UNMIK EU PILLAR

ECONOMIC STRATEGY AND PROJECT IDENTIFICATION GROUP
(ESPIG)

Towards a Kosovo Development Plan

The state of the Kosovo economy and possible ways forward

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Over the last two years the Government, UNMIK and the international community have developed an impressive number of economic policy and strategy documents. In many areas, this analytical work and its implementation are far advanced. One essential link is, however, still missing – a consolidated, comprehensive development strategy that would gather all economic policy actors around a common analysis of the economic challenges Kosovo is facing, a vision for its future development, as well as the necessary policy and spending priorities. Such a strategy is also needed to make efficient use of declining donor contributions and to enhance the prospect of gaining access to international loan finance.

In March 2003 UNMIK Pillar IV and the Government established the Economic Strategy and Project Identification Group (ESPIG) in order to facilitate the work on a development strategy. Co-chaired by Pillar IV and the Office of the Prime Minister, ESPIG includes representatives from the Ministry of Finance and Economy, the Ministry of Trade and Industry, the Ministry of Agriculture, Forestry and Rural Development, the World Bank, and the International Monetary Fund as permanent members. Since July 2004 ESPIG is supported through a project funded by the European Agency for Reconstruction. ESPIG does not have – and does not intend to have – policy competencies of its own; it rather understands its role as a mediator that gives impulses to the debate and the work of the competent PISG and UNMIK institutions.

ESPIG started its work by jointly drafting a Law on International Financial Agreements, which was submitted by the Government to the Assembly and promulgated by the SRSG on 9 August 2004. The Law regulates the procedure to be followed before an international financial agreement can be signed by the SRSG, involving both the Government and the Assembly. Moreover, the Law regulates issues of financial liability, duties established, arbitration and the choice of law, thus giving International Financial Institutions additional political securities necessary to become active in Kosovo.

In the first half of 2004 ESPIG organised a series of three day-seminars to promote further the debate on a development vision for Kosovo. The goal was to build consensus on the state of the Kosovo economy, to create transparency of the strategic work already undertaken by the various policy actors in Kosovo, to facilitate the debate on a comprehensive economic development strategy, and to discuss the way forward.

The concluding seminar on 15 July 2004 in Mitrovica brought together 120 high-ranking participants from the Government, UNMIK, the civil society and the international community. In its preparation, ESPIG commissioned the collection of over 400 economic policy documents, which have been compiled on a widely distributed

CD. This initiative has been made possible with the active engagement of the European Stability Initiative (ESI) and the generous support of the UK Department for International Development (DFID).

The seminar was opened by Prime Minister Bajram Rexhepi, followed by a presentation of the Minister of Finance and Economy Ali Sadriu on the Medium-Term Expenditure Framework. Amongst the discussants were the Minister for Culture, Youth and Sport, the Permanent Secretaries of the MFE and the Ministry of Transport and Communications, senior staff of most other Ministries and UNMIK Pillars, representatives from think tanks, civil society, DFID, EAR, USAID, and – last not least – the new consultant team contracted by the EAR to support ESPIG's further work.

Two outside experts focused their presentation on a proposal to agree a development strategy that contains 3 major elements:

(i) **A vision to integrate Kosovo into European structures**, based on a realistic assessment of the current state of Kosovo's economy and what it takes to move closer towards European integration.

(ii) **The goal to develop competitive industrial and agricultural enterprises**, to remove respective growth barriers, and to target scarce public funds into human resources and physical infrastructure that are key to reach this goal.

(iii) **The instrument of a Kosovo Development Plan**, which has been well established in the EU accession countries, for planning and prioritising public activities.

Participants agreed that ESPIG should advance the idea of a Kosovo Development Plan further. Therefore, ESPIG intends to hold a follow up seminar with the aim to identify the institutional requirements for a Kosovo Development Plan. For this purpose, experts who have already worked on National Development Plans themselves – for example from Bulgaria or Estonia – will be invited.

With the publication of the present paper, the ESPIG co-chairs want to prepare the further steps towards a Kosovo Development Plan. The paper has been drafted by John Bradley from the Economic and Social Research Institute (Dublin, Ireland) and Gerald Knaus from the European Stability Initiative (Berlin, Germany) on the basis of their presentation in the Mitrovica seminar. The contributions to the debate by the participants were duly taken into account. We hope that with this contribution we can set a milestone for Kosovo's future economic development strategy.

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Towards a Kosovo Development Plan

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This paper is based on input and research undertaken by ESI and LLA staff, especially *Marcus Cox, Rreze Duli, Eggert Hardten* and *Verena Knaus*.

EXECUTIVE SUMMARY

The key priority for this and future Kosovo governments is to identify ways in which Kosovo can catch up with the rest of Europe. The overriding goal of Kosovo's economic policy must be to bring about a substantial process of *convergence* towards European living standards within the next generation.

To achieve this objective all government ministries, public institutions and agencies involved in formulating and implementing economic development policy – both at the central and at the local level – need a common strategic focus. The role of UNMIK, the European Union and of international donors is to support this focus on economic and social convergence and to assist with advice and – as part of the process of European integration – economic resources.

Successful convergence involves no less than a silent structural revolution. It requires the systematic transformation of Kosovo's manufacturing and agricultural sectors and the shift from a society in which a large part of the population relies on remittances and subsistence agriculture towards one in which an educated work force produces competitive products and services that can be sold on European markets. This involves profound shifts in the ways Kosovo's citizens learn, work, produce and interact with the global economy. As a result, convergence requires any government of Kosovo to communicate effectively with all citizens, to involve entrepreneurs and to draw on the talents of all sectors of society.

The challenges Kosovo's institutions, entrepreneurs and citizens face today are huge. Every citizen of Kosovo is aware of the serious economic situation. Following the economic crisis in the 1980s and the disastrous decade of the 1990s, economic growth in the post-war period has also depended overwhelmingly on transfers, both diaspora remittances and international assistance. The domestic revenue base remains low and public services are underfunded. The continuing decline in international aid means that urgent public investment needs in human resources and physical infrastructure are under pressure.

We are conscious of the impact that the recent as well as future enlargement of the European Union is likely to have on the economic development of Kosovo. This year the Union has been enlarged by ten new states, many of which have made rapid and successful transitions to liberal policy regimes. EU development aid is being made available to these countries to help them "catch up" with the rest of the European Union. These countries are becoming remarkably attractive locations for inward investment. In this increasingly competitive environment, the quality of strategic thinking as much as the efficiency of Kosovo's entrepreneurs and businesses will be what determines future performance.

For this reason we believe it is vital not to wait any longer but to already now begin to initiate a process leading towards an EU inspired **Kosovo Development Strategy**. Such a strategy will also provide a basis for presenting a strong case for continued international financial support, particularly from the European Union, without which prospects for sustained improved economic performance in Kosovo are remote.

Kosovo's decision makers must not wait until the process of Europeanisation begins formally before drawing up such a development strategy. As a sign of commitment to the process of convergence and to structural reforms we propose to adapt the concepts and modalities of EU-type *National Development Planning* to the Kosovo policy process. This process was actually designed by the European Commission to accelerate growth and convergence in the poorer EU member states and applicant states. It is not the nature of Kosovo's development challenge that is unique. Rather it is its depth, in terms of a severely disadvantaged starting point. The strategy documents produced in recent years within the Kosovo government ministries, together with the analysis and investment aid of the international agencies, represent the first stage of this process.

National Development Planning involves the following stages:

(i) A full and realistic assessment of the strategic development requirements of an economy moving towards EU integration;

(ii) Design and costing of detailed and coherent ministerial strategies to remove barriers to faster growth, focused on investment needs in the key areas of human resources, physical infrastructure, and carefully targeted aid to stimulate the productive sectors of the economy;

(iii) Rigorous ex-ante assessments of the likely consequences of such a development programme in terms of generating sustainable accelerated growth and convergence towards EU standards of living.

Despite Kosovo's obvious resource constraints, an immediate start can be made to address the informational inputs necessary to support this process. One of the priorities of the post-election period must be to prepare a Kosovo-wide population census, followed by further work to establish a solid basis for all economic statistics and analyses. All institutions and government agencies in Kosovo must be able to do their planning from the same statistical starting point. Another priority of the post-election period must be to ensure that the Kosovo Trust Agency and the enterprises under its authority make more quality information on their activities and investment plans available to all other institutions involved in economic policy-making.

A third priority is to begin with the capacity building that will be required, drawing on the relevant experiences of other small, open economies who have already drawn up their National Development Plans and who are now involved in bringing about convergence with higher European living standards (e.g. Bulgaria, Estonia, Lithuania or Slovenia). For that purpose, it is essential to increase contacts with public institutions in these countries and ensure that all those involved in economic policy making in Kosovo are familiar with these experiences.

Since the implementation of any National Development Plan will take place at ministerial level, it will be vital to regard the drawing up of all the different ministerial strategy documents as a series of closely interconnected and interrelated processes. It is one of the most urgent tasks of any future government to establish a robust system of inter-ministerial co-ordination for the coming years if the ambitious goal of drawing up a National Development Plan is to be achieved.

The development of economic strategies for the key sectoral "engines of growth" will require close co-ordination between the Ministries of Agriculture, Forestry and Rural Development and the Ministry of Trade and Industry . The other ministerial strategies must be viewed as supporting the goal of industrial and rural development by providing inputs that are absolutely vital to success. Ensuring that Kosovo's future work force has the educational qualifications to be able to compete in the emerging European and global economy will be central and will almost certainly require significantly more resources to be allocated to this sector than is happening at present.

In most EU member states, responsibility for managing the National Development Planning process (NDP process) is given to a special economic strategy unit located within the Ministry of Finance. This unit is usually separated from the budgetary side of the Ministry, but its activities must be consistent with overall budgetary strategy. It controls the drafting of the National Development Plan, liases with the other economic and social ministries as they feed their sectoral strategies into the wider NDP, and is also responsible for reconciling conflicts that may arise between ministries.

