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**A DIAGNOSTICS APPROACH TO ECONOMIC GROWTH AND
EMPLOYMENT POLICY IN LOW INCOME ECONOMIES: THE
CASE OF KOSOVO**

Kunal Sen and Colin Kirkpatrick

**Institute for Development Policy and Management
School of Environment and Development
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1. Introduction

Kosovo's declaration of independence from Serbia in February 2008 marked the culmination of a process of transition to self-governing nationhood which began in 1999 with the establishment of the United Nations Interim Administrative Mission in Kosovo (UNMIK). While the International Court of Justice has been asked by the UN General Assembly to give a non-binding advisory opinion on the legality of Kosovo's declaration of independence, more than fifty countries, including the United States and the majority of European Union members, have already formally recognised Kosovo's independence.

The transfer of authority from UNMIK and the Provisional Institutions for Self-Government (PISG) to the newly elected government has shifted attention to the economic agenda and has raised public expectations that self government will accelerate the rate of economic improvement in the standards of living for the citizens of one of Europe's poorest nations.

The economic challenges facing Kosovo are considerable. Essential infrastructure services were severely damaged in the conflict and have suffered from many years of under investment. Historically, economic growth has been well below the rate achieved in neighbouring economies and the level of per capita income is among the lowest in the Balkans region. More than one third of the work force is unemployed and the number of unemployed is rising rapidly as more young people enter the labour force each year. Many households depend on remittances from abroad to meet their consumption needs. To overcome these challenges will require choices to be made on the use of scarce resources to maximise future economic growth and employment opportunities.

Economic analysis of Kosovo's recent performance is hampered by the limitations in the available data. The macro data have been subject to periodic revision and different estimates have been prepared by various agencies and organisations. There have been major demography and population shifts, including large international migration flows, which have added to the difficulties of obtaining reliable economic growth per capita estimates.

Early economic transformation was based on industrialisation and development of the mining sector, but by the mid-1990s large scale deindustrialisation and neglect of

necessary maintenance caused negative economic growth and a reversion to the agrarian economy. The war had a further damaging impact on the physical and human resources needed for economic growth and as a result, Kosovo's post-war growth performance began from a very low starting point.

Table 1: Growth Performance, Kosovo, 2004-2006

	2004r	2005r	2006r	Ave. 2004-2006
Real GDP growth (%)	3.4	2.4	3.3	3.0
GDP per capita (euros)	1464	1453	1483	1338
Gross National Disposable Income per capita (euros) ^a	1585	1603	1671	

Note: a. The estimates of GNDI per capita are higher than GDP per capita, reflecting the role of remittances in supporting domestic consumption.

Source: IMF (2008a)

Table 1 shows that growth over the period 2004-06 has an average of 3%. However, Kosovo's rate of population growth is the highest in the region, and this has significantly lowered the growth in per capita income. Economic growth in Kosovo has also been the slowest in the region (Table 2). For 2005-2006, its GDP per capita growth rate has been 0.6%, with the next highest being Macedonia at 1.8% (for 2002-2006).¹ In contrast, countries like Albania, Moldova, and Romania have grown at rates of 5% and above in the post-2001 period.²

¹ The growth rates per capita for Kosovo are obtained from the revised GDP per capita figures from the IMF (2008a) which are only provided for 2004-2006.

² Historically, Kosovo's growth rate and income per capita levels have been low compared to the other members of the former Socialist Federal Republic of Yugoslavia

Table 2: GDP per capita growth rates, Kosovo and Comparator Countries

Country	2002	2003	2004	2005	2006	Average	Ranking
Kosovo	n/a	n/a	n/a	-0.8	2	0.6	7
Albania	.5	.2	5.3	4.9	4.7	5.5	3
Bosnia	.8	.1	6.4	5.1	5.7	4.5	5
Macedonia	.6	.6	3.9	3.6	2.9	1.8	6
Moldova	.3	.1	8.8	8.8	5.2	7.3	1
Montenegro	.7	.0	6.3	6.3	7.7	4.7	4
Romania	.7	.5	8.7	4.3	8.2	6.1	2

Note: n/a: not available.

Source: GDP per capita growth rates for Kosovo from IMF (2008a) and GDP per capita growth rates for other countries, from World Bank, World Development Indicators.

This paper provides an assessment of Kosovo's economic prospects and proposes an agenda of sequenced policy measures for the promotion of economic growth and employment. The paper applies a 'diagnostics' analytical framework to identify the currently most binding constraints on economic growth and job creation. The results of the diagnostic analysis are used to identify the areas where policy intervention is likely to be most effective in terms of growth and job creation. This diagnostic approach is discussed in the next section of the paper. The third section applies the diagnostics approach to Kosovo, and identifies the binding constraints on growth and employment. The final section provides a short summary and conclusions.

2. Growth and Employment Diagnostics

The diagnostics methodology used in this paper builds on the growth diagnostics (GD) approach developed by Rodrik and others, by including employment in the analysis.³ Our diagnostic approach also draws on the 'evidence-based' impact assessment approach to policy analysis and decision-making, where the selection of policy interventions is based on a systematic assessment of the likely consequences of alternative policy choices.⁴

The growth diagnostics method is designed to help identify the key binding constraints on improving economic growth performance. Such an approach avoids one-size-fits-all strategies which have proved to be unsuccessful in many parts of the developing world. The GD approach allows the formulation of growth strategies that target policies which ease the most binding constraints on the economy at a point in

³ The growth diagnostics methodology is explained in Hausmann et al (2004, 2005, 2006)

⁴ Impact Assessment (IA) is widely used in developing countries and transition economies as a tool for evidence-based policymaking. See SIGMA (2007); Kirkpatrick and Parker, (2007, 2008).

time.⁵ The starting point of the approach is a ‘growth diagnostic decision tree’, where the proximate cause of low economic growth is low rates of private investment. Constraints on investment are then classified into three broad categories: access to finance, appropriability of returns to investment, and availability of complementary factors of production. Therefore, investment and growth is constrained because entrepreneurs and investors cannot get the capital they need to start a business or to expand operations, or because investors do not want to invest as they do not expect to retain a sufficient share of the fruits of their efforts, or because complementary factors such as public infrastructure, human capital and labour skills are missing (Enders, 2007). The growth diagnostic decision tree is depicted in Figure 1. As the Figure makes clear, finding the branch of the diagnostic tree that may contain the binding constraint is not enough. It is necessary to hone down further to identify the precise ‘micro’ constraint that underlies the overall macro constraint on economic growth. As is standard in the GD literature, the ‘micro’ constraints are identified by analysing surveys of firms’ perceptions in Kosovo on the constraints to their investments and growth, and benchmarking these against firm surveys in comparator countries. The analysis of firm surveys is supplemented with the analysis of macroeconomic and labour market data wherever necessary.

The primary factor that may constrain employment creation is weak economic growth. Strong economic growth leads to continuous upward shifts in the long-run demand for labour curve leading to employment growth over the long-term.⁶ However, the relationship between economic growth and employment growth is not the same across countries or over time, and some types of economic growth may lead to faster job creation than others. Patterns of economic growth which are biased towards labour-intensive sectors such as smallholder agriculture and small and medium enterprises in the manufacturing and services sectors are more likely to lead to faster employment growth than growth patterns that are biased towards capital-intensive (such as pharmaceuticals) and resource-intensive sectors (such as mining). Moreover, in transition and developing countries which are undergoing economic transformation and reforms, the initial sources of economic growth may be high rates of labour productivity growth, which may lead to job losses in the short to medium term. As labour productivity gains are sustained, employment growth is expected to pick up in the long run.

