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How 'friendly' is Kosovo for Foreign Direct Investments: A Policy Review of Gaps from a Regional Market Perspective

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How ‘friendly’ is Kosovo for Foreign Direct Investments: A Policy Review of Gaps from a Regional Market Perspective

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HOW 'FRIENDLY' IS KOSOVO FOR FOREIGN DIRECT INVESTMENTS: A POLICY REVIEW OF GAPS FROM A REGIONAL MARKET PERSPECTIVE

I. INTRODUCTION

Foreign direct investment (FDI) is widely recognized for its positive impacts on economic growth and transformation.¹ It is also considered an important channel for the development and accumulation of human capital and the diffusion of new ideas and business skills across national borders. Foreign investment inflows can positively influence employment and may represent an important source of technological advancement in the host country. Global trends show that competition for attracting FDI is especially strong among developing countries, as it represents an important source of foreign capital and can have positive spillover effects on the host economy. FDI may facilitate rapid economic growth in developing countries by increasing savings and investment and by transferring experiences, technologies, and know-how from developed countries.² The impact of FDI on growth may also positively affect poverty levels in the host country by increasing employment opportunities and wages.³ Therefore, developing countries offer various incentives to attract investors and divert them from investing in competing countries.⁴ As the competition between countries in attracting FDI becomes increasingly intense, multinational enterprises (MNE) have a range of choices when choosing the investment location.

It is of high importance for the potential host country to identify and further develop incentives that attract FDI inflows. Market size and growth potential, business opportunities, as well as investment attributes (such as strong institutions and investor friendly regulations) are some of the most powerful incentives for foreign direct investment.⁵ Therefore, improving the investment climate is an important step and opportunity for countries seeking to attract foreign investments. As the business climate is of utmost importance for attracting FDI, the government policies and practices should aim to reduce investors' costs and perceived investment risks, to offer various incentives for investors, and to create an investment climate favourable for capturing FDI and its associated benefits.

Kosovo is limited in its ability to attract foreign investment due to the lack of information distribution within global markets, poor international communication regarding its economic environment and opportunities for foreign investment, and the absence of a credit rating by a credible foreign rating agency. Foreign investment inflows have also been hindered by high degrees of corruption, slow and ineffective business environment reforms, lack of transparency, economic inactivity in many sectors, negative perception by foreign investors and diaspora populations, and the failure of institutions to implement and achieve their set objectives.

Nevertheless, it should be noted that Kosovo has recently signed its first contractual agreement with the European Union, namely the Stabilization and Association Agreement (SAA). The agreement enables Kosovo to liberalise trade with all EU member states, strengthen regional

¹Amerasinghe, N. and Modesto, J. (2012). Foreign Direct Investment in Asia: Lessons of Experience. *Asian Institute of Management*, 12-003, p. 1-51.

² Mottaleb, K. and Kalirajan, K. (2010). Determinants of Foreign Direct Investment in Developing Countries: A comparative Analysis. *ASARC Working Paper 2010/13*, p. 1-27.

³ Klein, M., C. Aaron and B. Hadjimichael (2001), 'Foreign Direct Investment and Poverty Reduction', *Working Paper 2613*, World Bank, Washington, D.C., p. 1-41.

⁴ Bilas, V. Franc, S. and Cenani, D. (2012). FDI Incentives in Croatia and Chosen Developing Countries. *Institute of International Politics and Economics*, p. 329-352.

⁵ Hornberger, K. Battat, J. and Kusek, P. (2011). Attracting FDI: How much does Investment Climate Matter. World Bank, *View Note Number 327*.

cooperation by aligning its political and economical preferences with EU member states, and implement a suitable institutional framework to increase Kosovo's competitiveness.⁶ The SAA, apart from regulating the trade regime between the EU member states and Kosovo, also states that 'cooperation between the Parties in the field of investment promotion and protection shall focus on protection of foreign direct investment and shall aim to bring about a favourable climate for private investment, both domestic and foreign, which is essential to the economic and industrial revitalisation of Kosovo'.⁷ The agreement is expected to provide a stable legal framework in line with EU legislation, a more favourable business and investment environment in Kosovo, and institutional restructuring which will assist Kosovo's further integration into the European and world economies. The implementation of the reforms foreseen by the SAA agreement would trigger greater investment of foreign strategic capital due to the improved business conditions, enhanced quality of products and services, as well as market competitiveness. Proper implementation of SAA reforms and quality standards will directly incentivize foreign investors to consider Kosovo as a potential investment country due to its fair and competitive market, favourable conditions, EU-compatible legislation, as well as benefits from the application of non-tariff barriers stemming from the SAA. This in turn would boost the overall economy and enhance job creation, thus improving the unemployment and poverty rates. Hence, it is of crucial importance for the institutions of Kosovo to implement the necessary standards and reforms stemming from SAA and to establish an enabling and encouraging investment climate as a means to increase Kosovo's attractiveness for both foreign and domestic investors.

This policy paper is organized as following: Section 2 provides a brief theoretical discussion of the main factors that affect investors' decisions and potential FDI effects on the host-country, followed by a discussion of the importance of FDI for Kosovo and the current legislative framework. Section 3 highlights Kosovo's FDI profile in general and by sector, as well as its position compared to other SEE countries. Section 4 discusses Kosovo's potential for attracting investments and its investment climate and scrutinizes the key deterrents for FDI in Kosovo. Section 5 examines the main types of investment incentives and compares Kosovo's incentive schemes with SEE countries. Section 6 considers the perceptions of EU and EFTA foreign investors operating in Kosovo. The last section offers a set of policy recommendations and solutions that would further enhance Kosovo's investment climate and its overall performance with regard to attracting FDI.

II. THE INVESTMENT CLIMATE AND FDI'S POTENTIAL EFFECTS ON THE HOST COUNTRY

II.1 The investment climate and its influence on investor's decisions: A guideline for policymakers

Research has identified a diverse set of factors that affect investors' decisions to invest abroad. Foreign investors tend to invest in a particular country for various reasons, as outlined in the table below:

⁶ Group for Legal and Political Studies (2014). The Trade Impact of the Kosovo-EU Stabilization and Association Agreement: An assessment of outcomes and implications.

⁷ The Stabilization and Association Agreement Between European Union, of the one part, and Kosovo, of the other part, Article 98: Investment, Promotion and Protection, pp. 108

Table 2.1: Foreign investors' reasons for investing in a particular country

<ul style="list-style-type: none"> □ Natural resource-seeking FDI □ Market-seeking FDI □ Efficiency-seeking FDI □ Strategic asset-seeking FDI 	<ul style="list-style-type: none"> □ Investors seek petroleum and mineral resources, and often forestry, agricultural and other natural assets; □ Investors seek new customers and clients by locating production in foreign markets rather than by exporting; □ Investors seek cost-productivity improvements lowering the cost of production within global production networks; □ Investors look for very specific tangible or intangible assets that complement the multinational's asset base.
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Source: USAID (2007). *Foreign Direct Investment: Putting it to work in developing countries*.

A country's ability to attract FDI depends primarily on its advantages and potentials for various types of investors.⁸ Market-seeking investors look for large and growing markets with expansion opportunities through regional trade agreements. Resource-seeking investors look for ample natural resources, whereas efficiency-seeking investors look for a competitive and efficient base for export production – such as the availability of a skilled or unskilled and cheap labour force – as well as other cost-effective production inputs.⁹

An enabling investment climate is also an important determinant that affects the decisions of foreign investors to invest in certain locations. Political and macroeconomic stability are normally considered important pre-requisites for attracting FDI inflows in a country.¹⁰ In turn, the quality of the investment climate also influences the extent to which the host-country will benefit from FDI and undergo economic development as a result of technological, managerial and marketing skill transfers to domestic businesses.¹¹ In addition, a sound policy and regulatory framework and the institutional capacity and efficiency needed to enforce the relevant laws and regulations are essential for the attraction of FDI. The administrative and regulatory obstacles an investor faces to enter and operate in different countries, the judicial efficiency in handling commercial disputes, as well as the hospitality towards foreign investors affect investors' decision regarding where to locate their investment capital.¹² A poor investment climate may limit

⁸ USAID (2007). *Foreign Direct Investment: Putting it to work in developing countries*. Nathan Associates Inc.

⁹ Gergely, J. (2003). Trends in Foreign Direct Investment Incentives. *Working Paper 05-2003* of the Associazione Universitaria Di Studi Europei, ECSA-Italy, Pavia.

¹⁰ Sun X. (2003). How to Promote FDI? The Regulatory and Institutional Environment for Attracting FDI. Paper presented at the *Capacity Development Workshops*, Foreign Investment Advisory Service, Morocco, Dec 2002

¹¹ Hornberger, K. Battat, J. and Kusek, P. (2011). Attracting FDI: How much does Investment Climate Matter. World Bank, *View Note Number 327*.

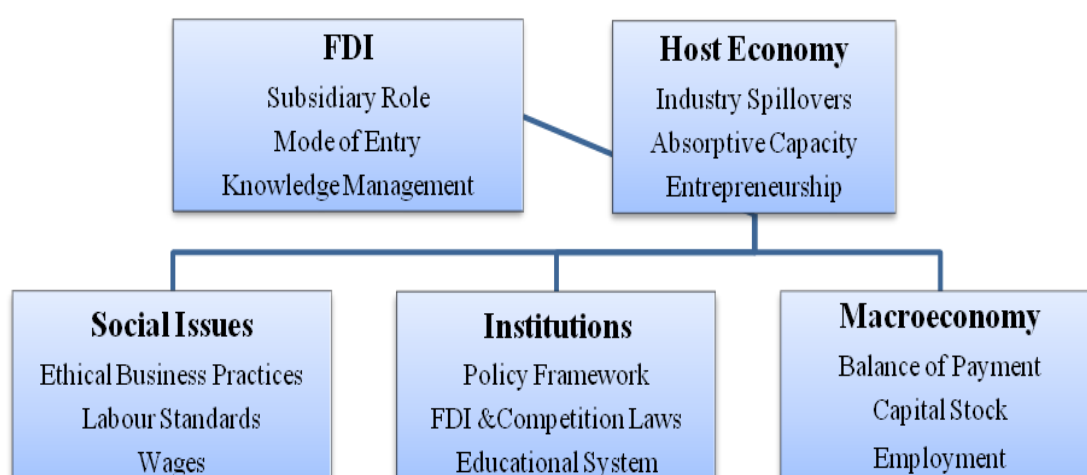
¹² Ibid.

both foreign investors and host economies abilities to benefit fully from business opportunities created by market size and growth potential.¹³ As such, an economy with a poor investment climate is therefore more likely to attract a lower level and quality of FDI than countries with enabling investment climates.¹⁴

II.2 Potential effects of foreign investment on the host country

Attracting and benefiting from foreign direct investment are complex processes which involve many stakeholders including local inhabitants, firms, and institutions and factors such as social issues and business environment.¹⁵ The channels through which FDI affects institutions and the macroeconomic state are portrayed in Figure 2.1.

Fig 2.1 Channels of FDI Impact



Source: Adopted from Meyer, K. (2005). *Foreign Direct Investment in Emerging Economies*. Templeton College Oxford Policy Discussion Paper, Emerging Markets Forum

Most FDI related interactions are bilateral. From a macroeconomic perspective, FDI influences the pillars of main concern to policy makers, such as employment, balance of payment and capital stock. Although not easily measured, in theory, FDI has a positive effect on these variables.¹⁶ FDI is also affected by certain policies and strategies designed by institutions. In order to successfully attract FDI, the government should, in addition to targeting FDI projects of particular importance for the host economy, develop policy frameworks and an education system in accordance with economic needs.¹⁷

As portrayed in Fig. 2.1, FDI affects social issues related to business behavior: ethical business practices, and labour standards and wages. It is a well-known fact that non-ethical behavior and failure to comply with standards may severely damage a firm's reputation. Hence, multinational companies, in order to preserve their reputation, generally tend to establish high

¹³ Ibid.