Whether this is also an appropriate structure for Kosovo will have to be decided after the elections by the new government. Clearly an equivalent strategic unit is urgently needed in Kosovo. Without it, the different ministerial strategic plans cannot possibly be integrated into a coherent national strategic plan, broadly prepared according to the above EU principles. There can also be no doubt that there is a need to substantially reinforce inter-ministerial co-operation at all levels and that in this effort Kosovo can draw on substantial experience in all the EU new member states which have put in place such robust systems of policy co-ordination.

Even in advance of any formal relationship with the EU, development planning in Kosovo should not be pursued in a European vacuum. The reality is that the economy of Kosovo is firmly embedded inside the encompassing economy of the enlarging European Union. This type of strategy process is now used in *all* the new member states. National Development Planning provides the most robust and logical process through which the Kosovo economy, with the assistance of the international community, can eventually converge to the standard of living of its EU neighbours.

A. INTRODUCTION

Policy makers in Kosovo face a number of very serious challenges as they attempt to design a framework appropriate to their development goals. Unlike the economies of Western Europe, policy makers in Kosovo do not have the wealth of detailed statistical information about the present functioning of the economy. They cannot draw on the accumulated analysis and research that access to such data permits in the more developed Western economies.

The data situation in Kosovo is even more serious than in the new EU member states which were part of the former Communist bloc of Central and Eastern Europe. Prior to the liberalisation, these countries already had well established Statistical Offices, that produced detailed socio-economic data according to the standards and conventions prevailing in the then centrally planned economies. After liberalisation, the statistical offices were able quickly to make a switch to the reporting and accounting standards used in the West, and were in a position to produce reasonably accurate national accounts and other national statistics (e.g., updating of the census of population, a census of industrial production, input-output tables, etc.) by the mid-1990s. The availability of such data is an essential prerequisite for economic policy planning.

At this moment economic analysis based on reliable official statistics is not possible in Kosovo. As EUROSTAT noted in June 2002, "A statistical system in the sense that there is a limited number of authorised producers of official statistics bound together by a common legal framework and a common statistical programme does not exist so far in Kosovo."[1] As a result, documents by the Ministry of Trade and Industry assume a population of 2.4 million[2], while the Ministry of Environment and Spatial Planning is designing a new spatial plan on the basis of 2.2 million inhabitants[3] and the Macroeconomic Policy Department in the Ministry of Finance and Economy refer to a resident population of between 1.7 and 1.85 million.[4]

Access to detailed and reliable national statistics is as important to national policy making as is access to financial data for the running and future planning of a commercial business. In the absence of reliable and appropriate data, it is difficult to evaluate current performance. It is even more difficult to plan for the future in any coherent way. Where data are unreliable, policy may be misdirected. Where data are unavailable, policy planning risks being postponed simply because it is so difficult to design and implement.

A core aspect of the ESPIG project involved the systematic gathering together of the whole range of policy planning papers that have been prepared over recent years within the Kosovo government, and within international agencies.[5] In this paper we draw on

1 Eurostat, Short Assessment Kosovo, June 2002, p. 21.

2 *Strategies of Kosovo's Mid-Term Economic Development (2003-2008)*, Ministry of Trade and Industry, June 2003.

3 Prioritetet e Zhvillimit Hapesinore dhe Bashkepunimit Rajonal Sfidat E Integrimit Te Kosoves Ne Iniciativat Evropiane, Conference on 5 July 2004, Ministry of Environment and Spatial Planning.

4 *Medium Term Macroeconomic Background to the Budget for 2005*, Macroeconomic Policy Department, MFE: "A general caveat is that Kosovo as yet has no officially authorised system of national accounts. Information quoted for the budget can be accepted as being reliable. Close collaboration with the IMF during recent Missions to Kosovo has revealed the difficulties in producing reliable estimates for GDP growth and its major components" (p.1).

5 The whole range of planning and economic analysis documents is available on the ESPIG CD-ROM, classified by Kosovo government departments and international agencies. The collection contains over 400 documents, ranging from Ministerial strategy papers to background documents and key economic legislation.

these documents and their rich analyses. This is not an evaluation in any formal sense. Such a process belongs within the Kosovo government institutions and departments, and within the wider Kosovo society. Our objective is more limited. Based on policy-making experience in the smaller EU member states, we wish to position the already existing policy planning process being carried out in Kosovo within the wider European experience. We illustrate how Kosovo might draw on the accumulated policy-making experience of the smaller new EU member states, as well as those "older" EU member states who have experienced over 15 years of *National Development Planning*. Ultimately, the disparate departmental and sectoral policy plans will have to be drawn together into something resembling the EU conception of a *National Development Plan*, and our examination should be regarded as a step in that direction.

In the context of European enlargement, Kosovo policy makers have no choice other than to prepare for future *National Development Planning* modelled on the European format. This is a time when the EU has just been enlarged, and now includes one state of the Former Socialist Federal Republic of Yugoslavia, namely the Republic of Slovenia. Two other states of the former SFRY – Croatia and Macedonia – are starting out on a path that will ultimately lead to membership of the EU. So, it is fitting that the EU policy planning framework – used by applicant, candidate and member states – should also be considered as a guideline for use by policy makers in Kosovo, as they face the challenges of an increasingly competitive environment.

B. THE STATE OF THE ECONOMY

1. A deepening crisis

Ever since the first international donor conference for post-war Kosovo was held in 1999, one widely shared policy objective was "setting the stage for private sector-led recovery and long-term growth".[6] The evidence is mounting that this objective has not been achieved. A look at official macroeconomic data reveals the paradox of post-war developments.

Official statistics presented at various donors' conferences appeared to show impressive GDP growth performance:[7] 11 per cent in 2001, 7 per cent in 2002.[8] The 2003 Kosovo budget envisaged 18 to 19 per cent growth rates for the period 2003 to 2005, and based its revenue forecast on these growth projections.[9]

At the same time, however, official estimates of the level of Kosovo's GDP have continuously been revised downwards:

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6 World Bank, *Donors Pledge $ 1 Billion for Kosovo*, 1999.

7 Gross Domestic Product (GDP) is a measure of what is produced in the economy. Gross National Product (GNP) is a measure of income available to Kosovo citizens. Given the large financial transfers into Kosovo, its GNP is larger than GDP. However, only limited attempts have been made to quantify GNP, and future financial inflows are difficult to predict. For indications of the Kosovo current account of the balance of payments, see: Report No. 28023-KOS, *Kosovo Economic Memorandum*, World Bank, Poverty Reduction and Economic Management Unit, Europe and Central Asia Region, April 27, 2004 (Table 2.1, page 7).

8 Ministry of Finance and Economy, *Kosovo Donor Meeting, November 2002*.

9 *The Kosovo General Government 2003 Budget*, p. 16.

- In December 2001, the IMF estimated Kosovo's GDP at €1.85 billion.[10]

- In June 2003, the IMF estimated Kosovo's GDP at €1.57 billion.[11]

- In December 2003, the International Financial Institutions and UNMIK estimated Kosovo's GDP at € 1.34 billion.[12]

This shows a disturbing lack of any reliable statistical base for evaluating the level of activity in Kosovo upon which growth figures could be calculated. It also reveals a growing sense of unease among international officials about the nature of the post-war economy.

To go beyond the official figures, it is important to look at what has actually changed in the *structures* of the Kosovo economy in the post-war period. Most growth since 1999 took place in the trade and retail sector, in public administration and above all in the construction sector. It has been estimated that €444 million was spent in 1999/2000 on repair of housing, public buildings and infrastructure, with 21 per cent of materials purchased locally. Brick factories did a lively business, as did carpenters and importers of tiles or furniture. However, as in any post-conflict country, the reconstruction boom was short-lived. By 2001, spending on construction in Kosovo had dropped to only 40 per cent of its 2000 high, and in 2002 it was expected to reach only 13 per cent.[13] In the rural municipality of Viti in South East Kosovo, ESI visited 69 of the 81 construction companies listed in the business register in 2003, and found that only 39 were still operating.[14]

The private sector that has emerged since 1999 is predominantly small-scale, low-capital-intensive ventures in trade and construction. Some local entrepreneurs were able to generate quick wealth as importers. However, apart from building materials, some furniture production and a small food-processing sector, there is hardly any local manufacturing. In Pristina's "industrial zone", the largest in Kosovo, 66 plots were rented out in 2002: only 16 were used for production, all with three employees or less, and most were producing doors and window frames.

The post-war boom was also transfer-financed, and therefore unsustainable. The estimated total public expenditure in 2000 in Kosovo was €6.3 billion. In 2003, this had gone down to €3.1 billion (see table). These are *very* rough estimates, undertaken by the Macroeconomic Policy Unit of the Ministry of Finance and Economy. But the overall implications are clear: GDP growth in Kosovo's economy was driven by external transfers, rather than from any lasting increase in the productivity of Kosovo's enterprises. As a result, as budgetary support and reconstruction aid are withdrawn, Kosovo's economy is almost certain to contract.

Kosovo's post-war economic development depended not just on donor-financed external aid, but also on transfers from the Kosovo diaspora, which made up a significant

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10 IMF, *Progress and Institution-building and the Economic Policy Challenges Ahead*, December 2001.

11 IMF, *Kosovo Main Indicators 2000-2004*, 16 June 2003.

12 UNMIK EU Pillar, *Kosovo Outlook 2004, Paper to the Working Level Steering Group*, 25 April 2004, p. 8.

13 CHF, *Kosovo Construction Sector Assessment Report*, January 2002.

14 ESI through the Lessons Learned and Analysis Unit of the EU Pillar of UNMIK undertook extensive research in Viti municipality throughout 2003.

component of household income. In 2002, the Ministry of Finance and Economy estimated that, of Kosovo's total income of €1,570 million, €720 million came from cash remittances.[15] According to these figures, Kosovo households received more cash income from relatives abroad than they did from working in Kosovo. However, with the route to new emigration to the EU now blocked, there is a substantial risk that remittance income will decline in the coming years.

