

In cooperation with:



Improving the Business Climate – Boosting Investment.

Proposals from German Business in Kosovo

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POLICY STUDY
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Executive summary

Following a series of reforms, Kosovo has made progress in improving the business environment over the past years. The aim of this study is to contribute to further improving the business climate in Kosovo. To this end, we visited companies that were founded with German capital in Kosovo or that trade intensively with Germany and asked them what barriers to growth they see and what suggestions they have for improvement. From the wealth of suggestions, we have selected four short-term and three long-term measures that were named most commonly by the companies.

Proposals for short-term policy measures

- » Increasing the efficiency of VAT-refund
- » Facilitating and fostering the installation of solar panels
- » Accelerating the implementation of data protection reforms
- » Facilitating the transport of goods through insurance policies

The short-term recommendations address reforms that have already been started but would be very important to be taken forward quickly in order to improve the business climate. The further improvement of speed and efficiency of the VAT-refund procedure is easy to implement, comes with no cost for the state budget and has a tremendous positive impact on the business climate, especially against the backdrop of high inflation. Moreover, the proposed taxation based on payments received is a very effective way of providing liquidity to micro and small enterprises. Similarly, for the proposals on solar panel installations and data privacy, although the reforms have started, the pace of reform is too slow and discourages investment. The proposed measures could be implemented quickly and easily because they do not burden the budget and allows Kosovo to draw on successful examples from other countries.

Proposals for long-term policy measures

- » Reforming the system of education and vocational training
- » Providing reliable infrastructure
- » Building a positive track record of successful investment lighthouse projects

The long-term recommendations address fundamental problems for the business climate in Kosovo. Admittedly, quick-wins are not to be expected here. The discrepancy between education and the qualifications required by companies leads to two effects that reinforce each other. First, companies are restrained in their growth because they cannot find enough or properly qualified employees. Second, many talented young people leave Kosovo because they cannot acquire education in Kosovo that is in demand in the labor market. While there have been some small attempts at reform, especially in the area of IT training, the problem is still large. Other obstacles to new and expansion investments are the lack of industrial sites with basic infrastructure and the unreliable electric power supply. Finally, the international economic development offers great opportunities for Kosovo as a nearshoring destination. Therefore, a positive and fast reform effort will likely be rewarded by the attraction of foreign direct investors that are currently seeking new productions and manufacturing locations. To this end, it is important that policymakers effectively communicate the improvement in the economic climate. This can be most effectively achieved by attracting high profile lighthouse investors to promote Kosovo to the foreign investment community.

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1. Introduction

Kosovo's economy has grown significantly over the last decade. The country is one of just four European nations to have experienced consistent positive growth rates in the years following the financial crisis (2008-2021), accumulating in recent years' high economic growth rates of up to 10.5% in 2021.¹ Nevertheless, Kosovo's growth model has been heavily dependent on remittances to finance domestic consumption over the past decades, and just recently started to gradually shift towards more investment and export-driven growth. As a result of this shift, exports of goods in 2021 have increased by almost 60% (yoy)², while foreign direct investment (FDI) has reached a peak value of EUR 450 m in 2021³.

Despite these generally positive trends and opinions from investors, a closer look reveals several barriers impeding upon the quality of the business climate in Kosovo. Removing these barriers faced by businesses and potential investors in the country is key for unlocking Kosovo's full potential as a target for investors in the post-pandemic world.

To this end, the proposals outlined in this study aim at pinpointing some of the concrete challenges faced by investors in Kosovo as well as suggestions on how to tackle these challenges. Both are based on in-depth interviews with company representatives in Kosovo, many of which recently decided to invest in the country. These interviews were conducted by the German Economic Team in cooperation with the German-Kosovar Business Association and Rex Consulting Group, resulting in a set of both short- and long-term proposals on improvements of the business climate in Kosovo.

For presenting these proposals, the study is structured as follows: the methodological approach is presented in section II. Specific short-term proposals on improving the business climate in Kosovo are presented in section III followed by three long-term proposals in section IV. The final chapter closes by presenting a summary and conclusions.

¹ Office of the Prime Minister, National Account Statistics 2022, accessible at: <https://ask.rks-gov.net/media/7030/gross-domestic-product-gdp-of-the-expenditure-and-production-approach-2008-2021.pdf>

² Economic Monitor Kosovo, German Economic Team, Rex Consulting, August 2022, accessible at: https://www.german-economic-team.com/wp-content/uploads/2022/03/GET_KOS_WA_03_2022_de_update.pdf

³ Quarterly Economic Bulletin January – March 2022, Republic of Kosovo, Ministry of Finance, Labour and Transfers Department of Macroeconomic Policy and International Financial Cooperation, retrieved from: <https://mf.rks-gov.net/desk/inc/media/E6D860D9-E982-456E-A251-AC7507B7025A.pdf>

2. Approach and methodology

This study contains reform proposals for improvements of the business climate in Kosovo from German and Germany-related businesses in Kosovo. The main aim was to generate proposals for reform that businesses themselves request. The study follows a bottom-up approach, based on a questionnaire prepared by the German Economic Team (GET). The questionnaire was sent to the member companies of the Kosovar-German Business Association „KDWW Kosovarisch-Deutsche Wirtschaftsvereinigung“ in May 2022.

