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**Republika Kosova-Republic of Kosovo**

*Qeveria-Vlada-Government*

*Ministria e Tregtisë dhe Industrisë*

*Ministarstvo Trgovine i Industrije-Ministry of Trade and Industry*

## **TRADE POLICY OF KOSOVO**

August, 2009

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## **INTRODUCTION<sup>1</sup>**

Negative trade balance is only one of the economic problems Kosovo is facing. The Kosovo institutions are aware that the change of this reality requires comprehensive economic and political approaches and reforms in order to change the operational environment in Kosovo, for the purpose of improving the competitive position of Kosovo in the world market. As a result, they aspire to change and supplement the existing economic policies and improve the institutional functionality. This would, to a great extent, advance the operational environment in Kosovo. Such a commitment has been clearly stated in the Mid-term Expenditure Framework (MTEF), a basic governmental document guiding the economy of Kosovo during 2009-2011.

To a large extent, such an environment will help determine the level of investment, production, and exports; and, the higher the growth in these dimensions the higher the economic growth and the welfare of Kosovo's citizens. As regards the level of investments, this environment determines the inflow of foreign investments, which are the key potential mechanism for revitalization of the Kosovo's economy and, as a consequence, strengthening of export sector.

Kosovo is committed to trade liberalization. Participation in regional and wider trade facilitating mechanisms has been one of the main policy objectives of Kosovo institutions. Enhancing trade in Kosovo through liberalized trade requires three aspects to be in place: import rationalization and replacement, trade facilitation, and export promotion. This is the UNCTAD (United Nations Conference on Trade and Development) integrated export strategy which gives equal importance to competitiveness in the domestic market and competitiveness in the foreign market. However, trade liberalization, in and of itself, is not sufficient to

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<sup>1</sup> This document has been prepared by the MTI with expert assistance from Dr. Petrit Gashi and Dr. Mumtaz Keklik. UNDP's support in the process is very much appreciated. The Document benefited from valuable comments provided by the participants of a roundtable discussion held in March 2009, where the first draft was presented. The interviewees of a current needs assessment for trade policy in Kosovo and the representatives of ECLO and GAP institute also contributed to the current draft with their comments.

enhance development. There are a number of reasons for this; firstly, trade policies should be formulated, implemented, and assessed in a manner, which prioritizes development rather than international trade outcomes themselves. Secondly, in order for the benefits from trade liberalization to be the highest and most sustainable, not only trade policies, but also trade-related development policies should be understood and well managed. Finally, trade is a cross-cutting concept affecting almost all areas of economic and social life. Therefore, there is an urgent need for improvement in the institutional quality, including the collaboration and coherence among all of the relevant actors that form the trade system in Kosovo. Accordingly, the areas requiring a significant reform include;

1. Trade liberalization (including here WTO accession) – sample schedule will be generated;
2. Trade related policies will further be identified and specifics of the policies and their implementation modalities will be identified;
3. Institutional change both within the MTI and across the trade system will be achieved in the context of an ongoing capacity development plan.

Our development partners (i.e. donors) will be identified and approached to achieve these three main objectives and conclusions in a given time period.

This document is a continuation of the 2004 year document and some previous governmental documents on the trade regime of Kosovo. Based on the fact that the situation in the trade balance remains unchanged, the institutions of Kosovo (in particular, Ministry of Trade and Industry (henceforth MTI) are committed to strengthen the given recommendations in the previous document as well as undertake additional steps that aim at promoting the export sector. The replenishments presented in the document take into consideration political changes as a result of independence of Kosovo, which has changed the context and the political position of Kosovo in the international arena, which is also reflected in the economic position of Kosovo in relation with other countries and international economic institutions. This document is in full compliance with MTEF and with other policies dealing with economic development, such as policies regarding business promotion, industrial and energy policies, etc. The design of

this policy has been treated in the context of EU integration process. Changes in this document also take into consideration the signals from the business community in Kosovo and other economic stakeholders.

This document was jointly drafted by the MTI and experts of the field. The major contributor from the MTI side was the Trade Department. The external expertise consisted of a local and international consultant supported jointly by the MTI and UNDP office in Kosovo. The document has been considerably enriched by the comments of economic international and local stakeholders. The paper is divided into three main parts: the first part is concentrated in current trends of Kosovo's foreign trade. This section discusses briefly the barriers, comparative advantages and potential markets for products of Kosovo. The second part analyses the present trade regime and the dimensions of the institutional environment which are important for promotion of export. The last part concentrates on the specific directions Kosovo should take in terms of trade policy, setting out a clear vision for increasing the potential of the export sector in Kosovo.

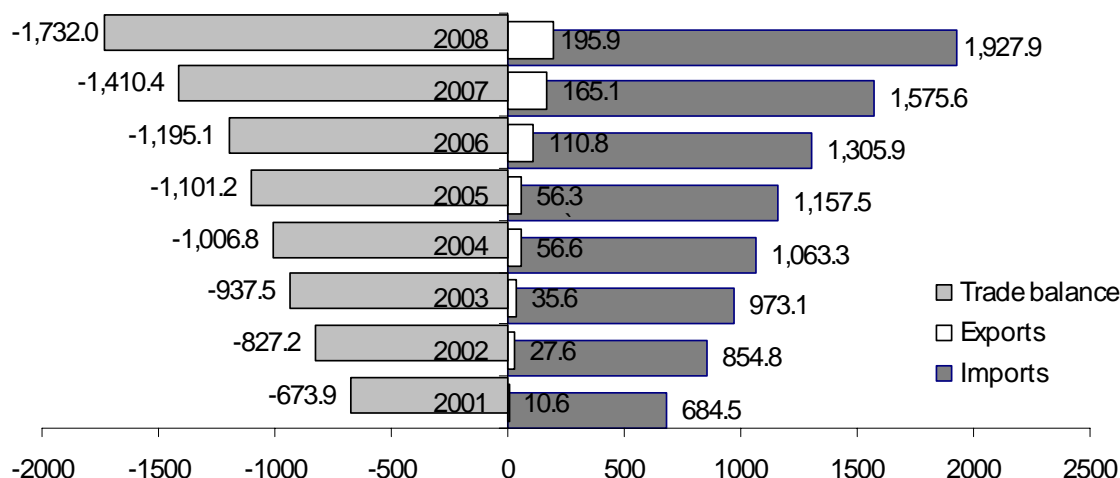
## **1. KOSOVO'S FOREIGN TRADE**

Kosovo is an open economy; the share of exports and imports to the GDP (or the market openness, i.e.  $\text{export} + \text{import}/\text{GDP}$ ) was almost 0.6 in the year 2008 (for previous years the situation does not change significantly). The foreign trade is

dominated by imports; the level of export is small resulting in high trade deficit. This part of the document will be focused on some particular aspects of the international trade in the post-war period. Initially, a discussion on the trade flows of Kosovo will be provided. Next, the discussion will focus on the barriers and other constraints facing export sector, as a result of which, generally, the Kosovo economy is not operating to its potential, and in particular the export sector. Finally, the section will elaborate on the comparative advantages (mainly static ones) as well as the potential foreign markets for Kosovar products.

### **1.1 Features international trade of Kosovo**

The Kosovar economy accounted a relatively low growth since 1999 (however, one should bear in mind the very high growth rate in the first year of the post-war period, albeit, from a very low base). Although during this period important macroeconomic steps were taken in reviving the Kosovar economy, still there are challenges remaining. One such indicator is the high negative trade balance, persisting since the end of 1999 (Figure 1). Kosovo is heavily dependent on imports (imports constitute around 50 per cent of GDP) and the trends indicate that in a short-run no major changes are to be expected. According to MTEF (2008, p.11) since 'Kosovo is a Euroised economy, it can improve its trade balance only through the real exchange rate depreciation, which can be achieved through lower relative prices with trading partners. This could come from wage reductions and improvements in domestic efficiency'.

**Figure 1: Trade balance of Kosovo (2001-2008; in mil. €)**

Source: Statistical Office of Kosovo, 2009

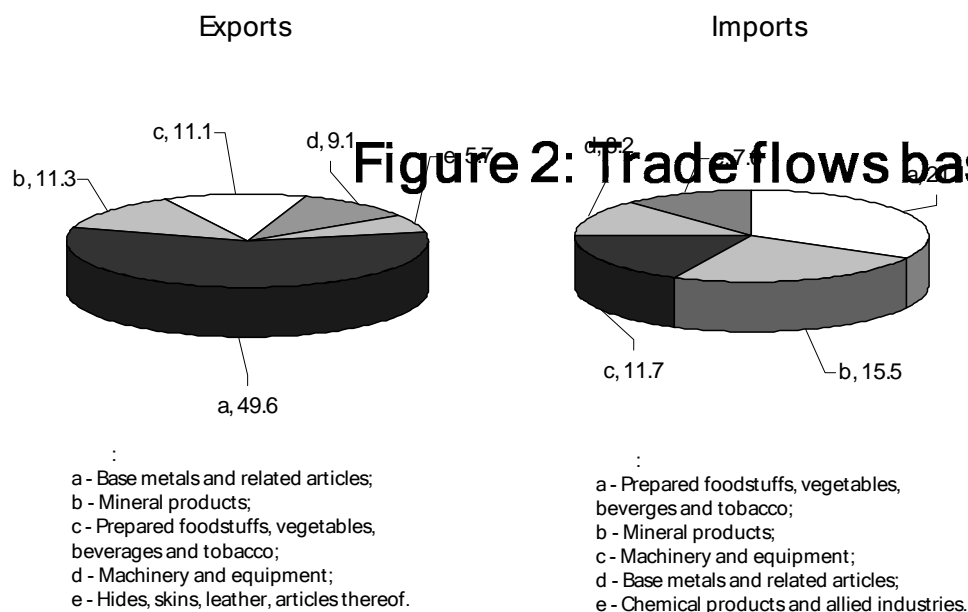
Exports in the post-war period have marked an impressive increase (over 60% in average for a year for the period 2001-2008), albeit, from virtually no exports.<sup>2</sup> On the other hand, for the same period, imports have marked significant increase of 15 percent on average per annum. In 2008, imports reached the figure of almost €2 billion, whereas the export just below €200 million. Even though the import coverage is still very low, it has increased steadily since 2001, reaching double figures in 2007 and 2008, 10.5 and 10.2 percent respectively (SOK, 2009). A more promising picture would occur if the so-called ‘virtual’ export is taken into consideration – which includes the consumption of International presence in Kosovo – according to which export covers 20 percent of imports (in the national accounts this part of export is considered as ‘export in services’).