The employment diagnostics are undertaken by separately analysing the demand and supply side factors that may explain high unemployment and low job creation. The key demand side factor that may explain high unemployment is an insufficiency of aggregate demand. Among supply side factors are frictional unemployment due to job search, structural unemployment due to a mismatch between the skills demanded in new jobs and the existing skills of unemployed workers, and labour market inflexibility. As noted previously, the most important supply side factor that may explain low job creation in Kosovo is the pattern and rate of economic growth. The employment diagnostic approach used in this paper will determine which factor or set

⁵ As Rodrik, one of the proponents of the GD methodology, argues, “the biggest bang for the reform buck can be obtained by identifying the most significant bottleneck in the economy at any point in time, and focusing efforts in alleviating that bottleneck” (Rodrik 2004, p. 9).

⁶ The empirical evidence for the positive growth-employment relationship is strong. Robust economic growth in developing countries in the 1990s has led to strong employment generation, with global employment rising by 400 million in 1993-2003 (DFID, 2007).

of factors can be seen as the binding constraint to job creation in Kosovo. Specifically, the analysis will assess the potential impact of improved economic growth performance on employment by examining the pattern of economic growth by decomposing per capita GDP growth into three components – i) growth of labour productivity ii) change in the employment rate and iii) change in the labour force participation rate.⁷

3. Identifying the Binding Constraints to Growth

3.1 Investment

The fundamental driver of economic growth is investment. Investment rates in Kosovo are not the lowest in the region; its average investment in 2004-2006 standing at 22.3% of GDP, the fourth highest in the region (Table 3).⁸ However, private investment has comprised only 60 percent of total investment for the period for which we have disaggregated investment data (2001-2003), and of private investment, only 30% has been in equipment, machinery and changes in stocks (IMF, 2005).⁹

Table 3: Investment rates, Kosovo and Comparator Countries

Country	2002	2003	2004	2005	2006	Average	Ranking
Kosovo	-	-	23	21.1	22.9	22.3	4
Albania	31.9	25.5	25.9	23.6	25.6	26.5	1
Bosnia	20.1	20.4	18.8	19.2	..	19.6	6
Macedonia	20.6	20.0	21.4	20.0	22.1	20.8	5
Moldova	21.7	23.2	25.3	29.1	30.8	26.0	2
Montenegro	17.6	16.6	20.5	21.8	21.6	19.6	6
Romania	21.7	21.8	22.3	22.6	23.9	22.5	3

Source: Investment rates for Kosovo from IMF (2008a), for other countries, from World Bank, World Development Indicators.

3.2 Cost of Finance

Is the cost and access to financing has been the binding constraint to growth in Kosovo? Using the World Bank's Productivity and Investment Climate Surveys (PICS),¹⁰ we find that almost one third of the surveyed firms reported that cost of

⁷ Consider the identity: $GDP\ per\ capita = (GDP/number\ of\ workers\ employed) * (number\ of\ workers\ employed/labour\ force) * (labour\ force/total\ population)$. Taking logs and then differences, we obtain: $growth\ of\ GDP\ per\ capita = growth\ of\ labour\ productivity + growth\ in\ the\ employment\ rate + growth\ in\ the\ labour\ force\ participation\ rate$. See the World Bank (2007d) for more details on this decomposition.

⁸ Investment rates for other countries are averaged over 2002-2006.

⁹ Among the various determinants of economic growth across countries, the variable that seems to really matter is the rate of investment in equipment and machinery investment - countries with higher rates of investment in equipment and machinery investment observe higher economic growth (De Long and Summers 1991).

¹⁰ The PICS for Kosovo includes 319 small and 10 medium sized firms. The survey comprised the following sectors: wholesale/retail trade (99 firms), transport and communications (82), manufacturing (77) and construction (7). The PICS has a similar coverage and set of questions as the EBRD-World

finance was a major obstacle to growth. (Table 4). Kosovo's relative position is sixth in the sample of 8 countries in South Eastern Europe. With respect to access to finance, 25.9 percent of firms in Kosovo state that they face major or very severe obstacles in accessing finance, the third highest in the region (Table 5).¹¹ Our initial inference, based on surveys of firms' perceptions of the binding constraints to their growth, is that while both cost of and access to financing are important constraints to growth, it is not clear at this stage whether finance is the key binding constraint.

Table 4: Cost of Financing as a Constraint on Firm Growth (percentage of firms' responses in each category)

	No obstacle (1)	Minor obstacle (2)	Moderate obstacle (3)	Major obstacle (4)	Very Severe Obstacle (5)	Total (4+5)	Ranking
Kosovo	47.7	12.0	8.6	11.7	20	31.7	6
Albania	17.5	30.7	27.1	24.7	-	24.7	5
Bosnia	17.7	19.4	29.41	33.5	-	33.5	4
Croatia	30.9	30.4	19.6	19.0	-	19.0	8
Macedonia	25.8	30.8	233	20.1	-	20.1	7
Montenegro	22.0	12.0	13.0	25.0	28	53.0	1
Romania	19.6	15.2	30.4	34.8	-	34.8	2
Serbia	19.9	15.3	31.4	33.5	-	33.5	3

Notes: a) For this and all other tables using the Productivity and Investment Climate Surveys in this annexe, the figures for Serbia exclude firms in Kosovo.

b) Surveys for Kosovo and Montenegro contain an additional category 'Very Severe Obstacle' which is not included in other surveys.

Source: World Bank, Productivity and Investment Climate Surveys, 2002 and 2003

Bank Business Environment and Enterprise Surveys (BEEPS), which was conducted in Kosovo in 2006 (World Bank 2006e). The PICS contains output and employment data, which the BEEPS data does not. We have used the output and employment data to compute employment intensities in the main report. Therefore, to be consistent with the use of firm surveys throughout the report, we use the PICS in the growth diagnostics. However, wherever necessary, we corroborate the inferences that we draw from our analysis of the PICS survey with the surveys results of the 2006 BEEPS for Kosovo.

¹¹ A similar finding emerges from the BEEPS 2006 – 56 percent of all firms in Kosovo cite access to credit / cost of credit as a problem of doing business, as compared to an average of 45 percent for South East Europe (Anderson, 2007).

