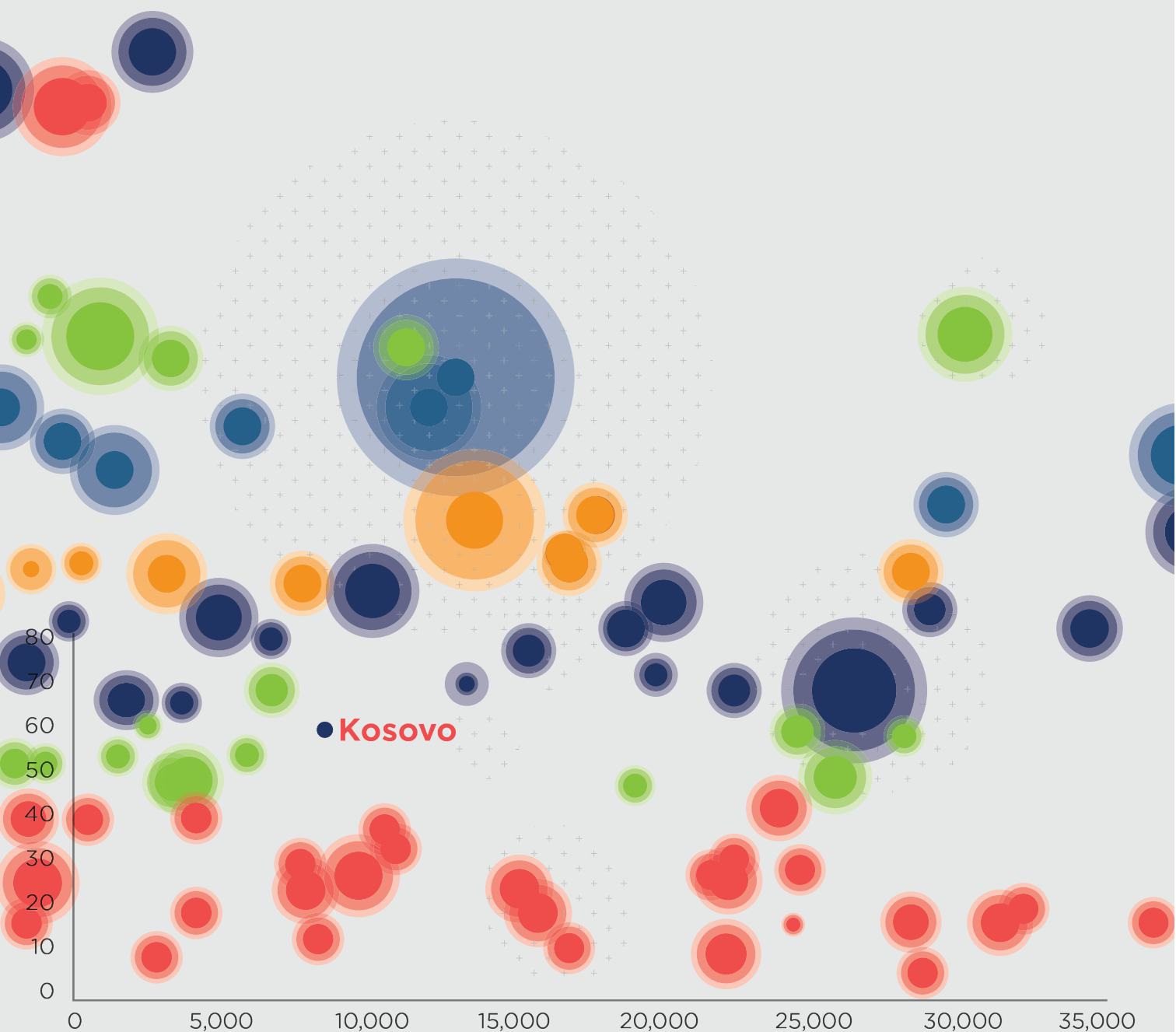


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KOSOVO CONSTRAINTS ANALYSIS



THE KOSOVO CONSTRAINTS ANALYSIS



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Abbreviations

AUK-RIT	American University in Kosovo–Rochester Institute of Technology
BEEPS	Business Environment and Enterprise Performance Survey
BRIC	Brazil, Russia, India, China
BTI	Bertelsmann Stiftung’s Transformation Index
CA	Constraints Analysis
CBK	Central Bank of Kosovo
CEFTA	Central European Free Trade Agreement
DALY	disability-adjusted life years
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia
ENS	energy not served
ENTSO-E	European Network of Transmission System Operators for Electricity
ERO	Energy Regulatory Office
ESM	Serbian Electricity System Operator
EU	European Union
EULEX	Kosovo European Union Rule of Law Mission in Kosovo
FAO	Food and Agricultural Organization of the United Nations
FDI	foreign direct investment
FLFP	female labor force participation
GDP	gross domestic product
GIX	Deutsche Gesellschaft für Internationale Zusammenarbeit
GNI	gross national income
GWh	gigawatt hours
HDI	Human Development Index
ICT	information, communications, and technology
IEEFA	Institute for Energy Economics and Financial Analysis
IFC	International Finance Corporation
ILO	International Labor Organization
IMF	International Monetary Fund
KAS	Kosovo Agency of Statistics
KBA	Kosovo Bankers Association
KEDS	Kosovo Energy Distribution and Supply [?]
KEK	Kosovo Energy Corporation
KFOS	Kosovo Foundation for Open Society
KIESA	Kosovo Investment and Enterprise Support Agency
KMC	Kosovo Manufacturing Club
KOSID	Kosovo Civil Society Consortium for Sustainable Development
KOSTT	Kosovo Transmission System and Market Operator
kWh	kilowatt hour
kV	kilovolt
KWN	Kosova Women’s Network
LCOE	levelized cost of electricity
LFP	labor force participation
LFPR	labor force participation rate.

LFS	Labor Force Survey
LMIC	low- and middle-income country
MAFRD	Kosovo Ministry of Agriculture, Forestry, and Rural Development
MCC	Millennium Challenge Corporation
MICs	middle-income countries
MFI	microfinance institution vs
MSME	micro- and small- and medium-size enterprise
MW	megawatts
MWh	megawatt hour
N11	Bangladesh, Egypt, Indonesia, Iran, Korea, Mexico, Nigeria, Pakistan, Philippines, Turkey and Vietnam
NGOs	nongovernmental organizations
NPLs	nonperforming loans
OECD	Organisation for Economic Co-operation and Development
PISA	Program for International Student Assessment
QALY	quality-adjusted life years
RAE	Roma, Ashkali and Egyptian
REER	real effective exchange rate
SAA	Stabilisation and Association Agreement
SAIDI	System Average Interruption Duration Index
SAIFI	System Average Interruption Frequency Index
SELDI	Southeastern European Leadership for Development and Integrity
SME	small- and medium-size enterprise
UN	United Nations
UNDP	United Nations Development Programme
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNICEF	United Nations Children's Fund
USAID	U.S. Agency for International Development
WGI	Worldwide Governance Indicator
WHO	World Health Organization

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Preface

The Kosovo Constraints Analysis is an attempt to accomplish a comprehensive analysis of constraints that hinder sustainable economic growth and poverty alleviation in Kosovo.

It analyses a variety of potential problems related to issues generated by historical legacies, geographical position of the country, the status of infrastructure components (including energy), the situation in the area of human capital and health, difficulties in accessing financial resources, innovation skills, rule of law issues, as well as problems related to macroeconomic risks and investment climate.

The paper used the HRV (Hausmann, Rodrik and Velasco) methodology in order to identify potential binding constraints to growth. In addition, an important tool used is the comparisons of Kosovo's performance with the achievements attained by other countries in the region and countries of a similar per capita income. Our analysis concluded that unreliable supply of electricity, weak rule of law, and environmental services represent the binding constraints to economic growth. But, we further note that low quality of education, access to finance for start-ups and low labor force participation (especially among women) are constraints to economic growth in Kosovo.

The Constraints Analysis (CA) was conducted in close cooperation with the MCC team based in Washington D.C. They visited Kosovo several times during 2016 and 2017 and we went through a number of consultation workshops, focus groups and interviews.

Stakeholders consulted included a wide set of government ministries and other public institutions, key civil society organizations, women's groups and business associations, financial institutions, ICT firms, manufacturing firms, tourism firms, international development partners/donors, chambers of commerce and other business associations, and various agricultural producers and farmers.

We would like to thank all of them for their instrumental contribution to this analysis, as we hope this report would shed light to your work in the fields covered here.

Alban Zogaj
Chief Economist at Millennium Challenge Kosovo Office

Introduction

Kosovo's Constraints Analysis (CA) report was prepared according to Millennium Challenge Corporation (MCC) guidelines as the first phase of Kosovo's threshold development program with the MCC. The constraints analysis approach is built on the foundations of the growth diagnostics methodology developed by Hausmann, Rodrik, and Velasco (2005). The analysis was performed by the Kosovo Core Team¹ and the MCC Washington team².

The CA paper aims to identify constraints that hinder economic growth and poverty alleviation in Kosovo. The rationale behind CA is that the main driver of sustainable economic growth is private sector investment and entrepreneurship. Private sector development contributes to the growth of the economy and supports poverty alleviation efforts. The study examines various factors that can potentially drive growth.

To identify binding constraints to growth and investment, the MCC team used the available to date research and existing data in Kosovo, but also visited Kosovo several times in 2016³. During these visits, many consultations, workshops, focus groups, and interviews were held around the country, including Prishtina (capital of Kosovo), Prizren, Gjilan, Peja, and Brezovica. Stakeholders consulted included a wide set of government ministries and other public institutions, including the Central Bank, the Kosovo Investment Agency, the Statistical Office of Kosovo, and the Agency on Gender Equality. In addition, the threshold development team consulted key civil society organizations; women's groups and business associations; nongovernmental organizations (NGOs); financial institutions; information, communications, and technology (ICT) firms; manufacturing firms; tourism firms; and international development partners and donors (for example, European Union [EU], United Nations Development Programme [UNDP], Swiss Agency for Development and Cooperation [SDC]); chambers of commerce and other business associations; and various agricultural producers and farmers.

¹ Alban Zogaj, chief economist; Edona Kurtolli, private sector development specialist; Burim Hashani, energy sector specialist; Adrian Prenkaj, rule of law consultant; Violeta Rexha, gender and social inclusion specialist.

² Sarah Olmstead, team leader; Stefan Osborne, economist; Brad Cunningham, economist; Jozefina Coutura, gender and social inclusion specialist; Jamie Shabalina, gender and social inclusion consultant; and Zaidoon Khouri, private sector development specialist.

³ The Kosovo Constraints Analysis was developed during the year 2016.

The analysis is broadly divided in two parts. In the first part, the CA provides a general overview of Kosovo's development, including its economic performance. In the second part, the CA further discusses particular factors and aspects according to the growth diagnostics model. Each part of the CA consists of a comprehensive analysis of the respective factor with the conclusion identifying whether this factor constitutes a binding constraint for growth and development of the country. The CA is based on comprehensive qualitative and quantitative analysis, using international as well as local sources and statistical data. For a more thorough analysis, Kosovo's performance is judged, where applicable, against a pool of so-called benchmark countries selected according to a number of criteria. These countries are Albania, Serbia, the Former Yugoslav Republic of Macedonia, Montenegro, and Bosnia and Herzegovina.

The study demonstrates that despite the progress achieved in recent years, there are areas of Kosovo's economy that require increased attention and effort, as they constitute constraints to further growth and development. If not addressed in due time and in a consequent manner, these constraints will hinder growth and, moreover, undermine the achievements of recent years. The findings of the analysis are grouped as binding and nonbinding constraints to growth.

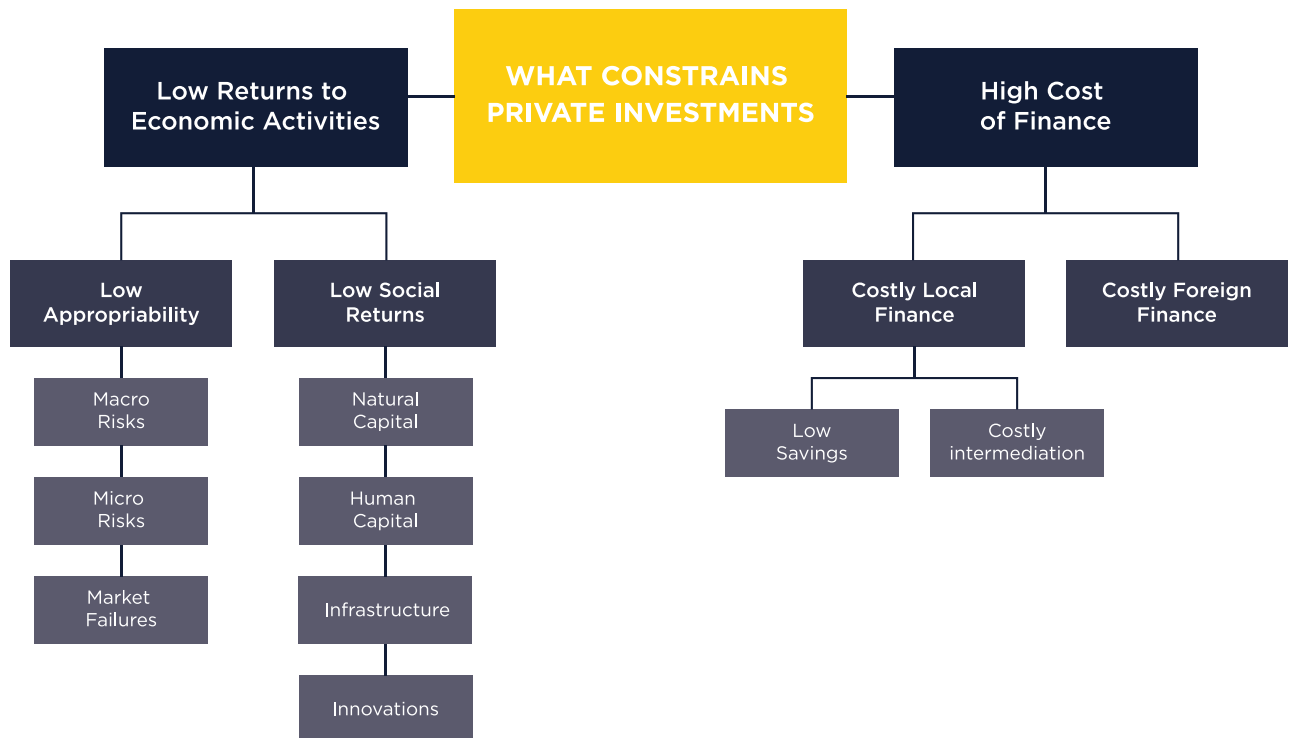
After analyzing several identified constraints to growth in detail and comparing them to other countries in the region, the team concluded that the most binding constraints to Kosovo's economic growth are (1) an unreliable supply of energy, (2) weak rule of law and perceptions regarding rule of law, and (3) poor environmental services (water, environment, and health). Later in the paper we will briefly present some of the main arguments.

Methodology of Growth Diagnostics

The purpose of the **Constraints Analysis** is to identify the root causes that deter households and firms from making investments of their financial resources, time, and effort that would significantly increase their incomes. The CA is not intended to dictate specific projects to be funded by the MCC, but rather to provide a framework that will help focus the consultative process on appropriate programs that will ease those constraints and stimulate economic growth.

In essence, successfully undertaking a CA involves posing and answering a sequence of diagnostic questions that highlight the “root causes” that constrain investment. The constraints analysis approach is built on the foundations of the growth diagnostics methodology developed by Hausmann, Rodrik, and Velasco (2005). They present the framework for the growth diagnostic analysis in the form of a tree, as shown in figure 1. The tree presents a hierarchical framework which we used to organize and motivate the questions/hypothesis (tested throughout this analysis) driving the CA. Answering those questions (what constraints private investments? Is it high cost of finance? Is it low returns to economic activities?) involves selecting and formulating the diagnostic questions in a sensible way for the country at hand; researching and marshalling key evidence and data that shed light on the questions; and answering the questions given the balance of such evidence.

Figure 1. Growth diagnostics framework.



Source: Hausmann, Rodrik, and Velasco (2005)

The CA builds on the premise that private investment, both domestic and foreign, represents the primary engine of economic growth. Countries seeking to accelerate growth are faced with the fundamental question that lies at the center of the CA exercise: What constrains private investments? The boxes in the second row of figure 1 suggest two distinct answers to this question: low returns to economic activities and high cost of finance. If evidence suggests the latter is true (that is, the cost of capital is high), the framework presents a series of issues that need to be considered to understand the systemic explanations. This framework keeps the focus on problem identification and prevents the premature leap to possible solutions (for example, subsidized credit) that would not address the underlying causes of expensive capital. If evidence shows that the cost of capital is not out of line with norms in comparable countries, then the growth diagnostics framework examines whether low returns to economic activities explains the current levels of private investment. In general, using the hierarchy of figure 1 as a guide, we consider in turn the questions suggested there, working our way down the framework to determine which of the possible explanations is most responsible for low investment and, in turn, low growth rates.

The constraints identified in the CA should be fundamental causes rather than symptoms. For example, discussions regarding the lack of dynamism within the domestic private sector often lead to the designation of “inadequate access to finance” as the problem but stop short of identifying the root cause as a financial system unable to deliver private capital efficiently and effectively. Possible root causes might include policies that limit or distort competition in the banking sector, weak capacity of banks to readily identify potential creditworthy borrowers, low domestic savings rates, or macroeconomic conditions that raise the domestic cost of capital and limit the number of profitable lending opportunities.

Alternatively, there may be evidence of low agricultural productivity as a constraint to growth, which could in turn be due to low levels of human capital with experience in cropping practices, poorly defined property rights suppressing investment in the land, or high levels of soil erosion. Often lack of sufficient water for irrigation is identified

as a constraint to agricultural productivity, leading to proposals for irrigation infrastructure that might actually exacerbate an underlying problem of poor management of ecosystem services provided by forests and watersheds. The CA should strive to identify, characterize quantitatively, and prioritize these more fundamental constraints. In practice, the CA should identify only core impediments to growth.

The evidence and data brought on these questions are drawn from diverse sources that will reflect any systemic bottlenecks to investment. Broadly speaking, the CA requires information on levels, trends, and cross-country comparisons with respect to a variety of variables and parameters, on both the micro- and macroeconomic levels, as well as qualitative evidence indicating the presence of constraints. Naturally, to expedite the process and avoid duplication of efforts, maximum use was made of existing relevant analyses of constraints to growth and readily-available data sources.

The threshold development team and MCC country team jointly identified core constraints using the four tests identified in the growth diagnostics methodology: (1) the shadow price of the constraint should be high with respect to comparator countries, (2) changes in the constraint should be correlated with growth and investment, (3) economic agents should be working around the constraint, and (4) sectors or industries that are dependent on the constraint should have lower growth. Each question was explored through quantitative and qualitative analysis.

Summary of Binding Constraints to Economic Growth in Kosovo

The following section summarizes the three binding constraints and some of non-binding constraints examined. A more in depth discussion of each is provided in the body of the report.

3.1. Lack of reliable electricity supply

Although many households and businesses complain about the high cost of electricity, Kosovo's electricity tariffs are comparatively low with respect to neighboring countries and comparable to other countries with similar gross domestic product (GDP). The main indicator of a high shadow price for electricity is the unreliability of supply, as evidenced by, for example, a System Average Interruption Duration Index (SAIDI) number of 67 and a System Average Interruption Frequency Index (SAIFI) number of 27. Businesses in Kosovo report comparatively high losses due to outages, indicating high costs due to electricity supply disruptions. Kosovo ranks extremely poorly on the World Bank's Doing Business report's Reliability of Supply and Transparency of Tariff index (WB, 2016), ranking 2 out of 7⁴. Kosovo's score stands out when compared to Serbia and Bosnia's 6 and FYR Macedonia's 5 (although Albania and Montenegro rate 0). Recent repairs to Kosovo's two power plants have significantly lowered outages, but without further investment very soon and a settling of Kosovo's participation in the European Network of Transmission System Operators for Electricity (ENTSO-E)⁵, reliability is expected to worsen again.

⁴ The reliability of supply and transparency of tariffs index encompasses quantitative data on the duration and frequency of power outages as well as qualitative information on the mechanisms put in place by the utility for reporting power outages and restoring power supply; the reporting relationship between the utility and the regulator for power outages; the transparency and accessibility of tariffs; and whether the utility faces a financial deterrent aimed at limiting outages (such as a requirement to compensate customers or pay fines when outages exceed a certain cap). The index ranges from 0 to 8, with higher values indicating greater reliability of electricity supply and greater transparency of tariffs.

⁵ Kosovo's admittance into ENTSO-E is dependent on agreement between Serbia and Kosovo. It is currently held up by disagreements over Kosovo's official name. Serbia refers to Kosovo as Kosovo and Metohija, which was its name while a province under Serbian control. This name is unacceptable to Kosovo.

Firms have invested in circumventing the constraint. Ownership of generators for firms is very high, and current usage of generators is high, although not significantly higher than comparator countries.

Demand currently outstrips supply, but there has been little movement on addressing the gap. Losses in the network are high, with 16 percent attributable to technical factors, 10 percent to commercial factors, and 5 percent to political problems.⁶ Citizens pay for electricity either through the tariff or taxes⁷, and the price is steep as a percentage of income. Two new power plants—a coal-fired plant and a large hydropower plant—have been in the works for many years, but neither has been started due to a variety of political and technical blockages.⁸

3.2. Weak rule of law

In a 2014 survey (IFC, 2014) of potential investors, the most frequent recommendation for Kosovo was “better anti-corruption” measures. Similarly, Kosovo consistently does worse than comparator countries on surveys of perception of rule of law, for example, the Corruption Perceptions Index by Transparency International (2015, 2016). These measures of the perception of rule of law seem to exceed reality. On every available metric of actual crime and corruption (for example, how often firms pay bribes) Kosovo’s performance is average or better than comparator countries. The 2014 IFC survey allows comparison of responses of potential versus existing investors. Among existing investors, only 20 percent had a negative impression of personal safety in Kosovo, whereas almost half of prospective investors had a negative view. This suggests that the international business community has an “excess perception” of rule-of-law issues in Kosovo that prevents investment.⁹

⁶ This specifically concerns Kosovar Serb customers living in North Mitrovica where the utility is unable to collect, given hostilities that continue to linger from the civil war, as well as the threat of intervention by neighboring Serbia.

⁷ Transfers from the government and donors to the Kosovo Electricity Corporation in 2012 were 21 percent of the corporation’s total income.

⁸ These barriers include numerous arguments over the proposed scale (the prospective coal plant has gradually been scaled down from 2100 megawatts [MW] to 600 MW) and transboundary politics around the proposed 305 MW hydropower plant

⁹ There is also the likelihood of some degree of selection bias; that is, some existing firms benefit from corruption and thus do not see it as an obstacle.

Myriad drivers fuel the negative perception of Kosovo among external investors. An IFC (2014) study found that “the most important and the second most important sources of information for potential investors appear to be online sources and personal visits” (IFC, 2014, p.23). The study found that negative stories dominate online media on Kosovo, such as the failed United Nations Educational, Scientific and Cultural Organization (UNESCO) membership bid, war crimes courts, and the opposition party releasing tear gas in parliament. Kosovo’s lack of international recognition by the United Nations (UN) and uncertain path toward EU accession may also influence potential investors. Sources of information that could provide investors with positive narratives of Kosovo are few. The Kosovo Investment and Enterprise Support Agency (KIESA), the agency in charge of investment promotion, has a small budget. The IFC (2014) study notes that Kosovo’s large diaspora is an underutilized resource for marketing the country and attracting investment. Consultations with Kosovar firms revealed that when they are looking for international partners it is challenging to overcome the country’s reputation, in large part due to visa restrictions and the difficulty of travel to secure business deals.

Although perceptions may exaggerate risks, real challenges face investors in Kosovo. The process of EU accession and establishing a new country has led to the development of increasingly sophisticated laws on paper, but the ability of line agencies to implement them has lagged behind. According to Pepaj (2016, p. 155): “Kosovo as a new country faces difficulties in professionalization of public administration and this is closely related to large number of case that are subject of judicial review which is not a case with other countries which have longer experience in public administration.” Unfortunately, the judiciary is not equipped to provide redress for the business community against poor implementation of the law by the public administration, despite hundreds of millions euros invested by donors in rule-of-law capacity building (training judges, software development, etc).¹⁰ “The Department for Administrative Matters within Basic Court of Prishtina operates with only three competent

¹⁰ Most recently, the European Union Rule of Law Mission in Kosovo (EULEX Kosovo) was extended through 2018 at an annual budget of more than \$70 million, one of the largest investment by the EU in Kosovo. This investment has been largely focused on criminal and not civil issues.

judges to resolve in the first instance administrative conflict cases for the entire territory of Kosovo. A judge of this department has about 800 pending cases, increasing each month by around 60 new cases.” (Pepaj 2016, p. 162). According to consultations with members of the business community, delays in the judiciary are especially long and harmful in cases regarding tax administration, customs duties, or regulatory disagreement. The Independent Review Board, which formerly handled tax and customs disputes, was reviewing nearly a thousand cases a year before being closed in 2013. In contrast, the court system now manages to settle only a fraction of that number and takes longer to reach a decision.

The combination of actual rule-of-law issues with the exaggerated perception of problems by the international business community creates a binding constraint to investment and growth in Kosovo.

3.3. Environmental services

Due to the confluence of factors in the health, water, and energy sectors that fall on the same branch of the growth diagnostics constraints tree, the threshold development team identified a constraint, “environmental services,” that captures the effect of related problems in these three sectors. Kosovo faces high levels of environmental contamination from a variety of sources, including electricity production (both through emissions affecting air quality and leaching of heavy metals and other contaminants into groundwater from coal-mining operations), other mining and industry (dumping lead and other heavy metals into the soil, water, and air), leaded gas vehicles, and unregulated or illegal solid waste removal. Coal-fired power plant Kosovo A is one of the most polluting power plants in Europe. All the rivers in Kosovo are classified as excessively polluted and have high levels of both bacteriological matter and heavy metals. Other contaminants are several times higher than established safe limits. While access to piped water in Kosovo is high—almost 98 percent of households have access—there are very few municipal wastewater treatment plants and very low access to other sanitation services, like solid waste disposal. According to our consultations with key stakeholders, Kosovo is not expected to meet requirements for EU accession without significant investments to strengthen implementation of new environmental laws aligned with EU standards.

Unfortunately, there is a lack of concrete and comparable data on health outcomes in Kosovo, in part because Kosovo is not included in WHO Global Burden of Disease statistics (http://www.who.int/topics/global_burden_of_disease/en/). Although a fair amount about the levels of contamination present in Kosovo is known, there is little information about the effect of these contaminants on productivity. Forty percent of respiratory incidents (due to both disbursed and point-source emissions) that require hospital visits are from the working-age population, but without international comparison, it is hard to know if that is a high number. Women's groups noted in consultation with the teams that lack of access to high-quality health care is a critical concern, not only due to gender-specific impacts on health outcomes but also due to the increased burden of care that health issues impose upon women. Firms have not complained about health preventing people from working but have complained about the cost of water and are required in some cases to do their own wastewater treatment. Some firms report digging their own wells to get around those costs.

Environmental contamination does not seem to be affecting farmers and other producers for now. For instance, being able to meet phytosanitary requirements to export agricultural goods to Europe does not currently rise to the level of a constraint. However, without investment to stem environmental contaminants, this could change. Levels of contamination are clearly high, but it is difficult at this point to rule environmental health definitely or definitely not a binding constraint to growth and investment. We recommend including it as a binding constraint pending further analysis and data collection on possible ramifications and whether they are borne out in Kosovo.

3.4 Nonbinding Constraints Examined

The following constraints were considered problematic for the Kosovo economy but did not rise to the level of being binding. There is no strict criteria for ranking the constraints, but the following analysis explains the main reasons why each is considered non-binding.

3.4.1 Education

Education is a top priority for the government of Kosovo, with development of human capital as one of the five strategic objectives in Kosovo's National Development Strategy (2016–2021). In the latest UNDP Human Development Index (HDI), Kosovo ranked 87th in the world, behind all other countries in the region, and performed poorly in the Program for International Student Assessment (PISA; 2016). Nevertheless, compared to all nations, Kosovo is on trend (Kosovo scores are consistent with those of the countries with similar level of development, meaning on per capita income basis) in all indicators except primary school enrollment, in which it is comparatively low. Kosovo is equal to comparator countries in secondary school enrollment. We therefore conclude that access to education is not a binding constraint. However, ethnic minorities—including the Roma, Ashkali and Egyptians—have markedly lower enrollment and completion rates for primary and secondary education. Females in minority communities are additionally disadvantaged for reasons that include the cultural preference for girls to stay home and the continued prevalence of early marriage.

While access to education is not a major concern, the quality of education is generally considered low (OECD, 2016). If the lack of human capital was a binding constraint for investment, there would be a lot of competition among firms for scarce skilled labor. This would in turn be reflected in markedly lower unemployment rates for skilled workers, a rise in wages, and significant inflows of skilled workers into Kosovo. In fact, returns to education are not particularly high (Kosovo is below all international average levels), and though unemployment rates fall with level of education, employment rates for all education levels are still high. Returns to education are higher for females and are particularly high for well-educated females, but this is a standard result across all countries. With an unemployment rate of 33 percent (KAS, 2016) and approximately 25,000 new labor market entrants per year, Kosovo has a surplus in its labor force. Additionally, evidence suggests that citizens of Kosovo—both men and women—have higher employment levels when they emigrate than when they stay in Kosovo. While there is probably some selection bias (émigrés may consist of relatively more employable Kosovars), it implies that education standards are not preventing access to European labor markets.

Additionally, businesses in Kosovo do not report extensive importing of skilled workers other than for specialized activities, such as fixing imported equipment, in which small countries generally lack expertise.

While education quality is not as high as the rest of Europe, it is unlikely that the addition of higher skilled workers would, in and of itself, increase growth and investment. Therefore, we conclude that Kosovo's challenge is primarily one of insufficient demand for skilled labor, most likely as a result of other binding constraints described above.

3.4.2. Low Labor Force Participation for Women

The labor force participation rate for women in Kosovo is the lowest in the region and among the lowest in the world, putting Kosovo on par with countries such as Bahrain, Pakistan, and Saudi Arabia. Although 61.8 percent of men are in the labor market, and their participation is just slightly below regional neighbors, only 21.4 percent of women in Kosovo are in the labor force. The employment rate for women is 12.5 percent, compared to 41.3 percent for men, giving Kosovo the highest gender gap in employment in the region.

Other related indicators show similar gender gaps. Women own only 10 percent of enterprises in Kosovo, compared to a global average of about 37 percent. Women also hold very few management positions in Kosovo. Just 7.2 percent of firms in Kosovo have a women top manager, compared to 18.5 percent globally and 18.7 percent in Eastern and Central Europe (World Bank, Enterprise Survey, 2013). Available data indicates that educated women emigrate at higher rates than less well-educated women. Women emigrants are also more likely to work while abroad than women who remain in Kosovo. Thirty-four percent of working age migrant women are employed compared to 12.4 percent of women employed in Kosovo, indicating that there are barriers to women attaining work in Kosovo (UNDP, 2014). In recent surveys, women cite "personal and family responsibilities" as the main reason for being inactive in the labor force. Overall, there is evidence that gender inequalities rooted in cultural attitudes and practices and amplified by institutional and policy-based

barriers and incentives limit women's economic participation and contribution. However, we conclude that the low participation rate for women does not result in a human capital deficit that rises to the level of a binding constraint, primarily because unemployment rates across the board and for women are high.

The low participation of women in the labor market, while not a binding constraint, is a critical cross-cutting concern that will impact the ability to ensure inclusive growth and job creation in Kosovo and maximize the country's human and economic development.

3.4.3. Access to Finance

Access to finance improved significantly in 2015/2016 and does not appear to be a binding constraint, especially for medium and large firms. The introduction of the private bailiff system in late 2014 resulted in significantly lower real interest rates. The banking sector now has plenty of liquidity, and investment lending has grown significantly with the decline in lending rates and their alignment with rates prevailing in comparator countries. The percentage of firms using commercial bank loans for financing is very high with respect to comparator countries. Nevertheless, most formal financing is used for working capital, and firms complained in consultations with the teams about the lack of access to investment funds or venture capital.

As is common in most developing countries, smaller firms in Kosovo may face challenges in accessing formal credit. In addition to being charged higher interest rates, smaller farms and businesses—and women-owned firms, in particular—find documentary and collateral requirements difficult to fulfill. There is no credit bureau coverage, and banks complain that small and medium firms commonly have multiple books, making it difficult for banks to assess loan applications. The preference among banks to lend to larger, audited firms may explain why the rate of nonperforming loans in Kosovo is comparatively very low. During consultations with women's groups and businesses, lack of access to finance was cited as a key obstacle for them, in part due to lower rates of asset ownership. Due to cultural norms, property owned by women is often registered in a male relative's name.

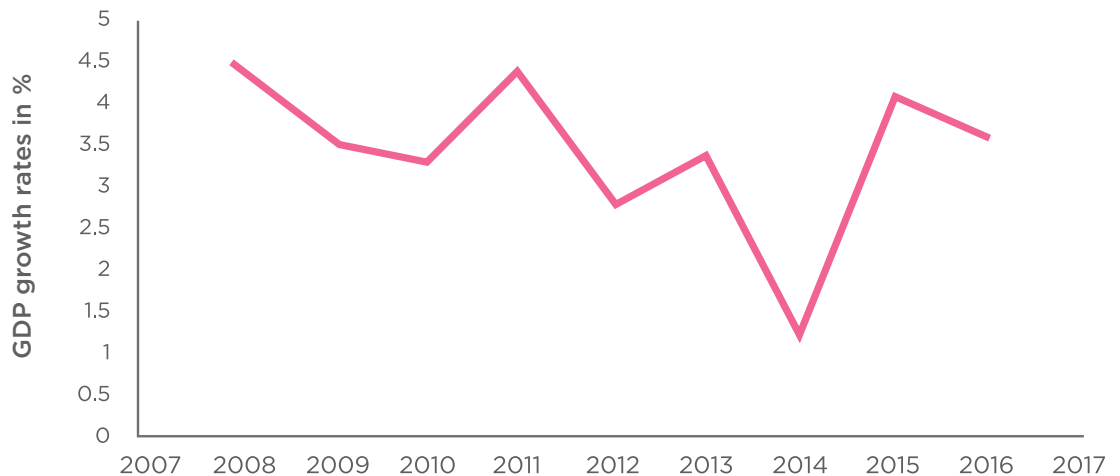
Overview of Kosovo's Economy

This chapter presents a brief overview of Kosovo's economic history and key features of the current economy. Understanding Kosovo's exceptional economic context helps assess its potential constraints to economic growth.

