CHAPTER 2:

EXTERNAL TRADE AND CUSTOMS

A. INTRODUCTION

As a province of Serbia and, therefore, a part of the Federal Republic of Yugoslavia (FRY), Kosovo was subject to the FRY trade regime and customs administration until the end of the hostilities in mid-1999. Customs administration ceased to exist with the withdrawal of FRY military and civilian forces. Between June 10, 1999, when UN Security Council Resolution 1244 established UNMIK, and September 3, 1999, there were no customs checking points at borders of Kosovo. KFOR carried out random checks on incoming trucks and automobiles for arms and hazardous materials. Goods flowing into Kosovo were not subject to tariff or non-tariff barriers (NTBs). By setting customs border controls in Kosovo on September 3, 1999, UNMIK introduced *de facto* an external trade regime and customs administration.

While this was not a free trade regime, it represented a radical transformation from the highly distorted FRY trade regime. By the same token, UNMIK has established a *de facto*, if not *de jure*, customs territory, albeit in a rudimentary form. The initial reach of the customs territory was limited to external boundaries of Kosovo – i.e., borders with Albania and FYR Macedonia. Concerns that the establishment of customs controls at boundary lines with the rest of FRY might be construed as bestowing upon Kosovo the status of a sovereignty thus overstepping the delicate bounds set in UN Resolution 1244 appear to have prevented UNMIK from formally declaring Kosovo a separate tax and customs territory from the rest of FRY.

The introduction of a simple, neutral trade regime was considered to be important in stimulating private sector led economic growth and reconstruction, and in creating the conditions for healthy exports. However, in the absence of adequate administrative machinery to collect taxes on consumption and incomes, UNMIK saw the introduction of the customs/external trade regime as the major source of revenue for the local recurrent budget of Kosovo. The design of the regime successfully avoided typical pitfalls associated with the use of the tariff structure primarily to maximize revenue usually occurring against the backdrop of distortions in production and consumption patterns. The introduced tariff structure is relatively uniform with two rates (0 and 10 percent *ad valorem*), thereby assuring a high degree of neutrality. In consequence, the regime is transparent, relatively easy to administer and has rather neutral impact on allocation of resources in the economy. In addition to the standard task of collecting duties and excise taxes, the Customs Administration (UNMIK-CS) has also been charged with collecting sales taxes. These are not levied on domestic sales as yet.

B. STRUCTURAL FEATURES OF THE TRADE REGIME

As noted, in early September 1999, UNMIK concluded that the trade regime of the FRY was too distorted to offer a basis for efficient growth in Kosovo. Therefore, it promulgated a new regime that represents the best international practice in foreign trade policy design (albeit with some important caveats) in three respects. *First,* a uniform tariff structure of 10 percent was introduced. This tariff structure is commendable in its simplicity and the low rate involved. The principle of the uniform tariff rates was, however, compromised by the simultaneous introduction of duty exemptions on some agricultural and medical products. Also compromised were the major advantages of the uniform tariff rate such as neutrality in protection afforded to various stages of production and the reduction in opportunities for rent seeking.[1]

Table 1: Goods Exempt from Customs Duties and Sales Tax

Pharmaceuticals
Medical and surgical instruments and apparatus
Milk
Cooking oil and fats
Vegetables
Fruits
Stamps and valuable papers
Goods imported by UNMIK, UNHCR, Red Cross and Red Crescent Societies, NGOs registered with the UN
Goods imported by foreign diplomatic missions for their official use

Source: Annexes I and II to UNMIK Administrative Direction No. 1999/01, 30 August 1999.

Consider the case of agriculture – an important sector of the Kosovo economy. In view of widespread effective subsidization of agricultural exports by partner countries, the 10 percent tariff and sales taxes that apply to certain agricultural products have the effect of assisting local Kosovar producers by giving them a 27 percent level of nominal protection. But for those agricultural goods that are exempt from tariffs (and sales taxes) – listed in Table 1 – matters are very different: local producers suffer a handicap. This negative incentive to local production is not likely to be a desirable outcome for an economy where agriculture accounts for around one-fifth of the total output with even a larger share of population employed in this sector.