Figure 1: The Growth Diagnostic Decision Tree

Low Levels of Private Investment

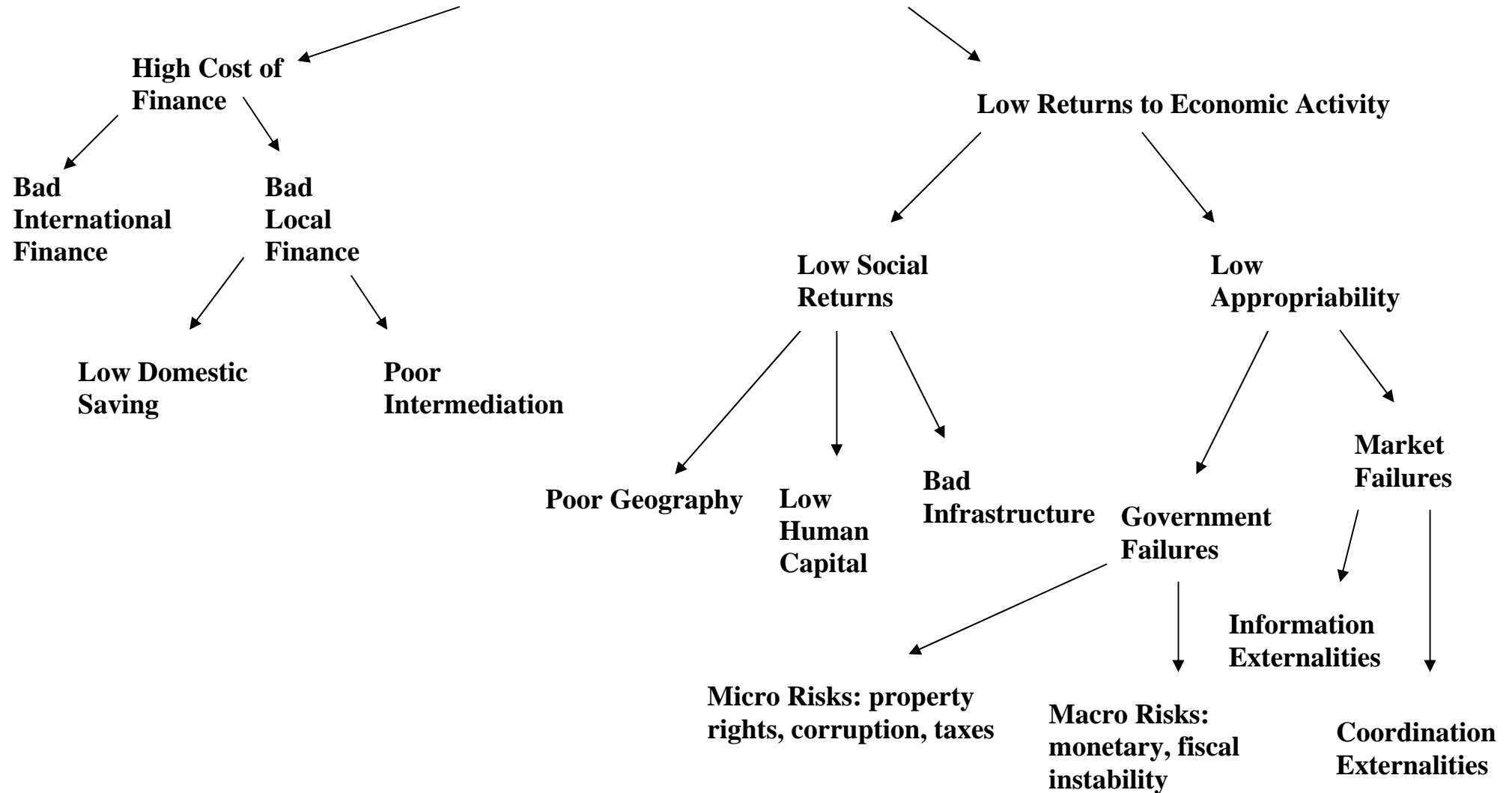


Table 5: Access to Financing (e.g. Collateral) as a Constraint on Firm Growth (percentage of firms' responses in each category)

	No obstacle (1)	Minor obstacle (2)	Moderate obstacle (3)	Major obstacle (4)	Very Severe Obstacle (5)	Total (4+5)	Ranking
Kosovo	57.4	10.2	6.5	13.9	12.0	25.9	3
Albania	42.2	23.1	20.4	14.3	-	14.3	7
Bosnia	27.5	15.0	35	22.5	-	22.5	5
Croatia	44.2	18.2	12.7	24.9	-	24.9	4
Macedonia	41.3	22.7	22.7	13.3	-	13.3	8
Montenegro	29.0	15.0	12.0	19.0	25	44.0	1
Romania	30.1	14.9	25.3	29.7	-	29.7	2
Serbia	32.0	15.6	29.9	22.5	-	22.5	5

Source: World Bank, Productivity and Investment Climate Surveys, 2002 and 2003

We therefore assess the importance of cost and access to financing more systematically by examining in turn the roles of international finance and domestic finance as constraints to growth in Kosovo.

International Finance

Kosovo has a negative national saving rate at -14.3 percent of GDP in 2006, and a high current account deficit, at -24.5 percent of GDP in 2006 (IMF, 2008a). In addition, firms in Kosovo possibly face higher costs of borrowing from international capital markets than firms in neighbouring countries due to the higher risk premium linked to political uncertainty. Both the large current account deficits and the higher risk premium faced by firms in Kosovo when borrowing from international capital markets would suggest that access to international finance may be a problem for investors in Kosovo. However, the Kosovo economy receives very large amounts of foreign assistance (10.7 percent of GDP in 2006) and remittances (9.6 percent of GDP in 2006). As the World Bank (2004) and Vathi and Black (2007) note, most of remittance inflows are used in residential investment and for the purchase of imported consumer goods. If access to international finance was an important constraint to growth in Kosovo, we would expect that the increase in remittance flows that occurred over the 2000s would have gone into productive investment. But this has not been the case, suggesting that access to international finance is not an important constraint to growth in Kosovo at the current juncture.

Domestic Finance

Are the problems faced by firms in Kosovo with respect to cost and access to finance due to poor domestic finance? If so, is it due to low rates of resource mobilisation in the economy or due to high costs of financial intermediation?

Examining Kosovo's performance with respect to domestic resource mobilisation, we find that domestic savings rates in Kosovo are among the lowest in the region (IMF 2008a; World Bank, 2008). The average domestic saving rate in 2004-2006 for Kosovo was -12.5 percent of GDP, whereas the domestic saving rates of Macedonia, Moldova, Montenegro and Romania as percent of GDP were 16.9, 11.7, 13.9 and 17.7 respectively. Kosovo's low domestic saving rate can be explained in part by the low growth rate of the economy,¹² and also by the fact that Kosovo is a post-conflict economy, where the propensity to save would be expected to be low in the early stages of post-conflict recovery. However, an encouraging feature of saving performance in recent years has been the increase in household deposits in commercial banks as percent of GDP from 12.3 in 2004 to 16.6 in 2006.¹³ Along with this has been an increase in the maturity structure of household deposits, with term deposits as a share of total household deposits increasing from 60.5 percent in 2004 to 70 percent in 2006, thus indicating an increasing confidence of households in the banking system.¹⁴

In spite of the weak performance of the Kosovo economy with respect to domestic savings, we see that financial deepening in Kosovo (as measured by the M2 to GDP ratio) is higher than all other countries in the region, except Albania (Table 6). There is also an upward trend in the M2 to GDP ratio from 52.2 percent in 2002 to 55.6 percent in 2004. Loans are also steadily increasing as a proportion of commercial banks' assets.¹⁵ In 2007, there has been a strong growth in credit, financed by deposits.¹⁶ Thus, if the volume of financial intermediation was a constraint to growth in the past, it is less likely to be so in the future.

Table 6: Financial Deepening (M2 to GDP ratio), Kosovo and Comparator Countries

Country	2001	2002	2003	2004
Kosovo	52.2	52.9	53.5	55.6
Albania	61.4	64.2	62.4	61.8
Bosnia	31.6	40.3	33.8	30.3
Macedonia	21.9	25.1	27.3	31.7
Moldova	n/a	n/a	12.0	12.9
Montenegro	24.0	24.4	24.4	26.5
Romania	22.7	26.7	30.0	32.9

Note: a) For the year 2004, we use previous GDP estimates for Kosovo from IMF(2005), and not the revised estimates, to make the estimate for 2004 comparable with the previous years; b) n/a = not available.

Sources: For Kosovo, M2 to GDP ratio calculations from data in IMF (2005); for other countries, from World Bank, World Development Indicators.

¹² Among the most important determinants of private saving rates is the growth rate of GDP (Athukorala and Sen 2004), which for Kosovo is the lowest in the region.

¹³ Authors' calculations from GOK (2008) and IMF (2008a).

¹⁴ GOK, 2008.

¹⁵ GOK, 2008.

¹⁶ IMF, 2008b.