The respondents of the questionnaire reported about problems and regulatory hindrances that they face in their operations in Kosovo and made concrete proposals to resolve these issues. Some of the returned proposals were straightforward, others concerned more complex issues and required more elaboration, so we decided to visit these respondents and discuss their challenges and ideas in person.

During two fact-finding trips in July and October 2022, we visited a total of 15 companies in Pristina, Prizen, Peja and other locations and interviewed the business owners or managers.

The proposals then underwent an extensive review and checking process by GET experts, external experts with specific expertise and the local partner associations. The review process was centred on ensuring that the proposals are consistent with a general reform direction towards transparent, competitive markets, as well as with pre-existing contractual obligations of Kosovo and contribute to inclusive, sustainable growth.

A restriction of our approach is that recommendations reflect the needs of incumbent companies and the specific profile of German investors in Kosovo, as those are the majority of companies organised in the partner organisation to this study. However, the advantage of the range of partners collaborating on this study was that we received reform proposals from a variety of sectors. Although our reform proposals stem from investors already present in Kosovo, they will often highlight the same issues that deter potential investors. Furthermore, implementation of the proposals will enable existing investors to invest more and expand their business activity in Kosovo.

3. Proposals for short-term policy measures

3.1 Increasing the effectiveness of VAT-refund

3.1.1 What is the issue for companies

Value added taxation (VAT) plays an important role in businesses' access to liquidity, i.e. short-term financing. If a company's VAT liability is negative, which means that the company can claim a refund, then the company is actually giving a credit to the government until the moment when the balance is cleared by the government through refunding the VAT. In this way, the state deprives companies of liquidity until the VAT refund. As many of the business representatives interviewed for this study reported, the current VAT refund system, according to them, poses three major and one minor obstacles for businesses in Kosovo:

1. When businesses claim a VAT refund in their VAT declaration, they are automatically and immediately faced with a tax inspection, according to the interviewed businesses. This is a problem because such a tax inspection takes up businesses' time and resources. Moreover, during the time of the tax inspection, businesses have to wait for the VAT refund to be paid, which jeopardizes their liquidity.
2. The VAT refund, even if approved, takes up to two months. This is a problem because it deprives businesses of working capital, which they then cannot use in time to buy raw materials, pay wages, etc.
3. The VAT debt/receivable is calculated on the basis of the accounts receivable. In other words, VAT becomes due when an invoice is issued, regardless of whether the invoice has already been paid or not. This is a problem because businesses complain of poor payment morale. Issued invoices are often paid late and sometimes not at all. When companies have to pay VAT on unpaid invoices, they are deprived of working capital, which in turn cannot be used for timely purchase of necessary raw materials, payment of wages, etc.

These three problems, briefly outlined, have recently been exacerbated by high inflation. This means that the current VAT system not only deprives enterprises of working capital, but also devalues their capital.

4. Last but not least, the VAT and corporate income tax accounts are not consolidated at the Kosovo tax administrations. This is problematic because companies that have debits and credits at the same time are burdened with interest payments on their tax debt, even if the sum of debits and credits results in a surplus.

3.1.2 Past reform measures and achievements

- » The Tax Administration of Kosovo introduced the electronic tax declaration system EDI. This is intended to reduce the time and administrative burden of filing VAT declarations.
- » A "Refund Management" tool within the new EDI system informs the company about the extent to which its VAT refund request has been reviewed by the Tax Administration. This could help to facilitate companies' liquidity planning.
- » The Tax Administration has started to implement a risk-based approach for VAT refund processing in 2020. Companies which are regarded as low-risk or medium risk in terms of tax fraud shall be subject to fewer inspections and receive their refunds faster.

According to the latest data of the Tax Administration of Kosovo for the period between January to November 2022, this has resulted in an improvement of tax refund procedures: From the moment the refund request is entered into the system until approval, it takes an average of 15 days for taxpayers in category "A" (considered low risk for tax fraud). For taxpayers in category "C", this period has been reduced to an average of 38 days. The time it takes for the money to be transferred to the businesses needs to be added to these averages, however.

3.1.3 Recommendations

1. Modern tax inspections follow a risk-based approach. Therefore, it is crucial that the above-mentioned regulation is implemented efficiently. Additionally, in cases where there is a risk of simple errors in the VAT declaration, the tax inspection should not suspend the VAT refund, but should take place in parallel with the payment of the refund or afterwards.
2. The transfer of the VAT credit to the company's bank account should be made within a few days. This would also require a more streamlined payment process with the Treasury.
3. Micro and small enterprises are especially prone to liquidity problems and generally have inferior access to finance. Therefore, micro and small enterprises should be allowed to opt for calculating their VAT liability on the basis of settled invoices. This means that a micro or small enterprise issuing an invoice subject to VAT will not declare the VAT at the time of issue. Only upon receiving payment for the invoice, the company should have to declare the VAT on the settled invoice. If, on the other hand, a micro or small enterprise receives an invoice subject to VAT from a third party, it should be able to immediately reclaim the VAT on this invoice, even if it does not pay the invoice until later.
4. The tax administration should use a system of consolidated accounting for VAT and corporate income tax. This means that debits and credits are always automatically consolidated, and taxpayers are charged with the balance of debits and credits. Currently, the consolidation of tax accounts is carried out only at the request of the company.

