

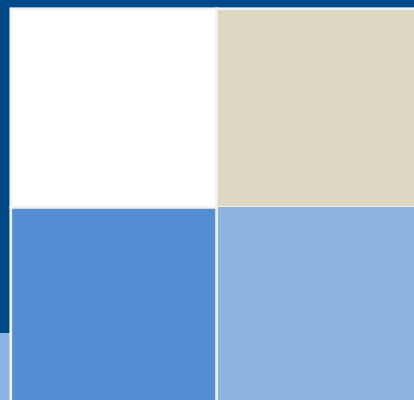
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Business environment in Kosovo:

- A view on the key policy implications



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Business environment in Kosovo: A view on the key policy implications

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BUSINESS ENVIRONMENT IN KOSOVO: A VIEW ON THE KEY POLICY IMPLICATIONS

I. Background

Business is an important tool for economic development and stability. The establishment of an enabling business environment has been broadly acknowledged as an essential precondition for the private sector response that leads to dynamic growth, and ultimately employment and income generation. The Government, therefore, has the main role in creating an enabling business environment. For this reason, it is of immense importance to design rules and regulations that stimulate the growth of enterprises. Recently, policy makers and multinational organizations have increasingly focused on a sound investment environment as a strategy for economic development. Various reports from international organizations link the need to reform the business environment with attracting foreign investors, the key developments that would smooth the country's economic progress and social stability.

Strengthening the business environment in Kosovo is a mechanism that would support an increase of foreign direct investments and would accelerate the institutionalization of competitive conditions for both domestic business growth and external businesses' investments in Kosovo. Moreover, the development of a more attractive business environment would in turn improve Kosovo's attractiveness in the region and for the whole of Europe. However, despite its importance, there has not been any significant improvement in the business environment of Kosovo over the past two years. Numerous shortcomings have been identified by several reports. Being in a fairly early stage of the transition process and also an early stage of state building, Kosovo is encountering severe challenges in creating an enabling business environment. Due to the lack of seriousness and maturity of policy-makers regarding this issue, Kosovo, together with Bosnia-Herzegovina, today ranks as the least attractive business environment in the SEE region. This lack of commitment from policy-makers and unsatisfactory business climate sends negative signals to foreign investors in regard to the possibilities for doing business in Kosovo. Based on the World Bank's Doing Business indicators, Kosovo ranked 117th out of 183 countries in both 2011 and 2012, while the indicators for starting a business, dealing with construction permits, protecting investors, and enforcing contracts ranked Kosovo even lower. While Kosovo's overall ranking remained the same from 2011 to 2012, Kosovo's rank for each indicator (except for one) either deteriorated or remained at the previous year's rank (see Table I).

Despite the existing necessity and incentives for progress, an efficient policy set-up that could improve Kosovo's business environment has still not been designed, while many of the institutions responsible for business growth have no innovative solutions with which to tackle these huge domestic policy failures.

In particular, corruption in the public sector continuously affects the business sector while, at the same time, forces efficient and effective policy choices to take a back seat to more politically oriented aims and decisions. Unlike in a free and progressively regulated market, Kosovo's current policy environment does not incentivize rational economic actors -- managers and businesses -- to act within the market logic. Because it is costly and ineffective to adhere to the outdated and

inefficient business policies, economic actors look for alternatives (which might not be indicative of rational market behavior or a rational business growth model in a more liberal and supportive policy environment). Corruption originates from several channels such as bureaucracy, excessive costs and informality. While considering the numerous challenges that business in Kosovo faces, this policy brief will focus on the challenges of corruption in the public sector, particularly corruption in public procurement, the challenges that informality poses for the business environment in Kosovo. This brief begins by scrutinizing the policy cases that have affected and shaped the current environment and moves to detail possible policy solutions that would further develop Kosovo's business environment and the overall performance of this sector.