Kosovo is a small developing country, located in southeast Europe on the Balkan Peninsula, with a population of 1.8 million, spread across 10,908 km², making it one of the most densely populated countries in the region. Ethnic Albanians make up the majority of the population (92 percent), while the largest minority is represented by ethnic Serbs (5 percent). Kosovo is the youngest country in Europe in terms of both history and demographics. Kosovo is one of the youngest states worldwide, becoming fully independent only in 2008. Its population is also one of the youngest, with a median age of 27 years and about 38 percent of the population under age 19 years. With a GDP per capita of €2,935 (~US\$3,283; Government of Kosovo, 2016) and average income around €360 (~US\$402) per month, Kosovo is also one of the poorest countries in Europe. According to the Kosovo Agency of Statistics (KAS; 2011), approximately 30 percent of the population is living below the national poverty line. While growth has not been fast enough for the country to converge with the level of wealth of comparator countries, growth has been remarkably stable. Kosovo was one of only four countries in Europe to record positive growth rates in the years following the global financial crisis of 2007–2008, with average annual growth of 3.5 percent since 2008. Performance in 2014 was an outlier, when real growth declined to 1.2 percent (figure 2), mainly caused by specific factors reflecting blockages caused by the prolonged creation of the government after the June 2014 general elections and a decrease in total investments. Growth, however, recovered to about 4 percent in 2015. Private consumption was the main driver of growth, which was fueled by the growth in remittances, public sector wages, and social

transfers. The inflows of remittances have enhanced the stability of the economy and financed most of the country's trade deficit. Investments, which lag behind savings, have flowed mainly into residential and commercial construction (Central Bank, 2016). Annual flows of foreign direct investment remain below levels received by comparable countries (figure 3).

Figure 2. GDP growth rates 2008–2016.



Source: Kosovo Agency for Statistics (2016)

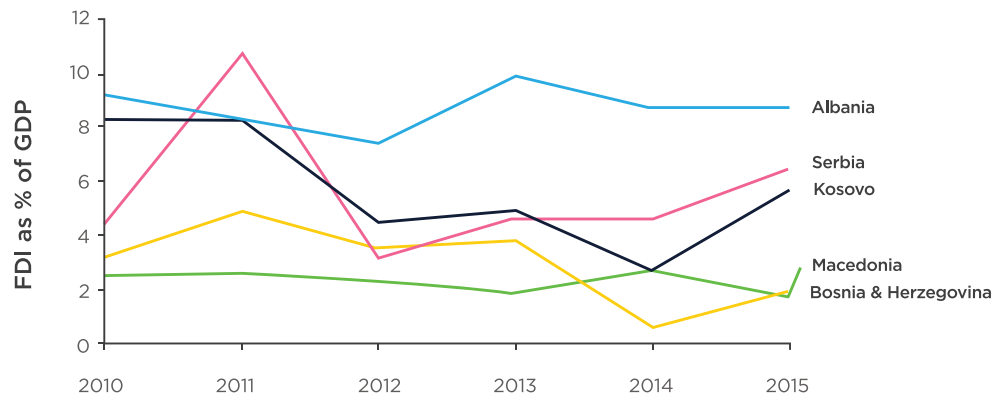
Note: GDP = gross domestic product.

Economic policies and reforms are continuously oriented towards strengthening the country's legal and institutional framework and the public infrastructure to be in line with the political objective of joining the EU. In 2013, the EU opened negotiations with Kosovo on a Stabilization and Association Agreement (SAA). The SAA with the EU, the first formal step toward eventual EU membership, was initiated by both parties in July 2014 and signed in October 2015. SAA implementation started in April 2016. In parallel, talks are taking place on visa liberalization, while Kosovo remains the only country in Southeastern Europe whose citizens require a visa to travel to the Schengen Area,¹¹ representing a distinct disadvantage relative to neighboring countries in the Western Balkans.

Kosovo is a service-oriented economy, with services making up around 70 percent of GDP, and is not as intensive in agriculture as might be expected (see figure 4). Agriculture makes up only around 12 percent of GDP (KAS, 2016), while industry makes up around 13 percent of GDP. However, the agricultural sector plays an important role in economic development and employment. Currently around 27 percent of workers are estimated to be in agriculture, and agricultural products constitute around 12 percent of total export value. Despite investments in the agricultural sector, Kosovo is still facing negative trade deficits of agricultural products (KAS, 2016). Imports of agricultural products remain relatively high, accounting for about 10 percent of all imports. Kosovo is one of the largest importers of food per capita in Europe.

¹¹ The Schengen Area consists of all EU member countries except Bulgaria, Croatia, Cyprus, Ireland, Romania, and the United Kingdom. It also includes Iceland, Liechtenstein, Norway, Switzerland, and, de facto, Andorra, Monaco, San Marino, and the Vatican.

Figure 3. FDI net inflows as percentage of GDP, 2010–2015.

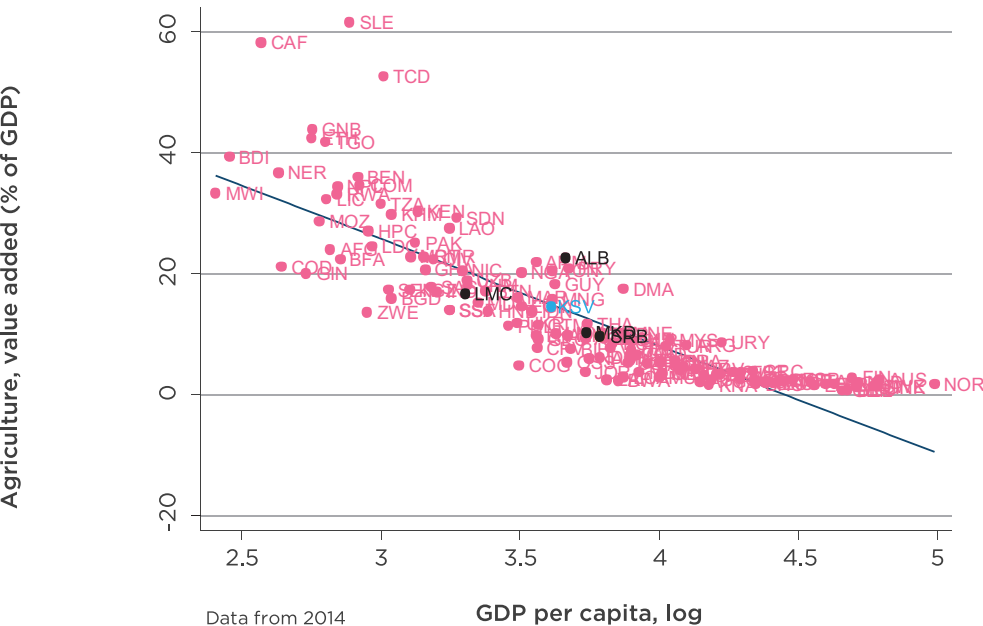


Source: World Bank WGI (2016)

Note: FDI = foreign direct investment; GDP = gross domestic product.

Kosovo's manufacturing sector continues to face low level of external competitiveness due to internal and external factors. The manufacturing sector's share of GDP is comparable to some countries in the region, but taking into account the development needs, including the need to create jobs, it is low. Recent data indicate that the sector with the largest number of workers and the highest turnover in 2015 remains the food industry, followed by the mineral nonmetallic products sector (KAS, 2016).

Figure 4. Agriculture, value added (percent of GDP).



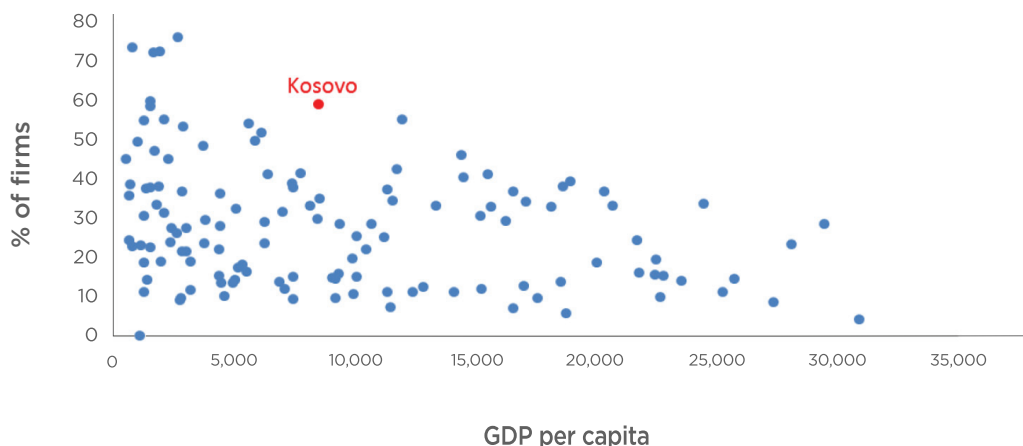
Source: World Bank data (2014) and MCC calculations. GDP = gross domestic product.

In recent years, development of the services sector had a significant effect on the economy of the country, mainly by closing the huge trade deficit and reducing other structural problems in the economy, especially unemployment. In the last decade, export of services was much higher than imports, and in some years the difference was twice the value of the imports.

The informal sector in Kosovo is considered large, although data is poor. More data is needed about many aspects of Kosovo’s informal economy, especially better estimates of the size of the informal economy. Analysis of firm-level data (World Bank 2016; Business

Environment and Enterprise Performance Survey, 2013) reveals that the share of firms that are severely affected¹² by the informal sector is one of the largest in the world (see figure 5). Furthermore, a comparison with other countries in the region reveals that this level is the highest in the region (World Bank, 2016). According to the World Bank (2016), approximately 35 percent of workers in Kosovo are engaged in informal employment. Typically, these are workers in small firms, unpaid family workers, and self-employed people in either small firms or non-professional occupations.

Figure 5. Firms severely affected by informality of competitors.



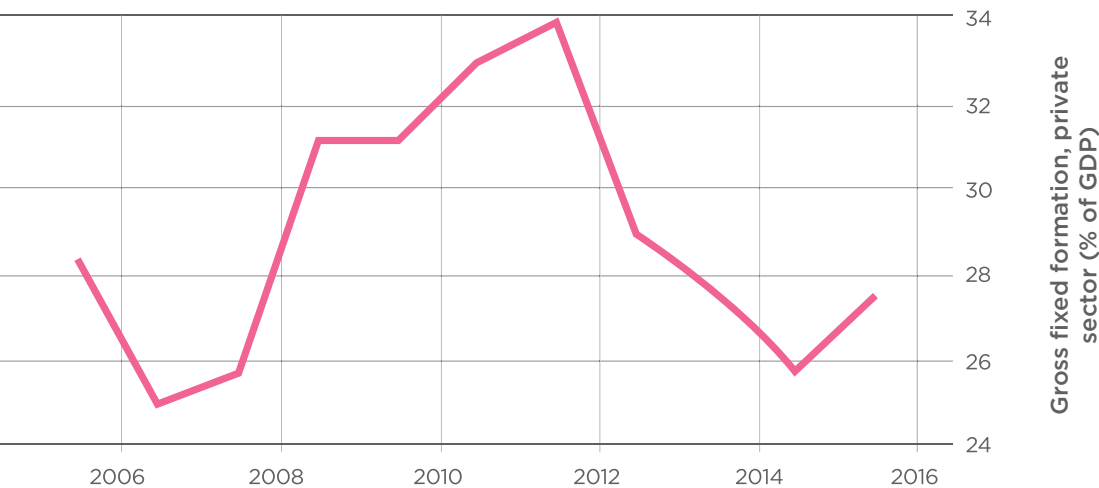
Source: World Bank (2016); Winkler, Ajwad, and Vasquez, forthcoming, based on the Business Environment and Enterprise Performance Survey (BEEPS) database, European Bank for Reconstruction and Development and World Bank, London, <http://ebrd-beeps.com/data/>, circa 2013, and World Development Indicators database.

Note: GDP = gross domestic product

¹² Substantial cost advantages that informal companies gain by avoiding taxes and regulations distorts the competition, because inefficient informal players stay in business and prevent more productive, formal companies from gaining market share.

Investments are crucial for Kosovo’s economic growth but has been declining in recent years (see figure 6). Public investments have increased every year, balancing the reduction in private investments (especially foreign direct investment [FDI]). Low levels of FDI in Kosovo continue to hamper growth. Despite rapid and continued improvement in its business climate since 2011, Kosovo receives less FDI than its regional peers. To illustrate, Kosovo’s FDI inflows are 5.6 percent of its GDP, while Albania, which has a less attractive enabling environment according to the World Bank, has 8.6 percent (figure 3).

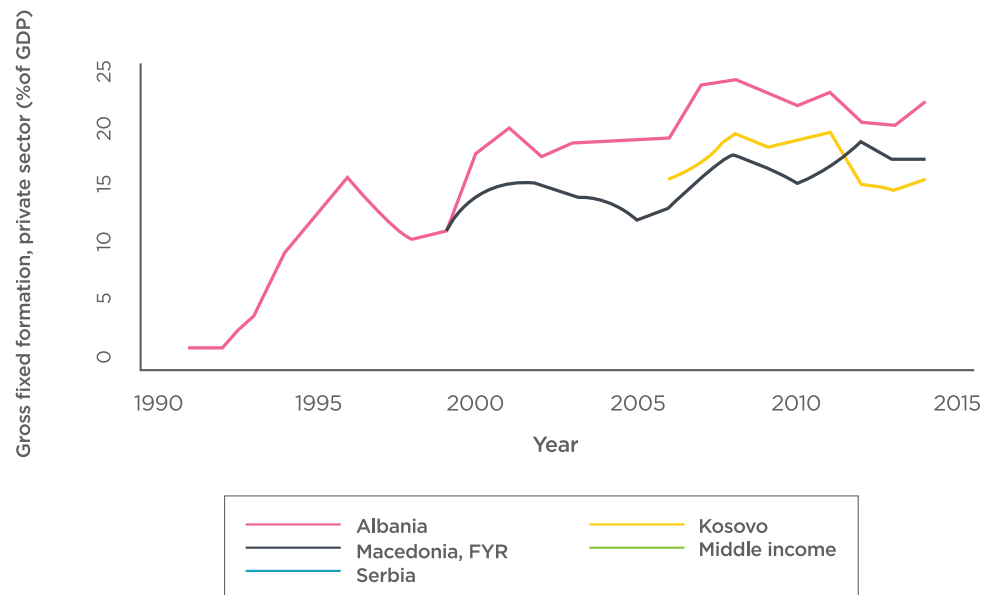
Figure 6. Kosovo’s gross fixed capital formation (investments) by private sector as percentage of GDP, 2005–2015.



Source: Central Bank of Kosovo (2016)
Note: GDP = gross domestic product.

To understand how reputational issues suppress FDI in Kosovo, Dalberg (2016) compared investor perceptions of Kosovo to on-the-ground realities. What they found is that, although there are a number of reasons that Kosovo may be a less attractive market than other countries (for example, small domestic market, lack of recognition by a large number of countries), the gap between perception and reality appears important in Kosovo.

Figure 7. Gross fixed capital formation (investments) by private sector as percentage of GDP, compared with other countries.



Source: World Bank open data

Note: GDP = gross domestic product.

Note: Middle income = middle income countries.

The report prepared by Dalberg¹³ (2016) suggests that Kosovo is, indeed, struggling with major reputational issues. The most salient perceptions include concerns over physical security, high levels of corruption (for example, bribes, nepotism, and exchanges of favors), and, to a lesser extent, lack of short-to medium-term political stability. These perceptions are perpetuated by a widespread confirmation bias held by international audiences related to Kosovo’s legacy of war and are reinforced by local newspapers, especially those associated with Serbia, with an incentive to make Kosovo look bad. Some of these issues (for example, questions about physical security, threat of war, and political stability) are clearly not as bad as the perception, but others, namely government corruption and the attractiveness of the domestic market, are real.

Table 1. Regional *Doing Business* rankings, 2010–2016.

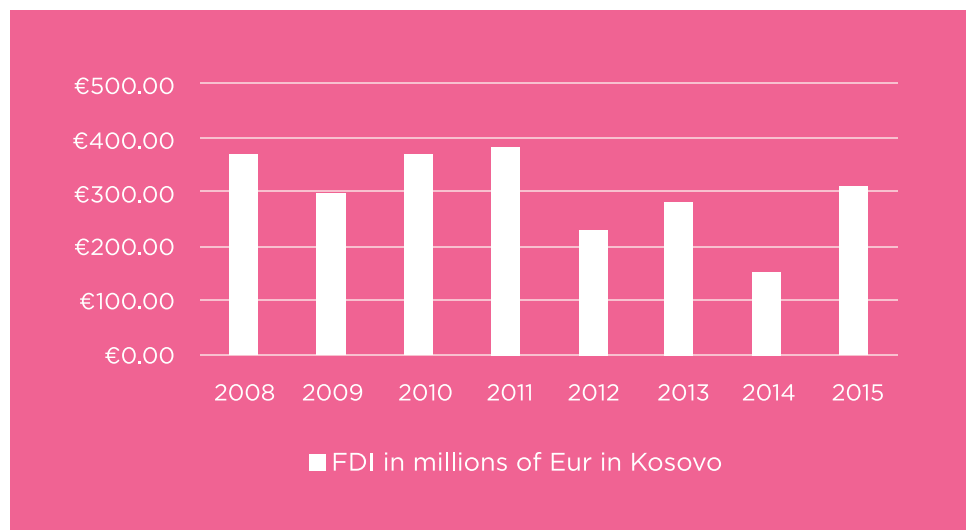
Country	2010	2011	2012	2013	2014	2015	2016	Change in ranking
Kosovo	118	117	117	98	86	75	66	+52
Bosnia & Herzegovina	110	127	125	126	131	107	79	+31
Serbia	90	88	92	86	93	91	59	+31
Macedonia	36	34	22	23	25	30	12	+24
Albania	81	77	82	85	90	68	97	-16

Source: World Bank Doing Business Report (2010–2016),<http://www.doingbusiness.org/>.

¹³ Unpublished internal report developed by Dalberg for MCC.

Government attempts to reduce corruption and increase transparency (for example, via e-procurement) are welcome, but interviewees typically expressed skepticism that these efforts will ameliorate the current situation. Both the perceived and real issues are hindering investment, albeit in different ways. The perceived image-related issues seem to have a greater impact on smaller companies, which not only have distorted views of Kosovo's image but simultaneously have a limited understanding of the market opportunities. For large multinational companies considering Kosovo, the issue of corruption is paramount. Although not always the case, many large companies decide not to invest at all or to impose a full ban on government tenders given the associated reputational risks.

Figure 8. Foreign direct investment in Kosovo (in millions of EUR).

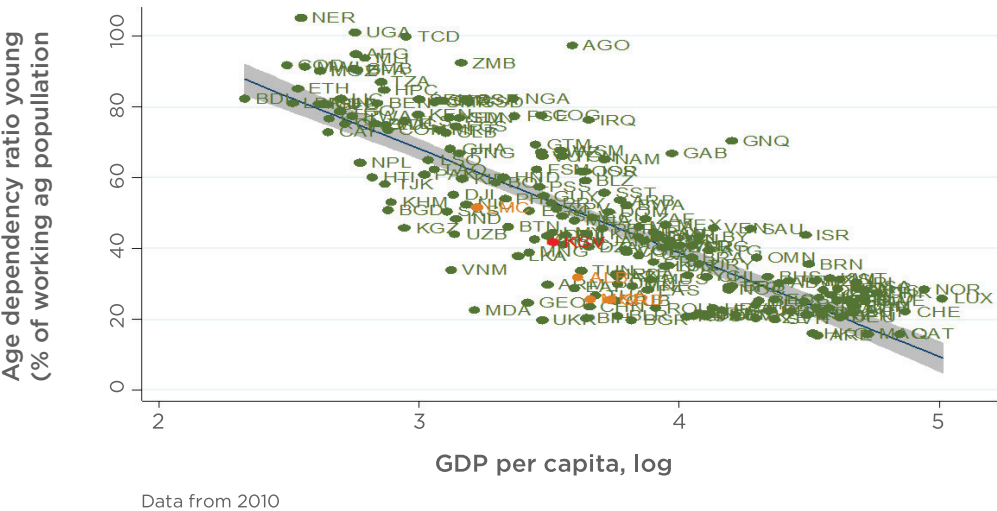


Source: Central Bank of Kosovo data (2016)

Note: EUR = euros; FDI = foreign direct investment.

In terms of dependency ratio, Kosovo stands below the worldwide trend, but much higher than its comparator countries, such as Albania, Serbia or FYR Macedonia (figure 9). Dependency ratios indicate the potential effects of changes in population age structures for social and economic development, pointing out broad trends in social support needs.

Figure 9. Age dependency ratio.



Source: World Bank data (2010).

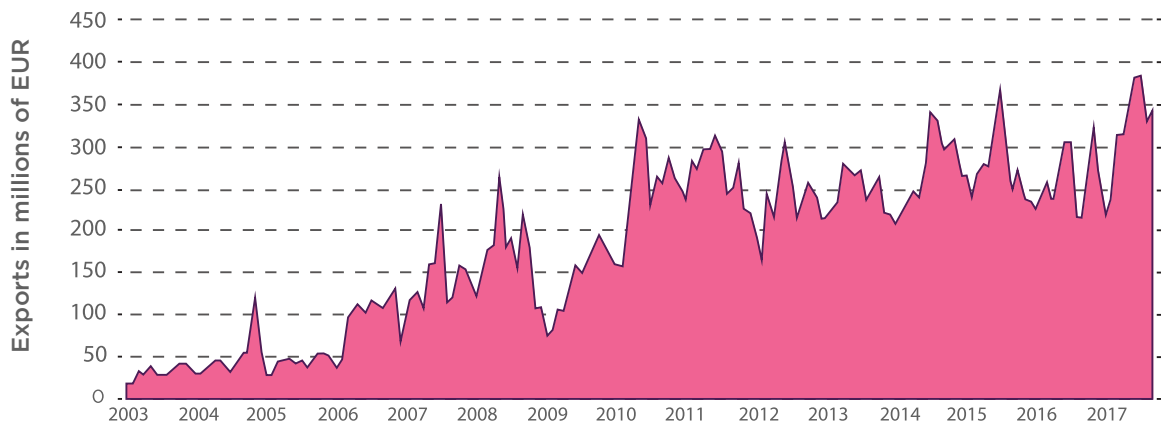
Note: GDP = gross domestic product.

Kosovo is rich in natural resources. Specifically, Kosovo owns large reserves of lignite, lead, zinc, silver, nickel, cobalt, copper, iron, and bauxite. Kosovo is also rich in high-quality construction minerals, such as granite, diabase, andesite, basalt, gabbro, and limestone. Kosovo’s minerals sector was the economy’s key growth engine in the 1960s and 1970s, providing employment to around 20,000 workers. Access to natural resources is one of the major factors in attracting

FDI. Development and exploration of existing mines in Kosovo are opportunities to increase employment and standard of living, allow development of industries, and increase exports and, hence, GDP. The value of Kosovo minerals is estimated at €12.5–€25 billion (Government of Kosovo, 2015). However, these resources have not been used efficiently to support economic growth. There are several constraints to full utilization of mining potential in Kosovo. One of the most striking remains the need to invest in new technologies and enter new markets and resolve the property rights which disable the potential for FDI and exploration. Other factors affecting this sector are the processes for licenses and permits, lack of consistency of mining policies, and stability of exploratory environment, all related to administration.

Kosovo's exports are relatively limited (figure 10). There was a flat performance in recent years, showing weak capacities of the country to compete in the regional and global markets. Kosovo has recently increased its export share in Serbia and FYR Macedonia and decreased its market share in EU countries.

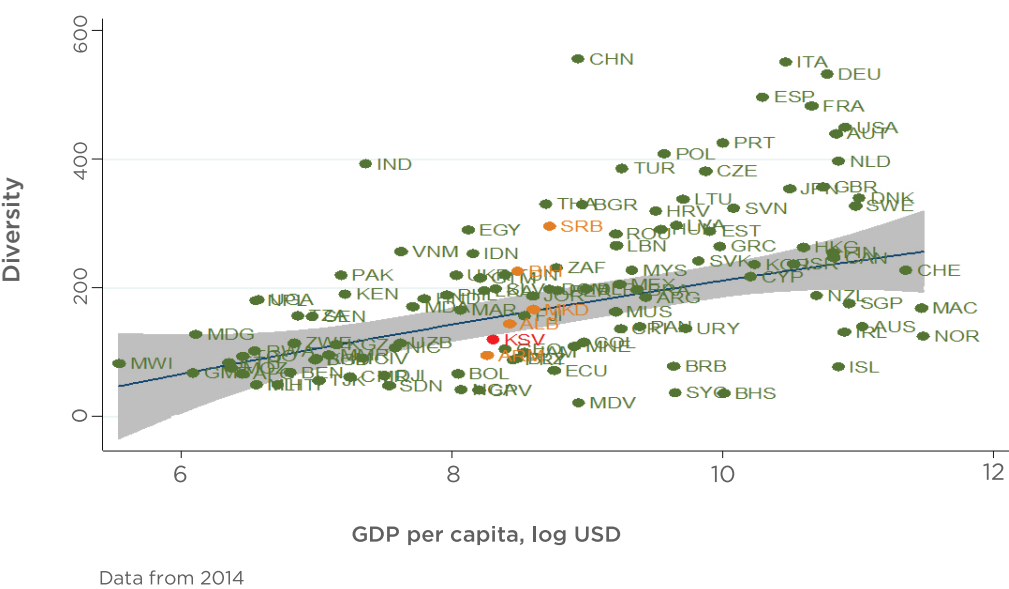
Figure 10. Kosovo exports in recent years.



Source: Kosovo Agency for Statistics (2017)

As already discussed, export markets are not diversified. The top five export destinations accounted for more than 60 percent of Kosovo's exports of merchandise in 2016. Product concentration is also high: only one product, ferronickel, accounts for almost 40 percent of total exports. Kosovo is below the worldwide trend in terms of export diversity (red dot in figure 11).

Figure 11. The diversity of Kosovo's export basket, 2014.



Source: World Bank data (2015)

Note: GDP = gross domestic product; USD = U.S. dollars.

According to the World Bank (2016) the Herfindahl Index (a measure of concentration of exports for Kosovo rose from 23 percent in 2008 to 30 percent in 2013, based on 21 export categories. The share of the top 5 export categories in total exports increased from 81 percent to 86 percent over the same period.

Countries can benefit substantially from emigration through remittances. Kosovo is a top 10 global remittance-receiving country, and just over 20 percent of households receive remittances. Remittances have increased over the past decade, representing three times FDI inflows and approximately 13 percent of GDP. Approximately 11 percent of remittances are used for investment, and they account for 67 percent of private sector transfers (Dobruna and others 2015; Möllers and Meyer 2014). Although remittances have a negligible impact on the most severely disadvantaged people, approximately 10 percent of Kosovar households claim that remittances are their primary income source (KAS 2010, in Möllers and Meyer, 2014) and around 40 percent of households with a migrant family member are lifted above the poverty threshold by the income gained (Möllers and Meyer, 2014). According to 2011 data from UNDP (2012a), the majority of migrants are males (67.5 percent). There remains a distinct lack of data on gendered experience in migration.

Poverty and joblessness have spurred migration. In a UNDP survey, among respondents' ages 18–36 years, approximately half expressed a desire to migrate (2014c). These sentiments were manifest in December 2014 through February 2015 when, following a loosening of restrictions for Serbs entering the EU and for Kosovars entering Serbia, anywhere between 50,000 and 100,000 Kosovars left the country (Dobruna and others, 2015), a figure that the World Bank (2015b) cites as 5 percent of Kosovo's population. Seventy percent of respondents cited economic issues as the primary factor, and just over half cited a lack of faith in Kosovo's institutions (in Dobruna and others, 2015). Returning individuals are vulnerable to impoverishment and require assistance, especially men, who are more likely to illegally emigrate and to be returned (Dobruna and others, 2015; Färnsveden and others, 2014).

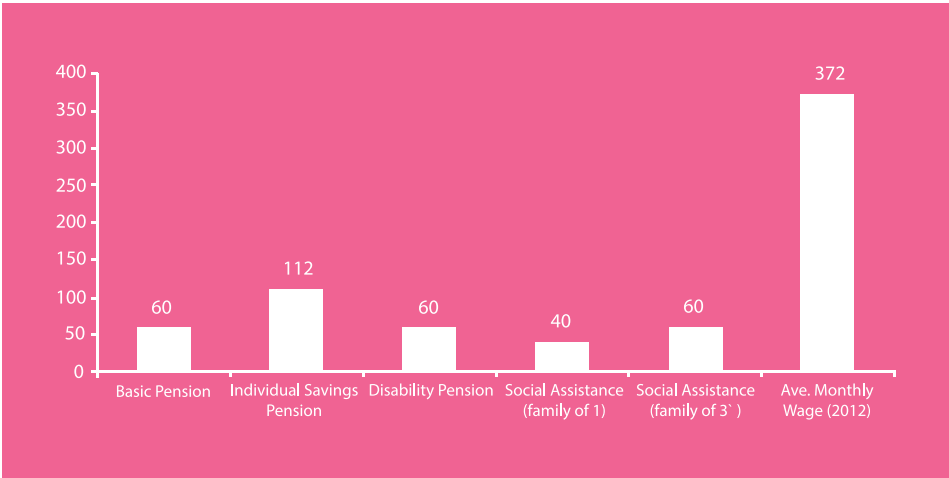
As a percentage to GDP, Kosovo's public debt is 12.5 percent (GOK, 2016). Despite the moderate growth of the debt in recent five years, this debt level ranks Kosovo as the country with the lowest level of public debt compared to other countries in the region. According to International Monetary Fund (IMF) estimates, the average public debt in southeastern Europe in 2015 was 60.5 percent of GDP. The position of the current and capital account in Kosovo deteriorated continuously, due to the high deficit in trade of goods. At the same time, the positive balance of services trade and the categories such as primary and secondary income continued to contribute to narrowing the trade deficit. The deficit of the current and capital account reached around 7.3 percent of GDP in 2015 (Central Bank of Kosovo, 2016).

Kosovo's economy is characterized by a continuous increase in trading activity, namely an increase of the value of total exports and imports of goods and services. The degree of trade openness (defined as $(X+M)/Y$) reached around 70 percent in 2015 (CBK, 2016). Kosovo's main trade partners are its neighbors, through the Central European Free Trade Agreement (CEFTA; approximately 27 percent of imports and 47 percent of exports), and EU countries (approximately 43 percent of imports and 31 percent of exports).

Kosovo continues to run a large trade deficit, with exports covering only about 12 percent of imports. Around 43 percent of exports are made up of base metals and articles made thereof; 12 percent are mineral products; 10 percent are processed food items, beverages, and tobacco; 9 percent are plastics and rubber; and the rest is leather and articles made thereof (KAS, 2017). In contrast, according to KAS (2017), around 14 percent of imports are mineral products; 12 percent are machinery and mechanical and electrical equipment; 12 percent are food, beverages, and tobacco; 10.4 percent are basic metals and articles made thereof; 9.4 percent are chemical industry products; 7.7 percent are means of transport; 6.8 percent are plastics and rubber and articles made thereof; 5.7 percent are plant products, and so forth.

The poverty rate at the national poverty line, having fluctuated between 35 percent and 45 percent before 2008, fell to 30 percent in 2011. More recent official poverty estimates are not yet available, but initial indications are that poverty continued to decline after that. According to KAS (2016) around 30 percent of the population was living below the national poverty line of €1.72 a day in 2011, while 10 percent were living below the national extreme poverty line of €1.20 a day. Opportunities for social mobility are extremely scarce among marginalized groups (for example, the Roma, Ashkali, and Egyptian [RAE] communities, who continue to face major challenges in their socioeconomic circumstances, lacking education and facing discrimination from the general public. In Kosovo, women are only marginally more likely to be poor than men (30.3 percent compared to 29.2 percent) but women-headed households are notably more likely to be poor than those headed by men (39.8 percent and 29 percent respectively). Children in women-headed households are less likely to be poor (cited in Färnsveden and others, 2014), and overall children are more likely to live in impoverished conditions (Warlich, 2013). Other groups with disproportionate levels of poverty include the elderly, households with a disabled family member, minority households (World Bank, 2015b), and those with low education. Poverty does not significantly differ across the urban and rural divide, but differs by region, with Mitrovica facing the greatest poverty (JICA, 2010). Weak social insurance and welfare programs exacerbate these challenges. Nationally, in the aggregate, social welfare benefits comprise 1 percent of individual incomes (KAS, 2016a). Kosovo does not have unemployment or child benefits (with limited exception to the latter), and young families, in particular women, tend to suffer from a lack of childcare support. The social assistance benefits that do exist include those for disability, war veterans, and small transfers for the poorest citizens, among whom 23 percent receive social assistance, in contrast to the government's objective of reaching 78 percent of such citizens (Dobruna and others, 2015).

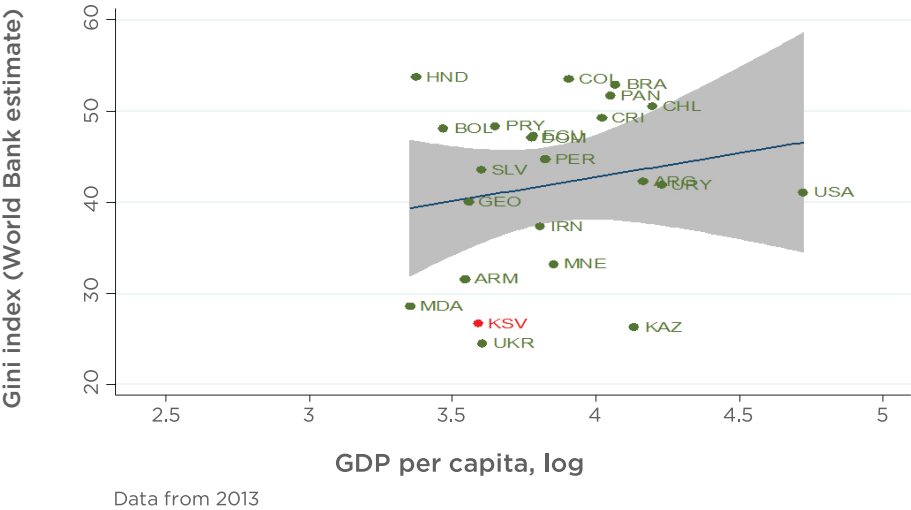
Figure 12. Monthly amounts of benefits (2012).



Source: UNDP (2014)

The Gini index reflects improvement in income distribution in recent years, falling from 30.3 to 27.6 during the period 2010 - 2013 (World Bank, 2016). Kosovo is well below the worldwide trend, in terms of Gini index (figure 13).

Figure 13. Gini index of Kosovo in comparison to other countries.



Source: World Bank data (2013) and MCC calculations.

Note: GDP = gross domestic product; KSV = Kosovo.

The employment rate (26.9 percent) and the labor force participation rate (41.6 percent) have remained extremely low and stagnant (KAS, 2016). Kosovo's young population represents both a promising resource on which to base future growth, as well as a growing source of concern. With unemployment of people ages 15 to 24 years at 58 percent, the economy has not shown the ability to create enough opportunities to employ the country's youth. Furthermore, the female labor force participation rate is the lowest in the region and among the lowest in the world.

Kosovo's Innovation and Export Diversity

It is useful to examine a country's productive structure and ask if the country's current mix of exports will be able to drive growth, or alternatively, if the country needs to discover new products for growth to occur. The question can also be whether the country can grow through the intensive margin or whether extensive margin growth is required.