3.1.4 Expected effects at a glance

Effect on companies	Improved liquidity
Effect on business climate	Positive impact on the business climate in general Support for the development of micro- and small enterprises specifically
Effect on state budget	No effects on tax revenues but effects on the timing of tax revenues No effects on state expenditures
Linkage with other policy areas/institutions	Economic policy Fiscal policy, Treasury SME policy
Effect on general economic development	Higher potential investments, due to improved business liquidity, resulting in positive economic growth

3.1.5 Risks of not reforming

There is a reasonable risk that the currently still cumbersome and, by international standards, partly lengthy VAT refund could contribute to slow down the development of the economy: investments are postponed, imports are delayed, supply chains are stalled. This particularly hampers the participation of capital-intensive and material-intensive industrial sectors in global value chains.

3.2 Facilitating and fostering the installation of solar panels

3.2.1 What is the issue for companies

Businesses and house owners in Kosovo are willing to invest in solar panels. Installing a solar panel system, for example, on the roof of a building, is a long-term investment. In order to make such a long-term investment, the conditions and the risk must be calculable. However, companies argue that the regulations for the installation of solar panels in Kosovo are neither predictable nor stable.

In the case of rooftop solar installations, the companies interviewed complained above all about the so-called Prosumer Support Scheme Ordinance, which regulates the feeding of electricity into the low-voltage grid and the corresponding feed-in tariff. According to the current Energy Regulatory Office regulation, the feed-in tariff is limited to a capacity of only 100 kW.⁴ This regulation is applicable since 2017. This means that each rooftop panel can only feed 100 kW into the grid. This restriction is far below the capacities of modern solar modules. Neighbouring countries have already updated their regulations (Northern Macedonia: 1,000 kW, Albania: 500 kW).

Furthermore, the bureaucratic effort for issuing permits for any kind of renewable energy system is time-consuming and non-transparent from the point of view of the companies. Specifically, the unclear requirements and lack of standardized procedures for obtaining a municipal permit for rooftop solar panels has been identified as another constraint to this sector.

3.2.2 Past reform measures and achievements

Renewable energy and in particular solar energy is considered a very young sector in Kosovo. The existing legal framework and incentives provided so far have only enabled modest development of the sector, with over 20 MW capacity installed so far.⁵

- » Recently, the Ministry of Economy has drafted a new Strategy on Energy for 2022-2031. Among five main strategic objectives the objective on: “Decarbonization and promotion of renewable energy” is the basis of the strategy. The objective is largely based on the diversification of the generation mix by investing in renewable energy sources and gradually phasing out lignite-based generation.

⁴ Energy Regulatory Office, Rule on Support Scheme for Renewable Energy Sources Generators, 2017, accessible at: http://ero-ks.org/2017/Rregullat/Rule%20on%20Support%20Scheme_2017.pdf

⁵ US AID, JO 27: Assessment of PV Generators in Kosovo, accessible at: https://www.usaid.gov/sites/default/files/documents/Assessment_of_PV_Generators_in_Kosovo.pdf

- » The Office of the Energy Regulator is currently in the process of drafting the new feed-in regulation for prosumers.⁶ This regulation is in the stage of public consultations. According to this draft regulation, the capacity limit for prosumers is raised to 200 kW.
- » Standardization of municipal permits has begun, but apparently this process has been put on hold because there is still discussion about assigning responsibilities for enforcement.

3.2.3 Recommendations

1. Regulation should provide long-term stable conditions for solar module installations. The feed-in limitation for the low-voltage grid should be abolished or updated to a capacity that is appropriate for the technical development in the upcoming decades. The feed-in tariff should be regulated in such a way that long-term planning is feasible, for example with inflation-indexed tariffs.
2. The procedures for issuing permits should be simplified and accelerated and made as transparent as feasible and should be standardized across all municipalities.

3.2.4 Expected effects at a glance

Effect on companies	Long-term investment planning Investment in solar panels
Effect on business climate	Positive impact on business outlook Increased attractiveness for foreign investors
Effect on state budget	Increasing tax revenues because of increasing incomes No negative effects on state expenditures
Linkage with other policy areas/institutions	Linkage with Energy and Climate Strategy Linkage with regulation of KEDS
Effect on general economic development	Catching up with the solar industry in an international comparison Job creation and income generation in the solar installation industry Attracting skilled workers to come to or stay in the country

3.2.5 Risks of not reforming

There is a reasonable risk that the brain drain in the solar panel installation sector is accelerating. National installation companies might cease to invest in Kosovo and instead expand their operations to Northern Macedonia and Albania as demand for solar panels explodes in the region and globally. Skilled workers might migrate to neighbouring countries and Kosovar companies might stop to train local workers.

