KOSOVO:

A STRATEGY FOR ECONOMIC DEVELOPMENT

19 December 2001

ICG Balkans Report No. 123
Pristina/Brussels

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ICG Balkans Report N° 123 — 19 December 2001

KOSOVO: A STRATEGY FOR ECONOMIC DEVELOPMENT

EXECUTIVE SUMMARY AND RECOMMENDATIONS

Kosovo cannot have a stable future without sustainable economic development. This report considers the task of promoting such development. After surveying the present state of the economy, it assesses the international efforts so far to lay the groundwork for future prosperity. It also considers the prospects for the former socially owned sector, including plans for privatisation and prospects for restructuring and investment.

Post-war reconstruction after the Yugoslav Army campaigns and NATO bombardment is only part of the challenge facing the international administration. Much of Kosovo's industry, long plagued by mismanagement and starved of investment, had become decrepit and would in any case have been unsalvageable.

As the official economy declined and repression increased in the 1990s, the grey economy was the only economic space – apart from subsistence agriculture – open to most Albanians. Together with remittances from relatives working abroad, this was how people survived. Thanks to the 'parallel system', Albanian entrepreneurship was well developed before the conflict of 1998-99, and quickly took advantage of the removal of Serbian domination in June 1999.

However, the remarkable boom in construction and trade since 1999 has evident limitations. It cannot compensate for the economy's structural problems. A significant proportion of the population continues to live in poverty. The reliance on émigré remittances and donor aid reveals the lack of domestic capacity in Kosovo's economy.

UNMIK's initial economic priorities were to re-establish the provision of basic goods and services, set up a minimal welfare net, and rehabilitate utilities. There has been reasonable success with the first of these priorities, and other notable achievements as well.

Business registration has been more successful than was expected. A sound legal framework for commercial activities is being put in place. The Customs Service has turned into a star performer in terms of generating revenue for Kosovo, thanks to strong international and local cooperation in training and implementing customs regulations.

Progress with the utilities, on the other hand, has been disappointing. To retain credibility, the international community needs to start delivering, especially in energy, telecommunications, water and roads. Communications to surrounding states are poor, and must be improved if economic growth and regional integration are to occur.

The international administration also needs to tackle the urgent structural problems facing Kosovo's industrial sector. There are potential opportunities for vertical integration in both agro-industry and manufacturing, which have 100 or so viable socially owned enterprises. To start developing the necessary competitive conditions, UNMIK's Department of Trade and Industry, together with UN lawyers in Pristina and New York, should establish the necessary mechanisms through privatisation, creative commercialisation, spin-offs or other means of making assets more liquid.

These economic issues also have a directly political dimension, one that affects all aspects of structural and institutional development in Kosovo. Potential investors have been deterred by the fact that they do not know which jurisdiction will finally apply. They need to have confidence that a future change in political status would not put their investment in question or fundamentally alter the environment where they would be doing business. Controversies over ownership have a similar deterrent effect.

Therefore UNMIK should press ahead with privatisation, addressing questions of property rights as they arise. It should guarantee potential investors that any final status settlement will include acceptance by the ultimate sovereign of privatisation decisions taken, and corresponding rights acquired, under international administration.

This step is both urgently needed and appropriate, given that UNMIK has restricted the competencies Kosovo's self-government institutions – now being set up after the November 2001 elections – to exclude crucial areas of economic decision-making.

Ways also have to be found to mitigate the impact of criminality. Law enforcement must be more effective, and the failings of the criminal justice system must be addressed. It must be easier as well as more profitable to act legally than illegally. Measures to increase confidence in the legal system should be implemented, such as witness and victim protection schemes, allied to a public information campaign on the damage done to society by the illegal extortion of taxes.

Kosovo's Serb population is as isolated economically as in other respects. Yet, despite the continuing mutual fear and suspicion, some contacts do take place around Serb enclaves. Fostering commercial contacts between Serbs and Albanians is not only vital in reducing the poverty and economic isolation of Kosovo Serbs. In a modest yet important way, progress of this kind in breaking down barriers between Serbs and Albanians could make a valuable contribution to addressing the broader problem of providing a safe and secure environment for a multi-ethnic society.

This report argues, in sum that there is definite scope for economic progress if the environment for privatisation, investment and restructuring can be freed up; if corruption and crime can be curtailed and education improved; if Kosovo's relations with its neighbours can be normalised, and the economy integrated into the region; if UNMIK can find the nerve to forge ahead with privatisation; and if the key outstanding political issue of final status can be addressed.

RECOMMENDATIONS

TO DONOR COUNTRIES AND INTERNATIONAL FINANCIAL INSTITUTIONS

1. Continue to provide substantial assistance, since Kosovo cannot realistically make significant progress to self-sufficiency until its final status is settled.

2. Work with Albania to develop a new road from Kosovo to Durres as an important step for better integrating Kosovo into the regional and wider European economy.

3. Press states in the region to recognise Kosovo vehicle registration plates as well as travel documents as a further step for integrating Kosovo better into the regional and wider European economy.

4. Continue to provide investment, expertise and training to the Statistical Institute of Kosovo.

TO THE UNITED NATIONS INTERIM ADMINISTRATION MISSION IN KOSOVO (UNMIK)

5. Move forward with privatisation of socially owned enterprises, which is fundamental to economic recovery, by pursuing UNMIK's Department of Trade and Industry (DTI) proposals, and extend DTI's creative

methods for commercialising socially owned enterprises.

6. Use the international community's authority to provide potential investors with guarantees that the eventual final status settlement will have to include acceptance by the ultimate sovereign of UNMIK's privatisation decisions and rights acquired under them.

7. Increase the capacity of the judicial system to deal with commercial disputes as a further urgent measure to improve the investment environment.

8. Develop as a top priority, in cooperation with Kosovo leaders, an education system capable of preparing young people to meet the demands of a modern economy.

9. Take measures, including an information campaign, to increase public confidence in the criminal-justice system, so as to encourage the reporting of crimes including corruption, extortion and high level fraud that presently debilitate the economy

10. Remove, or at least reduce, the damaging discrepancy between salaries paid to Kosovo citizens by international organisations (such as the UN and OSCE) and by the local administrative, judicial and other structures set up under UNMIK.

11. Put greater emphasis on practical, on-the-job training for local officials in administrative jobs, while maintaining the numbers of international officials in the civil administration until trained local staff are ready to take over those functions.

12. Continue to modernise the customs service including the increased use of computers to ensure accurate and reliable data.

13. Crack down on abuses of the trade agreement between Kosovo and Macedonia.

14. Push for restructuring in the agriculture sector since too many smallholders are farming undersized plots, producing yields that cannot compete with imports.

Pristina/Brussels, 19 December 2001

ICG Balkans Report N° 123 | 19 December 2001

KOSOVO: A STRATEGY FOR ECONOMIC DEVELOPMENT

I. INTRODUCTION

Kosovo cannot have a stable future without sustainable economic development. The task of establishing conditions for such development rests above all with UNMIK's Pillar IV, led by the European Union.[1]

UNMIK's task is to establish a functioning market economy based on the rule of law and attractive to investors. Post-war reconstruction after the Yugoslav Army campaigns and NATO bombardment is only part of the problem. Much of Kosovo's industry, long plagued by mismanagement and starved of investment, had become decrepit and would in any case have been unsalvageable.

The long-term prospects for growth are particularly threatened by the legacy of a decade of segregation between a Serb-dominated, ailing official economy and the unofficial economic activity within the 'parallel society' that the Albanians developed in the 1990s. While the official economy declined, the grey economy was the only economic space – apart from subsistence agriculture – open to most Albanians. Together with remittances from relatives working abroad, this was how people survived. It was an environment that offered few prospects for economic development.

Local entrepreneurial talents were released after 12 June 1999, when KFOR arrived. The high level of activity within a few days, with a wide range of food products being readily available in shops and markets, surprised incoming internationals, especially those who had expected dilapidation similar to that in Bosnia after Dayton.

There is still a striking contrast between the mostly defunct remnants of former Yugoslavia's socialist economy and the vibrant informal economy which, spurred by émigré remittances, has blossomed since the end of Belgrade's rule. This vibrancy is an unintended product of the policies imposed by the Serbs, who took over all state and socially-owned business and the education system in 1990/1, throwing out all Albanian management and keeping a few Albanians, but only as manual workers.

The legal system was also changed to hinder Albanians from engaging in open commercial and property transactions, particularly from purchasing real estate from Serbs, although transfers did occur that were either not recorded or where the title was held in the hands of a Serb stooge. These restrictions forced people to work out other ways of producing an income, thus promoting a thriving market economy in parallel to the official Serb-run one.

Obviously, sound economic development is impossible without physical security and the rule of law, neither of which is yet assured in Kosovo. Almost equally important is to build a sound financial sector capable of providing the services, especially credit facilities, that developing businesses need.

Yet these economic issues have a directly political dimension, one that affects every other aspect of structural and institutional development. Potential investors have been deterred by the fact that they do not know which jurisdiction will finally apply in Kosovo. They need to have confidence that a future change in political status would not put their

[1] UNMIK's four Pillars are: I. Humanitarian, led by UNHCR; II. Civil Administration, led by the UN; III. Democracy Building, led by OSCE; IV. Reconstruction, Recovery and Economic Development, led by the EU.

investment in question or fundamentally alter the environment where they would be doing business. Controversies over ownership have had a similar deterrent effect.

Economic development is too important and too urgently needed to await a resolution of Kosovo's long-term status. Accordingly, UNMIK should press ahead with privatisation, addressing questions of property rights as they arise. And in order to provide potential investors with the security they need for their investments, UNMIK should guarantee that whatever final status settlement is eventually concluded will have to include acceptance by the ultimate sovereign of privatisation decisions taken, and corresponding rights acquired, under international administration.

II. THE SITUATION TODAY

Although it has revived somewhat since UNMIK’s arrival, economic activity in Kosovo remains very limited. In November 2000, the province’s gross domestic product (GDP) was estimated by the World Bank at DM 3 billion (U.S.$ 1.4 billion), or some DM 1,400 per capita.[2] This is a remarkable increase from the November 1999 estimate of under DM 840 per capita.[3] This upturn follows a 50 per cent contraction during the years following Serbia’s 1989 seizure of power over Kosovo. By 1995, according to official statistics, per capita GDP had sunk to DM 840.

Nevertheless, a sizeable part of the population continues to endure conditions of severe hardship. A World Bank poverty assessment report, using data from the Living Standard Management Survey carried out in September to December 2000, covering 2,880 households, recorded that over 12 per cent of Kosovo’s population lived in extreme poverty.[4]

Remittances from émigrés are of crucial importance. The IMF estimates them at DM 1.2 billion annually – over 40 per cent of GDP. Since Kosovo's exports are negligible and the figure for imports is put at 85 per cent of GDP, these remittances, together with the DM 312 million (10 per cent of GDP) in humanitarian aid, are a key factor in financing the trade deficit.[5]

One of Pillar IV’s priorities since December 1999 has been the creation of an institutional framework as a precondition of recovery. The first necessity for developing sound economic policies is a relatively accurate data collection agency. At present, the only data available to UNMIK, the EU, and international donors comes from the Statistical Institute of Kosovo. The IMF Statistical Assessment mission established this office in July 2000 for data collection and management, as well as for implementing the business registration process. While the Statistical Institute has made progress, it needs strong international commitment

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[2] IMF (Corker, Rehm, Kostial), *Kosovo: Macroeconomic Issues and Fiscal Sustainability*, 2001.
[3] EBRD, Kosovo: Building Peace Through Sustained Growth, 3 November 1999.
[4] World Bank, Kosovo Poverty Assessment, October 2001.
[5] IMF (Corker, Rehm, Kostial), *Kosovo: Macroeconomic Issues and Fiscal Sustainability*, 2001.

for continued retraining and to bring methodology up to international standards. Without a concentrated effort to improve Kosovo's data collection, international and local decision-makers will be handicapped in their efforts to promote development.

