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Research Report

Policy Options for Economic Growth and Competitiveness of Kosovo

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Policy Options for Economic Growth and Competitiveness of Kosovo

Mario Holzner



Policy Options for Economic Growth and Competitiveness of Kosovo

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Executive summary

- › Kosovo growth dynamics are encouraging but the level of economic activity is very low. Mass unemployment hints at macro-imbalances. Net transfers from migrants are pivotal for covering the huge trade balance deficit, as manufacturing exports are almost non-existent.
- › Wages are low but increasing well ahead of productivity. The lack of an exchange rate policy is a substantial impediment. Transport infrastructure is of average, weak Balkan quality and the energy infrastructure is dismal, even for Balkan standards.
- › The good news is that fiscal space is abundant and overall external indebtedness low as well.
- › Apart from various institutional reforms, **conventional policy recommendations** comprise mostly supply-side measures that are effective in the medium to long run. These are similar to some of the following actions suggested.
- › Export capacities should be increased via FDI support and the solution of the Trepca mine status. An improvement in market access to neighbouring countries and the EU is of utmost importance. Modern cross-border transport (especially rail) and energy infrastructure should be upgraded.
- › The planned new coal-fired electricity plant and the refurbishment of the old blocks together with a powerful air pollution filter system are of crucial importance. Energy diversification via the redevelopment of the gas network and the improvement of power lines is another goal.
- › Secondary education, specifically vocational training including an apprenticeship system, should be developed.
- › A set of **un-conventional policy recommendations** for the short to medium run has the potential to more quickly increase aggregate demand and improve social conditions.
- › Circular migration flows and return-migration should be facilitated and incentive schemes for remittances to go into business activities should be developed.
- › Given the present current account constrained growth model of Kosovo, tax increases should target those with the highest income elasticity of demand for imports and government expenditures should involve as few imports as possible.
- › Tax progressivity could be expanded in the corporate and personal income and real estate taxes. Additional luxury taxes on high-end import goods should be applied.

- › A nationwide municipality housing project would solve the housing shortage and employ low-skilled with a comparatively low income elasticity of demand for imports. Moreover, local building materials such as cement and bricks could be used.
- › Area-wide public transport should also have the goal to offer jobs to the less skilled as well as to substitute widespread individual car imports.
- › A network of vocational training centres, health care centres, cultural and sports facilities could support local production as well as human capital and job creation.
- › A comprehensive incomes policy with a centralised wage bargaining system needs to keep the average wage level on a longer-term productivity (cum inflation) growth path.

Keywords: economic growth, competitiveness, industrialisation, infrastructure, economic policy, Kosovo

JEL classification: F43, O11, O14, O18, O20

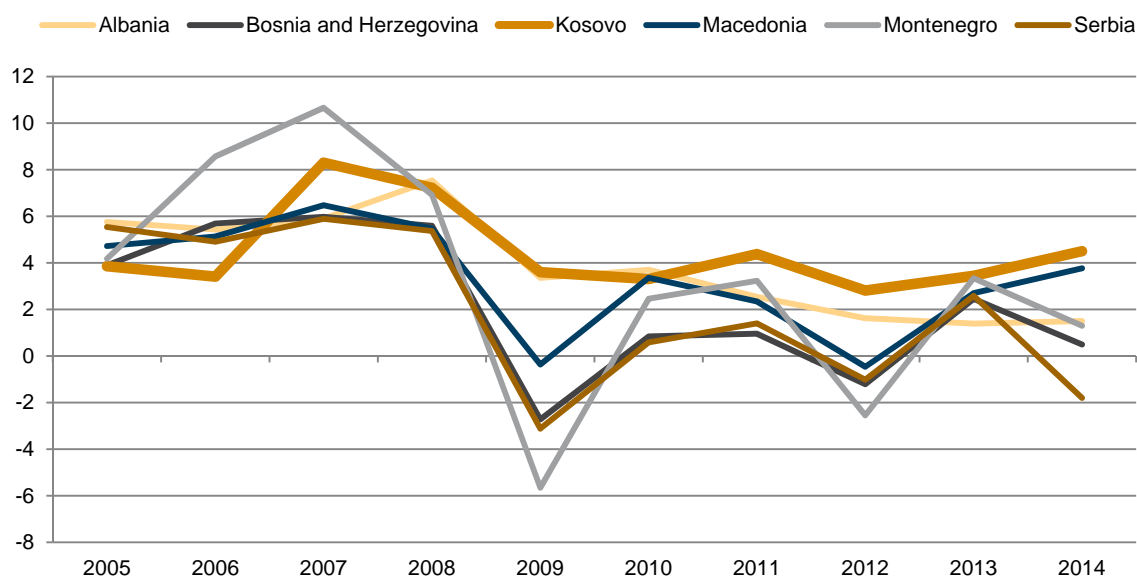
Policy Options for Economic Growth and Competitiveness of Kosovo

ANALYSIS

Kosovo growth dynamics are encouraging ...

