European Commission/World Bank

KOSOVO[*]

Donors' Conference
Brussels, Belgium

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PROSPECTUS

[*] Under UNSCR 1244/99

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I. INTRODUCTION

1. **On July 11, 2008, the European Commission (EC) will chair a donors' conference for Kosovo.**[1] The purpose of the conference is to mobilize external assistance to support Kosovo's socio-economic development with the aim of bringing greater prosperity to its people, and contributing to sustainable growth and a consolidation of democratic institutions and good governance practices. The conference will also be an opportunity to discuss Kosovo's key economic policy and EU approximation challenges, the preferred modalities of donor support, and principles of donor coordination.

2. **At the Conference, donors will be asked to pledge against financial needs identified in the Medium Term Expenditure Framework for Kosovo** adopted by the government on 12 June 2008. For the period 2008-2011, the MTEF identifies an overall external need for development assistance of around **€1 billion**, and a further **€400 million** to build up a reserve to help Kosovo in facing contingency liabilities.

3. **This prospectus integrates and summarizes the key findings and recommendations of technical background papers prepared for the donors' conference.**[2] As such, it complements the *Medium-Term Expenditure Framework, 2009-2011*, the Kosovo authorities' main submission to the conference.

4. **The rest of the prospectus is organized in four main sections.** Section II provides a summary of the main economic achievements and inadequately addressed problems over the period since 1999, with a particular focus on recent developments in 2007 and early 2008. Section III provides an overview of the level, sectoral breakdown and modalities of donor support which was provided to Kosovo during this period. Section IV then discusses future donor support to Kosovo during the period to 2011, including: (i) estimates of overall financing needs; (ii) sectoral focus; and (iii) preferred modalities. Finally, Section V concludes by summarizing reform and public spending priorities in five areas covered by separate technical background papers: (i) macro-fiscal policy and institutions: (ii) energy; (iii) transport (iv) employment, social protection and human capital development, and (v) rule of law.

II. ECONOMIC BACKGROUND

A. Key Achievements and Remaining Weaknesses

5. **Kosovo began its post-conflict transition from a very difficult starting point.** During the 1990s, its economy had already suffered from poor economic policies, lack of

[1] Under United Nations Security Council Resolution 1244 (1999).

[2] These technical background papers have been produced by experts funded by the European Commission and/or the World Bank, in consultation with other donors and the Kosovo authorities. These papers are intended to help the discussion at the July 11 Kosovo Donors` Conference by providing further information on sectors, and to facilitate donor coordination at the sectoral level after the conference.

domestic institutions, broken external trade and financial links, international sanctions, underinvestment, and ethnic conflict. Output halved in the early 1990s, and fell by at least another 20 percent as a result of the conflict at the end of the decade. Inflation remained at very high levels throughout the 1990s due to monetary financing of fiscal and quasi-fiscal deficits. By the end of the decade, income had collapsed, one-half of the population was unemployed, and more than one-half was poor.

6. **The subsequent joint efforts of the Kosovo authorities and the donor community brought improvements on several fronts.** After being sluggish for many years, *economic activity* is beginning to rebound (see Table 1). The use of the Euro, combined with generally responsible fiscal policy and substantial donor support (see next section) has contributed to keeping *inflation* in check during a long period after the end of the conflict. Positive features of the *business environment* include reasonably flexible labor laws, a modest tax burden, a good legal framework for business without many bureaucratic impediments, and a relatively dynamic banking sector. There has also been good progress in establishing and strengthening various *institutions*, e.g. enhanced capacity of the tax administration and customs authority.

7. **However, other serious problems were inadequately addressed, and continue to constrain growth and job creation.** By far the most critical problem area is the power sector, both in terms of its impact on the business climate (through unreliable supply of electricity) and the serious drain it represents on fiscal and donor resources. Transportation and telecommunications infrastructure also appear to be more serious obstacles to doing business than in neighbouring economies. In addition, the uncertainty arising from Kosovo's unresolved political status acted as a barrier to domestic and foreign investment, and to economic activity more broadly, including through the limits which it placed on privatization and the resolution of property ownership issues (especially in the crucial agricultural sector).

8. **In addition, Kosovo continues to exhibit some of the worst social indicators in the sub-region.** About 45 percent of the population is estimated to be poor, with 15 percent living in extreme poverty. These poverty rates are very high compared to neighboring economies, and unlike many countries in the region, have not changed over time. However, poverty is also shallow, with many people just above or just below the poverty line. Further, the transition to secondary school remains a barrier for many children, particularly girls and the poor - only 67 percent of children in the poorest quintile and 66 percent of girls are enrolled. Productivity in hospitals and primary health care (PHC) centers is low, as indicated by relatively low bed occupancy rates, a low-severity case-mix of patients in hospitals who could be treated in outpatient settings, and low patient to staff ratios in PHC facilities. Kosovo reports among the worst outcomes in the sub-region for life expectancy, tuberculosis, and access to safe water.

B. Recent Economic Developments and Reform Achievements

9. **The economy is showing increasing signs of vibrancy.** Real GDP growth has been on a modest upward trend, reaching at 4.4 percent in 2007 (see Table 1). The Kosovo

Consolidated Budget (KCB) generated surpluses in 2006 and 2007, underpinned partly by control of current spending, but also by buoyant revenues and weak execution of capital spending. Inflation - long under control if not negative - has recently rebounded to low double digits, fueled by rises in food and energy prices. Kosovo's external trade continues to be significantly out of balance, with the recorded current account deficit (CAD) (including grants) reaching 17.4 percent of GDP in 2007, even after large inflows of remittances (12.9 percent of GDP) and foreign assistance (8.9 percent of GDP). The growth of the CAD has been driven by private sector demand, with the conservative fiscal stance of the past two years having little apparent impact on external imbalances.

10. **Despite their positive trend, growth rates remain the lowest in the sub-region.** The same applies to the estimated level of per capita GDP, which was only €1,573 in 2007. This is mainly due to the weak energy and transportation infrastructure which harm the business climate. Other contributing factors include poor governance of public owned enterprises (POEs) and weak rule of law and public administration. As a consequence, reported unemployment remains broadly stable on an exceptionally high level (an estimated 43 percent in 2007, down from 45 percent in 2006, with youth unemployment at 76 percent).

Table 1. Kosovo - Main Economic Indicators, 2005-2008

	2005 Est.	2006 Est.	2007 Est.	2008 Proj.
National accounts				
Real GDP growth (in percent)	2.0	3.9	4.4	6.7
Investments (in percent of GDP)	21.4	23.0	27.2	30.9
National savings (in percent of GDP)	-4.4	-1.2	0.9	-2.6
Price changes (in percent)				
CPI	-1.4	1.5	4.2	8.4
General government budget (in percent of GDP)				
Revenues	21.1	23.0	26.9	23.2
Expenditures	24.2	20.5	19.6	23.9
Primary balance	-3.1	2.5	7.3	-0.7
Overall balance	-3.1	2.5	7.3	-1.7
External accounts (in percent of GDP)				
Current account	-13.4	-14.0	-17.4	-24.2
Foreign assistance	12.3	10.3	8.9	9.2
Remittances	9.2	11.6	12.9	11.7
Memorandum items				
GDP (in millions of euros)	2,977	3,099	3,343	3,379
GDP per capita (in euros)	1,438	1,476	1,573	1,729
Population (in thousands)	2,070	2,100	2,126	2,162

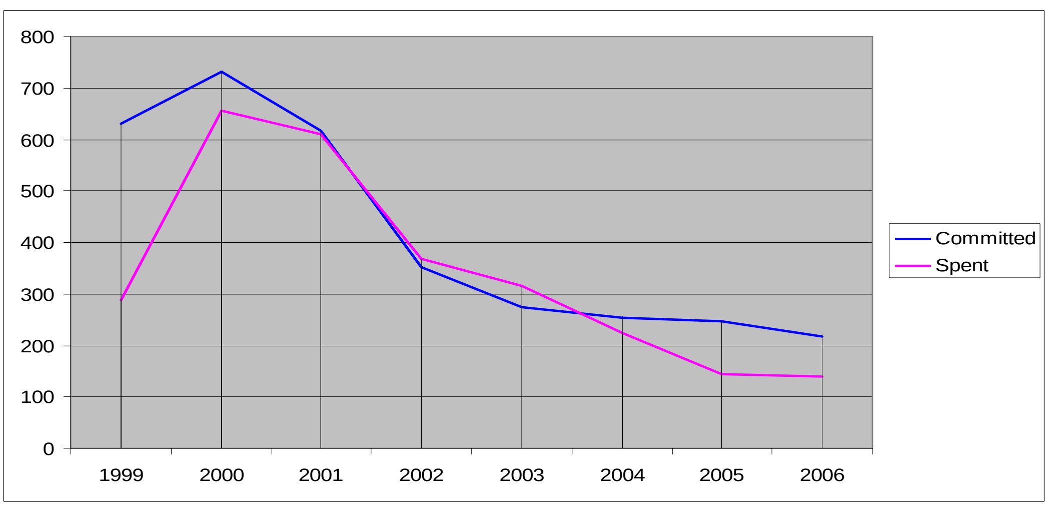
Source: IMF staff estimates. Projections for 2008 represent a normative scenario, which may differ from the approved 2008 budget.

11. **Kosovo did make some recent progress on structural and institutional reforms, even as status issues dominated government attention.** New laws on publicly owned enterprises (consistent with OECD principles on corporate governance), business organization, central banking and decentralization were recently promulgated. One insolvent bank was closed in 2006 while new foreign-owned banks started operations in 2007/08. A second mobile telecoms operator was licensed and has begun operations. In the energy sector, electricity transmission (KOSTT) was unbundled from generation and distribution (KEK), while an Energy Regulatory Office (ERO) was established. In early 2007, the government adopted a Strategy and Action Plan for Public Administration Reform. A similar effort has now been launched for public financial management.