Kosovo's official currency is the German Mark. It was introduced in September 1999 and will be replaced by the Euro early in 2002. Efforts to prepare people for the Euro have in general been poor in comparison with the countries of the Euro-zone. For example, there has been little effort to introduce dual pricing even though this has been in practice in the Euro-zone for over a year. Nevertheless, there is little doubt that most will cope with the transition. People have plenty of experience of introductions of new currencies in former Yugoslavia, as successive 'new' Dinars came and went. Adapting to ever changing exchange rates has long been part of everyday life.

As a province landlocked and dependent on its neighbours for trade, Kosovo must develop those sectors where it can find a competitive edge. Labour is abundant and cheap. There are potential opportunities for vertical integration in both agro-industry and manufacturing. There is a large concentration of 100 or so viable socially owned enterprises in these two sectors.[6] In order to start developing the necessary competitive conditions, the Department of Trade and Industry, together with UN lawyers in Pristina and New York, need to initiate the mechanisms either through privatisation, creative commercialisation, spin-offs or other means of making assets more liquid, so as to realise the potential of these sectors.

UNMIK's initial economic priorities were to re-establish the provision of basic goods and services, set up a minimal welfare net, and rehabilitate utilities. While there has been reasonable success with the first of these priorities, progress with the utilities has been disappointing. To retain credibility, the international community needs to start delivering, especially in energy, telecommunications, water and roads. Without concrete results, public pressure will grow for a change in UNMIK's management of the reconstruction effort. In one recent case, after two months of frequent and debilitating power cuts, an influential local paper called for the international head of the Supervisory Board of the Kosova Energy Cooperative (KEK) to 'go home'.[7]

A key step in UNMIK's strategy of transferring governmental responsibility to local institutions was the election for a new Assembly on 17 November 2001.[8] Following this election, the constitutional framework provides that local self-government institutions are to be set up with competence in a wide range of areas. These include aspects of economic and financial policy, fiscal and budgetary issues and some key areas of budgetary expenditure such as health, labour and social welfare, transport and communications and agriculture.[9]

However, these new institutions will have little real impact on major economic policies because the devolved competencies in this sphere are highly limited, and the Constitutional Framework leaves significant powers in the hands of the Special Representative of the UN Secretary-General (SRSG). These include final approval of the consolidated budget; monetary policy; arranging for the independent external audit of the budget; control of the customs service; control over cross-border/ boundary transit of goods; authority to administer public, state and socially owned property; regulation of public and socially owned enterprises; control over railways and civil aviation; control over the Housing and Property Directorate; defining the jurisdiction and competence for the resolution of commercial and property disputes; and appointments of the heads of several key bodies, including the Banking and Payments Authority and the Tax Inspectorate.[10] Hence Kosovo's new institutions will be in no position to tackle the main challenges to economic development. In this situation, the onus is clearly on UNMIK to take action along the lines proposed in this report.

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[6] The category of 'social property' was unique to communist Yugoslavia. Socially owned enterprises were notionally owned by the workers, although in practice communist managers were in control.

[7] 'Joe Trutschler Go Home', *Koha Ditore*, 17 August 2001.

[8] See ICG Report No 120, *Kosovo: Landmark Election*, 21 November 2001.

[9] UNMIK Regulation 2001/9 on a Constitutional Framework for Provisional Self-Government in Kosovo, Article 5.1.

[10] Constitutional Framework, Article 8.1.

A. POLITICS AND BUSINESS

Kosovo Albanians are busy, as they were during the Milosevic era, doing whatever is necessary to develop income streams to support their families. However, the difference between the early 1990s and today can be seen all over the province. Not only has reconstruction boomed: so too has internal investment. Businesses have sprung up like mushrooms. Sections of cities that were once neglected backwaters are being rebuilt. A Pristina Serb returning to check on his apartment remarked to ICG: 'The city is blossoming. They have done so much in just a year.'

Many families have multiple sources of income: remittances from the diaspora; food from farming a small plot of land; extended family enterprises such as a restaurant or small shop, all contributing to family income. Since the majority of large-scale employers await UNMIK action on commercialisation/privatisation, most have been forced to find their own ways to generate income.

Political interference in the former state companies and even public institutions by the main Kosovo Albanian parties is endemic, as politicians who were raised in an environment of one-party rule apply the only methods they know to secure power and economic benefits. In the absence of effective legal structures, and with cross-border links and parallel trading systems established over years, criminal elements are better organised, as in other transition economies, and better placed than legitimate enterprises to seize opportunities. The legal and illegal economies are separated by a wide and easily passable No-Man's Land of grey.

In 1992, in the third year of direct rule from Belgrade, the Democratic League of Kosovo (LDK), which coordinated Albanian non-violent resistance, organised a parallel election, establishing the self-declared Republic of Kosova with Ibrahim Rugova as its president. This was the cornerstone for creating a parallel society. Using funds generated from a voluntary 3 per cent tax on income both inside Kosovo and among the diaspora, the shadow parliament run by the LDK under its prime minister, Bujar Bukoshi, was able to fund a range of social programs, particularly schools and health services.

Following the 1995 Dayton Agreement which ended the war in Bosnia and Hercegovina but ignored the Kosovo problem, a split opened up between those favouring passive resistance, represented by the LDK, and others who favoured the use of violence, represented by a number of groups under the label of the Kosovo Liberation Army (KLA).

Albanians continued to pay their 3 per cent voluntary income tax. But the 'marketing' arm of the nascent KLA also targeted larger businesses and private business people. One Albanian interviewed by the ICG agreed that his donation to this group could be termed 'a reasonable extortion'.

Following hard on the heels of the incoming NATO troops in June 1999, the victorious KLA put into effect plans laid during the bombing to take over the reins of power. Using the Rambouillet framework[11] as justification, the KLA established a 'Provisional Government of Kosovo' under KLA political chief Hashim Thaci, the force behind today's Democratic Party of Kosovo (PDK). The Provisional Government not only appointed municipal councils and a central government of ministers; its supporters also put themselves in control of as many businesses as they could.

By the time UNMIK was deployed, new patterns of political and economic control had been set. International efforts to build a legal and institutional framework for a functioning market economy and to promote the restructuring and development of healthy enterprises had to deal with the new 'facts on the ground'.

While ostensibly Thaci's Provisional Government held open places for LDK, the latter refused to join, instead forming parallel structures based on former employment in the 1980s. This led to situations where some businesses had two sets of managers, oriented towards the KLA and the LDK, both formed from the ranks of those who had been thrown out by the Serbs and now wanted to reclaim their positions. There were of course varieties of combinations within this general division.

The situation was further muddied by confusion over the ownership of enterprises, stemming from

[11] Interim Agreement for Peace and Self-Government in Kosovo, 23 February 1999.

the Titoist doctrine of 'social ownership'. By the time UNMIK eventually managed to get enough people on the ground to deal with such matters, the veterans were well entrenched.[12] In many ways, Kosovo is still split among the warlord-controlled regions which arose during the conflict, and which rested on earlier power structures.

Among the major businesses created was the lucrative petroleum company Kosova Petrol, amalgamating the provincial assets of Beopetrol and JugoPetrol. The take-overs were justified by the argument that the enterprises concerned belonged to the former Albanian workers, and the managers were just getting them back to work. In the Pristina Grand Hotel, the present management took over an empty, looted facility and has ploughed back profits of some DM 12 million in refurbishing both it and other properties in the group.[13] The Peja Brewery has had similar challenges in re-establishing a market, not helped by problems due to fluctuating power supplies. Construction companies have prospered, but other businesses have struggled, including the metal-working industry and businesses that process imported raw materials. The quality of managers varies widely, from well-qualified professionals to purely political opportunists.

With no experience of running market-based commercial concerns with Western-standard accounting disciplines (and in some instances little wish for such transparency either), these sometimes self-appointed managers have effectively privatised these companies. The International Community's response has for the most part been 'don't ask, don't tell'. Moreover, the businesses that have been effectively privatised are now fair game for UNMIK's Central Fiscal Authority (CFA) to tax and regulate.

B. THE LEGAL ECONOMY

A priority for UNMIK is to bring business activities into the legal sector. Business registration was introduced by in early 2000, on the basis of registration taking place at municipality level, with fees for small enterprises[14] remaining at that administrative level while fees for medium and large enterprises were to be remitted to the central administration in Pristina.[15] As the table below indicates, business registration has met with considerable success. This information also shows the preponderance of small-scale business activities. Indeed, of the 14,669 businesses registered in December 2000, 13,256 were run by sole proprietors, while 550 were partnerships, with 80 listed as joint stock companies and 300 as private limited companies. This compares with 387 state and socially owned companies. Additionally, in December 2000 there were 14,912 so-called self-entrepreneurs, employing mainly one or two people, overwhelmingly in wholesale and retail trade.

Businesses registered[16]		
No. of employees	**31 December 2000**	**18 September 2001**
Less than 4	11,357	35,970
Between 5-9	2,627	3,694
Between 10-49	433	522
Between 50-99	92	111
More than 100	160	201
Total	14,669	40,498

These newly registered businesses are both ongoing and newly started enterprises. The ability of the CFA to enforce registration and the willingness of businesses to register is a considerable achievement, bringing business activities into the legal sector and expanding the tax base. The description of limited liability and joint stock companies needs to be viewed with suspicion, as at the time of registration in 2000, the Regulation about corporate entities had not been issued. It is possible that some private limited companies formed under pre-1990 legislation survived, but the actual number is unclear.

Over half of the registered businesses are in wholesale and retail, repair of motor vehicles, motorcycles and personal and household goods, with 11 per cent in manufacturing and a further 11 per cent in transport, storage and communications. Surprisingly, given the apparent abundance of cafes and restaurants, this sector accounts for only

[12] See ICG Balkans Report No. 79, *Waiting for UNMIK*, 18 October 1999, on UNMIK's build-up.
[13] ICG interview, March 2001.
[14] Classed as having under ten employees – paying DM 100, compared to larger businesses which pay DM 300.
[15] UNMIK Regulation 2000/8, 'On the Provisional Registration of Businesses in Kosovo', 29 February 2000.
[16] Data from the Statistical Institute of Kosovo, September 2001.

4 per cent of registered enterprises, although 13 per cent of self-entrepreneurs engage in this activity. Some 7 per cent of businesses are involved in construction.

While wholesale and retail trade is important, it can only survive on the back of a soundly based economy that provides wages to those who become the customers of the shops and importers. Types of industrial activity that might have prospects might include agro-industry and food processing, as well as higher value-added manufacturing such as textiles and engineering, where there should be room for import substitution. This in turn presumes a manufacturing base that has a high knowledge and skill input, from which the further deduction is that Kosovo's economic future depends on building a highly educated work-force. This also assumes that Kosovo's products will be competitive enough to compete with others currently produced and sold in the region.

Meanwhile Kosovo business people continue to develop what they can. The Albanian Business Union, founded in November 2000, seeks to bring together business leaders in the diaspora as well as within Kosovo, Albania and Macedonia, for mutual support, investment and trade.[17]

The initial boom in reconstruction drew on private savings, funds from abroad and other family sources. This is not an adequate basis for longer-term development. There is an urgent need for international funding agencies to provide additional lines of credit, to allow successful businesses to expand further.