1 There are strong arguments for tariff uniformity. First, because of its administrative transparency and simplicity, it reduces the scope for arbitrary actions by Customs officials. Second, the political economy of trade policy formation suggests that a credible commitment to a uniform tariff keeps potential lobbyists at bay. To be effective, the commitment has to be credible. Third, a uniform tariff rate is neutral and minimizes the net welfare cost. Uniform tariff structure equates the marginal distortion cost of protection in production across all sectors. For an extensive discussion, see V. Thomas, J. Nash and Associates, 1991. *Best Practices in Trade Policy Reform,* A World Bank Publication, Oxford University Press, Oxford, pp. 163-169.

Second, the foreign trade regime is devoid of non-tariff measures (NTMs) and quantitative restrictions (QRs). Commitment to keeping the trade regime free of NTMs and QRs is somewhat eroded by the caveat that these only remain "…suspended until further notice". (Section 2 of REG 1999/3). While so far NTMs and QRs have not been reintroduced, this unnecessarily opens the possibility for lobbying to implement these measures in the future.

Third, a further advantage of the system is that its registration procedures of traders (exporters, importers and forwarding agents) and licensing are non-discriminatory and transparent. There is no state trading and foreign trade activity is open to all firms. There are no non-automatic licenses and the existing regime offers limited, if any at all, opportunity for bureaucratic micromanagement of foreign trade.

C. POLICY ASPECTS OF THE TRADE REGIME: COVERAGE AND TAXATION

Although the Kosovo foreign trade regime has the right institutional design and low and almost uniform tariff rates, some of the policy measures raise concerns. *First*, the foreign trade regime is yet to be extended to cover all boundaries of Kosovo. There are no TCPs (Tax Collection Points) at the boundary with the rest of Serbia. This has two implications: it narrows the tax base leading to a significant loss of tariff revenue; and deprives the UNMIK Customs Administration of control over products entering its customs territory. According to a conservative estimate of the UNMIK-CS (Customs Service), the lost tax revenue amounts to around DM 50,000—100,000 per day.

Second, an important weakness of the trade regime stems from the recognition of the preferential trade agreement between FRY and FYR Macedonia. Granting of preferential status to FYR Macedonia has distorted trade flows and led to revenue losses for two reasons: FYR Macedonia has been traditionally an important trading partner of Kosovo; and a considerable portion of total imports into Kosovo transit through FYR Macedonia. The latter has provided opportunity to falsify certificates of origin. It also raised technical problems, as the implementation of preferential trade agreements regime requires enforcing rules of origin, which is complicated in itself and prone to fraud and corruption. The preferential trade agreement with FYR Macedonia imposes on the UNMIK-CS the responsibility to control imports on a discriminatory basis through the use of the rules of origin to determine the nationality of a product. The procedures to identify the origins of products are rather complex and subject to the WTO Agreement on the Rules of Origin. Their implementation requires considerable skills among customs officers and prolongs customs clearance at border.

UNMIK has undertaken to abolish the customs tariff at the same time as the introduction of a value added tax (expected to be in mid-2001) with the VAT to be set at a rate to ensure revenue neutrality. This decision is a major step towards removing the significant distortion that arises from the FYR Macedonia preferential trade arrangement and the treatment of commerce from the rest of Serbia as well as from Montenegro. Such a step would broaden the tax base and lead to a reduction in the disparity of taxes levied. A unified VAT rate of, say, 20 per cent, would result in a reduction of around 6 percentage points in the customs cum sales tax on imports (other than from FYR Macedonia) and a rise of 5 percentage points in the sales tax on imports from Macedonia and commerce flowing in from the rest of Serbia and Montenegro. Excise taxes would continue to be levied on all excisable goods regardless of origin.