These factors explain why, given the dependence on international transfers and consumption by international organisations and remittances, Kosovo's economic growth in the post-war period cannot be taken as representative of the future pattern of growth. It also shows why the depth of the structural economic problems did not become apparent during the construction boom. Massive international support to Kosovo has had an effect similar to what the discovery of oil might have had. Without raising the productivity of the work force, producing goods competitive at home or abroad or changing the nature of a backward rural economy, Kosovo could afford massive imports. In 2003, Kosovo imports totalled €968.5 million, while exports (mostly mushrooms, timber and scrap metal) amounted to only €36.3 million.[16] This in turn allowed the government to collect easy revenues by taxing imports at the border, enabling rapid expansion in public-sector employment. Five years after the war, Kosovo's budget remains highly dependent on taxing imports at the border.

Table 1: Evolution of Public Expenditure (million €)[17]
Ministry of Finance and Economy

	2000	**2001**	**2002**	**2003**
Kosovo General Budget – domestic revenues	43	167	337	413
Kosovo General Budget – donor grants	161	84	39	25
UNMIK budget	413	449	388	368
Reconstruction assistance by international NGOs	635	541	292	270
KFOR	*5,000*	*4,000*	*3,000*	*2,000*
Public enterprises (fixed capital formation)	*10*	*10*	*10*	*10*
TOTAL	**6,262**	**5,251**	**4,066**	**3,086**

Italics indicate rough estimates

This situation could not last. As donations declined – in the case of the largest donor, the EU, from a peak of over €300 million a year to €50 million – and the international military and civilian presence was reduced, the post-war boom turned into a post-war crisis. By 2003, the IMF noted that "activity in most sectors is stagnating."[18] In March 2004, the IMF was even less optimistic:

15 *The Kosovo General Government Budget*, 2003, p. 8.
16 Monthly Macroeconomic Monitor, April 2004, p.127.
17 Table included in the *Kosovo General Government Budget*, 2003. The 2004 budget gives different figures relating to the General Budget domestic revenues, but the overall structure of public expenditure does not change much as a result.
18 IMF, *Staff Visit Kosovo: Concluding Statement, November 2003*.

"Activity in most sectors has stagnated, given flat or even declining incomes and the lack of progress in addressing impediments to export competitiveness and access to neighbouring markets… Apart from some employment growth in the civil service, overall employment is likely to have stagnated, if not contracted."[19]

The prospects are for further hardship. As the IMF put it, sooner or later there would have to be "a painful retrenchment as growth falters and government revenues decline."[20] There is also little prospect of private investment picking up in the near future. Given the uncertainties over Kosovo's future political settlement and legal conundrums concerning privatisation, foreign direct investments is likely to remain marginal.[21] Present public expenditure is unsustainable: taxing the economy at 37 percent of GDP to finance spending that does not even maintain the existing capital stock "will not support self-sustained growth" (IMF).[22]

In sum, the post-war private sector that seemed to many foreign observers to be emerging with impressive speed in the first years after the war has proved to be shallow and short-lived. In many respects, it was a return to a private sector of the past, with roots in the pre-socialist times, which persisted to some extent throughout the Yugoslav era as 'small business', and expanded in Kosovo during the 1990s. In the post-war period, few Kosovo businesses were doing anything different to what they had done in the past. There were now simply more importers, corner-shops, cafes, hairdressers, carpenters and taxi-drivers. If Kosovo is to lift itself out of its present crisis, it will need a very different kind of growth.

2. Underemployment

The sudden end of the post-war boom has brought into sharp focus Kosovo's most important social problem: underemployment of a young and rapidly growing population. As transfers decline, Kosovo's main business sectors are forced to shed labour. As import-fuelled public revenues taper off, no further expansion of public administration or public investments will be possible.

Discussions of Kosovo's 'real unemployment rate' are often misleading. "Unemployment" is an administrative category that measures the number of those who are actively looking for work but fail to find it. In societies where unemployment status confers benefits, there are clear incentives for people to register. In Kosovo, there are no such benefits. Furthermore, in much of rural Kosovo, the notion of actively looking for work outside the household makes little sense. Almost all the businesses are run by families.

In Kosovo, most people work outside the formal economy, in casual or unregistered labour. This includes large numbers of subsistence farmers, who live almost entirely outside the cash economy. This informal economy is probably larger than the formal

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19 IMF, *Staff Visit to Kosovo Aide-Memoir*, March 10-19, 2004, p. 1.
20 IMF, *Staff Visit to Kosovo Aide-Memoir*, March 10-19, 2004, p. 1.
21 *Draft Strategy of the Privatisation Department of the Kosovo Trust Agency*, April 24, 2004.
22 IMF, *Staff Visit to Kosovo Aide-Memoir*, March 10-19, 2004, p. 4.

economy. However, the existence of a large grey economy does not make the problem of underemployment any less serious.[23]

In 2002, registered employment in Kosovo provided a total of 147,000 jobs.[24] The largest share – almost three quarters of all official employment – was in the public sector. These are the coveted jobs as teachers, police officers, judges and ministerial or municipal officials. When the Kosovo authorities include the grey economy in their employment estimates, they count 141,000 agricultural workers. As hardly any of these are registered with the tax authorities, they calculate this by counting every rural household as a farm and assuming that each has one member of the household employed in agriculture. In this instance, 'employment' is pure subsistence, with little produce ever reaching the market.

Even when the figures include the world of subsistence agriculture, together with large grey sectors in construction, trade and services, the total employment figure for Kosovo is only 325,000, where the working age population is around one million. This means that the employment rate (i.e. the numbers employed expressed as a percentage of the working age population) is less than a third. Even taking into account the youthful age distribution of the population, this is a very bleak picture. Every person employed is obliged to support five or six household members. In this environment, making household savings to finance business investments becomes extremely difficult.

Table 2: Employment in 2002
Ministry of Finance and Economy [25]

	Official employment (Wage tax data)	Official and unofficial employment (Estimates)
Agriculture	2,000	141,800
Trade, hotels, restaurants	21,400	39,500
Manufacturing	27,600	30,000
Education	28,900	28,900
Public administration	*23,500*	23,500
Construction	5,000	16,000
Donors / NGOs	*13,200*	13,200
Health	13,000	13,000
Transport/Communication	4,700	9,400
Personal services	4,700	6,600
Finance	3,200	3,500
Total	**147,200**	**325,400**

At the same time, Kosovo has the youngest population in Europe, with 36,000 young people pressing onto the labour market every year.[26] There is simply no possibility that domestic employment creation will absorb this increase in the labour supply in the near future. Furthermore, given the already extremely low productivity of agriculture, there is no way that the next generation can be supported from land-based production activities. To make farm-based production competitive will require productivity to be greatly increased, and agricultural employment to decline as a share of total employment.

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23 *Kosovo Labor Market Study: Policy Challenges of Formal and Informal Employment*, World Bank, Human Development Unit, Europe and Central Asia Region, June 26, 2003 (Informal Labor Market Analysis, pp. 39-43).

24 The 2004 Budget gives a figure of 139,000 (p. 11).

25 *The Kosovo General Government 2003 Budget*, p. 6.

26 *Kosovo Outlook 2004*, UNMIK European Union Pillar, 2004.

In the past, the problem of rapid population growth and chronic underemployment has been met by substantial emigration, mainly to Germany and Switzerland. The route to further emigration to these destinations is now largely closed. This will have two effects on Kosovo society. In the short term, it means that Kosovo's young people have no way of escaping from the poverty of the rural areas. In the longer term, it is likely to mean a tapering off of remittance income and a substantial increase in poverty, as the diaspora is no longer replenished with fresh emigration.

This is Kosovo's development trap. There is a desperate shortage of employment. Families with increasing numbers of dependents have very few opportunities to increase their cash income. They cannot save for the future or invest in new businesses. The old escape route of emigration is closed. The cash remittances sent back by family members abroad are likely to decline, leaving rural families without an important source of household income and the most important source of investment income. In the absence of a radical shift in policy, the next generation of young Kosovars has very little to look forward to except declining standards of living.

C. ANALYTICAL FRAMEWORKS

To our knowledge, there do not appear to be any attempts made to forecast the future of the economy of Kosovo, even for the short term. Budgetary forecasts are contained in the last two Kosovo budget publications, but these are more in the nature of extrapolations of policy intentions than judgements about the future performance of the private (or non-budget) sector of the economy.[27]

Short-term forecasts, with a 12-month time horizon, can be produced with simple judgemental-based methods. Most of the economic forecasting reported regularly in the media in the developed world is of this variety. Attention is usually focused on the demand-side of the economy, and on the incomes generated by expenditures on consumption, investment, and trade. Production capacity is regarded as fixed, the short-term issue being the rate of capacity utilization. Attention to public policy tends to focus on the immediately preceding and/or anticipated budget.

When one wishes to move into the future, the situation becomes more complicated. Investment activities can change the productive capacity of the economy; some sectors may decline, while others may grow; policy changes which have only minor short-term implications can have major long-term consequences. The ultimate consequences of policy or other shocks becomes difficult to disentangle using simple judgemental or *ad-hoc* methods.

As policy concerns shift to the medium term, a more formal framework is needed. In more developed economies, the medium-term macroeconomic planning framework is constructed as a formal economic "model", a computerised system built using data, and capable of being used to provide forecasts and policy impact analysis. In any such framework, GDP growth is determined over the planning horizon (say 1 to 5 years) in terms of likely sectoral growth (e.g., manufacturing, market services, agriculture and public services), the growth of the main expenditure items (consumption, investment, imports, exports, stock changes) and growth in incomes (wages, profits).

[27] *Medium-Term Macroeconomic Background to the Budget for 2005*, MFE, undated.

In the absence of formal macromodels for Kosovo, this chapter suggests alternative frameworks for looking at the economy. One option is to focus on core mechanisms in the macroeconomy (section 1); the other is to look at industrial policy using a micro-perspective; and the third is to list and explore the trade-offs that (inevitably) face public policy makers with limited resources. Finally, any conceptual framework should include an analysis of Kosovo's place in a changing Europe.