A factor inhibiting foreign trade, which is associated with the question of Kosovo's long-term status, has been the issue of the country of origin on product labels. For example, the state-run winery in Suhareka and Rahovec had some 30 to 40 million litres of saleable wine in vats, some of which was bombed by NATO and some of which had 'evaporated'. Under the former regime, most of this produce went to Slovenia or Belgrade for bottling under various trade names, but also to a German customer, Raecke, for bottling under the trade name Amsfelder. In attempting to revive this link, the winery management came up against EU regulations on country of origin. These meant that the bottles had to have FRY on the label, which was unacceptable to the Kosovo Albanian management of the winery. A compromise was eventually reached involving the use of 'Kosova-BRJ',[18] but only after many months of argument. A similar episode occurred with a confectionery company in Gjakova, Jatex, which turned down orders from Swiss, German and Austrian companies worth DM 5 million.[19]

C. The Grey Economy

During the 1990s, when Albanians were largely excluded from legal economic activity, the growth of the grey sector was an inevitable side-effect of Belgrade's policies. The working practices established then continue today. The challenge for UNMIK is how best to integrate grey economic activities into the legal economy. As noted above, some notable success has been scored in legally registering businesses. The most effective policy is to make the cost of entry into the legal system relatively low, combined with a powerful audit facility to encourage compliance. As a general rule, a high possibility of being caught with a consequence of prohibitive penalties is more effective than a multiplicity of bureaucratic systems, which encourage confusion and hide real responsibility.

The costs of registering businesses are minimal. However, there are relatively few advantages to be gained and one very obvious disadvantage: it exposes a business to the CFA's auditing mechanism. On 29 October 2001, UNMIK Regulation 30 established the Kosovo Board of Standards for financial reporting and a Regime of Financial Reporting for Business Organisations. Commenting on the success of the registration process, an UNMIK official stated that 'The fact that so many businesses have chosen to register is a credit to the citizens of Kosovo. [UNMIK has] actually provided little incentive and done very little marketing to encourage participation.'[20] One lever that UNMIK is able to use in its quest to convince businesses to register is through the allocation of fixed line telephones by Post and Telecommunication of Kosova (PTK). If a business has a telephone connection, then it should be possible to require it to register. However, a

[17] *Eksklusive* magazine, December 2000.

[18] BRJ signifies Bundes-Republik-Jugoslavija.

[19] *Koha Ditore*, 3 February 2001.

[20] ICG interview with UNMIK official, October 2001.

lack of strict oversight by PTK (which is as vulnerable to cronyism as other institutions) reduces the utility of this method of catching unregistered businesses.

The tax regime is not prohibitive. There is a reasonable tax structure for small and large businesses and in interviews with various business owners, complaints have been minimal.[21] The application and enforcement of the tax regime has been bolstered by the UNMIK regulation establishing accounting standards. As one CFA official stated, 'This will not only establish accounting standards in Kosovo, based on international standards. It will also help unify the auditing processes.'[22] Before this regulation the CFA had had to establish auditing procedures without a regulatory framework. Their efforts have achieved some success in reining in old habits established under the parallel system.

The construction industry has boomed since June 1999, with some awkward results. Buildings erected illegally are a major concern to municipal authorities everywhere, with different approaches being adopted according to local pressures. The most notorious result of attempts to control such activity was the murder on 11 September 2000 in Pristina of the Director of the municipal Department of Planning, Reconstruction and Development, Rexhep Luci, a respected architect. It was widely suspected that elements behind some of the illegal buildings that Luci was seeking to demolish organised the assassination. Press reports indicated that some 3,250 structures erected between June 1999 and January 2001 in Pristina would be legalised.[23] This figure gives some idea of the scale of the activity. The municipal authorities now take a pragmatic view of the problem; buildings will be permitted unless they conflict with utility provision or are unsafe.[24] As many as 90 per cent of new buildings may be legalised in this way. As for the remainder, it will be seen if there is sufficient political will to demolish them, among international or local officials, particularly where powerful local interests are involved.

Formal fees and taxes are one thing, but traders are also subject to requests for donations from unofficial structures, allegedly sometimes associated with past KLA members and/or criminal elements, which are not in the traders' best interests to ignore. In mid 2000, there was a spate of erecting substantial monuments to the fallen heroes of the KLA for the anniversary of the end of the NATO bombing campaign, financed out of voluntary donations, estimated sometimes at costing well over DM 100,000.

There is considerable anecdotal evidence that the civilianised successor to the KLA, the Kosovo Protection Corps (KPC), supplements the slender funds provided by international organisations with donations raised locally, either directly or through the organisation, 'Friends of the KPC'. Informal contacts suggest that sums of between DM 300 and DM 3,000 per business per month are collected by organisations connected with the former KLA, a donation calculated more on the area occupied by businesses than turnover. The 'Homeland Calling Fund' in the diaspora, which supported the KLA during the conflict, also seems still to be active. An important but unanswered question concerns what happens to this and other monies levied by the parallel structures, which represent a significant drain on the economy. None of it goes into the public sphere to improve the infrastructure – roads, water supply, waste disposal and so on.

Another major factor is the inflow of funds from the diaspora, mainly from Switzerland and Germany. A study by the Kosovo economic institute, Riinvest, in 1999 estimated the effect of funds from the diaspora at a total of DM 800 million per year, or about DM 5,500 per family.[25] The World Bank calculated DM 1.2 billion a year.[26] The extent of rebuilding throughout Kosovo is one indicator of the funds available to

[21] UNMIK Regulation 29/2000, 'On the Establishment of a Presumptive Tax'. Small businesses (other than certain financial institutions) that had gross receipts of less than DM 15,000 per quarter in all previous calendar quarters pay DM 400 per quarter. Large businesses pay the applicable fixed quarterly presumptive tax plus three per cent of their quarterly gross receipts, in excess of DM 15,000. Gross receipts for banks and other financial institutions consist of income on interest, fees, and commissions. Gross receipts for all other large taxpayers means gross sales.
[22] ICG interview with CFA official, November 2001.
[23] 'Vendim i çuditshëm – legalizimi i turpit', *Koha Ditore*, 26 January 2001.
[24] ICG interviews, October 2001.
[25] ICG interview with Riinvest, February 2001.
[26] World Bank, 'Kosovo Economic and Social Reforms for Peace and Reconciliation', February 2001.

those lucky enough to have relatives abroad. Another is the number of mini-buses for hire in Pristina – imported by visiting family members simply driving them down from Germany. (It is the same with cars, ownership of which has increased significantly since June 1999.) The Prime Minister in the Kosovo Albanian parallel government of the 1990s, Bujar Bukoshi, reported to the last meeting of the Parliament of the Republic of Kosovo that a total of about DM 1 billion had been collected to support the parallel structures between 1991 and 1999.[27]

By dint of Albanians' exclusion from political or economic power, opportunities for large-scale, organised corruption in the 1990s were limited. However, corruption always existed and as new institutional structures are built it has the potential to become endemic. The basis, again, is the network of connections forged during the armed struggle between political and criminal groups with a shared interest in arms-smuggling. There is also anecdotal evidence about corruption among civil servants, for example taking money to expedite applications for public-sector jobs or other documents, such as travel papers.[28] While corruption cannot be eradicated, it must be checked. Attitudes of international officials towards such activities vary from total non-acceptance to a greater tolerance based on the experience of their own countries.

There is frequent reference in the media to the Kosovo mafia and its links with similarly inclined organisations elsewhere. There is a real fear that these organisations will become so firmly entrenched in the economy that they will be able to control the whole territory once the international community transfers power to local authorities.

Ways have to be found to mitigate the impact of criminality. Effective law enforcement is of course one very important aspect, so that people making complaints about such activities can be sure that effective justice will follow, and that their safety will be ensured. In this regard, sorting out the failings of the criminal justice system is an urgent priority. Another is to make it easier and more profitable to be legal than illegal.

A transparent bureaucracy which places only a light load on business (anathema to centralist socialist economists); taxation which is easy to understand and collect at levels which allow reasonable retained profits; effective and powerful audit procedures with punitive penalties for those caught evading the system, are some of the policies which can help this process. For most businesses, if it is simpler and as profitable to be legal, and if the possibility of being caught is sufficiently high, with severe consequent penalties, then legal is the way to go. If earning a legal living is made too complicated, there will always be a strong temptation to adopt illegal methods.

The majority of Kosovo Albanians have been taught by long experience to suspect authority. This suspicion is clearest in attitudes to the police, who have traditionally been the instrument of state oppression. It is encouraging that in some recent cases, information has been given to the police to allow them to solve some crimes. There is still a long way to go, however, in terms of public confidence in the legal system, and particularly in overcoming the cultural habit of *omerta* or silence in the face of official investigation. This applies as much to corruption and high level fraud as it does to more obvious crimes such as murder and rape. Measures to increase confidence in the legal system should be implemented, such as witness and victim protection schemes, allied to a public information campaign on the damage which illegal extortion of taxes inflicts on society. Until now, neither UNMIK nor the OSCE, which is responsible for Pillar III Democracy building, has produced a public relations campaign of this kind.

The Customs Service has been a star performer in terms of revenue generation for Kosovo, despite its officers facing physical violence, threats and intimidation. An example is the death threats made to the Kosovo Albanian head of the Customs Service, and a visit to him by the PDK's Head of Intelligence, who told him to reinstate several officers removed from the Blace Border Customs Post with Macedonia. After their replacement by other officers, revenues from that post increased by 40 per cent.[29] Customs reckons that it now collects

[27] *Raport i Punës së Qeverisë së Republikë Republikës së Kosovës për Periudhën Tetor 1991 Dhjetor 1999,* January 2000. The report gives contributions from the diaspora in a lengthy narrative form that requires fairly detailed reconstruction to obtain an overall picture.

[28] The ICG was informed that the going rate for an application to join the Kosovo Police Service was DM 1,500, and for a UN travel document, DM 1,000.

[29] ICG interviews, March 2001.

upwards of 70 per cent of excise and tax on petrol.[30]

The success of the Customs Service is largely the result of strong international and local cooperation in training and implementing customs regulations. The Customs Assistance Mission, funded by the European Commission, established a presence in Kosovo in August 1999. As with the EU's similar operations in Albania and Bosnia and Herzegovina, the mission in Kosovo set out to modernise the UNMIK customs service and establish customs practices in line with those of the EU.

Nevertheless, despite the success in revenue generation, the customs service needs to improve. Accurate recording of imports is also key to the successful implementation of the value-added tax (VAT), introduced in July 2001. The customs service must be equipped with computers at administrative border posts, rather than having officers using paper and pencil to record daily totals and then sending hand-written weekly totals to one data processing computer.

The World Bank has pointed to the lack of tax collection points along the boundary with Serbia as enabling a significant loss of revenue due to unaccounted for cigarette imports.[31] One newspaper report stated that over 95 per cent of cigarettes consumed in Kosovo enter illegally.[32] The opening of these collection points, originally due for October 2000, was repeatedly delayed by UNMIK, reportedly for political reasons – first the Kosovo municipal elections (28 October 2000), then the Serbian parliamentary elections (December 2000), then Orthodox Christmas (January 2001). KFOR also had security worries, especially after the riots in Leposavic in early December 2000. The posts were finally established in March 2001. Ironically the opening of customs collection points inside Serbia helped the process of establishing the posts in Kosovo. This move by the Serbian authorities effectively acknowledged Kosovo as a separate customs zone.

One factor that puts domestic businesses at an unfair disadvantage is the widespread abuse of a trade agreement with Macedonia. There is a general import tariff of 10 per cent, plus excise on specified goods of 15 per cent, giving a cumulative 26.5 per cent.[33] Because of a 1996 negotiated trade agreement between the FRY and Macedonia, goods from Macedonia are subject to an import tariff of only 1 per cent. This, as a World Bank report has pointed out,[34] encourages the falsification of country of origin on documents. Imports are often falsely categorised as of Macedonian origin. The 1 per cent preferential tariff also applies to any Kosovo-origin goods being exported to Macedonia, but as traffic in that direction is almost nil, the benefit of the trade agreement is at present highly one-sided. Measures should be taken, above all by the Macedonian authorities, to crack down on such abuses of the trade agreement.

