructed since 1984. Neither of the TPPs has been retrofitted to ensure compliance with the Large Combustion Plant Directive (LCPD), which came into effect in Energy Community countries in 2018. Kosovo is thus breaching emission ceilings of sulphur dioxide, nitrogen oxides and dust from thermal plants.[92] The proposed 500MW coal-fired *Kosova eRe* power plant was cancelled in 2020 when the main investor pulled out. Urban heating systems depend almost entirely on lignite (94 per cent of total). Apart from its dependency on polluting fuels, the district heating system is characterised, as in the rest of the Western Balkans region, by outdated pipelines and a distribution network serving buildings with poor energy efficiency performance.[93]

The share of renewables in electricity generation is rising, but remains small. Until 2021 and the coming online of the new wind farm in Bajgora, renewable energy accounted for a minor share of 3 per cent in electricity generation. Total renewable installed capacity, as of 2021, comprised of 56.6 per cent onshore wind (137 MW) 39.3 per cent renewable hydropower (95 MW) and 4.1 per cent solar PV (10 MW).[94] According to a cost competitive renewable energy potential analysis, Kosovo could deploy 581 MW solar PV, 2327 MW wind and 495 MW hydro on a cost competitive basis.[95] Its hydro potential could come under pressure due to climate impacts.[96]

Distributional and efficiency losses are large. The total thermal efficiency of electricity and heating plants in Kosovo in 2018 was 29 per cent lower than the EBRD regional average.[97] In 2019, technical and commercial losses in the distribution network stood at 25 per cent.[98] Still, this is a major improvement on the situation in 2007, when losses were close to 50 per cent.[99] The improvement was helped by investments following the privatisation of the distribution network in 2013. In general, large non-technical losses are a consequence of the unauthorised use of energy, but also of unbilled electricity in some municipalities in northern Kosovo, where the distribution system operator and the supply company have no control.

[89] See World Bank (2014).
[90] See EBRD, World Bank and EIB (2018).
[91] See Ministry of Economic Development (2017a).
[92] See Energy Community Secretariat (2021).
[93] Ibid.
[94] In terms of total renewable generation (as of 2019): 67.8% was hydro (213 GWh), 28.9% was onshore wind (91 GWh), 3.4% was solar PV (11 GWh). See IRENA, accessed 10 May 2022.
[95] See IRENA, Joanneum Research and University of Ljubljana (2017).
[96] See USAID (2017).
[97] See International Energy Agency (2020)
[98] See Energy Community (2021b).
[99] See Ministry of Economic Development (2017a).

Unstable energy supply and frequent outages hit firms hard. The power shortages are a consequence of insufficient output, ageing grids and theft. According to the BEEPS VI survey, 60 per cent of Kosovar firms experience power outages.[100] This is a significant reduction from the previous survey round (2013), when 80 per cent of firms complained of outages. At the same time, however, it is still the second-highest percentage in the region after Bosnia and Herzegovina (63 per cent of firms). However, electrical outages seem to cause more damage to Kosovan firms than they do elsewhere. Kosovan companies typically deal with four outages per month, losing almost four percent of annual sales as a result. Bosnian firms, in contrast, typically experience 1.3 outages per month and lose less than one per cent of annual sales.

The energy sector is a large pollutant. Overall, the energy intensity of the Kosovan economy is almost four times the EU average. As a result of fossil-fuel dependency and outdated infrastructure, the carbon intensity of electricity production in the Western Balkan parties exceeded the average carbon intensity of electricity production (defined as kg CO_2/€ GDP) of the EU-27 more than threefold in 2020. Kosovo's CO_2 emissions intensity from the power sector has been even higher than that; the country's power sector is the most carbon intensive in the region.[101]

While the need for a green transition is obvious, it should follow just transition principles. This would help to ensure that the benefits of the green transition were widely shared, while mitigating negative consequences. A green transition would bring tangible economic and health benefits through new investments and improvements in air quality. Yet, these benefits are unlikely to be evenly distributed and past cases of transition have shown that large-scale asset closures can have adverse socioeconomic costs for directly affected employees, but also on broader geographic areas.[102] Kosovo already has the highest unemployment rate among EU candidate or potential candidate countries. There is a risk that a coal phase-out in Kosovo would have negative effects on employees working in the coal sector and, more generally, on Kosovo's coal region. For this reason, a just transition will be crucial. A just transition helps to ensure that the benefits of a green economy transition are shared, while protecting vulnerable regions and people from falling behind and employing broader economic diversification efforts in the relevant territories.

4.5. Weak SOE governance

Kosovo has more than 560 non-financial SOEs. The vast majority of them (more than 500) are "socially owned enterprises", managed by the Kosovo Privatization Agency (PAK). In addition, there are 18 centrally owned and 38 locally owned SOEs, organised as joint stock companies. These are usually referred to as publicly owned enterprises (POEs),[103] and operate under specific legislation (Law on POEs). Central-level POEs are present in energy, communications, transport, water and irrigation, and waste management, while the majority of local ones are bus stations and water and waste companies.[104] As shareholders, the government and municipalities exercise their rights in most POEs through the election of the board of directors.

Progress on resolving SOE issues is slow. The privatisation of socially owned enterprises is currently the responsibility of the PAK.[105] The agency is supposed to conduct the privatisation process through spin-offs[106] and voluntary liquidations. In recent years, the process has been slow, among other reasons due to the government's decision to freeze the privatisation of socially owned land (in November 2017) and to disruptions in the functioning of the PAK board, which has stalled decision-making. According to the European Commission, in 2019, in Kosovo, there were 222 SOE asset sales (worth €32 million in total). This number fell to 93 sales (worth €8 million) in 2020 due to frequent government changes and decisions to suspend and subsequently resume all activities related to privatisation or liquidation proceedings.[107] However, these numbers include the sale of assets such as land and machinery, making it difficult to estimate the extent to which sales contributed to the shift to more productive structures. The liquidation process seems to have stalled. The government has announced its plan to dissolve the PAK and replace it with a sovereign fund that would be responsible for investment, with a view to increasing the value of