III. REVIEW OF DONOR ASSISTANCE, 1999-2007

12. **Since 1999, Kosovo has received significant and sustained levels of donor assistance**. In total, some €3.5 billion has been committed and more than €2.7 billion spent in Kosovo over this period. The overall volume of aid was particularly high in the immediate post-conflict reconstruction phase, and since 2002, has given way to a phased decline to still very high per capita levels by world standards (see Figure 1). This generous support was instrumental in helping Kosovo in addressing the initial and urgent humanitarian and budget needs, and in mitigating the impact of the conflict. In a later phase, by providing financing for the Reconstruction and Recovery Program[3], donors supported efforts to stabilize macroeconomic conditions and to provide essential public services. This enabled the improvement of living conditions though the reconstruction of numerous damaged homes, repair of the water and power supply and kick-starting economic activity in Kosovo.

Figure 1. New Commitments to Kosovo between 1999-2006 (in €Million)[4]



[3] Toward Stability and Prosperity: A program for reconstruction and recovery in Kosovo. Published November 3, 1999

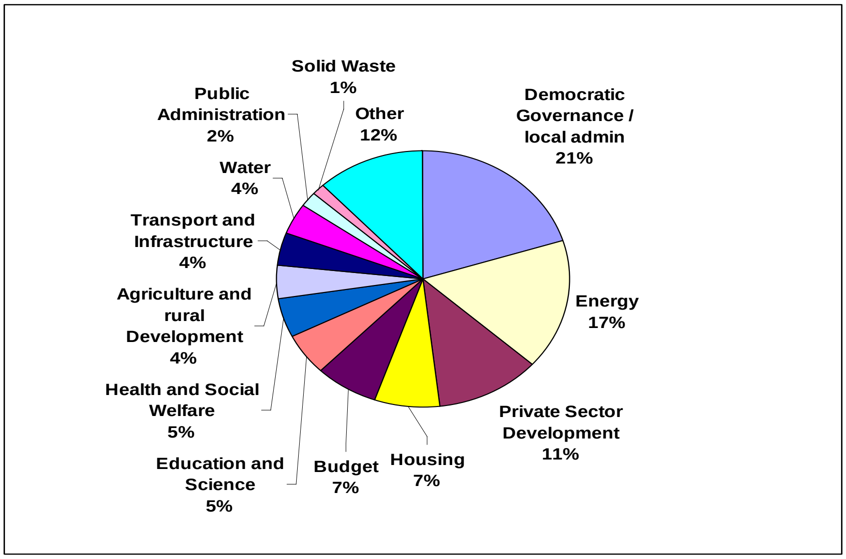
[4] Excludes amounts that have been provided by the European Commission for Humanitarian assistance (ECHO - €378 million), and for support of the Pillar IV of UNMIK (€125 million)

EU Member States and European Commission	66%
USA	18%
Other non EU bilaterals	10%
Financial Institutions	5%
Total	100%

Source: Donor Polling, 1999-2007

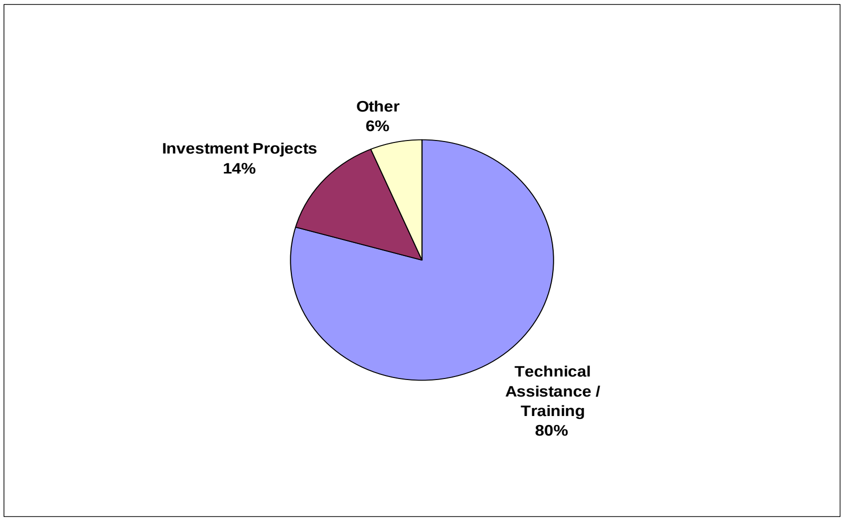
13. **The sectors which received the largest amount of external financing between 1999 and 2007 were energy, housing, institutions, and private sector development** (see Figure 2). The utilities sectors, which were 'high priority' sectors outlined in the Reconstruction and Recovery program (energy, solid waste and water), received €754 million, some 22 percent of donor commitments. Energy alone, funded mainly by the European Commission, accounted for €572 million, or about 17 percent. Democratic governance and institutions is the second highest funded sector, with €720 million, or 21 percent. Housing, which was heavily damaged during the conflict, received substantial support, amounting to 7 percent of the total. All of the other sectors, however, have implicitly been lower priorities for donors, none of which have received more than 5 percent of total donor support over 1999-2007. Amongst these lower priority sectors were agriculture, transport, health, education and social welfare.

Figure 2. Aid Trends: Sectoral Concentration 1999-2007 (€3.5 billion)



14. **As far as the modalities of assistance are concerned, the composition of aid has shifted from primarily reconstruction-related investments in early years, to the largest proportion now being provided in the form of technical assistance projects and programs** (see Figure 3).

Figure 3. Aid Trends: Prominence of Technical Assistance 2005-2007



15. **Moreover Kosovo has received, with a few limited exceptions in the earlier years, almost no direct budget support** and has received only limited aid in the form of program based approaches (such as "donor designated grants") relying on government Public Financial Management (PFM) systems. In previous years, this was most likely due to low donor trust in Kosovo PFM systems, and a more limited focus on government development policies and budgetary priorities.

IV. FUTURE DONOR ASSISTANCE TO KOSOVO – FISCAL FINANCING NEEDS, SECTORAL FOCUS AND PREFERRED MODALITIES

16. **This section aims to assist donors and international financial institutions, working together, in planning their assistance to Kosovo over the period 2008-2011.** The focus is on the challenges of designing a package of support which would meet Kosovo's financing needs while at the same time supporting policy reforms to enhance the prospects for macroeconomic stability and sustainable socio-economic development.

17. **As noted above, despite the budgetary surpluses achieved over the last several years, Kosovo's fiscal financing needs are set to increase in the near-term.** This increase is driven by three main factors: (i) the essential and long sought acceleration of on- and off-budget capital spending, following years of chronic under-execution; (ii) the expenditure obligations associated with Kosovo's implementation of the Comprehensive Status Settlement; and (iii) pressures to increase some elements of current spending, which have recently been contained to levels which may not be politically sustainable over the medium-term.

18. **This section discusses three critical dimensions of future donor support – (i) volumes, (ii) sectoral focus, and (iii) modalities.** Part A presents estimates of aggregate fiscal financing needs over the period 2008-11, based on the MTEF 2009-2011. Against the backdrop of historical donor support, Part B discusses the qualitative shifts in the

composition of spending outlined in the MTEF, hence also of the desired sectoral focus of donor support. Finally, Part C discusses the preferred modalities of donor support.

A. Aggregate fiscal financing needs 2008-11

19. **Kosovo's financing gap has been estimated in a Medium-Term Expenditure Framework (MTEF) 2009-2011[5] which was adopted by the government on June 12, 2008.** The analysis is based on a consolidated view including on- and off-budget needs. It leads to the identification of needs as a difference between expenditures (including notional debt servicing) and domestic resources (the Kosovo perspective, shown "above the line") and of the available financing (both local and external resources, mainly the donor perspective, shown "below the line"). The residual is the net financing balance or the financing gap. The investments described in the MTEF over time aim at reducing Kosovo's reliance on donors by removing existing constraints on growth and employment and by raising Kosovo's attractiveness to foreign investors. The MTEF also lists measures taken and further measures needed to improve the spending capacity of the authorities, following advice and analysis, especially from the World Bank.

20. **The overall net financing needs amount to €1,439 million for the period 2008-2011.** This figure comprises €548 million for on-budget and €490 million for off-budget financing needs, as well as €400 million for debt prepayment.[6] These calculations take into account that Kosovo currently does not have access to financial markets. They are also consistent with the targeted level of fiscal cash reserves that are held as a cushion against possible shocks and in view of the historically high volatility of budget outcomes. The planned reserve stands at €280 million in 2008 and then gradually decreases over time as Kosovo matures to €200 million in 2011.

21. **The framework outlined by the authorities is subject to a set of contingent fiscal risks that are identified in the MTEF.** The downside risks are related to energy (performance and financial needs of KEK), the environment, lost foreign currency deposits in SFRY bank accounts, unfavourable global economic developments, the implementation of the Comprehensive proposal for Status Settlement, and debt servicing. Upside risks are related to higher revenues and the privatization proceeds. An additional factor that will substantially influence Kosovo's fiscal situation and its dependence on donors is the possibility to access financial markets for borrowing. Depending on whether or not these fiscal risks will materialize (and if so, to what extent) and on how fast Kosovo will have access to financial markets, different scenarios can be drawn around the baseline scenario as presented in the MTEF.

[5] The MTEF is labelled "2009-2011" even though it also fully includes the year 2008, so it is actually a four-year framework.

[6] This figure is an estimate. The Kosovan authorities express that mentioning it does not mean recognition of these debt claims. However, they rightly include them in their prudent fiscal framework given the possibility that a significant share of the Serbian debt may eventually be transferred to Kosovo.

B. The sectoral focus of public spending and donor support

22. **Until recently, the near absence of direct budget support allowed the composition of KCB spending and the donor assistance program for Kosovo to be planned and analyzed in isolation from each other.** Technically, this also permitted the construction of sectoral allocations of donor support, as in Section 2 above. However, such a categorization was also misleading, as what really mattered was the total amount of resources – both domestic and donor – which went to a given sector or activity. For example, the level of KCB subsidies to the energy sector was not very informative if donors were also funding electricity imports outside the budget.

23. **The MTEF 2009-2011 represents a strong advance in moving to a more comprehensive view of public spending and its prioritization.** The macro-fiscal section of the MTEF combines on- and off-budget spending and financing in a single, more complete fiscal framework in which a significant amount of ultimately donor-funded spending is now shown 'above the line', with the financing itself 'below the line'. This delinking of sources of finance from particular spending items is crucial with the proposed increase in budget support, which is by definition untied to specific outlays. This more complete picture of spending will also assist donors in assessing the appropriateness of overall public spending, a crucial factor in their decision to provide or not provide budget support.