The spread between lending and deposit rates is a reliable indicator of the efficiency of financial intermediation, with low spreads indicating a more efficient financial system. The available data suggests that Kosovo's interest rate spread is among the highest in the region – in 2002, the interest rate spread for Kosovo was 12.0 compared to 7.9 percent in Albania, 9.8 percent in Bosnia and 8.8 percent in Macedonia (World Bank, 2004). Our calculations suggest that the interest rate spread has remained at this high level in Kosovo – for deposits and loans for over a year, it was 11 percent in 2006¹⁷. Real lending rates for Kosovo are also the highest in the region, which may explain to a large extent why many firms in Kosovo find the cost of finance to be high, as we have observed earlier.¹⁸ The high spreads and lending rates could be due to the high levels of inefficiency in the banking sector along with a high risk premium.¹⁹ The high levels of inefficiency could be due a concentrated market structure in the banking sector in Kosovo – in end-2006, there were five foreign owned banks and two domestically owned banks.²⁰ The increase in the return on equity and return of assets since 2005 also may reflect the concentrated nature of the banking system in Kosovo.²¹

The high risk premium faced by lenders in Kosovo can be attributed to perceived macroeconomic risks and overall political uncertainty.²² It could also be due to the small size of the market, the large number of small and medium enterprises, and the absence of reliable credit rating information on borrowers. In addition, the high risk premium could be due to the presence of weak and uncertain property rights with respect to land, which is the dominant form of collateral for most firms.²³ As a consequence, banks in Kosovo have tended to be conservative in their lending strategies, with average loan loss provisioning standing at 200 percent of non-performing loans, far in excess of prudential requirements.

One further aspect of the difficulties that firms and households face in accessing finance in Kosovo is the sectoral distribution of credit, with the agricultural sector obtaining only 3.4 percent of loans in 2006. Industry and energy obtained only 13 percent of bank loans in 2006. In contrast, trade obtained 64 percent of total bank loans in 2006.²⁴ The low provision of credit to agriculture and industry – both potentially important sectors in the growth process – can be explained by the conservative lending strategies of a banking sector, reluctant to lend to the higher risk but possibly high return segments of the loan market, and by the absence of a vigorous land market, which makes it difficult for banks to accept land as collateral.

¹⁷ Based on data obtained from GOK, 2008.

¹⁸ Over the period 2002 to 2006, real lending rates in other comparator countries ranged from 7% in Moldova to 12.5 % in Romania (World Bank, 2008).

¹⁹ IMF, 2005.

²⁰ Estimates of the Herfindahl Index – a measure of concentration – suggest an increase in concentration since 2004 (GOK, 2008).

²¹ GOK, 2008.

²² IMF, 2005.

²³ Weak property rights belong to a different category of constraints, to be discussed later in the Annexe.

²⁴ GOK, 2008.

To conclude, the available evidence suggests that cost and access to finance is an important constraint to growth in Kosovo, and that this is due to poor domestic finance, more than to poor international finance. This in turn can be linked more to the low efficiency of financial intermediation rather than to a low volume of financial intermediation. Among the sources of the constraint to poor domestic finance, the most important is a high risk premium to lending due in part to political uncertainty and in part to weak property rights in land.

3.3 Appropriability of returns to investment

We next examine factors that may have led to weaknesses in the appropriability of returns, and by doing so, weakened the incentive to invest, especially in high productivity activities. Weaknesses in the appropriability of returns could be due to government failures or market failures. With respect to government failures, this could be due to macroeconomic risks such as monetary and fiscal instability, which increase investors' uncertainty about the future path of the economy, or due to microeconomic risks such as high rates of taxation, corruption and regulatory and bureaucratic red tape that may increase the costs of doing business.

With respect to market failures, this could be due to absence of informational externalities such as a lack of innovation and self-discovery by entrepreneurs or the absence of coordination externalities such as a financial system that does not reward risk-taking.

Government failure

We first address government failure and examine in turn the nature of macroeconomic and microeconomic risks in Kosovo.

Kosovo's currency is the Euro, which implies that Kosovo does not have an independent monetary policy. Therefore, in Kosovo's case, macroeconomic stability is to a large extent a function of prudent fiscal policy. Kosovo has done well in building institutions for autonomous fiscal management and its fiscal record has been strong so far, with tax revenue growth outstripping expenditure growth in recent years.²⁵ Inflation is also relatively low at 1.2 percent in 2002-2006, the second lowest in the region (IMF, 2005).²⁶ It can be argued that macroeconomic risks are relatively small in Kosovo at the present time.

Microeconomic risks could be due to high rates of taxation or an inefficient tax administration which increases the implicit rate of taxation (due to delays in refunds of VAT proceeds), bureaucratic red tape linked to business licensing or customs administration, corruption, weak enforcement of contracts and property rights. We use surveys of firms' perceptions for Kosovo and comparator countries of the above factors being obstacles to their growth as a way of assessing the nature of the constraints in these areas.

²⁵ IMF, 2005.

²⁶ However, inflation rose year on year to 13.2 percent in May 2008, exceeding rates in most neighbouring countries (IMF 2008b). This suggests that macroeconomic risks may well become a binding constraint to growth in the near future if inflation is not brought under control soon.

Kosovo's tax system is based on a uniform and broad tax base, with very few exemptions.²⁷ Tax rates are generally low, with the VAT rate the lowest in the region.²⁸ Proposed tax reforms by the Government of Kosovo will make Kosovo's corporate tax rate on par with the rest of the region. The tax to GDP ratio shows significant buoyancy in recent years, indicating that the low tax rates have led to a low degree of tax evasion. Most tax revenues are collected at the border (in the second half of 2007, border taxes comprised 67 percent of government revenues), as may be expected in an economy with a high import to domestic consumption ratio.²⁹ Firms in Kosovo do not seem to regard tax rates or tax administration as obstacles to growth, as compared to firms in other countries in the region – only 30 percent of firms in Kosovo considered tax rates to be a major or very severe obstacle to growth as compared to 52 percent of firms in Montenegro and Romania (Table 7).

Table 7: High Tax Rates as a Constraint on Firm Growth (percentage of firms' responses in each category)

	No obstacle (1)	Minor obstacle (2)	Moderate obstacle (3)	Major obstacle (4)	Very Severe Obstacle (5)	Total (4+5)	Ranking
Kosovo	32.2	23.6	14.4	19.9	9.8	29.7	5
Albania	10.2	24.6	28.1	37.1	-	37.1	3
Bosnia	21.1	17.7	34.3	26.9	-	26.9	7
Croatia	24.6	16.6	31.0	27.8	-	27.8	6
Macedonia	27.2	25.3	26.5	21.0	-	21.0	8
Montenegro	10.0	13.0	25.0	21.0	31	52.0	1
Romania	12.0	10.4	26.0	51.6	-	51.6	2
Serbia	17.0	9.1	38.6	35.3	-	35.3	4

Source: World Bank, Productivity and Investment Climate Surveys, 2002 and 2003

We now look at the three aspects of the regulatory apparatus – business licensing, customs and trade regulations and labour regulations. We find that firms in Kosovo do not find that business licensing is a constraint to growth – in fact, the proportion of firms that see business licensing as a major or very severe obstacle to growth is the lowest among all the constraints considered (Table 8). In contrast, customs and trade regulation is seen as an obstacle to firm growth – 31.2 percent of firms in Kosovo see customs and trade regulations as being a major or very severe obstacle to growth, the third highest proportion in the region. As the World Bank (2004) notes, several firms have expressed dissatisfaction with excessive delays in VAT refunds and improper reference pricing. With a high degree of cash transactions in the economy, the upfront system of tax collection greatly reduces the liquidity available to firms in Kosovo to meet their working capital needs. Labour regulation is not seen as a hindrance to

²⁷ GOK, 2008.

²⁸ GOK, 2008.