¹⁴ Hornberger, K. Battat, J. and Kusek, P. (2011). Attracting FDI: How much does Investment Climate Matter. World Bank, View Note Number 327.

¹⁵ OECD (2002). *Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs*. OECD Publications Service, France.

¹⁶ Denisia, V. (2010). Foreign Direct Investment Theories: An overview of the main FDI theories. *European Journal of Interdisciplinary Studies*, No. 3, p. 53-59.

¹⁷ Meyer, K. (2005), 'Foreign Direct Investment in Emerging Economies', *Policy Discussion Paper*, Templeton College Oxford, p. 1-33.

labour standards and pay higher wages.¹⁸ Consequently, multinational companies benefit from these higher standards and wages, which lead to higher performance, while corporate–social responsibility increases the perceived value of products.¹⁹ Moreover, local firms tend to absorb the managerial, organizational, and structural characteristics from MNEs –referred to as the absorptive capacity.

On the other hand, even though MNEs may generate spillover effects, vertical or horizontal, which enhance the productivity and know-how of local firms,²⁰ the spillover might not always have a positive effect. Multinational enterprise activities have often been subject to criticism.²¹ One of the main criticisms has been the unfair competition resulting from MNEs taking advantage of low wages and their exploitation of weak labour standards in the host country.²² MNEs have also been accused of violating human and labour rights in developing countries, as governments failed to enforce such rights effectively. Moreover, MNEs with economies of scale, due to their global presence and their effective supply chains, tend to threaten the small-scale industries in the host economies by adopting their market shares.²³

There are cases when MNEs, in order to preserve their comparative advantage, transfer their outdated technology to the host countries.²⁴ As a consequence, host economies cannot reach their maximum potential. Additionally, MNEs may exploit the host country's resources in order to profit materially in the short run. According to a study conducted on developing economies, 25 – 45 percent of MNEs produce, with the same resources, fewer goods and services in host economies than in their home countries.²⁵ With regard to employment, in general, it is hard to assert the net effect of FDI.

II.3 Kosovo's Legislative Framework on FDI

Foreign direct investment in Kosovo is primarily regulated by the Law No. 04/L-220 on Foreign Investment, whose purpose is to promote, protect, and attract foreign investment in Kosovo, primarily by providing fundamental rights, protection measures and guarantees for foreign investors. The main aim of this law, which repealed the Law No. 02/L-33, is to improve the business climate and conditions in order to attract foreign investments and ensure fair treatment of investors in accordance with international standards. The law regulates all aspects of foreign investments, addressing non-discrimination, expropriation, compliance with obligations/standards and laws, and, among others, mechanisms for the resolution of investment disputes. The Law stipulates that foreign investments include but are not limited to:

¹⁸ OECD (2008), 'The Social Impact of Foreign Direct Investment', *Policy Brief*, OECD Publication.

¹⁹ Meyer, K. (2005), 'Foreign Direct Investment in Emerging Economies', *Policy Discussion Paper*, Templeton College Oxford, p. 1-33.

²⁰ Petrović, E., and Stanković, J. (2009). Country Risk and Effects of Foreign Direct Investment. *Economics and Organization*, Vol. 6, No 1, p. 9 – 22.

²¹ OECD (2008), 'The Social Impact of Foreign Direct Investment', *Policy Brief*, OECD Publication.

²² OECD Employment Outlook (2008). Chapter 5. Do Multinationals Promote Better Pay and Working Conditions?. Available at: <http://www.oecd.org/els/emp/43244752.pdf>

²³ Narula R. (2001). Multinational Firms, Regional Integration and Globalising Markets: Implications for Developing Countries. *Infonomics Research Memorandum*, p. 1-32.

²⁴ Robert E. Lipsey (2004). Home and Host Country Effects of Foreign Direct Investment. *National Bureau of Economic Research*, p. 333-382

²⁵ Theodore Moran (2005). How Does FDI Affect Host Country Development? Using Industry Case Studies to make Reliable Generalizations. in *Does Foreign Investment Promote Development? Institute for International Economics Center for Global Development*, p. 281-309.

- “movable and immovable property, including rights in and to such property such as a mortgage, lien, pledge, lease or servitude;
- intangible and intellectual property, including rights in such property, as well as goodwill, technical processes and knowledge;
- cash, securities, commercial paper, guarantees, shares of stock or other types of ownership interests in the Republic of Kosovo or foreign business organization; bonds, debentures, other debt instruments;
- claims or rights to money, goods, services, and performance under contract;
- concessions or licenses conferred by law, administrative act, or contract; and
- returns yielded by an investment in the Republic of Kosovo or an investment elsewhere”.²⁶

Foreign investors, in theory, enjoy treatment guaranteed by the law which gives them the same rights and responsibilities as domestic investors.²⁷ The law on foreign investment also provides assurance regarding the repatriation of capital and profit, and, contrary to the previous law, the definition of foreign investor includes also Kosovar citizens of diaspora.²⁸ It should be noted that foreign investors enjoy the right to settle investment disputes according to the requirements agreed upon between the foreign investors and the Republic of Kosovo. In the case that an agreement does not exist, foreign investors can request to settle the investment dispute through a court of competent jurisdiction in Kosovo or through local and/or international arbitration.²⁹

On the other hand, the Law on Strategic Investments in the Republic of Kosovo regulates the procedures for the attraction and selection of foreign investments categorized as ‘strategic’.³⁰ More specifically, the law aims to: (i) regulate the administrative procedures and criteria for the assessment, selection, implementation and supervision of ‘strategic projects’, whether local or foreign, (ii) regulate the procedures for the utilization of Kosovo’s property to implement strategic investments projects, and (iii) reinforce the principles and conditions set out in the legislation relevant to state aid and legislation stemming from the SAA.³¹ The adoption of this Law was of utmost importance since it is expected to attract foreign strategic investments, improve the business environment and investment climate in Kosovo, provide a legislative framework to facilitate negotiations with local and foreign investors, and, in turn, support the development of a sustainable economy.

II.4 What does FDI mean for Kosovo?

Kosovo has recorded steady economic growth rates over the past years, albeit from a low base, that can be largely attributed to public investments in post-conflict reconstruction, donor assistance, and remittances.³² However, the growth model is largely unsustainable in the long-term given that Kosovo does not stimulate private sector activities and investment as a tool to

²⁶ Law No. 04/L-220 on Foreign Investment Article 2: Definitions, paragraph 1.4: Investment

²⁷ Law No. 02/L-33 on Foreign Investment; The rights vested on this law are: constant protection and security, non-discriminatory treatment, compensation in case of nationalization, expropriation, violation of the legislation, and protection against retroactive application of laws.

²⁸ Defined in the law as: ‘any physical person who is a citizen of the Republic of Kosovo, but has residence abroad’. For more see Law on Foreign Investment, Article 1.3.2

²⁹ Law No. 04/L-220 on Foreign Investment Article 16: Mechanisms for the Resolution of Investment Disputes

³⁰ According to the Law on Strategic Investments in the Republic of Kosovo. “Strategic Investment” is the status proposed by the Strategic Investments Committee and approved by the Government of the Republic of Kosovo, which is given to investment projects, qualified as strategic under this Law, throughout the phases of implementation and operation of the strategic project in the territory of the Republic of Kosovo; whereas “Strategic Project” means any private and public-private investment project which meets the criteria determined under this Law

³¹ Law on Strategic Investments in the Republic of Kosovo

³² World Bank-Kosovo Partnership. Country Program Snapshot 2013, p. 4.

generate growth, create new jobs opportunities, or promote increasing incomes.³³ Kosovo's economy is characterized by a large trade imbalance, due to high dependence on imports and a low export base, which continued to increase in the first 9 months of 2015.³⁴ In 2015, exports from Kosovo increased by 0.2% mainly as a result of increased exports of plastics, rubber, food and mineral products. On the other hand, imports increased by 3.8% in 2015, which corresponded to a decrease of the coverage rate³⁵ from 12.8% in 2014 to 12.5% in 2015.³⁶

As a post-conflict and developing country, Kosovo needs wide-ranging investments, and there are many sectors with high investment potentials that foreign direct investors could benefit from.³⁷ That said, Kosovo could target export-oriented investment to increase its export base and take advantage of the potential benefits of increasing exports. Moreover, foreign investments can be used as an important tool to stimulate production and, hence, decrease Kosovo's high dependence on imports. Given the persisting high unemployment rate, foreign investments could also be utilized as an important tool to soften the unemployment rate. Additionally, FDI can contribute to human capital formation through training and labour mobility. In both developing and developed countries, domestic firms tend to under-invest in trainings, as is the case in Kosovo.³⁸ Largely due to the pre-transition educational structure, human capital in Kosovo remains underdeveloped; foreign investment inflows could be a driver of new skill and knowledge acquisition amongst Kosovo's labour force.³⁹ Multinational Enterprises usually provide trainings that are likely to bring advanced technical and management skills and technologies to the host-country's labour force. MNEs can support domestic firms, especially in the agricultural sector, by providing trainings in innovative methods, management, and new production techniques, as well as by providing technical assistance. Foreign investments which advance technological capabilities in export-oriented sectors may be particularly beneficial.⁴⁰

There is no specific data highlighting the effect of FDI on the overall level of employment in Kosovo.⁴¹ During the period 2007-2014, the level of employment remained quite stable but low, averaging at 26.5 percent. Contrary to expectations, the significant and continuous decrease of FDI since 2011 (see Fig. 2.2) does not appear to have negatively effected the levels of employment – at least formally. It should be noted however that Kosovo is characterized by a sizable informal sector⁴² and high level of informal employment,⁴³ which could be a factor that masks the translated effect of FDI on formal employment in Kosovo.⁴⁴

Kosovo remains the poorest country in South East Europe (SEE), with persisting high levels of poverty. According to the latest data, 29.7 percent of the population live in poverty whereas

³³ Ibid.

³⁴ Central Bank of Kosovo (CBK). Macroeconomic Development Report, No. 4, available at: http://bqk-kos.org/repository/docs/2015/CBK_Macroeconomic%20developments%204.%20doc.pdf

³⁵ Coverage rate – the coverage rate of imports by exports.

³⁶ Central Bank of Kosovo. Quarterly Assessment of the Economy, QIV/2015, available at: http://www.bqk-kos.org/repository/docs/2015/CBK_TM4_2015_English.pdf

³⁷ For a more detailed study on potential sectors see American Chamber of Commerce in Kosovo (2012). Case to Invest in Kosovo, available at: http://www.amchamksv.org/images/userfiles/files/9986_caseforinvestinginkosovorevised.pdf.

³⁸ Miyamoto, K. (2003). Human Capital Formation and Foreign Direct Investment in Developing Countries. OECD Development Centre, Working Paper No. 211.

³⁹ Ibid.

⁴⁰ Ibid.

⁴¹ Kosovo Agency of Statistics (KAS) and Ministry of Labour and Social Welfare (MLSW).

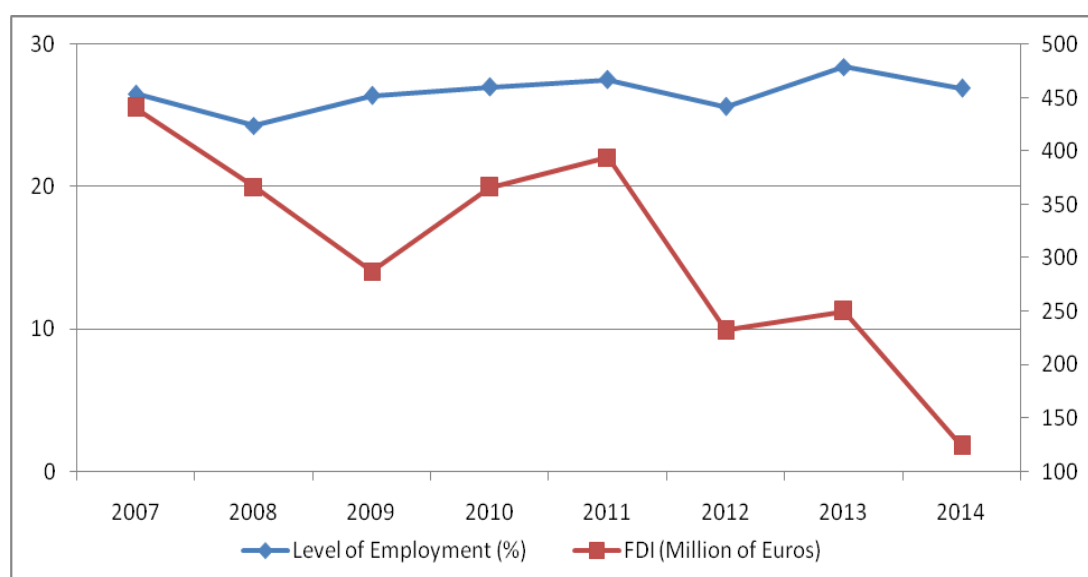
⁴² According to the European Agency for Reconstruction (EAR) in 2007, the estimated size of the informal economy in Kosovo for the period of 2004–2006 was 27 and 35 percent of GDP.