Table I: Rank of indicators in 2011 and 2012

Indicator	Rank in 2011	Rank in 2012	Progress/Deterioration
1. Starting a business	165	168	↓ Deteriorated
2. Dealing with Construction Permits	169	171	↓ Deteriorated
3. Getting electricity	120	124	↓ Deteriorated
4. Registering property	66	73	↓ Deteriorated
5. Getting credit	24	21	↑ Improved
6. Protecting investors	172	174	↓ Deteriorated
7. Paying Taxes	45	46	↓ Deteriorated
8. Trading across borders	129	131	↓ Deteriorated
9. Enforcing contracts	157	157	↔
10. Resolving insolvency	31	31	↔
Source: World Bank Doing Business Report 2012			

II. The state of business environment in Kosovo: main challenges and their impact on businesses

SMEs (small and medium enterprises) are a vital part of Kosovo's economy and account for approximately 40% of GDP. SMEs employ around 60% of formal sector employees and account for 99% of all businesses. However, despite their immense importance, especially as job generators, SMEs in Kosovo continue to face institutional barriers and other obstacles in the business environment (even after the declaration of independence in 2008 and the establishment of several relevant institutions).

Inheriting a state-run economy from the former Yugoslavia, Kosovo faced huge problems in installing the basic standards and mechanisms of a market economy in the aftermath of 1999. For example, the level of unemployment in Kosovo is estimated at 45.4%,¹ with the number of job

¹ Results of the Labour Force Survey (2009). Statistical Institute of Kosovo, p.32 Available at: http://esk.rks-gov.net/publikimet/doc_details/727-rezultatet-e-anketaeumls-saeuml-fuqisaeuml-punaumeumltore-2009.

seekers estimated at 335,260². Moreover, the government's plan for privatization threatens to put additional strain on the job market; Kosovo's market experienced rather huge social upsets by the trade unions in response to the process of privatization undertaken by the government which was very influenced by political interest and was seen as fully corrupt. In addition, the lack of a coherent and legally certain path for foreign direct investments threatened many foreign industrial investments in Kosovo. In particular, the lack of confidence in Kosovo's market mechanisms prevented many competitive sectors in Kosovo (i.e. tourism, mining and energy etc) from receiving foreign investments. As a result, there was no foundation for significant industrial development via foreign direct investments. Moreover, a sidelined but important facet relates with international recognition of Kosovo. As a result of its contested statehood, Kosovo was 'banned' from enjoying a customary capacity to export as well as communicate with international and regional markets. Most recently, the institutional capacity to fully implement the long list of newly printed regulations and laws is severely lacking. The new regulations and laws have in turn contributed to additional difficulties for businesses in Kosovo.

Assessments of Kosovo's business environment report an unfavorable business climate that inhibits the establishment and growth of local businesses and discourages foreign investors. These reports³ also paint a sobering picture of the state of business in Kosovo, which clearly hint to the fact that Kosovo's market did not improve significantly in the last years (see table I). For example, the Progress Reports of the EU continuously highlight the weak, regionally uncompetitive, and financially unsound legal and economic policy standards in Kosovo's business environment.⁴ Moreover, other reports note the weak rule of law, the large number of informal activities, corruption, and uncertainty over property rights as continual hindrances to the development of Kosovo's economy.⁵

With a reoccurring set of implications appearing in the business environment, the Government of Kosovo has undertaken reforms aimed at improving the business environment (see box I). However, Kosovo institutions continue to lack a consistent and efficient policy response that could address these challenges more pragmatically. As a result, businesses are still confronted with several problems, with corruption, informality, and regulatory burden as the most prevalent challenges.

² Ministry of Labour and Social Welfare, Annual Report (2011) 'Labour and Unemployment' p.17. Available at: <http://mpms.rks-gov.net/Portals/0/Librat/2011%20Raporti%20Vjetor%20Puna%20dhe%20Punesimi.pdf>.

³ World Bank Doing Business Report, 2010 and 2011, p. 10

⁴ European Commission, Kosovo Progress Report 2011. Brussels, 12.10.2011. SEC(2011) 1207
Available at: http://ec.europa.eu/enlargement/pdf/key_documents/2011/package/ks_rapport_2011_en.pdf

⁵ European Commission Progress Report on Kosovo 2011 and Riinvest Enterprise Barriers Survey 2011.