1. Core mechanisms in the Kosovo macroeconomy

In any economy an initial distinction should be made between those sectors that are exposed to the competitive world trading environment (the internationally *traded* sector) and those sectors that are sheltered from direct exposure to international competitive trade (referred to more simply as the *non-traded* sector). Broadly speaking, the traded sectors of most economies consist of manufacturing, commercial agriculture, and an element of market services directed at international markets (e.g., financial services, software, tourism, etc). The non-traded sectors comprise the rest (i.e., utilities, building services, subsistence agriculture, most of market services and all public or non-market services).

From an economic performance and competitiveness viewpoint the crucial sector in an economy like Kosovo is likely to be the manufacturing sector. The European development experience has been that manufacturing is the main "engine" of national growth. For small economies like Kosovo, manufacturing will eventually be almost fully exposed to international competition. Demand for manufacturing output is driven by external (or world) demand, by local or domestic demand, and by the competitiveness of the manufacturing sector. Competitiveness is determined by relative unit labour costs in a common currency, as well as by relative prices.

While the manufacturing sector usually has a certain primacy within the economy, the other sectors also have a role to play in national competitiveness. Manufacturing activities require many inputs from the service sector. The agricultural sector provides inputs to the food and drink sub-sectors of manufacturing. The public sector is responsible for the provision of health, education, and infrastructure, and fiscal policy has an impact on domestic demand through tax gathering and through expenditure programmes.

In Kosovo at present, the weakness of the exposed tradable sector is a serious barrier to growth and development. The market services sector – by itself – is unlikely to become an "engine" of growth. The public sector is too constrained fiscally to drive the economy forward, even if that were considered desirable.

A strategic aim of industrial policy in Kosovo will require the encouragement of businesses which are more technologically advanced than the present more traditional firms. Some of these activities will need to come from the inflows of foreign direct investment (FDI). For sophisticated plants, competitiveness is important for the long-run decision of where a production plant will be located. The level of output produced by such firms in Kosovo will be a function of their long-run international competitiveness, productive capacity and world demand levels. In addition to cost issues, there are many other non-cost factors that will influence the plant location decision, including the quality of infrastructure and the skill level of the labour force, the quality of public administrations and the security of property rights.

The traditional manufacturing sector (such as the production of construction material), is not particularly mobile and so has much stronger ties to the domestic economy. In a small domestic economy like Kosovo, this sector is likely to be a price taker and so the world price is the price set for traditional industry output. If this is the case, then the issue for this sub-sector is to ensure that costs (wages, energy, other materials, tax levels) are low enough to price at the world level and still make a profit.

For the food and drink sector, output tends to be driven by domestic as well as European demand as well as by the unit cost of production relative to European competitors. Competitiveness in this sector is particularly sensitive to the cost of inputs, while labour costs will have an impact on the amount of value-added that occurs in Kosovo. For Kosovo's agribusiness sector to be competitive, it needs to be prepared for competition with European products, meet basic food safety and quality standards and compete on costs of inputs.

At present, the manufacturing sector of Kosovo is both understudied and extremely underdeveloped. All of Kosovo's larger companies which developed under socialism are under the management of the Kosovo Trust Agency (KTA), which has very limited information on what is happening in the enterprises under its supervision. In the absence of any census of manufacturing production, we cannot evaluate either the size or structure of this vital sector. However, various informal studies suggest that those production activities making building components (bricks, timber, etc.) that boomed in the immediate post-war period, are now in serious decline. Activities in the area of food and drink are small in scale, suffer from erratic supply of basic utilities like electricity, and suffer from uncertain growth in their domestic market. The presumptive tax system (soon to shift to a profits tax) further discourages growth. The dominance of imports tax distorts cost structures. The tiny export volumes suggest that few of these activities are internationally competitive.

Kosovo's largest enterprises (both in terms of employment and in terms of their capital) are public companies, such as KEK (the Kosovo Electricity Company), PTK (Post and Telecommunications), water, waste and heating companies, and the Pristina airport. All of these companies are also under the authority of the KTA. For most of the post-war period their corporate governance structures were in continual flux, management was changing constantly, donor driven investment decisions and problems with governance meant that there were no multi-annual investment strategies or even basic annual reports or public audits. Given the crucial importance of these companies (and the cost and quality of their inputs) for the rest of the manufacturing sector it is essential to address the shortcomings of their corporate governance.

We summarise the above analysis by identifying five core mechanisms in the economy of Kosovo, as it is likely to evolve in the future. These are illustrated in the box below.

Core Mechanisms in the Kosovo Macroeconomy

(1) The exposed (mainly manufacturing) sector will be driven by world demand, elements of domestic demand, and international cost competitiveness. The existing manufacturing base is small and fundamentally uncompetitive. Upgrading of technology will require foreign direct investment. Only this sector can provide an "engine" of wider-based growth and development in Kosovo.

(2) The more sheltered market sector (mainly services and construction) will be driven by domestic demand (which is influenced by the volume of remittances in a post-reconstruction period) and cost competitiveness (which influences potential import substitutes). This sector will only flourish if the wider Kosovo economy is flourishing. It cannot function as an "engine" of growth.

(3) The public sector is policy-driven, but with a need to balance current budgets in a context where there is diminishing access to international donor finance for capital purposes. Relative to the present size of the Kosovo economy, the public sector is unsustainably large.

(4) Wages paid in the formal productive sectors of Kosovo are probably determined in a simple type of bargaining model, and are influenced by the factors that affect the supply and demand for labour – e.g. prices, taxes, and unemployment. The post-war construction boom may have distorted wage costs and created competitiveness problems for the embryonic manufacturing and service sectors. Wages in international organisations have created the biggest distortions.

(5) The labour market in Kosovo is highly dependent on demographic factors, such as the high natural growth of the labour supply, relative conditions in EU labour markets and possibilities for (legal or illegal) labour migration. Present rates of unemployment and underemployment are at crisis levels.

2. Industrial strategies

Industrial strategy is at the heart of modernisation and development. When a relatively less developed and mainly agricultural economy like Kosovo attempts to modernise, the primary requirement is for the farming sector to shrink as a proportion of the overall economy, and for the manufacturing sector (and elements of services) to expand and develop in a way that drives export growth through improvement in cost competitiveness. The particular features of the post-war reconstruction boom (resembling a resource shock like an oil find) has caused a serious erosion of cost competitiveness. The trend of structural change in the past decade, however, suggests that the absolute number of people engaged in subsistence agriculture as compared to the 1980s has actually increased, while a number of former industrial centres are contracting.[28]

For Kosovo agriculture is very important, and its development is tied up with the need to privatise a range of agri-based SOEs.[29] But a comprehensive development strategy needs wider sectoral goals. Pragmatic policy making also needs to be in tune with the best current thinking on international industrial policy frameworks.

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28 *Draft Strategy of the Privatisation Department of the Kosovo Trust Agency*, April 24, 2004; *Agricultural and Forestry SOEs in Kosovo: Assessment and Proposed Reform Initiatives*, KTA, August 2003.

29 *Agricultural and Forestry SOEs in Kosovo: Assessment and Proposed Reform Initiatives*, KTA, August 2003. (SOEs are Socially-Owned Enterprises)

The first such framework explained the rise of inward investment into smaller, less developed economies in Europe.[30] The product life cycle (PLC) can be defined as a process where "products come into existence, change in character, and eventually disappear or become altered out of all recognition". The Product Life Cycle framework stresses the primacy of the country that provides the source of inward investment, and the dependency of countries that "host" this investment. The product life cycle has a close link with international trade and foreign direct investment.

For technologically innovative products, at the early stage of their product life cycle, producers need great freedom and flexibility to modify, improve and test new processes at a time when the technology has not yet stabilized. Also, demand for innovative products tends to be relatively insensitive to price, so there is less pressure to seek lowest cost production locations. All of this argues for a home location in a large modern economy like the USA, Japan or Germany.

But as products mature, a certain degree of standardization takes place. The need for production flexibility declines, and there is now a greater need for lower production costs. Eventually some production moves abroad, initially into other more developed economies, but soon even to smaller and less developed economies (e.g., Slovakia, Estonia, Bulgaria, Kosovo). As a product fully matures, low cost considerations become paramount. Production declines in developed economies, and concentrates in very low cost, under-developed economies (China, India, etc.).

The product life cycle provides important insights into the reasons why certain types of foreign direct investment locates in small developing countries, as well as why they eventually depart. The bulk of FDI that has located in small EU countries (Ireland, Estonia, the Czech Republic, etc.) appears to consist of "global standardizers", i.e. firms that develop and produce a line of relatively standardized products which respond to a *homogeneous* world demand rather than to the *distinctive* needs of individual markets. This obviously includes such commodities as oil, chemicals and crude metals, but also transport equipment, computers and pharmaceuticals.

The implications of the PLC framework for Kosovo are clear. Given its underdeveloped state of human resources and infrastructure, and the very weak traditional manufacturing base, industrial strategy needs to target carefully a range of mobile investment in the mature or maturing end of the product cycle, e.g., food processing, clothing, furniture, basic engineering assembly. Only at a later stage in its economic development will it be feasible to target mobile investment in more technologically sophisticated areas like electronics, electromechanical devices, textiles, high value-added food products, etc.

The industrial strategy framework that dominates current international thinking was developed by Michael Porter (of the Harvard Business School).[31] Porter insists that sustained development is crucially dependent on development within the domestic market. Asking why some nations' firms are able "to sustain advantage in an industry and others are not" he identifies four broad attributes that shape the environment in which firms compete: *factor conditions* refer to the availability and quality of the factors of production such as skilled labour, infrastructure, etc; *demand conditions* refer to the

[30] The product life cycle (PLC) policy framework was developed by the late Raymond Vernon.