24. **For this reason, it will not be meaningful to compare past and future allocations of donor support.** If donors collectively choose to focus a very large share of resources on a particular sector, the authorities can respond by shifting their own resources towards other priorities, thereby achieving a *de facto* reallocation of donor support. As noted in Section 2, very little historical donor support was earmarked to sectors such as agriculture, transport, education or social welfare, among others. These are the same sectors which have been given priority in the MTEF 2009-2011. Donors can facilitate the reallocation towards these new priorities by shifting their financing towards these sectors, or by providing direct support to a budget which envisages such reallocation.

C. The preferred modalities of donor support

25. **This section aims to assist donors and international financial institutions, working together, in planning their assistance to Kosovo over the period 2008-2011.** The focus is on the challenges of designing a package of support which would meet Kosovo's financing needs while at the same time supporting policy reforms to enhance the prospects for macroeconomic stability and sustainable socio-economic development.

26. **The MTEF presentation distinguishes among three broad categories of support**: (i) **on-budget financing**; (ii) **off-budget financing;** and (iii) **provision for contingency liabilities** (including, possible debt prepayment). The second category of off-budget support (which is by definition project related) is in turn broken down into capital expenditure and technical assistance.

27. **Increasing the share of *donor support executed via the budget* would be desirable**, as it would fit donor activities in Kosovo's own prioritization and budget management processes through the MTEF and the Public Investment Program. At the same time, channelling resources through the budget will require adequate public financial management systems, e.g. budget preparation in line with strategic priorities, reliable budget execution, and satisfactory systems for procurement, *ex post* audit and monitoring. Also, budget support can reduce predictability of financing if weak commitment to the agreed reforms were to delay tranche releases. While the recent PEFA assessment gave a mixed review of existing practices, especially on procurement and audit, it did conclude that "the level of fiduciary risk is low enough for external partners to consider budget support for Kosovo".[7] The authorities are expected to develop an action plan based on the PEFA assessment.

28. **Support of on-budget expenditures will not be restricted to direct budget support.** Donors who are precluded from offering such support, or do not wish to, can still provide *indirect budget support* by financing projects identified through Kosovo's own prioritization processes (MTEF and Public Investment Programme). **Donors can also support some of the *off-budget capital spending*.** These funds are now included in the MTEF macro framework, such projects should still be planned with reference to the main priorities identified there.

29. **The MTEF's call for a gradual scaling back of *technical assistance (TA)/capacity building* is also sensible.** In 2007, Kosovo's Donor Coordination Centre wrote: "While the building of a new government structure certainly requires substantial TA, the current allocation is probably not the best mix to meet Kosovo's development needs".[8] The sheer number of separate TA activities makes them difficult to manage and coordinate and can lead to duplication and/or conflicting advice. TA should be selective and focused on the government's own priorities, hence increasing ownership. Attention needs to be paid to the sustainability of such activities after donor funding expires.

30. **On top of providing scaled-up aid in Kosovo via budget support, project related aid or technical assistance, assisting in building up a reserve for preparing Kosovo to face contingency liabilities, would be a useful mean to deliver additional aid**.

31. **Turning to alternative categorizations of aid modalities, there is also a need to move towards more <u>coordinated</u> forms of assistance.** Such coordination can involve the *approach* of donors to the economy or a given sector and/or the actual *financing* of donor support. At present, coordination of approaches is uneven across sectors, and when present, is usually informal and dependent on individual personalities. Coordinated financing is almost non-existent. This can sometimes result in overlaps, gaps, conflicting advice, and an increased administrative burden, both for the authorities and for donors.

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[7] Kosovo: Public Expenditure and Financial Accountability (PEFA) Assessment Report. April 2007.
[8] PISG. Office of the Prime Minister. Donor Coordination Centre. *Aid Management in Kosovo – Discussion Note – June 2007.*

32. **There is a need to improve overall donor coordination, with the government taking the lead**. Greater specialization among donors based on comparative advantage would facilitate coordination In some sectors, it can also include moving to a "light" Sector-Wide Approach (SWAp), where projects remain separate (parallel financing), but where all donor effors are based on: (a) a Government-led coordination process among participating donors (b) an approved sectoral policy document; and (c) a sectoral medium-term expenditure framework and annual budget;

33. **Some such approaches could be expanded to include pooled financing**. This can take three forms. First, it can involve the formal *co-financing* of traditional projects. Second, it can involve the pooling of funds in a policy-based *Multi-Donor Trust Fund* (MDTF) for budget support or other MDTFs for direct transfers. Finally, in a limited number of sectors which are best prepared for such a modality, it can include moving to a *"full SWAp" combined* with pooled financing. The World Bank has begun to establish and develop some MDTFs and SWAps for Kosovo, which donors are encouraged to consider joining.[9]

34. **There is a strong case for including policy-based support in the overall donor program for Kosovo**. Good macroeconomic, structural and social policies are critical for ensuring that aid flows contribute to growth and development.[10] Kosovo's policy program over the next three years will determine both the prospects for economic development and social stability and the needs for donor financing to achieve these aims. Given the strong pressures for the introduction of some reforms which would work against fiscal sustainability and development objectives, esp. in the social sectors, there is a strong case for including a significant share of policy-based support in the overall donor program for Kosovo. The reform benchmarks should be limited and focused on feasible and monitorable actual improvements in areas deemed particularly crucial for Kosovo's developmental agenda (e.g. energy, transport, employment, social protection, education and health. This approach would enhance aid effectiveness.

35. **In the near-term, the vast bulk of assistance to Kosovo's public sector is set to continue on grant terms.** Such a composition is appropriate, as the precise amount of public debt remains unclear, complicating the debt sustainability analysis which would normally inform an assessment of the desired split between grants and loans. In such an uncertain situation, it would be imprudent to envisage a significant share of financing needs being met through borrowing, at least from non-concessional sources. This issue should be revisited when the outlines of Kosovo's public debt burden become clearer.

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[9] The complexity and associated transaction costs for involved donors of establishing and managing such common mechanisms, esp. on agreeing to the details of the reform program, should not be underestimated. For this reason, consideration should be given to establishing minimum entry levels for actively participating in such mechanisms.

[10] Burnside, C. and Dollar, D, 2000, "Aid, policies, and growth", *American Economic Review* 90 (4), 847-868; Collier, P. and Dollar, D., 2002, "Aid allocation and poverty reduction", *European Economic Review* 46, 1475-1500; Isham, J. and Kaufmann, D., 1999, "The forgotten rationale for policy reform: the impact on projects", *Quarterly Journal of Economics* 114, 149-84.

V. KEY POLICY AND PUBLIC SPENDING PRIORITIES, 2008-2011

36. **Going forward, the Kosovo authorities will face three main economic challenges: (i) maintaining macroeconomic stability; (ii) controlling, adjusting and managing public spending; and (iii) accelerating reforms in several key sectors.** This section summarizes these challenges, as described in detailed technical papers prepared for the Donor Conference. These papers and the summary are selective and do not cover all elements of the reform agenda. However, analyses of other important areas such as private and financial sector development, and agriculture and rural development, are available elsewhere.[11] This section begins with a discussion of macro-fiscal issues, before turning to the reform and public spending agenda in three key sectors: (i) energy; (ii) transport; and (iii) employment, social protection and human capital development.

A. Macro-Fiscal Policy and Management

37. **The main macro-fiscal <u>policy</u> challenges are maintaining a sustainable fiscal stance and improving the effectiveness of public spending.[12]** The MTEF fiscal framework rightly envisages the contained growth of non-status related current spending, combined with prioritized and boosted public investment. However, pressures for large increases in current spending (especially on wages and social transfers) are significant and need to be managed. The Government's commitment in the MTEF to develop a White Paper to address the issues of social support and welfare provision is a useful first step in avoiding uncoordinated and potentially expensive *ad hoc* spending initiatives. Improved billings and collections in the power sector will be crucial for containing direct and indirect subsidies. While some increase in capital spending is desirable, the budgeted three-fold increase in 2008 (relative to the 2007 outturn) is ill-timed, both due to its macroeconomic impact and its inconsistency with implementation capacity in most line ministries. A mid-year budget review could scale back planned capital spending to a more realistic level. On the revenue side, the focus needs to be on improved tax administration. Finally, as recognized in the MTEF, Kosovo needs to establish and/or increase prudent cash reserves to insure against a number of risks.

38. **Additional expenditure commitments will arise from Kosovo's implementation of the Comprehensive Proposal for the Kosovo Status Settlement** enshrined in the Constitution of Kosovo. These costs can be grouped into five categories: (i) decentralization, (ii) minorities, (iii) security sector, (iv) new institutions, and (v) new obligations (including debt servicing). Detailed estimates of these costs are provided in a technical background paper endorsed by the government of Kosovo.[13] Estimates of such costs are also appropriately included in the MTEF 2009-2011.

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[11] The reform priorities in these areas have previously been elaborated in *inter alia*, World Bank – *Kosovo Economic Memorandum*, May 18, 2004.
[12] For a detailed and up to date summary of these challenges, see IMF, *Kosovo–Assessment Letter to the European Commission*, July 11, 2008.
[13] *Financial Impact Assessment of Kosovo's Comprehensive Status Settlement (abridged version).*

39. **Going forward, Kosovo will also face numerous challenges in reforming and strengthening its <u>institutions</u> of public financial management (PFM).** The recent Public Expenditure and Financial Accountability (PEFA) assessment[14] shows that Kosovo has made noticeable progress in improving its PFM system in recent years. In particular, the computerized treasury system is reasonably well-functioning and comprehensive. The centralized budget execution, accounting and payments system linked to the treasury further reduces the risk of funds being misappropriated. In addition, the customs administration has improved its efficiency and transparency over the years. However, weaknesses remain. Kosovo's PFM system still lacks long-term direction and annual resource allocation does not adequately reflect national and sectoral strategies. Public procurement, internal controls and external audit still need improvements to fully perform their functions in ensuring efficiency and fiduciary control. An action plan for the overall reform of public finance management and accountability would need to be developed and monitored by a single institutional unit.