Extensive margin growth is growth through developing new products and services that are not currently produced in the country. Developing new sectors in which a country is competitive can be a critical driver of growth. However, extensive margin growth faces challenges of self-discovery (identifying which opportunities are profitable) and coordination (coordinating complementary investments in human capital, supply chain, government services, and so forth).

If a country's current mix of products is sufficient to support higher levels of income (that is, there is enough complexity) growth can be driven by the **intensive margin**—growth through simply making more of the products and services already being produced in the country. In this situation, a capital accumulation approach of the growth diagnostic methodology can be pursued without consideration for the potential coordination problems and self-discovery problems that arise with investment in the extensive margin.

One of the most effective metrics for examining the need for intensive versus extensive margin growth **is economic complexity**.¹⁴

¹⁴ Economic complexity is expressed in the composition of a country's productive output and reflects the structures that emerge to hold and combine knowledge (Hausmann and others, 2006).

When complexity is high relative to GDP per capita, countries can grow through the intensive margin. In lower complexity economies, extensive margin growth is required to find new products and services that can support higher levels of income per capita.

As a first step of considering whether Kosovo's productive structure can support higher incomes, we look at how diverse production is. High levels of diversity imply higher complexity. Figure 11 above shows that Kosovo's economy is slightly less diverse than other economies at similar levels of income. However, this measure of diversity is a simple count of the number of products produced by each country; it does not consider the differences between products and the implication those differences hold for complexity.

Refining the measure of diversity requires asking how ubiquitous each of the products a country produces is. Ubiquitous products are those that many other countries currently produce. Products that are ubiquitous imply a lower value for a country's overall economic complexity than do products that few other countries are able to produce. Using this metric, Kosovo's export products are somewhat ubiquitous, but are comparable to other countries at similar levels of income. It is notable, however, that strong performing economies such as China (CHN in figure 14) are producing significantly less ubiquitous products than Kosovo, which likely benefits China's ability to grow in those products as they face less international competition. To illustrate, consider an industry such as textiles, which makes up 10 percent of Kosovo's export basket. This industry is ubiquitous—many countries produce textiles—and as such it faces significant competition. Therefore, although textiles can be an important contributor to growth, it is a difficult sector to drive growth into upper-middle-income status.

Figure 14. The average ubiquity of products in Kosovo and other countries, 2014.



Data from 2014

Source: World Bank data (2014)

Note: CHN = China; GDP = gross domestic product; KSV = Kosovo.

These two measures, diversity and average ubiquity, can be combined into one measure—overall complexity.¹⁵ This gives a summary statistic of whether there is enough complexity to support growth in existing industries. As shown in figure 15, given Kosovo's level of economic complexity, other countries have achieved higher levels of GDP. This suggests that Kosovo has room to grow at its current level of economic complexity.

¹⁵ For an in depth discussion of complexity metrics, see The Atlas of Economic Complexity, Mapping Paths to Prosperity, by Ricardo Hausmann, and others (2014)

Figure 15. GDP per capita as a function of the Economic Complexity Index.



Data from 2014

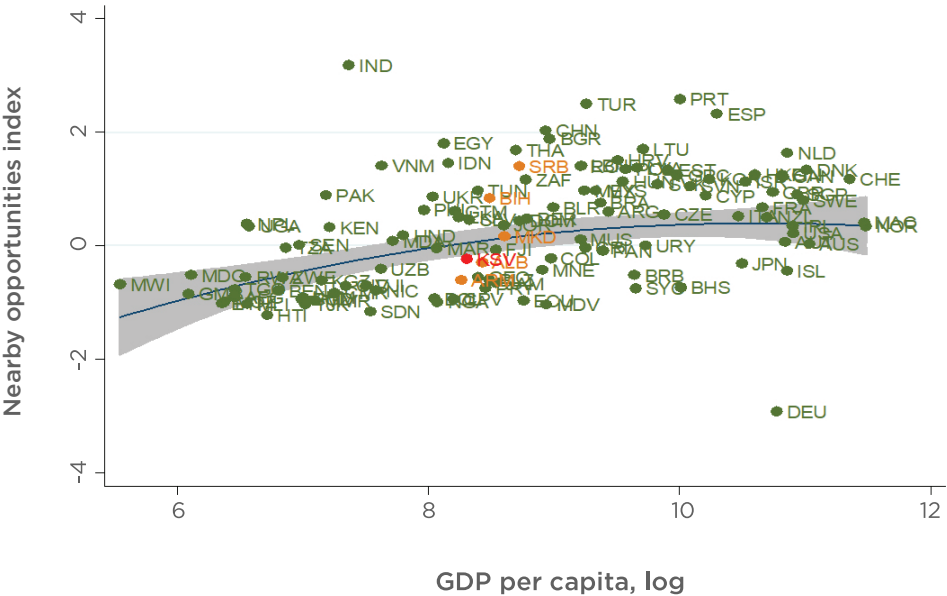
Source: World Bank data MCC calculations.

Note: This graph has GDP per capita on the Y axis to illustrate income as a function of ECI

In addition to current complexity, it is useful to examine how difficult it is to increase complexity by adding new products. Production of new products often builds on capabilities present in existing products (or services). The relatedness of all products has been established through literature on the product space (for example, Hausmann and others, 2014), which can be used to assess how many new opportunities Kosovo has that closely build on existing products. As illustrated in figure 16, it appears that Kosovo’s existing productive structure provides relatively few opportunities for new activities. To illustrate this concept, consider metals, which make up considerable proportion of the country’s basket. While metals may

include relatively complex industries, the underlying capabilities tend not to spill over into new sectors. In contrast, data suggest that an industry like crank-shaft production is highly related to various other industries, including power tools, furnaces, and tractors.

Figure 16. Nearby Opportunities Index, 2014.



Data from 2014

Source: World Bank data (2014)

Note: CHN = China; GDP = gross domestic product; KSV = Kosovo.

The analysis above utilizes international trade data, which does not capture the services sector very well. Therefore, it is important to consider that Kosovo’s growth in the area of tradeable services like information technology is likely an encouraging sign of the economy’s level of economic complexity.

Does Costly Finance Pose a Binding Constraint to Kosovo's Growth?

This chapter examines whether access to finance is a binding constraint to Kosovo's economy. The chapter further explores the underlying institutional and policy issues that may constrain the flow of investment finance in the economy of Kosovo.

Rather than just looking at issues in the supply of finance, the constraints analysis methodology weighs the supply side against the demand situation in the finance market. The supply side can be constrained by inability to assess risk, lack of competition in the financial system, low savings, and so forth. The demand side can be constrained by lack of infrastructure, tax policy, or myriad other constraints that reduce the number of profitable investment opportunities in a given country. Thus, the quality of the demand for finance is affected by other branches of the diagnostic tree. Weighing these factors, we find that the supply of finance is not a binding constraint holding back investment and growth relative to the other constraints identified herein that affect the demand for finance.

As the financial sector is predominated by banking, examining the indicators on lending practices, banking products, and interest rates, as well as the regulatory framework, is a first step for finding signals on whether financial intermediation is inadequate in Kosovo. Other sources of finance, such as microfinance institutions, the donor community, and remittances, are also considered important contributors to the flow of finance in small- and medium-size enterprises (SMEs).

6.1. Banking sector indicators

The analysis of the financial sector begins with an overview of its structure and comparison of indicators against previous years in Kosovo and against other countries where possible.

There are 88 financial institutions licensed to operate in Kosovo, out of which 10 are commercial banks, 15 insurance companies, two pension funds, 43 financial auxiliaries (exchange offices and money transfer bureaus), and 18 microfinance institutions. In the past four years, the number of commercial banks, pension funds, and microfinance institutions (MFIs) remained unchanged, while insurance firms and financial auxiliaries increased. The Kosovo Banking Association reports 263 bank branches and sub-branches throughout Kosovo, with SME lending specialists present in most major cities (seven main regions: Prishtina, Peja, Gjakova, Prizren, Ferizaj, Gjilan, Mitrovica) .

Kosovo's Central Bank (CBK) is a fully authorized legal organization with a budget controlled by the state, which oversees the financial institutions as instructed by law (Law No.02/L-074 articles 1 to 15). The Central Bank's objective is to foster and maintain a stable financial system and a safe, sound, and efficient payment system, as well as to achieve and maintain domestic price stability by adhering to the principles of an open market economy with free competition.

Total financial system assets amount to €4.73 billion, with an annual growth of a little under 10 percent (CBK, 2016). Financial intermediation, as the financial system assets to GDP ratio, is currently at over 82 percent, reports the CBK. As this percentage has been steadily increasing from previous quarters, it implies that the banking system is reliable and being used for more financial transactions. Worth noting is that the microfinance sector has had a slight decrease of the financial intermediation share, while the rest of the sectors experienced growth. Nevertheless, in comparison to other countries in the region, the financial intermediation level is lower. In relation to the size of the economy, the Central Bank report concludes that there is room for growth in the financial sector.

The CBK reports that the structure of assets of the financial system is the banking sector 69.1 percent, the pension sector 25 percent, the insurance sector 3.2 percent, and the microfinance sector 2.5 percent. Financial auxiliaries only make up 0.2 percent of the total financial assets.

Insurance companies in Kosovo deal with all types of insurance, ranging from health to home, vehicle, and property insurance. It is a growing sector with total assets rising by 13 percent in 2012; however, it represents roughly less than 3.5 percent of the total assets of the financial sector in Kosovo.

The 18 MFIs account for only about 4 percent of total lending loans, mostly to households. (CBK, Financial stability Report, 2016). Included in this number is Crimson Capital, a purchase-order finance organization with €5 million in assets, which tries to actively serve the SME sector. MFIs in Kosovo operate on a small scale because they have no access to deposits, and they serve the microbusiness segment.

The net foreign asset position of Kosovo's financial system is € 1.36 billion. As of June 2015, CBK reports that the total value of external sector investments is €1.63 billion and the structure of external assets is made up of 64.8 percent assets and other equities, 16 percent deposits, 14 percent securities, 5 percent loans, and 0.2 percent other. The Kosovo Pension Savings Fund at CBK was invested in the external sector, hence there was growth in assets and equities, as well as some high liquidity in banks. Liabilities amount to €266.6 million and are 63 percent loans, 35 percent deposits, and 1.8 percent other liabilities. Liabilities are reported to be experiencing growth slowdown, which could have been affected by low interest rates on deposits in Kosovo (CBK, 2016). The Central Bank states that looking at the official figures throughout the years, Kosovo has been a net creditor against other countries, meaning that international assets are higher than international debt.

6.2. Non-banking markets

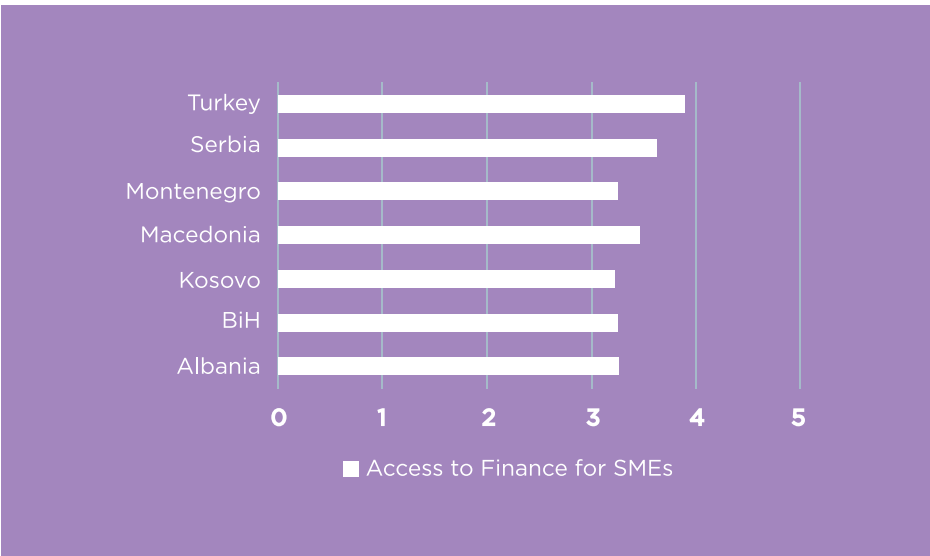
Generally, capital markets provide funding for large firms, whereas in Kosovo, due to the absence of capital markets, both large and small firms are bank clients. As start-up funds are practically nonexistent in Kosovo, new funding instruments such as private equity, capital markets, and business angel networks are necessary to produce working capital for future potential enterprises and growth capital for existing businesses, specifically for start-ups. Financiers usually require evidence from financial reports for a convincing amount of time to consider the suitability of firms for funding.

Institutionally, Kosovo doesn't have an active bankruptcy law (Law No.04/L-093), and courts are not efficient. However, the introduction of the private bailiff system is proving to be efficient and valuable. There is lack of support services for SMEs and start-ups, with low government initiatives for development programs. There are donor agencies such as the World Bank, the European Bank for Reconstruction and Development (EBRD), and the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) active in this area. The OECD 2016 report makes a comparison of the last 10 years' performance of the Western Balkan countries and Turkey, where it is noted that economies continue to rank low in measures of credit guarantee plans, with Kosovo ranking the lowest. The report also states that access to business and SME support should be better matched to demand by adapting business support services, and governments should tailor their support to SMES to increase their readiness for investment (equity financing, business skills development, etc.). Compared to 2012, Kosovo's support services for

SMEs and start-ups has made progress in 2016 with an average coefficient of 2.74 in 2016, compared to only 1.88 in 2012. However, the OECD report also states that Kosovo has the lowest score for access to finance for SMEs when compared to other countries in the region as seen in figure 18.

Nevertheless, within this scoring dimension, Kosovo scores relatively average on financial literacy, nonbank financing, and bank financing. Little effort (by the banking sector) is being put into factoring as a financing option for firms, and OECD suggests reforming the legal framework. Kosovo’s access to finance for SMEs has increased in 2016 compared to 2012, which could be partly due to the decrease in interest rates in the past four years. When assessing the implementation of the Small Business Act for Europe, OECD in 2016 also reported that Kosovo had noted stronger performance in technical regulations access to finance for SMEs and the operational environment, but still needed improvements in innovation, SME greening, entrepreneurial learning, and women’s entrepreneurship. Figure 18 gives a better picture of Kosovo’s performance in OECD indicators for access to finance in comparison to other countries in the region.

Figure 18. Access to finance for SMEs (by country).



Source: OECD (2016).

Source: BiH = Bosnia and Herzegovina; SMEs = small and medium-size enterprises.

Factoring is currently not an option, and remains unavailable. Some analysis had been made by the Kosovo Manufacturing Club (KMC), where the Kosovo Bankers Association (KBA) had stated that to have successful financial factoring, there needed to be certain reforms in the business environment and should be applied gradually in a combination of collateralization of contracts, including factoring (KBA, 2016).

6.3. Market for lending and savings

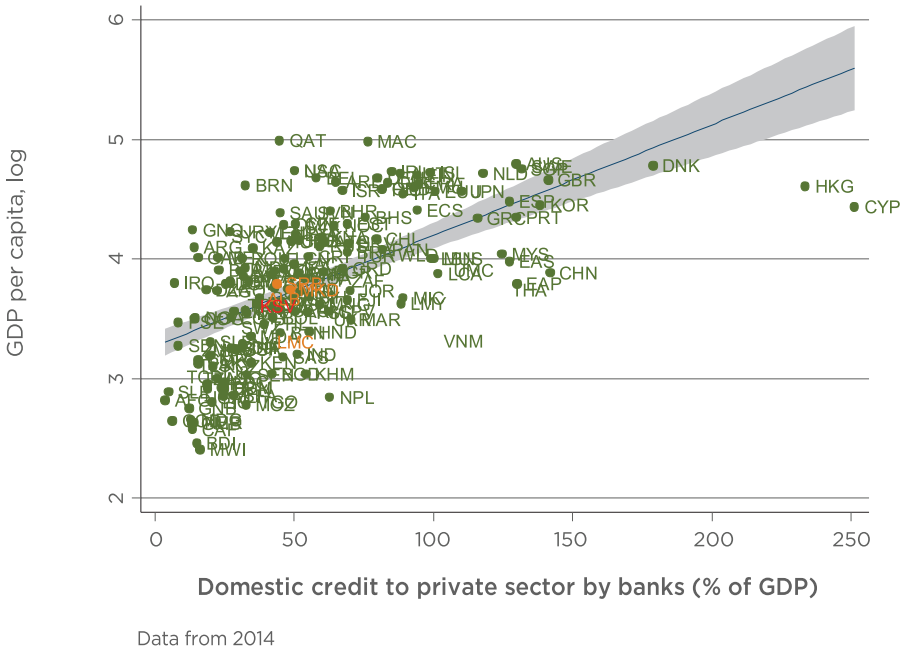
The financial system connects savings to firms that can invest in productive activity. Therefore, the growth diagnostic methodology starts with examining whether the market for loans is able to supply the needs of firms. If not, it works its way back to examine potential underlying causes, such as financial intermediation or low savings.

In the simplified market for loans, the banking system supplies loans while firms and entrepreneurs demand financing based on the available profitable projects. Actual curves of supply and demand are difficult to observe, but equilibrium quantities and prices can be considered. If the market clearing quantity of lending, Q_0 , is less than the optimal level, Q^* , it may be due to a combination of supply or demand constraints. While quantities can be driven by either supply or demand, high prices are a signal that demand exceeds supply and vice versa. Therefore, the methodology begins by benchmarking quantity but subsequently examining prices as identified by interest rates.

6.4. Quantity of lending

Domestic credit to the private sector is a useful measure of the quantity of finance flowing in the economy. Kosovo is average compared to middle income countries. In figure 19, Kosovo is shown in red and it is on the average line of GDP per capita and domestic credit to private sector by banks as a percentage of the GDP, compared to low income countries.

Figure 19. Domestic credit to the private sector by banks
(percent of GDP)



Source: MCC calculations, World Bank data (2014)

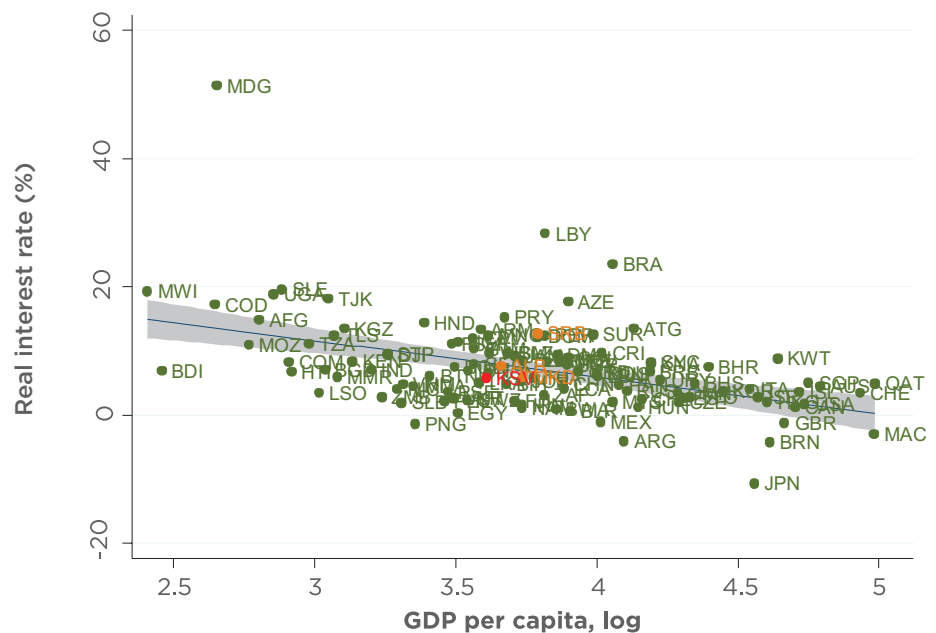
Lending has shown positive growth trends of over 2 percent each year since 2009. To keep nonperforming loans (NPLs) low, criteria are demanded by banks. Nevertheless, the growing level indicates broadening of the formal banking sector; however, start-up credit is largely unavailable in banks, with preference being given to already established firms with strong financial statements—a fact that could hinder growth by ignoring the potential of start-up small enterprises.

The price of finance (interest rates) helps distinguish between low demand and low supply. If a quantity is low due to low demand, prices should also be low. But if low supply is the culprit, prices should be high. Figure 20 illustrates Kosovo's position (marked in red), in relation to the real interest

rate, compared to GDP per capita regarding the supply of finance. With data from 2014, we can see that Kosovo is a bit below average compared to middle-income countries (MICs) and other comparator countries in the region: Albania, FYR Macedonia, and Serbia.

Credit rates fell from 12.9 percent in 2012 to 9.3 percent in 2014, marking the first single-digit rates since the war in 1998. The interest rate for SMEs is below 8 percent (CBK, 2015), which has paved the way to an increase in lending. The long-term interest rate was always high in Kosovo compared to other countries in the region until 2012. However, with the decrease of interest rates, there are growing shares of longer-term credits, indicating healthy levels of liquidity from banks and better opportunities for firms. Nevertheless, collateral requirements still seem to be problematic as banks do not generally accept receivables or inventory as collateral, focusing primarily on machinery, vehicles, and real estate, as discussed in the next section.

Figure 20. Real interest rates by per capita GDP.

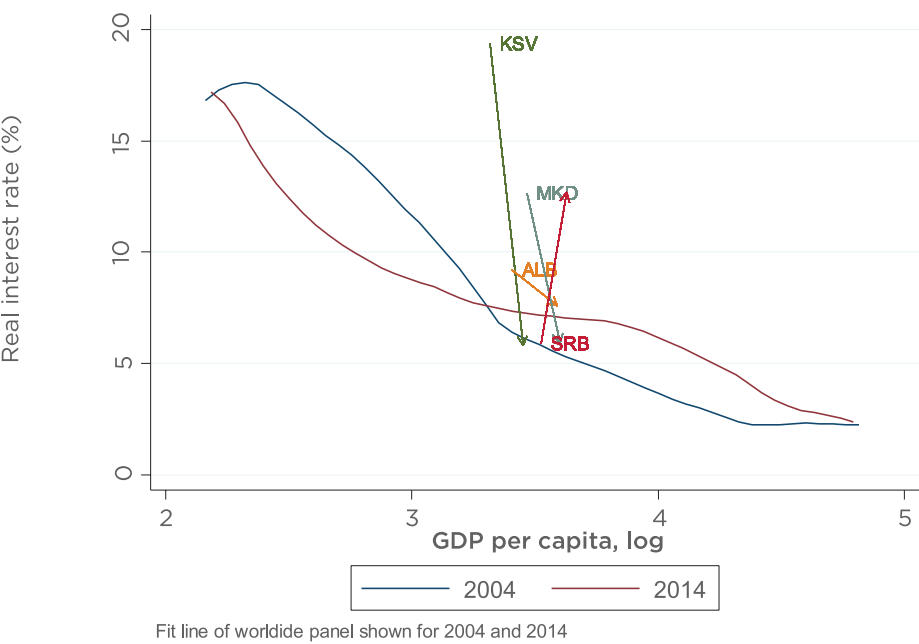


Data from 2014

Source: World Bank data and MCC calculations (2014).

Note: GDP = gross domestic product; KSV = Kosovo.

Figure 21. Real interest rates changes for Kosovo and comparator countries, 2004 and 2014



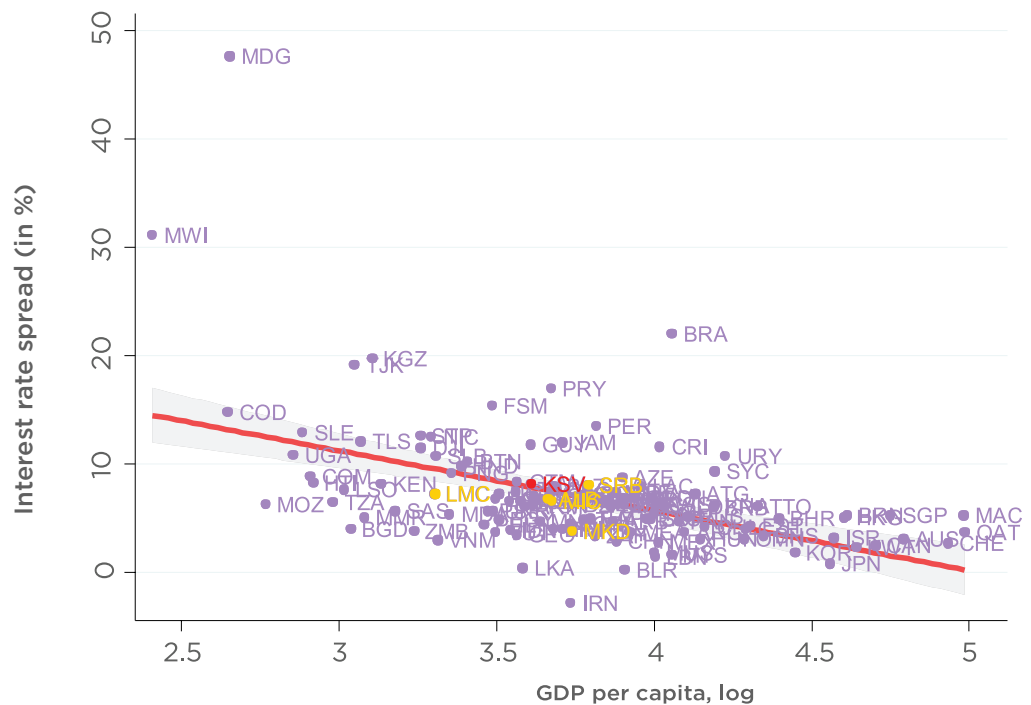
Source: MCC calculations, World Bank data (2014)

Note: ALB = Albania; GDP = gross domestic product; KSV = Kosovo; MKD = FYR Macedonia; SRB = Serbia.

Figure 21 showcases the real interest rate trend for Kosovo and other comparator countries, such as FYR Macedonia, Albania, and Serbia. Each arrow illustrates the country's starting position in 2004 and ending position in 2014. Kosovo displays the most significant decline of interest rates among the comparator countries.

The spread between deposit and lending rates is used as a measure of the effectiveness of financial intermediation. Figure 22 depicts in red Kosovo's position which shows a better position compared to MICs, as well as comparator countries such as Albania, Serbia, and FYR Macedonia. USAID's Kosovo Growth Diagnostics 2012 found that high spreads drove up the cost of finance in Kosovo, leading to finance becoming a constraint. However, the current decline in spreads and interest rates means that the cost of borrowing is now cheaper and paves the way to increasing loans to finance investment by firms. Declining spreads may partially be attributable to lower risks to lending resulting from the introduction of the private bailiff system.

Figure 22. Interest rate spread for Kosovo and comparator countries, 2014.



Source: MCC calculations, World Bank data (2014)

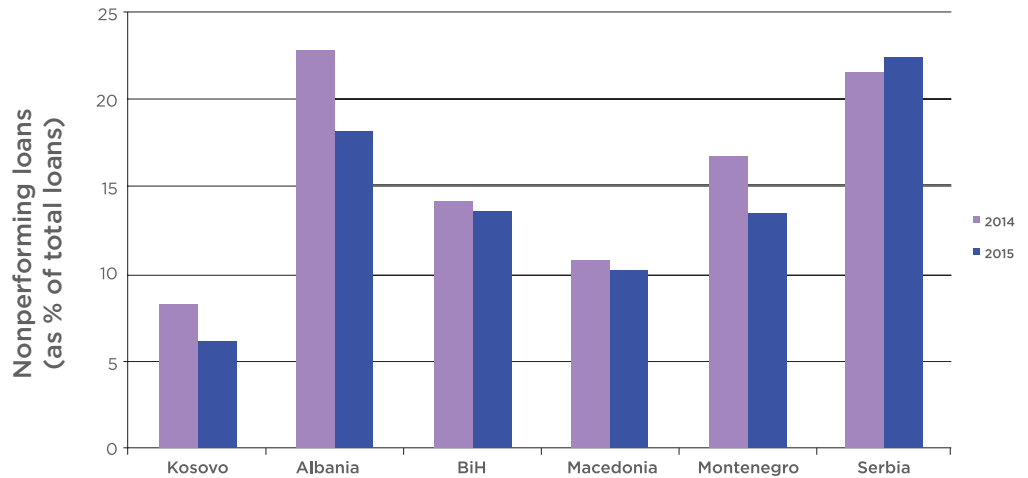
Note: GDP = gross domestic product; KSV = Kosovo; LMIC = Low middle income countries

The number of NPLs is low, suggesting banks are conservative in their lending practices. NPLs are lower than in neighboring countries (figure 24). World Bank in 2015, reported that between 2011 and 2013, NPLs in Kosovo rose from 5.9 percent to 8.7 percent of total loans, with the loan-loss provisions against adversely classified loans at 115.4 percent, hence remaining adequate. The European Investment Bank 2016 Access to Finance report states that NPLs for SMEs are higher than for other loans, as high as 12 percent for current loans. This could be due to the inability of firms to manage growth and accounts receivables, in turn impacting business performance.



Source: MCC calculations, World Bank data (2014)

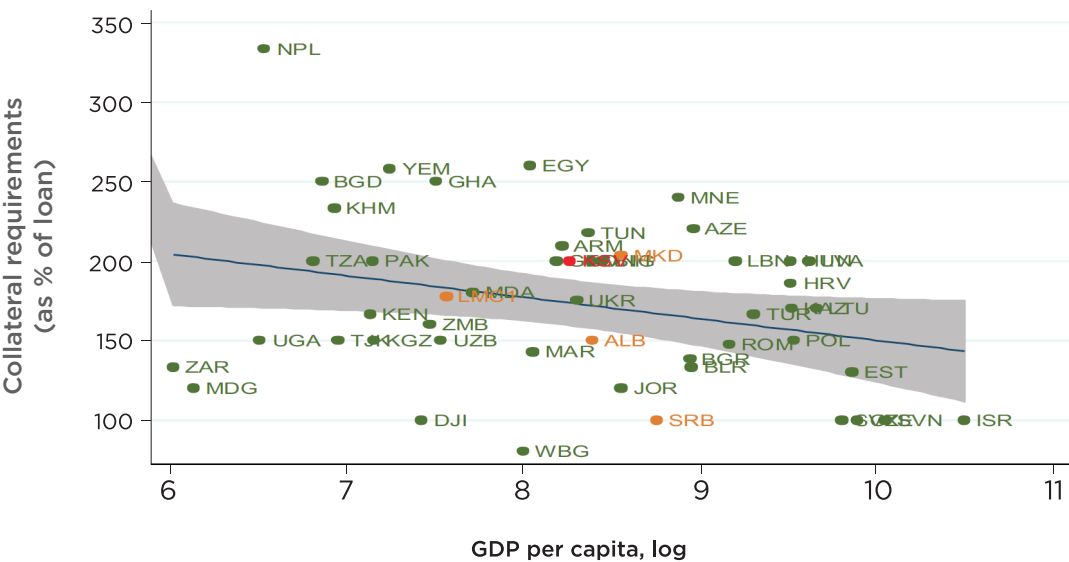
Figure 24. Nonperforming loans in Kosovo and comparator countries, 2014 and 2015.



Source: Central Bank of Kosovo (2016)

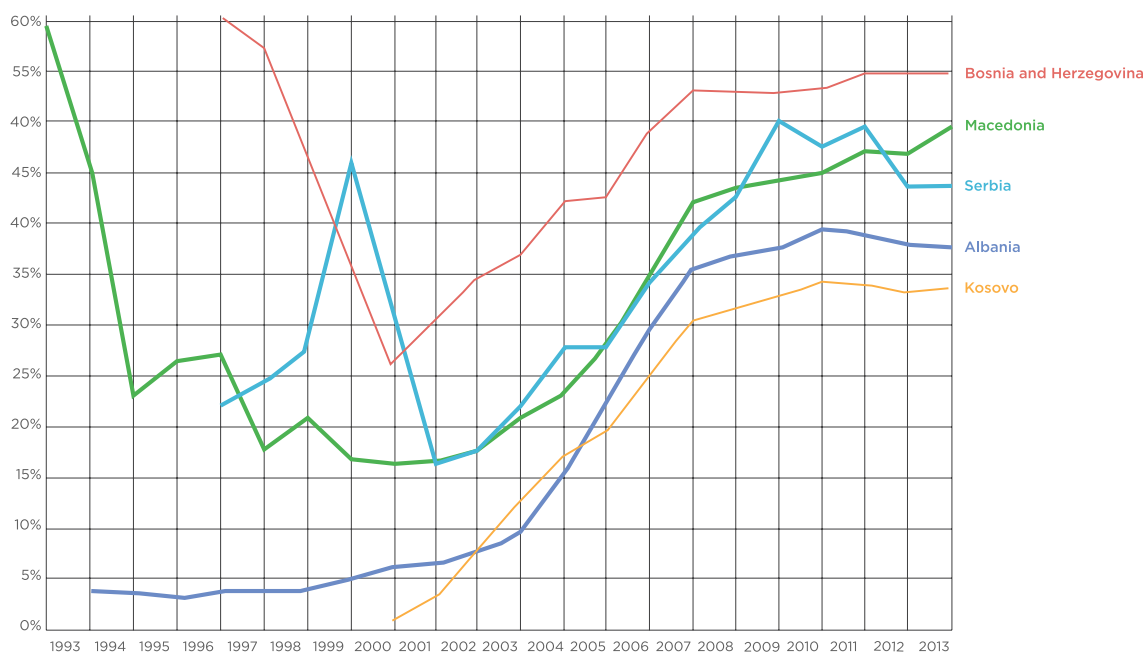
When comparing the collateral requirements of banks in Kosovo, the median firm in Kosovo faces above-average collateral requirements relative to other countries at Kosovo's income level. Yet, the level is not extreme. Figure 25 shows that in Kosovo, the percentage of the value of the collateral needs to be at 200 percent of the value of the loan.

Figure 25. Collateral requirements relative to other countries at Kosovo’s income level



Source: MCC calculations, World Bank data (2014)

More information on what is included in the collateral can be seen on figure 25. Land, buildings, accounts, equipment, personal assets, and other types of collaterals were compared with neighboring countries Albania, FYR Macedonia, and Serbia, as well as MICs. Kosovo relies heavily on equipment for collateral; this could be due to the fact that lack of clarity of land ownership poses a constraint for land as collateral. Other countries rely mostly on real estate property as collateral, whereas Kosovo relies more on equipment.

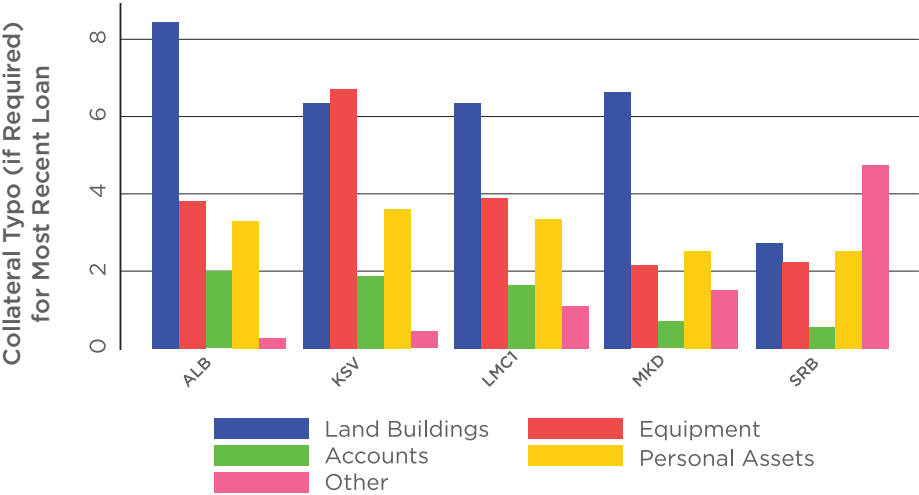
Figure 26. Domestic credit to private sector (percent of GDP).