[100] See EBRD, World Bank and EIB (2018).
[101] See Energy Community (2021a).
[102] See EBRD (2020).
[103] According to the statistical office, "publicly owned enterprises include all publicly owned enterprises, or are established by public funds or under public law and are not public authorities or part of public authorities".
[104] For the list of POEs, see Kosovo Agency of Statistics, Ministry of Finance and Central Bank of the Republic of Kosovo (2019).
[105] For more detail information on privatisation in Kosovo, see Loku and Loku (2016).
[106] The spin-off refers to the creation of a new company by the PAK and transfer of a part or all of the assets of a socially owned enterprise to this new company. The shares of the new company are then sold by the PAK to private investors.
[107] See European Commission (2021).

strategic POEs, such as mining company Trepca, which holds Europe's largest lead-zinc and silver ore mine, and Post and Telecom of Kosovo.[108]

The frequency and quality of financial reporting is inadequate and financial oversight is not ensured. The Publicly-Owned Enterprise Policy and Monitoring Unit (PMUPE) of the Ministry of Economic Development supports the government in exercising its responsibilities with regard to POEs. Under the law, POEs should systematically report to this unit on their performance, while the PMUPE should publish on its website all important documents and information on individual POEs, as well as a consolidated financial statement for all POEs. However, the latest annual reports for only a small number of POEs are available on the PMUPE website. Possibly due to POE delays in submitting their reports, there have been significant lags in the publication of the PMUPE annual report too.[109] The IMF also observes that POE financial statements are only partially published on a centralised website and that the oversight unit is not required to review them.[110] The quality of financial reporting of Kosovan POEs also seems to be weak. The National Audit Office (NAO) issued a modified opinion on the 2018 annual financial statements for 10 of the 11 audited POEs, saying that the documentation contained (material) misstatements of accounts.[111]

Financial performance of POEs appears weak. The latest available document on the financial performance of POEs is the NAO report on POE performance in 2020.[112] The report looked at 10 central and two local POEs. While seven POEs had a positive financial result with total company profit of around €1.1 million, the other five recorded losses totalling €19.5 million. Around €18 million of losses were made by only two POEs (Kosovo Telecom and Post of Kosovo), which at the same time had significant short-term liabilities (almost €80 million in total). Some of the companies rely heavily on budget funding. The report highlights that all POEs are on the verge of profitability and, in real terms, operate at a loss. Ineffective rule of law and political problems may be significant factors harming the financial performance of POEs.[113]

Corporate governance is weak. The corporate governance of SOEs in Kosovo is regulated by the Law on Publicly-Owned Enterprises, the Law on Business Organisations and the Corporate Governance Code for Publicly Owned Enterprises (enacted in 2010 and reviewed in 2014). Some of the shortcomings in the existing legal framework governing SOEs in Kosovo are as follows:

- The old state ownership policy is in need of an update, as it has lost relevance and has limited applicability in practice. The policy is set out in very general terms and does not contain criteria on which the State could determine overall objectives for various SOEs.
- There is a lack of clarity on the duties and responsibilities of boards of directors. The key functions of boards should be clarified, while the transparency of boards towards other stakeholders and the general public should be improved through more robust and clear disclosures and reporting standards.
- There are inconsistencies between the Law on SOEs and the Corporate Governance Code for SOEs as regards the functioning of SOEs in general.
- There is a poor legal and institutional framework for measuring and monitoring SOE performance.

There are other issues as well. These include political influence, a lack of strategic planning, the absence of management accountability, inadequate segregation of duties, incomplete reporting, a lack of published regulations, reports and information for transparency purposes, ineffective internal audits, and inadequate budget planning processes, with insufficient analyses, including risk assessments. In addition, the independence of POE boards with regard to the state as owner has not been ensured and most of the companies are overstaffed.[114]

Wages are significantly higher in POEs and the rest of the public sector than in the private sector. In 2020, the average monthly POE gross wage was €769 (€624 in the public sector) compared with €380 in the private sector. At the same time, POE wages have increased far more than private-sector wages since

[108] Ibid.
[109] See Riinvest Institute (2015a).
[110] See IMF (2019).
[111] See NAO (2019).
[112] See Kosovo National Audit Office (2020).
[113] See GAP (2015a).
[114] For more detail on these issues, see, for example, NAO (2019), GAP (2015b), Beqiraj (2017) and Ministry of Economic Development (2017b).

2012 (37 per cent compared with 13 per cent).[115] This negatively affects the attractiveness of employment in the private sector.

[115] See Kosovo Agency of Statistics (2020b).

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Annex 1: Qualities of a sustainable market economy

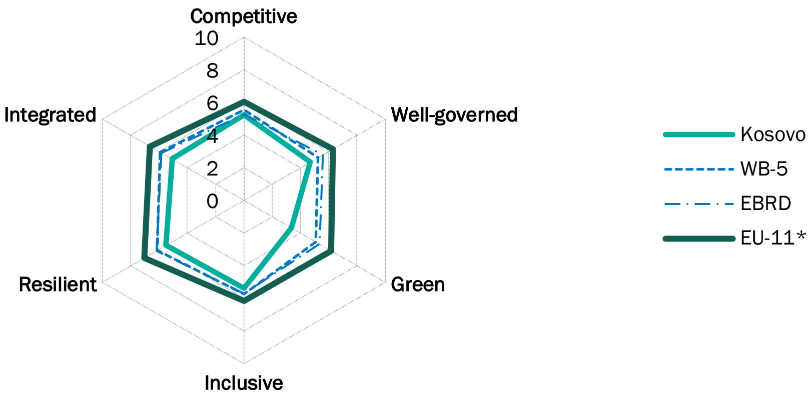
In the EBRD's 2021 Assessment of Transition Qualities (ATQ), Kosovo ranks 30th out of the 38 economies in which the Bank invests.[116] In the EBRD's recently adopted methodology for measuring transition, the ATQs are composite indices on the six desirable qualities of a sustainable market economy (*competitive, well governed, green, inclusive, resilient, and integrated*), obtained by combining information on a large number of indicators and assessments.[117]

Kosovo underperforms the region and the EBRD average on all qualities. The country lags the Western Balkans-5 average most on the "green" and "integrated" qualities (1.7 and 0.8 index point difference, respectively), followed by the "resilient" and "well-governed" qualities (0.5-0.6 index point difference). The lag is smallest for the "competitive" and "inclusive" qualities (0.3-0.4 index point). It should be noted, however, that some indicators needed for the calculation of ATQ scores were not available for Kosovo, meaning that regional averages were used instead. The lack of data was particularly pronounced in case of the "integrated" and "green" qualities, while the score for the "resilient" quality was based on a full set of data.

The following sections provide brief snapshots of each quality.