40. **One area where further progress is particularly crucial is the *execution of capital spending*.** Public investments in Kosovo have moved from being almost entirely donor-funded (and off-budget) in 2000-2001, to primarily domestically-financed from the KCB. KCB-financed capital spending went from a negligible €6.6 million in 2001 to almost €200 million in 2004, before falling back to €133 million in 2006. Actually executed capital spending now accounts for around one-fifth of total KCB spending. However, implementing capital projects has become increasingly challenging for the authorities. As the size of capital appropriations increased, execution deteriorated. The execution rate fell from 87.5 percent in 2005 to 70 percent in 2006, before marginally improving to a still poor 75 percent in 2007. The envisaged increase of capital outlays in the MTEF to some €400 million per annum in the 2008-11 period and Kosovo's desire to shift the composition of donor aid towards budget support, further increases the importance of effective implementation.

41. **The reasons for recent chronic underspending have been carefully studied in a World Bank report.[15]** Its main conclusion is that while Kosovo has a solid legal and regulatory framework, capacities to implement the specified procedures are limited. As a result, capital underspending results from a range of issues relating to the way in which public investment projects are planned, budgeted and implemented. The report's key findings and recommendations are summarized in Box 1.

42. **Since the adoption of the Strategic Reform Plan in early 2007, *tax administration* has improved somewhat, although it remains too weak to keep up with the growth in the number of taxpayers.[16]** The Tax Administration of Kosovo needs to focus much more on improving the foundations of tax administration, namely establishing sound taxpayer registration systems and processes for tax declaration, filing, and payments. Without dramatic improvements in these areas, and a significant upgrading of the

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[14] Kosovo: Public Expenditure and Financial Accountability (PEFA) Assessment Report. April 2007.
[15] World Bank. *Kosovo: Policy Note on Public Investment Management.* October 2007.
[16] This paragraph is from the Aide Memoire of the last IMF staff visit to Kosovo, April 21-28, 2008. http://www.unmikonline.org/docs/2008/reports/IMF-Aide_Memoire_Final-April-2008.pdf.

outdated IT system, any other action will bear little fruit. Both sufficient resources and strong strategic leadership are also essential for achieving reform success. Without substantial strengthening of tax administration, Kosovo's otherwise comparatively good overall tax system will neither deliver improved compliance nor reduce the scope of informal activity in the economy.

Box 1 – Kosovo – Reasons for Capital Underspending

The World Bank report provides a detailed diagnostic of the problems with capital spending, their causes, and key near-term and medium-term recommendations for improving public investment management.

The legal and regulatory framework for public investment management and procurement is largely appropriate. Capital spending is being incorporated into the annual budget process which is governed by the Law on Public Financial Management and Accountability. In addition, several provisions of the law on public procurement which were seen as causing delay and inefficiencies were revised in 2008. However, capacities to implement the specified procedures are limited. As a result, full use is not being made of the procedures elaborated under the legal framework.

Following the deterioration in execution performance in 2006, the Ministry of Finance and Economy carried out a review of the causes of underspending. The review pointed to a range of issues relating to the way in which public investment projects are planned, budgeted and implemented. The review included a survey of projects, which showed that some 40 percent of projects faced delays in the procurement process and one-third of projects had delays in implementation.

The World Bank report identifies two main underlying causes of underspending: (i) the single year outlook; and (ii) capacity constraints. The single year outlook limits the time over which projects can be implemented and leads to a large number of small projects. This cause does not derive from the legislation, but from the application of the laws, especially from the short-term planning and management outlook. Capacity constraints also adversely affect capital spending and are reflected in absence of strategic focus and inadequate preparation of the capital program.

To improve the performance of capital spending, the authorities should distinguish between those measures that could be expected to have an immediate effect on the implementation of the 2008 and 2009 budgets, and those which would primarily affect the implementation of the capital spending program in 2010 and beyond. The immediate measures should focus on: (i) finalization and better planning of the 2009 capital spending program; and (ii) revision of public procurement procedures. The medium-term measures should include: (i) integration and further development of Public Investment Plan procedures; and (ii) strengthening institutions and capacity building.

The Kosovo authorities have recently implemented some of the proposed recommendations. The format of the Annual Budget was revised to show for each project its total estimated cost together with a breakdown of these costs over the full implementation period of the project, with a clear indication of projects' distinct capital, current, and recurrent cost components (amendments will become effective in 2009). The obligation to have technical designs and tender documentation finalized before the start of the fiscal year was already introduced in the 2008 budget.

Other important measures with a potential high impact on spending efficiency include: (i) encouraging budget organizations, where possible and appropriate, to group small investment activities into larger projects; (ii) providing guidance to municipalities on making more realistic forecasts; and (iii) improving procurement operations, including by budget organizations developing a schedule for the coming year that sets out a timetable for planned procurement activities.

B. The Energy Sector

43. **Kosovo's main energy sources are domestic lignite for power generation, imported petroleum products for the transport sector, and heavy fuel oil for district heating.** Fuel wood, often combined with electricity use, is the main fuel for residential heating in single dwellings. Kosovo does not currently have access to natural gas. As the energy sector is dominated by the electric power sub-sector and its problems, the rest of this section will focus on the key issues in this sub-sector.[17]

44. **The power sector's generation, distribution and lignite mining assets are operated by the publicly-owned Kosovo Electricity Company (KEK).** KEK suffers from major technical, financial, staffing and managerial problems. The vast bulk of KEK's generation capacity is in two thermal power plants – Kosovo A and B.[18] The plants operate well below their installed capacity and experience frequent outages due to age (Kosovo A) and/or lack of funds for proper maintenance (both A and B). The total consistently available domestic generating capacity is not enough to meet the average load, let alone peak demand in the winter. As a result, large amounts of electricity have to be imported and extensive load-shedding implemented. All of the lignite used by the power plants comes from the Mirash and Bardh mines that are nearly exhausted. To compensate for their depletion, a new mine (Sibovc SW) needs to start producing lignite in 2010 but development of this mine has not yet commenced due to a lack of excavators.

45. **The transmission system is managed by the Kosovo Transmission System and Market Operator (KOSTT).** Through UNMIK, Kosovo is a Contracting Party to the regional Energy Community and is linked to the regional system via interconnections with Serbia, FYR Macedonia, Montenegro, and Albania. Kosovo is also at the center of the north-south transmission interface of the South East European market, and important for power flows to and from Serbia, FYR Macedonia and Greece. Outage of any segment of this transmission path would have a negative impact on power flows in the southern region of SEE. KOSTT is well managed but underinvestment due to lack of funds has limited the grid's transfer capacity to below Kosovo's winter peak demand.

46. **KEK has long suffered from underinvestment, physical damage, lack of payment discipline, weak management, and overstaffing.** During the 1990s, the whole system received virtually no funding for maintenance and rehabilitation, resulting in reduced efficiency and technical failures. KEK's physical assets were then impacted by the Kosovo conflict, and later by a major lightning strike on Kosovo B. Subsequent donor- and KCB-funded investments to repair this damage and reinforce the system prevented a humanitarian catastrophe but were not enough to improve service. The waiver of payment of electricity bills in the early post-conflict years and a tolerance of electricity theft shifted the perception of electricity from a paid to a free commodity among part of

[17] The more detailed technical paper prepared for the donor conference discusses other energy sector issues, including district heating, liquefied petroleum gas, natural gas, renewable energy, energy efficiency, as well as environmental and social issues (including resettlement) in the power sector.

[18] Kosovo has only about 43 MW of operational hydropower capacity although there is significantly more potential.

the population, leading to major funding shortages. Since many managers and top technicians had left Kosovo, both management and sector expertise needed to be rebuilt starting in 2000. Foreign technical assistance and management advisers could not produce long-term improvements. KEK remains chronically overstaffed: many of its about 7,000 workers are poorly qualified and some are involved in corrupt practices. The lack of a strategy to align staff with needs, and the political inertia related to downsizing KEK for fear of a backlash, continue to plague the company.

47. **Given these constraints, the runaway growth of electricity demand required substantial imports and load shedding to balance the system.** Fueled by massive non-payment, electricity consumption in Kosovo increased by almost 7 percent per year from 2000 to 2007. The average price of imports increased from €41/MWh in 2004 to about €130/MWh in 2008, primarily reflecting electricity shortages in the SEE region. Power imports reached €45 million in 2007, of which the KCB funded €10 million. Kosovo has also resorted to extensive load shedding over the past few years to balance demand and supply.

48. **As a result, KEK's operational and financial performance has been very poor.** Its estimated 2007 net operating loss (excluding budgetary and donor grants) was about €55 million and the company's net worth is minimal. KEK's inability to make the necessary investments and properly maintain its assets causes further deterioration of the electricity supply, making consumers even less willing to pay for poor service.

49. **This poor performance also had adverse impacts on public finances and the business environment.** KEK remains a costly burden on the KCB, while also absorbing a large share of donor support to Kosovo. From end-1999 to 2008, it received about €1,052 million in subsidies, of which €459 million was from the KCB and €593 million from donors (of which €415 from EAR/EC). This transfer of over €100 million per year was equivalent to 4 percent of GDP. KCB allocations of about €70 million per annum during the last three years represented 11 percent of total budgetary expenditures. KEK's low quality of service imposes high costs on Kosovo's economy, with the unreliable supply of power often being cited as the largest single barrier to investment in Kosovo.

50. **At the same time, the sector is one of Kosovo's most promising sources of long-term growth and fiscal financing.** The *Generation Investment Study*[19] identified power generated from lignite from the large Sibovc field as a prime regional least-cost development option. Sibovc lignite offers a unique resource rent that has not yet been tapped, while lesser quality/quantity deposits provide electricity in other parts of Europe.

51. **With all of these serious issues outstanding, KEK must be fundamentally overhauled and the Government must play its part to make it an effective enterprise and improve the performance of the electricity sector.** The two most pressing issues are: (a) taking measures to contain the growth of electricity demand and strengthen KEK's finances; and (b) immediately beginning the development of a new lignite mine

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[19] European Commission/World Bank, *South East Europe Generation Investment Study*, 2005; updated in October 2006 (World Bank).

given a looming lignite supply gap. Although generation, transmission and distribution assets are also in need of improvement, commercial losses (theft and non-payment of electricity) rather than lack of capacity are the main issue in the sector.