Source: World Bank data (2015)

Property rights may particularly impede SMEs access to finance because housing built after 1999 does not always have occupancy certificates and was sold without official titles to the properties (BFC, 2016). Shortage of leases and lack of clarity of ownership of lands are constraints for land and real estate as collateral. There are difficulties with disposing of real estate in smaller communities, which creates barriers as banks tend to discount the value of such collateral (BFC 2016). Resolving disputes is claimed to be difficult and lengthy. World Bank's Doing Business report for 2017 measures the time in days it takes to resolve a dispute, counting from the moment the plaintiff files a lawsuit in court until payment (including the waiting time), and Kosovo lists 330 days in total, while Europe and Central Asia list 485.9 days, and OECD high income countries list 553 days. Furthermore, regarding the quality of judicial processes—which measures whether an economy has adopted good practices in its courts structure and proceedings, case management, court automation, and alternative dispute resolution—Kosovo scores 9.5 out of 18, slightly lower than Europe and Central Asia listed at 10.3, and OECD high-income countries scoring 11. For resolving insolvencies, the time and cost required for resolving bankruptcies is measured in terms of administrative procedures and recovery rates, that is, how many cents

on the dollar secured creditors recover from an insolvent firm at the end of insolvency proceedings. Kosovo is listed at 38.8 cents on the dollar, while Europe and Central Asia are listed at 38.2, and OECD high-income countries at 73.0. Overall Kosovo ranks 163rd in 2017, a change in rank from 164 in 2016.

Figure 27. Collateral types for Kosovo and comparator countries.



Source: MCC calculations

Note: ALB = Albania; KSV = Kosovo; LMC1 = Low middle income countries; MKD = Macedonia, FYR; SRB = Serbia.

6.5. Conclusions

The USAID Kosovo Growth Diagnostics report in 2012 identified access to finance as a major constraint. Moreover, it argued that the main cause for the high cost and limited access to capital is the lack of enforcement of judgements, decisions, and contracts and that banks are extremely cautious in lending, as it is difficult to collect bad loans. Our analysis finds that this was a correct diagnosis in 2012; however, access to finance has improved significantly since 2010. Recently, the introduction of the private bailiff system has resulted in significantly lower real interest rates. Access to finance does not appear to be a binding constraint at this juncture. However, it might be considered a moderate constraint as SMEs are still finding constraints in access to finance especially for start-up firms. Arguably, banks are conservative in their lending practices, and firms are not very financially literate, hence there is no dynamic match between the demand and the available products in the market.

Do Macroeconomic Risks and Distortions pose a Binding Constraint to Growth in Kosovo?

Macroeconomic imbalances and risks can become binding constraints to economic growth. These risks can take many forms, but generally fall into three categories of macroeconomic management:

1. Fiscal policy and public debt crisis risk
2. Financial crisis risk
3. Monetary policy, exchange rate, and balance of payments risk

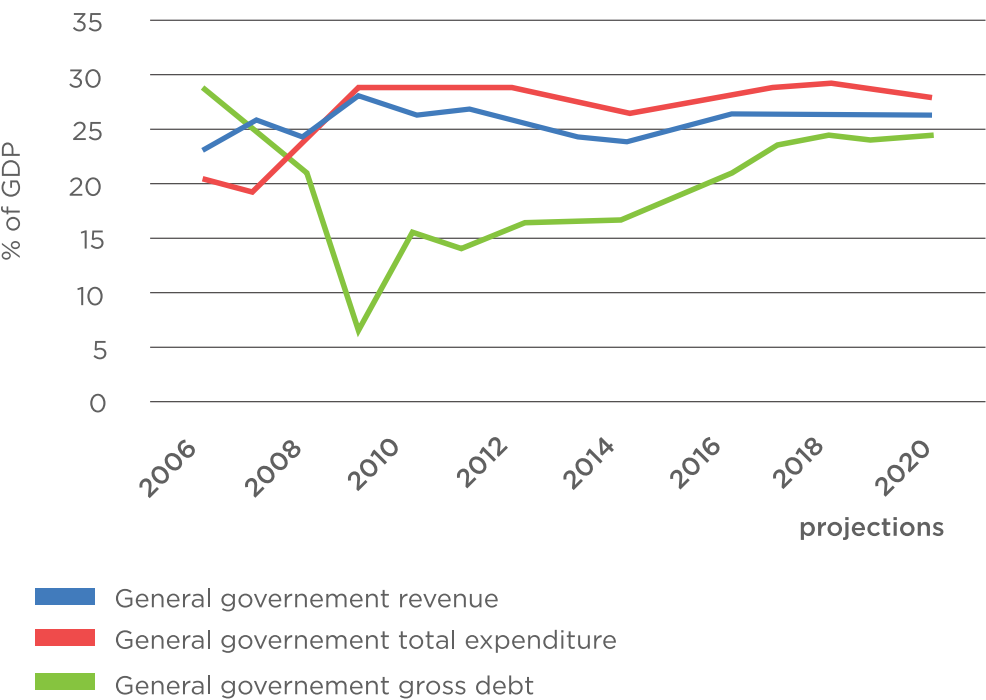
Kosovo in general has had sound macroeconomic management. Fiscal policy has been prudent, the risk of financial crisis appears low, and adoption of the euro provides relatively stable currency management. The significant inflow of transfers to Kosovo generates some concern of an overvalued real exchange rate; however, the impacts do not appear to be severe enough to present a binding constraint to growth.

7.1. Fiscal policy management

As identified in recent reports by the IMF,¹⁶ Kosovo has maintained relatively sound fiscal policies. The country has avoided accumulating debt and maintained low debt to GDP ratios (figures 28 and 29). This conservative fiscal policy is likely reflected in a moderate price of external borrowing, despite the penalty Kosovo undoubtedly pays due to its mixed geopolitical recognition.

¹⁶ For an in depth discussion of complexity metrics, see The Atlas of Economic Complexity, Mapping Paths to Prosperity, by Ricardo Hausmann, and others (2014)

Figure 28. General government revenue, expenditures and gross debt 2006 – 2020



Source: Central Bank of Kosovo and GOK (2016)

Note: GDP = gross domestic product

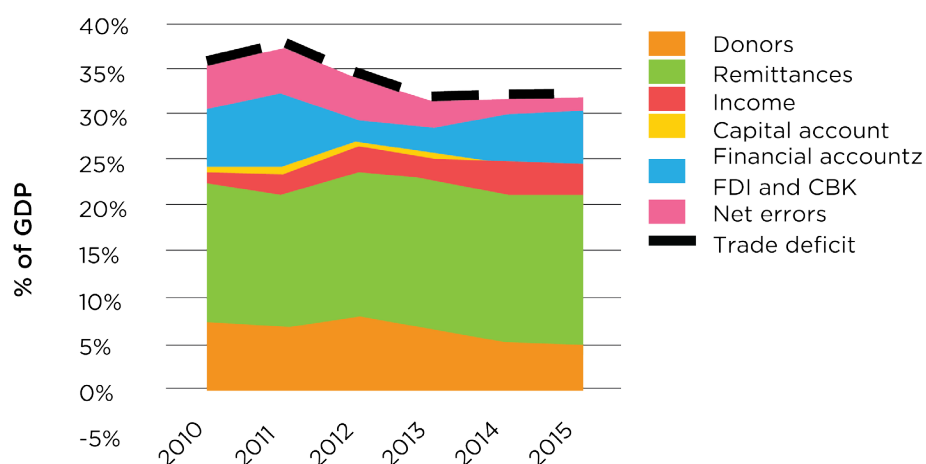
The high level of remittances and similar inflows that support consumption raise concerns that Kosovo may be experiencing Dutch disease. Dutch disease is characterized by financial inflows (for example from remittances or natural resource wealth) driving up domestic consumption of both traded and nontraded goods. Because nontraded goods must be produced domestically, Dutch disease causes the price of nontraded goods to increase relative to traded goods to incentivize domestic firms to meet the increased demand. While the domestic economy becomes specialized to meet demand for nontraded goods, the demand for traded goods can be met by imports. The economy may become overly specialized in nontraded goods if the export sector loses too much competitiveness due to domestic inputs to production (for example, labor, land) becoming more expensive.

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As illustrated in figure 31, Kosovo has received a high share of remittances relative to GDP. Other sources of transfers such as diaspora investment in real estate and foreign aid are also significant and operate similarly to remittances: they constitute an inflow of foreign currency, are not necessarily made for financial gain, and do not directly flow back out of country.

These inflows have resulted in a demand driven economy and some signs of real exchange rate appreciation. As illustrated in figure 31, most foreign direct investment has gone into sectors like construction, real estate, and trade that are driven by domestic demand that has grown through repatriation of income earned abroad rather than increased production within Kosovo. Kosovo's 2015 IMF Article IV Consultation identified an overvalued real exchange rate of 15–18 percent.

Figure 31. Kosovo trade deficit financing (% of GDP)



Source: Central Bank of Kosovo (2016)

Note: GDP = gross domestic product.

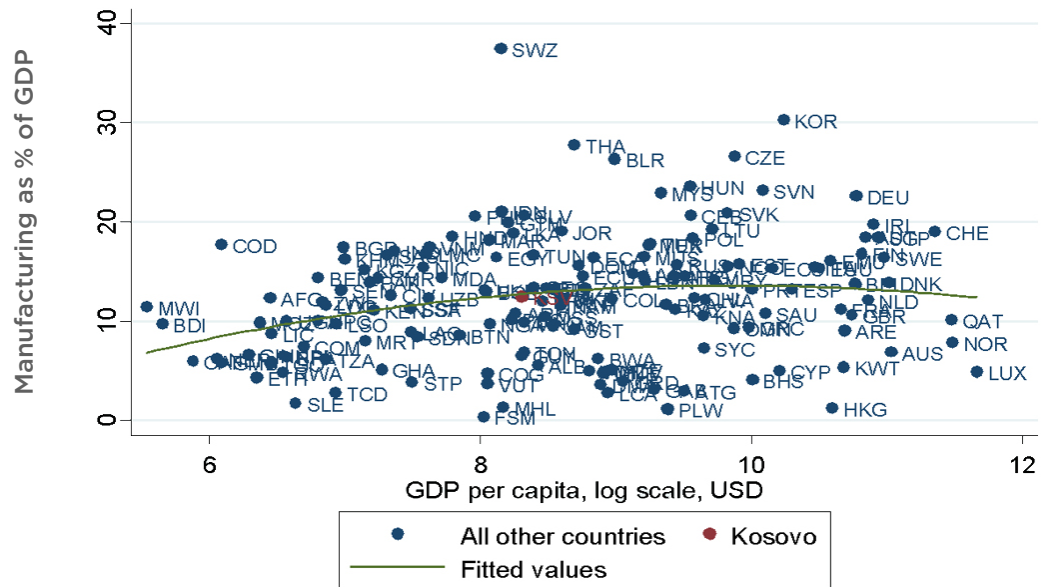
Table 2. FDI distribution by sector 2008 – 2015

FDI by sector	2008	2009	2010	2011	2012	2013	2014	2015	Total
Agriculture, hunting, forestry,fishing	8.5	13.1	0.9	0.6	0.3	0.4	0.2	0.9	24.8
Mining/quarrying &Electricity/gas/ water supply	34.1	15.7	17.7	-5.0	-22.8	34.6	17.6	-12.7	79.1
Manufactur	53.7	57.6	101.1	46.9	27.4	11.5	-34.0	23.1	287.4
Construction	13.5	35.6	54.2	133.1	31.1	17.3	-19.9	46.3	311.2
Transport, storage & communication	51	21.9	-15.9	29	32.4	51	-9.1	-6.2	154
Fincancial intermediation	109.6	75.3	39.4	33	22.4	4.4	41.9	64.3	390.3
Real estate, renting & business activities	62.2	43.9	75.5	60.5	115.7	136.1	142.1	189.6	825.5
Other sectors	37.2	32.5	95.7	86.4	22.5	25	12.4	19	330.7

Source: Central Bank of Kosovo (2016)

While transfers flowing into Kosovo have shaped the type of activities that drive growth, extreme real effective exchange rate (REER) appreciation of the type that would significantly constrain growth in the tradeable sector seems unlikely. Labor markets are still priced moderately, with most workers receiving between €300 and €400 per month. Furthermore, manufacturing has maintained a sizeable share of GDP (figure 32). Finally, in extreme cases of Dutch disease, REER should be highly volatile, and this is not observed in Kosovo.

Figure 32. Manufacturing as percent of GDP (2014)



Source: World Bank data (2014)

While the nontraded goods sector has been the biggest driver of growth and investment, other constraints besides Dutch disease are more critical determinants of Kosovo's export competitiveness. Due in part to the slack in the labor market, the economy is not producing at its possible limit, thus allowing expansion into the non-tradeable sector without significant real exchange rate appreciation or volatility. Labor wages also remain at or below regional comparator countries. While not growing rapidly, the tradeable sector is at a comparable size to neighboring countries.

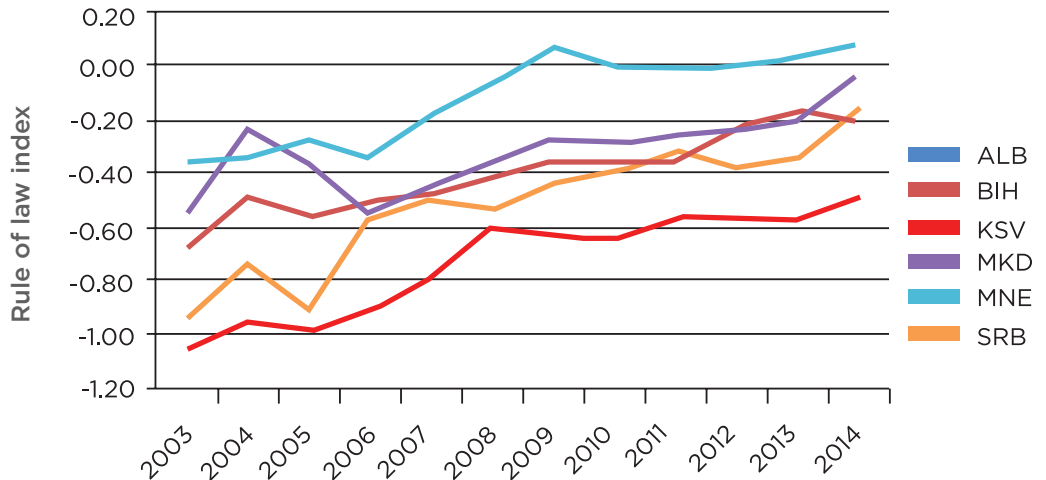
Does Low Appropriability Pose a Constraint on Growth and Investment in Kosovo?

The incentive for investment that firms face in any country is affected by the share of the overall return on investment they are able to retain versus the share that goes to other actors. Issues such as theft, corruption, taxation, and labor regulation can reduce the share of the overall return that goes to the original investor. In the growth diagnostics methodology, this is called the *appropriability* of the investment return by the original investor. This chapter examines whether low *appropriability* is a constraint on growth and investment. We conclude that many aspects of *appropriability* are not constraining, including crime, taxation, and labor relations. However, some rule-of-law issues are reducing *appropriability* and constraining investment. These have to do with consistent implementation of policy across the public administration. Furthermore, an excess perception of rule-of-law problems by the international business community exacerbates the issues. Overall, the predictability and perception of rule of law is a binding constraint to investment and growth in Kosovo.

8.1. De facto issues in rule of law

Investment and growth are best promoted when the rule of law is characterized by credible rules and policies that are consistently applied to regulate business and government interactions. Figure 33 examines Kosovo against its comparator countries on the World Governance Indicators Rule of Law index, which captures the extent to which “agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.” The country’s performance has improved over time, but still ranks last among regional comparator countries.

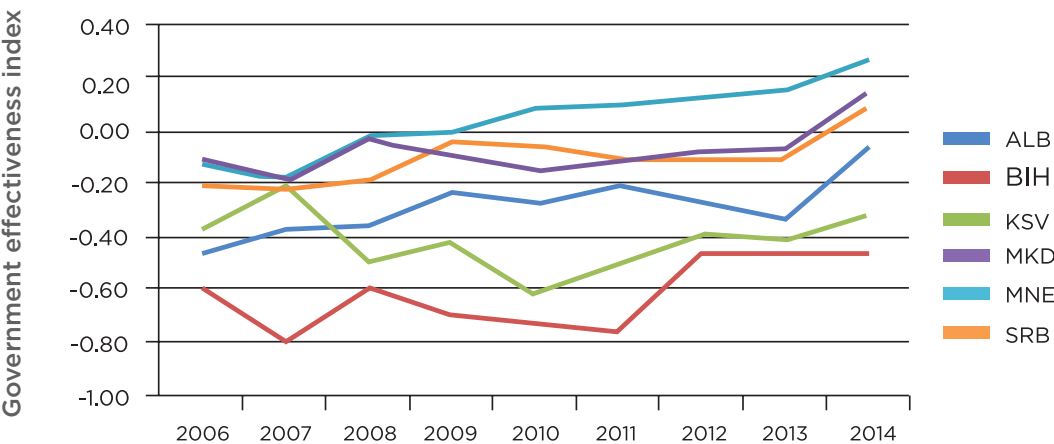
Figure 33. Regional comparison of Rule of Law Index, 2003-2014.



Source: World Bank, World Governance Indicators (2015)

The process of EU accession and establishing a new country has led to the development of increasingly sophisticated laws on paper, but the ability of line agencies to implement these regulations has lagged behind. Therefore, low scores on rule of law are not driven by deficiencies in the policy framework but are due to the challenge of implementing a rapidly evolving policy framework within the public administration. The implementation challenge is reflected in Kosovo's poor performance in the Worldwide Governance Indicators (WGI) Government Effectiveness index (figure 34), on which Kosovo also ranks last among regional comparator countries.

Figure 34. Regional comparison of Government Effectiveness Index, 2006–2014.



Source: World Bank data (2015)

Note: ALB = Albania; BiH = Bosnia and Herzegovina; KSV = Kosovo; MKD = Macedonia, FYR; MNE = Montenegro; SRB = Serbia.

Interactions with the public administration appear to be most challenging in the areas of tax administration, licensing, and permits. The 2013 Enterprise Survey reveals that senior managers spend 13 percent of their time dealing with the requirements of government regulations and 28 percent of firms identified tax administration as a major constraint to their business growth.

In many economies, the judicial system can provide a last resort method of recourse for firms that are aggrieved by a misapplication of the rule of law. Unfortunately in Kosovo, the judiciary is not effective at providing redress for the business community against

poor implementation of the law by the public administration.¹⁹ According to Pepaj (2016, p. 155): “Kosovo as a new country faces difficulties in professionalization of public administration and this is closely related to large number of case that are subject of judicial review . . . The Department for Administrative Matters within Basic Court of Prishtina operates with only three competent judges to resolve in the first instance administrative conflict cases for the entire territory of Kosovo, where a judge of this department has about 800 pending cases, increasing each month by around 60 new cases.” According to consultations with stakeholders, delays in the judiciary are especially long and harmful in cases regarding tax administration, customs duties, or regulatory disagreement. In many of these cases, judges lack the specialized experience needed to make decision, are averse to deciding against the government, and frequently return cases back. While many of these cases are eventually found in favor of the private sector on appeal, the delay in reaching a decision is costly, as firms are required to pay the fee or fine before being able to challenge it in court. The Independent Review Board, which formerly handled tax and customs disputes, was reviewing nearly a thousand cases a year before being closed in 2013. In contrast, the court system now manages to settle only a fraction of that number and takes longer to reach a decision.

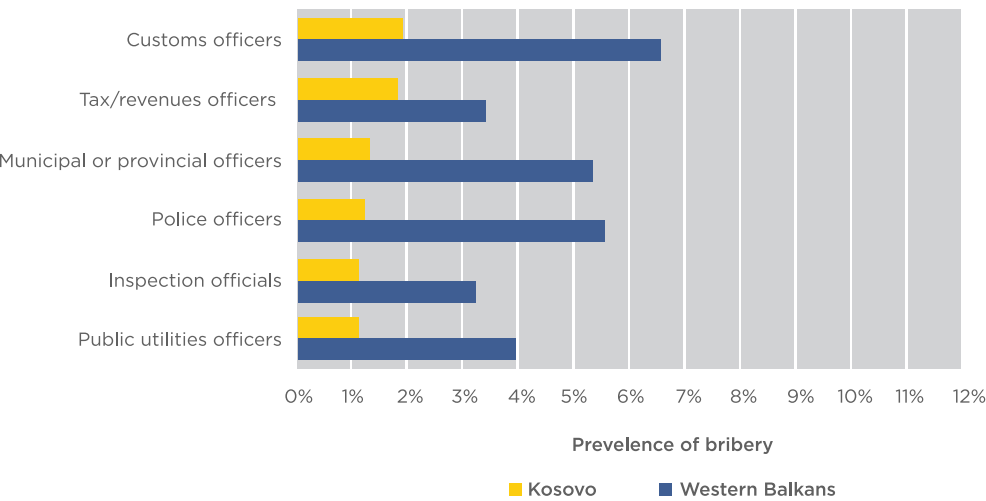
8.2. Perception and reality of corruption

In some cases, grievances by the private sector stem not from simple ineffectiveness of the public administration, but from actual corruption. The 2016 Assessment of Corruption in Kosovo by the Southeastern European Leadership for Development and Integrity (SELDI) identified that perceptions of corruption in Kosovo are extremely high. Similarly, Kosovo does poorly on other indicators of the how the public perceives corruption, such as those done by Transparency International (figure 35). On both of these indicators, Kosovo ranks last in the region.

¹⁹ This is despite hundreds of millions invested by donors in rule-of-law capacity building as these investments have been largely focused on criminal and not civil or commercial issues. Most recently, the EULEX Kosovo was extended through 2018 at an annual budget of more than \$70 million, one of the largest investments by the EU in Kosovo.

Examining measures of corruption in practice rather than just perception, however, Kosovo tends to do much better relative to the region. Assessments of the frequency of bribery in particular are low.

Figure 35. Prevalence of bribery in Kosovo and the Western Balkans.



Source: UN Office on Drugs and Crime; “Business, Corruption and Crime in Kosovo: The Impact of Bribery and Other Crime on Private Enterprise” (2013).

Using responses from the World Bank Enterprise Surveys, we examined the correlation between the percent of firms that experience a bribery request versus the percent that identify corruption as a constraint. While these indicators have a positive and statistically significant correlation across countries, Kosovo appears to be an outlier. In both 2009 and 2013, perception of corruption in Kosovo exceeded the level of most other countries with comparable incidence of bribery (figure 36).

Figure 36. Perception of corruption in Kosovo and comparator countries.

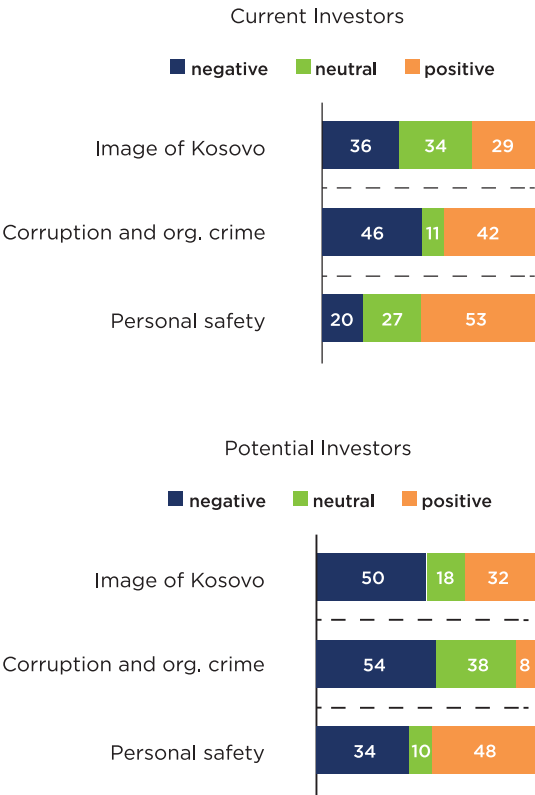


Source: World Bank data (2015)

The IFC undertook a survey in 2014 of potential investors in Kosovo. The survey provides comparison of responses of potential versus existing investors and thus allows analysis of how perception of Kosovo's rule of law differs between potential investors and those currently operating (figure 37). The results find that across every dimension of rule of law in the survey, potential investors had a worse perception than investors who were currently operating. While this might be explained by a variety of factors,²⁰ it suggests that potential investors might view rule of law as worse than the reality experienced by actual investors.

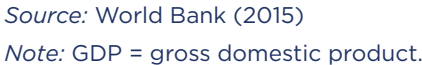
²⁰ For example, current investors may benefit from corruption or rule of law issues and thus do not see it as negatively.

Figure 37. Survey of current and potential investors in Kosovo.



Source: IFC (2014)

Potential investors’ perception of personal safety is particularly surprising and has the largest differential with current investors. Among existing investors, only 20 percent had a negative impression of personal safety in Kosovo, versus almost half of prospective investors expressing a negative view. Data on personal safety support the more optimistic view of current investors. Kosovo’s homicide rate is one of the lowest in the region. According to the 2013 World Bank Enterprise Surveys, the cost to firms from theft and vandalism was only 3.1 percent of sales, lower than the Europe and Central Asia average of 3.5 percent and much lower than the worldwide average of 5.1 percent. This suggests that the international business community has an “excess perception” of rule of law issues in Kosovo that prevents investment.



Sources of information that could provide investors with positive narrative of Kosovo are few. KIESA, the agency in charge of investment promotion, has a small budget. The IFC also noted that

Kosovo's large diaspora is an underutilized resource for marketing the country and attracting investment. Consultations with stakeholders revealed that Kosovar firms looking for international partners find it challenging to overcome the country's reputation in large part due to visa restrictions and the difficulty of travel to secure business deals.

8.3. Conclusions about low appropriability

Kosovo remains behind the region in many rule-of-law indicators and scores poorly on third-party assessments of accountability, corruption, and rule of law. However, there are also excessive perceptions of rule-of-law issues that differ from reality. When it comes to surveyed experience of bribery rates, Kosovo performs near the region's average or does better than comparator countries. While perception might be worse than the reality, there are significant challenges that must be addressed. Interaction of businesses with the public administration are the most problematic area of rule of law for businesses. The private bailiff system has proved to be successful and has had a direct effect in the encouragement of private sector investment. Yet the combination of a number of rule-of-law issues with excess perception problems, especially corruption, presents a binding constraint faced by businesses in Kosovo.

Does a Shortage of Human Capital Pose a Binding Constraint to Growth in Kosovo?

9.1. Education and skills

To be able to reach the same levels as developed economies, developing economies typically need to adopt technological advances to their own country context. And to be able to adopt new innovations, firms need access to a pool of laborers with the skills to create, assimilate, and use new productivity-enhancing technologies. The lack of people with skills to take advantage of new technologies can potentially inhibit private investment and economic growth. The Growth Diagnostics methodologies check for this constraint by testing for one of two possible constraints: lack of access to education or lack of quality of education.

Access to education is an issue if the performance of the education system is adequate (in terms of academic achievement of the students), but there are simply not enough schools or seats in existing schools. The shortage of skilled labor leads firms to bid up the wages of skilled workers. In addition, the returns to education will be very high (as a rule of thumb, above 10 percent), and unemployment among skilled workers will be relatively low. The first test is therefore a Mincer equation measuring the shadow price of labor (the returns to education). The second test for access is to see if increasing the number of schools and seats is associated with increased investment or economic growth, although the time span available for Kosovo is too short to perform this test. The third test—circumvention—is performed by testing to see if domestic firms are importing skilled laborers from abroad. The fourth test—camels and hippos—would test to see if firms that rely on skilled workers are growing relatively slowly compared to other sectors.

Quality of education, in contrast, might be a binding constraint if there are enough seats but for whatever reasons the quality of education provided is deficient, resulting in students who graduate from the various levels of the school system without the typically expected skills (for example, literacy). If school graduates do not have the skills typically expected for their level of education, firms will not be willing to pay a premium for them having graduated from the school system. The shadow price of labor in this case will be relatively low. Again, because of the short time span, it would be difficult to perform the second test, and measuring quality of education over time is difficult without a long enough span of quality-related metrics (for example internationally administered academic achievement tests). Similar to access, the shortage of skilled labor domestically should lead to the importation of skilled labor from abroad, and sectors that rely on skilled labor should grow slowly relative to the rest of the economy. Another reason returns to education can be low is that job creation is low for reasons unrelated to the quantity or quality of education supplied. If the following combination of test results occur, it is unlikely the education quality is the binding constraint—if returns to education are low, unemployment is high, highly educated Kosovars emigrate (more than comparator countries) because of the lack of domestic jobs, and sectors that depend on skilled labor are growing neither faster nor slower than the rest of the economy.

Based on Kosovo's historical context, many stakeholders suggested that quality of education may be a binding constraint to growth. For almost two decades, prior to 1999, the education system in Kosovo (as other sectors) went through a period of huge de-investment. Between 1992 and 1999, two separate systems existed, one official system for Serbs (organized in proper school buildings) and one unofficial system for Albanians (organized mostly in private locations). In 1992, the Serbian authorities sacked 23,000 Kosovo Albanian teachers on the same day and imposed a unified Serbian curriculum, effectively closing down Albanian-language education altogether. From that time until 1999, a parallel education system was self-financed by Albanians, through a shadow fund collected mainly from the diaspora. The unofficial system of education for Albanians was continuously subject to repression and intimidation. Quality inevitably suffered, and numbers decreased, especially among girls. By 1996, primary school enrollment was down by nearly 12 percent; secondary school enrollment by 21 percent; and university enrollment by nearly half (OECD 2001). In addition, of the total number of school buildings in Kosovo (approx. 950, used mostly by Serb students)

nearly all had poor facilities: 15 percent had no toilets of any kind and only 20 percent had a water supply inside the building. So, in the first decade after 1999, investing in infrastructure (schools and other facilities) was the government's main focus.

In recent years, considerable progress has been made in improving access to education, mostly at the preprimary and upper secondary levels, even though gender balance has not yet been reached. According to the United Nations Children's Fund (UNICEF; 2016), almost universal primary school enrollment has been achieved for the Kosovo Albanian and Kosovo Serbian communities (97.5 percent and 99 percent respectively). Enrollment of minority communities (Roma, Ashkalia, Egyptian, Turkish, Bosniak, and others) remains comparatively low, with only 77 percent of children between the ages of 6 and 14 enrolled in school. While enrollment rates in primary and lower secondary education are almost universal, upper secondary school net attendance ratio is at 82 percent (UNICEF, 2015).

Despite significant advances in access to education, quality of education has lagged behind. In the latest UNDP Human Development Index (2016), Kosovo ranked 87th in the world, behind all other countries in the region, and also performed poorly in PISA tests.

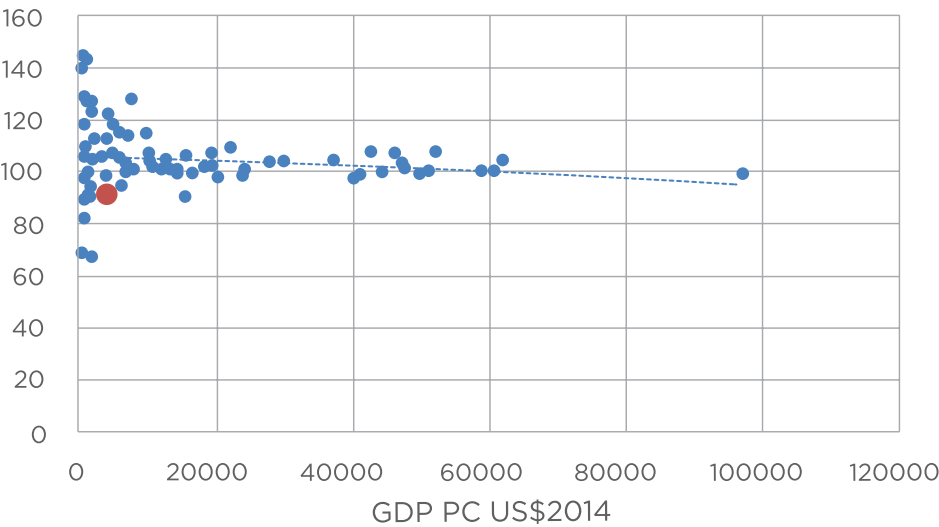
Because of its proximity to the EU (and Kosovo's desire to eventually accede to the EU), Kosovar companies must compete in the EU marketplace. It is therefore understandable that Kosovo companies are concerned that the low level of educational achievement of Kosovo students adversely affects their competitiveness. However, student achievement is correlated with the level of GDP per capita, and Kosovo's GDP per capita is among the lowest in the region, so low achievement levels are not necessarily unexpected. While educational achievement is low in absolute terms (particularly compared to EU competitors), is it so low relative to Kosovo's income level that it is a binding constraint to growth? This is the question the tests will attempt to address.

9.1.1. Testing for access to education

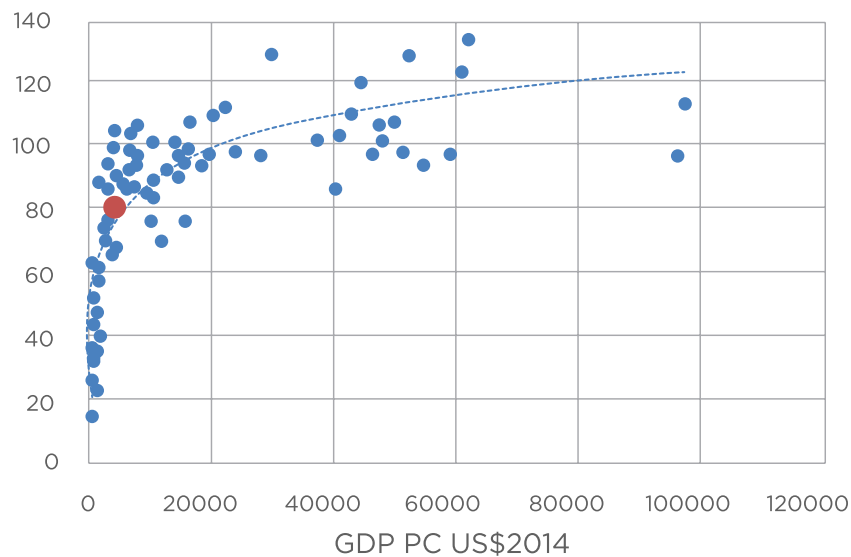
As mentioned above, Kosovo has achieved significant advances in access to education in recent years, and this is reflected in statistics comparing enrollment in Kosovo to other countries. Figure 39 shows that gross enrollment ratios in secondary and tertiary education are comparable to other countries at a similar level of economic development. Only at the primary level are enrollment rates below average.