According to the ILO and the World Bank estimates, over half of the total employment in Kosovo were informally employed in 2003 and 2004.⁴³ For more see: World Bank (2003). Kosovo Labour Market Study: Policy Challenges of Formal and Informal Employment. Washington D.C.; See also: Corbanese, V. and Rosas, G.(2007). Youth transition to decent work: Evidence from Kosovo. ILO Employment Policy Papers, Geneva.

⁴⁴ Having a sizable informal sector makes the indicators of employment and unemployment rates unreliable.

10.2 percent live in extreme poverty.⁴⁵Promoting and facilitating foreign investment, in addition to employment, could contribute to greater welfare improvements in Kosovo.

Fig 2.2: FDI and employment level⁴⁶ trends, 2007-2014



Source: CBK and Kosovo Agency of Statistics; Left axis is the employment level, whereas right axis is the FDI trend

Kosovo could also benefit from the high investment potential of diaspora capital, given the large remittances it receives on annual basis. According to a UNDP report, the majority of emigrants from Kosovo are employed,⁴⁷ suggesting that the earning power of Kosovo's diaspora population is substantially large.⁴⁸ According to the Central Bank of Kosovo (CBK), remittances from diaspora increased to 693.68 million in 2014, an increase of 12 percent compared to 2013 (see Fig. 2.3).⁴⁹ Diaspora capital could be utilized as an important source of finance to fill the investment gap. However, studies report that remittances in Kosovo are mainly used for household consumption rather than for investment.⁵⁰ According to the latest data, around 40 percent of remittances are used for household consumption, another portion for housing and human capital investment, whereas only a small amount is used for business investment.⁵¹

⁴⁵ Statistical Office of Kosovo 2011.

⁴⁶ Considering the fact that employment level in Kosovo has been constant and no data is available for years 2010 and 2011, the employment figures for these two years were assumed depending on the previous year's trend. Moreover, the data for year 2012 portrays only the first 6 months of 2012.

⁴⁷ More precisely, 95.4% of male emigrants and 84.4% of female emigrants are employed.

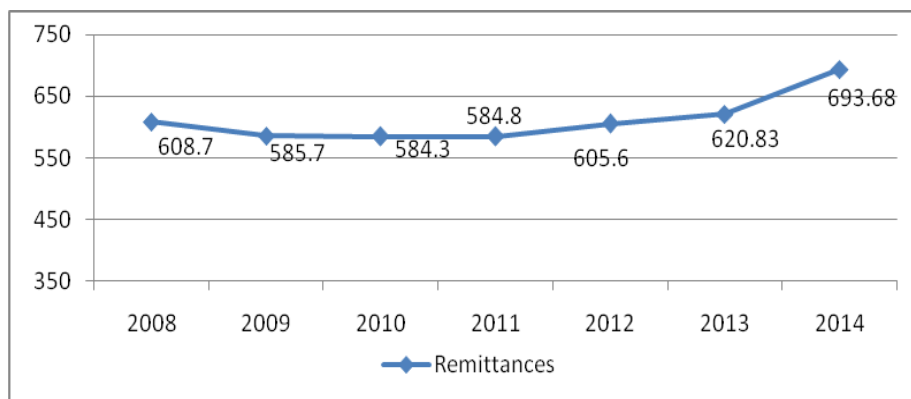
⁴⁸ Havolli, S and Jazbec, B. (2011), Determinants of Migrants' Investments: Is there Room for Policy-Making? Central Bank of Kosovo (CBK), p. 103-107.

⁴⁹ Central Bank of Kosovo (2012). Annual Report 2011, p. 64.

⁵⁰ Central Bank of Kosovo (2015). Annual Report 2014

⁵¹ UNDP (2013). Kosovo Remittance Study.

Fig. 2.3: Remittances in Kosovo from 2008 to 2014, in million €



Source: Retrieved from CBK data

Kosovo has been unsuccessful in establishing effective mechanisms for utilizing diaspora capital for generating economic growth. It is worth mentioning that Kosovar emigrants, similar to foreign investors, hesitate to invest in Kosovo given the weak rule of law, lack of administrative capacity, and, among other factors, the overall unsatisfactory economic environment.⁵² In addition, investors' reluctance to invest is strongly associated with the negative perceptions of Kosovo⁵³ and its high levels of corruption.⁵⁴ Kosovo needs to reduce the obstacles that diaspora investors face and consider introducing an incentive program targeting diaspora populations in order to absorb the investment capacity of Kosovo's diaspora. Ideally, Kosovo's diaspora can play a dual role by providing remittances and investments and positively influencing the perceptions of foreign investors about Kosovo. The latter could serve as a catalyst for international connections, foreign investments, and as means to facilitate foreign trade.⁵⁵

III. FDI IN DEVELOPING COUNTRIES: WHERE DOES KOSOVO STAND?

Over the last 30 years, transition economies have made significant progress in becoming major market players.⁵⁶ Given the potential positive impact that FDI can play in accelerating growth and economic transformation, developing countries have increasing interest in attracting FDI.⁵⁷ Developing economies have made significant progress in attracting FDI during the period 2000-2010, largely as a result of improved political and economic conditions.⁵⁸ However recent figures show that FDI net inflows in SEE countries decreased by 62% between 2008 and 2014. During this period the distribution of FDI among SEE countries has been uneven, with EU member states (Bulgaria, Croatia, and Romania) generally attracting the largest share of FDI.

⁵² UNDP (2012). Kosovo Remittance Study.

Available at: http://www.kosovo.undp.org/repository/docs/KRS2012_English_858929.pdf.

⁵³ Xharra, B. and Walisch, M. (2012). Beyond Remittance: Public Diplomacy and Kosovo's Diaspora. *Foreign Policy Club*, p. 7.

⁵⁴ IOM and UNDP (2013). Facilitating investments from Diaspora in Kosovo: Assessment and planning of new strategies in local and central levels.

⁵⁵ Ibid, p. 9.

⁵⁶ During the last decade though, some of the transition countries (CEE), namely Poland, Hungary and the Czech Republic, have made strikingly faster progresses and have become much attractive to FDI. All of the transitioning CEE countries have been building the new economic system via deregulation of prices, liberalization of trade, privatization, external assistance and capital market development – See: Kornecki, L. (2010). FDI in Central and Eastern Europe: Business environment and current FDI trends in Poland. *Research in Business and Economics*, OC09064.

⁵⁷ Amerasinghe, N., and Modesto, J. (2012). Foreign Direct Investment in Asia: Lessons of Experience. *Asian Institute of Management*, p. 12-003.

⁵⁸ Hornberger, K. Battat, J. and Kusek, P., (2011). Attracting FDI: How much does Investment Climate Matter. World Bank, View Note Number 327.

During the last decade, Kosovo lacked innovative policies, which could have stimulated or boosted the level of exports and attracted a higher level of foreign investment.⁵⁹ In recent years, the Government of Kosovo has undertaken several reforms aimed at improving the business environment as a means of promoting enterprise development, increasing employment, improving welfare and reducing poverty. However, according to the latest World Bank Doing Business Report 2015,⁶⁰ Kosovo still ranks very poorly in this regard. Compared to other SEE and developing countries which have shown serious commitment to attracting FDI, this has not been a government priority in Kosovo. The FDI inflows in Kosovo in 2012, 2013 and 2014 have been the lowest in the SEE region. While Kosovo has outperformed BiH and Macedonia in some years during the 2008-2014 period, other countries like Romania, Bulgaria, and Croatia have attracted massive inflows in comparison (see Table 3.1). In 2014, FDI in Kosovo hit a record low, having decreased by 72% compared to the previous year, similar to Macedonia which also experienced a drastic decline in FDI.⁶¹

Table 3.1 FDI net inflows in SEE countries during 2008-2014 period (in mil US\$)

Country	2008	2009	2010	2011	2012	2013	2014
Albania	1,240	1,343	1,089	1,049	920	1,253	1,149
BiH	1,004	138	443	471	391	336	496
Bulgaria	10,296	3,896	1,241	2,099	1,787	1,989	1,971
Croatia	5,187	3,198	1,424	1,414	1,453	927	3,936
Kosovo	536	408	486	546	293	343	199
Macedonia	611	259	301	507	337	402	60
Montenegro	975	1,549	758	556	618	446	496
Romania	13,849	4,926	3,204	2,557	2,629	3,854	3,864
Serbia	4,055	2,928	1,693	4,929	1,276	2,059	1,999

Source: World Bank Indicators

III.1 Kosovo's FDI Profile

As table 3.2 shows, the FDI inflows have fluctuated over the 2007-2014 period. Contrary to expectations, FDI inflows declined after Kosovo's declaration of independence in 2008. Although, the decline in 2009 has been mainly attributed to the financial crises all over Europe.⁶² From 2011 until 2014, FDI in Kosovo continued to decline regardless of the fact that Kosovo's ranking in the 'Doing Business and Corruption Perception Index' improved (see Fig 3.1).⁶³ According to CBK, the drop in FDI can be mainly attributed to the Eurozone crises that led European countries,

⁵⁹ FES (2011). Economic Challenges 2011 Plus. *Briefing Paper*, p. 12; Available at: <http://library.fes.de/pdf-files/bueros/kosovo/08110.pdf>.

⁶⁰ See section 4.

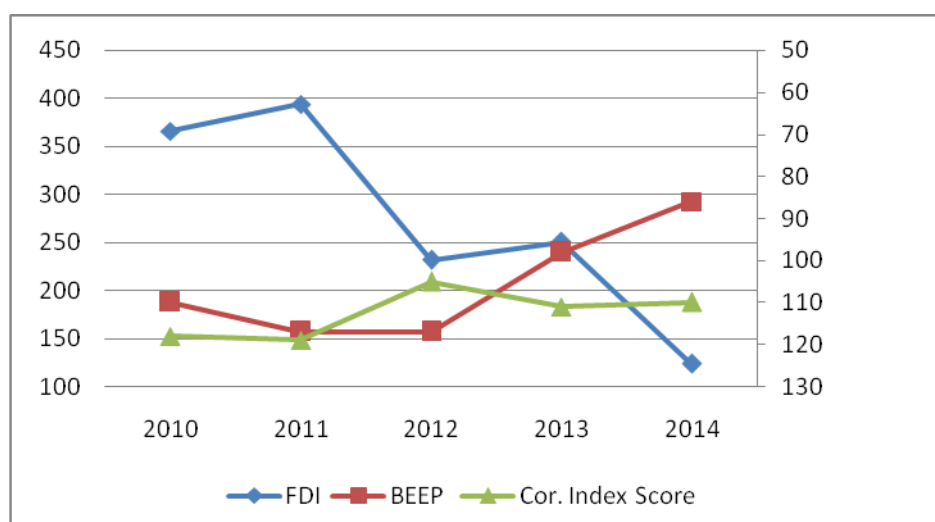
⁶¹ For the former 2012 marked a drastic decline in FDI inflows from 2,700 million in 2011 to a level of only 355 million.