Regarding the structure of exports, they are mainly in the form of the raw material and unfinished products (see Figure 2). Exports are dominated by scrap metal as well as mineral products which during the period 2002-2008 covered, on average,

<sup>2</sup> A precautionary note: Kosovo lacks good quality data; hence, the outcomes of the discussion should be taken with a certain degree of caution. Although data on the foreign sector are considered of good quality by different stakeholders, on the course of drafting this document the authors have faced inconsistencies in data produced by different agencies. There is a widespread consensus that data produced by the Statistical Office of Kosovo are more reliable, hence, we use their data.



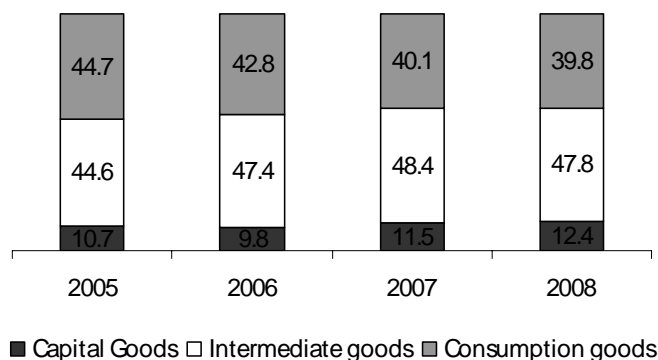
about 60 per cent of total export. From 2002 until 2008 Kosovo exported base metal and other related articles of over €300 million. These commodities are in the form of scrap metal, which is mainly sold in Macedonia, Greece, Italy, and other countries. Scrap is mostly in the form of iron and steel, copper, zinc, and other metals. Another component of this category is the exports of nickel and iron that has accounted an increase in exports by around 70 percent from 2007 to 2008. Mineral products comprise another significant component of the Kosovar exports. For the period 2002-2008, the latter category generated on average over 17 percent of total Kosovar products (ranging from over 5 percent in 2002 to over 35 percent in 2007). Another important export component is machinery and equipment, a commodity showing positive trends in the structure exports since 2002. Year 2007 marks the highest level of exports of this commodity, of over €20 million or 13 percent of the total. Food products and drinks cover an important percentage of export (in average around 12 per cent from 2002 until 2008). In this context, it should be noted that wine is exported to Germany and some the countries of the region. Apart from this, leather and related products as well as the plastic industry have a significant share in the structure of Kosovo's exports. Less significant commodities in terms of exporting are chemical and related products, decorative stone, cellulosic products, and live animals.



Source: Statistical Office of Kosovo, 2009

On the other hand, in the post-war years, consumer goods comprised the largest part of Kosovo's imports (Figure 2). Food products have had the dominant position in imports structure since 1999, covering on average 22 percent of the total (for the period 2002 – 2008). The share was even larger in the first years after the war, which is understandable having in mind the needs of the population after the war and the collapse of Kosovo economy. However, one should note the constant drop of the food imports in the structure of imports (from 26 percent in 2002, to 19 percent in 2008). Generally, since 2002 the structure of imports has been changing constantly. Mineral products have marked significant increase since 2002, from 14.5 percent to 21 percent in 2008. An increase is noted in the category of machinery, appliances, and electrical equipment, which make the third largest group of commodities imported in Kosovo. These changes have been noted in the latest Balance of Payment report prepared by the Central Bank of Kosovo (see Figure 3).

**Figure 3: Broad Economic Categories, % of total imports**



Source: Central Bank of Kosovo (2009)

This qualitative change in the structure of imports is indicative of the new trend of Kosovar economy for revival and strengthening of the manufacturing sector. It indicates that there is some imports substitution going on. In fact, it shows a tendency of the economy to gear up in terms of higher level of competitiveness.

There are a number of other commodities comprising a significant share of Kosovar imports. Although not as important as in the case of exports, base metal and related articles comprise a significant chunk of total imports. Similar to mineral products is the group of machinery and equipment; the share of this commodity has undergone a significant steady increase in the structure of imports, from over 6 percent in 2002 to over 9 percent in 2008. Another important component in the structure of imports are the chemical products, which on average covered over 7 percent of total Kosovar imports from 2002 to 2008. Furthermore, transport vehicles, live animals, plastics industry, and wood products are some of the important commodities in the import structure of Kosovo.

The structure of export and import based on trade partners is presented in the following table. The EU and CEFTA member countries are the main partners of Kosovo in the foreign trade. Over  $\frac{3}{4}$  of imports and exports were realized with these groups of countries during the period 2003 – 2008 (similar situation is also prior to 2003). As regards the trade with CEFTA countries, the structure shows

that the relations with the former Yugoslav republics remain rather tight. During the period under consideration, Macedonia and Serbia were the main regional partners covering around  $\frac{1}{3}$  of exports and imports of Kosovo, respectively. In 2007 and 2008, as Figure 4 and 5 show, imports from these countries covered 30 and 29 percent of total imports; the exports from Kosovo to these countries were lower than the average, i.e. 22 and 15 percent respectively. However, export to Serbia seems it will not persist in 2009 as the Serbia has been blocking Kosovar products entering their market.<sup>3</sup> Other countries in the region have a lower share; the importance of Albania as a trade partner is increasing especially after entering into force of the 2004 FTA. The export to Albania has marked a significant increase: from 3.2 percent in the total of Kosovar exports in 2003 to 12.6 and 10.7 percent in 2007 and 2008, respectively. Other countries of the region do not have a significant share in the trade flows with Kosovo.

**Table 1: Main trade partners (in %)**

		2003	2004	2005	2006	2007	2008
<b>EU</b>	<i>Export</i>	41.7	29.3	38.8	38.2	42.6	47.8
	<i>Import</i>	28.4	39.9	38.0	34.8	35.2	36.2
<b>CEFTA</b>	<i>Export</i>	51.3	41.6	53.0	46.7	41.3	30.9
	<i>Import</i>	45.6	34.7	38.0	41.1	36.7	37.5
<b>Other</b>	<i>Export</i>	7.0	29.1	8.2	15.1	16.1	21.3
	<i>Import</i>	26.0	25.4	24.0	24.1	28.1	26.2

Source: Statistical Office of Kosovo, 2009

As regards the trade flows with the EU countries, Italy has been absorbing the largest share of Kosovar exports, covering on average about 30 percent of total Kosovar exports to the EU countries from 2003 until 2008. Italy is followed by Germany and Greece. The same countries are also the main source of imports (for the same period as above) however, with a different ordering; Germany is the EU largest exporter to Kosovo, followed by Greece and Italy.

<sup>3</sup> Serbia and Bosnia and Herzegovina have not been recognising the customs stamps of Republic of Kosovo.

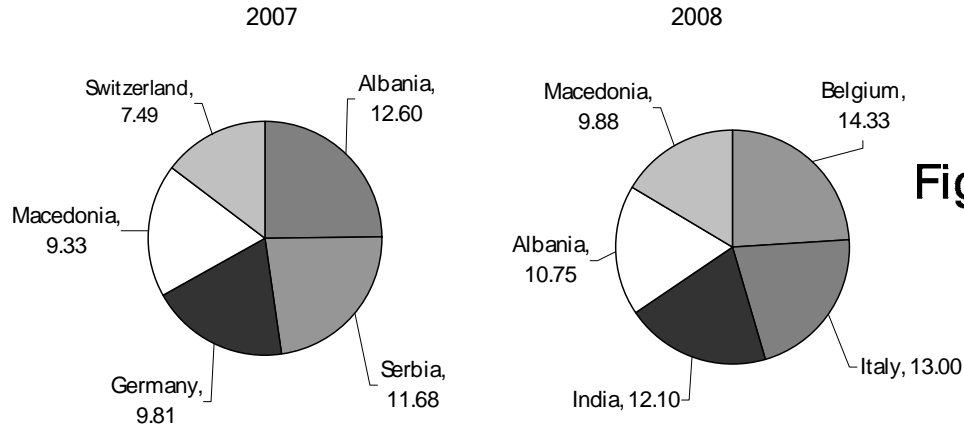


Figure 4: Major export destinations

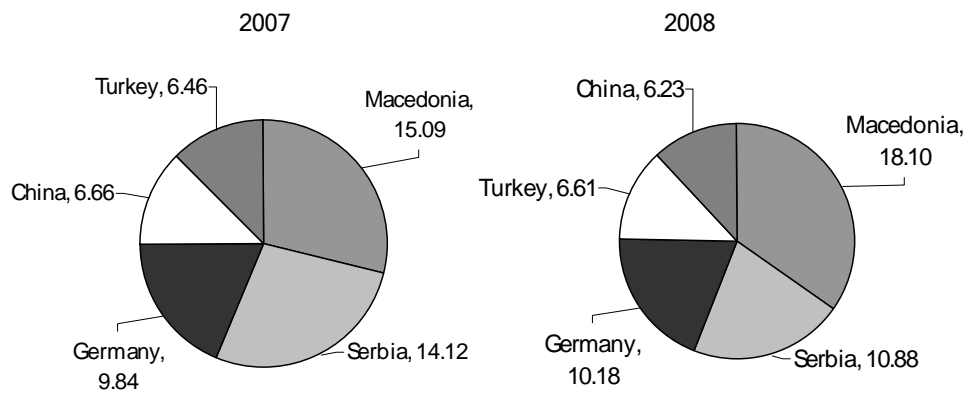


Figure 5: Major import sources

Source: Statistical Office of Kosovo, 2009

In the category of 'other' countries (see Table 1), the main partners have been Turkey and Switzerland as export destinations, whereas China and Turkey in terms of imports. However, 2008 has marked a significant change in terms of export destinations (see Figure 4). Belgium and India have become two major export partners of Kosovo. This is due to the activities of base metal exporting companies (iron and nickel). Belgium and India have absorbed over 25 percent of total Kosovar exports in 2008. However, it seems that this trend is unlikely to persist as there are indications that this sector has been hit badly by the current

financial crisis. The data show that only in January 2009 Kosovo has exported €1.3 million to India, whereas it has exported none in February; exports to Belgium in first two months of 2009 are zero. In 2008, for two months Kosovo exported to these two countries €9.6 million.