52. **The most important issue to be addressed is the low level of billings and collections.** In 2007, technical losses constituted 16 percent of demand (production plus net imports) while another 44 percent was stolen or otherwise not paid for ("commercial losses") (see Figure 4). Theft accounted for over 22 percent of demand, primarily the result of actions by customers but often facilitated by KEK employees. In short, fully 60 percent of demand was not paid for. In 2007, commercial losses were 1,900 GWh, equivalent to the entire production of Kosovo A plus part of Kosovo B's output. At 2007 prices, this represents annual lost revenues to KEK of €99 million, an amount which would have allowed KEK to cover all its operating expenditures and electricity imports, and part of the capital investments that were made over this period. Also, if theft and nonpayment were eliminated, demand could go down by about 15 percent and money would be available for maintenance, investments and power imports, if still required.

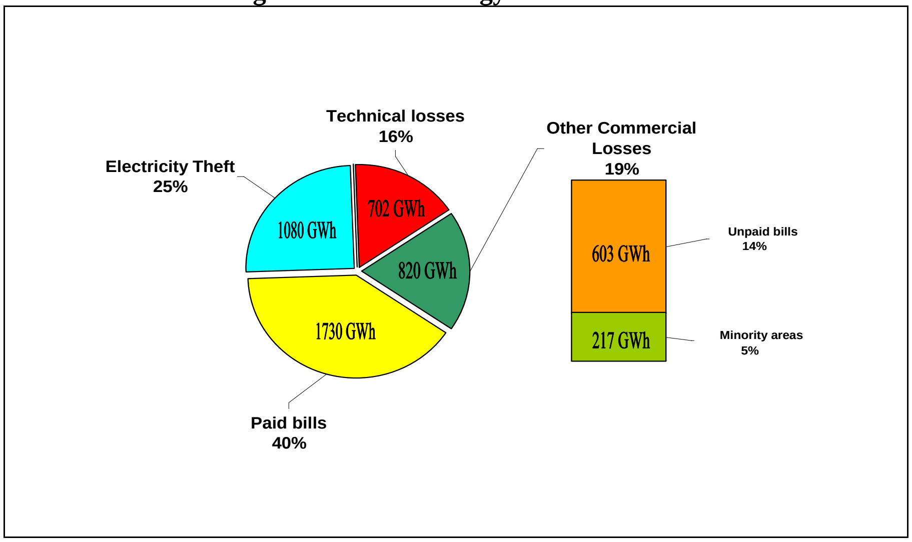
53. **The second most urgent matter is beginning the development of a new lignite mine to supply existing generation plants.** The dwindling production from the Mirash/Bardh mines will gradually need to be replaced by the new Sibovc SW mine starting in 2010. Under ideal conditions, a mine of this size would take four years to develop. While this mine could be operated by a private investor from 2010, avoiding a costly disruption of lignite supply requires its development to start without further delay. These initial investments during 2008-09, which could total around €110 million, need to be undertaken by the public sector (KCB and KEK). The inclusion of an €75 million credit facility in the KCB/MTEF to fund equipment refurbishment or new excavators for this purpose is thus encouraging. EAR and KfW are providing €25.2 million for the refurbishment of two excavators; €15 million in KCB co-financing is needed.

54. **Reducing commercial losses will require limited investment but significant political will.** Some technical improvements can increase the amount of billed electricity. KEK has already implemented a detailed energy balance reporting system to quantify lost energy for each district. Further progress requires expansion of secured metering, both at the distribution transformer and end-user levels, with meters being in accessible locations and secured to prevent tampering. Introduction of 100% metering with smart meters could be piloted in one or two cities. Such metering schemes would support KEK's efforts to introduce individual staff accountability for billing and collection, allow targeted demand management, and facilitate end-user energy efficiency.

55. **KEK needs to be supported by vigorous parallel actions by the government and the judiciary.** Strong penalties should be instituted for electricity theft and for corruption by KEK staff, if necessary by amending the Criminal Code. KEK should be allowed to dismiss dishonest and ineffective employees, without the latter having undue recourse. The police should assist KEK in systematically identifying cases of theft and, where necessary, make arrests. The courts should be resourced and empowered to deal expeditiously with the large backlog of electricity theft and non-payment cases and to

deal with new cases in the same manner. KEK should be given full ownership of all end-user meters and be solely in charge of meter purchasing and installation.

Figure 4. KEK's Energy Balance – 2007



Source: KEK; LPTAP Project Office

56. **Containment of demand also requires a program of gradual tariff increases.** Kosovo's electricity tariffs remain well below cost recovery levels, let alone the marginal cost of imports. While the Energy Regulatory Office (ERO) is formally charged with setting tariffs, it was subjected to direct government intervention on a proposed 2007 tariff increase and its budgetary independence has been eroded by the Kosovo Assembly. ERO's autonomy and independence is: (i) a requirement of the Energy Community (Athens) Treaty; (ii) necessary to ensure that KEK and KOSTT can become self-sustainable; and (iii) vital to shore up prospective investors' confidence. ERO should be allowed to exercise its authority to set end-user tariffs, based on economic criteria.

57. **The burden that tariff increases and collection enforcement will impose on poorer households is a legitimate concern**. Although electricity prices are low, the total energy bill for the average Kosovar (when paid) is still a substantial share of disposable income. However, this is best addressed through targeted support programs to needy households. Shifting the burden to KEK undermines its financial viability and deters investors. However, the existing support program, while relatively well targeted, is inadequately funded and has insufficient coverage of the poor (see later section).

58. **Considering projected demand growth, high power import prices, and the lead time until the planned Kosovo C plant is commissioned (around 2015), Kosovo should also invest in enhancing the capacity and reliability of existing generation capacity.** Again, since any engagement of the private sector in operating these plants will take time, the initial outlays need to be funded by KEK and KCB. The focus should be on the B units, which consume less fuel and produce fewer emissions than the A units, yet operate below design capacity. With proper investment and maintenance, Kosovo B should be able to operate more reliably and at increased capacity through 2024. Units

A3-A5 should be maintained to provide service until 2017, when Kosovo A is expected to be closed down under the EU's Large Combustion Plant Directive.[20]

59. **The Kosovo C (new mine/new plant) project aims to attract private capital and expertise to develop new lignite mining and power generation capacity.** It envisages construction of up to about 2,000 MW of generation capacity to supply the domestic and regional market, supported by new mining operations in the Sibovc lignite field, including the Sibovc SW Mine (which would supply KEK's existing power plants). The World Bank is supporting these efforts through the Lignite Power Technical Assistance Project (LPTAP), which funds related advisory services. EAR has funded an options study and technical studies in support of LPTAP. In December 2006, the government short-listed four prequalified bidders.

60. **The Transaction Advisor has reviewed and endorsed the prequalification procedure and begun to develop the Request for Proposals.** The current emphasis is on completion of the Strategic Environmental and Social Assessment (SESA) and a draft Sibovc Development Plan (SDP). Informed by the SESA and SDP, the Government will need to decide on several key issues, including the size range of the generating units to be constructed. It also needs to choose the composition of the package from various sub-combinations of the New Mine (all or part of the Sibovc Field), the New Plant (i.e., Kosovo C), and Kosovo A and/or B and certain transmission lines. The background paper discusses the strengths and weaknesses of various options. However, in evaluating these options, two over-arching criteria are: (i) maximizing the return to Kosovo from its lignite resource; and (ii) allowing Kosovo to best address the impending risk of a lignite and electricity supply gap in 2010-2011 as the Mirash and Bardh mines near exhaustion.

61. **After review by the government, the advisors will finalize the Request for Proposals for issuance to the short-listed bidders.** Based on past experience, and subject to resolution of legal matters, the remaining steps culminating in financial closing could be completed by around end-2009. If carried out in an open, competitive and transparent fashion, the Kosovo C/Sibovc transaction offers a break with past practices, and promises the introduction of world class private sector investment and international good practice on environmental and social issues in mining to Kosovo.

62. **Engagement of the private sector could require Kosovo to take on significant contingent liabilities, either directly or indirectly through KEK and KOSTT.** The technical paper discusses these issues in more detail. It is important for all contingent liabilities to be stated in accordance with IMF guidelines or other best practices. Even more important is exercising appropriate caution when negotiating such clauses, with due attention to fiscal limits and to ensuring a reasonable distribution of the risks between the state and private sector.

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[20] The ongoing overhaul of A5, which should extend its life to 2017 and add about 120 MW of capacity, should be completed. Given the very poor environmental performance of Kosovo A, investments should also be made in environmental impact remediation and in meeting applicable EU standards. Units A3 and A4 already underwent an overhaul in 2007, and are operating intermittently. In contrast, units A1 and A2 are too old, inefficient and environmentally damaging to warrant further rehabilitation.

63. **Further upgrading and new investment are needed in the transmission and distribution networks to reduce losses, while demand side investments in energy efficiency should be undertaken to help curb demand.** Targeted investments will improve the reliability of the transmission system, eliminate power transfer constraints facilitate regional power exchanges, and help reduce technical losses. Finally, they will facilitate billing and collection. Reinforcement of Kosovo's interconnections to the regional electricity market is essential for ensuring the security of Kosovo's electricity supply. Rehabilitation of several substations is necessary to decrease technical losses and improve service and reliability. The most urgent investments in the distribution network concern metering assets at the sub-station level and secure metering at the end-user level. The technical paper provides detailed investment project proposals.

64. **Finally, several other reforms need to be advanced.** These include: (i) finalizing the Government's energy sector strategy; (ii) undertaking further unbundling of KEK to meet Kosovo's obligations under the Energy Community Treaty and facilitate private participation; (iii) developing a sound legal and institutional framework for concessions and/or privatization to strategic investors; (iv) exploring the desirability and feasibility of privatizing KEK Distribution; and (v) developing a royalties regime for lignite extraction. Any concessions or privatizations need to be carefully prepared, and the process needs to be conducted in an open, transparent and competitive manner. Again, their success will be intimately linked to improvements in the financial performance of the sector, especially through better billings and collections.

C. The Transport Sector

65. **An efficient and effective transport system is crucial for sustained economic growth and poverty alleviation in Kosovo.** In addition, Kosovo's geographical location and landlocked status, and the impacts on trade, transport costs and growth, underlines the importance of not only developing such a system, but also integrating it with those of neighbouring countries.

66. **Conflict and subsequent neglect has left Kosovo with a transport system that is inadequate for its needs and incompatible with European standards.** The direct war damage was largely addressed during 1999-2003, when large-scale donor-funded reconstruction efforts rightly focused on the main road and rail networks. However, this focus, together with limited subsequent support from domestic sources, also resulted in inadequate maintenance.