This would mean that Kosovo cannot keep up with the development of the international solar industry and is falling behind internationally in this important sector of the future.

⁶ Energy Regulatory Office, Draft Rregulla per Vet-Konsumatoret me Burime te Ripertertshme, accessible at: [https://www.ero-ks.org/zrre/sites/default/files/Lajmet/njofitimet/DRAFT-RREGULLA%20PER%20VET-%20KONSUMATORET%20ME%20BURIME%20TE%20RIPERTERTSHME.%20\(00000002\).pdf](https://www.ero-ks.org/zrre/sites/default/files/Lajmet/njofitimet/DRAFT-RREGULLA%20PER%20VET-%20KONSUMATORET%20ME%20BURIME%20TE%20RIPERTERTSHME.%20(00000002).pdf)

3.3 Accelerating the implementation of data protection reforms

3.3.1 What is the issue for companies

Both sectors, IT outsourcing and business process outsourcing (BPO), are growing and find fertile conditions in Kosovo. The business climate could be improved and thus growth further facilitated if manageable efforts were made regarding the regulatory environment.

Outsourcing firms work mainly with international clients, with European clients currently making up the majority of current and potential clients. When providing outsourcing services to European clients, Kosovar companies must comply with the data protection regulations of the countries in which their contractual partners are located, i.e. the European General Data Protection Regulation (GDPR). The Kosovar companies must conclude a so-called order processing contract in which they commit to take technical and organizational measures to ensure the data protection of their European customers.

Although the legal framework in place in Kosovo is in line with European General Data Protection Regulation, the practical implementation of data protection standards is not advanced.

As a consequence, Kosovar outsourcing companies need to invest time and resources to build confidence among contractors that are able and willing to meet higher standards than the currently prevailing standards in Kosovo. This increases transaction costs and could even be a barrier to acquiring European clients, especially small and medium-sized European companies.

If, on the other hand, Kosovo were known for not only having strict data protection regulations on paper, but that all companies comply with them and that the authorities also monitor compliance and sanction deviants, it would help individual companies gain the trust of potential European customers.

3.3.2 Past reform measures and achievements

Kosovo has passed Law No.03/L-172 on the Protection of Personal Data, which is in line with the General Data Protection Regulation in 2019. Article 1, Paragraph 2 of this Law provides that: *"2. This Law is in compliance with Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation)."*⁷ According to provisions of Law on Protection of Personal Data, Personal data are processed under similar standards with those provided under GDPR standards.

However, the Information and Privacy Agency (IPA), which is responsible for implementing and enforcing the Data Protection Regulation, has been inoperative for almost three years and has only recently begun its work.

3.3.3 Recommendations

Since Kosovo has adopted a new law on Data Protection which is in line with EU GDPR, Kosovo institutions shall work on the proper implementation of these standards in practice. To this end, the following measures are suggested:

⁷ Official Gazette of the Republic of Kosovo, accessible at: <https://gzk.rks-gov.net/ActDetail.aspx?ActID=18616>.

- » Improving the institutional capacity of the Information and Privacy Agency in providing advice on the implementation of the personal data protection law to the private sector
- » Providing accurate information for citizens and businesses regarding data protection including rights and obligations with regard to data processing
- » Improving the accountability of the private sector as data processors and controllers
- » Providing proper guidelines with regard to data processing for the private sector, including guidelines on preparing internal data protection policies by the private sector
- » Providing data processing agreements and similar template documents that will improve the implementation of the data protection legal framework by the private sector

3.3.4 Expected effects at a glance

Effect on companies	Lower transaction costs for IT/BP-outsourcing Easier acquisition of European clients Increasing potential markets Higher administrative burden for companies
Effect on business climate	Positive impact on business outlook Increased attractiveness for local and foreign investors
Effect on state budget	Increasing tax revenues because of increasing incomes in the sector No effects on state expenditures
Linkage with other policy areas/institutions	
Effect on General Economic Development	Fostering the sectors: IT/BP-outsourcing, data protection, IT security Attracting foreign investors Job creation and income generation in the IT/BP-outsourcing, the data protection and the IT security industries Attracting skilled workers to come to or stay in the country

3.3.5 Risks of not reforming

There is a reasonable risk that the demand for IT and BP-outsourcing services stagnates or declines as data protection compliance is becoming more and more important for European contractors.

3.4 Facilitating the transport of goods through insurance policies

3.4.1 What is the issue for companies

Transportation companies in Kosovo face significant problems with the transportation of goods to and from some of the Western Balkan (WB) countries as well as to and from the EU member states. These include visa issues and the recognition of personal documents, driving licences or table plates from Serbia and Bosnia and Herzegovina. In general, challenges regarding transportation of goods are linked to a lack of bilateral agreements regulating the transport of goods as well as a lack of membership in international agencies and conventions⁸. Among the most important agreements in this regard are the Green Card Agreement and the Convention on the Contract for the International Carriage of Goods by Road (CMR).