## **1.2 Identification of barriers on foreign trade**

Reasons for the poor performance of the export sector in Kosovo are many and of all natures; political, historic, and economic.<sup>4</sup> Most of these deficiencies are linked with each other; for instance; for a long period (and somehow the issue is still relevant) the unresolved political status has been a hindrance to the development of Kosovo. In this context, there are some factors which should be specified and which have had an impact in the development of the enterprise sector, and particularly in the export sector: the post-war Kosovo has inherited industries and companies in almost a total collapse as a result of destruction and theft; delays and many complications in the privatization process have made even more difficult for them to recover. On the other hand, for many years Kosovo was not part of regional initiatives aiming liberalization of trade, mainly due to unresolved political status. Furthermore, the level of Foreign Direct Investments (FDI) has not been satisfactorily (insignificant early after the 1999, however, relatively high since 2005), a factor very important in many transition countries in boosting their economies and particularly their export sector. Informal economy is also a dimension that should be mentioned.<sup>5</sup> Lastly, we shall point out irregular power supply and limited road infrastructure as part of Kosovar reality.

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<sup>4</sup> We do not intend to identify in any way all the doing business barriers in the post-war Kosovo. The aim of this part is to identify the present context in which business is being and has been conducted in Kosovo as well as implications of these hindrances to the activities and exporting enterprises.

<sup>5</sup> According to the EC (2008) the informal economy in Kosovo amounts to some estimated 30% of GDP in Kosovo, or €700 million per year (The European Commission Liaison Office to Kosovo press release of 27 August 2008. Available at: [www.delpn.ec.europa.eu/repository/docs/Informal\\_economy\\_confrence\\_eng.pdf](http://www.delpn.ec.europa.eu/repository/docs/Informal_economy_confrence_eng.pdf). Accessed on: June 12, 2009).

These problems, which are basically related to the specific reality of the post-war Kosovo, in constellation with the emerging institutions and policies, have hampered the development of the private sector, a sector which should be able to bear the main burden for export. Currently, the private sector is almost entirely comprised of not very efficient small and medium enterprises (SME). Almost total inexistence of large scale enterprises in the structure of enterprises in Kosovo has had an direct impact on the low level of export since those are the enterprises that are very active in exporting activities in most countries, as a result of their potential and resources. On the other hand, specifically the absence of large enterprises had an impact on the development of SMEs because the former as they usually comprise a significant share of the demand for SMEs' products and services. This fact has had an effect on a large number of SMEs not going through the dynamic life cycle of their development and growth into large scale enterprises which would then be an additional source for potential for export.

In the context of impediments related to economic policies and institutions, one should discuss the tax policy. The latter has continuously caused dissatisfaction among the business community, although facts have often not been argued (see later discussion). The financial system has also attracted the attention as a hindrance for business development in Kosovo. In the context of enterprise development and in relation with the financial system, is law enforcement (particularly contract enforcement) which serves as a major impediment. Then, in the context of export sector, it should be noted that inexperienced customs service, the complexity of reimbursement procedures of the value added tax (VAT)<sup>6</sup>, underdeveloped institutions for quality assurance, and other impediments.

In addition, the flow of Kosovo's export has been hampered by the measures and instruments applied in the trade policies of other countries; Kosovar exporters

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<sup>6</sup> The amendment of the Law on VAT (to be enacted soon) simplifies greatly the reimbursement procedures of VAT.

were forced to face the tariffs charges (for example, transit taxes) as well as non-tariff charges (such as subsidies). Particularly, the latter were prevalent and have taken different forms.

Lastly, companies bear a part of responsibility for a poor performance of the foreign trade sector in Kosovo. Some firm specific problems affecting firm's competitive position in the foreign market are as follows: the absence of strategy to do business internationally, innovative approach both in production and work process (through which they would achieve product differentiation and increased effectiveness of firm's organization structure), limited number of links with foreign partners, limited possibilities to enter business networks (in which different companies would be responsible for different activities from production to placing the product in the market), and some other aspects.

### **1.3 Potential markets for Kosovo products**

According to MTEF (2008, p.14), for the projected period exports of Kosovo until 2011 are expected almost to double relative to 2007 (a 17.7 percent increase annually has been projected). In MTEF it is not stated explicitly which products or industries would bear the main burden of this additional export and in which markets this exports could be placed. Further, the discussion will concentrate on the potential export industries in Kosovo by analyzing comparative advantages of Kosovo, and then we will proceed with the potential markets for Kosovar products.

Based on the official data it is difficult to identify clearly the sectors or industries in which potentially Kosovo has comparative advantage. The structure of exports in the last ten years does not give a clear picture from which we could draw certain conclusions regarding this matter. Moreover, pre-war data for Kosovo on the trade flows do not provide much. Regarding comparative advantage of Kosovo some indications can be drawn based on the potential production factors



Kosovo has, that is, natural resources and human capital. Like in the *Trade Policy for Kosovo 2004*, extractive industries and energy sector remain the industries with the notable comparative advantage. Kosovo has a notable advantage in the electricity production, bearing in mind huge demand for energy in the region and wider as well as the low cost by which the lignite-based energy could be produced in Kosovo. Other mineral resources have a notable potential particularly considering the increasing trend of prices in the world market for these commodities.

In this context, agriculture should be also mentioned as well, considering the quality of arable land and the large percentage of the availability of workforce in Kosovo. However, the sector has been having huge difficulties as it has been subsidized in other countries, whereas Kosovo has not been able to apply any significant measure to boost the sector.

However, Kosovo's economy, and as a result the export sector, cannot completely rely on the extractive industries nor agriculture. Kosovo should opt to utilize on other sources of comparative advantage and it should find other market mechanisms to expand the export activities. In this context, one should extend the discussion on dynamic comparative advantages for Kosovo. The extractive industries and energy sector are essentially static comparative advantages as they comprise merely a reallocation of domestic resources. On the other hand, one should also consider the fact that additional resources created or resources made available through imports can provide foundation for generation of new comparative advantages. This is a long-term process; the Government of Kosovo is committed to enacting policies which will promote new opportunities for change through time, as dynamic change in industries' comparative advantage requires years. However, potential industries for this process for the moment is difficult to identify in Kosovo; at best, the Government of Kosovo will consider ways of generating comparative advantage particularly through the mobilization of human capital, or other potentials it has. Nonetheless, the choice of industry on which the Government policies will be directed has to have the highest productivity,

strong linkages with the rest of the economy, and it should be one of the industries for which the future competitiveness is important.

Regarding the potential markets, it could be said with certainty that the greatest potential remains that of the EU market. The data of Kosovo's trade partners for the last years indicate an increasing tendency of Kosovar businesses to direct themselves towards EU market. Such a tendency it is seen also for the countries of the region. Development of relationships with the EU is critical to economic development of Kosovo. Due to the size and absorbing potential of the EU, Kosovo would benefit from the increase of demand for its products in EU countries and likely investments that would potentially occur. Afterwards, the investments would result in transfer of knowledge and innovations that would have an accelerating and multiple effects in the economy of Kosovo.

However, that being said, in no way we are trying to minimize the importance of the regional market. Factors related to language, culture and common history will remain important for trade exchanges between some countries of the region of Balkans. Then, low transport costs, joint participation in the integration initiatives, and the common goal of joining the EU, are the factors that should be taken into consideration in the future trade relations of Kosovo with the countries of the region.

In this contest, apart from the EU and CEFTA zone, an important market and with the potential of increase will remain the Turkish market.

## **2. TRADE REGIME AND INSTITUTIONAL LINKAGES<sup>7</sup>**

Foreign trade is considered to be one of main growth instruments for Kosovo. For

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<sup>7</sup> Part of information in this section is based on *Trade Policy for Kosovo, 2004*.

this reason, trade policy remains one of the key aspects of the overall economic policy (for a linkage between trade policy and macroeconomic policies see Box 1). Kosovo has a trade regime which is simple and easily manageable, a transparent and non-discriminatory. All these attributions are important in promoting a competitive export sector. Further in this section we will discuss in details the mechanisms of Kosovo's trade regime. In the section following this, we will provide suggestions on the directions that the trade policy of Kosovo should pursue in the coming years.

### **Box 1: Trade Policy and Macroeconomic Policy**

#### ***Trade Policy Affecting the Macroeconomic Policy***

Changes in trade policy alter the development content of macroeconomic policies. The most obvious way of this is through the impact of trade policy on fiscal policy, which is the main vehicle for countries to conduct effective social and industrial policy.<sup>1</sup> Trade policy affects both revenue and expenditure sides of the national budget.