Figure 39. Primary, secondary, and tertiary gross* enrollment ratios Kosovo and worldwide

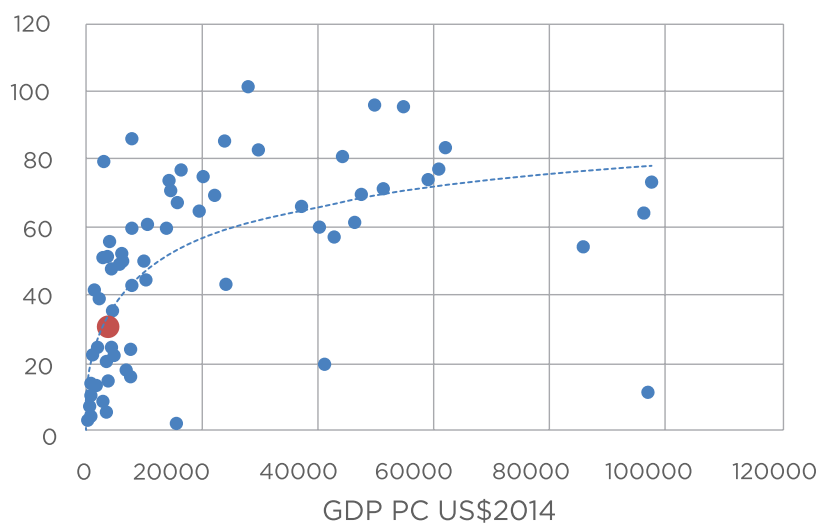
a. Gross primary enrollment ratio



b. Gross secondary enrollment ratio



c. Gross tertiary enrollment ratio



Source: World Bank (2015)

Source: GDP = gross domestic product; PC = per capita.

* Only gross enrollment figures were available for Kosovo

The primary indicator that skilled laborers are in short supply as a result of lack of access to education would be abnormally high returns to higher education. Table 3 shows the returns to education as measured using the Kosovo labor force survey data (2013, 2014, and 2015).

Table 3. Economic returns for men and women by education level

	Annualized Mincer Returns		Unemployment		Participation	
	Male	Female	Male	Female	Male	Female
Primary			48%	29%	13%	3%
MS ("College")	8.6%	4.3%	43%	47%	41%	7%
Secondary vocational,2-3 years	4.1%	8.9%	30%	32%	61%	14%
Secondary vocational,4-5 years	1.6%	8.9%	32%	44%	69%	37%
Secondary general	1.7%	7.0%	32%	54%	57%	21%
High	7.3%	14.4%	8%	16%	60%	71%
University	11.3%	13.8%	16%	28%	71%	60%
Masters	9.6%	6.5%	14%	23%	86%	82%
PhD	9.1%	3.5%	7%	11%	91%	88%

Source: MCC calculations, KAS data (2013, 2014, and 2015).

The average returns to education worldwide are 10 percent at the primary level, 7 percent at the secondary level, and 15 percent at the tertiary level. The returns to education in Kosovo are lower than these thresholds at all levels of education. The analysis and the results of discussions with stakeholders lead us to conclude that access to education is not an issue in Kosovo.

9.1.2. Testing for Quality of Education

The returns to education in table 3 are consistent with the hypothesis that poor quality of education is a binding constraint to growth in Kosovo. PISA²¹ scores are available for Kosovo for 2016 but unfortunately are not conclusive—they confirm that achievement in Kosovo is low, but not necessarily lower than expected—because Kosovo is at the very bottom of the sample for both scores and per capita income, there aren't enough comparator countries to show whether Kosovo's performance is above or below what it should be. We turn to the other three tests to provide circumstantial evidence to support or reject the hypothesis. Unfortunately Kosovo has not been in existence as a country for very long, and it is generally difficult to get a time series of Kosovo-specific data that is long enough to perform the second test. We focus primarily on the circumvention of the constraint test and the camels and hippos test.

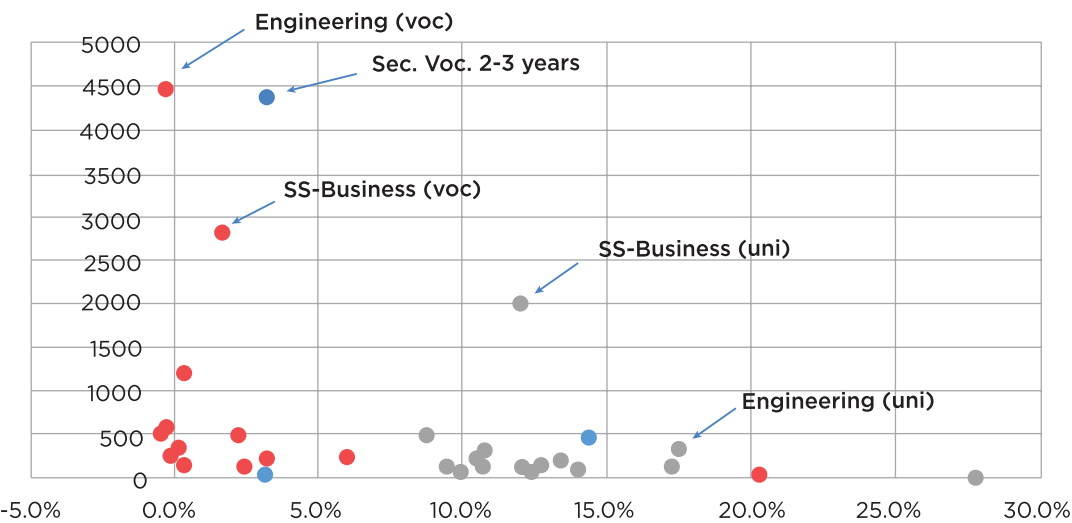
For the circumvention test, we tried to gather evidence of the flow of skilled labor into or out of Kosovo. Unfortunately we only have data on the outflows of labor, which is more suitable for testing whether low returns to education are caused by lack of job creation rather than poor education quality. We do find that a very high percentage of emigrants from Kosovo are secondary educated, perhaps indicating a lack of jobs for skilled laborers in Kosovo.

²¹ The Programme for International Student Assessment (PISA) is a triennial international survey which aims to evaluate education systems worldwide by testing the skills and knowledge of 15-year-old students.

For the camels and hippos test, we test whether industries that rely on skilled labor grow more slowly than other industries. To do this we need to identify laborers that might be considered highly skilled and then calculate the share of such workers in various industries across Kosovo for comparison.

Figures 40 and 41 are an attempt to illustrate the most numerous secondary vocational and tertiary fields of specialization by ordering them according to returns to education, for men and women separately.

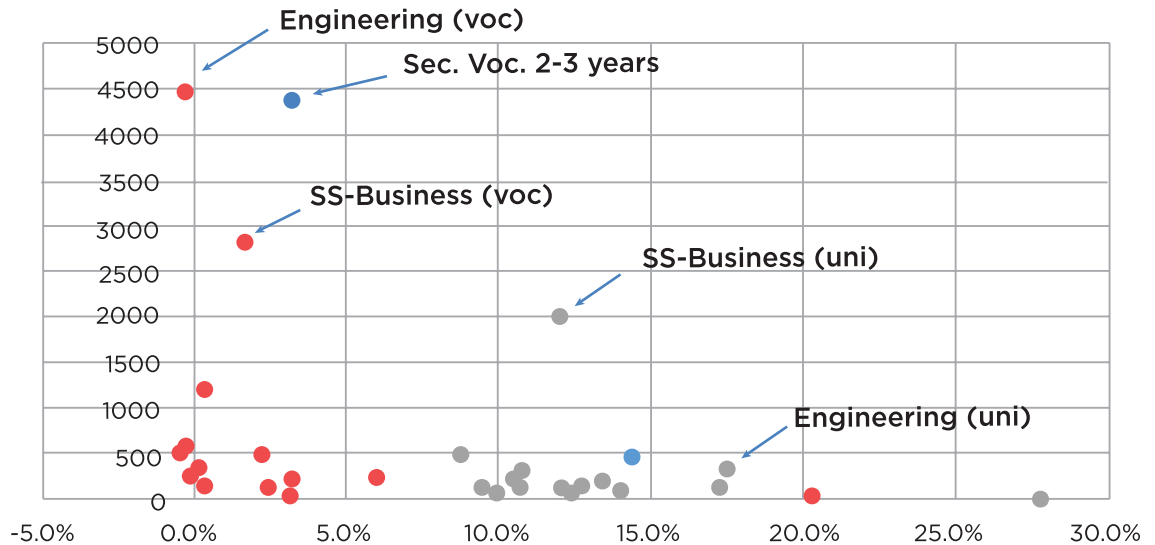
Figure 40. Fields of specialization and returns: Men.



Source: MCC calculations, KAS data (2013, 2014, and 2015).

Note: Number of graduates on y axis, returns on x axis.

Figure 41. Fields of specialization and returns: Women.



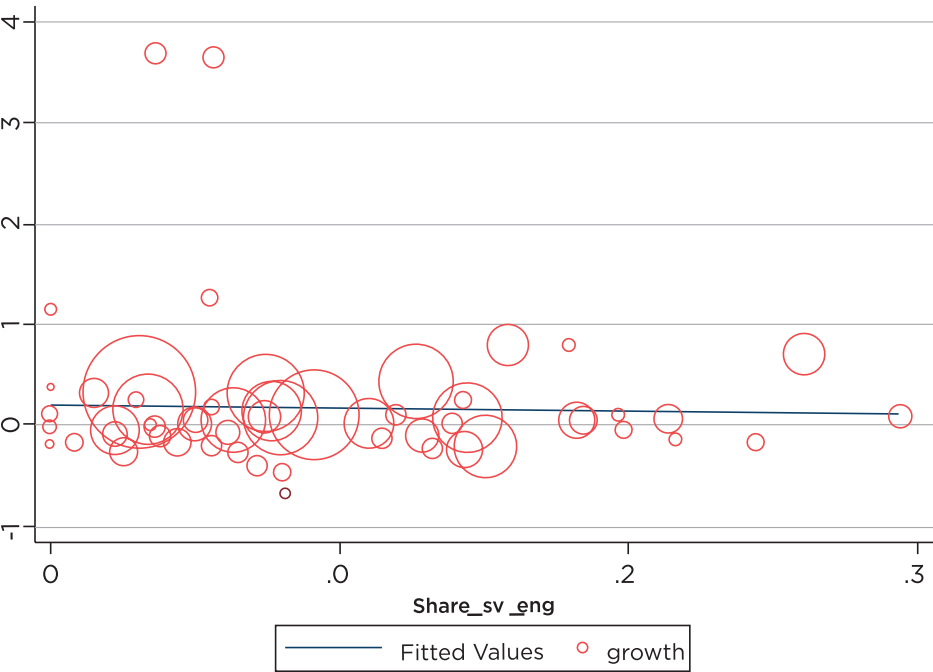
Source: MCC calculations, KAS data (2013, 2014, and 2015).

Note: Number of graduates on y axis, returns on x axis.

For men, the most common field of specialization at the secondary level is engineering, with 4,500 graduates per year, and social sciences and business, with almost 3,000 graduates per year. At the tertiary level the most common degree is social sciences and business. For women, there is a similar pattern, with the addition of traditionally female occupations such as health and education. There are also a significant number of female specialists in engineering at the secondary vocational level. For our tests, therefore, we choose engineers trained at the secondary level as our indicator of “skilled labor.” A regression of industry growth against share of second-

ary-trained engineers (weighted by total number of laborers) yields a very small downward trend (industries with a high share of engineers grow relatively slowly) but the trend is not significantly greater than zero, so the test finds no evidence to support the hypothesis that quality of education is a binding constraint to growth in Kosovo. Similar regressions using other specializations as the indicators reach a similar conclusion.

Figure 42. Share of laborers trained in engineering vs. output growth.



Source: Source: MCC calculations, KAS data (2015)

9.2. Health and environmental services

Health indicators in Kosovo are very unreliable. There are no World Health Organization (WHO) statistics available for disability-adjusted life years (DALYs) and quality-adjusted life years (QALYs) that can be compared against neighboring countries. Existing data is quite old, but Kosovo performs fairly favorably in most measures. That said, evidence from our consultations suggests there are negative costs due to high levels of pollution. Additionally, Kosovo has the lowest rate of public expenditures on health in the region. The health infrastructure is generally considered to be poor, with Kosovo citizens regularly travelling to FYR Macedonia and Turkey for both routine and specialty treatments. The levels of medical tourism are so great that FYR Macedonia recently built a large hospital complex on the Kosovo border to better meet demand.

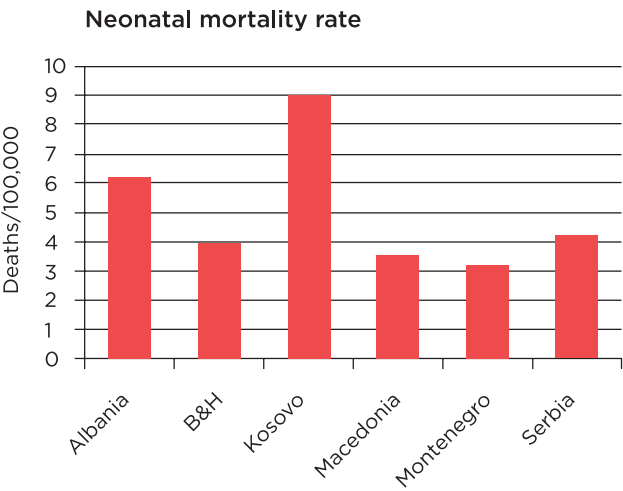
Kosovo has the highest fertility rate²² (2.1 births per woman) and the lowest life expectancy (71 years) in its region. Life expectancy has been growing, but the gap between life expectancy in Kosovo and surrounding countries has persisted. The fertility rate has also dropped significantly since a high of 5 in the 1980s, but remains well above neighboring countries.

In terms of general health statistics, Kosovo does not fare too badly, except on neonatal and under age five mortality rates (figure 43).

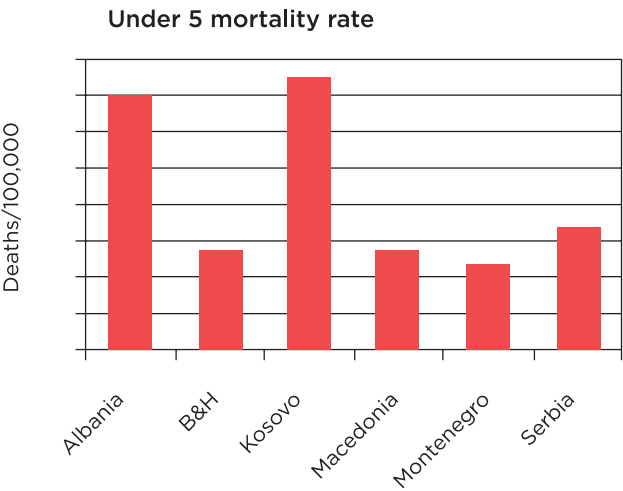
²² Births per woman.

Figure 43. Kosovo and comparator countries' mortality rates.

a. Neonatal mortality rate



b. Under 5 mortality rate



Source: Kosovo MICS data (2014)

Note: B&H = Bosnia and Herzegovina

However, it is not clear whether health statistics in Kosovo are artificially low for a couple of reasons. First, statistics mostly reflect hospital data, but health center data is not well integrated, and thus statistics might be low and only show the most serious cases. Second, low statistics may be because of the high level of medical tourism, as mentioned. If most residents are seeking treatment elsewhere, they would not be accounted for in health statistics (certainly not morbidity, though probably mortality would be more accurate).

Kosovo rates fairly low in terms of physicians and hospital beds by population next to neighbors, but compared to all countries are roughly comparable. Many physicians have reportedly left the country (and the Balkans more generally) to work abroad, where pay is higher, and there is better access to equipment and collaboration.

9.3. Pollution

Generally, the relatively high PM_{2.5} concentrations²³ in Kosovo lead to bronchitis, asthma, and heart conditions in vulnerable populations. Relatively high lead exposure, extending from past and current use of leaded gas vehicles and mining, can lead to IQ loss and other behavioral issues in exposed children. All main rivers in Kosovo are classified as extensively polluted from the source, with high levels of bacteriological and heavy metal contamination. Exposure to pollution from water sources is exacerbated because there is almost no wastewater treatment in the country. A couple of small municipalities now have water treatment works, but from after the 1999 until 2017, the initial effort by donors and the government was to get households water connections in the first place. Only now that many households are using piped water systems (access to piped water is one of the highest in the region, although about a third of the population uses private wells or communal networks) is wastewater treatment coming forward as an issue. This is especially an issue for industries, most of which have to invest in their own

²³ PM_{2.5} consists of “fine particles” with aerodynamic diameters less than or equal to 2.5 microns (µm). PM₁₀ includes both fine particles (PM_{2.5}) and “coarse particles,” which is the subset of PM₁₀ that is larger than 2.5 µm and smaller than 10 µm. The chemical makeup of particles varies across the U.S.

wastewater treatment. Although this is the case in many countries (the heaviest polluters have to do a certain level of remediation before releasing waste into the public system), it is an additional cost of doing business for the small firms that predominate in Kosovo. Further, once firms have done their own treatment, it is difficult to get rid of the waste. Solid waste collection and disposal, particularly for industrial producers, is poorly regulated and there are few certified hazardous waste dumps in the country. Leachate from solid waste collection points and mines is a significant risk to water quality, expressing methane, dioxins, heavy metals, and other harmful contaminants into the water table.

Energy production in Kosovo is massively polluting: coal-fired plant Kosovo A, built in the 1960s, releases roughly 2.5 tons of ash into the air hourly. The existing power plants also impact water security, not only because they use substantial water resources but also because they are sources of surface and underground water pollution (Kosovo Foundation for Open Society [KFOS], 2016). There may be significant overlap between energy and health—both in terms of outdoor air pollution from power generation and also possibly indoor air pollution due to heating with biomass.

The Kosovo Civil Society Consortium for Sustainable Development (KOSID) claims that outdoor air pollution due to industry and energy production has caused damage estimated at up to 163 million euros and contributes to increased mortality. Alarming World Bank (2013) statistics on health costs conclude that air pollution is estimated to cause 852 premature deaths, 318 new cases of chronic bronchitis, 605 hospital admissions, and 11,900 emergency visits each year. Mortality affects mostly the young and old, but DALYs affect working age people almost as much as those over age 60 years (40 percent of attributable events for those ages 15 to 59 years and 49 percent for those over age 60, with men slightly more affected than women). This has negative implications for the health and well-being of the workforce.

We were not able to find consistent sources on comparator countries, but using one estimate from a 2014 paper on air pollution in Serbia, we calculated that Serbia had 28.4 deaths per 100,000 people due to air pollution, the 10th highest mortality due to air pollution. Using the above figures, Kosovo's mortality rate from air pollution is approximately 47 deaths per 100,000 people.

The World Bank analysis (2013) suggests the cost of environmental degradation in Kosovo is from 2.9 percent to 7.8 percent of GDP, with the midpoint at 5.3 percent.

At least one study has demonstrated that the health effects of living in Obilić (also known as Kastriot) where the thermal power plants are located, are high (Zeneli and others, 2011). These communities complain of significant health effects, particularly respiratory diseases but also heart and lung disease, cancer, mental health diseases, and diabetes (Krampe and Kostić, 2014).

While ash management has improved, there are also additional impacts on water resources. Finally, the mine associated with the construction of the Kosovo e Re power plant will require the resettlement of 7,000 people. A survey of the nine affected villages found that only 20.9 percent of individuals there were employed while 19.4 percent were “housewives,” leaving a high number of inactive and unemployed individuals, many of whom are reliant on land as a safety net. There are further worries regarding inadequate compliance with international involuntary resettlement policies and procedures and resultant impacts on vulnerability among the affected (Downing, 2014).

9.4. Conclusions about the shortage of human capital

Compared to all nations, Kosovo is comparable in all education indicators, except primary school enrollment, in which it is comparatively low, though secondary school enrollment matches comparator countries. We therefore conclude that access to education is not a binding constraint, although ethnic minorities, including the Roma, Ashkali, and Egyptians, face markedly lower enrollment and completion rates for primary and secondary education. Female minorities are doubly disadvantaged for reasons that include the cultural preference for girls to stay home and the continued prevalence of early marriage.

While access to education is not a major concern, the quality of education is generally considered low. If the lack of human capital was a binding constraint for investment, there should be a lot of competition among firms for skilled labor. This would in turn be

reflected in markedly lower unemployment rates for skilled workers, as well as a rise in wages and significant inflows of skilled workers into Kosovo. In fact, returns to education are not particularly high (Kosovo is below all average levels), and though unemployment does fall with level of education, all rates are still high. Returns to education are higher for females and are particularly high for well-educated females, but this is a standard result across countries. With an unemployment rate of 33 percent and around 25,000 new labor market entrants per year, Kosovo appears to enjoy a surplus in its labor force. Additionally, it is telling that citizens of Kosovo who emigrate experience higher employment levels—both men and women—than when they stay in Kosovo. While there is probably some selection bias, it does imply that the quality of education is not so bad that it prevents people getting jobs in Europe. Additionally, businesses in Kosovo did not report extensive importation of skilled workers from elsewhere, other than for specific activities such as fixing specialized equipment, for which a country as small as Kosovo would not be expected to have expertise.

Thus, while the quality of education is undoubtedly not as high as that received in the rest of Europe, it is unlikely that the addition of higher skilled workers would, in and of itself, increase growth and investment. Therefore we conclude that the problem is primarily one of insufficient demand for skilled labor, most likely as a result of the binding constraints described previously.

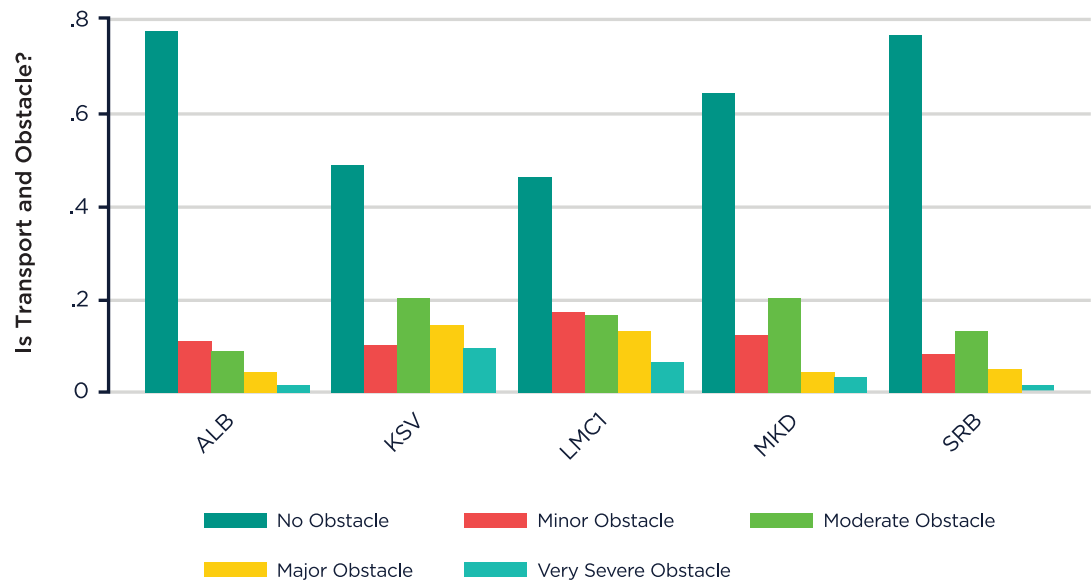
Does a Lack of Adequate Infrastructure Pose a Binding Constraint to Growth in Kosovo?

10.1. Transportation Infrastructure

Kosovo's transportation has improved since the breakout of the 1999 war. Upgrades to infrastructure have had a positive role in supporting the economic growth in Kosovo, with improvements to road infrastructure, urban transport, and air transportation. KAS (2016) reports that 90 percent of roads are asphalted; there are 1,943.3 km of paved roadways (out of 2,033.4 km), and 90 km remain unpaved. The road infrastructure has 630 km of main roads according to the Ministry of Infrastructure, and they are well developed and in good condition.

The Ministry of Infrastructure reports three highways as complete and semi-complete: R6, R7, and R71. The development of these routes as motorway projects is considered major infrastructure investment in Kosovo. The first highway is the 101 km long R7 motorway, or the Ibrahim Rugova Highway (European Route E851), completed in 2013. It links the Kosovo capital to Albania and shortened the road travel time between the two countries from seven hours to three hours. The Albanian side of the road was completed in 2010. The motorway is part of a larger plan to connect Kosovo, Serbia, and FYR Macedonia. The second highway, currently set to be completed at the end of 2018, is the R6 motorway or the Arbën Xhaferi highway, connecting Prishtina to the FYR Macedonia capital, Skopje. The new highways in Kosovo are an important link between Western and Eastern Europe. Specifically, when the highway leading to Nish is completed, it will officially link to the Pan-European Corridor X running through Austria and Greece (EBRD, 2011).

Figure 44. Is transport an obstacle to growth in Kosovo?



Source: World Bank data (2014)

Conflicting reports have arisen regarding the involvement of the firm Bechtel-Enka in the construction of the road. Initially the cost was lower, however, it has risen to around €820 million for 77 km of motorway (The Guardian, 2014).

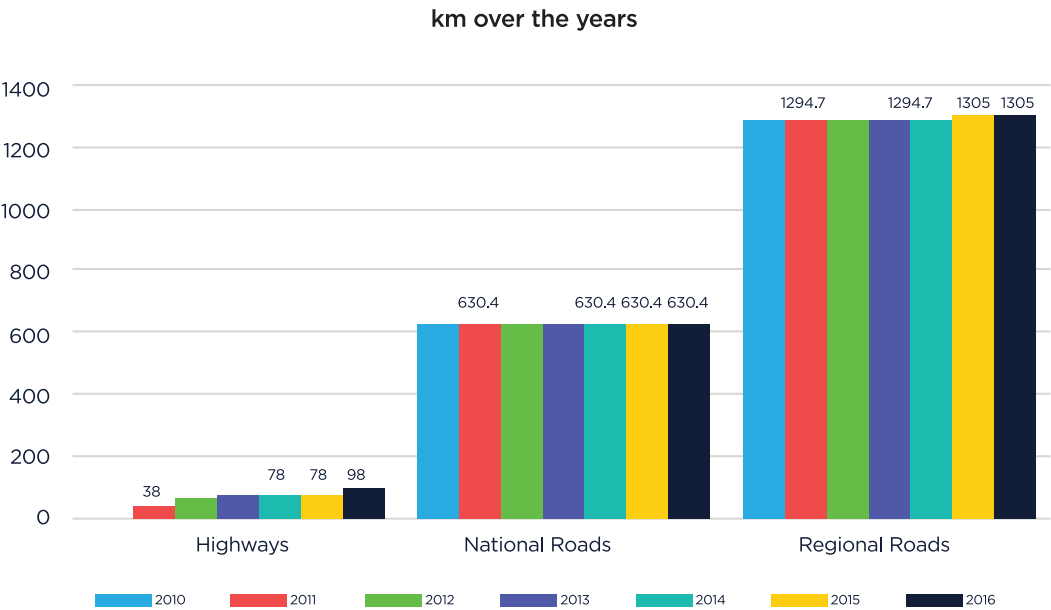
Complete data about the Kosovo transportation system is not available, and the data available is old and does not completely count the municipal roads. Comparisons made with other low- and middle-income countries (LMICs) place Kosovo in the middle with regards to road density, controlling for population density and GDP per capita. However, on the paved road density, controlling for population density, Kosovo is a little below average, with other LMICs being slightly higher.

The *Doing Business* report indicators on the cost of imports show Kosovo as improved, but still at a higher than average cost of imports when streamlined on GDP per capita. From 2009 and on, the log of cost to imports is listed as decreasing toward the fit line of the worldwide panel. Traffic in Kosovo has been characterized as dense, but not much denser than expected, with Kosovo being exactly at the average line, and better than LMICs regarding number of vehicles per kilometer of road. Moreover, transport is characterized as posing no obstacle (figure 44).

The Ministry of Infrastructure of Kosovo defines public roads as common road spaces for transport, which can be used by travelers according to the rules set by competent agencies. Highways are defined as public roads built for motor vehicles only, with clearly defined one-way lanes of travel 3.5 meters wide, with two emergency lanes each 2.5 meters wide. National roads connect two or more cities within Kosovo and might connect Kosovo to other destinations outside the border. Regional roads are public roads connecting economic centers of two or more regions. Local roads connect inhabitable spaces within communal or municipal areas. Urban roads connect neighborhoods within a municipality. There is also a final category called uncategorized roads. These roads are public and used for access to forests, lakes, or agricultural destinations. As for progress regarding roads, the Kosovo Statistical Agency reports 5 percent of roads as highways, 31 percent as national roads, and 64 percent as regional roads.²⁴

²⁴ Details on exact roads per region can be found at http://www.mi-ks.net/repository/docs/Harta_e_Mirembajtjes_se_rrugeve_2014_2015.pdf.

Figure 45. Road type by kilometer in Kosovo.



Source: Ministry of Infrastructure (2016)

A healthy transportation system provides for a healthy economy and ensures an easier flow of goods and people. However, public transportation is not at the desirable level, although plans are in place to make improvements. The Agency for Gender Equality, on its 2011 report, states that 40 percent of women cite transportation to work as a difficulty, hence posing as an obstacle to women accessing jobs. Moreover, half of public buildings are considered inaccessible by persons with disabilities.

The responsibility for infrastructure, transport, and road maintenance falls under the Ministry of Infrastructure, though local roads are under the administration of the municipalities. In the Ministry of Infrastructure there are departments dealing with road management, road infrastructure, land transport, legal issues, licenses, automobiles,

policy coordination, civil aviation, and inspections. These departments are all regulated and directly linked to municipalities regarding roads and infrastructure in general. The Ministry of Infrastructure, in its 2016 presentation at the Sarajevo summit, stated that they want to make Kosovo the transit country for traffic from Southeast Europe, connecting the main corridors and routes of the region.

Regarding railways there is a slow but functional rail train with 333 km of track managed by Infrakos and run by Trainkos (both public enterprises). It is not particularly popular due to its slowness. There are eight diesel locomotives circulating in Kosovo, with 27 cars, 18 for luggage and goods, and 9 for passengers. In the past 10 years the weight of goods transported has increased from over almost 300,000 tons of goods per year to over 700,000 tons per year; however, the number of passengers has been on the decrease.

The Civil Aviation Agency sets the legal framework for air traffic, lists passenger rights, and publishes air traffic data, including companies operating in Kosovo. Air travel is popular, with Prishtina International Airport serving as the country's hub. There are also airports in Gjakova and Podujevo that are currently shut down. They previously served as domestic-flight airports and have limited chances of revival to full capacity airports like the one in Prishtina. Air transport has increased in popularity, going from serving 931,000 passengers in 2005 to over 1 million passengers in 2016, according to the Prishtina Airport "Adem Jashari" 2016 yearly report. Most flights come in during the summer season from the diaspora populated cities of Western Europe. An important fact to consider is that Prishtina is also within a two-hour drive of Skopje's international airport, and many travelers choose Skopje as their arrival city.

Transport is not a major constraint in Kosovo considering that in most parameters Kosovo stands better than LMICs. With the latest investments in road infrastructure, and with the increased popularity of flights after the privatization and enlargement of the capital city's airport, transport has significantly improved and does not pose a barrier to doing business. On the contrary, it contributes to faster movement of goods and people.

10.2. Energy

10.2.1. Kosovo's electricity sector background

Kosovo's electricity sector has been implicated as a constraint to growth before by the USAID, in their growth diagnostic 2012. Consequently, the Government of Kosovo has undertaken a series of important reforms in the power sector aimed at liberalizing and developing the Kosovo electricity market, especially focusing on the establishment of legislation and regulation in accord with the European Union Acquis. As of 2005, Kosovo is a full member of the Energy Community of South East Europe, committed to implement the Acquis Communautaire in Energy, Competition, Renewables and Environment. A significant contributor to the electricity constraint is Kosovo's unusually high reliance on coal-fired electricity, particularly for heating in the winter. In addition to institutional reform, therefore, Kosovo is taking steps to promote alternatives to coal-fired electricity for heating, such as district heating, as well as alternative energy sources, such as renewables, and increased efficiency of electricity usage, such as building codes. In this section we will test to see if electricity is still a binding constraint to growth in Kosovo.

The process of energy sector reformation in Kosovo dates from 2004 with the establishment of the Energy Regulatory Office (ERO). ERO has been established as an independent authority and is operating on the basis of detailed primary and secondary energy legislation (roughly equivalent to regulation by federal agencies in the United States). ERO does the economic regulation of the sector, and its board reports to parliament. It issues licenses for the following operations: electricity generation, transmission system operator: electricity distribution system operator, market operator, public electricity supply, electricity import and export, district heating production, district heating distribution, district heating public supply, and cogeneration of electricity and heat.

In the electricity sector, there are four main licensees: KEK, KOSTT, KEDS and KESCO. The Transmission System and Market Operator (KOSTT) is publicly owned and has been completely separated (ownership unbundling) from the Kosovo Energy Corporation (KEK) with ownership of lines of 110 kilovolts (kV) and above. KEK JSC is a wholly government-owned, vertically integrated utility that owns and operates the Kosovo A and Kosovo B lignite-fired power plants and the associated lignite mines.

The distribution and supply divisions (KEDS) were unbundled from KEK and privatized in May 2013 by the Turkish consortium Calik-Limak. By the end of 2014, the distribution division (KEDS) was unbundled from the supply division (KESCO), thus paving the way for liberalizing the market through introduction of other suppliers in the market. According to the Law on Electricity, beginning in January 2015, all customers are eligible, and thus have the right, to choose their supplier and be billed with nonregulated tariffs.

In addition to institutional reform, Kosovo is attempting to diversify away from coal-fired electricity by, with donor assistance, encouraging district heating as a substitute for electric heating, encouraging independent power providers of renewable electricity sources to enter the market, and encouraging more efficient use of electricity (by using insulation, for example).

Another problem Kosovo has is that, because of the unreliability of the current supply of coal-fired electricity, it relies a lot on imported electricity. This has two problems: first, imported electricity tends to be more expensive than electricity produced from the coal-fired power plants, leading to price uncertainty in the electricity market (and hardship for poor households). Second, the Kosovo transmission system interconnection capacities and transit control, as part of the control zone, are still run by the Serbian Electricity System Operator (ESM), which tends to increase the amount of time between an unexpected outage and a response from the transmission system—this makes outages last longer. The effort to grant Kosovo control over the power transmission system on its territory (by granting it membership in the European power transmission group ENTSO-E) has been held up by the Serbian government indefinitely.