²⁹ IMF, 2005.

growth, which is not surprising as Kosovo has fairly flexible labour markets, with few impediments to hire and fire workers.³⁰

Corruption is seen as a problem in Kosovo, with 35.2 percent of firms considering corruption to be a major or severe constraint to growth. Kosovo's rank among the eight countries in South East Europe is third, indicating that corruption is a key constraint to growth (Table 9). According to the BEEPS 2006, bribes as a share of sales in Kosovo is 1.4, when the average for South East Europe is 1.0. However, according to the same survey, bribes are not as frequent in Kosovo as in neighbouring countries. Bribe-giving is most frequently observed in customs, taxation matters and in the procurement of government contracts.³¹

Contract enforcement and the functioning of courts are seen as problems by firms in Kosovo. The percentage of firms that see the legal system/conflict resolution as a constraint on growth is 23.9 percent, according to the PICS (Table 10). This is the fourth highest in the region. According to the BEEPS 2006, 53 percent of all firms state that the functioning of courts is a problem doing business.³² Only 16 percent of firms in Kosovo agree that courts are able to enforce their decisions, and only 18 percent feel that courts are quick and that they are fair and impartial. The percentage of firms in Kosovo stating that implementation of laws is consistent and predictable is half than the the average for South East Europe. As a consequence, only 15 percent of all firms in Kosovo use courts to solve an overdue payment, as compared to an average of 40 percent for South East Europe.³³

There are problems not only with the enforcement of property rights but also with their establishment and registration. There is a lack of property records which were transferred to Serbia and are not available yet.³⁴ As we have noted in the analysis of access to finance as a constraint on growth, this has led to a lack of confidence in collateralized business transactions. Weaknesses in the legal system can be attributed to weak municipal court performance where appeals and adjournments are easy to obtain, and there are no effective sanctions for non-compliance of court judgements.³⁵ Court judgements are considered to be unpredictable, the process of settlement of cases is lengthy³⁶ and there is a lack of clarity of laws and the execution of judgements in courts, with different legal systems in place.³⁷ Weaknesses in property rights and the rule of law can be seen as a binding constraint to economic growth in Kosovo.

Table 8: Business Licensing as a Constraint on Firm Growth (percentage of firms' responses in each category)

Country	No obstacle	Minor obstacle	Moderate obstacle	Major obstacle	Very Severe	Total (4+5)	Ranking
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³⁰ World Bank, 2004.

³¹ Anderson, 2007.

³² Op. cit..

³³ Op. cit..

³⁴ UNMIK, EPO, 2005.

³⁵ Op. cit..

³⁶ The average time that a case is with the courts is 18 months (UNMIK, EPO 2005).

³⁷ World Bank, 2004.

					Obstacle		
Kosovo	69.4	19.4	5.9	2.5	2.8	5.3	8
Albania	42.5	18.3	16.3	22.9	-	22.9	1
Bosnia	42.3	25.0	20.8	11.9	-	11.9	5
Croatia	38.0	28.8	23.9	9.2	-	9.2	6
Macedonia	34.8	23.2	24.5	17.4	-	17.4	4
Montenegro	42.0	20.0	16.0	11.0	11.0	22.0	3
Romania	34.2	22.0	20.7	23.2	-	23.2	2
Serbia	44.0	19.0	29.3	7.8	-	7.8	7

Source: World Bank, Productivity and Investment Climate Surveys, 2002 and 2003

Table 9: Corruption as a Constraint on Firm Growth (percentage of firms' responses in each category)

Country	No obstacle	Minor obstacle	Moderate obstacle	Major obstacle	Very Severe Obstacle	Total (4+5)	Ranking
Kosovo	35.0	15.7	13.3	14.8	20.4	35.2	3
Albania	7.4	22.8	22.2	47.5	-	47.5	2
Bosnia	28.0	13.7	23.6	34.8	-	34.8	5
Croatia	38.2	17.3	22.0	22.5	-	22.5	7
Macedonia	35.0	15.9	17.8	31.2	-	31.2	6
Montenegro	18.0	16.0	16.0	13.0	37.0	50.0	1
Romania	21.2	22.8	21.2	34.9	-	34.9	4
Serbia	47.0	20.0	16.7	16.3	-	16.3	8

Source: World Bank, Productivity and Investment Climate Surveys, 2002 and 2003

Table 10: Legal system/Conflict Resolution as a Constraint on Firm Growth (percentage of firms' responses in each category)

Legal	No obstacle	Minor obstacle	Moderate obstacle	Major obstacle	Very Severe Obstacle	Total (4+5)	Ranking
Kosovo	40.7	19.8	13.6	12.0	13.9	23.9	4
Bosnia	24.9	21.1	26.5	27.6		27.6	5
Croatia	25.0	20.2	32.1	22.6		22.6	6
Albania	9.8	28.1	29.3	32.9		32.9	2
Macedonia	32.3	17.4	23.2	27.1		27.1	3
Montenegro	12.0	16.0	22.0	25.0	25.0	50.0	1
Romania	26.1	24.1	28.9	20.9		20.9	7
Serbia	36.2	29.0	21.0	13.8		13.8	8

Source: World Bank, Productivity and Investment Climate Surveys, 2002 and 2003.

Market Failures

Market failures may be due to information externalities related to the inability of firms to diversify into and export new products. Market failures could also be due to coordination failures that may arise from ineffective coordination between the government and the private sector, or between the national and subnational governments.

Kosovo's export structure remains highly concentrated, with base metal and articles of base metal comprising around 50 percent of total commodity exports in 2006. The disaggregated trade data does not show any growth in new and non-traditional exports for Kosovo for 2004-2006. The lack of diversification in the export basket of Kosovo is not surprising, given the small manufacturing base in the country and that the economy is slowly emerging out of a post-conflict situation. It would be premature to observe informational externalities in an economy which has just began the process of integration with the world economy.

With respect to coordination failures, the SME Policy Index published by the OECD (2007) shows that small and medium enterprises find representing their views to the government to be difficult. There seems to be an absence of formal consultations between the government and the private sector. As already noted, there is also a problem in the coordination of policies relating to capital expenditures between national and municipal authorities. Coordination failures are important in Kosovo's context, though there is a lack of reliable evidence to suggest that they are a binding constraint to growth.

To conclude, our analysis of appropriability concerns finds that macro government failures related to high inflation or imprudent fiscal policy cannot be seen as a binding constraint to growth in Kosovo. With respect to micro government failures, there is no evidence of high and distortionary tax rates, significant bureaucratic red tape or rigid labour regulations as being key constraints to growth. However, there is a high degree of corruption and weaknesses in the establishment, registration and enforcement of property rights related to a weak judiciary and lack of clarity in legal systems that underpin commercial transactions. Thus, weak property rights can be seen as a binding constraint to growth. Market failures in the form of the inability of firms to move into new products and weak coordination between the government and the private sector, and between different levels of the government are present. However, while they may have played a contributing role to the weak growth performance, they cannot be viewed as a binding constraint to economic growth.

3.4 Social Returns

Can Kosovo's poor economic growth be explained in terms of low social returns either due to geographical factors or the lack of factors complementary to capital accumulation?

Geography

Kosovo is a land-locked country, a geographical characteristic which has often been seen as an obstacle to growth.³⁸ However, Kosovo is in a temperate climatic zone, a geographical characteristic which is seen as favourable to growth.³⁹ Kosovo has abundant lignite resources which can allow its energy sector to be a net exporter in the region.⁴⁰ Finally, Kosovo's location in South East Europe, and its proximity to the large European Union market suggest that on balance, Kosovo's geographical location cannot be seen as unfavourable to economic growth.

Infrastructure

Both the World Bank (2004) and the IMF (2005) point to the lack of reliable electricity provision by the state-owned utility company, KEK, as a key binding constraint to growth. This is clear from the Investment Climate Surveys which show that two thirds of firms in Kosovo consider electricity as a major or very severe obstacle to growth. Among all the obstacles considered, electricity has the highest relative ranking as a constraint among firms in Kosovo.⁴¹ The problem of inadequate electricity supplies as a major constraint on economic growth also comes out strongly in previous investor surveys and in consultations with stakeholders in Kosovo.⁴²

The constraint with infrastructure is also observed in the case of transportation, with 35.2 percent of firms in Kosovo considering transportation as a major or very severe obstacle, the highest in the region. With respect to communications, the proportion of firms in Kosovo that see it as a major or very severe obstacle is the second highest in the region. Therefore, the lack of infrastructure – a crucial complementary factor for economic growth – is clearly seen as an important constraint, if not the key binding constraint to growth.⁴³

Human capital

In contrast to infrastructure, firms in Kosovo do not see skills and education as an obstacle to growth, with only 6.8 percent of firms finding skills and education as a major or very severe obstacle to growth. The SME Policy Index 2007 also indicates that the small enterprises do not see skills as a constraint to their operations relative to other countries in the Western Balkans.⁴⁴

On the other hand, relative wages are increasing in favour of skilled workers in Kosovo. In 2004, the ratio of wages of workers educated to the tertiary level to the

³⁸ Collier, 2007.

