

# BRIEFING PAPER

## PRIVATE SECTOR DEVELOPMENT

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### Introduction

Despite the global economic crisis, Kosovo has experienced positive economic growth rates during the last years (CBK, 2010; European Commission, 2010). However, during 2009 and the first half of 2010 it is estimated that this growth is primarily attributed to government consumption and investments (European Commission, 2010). Considering this and other challenges that the Kosovan economy currently faces (summarized in the previous briefing paper), we consider the development of the private sector to be a priority for the Kosovan society.

As the problems that hinder the development of the private sector have been identified in numerous previous studies and reports, this study will focus on some selected problems and particularly on the latest developments in the country which have a direct impact on the private sector.

This briefing paper followed by a roundtable discussion will seek to **present opinions and experiences of businesses** in Kosovo and the associations that represent them, and to **promote debate** among business representatives, the civil society and Kosovan institutions. The intention is the **development of recommendations** in order to improve the business environment for the private sector in Kosovo.

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# 1. The Challenges

Numerous studies and reports by domestic and international organizations (i.e. Riinvest, various years; Riinvest, 2009; World Bank, 2010; European Commission, 2010) have identified a long list of challenges which the private sector in Kosovo faces, among which the most cited have been:

- Unsatisfactory rule of law (including the difficulties in contract enforcement, tax evasion and corruption) and unfair competition that emerges as a consequence;
- Power shortages;
- Low level of infrastructure development;
- Limited access to finance;
- The level of workforce skills;
- Duration and/cost of bureaucratic procedures for:
  - Opening a business (licenses from the Municipality, certificate from the Business Association of Kosovo, obtaining a fiscal number, registration in the Kosovo Tax Administration, etc.);
  - Obtaining a construction permit;
  - Obtaining licenses (from the central and the local level);
- The unsatisfactory level of foreign investor protection;
- Limited access to international markets.

*Labour law and minimum wage are two new potential deteriorating factors*

The latest developments that can be potentially problematic for the private sector are:

- The new labour law
- The minimum wage

Considering their number and complexity, some of those challenges such as the level of infrastructural development (in particular the power supply), access to finance, corruption, procedures for obtaining licences and permits, and the attraction of foreign direct investment (FDI) and the competitiveness of Kosovo enterprises in foreign markets are going to be discussed in separate roundtables in the coming months. The rest of this briefing paper focuses on **law enforcement and its consequences for market competition, workforce skills, labour law, and minimum wage**.

As most of these problems in these areas have been merely identified as relevant to private sector development in previous studies, this briefing paper seeks to present the opinions and experiences of Kosovan businesses related to these problems, the manner in which these problems influence doing business in Kosovo, and measures that central and local government could undertake to solve these problems.

## 2. Rule of Law and Market Competition

The unsatisfactory level of law enforcement has been identified as one of the key challenges facing the Kosovan private sector (e.g. Riinvest, various years; Riinvest, 2009; European Commission, 2010). The consequences in this respect range from the direct impact in contract enforcement to problems of tax evasion and corruption which lead to unfair market competition.

### Contract enforcement, intellectual property rights and competitiveness

The absence of an effective and efficient mechanism to secure **contract enforcement** hinders the development of Kosovan businesses in many aspects. First, businesses face losses due to *the failure of their buyers or suppliers to meet contractual obligations*, for which there are no consequences. An interviewed dairy-processor, for instance, reports that it obtained a loan from an international financial institution to buy cows which were distributed to farmers. The latter were, in return, obliged to repay a part of the loan and supply the processor with milk, which they never did. The company reports that the lawsuits it filed eight years ago about this case are still open to date. Unfortunately, the severity of the consequences of problems like this one extends beyond the cost of the direct losses that firms incur. Namely, the uncertainty that the lack of contract enforcement introduces is likely to **prevent firms from entering into business transactions altogether**. This is also likely to be one of the reasons why both credit extensions of firms to clients and purchases on credit by firms reported by Kosovan companies are much lower than those reported by other transition economies in the region as well as those in Europe and Central Asia in general (World Bank, 2010), thus making input purchases and product sales more difficult for these firms.

*Lack of IPR and poaching employees discourage high value-added activities*

A highly surprising finding related to legal and judicial issues is the one by the World Bank (2010), claiming that the percentage of firms reporting that courts are *not* a problem in doing business is ten percentage points higher in Kosovo (at 56%) compared to the average of South-East Europe (SEE) other economies in the region and to those in transition economies in Europe and Central Asia (ECA). However, reading this figure in the light of the finding that only 3 percent of Kosovan firms have been to court in the past three years compared to the average of 32% and 27% in SEE and ECA, respectively, a more appropriate conclusion seems to be that Kosovan **businesses do not have faith in the judicial system, and do not even take it into account their decision-making**.