Box 1: Reforms in Doing Business in Kosovo (Source: Ministry of Trade and Industry)

Aiming to enhance the capacity for conducting business in Kosovo and improve the ranking in the World Bank Doing Business Report, the Government of Kosovo has commenced a reform agenda. To date, several reforms have taken place:

1. The requirement of obtaining a work permits in order to start-up a business has been eliminated, and the procedure for registering a business has been simplified.
2. The business registration fee has been eliminated. Prior to this reform, it cost € 24 to register a LLC business
3. The required deposit of main assets for businesses of the Joint Stock Companies has been reduced from €25.000 to €10.000. While of the required rate of deposit for LLC businesses was formerly €1.000, this required deposit of businesses' main assets has been removed.
4. The declarations on conflicts of interest have been advanced for directors and relevant officers. Also, the competent courts can easily annul transactions that violate the rules on conflicts of interest.
5. In order to export or import goods to or from Kosovo, businesses have been required to submit eight (8) different documents. Now the exporting and importing companies are not obliged to obtain export/import certificates. Yet, despite this reform, businesses still face several challenges due to the inefficient functioning of 'One Stop Shops'.⁶

III. Effect of corruption on doing business

Corruption in business is an important global concern to both developing and developed countries. Moreover, corruption is one of the main obstacles for economic and social development. In Kosovo, corruption remains prevalent in many areas and affects the access of citizens to public services. Many agree that corruption is the most severe problem for Kosovo's business environment, as is frequently voiced in reports by the European Commission and Transparency International.⁷ Several laws⁸ have been adopted as part of the government's anti-corruption program, which aims to decrease public officials' vulnerability to corruption and bribery. Nevertheless, in some respects, corruption continues to be classified as a major obstacle for business growth in Kosovo by businesses and foreign investors. Several surveys report perceptions of corruption to be widespread within the business sector. For example, a survey of the American Chamber of Kosovo (ACK) conducted in 2008 revealed that around 40% of Albanians and 18% of Serbs who run businesses report to that they are faced with corruption.⁹ Even by regional standards, corruption is a serious problem for Kosovo. According to the World Bank (2009), perceived corruption is one of the biggest obstacles for increasing investment, and 73% of the companies surveyed consider corruption as a major constraint on doing business in Kosovo.¹⁰ Also according to Transparency International's Global Corruption Barometer (2010), perceived corruption within the business and private sector is

⁶ Ibid

⁷ European Commission, Kosovo Progress Report 2010, and Kosovo Progress Report 2011, p.28 and 30, respectively; Transparency International Global Corruption Barometer (2010)

⁸ such as the Law on the Prevention of Conflicts of Interest and the Act on the Disclosure of Information by Public Agencies

⁹ American Chamber of Commerce, Report Study on 'Impact of Corruption on Kosovo's Business Community' 2008, p.14. Available at: http://www.amchamksv.org/images/userfiles/files/7437_impactofcorruptiononkbc.pdf

¹⁰ World Bank & IFC Enterprise Surveys 2009, p.14.

high in Kosovo, who received a score of 3.3 on a 1 to 5 point scale.¹¹ In global rankings, out of 178 countries rated by Transparency International, Kosovo was ranked 110th and 112th in 2010 and 2011, respectively.¹²

Along with corruption in the public tendering sector, studies report that the size of Kosovo's informal economy is problematic.¹³ Over-regulation and excessive costs commonly resulted in firms choosing to operate informally and to devote their resources to influence a regulatory environment in their own favor.¹⁴ In addition, over-regulation or improper regulation incentivizes businesses to take part in informal activities such as corruption and nepotism,¹⁵ which in turn harms the growth of formal SMEs.

IV. Public procurement process

The corruptive behavior of the public sector hugely affects the certainty and efficacy of the business environment. Therefore, it is important to note that the public procurement market in Kosovo is estimated to amount to around 800 million euro, thus representing roughly 14% of the country's GDP.¹⁶ In addition, a large proportion of firms in Kosovo are directly dependent on public tenders or public expenditures due to the inefficiency and scarcity of the market machine to provide means for the growth of the private sector. This situation breeds corruption and control from partisan offices. Public tendering, therefore, represents a key issue, whereby firms become vulnerable to the partisan control and accordingly politicized; this politicization seriously hinders the market opportunities and the private sector's self-regulating growth.¹⁷ This corruptive linkage, nowadays a very common determinant in Kosovo's public procurement market, not only hinders the efficiency of the business environment but also demises the concept of a market economy wherein competition is the determining indicator for a firm's success.

The criteria for awarding public tenders are observed to be unreliable and uncertain. The public tendering officers often introduce artificial criteria concerning the eligibility and qualification process in favor of certain (or a group of) economic operators.¹⁸ This has hindered the ability of many qualified economic operators to be eligible for participation in the bidding process. Moreover,

¹¹ Transparency International Global Corruption Barometer (2010). Number 1 meaning 'at all corrupt' and 5 'extremely corrupt', p.24. Available at: http://www.transparency.de/fileadmin/pdfs/Wissen/Korruptionsindizes/GCB_2010.pdf

¹² Transparency International Corruption Perceptions Index 2010 and 2011, p.4 and p.7, respectively.