Together with neighbouring Albania, Kosovo is one of the few European economies that have not experienced negative economic growth since the outbreak of the global financial crisis – one of the reasons being the weak integration in international trade and finance networks. However, while GDP growth in Albania started to dwindle ever since, Kosovo was able to maintain an average real GDP growth rate of about 4% per annum. By more recent European standards this is quite a high growth rate – certainly the highest in the Western Balkans (see Figure 1). No doubt a favourable economic election cycle has also contributed to a good timing of public sector demand management. Parliamentary elections were held in 2010 and 2014. In this period a number of substantial infrastructure projects in road and air transport contributed to economic dynamism.

Figure 1 / Gross domestic product, real growth rate in %



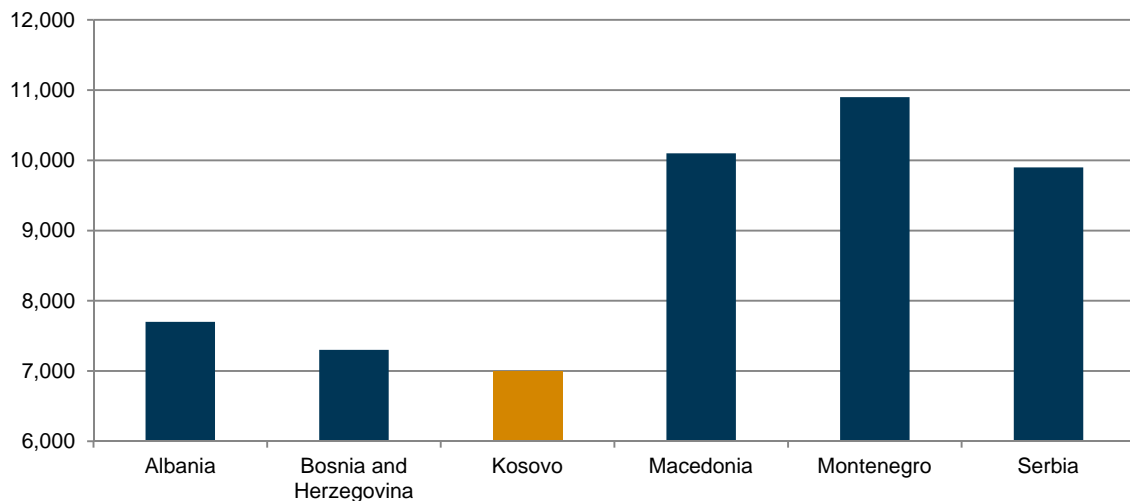
Source: wiiw Annual Database.

... however, the level of economic activity is very low

It has to be mentioned that Kosovo growth dynamics can to a large extent be explained by Alexander Gerschenkron's theory of the 'exploitation of the advantages of economic backwardness'. This backwardness is indicated by an extremely low level of economic activity. The country's GDP per capita

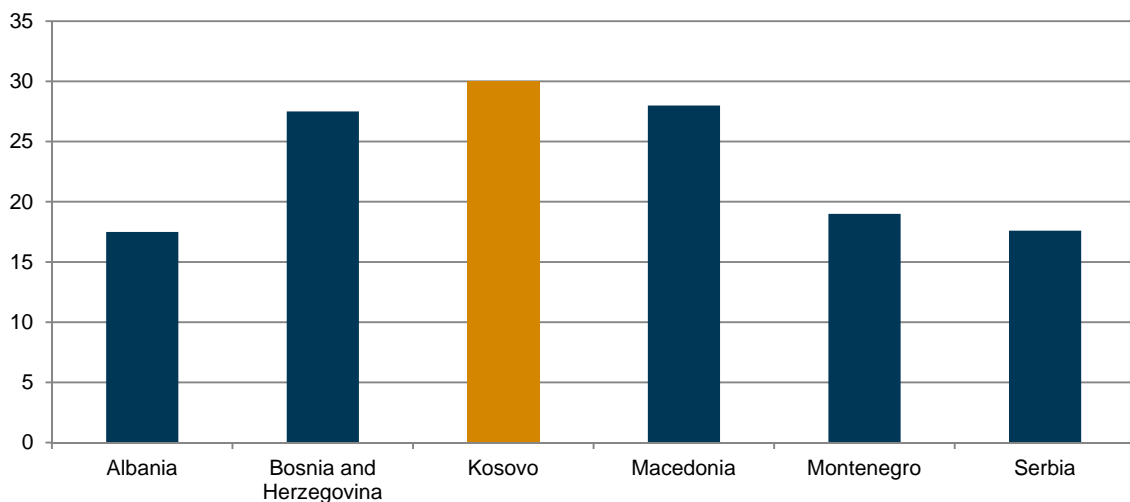
at purchasing power parities is only at about 7,000 euros. This makes it the least developed economy in the Western Balkans (see Figure 2) and one of the poorest economies in Europe. The current EU-28 average is at more than 27,000 euros.