Figure 14. ATQs in 2021

(1 – 10 best)



Source: EBRD calculations

[116] The score is calculated as a simple average of scores for the six transition qualities.
[117] For more detail, please see EBRD (2017), pages 105-116.

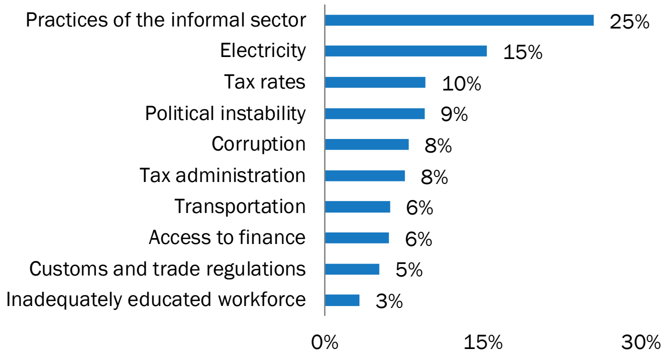
Competitive (ATQ = 5.2)

The economy is characterised by a large number of family-owned micro companies and high informality. Despite some improvements in the business and regulatory environment, the country still encounters many regulatory, administrative and other obstacles to competitiveness. Labour-market challenges, low quality of education, skills shortages, difficult access to finance and limited capacity to innovate weigh on the capacity to generate value added.

- Scores -0.29 (on a scale of -2.5 to 2.5) on regulatory quality[118]
- Kosovo ranks 25th out of the 38 economies in which the EBRD operates for the SME business environment[119]
- New business density in Kosovo reached 3.99 registrations per 1,000 individuals in 2018 – the 11th highest in the EBRD region[120]
- 35th in the Knowledge Economy Index out of the 38 economies in which the EBRD invests[121]

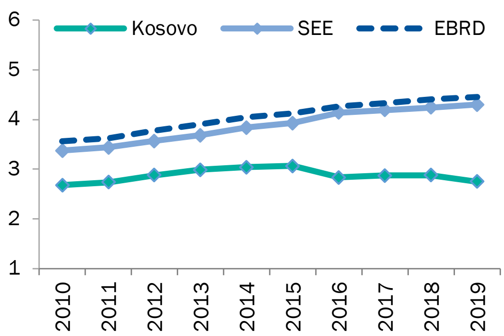
Figure 15. Top 10 constraints on doing business

Percentage of firms identifying it as such



Source: BEEPS VI[122]

Figure 16. EBRD Knowledge Economy Index



Source: EBRD

- SMEs play a prominent role in the economy. They account for 99.9 per cent of all enterprises and employ a high proportion of the population (76 per cent). A vast majority of SMEs (93 per cent) are micro companies employing fewer than 10 people. According to the SME Policy Index,[123] Kosovo's SMEs lag those of its Western Balkans peers primarily in terms of entrepreneurial learning and women's leadership, as well as SMEs in a green economy.
- The regulatory and administrative burden, as well as wider governance weaknesses, continues to hamper the business environment. Despite improvements in recent years, processes for obtaining licences and permits need to be streamlined further. The business inspection reform should be re-energised, as weaknesses in the framework and implementation continue to burden the private sector. Generally, weak institutional capacity is hindering the effective implementation of business regulations.
- In BEEPS VI, a quarter of firms cited competition from the informal sector as the main obstacle to doing business.[124] Kosovo's informal economy has been estimated at 30-40 per cent of GDP. For the rest, the high degree of informality creates unfair competition among firms, makes their access to finance more difficult and prevents firms from growing faster.
- Kosovo's economic growth over the past decade has largely been dependent on domestic consumption, fuelled by remittances. Only in more recent years has growth become more export and investment driven. Services based on travel and on visits by the country's large diaspora account for

[118] See World Bank World Governance Indicators.
[119] According to the EBRD SME Index.
[120] Data from the World Bank's Entrepreneurship Database.
[121] See the EBRD Knowledge Economy Index.
[122] See EBRD, World Bank and EIB (2018).
[123] See OECD (2019a).
[124] See EBRD, World Bank and EIB (2018).

close to half of GDP and employ 70 per cent of the workforce. While service exports have been hovering around four times the volume of goods exports, goods exports are increasing in significance, doubling in nominal terms since 2019. The trend has shifted thanks to growing furniture exports, which are expected to continue supporting the economy's external competitiveness.

- Another constraint on competitiveness is the unreliable energy supply. Power outages are frequent and carry significant costs for businesses (4 per cent of annual revenues, according to the BEEPS VI).[125]
- State intervention in the form of subsidies is relatively high. Subsidies to the private sector, public corporations and other sectors amounted to 1.9 per cent of GDP in 2019. This is below levels seen in Bulgaria, North Macedonia and Serbia, however (2.4, 2.7, and 2.4 per cent respectively).
- The average applied tariff rates on imported goods was 5.9 per cent in 2017-19. That appears to be significantly above the Western Balkans-5 and EBRD averages. Some trade liberalisation has taken place. The country is a member of CEFTA and its SAA with the EU has been in force since April 2016. Brussels viewed the 100 per cent tariffs on goods imported from Serbia and Bosnia and Herzegovina, introduced in November 2018 and lifted in June 2020, as a violation of these agreements.
- Capacity to innovate is limited. Kosovo's knowledge economy is nascent. The EBRD Knowledge Economy Index shows its performance to be well below that of its regional peers and in the bottom quintile of the economies in which the EBRD invests (ranking 35th out of 38). According to the index, the country lags most in the skills required for innovation and ICT infrastructure.[126]
- Kosovo's exports of more advanced and sophisticated services are among the lowest in the Western Balkans region, but have been rising in recent years. ICT accounted for 7 per cent of total services exports in 2020. In contrast, thanks to its vast diaspora, the country records significant exports of travel-related services. These accounted for 68 per cent of total services exports in 2020, the highest share in the Western Balkans.
- Access to credit is a significant challenge for the private sector, according to surveys such as BEEPS and SAFE. In 2020, credit to the private sector was 51.6 per cent of GDP, slightly lower than the Western Balkans-5 average of around 51.9 per cent, while SME access to finance was rated worse than the regional average.[127]
- The low quality of education and skills shortages weigh on the competitiveness of the Kosovan economy. Its average 2018 Programme for International Student Assessment (PISA) score was the lowest in the region and one of the lowest of all of countries tested.[128] Improvements in this area would require an overarching reform effort. Another issue is Kosovo's high level of emigration, which is potentially depleting the economy of its most skilled workforce.