³⁹ Sachs, 2003.

⁴⁰ World Bank, 2004.

⁴¹ Electricity connections in Kosovo take longer than any other country in the region, and insufficient electricity connection increases the price of electricity, which directly affects the cost of production. The electricity situation is also a negative signal to potential foreign investment in Kosovo (UNMIK, EPO, 2005).

⁴² See for example, [Survey of Existing Investors in Kosovo, Output Report No. ISTE 18](#)

⁴³ It should be noted that the ranking on constraints to firms in Kosovo in BEEPS-2006 (World Bank 2007) relative to the average for South East Europe and for Europe and Central Asia is very similar to what we observe in the PICS 2002/2003. Thus, the relative score of the degree of constraint faced by firms in Kosovo for electricity, transportation and communication is higher than the other indicators included in the survey.

⁴⁴ OECD, 2007.

wages of workers educated to the primary level was 1.1⁴⁵. This increased to 1.14 in 2006. The growth of real wages increased from 6.5 percent in 2002-2004 to 16.5 percent in 2004-2006.⁴⁶ Thus, there is evidence of an increasing demand for skilled workers which is not being fully met by supply. Furthermore, Kosovo's enrolment rate for 5-14 years age group at 82.3 percent is lower than the EU average and its tertiary net enrolment rate at 17 percent is one of the lowest in the region.⁴⁷ While a shortage of skills and low human capital formation is not yet a binding constraint to growth, it may become so in the foreseeable future.

To summarise, our analysis indicates that low social returns of investment are a binding constraint to growth. This is primarily due to the lack of provision of public goods, and especially electricity and transport. Other factors that may depress the social returns to investment such as poor geography and low human capital cannot be seen as being binding constraints to economic growth.

3.5 Summary of Growth Diagnostics Findings

Based on the application of the growth diagnostic methodology to Kosovo, we identify the cost and access to finance to be the first binding constraint to growth. Our analysis suggests that this is due to poor domestic finance, more than to poor international finance. This, in turn, can be linked more to the low efficiency of financial intermediation rather than to a low volume of financial intermediation. Among the sources of the constraint to poor domestic finance, the most important appears to be a high risk premium to lending due in part to political uncertainty and in part to weak property rights in land.

The second binding constraint is the low social returns to investment due to the poor provision of public goods, especially electricity and transport. In contrast, other factors that may depress the social returns to investment such as poor geography and low human capital are not found to be binding constraints to economic growth.

The third binding constraint is weaknesses in the rule of law, particularly related to the establishment, registration and enforcement of property rights. Deficiencies in court procedures and weaknesses in municipal court performance along with a lack of clarity of the legal systems that underpin commercial transactions have led to ineffective enforcement of creditor rights and of contracts, and acted as a major obstacle to investment and growth in Kosovo.

4. Identifying the Binding Constraints to Employment

4.1 Employment and Labour Market Characteristics

Economic growth generates jobs and household incomes and is therefore a necessary condition for a sustained growth in employment.⁴⁸ Economic growth and job creation

⁴⁵ GOK, 2006.

⁴⁶ GOK, 2006.

⁴⁷ World Bank, 2007c.

⁴⁸ DFID (2007, 2008)

can also contribute to poverty reduction by increasing the demand for labour, which is often the only asset of the poor. But similar rates of economic growth can have different effects on employment prospects and on broader dimensions of human development. The number and types of jobs that are generated by a given rate of economic growth will depend on the characteristics of growth and the types of labour that is required to sustain this growth pattern. Different types of growth have different requirements in terms of the skills, gender, and work experience of the work force. Economic growth will also have implications for the balance between the formal and informal sectors, where for example, employment in the informal sector can increase with economic growth as small enterprises that have elected to remain outside the regulated sector expand their activities.⁴⁹

.According to the Statistical Office of Kosovo, the working population (those aged between 15 and 64) represent 61 percent of the resident population (GOK, 2006)⁵⁰ Official estimates of the unemployment rate give a figure of 39%-41% of the economically active population. World Bank estimates taking account of seasonal and informal employment suggest unemployment is lower than the official figure (World Bank, 2006).⁵¹ Compared to neighbouring countries, Kosovo has the second highest level of unemployment (EC, 2008a).

The informal sector accounts for a significant share of economic activity in Kosovo. Recent estimates based on household consumption data indicate that informal activities account for between a quarter and one third of GDP (B& S Europe, 2007). The informal sector has a 'grey' and 'black' component. The former consists of legal activities that are hidden or not recorded in taxation or regulations, the latter consists of income generation from illegal activities.⁵² It is estimated that 98% of enterprises in Kosovo employ less than ten employees. A significant number of small enterprises are believed to be operating in the grey economy and are estimated to be providing as much as half of total employment in Kosovo⁵³.

4.2 Employment Diagnostics

In the macroeconomics literature, the causes of unemployment are usually categorised into *demand side* and *supply side* explanations. We first examine demand-side explanations of Kosovo's high unemployment rate.

Demand Side Factors

The inability of workers to find jobs in the economy could be due to insufficient effective demand for goods and services in the economy, which in turn implies that there is insufficient demand by firms to hire workers at the going market wage. Insufficient effective demand for goods and services is usually seen to be a cyclical phenomenon, linked to a downturn in economic activity and not due to long-term structural factors to do with weak economic growth. If unemployment is taken to be

⁴⁹ World Bank (2007a)

⁵⁰ The resident population is estimated to be 2.1 million. An additional estimated half million Kosovans are living abroad.

⁵¹ Individuals are required to register as unemployed to receive social security. A proportion of those registering may be working in the informal sector.

⁵² The grey informal sector accounts for almost 90% of the informal sector in Kosovo.

⁵³ World Bank, 2004, and IMF, 2005

caused by insufficient effective demand for goods and services, the solution is seen to be an increase in aggregate demand induced by appropriate fiscal and monetary policies, such as an increase in government expenditures or a decrease in interest rates brought about by an expansionary monetary policy.⁵⁴

Two features of Kosovo's labour market do not favour demand side explanations of Kosovo's high unemployment rate. Firstly, about 94 percent of the unemployed have not worked before, indicating that the majority of the unemployed are first time entrants to the labour market (GOK, 2006). Secondly, about 92 percent of workers looking for jobs have been doing so for more than a year (GOK, 2006). These two facts suggest that long-term factors due to insufficient labour absorption, especially of those coming into the job market for the first time⁵⁵ as a consequence of poor economic growth rather than cyclical factors due to a collapse in effective demand for goods and services are more important in explaining the high unemployment rate in Kosovo. In addition, given Kosovo's high trade deficit at 47 percent in 2003 (IMF, 2005) and the strong growth in real private consumption, which was in excess of 5 percent per annum in 2004-2006 (GOK, 2008), insufficiency of effective demand as an explanation of Kosovo's high unemployment rate does not seem to be supported by the macroeconomic data.