Figure 2 / Gross domestic product per capita, EUR at PPP, 2014



Source: wiiw Annual Database.

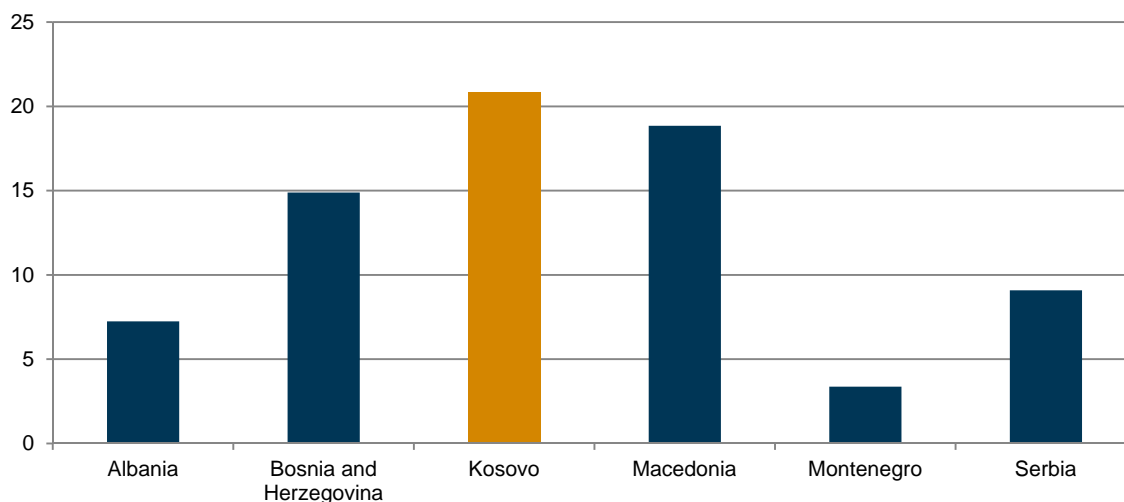
Figure 3 / Unemployment rate LFS, total in %, period average, 2014



Source: wiiw Annual Database.

Mass unemployment hints at macro-imbalances

Large-scale unemployment is typical of all Western Balkan economies. However, also in these statistics Kosovo is the inglorious front-runner (see Figure 3). The current unemployment rate is as high as 30%. Moreover, many have given up to search for work and hence have dropped out of the labour force and become inactive. This indicates the vast idle capacities and massive macroeconomic imbalances.

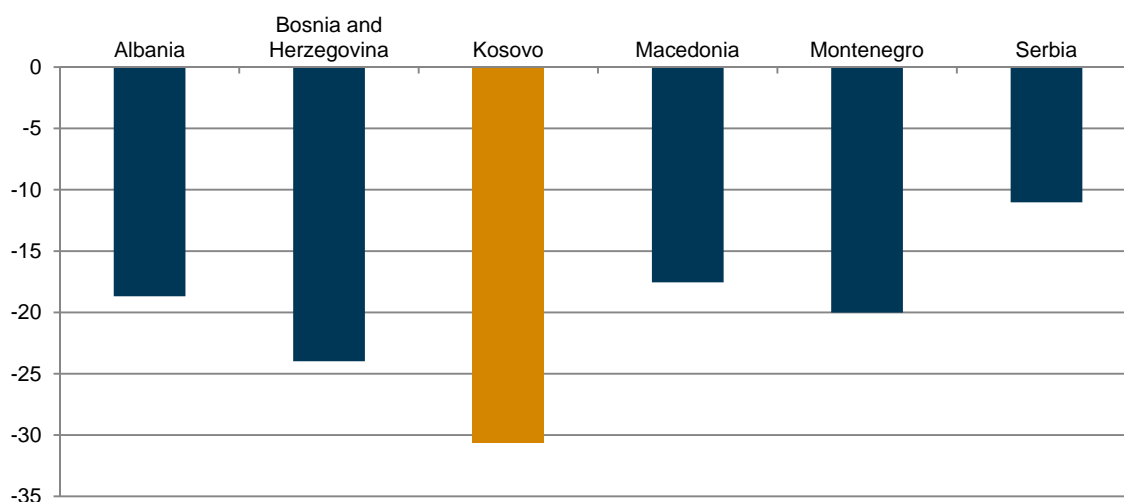
Figure 4 / Balance on secondary income, in % of GDP, BOP – 6th edition, 2014

Note: For Montenegro current transfers, net, in % of GDP, BOP – 5th edition.