On the revenue side the impact is direct. Tariff reduction, at least in least developed and upper middle income countries tends to reduce, rather than increase, government revenues (Rao 1999<sup>8</sup>; Khattry and Rao, 2001<sup>9</sup>).

This means that there is a positive relationship between trade revenues (in fact total government revenues, according to recent research) and tariff revenues. Proponents of rapid trade liberalization argue that as the volume of trade increases the total revenues from trade related taxes actually increase, even if tariffs are reduced. Unfortunately, data at least at the cross-country level do not support this claim. While there is serious research to be done, in many developing and least developed countries the relationship is positive. Cambodia, for instance, has been liberalizing its current account over the last decade, albeit steadily. The share of trade revenues in the total government revenues in the last half a decade reduced from somewhere around 50% in the second half of the 1990s to 24% currently.

Tariff liberalization and other types of trade liberalization policies are, therefore, more than likely to put an additional financial burden on the government budget, limiting their ability to conduct meaningful social and economic policies, which would otherwise benefit trade, further growth, and human development.

Government revenues are also affected by the cost of implementation of WTO agreements. For example, according to Michael Finger the cost of implementing three WTO agreements customs valuation, sanitary and phytosanitary measures (SPS), and intellectual property rights (TRIPs) costs a typical developing country \$150 million. This is equal to a year's development budget for many of the least-developed countries (Finger and Schuler, 1999<sup>10</sup>; Rodrik 2001<sup>11</sup>).

<sup>8</sup> Khattry, B. and Rao, M. (2002), *Fiscal Faux Pas?: An Analysis of the Revenue Implications of Trade Liberalization*, *World Development* 30(8): 1431-1444.

<sup>9</sup> Rao, J. Mohan 1999, *Openness, Poverty and Equality*, Background Paper, *Human Development Report 1999*. UNDP: New York.

<sup>10</sup> Finger, M. J. and Schuler, P. (1999), *Implementation of Uruguay Round Commitments: the Development Challenge*, World Bank policy research working paper no. 2215, September 1999.

<sup>11</sup> Rodrik, D. (2001), *The Global Governance of Trade As If Development Really Mattered*, Background Paper, New York: UNDP

Conducting sustainable social and industrial policy is a costly business. Industrial policy schemes, such as selective credit schemes, training schemes, support for SMEs etc, require considerable amount of financial resources. The impact of trade policy changes on the expenditure side of the government budget, and thus the actual flexibility of fiscal policy making for developmental purposes, is more indirect, but nevertheless exists. The positive or negative revenue effect on the revenue side has some important implications development expenditures (or the development budget), and there is indeed positive correlation between trade tax revenues and certain key development related expenditures such as education and health, and expenditures on public investment etc. As revenues decrease governments' policy making capacity and maneuvering ability decreases. This is reflected mostly in the social expenditures and the development budget, as for many reasons the governments are restricted to keep some core expenditures, such as those related to their national security.

For example the government of Nepal is currently deriving around 27 per cent of its total revenue from import taxes. Total commodity tax based on foreign trade is more than 32 per cent of the total regular budget. Expenditures such as military, police, and debt service constitute more than 40 per cent (in the budget of the year 2003 it is 50%) of the government budget. Given the political conflict situation it should be very difficult to reduce security-related expenditures in the face of an actual decline in the total revenues due to lower tariffs.

There are ways to recover the revenue loss, through different, 'permitted' ways of raising trade related taxes such as VAT. However, their effectiveness vis-à-vis more direct trade related taxes is doubtful.

## **2. Macroeconomic Policies and Trade Expansion**

So, the end result is that the development content of macroeconomic policies, in this particular case the fiscal policy, changes. In the context of rapid trade liberalization, this is quite ironic, because the recent research also shows that the expansionary macroeconomic policy, which requires more fiscal resources and better budgetary allocation for developmental purposes (social and industrial), proves to be more useful for expanding a countries trade capacity. Rapid and unregulated trade liberalization therefore serves the opposite purpose and while claiming to expand trade, it actually limits it.

Recent empirical research demonstrates that expansionary macroeconomic policy actually results in better trade outcomes. Looking at trade and investment (FDI) policies of a group of Latin American countries in relation to their growth performance over the last three decades, John Weeks, for instance, argues that the relationship between trade and GDP growth depends on the dynamics of the transmission mechanisms and complementarity (or lack thereof) between export and non-export sectors in the domestic economy. GDP growth can only be enhanced if the export sector can generate positive growth dynamism in the non-export sector (Weeks 2003).<sup>12</sup> This complementarity has been greater in countries where the transmission mechanism was facilitated by expansionary macroeconomic policies (monetary and fiscal policies as well as exchange rate regime) and where there are solid industrial policy measures in place. A contractionary macroeconomic policy framework -- using restrictive monetary and fiscal policies for instance-- will be likely to negatively influence "export dynamism", measured by the elasticity of real exports and non-export GDP, by compressing (especially domestic) demand. This reduces the stimulating effect of exports on non-export production and thus on GDP growth (Weeks 2003). The linkage operates through the crowding in and income effects of government expenditures. It could also be conducive for attracting FDI. As long as there are no high inflationary pressures, an increase in government expenditures to expand domestic market serves to attract FDI. China's move to develop its Western Provinces, for instance, did not go unnoticed by foreign investors.

Effective social policy and a fair and equitable governance structure, prioritizing spending on

<sup>12</sup> Weeks, J. (2003), Exports, Foreign Investment and Growth in Latin America: Skepticism by Way of Simulation. Working Paper Series No.117, School of Oriental and African Studies, Department of Economics: London

education and health as well as investment in basic infrastructure, which largely depend on expansionary macroeconomic policy, are also important for positive and sustainable human development outcomes as well as increased trade performance.

*Source:* Keklik, M. and Memis, E. (2005), Human Development Impact Assessment of Trade Policies, Policy Papers, UNDP Regional Center in Colombo, Sri Lanka.

## **2.1 Tax policy in the context of trade policy**

Recently, the Government of Kosovo took major steps in making the tax policy more conducive to business and investments (the new tax schedule entered into force on January 1, 2009). Kosovo is now applying tax rates very competitive relative to the region of South East Europe (SEE). In addition, tax system is conducive to export activities. Exports are not charged with VAT or custom tariff. In the case of VAT, it should be clarified no VAT charge will be applied either on imported inputs (VAT rebate applies), other production inputs, or final exported products. In other cases, VAT is uniform and as such is collected for all goods, only in some specific cases (see below).

As pointed out above, goods destined to the foreign markets are not charged with customs fees. On the other hand, imports, with some exemptions, are charged with customs tariff of 10 percent. Firstly, products from Serbia and Montenegro are not charged with customs tariffs, and the countries with which Kosovo has signed FTA are charged only with 1 percent tariff. Also, certain categories of products are exempt from customs; for instance, artificial fertilizers, medical equipment, and finally goods for humanitarian purposes. In 2004 some products and agricultural machinery were partly released from customs tariffs and VAT.<sup>13</sup> During 2007, a number of Regulations have been enacted to reduce even further customs tariffs for a number of commodities.<sup>14</sup>

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<sup>13</sup> UNMIK Regulation 2004/13 provides for (a) reduction of customs tariffs for capital goods from 10% to 0%; (b) reduction of custom tariffs on raw material for agrobusiness and some other production sectors from 10% to 0%; and (c) reduction of customs tariffs of intermediate substances for further processing from 10% to 0%.

<sup>14</sup> UNMIK Regulation 2007/12 provides the exemptions from customs duties of some raw materials, necessary for the production process; under Regulation 2007/1 no customs duties are required for fuel and fuel products destined for production activities; and UNMIK Regulation 2007/31 no customs duties are required for import of wheat and maize.

In Kosovo, commodities such as tobacco, coffee, alcoholic and non-alcoholic drinks, wine, beer, fuel and related products, vehicles, etc. are charged with excise tax. The excise is applied also for the same categories of goods that are produced within Kosovo. The rate is set as a specific tariff. For the purpose of stimulating the domestic production the excise is not paid for mazut in the cases when it is used as a raw material.

## **2.2 Trade liberalization**

As pointed out earlier, Kosovo is committed to trade liberalisation. Kosovo institutions have been part of processes and undertakings for trade liberalization in the region, particularly those initiated by the Stability Pact. Although, not equal part in the latter mechanism, Kosovo made clear its commitment to respect obligations of the Memorandum of Understanding for Trade Facilitation and Liberalization (henceforth MoU), signed by the countries of SEE in 2001 within the auspices of Stability Pact.<sup>15</sup> The final objective of this activity was implementation of bilateral FTAs among the countries of the region. According to MoU, FTA-s were mandatory to the signatory countries, apart from Kosovo in which case countries were merely advised to sign FTA if they deem this step as beneficial. However, Kosovo was rather active in the process signing the first FTA with Albania, and later with Macedonia, Bosnia and Herzegovina and Croatia. The entire negotiation process was concluded by extending CEFTA agreement with SEE countries in 2006, thus, converting the bilateral agreements into one single FTA (more on CEFTA see Box 2). Kosovo become an equal member with full rights. Although Kosovo as a part of CEFTA agreement has certain responsibilities, there are many positive aspects to the process. One of these benefits will primarily be free flow of goods and services. The purpose of CEFTA is creation of rules and mechanisms by which foreign trade is governed in the region. These rules have been

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<sup>15</sup> It should be noted that this Memorandum of Understanding does not oblige the countries signatories of the agreement for free trade with Kosovo, in spite of the fact that the same document obligates the other countries to sign the agreement amongst each other.

harmonized with the principles of the EU and WTO. Experience gained in the trade with the region will make Kosovo's products competitive for the EU market and wider. Also, Kosovo in the process will gear up institutions and policies to comply with the requirements of WTO (see later discussion). Another purpose of CEFTA is a creation of an attractive regional market which would create new opportunities for domestic businesses or foreign investors. This dimension is particularly important for Kosovo, as FDI are of paramount importance in improving competitive position of Kosovar industries in foreign markets.