Third, at present, sales and excise taxes on goods are applied to imported goods only. Since these taxes are levied only on imports, they constitute trade measures; they discriminate against imports. It is entirely understandable that under current conditions of weak local capacity and lack of an internal tax administration, there was no tax base other than imported goods. The intention of UNMIK to widen the tax base to domestic products when VAT is introduced is welcome.[2] The imposition of such taxes on domestic goods will level the playing field vis-à-vis imports and diminish incentives for evasion.

Fourth, while the 10 percent 'almost uniform' tariff rate is very low by the standards of developing countries, the aggregate burden of border taxes is in fact quite considerable. The sales tax of 15 percent is applied on the post-tariff value of imports. Thus, the actual 'tax burden' for non-food, non-medicine products (i.e., those not listed in Table 1) amounts to 26.5 percent *ad valorem* (see the last row of Table 2). For products subject also to excise taxes with rates varying between 5 and 50 percent, total payment rises even further since excise is calculated on the basis of the value of imports post tariff tax. Thus, products subject to excise taxes bear the 'tax burden' amounting to between 33 percent (wines) and 90 percent (diesel, gasoline, strong alcoholic beverages) of the value of these products prior to customs.

Such tax burdens are not unusual; they prevail in many countries, developed or developing. However, several problems emerge. The preferential trade agreement between FRY and FYR Macedonia has created a potential source of evasion and consequent loss of revenues. Imports originating in FYR Macedonia are not subject to custom duties, as noted above, but only to a 1 percent *ad valorem* customs fee. Thus, the fee lowers total tax on non-excise goods from 26.5 percent *ad valorem* to 16.2 percent that amounts to the loss in revenue 10.3 percent of the value of imports from FYR Macedonia (duty and sales tax combined – see the last row of column 4 in Table 2). On products subject to excise tax, the losses are higher ranging between 16 and 11 percent of the value of imports of these products (Column 4 in Table 2).

Fifth, a clear case can be made for a wider use of specific taxes, provided that this is done in a simple and transparent manner, in place of *ad valorem* taxes - with the exception of coffee, all excise taxes are in *ad valorem* terms (Table 2). Since Kosovo uses the deutsche mark (or more broadly Euro) as the main transaction currency, the 'inflation'

[2] There is a proposal to extend the base of sales tax first to larger domestic firms and subsequently to all firms with Customs Administration in charge of collection. While an effort by UNMIK to widen the tax base is commendable, this proposal suffers from two major weaknesses: sales tax should not be collected in the production source; and customs administration should focus on movements of goods and services across borders or boundaries.

argument against specific taxes does not apply.[3] But there are other arguments as well. In the absence of sophisticated control techniques, the advantages of specific taxes are considerable: they are simpler and thus easier to implement and more difficult to evade; and they remove the incentive to under-invoicing, which is particularly strong in case of high excise rates.[4] While it would be tempting to recommend a wider use of excise tax, the decision should take into account broader context of taxation reform in

Table 2: Aggregate Border Tax *Ad Valorem* Burdens on Products from Non-Preferential Partners, FYR Macedonia, and the Rest of FRY (in percent)