⁸ These conventions include the AETR, APC, TIR, e-CMR, CVR, ECMT, 1968 Vienna Convention on Road Traffic.

Kosovo is the only country in Europe that is not a part of the "Green Card" system, a system used by 48 countries in Europe. The Green Card system is an insurance for vehicle accidents, occurring outside of country of residence. Hence, when a car is involved in an accident in any other Green Card member country, the insurance covers the expenses of the accident.⁹ Since Kosovo is not a member of the Green Card system, shipping products by Kosovar carriers is more expensive, as Kosovar companies are required to pay additional insurance, which in turn lowers their ability to compete equally with other companies in the region and beyond.¹⁰ In 2011, the Kosovo Insurance Bureau (KIB) applied for Green Card membership, however, unsuccessfully.

CMR is an international agreement that was signed in Geneva on 19 May 1956, and relates to various legal issues concerning commercial transportation of goods by road. The convention has been ratified by the majority of European states.

Joining the CMR convention or providing the CMR insurance would be very helpful for transportation companies since this is a mandatory request for companies that transport goods in EU countries. Further, the CMR Convention unifies the transport documentation, transports completed by succeeding carriers, the terms of the contract for the transportation of goods by road, the liability of the carrier, the method of complaints, and complaints and claims resulting from the carriage.¹¹

Due to the above-mentioned obstacles, many Kosovar companies need to hire foreign freight forwarding companies primarily from Serbia and North Macedonia in order to import or export goods to and from EU countries¹². This increases costs especially for micro and small businesses that export smaller quantities of goods to or import from EU countries, because they cannot transport individual small deliveries with their own truck or van. Spontaneous participation in a trade fair in the EU, for which a few samples need to be transported, is also made more difficult.

Larger companies, on the other hand, that export or import large volumes with each delivery will use freight forwarders anyway, who then have all the insurance and permits and take care of all the formalities. The problem described is basically a non-tariff trade barrier for micro and small enterprises.

3.4.2 Past reform measures and achievements

The Green Card membership of KIB at least in principle requires in the membership of Kosovo in the United Nations (UN). While alternative solutions to this specific requirement may be conceivable, Kosovo was also facing other barriers for obtaining the Green Card membership, such as the large number of unregistered vehicles. Up until 2020 there were around 30% of unregistered cars in Kosovo.¹³ To tackle this issue, the KIB, the Central Bank of Kosovo, the Ministry of Environment, Spatial Planning and Infrastructure, and the Civil Registry Agency, have signed a memorandum of cooperation for the implementation of the project for the placement of stickers on vehicle windows in April 2022.¹⁴ As a result of

⁹ COB, The Green Card, accessible at: <https://www.cobx.org/article/39/green-card>

¹⁰ German-Kosovar Chamber of Commerce & Iron Consulting, International Road Freight in Kosovo, March, 2022.

¹¹ United Nations, Convention on the Contract for the International Carriage of Goods by Road (CMR). Geneva, 19 May 1956, accessible at: https://treaties.un.org/doc/Treaties/1961/07/19610702%2001-56%20AM/Ch_XI_B_11.pdf

¹² German-Kosovar Chamber of Commerce & Iron Consulting, International Road Freight in Kosovo, March, 2022.

¹³ GAP Institute, Pagesa e polisave kufitare nga buxheti i shtetit, 2021, accessible at: https://www.institutigap.org/documents/91259_Polisat%20Kufitare.pdf

¹⁴ Central Bank of the Republic of Kosovo, 2022., accessible at: <https://bqk-kos.org/the-memorandum-for-the-implementation-of-the-placement-stickers-is-signed/?lang=en>

this reform, there are only 4.8% unregistered cars in Kosovo to date.¹⁵ This means that KIB has fulfilled another technical criteria for the Green Card membership. In addition, in 2021, KIB has signed a Memorandum of Understanding with Montenegro for mutual recognition of Motor Third Party Liability Insurance (MTPL) certificates and arrangements for processing and payment of claim damages. Further, KIB has improved the relations with the Albanian Insurance Bureau and has made agreements with other WB countries for recognition of insurance policies, including Serbia and Montenegro.¹⁶

3.4.3 Recommendations

Kosovo has fulfilled the technical criteria for Green Card membership, but the UN membership still remains as a key requirement. However, Kosovo institutions could try to find other modalities for joining the Green Card. One possibility would be membership through another member as a guarantor state or reaching as many individual agreements with other countries as possible.

Nonetheless, prior to applying for membership, Kosovo also needs to fulfil other remaining criteria, that is, adopting the ratification of the Vienna Convention on Road Traffic of November 8, 1968, and the Vienna Convention on Road Signs and Signals of November 8, 1968.

With regards to the implementation of the CMR contract insurance, the Kosovo authorities should further accelerate their efforts for membership in all relevant international transport conventions and agreements.