**Box 2: Central European Free Trade Agreement (CEFTA)**

Original CEFTA agreement was signed by Visegrád Group countries (i.e. Poland, Hungary, and Czech and Slovak Republics) on December 1992 in Poland and it entered into force in July 1994. Through CEFTA, participating countries hoped to mobilize efforts to integrate into EU and other international institutions. Later, under the auspices of the Stability Pact for SEE, the Agreement on Amendment of and Accession to the CEFTA was signed in Bucharest on 19 December 2006. This Agreement substituted all the bilateral agreements previously applied in the region of SEE. Full implementation of CEFTA started at the end of 2007.

CEFTA envisages an improved mechanism for settlement of disputes that might occur during the agreement implementation, which represents a new quality and a factor of higher security of liberalisation in the region. Besides the abovementioned, new areas have been opened for development of mutual relations as regards liberalisation of services, investment issues, public procurements, intellectual property, and possibility for CEFTA cumulation of origin among the Parties.

CEFTA also provides for that mutual trade relations among CEFTA Parties should be developed in conformity with WTO rules. This practically implies that even before WTO membership, the systemic setting of the economy should be adjusted to WTO rules, representing a strong factor of predictability and transparency for foreign partners, foreign investors and entrepreneurs themselves.

Source: <http://www.cefta2006.com> (Accessed on: May 25, 2009)

However, the experience of Kosovo with CEFTA so far has not been very positive due to political animosities persisting in the region. Since UNMIK was a signatory of the CEFTA on behalf of Kosovo (Kosovo's international representation was the reserved right of UNMIK until the declaration of independence, and the negotiating process for bilateral FTA-s and CEFTA were conducted by UNMIK representatives), Serbia and Bosnia and Herzegovina do not recognise the institutions of Republic of Kosovo and the documentation issued by them. Hence, Kosovo's export to these countries has been at the stand-still for several months, although there are ongoing efforts to solve the situation. In addition to this issue, there is a general feeling within the Kosovar institutions and business community that CEFTA will not produce the

expected benefits for Kosovo. There are claims that the process of adhering to CEFTA was not well thought, and the decisions were taken without an analysis or any impact assessment.<sup>16</sup>

As regards the EU market, trade relations of Kosovo with the Union are specified under the Council Regulation 2007/2000 of September 2000. This Regulation recognizes Kosovo as an autonomous customs unit, whereby 95 per cent of Kosovo's products are exempt from customs tariffs. Customs and quantity limitations remain in force only for a limited number of products (veal, sardines, wine and some textile products). Also, Kosovo is part of the Stabilization Association Process (SAP) although in a different form compared to the other countries of the region. As a small number of countries within EU have not recognised independent Kosovo, a Kosovo Tracking Mechanism (KTM) remains in force designed to guide Kosovo towards necessary reforms for membership in EU. This mechanism should be used for an easier access to the regional and EU market, since the EU through SAP (KTM in the case of Kosovo) is committed to further liberalization with countries of the region and between the countries of the region. Relations with EU are essential for the development of the Kosovo's economy having in mind the fact that the EU is the market with the greatest potential, not only for Kosovo but the whole region, and the main source of investments.

The recent development in the context of liberalization is the inclusion of Kosovo in the Generalized System of Preferences (GSP) by the United States of America (see more on the following Box). This program is designed to promote economic growth in developing countries by offering preferential treatment for a significant number of commodities. So far, the USA market did not have a significant share in the total Kosovar exports, however this development may change the situation. The GSP potentially creates new opportunities for Kosovar exporters, although

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<sup>16</sup> This conclusion is drawn based on the outcomes of the report produced by Keklik and Gashi (2009), which maps the capacity assets and needs of Kosovo Institutions with regard to analyzing and formulating trade policies. The report was commissioned by UNDP. (See later discussion).



real effects may take longer time.

**Box 3: Generalized System of Preferences (GSP)**

The GSP program was instituted on January 1, 1976 aiming to expand the choices of American industry and consumers while creating economic opportunities through increased exports from developing countries. The GSP program provides duty-free entry into the U.S. market for over 3,400 exports from designated beneficiary developing countries and about 1,500 additional exports from least-developed beneficiary countries. The GSP program extends this opportunity for enhanced access to the U.S. market to 131 countries and territories (including 44 least-developed countries).

*Source:* [http://www.ustr.gov/Trade\\_Development/Preference\\_Programs/GSP/Section\\_Index.html](http://www.ustr.gov/Trade_Development/Preference_Programs/GSP/Section_Index.html) (Accessed on: May 25, 2009)

### **2.3 Membership in WTO**

Although, very much aware that the membership in WTO is a very complex process, Kosovar institutions have been considering accession to WTO as an important step towards fully integrating in the world trading system. First of all, it should be understood that FTA or the regional agreements regarding the trade liberalization (such as CEFTA), are always the second best choice compared to multilateral liberalization, something that WTO membership would provide. Membership in WTO is a complex process for two reasons: first, this process requires commitment of the applicant country to implement the policies that are related to the process of membership in WTO; and, secondly, is the complexity of issues that may be raised by the members of WTO during the negotiation process that complicates the entire process. Negotiations include many issues and quite complex ones, such as: agriculture, textile and apparel industry, banking system, telecommunication, industrial and product standards, intellectual property, etc.

However, benefits from membership are significant, particularly for small countries such as Kosovo, which depend heavily on foreign trade. The benefits are as follows:

- Requirements for membership in WTO result in comprehensive empowerment of policies and institutions of the country;

- Membership in WTO ensures access to the main world markets. Kosovo as a country in transition would benefit from the *Most Favoured Nation* clause. This status means an equal or non-discriminatory treatment by the country members of WTO. What does this mean? If a country member offers preferences to another member country than these preferences would be applied for the rest of the member countries (in this case to Kosovo as well). This treatment has many implications for relations within the national economy of the member country and its position in the foreign market. This concept is the cornerstone of the WTO policies (there are plentiful information on this concept, therefore we are not going to discuss them further). And,
- Membership enables access to dispute settlement mechanism. For Kosovo as a small country this mechanism is of particular importance.

WTO has played an important role in liberalization of world trade. However, abolition of tariff barriers as a result of negotiations within WTO has caused a new category of hindrances to emerge, that is, non-tariff barriers. These barriers in most cases hinder international trade more than the tariff barriers. This happens because WTO rules are not exactly specific in this context, allowing countries to apply them. Therefore, Kosovo will see the further liberalisation (including here joining the WTO) in a context of numerous other factors so as to benefit most from the process.

## **2.4 Institutional aspects and trade regime of Kosovo**

The quality of institutions is very important factor in economic development and also in undertaking business activities abroad. Recently, alongside classic factors – physical and human capital – the quality of institutions has been considered as a comparative advantage of the country together with knowledge, financial system, and other relevant factors. Performance of institutions is mainly responsible for creating a favourable climate for business. Although, effects of the institutional

quality may seem to be indirectly linked to the development of export sector, there are some institutional mechanism dealing directly with the development and advancement of export sector. In Kosovo, the main institutional role is on MTI which proposes policies and designs mechanisms for the implementation of these policies. An important development within the institutional advancement is the Law on Foreign Trade Activities enacted in 2003 and another important law of particular importance is the Antidumping Law which has been drafted and soon to be enacted by the Assembly. These laws regulate trade relations and determine mechanism for realization of foreign trade.

In the context of legislation, the Customs Code should be mentioned which was approved based on the Regulation 2004/1. The code set out new mechanisms to facilitate the trade. Business friendly parts of the Code include provisions for:

- Bonded warehouses which enable storage of goods under Customs supervision. The benefits from such a system are all encompassing; the primary advantage of bonded warehouses is that it eliminates the exporter's exposure to customs and tax expenses for unsold goods. That is, for the products stored in bonded warehouses payment of duties is deferred until the goods are sold. The other benefits of this facility stretch to protection of businesses from inflationary risks, offering businesses a convenient way to test the market and fine-tune their export strategies, and even providing a physical security for the products of companies.
- Regulated and monitored inward and outward process relief; in other words, enabling individual companies to bring into Kosovo, without paying tax or duty, components for the production of goods destined for export;
- Transit of goods under bank and other forms of guarantee. This procedure will permit the movement from one point within Kosovo to another of goods of other countries transiting Kosovo, and goods originating in Kosovo but destined for exports.
- The establishment of free economic zones for manufacture and export if these instruments are deemed necessary by the policymakers. In these

zones companies would be taxed very lightly or not at all to encourage their development.

In order to realize instruments provided for under the Customs Code, a further increase in the effectiveness of Customs Administration is required. This service has been responsible for the most part of revenues collected for the budget of the country. However, in spite of these achievements, the possibility of smuggling is a matter of concern.

Tax administration also plays an important role especially in the reimbursement of VAT for goods that are destined for exports.

A highly important institutional dimension within the trade policy is the presence of institutional mechanisms for export finance and insurance. In Kosovo these mechanisms are nonexistent, forcing many transactions in cash. These mechanisms would offer assistance to exporting companies in cases when financial risk of a country or a specific industry is higher than the potential of banking sector to cover this risk. These mechanisms would not compete against the financial institutions (which in Kosovo offer export guaranties) but would interact for strengthening of export sector in Kosovo (such instruments may be credit letters, guarantees that cover the risk of payment, payment guarantees in advance, exchange cheques etc). In case of Kosovo these instruments become even more relevant having in mind the fact that the largest part of the enterprise sector is SME which are very sensitive when facing a certain level of risk and foreign competitiveness.