D. AGRICULTURE

Although much current agricultural activity is small-scale or subsistence farming, the agriculture and agro-industry sector should have potential long term growth prospects. However, for the potential to be realised, and in order for large scale production to be worthwhile there will need to be investment in processing, marketing and distribution. The destruction by Serb forces of livestock and villages, plundering of equipment and other results of the conflict, including the laying of landmines, mean Kosovo's agricultural economy is recovering only slowly.

The Emergency Assistance Program of 1999-2000 was designed to help the rural population to rebuild their lives and economy. Priorities were restarting production of staple food crops, safeguarding cattle and sheep, and a limited restocking of cattle herds. The Program for Agriculture for 2000-2001 included continued emergency assistance to some 20,000 to 25,000 rural households which remained

[30] One of the fastest growing visible businesses is petrol stations, which have sprung up on every main road. Several interlocutors suggested to ICG that a strategic reason for this proliferation might be as reserve stocks dispersed throughout the province in case of renewed conflict. A similar reason is proposed for the number of new pharmacies.

[31] World Bank, 'Kosovo: Economic and Social Reforms for Peace and Reconciliation', February 2001. ICG interview with World Bank official, February 2001.

[32] 'Në Kosovë, mbi 95 për qind e cigareve futet ilegalisht', *Zëri*, 22 March 2001.

[33] The import tariff is charged on top of any excise, hence the additional 1.5 per cent.

[34] World Bank, 'Kosovo: Economic and Social Reforms for Peace and Reconciliation', February 2001.

vulnerable. Steps were taken to ensure adequate supplies of seed, fertiliser and agro-chemicals, the total assistance amounting to some DM 130 million. DM 66 million has been or needs to be spent on repairing and reinstating farm machinery,[35] over half of which was lost in the conflict.

Formerly self-sufficient in milk and meat, Kosovo now depends on imports. To speed up the rebuilding of herds, an import scheme for cattle is in place, costing some DM 24 million, provided mainly by Switzerland and the World Bank. One difficulty was that pre-existing private distribution chains were disrupted by the grant-funded supplies, leaving merchants with capital tied up in stock which farmers, in anticipation of getting stock for free, were reluctant to buy. It was an example of what can go wrong when well-meaning international organisations do not consult locals.

Infrastructure projects include rehabilitating the dilapidated irrigation system. UNMIK intends to invest a total of DM 92 million over the three years 2001 to 2003 in restoring irrigation schemes and capacity building in terms of management, village associations, and establishing cost-recovery mechanisms. With some 80,000 hectares in the six major irrigation schemes, this covers the principal high-value land, allowing cash crops such as vegetables to be grown.

Processing facilities are more difficult to restart, as they require investment in machinery and working capital despite much uncertainty about the quantity and quality of raw materials, as well as competition from imports. The unclear ownership of state or socially owned companies, which will be examined below, is another handicap. Companies engaged in food-processing include the Peja brewery, which also has on its books workers from the co-located sugar beet, industrial alcohol and maltings factories which formed part of the integrated complex, but are now inactive.

Apart from promoting recovery, UNMIK needs to initiate restructuring in the agriculture sector. Land holdings average 2.4 hectares, in a range from 0.5 up to 30 hectares, although there are very few of the larger size. The Department of Reconstruction estimates that some 40,000 to 50,000 families rely on farming for subsistence, and 120,000 families list farming as one of their activities. Possibly 20,000 to 30,000 holdings are commercially viable, leaving the balance as subsistence or part-time farms.[36] This is a result of the inheritance system splitting land among the sons, although in many cases one member tends to run the collection of plots for the benefit of the whole family, the rest of whom are engaged in other activities. Land is deliberately split between plots of varying quality, to give fair shares of each. While cows are especially valued, some NGOs are importing goats, which can survive on harsher feeding conditions. As fields are generally small, the economies of scale to be gained from the use of machinery are modest.

Simply, there are too many smallholders farming undersized plots, with yields that cannot compete with imports. As a result, many are hardly producers at all, instead engaging in the trade in imported foodstuffs. Locally grown fresh fruit and vegetables are hard to find in Kosovo. One local expert said that 'Kosovo has its own market but we have given it to our neighbours while our products decay in our cellars.'[37] There are signs of a similar trend to that seen in Bosnia, where the elderly and middle aged return to the land, to revert to a way of life they are used to, while the young move to the cities or emigrate. Since the end of the conflict, there has been a mass movement into the towns and cities, especially Pristina.

As with other sectors, the unavailability of sufficient credit is a serious obstacle to agricultural development. The Department of Reconstruction has put in place an Agribusiness Development Unit (ABU) which, as well as its advisory and capacity building role, has funds of DM 20 million available to support agribusiness and commercially viable farmers. It started operations in March 2001. The ABU has another DM 13 million available for seed production and horticultural development. There is no shortage of schemes. For example, the vegetable oil processing factory in Ferizaj wants to supply credit to farmers for sunflower seed, which would be processed in the

[35] UNMIK publications: Kosovo Reconstruction 2000; Kosovo 2001-2003 from Reconstruction to Growth. Funding agencies are mainly Sweden, Luxembourg and the World Bank, but also non-governmental organisations such as World Vision.

[36] ICG interview March 2001 with Agribusiness Development Unit official.

[37] Bajrush Shala, professor at Agriculture Faculty, University of Pristina, *KosovaLive*, 18 October 2001.

factory. Small dairies have already been supplying farmers with concentrates, and would like to supply cows.

E. THE KOSOVO SERBS

The Serbs' economic activity in Kosovo, like that of Albanians, survives mainly on trading and subsistence agriculture. The particularly poor state of the Serb economy is transparently obvious when driving into the Serb-inhabited enclaves. Crossing from the bustle of southern Mitrovica, where parking and traffic conditions are almost impossible and signs of private economic initiative are all around, into the Serb-controlled north side of the town is instructive. Relatively few shops are open, with limited supply. Serb civil servants and teachers working for UNMIK draw two salaries, one from UNMIK and one from Belgrade. Belgrade still pays pensions and social security stipends (unlike UNMIK). In theory this should mean that at least some Serbs are better off than before, but due to insecurity over the future, there is no confidence to spend.

Mitrovica's economy, for both Serbs and Albanians, used to depend on the Trepca mining complex. In contrast to the Albanian boom in private investment, the virtual end of production at Trepca has not been matched by a rise in private initiative among Serbs. Serb gangs had made an income from bringing in tax-free petrol, diesel and building materials from Serbia to sell on in the rest of Kosovo. However, this has been affected by the UNMIK decision to put tax collecting road blocks on the routes, which led to violent confrontations in May 2001, and the disruption of 'trade'.

Elsewhere the other two main enclaves are also stagnating. Shterpce/Strpce, a mountainous area southeast of Prizren, should have potential for tourism, with a viable ski resort as well as possibilities for sheep farming and forestry. However, the intransigent attitude of the local (now illegal) municipal authority means that there are virtually no visitors, and all the formerly Albanian-owned holiday homes and the hotels are occupied by Serbs. Gracanica, which is politically more moderate, has a few restaurants and nightclubs patronised by international officials from nearby Pristina. However, the isolation of this cut-off enclave means that there is little other economic activity.

Despite the general impression that Serbs are trapped in such enclaves, there are Serb-inhabited villages all over Kosovo, carrying on their traditional, near subsistence agricultural activities. This has occasionally been brought to everyone's attention when protests are organised, and roads around Kosovo are blocked.

Such disruption, combined with continuing high levels of suspicion, meant that initially few Albanians welcomed shopping expeditions by Serbs from the enclaves, or public commercial contacts with them. Even so, small successes in towns like Gjilane/Gnjilane, where Serbs have set up stalls for market day, offer glimmers of hope. Based on the experience of Bosnia, trading contacts could be a first important bridge to help reintegrate the two communities. Indeed, trade between northern and southern Mitrovica does take place, often through intermediaries, notably Bosniacs. UNMIK could foster such contacts by enforcing the requirement that all Kosovo vehicles be registered with Kosovo licence plates. At present, most Serbs retain the Yugoslav licence plates, which are instantly recognisable and severely limit their ability to move around freely and securely.

Fostering commercial contacts between Serbs and Albanians is not only vital in reducing the poverty and economic isolation of Kosovo Serbs. In a modest yet important way, progress of this kind in breaking down barriers between Serbs and Albanians could make a valuable contribution to addressing the broader problem of providing a safe and secure environment for a multi-ethnic society.

F. THE INTERNATIONAL PRESENCE

With at least 8,000 civilian internationals in Kosovo, the international presence has a significant impact on the economy. Staff on international salary scales have an inflationary effect, and it is common in many situations for there to be one price for internationals and a lower one for locals – as with property rents in Pristina.

Compared with the Kosovo Consolidated Budget for 2001 at DM 740 million, the UN Mission alone costs about DM 1.2 billion per year, although of course not all of this comes into Kosovo: salaries are remitted to international staff in their country of choice. The input of KFOR is not easily calculated, with the plethora of Troop Contributing Nations all having different policies, but the effect on local wage rates is similar to that made by the UN, OSCE, EU and others.

Apart from the spending power of so many foreigners paying rent, consuming and using services, international organisations distort economic conditions by paying local staff employees on a scale beyond the reach of the local economy. The UN Mission pays drivers, cleaners, security guards and so forth salaries averaging DM 1,000 per month, with some receiving up to DM 2,000.

By comparison, those local civil servants paid out of the Kosovo Budget, including teachers, judges, and members of the Customs and Kosovo Police Services typically receive between DM 200 and DM 1,000. As a consequence, anyone with even a low standard of English seeks to be employed by international organisations (especially the UN, the OSCE and the EU), to the detriment of schools, hospitals and the government sector generally. When asked how he expected to recruit well-qualified civil servants to the Joint Administrative Structure on such low pay scales, one international institution head remarked 'They [local Kosovo inhabitants] can apply for second jobs.'[38]

A related issue concerning the salary levels of local officials is the need to discourage corruption. Apart from the risk of putting off qualified potential employees, low salaries also encourage corruption in jobs which already invite it. In the case of the CFA's local auditors, international officials hope that a DM 500 monthly take-home pay will encourage performance and discourage corruption. And in the case of local customs officials, monthly salaries of over DM 1,000 are intended to stem corruptibility. As in other areas of the world where international officials work shoulder to shoulder with locals and large pay differentials exist, a balance needs to be sought, so that local employees are encouraged to participate in state institutions, but to participate honestly.

Finally, the Customs Service complains that while it is difficult enough to enforce customs compliance on local traders, too often international officials working for UNMIK, KFOR, NGOs and subcontractors escape the duties that should be applied. According to an international source in the UNMIK customs office, international officials are ready to disregard the law when it comes to their own goods or project considerations. 'They are abusing the privileges of their exemptions.'[39] Even when a rebate system was suggested which would account for legitimate non-levied imports, international staff in UNMIK objected.

[38] Interview with an international official from Pillar IV.

[39] ICG interview with UNMIK Customs Official, September 2001.

III. THE INTERNATIONAL STRATEGY

The key elements of the international strategy for rehabilitating Kosovo's economy can be identified as follows:

- Emergency relief and reconstruction
- Development of an institutional framework
- Development of a suitable legal environment
- Commercialisation and privatisation of socially owned enterprises
- Promotion of the private sector

To carry out these tasks, UNMIK Pillar IV has set up the following institutions in the financial and economic administration:

- The Banking and Payments Authority of Kosova (BPK), Kosovo's 'central bank', responsible for issuing licences for financial institutions and developing a banking system for a market economy.
- The Department of Reconstruction, with an oversight role, coordinating the EU's efforts in Pillar IV.
- The Central Fiscal Authority (CFA), including the treasury, budget office, tax administration and customs service.
- The Public Utilities Department, responsible for developing reliable utility services in a market economy complete with a functioning regulatory framework. This involves establishing functioning and reliable Public Utility Service Providers.
- The Department of Trade and Industry (DTI), charged with commercialising state-owned and socially owned enterprises and encouraging private-sector development, inward investment and foreign trade.