Product Groups	Rate	Non-preferential partners		FYROM			Montenegro and Serbia		
		Excise tax and tariff rate (10%)	sales tax (15%) on column 1	excise tax and customs duty (1%)	sales tax (15%) on column 4	*difference between columns 2 and 4*	excise tax and customs duty (0%)	sales tax (15%) on column 6	*difference between columns 2 and 7*
		1	2	3	4	5	6	7	8
Gasoline	Ad valorem 50%	65.0	89.8	51.5	74.2	***15.5***	50.0	72.5	***17.3***
Diesel	Ad valorem 50%	65.0	89.8	51.5	74.2	***15.5***	50.0	72.5	***17.3***
Strong drinks	Ad valorem 50%	65.0	89.8	51.5	74.2	***15.5***	50.0	72.5	***17.3***
Cigarettes	Ad valorem 25%	37.5	58.1	26.3	45.2	***12.9***	25.0	43.8	***14.4***
Beer	Ad valorem 15%	26.5	45.5	16.2	33.6	***11.9***	15.0	32.3	***13.2***
Alcohol/ethanol	Ad valorem 15%	26.5	45.5	16.2	33.6	***11.9***	15.0	32.3	***13.2***
Mobile phones	Ad valorem 15%	26.5	45.5	16.2	33.6	***11.9***	15.0	32.3	***13.2***
Satellite dishes	Ad valorem 15%	26.5	45.5	16.2	33.6	***11.9***	15.0	32.3	***13.2***
TV sets	Ad valorem 15%	26.5	45.5	16.2	33.6	***11.9***	15.0	32.3	***13.2***
VCR	Ad valorem 15%	26.5	45.5	16.2	33.6	***11.9***	15.0	32.3	***13.2***
Cigars and cigarillos	Ad valorem 10%	21.0	39.2	11.1	27.8	***11.4***	10.0	26.5	***12.7***
Other manufactured tobacco	Ad valorem 10%	21.0	39.2	11.1	27.8	***11.4***	10.0	26.5	***12.7***
Soft drinks	Ad valorem 10%	21.0	39.2	11.1	27.8	***11.4***	10.0	26.5	***12.7***
Wines	Ad valorem 5%	15.5	32.8	6.1	22.0	***10.9***	5.0	20.8	***12.1***
Coffee	Specific DM 3 kg.	N/A	N/A	N/A	N/A	***N/A***	N/A	N/A	***N/A***
Non-excise products	0	0.0	26.5	0.0	16.2	***10.4***	0.0	15.0	***11.5***

Source: See Table 2.

[3] This was the right choice because the inflation-prone Yugoslav dinar was expected to be the only legal tender in Kosovo. With the acceptance of D-Mark (Euro) as an officially recognized currency, concerns about inflation undercutting collected taxes lost their relevance.

[4] For instance, a DM 100 underinvoicing of petroleum yields the ‘saving’ of DM 90 in terms of unpaid taxes. This is undoubtedly a strong incentive to underinvoice imports.

Sixth, imports by Non Governmental Organizations with Public Benefit Status—registered with UNMIK—are exempt from duties. Considering a very large number of NGOs providing assistance in Kosovo, the potential for abuse and the use of fraudulent exemption forms is quite significant. According to the UNMIK-CS, an apparent increase in the number of NGO-destined shipments crossing Kosovo's boundaries in comparison to the situation in 1999 seems to indicate that some of them may be diverted for commercial purposes.[5] One may thus consider levying appropriate charges at the border subject to refund upon presentation of detailed information.

D. Implications of the Trade Regime for Nascent Exports

The trade regime is clearly supportive of exports: it is liberal; transparent and open; and it relies upon the use of a convertible currency, the deutsche mark. If an institutional environment favorable to private business environment complements the current regime, then clearly conditions for sustainable economic growth ought to be created.

In two aspects, though, the trade regime presents a significant impediment to Kosovo's nascent exports. The first is legal or institutional in nature – the formal recognition by trading partners of Kosovo's trade regime and, in particular, trading arrangements in the context of the Stability Pact; the second, certain disincentives to exports arising from the trade and tax regimes.

The *de facto* establishment of a customs territory by UNMIK was neither accompanied nor followed by its *de jure* recognition. Its legal status as a foreign trade entity continues to remain vague and issues arising from this ambivalence tend to be addressed on *ad hoc* rather than systemic basic. As a consequence, Kosovo does not show up in Customs Codes of any country including that of its preferential trading partner—FYR Macedonia. Except for the EU (see below), Kosovo's trade and customs regime is treated as a part of the FRY trade and customs regime, and its exports are subject to the same conditions of access as those faced by exporters from the rest of Serbia or Montenegro.

With the entry into force of the Council Regulation No. 2007/2000 (18 September 2000), the EU has formally recognized Kosovo as an autonomous customs territory "in accordance with UNSC Resolution 1244 (10th and 11th preambular)" and linked to the EU's Stabilisation and Association Process.[6] The Regulation extended trade preferences to Kosovo, which previously were limited to Croatia and Bosnia-Herzegovina.[7] It has

---

5 According to the estimate of the UNMIK-CS, the average number of trucks crossing the Kosovo boundaries increased from 120 trucks in September—October 1999 to around 230 in September—October 2000.