67. **Growing incomes have led to significant increases in vehicle ownership and usage.** The greatest traffic volumes are in and near Pristina, where roads have reached capacity and congestion is heavy. Kosovo is likely to continue experiencing annual growth in vehicle ownership and use in a range of between 3–6 percent.

68. **Going forward, the first priority is maintaining and improving the <u>existing road network</u>.** Recent surveys found that 12 percent of the primary road network, 26 percent of the regional network, and 94 percent of the local network are in poor or very poor condition. A number of bridges and structures also need urgent repair. Without adequate

maintenance, roads deteriorate and costs to users increase, until reconstruction is necessary, at greater expense than any short term saving.

69. **This requires increasing expenditure on maintenance.** Recent budgetary allocations have been well below levels required to maintain the existing network, let alone to begin clearing the maintenance backlog. The local road network under the municipalities is particularly susceptible to inadequate maintenance as a result of limited resources at the local level, inadequate capacity, and competing budgetary interests. Paving key regional roads would be the next priority, together with key upgrades to the primary road network. The accompanying sector report provides a more precise breakdown of needs.

70. **This also requires enhanced capacity to manage and maintain the road network.** The use of an asset management system is essential for ensuring that limited funds are spent on those sections of the network that provide the highest economic benefit. While significant progress was made during the 2006 budget process in the use of economic analysis to evaluate investment projects, the full use of asset management approaches remains limited at this time. There is little regular monitoring of the condition of the infrastructure, although the measurement of traffic volumes has started. On the local road network, similar efforts are needed but in a simplified manner.

71. **Adequate maintenance needs to be complemented by a well-planned program of new investments, including for upgrading the core network.** Improved integration with the regional transport network is crucial for strengthening trade links with neighboring economies, and for giving better connectivity to more remote areas. Core network development has been fully and continuously supported by the European Union, starting with several key studies, and the subsequent establishment of the South East Europe Transport Observatory (SEETO) in 2005, to create a regional consensus to develop a core transport network in a manner consistent with the EC Common Transport Policy. Kosovo is crossed by two routes on the SEETO core road network for a total of 310 km – Route 6 from Montenegro to former Yugoslav Republic of Macedonia, and Route 7 from Albania to Serbia. Both routes also connect the main economic centres within Kosovo.

72. **The construction of Route 7 is seen as the immediate national priority.** Work on the southernmost section between Morine and Prizren is scheduled to start in the summer of 2008, to link with a new highway in Albania which is scheduled to open in 2009. A recent feasibility study correctly recommended a combination of new construction and upgrading along both corridors in a phased implementation in line with the resources and fiscal envelope available to the Government, with further survey and design work needed on particularly costly segments.

73. **The attraction of significant private finance is a possible solution for the longer term.** A study conducted last year to establish the viability of public-private partnerships in Kosovo concluded that: (i) tolling was not an option at this time, given the low traffic volumes on much of the route and willingness to pay concerns; (ii) the institutional framework was too weak to make a large PPP likely in the medium term; and (iii) certain essential actions are necessary prior to the preparation of a pilot – including the

completion of an investment grade traffic study, a strengthened legal and administration framework, and improvements in the rule of law.

74. **Kosovo needs to significantly improve its road safety conditions.** Reported traffic accidents increased from 5,416 in 2003 to 13,917 in 2005. The fatality rate per 10,000 vehicles is over 9 times higher than the rate in the 'safest' European Union countries, and one of the worst in the region. Contributing factors include increases in traffic volumes, the poor historical alignment of roads, uncontrolled development along strategic roads, and variable design and maintenance practices. Measures to begin addressing these problems include the undertaking of a Network Risk Analysis and risk rating for a large part of the road network, to identify those links/locations with the highest risk of accidents to achieve the greatest benefit for any safety investment.

75. **Despite limited maintenance, Kosovo's 333km long system of single track non-electrified railways is mostly in good/fair condition**. There are two main lines – North to South (148 km on SEETO core route 10 between Serbia and FYR Macedonia) and North East to West. The North-South line is the only line currently operational for both cargo and passenger services.

76. **Kosovo Railways (KR) manages the railway infrastructure and operates both passenger and freight services**. KR is one of the least productive railway companies in the SEE region. It suffers from among other factors: the collapse of bulk traffic volumes following the conflict; the atomization of the former Yugoslav Railways; and fierce competition from road transport. The main physical problems in the railways sector include rolling stock which is generally old and in poor condition, and poor quality infrastructure on some segments.

77. **Freight traffic has recently begun to grow sharply, with potential for further increases.** This has primarily been linked to the reopening of one nickel mining and smelting operation. The successful resumption of activities in other extractive and basic industries, and the resulting need to move heavy bulk freight, could produce further increases, as could the opening of strategic regional networks.

78. **In contrast, the sustainability of recent modest increases in passenger traffic is questionable**. These increases have come at the cost of higher subsidies, as passenger volumes and revenues remain low. The intense competition with road based modes, and Kosovo's modest size, suggests that passenger volumes are unlikely to return to anywhere near pre-war levels. This calls into question KR's current strategy of trying to expand passenger services.

79. **Pristina International Airport (PIA) is operating relatively satisfactorily**. As recent and projected operating revenues exceed operating expenses before investments and loan repayments, PIA should be able to meet its investment needs without government support. A key priority for the sector is achieving licensing by the International Civil Aviation Organization (ICAO), which would produce savings relative to the cost of its current provisional license. A second priority is full implementation of the agreement establishing the European Common Aviation Area (ECAA), to which Kosovo is a signatory. The implementation of the first phase of this agreement – an extension of the Single European Sky – is currently underway. In March 2007, MTC established a working group to coordinate the drafting legislation which establishes the

Kosovo Civil Aviation Authority and covers all areas of civil aviation activity in accordance with EU legislation.

80. **The <u>urban transport</u> network is showing considerable signs of strain**. The economic development and rapid population growth in and around Pristina, and the associated growth in the motor vehicle traffic, is placing an increasing strain on the road infrastructure in the area. The convergence on Pristina of key routes to-from the north, south and west causes through traffic to merge with local traffic, further exacerbating traffic jams. The proposed solution was the construction of a ring road around Pristina, but the proposed function of this road and Route 7 overlap, making this proposal a long term consideration. There is a severe parking shortage in city center. The urban public transport system offers a fragmented and low quality service. A mix of public and private companies operates a limited number of buses in poor technical condition, resulting in unreliable and low quality service.

81. **There is currently no coherent <u>policy</u> or strategy to guide the development of the transport sector in Kosovo**. In a context of conflicting demands within and across the sub-sectors and finite resources, priorities need to be carefully determined within the context of a Sector Wide Strategy and Policy. Such a document would consider carefully the tradeoffs both within and cross the different sub-sectors, and produce an investment plan, reflective of both current and future demand on all modes, but also consistent with the available fiscal envelope. The European Agency for Reconstruction (EAR) is now funding the preparation of a comprehensive Multi-Modal Transport Sector Policy and Strategy. The first draft should be ready in the late summer of 2008.

82. **Ensuring the effective and efficient functioning of organizations of the sector requires strengthening the institutional framework and developing a trained and effective cadre of public servants.** Despite improvements, the limited number and quality of human resources in these organizations remains an endemic problem. One reason is that limitations in public sector salaries, and the current constraint on hiring, means that suitable staff is unavailable to benefit from the currently modest levels of technical assistance and capacity building being provided to the sector. A significant increase in the provision of technical assistance without the freedom to hire suitable recipients will undermine the value of any future technical assistance.

D. Employment, Social Protection and Human Capital Development

83. **Promoting the "jobs agenda", delivering social protection in an effective and fiscally sustainable manner, and strengthening human capital rank high among priorities for Kosovo's development.** Indeed, Kosovo's post-conflict economic recovery, although supported by extensive foreign assistance and private inflows, has not led to significant job creation and/or an improved stock of human capital. In turn, joblessness is a key cause of income poverty. Kosovo also has some of the worst human development indicators in South Eastern Europe. These challenges are particularly complex given Kosovo's recent slow growth, relatively young population, emerging pressures to greatly expand social programs, and recent history and post-conflict context.

84. **This section of the prospectus discusses key challenges and policy priorities in four areas**: (i) employment; (ii) social protection (social assistance, benefits for veterans and their next of kin, and pensions); (iii) education; and (iv) health care.

a. Employment

85. **Unemployment, while beginning to decline, remains extremely high.** The reported unemployment rate has declined slightly from 52 percent in 2003 to a still very high 45 percent in 2006, while the employment rate has risen from 25 to 29 percent of the working age population, still the lowest in the sub-region. The situation is especially dire for young people, with reported youth unemployment of around 76 percent. The challenge of youth unemployment is particularly daunting given that Kosovo has the youngest population in Europe and relatively high fertility rates (2.7).

86. **The main barrier to increased employment is chronically low demand for labor.** For this reason, the most crucial reforms for strong and sustainable job creation fall largely (although not entirely) outside the labor market. Significant improvements in the economic situation will require a multi-sectoral strategy to maintain macroeconomic stability and create a more dynamic private sector through improvements in the business climate.

87. **In the short- to medium term, as prospects for economic expansion and job creation improve, labor market reform can also contribute to a better environment for job creation.** Two potentially important issues are the regulatory framework and labor costs. Labor market regulations – including on the hiring, firing and deployment of workers – can have significant impacts on employment, especially in the formal sector and for youth and women. In Kosovo, the existing labor legislation does not appear to be a significant barrier to employment, although recent new drafts threaten to introduce some very costly rigidities (e.g. relating to severance and minimum wages). The legislation and these proposals need to be carefully reviewed to assess their fiscal and labor market implications.

88. **The other aspect of the labor market framework that requires analysis is total labor costs.** There are concerns that distortions in the labor market may be leading to (Euro-based) wages which are high relative to productivity. Analysis is needed to determine the extent to which wages, and the additional non-wage costs coming from social charges and other obligations, are constraining employment.