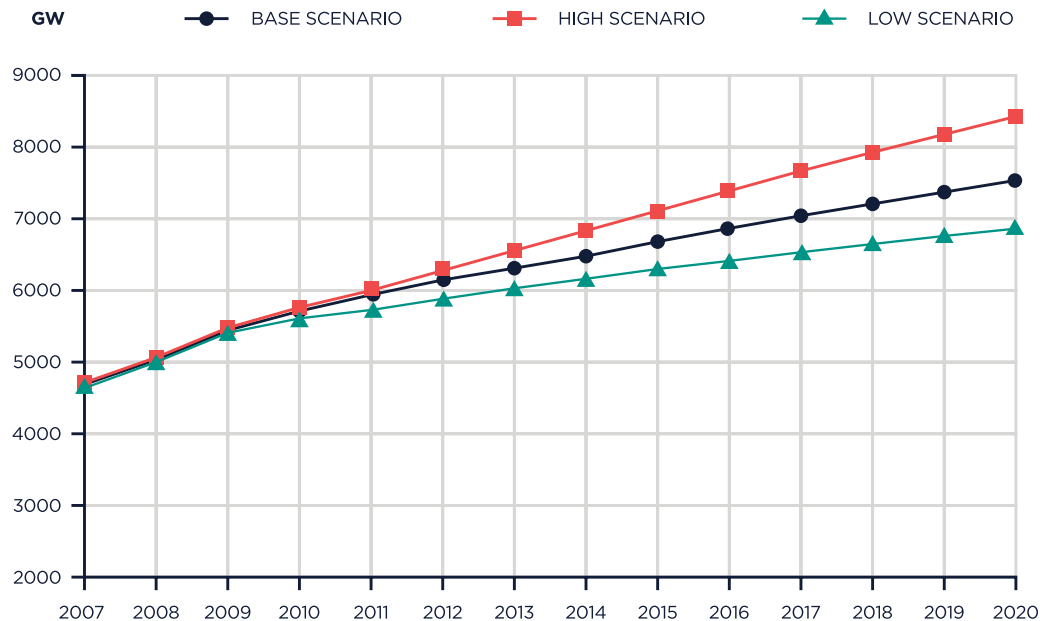
While Kosovo has successfully implemented the policy and institutional reforms necessary to allow private sector participation in the electricity market, the amount of outside investment to date has been disappointing. Part of the problem is that Kosovo's small market was supplied primarily by two large coal-fired power plants (Kosovo A, built in 1962, and Kosovo B, built in 1983), and the electricity grid is designed to deliver electricity from those large plants to consumers. Allowing small electricity suppliers, particularly suppliers of renewable energy, into the market requires investments that would allow electricity to flow in a more distributed manner, and that investment has not happened yet. Currently, the World Bank and other investors are preparing to invest in a new power

plant, Kosovo e Re, to be built by 2023, and decommission Kosovo A (which is the dirtiest plant in Western Europe). Because of the scarcity of new suppliers, Kosovo still lacks the generating capacity to meet increasing demand; is highly dependent on imported electricity (which is relatively expensive); and relies on large power plants, which limits the flexibility in the power supply. Furthermore, despite improvements in collections by private sector investors in distribution and supply, there is still a high level of technical and nontechnical losses, particularly because of the inability to access the northern, majority Serbian part of Kosovo and the non-implementation of the agreement for KOSTT to become a member of ENTSO-E.

10.2.2. An unreliable supply of electricity: The main economic constraint

Now we will test to see if electricity is still a binding constraint in Kosovo, despite all the progress made in institutional reform. The main constraint that impedes robust growth is inadequate infrastructure, particularly energy, which increases operating costs for companies. Also, the quality of power decreases the further outside of Prishtina a company is located and the frequency of power outages increase. Private lines from KEDS are costly, and approval is not guaranteed. This has the largest impact on small and medium farmers and manufacturers (Productive Sector Analysis Report, Dahlberg, 2016). First we consider baseline electricity consumption, to provide context. The supply of power in Kosovo has not kept pace with the demand. This is evident from the declining electricity production per capita. Kosovo's electricity operating capacity is about 900 MW, almost all of which comes from two antiquated, coal-fired power plants. The rest comes from hydroelectric plants that provide about 50 additional megawatts of capacity.

Electricity consumption and peak demand in Kosovo grew more than 90 percent between 2000 and 2010 (USAID Growth Diagnostic Report, 2012). Electricity consumption grew at an average annual rate of 6.7 percent, and peak demand at an average annual rate of nearly 6 percent. Most of the electricity demand in Kosovo is residential (approximately 63 percent), followed by commercial and industrial.

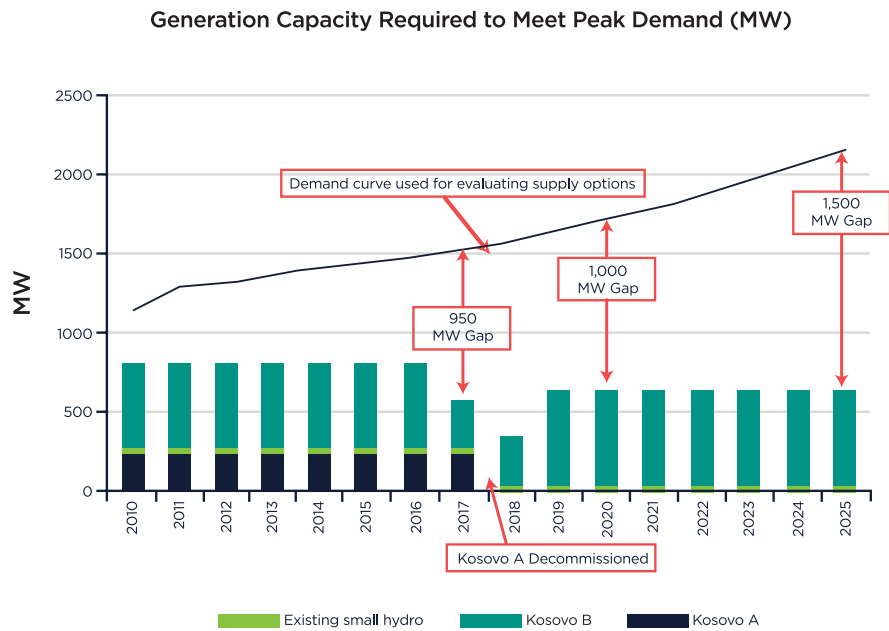
Figure 46. Projected electricity demand in Kosovo 2011-2020

Source: World Bank (2011)

Note: GW = gigawatts.

World Bank's "Development and Evaluation of Power Supply Options for Kosovo" paper, produced in 2011, forecasts (figure 46), that electricity consumption in Kosovo would grow by 4.6 percent per year and Kosovo's would need new firm capacity of 950 MW by 2017 (after Kosovo A has retired), 1,200 MW in 2018 (when one Kosovo B unit is out of service), 1,000 MW in 2019, and about 1,500 MW in 2025. The study concludes that Kosovo needs a mix of renewable and thermal energy to meet its demand for peaking and base-load capacity. Figure 47 shows the projected generation capacity needed to cover the demand in Kosovo for the next decade.

Figure 47. Generation capacity required to meet peak demand (MW).



Source: World Bank (2011)

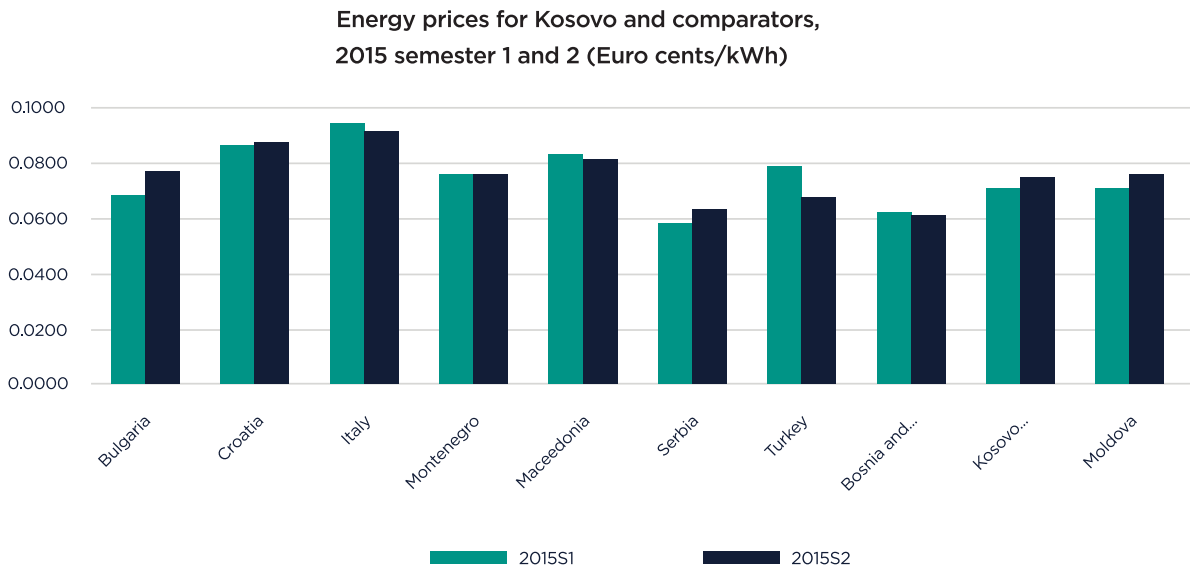
Note: MW = megawatts.

10.2.3. Test 1: The constraints impose high costs

It is generally difficult to use electricity prices for the first test of the constraints analysis methodology because they tend to be administratively set. Often electricity prices are below cost recovery, meaning that the government is either explicitly or implicitly subsidizing electricity prices. Indeed, electricity prices in Kosovo per kilowatt hour (kWh) are not high compared to the region as seen in figure 48, although prices are low mainly because the coal-fired power plants the country depends on for power are completely depreciated. Once replacements are online, electricity prices will likely increase significantly given the current regulatory regime.

The levelized cost of electricity (LCOE) for the new Kosovo e Re (sometimes referred to as Kosovo C) power plant is estimated at €81.42 per megawatt hour (MWh), much higher than estimations of costs for renewables or imported power (multiple sources in Kittner and others, 2016). According to the Institute for Energy Economics and Financial Analysis (IEEFA), the new plant would increase consumer costs by as much as 50 percent in the first year of operation, constituting an increase in the average household electricity expenditures to 12.9 percent of annual income. This is a rate more than double that of EU households and one that would mean more than half of families would face “energy poverty” by the 10 percent income standard and that the poorest families would pay almost 40 percent of annual household income for electricity (Sanzillo and Schlissel, 2016), all things being equal (for example, should there not be significant interventions in energy efficiency measures or changes to subsidies for impoverished families).

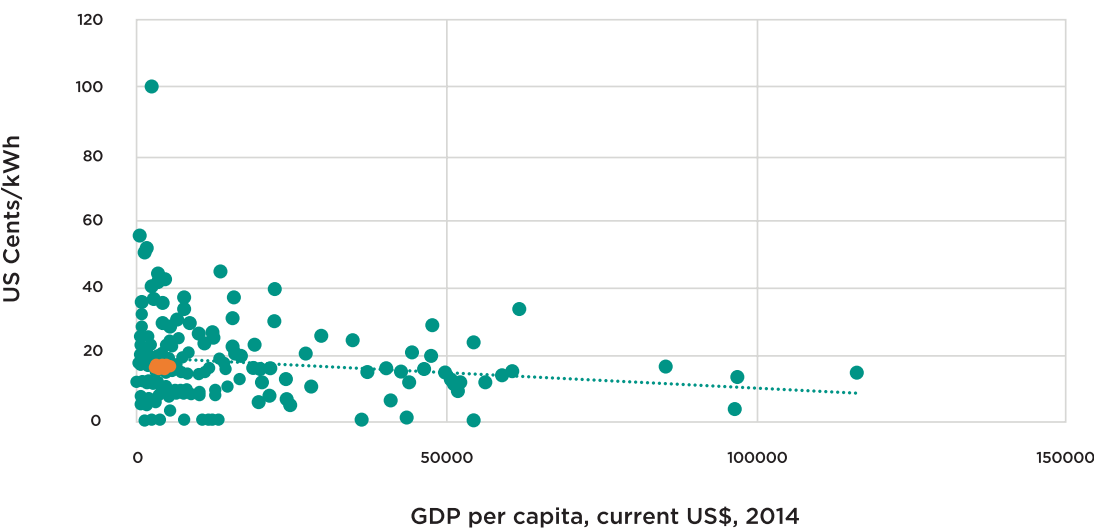
Figure 48. Electricity prices for Kosovo and comparator countries, 2015, semester 1 and 2 (euro cents/kWh).



Source: Doing Business; World Bank (2016).

Note: kWh = kilowatt hour.

Figure 49. Electricity prices for Kosovo and comparator countries by GDP.



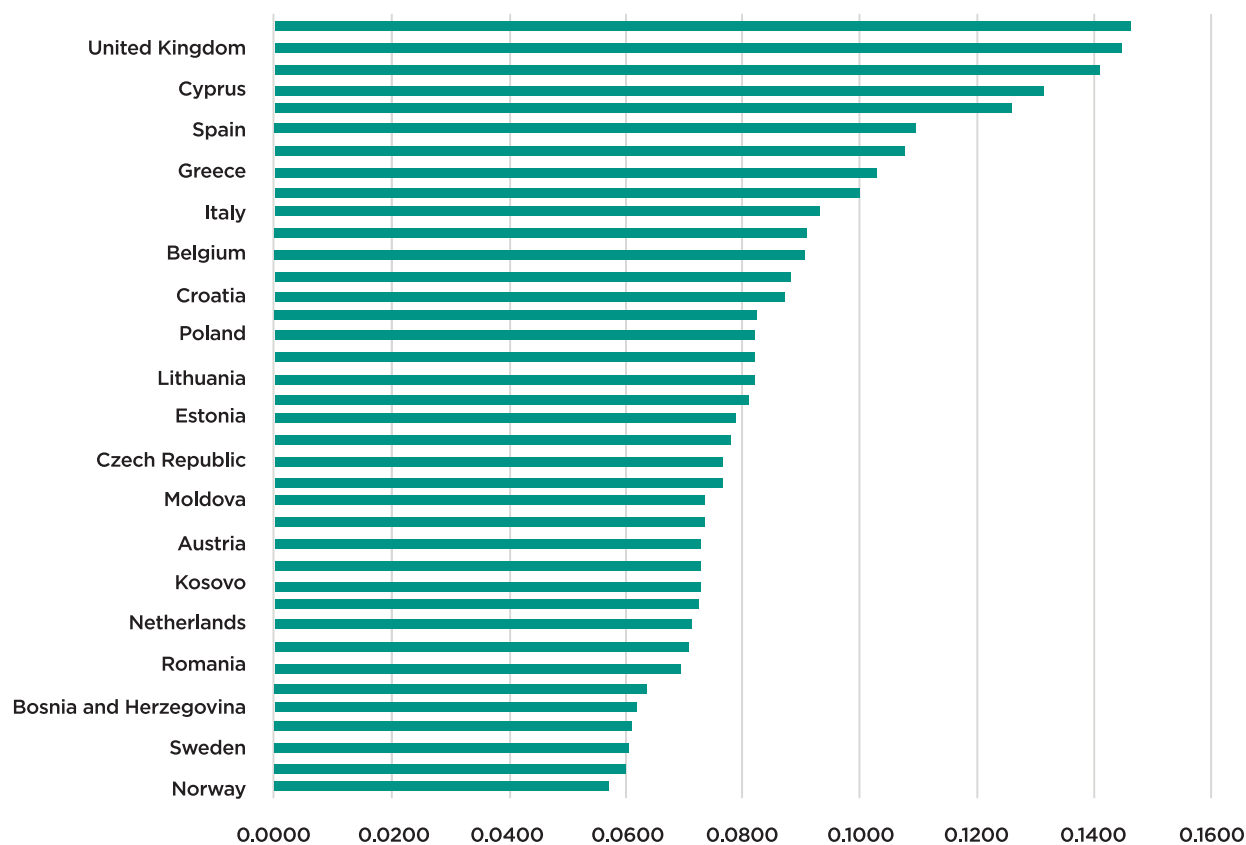
Source: Doing Business, World Bank data (2016)

Note: GDP = gross domestic product; kWh = kilowatt hours.

As may be seen in figures 48 and 49, per kWh electricity prices in Kosovo are right on trend, and the same can be seen in figure 50 for industrial energy prices, which are also not high compared to the comparator countries.

With regards to energy consumption levels, Kosovo ranks quite high. Perhaps because of low prices, there has not been much of a focus on energy efficiency, although more than 60 percent of consumption is by households (ERO Annual Report 2016). Based on figure 50 it may be seen that on per capita basis, Kosovo’s ranking is higher than average, that is, over the median of similar income countries.

Figure 50. Industrial electricity prices, Kosovo and comparator countries.

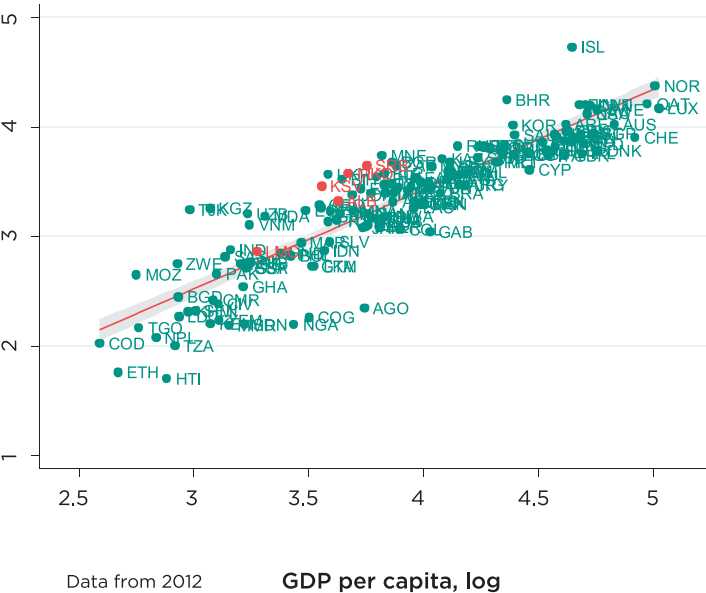


Source: World Bank data (2016)

Efficiency. Although electricity prices are low, the share of electricity bills in household expenditure is high, and the expectation is that people would change their electricity use habits to lower their bills. However, residents don't seem to be using the easiest and most obvious workarounds, such as taking energy efficiency measures. According to some estimates, more than 90 percent of current construction in Kosovo is illegal, that is, without full applicable permits.

In winter when the tariffs are higher, much of household electrical energy is used for heating, and the higher usage means that residents will be using the expensive third block (>600kWh) amount of energy. According to an American University in Kosovo–Rochester Institute of Technology (AUK-RIT) study in 2013, very few households in Kosovo have insulation. One estimate suggests that one generator of Kosovo A could be shut down simply by switching all lightbulbs from incandescent.

Figure 51. Electricity consumption per capita for Kosovo and other countries (kWh).



Source: World Bank data (2012)
Note: GDP = gross domestic product; KSV = Kosovo; kWh = kilowatt hours.

Box 1. Use of Wood for Heating

Wood is relied upon primarily because it is cheaper than electricity (Bowen and others, 2013). Therefore, households in which there are fewer employed members are likely to depend more on wood fuel than households with more employed members (FAO, 2015). Kosovars also cope by limiting their heated living space. Approximately 41 percent of Kosovo homes heat only one room, and 33 percent heat only two (Bowen and others, 2013). Further, among low-income respondents, only 41 percent of household space was heated in the winter (English and others, 2015b). The average amount of wood consumed by urban (63 percent of heating energy) and rural (100 percent of heating energy) households was 9.75 cubic meters and 11.47 cubic meters, respectively. Interestingly, 35 percent of all wood-fuel came from illegal harvesting according to an AUK study. The supply of wood for heating is also not unlimited. Although approximately 43 percent of Kosovo is covered in forest—60 percent of it public and 40 percent private—current consumption exceeds renewable supply, and demand is increasing. At this rate of consumption, without intervention for reforestation, Kosovo forests would be entirely depleted by 2028 (Pira and others, 2011). These issues are a worry not simply from an environmental perspective; due to expected shortages, price increases can be expected to have a significant, in some cases potentially tragic, effect on the most vulnerable households. Wood-burning stoves produce black carbon, a residue that is the second largest contributor to climate warming after carbon dioxide (Bond and others, 2013). It is thought that black carbon is responsible for 16 percent (Atlantic Consulting, 2009) to 18 percent (Rosenthal, 2009) of global warming. Over the past decade, research has linked wood stoves with an increased risk for health conditions, including cancer, heart disease, and respiratory diseases (WHO, 2015). Risks are particularly high in the case of high-emitting, low-efficiency wood-burning technologies. In Kosovo, to save on energy expenditures, many families purchase low-quality wood, contributing to pollutants (Bowen and others, 2013). Studies in LMICs have also demonstrated negative health effects associated with the indoor air pollution from burning fuels in the home, including wood, affecting the primary energy users.

One of the most viable options to increase energy efficiency and reduce household heating costs is central heating. As mentioned earlier, at the end of 2014, the Prishtina district heating system was updated. Steam from Kosovo B was directly connected through Termokos, the Kosovo District Heating Authority, to its 12,000 end users. The implications were substantial and immediate. A year later, electricity consumption decreased by 34 percent, billing collection increased by 176 percent, customer dissatisfaction fell from 94 percent to 8 percent, and Termokos operational expenditures were reduced by €10 million. Furthermore, for customers, services became more reliable, energy poverty decreased from 88 percent to 83 percent, and households started to heat much more of their overall residential space. This implies that it is important to evaluate options of expanding the district heating supply to other parts of the country.

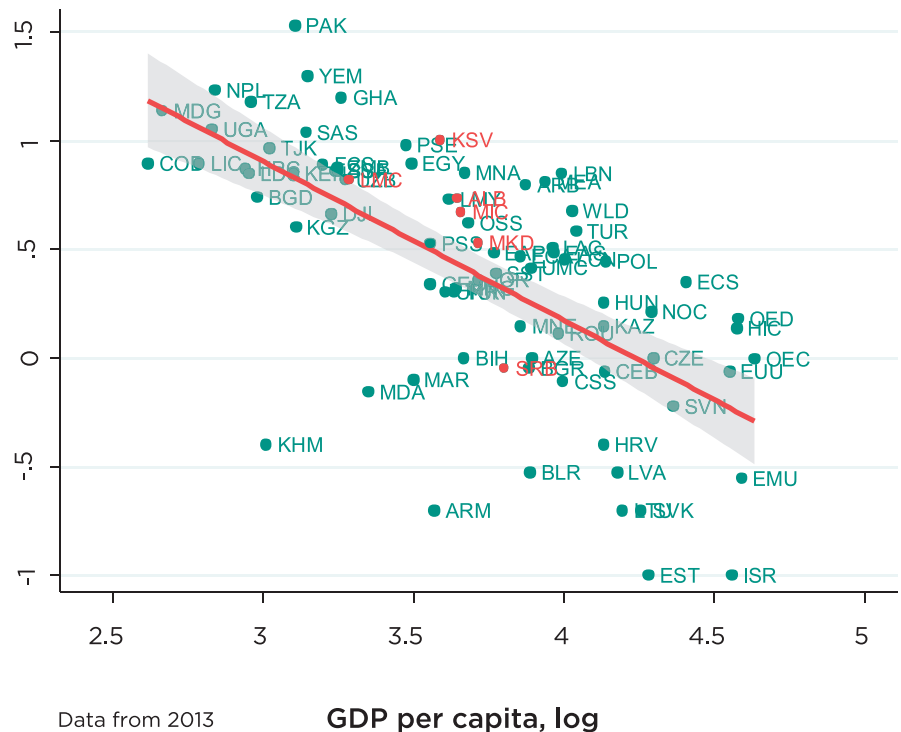
Outages. A more reliable indicator of the shadow cost of electricity is the frequency and duration of outages for businesses and households. While access to basic connectivity in Kosovo is good, access to sufficient electricity is weak. Frequent outages are costly to consumers and require them to rely on alternative energy sources. Although the situation is constantly improving, especially in the last few years, Kosovo still ranks worst among comparator countries. For the majority of businesses (micro and small and medium enterprises) these solutions have a significant impact on their profitability. For those at home, running out of electricity in the depths of winter is more than a health concern; it affects income-generating activities. Many of these latter businesses are reliant on central connections. When connections are lost, so are the products and potential consumers.

Insufficiency can lead to periods of low voltage, which can be extremely costly if they spoil goods or ruin the motors of electronics. For similar reasons, insufficiency has a large impact on small businesses, those same businesses facing the most outages and relying more on less technologically advanced household appliances. Kosovo businesses incur about €296 million in additional costs due to irregular energy supply annually, according to a USAID (2012) study.

However, load shedding levels have dropped considerably, from 257,975 MWh in 2011 (4.5 percent of consumption) to 91,934 MWh

in 2014 (1.7 percent of consumption). Some of this improvement is due to emergency repairs funded by donors, and some has been accelerated after privatization with higher level of investment being carried out at the distribution level and more efficient operations, including much cheaper import costs. However, if delays continue on building replacement baseload, USAID energy experts estimate that Kosovo A could get worse again because it is basically not reparable anymore. In that case, load shedding would again worsen or the gap in the energy supply would need to be covered through imports. Low voltage also jeopardizes household well-being because half of households reported that, on their incomes, they would not be able to afford an unplanned expenditure of €500 (KAS, 2015). Figure 52 shows the log of value lost due to electrical outages (as a percent of sales).

Figure 52. Value lost due to electrical outages per capita.

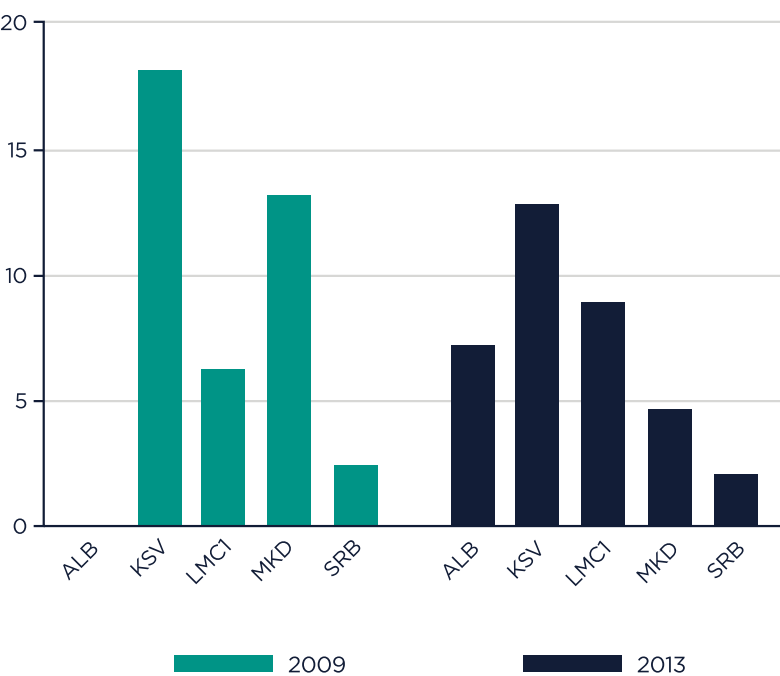


Source: World Bank data (2013)

Note: GDP = gross domestic product; KSV = Kosovo

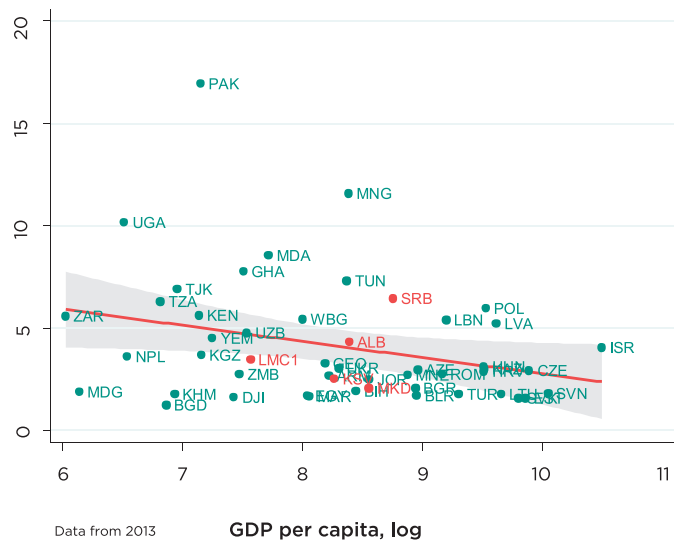
It is clear from figures 53 and 54 that Kosovo incurs very high losses in annual sales from power outages compared to comparator countries, and the negative impact of the outages probably costs around 5 percent of GDP annually (World Bank, Doing Business report, 2013). However, based on some data the situation in terms of how long the outages are or the number of outages experienced is not much higher than in similar income countries. Based on the data from figures 57 and 58 it is unclear why businesses would be so sensitive in terms of losses with respect to comparator countries, despite actually seeing less unreliability. It might be that the problems are embedded into business peoples' mindset after 15 continuous years of interruptible supply while the issue of load shedding has still not been completely mitigated.

Figure 53. Losses resulting from power outages as percent of annual sales for Kosovo and comparator countries.



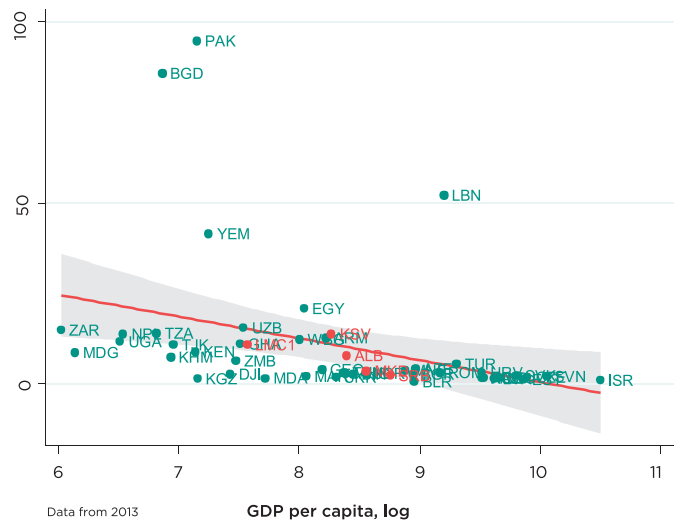
Source: USAID (2012)

Figure 54. How long average power outages last by country.



Source: World Bank data (2013)
Note: GDP = gross domestic product; KSV = Kosovo.

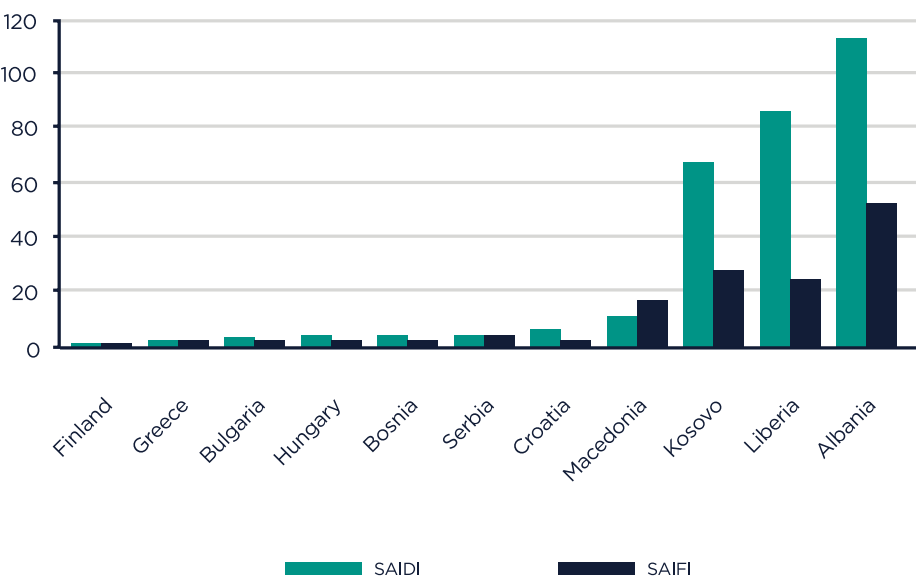
Figure 55. Power outages experienced per month.



Source: World Bank data (2013)
Note: GDP = gross domestic product; KSV = Kosovo.

In comparison to other comparator countries, SAIDI and SAIFI indexes are relatively high in Kosovo (figure 56). KEDS does detailed monitoring on feeder level, but is not in position to provide a breakdown of detailed SAIDI and SAIFI data, such as figures by source of outage, for example, generation, failure of transmission line, failure of distribution equipment, faulty poles, vegetation, equipment failure, windstorms, excess consumer demand. Figure 56 shows the KEDS report on SAIDI and SAIFI for the years 2014 and 2015 (KEDS, CEO, 2016). Currently, according to KEDS, there are no targets for SAIDI and SAIFI, but there will be a discussion at the next regulatory review between KEDS and ERO.

Figure 56. SAIDI and SAIFI for Kosovo and comparator countries.



Source: KEDS (2016)

Note: SAIDI = System Average Interruption Duration Index; SAIFI = System Average Interruption Frequency Index

Table 4. SAIDI and SAIFI for 2014 and 2015.

Reports 2014

Description	January	February	March	April	May	June	July	August	September	October	November	December
SAIDI - due to planned distribution system interruptions (hours in decimal)	0.33	0.75	0.57	0.31	0.20	0.28	0.17	0.49	0.14	0.63	0.47	0.64
SAIDI - due to unplanned distribution system interruptions (hours in decimal)	5.03	4.37	5.98	7.89	5.74	8.37	9.36	6.92	8.17	8.57	5.16	4.96
SAIDI - due to planned distribution system interruptions (count)	0.17	0.28	0.26	0.20	0.15	0.28	0.10	0.26	0.07	0.19	0.19	0.56
SAIDI - due to unplanned distribution system interruptions (count)	1.57	1.57	2.22	2.19	1.99	3.26	3.79	2.94	3.09	2.79	2.18	2.37

Reports 2015

Description	January	February	March	April	May	June	July	August	September	October	November	December
SAIDI - due to planned distribution system interruptions (hours in decimal)	1.06	1.97	1.71	1.83	1.49	1.99	1.54	1.97	1.84	2.43	1.40	1.46
SAIDI - due to unplanned distribution system interruptions (hours in decimal)	5.46	7.22	8.51	7.22	6.00	5.03	6.54	8.73	7.26	6.61	9.15	4.02
SAIDI - due to planned distribution system interruptions (count)	0.55	0.78	1.02	1.14	0.93	1.11	0.90	1.03	0.92	1.22	0.92	0.91
SAIDI - due to unplanned distribution system interruptions (count)	2.26	3.22	6.53	4.30	3.52	3.72	5.17	5.40	4.67	4.25	4.82	2.87

Source: KEDS, 2016

Note: SAIDI = System Average Interruption Duration Index; SAIFI = System Average Interruption Frequency Index.

Until 2014, KEDS did not have proper monitoring of energy not served (ENS) due to lack of appropriate call-center, segregation of maintenance, and black-out operations. This service was established in September 2014 and so data for 2015 is considered accurate. However, ENS is not only monitored by KEDS. Table 5 shows ENS due to planned and unplanned interruptions in 10kV feeder and load shed report for the year 2015.