6 Note that the official title is "Council Regulation (EC) of 18 September 2000 introducing exceptional trade measure for countries and territories participating in or linked to the European Union's Stabilisation and Association process …"

7 Prior to the Regulation 2007/2000, the so-called autonomous trade preferences granted by the EU to Yugoslavia in the 1980 Cooperation Agreement applied only to Bosnia and Herzegovina and Croatia (see *Trade Relations between the European Community and South Eastern Europe*, Discussion Paper,

also considerably widened trade preferences already applied by removing the remaining tariff ceilings for industrial products and by improving conditions in access to EU markets for agricultural products.[8] Goods subject to preferential treatment include also such sensitive products as steel and textiles. In consequence, the percentage of duty-free tariff lines will increase to 95 percent (from 80 percent under autonomous preferences). Once the Kosovo customs has effective procedural and organizational procedures harmonized with the EU for issuance certificates of origin, they would then be accepted by EU Customs.

Clearly, Kosovo will have to look not only to EU countries but also to its neighbors as potential clients for its exports. For it to be able to export successfully, a number of questions regarding its trade status will have to be clarified: these questions arise from the fact that, though a province of Serbia and a part of FRY, it enjoys a distinct trade and customs regime. For example, how will Kosovo's commerce (particularly the sale of goods and services) to Montenegro and the rest of Serbia be treated, when Kosovo would be importing goods and service under a different regime to that of Montenegro and the rest of Serbia? Moreover, will exports of Kosovo to its trading partners be subject to MFN treatment accorded automatically among WTO members? Or will such exports be subject to often higher tariff rates levied on non-WTO members with no special trade agreements with a given partner? How will Kosovo link into trade networks designed under the aegis of the Stability Pact?

These issues have constitutional and political dimensions that UNMIK will have to address. From a purely economic standpoint and one that seeks to maximize the growth prospects of Kosovo, it would appear important that UNMIK, in cooperation and support of the EC, should obtain duty-free access for Kosovo products to Albania, Bulgaria, Bosnia and Herzegovina, Croatia and Slovenia. One possibility would be to accomplish this goal through integration into the existing network of bilateral free trade agreements among Balkan countries. If regional cooperation could be extended to the setting up of a free trade area at least among countries that are part of the EU process of stabilization and association for Western Balkan countries and customs territories, then Kosovo would clearly benefit.

The trade status of Kosovo should encompass the issuance of certificates of origin in conformity with the definition of the concept of "originating products" provided for EEC Regulation No 2454/93 by UNMIK. The acceptance of these certificates should not be negotiated on a country-by-country basis, but rather solved 'wholesale' through such an institutional device as, for instance, OECD, the EU and other signatories of Pan-European Cumulation Agreement (28 European countries including EFTA, EU and its associate candidate countries). Whatever the mechanism selected - in addition to

---

Stability Pact: Meeting of the Economic Working Table, Brussels, 9 October 1999), but neither to FRY nor the UNMIK customs territory.

8 Albania obtained the same preferences. It was reported that identical preferences the EU will grant to FYR Macedonia (Agence Europe, Brussels, 20 September 2000).

countries covered by the above arrangements - it must also include Albania, Bosnia and Herzegovina, Croatia and FYR Macedonia.

The fiscal disincentive to exports arises from the fact that the trade regime does not provide for a scheme for rebate of tariffs and taxes on imported inputs used for exports, thereby unwittingly penalizing exports, in particular, inward processing activities. Typically, such activities are an important source of employment and growth in transition economies, especially in the initial phases.[9] Moreover, by not introducing schemes that support exports specifically – duty drawbacks, rebates, in-bond manufacturing or temporary admission – the trade regime makes it less attractive, perhaps quite unattractive, for foreign firms to establish processing activities in Kosovo.