⁶² Central Bank of Kosovo (2012). Financial Stability Report; In addition to the decrease on FDI in 2009, financial crises resulted also in a decrease on the level of remittances and exports in Kosovo.

⁶³ WB Doing Business ranking is based on the older methodology.

which constitute the largest share of FDI in Kosovo, to invest less in Kosovo.⁶⁴ The decline can also be attributed to the slowdown of the privatization process in Kosovo in 2012.⁶⁵ However, economic experts argue that the persistence of weak rule of law, high levels of corruption, and organized crime in Kosovo have also largely contributed to the sharp decline of FDI.⁶⁶

Fig3.1: FDI, Doing Business and Corruption Perception Index, 2010 – 2014



Source: CBK, World Bank, Transparency International

Note: The figures are in millions of Euros; The GDP figures are portrayed on the right axis, whereas FDI on the left axis

FDI in Kosovo increased at a slower pace compared to GDP for the period of 2009 – 2011. Despite GDP growth since 2008, FDI has decreased substantially since 2011 (see Fig 3.2). According to the annual report of CBK, the economic growth in Kosovo in 2014 was mainly driven by the increase of consumption, suggesting that FDI has not significantly impacted the composition of GDP. As far as SEE countries are concerned, Table 3.2 shows that between 2008 and 2014 most countries marked relatively low shares of FDI to GDP, with the exception of Montenegro and Albania. The figures also suggest that the share of FDI to GDP in Kosovo has been minor and similar to that of Bulgaria, relatively higher than that of BiH, Macedonia, and Romania, yet well below that of Montenegro.

Table 3.2: SEE countries FDI net inflows as a share of GDP

Year	2008	2009	2010	2011	2012	2013	2014
Albania	9.6	11.2	9.1	8.1	7.5	9.8	8.7
Bosnia &H.	5.	0.8	2.6	2.5	2.3	1.9	2.7
Croatia	7.4	5.1	2.4	2.3	2.6	1.6	6.9

⁶⁴ Central Bank Kosovo (2012). Annual Report 2011, p.71 and Annual Report 2012, p. 82.

⁶⁵ *Koha.net* web portal, Article 'BQK: Ekonomia e Kosovës, në rënie', available at: <http://www.kohaditore.com/?page=1,3,137144>, accessed at 03.03.2013.

⁶⁶ *Albinfo* web portal (2013), 'Këq me investime të huaja', available at: <http://www.albinfo.ch/sq/node/21694> ; See also: *Telegrafi* web portal (2013), 'Korrupsioni po i largon investitorët e huaj nga Kosova', available at: <http://www.telegrafi.com/ekonomi/korrupsioni-po-i-largon-investitorët-e-huaj-nga-kosova-46-13433.html>.

Kosovo	9.4	7.2	8.4	8.2	4.5	4.8	2.7
Macedonia	6.2	2.8	3.2	4.8	3.5	3.7	0.5
Montenegro	21.6	37.4	18.3	12.3	15.1	10	10.8
Serbia	8.2	6.9	4.3	10.6	3.1	4.5	4.6
Romania	6.7	2.9	1.9	1.4	1.5	2.0	1.9
Bulgaria	18.8	7.5	2.5	3.7	3.3	3.6	3.5

Source: World Bank data

FDI inflows in various sectors in Kosovo have fluctuated during the period 2008-2015; FDI was predominantly concentrated in the financial and real estate sector, whereas the agriculture and mining/energy sector received much lower levels of foreign investment on average (see Table 3.3). During this period, the FDI inflows in the agriculture, hunting, forestry and fishing sector constituted the lowest share of FDI compared to other sectors, amounting to a total of €24.8m; the highest inflows in this sector were in 2009 and lowest in 2014. The mining and energy sector was second to last with regard to FDI inflows, which amounted to an 8-year total of €79.1m. Even though FDI inflows in the aforementioned sectors were quite low, there is significant potential for growth in these sectors under the SAA framework.

Agriculture and farming have traditionally been an important economic activity in Kosovo, accounting for around a quarter of the total domestic output. This sector offers substantial investment opportunities for foreign investors as 53 percent of the land is considered to be arable land and offers potentials for high yield due to a beneficial climate, natural conditions and/or soil composition. In addition, this sector offers low production costs, relatively cheap labour, and competitive prices for agricultural inputs, as well as open access to the CEFTA and EU markets. Most importantly, there is potential for import substitution in this sector as the demand for agricultural products is very high. Increasing investment and output in this sector could improve the trade balance by increasing Kosovo's export capacity under the framework of SAA.

The manufacturing sector during the period 2008-2015 has attracted foreign investment amounting to a total of €287.4m, the highest and the lowest share being in 2010 and 2014 respectively. Meanwhile, the construction sector during the same period has attracted foreign investment amounting to a total of €311.2m, the highest and the lowest share being in 2011 and 2014 respectively. During this period, Kosovo undertook reforms which minimized the time and cost needed to obtain the necessary documents and approvals for construction procedures, as shown by the WB Doing Business Report Construction Permit indicator.⁶⁷

Transport, storage and communication sectors during the 2008-2015 period attracted FDI inflows amounting to €154m but observed a considerable decline in the last two years. Investments in the transport and telecommunication sector were largely demand driven. The transport sector in Kosovo has been gradually improving, especially after the conflict, and investments were concentrated on road infrastructure.⁶⁸ During 2010, investments in road

⁶⁷ World Bank Doing Business Report, 2013. The improvements in ranking for this indicator are a result of the reforms government has undertaken such as: The new law on construction that is expected to ease for businesses and individuals the process of getting a construction permit, given that it includes the principle of "consent by silence", if applicants do not receive an answer for the permit within the legal deadlines; also the expenses and time to register the building after construction have decreased by 80 percent.

⁶⁸ USAID, (KPEP) (2009). Construction in Kosovo: Growing Opportunities for Kosovo Building Materials Manufacturers, pp.11.

infrastructure amounted to €200 million, which accounted for almost 50 percent of the total public investment.⁶⁹

Despite the lack of the country code, the telecommunication sector managed to attract FDI inflows.⁷⁰ This sector has expanded in recent years mainly due to high demand which led other companies, such as Kujtesa and IPKO, to invest in this sector.⁷¹ IPKO's investments were a major source of FDI in 2007 and 2008.⁷² According to 2014 and 2015 statistics, Kosovo's penetration rates⁷³ regarding the fixed-line, internet and mobile communication services were respectively 3.1 percent, 76 percent, and 97.6 percent.⁷⁴

The financial and real estate sectors have attracted the highest share of FDI inflows during the 2008-2015 period, amounting to €390.3m and €825.5m, respectively. The financial sector in Kosovo, which was almost non-existent after the conflict, is considered a success story with regard to attracting FDI.⁷⁵ High demand among individuals, SMEs, corporations, and the public sector led to the establishment of this sector.⁷⁶ Moreover, local and foreign banks were driven by the high market share; excessively high interest and profit rates could have been additional factors that stimulated FDI in this sector. In 2015, foreign banks in Kosovo accounted for 90.4 percent of the total banking assets.⁷⁷ After reaching its peak in 2008, the FDI inflows in this sector gradually decreased until 2013, followed by an increase in the coming years.

The real estate, renting and business activities sector has attracted the highest share of FDI inflows during the 2008-2015 period, reaching its peak in 2015. The large share of FDI inflows in this sector were driven by Kosovo's diaspora, with 60 percent of diaspora investments oriented towards the real estate sector, according to an IOM and UNDP study. In addition, the U.S. Overseas Private Investment Corporation signed an investment agreement with Kosovan authorities in 2009 which led to American investors investing in the real estate development sector.⁷⁸ The current legislation on real estate, which guarantees fair and equal treatment of foreign and national investors, likely had a positive impact in this regard.⁷⁹

⁶⁹ Jashari, V. (2010). Road Infrastructure development and investment in Kosovo. *Capstone Project* in partial fulfillment of a Master's of Science at RIT, pp.19.

⁷⁰ KPMG (2011). Investment in Kosovo, pp. 11.

⁷¹ Investment Promotion Agency in Kosovo (IPAK), available at: <http://www.invest-ks.org/?cont=22>.

⁷² State Portal of the Republic of Kosovo, 'Citizens: Mobility and communication: Telecom', available at: <https://www.rks-gov.net/en-US/Qytetaret/LevizshmeriaDheKomunikimi/Pages/Telekomi.aspx>

⁷³ Market share of the fixed line, internet and mobile communication services.

⁷⁴ Data were retrieved Ministry of Foreign Affairs, from http://www.economywatch.com/economic-statistics/Kosovo/Internet_Penetration_Rate/ and <http://www.budde.com.au/Research/Kosovo-Telecoms-Mobile-Broadband-and-Digital-Media-Statistics-and-Analyses.html>

⁷⁵ Maloku, E. (2011), 'Role of Central Bank in the Establishment and the Development of Financial System in Post-War Kosovo', *Journal of Knowledge Management, Economics and information Technology*, Issue 5, Aug 2011, p:1-20

⁷⁶ The Kosovo Competition Authority (2011), 'Analysis of Monitoring the Competition in the Banking Sector in Kosovo', p.7.

⁷⁷ Central Bank (2015) Financial Stability Report 2015

⁷⁸ US Commercial Service (2012). Doing Business in Kosovo: 2012 Country, p.3, available at: http://photos.state.gov/libraries/kosovo/312585/files/2012_Pristina%20CCG_final.pdf.

⁷⁹ Global Legal Group (2012). The International Comparative Legal Guide to: Real Estate 2011, Chapter 24, p.174, available at: http://www.bogalaw.com/pdf/RE11_Chapter-24_Kosovo.pdf.

Table 3.3 Foreign Direct Investments by sector (%) during 2008-2015

FDI by sector	2008	2009	2010	2011	2012	2013	2014	2015	Total
Agriculture, hunting, forestry, fishing	8.5	13.1	0.9	0.6	0.3	0.4	0.2	0.9	24.8
Mining/quarrying & Electricity/gas/water supply	34.1	15.7	17.7	-5.0	-22.8	34.6	17.6	-12.7	79.1
Manufacturing	53.7	57.6	101.1	46.9	27.4	11.5	-34.0	23.1	287.4
Construction	13.5	35.5	54.2	133.1	31.1	17.3	-19.9	46.3	311.2
Transport, storage & communication	51	21.9	-15.9	29	32.4	51	-9.1	-6.2	154
Financial intermediation	109.6	75.3	39.4	33	22.4	4.4	41.9	64.3	390.3
Real estate, renting & business activities	62.2	43.9	75.5	60.5	115.7	136.1	142.1	189.6	825.5
Other sectors	37.2	32.5	95.7	86.4	22.5	25	12.4	19	330.7

Source: Central Bank of Kosovo

IV. POTENTIAL, INCENTIVES AND WEAKNESSES OF KOSOVO'S FOREIGN INVESTMENT CLIMATE?

IV.I. Potentials and incentives

Kosovo has a strategic geographical position, as it is located in the heart of the Balkans. The highway to Albania and the planned highway to Macedonia are expected to decrease the transport time to these countries to three hours and one hour, respectively. Moreover, Prishtina International Airport offers airline flights/connections to many European and international cities. Kosovo's skilled, multilingual and motivated labour force, which constitutes 65% of total population, is considered an important asset in attracting FDI.⁸⁰ Moreover, its labour force is considered to be the cheapest in the region which makes Kosovo a competitive location for foreign direct investment.