89. **Focused and cost-effective active labor market programs (ALMPs) can also contribute to a more job-friendly labor market.** While employment services and training programs will have limited impact in a labor market as slack as Kosovo's, they can play some role in improving the employability of job-seekers and disadvantaged workers. The Public Employment Service (PES) has limited capacity and severe budget constraints. Starting to build capacity of the PES now would be a useful measure for the future. The draft Employment Promotion Law should also be reviewed in terms of whether it establishes an appropriate regulatory framework for ALMPs.

90. **While the noted reforms will be crucial for improving future labor market conditions, there are reasons to also consider measures that could have more immediate and direct job creation impacts.** Such interventions are controversial since they can have significant costs and uncertain benefits, especially beyond the short-term. However, in the case of Kosovo where there is so much slack in the labor market, they deserve consideration.

91. **Public works/workfare and subsidies on wages or social insurance are two such options.** Public works programs have proven effective for creating short-term employment for truly jobless workers if carefully targeted and if the wage is set below the equilibrium wage for unskilled labor. This may be an appropriate intervention for prime-age workers with little chance of finding private-sector jobs. On the other hand, wage or social insurance subsidies (ideally combined with some training) may be more appropriate for giving younger people a foothold in the labor market. Analytical work would be needed to assess these options and propose designs that ensured the desired targeting, incremental job creation with minimal substitution and deadweight effects, limited distortionary effects in the labor market, and consistency with available fiscal resources. These measures would be more justifiable, of course, if the reforms with a longer term effect discussed above are seriously implemented at the same time.

92. **Recently weak donor coordination has led to a proliferation of small-scale employment programs targeted at youth**. In Kosovo, most such programs are financed and/or implemented by donors, who therefore play a major role in defining the policy agenda. However, not all donors have a common agenda, with some seeming to favor VET-related programs, while others prefer programs that seek to directly promote employment, such as apprenticeships and entrepreneurship support. As a result, there is a proliferation of expensive programs with limited scope and coverage.

b. Social Protection

93. **Social assistance, benefits for war veterans and their next of kin, and pensions are the three main social protection programs in Kosovo.** This section elaborates key priorities in each of these areas, while emphasizing the need to reallocate resources within social protection from the relatively generously funded and untargeted veterans benefits programs towards the currently underfunded and better targeted social assistance and pension systems.

94. **Kosovo's <u>social assistance</u> program aims to provide cash benefits to the poorest segments of the population.** The level of the benefit ranges from €35 to €75 monthly, depending on the size and other resources of the family, with the average being €52. Currently, 161,863 individuals in 37,392 families are receiving benefits. The benefit was supposed to have been indexed to inflation but has not been increased since 2003.

95. **The program appears to be relatively well-targeted, but could be expanded and strengthened if and when fiscal resources permit.** About 45 percent of benefits are estimated to be reaching the poorest quintile of the population, with only 6 percent going to the richest quintile (thus outperforming comparable schemes in Albania, Bosnia, and

Serbia). However, only about 23 percent of the poor and 34 percent of the extreme poor are reached by the program, and the benefits are insufficient to bring many recipients above the extreme poverty line. Priority actions could involve: (a) increasing funding for the program to raise the level of benefits and/or expand coverage of the poor (possibly through the containment of outlays on veterans benefits - see below); and (b) requesting technical assistance to strengthen program management, including formalizing good practice in decentralized targeting practices. These actions take on particular importance given the current global food price crisis.

96. **Kosovo could also explore the possible role for conditional cash transfers.** CCTs have been used in dozens of countries, with the dual goal of reducing current poverty (through targeted cash transfers to poor families with children) and reducing future poverty through improved human capital (by conditioning benefits on human capital investments, such as attending secondary school). Significantly higher drop-out rates among the poor at the secondary-education level do suggest that demand-side constraints prevent access for the poor (and particularly poor girls) to education. Cash transfers conditional on school attendance could help alleviate these constraints, providing incentives for children to enroll, attend and stay in school. In Kosovo, given that the existing social assistance program appears well targeted to the poor, one option could be to expand coverage to target poor families with children and introduce education- (and possibly health-) related conditionalities. Alternatively, a new program could be considered, though most CCTs around the world have taken around 18 months to design, launch and refine to function adequately.

97. **Spending on effective programs – such as targeted social assistance program – competes with more generous outlays on veterans benefits, which are not targeted to the poor but are highly politically sensitive.** Based on the relevant 2006 law, five categories are eligible to life pensions. In the first year of implementation (2007), only two categories were paid benefits at only 70 percent of the statutory amount. In 2008, the KCB allocated €20.5 million for these programs, an amount considered sufficient to pay out the full benefit to all five categories. While the Kosovo Assembly is due to review and amend the law this year, no amendments have yet been put forward by MLSW.

98. **The law is likely to be unaffordable if it continues to be implemented under the same provisions and criteria.** Unlike in neighbouring economies, Kosovo's veterans' benefits program does not require means-testing. Benefits are also quite large relative to other social benefits, in some cases well above the average wage, and exist for the life of beneficiaries. Given the number of families which may have suffered deaths and invalidities, the number of beneficiaries might be much higher than currently estimated.

99. **The costs of implementing the law can be contained by capping them in real or even nominal terms.** Options for introducing means testing in the future could be explored. Alternatively, the Government could establish a maximum budgetary expenditure on veterans' benefits and prorate all benefits established under the law to exhaust this budget. Such rules have been successfully implemented in Bosnia and Herzegovina and were already implemented in Kosovo in 2007, when only 70 percent of the value of benefits was paid.

100.**Kosovo's current <u>pension</u> system represents a reasonably optimal mix of providing a minimum subsistence level to all elderly, irrespective of contributor status**.[21] It is important to maintain these features in the near-term given the high informality in labor markets and a defined contribution savings-oriented system designed to provide additional benefits to current workers when they retire. The first component of the pension system has had an important role in reducing both extreme and absolute poverty, even more than the means-tested social assistance program. The second component is designed to provide additional future benefits to current workers without imposing further liabilities on the Government and with appropriately low contribution rates, given the high rate of unemployment.

101.**Nevertheless, the Government continues to face pressure to return to a more generous, but unaffordable, ex-Yugoslav-type pension system**. All ex-Yugoslav countries except Slovenia have substantially reformed their inherited pension systems because these were unaffordable. Ironically, while Kosovo pensioners and some officials have sought to reintroduce major elements of the old system, the other countries are moving towards the existing Kosovo system. While the original basic pension law dictated that the pension would be inflation indexed, this policy has not been followed. If fiscal space permits, one short-term option pending a more thorough pension reform strategy would be to restore inflation indexation for those who are not receiving the increased basic pension which the Government has been providing to those with 15 years of verifiable contributions to the ex-Yugoslav system. The Ministry of Finance has already included the additional expenditure for inflation indexation in the MTEF 2009-2011. The Government should wait to allow these changes to be absorbed before embarking on any further changes to the pension system. There is a need to avoid increases in social contribution rates which would only increase the already high unemployment rate. The Government also needs to protect the mandatory pension contributions which are invested by KPST.

c. Education

102.**As Kosovo enters a new phase of development and integration into Europe, building the skills of young people for work and life will be crucial for poverty reduction, as well as for peace and stability**. While the most important cause of joblessness is currently low labor demand, the lack of relevant skills (to labor market needs) limits the ability of many people to get productive employment and to perform well the tasks required by employers. Although Kosovo is still far from being a skill-intensive economy, there are already signs that the demand for skills is increasing and

[21] The pension program in Kosovo provides benefits to all individuals of age of 65 and above, irrespective of previous contribution history, at the current level of €40 per month. This benefit, which has been fixed since 2005, is provided to 128,000 people. In addition, formal sector workers and their employers aged 55 and younger in 2002 are required to contribute 5% of wage each to an individual account with the Kosovo Pension Savings Trust (KPST), an autonomous public entity which manages retirement savings by investing the money with internationally recruited asset managers and provides payments either by lump sum or as periodic withdrawals when they retire or become disabled. Beginning in 2008, the government decided to acknowledge those who had contributed to the ex-Yugoslav pension system by providing €75 per month instead of the €40 to those who could prove that they had contributed 15 years or more under the former system. The Government is still accepting applications for this increased pension, but estimates that only 35,000 of the total beneficiaries will qualify on the basis that there were 33,800 old age pensioners in 1998 and that 1,700 applications were still being processed.

shifting towards more general skills that allow workers to adapt to changes in demand. But the supply of skills (produced by the education and training system) has not responded to these changes in demand.

103. **Kosovo's education system suffers from low enrolment at higher levels and from poor quality.** While net primary enrolment is high (95 percent), secondary enrolment (75 percent) and tertiary enrolment (16 percent) are lower than in neighbouring economies. This reflects a problem of retention and high drop-out rates. The transition to secondary school remains a barrier for many children, particularly girls and the poor—81 percent of boys/children in the richest quintile are enrolled in secondary education, compared to only 67 percent of children in the poorest quintile and 66 percent of girls. More serious is the poor quality of much of the education provided, exacerbated by high teacher absenteeism and multiple-shift schools which reduce the effective teaching day. Although data on student learning are limited, a recent pilot assessment of children in grade 5 showed poor learning outcomes, particularly in mathematics. Poor quality also undermines Kosovo's drive for meeting the EU Lisbon Agenda.

104. **As described in the MTEF 2009-2011, the government has identified education as a priority area for economic and social development.** It has also produced two sound strategic plans for education (pre-university education 2007-2017 and higher education 2005-2015), which are being used as the basis for moving towards a SWAp, with donors aligning around a credible education sector strategy and supporting the necessary capacity building at the ministry of education to plan, implement, monitor and evaluate. These strategies lay out a broader reform agenda, key elements of which are outlined below.

105. **A first priority is establishing the institutional foundation of the education system.** This involves developing a legal framework that defines the roles and responsibilities of different administrative levels for different levels of education. In line with the Constitution, the Kosovo Assembly recently passed a fiscal decentralization law, which includes general guidelines on determining the education grant to municipalities. The draft municipal education law, which defines the competencies of municipalities in pre-university education, is being discussed in the assembly. A next step in implementing the fiscal decentralization law is the design and implementation of a new formula for education grants to municipalities that better reflects the needs of schools. A working group has been set up for that purpose.

106. **Kosovo also needs to selectively expand its school network on a strategic basis.** The construction of new schools should be based on professional school mapping to take account of the sizable movement of population during the years of instability and the fact that quadruple shift schools exist in some urban areas.