E. IMPLEMENTATION

Given weak local capacity, AD 1999/01 envisaged gradualism in establishing customs border points (CBPs) by the UNMIK-CA. The customs controls were established first at one crossing point with FYR Macedonia, then Albania. Several other border-crossing points remain to be covered. EU Customs Assistance Mission in Kosovo (CAM-K) has played crucial role in this process but its resources remain limited and declining. With the current staff of seven customs officers and the prospect of opening two TCPs at the boundary with Serbia, CAM-K can hardly provide badly needed technical assistance and supervision of CAM-CS. Without CAM-K customs border controls would not have been established, and without their continued and expanded support the quality of customs control will dramatically deteriorate.

The CAM-CS was (and remains) understaffed. It came into being with hiring of 14 customs officers – previously with FRY Customs Administration – on August 3, 1999. By the end of August it employed 42 ex-FRY customs officers. With subsequent recruitment, its staff has risen to over 100 officers. Considering, however, that UNMIK-CS should cover not only external borders of FRY but also boundary lines with Montenegro and the rest of Serbia, the current level seems to be well below levels needed to cover all crossing points as well to open one or two inland customs processing stations. Estimate suggests that at least 90 more customs officers would be needed to perform these functions.

Despite an impressive record of implementing customs control, the CAM-CS does not have adequate administrative capacity to process shipments efficiently in all CBPs and a TCP. Technical problems at the border augmented by the absence of in-land customs clearance facilities and warehouses have often created disorderly conditions at CBPs and further delayed their opening. For instance, although Section 5 of the Administrative Direction No. 1999/1 set the date for the opening of Globocice/Globocica BCP for September 13, 1999, this CBP remained closed almost six months later and long delays have occurred frequently at various CBPs (especially in Hani i Elezit/Gjeneral Jankovic.

[9] For instance, inward processing of textiles accounted for 20 percent of Bulgaria’s exports to the EU in 1997 and 23 percent in 1998. The cost of labor in Kosovo is much lower than in neighboring Bulgaria.

Box 1: Tax Collection Point (TCP) in Pec at the Boundary Line with Montenegro

Faced with diversion of trade routes to entry points not covered by customs border controls, UNMIK opened a TCP in Pec at the boundary in Montenegro on February 14, 2000. The TCP was physically set in Kula - high in the mountains on a narrow twisty road leading to Montenegro not far from the Italian KFOR checkpoint.

But the opening got to a rocky start, as truck drivers - apparently taken by surprise - blocked the passage and refused to surrender to customs procedures. Citing security reasons the KFOR requested moving the TCP to another location. The TCP was moved to Pec. The Pec TCP has the staff of 24 customs officers and a TCP Head–4 of them worked for the FRY Customs Administration including Head of the TCP.

Since its present location would allow truck drivers to easily by-pass the TCP, it has been split into two parts separately located and performing different functions. Customs officers located in the first site perform initial assessment of papers, conduct initial examination of freight to determine any possible discrepancies between freight and documents. All relevant data about the shipment, its driver, trucks, and importers are duly recorded in a registration book. If a document is missing or a shipment is not for an NGO registered with UNMIK, or there is discrepancy between the import declaration and freight content, drivers' documents (passport, drivers license, etc.) are deposited with UNMIK customs officers and sent through a courier to Site 2. Both sites are open 24 hours and three customs officers are assigned to it.

Customs officers in Site 2 are responsible for conducting all relevant customs procedures. Customs officers there first check the papers. If they accept the import declaration, then they calculate the customs revenue due and physically examine each cargo. If everything is OK, they release the cargo after the receipt of a payment in cash. The whole procedure then takes around 10 minutes.

While customs officers, dressed in clean UNMIK uniforms, seem to be competent and professional, the existing physical arrangements have several weaknesses:

- The two-site layout and the location of the first site are not right. Dirt roads before the Site 1 offer opportunity to enter the UNMIK territory without customs clearance towards Mitrovice, Calican village or Istogu. Once traders master them fully, customs revenues will decline. It seems that all customs procedures should be performed in one site and the site should be located before the intersection. In the meantime, KFOR would seem to be in good position to limit access to these roads.
- Working conditions are very difficult and dangerous especially to customs officers in Site 1. The “office” in Site 1 is a van with a small table inside. A marked police SUV with two policemen parked on the other side of the road provides security. This may not be inadequate if two or more traders collude to avoid customs. The office in Site 2 is in sort of a mobile home. It is not equipped with amenities and space is limited – if there are more than 2 patrons, one of them has to be outside.