In addition, Kosovo has been promoting and implementing a set of incentives and a legal framework which aim to promote growth of the small and medium enterprise (SME) sector and attract foreign investment. Kosovo imposes a standard Value Added Tax (VAT) rate of 18 percent and a reduced VAT rate of 8% for goods and services.⁸¹ Apart from Montenegro which imposes a 9 percent profit tax rate, Kosovo has one of the lowest rates in the region at 10 percent. Moreover, it offers a zero percent import tariff on selected raw materials and a range of capital, intermediary, and pharmaceutical goods. Following the practice of many countries, Kosovo has established the Investment Promotion Agency (IPAK), now Kosovo Investment and Enterprise Support Agency (KIESA), to provide investor facilitation and services. KIESA assists investors with analyzing investment decisions, establishing businesses, identifying suitable property options to

⁸⁰ Kosovo Agency of Statistics (2015). Kosovo in figures 2014

⁸¹ KPMG in Kosovo (2015). New Kosovo Tax Legislation. Available at: <https://www.kpmg.com/AL/en/IssuesAndInsights/ArticlesPublications/Tax-News/Documents/2015-01-Kosovo-Tax-News-En.htm>

accommodate operations, obtaining necessary approvals from authorities, facilitating a fast start-up of the facility, and finding local partners in Kosovo.⁸²

Aiming to establish principles for the stable development of a pure market economy, Kosovo has worked towards establishing free movement of goods with several trading partners.⁸³ By unilaterally adopting the Euro as a currency in 2002,⁸⁴ Kosovo eliminated the exchange rate with EU countries thereby reducing the transaction costs and barriers for trade with and investment from Europe. In addition, since 2007 Kosovo enjoys a free trade regime with CEFTA members, Autonomous Trade Preferences with the European Union, preferential customs free entry for US products, and trade preferences with Japan and Norway.⁸⁵ Recently, Kosovo has signed trade preferences with Turkey in 2013 and the SAA agreement with the European Union in 2015.⁸⁶ Kosovo's failure to fully utilize the CEFTA agreement, due to implications vis-à-vis its statehood, has been considered to be a detrimental factor for Kosovo's potential market growth. The decision to prohibit the import and transit of Kosovar products by two members of CEFTA, Bosnia and Herzegovina (BiH) and Serbia in 2008, led to a decrease of exports by 9.8 percent and an increase of transportation costs by 5-10 percent.⁸⁷ The non-compliance with the CEFTA agreement and trade blockage by Serbia and BiH have negatively affected the FDI inflows to Kosovo.⁸⁸

Kosovo has undertaken several reforms to remove regulatory obstacles with the aim of improving the business environment conditions, easing procedures, and shortening the necessary time to open a business (see box 1). As Table 4.1 shows, it was only from 2013 that Kosovo showed improvement in its overall performance, reaching its best rank in 2015. Of note is the fact that Kosovo has improved its ranking with regard to 'protecting minority investors' from 2013 onwards.⁸⁹ According to the 2015 WB Doing Business report, Kosovo ranks 75th out of 189 countries, ranking higher than BiH and Serbia but lower than Albania and Macedonia. The report further suggests that Kosovo has made considerable progress vis-a-vis starting businesses, getting electricity, and registering property but has declined with regards to collecting taxes and resolving insolvency.⁹⁰

In recent years, Kosovo has improved its performance in the 'starting a business' indicator, by abolishing the minimum capital requirement and creating a one-stop shop for starting a business. According to the aforementioned 2015 report, starting a business in Kosovo takes 11 days on average, 4.5 days in Albania, and 37 days in Bosnia and Herzegovina.⁹¹ According to the Doing Business database, economies with a one-stop shop mechanism generally need less than 20 days to start up a business, compared to other economies where the procedure can last for

⁸² For more see IPAK's website: <http://www.invest-ks.org/?cont=43>.

⁸³ Investment Promotion Agency of Kosovo (IPAK). Free Trade Agreements, available at: www.invest-ks.org.

⁸⁴ Svetchine M. (2005). Kosovo Experience with Euroization of its Economy. *Fifth Conference of the Bank of Albania*, March 2005, p. 235.

⁸⁵ Ibid.

⁸⁶ 'Kosova nënshkruan marrëveshjen për tregti të lirë me Turqinë'. *Telegrafi*, September 27, 2013. Accessed on 30 January 2014 from <http://www.telegrafi.com/ekonomi/kosova-nenshkruan-marreveshjen-per-tregti-te-lire-me-turqine-46-15816.html>; European Council Press Release (2015), available at: <http://www.consilium.europa.eu/en/press/press-releases/2015/10/27-kosovo-eu-stabilisation-association-agreement/>

⁸⁷ GAP Institute (2011). Kosovo in CEFTA: In or Out?, p. 10.

⁸⁸ GAP Institute (2011). Kosovo in CEFTA: In or Out?, p. 4-5.

⁸⁹ World Bank Doing Business Report (2013). Improvements in Protecting investor indicator reflect the revision of the Law on Business Organizations, which improved both, the disclosure (transparency of related-party transactions) and the director liability index (liability of self dealing).

⁹⁰ World Bank Doing Business Report (2015).

⁹¹ World Bank Doing Business Report (2015).

more than 40 days.⁹² The one stop shop service was introduced in Kosovo in 2011; however, it has not been functioning effectively.⁹³

Besides the starting a business indicator, Kosovo has shown progress in registering property compared to previous years and also compared to most countries in the region.⁹⁴ It should be noted however that reforms undertaken in Kosovo in 2015 have increased the fee for the registration of property.

Contract enforcement and resolving insolvency are two indicators in which Kosovo ranks among the lowest, also compared to the SEE countries, with a global ranking of 138 and 164 respectively.⁹⁵ Kosovo has not pursued a single reform for improving contract enforcement or resolving insolvency. The massive number of backlog cases and the length of time needed to enforce a contract, as well as perceptions of the judiciary as the most corrupt branch of government,⁹⁶ are some of the factors that have deterred foreign investors from investing in Kosovo.

Table 4.1: Rank of Kosovo in WB Doing Business Report and the rank of indicators during 2011-2015

Year	2011	2012	2013	2014	2015
Overall rank*	119	117	96	86	75
1. Starting a business	163	165	126	100	42
2. Dealing with Construction Permits	173	169	152	136	135
3. Getting electricity	/	120	120	121	112
4. Registering property	65	66	75	58	34
5. Getting credit	32	24	24	28	23
6. Protecting minority investors	173	172	95	98	62
7. Paying Taxes	41	45	42	43	63
8. Trading across borders	130	129	122	121	118
9. Enforcing contracts	155	157	139	138	138
10. Resolving insolvency	31	31	86	83	164

Source: World Bank Doing Business Kosovo

⁹² World Bank and IFC (2010). Doing Business 2011: Making a Difference for Entrepreneurs, p. 22.

⁹³ Office of the Prime Minister (2011), 'Action Plan of the Economic Vision of Kosovo 2011-2014', available at: http://www.kryeministri-ks.net/repository/docs/Action_Plan_of_the_Economic_Vision_of_Kosovo_2011-2014.pdf.

⁹⁴ World Bank Doing Business Report (2015).

⁹⁵ World Bank Doing Business Report (2015).

⁹⁶ http://www.kgik-ks.org/repository/docs/Raporti-Vjetor-KJC-ENG_439854.pdf; <http://www.business-anti-corruption.com/country-profiles/europe-central-asia/kosovo/corruption-levels/judicial-system.aspx>

In recent years the government has increased efforts to promote Kosovo as a FDI friendly environment, focusing on targeting core sectors. This promotion, however, has mainly highlighted resources and country characteristics since not many policies have been designed to specifically target FDI *per se*. The promotion of foreign investment in Kosovo, whether targeted to the economy in general or to specific sectors, is of tremendous importance. The potential for promotion will be constrained if fundamental conditions related to markets, resources, costs and the general business environment are not satisfactory.⁹⁷ Thus, a crucial precondition for promotional success is the establishment of an enabling investment environment and innovative, well-designed policies and incentives, especially related to specific sectors/activities. Once the investment climate and targeted sectors are made more attractive, authorities should subsequently promote them as such.

IV.2 Key deterrents of FDI in Kosovo: Where should the government focus?

Over the seventeen years since the conflict, Kosovo has lacked a sound strategy for economic development, stemming from a lack of serious and relevant economic policies and ad-hoc decisions. In general, there is a lack of FDI culture and understanding in Kosovo, and the government lacks a clear and sound strategy for attracting foreign direct investment.⁹⁸ While a wide range of policies could positively influence FDI inflows, most policies have not been designed to specifically target FDI. Although Kosovo has undertaken thorough reforms with regard to improving the business environment, inadequate regulations continue to harm Kosovo's ability to attract and retain foreign investments. Kosovo needs to improve its current image; foreign investors perceive Kosovo as unattractive for investment, given its vast deficiencies in rule of law and widespread corruption. Political instability, corruption and unfair competition, improper implementation and weak law enforcement, lack of financial incentives and poor infrastructure, poor business climate, and high poverty rates are reported to be some of the obstacles deterring foreign investors from investing in Kosovo.⁹⁹ In particular, Austrian investors in Kosovo have reported that high corruption, insufficient support for foreign investment, and administrative procedures are some of the main problems they have encountered in Kosovo.¹⁰⁰ In addition, the German Ambassador has recently pointed out that Kosovo's economy is highly dependent on consumption rather than investment, the latter being hindered by an unfavorable business environment and lack of investment guarantees.¹⁰¹

Corruption creates an unfavourable business environment and is a critical constraint for private sector development and sustainable economic growth. Besides the negative impact corruption has on the economy, it also undermines firms' operational efficiency and raises the risks and costs (e.g. bribes) associated with doing business. In Kosovo, corruption has created an unfair market where there is inconsistency and lack of enforcement of trade and business regulations, enabling firms to operate informally, evade taxes or custom duties, and avoid licensing restrictions. Several reports highlight that the immense levels of perceived corruption negatively impact the image of Kosovo amongst foreign investors. According to the Corruption

⁹⁷ Cass, F. (2007). Attracting FDI to transition countries: The use of incentives and promotion agencies. *UNCTAD Working Papers*, available at: http://www.unctad.org/en/docs/iteit20072a3_en.pdf.

⁹⁸ Investment Promotion Agency of Kosovo (IPAK) currently has an Investment Promotion Strategy; however, in the governmental level there is no published strategy regarding the investment.

⁹⁹ Kida, N. (2015). Obstacles Encountered by Foreign Investors in Kosovo. International Conference on Issues in Business Administration and Economics

¹⁰⁰ Kosovo Chamber of Commerce and Austrian Federal Chamber of Commerce (2014). Economic Barometer in Kosovo.

¹⁰¹ Telegrafi. Viets: Mjedisi biznesor është i vështirë dhe nuk ka garanci për investime. May 2016

Perception Index 2015, Kosovo ranks 103rd globally with a score of 33 on a 0-100 scale,¹⁰² indicating that the public sector in Kosovo is perceived to be highly corrupt. The 2014 Human Development Report and 2015 EC Country Report identify corruption, alongside limited access to finance, administrative inefficiency, lack of capacity, deficient rule of law and legal enforcement, as the primary factors which hinder investment and negatively impact the business environment in Kosovo.¹⁰³

Box. 1 Business Reforms in Kosovo

- ☐ A new law on strategic investment was been approved
- ☐ Tax clearance documents required for applying in public procurement activities/tenders will have a longer validity, reducing the time businesses spend in preparing the tender application Kosovo has abolished the annual business license fee
- ☐ Kosovo has abolished the annual business license fee;
- ☐ Kosovo has introduced a private bailiff system.
- ☐ Kosovo has established a new phased inspection scheme and substantially reduced the building permit fee.
- ☐ Kosovo has eliminated the requirement for validation of the main construction project, eliminated fees for technical approvals from the municipality and reduced the building permit fee
- ☐ Kosovo has introduced a new notary system and by combining procedures for drafting and legalizing sale and purchase agreements.
- ☐ Registration of business entities at Kosovo Customs institution for import/export purposes has been removed; instead, 'VAT number of the business entity will be used;
- ☐ The minimum capital requirement has been abolished;
- ☐ The new law on construction will ease procedures to get a construction permit, including the principle of “consent by silence”; if applicants do not receive an answer for the permit within the legal deadlines;
- ☐ 80 % of expenses and time to register the building after construction have decreased;
- ☐ The declaration of income tax and pensions contributions can now be done electronically, the law for notary services has been approved and became effective; and 39 Notary have been certified throughout Kosovo;
- ☐ Municipal centres for opening businesses (one stop shops) have been established which has decreased the time (and costs) of opening a business in Kosovo;
- ☐ The Law on Obligations has been approved, which also contains a provision which provides for the inclusion of interest rates in late payments;
- ☐ The interest rate paid to businesses in case of late reimbursements

¹⁰² Transparency International: Perception Corruption Index 2012; A 0 scale means that a country is perceived as highly corrupt and 100 means it is perceived as very clean, available at: <http://www.transparency.org/cpi2012/results>.