Inability to enforce contracts also affect the level of firms' investment in their employees' skills and their innovative capacity. Firms in some sectors report **employee poaching** as a major problem. Due to the lack of a mechanism to enforce employment contracts, firms that invest in expensive employee-training end up losing their employees to competitors. Again, this type of problem may explain why, as discussed in the next section, Kosovan firms are far less likely to

invest in employee-training compared to firms in other transition economies (World Bank, 2010). This is particularly worrying because it directly affects the competitiveness of Kosovan firms on the market and it hinders the development of high value-added products and services which are relatively skill-intensive.

A related problem, the **lack of intellectual property rights (IPR)**, is perceived as an obstacle by the American Chamber of Commerce in Kosovo (Musa, 2011), and particularly by companies in the ICT sector. In software development, for instance, it is difficult for firms to prevent (ex-)employees from transferring software developed in the firm (or slightly modified versions) to a competitor which then sells it as their own (Çavolli, 2011). In this case, however, the problem lies not only in enforcement, but also in the inability of the original developer to patent the software. The issue if IPR may affect relatively few Kosovan businesses currently, but it is a crucial precondition for the development of high value-added activities and a key factor in (current and potential) foreign investors' willingness to transfer know-how to their Kosovan subsidiaries.

### Tax evasion and market competition

Fiscal policy in Kosovo is considered favourable in terms of the level of tax rates, however all the interviewed business associations report problems in its implementation. The limited capacities within the Tax Administration sometimes lead to **ambiguity in interpretation of the law and estimation of the tax base**, as a result of which tax-paying businesses often end up paying fines because they were unable to appropriately estimate their tax liabilities. Moreover, the ambiguity in implementation costs businesses time and increases the scope for corruption.

Problems in the implementation of fiscal policy however have an even more severe impact through the effects of **tax evasion** on (unfair) competition on the Kosovan market. Kosovo Chamber of Commerce considers tax evasion to be the single most important **generator of unfair competition** (Rukiqi, 2011). The interviewed firms also report that they face very harsh competition from competitors who do not pay taxes and as a result are able to sell their products at significantly lower prices.

On a related note, the recent **increase in government expenditure has put pressure on the Tax Administration and Customs to increase revenues**, and the interviewed businesses appear to be anxious on the potential consequences this may have for their business. On the one hand, businesses

*The fight against tax evasion should be implemented in a manner that improves competition*

and business associations are aware that this can potentially have positive effects for the economy if tax evasion is reduced (and levelled) across individual businesses and across industries. However, under the conditions explained above, i.e. where there is scope for corruption and there is already high tax evasion (in some businesses more than in others), it is reasonable for businesses to fear that the revenue collecting agencies will choose the path of least resistance and target companies that already pay relatively more and/or are not involved in corruption. In this respect, ***the Government and its agencies should make sure that the approach in their fight against tax evasion is inclusive and it is in favour of improving competition.***

Finally, the ***provision of licences and permits (both at central and local level)*** are considered as another source for corruption and unfair competition (i.e. if they are issued quicker and/or more easily for some firms than others). The number of licences and permits and the complexity and cost of procedures (concerning time and money) has been recognised as a serious problem in Kosovo by the World Bank's Doing Business report. Similarly, the three largest business associations in Kosovo, OEK, AmCham and AKB, when interviewed for the purpose of this policy brief, have ranked this as a ***top barrier to doing business in Kosovo***. While recognising that it is beyond the scope of this policy brief to individually analyse licences and permits and their respective procedures and costs, it is ***recommended that the possibilities of reducing their burden in firms is to be analysed by the relevant institutions at both the central and local level.***

### 3. Workforce Skills

Skills and education of the workforce is a key determinant of Kosovan businesses' (lack of) competitiveness both on the domestic market and abroad. Previous studies by Riinvest Institute (Riinvest, various years; Riinvest, 2009) have found that ***the level of education of managers and employees of private businesses is relatively low***, with most of them having secondary education as the highest level of educational attainment. These findings have been also confirmed by the World Bank (2010) which suggests that the skills and education of the workers are the private firms' most severe problem in 2008. According to this survey, 24 percent of Kosovan firms indicate that skills and education of the workforce are not a problem, compared to an average of 42 percent and 33 percent in the SEE region ECA regions respectively. Similarly, according to World Bank's (2010) BEEPS survey, the share of employees who have a university degree or higher in the SEE region is twice as high as that in Kosovo (15% compared to 7%) while that in the ECA region is over three times as high (24%). ***Firms in Kosovo are also less likely to offer training to their employees.*** In the production sector the

*The level of employee education and training are many times lower in Kosovan firms compared to other transition economies*

share of employees participating in training is just over five times as high in the SEE region in comparison to Kosovo, while the share in the ECA region (where skills are already at a significantly higher level) is four times as high compared to Kosovo (World Bank, 2010).

