

Transforming Kosovo – Seeking a Balance between Market Discipline and Political Stability

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1. Rent-seeking in Transforming Economies and the Transformation of Rent-seeking

Defined as broadly as possible, rent-seeking is an activity that aims to create income opportunities through political interventions while bypassing or eliminating market competition. In contrast to rent-seekers, profit-seekers realize their income through competitive behavior in conformity with market rules. There are various forms of rent-seeking.

While the ultimate goal of transformation/transition is a system that largely eliminates rent-seeking, it is important to recognize that during the transition process rent-seeking opportunities go through several stages. For analytical purposes, one can roughly differentiate between four stages:

- ▶ Stage 1: The *socialist economy*, while ideally characterized by economic planning, in practice developed various forms of »market substitutes« that made it possible to overcome the shortages experienced by socialist enterprises. Analysts of the Soviet economy spoke of an »administrative market« which was largely based on – increasingly complex – barter chains. In contrast, Yugoslavia tried to officially integrate market elements into its economy relatively early. In the socialist economy, rents were realized mainly through the differences between administered and market prices on the black market.
- ▶ Stage 2: The *immediate post-socialist economy* is characterized by the removal of ultimate political control over the economy but without the fundamental institutions of a market economy for the time being. In particular, there are as yet no institutions to ensure that the necessary hard budget constraints are imposed. Providing ample opportunities

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for rent-seeking, the immediate post-socialist economy is unsustainable and shows signs of disintegration, such as high inflation rates. Rents are realized through politically granted

- licenses and quotas in external trade,
- preferential access to credits at often negative real interest rates,
- political guarantees and subsidies for loss-making activities,
- usage rights for public enterprises and assets, and so on.

▶ Stage 3: *Political capitalism* is characterized by politically regulated and segmented markets, but with hard budget constraints largely in place. Rent-seeking fundamentally changes its form by accepting and taking account of the market mechanism. While limiting competition – and thus growth potential – rent-seeking at this stage no longer causes the disintegration of the economy. Rents are now realized, among other things, through

- creation of regional or sectoral monopolies or oligopolies,
- introduction of non-tariff barriers in external trade,
- restrictive licensing,
- corrupt practices in public procurement.

▶ Stage 4: The *functioning market economy* is ideally characterized by generally established and accepted market rules, full transparency, and good governance. Even if profit-seeking is not established as the sole form of income generation, it is clearly dominant: rent-seeking is now an exception to the rule and credibly countered by market institutions.

2. Kosovo before the Establishment of UNMIK

In the 1990s, aggravated by the consequences of the war economy of the Milosevic era, Kosovo bore many characteristics of the immediate post-socialist economy (Stage 2):

- ▶ hyperinflation was eroding private savings;
- ▶ preferential credits disappeared and gave way to serious disinvestment;
- ▶ shady privatization transactions that were not finalized;
- ▶ smuggling activities breaking the international embargo.

Moreover, there was an apartheid-like political regime that forced ethnic Albanians – about 90 percent of the population – out of public jobs, including industry and public utilities that were largely socially owned.

Kosovo Albanians survived by developing private business opportunities much earlier than their Serb countrymen, and by establishing an underground education and health system. Most of these activities were illegal, at least to some degree (for instance, tax evasion), so that the borderline with criminal activities was blurred. However, due to the oppressive character of the Serbian regime all activities directed against the state found widespread support in the Albanian majority population.

The clandestine parallel society that evolved in this period continues to affect Kosovo society and politics today.

In the late 1990s, two major camps evolved on the Kosovo Albanian political scene (although they were far from homogenous and prone to internal conflict).

The Democratic League of Kosovo (LDK) of Ibrahim Rugova, largely formed from Kosovo Albanian cadres from Yugoslavia, had long favored a policy of non-violent resistance, not least because of the realistic fear that it would be easily defeated in an uneven armed conflict with the Yugoslav Army. Only when armed resistance developed was the so-called »Armed Forces of the Republic of Kosovo« (FARK) set up as a paramilitary organization loyal to LDK.

The driving force behind armed resistance, however, was the Kosovo Liberation Army (KLA), whose members were dissatisfied with the LDK's obviously unsuccessful passive resistance strategy. The KLA was supported by diaspora circles and able to win over a significant number of LDK cadres in the municipalities.

Both camps secured the necessary funds for arms partly through illegal economic activities.

With popular support increasing, the KLA embarked on a high-risk strategy of attacking representatives of the Serbian regime, due to which a good part of the Albanian civil population fell victim to acts of »counter-terrorism.« In 1998, the KLA was close to defeat.