Two sites should be combined and moved to a location closer to the Montenegrin boundary. According to an estimate of the UNMIK-CS, loss in customs revenue due to trucks bypassing the ill-located TCP amount to DM 150,000. Security arrangements and work conditions should be addressed as soon as possible.

Pec/TCP at the boundary with Montenegro – whose opening marks an important step to tighten customs controls – brings to fore organizational and technical problems faced by UNMIK-CS. As noted in Box 1, its facilities are provisional at best; the location was changed twice and still has not tightened border controls; its physical layout gives customs officers a considerable discretion in sending a shipment for a final customs clearance; and working conditions are extremely difficult.

Addressing these key issues in implementation will require a continued and increased presence of CAM-K. Consider the following: UNMIK considers the introduction of temporary importation, duty-drawback mechanism or warehousing. This will increase pressure on UNMIK-CS, already rather strained administrative capacity. UNMIK plans to complete soon the process of establishing a separate tax and customs territory. This will involve opening and establishing additional TCPs and BCPs covering all major entries into Kosovo. More personnel will have to be hired and trained. UNMIK-CS does not have this capacity. Furthermore, with drastically reduced possibilities to tax-free entry into Kosovo, there will be growing pressures to corrupt UNMIK-CS customs officers. Only CAM-K can provide external monitoring until UNMIK-CS develops intelligence, surveillance and anti-smuggling capacities.

F. RECOMMENDATIONS

Sustainable economic growth is one of the main challenges in Kosovo. The preceding discussion suggests that without triggering exports, this challenge will be difficult, if not impossible, to achieve. Given the small size of businesses operating in Kosovo and the absence of marketing know how as well as established commercial contacts with remote international markets, access to regional, neighboring markets is crucial. But without the recognition of locally issued certificates of origin, Kosovar firms will not be able to sell their products. Without obtaining at least the same conditions in market access as those accorded to preferential partners of Balkan countries—and all of them have signed preferential with several trading partners including the EU—they stand little chance to compete successfully. Similarly, the capacity of Kosovar firms to market products depends on the cost of imports.

Hence, four major issue-areas should be given special consideration: access to regional markets; the status of Kosovo in terms of international economic relations; external trade policies; and tax policy. The broad recommendations are: (i) implementation of UNMIK’s decision to abolish duties on all imports when VAT is introduced; (ii) that the issue of Kosovo’s trade status be given urgent attention; (iii) that the trade and customs regime should be modified as to make it more friendly to exports and consequently imports; and (iv) that incentives for evasion of tariffs and duties should be minimized through measures aimed at broadening the tax base.

Promoting regional cooperation

The Council Regulation No. 2007/2000 (18 September 2000) offers Western Balkan countries and territories an unique opportunity to benefit from expansion in trade with the EU. The challenge is to exploit this opportunity. Their ability to take advantage of improved access to EU markets hinges critically upon establishing environment conducive to the development of regional trade unhindered by tariffs or prohibitive customs procedures. This involves not only vigorous implementation of liberal structural reforms but also the removal of barriers to regional trade.

In this context, UNMIK’s decision to abolish duties on all imports, as noted above, and to work closely with the EC on liberalizing regional trade is welcome. The emergence of a free trade area encompassing Balkan countries and territories and the EU would remove one of the obstacles (too small markets) to high quality Foreign Direct Investment.

Kosovo's Trade Status

Kosovo's external trade-related status remains nebulous; this adversely affects access to foreign markets by firms operating in Kosovo. The decision of the EU to grant autonomous status to the Kosovo as well as to offer preferential treatment to exports originating there is encouraging.