¹⁰³ European Commission (2015). Kosovo Country Report 2015.

- has increased to 2.4 percent per year;
- The number of documents required for import/export purposes has been reduced from 7 to 3 documents (export declaration, accompanying invoice, and EUR 1- with the request of the party)

Source: Ministry of Trade and Industry, American Chamber of Commerce, *WB Business Reforms in Kosovo*

Investment decisions by foreign investors are also heavily based on non-economic elements such as pressure by the host country, host-country contacts, and rent-seeking alliances. According to a 2010 survey conducted by the American Chamber of Commerce (AmCham), 31.6 percent of foreign investors would consider leaving Kosovo if no significant progress is made on *'the ground,'* with rule of law perceived to be the main area that needs improvement.¹⁰⁴ Additionally, lack of transparency, resulting from unclear business regulations and frequent legal changes at the central and local level in Kosovo, leads to information asymmetries in the market.¹⁰⁵ Transparent economic policies promote and facilitate cross-border acquisition and merger processes,¹⁰⁶ which are prerequisites for FDI attraction. As such, the lack of mechanisms for information distribution in international markets regarding the overall economic environment and the absence of a creditors rating have limited Kosovo's ability to attract foreign investors. According to the aforementioned survey, 60 percent of foreign companies not present in Kosovo have a moderate or fair knowledge about the country's business environment and its investment potentials; on the other hand, 30 percent have no knowledge or information.¹⁰⁷ These figures indicate that relevant institutions and agencies in Kosovo should raise awareness, promote Kosovo's investment climate abroad, and inform prospective foreign investors about human and natural resources and other investment potentials in Kosovo.

V. INVESTMENT INCENTIVES

Incentives are of particular importance during the early and transitional phases of attracting foreign investors, and their relevance could diminish as the process advances and the investment climate matures. However, it takes time for countries to create legal, institutional and administrative frameworks, to ensure their effective implementation, and, in turn, make the business environment more attractive to foreign investors.¹⁰⁸ Incentives could offset obstacles related to the business environment and signal governments' commitment to attracting FDI and export-oriented investment.¹⁰⁹

¹⁰⁴ American Chamber of Commerce in Kosovo (2010). *Kosovo in the Eyes of Foreign Investors*.

¹⁰⁵ Information asymmetries in the market create an appropriate setting for opportunistic behaviour by certain parties.

¹⁰⁶ Caetano, J. and Caleiro, A. (2005). *Corruption and Foreign Direct Investment: What kind of relationship is there? Economics Working Papers no. 18/2005*, University of Évora, Department of Economics.

¹⁰⁷ American Chamber of Commerce in Kosovo (2010). *Kosovo in the Eyes of Foreign investors; The survey was conducted with 49 foreign companies operation in Western Balkans and Southeastern Europe*.

¹⁰⁸ Cass, F. (2007). *Attracting FDI to transition countries: The use of incentives and promotion agencies. UNCTAD Working Papers*, available at: http://www.unctad.org/en/docs/iteiit20072a3_en.pdf.

¹⁰⁹ Ibid.

A review of the trends related to the use of FDI incentives worldwide shows that in recent years the competition for FDI based on incentives has been increasing.¹¹⁰ Although investment incentives are not a critical determinant of FDI, in a competitive environment they can play a crucial role in diverting investments away from neighbouring or competing countries. Thus, many countries have enriched their incentives for this purpose¹¹¹ and have used them as a tool to attract foreign investment. Although incentives may be offered to investors inconsistently or even discriminatorily, they are useful on a broad scale considering the positive effects that FDI can have on the overall economic development.¹¹² Incentives are measures specifically designed to either increase the profitability of a particular investment or to reduce its costs and/or risks.¹¹³ Investment incentives are often divided into three main categories - financial, fiscal and other.

The main function of *fiscal incentives* is to reduce the tax burden for foreign investors. Fiscal incentives may include reduced profit tax rates on foreign investments, postponed profit tax payments, avoidance of double taxation, accelerated amortization, tax deductions related to employment of local workers, customs free import of capital equipment and machinery, and, among others, reinvestment allowances. In the developing regions, after-profit tax rates, tax holidays, exemptions from import duties and duty drawbacks are some of the main types of tax incentives available to foreign investors. Nearly 80 percent of Central and Eastern Europe countries offer reductions of the standard income-tax rate and tax holidays to foreign investors.¹¹⁴ Investors compare the tax burden in different countries and tend to choose a country with lower taxes. According to UNCTAD survey, around 30% of all fiscal incentives are dedicated towards foreign investments in the surveyed countries.¹¹⁵

Financial incentives include the direct provision of funds to firms (in order to finance investments or operations in the host country) or defrayed capital or operation costs. They are most commonly offered in the forms of government grants, subsidized credit, employment or R&D subsidies, government equity participation, and insurance at preferential rates. Compared to developed countries, developing countries do not usually provide financial incentives; however this trend is changing as developing countries are increasingly offering government subsidies or employment and R&D incentives.¹¹⁶

In addition to the aforementioned incentives, countries offer other kinds of incentives which aim to increase profitability or decrease the costs of investment. This 'other' group of incentives includes offering infrastructure and utilities under more favourable conditions, preferential arrangements with the government, and, among others, special exchange rate regimes and repatriation rules.

V.I Comparison of incentive schemes in SEE countries and Kosovo: Where are we lagging behind?

SEE countries aiming to increase their competitiveness and attract substantial FDI have introduced a variety of incentives including financial incentives. Tables 5.1, 5.2, and 5.3 demonstrate that the incentive packages provided by most of the SEE countries are far richer than those provided by Kosovo. The incentive packages offered by Serbia and Croatia are

¹¹⁰ Gergely, J. (2003). Trends in Foreign Direct Investment Incentive. *Working paper 05-2003* of the Associazione Universitaria Di Studi Europei, ECSA-Italy, Pavia.

¹¹¹ Ibid.

¹¹² Bilas, V. Franc, S. and Cenan, D. (2012). FDI Incentives in Croatia and Chosen Developing Countries. *Institute of International Politics and Economics*, p. 329-352.

¹¹³ Gergely, J. (2003). Trends in Foreign Direct Investment Incentives. *Working paper 05-2003* of the Associazione Universitaria Di Studi Europei, ECSA-Italy, Pavia.

¹¹⁴ Ibid.

¹¹⁵ Ibid.

¹¹⁶ Bilas, V. Franc, S. and Cenan, D. (2012). FDI Incentives in Croatia and Chosen Developing Countries. *Institute of International Politics and Economics*, p. 329-352.

seriously competitive, but even BiH, Albania and Macedonia pose competition for Kosovo in this regard. Kosovo has based its FDI ‘incentive’ program only on investment protection agreements and some fiscal relief measures, and even those incentives are far less robust than those offered by the majority of SEE countries. While financial incentives are not available in Kosovo, countries such as Croatia, BiH and Serbia offer a very rich package of financial incentives including subsidies, employment and R&D incentives (Table 5.2). As such, Kosovo needs to introduce various financial incentives in the coming years in order to compete with neighbouring countries and to gain competitive advantage in attracting FDI.

The Government has declaratively focused its reform efforts on reducing the high unemployment and poverty rates and improving the business and investment climate. However, despite reforms in doing business, Kosovo still lacks innovative policies that can stimulate and attract FDI. Many initiatives to push forward the provision of incentive packages failed to gain government support. According to KIESA officials, their policy proposals on introducing a more competitive incentive program were refused by the government mainly due to heavy financial and legislative implications. Given the scarcity of financial resources and unwillingness to amend/draft a number of laws, the government has shied away from designing a more robust incentive program.¹¹⁷ This suggests that attracting FDI is not a priority on the government’s agenda. As the Government continues to highlight the scarceness of financial resources as a key obstacle in this regard, it is likely that, in the coming years, the ‘incentive program’ will continue to be based on scarce fiscal reliefs for investors.

Table 5.1 Fiscal Incentives in selected SEE Countries including Kosovo¹¹⁸

Country	Fiscal Incentives	
	Profit tax rate	Other fiscal reliefs
Kosovo	10%	<ul style="list-style-type: none"> - 0 percent import tariff on selected raw materials and a range of capital and intermediary goods and also pharmaceutical goods; -Tax and capital losses can be carried forward for up to seven successive tax periods; -Avoiding double taxation; -0 percent customs duty on the import and export of certain capital goods, . technology equipment, raw materials, agricultural production inputs, and services, production lines and machinery, equipments and materials used for electronic and media

¹¹⁷ Kreshnik Thaqi and Dardan Nallbani: Senior Investment Promotion Officers, Investment Promotion Agency of Kosovo (IPAK), Personal communication, Prishtina, January 2013.

¹¹⁸ AIDA (2012). Albania, a destination for Foreign Direct Investments, p.11; available at: <http://aida.gov.al/wp-content/uploads/2012/12/Shqipëria-Destinacioni-i-Investimeve-tuaja.pdf>; Agency for Foreign Investments and Export Promotion of the Republic of Macedonia; available at: <http://www.investinmacedonia.com/node/30>; Foreign Investment Promotion Agency of Bosnia and Herzegovina, available at: http://www.fipa.gov.ba/informacije/povlastice/strani_investitori/Default.aspx?id=141&template_id=81&pageIndex=1; DFK International: why Serbia? , available at: <http://www.konsrev.rs/en/why-serbia> ; Investment Promotion Agency of Kosovo, available at: <http://www.invest-ks.org/>; Montenegrin Investment Promotion Agency, available at: <http://www.mipa.co.me/page.php?id=9>; Croatia: Agency for Investment and Competitiveness, available at: <http://www.aik-invest.hr/en/why-croatia/>.

Albania	15%	<ul style="list-style-type: none"> -VAT exemptions on raw materials in clothing industry, manufacturing, energy, and goods for exploration/research of petroleum operations; -Fiscal losses can be carried forward for three consecutive years; -Corporate income tax exemption for cinematography productions; -Custom exemptions of imported machines and equipment's used for capital investments in energy sector; -Value Added Tax and Custom Exemptions in Free Zones
Croatia	20%	<ul style="list-style-type: none"> -Attractive tax incentives; 0 profit tax up to 10 years; -Double taxation avoidance agreements with 55 countries; -0 percent customs within the EU; -Free Trade Zone
BiH	10% Corporate profit tax exemptions from 1 to 5 years	<ul style="list-style-type: none"> -Double taxation avoidance agreements; -Exemption from paying VAT on the import of goods in free zones; -BiH offers a corporate income tax exemption for companies whose exports exceed 30 percent of total income (turnover); -Custom free equipment imported as part of share capital
Serbia	15%	<ul style="list-style-type: none"> -Corporate Income Tax Holiday for 10 years for large investments and job creation; -Carrying Forward of Losses for 5 years; -The law on avoiding double taxation; accelerated depreciation of long term assets; -Income tax exemptions; -Value Added Tax and Custom Exemptions in Free Zones; - Custom Free Import of equipment, machinery, raw materials and semi finished goods
Montenegro	9%	<ul style="list-style-type: none"> -Avoiding double taxation; -VAT: 17%, 7% and 0% -Tax credits – The amount of tax due can be reduced by 25% of the amount invested in fixed assets for the respective tax period; -Incentives for non-developed areas: Corporate tax-free for the first three years for new founded companies in production sector -Custom Exemption Tariff: Import of raw materials and equipment
Macedonia	10%	<ul style="list-style-type: none"> -Companies qualifying for the simplified tax regime with overall annual income s between 3 -6 million MKD, will pay 1% CIT -Preferential VAT Rate of 5% for agricultural machines, accommodation services, computers, food products, publications, pharmaceutical and medical devices, software, and transportation of persons -Technological Industrial Development Zones (TIDZs): personal and corporate income tax exemption for the first 10 years; -Exempt from payment of value added tax and customs duties for goods, raw materials, equipment and machines.