Further, private businesses in Kosovo often report that the **skills of educated workers are not satisfactory** (Riinvest, various years). In particular, representatives of firms feel that secondary and tertiary education does not prepare the labour force entrants for the labour market, part of the problem being their lack of “practical skills”, i.e. applying knowledge to solve problems in a workplace setting. Deficiency of skilled labour appears to affect virtually all economic activities. In some vocations – like food processing and mechanical engineering – this problem appears to be so severe that firms report that they have to hire staff from neighbouring countries, which significantly increases their production costs.

Improving the quality of education is a key factor in improving the quality (and thus competitiveness) of Kosovan products and services in the country and abroad. On the other hand, there are cases in some vocations (e.g. welders) where even though there are experienced workers available, their **skills are not formally certified**, which (under information asymmetry) makes it difficult for potential foreign investors to recruit workers (Rukiqi, 2011). Examples like this one illustrate the **importance of having also (formal) vocational education and training** and the importance of having **a qualified workforce for attracting foreign direct investment into the country**. Especially, as the level of workforce skills not only affects the willingness of foreign firms to set up a subsidiary, but also the level of technology and know-how they invest into a country.

An encouraging outlook for the ICT sector is reported by the Kosovo Association of Information and Communication Technology where training is successfully provided by companies such as CISCO, Microsoft and ORACLE. According to this association, Kosovo is a leader in terms of CISCO engineers per capita and all of them are employed (Çavolli, 2011).

## 4. Labour Law

Laws on labour have a direct effect on the production costs of the private sector and as such they determine its market competitiveness, but also the attractiveness of an economy as a destination for foreign direct investment. Accordingly, the new labour law in Kosovo is recognised as an important development by private businesses and business associations.

The interviewed business associations all feel that the new labour law is a cause for concern to the private sector, even though it is still early to estimate the magnitude of its effects. First, the **new law increases the cost of labour** because the working hours are shorter and the holidays are longer. Second, the law increases the relative cost of hiring women due to the longer maternity

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women*



leave (up to one year). The latter, which was presumably supposed to be in favour of working women, is very likely to have the exactly opposite effect. This law **discourages private firms from employing women, and in this sense it can be considered discriminating**. When asked about the new law, one interviewed manager went so far as to state:

*“...it is absurd for an employee to be away from the workplace for a year. If this law is not changed, we will not hire any more women in our firm.”*

Alternatively, firms may **increase the tendency to hire women informally or not offer them long-term contracts**. Moreover, even if firms are willing to hire women and provide the long maternity leave as foreseen by the law, it is not in the favour of women employees themselves to stay away from the labour market for long because **their knowledge and skills will depreciate and their prospects for a promotion will deteriorate**.

Finally, the law is **seen as detrimental** for the position of women in the labour market **by working women** who were interviewed for the purpose of this policy brief. Considering all of the above, it is **strongly recommended here that this law is to be revised**.

## 5. Minimum Wage

Another aspect of labour regulation which has been discussed recently is the introduction of a minimum wage. Recognising the potential risks of increasing labour costs, this is seen as another issue which is vital to Kosovan firms' competitiveness.

In contrast to other labour regulation discussed in the previous section, businesses and business associations do not appear to have such strong (opposing) opinions on this issue. However, they do recognise that the level of minimum wage is a crucial factor, which determines its effects and thus its setting should be treated very cautiously. The Economic Chamber of Kosovo (ECK) notes that a minimum wage is obligatory according to the International Labour Organisation (ILO) Convention, but it cannot be seen only as a means of fighting poverty. In this sense, the Alliance of Kosovan Businesses (AKB) stress that the minimum wage **should not be set on the same level as in the neighbouring countries** and that it should be based on in-depth analyses (Shahini, 2011). The ECK also stresses that the minimum wage **should reflect the level of labour costs and the overall development level of the economy and the cost of living**, on the one hand, and the **willingness of firms to pay this wage**, on the other (Rukiqi, 2011). Otherwise, as the AmCham notes, the introduction of the minimum wage **could lead to a higher willingness of firms to increase informal employment** (Musa, 2011).

*The minimum wage should be set based on extensive analyses*

## 6. Additional Points from the the Roundtable Discussion

The participating businesses and other organisations largely agreed with the arguments presented in this briefing paper. In addition, the following points were raised:

### Rule of Law and Competition

Both Lumnije Ajdini (AKB) and Arian Zeka (AmCham) expressed their worries about the work of the **Independent Review Board** within the tax administration. The board is supposed to process complaints within 30 days, but cases tend to be delayed (sometimes up to two or three months). Delays in the **reimbursement of VAT, (over)valuation of goods and the (lack of) customs in Northern Kosovo** were cited by AKB as further problems.