[31] Porter's seminal 1990 book, *The Competitive Advantage of Nations*, is required reading for policy makers. A recent reformulation of Porter's work is Michael Best's *The New Competitive Advantage* (2001).

nature of local and external demand for the industry's product or service; *related and supporting industries* refer to the presence or absence of supplier industries and related industries that are also internationally competitive; and *firm strategy, structure and rivalry* refer to the national conditions governing how companies are created, organized, and managed.

Porter suggests that there are different stages of competitive development. At the early stages, competitive development is driven by factor conditions, and draws on low cost labour and/or abundant natural resources. The next stage is investment driven. In the third stage, competitiveness is innovation driven.

Table 3: Porter's stages of national competitive development

Key driver of growth	Source of competitive advantage	Country examples
Factor conditions	Basic factors of production (e.g., natural resources, lower skilled labour)	South Korea, Singapore and Ireland (before 1980s) **Kosovo today**?
Investment	Capital equipment, transfer of technology	Japan (during 1960s) South Korea (during 1980s) Ireland (after 1980s) **Kosovo within the next decade?**
Innovation	All four elements of Porter's framework	Germany, Sweden (post-war) Japan (since 1970s) Italy (since early 1970s) Ireland (post 2000)? **Kosovo post-EU membership**?

This approach has strong implications for the design and execution of industrial policy in an economy like Kosovo, and provides a useful checklist of what types of policy intervention are likely to be effective. Porter's competitive framework – the current business strategy orthodoxy throughout most of the developed and developing world – suggests that a small open economy can implement a strategy in a sequence of separate stages: factor driven; investment driven; and innovation driven. For example, in the case of Ireland, the first stage lasted almost 25 years, from the late 1950s to the mid 1980s. It was "factor" driven, based on policies of low rates of corporation tax, low wages, and subsidized capital formation. The second stage lasted from the late 1970s to the late 1990s, during which there has been massive public and private investment in plant, infrastructure and human capital, co-funded generously through EU regional aid from 1989 onwards. Irish policy-makers are now seeking to shift to Porter's third (innovation driven) stage.[32]

Porter's contribution also lies in the detailed study of individual successful nations, regions and industries that illustrate these interactions at work. There is an urgent need for more such micro-studies of sectors and enterprises in the Kosovo context. Some of this work is already under way, but the lack of firm data makes it impossible to identify

[32] A report was published in Ireland on July 8th, entitled *Ahead of the Curve: Ireland's Place in the Global Economy* which tackles the challenge of moving from Porter's second (investment driven) stage of growth to the third (innovation driven) stage. A previous report, entitled *A Time for Change: Industrial Policy for the 1990s*, published in 1992, laid out the strategy for transition from the first to the second stage of growth.

the preconditions for industrial renewal in the manner required in Porter's "diamond" of competitive advantage.[33]

3. Trade-offs for policy makers

Any government that is trying to come up with a development strategy needs to find a way to deal with competition for scarce resources. The dilemmas to be faced involve issues such as efficiency (or growth) versus equity (or redistribution); sectoral diversification versus sectoral concentration; the optimal pace of change and renewal (shock versus gradualism).

The constraints on public financial resources in Kosovo today are very apparent, illustrated most recently by the 2004 budget. Within the structure of this budget, one can usefully classify expenditure policies under three headings:

a) Current social expenditure, in the areas of income support, health, basic education, public administration, social infrastructure, etc. This presently absorbs most of the available finance.[34] This type of expenditure is central to implementing the government's role in directly supporting and improving the living standards of the citizens of Kosovo. Given the limited financial resources available through tax-raising sources, and the low level of income per head in Kosovo, this is a daunting task.

b) Investment expenditure funded out of the Kosovo budget. This is usually aimed at repair and maintenance of the fabric of physical and economic infrastructure rather than at its renewal and development. Also included would be aspects of human resources, such as vocational training and higher education.

c) Investment expenditure funded through international donors.

Within any government there is tension between the aims of promoting economic growth and development, on the one hand, and the desire to ensure that resources are distributed in a fair way on the other. When resources are tightly constrained in the short term, this tension can only be relaxed when successful policies to promote growth generate increased domestic and international financial resources that permit social objectives to be tackled with greater vigour.

In the case of the poorer EU member states, the task of dealing with the tension between policy objectives was made easier because the distinction between efficiency and equity objectives was "institutionalised" through the process of *National Development Plans.* Access to EU structural assistance increased greatly the financial resources for economic development, while leaving the government with more scope to devote resources to equity goals. In other words, it reduced the trade-off between efficiency and equity, and permitted both to be tackled at the same time. EU structural assistance had ambitious

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[33] *Sectoral Analysis*, KTA, March 20, 2003; Report No. 28023-KOS, *Kosovo Economic Memorandum*, World Bank, Poverty Reduction and Economic Management Unit, Europe and Central Asia Region, April 27, 2004 (Potential and Constraints to Growth at the Sectoral Level, pp. 42-61).

[34] For details of social spending, see the individual departmental allocations in Government of Kosovo – Budget 2004. Social expenditure probably accounts for over 70 per cent of total budget expenditure.

goals, i.e., the provision of financial aid (in the context of a domestic co-finance requirement) to implement policies whose *explicit* aim is to transform the underlying structure of the beneficiary economies. Such policies move far beyond a conventional demand-side, cyclical stabilisation role of public expenditure. They are directed at the promotion of structural change, the acceleration of medium-term growth, and the eventual achievement of real convergence through efficiency improvements in supply-side processes.

For instance, one striking feature of Kosovo's present government expenditure is the low (in absolute terms as well as relative to GDP) public expenditure on education. This is all the more remarkable given the youth of the general population and the disastrous legacy of education during the 1990s, under the Milosevic regime. The longer-term consequences of this for growth would become immediately apparent once one looks at education spending needs from the perspective of industrial strategy and the promotion of convergence and structural change.

In a longer term perspective, growth, development and renewal strategies need to be placed at the centre of government activity. They need to be distinguished from the day-to-day activities of social ministries.

4. A changing regional context

Policy makers in Kosovo need to be conscious of the impact that the recent enlargement of the European Union (and future enlargements including Bulgaria and Romania, as well as possibly Croatia, Macedonia and Turkey) is likely to have on their own economic development. The Union has been enlarged by ten new states, many of which have made rapid and successful transitions to liberal policy regimes. At an economic level, the nature of the restructuring has left no corner of their economies untouched. At a business level, whole sectors of industry had shrunk or vanished, while new sectors were rising from the ashes.

EU development aid was made available to these countries during the pre-accession period. Recently – as these countries moved towards EU membership in June 2004 – the pace quickened. *National Development Plans* covering the period 2004-2006 represented a step change. These new members are becoming remarkably attractive locations for inward investment. In this increasingly competitive environment, the quality of Kosovar strategic thinking as much as the efficiency of its businesses will be what determines future performance.

The process of global competition is organised today mainly by multinational firms. Production tends to be modularised, with individual modules spread across the globe so as to exploit the comparative advantages of different regions. Hence, individual small economies like Kosovo have less power to influence their destinies than in previous periods of industrialization. They need to refocus policies on location factors, especially those which are relatively immobile between regions: the quality of labour, infrastructure and economic governance, and the efficient functioning of labour markets.

The national wealth creation strategy in Kosovo will need to adapt to the requirements of firms in the global corporate environment, and not the other way around. Compared to some of the more dynamic new EU member states, Kosovo is a fundamentally unattractive place in which to invest. It is essential for Kosovo to convince foreign investment that it should locate here, in a situation where uncertainty and delays in reforms are working in the opposite direction.[35]

The resources available to public policy in the field of agriculture are clearly inadequate to address the major structural challenge (to raise productivity, support the commercialisation of agriculture and promote non-agricultural employment in rural areas). Realistically, it is unlikely that any fundamental restructuring of agriculture would be successful unless and until Kosovo receives substantial support in this area from the European Union.

Attracting foreign investment in the field of mining and electricity (energy production based on domestic lignite reserves), is identified as essential by the World Bank. But the obstacles to this remain enormous, starting from the legal confusion over the utility companies and concessions to the overall insecurity linked to Kosovo's uncertain status. Even if these obstacles were overcome, and electricity could be produced cheaply in Kosovo, this would be only of benefit to the rest of the economy to the extent that any cost advantage was exploited by other sectors, mainly manufacturing. If the level of human resources were low – due to constrained education and training budgets – it is doubtful if an energy or mining cost advantage could be fully exploited in terms of wider industrial renewal.

While some of these challenges are unique to Kosovo, in most other areas policy-makers are in a position to benefit from the experiences of the new EU member states, just as the new member states were in a position to learn from the previous experience and outcome of the older lagging EU member stages like Greece, Ireland, Portugal and Spain. Policy makers here need to break free from narrow and reactive policy mind-sets.

Conceptual frameworks and policy design and implementation must evolve in parallel. Frameworks are like maps that tell you where you are, where you need to go, and the direction that you must take in order to get there. Policy design and implementation deal with the messy business of gathering resources, making pragmatic choices, overcoming obstacles, and bringing the team along with you to your ultimate goal. Having a wonderful map, but an impossible route is useless. Wandering aimlessly in the wilderness without any maps is equally futile.

Getting the medium-term strategy right is vital mainly because change is very difficult and errors are very costly. The complexity of Kosovo's development challenge demands a concerted focus to break out of a previous era characterised by a lack of a strategic perspective that led to of erratic growth and stagnation. This will require also a culture of excellence in economic and business analysis. Realistic policies must be identified that can command broad agreement.

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35 *Draft Strategy of the Privatisation Department of the Kosovo Trust Agency*, April 24, 2004.