Source: wiiw Annual Database.

Net transfers (mostly from migrants) are pivotal ...

Regular migration waves have resulted in a large Kosovo diaspora, especially in Germany and Switzerland. Kosovo migrant workers are sending home substantial amounts of foreign currency which keep up a minimum level of domestic consumption. Balance of payments secondary income flows, which to a large extent contain these remittances, are substantial. In 2014 they made up more than 20% of GDP (see Figure 4). This is again a peak value among the Western Balkan societies which also share a long history of migration.

Figure 5 / Balance on goods and services, in % of GDP, BOP – 6th edition, 2014

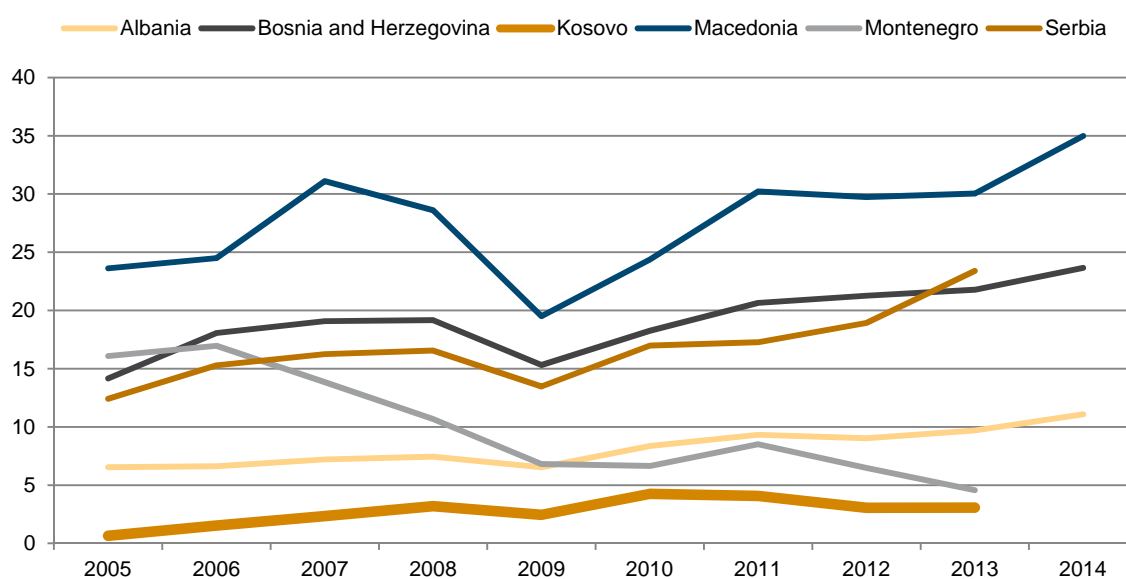
Note: For Montenegro current transfers, net, in % of GDP, BOP – 5th edition.

Source: wiiw Annual Database.

... for covering part of the huge trade balance deficit

Foreign income influx is covering a large share of the huge trade balance deficit that is the ultimate indicator of the lack of competitiveness Kosovo faces. In 2014 the deficit of the balance on goods and services as a share of GDP was at more than 30%. This is a value that is extremely high, even for the Western Balkans (see Figure 5). The country is literally unable to cover its imports by exports.

Figure 6 / Exports of manufactured goods (SITC groups 5-9), in % of GDP



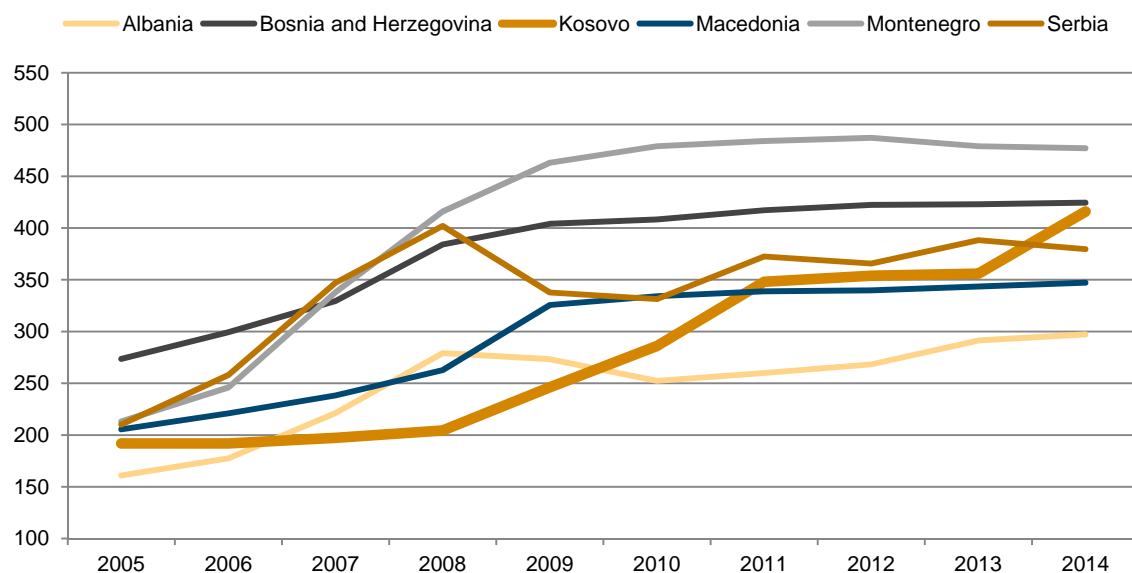
Source: wiiw Annual Database.