The road infrastructure is another problematic dimension. Kosovo is a country with relatively limited road network with the region. The highway linking Kosovo with the port of Durrës in Albania would create access to the sea for Kosovo. This would enable the Kosovar economy to benefit from lower transport costs as the sea transport is much cheaper and with less "complications" compared to road

transport.<sup>17</sup> In the context of transporting difficulties, we should mention the absence of Kosovo from *Transports Internationaux Routiers* (TIR), an international transit system. This system enables the transport of products from the country of origin to the destination without customs control in the transit countries. This instrument minimizes financial and administrative charges, hence, Kosovo should aspire to membership in this institution.

Within the institutional framework, one should consider the mechanisms in charge of standards and the quality of products, known as for sanitary and phytosanitary standards. In Kosovo, in this direction ministries and agencies are engaged, such as Kosovo Food and Veterinary Agency within Primeminister's Office, Agency for Standardization and Accreditation within MTI and the National Health Institute within the Ministry of Health. One of important factors resulting in a low level of exports in western markets are health and safety standards required by foreign partners. This dimension of institutional reform is particularly important in relation to the full membership of Kosovo in WTO. In addition to strengthening the institutions for implementation of sanitary and phytosanitary standards, as a member of WTO, Kosovo would be obliged to develop institutions treating Technical Barriers in Trade (TBT) and Trade Related Intellectual Property Rights (TRIPS). These instruments are also important to monitor activities of other exporting countries in the sense of the level of fulfilment of import standards.

Another institutional component are the international organizations operating in Kosovo, a number of them supporting the advancement of the export sector in Kosovo. These organisms have mainly been concentrated in institutional build-up or businesses development in order to gear up the competitiveness of the domestic industries. UNDP, EU mission, and World Bank have been involved in the support for trade related institutions, especially within the MTI. On the other hand, USAID through different programmes have been supporting businesses

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<sup>17</sup> According to Haussmann (2001) costs of road transport are seven times higher than transporting through sea. See Haussmann, R. (2001), Prisoners of Geography, *Foreign Policy*, January – February, p. 45-53.

Kosovo wide in different business processes, and notably in export activities.

Lastly, business associations are important factors in promoting export. Their task in context of export promotion has been mainly in providing information on foreign markets.

### **3. DIRECTIONS OF KOSOVO'S TRADE POLICY**

Kosovo is fully committed to trade liberalization. Enhancing trade in Kosovo through liberalized trade requires three aspects to be in place. These are import rationalization and replacement, trade facilitation, and export promotion. This is the UNCTAD (United Nations Conference on Trade and Development) integrated export strategy which gives equal importance to competitiveness in the domestic market and competitiveness in the foreign market. The first category deals with policies which aim at building competitive capacities in the internal market. The second group of policies consists of measures facilitating foreign trade. Instruments of the second group aim at improving border bureaucracy and decreasing transaction costs occurring at the border crossings. Finally, the third group considers measures aiming at promoting exports. These instruments focus on the performance improvement of domestic companies in foreign market.

However, the MTI, and Government of Kosovo for that matter, is fully aware that trade liberalization, in and of itself, is not sufficient to enhance development. Firstly, trade policies should be formulated, implemented, and assessed in a manner, which prioritizes development rather than international trade outcomes themselves. This means that tariff and non-tariff reductions should be managed through sectoral (timebound) selection, sequencing, and phasing.

Secondly, in order for the benefits from trade liberalization to be the highest and most sustainable, not only trade policies, but also 'trade related development policies' should be understood and well managed. As we pointed out, enhanced competitiveness, for example, is of utmost importance for export promotion. But policies that improve competitiveness are not direct trade policies, but trade related policies (i.e. policies that have very important implications in terms of trade).

Finally, trade is a cross cutting concept affecting almost all areas of economic and social life. Therefore, there is an urgent institutional need for strengthening collaboration and coherence among all of the relevant actors that form the trade

system in Kosovo. The MTI is committed to strengthening relationships with and involving private sector, trade unions, labor unions, and the international institutions in the process of decision-making.

Therefore, MTI considers that trade policy in Kosovo should focus on trade policies on the one hand and trade-related development policies on the other, in order to be successful in contributing to the development process. While doing this, the spatial and temporal aspects of trade and related policies should be considered very carefully. In order to achieve a good trade policy trend, however, institutional needs for trade and trade related development policy formulation should be fulfilled. Therefore in the final subsection of this section we will discuss some institutional needs that Kosovo should address in the short term.

The subsections discuss trade policies in the context of first, trade agreements; and, second, trade-related development policies. These two are equally important. Further, we embark on discussing the need for strong institutional cohesion, so to make the trade and trade-related policies work better.

As it is seen in the above discussion, a number of aspects treated here are cross-cutting issues. The policy actions here require not only the MTI efforts, but also the efforts of a number of other stakeholders involved in the trade-policy process (government institutions and other non-governmental organizations). This is basically the case for a great majority of the dimensions discussed here. In such cases this document proposes measures to address the issues jointly, while in cases when the responsibility lies solely with MTI, the latter commits itself to applying specific measures. It should be made clear that the leading agency in the process of trade-policy making is MTI, however there are a number of other governmental and other relevant stakeholders involved in the process because of the cross-cutting nature of trade policies.<sup>18</sup>

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<sup>18</sup> For more on the institutional linkages in the trade-policy making process in Kosovo see the mapping of the capacity assets and needs of Kosovo Institutions with regard to analyzing and formulating trade policies. The report has been prepared for UNDP by Keklik and Gashi (2009).



### **3.1 Trade Agreements**

There are three important aspects of any trade agreement, which in turn determine trade policies in a country. These are market access, where most of the negotiations (for example in the WTO) take place in the areas of agriculture, Non-Agricultural Market Access (NAMA), and services; the legal, institutional and regulatory changes; and policy space.

#### **3.1.1. Market Access**

As we discussed earlier, free trade agreements and especially membership to the WTO would primarily give Kosovo the opportunity to access other countries' markets relatively easily, with a reduced transaction cost. In addition, the process means reducing (or agreeing to reduce) tariff and non-tariff barriers in some key areas of importation. Both aspects have some important implications in terms of growth, employment, distribution and allocation of income, assets and resources, and human development in general. It is most important to generate a schedule that would serve Kosovo's overall development goals.<sup>19</sup> In this context, as these issues transcend the MTI responsibilities, the latter considers that a number of steps should be taken jointly with other relevant stakeholders:

- The question of market access should, therefore, be dealt with from the viewpoint of accessing other country markets as well;
- A sample schedule of tariff and non-tariff barriers for goods and services that would give Kosovo the most benefit from a human development perspective should be generated. Equally importantly, however, it would include what Kosovo can demand from other countries and in what areas of goods and services.

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<sup>19</sup> Proper setting of the effective rate of protection is a crucial aspect of market access negotiations.

- The impact of tariff reduction in areas that are important for Kosovo's industrial and agricultural diversification and realizing its potential competitiveness should be examined very closely.
- Cross-sectoral impact should also be a part of this. Opportunities to use Kosovo's major comparative advantage products, as negotiation chips, should also be analyzed very rigorously.
- Preferential tariff systems and differences as well as alternatives to simple tariff system should also be explored.

### **3.1.2. Regulatory, Legal, and Institutional Framework**

Kosovo needs strengthening further its regulatory, legal and institutional framework in order to be able to integrate into the global economy through trade and (the right type of) investment. In this context, MTI suggests a number of measures that require joint effort: first, a study of the existing framework should be done. Second, the overall existing framework should be compared to the rules and regulations that bilateral, regional, and multilateral (WTO) agreements would require, and gaps should be identified. The next step is to explore flexibilities within the global trading system that would best serve for the effective implementation of the country's development strategy, currently the MTEF, while being compliant with multilateral and other rules. For example, one question under this category could be: what are the existing intellectual property regulations, and what the WTO regulations would require within the TRIPS agreement. After this comparison, the industrial policy measures that could be constrained by such a change in the WTO system should be raised and sorted out within the negotiation parameters. The final step would be to find the flexibilities and try to justify their usage in the possible trade agreement schedules. This is a part of the policy space, but looking at the issue from a more institutional and regulatory perspective.

### **3.1.3. Policy Space**

The rules and regulations in the WTO and other FTAs as well as commitments in

the market access area may limit development policy options of a member country. Yet there may be sufficient flexibilities in the system allowing a member country to formulate and implement its unique development strategy. The main idea here is to link the free trade and best policy options for Kosovo to its flexibility to formulate and implement a solid development strategy while participating in the global economy. The MTI considers that the discussion on policy space should mainly focus on the macroeconomic and sectoral impact of free trade and agreements. The impact should be assessed and necessary policy options and modalities (such as sequencing and phasing) should be discussed. One area under this is the impact of tariff reduction on government revenues and, ultimately, the government's ability to sustain development, social and poverty eradication policies. The size of tariff revenues in Kosovo is substantial in the government revenues. The MFE (2009) reports that around 85 percent of government revenues are tariff based. Almost 65 percent are collected at the border, whereas over 20 percent are collected internally.<sup>20</sup> Furthermore alternatives to recover even the existing amount of tariff revenues after tariff liberalization may have some important consequences for development (and equality oriented) revenue generation. Therefore, viable alternatives from a human development perspective should also be explored. For example, following a fiscal impact analysis, proposals should be made in terms of how to make up for a likely revenue decline. Structural aspects of taxation should also be explored, as much as they relate to trade issues and the WTO accession. The impact on overall growth and international as well as domestic investment should also be an important part of the discussion, but with an unassuming attitude regarding the generation of employment opportunities.