D. POLICY PLANNING

Domestic budgetary resources in Kosovo are so limited that, in the absence of large-scale external investment aid, no significant progress is likely to be made towards raising living standards even to the low levels of the poorer new EU member states such as Estonia, Latvia and Lithuania.[36]

The only realistic path towards realizing a better economic "vision" for Kosovo must involve systematic planned restructuring and sustained external investment. Within the next ten years, Kosovo is likely to be surrounded by neighbouring states that are either members of the EU, or are in the final stages of achieving membership. Consequently, any "vision" of economic development will be dominated by two factors:

(i) The ability of the Kosovo government to put in place a domestic policy framework that will accelerate the process of transition to a functioning market economy. Initially, at least, all available domestic sources of finance – however limited - will need to be focused on that goal;

(ii) The ability of Kosovo to make a gradual switch from the (declining) multi-donor external funding of recent years to a more stable system of development support similar to that currently available to the new EU member states.

The analysis and planning phase needs to start now. Progress in this phase – involving both a learning process by policy makers in Kosovo as well as a communication process addressed at the EU – will need to precede any realistic possibility of securing significant outside structural assistance.

1. Monitoring economic performance

As the Statistical Office of Kosovo is so far not producing macroeconomic accounts, the role of monitoring the evolution of the Kosovo economy is presently played by the Ministry of Economy and Finance preparing the *Monthly Macroeconomic Monitor Kosovo* (*MMMK).* The most recent issue was published in April 2004. This is a "monitoring" document, reviewing past performance. It does not publish any forecasts of the future.[37]

The *MMMK* is a useful document for understanding the Kosovo economy, but it suffers from inadequate and incomplete data. Its analysis starts with population data which, in the absence of an up-to-date census, remain a major source of difficulty. It proceeds to analyse developments in the labour market, the inflation environment, money and banking, fiscal issues, the enterprise sector, and concludes with foreign trade.

However, the *MMMK* contains no independent measures of demand-side activity in the economy, other than budget expenditure and some financial indicators. This implies that

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36 GDP per head in the three Baltic states is about 40 per cent of the EU average. This is over twice the level of GDP per head in Kosovo.

37 Although the *Monthly Macroeconomic Monitor* does not publish forecasts, it would be surprising if forecasts of aspects of the economy were not routinely prepared as part of the monitoring process. As data sources improve, and trends can be detected and analysed, the publication of even rudimentary short-term forecasts is likely to play a beneficial communication function to both the private and public sectors.

it is almost impossible to forecast tax revenue, since the tax base (mainly consumption and imports) cannot itself be predicted with any confidence. Nor is it possible to forecast, or even monitor, investment performance, other than that element directly financed through the Kosovo budget.

Monitoring of the supply (or output) side of the economy is also missing from the *MMMK*, other than the extent to which business registrations are monitored. The very small size of most new and existing enterprises makes it very difficult to monitor performance. Related to this is the absence of data on the income side of the economy (e.g., distribution between wages and profits).

2. The annual budget

Even in economies that enjoy comprehensive, timely and reliable economic statistics, budgetary planning is an inexact science, and the outcome can sometimes be very different from the initial projections made when the budget is launched. It is useful to examine possible sources of error.

Forecasting errors on the revenue side of the budget can arise for many different reasons. The most obvious cause is that the underlying tax base does not evolve as expected. There may be changes in the path of the tax base due to external "world" effects or due to internal "domestic" issues. Even if the tax base performs as expected, there may be problems with compliance and tax collection.

Forecasting errors on the public expenditure side can also arise for many different reasons. Moneys allocated may simply not be spent. Expenditures associated with "automatic" payments (income support, health, education) may have been incorrectly predicted. Unexpected costs may arise, that were not correctly budgeted.

All these problems arise in economies that are considerably more advanced than Kosovo. But there is an important difference between budgetary planning in Kosovo and elsewhere:

a) In Kosovo, much economic analysis starts off with the public budget (since this is one area where reasonably accurate and timely data are available), and uses these data to infer what is happening in the private (non-budget) part of the economy.

b) In the economies of the EU small states, budget analysis is based on an analysis of economic forces that emanate mainly from the private (non-budget) sector and from the international economy. The projected performance of the private sector (derived in various ways, including the use of formalised economic models), combined with decisions on the main public expenditure policy instruments, are used to infer the budgetary outturn (i.e., revenue projections and the public sector borrowing requirement). However, there are almost no accurate and timely data available in Kosovo that would permit policy-makers to chart the likely evolution of the private sector in this way.[38]

[38] For an description of attempts to produce budget revenue forecasts in Kosovo for the years 2005-2007, see *Budget 2005 Macro Background*, April 2004. However, the limited data on labour force, investment and productive capacity makes this exercise very conjectural.

In conclusion, it appears to be the case that budgetary planning in Kosovo is hampered by the absence of an effective system for monitoring and forecasting the main output, expenditure and income aspects of the macroeconomy. The consequences in terms of budgetary planning - in the narrow sense of ensuring an orderly evolution of the government's finances - are serious. But the possible consequences for the longer-term planning of state expenditure and its role in promoting sustained development are even more serious.

3. Sectoral analyses

The national "budget" is not a national "plan", other than in the very narrow sense of describing the planned evolution of public expenditure that is sustainable by the ability to raise tax and other revenues (and, in the case of sovereign states, the ability to raise public debt). When we switch to the micro and business aspects of public sector activities, we need to address more than the public finance aspects of government activities. In addition, we must examine the trade-offs between different uses of public financial resources in the context of a wider economic development plan.

The planning documents of most ministries have micro/industrial aspects as well as social aspects. Two sectoral strategies stand out as being particularly important to Kosovo: a strategy aimed at industrial and economy-wide development prepared by MTI; and a strategy for agriculture prepared by MAFRD, aimed at agricultural strategy.[39]

Policies aimed at developing the manufacturing sector, as well as other aspects of market services, are primarily the responsibility of MTI. These were set out in *Strategies for Kosovo's Medium-term Economic Development: 2003-2008* (MTI, June 2003). After two introductory chapters (Part I of the document) that set out some historical background and present economic challenges, the MTI document looks at strategic priorities in productive sectors, strategic priorities in social aspects of the economy and strategic priorities in the labour market.

However, much of the MTI analysis is of a very general kind, with few specifics. There is no detailed analysis of the structural characteristics of the Kosovo labour market, and no specific policy targets. In the section on "Strategic priorities in the area of investment" a distinction is made between the promotion of domestic investment and strategies aimed at fostering foreign investments; however, no specific policy proposals are made. In addition, the relationship between the promotion of exports is linked to the need for higher investment in the productive sector, but the policy implications are not traced out in any detail.

Based on the above set of policy priorities, the MTI strategy document concludes with an attempt to quantify the likely impacts of the proposed policy innovations on the performance of the Kosovo economy. Although quantifications are made, there is no indication of how these were arrived at, so it is difficult to evaluate the projections.

Over the 5-year period, GDP growth is projected at averaging 28 per cent per year, and GDP per head increases from 1,049 euro in 2004 to 3,312 euro by 2008. Total investment expenditures are projected as averaging just under 1 billion euro per year for

[39] Some of the missing links in the MAFRD and MTI strategy documents are supplied in the strategies prepared by the international donor agencies (such as the European Agency for Reconstruction, UNDP, UNMIK, USAID, the IMF and the World Bank).

the five-year period. The public share of this investment (to be funded from the Kosovo budget) is almost 600 million euro per year.[40] Total employment is projected to rise from a base of 371,000 in 2003 to 654,000 in 2008, i.e., an annual increase of just over 55,000. Assuming the MTI "low fertility with migration" projection of population, the reduction in the rate of unemployment would be modest, even in the presence of such strong employment growth.

We find these results to be extraordinarily optimistic. Even if the financial resources were made available to implement the MTI strategy, the projected impacts on the Kosovar economy greatly exceed anything experienced by other less developed EU countries, where even higher levels of international aid were forthcoming.

To improve the MTI economy-wide development strategy will require inputs from those aspects of other departmental plans that have a bearing on how such a step change in economic performance might be achieved, as well as how it might be financed. For example:

- The quality of education and human resources is known to be crucial to the success and development of a modernisation strategy. But the policy strategy documents prepared by the Ministry of Education and Science stress the huge gap between present standards in Kosovo and those standards that would be needed to support modernisation and rapid growth.[41]

- The poor environmental state of Kosovo, and the resources needed to prevent further deterioration, are stressed in the strategy documents prepared by the Ministry of the Environment and Spatial Planning and elsewhere. These are costs that must be incurred prior to any strategy of faster sustained growth.[42]

- The human resource challenges facing Kosovo, as it attempts to build higher skills through vocational training, are very serious, and the difficult issues are stressed in the strategy documents prepared by the Ministry of Labour. Even with the magnitude of the challenge, there does not yet appear to be a comprehensive strategy in place.[43]

- The physical infrastructure deficiencies in Kosovo are reasonable well known, but have tended to be funded through bilateral donor aid programmes. In the absence of a comprehensive programme dealing with physical infrastructure, involving a realistic and clear identification of investment needs, and likely returns to

[40] The average public investment policy multiplier (i.e., the five-year increase in GDP divided by the five-year increase in public investment) is just over 2. This is somewhat higher than one might expect for a small open economy like Kosovo. But the main question lies not with the assumed size of the policy multiplier, but with the ability of the Kosovo budget to finance the projected increase in public investment expenditure of almost 3 billion euro over five years.

[41] *Kosovo Labor Market Study: Policy Challenges of Formal and Informal Employment*, World Bank, Human Development Unit, Europe and Central Asia Region, June 26, 2003 (Labour Market Characteristics, pp. 13-27); Labour and Employment, Annual Report 2003, Ministry of Labour and Social Welfare.

[42] *Kosovo Profile*, Ministry for Environment and Spatial Planning/Institute for Spatial Planning, July 2004.

[43] Labour and Employment, Annual Report 2003, Ministry of Labour and Social Welfare.

investment, it is difficult to evaluate these aspects of the MTI economy-wide strategy.[44]

In the case of MAFRD[45], the targeted sector is agriculture, both in terms of farm production activities, the supply of raw materials for processing in the manufacturing sector, and in terms of welfare measures aimed at supporting income of the farming community.[46] The MAFRD "mission statement" emphasises the facilitation of structural change in the rural economy, and the need to support employment and income generation through improvements in agriculture. Strategic choices include diversification into other areas of activity within rural areas, privatisation of socially owned enterprises, import substitution and export promotion. Policy priorities include increasing productivity through training and investment schemes, as well as the promotion of supply-chain links between production and manufacturing in the food processing area.