As well as the EU, which is formally charged with economic regeneration, the U.S. Agency for International Development (USAID) and its contractors are major players in the economic field. This has led to some tension, with some EU employees and USAID contractors complaining of 'culture clashes'. Outside the EU countries and USAID, the array of nations represented within UNMIK has provided further opportunities for disagreement.[40]

In addition to the objective challenges presented by the poor state of Kosovo's economy, the international community has faced philosophical differences among its members over such matters as the appropriate degree of state interference. Apart from the question of levels of welfare support, there is the question of state ownership of trading corporations, such as telecommunications, energy generators and distributors, and other major utilities suppliers. In general, Pillar IV favours as little state management as possible. Local business people and economists generally favour a market-based free enterprise economy, although again opinion varies as to its extent, and there are still those among the older generation wedded to a strong state role.

A debate about the accounting program instituted for the Banking and Payments Authority (BPK) typified the problems that can arise because of differences among international mission staff working on short-term contracts. A Norwegian accounting program, implemented in 1999, has led to many problems because of its complexity and unwieldiness. Despite many complaints about the system, no one has made the decision to determine if the problem is the program itself or user error. Some international officials complain that the short-term horizons of contract workers who pass through Kosovo briefly on their way to the next job militate against effective long-term planning.[41]

The philosophical, or cultural, differences among some international staff is matched by a certain clash of perceptions, or expectations, between internationals and 'locals'. Resenting what they see as a reluctance to consult qualified locals, some Albanians have the impression that they have exchanged one colonial master for another, albeit more benign. This perception is reinforced by the lack of attention on the part of international organisations involved in government to developing local management capacity. As the UN Mission reduces its Civil Administration component, there are few locals trained and ready to take over the functions of departing international

[40] For example, one EU official told ICG that he was called 'a fascist' by an international colleague after expressing strong positive views on privatisation.
[41] ICG interview with USAID contractor, August 2001.

staff. The UN needs to revise its policy and give higher priority to mentoring and training locals as replacements.

A. EMERGENCY RELIEF AND RECONSTRUCTION

Following the entry of NATO and other international organisations into Kosovo in June 1999, initial efforts were concentrated on emergency relief. The rapid reconstruction effort by Albanians themselves shortened the emergency phase, which should have been more tightly targeted to those most in need. Organisations accustomed to emergency relief in Bosnia and Herzegovina and under-developed countries in the Third World were slow to grasp the self-starting capacities of Kosovo Albanians experiencing freedom for the first time. Also, these organisations were in many cases not equipped to cope with development rather than emergency work. This meant that emergency relief was not converted into reconstruction and development aid until well into 2000.

The massive sums needed to reconstruct Kosovo's physical infrastructure have to come from donors. Pillar IV has to ensure the most appropriate use of donor funds in a setting where many donors are involved and are under no obligation to follow the EU's priority guidelines. Donor co-ordination has improved since the bulk of the work was taken over by government agencies and the smaller emergency-relief NGOs have moved on,[42] but overlap and gaps have not been removed. A particular instance was school rebuilding, where several organisations might have been competing in one village, while a neighbouring village was ignored.[43] The enormity of the restructuring required also means that even the considerable amounts of money which have been and are due to be spent will not do more than get the basic infrastructure up to a minimal level of adequacy.

The EU has led the effort to provide materials to reconstruct the estimated 120,000 war-damaged homes. Some 70 per cent of reconstruction funds have come from EU member states, operating for the most part through the European Commission. As the EU funding agency, separate from Pillar IV, the European Agency for Reconstruction (EAR) is responsible for managing the main EU assistance programs in Kosovo. In 2000-2001, the EAR had responsibility for over 547 million Euros.[44] With this large sum, the EAR prioritised the reconstruction of Kosovo's neglected infrastructure, concentrating on energy, housing, transport and water supplies as well as ancillary projects in agriculture, enterprise development, health, and local government/civil society.

By the end of 2000, the EU reported that over 40 per cent of war damaged homes (50,000 of 120,000) still needed rehabilitation.[45] The same report noted that the Albanians themselves had led the housing reconstruction boom. 'The majority of those which have been repaired or reconstructed have been done so by Kosovars themselves without donor assistance.'[46] The reconstruction boom was coupled with a construction boom. Many Albanians are finally building their 'dream house' now that they no longer fear the risk of losing this capital investment (for Albanians to build a large home during Serb rule was to invite trouble).

Moreover, as noted above, population movement from rural to urban areas is occurring rapidly all over Kosovo. An EU assessment stated that:

> Illegal building activities have spread widely, which affects the spatial development of Kosovo as a whole and the environment of both towns and villages. This has placed added pressure on the already stretched urban infrastructure including electricity and water supplies, sewage, garbage collection, and transport. There is no central government capacity to regulate urban and spatial planning and the capacity of municipalities to undertake this function is limited or non-existent. The result is inconsistent and erratic application of existing planning regulations and

[42] At the height of the emergency phase in late 1999, there were over 400 NGOs registered with the UNHCR/OCHA Humanitarian Community Information Centre in Pristina. This number had halved by early 2001.
[43] ICG interview Department of Reconstruction.
[44] European Agency for Reconstruction website.
[45] European Union, *Kosovo 2001-2003 from Reconstruction to Growth*, December 2000, p. 34.
[46] Ibid.

> building laws. Uncertain ownership of property, including housing, creates additional problems. All these issues will need to be addressed in 2001.[47]

As this EU assessment identified, patterns of population movement and new construction have important repercussions for infrastructure reconstruction. Rebuilding Kosovo's neglected and decrepit infrastructure, in such areas as power generation, water supply and communications, is a far greater challenge than the relatively simple task of rebuilding and repairing damaged housing stock. Dissatisfaction with the perceived slowness to bring about improvements, as seen, for example, in the continued incidence of power cuts and water shortages, is widespread. However, the sheer challenge of ensuring the current supply and rebuilding an adequate infrastructure for the future is enormous. In many ways it is still too early to judge the success of the EU's infrastructure programs.

1. Telecommunications

A significant sector requiring redoubled efforts by the international community is telecommunications. The pre-1998 telephone penetration rate for Kosovo was only six lines per 100 inhabitants (the second lowest rate in Europe.) The PTK (Post and Telecommunications of Kosovo) runs at a loss but has succeeded in increasing revenues through the Alcatel Mobile network. In 2001 more donor money (DM 1.7 million) was allocated for 'planning, management and finance' and the postal service than for telecommunications (DM 210,000). This order will be reversed in 2002-2003, but the pressing need for reliable telecommunications services remains.[48]

The lucrative mobile phone concession triggered significant discord between the local PTK leadership and UNMIK's Joint Civil Commission (JCC) on Postal and Telecommunications Services over selecting the contractor. The decision in November 1999 to award the concession to Alcatel-Monaco rather than to Siemens foreshadowed the disputes that would arise over determining management and ownership of state and socially owned enterprises. The UN settled on Alcatel despite strong support for Siemens from the Albanian management in PTK.

'As I understand it, they have the right to supervise – and they are doing that – but not to stop us and to give us solutions,' Agron Dida, PTK's general manager, was quoted at the time. 'The owner of this company is the people of Kosovo, not UNMIK.' The UN took a different view, backing the JCC's decision in favour of Alcatel. 'PTK is not a private company but a public company. And so the JCC has the rights of an owner that would be the rights of a shareholder in a private company,' said Pascal Copin, UNMIK's director of post and telecommunications. Dida also stated that PTK's objections to the Alcatel stemmed primarily from a plan to use a main switch, which routes all calls in the network, and billing system in Monaco.[49]

Alcatel has been persistently criticised for high rates and poor service. Businessmen are carrying three or four phone contracts (Kosovo, Yugoslavia, Macedonia, Montenegro) because the pre-paid rates are more competitive and the cost for purchasing a roaming contract from Alcatel is prohibitive. In 2003 there will be an open bidding process for the Kosovo mobile phone network.

2. The Energy Sector

The biggest immediate challenge is the energy sector. Making the electricity grid operational again was an international priority from the outset. The whole system had been run down. Albanian former employees came to reclaim their jobs at the Kosova Energy Cooperative (KEK), and worked without pay in appalling conditions to restart the coal mines and generating plant at the heart of the system near Obiliq/Obilic. The KEK senior management (self-appointed with the agreement of the Interim Administration) had little recent management expertise, and their technical knowledge was a decade out of date.

The Department of Trade and Industry (DTI) put in a contract management advisory team, without any executive powers, to help the local staff organise the reconstruction and operation of the system, which the locals resented, and this was

[47] Ibid, p. 35.
[48] Ibid, p. 26.
[49] Reuters, 'Row Erupts over Kosovo Mobile Network Contract', 16 November 1999.

compounded by various contractual disagreements between the consultants and UNMIK. UNMIK set up an Emergency Task Force for Utilities which brought some coordination to power cuts during the hard winter of 1999—2000. The state of the equipment prevented much orderly planning. Because the main 400 kV transmission lines were down, preventing imports from other Balkan countries, power was imported from Serbia, and to a lesser extent from Albania, on the less efficient 220 kV lines. Another major problem, with a persisting legacy, is that the policy on coal extraction in the latter period of Serb control was extremely short-term, resulting in shortfalls in coal supplies to the generating plant.[50]

The lack of management expertise among Albanian staff meant that crises arose frequently because of a lack of planning for essential chemicals to treat the water and oil to restart the generators, requiring frequent emergency resupply of these items, at considerable cost. During 2000, one of the two generators was overhauled at the more modern power station, Kosovo B, and the high voltage 440 kV transmission lines were restored. Import agreements were negotiated with Bulgaria, Romania and other neighbouring countries.

This allowed a more consistent power supply at about twice the levels of the previous year during the milder 2000—2001 winter, and gave more time for the coal mines and power stations to be brought back into some sort of order. Even so, distrust of Serbia re-emerged during the negotiations over imports. Kosovo's power system was designed, built and operated as an integral part of the former Yugoslav one, and all switching for imports is still controlled by the Serbian Power Company (EPS). This caused the KEK management to boycott the discussions, until Pillar IV convinced them that the only alternative was another winter without power.[51]

Despite the progress achieved, breakdowns have continued. Once Kosovo B is fully refurbished, the potential supply of electricity is about 560 to 600 MW, well above the summer demand and almost sufficient for winter consumption. But after more than two years of international rule problems still persist, and Kosovo A, although strictly speaking at the end of its normal life, will have to limp on for another five to seven years. Two independent consultants have agreed that this is possible and would represent the best economic choice. In the short term, a peaking generation plant will need to be constructed as an interim step until a new base load lignite fired production facility is built.

KEK is also hindered in its operations by lack of payment by consumers for electricity. In a country where jerry-rigging of links to power lines is common, there has been mass population movement, and even if the correct name can be attached to an address, the meter hasn't worked for years, organising a customer base and a billing system will be stiff challenges. Correcting this situation is a fundamental plank of UNMIK's strategy for the sector, and further financial subsides for KEK depend on getting revenue collection back to an acceptable level. This is a key objective for the management contractor who will come in to run KEK.