[125] Ibid.
[126] See EBRD (2019).
[127] See European Commission and ECB (2019).
[128] See OECD (2018).

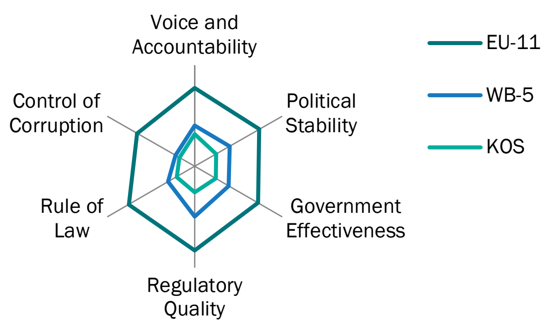
Well governed (ATQ = 4.7)

Public governance challenges include weak institutions and rule of law, high informality, an inefficient judiciary, the high prevalence of corruption and organised crime. The government has been making efforts to address these issues, but progress has been slow. There is room for improvement in the corporate governance of SOEs.

- 87th out of 180 countries in the Corruption Perceptions Index 2021[129]
- Scores -0.39 (on a scale of -2.5 to 2.5) on the rule of law (World Bank World Governance Indicators 2021)[130]
- Scores -0.32 (on a scale of -2.5 to 2.5) on government effectiveness (World Bank World Governance Indicators 2021)[131]

Figure 17. Worldwide Governance Indicators

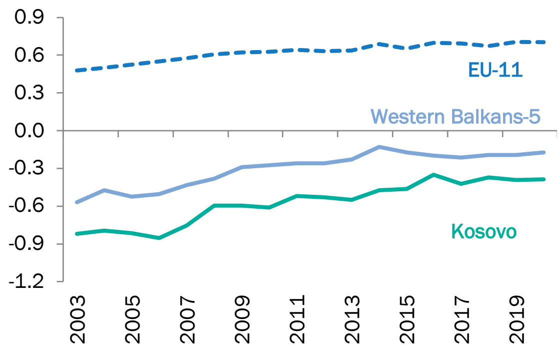
Index, from -2.5 (weak) to 2.5 (strong)



Source: World Bank Worldwide Governance Indicators 2020

Figure 18. Rule of Law

Index, from -2.5 (weak) to 2.5 (strong)



Source: World Bank Worldwide Governance Indicators 2020

- Kosovo scores worse than the Western Balkans-5 average on all six World Bank World Governance indicators.[132] It performs weakest in the areas of control of corruption and rule of law (-0.45 to -0.39 on a scale of -2.5 to 2.5).
- The country is still characterised by a weak rule of law, despite significant international efforts over the past two decades. The international community has supported the rule of law system in Kosovo through the UNMIK and EULEX, both of which have exercised executive power over the Kosovan judiciary. The EULEX was launched in 2008 and its judges and prosecutors were embedded in the Kosovo justice system until mid-2018. Currently, the mission monitors select cases and trials in Kosovo's criminal and civil justice institutions. Its mandate will end in June 2023.
- The judicial system is rather slow and inefficient, prone to political interference and viewed with little public trust. According to Transparency International, weaknesses in law enforcement all over the Western Balkans are a consequence of captured political systems in which politicians exert influence on all walks of public life, while being close to wealthy private individuals or, sometimes, underground networks.[133] On the positive side, Kosovo's basic courts have reduced their backlog and introduced mediation within the court system. In October 2017, the Serbian judiciary was integrated with the judicial system of Kosovo, so the system has been unified. There has been some progress on setting up commercial courts.

[129] See Transparency International (2021).
[130] Data are for 2020. See World Bank Worldwide Governance Indicators.
[131] Ibid.
[132] These are: voice and accountability, political stability and absence of violence/terrorism, government effectiveness, regulatory quality, the rule of law and control of corruption.
[133] See Transparency International (2020).

- According to the European Commission,[134] Kosovo is in the early stages of its fight against organised crime.
- An insufficiently transparent, efficient and accountable public administration contributes to Kosovo's high prevalence of corruption. In the 2021 Corruption Perceptions Index, Kosovo ranked 87th out of 180 countries, 17 places higher than the year before.[135] According to the European Commission,[136] corruption is widespread and the country is "at an early stage/has some level of preparation" in the fight against corruption. Corruption is present in the procurement cycle, among other areas; 99 per cent of public contracts in 2018 were awarded based on a lowest-price criterion, unlike the best-practice EU Directive on public procurement, which prescribes the use of a price-quality ratio. Recently, some important pieces of legislation have been adopted in this regard, the implementation of which will be critical.
- Kosovo's high level of informality is also reflected in its low government revenues. At 26 per cent of GDP, its revenues are lowest in Western Balkans and among the lowest in Europe. In May 2019, Kosovo adopted a revised strategy and action plan for fighting informality in 2019-23.
- In recent years, Kosovo has made enforcing contracts easier by introducing a private bailiff system and a consolidated law on voluntary mediation. It takes 330 days to enforce a contract through the courts, significantly less time than in Croatia (650 days), Albania (525 days) or high-income OECD countries (590 days).[137] In contrast, the cost of the process is still relatively high (close to 35 per cent of the claim value) and the quality of judicial processes is rated "medium".
- By the EBRD's assessment,[138] the country's corporate governance framework is of "medium" strength, with three areas (transparency and disclosure, internal control and rights of shareholders) estimated as "fair" and the other two (stakeholders and institutions, and structure and functioning of the board) between "weak" and "fair".[139] While the independence of directors is deemed "very weak", financial information disclosure is considered "strong". The quality of corporate governance in SOEs is "weak".

[134] See European Commission (2020).
[135] See Transparency International (2021).
[136] See European Commission (2021).
[137] See World Bank (2020a).
[138] See Cigna, Ahma and Sigheartau (2017).
[139] The ratings are ordered as follows from worst to best: very weak, weak, fair, moderately strong, strong and very strong.