¹³ Klapper, L. (2006). "Entrepreneurship: How Much Does the Business Environment Matter?" View-Point, note number 313, The World Bank, November; World Bank (2005)

¹⁴ Baumol, W. (1990). Entrepreneurship: Productive, Unproductive, and Destructive. *Journal of Political Economy*. 98(5), 893 – 921. <http://dx.doi.org/10.1086/261712>

¹⁵ Smallbone, D. (2002). Institutions, administrative reform and SME development in transition economies: Some policy issues. Paper presented at Conference on Economic Development and Reconstruction Policies in SEE, Dubrovnik, 25–28 April; Bartlett, W., and Bukvić, B. (2001). Barriers to SME growth in Slovenia. MOCT—MOST. *Economic Policy in Transition Economies*, 11 (2), 177–195. <http://dx.doi.org/10.1023/A:1012206414785>

¹⁶ Sigma/OECD (2011) „Kosovo General Assessment“. May, 2011, available at: <http://www.sigmaweb.org/dataoecd/40/29/48970710.pdf>.

¹⁷ Group for Legal and Political Studies, Policy Report 03/2012, 'Dissimilar Patterns of (Mis)Using the Public Money: Trends and Practices of Public Procurement Management in Kosovar Municipalities', February 2012, available at: <http://legalpoliticalstudies.org/download/Policy%20Report%2003%202012%20english.pdf>.

¹⁸ See Anti-Corruption Agency, Opinion, Municipality of Shterpce, dated 08.09.2011, available at: http://www.akk-ks.org/repository/docs/Opinion_Shterpca.pdf, Anti-Corruption Agency, Opinion, Municipality of Obiliq, dated 04.10.2011, available at: http://www.akk-ks.org/repository/docs/Opinion_Obiliqi.pdf.

the assessment of the merit of the bidders is based in unspecific and immeasurable criterion, which paves the way for misuse of authority and the awarding of certain tenders who exist within their preferred partisan firms. This practice clearly disrespects the rules of awarding tenders based on merit. This raises several concerns regarding the pervasiveness of practices of favoritism and regarding the links between businesses and procurement offices.

V. Corruption and informality

The informal economy in Kosovo is a serious challenge, mainly prompted by weaknesses in spending policies and law enforcement, as well as the fight against corruption and nepotism.¹⁹ Kosovo has the highest rate of tax evasion in the region. However, this tends to be mainly a result of insufficient inspections of businesses by the tax authorities²⁰ and close connections between businesses and partisan offices or groups. A recent UNDP's Human Development Report points out that the Kosovo Tax Administration (ATK) consists only of 350 tax inspectors, which is largely insufficient considering that around 40% of business income is not reported to the ATK offices.²¹ Moreover, corrupt officials fuel these practices, because they benefit from receiving additional private income (bribes) in exchange for accommodating those participating in, and profiting from the informal activities. This results in an unfair business environment for formal businesses, as many of them declare and pay their tax obligations as opposed to their informal economic counterparts.²² Additionally, this environment provides for the development of unfair competition, as informal businesses are able to sell their products at significantly lower prices.

VI. Corruption and Bureaucracy

As a result of poor design and implementation of public policies, firms face several obstacles, commonly made manifest in excessive costs and burden of regulations, which influences informality and discourages compliance. Heavy compliance costs are considered to weaken business productivity, thus affecting growth or the number of new businesses that choose to enter the market. Due to excessive regulations, many businesses in Kosovo report spending long hours of their time dealing with the requirements that arise from government regulations.²³ For example, World Bank & IFC Enterprise Surveys 2009 reports that senior management spends almost 10% of its time each year dealing with requirements of government regulations.²⁴ Similarly, the WB Doing Business Report 2012 reveals that starting a business in Kosovo takes excessive administrative time and requires lofty costs. Likewise, the same report notes that companies spend in Kosovo spend an excessive amount of time (more than one-and-a-half times the regional average) dealing with taxes, while also making excessive payments. This, consequentially, provides incentives for corrupt practices such as bribery, which mainly takes place during inspections and interactions between businesses and authorities.