Exports of manufactured goods almost non-existent

Apart from the inability to export goods and services, it is also the particularly small share of higher value added exports of manufactured goods in the Kosovo economy that is worrying. The share of manufactured goods exports as a share in GDP is far below 5%. This is even for the humble levels in the Western Balkans an extremely low value. Moreover, there is no encouraging trend to be observed in recent years (see Figure 6). Also the skills and technology content of these exports is rather small. The dominant export group consists of manufactured goods classified chiefly by material.

Wages low but increasing (well ahead of productivity)

The average wage level (for the few who actually have a job) used to be extremely low. In recent years it has still been low by European standards but has been increasing steadily ahead of productivity. An important factor were wage hikes in the public sector around election years (see Figure 7). Given the fact that Kosovo has unilaterally taken over the euro as its currency and hence lacks an own exchange rate policy makes a balanced incomes policy that considers macroeconomic conditions crucial for the future.

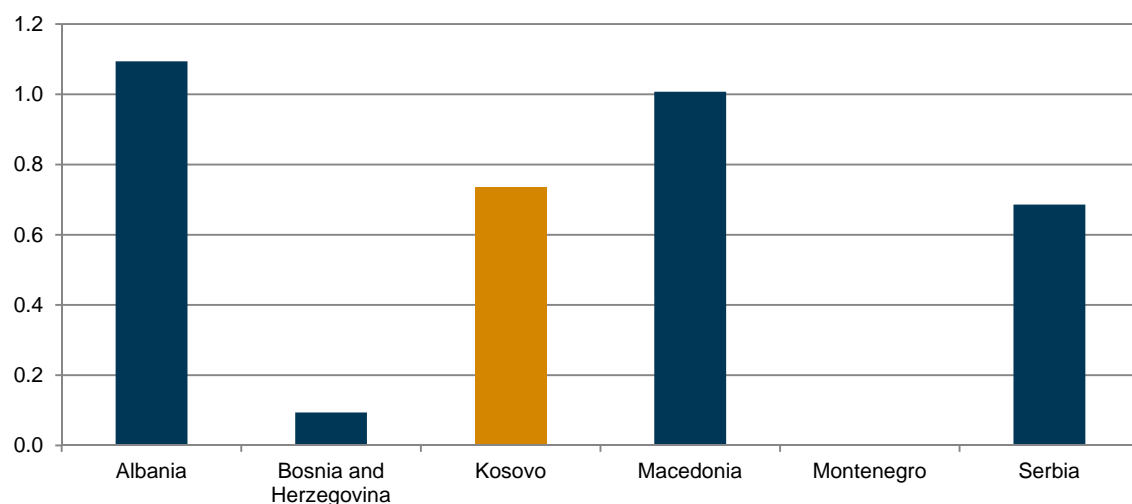
Figure 7 / Average monthly net wages in EUR

Note: For Albania average monthly gross wages.

Source: wiiw Annual Database.

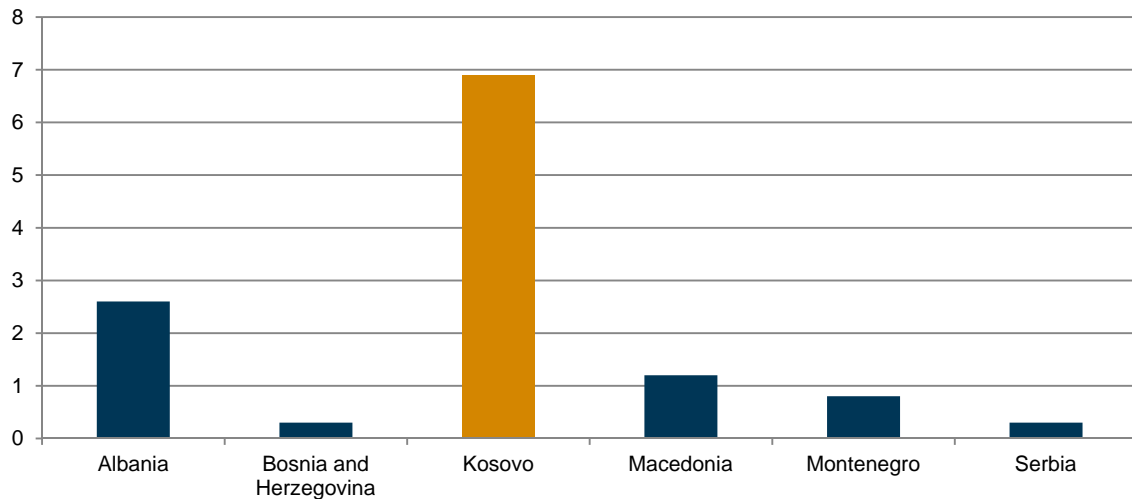
Transport infrastructure of average, weak Balkan quality