From what has been discussed in section 3.1, the main recommendation for the players involved in trade policy design is as follows: A sample trade free trade agreement (preferably WTO) schedule that would provide the most benefits for

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<sup>20</sup> Ministry of Finance and Economy (2009), *Buletini Gjysmëvjeter Makroekonomik*. [Online]. Available at: [http://82.114.64.12/~mfe-ks/index.php?option=com\\_docman&Itemid=79](http://82.114.64.12/~mfe-ks/index.php?option=com_docman&Itemid=79) (Accessed on: 08 June 2009).

development in Kosovo should be generated, using above three areas as analytical entry points. This would provide solid proof for the dialogue with both domestic and negotiation partners (international). The exercise aims at increasing the opportunities and reducing possible risks of WTO accession from a development perspective. The final output of this effort would provide the negotiators necessary development tools and arguments when they go around the negotiation table during the accession process.

### **3.2 Trade-related Development Policies**

Trade related development policies can be classified as macro level policies or micro (or meso) level sectoral policies. Trade-related macroeconomic policy discussion is, for the time being, limited to the impact of trade liberalization on government revenues and financing trade related sectoral policies.

In the following part the document proposes some possible measures that could be taken at the sectoral level. The discussion focuses on the two priority sectors, agricultural trade (or agriculture in general) and industrial trade (or industry in general). In addition, there are some cross-cutting aspects briefly covered at the end of the section. As a matter of fact, the entire discussion here goes beyond the MTI mechanism and functions, stretching in a number of components of the leadership in trade policy making.

Trade related sectoral policies have different time horizons in terms of their impact. Therefore, we discuss short, medium and long term policy options in the part right after the sectoral discussion.

#### **3.2.1 Sectoral Discussion<sup>21</sup>**

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<sup>21</sup> This section largely draws on UNCTAD (2008), *Export Performance Following Trade Liberalization: Some Patterns and Policy Perspectives*, in *Economic Development in Africa* Series: Geneva.

### 3.2.1.1 Agricultural Exports

The following should be addressed to improve agriculture exports: supply side impediments; diversification and value adding processes; and, market access and participation. We turn our attention to each of these dimensions.

#### *Supply side constraints*

An integrated programme of ‘supply-side measures’ could be developed. These measures could have two main objectives of tackling supply-side constraints critical to:

- Creating greater incentives to encourage investment in the agricultural sector, and to improve agricultural productivity and exports; and
- Enhancing the competitiveness of Kosovar agricultural exports vis-à-vis those of emerging economies.

Accordingly the Programme should have the following components:

*[i] Incentive package* - A comprehensive package of fiscal and other incentives to investors in the agricultural sector should be developed. For example, greater incentives and facilities could be provided to those investing in new market dynamic income-elastic products such as horticultural products and processed food. In this regard, the following steps should be taken:

- Set up an input subsidies programme, carefully designed and targeted at specific groups to improve agricultural productivity;
- Improve access to credit by enhancing the efficiency of the financial sector, including reducing segmentation between formal and informal sectors, and improving interactions between financial institutions and the private sector (see discussion below);
- Set up special export development and investment funds to provide financial resources in support of business ventures in agriculture.

*[ii] Improving productivity* - The Government of Kosovo, perhaps in collaboration with private-sector agents, will increase the level of investment in technology,

infrastructure (roads, irrigation facilities and post-harvest storage), extension services, supply of inputs, and research and development to improve productivity and quality of smallholder farms. It should also improve marketing systems. Specifically, increases in productivity and in agricultural supply response could be attained through doing the following:

- Design and implement ‘green box’ policies, especially to support poor farmers in remote rural areas (see the Box below for explanation ‘green box’ policies).
- Provide health, water and educational facilities as a means of improving the overall quality of rural life.

**Box 4: “Green Box” Policies<sup>1</sup>**

The WTO provides the following explanation for “green box” policies:

‘The green box is defined in Annex 2 (Domestic Support: The Basis for Exemption from the Reduction Commitments) of the Agriculture Agreement. In order to qualify, green box subsidies must not distort trade, or at most cause minimal distortion (paragraph 1). They have to be government-funded (not by charging consumers higher prices) and must not involve price support.

They tend to be programmes that are not targeted at particular products, and include direct income supports for farmers that are not related to (are “decoupled” from) current production levels or prices. They also include environmental protection and regional development programmes. “Green box” subsidies are therefore allowed without limits, provided they comply with the policy-specific criteria set out in Annex 2.’

<sup>1</sup> In WTO terminology, subsidies in general are identified by “boxes” which are given the colours of traffic lights: green (permitted), amber (slow down — i.e. be reduced), red (forbidden). In agriculture, as things are more complicated the Agriculture Agreement has no red box.

Source: [http://www.wto.org/english/tratop\\_e/agric\\_e/agboxes\\_e.htm](http://www.wto.org/english/tratop_e/agric_e/agboxes_e.htm) (Accessed on: 08 June 2009)

### *Diversification and value addition*

The Government of Kosovo needs to develop programmes that promote diversification towards higher value added products in Agriculture. These will enable Kosovo to increase its gains from agricultural production and trade. It will also permit the country to reduce their vulnerability to commodity price volatility. Some possibilities include the following:

- IPAK in collaboration with relevant business associations should launch programmes to collate and disseminate market information to producers;
- Establish ‘a diversification fund’ with support from development partners (i.e.

donor community).

Programmes to promote market penetration and improved market access will also be considered.

### *Market Access and Participation<sup>22</sup>*

Kosovo must increase its participation in global value chains to be able to access the markets of developed countries and emerging economies. Participation in these chains gives producers access to information about markets and enables buyers to obtain information about, and develop confidence in, the supplier. For specific products, however, the entry of producers, processors and traders into the value chain depends on product characteristics, technical requirements, market structures and the organization of trade.

The determining factor in market entry is the capacity to upgrade and produce according to specific requirements relating to quality, health and environmental standards, as well as consumer preferences and tastes. Exactly due to these constraints, our products have not been able to penetrate EU markets. With this in mind, the following should be considered:

- The MTI, in collaboration with business associations, will set up capacity-building programmes to assist with trade standards compliance;
- Information bureaus should be set up to give information on requirements for participating in global value chains, to promote the use of opportunities in dynamic markets.

#### *3.2.1.2 Industrial Exports*

Three interrelated actions can be proposed to strengthen the productive capacity of the industrial sector: increasing the competitiveness of manufacturing firms, helping the expansion of firm size, and facilitating firm access to factors of

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<sup>22</sup> This is complementary to the general discussion above on the market access; it is an extension for agriculture.

production in order to invest and grow.

### *Increasing Firm Competitiveness*

Efficiency is the most important factor that determines a firm's competitiveness and participation in export markets. In Kosovo, the need to increase competitiveness through the overhaul of the current production and export infrastructure cannot be overemphasized. Competitiveness must be built at the economy and firm level.

[i] Competitiveness at the economy level - Building competitiveness at the economy level has to deal with several issues:

- Improving the basic productive infrastructure to make production more reliable;
- Encouraging cross-border trade infrastructure; ineffective customs administrations are a hindrance to the free flow of goods in the region. Greater effectiveness of this institution would decrease transaction cost of foreign trade.

[ii] Competitiveness at the firm level - Firm competitiveness for exporting could be improved through three channels:

- Increasing labour productivity by promoting vocational training, on-the-job training and the sharing of best practices in production processes;
- Building firm-level technological capabilities so that they can upgrade technology to meet the standards and other norms required by the current trading system as well as export markets;
- Devising appropriate incentives to orient manufacturing production towards the export market in order to benefit from the efficiency gains and other advantages accruing to exporting. This could be done through increased efficiency of export promotion activities of IPAK. The latter is tasked with providing information on market opportunities, standards and other export requirements.



*The need for large manufacturing firms*

As we pointed out earlier, the size distribution in the industrial and manufacturing sector in Kosovo is heavily skewed towards very small firms. A greater presence of large firms in the economy could be made possible through the following: [i] encourage the creation of large manufacturing firms, right from the beginning; [ii] create an enabling environment that helps young small firms to grow and become large. In this context, the following should be attempted:

- Encouraging FDI in the manufacturing sector;
- Identifying and encouraging those Kosovar entrepreneurs who are capable of mobilizing the required resources to start large firms.

*Facilitating access to credit to invest and foster firm growth*

One reason why Kosovar entrepreneurs start very small firms could be their limited access to capital. Start-ups rely on the private resources of their owners since they cannot have sufficient access to credit or raise resources from the capital market. The question of start-up size would not be an issue if firms could easily access factors of production, particularly credit, in order to invest, grow and eventually reach the large size needed to be competitive in export markets. There are two key areas of focus, MTI believes: facilitating better access to credit and fostering interactions between financial institutions and the private sector.

[i] Access to credit - Access to credit is among the most important determinants of firm performance. However, it seems that the transactions costs of processing smaller firm applications to credit are simply too high. This problem can be alleviated in two ways:

- Developing and supporting credit institutions more adapted to the needs of the small firms. These institutions may have a role to play in the short term, but it is doubtful if they are the best long-term solution to the credit problem, given their limited resources. Therefore, further modernization of the financial sector should be the long-term objective to create a deeper financial sector.
- Creating credit information bureaus could narrow, at low cost, the information

asymmetry between small credit applicants and financial institutions. These institutions collect information on the creditworthiness of potential applicants and share it with lenders at relatively low cost. This could be part of a government programme that aims to finance substantial part of the risk premium for smaller firms (see below).