Table 5.2 Financial Incentives in selected SEE Countries including Kosovo¹¹⁹

	Financial Incentives
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¹¹⁹ AIDA (2012). Albania, a destination for Foreign Direct Investments. p.11; available at: <http://aida.gov.al/wp-content/uploads/2012/12/Shqipëria-Destinacioni-i-Investimeve-tuaja.pdf>; Agency for Foreign Investments and Export Promotion of the Republic of Macedonia; available at: <http://www.investinmacedonia.com/node/30>; Foreign Investment Promotion Agency of Bosnia and Herzegovina, available at: http://www.fipa.gov.ba/informacije/povlastice/strani_investitori/Default.aspx?id=141&template_id=81&pageIndex=1; Serbia Investment and Export Promotion Agency, available at: <http://siepa.gov.rs/en/>; Investment Promotion Agency of Kosovo, available at: <http://www.mipa.co.me/page.php?id=9>; Montenegrin Investment Promotion Agency, available at: <http://www.aik-invest.hr/en/incentives/>.

Country	Subsidies	Employment incentives	R&D incentives
Kosovo	/	/	/
Albania	/	/	/
Croatia	<ul style="list-style-type: none"> -Depending on the unemployment rate: Incentives for capital expenses - cash grants 10%-20% of eligible cost of specific investments; -Incentive measures for labour-intensive investment projects (100- 500 employees and higher) 25%-100%; -Free trade zones 	<ul style="list-style-type: none"> -Depending on the unemployment rate: <ul style="list-style-type: none"> a) Subsidies from EUR 3 000-9 000 or covering 10-30% of employment costs; b) Increase for Technology Innovation and Development Centers from 1 500€ - 4 500€; c) Increase for Business Support Strategic Activities 750€ - 2 250€; -Training incentives: - Specific training 25% - 45%; General training 60% up to 80% 	<ul style="list-style-type: none"> -Subsidizing 100%, 50% or 25% of the amount of justified project expenses, depending on the type of the research; -Decrease of profit tax rate and state subsidy in respect of eligible costs of scientific and development research; - Incentives for innovation and development activities: 20% of the eligible cost of buying the high technology plant/machinery;
BiH	<ul style="list-style-type: none"> -The Investment Promotion Fund gives grants that can amount to EUR 150 000 -Financial incentive for tourism sector - small-scale state aid (grant) 	-Employment support program	<ul style="list-style-type: none"> -Financial support for scientific, and research & development projects -Financial support for research in the field of technological development, knowledge and technology transfer, and encouragement of application of scientific research results
Serbia	<ul style="list-style-type: none"> -For large investments grants can amount to 20% of the amount of investment; -Grants in the amount of USD 2000-10 000 for Greenfield and Brownfield investments in exporting, production or R&D activities 	<ul style="list-style-type: none"> -4,000-10,000€ for each new job created conditional on a minimum amount of investment and persons employed; -One-time state grants in the amount of EUR 1 100 for the employment of persons, whose contracts were terminated due to the bankruptcy of a previous employer; -Salary tax exemptions -The apprentice program incentives: <ul style="list-style-type: none"> a) State grants for the professional training of novices; b) Providing salary reimbursements for a total of 10,000 first-time employees; c) The retraining programs in which expenses can be covered in the amount up to EUR 780 per employee 	-Grants in the amount of EUR 2 000-10 000
Montenegro	-Capital investments of at least €10 million which ensure the opening of at least 50 new jobs	-Employment support programs	/

Macedonia	-Up to €500.000 grant as incentive towards building costs depending on the value of the investment and the number of employees	/	/
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Table 5.3 Other Incentives in selected SEE Countries including Kosovo¹²⁰

Country	Other Incentives
Kosovo	-Multilateral Investment Guarantee Agency (MIGA) (member of the World Bank Group) guarantees investments in Kosovo up to the value of 20 million. -US Overseas Private Investment Corporation (OPIC) also provides political risk insurance for foreign investors in Kosovo. -Land lease for up to 99 years at attractive concessionary rates;
Albania	-Concessionary rates of 1€ for state owned assets, natural resources and economic activities;
Croatia	-Business support services (customer relations centers, shared activities centers, IT centers, software development centers)
BiH	-Agreements on the investment protection promotion; free trade agreements; -FDI insurance instruments with European Union Investment Guarantee Trust Fund for Bosnia and Herzegovina; -Brcko district incentives Exemption from utility fees for displaying the company; Compensation of expenses of connection to power, water and sewage network and several administrative fee compensations; -Compensation for amount of new investments invested in purchase of fixed assets and up to the amount of determined and paid profit tax or income tax in period for the year in which purchases of fixed assets was made.
Serbia	-Trade Agreements -Foreign companies can establish a privately-owned Free Zone based on the project approved by the government. -Local Incentives such as: city construction land lease fee exemptions or deductions and land development fee relief
Montenegro	-Trade agreements with the EU, free trade with Russia and Turkey; average import customs is 6,6% -Land in Macedonia is available under long-term lease for a period of up to 99 years

¹²⁰ AIDA (2012). Albania, a destination for Foreign Direct Investments. p.11; available at: <http://aida.gov.al/wp-content/uploads/2012/12/Shqipëria-Destinacioni-i-Investimeve-tuaja.pdf>; Agency for Foreign Investments and Export Promotion of the Republic of Macedonia; available at: <http://www.investinmacedonia.com/node/30>; Foreign Investment Promotion Agency of Bosnia and Herzegovina, available at: http://www.fipa.gov.ba/informacije/povlastice/strani_investitori/Default.aspx?id=141&template_id=81&pageIndex=1; Serbia Investment and Export Promotion Agency, available at: <http://siepa.gov.rs/en/>; Investment Promotion Agency of Kosovo, available at: <http://www.invest-ks.org/>; Montenegrin Investment Promotion Agency, available at: <http://www.mipa.co.me/page.php?id=9>; Croatia: Agency for Investment and Competitiveness, available at: <http://www.aik-invest.hr/en/incentives/>.

Macedonia	-Land lease for up to 99 years at attractive concessionary rates; free connection to utilities; no customs duties for export production
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VI. FOREIGN INVESTORS' PERCEPTIONS OF KOSOVO

Group for Legal and Political Studies cooperated with the European Investors Council (EIC) to conduct a survey gauging the perceptions of foreign investors operating in Kosovo on the country's investment climate. A total of 16 investors were selected randomly from European Union (EU) and European Free Trade Association (EFTA) countries. The majority of these investors are also members of the European Investors Council with which they closely cooperate. The survey, which was conducted during July - September 2016, included 21 multiple choice and open ended questions on barriers, benefits, opportunities, and other investment factors related to their experiences of doing business in Kosovo.

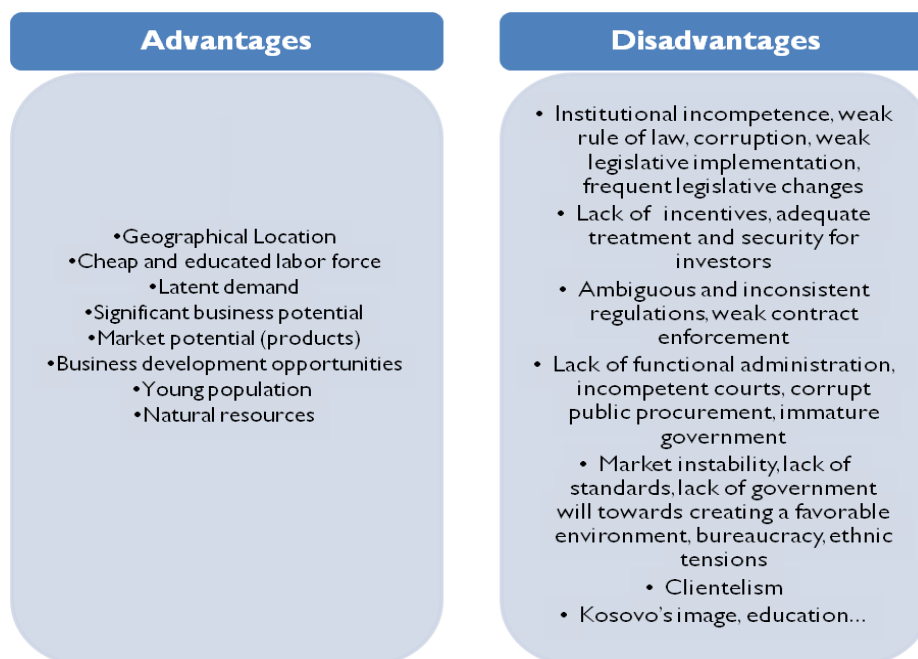
From the overall sample, 75% of the investors originate from EU countries whereas the rest are from non-EU EFTA countries. Half of the investors surveyed operate in the service sector (including the financial, insurance, telecommunication, and accommodation sectors, amongst others), while the rest operate in the manufacturing, energy, and pharmaceutical sectors. Most respondents, roughly 63%, started investing in Kosovo after 2005, 25% began investing between 2000 and 2005, and the other 12% did not report their investment period. It should be noted that only three investors from the sample acquired information about Kosovo's investment opportunities from the Government, which is a matter of concern given the role that the latter should play in attracting foreign direct investment. Other investors acquired such information from friends, embassies, USAID, partners, personal experiences, online portals, diaspora, clients, and previous involvements in the region.

The main factors which triggered respondents' interest in investing in Kosovo's market were expansion, market potential and regional connections, potential resources, market opportunities, low taxes and labor cost, amongst others. The respondents have also highlighted the advantages and disadvantages they have encountered during their operation in Kosovo's market (see Box 2). It should be noted that the investors are highly dissatisfied with the local business climate in Kosovo as well as institutional treatment towards them. The following quotes demonstrate investors' immense dissatisfaction while operating in Kosovo.

"Government sees us [foreign investors] as a mean[s] to fill their budgetary deficit rather than opportunities to contribute to economic development"

"Local authorities have directly assisted our competitor while discriminating [against] our business leading to unfair competition. This is very discouraging for foreign investors especially when the unfair competition is promoted by the municipality itself"

Box 2: Perceptions on Advantages and Disadvantages of Investing in Kosovo



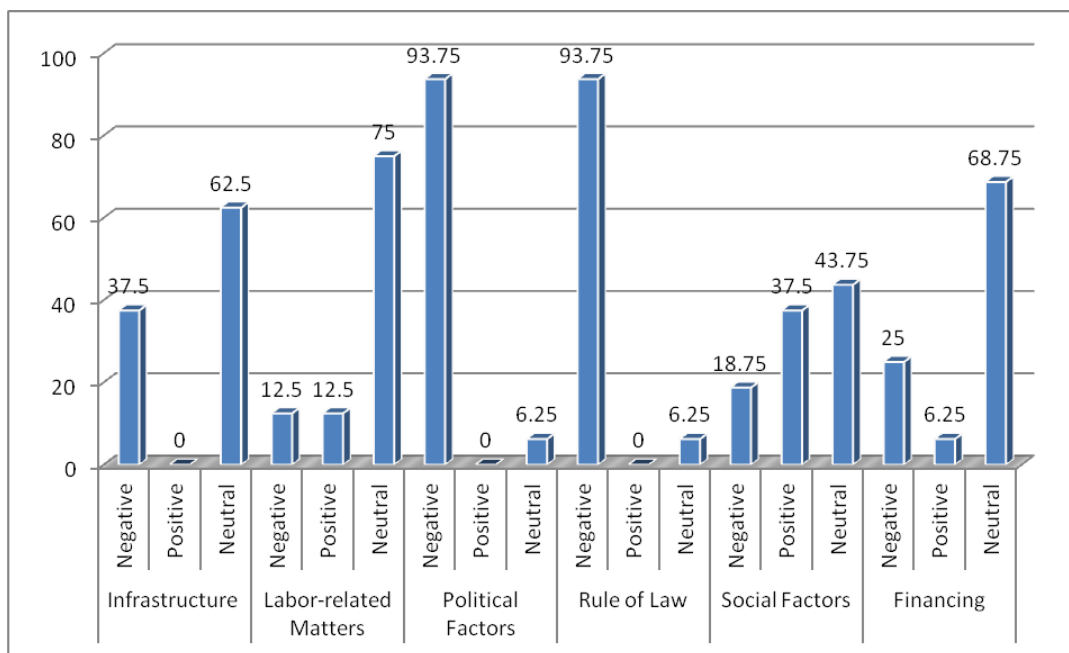
In addition to the disadvantages mentioned above, the respondents also added to the list of barriers the lack of qualified employees, poorly functioning free market economy, slow economic development, inconsistent long term policies, and discriminatory treatment from local authorities, amongst others. These factors, alongside with the aforementioned disadvantages, reflect an unfavorable business climate in Kosovo, which has contributed to investors' decisions to locate their investments abroad.