The NATO campaign, which commenced in March 1999, at first worsened the situation for the Albanian civil population which now became the primary target for Serbian attacks and ethnic cleansing. However, it revived the KLA and made its offspring – in particular, Hashim Thaci's Democratic Party of Kosovo (PDK) and Ramush Haradinaj's Alliance for the Future of Kosovo (AAK) – the most important post-conflict power broker.

3. UNMIK and the Institutional Vacuum of 1999

UN Security Council Resolution 1244 (1999) of June 10, 1999, laid the basis for the termination of the NATO campaign and established a civil and military presence in Kosovo (the United Nations Interim Administration Mission in Kosovo, UNMIK, and the Kosovo Force, KFOR). The modalities of the withdrawal of Yugoslav forces from Kosovo were agreed upon in the Agreement of Kumanovo.

Although KFOR troops entered Kosovo relatively quickly, the return of the Kosovars who had been forced to flee to neighboring countries was even speedier. Now the Kosovo Serbs fell victim to violent acts of retaliation, and many were forced to flee to the northern part of Kosovo (where they in turn retaliated against Albanians) or enclaves scattered over the rest of the territory.

The withdrawal of Serbian state structures created an institutional vacuum that was immediately filled by Kosovo Albanians – often associated with the KLA – who took over municipal administration and vacant enterprises before the international forces stepped in. The build-up of UNMIK's administrative structures was too sluggish to provide an effective alternative to the local power brokers who had gained experience in the parallel society of the 1990s.

As the self-appointed enterprise and municipal managements had evidently brought some sort of order to the overall chaos, and there was an expectation that this would be an efficient way of effecting a transition from the Kosovo Liberation Army to civil life. The UN Interim Administration Mission and the international community in general accepted the fait accompli.

4. Creation of Stable Conditions for a Market Economy

In the second half of 1999, UNMIK structures gradually became operational. In the economic realm, UNMIK Pillar IV – the »European Union Pillar« – concentrated on creating a stable macroeconomic framework and basic economic legislation.

This economic policy ensured that there was no return to the chaos of the immediate post-socialist economy (Stage 2) and that the basic institutions of a market economy were put in place. In particular, this included the following:

- ▶ The German mark (later the Euro) as the de facto currency immediately left the inflationary environment of the Yugoslav dinar behind.
- ▶ The new Banking and Payments Authority of Kosovo provided effective banking and insurance sector supervision.
- ▶ The Kosovo Budget was not allowed to run a deficit, and a zero-subsidy policy was pursued.
- ▶ The new tax system introduced a small number of transparent taxes.
- ▶ The customs regime provided for a simple ten percent import tariff across the board, with minimal exceptions.
- ▶ Basic economic legislation and easy business registration laid the foundations for an impressive boom in legally operating SMEs.
- ▶ Procurement rules and auditing mechanisms were gradually developed to improve transparency and accountability.

5. The Missing Link: Socially and Publicly Owned Enterprises

The estimated 350 socially-owned enterprises (SOEs – in industry, commerce, and agriculture) and 60 publicly-owned enterprises (POEs – mostly utilities) remained at the post-socialist stage much longer than any other sector of the Kosovo economy. In this way, the typical forms of rent-seeking attributed to the immediate post-socialist economy (Phase 2) remained.

In late 1999, all SOEs and POEs were run by self-appointed managements which UNMIK largely accepted as legitimate partners in an emergency situation. With very limited personnel resources, UNMIK restricted direct interventions in management to a few of the biggest enterprises, such as the Kosovo Electricity Company (KEK) or Post and Telecommunications of Kosovo (PTK). However, even here international managers were single individuals working alongside a largely self-appointed local management. (It was only in 2004 that a Turnaround Management Team was contracted for the ailing KEK.)

Although the EU Pillar produced a White Paper on the privatization of SOEs and POEs as early as 2000, the highly contentious property issues underlying the enterprise question led to a two-year deadlock on creating the legal foundations for this standard policy in transition. At the beginning, therefore, UNMIK had to restrict itself to a strategy that tried to attract private management and investment to SOEs through temporary lease contracts – with very modest success.

As a consequence of the lack of clarity regarding ownership and the future, a major proportion of SOEs were subject to asset stripping by management and workers. Renting out premises, machinery, and parts of the workforce became a major occupation of the cash and investment starved enterprises – some of them became Kosovo's first real estate agents. Needless to say, the cash flow from such transactions remained largely unaccounted for. Municipalities, too, benefited from these transactions by imposing licenses and taxes on SOE revenue that was registered as official Budget revenue.