Arian Zeka (AmCham) informed the participants about the **establishment of two Arbitrage Centres**, one at the KCC and one at AmCham. The staff of both centres has been recruited and trained, and two cases have already been solved. On a related note, Muhamet Mustafa (Kosovo Parliament) suggested that commercial courts should be established in each region in Kosovo.

**Better coordination among Kosovan institutions** was recommended. For instance, Arian Zeka (AmCham) points out that companies that bid in public tenders have to obtain a **certificate from the tax administration to prove that they have paid their taxes** and the **transaction costs to businesses which could be avoided** if these institutions were to exchange information instead. Better coordination among public institutions and universities was also recommended. For instance, Lulzim Sylja, a business owner, suggested a change regarding a specific licence issued by MTI for firms in the energy sector where **MTI does not currently recognise Bachelor diplomas in engineering** (which are obtained after three years of study in the reformed higher education system) and businesses are required to hire engineers who were educated in the previous system (even if just for the purpose of “renting” their diploma).

**The problems with construction permits**, especially in the Municipality of Prishtina, was said to be caused primarily by the staff’s level of technical competence (at all levels) and the tendencies for corruption, which in turn are partially caused by low wages.

Muhamet Mustafa (Kosovo Parliament) suggested that an **advocacy group** of business associations and civil society organisations should be created which would work with the relevant Parliamentary Commission to address private sector development issues.



## Workforce Skills

Lulzim Sylja stressed that he has problems finding qualified electricians and machinery technicians, but there is scarcity of qualified labour in virtually every vocation. He also pointed out the emerging and urgent needs in the labour market that are related to the **construction of the powerplant “Kosova e Re”, where 300 engineers and thousands of technicians will be needed**. As a solution, he suggests that new vocational secondary schools be established throughout the country; **their curricula should be reviewed to reflect labour market needs; they are equipped with labs and supplied regularly with expendable materials for practical work**. Currently, he points out, **even the part of the funding that is allocated for this purpose is not actually used appropriately by the public institutions**. For instance, in the case of tender awarded to a local firm to supply vocational secondary schools with (expendable) lab materials, merely a 10% of the actual value of the tender (and supply) was implemented even two years after signing the contract.

Ilir Rexha (GIZ) pointed out that a major problem with the vocational education sector is public ownership and management of the (current) **VET centres and that public-private partnerships would provide superior results**.

## Labour Law

A private consultant pointed out that the labour law has been **misinterpreted by the Government and that the private sector was misled into following this interpretation**. The Parliament, he argues, meant that there should be eight working hours a day, exclusive of the lunch break (which is not paid). The other half-hour break in the law refers to short 15 minute breaks during the working hours (e.g. for smoking or physiological needs). **Accordingly, it was recommended that the Parliament initiates an interpretation of the law and informs the public on the correct interpretation**.

AKB points that the new labour law has **adversely affected seasonal workers**, especially in construction and agriculture, and this should be further discussed.

## Minimum Wage

One private business representative stated that a minimum wage of 180 euros per month is reasonable.

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## About the Friedrich-Ebert-Stiftung

As a private non-profit organization, the Friedrich-Ebert-Stiftung is committed to the ideas and basic values of social democracy. **Social Democracy** is based on social, human and civil rights and seeks to reinforce them. It broadens and consolidates the basis of political democracy by including social justice, democratization of society, social security, sustainable development and international solidarity. It strives to secure equal opportunities in life and the right to have a say in the affairs of their community for all citizens, both men and women.

The main areas of our work are: **Promoting democracy and supporting civil society** by assisting representatives of political institutions and civil society organizations as well as journalists, academics and trade unions. **Also we help to advance the decentralization process and local democratic governance by supporting the debates on concepts of Good Governance** at the local level and encouraging active participation of all ethnic communities in local government. Moreover, FES supports a **socially just and sustainable economic development** by means of enabling the social dialogue between government, trade unions and employers' organizations. Another aim is to promote **regional and international** integration by reviewing the European integration process with stakeholders. In addition, progressive policy proposals for Kosovo's integration at the regional and the international level are debated with civil society organizations and decision-makers.



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## About the Riinvest Institute

The Institute for Development Research - Riinvest has been operating since 1995 as a non-profit research organization, with a mission to promote modern economic development in Kosovo based on a philosophy of entrepreneurship. Between 1997 and 1999, Riinvest conducted research activities oriented towards the growth of knowledge and information on domestic and international factors influencing Kosovo's economy and their successful reconstruction. Since 2001, our main activities have included research on policies and policy advocacies on expansion of the business environment and construction of conditions towards economic viability.

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