3. Transport and Regional Integration

Despite the efforts already undertaken to repair damaged roads, transport infrastructure remains inadequate in many areas, even by regional standards. Building modern highways is for now the stuff of dreams at a time when many existing roads are in dreadful disrepair. Poor transport connections are also an important factor inhibiting Kosovo's integration into the regional economy. Kosovo businesses are disadvantaged by the fact that Kosovo-registered trucks are unable to leave Kosovo as the registration plates are not recognised in most countries in the region, including, crucially, Macedonia and Serbia, which are the most accessible routes for trade to and from Kosovo. Individuals get round this problem either by having two sets of licence plates or by cross loading at the border. The international community should press for recognition of Kosovo registration plates as well as travel documents by states in the region.

[50] Cutting down the width of the terraces from around 100 metres to about 30 metres meant that excavators had to dig away seven times more overburden (the earth and rock above the coal seam) than coal. A phased return to wider terraces is in hand which will lead to a one-to-one ratio of overburden to coal by 2002.

[51] The Albanian managers were even proposing as an alternative the digging of as much coal as possible to the detriment of the mines' longer term viability. ICG interviews, February 2001.

The surge in trade and construction-led economic activity in Kosovo since 1999 has sucked in imports, including from countries in the region such as Macedonia, Slovenia and Croatia. The lack of productive capacity in the two years since the end of the conflict largely explains why the province's trade balance is heavily skewed in favour of imports, with the deficit being financed by diaspora remittances and donor aid.

A start-up project well worth pursuing would be to provide Kosovo with an easy outlet to the sea through Albania. There have been proposals from some quarters to build a modern road to Durres, as a much-needed alternative to the existing routes to Macedonia and Montenegro.[52] The existing route took such a pounding from international traffic in 1999 that NATO promised the government of Albania to rebuild it. Nothing was done. The recent closures of the border crossing into Macedonia at Blace/General Jankovic confirmed Kosovo's vulnerability to pressures from its neighbours. The route through Montenegro is long and has low capacity. Given the recent troubles in Macedonia, UNMIK and the EU should start serious planning with Albania for the Durres option as an important long-term contribution to Kosovo's normalisation and also to regional integration.

B. THE LEGAL FRAMEWORK

A basic requirement for investment is a high degree of security and predictability. This requires both the very important physical environment of security against crime, violence, riot and intimidation, but also a clear framework of law in which rights are protected and obligations can be enforced. Putting in place a sound legal framework is therefore a vital prerequisite for building a sound economy.

In Kosovo, discussion of the legal framework inevitably leads to the question of final status: will the province be restored to Yugoslav sovereignty, or will it become fully or conditionally independent? The total uncertainty on this issue inhibits serious investment by internal or outside agencies, given the possibility that jurisdiction might be returned to Belgrade, which would not necessarily recognise agreements made or titles acquired under UNMIK.

For serious internal investment or foreign direct investment to commence, property ownership – always a difficult issue in former communist states – must be clarified. Before investors can be expected to take over the 100 or so formerly state-owned enterprises or the 350 or more socially owned enterprises (SOEs) in Kosovo, they need to have security for their investment. More will be said about privatisation below.

So long as the question of long-term jurisdiction is not resolved, measures will be needed to provide guarantees about property and the rights of investors. If certain issues of property ownership and jurisdiction cannot be resolved for the time being, creative ways need to be found to provide an adequate interim legal environment. The World Bank, for example, has managed to get around the problem that Kosovo is not a sovereign entity. As the UN administration was set up under a UN mandate, the Bank has been able to provide assistance.

The legal infrastructure for commercial activities is gradually being put in place. As already discussed, business registration procedures were formalised in March 2000,[53] with municipalities allowed to retain the fees for small businesses, while remitting fees for medium and large enterprises to the central administration. Since the end of December 2000, Regulations have been signed on Contracts for Sale of Goods, on Foreign Investment, Pledges and on Business Organisations. In May 2001 the regulation setting up value-added tax in Kosovo was promulgated, becoming effective in July. Other measures were introduced in September and October 2001: a pilot program for taxes on immovable property, insurance regulations, measures against organized crime, payment transactions regulations.[54] Regulations on

[52] Apart from NATO's unfulfilled offer, there have been two recent proposals. One was made by the billionaire Behgjet Pacolli to the Albanian government, and another came from former Prime Minister of the self-styled Government of the Republic of Kosova, Bujar Bukoshi. The cost has been estimated at around U.S.$ 300 million.

[53] UNMIK Regulation 2000/8, 'On the Provisional Registration of Businesses in Kosovo', 29 February 2000.

[54] UNMIK Regulations 2000/68, 'On Contracts for the Sale of Goods', 29 December 2000; 2001/3, 'On Foreign Investment in Kosovo', and 2001/5, 'On Pledges', 7 February 2001; 2001/6, 'On Business Organisations', 8 February 2001; 2001/11, 'On Value Added Tax in Kosovo', 31 May 2001; 2001/23, 'On the Pilot Program for imposition of Taxes on Immovable Property in

Bankruptcy and Mortgages are to come. In its report on Kosovo in 2000, the World Bank highlighted the essential elements of a regulatory framework, of which competition laws and mechanisms for settling disputes have still to be established.[55]

Other business-related measures have included the introduction of a Presumptive Tax,[56] Hotel Food and Beverage Tax,[57] and a Sales Tax.[58] Equally importantly, excise taxes on a range of goods were introduced.[59] These were specifically not called customs duties, as they may be levied on internally manufactured products also. This avoided any question of Kosovo's status and therefore UNMIK's legal right to charge duties on goods being imported from Montenegro or Serbia. The range included the usual tobacco, alcohol and gasoline products as well as soft drinks, coffee, mobile phones, video cassette recorders, satellite dishes and television sets.

Of particular significance has been the introduction of VAT in July 2001. The average monthly revenue generated from VAT has been some DM 30 million. This more than triples the revenue generated by the sales tax introduced in January 2000, and which VAT replaced.[60] From the point of view of the average consumer and business person, VAT has appeared a complicated and often baffling tax. However, despite such teething problems, as in other transition economies the introduction of VAT is an important step, more efficient than the sales tax and in line with Western Europe.

Enforcing regulations is the biggest challenge. To this end, the Central Fiscal Authority (CFA) has trained over 200 tax auditors, with over 90 working in Pristina, responsible for ensuring that all businesses comply with tax regulations. These front line auditors are combing the communities encouraging compliance and wielding penalties that help jar the memories of tax evaders or avoiders. Evasion carries a penalty of 50 per cent of the total tax owed. This rises to 100 per cent if the auditor finds that no records or books have been kept. For not filing a return, the penalty is 5 per cent per month.

C. THE FINANCIAL SECTOR

International efforts to develop a sound financial sector, capable of meeting the needs of a modern economy, may have been aided by the collapse of the former financial system in 1999. By contrast with Bosnia, for example, Kosovo is largely unburdened by the complex vestiges of the old Yugoslav system. For example, replacing the former state payments mechanism, the Public Payments Bureau, has proved enormously challenging in other parts of former Yugoslavia. In Kosovo, where the Payments Bureau ceased to operate in June 1999, the international community decided to get it right from the start. The system was quickly subsumed, together with the National Bank of Kosovo, into the Banking and Payments Authority of Kosovo (BPK), established by the former head of UNMIK and Special Representative of the Secretary-General, Bernard Kouchner, on 17 November 1999.[61]

As Kosovo uses the currency of another country (Germany), the BPK is not responsible for monetary policy. Otherwise it performs most of the functions of a Western-style central bank. It has professional banking senior management. Its primary responsibility is licensing banks and other financial institutions. It also provides banking and payment services for public entities, as well as operating clearing and payment services to Kosovo's banks. As of September 2001, the BPK had licensed six commercial banks, and, as the banking regulator, closely monitors their progress. In July 2001 the BPK reported DM 47,929 million in outstanding commercial loans and DM 507,035

Kosovo', 29 September 2001; 2001/25, 'On Licensing, Supervision and Regulation of Insurance Companies and Insurance Intermediaries', 5 October 2001; 2001/22, 'On Measures Against Organized Crime', 20 September 2001; and 2001/26, 'On Payment Transactions', 8 October 2001.

[55] World Bank, 'Kosovo Economic and Social Reforms for Peace and Reconciliation', February 2001.

[56] UNMIK Regulation 2000/29, 'On the Establishment of a Presumptive Tax', 20 May 2000.

[57] UNMIK Regulation 2000/5, 'On the Establishment of a Hotel, Food and Beverage Service Tax', 1 February 2000. This was designed primarily to tax foreigners, the main users of hotels and restaurants.

[58] UNMIK Regulation 2000/3, 'On Sales Tax in Kosovo', 22 January 2000.

[59] UNMIK Regulation 2000/2, 'On Excise Taxes in Kosovo', 22 January 2000.

[60] ICG interview with Central Fiscal Authority official, November 2001.

[61] UNMIK Regulation 20/1999, 'On the Banking and Payments Authority of Kosovo', 15 November 1999.

million in deposits for Kosovo's (then) four commercial banks and other non-bank financial institutions. As of October 2001, BPK reports no non-performing loans in any of the banks' portfolios.[62]

The first bank to receive a licence was the Micro Enterprise Bank (MEB). The MEB is backed by a consortium of west European banks and financial institutions, and has west European management. It opened officially on 24 January 2000. As of October 2001 it had about DM 200 million in deposits, mainly invested in Western European securities. Its loan program, geared to small-scale loans, is on track with its business plan, although it could expand its local lending considerably given the extent of its deposits.

Banke e Re e Kosoves, funded by Kosovo businesses, was granted a full licence on 9 February 2001. The largest shareholder is a consortium of workers of the Kosova Hotel and Tourism Company, a socially owned enterprise which operates the Grand Hotel in Pristina, and other hotels and restaurants in the city. The Peja brewery is also a shareholder in this bank. Although the brewery anticipated receiving credit from the bank, to-date Banka e Re e Kosoves has not extended a credit line to its shareholder.[63] This expectation on the part of the Peja brewery highlights the mentality reported in a recent World Bank document, which harks back to the bad practices of communist Yugoslavia:

> There is a tendency on the part of older bankers in Kosovo, whose activity was curtailed in the 1990s, to return to practices of the 1980s, when enterprises owned the banks. This spawned a non-commercial orientation of the banking system, which relied on connected lending, excess concentration, distorted classifications, and a passive role whereby banks merely disbursed credits to their enterprise owners.[64]

As of November 2001 another three applications for banks funded by consortia of Kosovo Albanians were being processed by the BPK, which is concerned to ensure that their financial backing and their policies are as sound as possible. With lending to any one borrower or related group of borrowers restricted to 20 per cent of capital to ensure adequate liquidity, bank loans are very limited (a maximum of DM 600,000 on the lowest capitalisation of DM 3 million). As an aside issue, the question of compensation by Serbia for the foreign exchange funds misappropriated by Belgrade from the Bank of Kosovo in 1991 has been raised with the Belgrade authorities, although no resolution looks imminent.

A key negative consequence of the shortcomings of the banking sector is the difficulty that businesses experience in gaining access to credit facilities. As an alternative way to meet this need, on 22 October 1999 the SRSG signed a Regulation authorising financial institutions other than banks to make micro-credit loans of up to DM 2,000 to individuals and small businesses.[65] Since then, ten non-banking credit organisations have been licensed, almost all for micro-finance.

The pilot phase of a Rural Micro-Finance Project started in November 2000 in Kline and Vushtrri/ Vucitrn, offering village-based credit and savings associations, with the aim of expanding to 72 associations, covering one-third of villages in Kosovo by the end of four years. Initial capital of DM 4 million was provided equally by the Agence France de Developpement and the EU, with DM 20.9 million funded for Phase Two and DM 25 million still to be funded for Phase Three in 2003 and beyond. The World Bank and EU are co-financing a Small and Medium Enterprise (SME) Programme with an investment of DM 20 million, targeting all such enterprises, including light manufacturing, high value-added services and agro-processing.