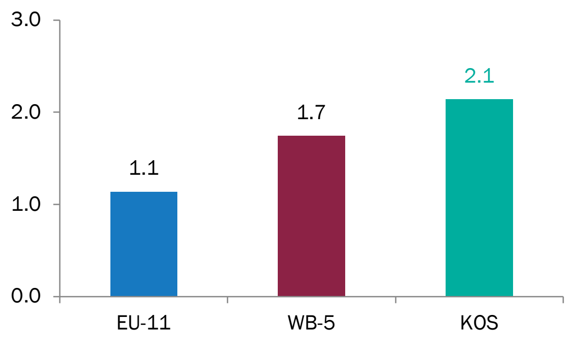
Green (ATQ = 3.3)

For a green economy transition, Kosovo needs to focus on investing in sustainable energy and pursuing a just and fair transition away from carbon-intensive sectors. Its energy system depends overwhelmingly on lignite coal, which not only produces significant GHG emissions, but poor air quality, with human and economic impacts. In addition, improvements in waste and wastewater treatment are needed.

- Two lignite-fired power plants generated 96 per cent of electricity in 2020[140], while 94 per cent of district heating depends on lignite.[141]
- The energy sector accounts for 88 per cent of the GHG emissions in Kosovo.[142]
- Mining and electricity supply employed 10,940 in 2020 (6 per cent of the workforce)[143]

Figure 19. PM2.5 premature deaths

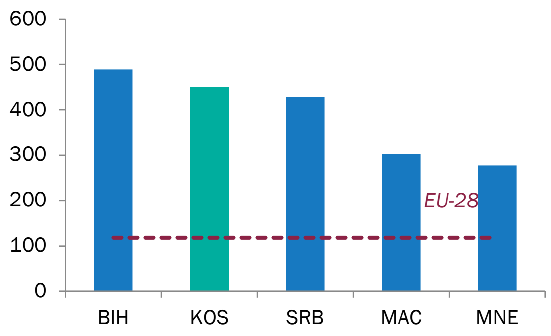
Per 1,000 of population



Source: European Environment Agency and authors' calculations

Figure 20. Energy intensity

Kgoe per 2018 € of GDP



Source: Eurostat

- Kosovo's progress has been relatively slow on aligning its environmental legislation with the EU Acquis compared with other Western Balkan peers. As a contracting party to the Energy Community, Kosovo transposed the EU's Third Energy Package into national law in 2016 and is currently working on the approval and implementation of relevant secondary legislation. It has started on its draft National Energy and Climate Plan (NECP), though target setting and scenario development are still lacking.[144]
- Kosovo's energy sector is characterised by high carbon intensity, linked to its dependence on coal, served by outdated infrastructure. Coal is the country's prevalent and most important source of energy, with almost all electricity generated by two antiquated and unreliable coal power plants. The country's district heating systems depend almost exclusively on coal/lignite.[145] The thermal efficiency of electricity and heat plants in Kosovo in 2018 was 29 per cent less than the EBRD region average.[146] Furthermore, energy demand is often not met due to frequent power outages.[147]
- There is significant potential in renewable energy (RE), which accounts for only a minor share of electricity generation, primarily from hydro and wind sources. While the country reached its 2020 target for renewable energy as a share of energy consumption of 25 per cent,[148] this was primarily due to a revision in the calculation of] biomass consumption for heating in households rather than

[140] See IEA Data Browser. The figure is likely lower since the Bajgora wind farm came online in the second half of 2021, though this has yet to be reflected in the statistics.
[141] See Energy Community (2021b).
[142] See Kosovo Agency of Statistics (2016).
[143] The number includes employees in the sectors 'mining and quarrying' and 'supply of electricity, gas, steam and air conditioning'. See Kosovo Agency of Statistics Database.
[144] See Energy Community (n.d.).
[145] See Energy Community (2021a).
[146] See IEA (2020).
[147] Total energy supply per capita in Kosovo (in 2019) was below the world average and only half of the EU average. See IEA (n.d.).
[148] See Eurostat (2020).

investment in renewables[149]. Estimates indicate that Kosovo could deploy 581 MW solar photovoltaic cells and 2,327 MW of wind on a cost competitive basis.[150]

- Energy intensity in Kosovo is among the highest in the Western Balkans and almost four times the EU average.[151] Households account for the largest share of final energy consumption (38 per cent in 2017),[152] more than in any other Western Balkans country and significantly above the EU average (27 per cent). The largest source of energy consumption in the residential sector is biofuels and waste, followed by electricity. There is significant energy savings potential in the residential sector.[153] Kosovo fell short of meeting its energy-saving target for buildings of 9 per cent by 2018 under the third National Action Plan on Energy Efficiency (NEEAP) 2016-18.[154] The NECP will set energy efficiency targets for 2021 onwards.[155]
- Uncontrolled air pollution from the energy sector[156] and household heating remains a serious issue. In 2016, Kosovo ranked first among 41 European countries on the number of premature deaths attributable to dust/particulate matter ($PM_{2.5}$), at 2.1 deaths per 1,000 people.[157] The total economic cost due to the health effects of air pollution in Kosovo has been estimated at between €37 million and €158 million a year (between 0.9 and 3.8 per cent of GDP).[158] The country's strategy for air quality and the law on ambient air quality are insufficiently enforced.
- Kosovo has a relatively small and limited amount of freshwater resources and the water resources available are unevenly distributed. Climate change may aggravate issues with the supply and quality of water, particularly in the summer months.[159] Freshwater shortages could occur in the near future in dry years if appropriate adaptive actions are not taken. Industry and agriculture are particularly exposed to climate-driven hazards.[160] Parliament passed a Climate Change Strategy 2019-28, which sets out the need for a legal framework on the management of groundwater and wastewater, as well as the associated risks.
- The waste management system is under-developed and inefficient. Local authorities struggle to deliver basic services in both urban and rural areas.[161] There are many illegal landfills. Recycling is limited and collecting recyclables is largely done by the informal segment of the labour market. Furthermore, river water quality is poor due to the lack of wastewater treatment plants, the uncontrolled disposal of waste and poor maintenance of riverbeds.

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149 See IRENA (2019) and Energy Community Secretariat (2019).
150 See IRENA, Joanneum Research and University of Ljubljana (2017).
151 See Eurostat (2019).
152 See Eurostat database.
153 See Kosovo Energy Efficiency Agency (2020).
154 The 9 per cent (or around 92 ktoe) target was set in the Kosovo Energy Efficiency Action Plan (KEEAP) 2010-18. Adoption of the final draft of the NEEAP 2019-21 is pending.
155 See Energy Community Efficiency Indicators.
156 The energy sector is one of largest polluters in the country, especially in the region around the capital, where existing thermal power plants are located.
157 See EEA (2019).
158 See European Commission (2019).
159 For more details, see, for example, World Bank (2018).
160 See USAID (2017).
161 See EEA (2018).