It is suggested that the following policy proposals be given consideration and discussions take place with the EC and other interested international partners:

- OECD countries (excluding the EU and its Central European associates that are OECD members—Czech Republic, Hungary and Poland) should accord Kosovo similar recognition to that given by the EU and should grant at least GSP status to Kosovar exports.

- With the inclusion of Kosovo into the trade provisions of the EU Stabilization and Association process, UNMIK, in cooperation and support of the EC, should secure duty-free access for products originating in its territory to markets in the Western Balkan countries (Albania, Bosnia and Herzegovina, and Croatia), those in other countries of the former Yugoslavia, i.e., FYR Macedonia and Slovenia as well as in Bulgaria and Romania.

- As a first step designed to foster effective regional cooperation recommended by the Council Regulation on Exceptional Trade Measures, UNMIK's decision to abolish tariffs on imports when VAT is introduced (expected to be in mid-2001) is notable. Using the support of the EC, Kosovo should seek clarification of its trade status and obtain duty-free access for products originating in Kosovo.

Moving Towards an Export-Friendly Trade Regime

The current trade regime in Kosovo likely discourages both exports (especially as these involve imported inputs) and inward processing activity in Kosovo and consequently FDI inflows. The inward processing has been an important source of employment and hard currency earnings in all transition economies especially during the initial phases of moving to market-economy. With the planned introduction by the EC of separate textile quotas for Kosovo, UNMIK should contemplate establishing arrangements friendly towards inward processing as soon as possible.

- Consideration should be given to introducing a scheme (temporary admission, duty drawback, rebates, etc.) that would provide incentive to foreign firm to establish production activity, to outward processing in Kosovo and to domestic firms to become involved in exports.

Notes: (1) Without a clarified trade status for Kosovo, the benefits of a scheme will be marginal at best; (2) Operationalization of a scheme would require substantial assistance by CAM-K. Therefore, assistance capacities of the CAM-K should be considerably expanded in order to assure a smooth introduction of an import regime allowing for the development of inward processing activity.

Although committed to the principle of uniform tariff rate, the UNMIK foreign trade regulations exempt several product categories including important agricultural products, which results in discriminating against the agricultural sector and may undermine its recovery.

- In order to assure neutrality in incentives, one should confine exemptions to tariffs to such products as pharmaceutical and medical instruments and goods imported by UNMIK, diplomatic missions, international organizations and NGOs registered with UNMIK. Thus, it seems that milk, cooking oils and fats, and fruit should be removed from the list of products exempt from custom duties and sales tax.

In order to lessen the burden on UNMIK-CS and remove the source of distortion in supplying routes to Kosovo, no preferential trade agreements should be a component of the UNMIK foreign trade regime.

Note: The planned elimination of tariffs in mid-2001 upon the introduction of a VAT scheme would of course make the FTA with FYR Macedonia immaterial.

Reducing Incentives to Smuggling and Underinvoicing

Broadening of the tax base would significantly moderate the existing incentives to smuggling and underinvoicing. The most effective way of broadening the tax base and removing distortions is to suspend the customs tariff and make countervailing adjustments in the sales tax (as discussed earlier); this will occur once VAT is introduced. Tax base can be significantly broadened also by additional ancillary measures: (i) setting TCPs in all crossing points (including those with the rest of Serbia) to Kosovo (ii) tightening boundary controls in existing TCPs (e.g., closing the possibility of by-passing controls in TCP/Pec by importers); (iii) tightening controls over imports by NGOs by, for instance, introducing the refund scheme; (iv) reducing the level and dispersion in excise tax rates; and (v) moving from *ad valorem* excise taxes to specific taxes for at least some products.

Successful broadening of the tax base would significantly increase tax revenue and would offset the fall in revenue due to the abolition of tariffs and possible cuts in excise tax rates on some products.

The dispersion in excise rates on similar products creates opportunities for corruption and therefore should be reduced.

- The excise rate should be uniform for at least the following sets of products: cigarettes, cigars, and cigarillos; beer and wines; gasoline, diesel and heating oil (the excise should be imposed on the latter at the same rate as on gasoline and diesel) .