Table 5. Energy not served in 2015

Description	January	February	March	April	May	June	July	August	September	October	November	December	Total
ENS- due to planned interruptions ^s in the distribution system (GWh)	0.81	0.98	0.80	0.94	0.72	0.93	0.76	1.02	0.86	1.25	0.74	0.96	10.77
ENS- due to unplanned interruptions in 10kV feeder (GWh)	6.99	2.67	3.43	2.47	2.18	1.77	2.61	3.63	2.81	2.37	3.88	1.48	36.30
Load Shed - Total (GWh)	4.79	13.74	5.30	10.55	1.38	0.64	6.64	11.47	2.00	6.92	2.90	1.06	67.35
												Total	114.42

Source: KEDS, 2016.

Note: ENS = energy not served; GWh = gigawatt hours.

Grid Connection.

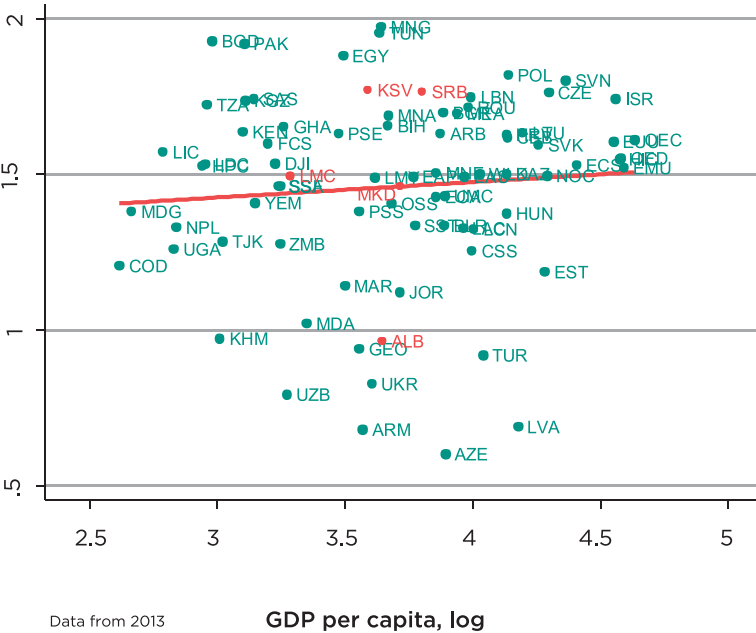
There were many complaints from businesses regarding the high cost of connecting to the grid. With regards to the time it takes to obtain a connection based on World Bank reports, Kosovo ranks much better than its comparator countries. Although it is important to note that the Enterprise Survey and Doing Business reports show significantly different delays in obtaining connections, probably due to methodological differences and the types of businesses interviewed (those in more remote areas tend to have bigger problems and thus tend to complain more). Table 6 show the data from Enterprise Survey Kosovo infrastructure indicators.

Table 6. Kosovo infrastructure indicators

Indicator	Kosovo	Europe & Central Asia	Kosovo
Number of electrical outages in a typical month	10.7	2	6.5
Duration of a typical electrical outage (hours)	1.9	1.2	2.5
If there were outages, average duration of a typical electrical outage (hours)	2.5	3.6	4.4
Losses due to electrical outages (% of annual sales)	6.9	1.2	2.6
If there were outages, average losses due to electrical outages (% of annual sales)	10.1	2.9	4.7
Percent of firms owning or sharing a generator	65	21.5	33.2
Proportion of electricity from a generator (%)	8.1	2.5	7.5
If a generator is used, average proportion of electricity from a generator (%)	13.6	11.3	20.5
Days to obtain an electrical connection (upon application)	58.8	31.5	32.6
Percent of firms identifying electricity as a major constraint	49.5	18.5	31.1
Number of water insufficiencies in a typical month	2.8	0.4	1
Proportion of products lost to breakage or spoilage during shipping to domestic markets (%)	0.3	0.7	1.2
Percent of firms identifying transportation as a major constraint	22.7	9.2	18.3

Source: Enterprise Survey Kosovo infrastructure indicators.

Figure 57. Delay in obtaining an electrical connection (days).

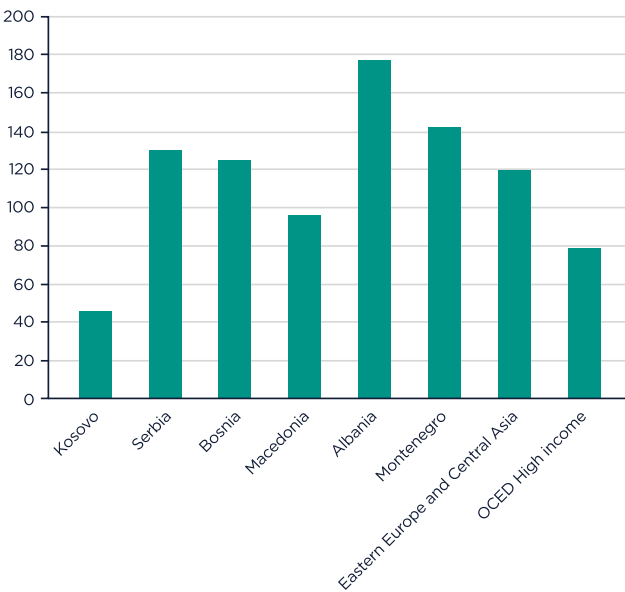


Source: *Doing Business*, World Bank (2013)

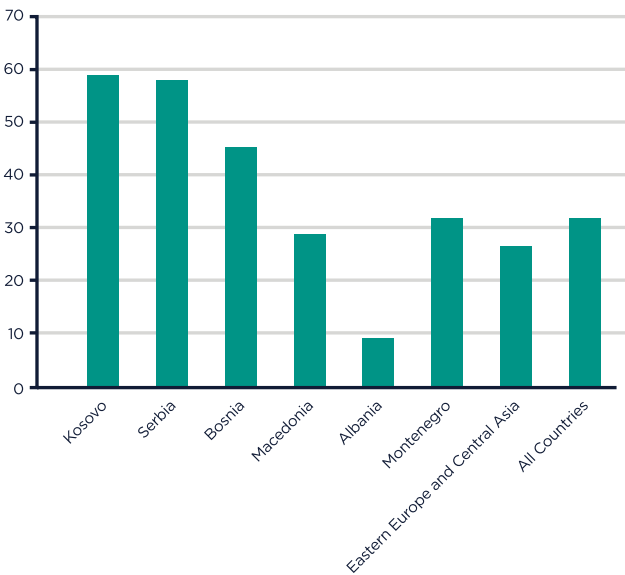
Securing a first-time electrical connection costs a business 788 percent of an average per capita income (WB, 2013). Combined with barriers such as the time it takes to receive electricity (an average of 46 days based on the *Doing Business* report) and the number of procedures required (an average of seven), this ranks Kosovo 124 out of 189 economies in terms of the ease of getting electricity (World Bank, 2016b). On the other side, the Enterprise Survey Indicator on Infrastructure statistic shows the number of days to get electrical connection to be 58.8. Despite the ranking, the time it takes to get a connection and the cost is largely on par with or slightly better than regional comparator countries, particularly when considering that in other countries in the region it is reported that connection times can be reduced by paying a bribe.

Figure 58. Time in days to receive an electrical connection.

a. *Doing Business* Report



b. Enterprise Survey



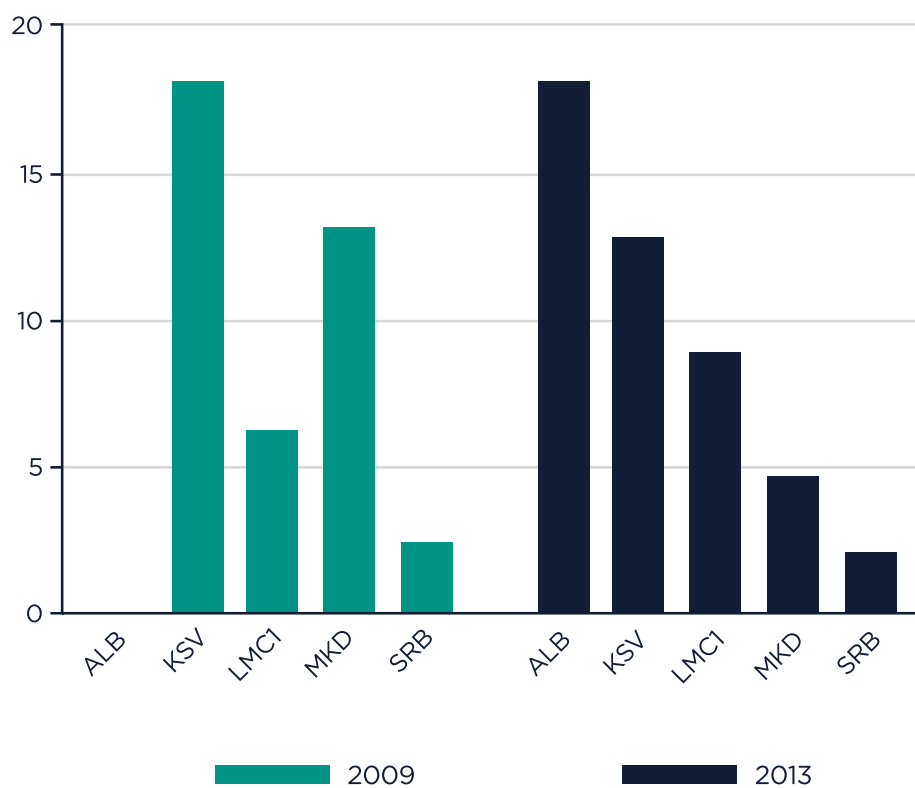
Source: *Doing Business*, World Bank (2013)

Doing Business shows what's on the books, but enterprise survey shows effective/self-reported firm data. This implies that, on the books, Kosovo is very competitive, but practically things take longer, while the opposite is true for most of their comparators (possibly due to corruption in comparator countries).

Both the cost and procedural barriers are presumed harder to bear by small business owners. According to MCC, "energy costs in fuel, equipment and maintenance account for about 25 percent of turnover for micro firms" compared to 4 percent for larger firms. For one baker, 50 percent of her business expenditure was electricity. Another entrepreneur, engaged in drying and selling medicinal herbs, noted that, due to electricity costs she can only run her dryer when entirely full, interrupting her ability to flexibly purchase and sell herbs and leading to spoilage. Figures 58 and 59 are from the Enterprise Survey, 2013, which reports extremely different data compared to the *Doing Business* Report (2016). The latter positions Kosovo at a better spot in this measure.

In general, though, there is an improvement on outages and load shedding levels. The improvement in outages is confirmed by the data showing that generation usage has gone down significantly. This implies that load shedding levels are much lower compared to previous years, but still not at satisfactory levels.

Nonetheless, almost 90 percent of firms in Kosovo have a generator and obtain 15 percent of their electricity from it. All these factors describe an electricity sector that is making improvements but is still a binding constraint.

Figure 59. Losses resulting from power outages, 2009 and 2013

Source: Enterprise Survey (2013)

Box 2. Imports and Trading

Currently, Kosovo solves its generation gap problem by importing electricity, which is expensive. Price per MWh purchased from KEK is around €28 (2015), while import average price for 2015 was around €55. Prices for imports several years ago could reach up to €120 per MWh.

Having to go through ESM for electricity import transactions (because of non-membership in ENTSO-E) leads to outages that are longer than those that would occur if KOSTT were able to undertake electricity import transactions directly. In normal operation of DAM imports wouldn't be a concern and KESCO would not be concerned about deviations caused by generation failures. In such cases, TSO (KOSTT) should use its reserve capacities and ensure import for the supplier, who would be able to provide energy to all its customers as nominated by it.

However, KOSTT still doesn't have reserves and moreover it doesn't control the capacities on the borders. Therefore, the only current solution is for KESCO to arrange import. However, this important electricity can start flowing in the system only once EMS announces free capacities to traders, which include trading process, nomination, and freeing capacities. As such, the earliest KESCO can bring energy in after an incident is six hours after the incident if the incident occurs during the day and around 1200–1300 the following day if the incident occurs at night. In normal operations, this entire process should be done by KOSTT, which would firstly activate free reserves and then hold tenders for imbalance.

Does Labor Force Participation and Social Inclusion Pose a Binding Constraint to Growth in Kosovo?

Kosovo has made substantial social, economic, and political progress in recent years; however, the nation continues to face steep challenges in ensuring full social inclusion. Only two decades after the end of the war (1999), its legacy is still manifest. Social and gender inequities are steep and entrenched within a social milieu that devalues women's economic empowerment. Labor market indicators are among the worst in the world; the status of health is low relative to comparator countries. For those who seek to make better lives, migration is often seen as the only viable choice, as private sector opportunities are lacking.

What follows in this section is a snapshot of social and gender inclusion challenges facing Kosovo.

11.1. Status of labor force participation

Although not identified as a binding constraint to growth, this part of the CA will examine the extent to which low female labor force participation (FLFP) is a constraint to sustainable economic growth.

Female labor supply is both a driver and an outcome of development of the country. Although FLFP can be an outcome of development, with more women in the labor force, an economy can grow faster in response to higher labor inputs. A large and growing body of international research has identified gender gaps in FLFP and female entrepreneurship as a constraint to economic growth and a cause of low per capita income (multiple sources in Gonzales and others, 2015). The International Labor Organization (ILO) estimates that women's paid and unpaid labor "may be the single most important poverty-reducing factor in developing economies (Heintz, 2006 in Elborgh-Woytek and others, 2013).

Marked increases in global FLFP in the last few decades have played an important role in economic growth in many countries, and future projections suggest that FLFP will have positive impact on global economic development (Lechman, 2014). A recent McKinsey report (2015) quantified potential gains. The authors estimated that closing the global gender gap in labor force participation, hours worked, and sectoral segregation could increase global annual GDP by 26 percent by 2025. Similarly, narrowing the gender gap in employment in the BRICS or N11 countries²⁵ could increase per capita income by 14 percent by 2020 or 20 percent by 2030 (Lawson, 2008). In Eastern Europe and Central Asia specifically, a 2012 report on women and men found that the countries in this region with substantial economic growth were also those with relatively higher FLFP and lower wage gaps between men and women (Sattar, 2012). This reflects the fact that those countries that have integrated women more rapidly into the workforce have improved their international competitiveness by developing export-oriented manufacturing industries that tend to favor the employment of women.

There is also evidence of a positive correlation between FLFP and economic diversification, the latter of which is critical for sustainable economic growth and improved macroeconomic performance, especially in earlier stages of development. Recently, the IFC provided evidence of these trends. Examining a number of factors, including a modified UN Gender Inequality Index, they found the following: (a) an inverse correlation between output and export diversification

²⁵ The included countries are Brazil, Russia, India, China (BRIC) and Bangladesh, Egypt, Indonesia, Iran, Korea, Mexico, Nigeria, Pakistan, Philippines, Turkey and Vietnam (N11). While there are issues concerning comparability, the results remain illustrative nonetheless.

and gender inequality; (b) an association of inequality of economic opportunities and lower FLFP with lower economic diversification; and (c) causality between the gender inequality and diversification relationship (Kazandjian and others, 2016). In sum “gender inequality, both in outcomes and in opportunities, negatively impacts export and output diversification in low-income and developing countries” (Kazandjian and others, 2016, p. 21). These factors are of particular relevance to Kosovo, a country with a large trade deficit and an export basket reliant on metals and minerals—a vulnerability in light of declining global commodity price.

Gains in reducing the gender gap in LFP are visible at the household level. Greater female control over resources is associated with higher spending on the health and nutrition of children, investments which enhance a nation’s future health and productivity (World Bank, 2012). In the case of Kosovo there is evidence that women with control over assets are also more likely than men to invest in business development.²⁶ And certainly, when more women enter the labor force, then social constraints weaken, enabling women to engage in work outside the home. With regards to wages, increased female labor market participation leads to an increase in the supply of labor, and in theory, could lead to lower wages. However, a gradual increase in female labor market participation is often in response to rising demand for certain jobs and is consistent with rising real wages. The increase in female labor market participation can also increase labor market flexibility and effect on income distribution with society.²⁷ Unfortunately, Kosovo appears to have a long way to go to avail itself of the economic opportunities that enhanced FLFP can provide.

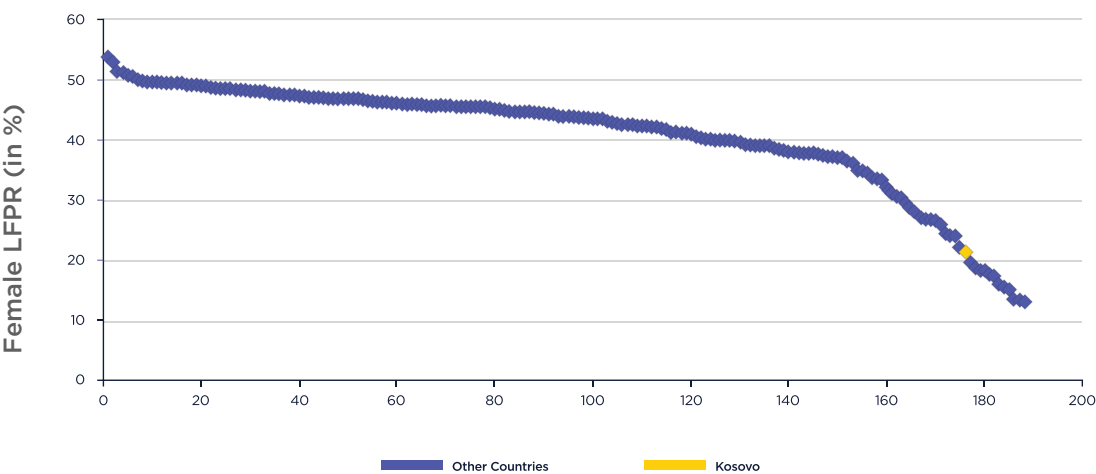
The high overall unemployment rate is one of the biggest challenges for the government in Kosovo. The government, in its National Strategy for Development 2016–2021, aims to address this challenge in the first pillar, which is increasing the number of children in preschool institutions to help to increase female participation in the labor market. According to World Bank rankings, in 2014 Kosovo’s labor force participation rate (LFPR) was among the 10 lowest countries globally.

²⁶ This comes from the fact that female-headed household receiving remittances are twice as likely as male-headed households to use them for business investment purposes (UNDP, 2014c).

²⁷ <http://www.economicshelp.org/blog/19315/labour-markets/impact-of-increase-in-female-labour-market-participation>

Since that time it has declined, from the 2014 figure of 41.6 percent to 37.6 percent in 2015. Unemployment also remains high, at 32.9 percent. This translates into an employment to population ratio of only 25.2 percent in 2015 (KAS, 2016c). The situation is made even more challenging due to the very low participation of women in the labor market. In 2015, female LFPR in Kosovo was a startling 18.1 percent (KAS, 2016c) and around 80 percent of working age women in Kosovo are neither employed nor looking for a job.

Figure 60. Kosovo female LFPR.

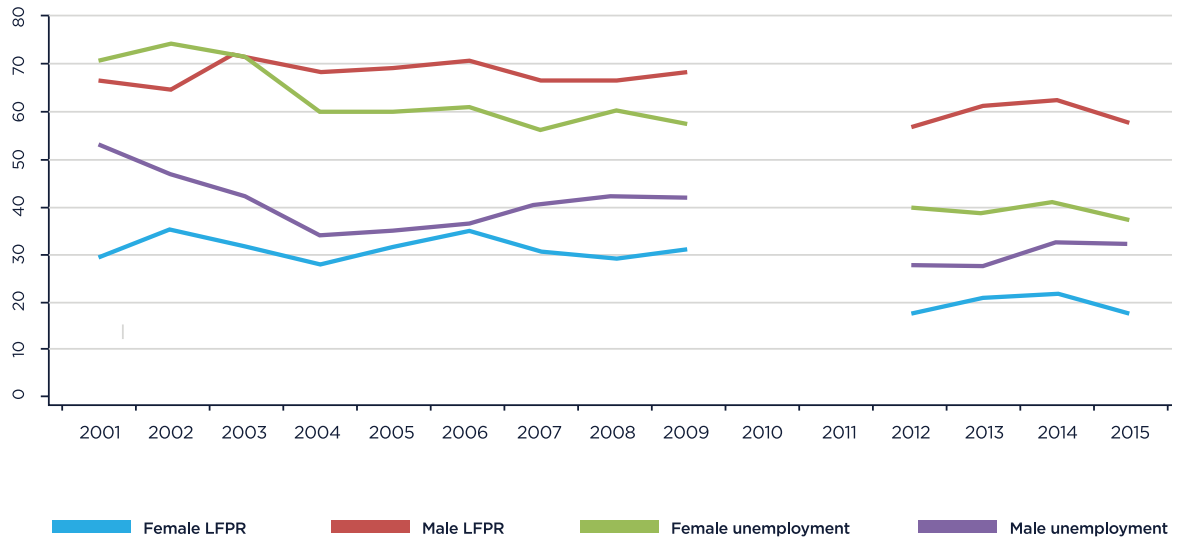


Source: World Bank (2014)

Note: Data for all countries presented, except Kosovo, was drawn from the World Bank. The Kosovo figure was from the LFS 2014.

Unemployment among labor market participants is also higher for women—36.6 percent compared to 31.8 percent for men. This results in an employment rate of only 11.5 percent for women, compared to 38.7 percent for men (KAS, 2016c). In 2014, Kosovo ranked 176 of 188 countries on the World Bank’s international FLFP rankings. Due to a decrease in the FLFP rate in 2015, its ranking might have declined since then.

Figure 61. The female labor force participation rates in Kosovo, 2000–2015.



Source: KAS data (2016)

Note: LFPR = labor force participation rate.

With more than half of the population below the age of 29, Kosovo has the youngest population in Europe. Those ages 15–24 years make up 19.4 percent of the total population and almost a third (28 percent) are of working age. Youth currently face double the unemployment rates of adults. In the aggregate, youth unemployment is 57.5 percent, and among females, 67.2 percent (KAS 2016). There are 25,000 (MCC CA Memo, 2016) to 35,000 (Krasniqi and Topxhiu, 2012) new job seekers every year, but net job growth is considerably less. KAS states that 328,694 individuals had jobs in 2016, which would represent a net growth of only 5,128 jobs compared to 2014, a significant barrier for new workforce entrants.²⁸

Figure 62. Western Balkans LFPR by gender, 2014.

	Men	Women	Total
Albania	74.2%	51.7%	63.0%
Bosnia and Herzegovina	67.1%	42.1%	54.5%
Kosovo	61.8%	21.4%	41.6%
FYR of Macedonia	77.3%	51.5%	64.6%
Montenegro	66.1%	52.3%	59.2%
Serbia	69.7%	53.9%	61.7%

Source: Human Development Report, UNDP (2016)

²⁸ <http://prishtinainsight.com/three-falsehoods-kosovos-economy>

There are also higher levels of unemployment among minority groups, particularly the RAE. A 2011 remittance survey found that although unemployment was 47 percent among Kosovo Albanians and 38.4 percent among Kosovo Serbs, the figure rose to over 60 percent for Roma and Ashkali individuals in Kosovo, and a startling 80 percent for Egyptian Kosovars. Youth unemployment among RAE is also extremely high. The last available data from 2007 cited an RAE youth employment rate of 17 percent compared to a figure of 23 percent for young Kosovar-Serbs and 29 percent for young Kosovar Albanians (in UNDP, 2012b). Furthermore, female RAE also face a lower labor force participation rate than male counterparts.

Figure 63. Kosovo, comparator countries female LFPR, 2014.

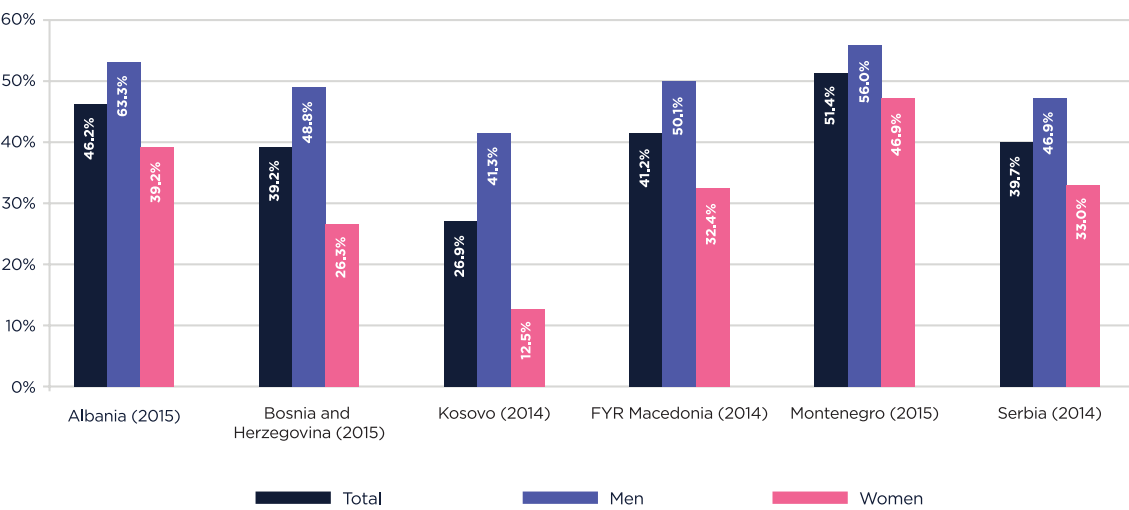
Ranking LFPR out of 188 Countries, 2014

Ranking	Country	LFPR (%)
172	Lebanon	24.54
173	India	24.17
174	Egypt, Arab Rep.	24.12
175	Pakistan	22.26
176	Kosovo	21.40
177	Bahrain	19.57
178	West Bank and Gaza	18.79
179	Jordan	18.37
180	Iran, Islamic Rep	18.34

Source: Human Development Report, UNDP (2016)

Note: LFPR = labor force participation rate.

Figure 64. Gender disaggregated employment rates in the Western Balkans Region.



Source: Human Development Report, UNDP (2016)

11.2. Factors affecting low FLFP: Discrimination and caregiving responsibilities

Although low FLFP can be portrayed as a lack of equitable employment opportunities, the relationship between FLFP and other factors is complex. Women's participation in the labor market varies greatly across countries, reflecting differences in economic development, legislation, norms, education levels, fertility rates, and access to childcare and other support services. Structural factors may have contributed to some extent to Kosovo's unemployment problem in general, and in particular for women. Given the complex nature of FLFP, it is important to highlight how socioeconomic factors affect the decision and ability of women to engage in the labor market. This section highlights two of these constraints: caregiving and discrimination.

In a study of 173 economies, Kosovo was one of only 18 that did not have any legal differences between men and women (World Bank 2016c). This equality is protected in legislation. Regarding employment, under the Labor Law, LGE, ADL, and Civil Service Law women enjoy equal legal rights in the workplace. As legal discrimination against women has been identified as an important barrier to women's labor force participation, (Gonzales and others, 2015), this is a significant asset. However, more work needs to be done to ensure application of the law, and discrimination remains a significant barrier to realizing equal rights. For example, several reports illustrate that perceptions of gender play a role in the hiring process. Kosova Women's Network (KWN) asked employers which gender of employee they would choose among those equally qualified: 47.6 percent chose men and 23.3 percent preferred women. When asked about suitability of employment opportunities in their workplace, 47 percent of employers stated that the jobs were suitable for men, and 35 percent for both men and women (Banjska and others, 2016).

Evidence suggests that being a woman of childbearing age is a disadvantage in the labor market, and that maternity provisions exacerbate this disadvantage due to employer reluctance to bear the financial burdens. The Labor Law stipulates 12 months of maternity leave of which the first 6 months are paid by the employer, the following 3 months by the state, and a final 3 months are optional leave without pay. In the KWN survey, 61 percent of employers claim not to pay maternity leave. The main concern arises out of the duration of the maternity leave and the compensation structure that characterizes it. The position of business representatives is that the provision imposes a high financial burden on businesses toward their employees making use of the maternity leave (Riinvest Institute, 2017).²⁹ Of those that said they would pay for maternity leave, on average they pay for 5.5 months of leave, at various percentages of a woman's salary. This indicates little knowledge of the legal regulation to pay 70 percent of a woman's salary for six months. Furthermore, whether or not they are willing to offer paid leave, an employee's marital and family status remains an important factor for employers.

²⁹ <http://www.riinvestinstitute.org/B93F542D-54E3-4B12-8183-97812B21AFD9/FinalDownload/DownloadId>

When asked, 44.9 percent of surveyed employers stated that they do consider the family planning intentions of a job applicants, 14.2 percent of employers stated that they had not hired a woman due to the financial difficulties of paying maternity leave, and 9 percent of employers said that their firm requested pregnancy tests among potential female hires prior to employment. These might be underestimates of discriminatory practices. Among job seekers surveyed, 62.7 percent of women and 65.9 percent of men were asked about marital status and plans to have children (Banjska and others, 2016).

Traditional gender roles and burdens of care are additional barriers that heavily influence FLFP. There are strong social norms that promote the notion that males are breadwinners, and females are caregivers and managers of the home. Such dynamics are reflected in the data. KAS found that 11.4 percent of women were not engaged in paid labor due to caregiving (compared to 0.2 percent of men) (KAS, 2016c). In another KWN survey, 17.8 percent of women said that they were not involved in paid labor due to caregiving responsibilities; a figure that rose to 39 percent when women could choose multiple reasons (Farnsworth and others 2016a). For women working part-time, a quarter cited the reason being care of children or incapacitated adults (KAS, 2015a). The 2015 Labor Force Survey found that, in addition to those citing caregiving, another 38.5 percent of women did not engage in paid labor due to other personal or familial responsibilities, compared to 3.8 percent of men (KAS, 2016c). Similarly, in the KWN survey, 16.1 percent of women identified housekeeping work as the main reason for not engaging in paid employment compared to 2.8 percent of men. According to another study, among those ages 25–54 years, women spend 80 percent of their time on household chores and men only 10–15 percent (cited in Färnsveden and others, 2014), revealing the gender-specific nature of this work. Thus, caring for others and for a home was a significant reason for not working in paid labor. For KAS, this represents half of women, for KWN, this represented 33.9 percent of women.

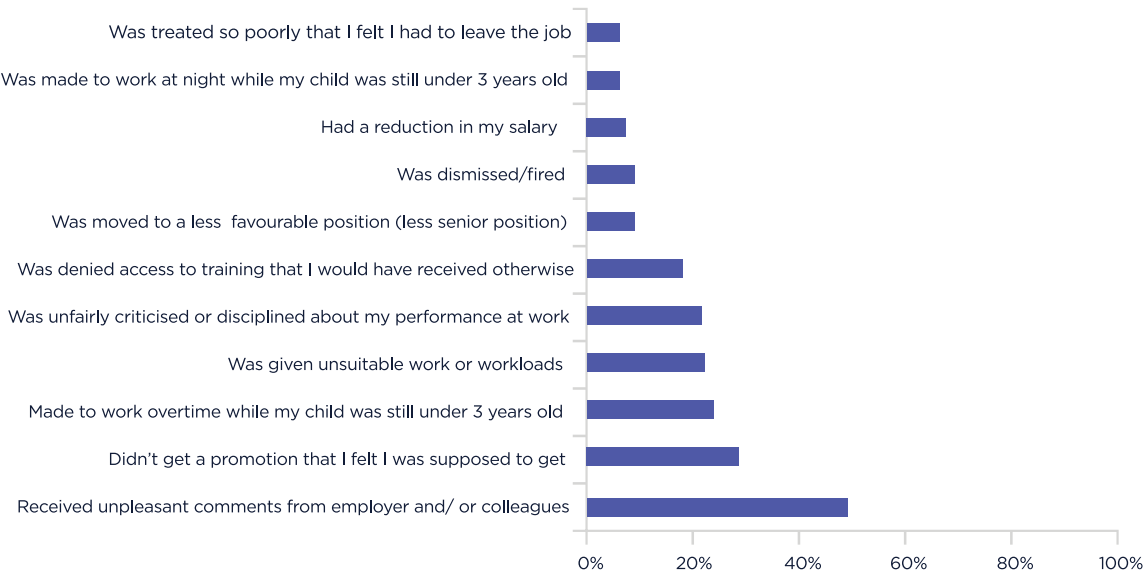
Despite cultural factors that promote women's role in the household, 91 percent of unemployed women surveyed responded that they were interested in paid employment. The same percentage stated that if they had childcare they would seek employment. Furthermore, 88 percent of women responded that they would use childcare services if they were affordable, available, and of sufficient quality, regardless

of their employment status. Despite high desire for daycare services, only 15.5 percent of Kosovar children use daycare services and more than half of employed individuals rely on unpaid family members for care (Farnsworth and others 2016a). Part of the reason is the cost. Some stakeholders have claimed that the cost is too high relative to salary. For others, there are simply not enough daycare spaces. Of daycares surveyed, 43 percent could not accommodate demand for their services. And, in some places there are no daycare services available at all. Currently, there are 12 municipalities without any registered childcare services and within municipalities, rural areas lack facilities (Farnsworth and others 2016a).

Care options are also limited by the lack of parental or paternity leave. Of women surveyed who took maternity leave, 44 percent of their husbands took paternity leave for an average of 4.5 days, some paid and others unpaid. Yet, 54 percent of men would take advantage of paid leave if it were available, and 38 percent would take it even if it were only paid to 70 percent of their salaries; only 9 percent stated that they would not take leave, regardless of whether it were paid. Unfortunately, a full 12 percent of surveyed firms stated that they would not be willing to provide leave to fathers. In addition to redistributing familial caregiving responsibility, parity in leave provision is required to ensure that women are not discriminated against in the labor market. Thus, KWN recommends that the government of Kosovo and relevant municipalities and ministries offer men equal rights to paternity leave and amend the Law on Labor and its current maternity leave stipulations to recognize these equal rights (Banjska and others, 2016).

It is not only younger women of child bearing years who are targeted for discrimination; women over 30 years of age are also discriminated against (CLE, 2014). The Labor Force Survey 2014 finds that among men the highest LFPR was for those ages 40–44 years; however, for women, it was highest between the ages of 25 and 29 years (KAS, 2015a). A preference for hiring women of younger ages was reflected in the KWN survey mentioned above. When asked about the preferential age group of women employees, 56.9 percent of employers stated women ages 18–30 years, 15.8 percent women ages 31–40 years. Only 7.8 percent of respondents stated that age did not matter and 14 percent that they did not know (Banjska and others, 2016). This requires further explanation as the average marital age for women in Kosovo is within this range.

Figure 65. Discrimination faced by respondents at work after returning from maternity leave.