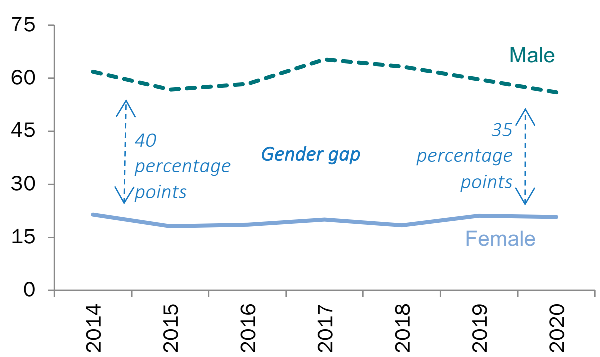
Inclusive (ATQ = 5.4)

Low labour-market participation and employment, especially for women, and high informal employment are the main characteristics of the labour market. The youngest nation in the Europe also struggles with the highest youth unemployment rate. Poverty and limited employment opportunities have led to significant emigration, worsening already pronounced skills mismatches.

- 35 per cent of the workforce is informally employed[162]
- 14 per cent of women are employed (compared with 43 per cent of men)[163]
- 49 per cent of youths (15-24) are unemployed[164]
- 44 per cent of the female population aged 15-plus had a bank account in 2017 (compared with 61 per cent in the Western Balkans-5)[165]

Figure 21. Labour-force participation rate by gender

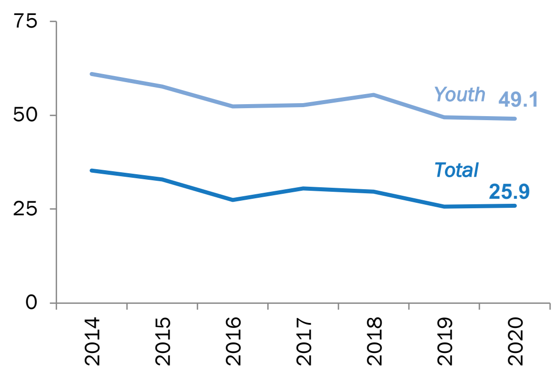
Per cent



Source: Kosovo Agency of Statistics

Figure 22. Unemployment rate

Per cent



Source: Kosovo Agency of Statistics

- A salient feature of the labour market is informality. According to the World Bank,[166] informality in Kosovo is among the highest in Europe, with more than a third of employees working informally. The groups most affected are those with low levels of education, youth, men and those living in rural areas. Almost half of employed youth and around a quarter of older workers (45–64 year olds) work in the informal sector. Informality declines with educational attainment, from over two-thirds of workers with less than primary education to 11 per cent for those with tertiary education.
- Labour-market participation in Kosovo is very low, especially for women. In 2020, the labour-force participation rate for the working-age people (15 to 64 years old) was 38 per cent. Although the rate has increased by around 1.5 percentage points since 2012, it is still one of the lowest in the world. The gender gap is also wide and has widened in recent years. While 56 per cent of male population was economically active in 2020, the same was true for only 21 per cent of women. In other words, almost 80 per cent of women are economically inactive.
- Relatively strong economic growth over the past five years has not translated into an equally strong rise in employment. The employment rate has increased only very slightly since 2014, to 28.4 per cent in 2020. The gender gap remains pronounced, with the employment rate in the working-age population being significantly lower for women (14 per cent) than for men (43 per cent).
- The unemployment rate remains high, especially for youth. In 2020, 26 per cent of the labour force and 49 per cent of youths were unemployed. Young women are the most disadvantaged group, with

[162] See World Bank (2017b).
[163] Kosovo Agency of Statistics (2020a)
[164] Ibid.
[165] See World Bank Global Financial Inclusion Database.
[166] See Cojocaru (2017).

57 per cent of them out of work. Similarly, only 6 per cent of young women had a job in 2020, compared with 16 per cent of young males according to national statistics.

- The share of young people neither in employment nor in education and training is highest in the region, at 33 per cent in 2020. However, these data should be observed in the context of Kosovo having the youngest population in Europe, with a median age of 29.5 years (compared with the median age of the EU population of 43.1 years). In 2018, those aged less than 15 years accounted for a quarter of population, while less than one tenth of the population was aged 65 years or over.[167]
- No data are available on the tertiary education attainment rate in Kosovo. However, Eurostat reports that from 2014 to 2019, Kosovo saw a much higher increase in the number of students in tertiary education, at around 7 per cent, than other Western Balkans countries or the EU average.[168]
- There is a large gender gap in access to finance. Only 44 per cent of women aged 15 and older had a bank account as of 2017.[169] Women also earn lower wages, on average, at all levels of education and in all industries. Regression estimates reveal that when educational and regional differences are taken into account, there is an 11 percentage-point wage gap between men and women.[170]
- Kosovo has to contend with high levels of emigration. Conservative estimates are that a third of Kosovans live abroad.[171] International migration plays an important role in reducing poverty and cushioning the problem of unemployment. At the same time, it is an important source of income, which makes members of households that receive remittances less likely to work.[172]

[167] See Eurostat (n.d.a).
[168] See Eurostat (n.d.b).
[169] See World Bank Global Financial Inclusion Databank.
[170] See Cojocaru (2017).
[171] See Hazer et al. (2021).
[172] For more detail, see, for example, Krasteva et al. (2018).

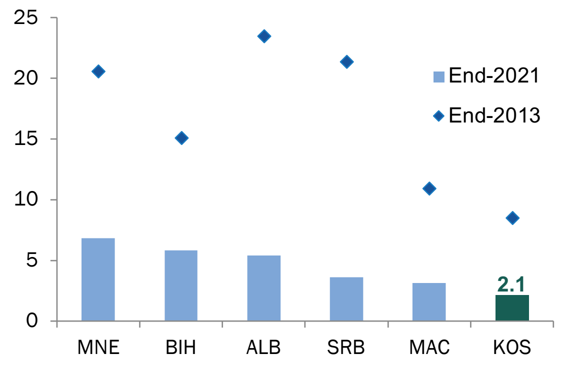
Resilient (ATQ = 5.5)

The banking sector is stable, while energy resilience could be improved. Kosovo's financial sector is dominated by banks, largely foreign owned, but microfinance institutions are present too. While the banking sector has generally been stable and performed well, access to finance remains difficult for many firms. The country has no natural gas interconnections, while private-sector participation in the electricity sector is limited.