3.4.4 Expected effects at a glance

Effect on companies	Lower transportation costs particularly for SME Easier access to EU markets Increasing potential markets
Effect on business climate	Positive impact on business outlook Unification of transport documentations
Effect on state budget	Increasing tax revenues because of increasing incomes in the sector
Linkage with other policy areas/institutions	Kosovo Insurance Bureau (KIB)
Effect on general economic development	Increased income generation in the Transport Sector Positive Impact on trade development

3.4.5 Risks of not reforming

There is a reasonable risk that the growth of export-oriented micro and small enterprises will be hindered. Sectors such as wood processing cannot unfold their full potential. It is difficult to establish direct business contacts with EU clients, and local producers are dependent on intermediaries who appropriate a large share of the value added.

¹⁵ Central Bank of the Republic of Kosovo, 2022, accessible at: <https://bks-ks.org/nuk-jemi-larg-zgjidhjes-qe-te-behemi-piese-e-byrose-se-kartonit-te-gjelber/>

¹⁶ Central Bank of the Republic of Kosovo, 2022, accessible at: <https://bks-ks.org/kartoni-i-gjelber/>.

Box 1: Flexibility of labour contracts**Flexibility of labour contracts**

The business climate also somewhat suffers from the fact that some companies are not well enough informed about the (quite advantageous) regulatory framework in Kosovo. This is illustrated by the following example: In our interviews, several entrepreneurs expressed their wish for greater flexibility in the drafting of employment contracts. In particular, they want to include a provision in individual employment contracts obliging employees to contribute to the costs of vocational training measures if the employee quits the employment relationship shortly after a training measure. In this way, entrepreneurs want to safeguard their investment in vocational training, as the high turnover of skilled workers is a major obstacle to in-company training and development.

Our background research has shown that the Labour Law in Kosovo allows this freedom of design of employment contracts and such a provision can be included in any employment contract. Whether such a contractual commitment is an adequate means of employee retention will not be discussed here.

It is therefore not a matter of a need for reform, because the legal framework conditions are already in place in this case for the specific concern of the companies. The recommendation would therefore be to improve the diffusion of knowledge about the framework conditions of economic action in Kosovo.

4. Proposals for long-term policy measures

4.1 Reforming the system of education and vocational training

4.1.1 What is the issue for companies

Skills shortage and finding qualified labour is increasingly becoming a burden for Kosovar companies. Albeit coming from different industries, many of the companies interviewed for this study have reported skills shortages which deeply impacts their productivity and performance. The companies specified the following problems:

- » Problems to find potential employees
- » Skills mismatch between demand and supply
- » High training costs for hired graduates
- » High fluctuation of the most qualified and trained employees

Businesses have reported that the skills mismatch is closely linked to the education system which does not equip students with the skills necessary to enter the labour market. In addition, the vocational education and training (VET) programs are inadequate and the curricula do not properly reflect the needs of industries according to the interviewed companies.

4.1.2 Past reform measures and achievements

The Kosovo government, particularly the Ministry of Education, Science and Technology (MEST), has taken some measures to address skills gaps and mismatches. These include:

- » Encouraging particularly female students to study Science Technology Engineering and Mathematics (STEM) programs and incentivizing them through scholarships.
- » Regulating the organization, implementation, assessment and health protection of students when learning at the workplace.
- » Planning school-based career centres that shall provide career advice to more than 20,000 pupils in the VET schools by the end of 2024.

In addition, the new Strategy on Education (2022-2026) recently adopted by the Kosovo Government addresses several other issues related to VET schools and the potential application of a dual system. Challenges identified in this regard include outdated equipment, lack of raw material and the insufficient preparation of instructors.

4.1.3 Recommendations

1. Carrying out studies to forecast the demand for labor to foster a clearer understanding of the potential needs of the market in the upcoming years. Based on these studies, Kosovo could better harmonize study programs with the labour market demands.
2. Increasing the cooperation and communication between the private sector, the VET schools and the Ministry of Education, Science and Technology (MEST).
3. Establishing career counselling within all high schools (not only VET schools).
4. Outside academic institutions, the development of a sophisticated market for private providers of on- the-job training and lifelong learning should be facilitated.

4.1.4 Expected effects at a glance

Effect on companies	Cost reduction because of lower search costs and lower training costs Improved retention rates Company growth
Effect on business climate	Positive impact on business climate Increased attractiveness for foreign investors
Effect on state budget	High expenditures in the short- and medium-term Increased tax revenues from income in the long-term
Linkage with other policy areas/institutions	National Strategy on Education (2022-2026)
Effect on general economic development	Positive impact on GDP and international competitiveness

4.1.5 Risks of not reforming

If the reforms envisaged in the strategy are not implemented or are implemented only half-heartedly, there is a risk that the shortage of skilled workers will become a bottleneck for business growth. At the same time, the most talented people will leave the country to get good professional training abroad, which in turn will exacerbate the problem. The brain drain and emigration will continue or even accelerate, and international investors will prefer other destinations.