There appear to be three main elements to the MAFRD strategy. The first stresses the need to move from an inefficient, low productivity, mainly subsistence agriculture to a more productive market oriented sector. This is the core role of MAFRD, and is described in detail in the *Green Book*[47]. The second stresses the need for greater integration of any improved agricultural supply with value-added processing in the manufacturing sector. Here there needs to be much greater synthesis of the planning of MAFRD and MTI. The third stresses the need to facilitate the movement of people out of agriculture into manufacturing and service activities that can flourish in the adjacent local towns, where the necessary infrastructure and economies of scale are available. This calls for an integrated rural development strategy of the kind developed in many of the Structural Fund programmes of the EU member states, where similar challenges arise.

E. EUROPEANISING DEVELOPMENT PLANNING

1. The European experience of convergence

The term "cohesion" first came into use in the late 1980s at the time when major reforms and expansions of EU regional aid were being carried out. As set out in Article 130a of the Treaty on European Union, there is an explicit aim to promote "harmonious development" with a specific geographical dimension: "reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions". Thus, there is an explicit recognition that wide disparities are intolerable in any community, if that term has any real meaning.

In the context of EU policy making, a *National Development Plan* is a document that sets out the structural measures that need to be implemented over an extended period (5-7 years) in conjunction with EU investment aid (i.e., *Convergence* (or *Structural*) and

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44 Government of Kosovo Budget – 2004, *General Donor Contributions in Kosovo during 1999-2003* (page 179); *New Donor Commitments for 2004* (page 181); USAID Mission in Kosovo, *Strategic Plan 2004-2008*, July 2003.

45 Ministry of Agriculture, Forestry and Rural Development.

46 Details of the strategy are set out in *The Kosovo Green Book: A strategy for Sustainable Agricultural and Rural Development in Kosovo* (MAFRD, May 2003). However, the financial resources available through the Kosovo Budget are very modest (0.4 per cent of total budget expenditures in 2004).

47 The *Green Book* is available on the MAFRD website and the ESPIG CD Rom.

Cohesion Funds), with a view to achieving the national and EU aim of greater economic and social cohesion.[48]

A description of the economic situation in the recipient country is usually placed as a preamble to its *National Development Plan*. The purpose is two-fold: first, to document and place on record the extent to which economic performance lags behind the EU norm, and second, to identify any barriers to faster growth and convergence (i.e., to cohesion) that can be addressed later by the policy initiatives contained in the NDP (usually referred to as Operational Programmes).

Cutting across the different aspects of the macroeconomic performance, the NDP proceeds to identify a series of actual and potential barriers to faster growth. With respect to the potential drivers of faster growth, these usually involve documentation of a relatively low level of human capital; low scientific R&D activity; low penetration of information technology; low rates of fixed investment in the economy. In addition, the social consequences of high unemployment, high long-term unemployment, and poverty are documented, since these can also become barriers to progress and change.

An important aspect of the macro review emphasises trade-offs that exist between some of the competing objectives of the NDP. For example, Kosovo has a high rate of unemployment, so there is an urgent need to increase employment (i.e., labour demand).[49] However, there is also an urgent need to drive up productivity so that wage rates can rise (thus increasing living standards) without competitiveness being eroded by high unit labour costs. One of the few ways in which both employment and productivity can rise is if there is extensive sectoral restructuring in the economy.[50] Thus, if there is a decline in traditional low added-value traditional industrial sectors eventually there needs to be a more than compensating growth in modern high productivity industries and their accompanying producer services.

NDPs often contain short "mission statements", as in Poland (for the period 2004-2006):

> "To develop a competitive economy based on knowledge and entrepreneurship, capable of harmonized development in the long term that will ensure growth of employment and improvement of social, economic and spatial cohesion as a member of the European Union, at regional and national level".

Generalised national "mission statements" of this kind tend to be aspirational and vague. But within the NDP a series of focused objectives are specified, that can be more closely related to explicit and quantifiable government policy goals. In the case of Poland, these were as follows:

(i) Achieving and maintaining high long-term GDP growth;
(ii) Increase in employment, in addition to raising the level of education of the work force;

48 The examples of the Irish *National Development Plans* can be consulted, covering the three periods 1989-93, 1994-99 and 2000-2006. They illustrate neatly how a country's development priorities and needs gradually evolve and change over time.

49 *Kosovo Labor Market Study: Policy Challenges of Formal and Informal Employment*, World Bank, Human Development Unit, Europe and Central Asia Region, June 26, 2003 (Policy Considerations: Creating an Enabling Environment for Growth), pp. 97-101.

50 *Kosovo Economic Memorandum*, World Bank, Poverty Reduction and Economic Management Unit, Europe and Central Asia Region, April 27, 2004 (Potential and Constraints to Growth at the Sectoral Level, pp. 42-61).

(iii) Integration into European networks of transport and information infrastructure;

(iv) An increase in the share of high value-added sectors in the economy and development of the technology needed to support the "information society";

(v) Participation of all regions and social groups in Poland in the processes of development and modernisation.

It is only when the NDP examines *how these five objectives might be attained* that the NDP process becomes specific to the needs of any economy. For example, the attainment of objective (i) – long term growth – will require a focus on fiscal stabilization and further restructuring and privatisation of the business sector. Fiscal uncertainty or instability is a serious impediment to growth potential, and policy success here will be crucial in relation to the NDP-type investment programmes, even though they will not be an explicit part of any NDP Operational Programme.

The attainment of objective (ii) – increased employment and education – usually requires the articulation of a series of active labour market policies, but will call into question the extent to which a country can mobilise support within civil society to underpin the evolution of competitiveness-friendly national wage bargaining and price-setting institutions.

The attainment of objective (iii) – infrastructure – is very specific to the particular country. For example, the task in Poland is greatly complicated by its physical size, its dispersed urban structure, and its position as a strategic cross road in trans-European communication networks. By comparison, the Irish or Estonian (and eventually Kosovar) objectives in this area are likely to be easier to identify.

The attainment of objective (iv) – structural modernisation – is a need shared with most of the CEE acceding states, but would be complicated in the case of Kosovo by the large size of the agricultural workforce as a share of total employment. The stark economic imperatives here – i.e., the desirability of facilitating rural-urban migration – pose serious social challenges, particularly since the transformation will be forced to take place at a much faster pace than, say, the analogous Irish rural restructuring of the years 1950–1970. The industrial and service sector modernisations are also likely to pose challenges that are specific to the Kosovo transition.

The attainment of objective (v) – spatial and social equity – raises very difficult challenges in terms of the possible tradeoffs between economic efficiency and social equity. The experience of the EU cohesion countries has been one of national (or external) cohesion but a degree of regional (or internal) divergence.[51] The insights provided by economic geographers and industrial strategists suggest that the engine of aggregate national growth is regional concentration, and that all regions cannot be winners in this game of agglomeration and specialisation. However, given the compact size of Kosovo, this is unlikely to pose insurmountable economic challenges.

In the light of the above range of more specific objectives, an NDP is designed and articulated in terms of key "development axes". In the case of Poland, these included:

- Support for enterprises' competitiveness: implemented through an Operational Programme "*Improvement of competitiveness of the economy*";

[51] *Third EU Cohesion Report*, Commission of the European Communities, Brussels, 2004.

- Development of human resources and employment: implemented through an OP "*Human resources development*";
- Creation of conditions to increase the level of investment, promote balanced development and spatial cohesion: implemented through an OP "*Transport – Maritime Economy*", but also including Cohesion Fund interventions in the two areas of "*Transport*" and "*Environment protection*";
- Structural adjustment in agriculture and fisheries, and rural development: implemented through two separate OPs, "*Restructuring and modernisation of the food sector and rural development*", and "*Fisheries and fish processing*";
- Strengthening of the development potential of the regions and counteraction of marginalisation of some area: implemented through an integrated "*Regional Operational Programme*".

2. Towards a Kosovo Development Plan

In its present stage of evolution, the planning process is taking place within the Kosovo government ministries, mainly on a departmental basis. Unfortunately, there appears to be only very limited information available concerning the performance of Publicly Owned Enterprises (POEs) and Socially Owned Enterprises (SOEs), and almost no information about the private enterprise sector.[52]

In the case of Kosovo, a situation has developed where a large part of what one might call the "public investment programme" is carried out in bilateral co-operation with a range of major international agencies and donors. What would be required to move from this situation towards a Kosovo NDP? And how could it be evaluated?

The first phase of strategic policy-making in Kosovo has started, and the progress to date is documented in the ESPIG CD-ROM containing the departmental and international plans and analyses. If it is accepted that the methodology of the NDP-type process is appropriate for Kosovo, then a clear set of consequences follow.

(i) Explicit developmental targets must be set

Prosperous developed countries can enjoy the luxury of setting a diverse range of socio-economic targets, since they tend to have adequate resources. Developing countries like Kosovo, on the other hand, need to focus on the over-riding target of accelerating growth of income per head. Given appropriate care in influencing income distribution within the country, other desirable socio-economic objectives tend to come into line as a direct consequence of economy-wide growth (e.g., facilitating improvements in social conditions in the health and education areas, improved environmental care, etc.). Of course, the normal budgetary processes operate in parallel with National Development Planning.