An important precondition for the build-up of productive capacities is basic infrastructure. As mentioned before, the Kosovo government has invested quite a bit in the construction of highways in the past several years. Compared to the country's size, Kosovo has now a road infrastructure of average (weak) Western Balkan quality. The rail infrastructure is in a rather poor condition.

Figure 8 / Kilometres of motorways per 100 km² of land area, 2013

Note: For Albania and Bosnia and Herzegovina year 2012.

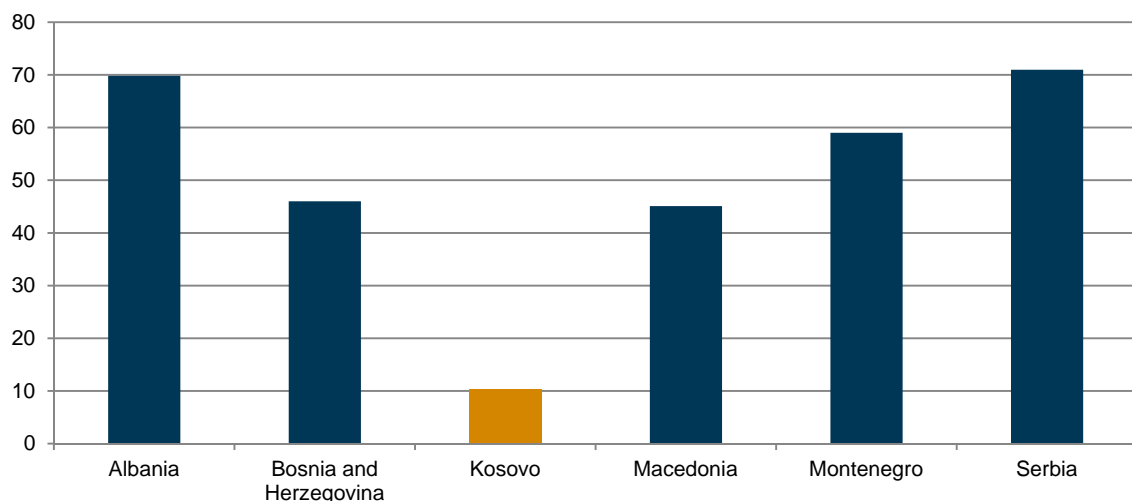
Source: Eurostat and wiiw estimates.

Figure 9 / Value lost due to electrical outages (% of firms' sales), 2013

Source: World Development Indicators (World Bank, Enterprise Surveys).

Energy infrastructure dismal, even for Balkan standards

A major impediment is the dismal situation in the electricity sector. Both the electricity generation capacities as well as the grid are in an extremely bad shape, despite the fact that the country possesses the world's fifth-largest proven reserves of lignite. Surveys suggest that the average Kosovo firm incurred losses of about 7% of sales in 2013 due to electrical outages (see Figure 9).

Figure 10 / General government gross debt, in % of GDP, 2014

Source: wiiw Annual Database.