4.2 Providing reliable public infrastructure

4.2.1 What is the issue for companies

There is a lack of suitable business sites for the establishment of production and/or manufacturing facilities in Kosovo. Investors are allowed to buy land, but in order to use it they need access to key infrastructure such as the electricity grid, water supply and roads. Some of the companies interviewed for this study stated that they are willing to expand their production facilities but lack suitable locations with the necessary infrastructure.

Businesses that plan new and expansion investment in higher added value services such as IT- or BP-outsourcing require business premises with even a more advanced infrastructure.

Additionally, many companies complained about the unstable electricity supply and several power outages that have affected Kosovo recently. This is a serious obstacle not only for energy-intensive producers, but also for the highly valued IT and BP-outsourcing sector. When providing IT-outsourcing services, it is often crucial to be online all the time. Emergency generators are not an adequate solution, as they do not ensure reliable energy supply and are costly for the companies.

4.2.2 Past reform measures and achievements

Kosovo has started to establish so-called economic zones, commercial land with basic and some advanced infrastructure for businesses. Of the ten zones created in Kosovo over the last decade, three are already fully and two partially operational.

However, the zones are currently hosting less than 150 companies, employing about 2,300 people in total, which is far below Kosovo's potential. The further development of these zones is proceeding far too slowly, the majority still requires major infrastructure development measures. According to the law resp. administrative instruction, Economic

Zones should have more advanced infrastructure and a portfolio of one-stop-shop services. However, the instruction is not fully implemented.

In addition, economic zones can only meet part of the demand because some investments are based on land ownership, because the real estate is needed as collateral for loan financing, for example.

If the goal is to attract foreign direct investors, the zones are not adequate for this. International investors expect higher standards than the basic infrastructure available in the zones to date.

4.2.3 Recommendations

1. Providing transparency on the quantity and quality of available commercial sites, e.g. through publicly accessible lists and the introduction of a site monitoring system.
2. Developing new areas for companies that want to purchase land with basic infrastructure, based on a guiding strategy and thorough feasibility studies.
3. Improving the fit between locational demand and supply.
4. Development of specialized industrial and technological parks or appropriate upgrading of existing zones that are internationally competitive in order to attract foreign investors.

For detailed recommendations on this topic, see also our Policy Paper PP 01/2022 "[Identifying reform options for Economic Zones in Kosovo](#)".

4.2.4 Expected effects at a glance

Effect on companies	Positive growth Expanding production facilities Facilitating cooperation between companies
Effect on business climate	Increased attractiveness for local and foreign investors
Effect on state budget	Increasing state investments through infrastructure construction Increasing tax revenues because of increasing incomes in the long run
Linkage with other policy areas/institutions	National Development Strategy Development policy on municipality level Fiscal policy Industrial and investment policy
Effect on general economic development	Facilitate the development of an industrial base of the economy Job creation Positive effects on GDP and international competitiveness

4.2.5 Risks of not reforming

Without the reliable public infrastructure that it takes for companies to set up or expand their production facilities, Kosovo cannot fully profit from the reorganisation of global value chains, especially as the country will not be able to compete with other locations for the attraction of international nearshoring investors. As a consequence, Brain Drain accelerates as Kosovo cannot compete with other countries demand for skilled workers.

4.3 Building a positive track record of successful investment lighthouse projects

4.3.1 What is the issue for companies

Potential foreign investors looking for international locations for direct investments, i.e. greenfield or brownfield investments, come across a number of negative reports from foreign investors in Kosovo when researching Kosovo as an investment location. These range from complaints that the Kosovo government has allegedly failed to fulfil contractual agreements with investors to accusations of expropriation. Given the size of Kosovo and the moderate amount of foreign investment by international comparison, the list of arbitration cases filed with the International Centre for Settlement of Investment Disputes (ICSID) is relatively long.

Apart from the outcome of the dispute settlement, such an accumulation of arbitration cases discourages potential investors.

In addition, there are some constellations of documented arbitration cases that are unusual in international comparison, where then active or former members of parliament or the cabinet and even presidents sided with investors against their own country. Regardless of the concrete assessment of the facts, this creates the impression of conflicts of interest that can jeopardise potential investment projects.

For investors who are primarily concerned with the short-term exploitation of tax or customs privileges, such reports may carry little weight. But investors who want to strengthen Kosovo's industrial base through long-term, substantial greenfield and brownfield investments and create high-quality, well-paid jobs need the prospect of long-term, stable and reliable frameworks and contractual arrangements.

4.3.2 Past reform measures and achievements

The negative reports and arbitration cases cited are from the past. However, it seems that Kosovo still suffers from the negative image of the past years.

Since 2021 at the latest, the Kosovar government has been paying more attention to avoiding conflicts of interest in negotiations with foreign investors and making reliable long-term commitments.