While the size of loans is appropriate for very small enterprises, the terms contain a risk factor with typically interest rates above 15 per cent, usually 18 per cent, and a maximum repayment period of three years. It is recognised that this support meets only a fraction of the finance required. In the agricultural sector, the Agribusiness Development Unit provides credit at

[62] ICG interview, October 2001.
[63] ICG interviews, February and November 2001.
[64] World Bank, 'Kosovo Economic and Social Reforms for Peace and Reconciliation', February 2001, p.71.
[65] UNMIK Regulation 1999/13, 'On the Licensing of Non-Bank Micro-Finance Institutions in Kosovo', 16 October 1999.

more attractive rates – between 9 and 12 per cent, with repayment periods of up to eight years – drawing from funds of nearly DM 60 million provided again by the EU.

USAID is establishing a loan fund for small and medium-sized enterprises with a local partner—the Kosovo Business Finance Fund. After initial kick-start funding, the aim is to transfer gradually to locally generated funds. It will be run on a commercial basis, aiming at relatively short-term loans from DM 40,000 up to DM 400,000 and eventually should develop into a full service bank. The absence of a proper banking and credit system with more competition is acknowledged both by UNMIK and by the local bodies involved with business as seriously inhibiting commercial development.

D. COMMERCIALISATION AND PRIVATISATION

Until 1991, Kosovo's economy was an integral part of that of former Yugoslavia, of which it was the poorest and least developed part. Industrialisation did not really occur in Yugoslavia's backwaters until the mid 1970s. Socially owned enterprises (SOEs), which provided the bulk of employment before 1989, received virtually no investment after the downturn in Yugoslavia's economy in the early 1980s. In addition, much useful equipment was removed to Serbia proper during the 1990s. Kosovo's SOEs were primarily geared to servicing a captive Yugoslav market, a market which has disappeared both because of the wars since 1991 and because the installed technology is completely out-of-date. Such enterprises are thus doubly disadvantaged.

Kosovo's Department of Trade and Industry (DTI) puts the number of SOEs at 350 or more, with over 60,000 current employees. About half of these are still 'employed', with the other half on unpaid leave. The SOEs were formally managed by those who worked for them, but were in practice mostly run by Communist Party managers. Of these, approximately one-third are still considered viable. The second third may have some assets of value. Continued neglect is eroding this residual viability and this value. The remaining third are considered defunct.

A survey of 192 SOEs by the Kosovo research institute Riinvest found that most were operating well below capacity.[66] The principal inhibiting factors, according to those surveyed, were the lack of financing, non-competitive technology, damages from past management and the war, and UNMIK's uncertainty over the character of social ownership. Of the 42,581 employees in the surveyed companies, only 24,662 (58 per cent) were actively employed, some 16,000 were on unpaid leave and 3,300 were staying at home on pay. Average monthly pay was around DM 200, which, according to the report, was about 2.3 times smaller than for workers in private companies. The survey also found that the majority of companies (83 per cent) were in favour of privatisation. Only 10 per cent were against the privatisation process. Of private enterprises included in the survey, 78 per cent favoured privatisation and were ready to participate in the process, including by buying shares.

Many of the SOEs are large conglomerates with diversified assets. Their present shape is a result of the cronyism, waste, and mismanagement that reached new levels during the turbulent 1990s. Milosevic often rewarded his supporters with stakes in state-owned enterprises, and Kosovo's SOEs were no exceptions to this rule. This period saw a number of highly dubious privatisations in which enterprises were turned over to Milosevic loyalists. Today the status of such enterprises is unclear. Even if privatisation were to be pushed for all enterprises forthwith, commercial banks would not be ready to lend significant amounts, given that essential documentation necessary to determine value is unavailable. A common view within the DTI is that such dubious deals involving SOEs that occurred in the 1990s should be annulled. They argue that ownership laws deemed unenforceable should also be deemed invalid.

The question of how to treat these privatisations from the 1990s highlights the broader problem over determining ownership of the SOEs. UNMIK feels that it is on a political leash held by the UN's Office of Legal Advisors (OLA) for the SRSG. The OLA's paramount concern is not to take actions over privatisation that could be seen as prejudging the final status decision by finally resolving property rights. Such lack of clarity over

[66] Riinvest, 'Social Enterprises and their Transformation/ Privatisation', March 2001.

ownership of property and other assets in state or socially owned businesses inhibits their sale.

The difficulty of establishing ownership of former socially owned enterprises has given rise to a lengthy debate within UNMIK about ways to reduce state involvement in the state and socially owned sector. The Department of Trade and Industry (DTI) has pushed for options to privatise enterprises, spin off their assets or liquidate them. UNMIK has the fiduciary responsibility to get such enterprises working and not to allow their assets to go to waste. Inaction over dealing with the SOEs today will cost more in the long run, as assets are left to decay. A cynical (and somewhat simplistic) view expressed by an Albanian manager awaiting privatisation was that 'If UNMIK succeeds in making the socially owned enterprises seem non-viable, than they will become non-viable.'[67]

Privatisation is the DTI's preferred option for potentially viable SOEs. Perhaps using legislation from before the break-up of former Yugoslavia, small and medium-sized SOEs should be converted into limited liability companies, with 60 per cent of the equity going to employees and 40 per cent held by the state, in the form of a Kosovo Trust Agency (KTA). Any new investor bringing new capital could then buy shares from the employees, or come to an agreed division of ownership in terms of new share issues, as in normal market economies. In some SOEs which have restarted production under their former management, workers contribute to an investment fund. One such example is the Peja brewery, where employees donate 10 per cent of their salaries.

This proposal has met with interest and scepticism from UNMIK and the UN in New York, and not only due to the fear of prejudging Kosovo's final status. The UN legal team does not want any action taken on businesses that could make the UN liable to the undetermined final owners of such businesses. The DTI's commercial law advisors argue against doing nothing and see the trust option as an optimal way both to fulfil UNMIK's fiduciary responsibility and to respect any serious claims that will arise after final status issues are resolved. Ongoing negotiations between the Pillars may lead to preliminary privatisation regulations, but given the differing priorities of the UN lawyers and the DTI, the gap is difficult to close.

However, privatisation of SOEs cannot wait for the resolution of Kosovo's final status. In order to give the economy the necessary boost, UNMIK should press ahead with privatisation and in so doing address questions of property rights as proves practically necessary. To provide potential investors with the security they will need before risking important money but without prejudging how status questions will finally be resolved, UNMIK should guarantee that part of an eventual settlement of Kosovo's status will have to involve confirmation by the ultimate sovereign of its privatisation decisions and the related rights acquired under international administration.

Although many international officials argue that privatisation is not the panacea for Kosovo's economy, it is the best way for many potentially viable SOEs to attract much needed investment. Potential investors have lobbied for changes to the current do-nothing policy. But such interest will not last forever.

For other SOEs with assets worth salvaging, it is suggested that these could be spun off and transferred to new owners at market value. This option is particularly suitable for the type of conglomerates that were so common in Kosovo, some of whose assets may have value although parts of the business are defunct. For some SOEs that are considered defunct, the best option is bankruptcy, with the residue of assets being held by the KTA.

Although privatisation is the DTI's favoured option, in order to leap-frog the legal roadblocks which obstruct outright privatisation, the DTI has proposed 'commercialisation' as a provisional phase of resuscitating SOEs. The approach is to develop management contracts with companies already operating in the relevant sector. This allows the assets to be utilised for a specified amount of time without prejudicing final ownership. Contracts, which run for ten years, require the successful bidder to invest a stated amount to bring the facility back into production, and then run it. The first to be signed was for the Sharr cement factory near the main border crossing with Macedonia, where Holderbank is committed to invest DM 32 million over the ten years of the contract.

[67] ICG interview with an employee of a socially owned enterprise, August 2001.

A number of other commercialisation contracts have followed. In early March 2001 a successful bid was made for the Prizren Slaughter House by the Pristina-based Fructus company, which will invest over DM 5 million in the facility, DM 1.2 million in the first three years of the agreement. Fructus is one of the first private companies founded in Kosovo (1989), wholesaling and retailing food products throughout the province.[68] The DTI is currently preparing other companies for commercialisation contracts. By late 2001 there will be investment commitments of over DM 100 million.[69]

While bidding out management contracts may be an effective way of getting otherwise derelict operations back to work, the actual number of jobs so far created and sustained by these commercialisations is reckoned at around 2,500. This amounts to about 1.8 per cent of the estimated SOE work force in 1999. Thus the commercialisation option is only a poor second-best to full privatisation.

1. The Case of Trepca

An issue of particular political as well as economic significance is the Trepca conglomerate. This consists of some 40 mines and factories located mostly in Kosovo, but also in Serbia and Montenegro. Its activities include chemical processing and production of goods as varied as batteries and paint. The heart of its operations and the source of most of its raw materials is the vast mining complex east of Mitrovica in northern Kosovo. It is badly run-down as a result of under-investment and poor management.

Trepca has assumed a symbolic significance for Albanians and Serbs that probably outweighs its economic potential, and the issue of control over the mines has assumed tremendous symbolic significance. Accordingly UNMIK has adopted a much more hands-on approach than with other former SOEs, becoming directly engaged in its affairs.

The actions of the Milosevic regime introduced huge confusion over the ownership of the complex. This may have been deliberate in order to exploit the resources, evade international sanctions, disguise the money flow, reward favoured cronies and, probably, launder money.

UNMIK's position is that it claims full legal authority under UNSCR 1244 to support the reconstruction of key infrastructure and other economic reconstruction. This entitles UNMIK to preserve and maintain the Trepca facilities, but it has not assumed physical ownership of Trepca assets, and has no comment on competing claims for ownership or compensation for past losses, some of which are currently subject to court cases in various countries.

Moreover, UNMIK reserves the right to press legal claims on an eventually proven owner for clean-up costs arising from past production practices and the pollution that resulted, which may exceed the value of the facilities themselves. A further financial penalty that any proven owner might face would be liability for the health problems caused to workers and others affected by pollution from the plants. A USAID-funded environmental audit of six mines, all three concentrators and the two metallurgical plants early in 2000 found that past practices had resulted in widespread and extensive environmental degradation.

Evidence about the extent of lead pollution from the Serb-run smelting plant at Zvecan, coupled with the refusal of the RMHK TREPCA controlled management to co-operate with UNMIK to resolve the problem, gave KFOR and UNMIK the political justification to take over the plant on 14 August 2000. The Milosevic-appointed director was barred from re-entering Kosovo, and the 2,320 Serb workers who signed on were immediately paid monthly stipends of DM 60 (importantly, in Deutsche Marks, not Dinars) by UNMIK. After a few days of

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[68] Other successes include: a contract to run the Progres agricultural processing factory in Prizren, won by local companies Elif 19 and Abi in March 2001; the Betonjerka concrete factory in June 2001; chicken and fish farms, and a polyester plates and moulded goods factory in July 2001;, a sunflower oil producer in August 2001; a textile and handicrafts enterprise in October 2001; and a bricks and blocks factory in November 2001.

[69] ICG interview with DTI official, September 2001.

demonstrations, calm was restored, and UNMIK was able to put in mining and environmental engineering consultants.

UNMIK has secured some donor support from the European Agency for Reconstruction and the Netherlands for the massive environmental clean-up that is urgently needed. Given the confusion over ownership, the uncertainty linked to final status and the scale of outstanding liabilities, securing a future for at least some elements of the Trepca conglomerate is especially problematic. UNMIK's preferred option is to encourage all stakeholders to sign a standstill agreement which allows commercialisation through leasing arrangements to commence, rather than undergo a long drawn out bankruptcy procedure. The current debts and liabilities would remain with the rightful owners, who may be identified eventually by a competent court.