[i] Creating a framework of interaction between financial institutions and the private sector. This could help to bridge the information gap between the demand for and supply of credit. In this regard:

- Regular contacts should be organized between representatives of the private sector and the banking system, possibly through the chambers of commerce, to exchange ideas on issues of mutual interest.
- Commercial banks could consider opening in their agencies special windows dedicated to small enterprises, as this has been successfully experimented within some countries. These windows go beyond the traditional loan evaluation functions. They also help small enterprises prepare their loan applications and provide some training in project management;
- Education programmes and outreach campaigns should be organized on a regular basis, to increase the awareness of private sector actors, particularly small enterprises, on different business opportunities available to them. Helping small firms to invest, grow and participate in export markets would be beneficial to all.

### *3.2.1.3 Cross-cutting issues*

In this context, two major dimensions should be discussed: private sector and FDI. Regarding the former, the application of global value chains to agriculture and manufacturing means that private sector development in those sectors cuts across several policy domains, including improvements in the overall business environment and contract enforcement, and the development of business service providers. Business associations should form a partnership with the Government to enforce contracts, including producing to meet specified standards. Similarly,

utilizing fully the effects of FDI<sup>23</sup>, especially in terms of increasing export potential of Kosovo, has wide-reaching policy implications.

### **3.2.2 The Timeframe of the Trade-related Development Policies**

The following are general parameters and examples (in bullet points) of trade related development policies that MTI considers are applicable to the case of Kosovo. These policies require joint efforts of different stakeholders involved in trade policy process. The list is now exhaustive but gives a general direction for the policy:

#### *Short term policies*

Some of the short term measures include duty drawbacks and exemptions and export financing schemes and incentives. From the trade related development policy side, there are possibilities of using accelerated depreciation allowance and other mechanisms, for instance in the industrial policy. More specifically, the programme will focus on:

- Identification of fiscal and industrial policy measures to boost exports with a view to increase the quality and quantity of employment in the short term. These measures could include innovative ideas (based also on other countries' experiences) for export promotion schemes for existing sectors, export financing and incentives, and agricultural, industrial, and service sector policy options such as accelerated depreciation allowance (for industries). A trade related macro policy setting that would be most conducive to export promotion and complementarity (such as alternative demand management policies) should also be considered. Such macro policy alternatives aim at improving competitiveness of the external sector.
- Fiscal and other measures to manage imports with a view of further export promotion. This should include analyses and reassessment of experiences in

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<sup>23</sup> FDI is very important for trade generation but is an issue that is beyond of this particular task, and as such it should be addressed separately in a more focused manner.

duty drawback regimes on the basis of other country experiences. It should also include innovative tools such as lines of credit facilities, which are to facilitate and expedite transactions between international buyers and sellers.

### *Medium term policies*

Kosovo has to overcome some important issues related to trade infrastructure (trade facilitation) and high cost of doing business. While some of the infrastructural issues could only be addressed in the longer term, the general belief within MTI is that most of these issues can be addressed within a medium term period. Accordingly, some proposed actions could include:

- Identification of measures to create a level playing field for both commercial and industrial exporters in Kosovo. These include the identification and proposals for elimination of existing and future obstacles of making Kosovar exporters (in all tradable sectors) internationally more competitive. This should focus not only on exports and exporters but also imports. Establishing easy access to imported inputs and intermediate capital goods is essential.<sup>24</sup> This will also help ease possible pressures on the domestic sectors (tradable and non-tradable) after the WTO accession. This requires identification of cost of capital (and cost of doing business in general) under the trading regime requirements and incorporate measures to reduce cost of doing business in Kosovo. Equally importantly, it should answer questions related to trade, production, and financial infrastructure (general as well as sectoral) and identify the areas where the country is lacking in infrastructure and come up with operational proposals. In the area of financial sector, the importance of the development of a long term capital market to improve competitiveness in key sectors and facilitate additional (modernization) investment cannot be overstated. Further, issues related to access to credit by export oriented SMEs should be addressed. Restructuring in some of these sectors will be necessary and this can be based on other country experiences.

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<sup>24</sup> The current trend in Kosovo in terms of the increasing ratio of imported inputs and intermediary goods on final goods is plausible (see the discussion in relation to Figure 3).

Activities also need to touch upon the issues of quality control and Sanitary and Phytosanitary (SPS) measures and Technical Barriers to Trade (TBT) issues as well as issues related to trade facilitation; incentive creation mechanisms, appropriate technology transfer and best practices. Appropriate technology transfer or technology generation is particularly important as medium term activities. The kind of technology transfer required to increase competitiveness in Kosovo will also need to take into account the concerns for generating equal and sustainable employment opportunities. The kind of technology transfer and/or R&D requirements will also be determined according to the sectoral needs and structures.<sup>25</sup>

- Identification of new and emerging markets for Kosovar exports. This activity will have to include the identification of new and emerging trade arrangement patterns, including an investigation of regional and bilateral options and outlets for short and medium term export promotion. Possibilities of different trade policies (medium term) depending on the regional and country settings should also be explored. Finally, possibilities should be explored for marketing abroad and image building activities, such as retail houses, trade houses and business centres.

### *Long term policies*

In addition to these short and medium term activities, there is a need to formulate policy options that would address problems over the long term. Long term activities should emphasize mainly the domestic export oriented investment aspects (through also joint ventures that guarantee appropriate technology transfer depending on the sectoral area). Also given the great demographic advantages, possibilities like outsourcing should be explored. Some proposed actions include:

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<sup>25</sup> For instance, depending on durable or non-durable sectors or resource based products.

- Identification and application of efficiency enhancement schemes (both marketing and productive) in core groups of (existing) export sectors. This policy action would require a sectoral and sub-sectoral needs assessment exercise and development of micro-level policy options. It should also have a clear focus on SMEs. This would also include proposals on training schemes for entrepreneurs, managers and workers (both on the WTO and also sector specific issues).
- Identification of additional developmental sectors for the purpose of sustainable and employment oriented export diversification, which in turn requires identification of sectors that the country has dynamic competitive and comparative advantages. The ongoing work of IPAK should be supported and broadened with a programme which is going to perform cutting edge analysis of dynamic (and static) competitive and comparative advantages and identify sectors that have potential and sustainable export growth. The exercise should also devise measures to generate and implement incentive schemes and safeguards in these areas so that the identified sectors can be quickly operationalized and made ready for international competition (including marketing and productivity efficiency schemes, modeled as well by other country experiences). The incentive schemes should be *selective and strictly timebound* according to sectoral specifications. The training schemes for workers, which should also have to be taken up in the medium term), will include vocational training schemes for (employed and potential) workers in alternative areas of export diversification. Development and application of training and retraining and productive and efficiency enhancement schemes both for the existing capital formation and also for the new industries should take place as part of longer term policy activities. Further, piloting of the potential sectors and incentive schemes should take place.

#### **4. Institutional Change for Development Oriented Trade Policy<sup>26</sup>**

Development oriented trade policy making, discussed above requires certain steps to be taken: *first*, alternative trade policy options need to be weighed against each other. This requires ex ante assessment of their impact on human development as well as their compatibility with trade related development policies. Following the identification of most optimal trade policy, their incorporation in national development strategy is required. This means that the whole process within and across relevant ministries led by the MTI is streamlined throughout. Implementation of the trade policy comes next. The implementation and the outcomes of trade policy must be well observed throughout the transmission process from trade policy to human development and back. Finally, an ex-post assessment should be conducted and interpreted only to fine tune the next set of trade policies. The process of development oriented trade policy formulation can therefore be summarized by the following six steps (some of which overlap):

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<sup>26</sup> This part draws on the outcomes of two reports produced by Keklik and Gashi in 2009 which map the capacity assets and needs of Kosovo Institutions with regard to analyzing and formulating trade policies and their effects on poverty reduction and human development as well as to interpret, implement and negotiate trade agreements. Based on the needs assessment a Capacity Development Plan has been generated. Reports provide additional insights and outcomes on the human and institutional development in trade related institutions in Kosovo. Reports have been commissioned by UNDP.

1. Formulation and interpretation;
2. Assessment (ex-ante);
3. Coordination (including incorporation into national development strategies);
4. Implementation;
5. Assessment (ex-post);
6. Fine tuning.

This process requires a set of tangible and intangible (both traditional and non-traditional) institutions both in and outside the Ministry of Trade and Industry (MTI), in addition to the institutions and agencies that are key for the trade and investment flows in and out of the country. Institutional development and integrity is necessary to translate and apply this *conceptual* structure of policy development into *practical* cases such as the WTO negotiations and CEFTA and EU agreements in the case of Kosovo.

Kosovo's trade institutions have a good deal of technical capacity personified by the individuals in the system. However, it is individual and uncoordinated and thus scattered. Furthermore, the technical capacity is not directed towards development oriented trade policy cycle. There is a very urgent need for coordination mechanisms both in the Ministry of Trade and Industry and in the system as a whole. It should also be reoriented towards development goals in an analytical manner. In this context, the MTI proposes three areas of intervention:

1. The MTI will analyse the possibilities of restructuring so to reflect more comprehensively the development orientation and sustainability in trade policy development. Traditional and non-traditional institutions including business processes and systems will be further operationalized. MTI will seek ways to add to its ranks additional human, financial, and technical capacity in order to sustain institutional development.
2. The institutional restructuring should further enforce coordination between the MTI and the overall trade system in Kosovo. Coordination cannot be achieved if there is nothing to coordinate about. This means that the



system must identify and evaluate its vision more specifically and check it against reality regularly.

3. Trade related data and knowledge institutions must be coordinated and their activities must be consistent and coherent in the system. MTI considers that the SOK should be made the only source for trade data and analyses.