On the positive side, these shadow activities brought idle assets into productive use, thus contributing to the post-conflict economic boom. However, as the municipal elections held in 2000 showed, the system was highly unstable and prone to conflict. The victory of the LDK led to a major shift in the balance of power, and the new municipal leadership in many cases tried to get their representatives into enterprise managements, often through intimidation and outright violence.

Finally, after a debate dominated by lawyers on both sides of the Atlantic, privatization legislation was introduced in 2002 and further improved in early 2005. Only then did privatization commence as an effective process. As a compromise between competing legal schools, privatization was restricted to SOEs, while POEs were allowed merely to undergo further structural change. For example, the many small water and waste utilities that were organized along municipal lines were consolidated into larger, viable companies. As the most important tool for improving governance in POEs, their proper incorporation into Western type joint-stock companies was initiated in 2004.

6. The Emergence of Political Capitalism

The conflict concerning SOE management made it clear that the unresolved enterprise question was badly affecting the development of democratic institutions. It created fertile ground for municipalities and parties to set up what American political science describes as »political machines.« Such »machines« ensure the re-election of the ruling party in a nominally democratic polity by bending to its service »independent« elements, including the civil service. Or, as a late International Crisis Group (ICG) report put it, »the parties have planted themselves like rival trees jostling for the light – with leaves and branches as their public faces, their

mutual exclusivity reinforced by separate large root structures of rival intelligence, underworld and criminal networks to feed and be fed by.»

At the central level, this was less obvious, as the first Kosovo-wide elections ended up in a political stalemate that could only be resolved by forming a grand coalition, including the LDK and its rivals PDK and AAK.

However, following the second nationwide elections in late 2004, the experiment of a grand coalition was given up. The LDK managed to win over the AAK and some smaller parties to form a coalition government that forced the PDK into opposition.

In the following months, and with the aim of reversing the loss of political power as soon as possible, the PDK broke the rules of the clandestine parallel society and went on the offensive, trying to use UNMIK as its major ally. In early 2005, the PDK presented a voluminous »Dossier« to the head of UNMIK, accusing the LDK and most of its ministers of involvement in mafia-like structures.

Indeed, there was increasing evidence of the emergence of a politically regulated market, or of »political capitalism« (Stage 3):

- ▶ Certain goods markets were apparently controlled by retail traders who established themselves as powerful oligopolies.
- ▶ Complaints by businesses against arbitrary license procedures increased.
- ▶ Many ministries experienced major personnel changes after the nascent institutions were handed over by UNMIK to the Kosovo government, and the recruitment of new personnel exhibited striking patterns of regional or family relations.
- ▶ Public procurement became a target for vested interests close to the powers-that-be.

While the »Dossier« clearly showed the merits of having a parliamentary opposition rather than a grand coalition, so far it has been a one-off exception in an otherwise relatively »mute« society. The media, despite some encouraging signs, is still far from providing a strong corrective to irregular political practices.

7. UNMIK's Dilemma: Balancing Market Discipline and Political Stability

For all its difficulties and mistakes, UNMIK was undoubtedly able to put Kosovo's economy on the right path by introducing basic modern market

institutions and hard budget constraints, and thus to overcome the danger that the institutional vacuum found in 1999 would further aggravate the economic disintegration of the 1990s (Stage 2).

However, there are clear limits to what an international protectorate can do to enroot these institutions in a society that is at least partly determined to use the opportunities for rent-seeking provided by unconsolidated institutions. Therefore, it is unrealistic to expect that such a protectorate will leave behind a fully functioning market economy (Stage 4). This goal will be achieved only if the local actors take ownership and provide the necessary checks and balances, through auditing, prosecutions, critical media, and parliamentary control. This, of course, is a process that an international protectorate cannot substitute, although it can contribute to the provision of transparency.

Moreover – and this has become particularly obvious in the conflict concerning SOEs – dismantling rent-seeking structures is a conflictual process that requires a politically strong actor imposing market discipline and hard budget constraints. In normal transition environments, success in this endeavor is often the result of power struggles from which a large proportion of rent-seekers must emerge as losers.

This poses particular challenges for a post-conflict environment in which an international mission is aiming to reduce potential triggers for further conflict, particularly when former conflicting parties are among the potential losers.

In the end, there is no alternative to balancing these conflicting goals. Peace-keeping always goes hand in hand with skilful political maneuvering: it will never be a straightforward instrument for providing the best possible economic governance.