Supply-side Factors

Supply-side explanations of high unemployment can be based both on short-run and long-term factors. With respect to the short-term, an economy may witness frictional unemployment in context of rapid economic growth as workers move from one set of jobs to another, and are temporarily unemployed in the context of job search. Given the long duration of unemployment in Kosovo and the disproportionate share of the unskilled and poorly educated in the pool of unemployed persons⁵⁶ (along with Kosovo's weak economic growth), very little, if any, of the unemployment phenomenon in Kosovo can be attributed to job search. A second supply-side explanation of unemployment that is mostly short-run in nature is the possibility that the unemployment is due to a high and sticky-downwards real wage that constrains the demand for labour. This explanation has some validity in Kosovo's context as the high levels of workers' remittance inflows and foreign assistance may have contributed to a high reservation wage in the Kosovo labour market, thereby providing an implicit floor to downward wage adjustments that can eliminate the excess supply of labour. An implication of this argument is that most of the unemployed are voluntarily so. There is absence of any reliable evidence on whether high reservation wages have been responsible for Kosovo's high unemployment. However, the high poverty rates in Kosovo at 45 percent, which is more than double the poverty rate of other countries in the Western Balkans, indicates that a large proportion of the population earn incomes close to the subsistence level.⁵⁷ The implied prediction of the reservation wage argument that most of Kosovo's

⁵⁴ In Kosovo's case, increases in aggregate demand via an expansionary monetary policy are not possible, given the absence of an independent monetary policy.

⁵⁵ These are mostly the youth, who comprise approximate 73 percent of the total unemployed pool in Kosovo (GOK, 2006).

⁵⁶ About 74 percent of the total unemployed pool have an education level below the upper secondary level (GOK, 2006)

⁵⁷ World Bank, 2007c.

unemployed are voluntarily unemployed does not seem consistent with the high poverty rates in Kosovo.⁵⁸

Among long-term causes, unemployment can be due to structural factors due to a mismatch between jobs offered by employers and potential workers. Thus, there may be job losses occurring in declining sectors and it takes time for these laid-off workers to be retrained to work in the expanding sectors. Unemployment can also occur if labour regulations are such that they discourage the hiring of new workers. Structural factors may have contributed to some extent to Kosovo's unemployment problem. According to GOK (2006), out of the unemployed workers who had a previous job, about 31 percent were employed in manufacturing. Since a large proportion of the privatisation of State-Owned Enterprises occurred in the manufacturing sector, the unemployment rate may have risen with the contraction of the state-owned sector, and where the private sector was relatively small to absorb these unemployed workers.

Structural unemployment could also be due to a mismatch between the skills desired of their potential employees by firms and the actual skills possessed by the current workforce. An increase in relative wages in favour of skilled workers would suggest an excess demand for skilled workers relative to unskilled workers by firms in Kosovo. Furthermore, if skills shortage is the key constraint to employment creation, this will not be able to explain why the number of workers with secondary schooling would be so high (24% of total unemployment in 2006). Arguably, the role of structural factors in Kosovo's unemployment problem is relatively minor.

With respect to labour regulations, firms in Kosovo do not consider labour regulations as a major constraint to their operations. The labour market in Kosovo functions 'in a virtually unregulated way, with few formal arrangements regulating employment relationships and wage determination'⁵⁹ Therefore, onerous labour regulations cannot be seen as the cause of the high unemployment rate in Kosovo.

The primary supply-side factor that may constrain employment creation is weak economic growth. Strong economic growth leads to continuous upward shifts in the long-run demand for labour curve leading to employment growth over the long-term.⁶⁰ However, in transition and developing countries which are undergoing economic transformation and reforms, the initial sources of economic growth may be high rates of labour productivity growth, which may lead to job losses in the short to medium term. As labour productivity gains are sustained, employment growth is expected to pick up in the long run.

We now assess to what extent both weak economic growth and the pattern of economic growth has contributed to Kosovo's high unemployment rate. To do this, we first decompose per capita GDP growth into three components – i) growth of labour productivity; ii) change in the employment rate; and iii) change in the labour

⁵⁸ Furthermore, only 16.2 percent of households receive remittances (Vathi and Black 2007), which makes the remittance induced high reservation wage argument for the high unemployment rate in Kosovo implausible.

⁵⁹ World Bank, 2004, p. 67.

⁶⁰ The empirical evidence for the positive growth-employment relationship is strong. Robust economic growth in developing countries in the 1990s has led to strong employment generation, with global employment rising by 400 million in 1993-2003 (DFID, 2007).

force participation rate.⁶¹ We present our decomposition for the period 2004-2006 using the IMF's revised estimates of GDP in Table 11. We see that the positive 1.9 percent in GDP per capita per annum growth rate actually translated to a negative 4.5 percent per annum change in the employment rate (which meant that the unemployment rate increased by 4.5 percent). This is due to positive growth in labour productivity at 8.5 percent per annum (even though the labour force participation rate was falling in the same period). We find that the employment elasticity of output for Kosovo in 2004-2006 was a negative 0.08. This explains why the positive economic growth of 2004-2006 was associated with a rising unemployment rate.

Table 11: Decomposition of GDP Per Capita Growth

Variables	2004	2006	Growth Rate per annum (percent), 2006-2004
GDP per capita	1464	1521	1.9
GDP per worker	6521	7731	8.5
Employment Rate	0.603	0.551	-4.5
Labour Force Participation Rate ^a	0.372	0.357	-2.1
<i>Memo Item: Employment Elasticity of Output, 2004-2006^b</i>	-0.08		

Notes: a. The Labour Force Participation Rate is calculated using the identity in Footnote 61..
b. The employment elasticity of output is the percent change in employment divided by percent change in GDP.

Sources: SOK (2005) and GOK (2008), our calculations.

The negative employment elasticity of output that we observe in Kosovo in 2004-2006 is not a unique phenomenon in South Eastern Europe. We present estimates of employment elasticities of output for several countries in this region in Table 12. We see that Kosovo does not have as large a negative employment elasticity of GDP as Macedonia and Romania. On the other hand, Albania, Croatia and Moldova have positive employment elasticities of output. Since all these countries observed positive economic growth in the period for which we have estimates of employment elasticities of output, it is clear that the experience of the countries in South East Europe with respect to the relationship between economic growth and employment has been diverse. For Albania, Croatia and Moldova, it has been a win-win relationship, with both positive outcomes in economic growth and employment growth. This has not been the case in Kosovo, Macedonia and Romania, where economic growth has coincided with falling employment.⁶²

⁶¹ Consider the identity: $\text{GDP per capita} = (\text{GDP}/\text{number of workers employed}) * (\text{number of workers employed}/\text{labour force}) * (\text{labour force}/\text{total population})$. Taking logs and then differences, we obtain: $\text{growth of GDP per capita} = \text{growth of labour productivity} + \text{growth in the employment rate} + \text{growth in the labour force participation rate}$. See the World Bank (2007d) for more details on this decomposition.

⁶² In general, the average experience of the transition countries of Central and Eastern Europe has mirrored the employment –growth experience of Kosovo, with economic transformation bringing about labour productivity increases that led to job shedding (Kapsos, 2005)

Table 12: Employment Elasticities and GDP Growth for selected countries in South East Europe

Country	Employment Elasticity	Average Annual GDP Growth (percent)
Albania	0.66	6.4
Croatia	0.47	4.1
Macedonia	-3.54	0.9
Moldova	0.25	5.5
Romania	-0.13	4.4
<i>Average for Central and Eastern Europe</i>	<i>-0.19</i>	<i>3.5</i>

Note: all figures for 1999-2003.

Source: Kapsos (2005)

Next, projections are made of the unemployment rate under various scenarios of the growth rate of GDP and the employment elasticity of GDP. We assume three scenario for the employment elasticity for Kosovo – first, a low employment elasticity of +0.15, second - a medium employment elasticity of +0.30, and third - a high employment elasticity of +0.60.⁶³ We also assume three growth scenarios – first, low growth of 2 percent per annum, second, a medium growth rate of 6 percent per annum and third a – a high growth rate of 8 percent per annum. We hold the labour force participation rate and labour productivity constant at their 2006 levels, and assume a population growth rate of 1.5 percent per annum (as is the case currently). The projections for the unemployment rate for the year 2015 are presented in Table 13.