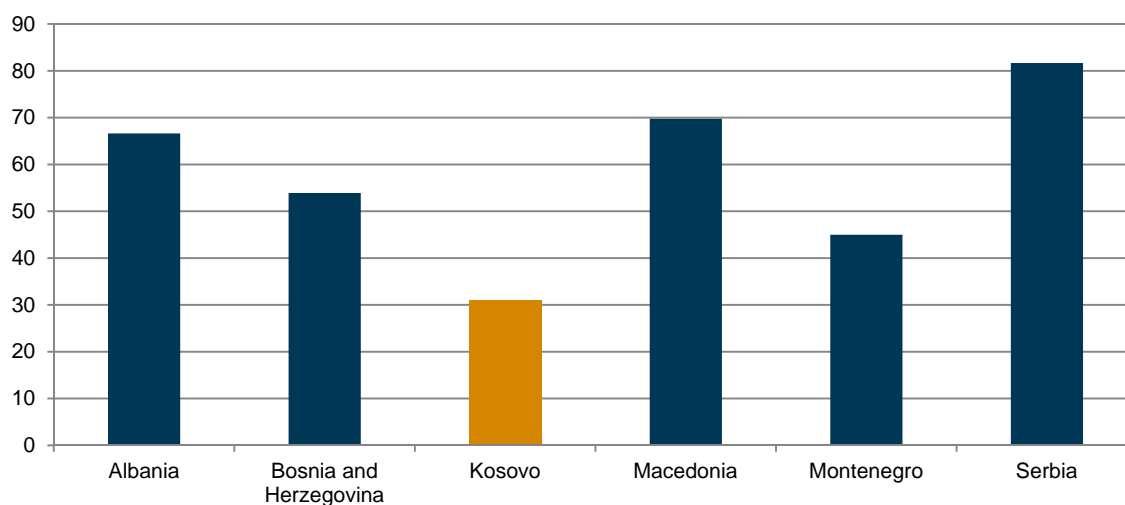
The good news: fiscal space is abundant ...

In order to further improve basic infrastructure more substantial public investment will be needed. Following the golden rule of fiscal policy, also future generations should participate in the financing of these infrastructure investments. Moreover, recent IMF studies have once again shown that public infrastructure investment has the highest GDP multipliers and that debt financed public investment generates more output and can hence be self-financing. Besides, Kosovo's public sector is hardly indebted at all. In 2014 general government gross debt in GDP made up only about 10%. Hence, fiscal space appears to be abundant (see Figure 10).

... and overall external indebtedness is low as well

In addition, also the overall external indebtedness (including the private sector) is very low. Gross external debt stands at less than a third of GDP (see Figure 11). It is time for extensive investment activity.

Figure 11 / Gross external debt, in % of GDP, 2014



Note: For Montenegro gross external public debt.

Source: wiiw Annual Database.

CONVENTIONAL POLICY RECOMMENDATIONS

Conventional policy recommendations typically include measures that are to a large extent effective in the medium to long run only, such as defined for instance in the 2015 National Economic Reform Programme of Kosovo. Apart from various institutional reforms, these comprise also measures which are similar to some of the following actions suggested.

Kosovo needs to **increase export capacities** massively. Other transition economies have previously done this via substantial manufacturing **FDI support** as well as support of domestic investment. This typically includes local authorities' efficient one-stop shops, industrial parks with privileged access to energy, transport and training facilities as well as some sort of a cluster policy. For current as well as for

future producers an **improvement in market access** to the neighbouring countries and the EU will be of utmost importance. This includes institutionalised cooperation with the business communities in the neighbouring countries, possibly along with the establishment of trade offices. Remaining regional cross-border barriers of all sorts have to be removed.

In the specific case of Kosovo a fast **solution of the Trepca mine status** and the quick restart of this industrial complex appears to be pivotal. This will probably involve a costly compromise with the Serb-controlled part of the mining firm but eventually this could open the way for a redevelopment of the once single most important employer in Kosovo as well as the emergence of additional producers further up the value chain.

A potential redevelopment of the Trepca complex as well as other industrial establishments will be in dire need of **modern cross-border transport and energy infrastructure investment**. Apart from further investment in highways connecting the country internally as well as with all its neighbours, it is **especially the rail network** that should be upgraded and extended given the prospects for transport of heavy freight. For obvious reasons a long-lasting solution of the electricity generation problem has to be tackled. Apart from the planned building of a **new coal-fired electricity plant**, the **refurbishment of the old blocks** should be advanced as well. Also the installation of **powerful air pollution filter systems** has to be pushed for public health and environment reasons. Further, the obsolete **gas network** should be re-established in order to allow for the diversification of energy sources. Additional electrical **power lines** should be built in order to connect to the neighbouring countries and share peak loads.

Public investment in education should **focus more on secondary education**. Specifically, **vocational training including an apprenticeship system** should be adopted. Similar education models can be studied in Austria and Germany. They should help to provide a skilled workforce for the infant manufacturing sector. However, this is a measure that might only have effects in the very long run.

All of the measures suggested above aim at the final goal of making industrialisation of broad sectors of the economy more likely by reducing large fixed costs, not affordable by a single firm, via government investment in physical and human capital.

UN-CONVENTIONAL POLICY RECOMMENDATIONS

While many conventional measures mostly target the supply side in the medium to longer run, there are usually less short- to medium-run measures recommended that have the potential to more quickly increase aggregate demand and improve the social conditions of the most vulnerable groups of society in developing nations. These comprise in Kosovo especially young families without job, comprehensive insurance and proper housing. This is a burning issue in Kosovo due to the comparatively high fertility rate and hence large young age cohorts that enter the labour market each year but cannot be absorbed there. The recent mass exodus of the young, particularly from smaller towns, is a warning signal. Unless immediate action is taken, the country will lose even larger shares of its population, a process that makes industrialisation even more unlikely for a number of reasons (e.g. relative increase of fixed costs of investment and Dutch disease effects of increased remittances flows).