4.3.3 Recommendations

For long-term investors, the long-term experience stories are significant. Therefore, Kosovo must quickly start to build a positive track record of successful foreign investment projects. The negative stories from the past need to be quickly overwritten with positive ones. It takes a multiple of success stories to compensate for negative narratives. Added to this is the difficulty that negative rumours often spread by word of mouth without proof, while positive reports need to be substantiated.

Therefore, large investment projects of internationally known and respected companies are best suited as testimonials for country image marketing. Such projects have a particularly high profile, which is why they are also called lighthouse projects.

If Kosovo succeeds in acquiring such a lighthouse project in the next few years, the list of arbitrage cases can be downgraded in importance, negative word-of-mouth rumours can

be neutralised. Thereby, the country image can be upgraded more than the best country marketing brochures ever could.

4.3.4 Expected effects at a glance

Effect on companies	Promising business cases for potential foreign investors Growth potential for local companies as potential suppliers
Effect on business climate	Positive impact on business climate Increased attractiveness for potential foreign investors
Effect on state budget	No short-term effect on state budget In some cases, public infrastructures need to be built for lighthouse projects-> effect on state investment Long-term increase in tax revenues from investors and employees
Linkage with other policy areas/institutions	FDI promotion/KIESA State procurement (e.g. in case of power purchase agreements) Environmental policy (in case of renewable energy investments)
Effect on general economic development	Positive effect on industrial development, SME development, employment, GDP

4.3.5 Risks of not reforming

If Kosovo is not successful in acquiring high profile FDI projects in the next few years, there is a risk that it could take much longer to build up a positive image as destination for FDI. Kosovo would not even appear on the radar of many foreign investors in the short and medium term.

5. Final remarks and outlook

There is an old German proverb that is more than 150 years old and can be translated as follows: “The lament is the greeting of the merchant.” Accordingly, we were prepared to receive a flood of complaints from our interview partners.

The opposite occurred. Some of the executives interviewed praised the country and the business climate in flowery terms, including some German investors whose statements were not biased by local patriotism. And even the more skeptical or partially disappointed respondents said they were all optimistic about their business future in Kosovo. This is a good prerequisite, as the subjective business climate is just as significant for the creation of entrepreneurial spirit as the objectively existing framework.

However, companies also reported on their day-to-day problems with administrative burdens and the legal environment and addressed major long-term impediments. Based on these reports from the business community, we have crystallized four short-term recommendations that do not require extensive financing or complex concepts to implement, but only will and courage.

Likewise, we support the call of the entrepreneurial community to tackle the three mammoth long-term tasks described above. For tackling these challenges, Kosovo can draw on a wide range of international experience.

Having said this, our background research revealed that many of the problems mentioned by the companies regarding the regulative environment have already been addressed by policymakers, i.e. legislation has already been improved or is in the reform pipeline. The discrepancy between companies' perceptions and actual changes in the regulatory framework is due, on the one hand, to the fact that the implementation of the new legislation is lagging behind.

On the other hand, there is obviously a serious information deficit. For the planning of new and expansion investments, not only the current but also the expected future environmental conditions are important. For this reason, companies must constantly keep themselves informed about the changes in the law that are currently being discussed in the areas relevant to them. However, since almost all private companies in Kosovo are small and medium-sized enterprises and therefore have few resources for monitoring the legal framework or even for advocacy, and the business associations and chambers that can take on such information tasks are still in the process of being established, policymakers in Kosovo must pay particular attention to ensuring that planned and adopted positive changes to the legal framework are communicated effectively to the business community.

This applies in a similar way to the promotion of foreign direct investment. The improvements in the framework conditions and also the significant reduction in the risks of corruption and nepotism should be communicated more effectively internationally. At the same time, Kosovo currently has a unique opportunity to gain an elevated place in global value creation, because in the next few years, global value chains will be reorganized. For Kosovo, there is a great potential for nearshoring investments. However, to be able to reap these opportunities, Kosovo needs to significantly speed up when it comes to enacting regulatory reforms, effectively communicating with the business community and attracting foreign investors.

Box 2: Enhancing private-public dialogue

Enhancing private-public dialogue

While the companies interviewed for this study recognize the reform achievements and incentives offered by the government during the past years, the interviews also highlighted the issue of a lack of regular communication with the government regarding both the design and implementation of policy reforms. A number of businesses emphasized the lack of a regular communication platform between businesses and the government, where businesses would be engaged as active parties in a public-private dialogue for building a policy environment conducive to sustainable development.

Companies mentioned that such public-private dialogue mechanism existed in the past in the form of “The National Council for Economic Development”. However, such a Council is not active anymore. This, to some degree, has surfaced in our analysis, as for a number of issues raised by companies reforms have already been initiated by the authorities. However, businesses seem to lack this information (e.g. the above sketched problem with the timing for VAT refund).

The National Council for Economic Development was a good example for a dialogue platform between senior public officials and the representatives of the business community on key economic policies that matter to both policymakers and the private sector. Therefore, to tackle the communication issues raised above in addition to the aforementioned need to speed up the implementation of reforms, it is suggested to continue with an open dialogue between the private sector and the government in a similar manner.