(ii) The development strategy must clearly identify fiscal and societal constraints

For any poorer country, constraints are only too plentiful. In the case of Kosovo, it is located in a peripheral or otherwise unfavourable geographic-economic area, close to zones of conflict and of deteriorating economic performance. There is an inadequate set of institutional structures. The initial level of development is exceptionally low, putting

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[52] *Draft Strategy of the Privatisation Department of the Kosovo Trust Agency*, April 24, 2004.

constraints on the availability of resources (i.e., policy makers face financial constraints from the balance of payments and in funding public sector borrowing requirements). It has an unfavourable initial economic structure, with a very large agricultural sector, an unsuitable configuration of industrial sectors, and a very under-developed market services sector. The level of human capital as well as the level of technology is low, placing constraints on feasible development strategies. The need to reduce exploitation of non-renewable resources may place further constraints on growth. But however challenging the constraints they need to be clearly identified and frankly admitted. The Kosovo government must identify its priorities based on an honest assessment of the social and economic challenge. If the Kosovo government does not do so with its specific political priorities, then the international agencies will do so with theirs!

(iii) The development strategy must identify suitable policy instruments

The availability of suitable social and economic policy tools is as important for the success of any development plan as the clear statement of objectives. These usually include increased investment, fiscal incentives aimed at stimulating the private sector, and appropriate wage-setting institutions. In particular, public investment will focus on infrastructure and human capital, with increased investment in health, education and research, while stressing the need to improve telecom and transport infrastructures as well as building information technology competences.

Both foreign and indigenous firms require incentives, designed to make the region more attractive to local as well as inward investment, since this latter will be the main facilitator of technology transfer and the re-orientation of manufacturing towards fast growing export markets. An evolution of wage rates that disregards the need to maintain international cost competitiveness will choke off growth. Consequently, any strategy can benefit from forms of Social Partnership among the three main institutional players – government, trade unions and employers – aimed at producing an orderly evolution of wage costs that preserves cost competitiveness.

The fact that Kosovo is still a long way from even contemplating applying for EU membership should not deter it policy makers from starting down a road of economic development strategy in the absence of the type of EU financial support that is made available to candidate and member states. The national development strategy should be outlined, and small-scale domestically financed prototype projects initiated to encourage "learning-by-doing" and to demonstrate to the international community the serious intent and discipline of the Kosovo government.

(iv) The strategy process must include a rigorous system of monitoring and evaluation

The term "monitoring" refers to the verification of adequate compliance with policies agreed and codified in the NDP treaties and their supporting documents, including financial aspects (was funding spent according to the plan?), as well as the collection and analysis of relevant activity and performance indicators (length of roads built, numbers of people trained, etc.).

Effectiveness is usually evaluated by relating an output, result or impact indicator to a quantified objective. It implies an assessment of performance against the anticipated outputs and results. Ideally one would like to be able to identify a hierarchy of targets in the following sequence: a policy action, leading to a direct output achieved, to an intermediate and then final target attained.

This sequence of targets can be illustrated by means of the important transport programmes of an NDP. The immediate policy action is a road construction undertaken. The direct output attained would be a certain number of km of new road completed. The intermediate target would be travel time reduced by a certain amount. However, the final target would be a boost in activity by those entrepreneurs using the road.

Needless to say, this approach is dogged by imprecision and subjectivity. But the point is that the eventual composite "rating" of each measure is not as important as the process of analysis and negotiation that is required to arrive at a consensus and assign that "rating". Many interesting and relevant insights can be obtained from the schema. The technique is also of use in communicating with donors, since resources made available are sometimes related to the credibility and rigor of the national ex-ante analysis.

The term "evaluation" refers to the examination of whether the NDP programmes implemented actually brought about the achievement of the desired goals. This involves the tracing out and quantification of the chain of causality between structural measures being applied and the securing of intended objectives. At the most aggregate level, the basic question is whether or not the NDP programmes taken as a whole promoted convergence (or cohesion). At a more detailed level, one might seek to evaluate how an individual project (such as the construction of a specific section of new road, the execution of a specific training scheme, or the provision of a specific aid to company export marketing) increased economic efficiency or addressed market failure.

Before any macroeconomic evaluation of the NDP can take place, the individual investment and other programmes need to be amalgamated into more aggregate economic categories.[53] There are various reasons for this.

The most useful and logical categories for **aggregating** the NDP are as follows:

(i) Investment expenditures on physical infrastructure;
(ii) Investment expenditure on human resources;
(iii) Expenditures on direct production/investment aid to the private sector (i.e., manufacturing, market services and agriculture).

For each of these economic categories of NDP investment expenditure, there are three possible sources of funding:

(i) Donor transfers in the form of subventions to the domestic public authorities
(ii) Domestic public sector co-financing, as set out in the NDP treaties;
(iii) Domestic private sector co-financing, as set out in the NDP treaties.

NDP investment programmes influence the economy through a mixture of supply and demand effects. Short term demand effects arise as a consequence of increases in the expenditure and income policy instruments associated with NDP policy initiatives. Through "multiplier" effects, there will be knock-on changes in all the components of domestic expenditure (e.g., total investment, private consumption, the net trade surplus, etc.) and the components of domestic output and income.

[53] A review of previous EU NDPs illustrates how the complexities can be reduced to simpler aggregate categories. The evolution of the three Irish NDPs (covering 1989-93, 1994-99 and 2000-2006) shows the increasing sophistication of the process, driven by "learning by doing".

These demand effects are of transitory importance and are not the *raison d'etre* of the NDP, but merely a side-effect. Rather, the NDP interventions are intended to influence the long-run supply potential of the economy. These so-called "supply-side" effects arise through policies designed to:

(i) increase investment in order to improve physical infrastructure as an input to more efficient private sector productive activity;

(ii) increase in human capital, due to investment in training, an input to higher private sector productive activity;

(iii) channel public funding assistance to the private sector to stimulate investment, thus increasing factor productivity and reducing sectoral costs of production and of capital.

Thus the NDP interventions are designed in order to improve the aggregate stock of public infrastructure and of human capital, as well as the private capital stock. Providing more and better infrastructure, increasing the quality of the labour force, or providing investment aid to firms, are the mechanisms through which the NDP improves the output, productivity and cost competitiveness of the economy. In a certain sense, these policies create conditions where private firms enjoy the use of additional productive factors at no cost to themselves. Alternatively, they may help to make the current private sector inputs – that firms are already using – available to them at a lower cost, or the general conditions under which firms operate are improved as a consequence. In all these ways, positive externalities may arise out of the NDP interventions.

To summarize, all EU-type *National Development Plans* involve:

(a) A detailed statement of the socio-economic *status quo ante*,
(b) A clear diagnosis of the major barriers to faster growth and development,
(c) An identification of a range of policies that will address these problems,
(d) A formal costing of these policies,
(e) The execution of an *ex ante* evaluation of the extent to which the NDP will promote cohesion.

Since the implementation of any National Development Plan will take place at Departmental level, it will be vital to regard all the different Departmental strategy documents as a series of closely interconnected and interrelated processes. The development of economic strategies for the key sectoral "engines of growth" will require co-ordination between MAFRD and MTI. The other Departmental strategies must be viewed as supporting the goal of industrial and rural development by providing inputs that are absolutely vital to success: for example, MEST (basic and higher education and research); MESP (the spatial dimension to growth); MLSW (human resources and training); MTC (transport and communication infrastructure).

Policies are first designed at the Departmental level, within overall NDP-type guidelines pre-established via the overall managing authority (see below). Costing and micro impact analysis initially takes place at the Department level, and costs are subsequently aggregated and reconciled by the managing authority. After the strategy has been integrated, it then needs to be costed and evaluated at the macroeconomic level, in terms of its macro objectives (e.g., income and welfare effects, unemployment reduction, fiscal impacts on budget balance, impacts on the balance of trade and the current account, inflationary impacts, etc. This is a fairly technical task, and usually requires the assistance of local specialist agencies (e.g., RIINVEST or university departments), working in association with the managing authority.[54]

3. Concluding remarks

EU-type National Development Planning will not hand Kosovo answers to all of its economic challenges. But an EU-type strategy process, as now used in *all* the new member states, provides probably the most robust and logical process through which the Kosovo economy, with the assistance of the international community, can eventually converge to the standard of living of its EU neighbours. After all, it is not the nature of Kosovo's development challenge that is unique. Rather it is its depth, in terms of a severely disadvantaged starting point. The strategy documents already produced within the different Ministries, together with the analysis and investment aid of the international agencies, represent the first stage of a process that will call for clear thinking and extraordinary levels of co-operation if Kosovo's development goals are to be met.

In most EU member states, responsibility for managing the NDP process is given to a special economic strategy unit located within the Ministry of Finance. This unit is separated from the budgetary side of the Ministry, but its activities must be consistent with overall budgetary strategy. The unit controls the drafting of the NDP, and liases with the other economic and social ministries as they feed their sectoral strategies into the wider NDP, and is also responsible for reconciling conflicts that may arise between ministries.

Clearly such a strategic unit is urgently needed in Kosovo. Without it, the different ministerial strategic plans cannot possibly be integrated into a coherent national strategic plan, broadly prepared according to the above EU principles. Even in advance of any formal relationship with the EU, development planning in Kosovo should not be pursued in a European vacuum. The reality is that the economy of Kosovo is firmly embedded inside the encompassing economy of the enlarging European Union. The dilemmas that this poses for Kosovo policy makers have been succinctly summarized by the Japanese strategist, Kenichi Ohmae as follows:

> "The world economy today represents a simultaneous shift of power from the traditional national government down to region-states, and up to super-national economic blocs. Governments in tune with this change will seek economic stability through the latter, and prosperity by means of the former".

Within the newly enlarged EU, and in light of its proposed constitution, some powers that were previously the prerogative of nation states are passing to supranational agencies like the European Central Bank and the European Commission. But small nation states within the Union retain considerable freedom for local policy initiatives directed at improving their ability to compete successfully within the enlarged single market. Indeed, the European economy is becoming a series of interacting regions, where national boundaries have lost much of their previous economic and business significance. Policy making in Kosovo urgently needs to adapt to this new reality.

[54] In EU Structural Fund programmes, micro and macro evaluation studies, carried out at arms length from the government, are *mandatory*, as part of the formal treaties setting up the Structural Funds for each beneficiary country.