However, migration will remain an important factor in the foreseeable future. Hence, in the negotiations with the EU and the neighbouring countries it should be stressed that legal migration is to be favoured over illegal migration in order to **make circular migration flows and return migration more likely**. One could also try out **incentive schemes for remittances** to go into business activities and supporting training programmes (e.g. if family members can get top-up governmental training support for a part of vocational training costs) rather than into private housing and imports. Following a remittances adapted version of Thirlwall's Law, it is also important to always consider the present current account constrained growth model of Kosovo. Minimising imports at given levels of foreign transfers is imperative.

It is worthwhile to consider historical analogies. One would be the case of the city of Vienna after World War I. The war had caused a massive drop in GDP. Many refugees were adding to the vast army of unemployed in the city that at that point in time had a population size similar to the one post-war Kosovo has today. Poverty was widespread. There was a housing shortage and health care was terribly underdeveloped. The youth lacked proper education as well as cultural and sports facilities. All these features apply to a large extent also to the current case of Kosovo. The aim of the city government of Vienna in the 1920s was to remedy all these social deficits and thereby also to provide for mass employment within a relatively short time period. Tax sovereignty was used to implement progressive taxation in order to finance municipality housing, mass education, health care institutions, public transport, cultural and sports facilities as well as various insurance and other services institutions.

Some of these successful policies could be applied (in a modernised way) to the case of the Kosovo economy. Therefore additional funds have to be tapped. The current system in Kosovo has some elements of **tax progressivity that could be expanded further** especially in the corporate income, personal income and the real estate taxes. However, one might want to be careful about disincentives for young professionals and skilled workers to stay in the country. A more sophisticated tax structure could achieve both goals. **Additional luxury taxes** on high-end import goods such as high-powered cars should be applied. In general, all interventions should also have an eye on reducing the country's import dependency. Tax increases should target those with the highest income elasticity of demand for imports (typically higher-income population). Government expenditures should involve as few imports as possible. Hence any construction activity must be evaluated according to its import content. Simple infrastructure using local building materials should be favoured over technically complicated constructions such as tunnels that imply the usage of costly and mostly imported high-end machinery.

A **nationwide municipality housing project** would serve this goal in several ways. The construction would employ low-skilled unemployed and inactive population with a comparatively low income elasticity of demand for imports. Moreover, local building materials such as cement, bricks and woodwork could be used. In addition, larger housing units could help to curtail the uncontrolled building of private one-family dwellings. Central Kosovo in particular is transforming into a large sub-urban space that is constantly destroying valuable agricultural land that could instead be used for the local production of food. The set-up of a preferred and cheap **area-wide public transport** system should also have the goal to offer jobs to the less skilled as well as to substitute widespread individual car imports.

All over the country a **network of vocational training centres** should be established. They should focus on occupational profiles that can be employed in the few companies operating locally. Together with these firms an apprenticeship system should be established. This should help to lower the costs of domestic production and improve the skills of the population. Similarly, an inclusive and comprehensive

network of health care centres should be developed with the aim to improve the social conditions of wide segments of the population, also giving them the essential security which is needed for the medium- to long-term planning of economic agents. An efficient and centralised medical trust should try to minimise the costs for medicine imports. A well-organised health care sector could have the potential to become a regional supplier of health services, thereby generating export revenues.

Given the specific age structure of Kosovo it should not be forgotten to supply **cultural and sports facilities** to the large young-age population of the country. Every town should, for instance, aim for the construction of indoor and open-air swimming pools. Apart from improving public health conditions this would again offer jobs for the less skilled in construction and maintenance with low import intensity. These cultural and sports institutions could, in one or the other case, have the potential to attract also tourists from the region which could help to improve the current account.

As complements to the before-mentioned conventional medium- to long-run policy recommendations that mostly aim at improving the supply side of the economy of Kosovo, these un-conventional short- to medium-run measures should aim at increasing local demand involving a minimum of imports in order to offer the remaining local population that has not yet migrated a basis for a decent life in Kosovo. Ultimately, both sets of policy actions should yield an increase of domestic production and hence a balanced growth of wages following improvements in productivity.

Given the lack of an exchange rate policy, it will be of utmost importance that short-run demand booms will not increase the average wage level above a longer-term productivity (cum inflation) growth path. A **comprehensive incomes policy** with a centralised wage bargaining system is therefore of crucial importance. The involvement of the major interest groups in the country is indispensable for success. However, this implies a very high level of coordination and cooperation which realistically can be achieved only with strong government interventions in the medium to long run.

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