107. **Demand-side constraints to secondary attendance need to be reduced.** Much higher dropout rates among the poor suggest that part of the problem lies in the unaffordability of secondary school among poor families (beyond tuition, which is free). Such constraints can be addressed through needs-based social assistance grants, possibly as CCTs which would provide a cash transfer to adolescents in poor families (or

adolescents with characteristics that make them more likely to discontinue schooling) conditional on attending secondary school.

108. **Quality can be improved by strengthening teacher incentives and training.** Well-motivated and prepared teachers are critical for the success of reforms to improve the quality and relevance of curricula. At present, 18 percent of teachers are not qualified. Salary levels are low (about 2/3 of the average wage in Kosovo) and compressed. Well-designed and well-implemented monetary incentives (including linking promotion to performance) can attract and motivate better qualified teachers to work to their potential. This process will require the certification of all teachers and increased resources to cover the incentive payments. Such reforms need to be consistent with available fiscal resources as defined in the MTEF and the implementation capacity of the MEST, and may need to be accompanied by other measures to limit the overall wage bill in the sector. Quality improvement also requires the provision of appropriate pre-and in-service training, particularly in student-centred methods.

109. **Further improvements are also required in higher education and post-school learning.** The expansion and improvement of higher education can be promoted through the introduction of alternative (to tuition fees) supply-side financing mechanisms for higher education institutions that are efficiency-enhancing, such as competitive and performance-based funding, as well as stronger quality assurance. There is also a need to develop a policy and organizational framework for post-school learning with clear links to the formal school system and informed by the demands from the labor market and society. Strengthening the connection between school and work involves establishing partnerships with local employers to provide work-based learning opportunities.

d. Health

110. **A healthy population is needed to advance economic growth in Kosovo.** In 2007, the Government spent 10.3 percent of total expenditures on health, but Kosovo does not have a reliable health information system that would allow analysis of the performance of health spending and comparisons of international health statistics. The few reliable indicators suggest the health status of the population is poor. Kosovo reports the lowest life expectancy at birth in South Eastern Europe;[22] an increasing number of new tuberculosis cases; more than 20 percent of the rural population without access to safe drinking water and thus at higher risk for infectious diseases; and a relatively high perinatal mortality rate[23]. The current level of government spending covers about half of total health expenditures, while patients contribute the remaining half with out-of-pocket payments. Out-of-pocket health expenditures increase the poverty rate by about 3 percentage points, suggesting that some low-income individuals may not seek care as they cannot afford it. These findings highlight the need to improve access and the provision of quality health care particularly for the poor and rural population; and to establish comprehensive health statistics to monitor and evaluate the use of health funds.

[22] Life expectancy is 69 years in Kosovo, compared with 73 in Serbia and 74 in Bosnia and Herzegovina.
[23] Perinatal morality was 23 per 1,000 live births in 2006 (UNDP 2007). There are no reliable data for infant, child and maternal mortality based on household survey data or comprehensive health statistics.

111.**The provision of health care is hampered by insufficient coordination, management and technical capacity, causing patients to seek care abroad.** Health facilities are managed by bureaucratic rules rather than on the basis of efficient operations. Although Kosovo has the lowest hospital bed density in Europe, its hospitals are underutilized as shown by very low admission and occupancy rates, short average hospital stay, and a low patient severity case-mix.[24] Uncoordinated investment in medical technology has led to a situation where technical equipment is unused. The public pharmaceutical procurement system is struggling to overcome management and governance deficiencies, resulting in regular stock-outs of even basic drugs in health facilities. PHC centers are underutilized which is to some extent driven by physicians working in dual-practice and referring patients to their private practice. Low productivity in health facilities and idle resources suggest that patients – who can afford it – go to the private sector and/or for more complicated secondary and tertiary care.

112.**The Government's mission is to develop a sustainable health system comparable to European standards that provides quality care to all people living in Kosovo.**[25] Getting better health outcomes requires more efficient use of existing resources with the objective of achieving higher productivity by improving access to better quality of care, and coordinated investment and management in health facilities and pharmaceuticals. A special focus is the prevention of communicable and non-communicable diseases and improved access for low-income groups. Achieving these mission objectives will need concentrated efforts in the following five key-areas.

113.**First, the health financing system needs to be modernized.** This system should provide financial risk protection for individuals by reducing out-of-pocket payments and set financial incentives through the payment system to providers to improve quality and efficiency in service delivery. All public health funds – including PHC funds - should go through a single health insurer that is the purchaser of care and contracts with providers. Additional revenues generated by co-payments must stay within the system, retained and registered by health facilities following international accounting practices. Providers must be equipped with accounting and financial management to ensure they reinvest their revenues into the delivery of quality services and pharmaceuticals.

114.**Second, the health sector masterplan needs to guide all investment in health facilities and medical technology to ensure their sustainability.** The masterplan for the health sector provides a sustainable health network plan based on a thorough assessment of the population's socio-demographic situation, and taking into account the financial constraints to maintain such a network. Any investment in construction and renovation of public hospitals, specialties, PHC centers and medical technology (e.g. radiology, CTs, MRIs, laboratory, etc) should therefore follow the recommendations of this masterplan.

115.**Third, substantial investment is needed to assure quality of care.** The MOH should invest in setting up an accreditation and licensing system for all health care

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[24] All regional hospitals and the Pristina clinical center report communicable diseases and childbirth as their most frequent diagnostics.
[25] MTEF 2009 – 2011. p. 98.

providers, and a future health insurance should only contract with accredited (public or private) providers. Staff needs to be trained and equipped to assure quality of care, and independent inspection should guarantee contracted quality standards.

116.**Fourth, management needs to be improved to ensure efficient allocation and use of scarce resources**. Management reforms include separating purchaser and provider, increasing management autonomy for health facility directors, and passing laws to give health facility directors managerial authority. Increased autonomy should cause managers to effectively produce health services; and their performance must be evaluated against an established set of performance standards. Improving productivity requires adjusting human capacity in health facilities based on a human resource strategy and redirecting resources to improve availability and quality of services and pharmaceuticals.

117.**Fifth, it is critical that Kosovo invest in the implementation of a carefully sequenced and phased Health Management Information System (HMIS).** HMIS implementation should start with developing a comprehensive strategy with wider consultation of stakeholders, and based on the strategy, prepare the required legislation, and phase in capacity-building and implementation. The HMIS should produce financial statements and audit reports, health performance and outcome information, and annual reports on the overall performance of the system. The Government should use results for reporting progress, international comparison and health policy formulation.

E. RULE OF LAW

118.**Rule of law and respect of fundamental rights are at the heart of the political criteria for advancing towards the European Union and a key condition for political, economic and social development.** A number of measures remain to be undertaken which would improve the efficiency and effectiveness of the system. Some of the most pressing needs and challenges in the rule of law sector in Kosovo in order to identify possible areas for international support.

119.. In order to further develop the rule of law sector in Kosovo, the **EU has pledged a civilian mission called "EULEX Kosovo" within the framework of the European Security and Defence Policy (ESDP), established by a Council Joint Action of 4 February 2008**. EULEX Kosovo shall support the Kosovo authorities by monitoring, mentoring and advising within the broader rule of law area – in particular in the police, judiciary, customs and correctional services.

120. **In the area of border/boundary control** basic structures exist, but need to be strengthened and further developed. The outer borders/boundaries of Kosovo (border-/boundary length to Albania – 150 km, to the former Yugoslav Republic of Macedonia (fYRoM) – 140 km, to Montenegro – 70 km, to Serbia – 245 km) are neither clearly determined, nor respectively marked. The border is not controlled in a systematic manner.

121.**The Border and Boundary Police (BBP) is a service within the Kosovo Police Service (KPS)** and thus subordinated to the Ministry of Internal Affairs (MIA). The competence of the BBP is essentially limited to border crossing points. The present number of personnel amounts to about 1.200 BBP staff, including the civil employees. The number of staff does not permit to complete successfully the police tasks set assigned to the service. The BBP personnel do not benefit from social or legal protection. **The educational and training of the BBP needs** to be intensified and its **equipment telecommunication connections and data bases enhanced and made compatible with European standards** to improve controls on illegal border/boundary crossings, especially at the green border.

122. **The Kosovo judicial system still faces substantial difficulties and persistent weakness.** There is a lack of trust by the population in the judicial system due to delays in adjudications. There is no differentiation between backlog and pending cases and figures vary between 1.5 million and some 50.000 cases. Courts and prosecution offices suffer from insufficient staff numbers, insufficient training and deficient infrastructure. Court and prosecution buildings generally lack space and often there are insufficient trial and interrogation rooms. Judges and prosecutors are overloaded. There is a reluctance to indict high profile criminal cases. Parallel courts continue to function in areas with a majority of Kosovo Serb inhabitants.

123.**The judicial reform process based on the Kosovo Ministry of Justice Strategic Plan 2006-2011, its implementing Action Plan as well as the Kosovo Judicial Council Strategic Plan for the Kosovo Judiciary 2007-2012 has been launched**. The reform comprises essential strategic goals such as establishing a strong legal and administrative framework for court organisation and operations, developing and implementing effective procedures for the appointment, development, promotion and discipline of judges, establishing effective procedures and practices for budgeting and financial management in and for the courts, eliminating case backlogs before the courts, implementing modern systems of communication and information management at the courts, to create an efficient and modern judiciary.

124.The **Kosovo Police Service (KPS)** consists of approximately 8.000 officers that need further capacity building to comply with European standards and practices. Improving internal organization, clear definition of chain of command and communication within the KPS and with other law enforcement services is urgent. The KPS is still ineffective in investigating cases of serious crimes. Training and specific equipment is very much needed to enhance capacities for fighting against drug trafficking, money laundering and trafficking in human beings.

125.**Corruption remains wide-spread and a major obstacle to good governance.** The Kosovo Anti-Corruption Agency (KAA) is operational since February 2007 but its independence is jeopardized by undue political pressure. The Agency is expected to produce a new comprehensive Anti-corruption Strategy. A new Action Plan will cover sectoral plans to fight corruption within the public administration as well as in civil society.

126. While the legal framework still needs improvement, the biggest challenge is with **the proper implementation of the existing laws**. Furthermore, the judiciary and the law enforcement bodies lack specialized training, material resources and technical capacities to successfully investigate corruption.