IV. INVESTING IN PEOPLE

The long-term prospects for the economy lie in making the best use of the province's most prolific resource – people. Given the backwardness of Kosovo's economy and its incapacity to absorb the rapidly expanding population – quite apart from the difficulties of living under Serb misrule – emigration, whether temporary or long-term, has been the only way for large numbers of Kosovo's population to make a dependable living. This emigration is composed mainly of guest workers in Western European countries. This pattern is likely to continue for some time to come.

In addition, a significant portion of Kosovo's income comes from the diaspora. Given the predicted shortfall in indigenous populations of working age in the countries where the Kosovo diaspora live, especially in Western Europe, a change in immigration policy to give greater flexibility to such guest workers could have advantages for all sides. To ensure greater social stability, immediate family members (spouse, children) should be allowed to accompany the worker.

To enhance the prospects for people to work productively within Kosovo, improved education opportunities are of key importance. Kosovo needs to develop an education system capable of preparing people to meet the demands of a modern economy. This is especially so given the age profile of the Kosovo Albanian majority of the population, with over 50 per cent under 22 years of age.[70] Changes in syllabus are needed; there should be no return to the emphasis on liberal arts that characterised higher education in the 1970s and 1980s. Kosovo needs skilled engineers, technicians and managers. Adult education and training are also vital, for both economic and social reasons.

One of the legacies of the previous centrally run economy, aggravated since 1990 by the apartheid system imposed by Belgrade, is the lack of competent managers, including people with skills in personnel, accountancy, marketing, strategic planning and company direction. Technical skills are decades out of date, as has been noted. Add to these knowledge gaps, an educational system

[70] Kosovo Institute of Statistics.

based mainly on learning-by-rote, instructive rather than explorative methodology, with school directors appointed for their political connections and it is obvious that there are major structural defects to be put right.

It is not just a case of teaching the students, but teaching those who teach the teachers. For example, in the computer department of the University of Pristina, Fortran – out of date a decade ago – is still taught because the lecturers do not know anything else. Classroom size is another factor. Although the province-wide average is a healthy 20 or so, this masks severe overcrowding in the main cities, where the average is 40 or over. Lack of physical facilities is commonplace despite a major building program, with shifts meaning that some students start at 7.00am and others finish at 8.00pm.[71]

The disastrous situation was recognised by the UN administration, which early in 2000 set up a strategic initiative called Developing an Education System for Kosovo (DESK), to design a unified and comprehensive education system. The DESK working groups covered kindergarten, pre-school and primary education; secondary education; higher education and research. DESK has been subsumed into different projects covering these areas as well as vocational education, although funding for most of these has yet to be obtained. A primary and secondary school in-service teacher-training program was proposed in 2000 to train 600 teachers who could then pass on their knowledge to the other 22,000. Teacher training is funded for 2001, although not for the complete three years of the current plan. A proposal in 2000 to build a central multi-user laboratory in Pristina university costing about DM 15 million and to equip computer and science laboratories in secondary schools has still to be implemented.

Recently announced plans to establish a Kosovo branch of the American University in Bulgaria would, if they are fulfilled, go a long way to improve educational alternatives for Kosovo's students. This branch would be named 'The American College in Kosovo' and provide 800 to 1000 students the opportunity of U.S.-accredited courses leading to two-year associate's and four-year bachelor's degrees. Funding would come from 'the resources that Kosovars at home and abroad are ready to dedicate to this project, to work with UNMIK and the University of Pristina to organize a college that will best serve the needs of Kosovo.'[72] The U.S. strategy for finding local funding is intended to avoid undercutting international donor support to the University of Pristina.

Education consumed about 27 per cent of the 2000 Kosovo Consolidated Budget and accounts for some 37 per cent of the total wages and services budget for 2001. Given the age profile of the population, the situation in schools will continue to be difficult over the next few years, with a follow-on impact on employment.

In the longer term, the increasing urbanisation of the population and, hopefully, the lessening of rural poverty will bring the birth rate down to more sustainable levels. A sustained educational campaign is needed to persuade rural Albanians that, contrary to well-entrenched belief, large families are no safeguard against economic hardship, and indeed harm their long-term economic, and ultimately political prospects by putting intolerable pressures on the whole fabric of their society.[73]

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[71] The international Co-head of the Department of Education and Science was asked to comment on these views expressed by others associated with the education process, but did not reply.

[72] Published article in *Koha Ditore* by Michael McClellan of the U.S. Office, Pristina, 7 November 2001.

[73] Birth rates in urban areas were in line with the rest of the former Yugoslavia.

V. CONCLUSIONS

Kosovo's economy is in certain ways in better shape than some of its neighbours' economies. It has a stable currency. Its war was much briefer, less bloody and destructive than Bosnia's. Most refugees (though not, of course, the Serb refugees) returned quickly in the immediate aftermath of the fighting. Post-war reconstruction proceeded much more rapidly than in Bosnia. Unlike Macedonia or Serbia, the more problematic state industries are largely closed, and are unlikely to re-open, so there will be much less of a burden on any future government.

Nevertheless, the province's complete dependence on imports and its under-developed and decrepit infrastructure (energy, telecommunications, roads, water) will provide continuing challenges. Unemployment is, however, a serious problem, and carries with it the risk that some young men may again turn to nationalistic or even violent politics for lack of a tangible stake in a stable future.

The Kosovo economy is highly dependent on remittances, largely from Europe, as well as international aid inputs and associated spending. Most activity is driven by consumer spending and construction. While small businesses, fuelled by a mixture of cash from the diaspora and remarkable entrepreneurial spirit, have thrived in the initial post-war boom, their prospects for development are hampered by problems such as limited access to reasonably priced credit.

A major challenge is to bring as much as possible of the large grey economy into the legal sector. UNMIK has enjoyed some success in registering businesses and in introducing a tax regime designed to encourage business. However, tougher action against corruption and organised crime is required, with effective audit procedures backed up by a financial police and stiff penalties for transgressors.

The success of efforts to rebuild and restructure Kosovo's economy has been, and will continue to be, limited by the international refusal to address the question of the province's final status. Notwithstanding the vigour of the private sector in small-scale enterprises, longer-term development requires major investment that cannot come as long as the question of jurisdiction remains open. As described in this report, the privatisation of former socially owned enterprises is hindered by the UN's concern not to make decisions that could be seen as prejudging Kosovo's final status. These amount to a strong argument why the status issue should be addressed sooner rather than later.

The UN administration should recognise its fiduciary responsibility to ensure that salvageable economic assets in Kosovo are not left to decay further and go to waste. In the absence of a decision on final status, the type of creative arrangements for establishing a caretaker trust allowing SOEs to operate forward by the Department of Trade and Industry should be implemented and extended.

Economic life has been severely disrupted over the past decade. The Milosevic regime's contempt for Kosovo's longer term needs, along with years of international sanctions against Yugoslavia, the Albanians' non-violent resistance and 'parallel society' during much of the 1990s, and the violence of 1998-99 have all taken their toll. In such circumstances, doing business legally was not an option for most Albanians. Working outside the law was a way of life and a necessity as well as a political statement. Criminal elements stepped into the breach to furnish all manner of supplies, including arms. In the general lawlessness that prevailed, such criminal gangs built powerful positions in Kosovo society, and often became blurred with the armed groups fighting against Serb rule.

When the international administration took over in 1999, one of its biggest challenges was to confront the criminal elements. Effective action requires much tougher security on Kosovo's borders, combined with steps to provide Kosovo with an effective criminal-justice system. The fight against organised crime is likely to have only limited success until locals are given a bigger role in law enforcement. Thus training of Kosovo police and magistrates in investigative techniques are urgently needed. Another vital component of the fight against crime is UNMIK's efforts to encourage businesses to register and operate legally.

Other helpful measures would include public information campaigns to encourage the population to look upon the forces of law and order as their protectors, as opposed to instruments of oppression. People need to be persuaded of the damage done to their society by corrupt and criminal elements.

The poor availability of credit is the most important factor inhibiting local businesses from expanding or rebuilding. At present, much economic activity revolves around mainly imported consumer goods. Much of the metal-bashing industrial base of Kosovo’s former economy will remain derelict, given the antiquity of its technology and the loss of its former Yugoslav market. Other industries are needed. Adding value to small-scale agriculture is an obvious area, requiring investment in food processing and dairy products as well as improvement of the farming infrastructure.

The problems for Kosovo’s economy are more than just post-conflict reconstruction. Decades of under-investment have left much of the economy in tatters. Education, especially in the form of vocational and professional training, will be a key factor in the long-term development of the economy, and indeed of society in general.

The remarkable boom in construction and trade has evident limitations. It cannot compensate for the economy’s structural problems. A significant proportion of the population continues to live in poverty. The reliance on émigré remittances and donor aid reveals the lack of domestic capacity in Kosovo's economy. However, there is definite scope for progress if the environment for privatisation, investment and restructuring can be freed up; if corruption and crime can be curtailed and education improved; if Kosovo’s relations with its neighbours can be normalised, and the economy integrated into the region; if UNMIK can find the nerve to forge ahead with privatisation; and if the key outstanding political issue of final status can be addressed.

Pristina/Brussels, 19 December 200

APPENDIX A

MAP OF KOSOVO

APPENDIX B

ABOUT THE INTERNATIONAL CRISIS GROUP

The International Crisis Group (ICG) is a private, multinational organisation committed to strengthening the capacity of the international community to anticipate, understand and act to prevent and contain conflict.

ICG's approach is grounded in field research. Teams of political analysts, based on the ground in countries at risk of conflict, gather information from a wide range of sources, assess local conditions and produce regular analytical reports containing practical recommendations targeted at key international decision-takers.

ICG's reports are distributed widely to officials in foreign ministries and international organisations and made generally available at the same time via the organisation's Internet site, www.crisisweb.org. ICG works closely with governments and those who influence them, including the media, to highlight its crisis analysis and to generate support for its policy prescriptions. The ICG Board - which includes prominent figures from the fields of politics, diplomacy, business and the media - is directly involved in helping to bring ICG reports and recommendations to the attention of senior policy-makers around the world. ICG is chaired by former Finnish President Martti Ahtisaari; former Australian Foreign Minister Gareth Evans has been President and Chief Executive since January 2000.

ICG's international headquarters are at Brussels, with advocacy offices in Washington DC, New York and Paris. The organisation currently operates field projects in nineteen crisis-affected countries and regions across four continents: Algeria, Burundi, Rwanda, the Democratic Republic of Congo, Sierra Leone, Sudan and Zimbabwe in Africa; Myanmar, Indonesia, Kyrgyzstan, Tajikistan, and Uzbekistan in Asia; Albania, Bosnia, Kosovo, Macedonia, Montenegro and Serbia in Europe; and Colombia in Latin America.

ICG also undertakes and publishes original research on general issues related to conflict prevention and management. After the attacks against the United States on 11 September 2001, ICG launched a major new project on global terrorism, designed both to bring together ICG's work in existing program areas and establish a new geographical focus on the Middle East (with a regional field office in Amman) and Pakistan/Afghanistan (with a field office in Islamabad). The new offices became operational in December 2001

ICG raises funds from governments, charitable foundations, companies and individual donors. The following governments currently provide funding: Australia, Canada, Denmark, Finland, France, Germany, Ireland, Japan, Luxembourg, the Netherlands, Norway, the Republic of China (Taiwan), Sweden, Switzerland and the United Kingdom. Foundation and private sector donors include the Ansary Foundation, the Carnegie Corporation of New York, the Ford Foundation, the William and Flora Hewlett Foundation, the Charles Stewart Mott Foundation, the Open Society Institute, the Ploughshares Fund and the Sasakawa Peace Foundation.

December 2001

APPENDIX C

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APPENDIX D

ICG BOARD MEMBERS