Source: Banjska and others (2016)

There are other instances of discrimination against women in the labor market that are not specific to age. This includes cases of gendered wording in job advertisements. A study conducted by the GAP Institute (2017) found evidence of gender bias in the advertisement of positions, discouraging women from applying to the jobs. This same study found that vacancies in public institutions contain gender stereotypes, For example, for vacancies and positions like assistant, salesman, receptionist, and cleaner, women are required; whereas for positions such as manager, executive director, and engineer, men are mostly required. The same study also found evidence of discrimination in the interview and hiring processes, even among public enterprises, particularly for decision-maker positions. For instance, the GAP Institute reviewed 14 interview panels in public enterprises, and only two had women on them. Of cases reviewed, of the 1,814 candidates who were submitted for

board membership in public enterprises, 197 were chosen for further consideration, of which only 17, or 8.6 percent were women. Further, of the 82 finally chosen, only 12 percent were women, despite the fact that those female candidates were more qualified on the basis of the relevant point system (stakeholder consultation, 2016). In a report titled “Representation of Women in the Boards of Publicly Owned Enterprises and Independent Agencies,” the GAP Institute analyzed gender representation in 31 publicly owned enterprises and 31 independent institutions and agencies. Out of 159 board members in 31 publicly owned enterprises, 135 are men and 24 are women, and only five boards are chaired by women.

Another issue of discrimination in employment is sexual harassment.³⁰ An estimated 48.5 percent of Kosovars have reported experiencing some form of sexual harassment over the course of their lives, representing 64.1 percent of women and 32.5 percent of men. Although a prevalent issue, there are no specific laws that address sexual harassment and within the laws that exist there are no clear criminal penalties (World Bank, 2016c). Sexual harassment is only defined in the LGE and awareness of the issue remains low (U.S. State Department, 2014). This contributes to a strong tendency to “blame the victim.” Approximately 77.6 percent of Kosovar women and 70.3 percent of men believe that “women bring harassment problems on themselves by dressing or acting provocatively” (Qosaj-Mustafa and others, 2016).

11.3. Education and the misallocation of labor

International research has demonstrated that high-quality human capital is a critical component of economic growth and an unqualified workforce is a high-intensity barrier (UNDP, 2016). Specifically, the exclusion of women from equitable educational opportunities and their relative absence in the labor force and in management reduces talent in the human capital pool. In turn, this exclusion of women limits a nation’s ability to innovate and adapt technology, negatively

³⁰ According to the U.S. Equal Employment Opportunity Commission, sexual harassment is defined as “unwelcome sexual advances, requests for sexual favors, and other verbal or physical conduct of a sexual nature when: submission to such conduct is made either explicitly or implicitly a term or condition of an individual’s employment, or submission to or rejection of such conduct by an individual is used as a basis for employment decisions affecting such individual, or such conduct has the purpose or effect of unreasonably interfering with an individual’s work performance or creating an intimidating, hostile, or offensive working environment”

impacting export and output diversification, and thus economic growth, in low-income and developing nations (Kazandjian and others, 2016).

In Kosovo women average one less year of education than men (UNDP, 2012b). Indicators for women and men are respectively: illiteracy (7 percent vs. 2 percent), basic educational attainment (62 percent vs. 37 percent), and higher educational completion (27.3 percent vs. 60.6 percent). Stakeholders have also noted very low levels of education among rural women over the age of 40 years. However, younger generations enjoy more equitable levels of enrollment. In 2011/2012, girls were marginally less likely to be enrolled in all levels of education except at the university level, where their enrollment rates in 2013/2014 exceeded those of males (53.6 percent vs. 46.4 percent), but not at the graduate level, where it was lower (44 percent vs. 56 percent) (cited in Beqiri and Selimi, 2015). The gender gap reduces available talent in the labor market. Enterprises of all sizes consider lack of skilled staff an impediment to business growth (UNDP 2012, 66). The World Bank Country Snapshot 2015 states that 23 percent of enterprises believe that a lack of education and skill in the Kosovo workforce is a major impediment to business growth (2015, p. 6). Evidence for a skill gap is found in returns to education. An individual with a tertiary education is less likely to be unemployed, whereas among those with no education, 64.6 percent are unemployed. With regards to a salary premium, USAID finds: “a person with primary education can earn 37 percent more than a person with no schooling, a person with high school education earns 69 percent more than a person with no school, and a person with university or higher education earns 94 percent more than those with no schooling” (2012). More recently, it was reported that the salaries of those with postgraduate degrees are almost double those of a university degree holder (€607/month vs. €319/month; Mehmedi and others, 2014).³¹

Women in Kosovo are also less likely to be employed than men of similar educational attainment, reducing efficient allocation of talent. At the secondary vocational, secondary gymnasium, and tertiary level female unemployment is higher than that of men, respectively

³¹ The MCC CA Memo (2016) did not find a high returns to education in terms of salary, noting that Kosovo was below average global returns. The additional data above in its current form is incomparable, but might elucidate some aspects of a premium, particularly at the graduate level.

34.8 percent vs. 40.8 percent, 25.7 percent vs. 45.8 percent, and 13.7 percent vs. 27.3 percent (KAS 2016c). Furthermore, a higher percentage of employed women have completed tertiary education (36 percent female vs. 21 percent male), indicating that women may need higher educational attainment to overcome barriers to employment. The inability of highly skilled women to utilize their talent at home has driven educated women to migrate internationally at greater rates than educated males, and at greater rates than less educated females: 19.1 percent of migrant women have attained tertiary education compared to just 7.2 percent of non-emigrant women, indicating that educated women's employment prospects might be more promising abroad: 34 percent of working-age women migrants are employed compared to just 10 percent of their non-migrant Kosovo counterparts (UNDP, 2014c).

These trends are also revealed at the level of vocational training. In Kosovo, those with vocational training actually have high labor participation rates and are 36.2 percent of those employed, but represent only 26.9 percent of graduates (KAS 2016c). Although women are slightly underrepresented in vocational schools (in 2014, 44 percent of vocational students were female compared to 56 percent male), their representation is often segregated into gender stereotypical fields that are less in demand and garner lower wages. For the same reasons, unemployed women might find it harder to receive assistance in the job market than men. According to one source, the Kosovo Employment Office has a much stronger record of finding employment for men, particularly at younger age levels. For example, 40 percent of all persons they found work for were men between the ages of 25 and 39. However, women in this age group made up only 11 percent of those who found employment (Banjska and others, 2016). An official for the unemployment office did note that, although they have no gender analysis or strategy, they do have a policy of trying to promote women's employment. Unfortunately, 60 percent of available jobs are for vocational graduates in male-dominated fields.

Excluding qualified women from the labor force also exacerbates the overall quality gap that Kosovo faces. Quality constraints are indicated in the results of the 2015 Programme for International Student Assessment (PISA), which revealed that out of 72 participating countries, Kosovo is one of the three worst performing ones.

Some 40 percent of graduates with a vocational diploma and 35 percent of graduates with a university degree do not have the necessary skills demanded by the labor market. Vocational education and training programs are poorly coordinated, lack appropriate strategies and priorities, and do not reinforce Kosovo's economic development strategies.

Another aspect of the misallocation of talent is that women are often segregated into lower-demand fields. Jobs with the highest employment opportunities are business and administration (25 percent), personal services (14 percent), manufacturing and processing (13 percent), architecture and construction (9 percent), transport services (7 percent), engineering and engineering trades (6 percent), and security services (6 percent) (Alled, 2015). Moreover, according to the Kosovo Education Strategic Plan (MOEST, 2015), "the number of students in Engineering (Mechanics, Energy, Electricity, Metals, Automation), Manufacturing/Processing (food processing, metal processing, plastics processing, wood, leather and textile processing) and Construction (architecture and spatial planning, construction and civil engineering) is lower than the market demand for these professions."

Although women are well represented at the university level, their choices of study and subsequent career paths are less likely to align with the above in-demand sectors. At the university level, women are concentrated in philosophy, philology, medicine, and education. Men are concentrated in construction, architecture, and mechanical engineering. In terms of employment, 52 percent of females are employed in education, trade, and health care, whereas 45 percent of males are employed in manufacturing, construction, and trade (KAS, 2016c). It is in fields where men are more highly concentrated that demand is growing.

There are many reasons why people chose less promising fields. It can include socialized preference or the trajectory of early educational experiences. It could also include a desire to avoid discrimination. In a study conducted in the EU, the experience of sexual harassment was greater for women in more male-dominated fields or more male-dominated workplaces (cited in Qosaj-Mustafa and others 2016). This can influence the desirability of working in certain fields. Furthermore, women might face direct discrimination from employers who believe males are more suited to certain types of work.

At the same time, differences between men and women with regards to their tertiary field of choice is less stark than is implied by job market segregation. For example, although women are underrepresented in agricultural studies, and are only 20.4 percent of students in agricultural or veterinary science (Färnsveden and others, 2014), their presence in this field of employment is only half of this, at 10.4 percent of the workforce in agriculture, forestry, or fishing (KAS, 2016c). This is despite the fact that the labor market demand for this field is double the number of graduates (MOEST, 2015).

An additional factor in the misallocation of talent is women's overwhelming concentration in public sector employment. A 2011 survey found that 58 percent of women who worked were employed in the public sector (AGE, 2011). By another estimate, in 2013, 42.7 percent of all employed women worked in the government, compared to 28 percent of all men. The total governmental workforce was thus composed of 30.3 percent women, a substantial overrepresentation considering their overall employment numbers (Open Data Kosovo, n.d.). Even among those who study in high-demand fields, female graduates might choose to use their studies for public sector work, particularly in education. This is reflected in the fact that among those who graduate from technical fields, women are more highly concentrated in jobs in education, particularly at the high school level (AECOM, 2015).

One of the reasons for women's preference for work in the public sector is because these jobs offer more security and are more likely to provide benefits (especially in relation to maternity leave). Further, women employed in the private sector, who very often belong to the informal economy, are highly vulnerable to unique financial, emotional, and physical risks. This lack of security also includes working without a contract. Riinvest, commenting on a survey he did in July 2017, stated that the number of women working without a contract is worrying: one in three women working in the private sector do not have a work contract. Even if they do have one, it is short and a fixed-time contract. This is concerning because such contracts improve the bargaining power of employers over employees.³²

³² <http://www.riinvestinstitute.org/B93F542D-54E3-4B12-8183-97812B21AFD9/FinalDownload/DownloadId>

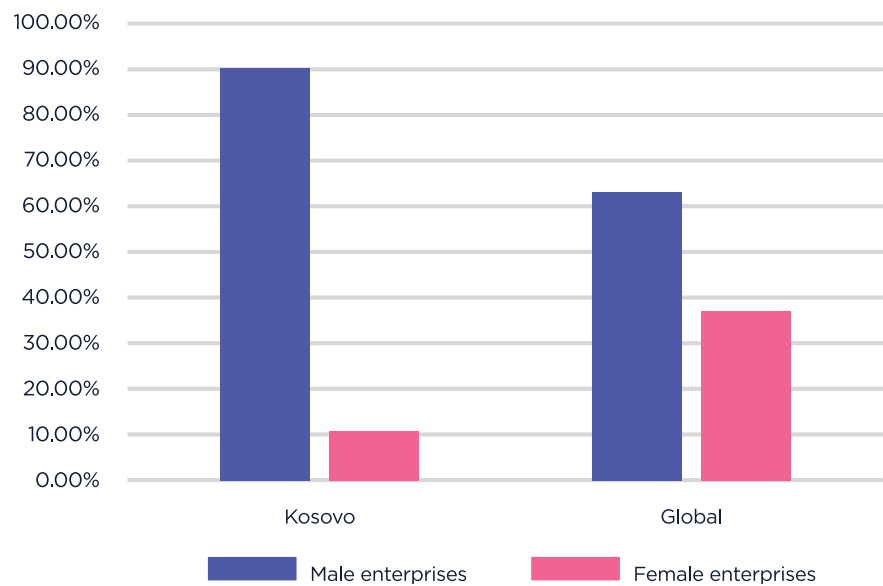
On average, employees in this sector also work fewer hours a week than employees in state-owned enterprises or private companies or those in the employ of private individuals (KAS, 2016c). This can be an asset to a woman who has caregiving or household responsibilities. Women in public sector jobs are also more likely to have better opportunities to engage in pension plans (Farnsworth and others, 2016a).

Finally, female talent is excluded from management. Among employed women, only 4 percent attain management positions, and of these, most work in the government or in state-owned companies (World Bank, 2012). According to another estimate, just 7.2 percent of firms have a top female manager, compared to 18.5 percent globally and 18.7 percent in Europe and Central Asia (World Bank, n.d.). An additional study conducted by the Kosovo Chamber of Commerce in 2012 revealed that, of 71 public and private sector firms in four sectors (ICT, tourism, agriculture, and finance), 95.8 percent of decision-making positions were held by men (cited in CLE 2014). The exclusion holds true when looking exclusively at the public sector. Although this sector has a relatively high percentage of female employees, at 38 percent, women hold only 9.5 percent of high-level public servant positions. There might be evidence as well that due to discrimination in hiring and firing, to procure a decision-making role, women are required to have higher educational levels than men in similar positions (Färnsveden and others, 2014). These exclusions come with economic consequence. Studies have revealed that female representation in high-level management is associated with increased corporate profitability. This includes higher scores on all nine organization dimensions associated with enhanced operating margins (McKinsey, 2008 in Elborgh-Woytek and others, 2013). This is due to factors such as diversity of perspectives, greater female customer orientation, and less high-risk decision making.

11.4. Women and entrepreneurship

Gender gaps in education and labor force participation contribute to gaps in entrepreneurialism, which similarly reduce the pool of talent in a country, and thus impede diversification and economic growth.³³ Furthermore, when women are excluded from equitable entrepreneurship opportunities, they are more likely to join the labor force, not only reducing the potential innovation that entrepreneurship contributes but also decreasing wages and thus income per capita (Kazandjian and others, 2016).

Figure 66. Share of enterprise ownership, male vs. female, Kosovo vs. global.



Source: IFC (2016)

³³ See IFC 2016; Female Entrepreneurship Index 2015 Report, 2015; McKinsey Global Institute, The Power of Parity:

In Kosovo, women account for only 9 percent of individual entrepreneurs (World Bank, 2012), between 5 and 11 percent of formal businesses owners (USAID, 2014a), 13 percent of sole SME owners, and 3 percent of SME co-owners (KOSME, 2014). This is much lower than in comparison countries. In Europe and Central Asia, women account for approximately 33 percent of individual enterprises and are owners in 36 percent of enterprises (World Bank, 2012). Globally too, Kosovo fairs poorly. Among reporting countries, in 2015, the global average of firms with female ownership was 35.4 percent. In terms of the business environment, among eight regional comparator countries, Kosovo has the lowest score in terms of “entrepreneurial learning, women’s entrepreneurship, and enterprise skills” (OECD, 2016).

Women who own businesses also face disadvantages. In Kosovo, 99.9 percent of women-owned businesses are microenterprises with nine employees or less. Although in general 98 percent of businesses in Kosovo are micro- and small- and medium-size enterprises (MSMEs) (USAID, 2014a), women-owned businesses are much smaller than those of men, with an average of 3.07 employees compared to 5.7 in men’s microenterprises. Among women who own businesses, just under 30 percent are the primary managers of those businesses; and in approximately 59 percent of these businesses, daily operations are conducted by male spouses (CLE, 2014). These rates are more disappointing when looking at incentives. One survey found that 62 percent of female entrepreneurs did not start their business based on a desire to expand and innovate; they did so because they lacked other opportunities to earn an income. Further, among women entrepreneurs, few desire to expand their sales to national or international markets (only 8 percent and 4 percent respectively) (SHE-ERA 2006 in World Bank, 2012). Although this study is a decade old, it elucidates worrying trends reflected in recent (October 2016) stakeholder consultations and interviews.

These unpromising statistics are due to the steep disadvantages women face. Although Kosovo has improved its performance on e-services and SME support services in the past decade, among eight assessed economies in the Western Balkans and Turkey, Kosovo was the only country whose score declined in terms of the ease of business registration (OECD, 2016). This exacerbates the challenges that women face. There is evidence that female owners are more likely than male owners to perceive of the regulatory environment as

difficult to navigate, and firms with female ownership more frequently cite difficulty in dealing with tax administration, licenses and permits, land access, and court proceedings (World Bank, 2012). This could be due in part to their relative lack of participation in the labor market and lack of participation in decision-making roles specifically, which would indicate less experience in exercising skills amenable to entrepreneurship. It might also be related to greater scrutiny by tax or regulatory authorities. Cultural factors are an issue as well. According to a CLE/USAID survey, 33–50 percent of respondents believe that women might be excluded from business opportunities because they do not have “an affinity for business” and 41.58 percent of male respondents and 26.46 percent of female respondents believe that men are better business leaders than women (CLE, 2014). Partly for these reasons, among many women there is a practice of deferring to male family members in business decisions even when a woman is an owner of that business (Cozzarelli 2012 in CLE, 2014).

Disadvantage is exacerbated by difficulty in obtaining collateral. According to the IMF, globally the lack of equitable access to inputs is the primary factor that reduces the relative productivity of women-owned businesses. Generally, reducing the gap in assets would stimulate investment, promote output, and thus drive economic growth (multiple sources in Elborgh-Woytek and others 2013; Gonzales and others 2015).

In Kosovo, collateral requirements are higher than in neighboring countries (USAID 2014a), as are the barriers to women’s ability to obtain collateral. One issue is financial inclusion, identified as a factor in FLFP (Gonzales and others 2015). According to the Global Financial Inclusion Database, only 36.3 percent of women had an account at a financial institution, compared to 59.4 percent of men. More significantly, although enjoying equal legal rights to inheritance and property ownership through marriage, stakeholders frequently mention women’s inability to exercise these rights in practice. Thus women continue to have extremely low rates of property ownership. The government estimates that women own 5 percent of their apartments or homes and men 95 percent (KAS, 2016b) and that women make up only 15.3 percent of individual or joint property owners (MESP, 2016 in Farnsworth and others 2016b). Lending rates are even lower; only 3 percent of all loan credits are granted to women (ERBD, 2013 in CLE 2014) and women have a higher rate of rejected loan applications (Färnsveden and others, 2014).

Women also borrow smaller amounts than men, more likely for daily family needs than for the investment (ERBD, 2013). Barriers to loan procurement might further increase with the contraction of the micro-finance sector, often more supportive of women entrepreneurship (cited in CLE 2014). Unfortunately, there is little recognition of these challenges. According to a USAID Contract Law Enforcement Program study, 80.5 percent of respondents believe that both sexes have an equal chance of obtaining a loan (CLE, 2014).

This reflects a more general problem, identified by OECD (2016). It concludes that one of the main challenges to women's entrepreneurship in the region is the low level of awareness of the positive impact of women's entrepreneurship on economic and employment growth and national competitiveness. Mitigating this barrier requires targeted, proactive strategies that themselves will require better data and data monitoring. Currently, Kosovo does not have a definition of women-owned enterprises, which hinders the collection of data that could lead to better understanding of women's specific needs and challenges, as well as their role as profitable clients and strong economic contributors.

11.5. Agricultural employment and entrepreneurship among women

The lack of agricultural productivity in a rural country such as Kosovo hinders economic growth, especially in light of barriers to alternative employment for women. According to the 2014 Statistical Yearbook, only 2 percent of registered businesses are agricultural and only 5 percent of households cite their main income as agriculture, quite low compared to remittances, cited as the main source of income for about 8 percent of households.³⁴ However, the Food and Agricultural Organization of the United Nations (FAO) estimates that agriculture actually accounts for 42 percent of the workforce, most working informally (FAO 2012). Another estimate finds that although over 60 percent of the population is reliant on agriculture, only 30 percent of the workforce is declared (FES, KFOS & Riinvest 2013).³⁵

³⁴ This is also half of the number of households citing agriculture as their main source of income in 2005

³⁵ MCC estimated this figure based on literature reviews. This author has not yet been able to identify greater support for this finding.

Numerous stakeholders have voiced a specific concern that agricultural labor is being undercounted, especially among women. Although it does appear that there is informality among agricultural businesses, data does not necessarily preclude hidden amounts of significant income generation and labor. In examining the Labor Force Survey (LFS) methodology,³⁶ there is no evidence that Kosovo is undercounting agricultural work. First, the definition used by KAS is very similar to that used internationally, and as suggested in ILO guidance. Second, in 2012 the LFS became more inclusive of informal workers, including unpaid agricultural workers. Yet, from 2012, fewer agricultural workers were counted. The great decline in agricultural workers over time implies that the figures of agricultural workers today could not be high underestimates. From 2004 there was a decline from 25 percent of the labor force in agriculture to 2.6 percent. The percentage of those in agricultural in 2014 was only 10 percent of what it was in 2004, but we can presume that, should criteria for capturing workers have been the same in 2014 as in 2004, we would have less than 2.6 percent. Such a significant decline would imply that there could not be a dramatic undercounting of agricultural workers today, since the decline itself is not in question.

³³ Sampling methodology was not examined, only the LFS questions over time and in comparison with international standards for such questions.

Figure 67. Percentage of the Labor Force in Agriculture, 2001-2014.



Source: Data from KAS 2015c.

Note: 2005–2009 are categorized as “agriculture” and 2013 to 2014 are categorized as “agriculture, forestry and fishing.” There is no data for 2010–2012.

Third, even if KAS wanted to formally include in its data employed agricultural workers whose labors were not a significant contributor to household consumption, the potential increase could only be a proportion of the 20.2 percent of individuals that declared any form of work. This is because among all respondents declaring work, 29.3 percent answered that they did engage in an hour of unpaid (own consumption) agricultural work in the week prior, but did not consider it an essential part of consumption (and thus it was not “employment”). Of these, a full 31 percent were labeled unemployed, and 69 percent inactive. The unemployed are presumably looking for work and free to engage it in, and thus are not miscounted. Therefore, should the survey’s representativeness be trusted, as it is only this pool of 20.2 percent of all individuals declaring any form of work that could be mislabeled, which is of course much less than 20 percent of the total working age population that could be discounted. Certainly, some of these workers would be included, but others are likely to consider farm-care tasks to be household chores or hobbies.

An additional reason not to assume dramatic undercounting is that, simply, there might not be a significant amount of agricultural work available. There is evidence of low and declining economic productivity in agriculture. Family farm size has been decreasing from the socialist period, to reach approximately 1.5 hectares on average, less than half the average in some comparator countries, including Serbia. These factors are compounded by household size. The average rural household size is 6.5 persons (KAS 2014). Considering an average household farm size of 1.5 hectares would be approximately 0.23 hectare per person, just above the Kosovo Ministry of Agriculture, Forestry, and Rural Development (MAFRD) estimate of what is required for minimum self-sufficiency of consumption, 0.17 hectare (in Osmani and others, 2013). Another estimate places the number of agricultural workers in Kosovo at 1.65 per hectare (Shamsiev and others, 2010 in World Bank, n.d.).³⁷ This represents the highest number of workers per hectare among all countries of the Europe and Central Asian region, and potentially too high to be lucrative. In fact, the sale of agricultural products only accounts for approximately 27 percent of a rural household's total cash income (Osmani and others, 2013). Thus, agricultural families are not necessarily earning significant income from agricultural pursuits or working hours that they would feel conform to legitimate, gainful employment. This is exacerbated by additional factors, including decreasing hectares under irrigation, dedicated FDI, and government support. Compounded by the introduction of subsidies and credits for trade partners, agriculture's contribution to the economy is declining (KAS 2015d; MAFRD 2014; World Bank 2015, 2010).

³⁷ From both sets of preceding data, medians are currently unknown, but could be further researched.

Finally, no evidence was identified to suggest undercounting specifically of women in agriculture. Although the overall percentage of workers in agriculture declined with the change in LFS methodology, the participation of women increased. This might imply that although all agriculture work relative to other employment declined (and greater perhaps than implied by a comparative) from 2012, the new methodology captured more women, possibly because they are more likely to engage in agriculture for subsistence. This is reflected in the Agricultural Household Survey, which drew data exclusively from households that use their land for agriculture. This survey found that fewer women than men worked in agriculture and, among women who did work, over half (54 percent) were occasional workers compared to 40 percent of men (KAS, 2014).

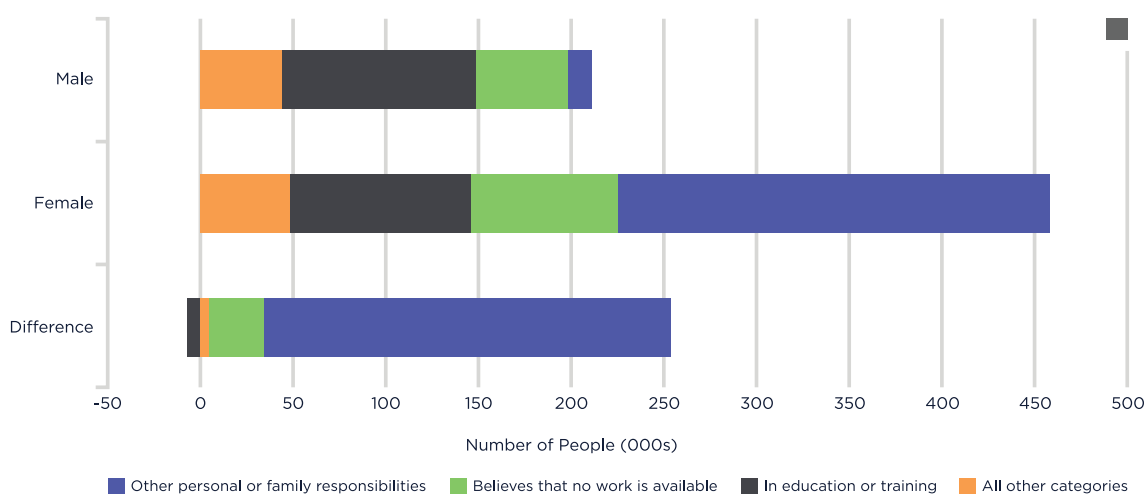
Table 7. Data on agricultural employment, 2014.

	Total (%)	Women (%)	Men (%)
Full time (%)	20	6.2	13.7
Part time (%)	35	11.1	24.0
Occasional	45	20.3	24.7
Total Agricultural Workers	100	37.6	62.4

Source: Agricultural Household Survey 2014

When looking at reasons for inactivity, the LFS found that 38.8 percent of the total population of women of working age were not working due to “other personal or family responsibilities,” whereas only 2.2 percent of the population of working age men were not. This implies that women’s unpaid farm labor is not heavily obscured under a category of inactivity related to family responsibilities (Romero n.d.). According to Romero, this also suggests that men who engage in family farming are additionally engaged in other formal paid labor, which would then make it possible to assume that family farming is not necessarily a type of employment that is underappreciated in LFP statistics.

Figure 68. Inactive individuals by reason of inactivity, 2014.

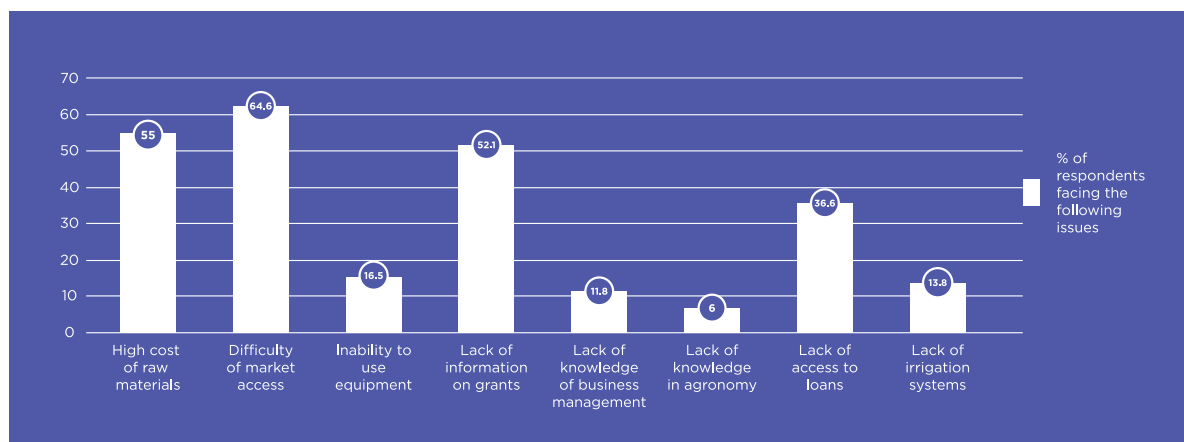


Source: Cited in 2016 Human Development Report: Making the Labor Market Work for Women and Youth.

Although no evidence is apparent, some undercounting of agricultural labor could exist. To explore these gaps, KAS could include within its agricultural employment figures all those who do any agriculture (with the caveat that this might include those doing it for hobby or home maintenance). They might also capture the number of individuals who consider themselves to be significantly engaged in family farming and the time spent in all productive activities, including household work (that is, household labor that substitutes market goods and services). Finally, more participatory methodologies could be used to clarify gaps or cross-check questionnaire data. This might be important in the case of Kosovo. On two occasions stakeholders mentioned that, compared to citizens of other nations, Kosovar citizens are less likely to answer questions about income and labor truthfully. The reasons given include distrust of government, fear of administrative scrutiny, and perception that “work” is something that occurs outside of the home. The extent to which these perceptions are true remains to be seen. The recently commissioned survey by MCC that is currently being designed should help gain further clarity on these issues.

Bearing such interventions, at the moment what is more apparent is that women’s lack of recorded participation has more to do with a number of specific barriers that inhibit women’s full and equitable participation in agricultural pursuits. Among 1,557 of SHE-ERA’s (local NGO) beneficiaries in agriculture, respondents cited the primary barriers to agricultural business establishment and expansion (see figure 69).

Figure 69. Primary gender-based barriers for agricultural business establishment and expansion.



Source: She-Era (2016)

All these difficulties are likely to affect women more than men. First, the high cost of raw materials and access to irrigation systems are often related to income. Women have fewer resources than men and only hold 20 percent of all income earned in Kosovo (KAS 2015a). Second, agricultural land ownership among women is very low; in 2014 only 4.9 percent of women owned agricultural land (KAS, 2016d). With regards to finance, not only is there a lack of knowledge about available opportunities, but women own less collateral. Among the beneficiaries of SHE-ERA's survey, only 12.4 percent had any property in their own name, and only 9.8 percent of beneficiaries had registered a formal business (SHE-ERA, 2016).

Women also have greater barriers to market participation, given their additional household and care tasks.

The SHE-ERA survey found that 88.57 percent of women were predominantly responsible for household chores in addition to agricultural work, compared to only 0.58 percent of men. Such burdens can make it difficult to bring products to market. Of course women's lack of connections and networks, as well as relative exclusion from information, exacerbates these barriers. This is revealed in the fact that 45 percent of men, compared to just 2.8 percent of women, are responsible for market placement. Further, women tend to engage more in food processing, 15.6 percent of women, compared to 5.6 percent of men hold this responsibility (SHE-ERA 2016). This niche might marginalize women. Although food processing is a promising industry, there are currently few opportunities to export. UNDP (2012b) noted that 86 percent of food processing enterprises had zero exports in the three years preceding their report. Food processing is also highly sensitive to the reliability of energy, a concern in Kosovo.

The inability to use equipment and the lack of knowledge of business practices and agronomy and veterinary sciences (challenges cited in figure 69) are related to a relative lack of education among older women. In consultation for this deep dive, stakeholders cited specific barriers to education for middle-aged to older rural women, including insecurities during the war, poverty, and customs favoring the education of boys over girls. With regards to the lack of information, in some rural communities women are much more likely to spend their time at home and less likely to engage in social or community activities, again particularly among older generations.

Support to mitigate these obstacles is lacking. With regards to the agricultural sector, farmers' associations are largely composed of male participants, and associations catering to women are rare. Both are additionally burdened by the current legal lacuna on NGOs. In other international contexts, groups that have no net profit can claim nonprofit status, and thus tax benefits, as long as profit made is reinvested in the organization. Such an arrangement would work well for women's agricultural cooperatives and associations. However, they do not have this option. Therefore, multiple respondents discussed the upcoming Law on Social Enterprises, currently in draft form. This new legislation would enable organizations such as agricultural cooperatives to sell their product without burdensome taxes.

There is also the issue of discrimination, indirect or otherwise, on behalf of MAFRD. Data from 2012–2015 showed that women were

far less likely to be grant beneficiaries. With regards to investment grants, women were only 15.81 percent of beneficiaries in 2012, 16.63 percent in 2013, and 17.38 percent in 2015 (SHE-ERA 2016). Although improving, rates are still low. In addition to the issues addressed in figure 70, the requirement that an applicant both own land and have completed secondary education is highly exclusionary for rural women. Currently, MAFRD does not sufficiently collect and analyze data on the basis of sex, age, income, and region, and their rural development plan (2014–2020) is insufficiently inclusive of rural women and other marginal groups.

Women are well placed to contribute to the agricultural sector, particularly if the barriers to productivity mentioned above are mitigated. As the FAO states, “closing the gender gap in agriculture would generate significant gains for the agricultural sector and for society. If women had the same access to productive resources as men, they could increase yields on their farms by 20–30 percent. This could raise total agricultural output in developing countries by 2.5–4 percent, which could in turn reduce the number of hungry people in the world by 12–17 percent.” Unleashing the potential of female producers is key to capitalizing on Kosovo’s significant potential in this field.

11.6. Conclusions

This chapter detailed multiple ways in which low FLFP and female entrepreneurship act to constrain economic growth. One underlying theme is that low FLFP, low female entrepreneurship and the concentration of educated women in health, education, and other public sector jobs are reducing the allocative efficiency of human capital, compounding a skills gap and acting as a constraint to economic growth. The paper also provided evidence that those areas of the economy that have great potential, including engineering, manufacturing and processing, construction, and agriculture, are also those facing talent shortages and are also those that have disproportionately low levels of female employment and entrepreneurship.

Thus, in many ways the case of Kosovo reflects international research that finds that inequitable educational opportunities by gender, low

FLFP, and barriers to female entrepreneurship reduce talent in the human capital pool and thus operates as a constraint to economic growth.

Overall, there is evidence that gender inequalities rooted in cultural attitudes and practices and amplified by institutional and policy-based barriers and incentives limit women's economic participation and contribution. In terms of the latter, whereas legal barriers to equity are few, equal treatment in practice is a problem. Women have less access to financial inclusion, property rights, and assets. They are discriminated against in the job market and unable to avail themselves of mechanisms that support entrepreneurship. In case of Kosovo it is also important to consider traditional perceptions of gender roles—in particular perceptions about women's role in the household. Women continue to be expected to do the bulk of household work and care giving. They struggle to allocate their limited time across many competing activities inside and outside the home and receive little public support in doing so. This traditional view of gender roles also affects women's work outside the household. The perception that women are fit for jobs resembling housekeeping and caregiving affect the opportunities available in the labor market, while insecurities in private sector pursuits compound women's double burden, in turn incentivizing highly educated women to choose careers in the public sphere over the private.

Although these constraints have economic consequence, the team concludes that the low participation rate for women does not result in a human capital deficit that rises to the level of a binding constraint, primarily because unemployment rates across the board, as well as for women, are high. Nevertheless, the low participation of women in the labor market, although not a binding constraint, is a critical cross-cutting concern that will impact the ability to ensure inclusive growth and job creation in Kosovo and maximize the country's human and economic development.

To reverse these trends, a wide variety of interventions is required. Policies should consider both supply- and demand-side dimensions, including access to better education and training programs in line with demand in the market. In addition, policies should consider other supportive institutions to ease the burden of domestic duties, such as childcare. Finally, the government should encourage private sector development that can increase secure and equitable job opportunities for women while enforcing laws meant to ensure the same. When more women enter the labor force, then women's capabilities typically improve, while social constraints weaken, enabling women to engage in work outside the home.

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