⁶³ To keep these assumptions in perspective, the global mean for total employment elasticity of GDP in 1999-2003, for which estimates are available, was +0.30 (Kapsos, 2005). The highest employment elasticity of GDP by region was +0.57 for Australia and New Zealand. The lowest was for the Caribbean at -0.42.

Table 13: Projections of the Unemployment Rate in Year 2015 under different assumptions of economic growth and the employment elasticity of output^{a,b}

	Low Economic Growth: 2% per annum	Medium Economic Growth: 6% per annum	High Economic Growth: 8% per annum
Low Employment Elasticity: +0.15	49.5%	46.7%	45.2%
Medium Employment Elasticity: +0.30	47.0%	41.1%	37.9%
High Employment Elasticity: +0.60	41.9%	28.4%	20.6%

Note: a) Economic growth is the growth in per capita GDP.

b) Unemployment Rate in 2006 is 44.9%.

Sources: our calculations, from GOK (2006b), GOK (2008) and IMF (2008a).

What these estimates suggest is that to have a significant impact on Kosovo's unemployment problem, not only is it important not only to increase the rate of economic growth, but also to increase the employment elasticity of GDP. Even with high economic growth of 8% per annum, if the employment elasticity of output is low at 0.15, the unemployment rate in 2015 will actually be higher than its 2006 level. On the other hand, with low economic growth at 2% per annum, with a high employment elasticity of 0.60, the unemployment rate in 2015 will only be slightly lower than its 2006 level. When both economic growth and employment elasticity of output are high, the unemployment in 2015 will be less than half its 2006 level.

4.3 Summary of Employment Diagnostics Findings

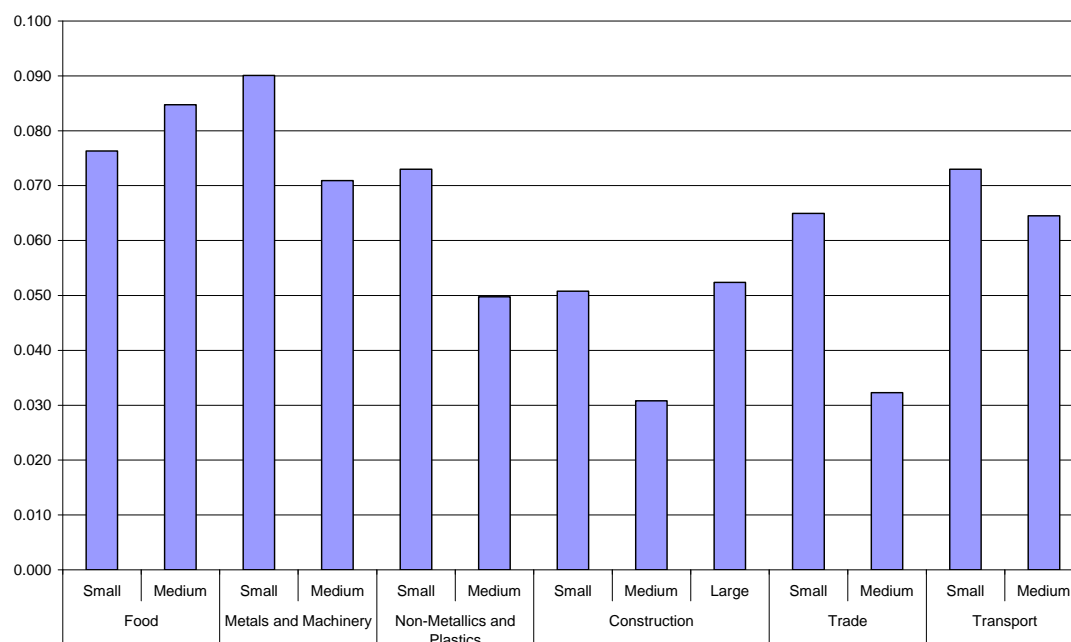
The employment diagnostics indicate that policy options for increasing employment growth must necessarily focus on increasing both economic growth and the employment intensity of growth. In Kosovo's case, with about two thirds of its workforce employed in agriculture, and with the large numbers of smallholder farmers in the agricultural sector, one important way to increase the employment intensity of growth is to ease the constraints to the growth of the smallholder agricultural sector. The agricultural sector has strong potential for growth in Kosovo with fertile land and a temperate climate suitable for agricultural production, along with the availability of land for extensive cultivation.⁶⁴ The constraints that have been found to be important in explaining overall economic growth in Kosovo – access to domestic finance and provision of public goods - are particularly relevant for the agricultural sector.. Limited access to finance for the smallholder agricultural sector and the poor provision of rural infrastructure have been obstacles to the growth of a dynamic agricultural sector, and in particular, may have hindered the development of a commercialised agrifood sector.

A second sector that is important from the employment creation potential is the small and medium size enterprise sector in manufacturing and trade. Figure 2 shows the employment intensities of production for small, medium and large enterprises for

⁶⁴ World Bank, 2004.

different manufacturing sectors and for construction and trade.⁶⁵ It is clear that in most sectors, small enterprises use more labour per unit of output than medium enterprises. Employment intensity of production is more pronounced in manufacturing industries such as food and metal and machinery. Thus, a growth strategy that is biased towards small sized enterprises, especially in manufacturing, is likely to have a strong positive effect on the employment elasticity of output. Furthermore, given that small enterprises are more likely to employ unskilled workers as compared to larger firms, a small enterprise driven growth strategy will also have a positive impact on the problem of the large number of unskilled workers in Kosovo.

Figure 2: Employment Intensity of Production by Firm Size and Sector, Kosovo



Source: Calculated from the Productivity and Investment Climate Surveys, The World Bank (2003)

Making it easier for entrepreneurs to access funds for business start-ups will have a strong positive effect both on economic growth and the rate of job creation.⁶⁶

In conjunction with policy actions that ease the finance constraints on the growth of the smallholder agricultural sector and the small enterprise sector in manufacturing, a public works programme related to construction and maintenance of secondary and local road networks will have an immediate benefit in creating jobs to unskilled workers.⁶⁷ This would have the double benefit of providing employment possibilities in the short run and easing the transport constraint to economic growth.

⁶⁵ We use the definition of the Ministry of Trade and Industry for small and medium enterprises – a firm is classified as small if it has less than 20 employees, and medium if it has 20 to 99 employees.

⁶⁶ The SME Policy Index notes that constraints faced by small enterprises in Kosovo in accessing cheaper and faster start-up funds is among the highest in the Western Balkans (OECD 2007).

⁶⁷ The construction and maintenance of secondary and local roads, especially in rural areas, is expected to be unskilled labour intensive, as compared to most other types of public works programmes.

5. Summary and Conclusions

Economic growth is once again the central focus for development policy. In part as a reaction to the disappointing results of the reform agenda of the 1990s, national governments and the international development agencies alike are seeking to identify the specific policy interventions that are needed to move to an economy to a higher and sustained growth trajectory. At the same time, rapid expansion in labour supply has highlighted the need for employment -intensive growth. This paper has presented an application of the diagnostics approach to development policy, which seeks to identify the key constraints to economic growth and job creation.in a particular economy by taking into account the institutional context and realities of the economy in question.

Application of the growth and employment diagnostic methodology to the economy of Kosovo identified the binding constraints to more rapid economic growth and job creation and pointed to the key areas where targeted policy interventions could be expected to move the economy onto a higher growth and job creation path.

Our analysis has focused on the immediate constraints to faster economic growth in Kosovo. But, as the current constraints are relaxed, new binding constraints will emerge, and to maintain an improved growth performance over time will require a continuous process of diagnostic analysis. As the initiators of the growth diagnostics approach have rightly observed, 'What is required to sustain growth should not be confused with what is required to initiate it' (Hausmann et al., 2004).

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