- Banking sector capital adequacy ratio was at 14.8 per cent as of February 2022.[173]
- 2.2 per cent of loans to were non-performing as of February 2022.[174]
- 26 per cent distribution losses in the power grid[175]

Figure 23. NPLs

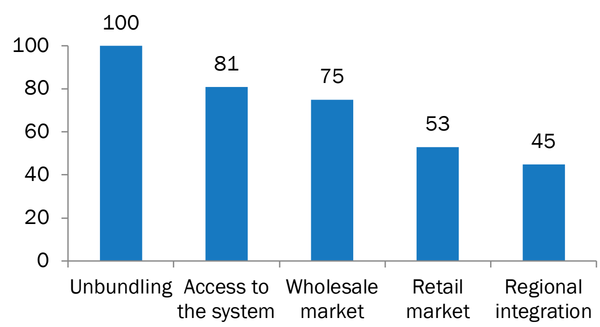
Per cent



Source: IMF and national authorities

Figure 24. Electricity sector reform implementation

Per cent



Source: Energy Community (2021b)

Financial resilience

- The Kosovo's financial system started operating effectively from scratch in the early 2000s. It is dominated by banks, the majority of which are foreign owned (nine out of eleven). As a result of the increased competition, the top three banks' share decreased from 75 per cent in 2010 to 56 per cent of total banking sector assets as of 2020.[176] Twenty microfinance institutions were present (12 foreign owned) in 2020, accounting for 4 per cent of financial-sector assets.[177] The law for banks and microfinance institutions is largely harmonised with Basel II requirements, with the central bank having taken made efforts to move towards Basel III and propose a new law on MFIs and non-bank financial institutions. It has also approved improvements to the credit registry that enhance its supervisory functions. The stability of the banking sector is important for the insurance sector too. Due to limited investment opportunities, the insurance sector (which comprises 3 per cent of total financial-system assets) holds half of its assets in banks as deposits.
- Banks are well capitalised and liquid, with the lowest share of low-quality assets in the region. The capital adequacy ratio stood at 14.8 per cent and the liquidity ratio[178] at 34.1 per cent as of February 2022.[179] At the same time, the NPL ratio is at 2.2 per cent per cent of total loans, the lowest of the Western Balkans countries, and loan-loss provisions to NPLs are among the highest (150 per cent).[180] Profitability has remained robust, despite challenges from the Covid-19 crisis. The country unilaterally adopted the euro in 2002 and bank lending in other currencies is minimal.

[173] See CBK (2022).
[174] Ibid.
[175] See Energy Community (2019).
[176] See CBK (2021).
[177] Ibid.
[178] Defined as liquid assets to short-term liabilities.
[179] See CBK (2022).
[180] Ibid.

- Lending growth amounted to 15 per cent in 2021, following a deceleration of 7 per cent in 2020 due to banks' risk aversion.[181] Banks imposed high collateral requirements in 2020, which constrained SMEs' borrowing capacity. The Credit Guarantee Fund of Kosovo (KCGF) started operating in 2017. The fund issues portfolio loan guarantees to financial institutions that cover of up to 50 per cent of the risk on loans to SMEs. The KCGF is supported by the Kosovan government, as well as donors and international financial institutions, and has underpinned financial liquidity during the Covid-19 pandemic through a guarantee scheme of up to 80 per cent for financial institutions.
- Deposit funding remains ample. The loan-to-deposit ratio was at 76 per cent as of end 2021, with the majority of deposits belonging to households. The trend in growth of deposits has changed and surpassed credit growth in 2019,[182] in part due to banks' elevated risk aversion. The former has also contributed to an increase in the share of transferable deposits, which account for around two-thirds of total deposits. The majority of loans, in contrast, have a 2-10-year tenor, so there is a maturity mismatch. The Deposit Insurance Fund of Kosovo was established in 2011, with a main mandate of compensating within 30 days insured deposits in case of licence revocation or bank closure. The Fund is working to implement European Banking Authority guidelines and EU directives on the application of risk-based premiums
- There is room for more financial deepening. In 2020, private-sector credit stood at 48 per cent of GDP. According to the BEEPS VI survey carried out in 2019, the share of firms identifying access to finance as a major obstacle to doing business was 47 per cent.[183] There was some progress in relaxing lending standards before the pandemic, however, since then, banks have tightened collateral requirements. What is needed, among other things, are the full implementation of the law on enforcement procedures, an acceleration of the resolution of commercial cases, a strengthening of property rights and supervisory efforts to ensure losses are transparently reflected. Flexible use of well-preserved capital buffers without the dilution of prudential standards or accounting requirements would support lending to viable firms.[184, 185]
- Capital markets remain underdeveloped. There is no stock exchange and financial instruments consist of government T-bills and bonds. Banks and pension funds are major buyers of government securities and there is little secondary market activity.

Energy resilience

Gas

- The country has no established gas market, although it has theoretically opened up for competition. Kosovo has no natural gas interconnections. Legislation governing the gas sector has been introduced in anticipation of the introduction of gas into the country.

Electricity

- End-user prices are largely regulated, with liberalisation efforts for medium voltage customers having stalled. Three high voltage customers (Sharrcem, Trepça, Ferronikel) connected to the 220kV or 110kV networks buy power at market prices.
- There are good physical interconnections in place with neighbouring countries, but these have limited use due to an ongoing dispute between the transmission system operators of Kosovo and Serbia. However, as of 2020, Kosovo's interconnection capacity with Montenegro, Albania and North Macedonia was allocated by the Coordinated Auction Office in South East Europe (SEE CAO).[186] In addition, the European Network of Transmission System Operators for Electricity (ENTSO-E) approved Kosovo's request to become an independent regulatory zone with Albania.[187] This has allowed the operationalisation of a 400kV interconnector, which was completed in 2016 but not put into use, and paves the way for the establishment of a joint day-ahead market (DAM). Significant distribution losses persist in the electricity network.
- The Kosovan energy sector has gone through a process of unbundling, with generation, transmission, distribution and sales owned by separate legal entities. Distribution system operator (Kosovo

[181] According to CBK statistics.
[182] See IMF (2022a).
[183] See EBRD, World Bank and EIB (2018).
[184] See IMF (2018a).
[185] See IMF (2021a).
[186] See Todorovic (2020).
[187] See bne IntelliNews (2020).