¹⁹ European Commission, Kosovo Progress Report 2011, p.38.

²⁰ Article on daily Koha Ditore "Sa inspektohen bizneset në Kosovë?" Available at: <http://www.koha.net/?page=1,3,101086>

²¹ UNDP Human Development Report 2012, Private sector and employment.

²² Combating Corruption in Kosovo: A Citizens' Perception Survey in Support of the Kosovo Anti-Corruption Strategy. PISG and UNDP.

²³ Olivera Ceni, Kosovo Chamber of Commerce (OEK), Personal Communication, May 2012

²⁴ World Bank and IFC Enterprise Survey (2009) Available at: <http://www.enterprisesurveys.org/>

Countries such as Croatia and Bulgaria have introduced guillotine practices via which the unnecessary and outdated rules are removed from the list of necessary requirements. This, on the one hand, provides a foundation for fixing some of the most critical problems resulting from unnecessary and inefficient regulations, while also helping to lower the regulatory and administrative costs of businesses and incentivizing increased compliance. Moreover, this practice provides opportunities to build a permanent system for the quality control of new business regulations and to prevent the recurrence of problems.

VI. Policy Recommendations

Tackling the problem of corruption in the public sector is essential for improving the business environment in Kosovo. As such, GLPS proposes the following as critical first steps for tackling corruption in the public sector:

1. Investigate irregularities in public tendering: Public prosecution is the key authority that addresses tendering practices that involve partisan control and corruption. Public prosecution exists in the most proper, effective and legally inclusive dimension. Thus, the public prosecution must be far more vigorous and must make accountable all the responsible authorities in order to eliminate the malpractices identified within the procurement processes. In addition, public prosecution must address this through self-initiated investigations, thus playing its role more responsibly and effectively.
2. Define specific and measurable criteria for public tenders: Therefore, we recommend that the procurement authorities and the officers at both the central and local levels take seriously the need to set measurable and specific criteria of public tendering. The Public Procurement Regulatory Commission should establish rigorous mechanisms to observe the procurement authorities' credibility, whereby the latter constantly issues legal directives and regulations to fight the abuse of power by procurement authorities/officers. This will provide a foundation for fair competition and open opportunities for all economic operators in the bidding process.
3. Link the identification of informal businesses with rewards: Authorities should consider establishing performance incentives for tax inspectors, offering rewards for identifying and transforming businesses that operated informally into part of the formal market. This will provide for a higher number of tax payers resulting in a greater amount of tax revenue for the state. In addition, this would reduce the incentives for corrupt behavior by inspectors, as they would be provided with a financial stability.
4. Increase the efficiency of tax inspections: In order to do this, the number of inspectors must be increased, as the authority is largely understaffed.
5. Established One-Stop Shops are expected to have a large effect on reducing informality, as the regulatory burden will be reduced. Thus, efforts must be directed towards making one-stop shops fully functional and efficient (i.e. offering the services, issuing documents/permits).
6. Reduce the regulatory burden: Considering the high rate of informality, there is a considerable need to persuade informal businesses to translate their activities into the formal economy. Thus, the costs and lengthy procedures for obtaining licenses and permits and processing tax statements should be decreased. Moreover, enhanced coordination of

actors across multiple jurisdictions must take place in order to reduce or even eliminate excessive and overlapping demands on businesses.

7. The introduction of a guillotine practice should be considered, following the example of other countries such as Hungary and Croatia. Concretely, the government should instruct all the relevant institutions to prepare inventory lists of their regulations. As a result, the unnecessary, outdated and illegal rules would be identified and removed from the lists.
8. Increase awareness: Once the aforementioned reforms and benefits are made available for the targeted audience, a communication program should be implemented to raise awareness of their existence and educate informal businesses on their use. This implies the need to provide training programs for businesses, which should emphasize the benefits of existing within the formal market economy.

Policy Analysis

Policy Analysis in general is a policy advice paper which particularly aims to influence the key means through which policy decisions are made in both local and central levels of government. The purpose of Policy Analysis is to address, more in-depth, a particular problem, to examine the arguments related to a concerned policy, and to analyze the implementation of the policy. Through Policy Analysis, Group for Legal and Political studies seeks to stimulate wider comprehensive debate on the given issue via presenting informed policy-relevant choices and recommendations to the key stakeholders and parties of interest.