Distribution Services, KEDS) and the universal public supplier (Kosovo Electricity Supply Company, KESCO) are both privately owned companies, while the primary electricity generating entity (KEK) remains in public hands.

- Private-sector participation in the electricity sector remains limited. The sector was entirely state dominated by KEK until 2013, when the distribution and supply company, KEDS, was privatised. In 2015, further unbundling ensued, with supply activities being transferred to the newly established KESCO. Generation remains dominated by state-owned KEK, while the private sector is entering the market through renewable energy sources.
- Kosovo, as an Energy Community contracting party, transposed the EU's Third Energy Package into national law in 2016 and is currently working to approve and implement relevant secondary legislation. A sector regulator (the Energy Regulatory Office, ERO) has been established, though some steps remain to be taken until it reaches full independence.[188]

[188] See, for example, Energy Community (2019).

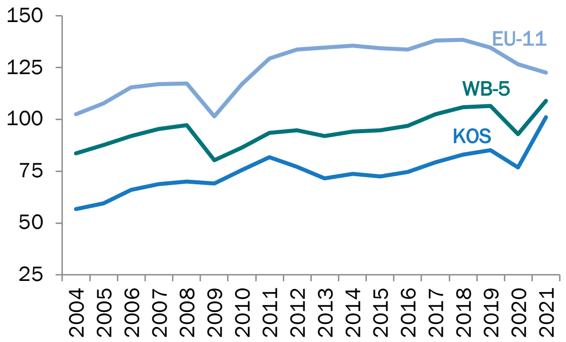
Integrated (ATQ = 5.1)

Kosovo is less economically open than the average Western Balkans economy, both in terms of trade and investment. Its level of diversification is low, with metals its main export products, though it has recently scaled up the production and export of furniture. There is also room for improvement in its transport connectivity. Kosovo's SAA with the EU has been in force since April 2016.[189]

- Trade as a share of GDP is 101 per cent compared with 109 per cent in the Western Balkans-5 as of 2021[190]
- The average annual net FDI inflow is 3.4 per cent of GDP (2017-20)[191]
- The FDI stock per capita is about 50 per cent of the Western Balkans-5 average (2020)[192]

Figure 25. Trade openness

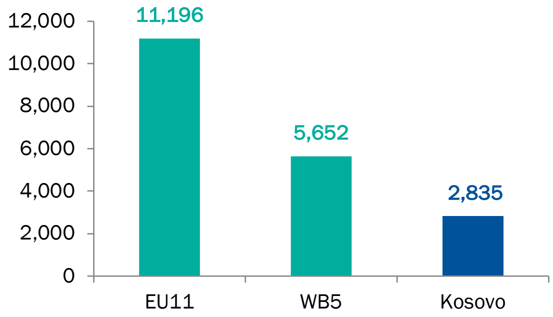
Percentage of GDP



Source: World Bank World Development Indictors, authors' calculations

Figure 26. FDI stock per capita, 2020

US$



Source: UNCTAD, Central Bank of the Republic of Kosovo and authors' calculations

- Kosovo's trade openness[193] has increased over the past decade, from 86 per cent of GDP in 2011 to 101 per cent in 2021, due to a large increase in service exports on the back of renewed mobility and strong support from the diaspora. However, it remains below the WB-5 average of 109 per cent, with goods exports (at 10 per cent of GDP) at an early stage of diversification and among the lowest in the Western Balkans.
- The country signed a Stabilisation and Association Agreement (SAA) with the EU, which entered into force in April 2016. This means it benefits from the removal of customs duties and reduced prices on imported products, while Kosovan producers have greater export potential if they comply with EU standards.[194]
- Goods exports are negligible, at around 10 per cent of GDP as of 2021, but have been growing in recent years. Base metals and plastics make up around half of the exports, agro-food accounts for 16 per cent, while miscellaneous manufacturing is the fastest-growing segment due to furniture exports.
- Service exports are almost four times higher than goods exports and have more than doubled since 2008, reaching 23 per cent of GDP in 2019, before declining to 15 per cent amid travel restrictions due to the Covid-19 pandemic. In 2021, service exports grew 189 per cent year on year, surpassing 2019 levels by 15 per cent. However, these exports consist primarily of travel services linked to the country's large diaspora.
- Kosovo has seen less FDI than any other Western Balkans country. At around €2,800 at end 2020, its FDI per capita was more less than a fifth of the Western Balkans average. This may indicate issues in

[189] The analysis of the integrated quality for Kosovo is hindered by a lack of data, in particular, on the quality of physical infrastructure.
[190] Author's calculations based on national sources.
[191] See EBRD (2021).
[192] Author calculations based on UNCTAD and central bank data.
[193] Trade openness is measured as a sum of imports and exports of goods and services over GDP.
[194] See Shala, Gerbeshi and Hyseni-Pajaziti, 2018.

the business environment, as the OECD FDI Regulatory Restrictiveness Index listed Kosovo as the least restrictive country in 2019.[195] FDI is predominantly in non-tradable sectors, primarily real-estate. Enhancing the FDI going into tradable sectors could enhance the competitiveness of the economy.

- There have been no portfolio investment inflows into the country.
- Transport connectivity could be improved. The country's main modes of transport are roads and rail, but the road network is much more developed than the railways. Close to 40 per cent of firms in the BEEPS VI survey identified transportation as a major constraint on their business. This was particularly true for exporters (55 per cent).[196]
- Transport and other infrastructure require significant investment, particularly the maintenance of the existing network. The development of transport infrastructure is slowed by delays in project implementation, in particular, public procurement.
- Trading across the border could be improved to decrease the time needed and the cost of importing and exporting goods.
- According to Eurostat,[197] in 2020, Kosovo had the highest share (96 per cent) of households with home-based internet access in the region. This is also somewhat above the EU average (92 per cent).
- Firms in Kosovo still face major constraints when it comes to electricity. In the BEEPS VI survey, they cited losses of 4 per cent of annual sales due to electricity outages,[198] a significant burden. While the number of procedures and cost is higher than the regional average, the time required to get electricity (36 days) is significantly lower than in other Western Balkans countries and new EU member states.

[195] See OECD FDI Regulatory Restrictiveness Index.
[196] See EBRD, World Bank and EIB (2018).
[197] See Eurostat database.
[198] See EBRD, World Bank and EIB (2018).

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This document was approved in July 2022.

Photography: Getty Images.

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