In line with Kosovo's performance in the World Bank Doing Business Indicators, one of the most problematic areas for foreign investors appeared to be contract enforcement, cited by 68% of respondents. While operating in Kosovo, investors also faced difficulties corresponding to other WB indicators such as dealing with construction permits (cited by 25% of respondents), paying taxes (25%), and registering property (18.7%). Factors corresponding to additional WB indicators posed minor challenges to foreign investors (getting electricity, resolving insolvency, and trading across borders), whereas no challenges were encountered by respondents with regards to starting a business or protecting minority investors.¹²¹

It should be noted that almost all respondents, 93.75%, have negatively evaluated political factors and rule of law in Kosovo. Respondents also negatively evaluated the infrastructure as well as financing (access to credit). However, 37.5% had a positive perception of the social factors in Kosovo (See Fig. 6.1).

¹²¹ It should be noted that respondents were able to choose more than one answer regarding the difficulties related to the World Bank Doing Business indicators.

Fig. 6.1: Investors perception



Worrisome is the fact that the majority of respondents perceived the business climate in Kosovo to have deteriorated since their initial investment. Some of the factors which contributed to this perception include lack of implementation of the existing legislative framework, no tangible results, contract enforcement problems, and, amongst others, unfair treatment by local institutions. It should also be noted that the majority of respondents operating in Kosovo perceive other neighboring countries to be more favorable in terms of business climate. For instance, they claim that Macedonia offers a greater variety of and more attractive incentives, better treatment towards foreign investors, and clearer investment policies. On the contrary, Kosovo does not prioritize investment or initiate significant reforms and does not protect foreign investors. Furthermore, respondents, based on their experiences, highlighted that Kosovo's institutions are not cooperative and helpful towards them in Kosovo. More precisely, they reported that institutions negatively affect their businesses, do not appreciate the effect of FDI on the economy, show no interest in improving current conditions, do not keep their promises, and are reluctant to deal with regulatory problems. They found that institutions only cooperate with foreign investors for their own publicity and narrow interests. Even though Kosovo has based its FDI 'incentive' program on investment protection agreements and some fiscal relief measures, surveyed investors stressed that no incentives of any kind were provided to them. While investors found it more important to receive fair treatment from Kosovo institutions rather than any kind of incentives, they met with an unfavorable business climate stemming largely from unfair competition promoted by local authorities. It is of paramount importance for Kosovo institutions to both ensure a fair business climate and to introduce FDI incentive packages, fiscal and financial, in order to compete with the neighboring countries and to create a more favorable investment environment for existing and potential investors.

As mentioned, corruption has a negative impact on the functioning of the economy and is a major deterrent for FDI. This said, 87.5% of the surveyed investors from EU and EFTA countries reported that corruption is a huge obstacle for their investments in Kosovo. They highlight that discrimination, ongoing unfair tendering procedures, bribes, clientelism, and, amongst others, politically affiliated businesses are very common while doing business in Kosovo. It is particularly

concerning that some of the EU and EFTA investors, 3 out of 16 respondents, were subject to requests outside the scope of law, i.e. bribery.

Dispute settlement mechanisms are of crucial importance for ensuring that states are capable of protecting their investments and international agreements in case of possible violations. This said, given the irregularities surrounding the investment climate in Kosovo, a large number of surveyed investors have experienced disputes while operating in Kosovo which led to unpleasant experiences. In addition to the costs affiliated with the process, settling disputes can be a very lengthy process (3 or more years) due to inefficient and unreliable courts. Even though alternative dispute resolution mechanisms exist in Kosovo, they are usually characterized by a lack of competence in economic and commercial matters.

Regarding future investments, roughly 19% of the respondents are either planning to expand geographically or to increase their investment operations in Kosovo, whereas around 44% are not planning any substantial new investments in Kosovo the foreseeable future. It should be noted that approximately 25% of the surveyed foreign investors in Kosovo are either planning to cut their investments in Kosovo or to freeze them, given the unfavorable business climate in Kosovo and lack of competent rule of law institutions (see Fig. 6.2).

Fig 6.2: Future Investment Decisions

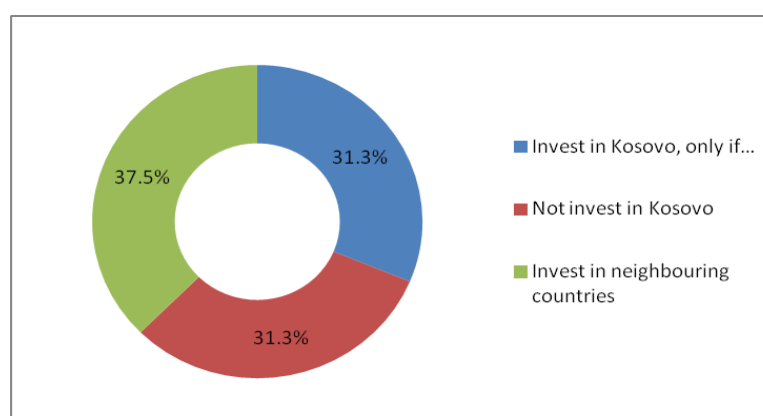


31.3% of respondents claim that they would continue to invest in Kosovo because they have already invested large amounts of capital but only if the current investment climate and reforms improve. The remaining respondents stated that, in the case they decide to invest further, they would not choose Kosovo as an investment location (31.3%) or would likely invest in one of the neighboring countries such as Macedonia, Albania, or Greece (37.5%) (see Fig. 6.3). This suggests that the current investment conditions in Kosovo are discouraging foreign investors from infusing further capital into Kosovo's market and prompting them to choose neighboring countries as more favorable investment locations.

Based on survey results, some of the long term challenges that appear to most negatively affect the investors' perceptions of Kosovo's business climate include the lack of investment funds and projects, corruption, poor law and contract enforcement, lack of purchasing power, lack of investment safety, unequal and unfair treatment by authorities, and poor access to raw materials, amongst others. All the investors surveyed believe that the Government of Kosovo should tackle and address all of the aforementioned challenges in order for the legislative environment to improve and for the market to become more competitive and attractive for foreign investment. Moreover, the Government should support the sectors with higher potential, understand and promote the advantages of Kosovo's market, and not concentrate on ad-hoc

projects which almost never generate positive outcomes. It is of the utmost importance for Kosovo's Government to prioritize the enhancement of the current legislative framework, incentive packages, and investment climate in general in order to attract and change the negative perceptions of foreign investors. Roughly 56% of the respondents would not recommend or encourage other foreign companies to invest their capital in Kosovo's market, whereas the rest are hoping for substantial positive changes in the current investment environment in order to recommend Kosovo as a potential investment location.

Fig 6.3: Reinvestment perceptions



The overall perceptions of Kosovo by EU and EFTA foreign investors operating in the country are influenced by the negative factors characterizing the unfavorable investment climate in Kosovo. As elaborated above, foreign investors perceive the investment climate in Kosovo to be quite poor and plagued by corruption, lack of fair treatment, poor implementation of legislative frameworks, lack of contract enforcement, and amongst others, lack of investment safety. Given that foreign direct investment is of paramount importance for sustainable economic development, the Government of Kosovo should concentrate on addressing each problem highlighted by the surveyed foreign investors in order to regain their trust, retain their presence, and increase investments. This, in turn, would demonstrate Kosovo's commitment to developing a positive investment image and could attract a larger pool of potential foreign investors which are crucial for long-term economic development.

VII. WAY FORWARD: TACKLING THE NEED FOR SOUND POLICY SOLUTIONS

Given the current state of the investment climate in Kosovo, relevant institutions and agencies should dedicate their financial resources and institutional capacity towards creating an enabling business environment and infrastructure in order to successfully attract foreign direct investments. Kosovo possesses favorable investment opportunities including a young, skilled and cost-effective workforce, the euro as the official currency, access to world markets, low taxes, EU-compatible legislation, a strategic location, and great sectoral investment opportunities. By promoting these investment opportunities and providing means and incentives for FDI in specific sectors and locations, Kosovo can attract and maximize the benefits of foreign investments in the host economy. Given the potential benefits stemming from foreign investments, the government should undertake a series of policy and promotional initiatives, as follows:

- a) increase its commitment to attracting FDI by reducing obstacles for investment, by undertaking further reforms to improve the business environment, and by ensuring higher effectiveness/implementation of reforms already in place;
- b) increase the attractiveness of investing in core sectors, by offering well designed, innovative policies and regulations and modern infrastructure;
- c) focus on targeting specific types of FDI with greater potential for benefiting the country, especially in less developed regions; and,
- d) increase Kosovo's competitiveness for attracting FDI in the region by offering incentive programs.

An important precondition for attracting increased FDI inflows is to draft a proper and sound government FDI-oriented strategy. The strategy and activities of the government must be designed in response to the economic needs of Kosovo and should consider the investors' needs and requirements, both domestic and foreign, and the status of foreign direct investment markets.¹²² The process of reforming the investment climate must be accelerated in order to improve Kosovo's business environment, image of Kosovo to foreign investors, and overall ranking in the Doing Business Report. A starting point would be to focus on 'Doing Business' indicators where Kosovo has ranked poorly, including: dealing with construction permits; paying taxes; enforcing contracts; protecting minority investors, trading across borders, resolving insolvency and improving access to electricity. Considering the good performance of Macedonia, as a highly ranked country (far better than any other SEE and most European countries) vis-a-vis the ease of doing business,¹²³ Kosovo should learn from its experience in the process of reforming the business environment and infrastructure. In addition to new reforms, it is of high importance to ensure successful and effective implementation of reforms already in place. Of note is the One Stop service for business start-ups which has been in place since 2011. The service has not been successful due to difficulties in implementation. In order to function effectively and improve the process of starting a business, this program should be carefully revised and adapted in line with the unique needs of the business environment in Kosovo. Moreover, Kosovo should establish unique business identification numbers that would simplify the process and decrease the time needed for starting a business.

While Kosovo offers natural resources and investment opportunities in many sectors, Kosovo lacks specific policies and incentives for targeting investors. As such, Kosovo should push forward several broad policy proposals, focusing on the already identified core sectors considered to have the greatest potentials to attract foreign investors, including a) Business Process Outsourcing (BPO); b) Renewable Energy; c) Wood and Metal Processing; d) Agribusiness-Food Processing and Packaging; and e) Textile. To attract greater FDI in these sectors, the government should develop sound and innovative policies and regulations and infrastructure to increase the competitiveness and attractiveness of these core-targeted sectors. In addition, the government must increase its efforts to anticipate and respond to investors needs in these sectors and reduce obstacles in doing business and perceived risk. FDI should be promoted more selectively, focusing on activities, technologies and investors that could be particularly beneficial for the aforementioned core sectors.

Many core sectors, such as mining, agriculture and energy, have so far failed to attract foreign investments. Considering the enviable natural resources in Kosovo, the recovery of the

¹²² The Ministry of Foreign Affairs has drafted a Strategy for Commercial Diplomacy; however, this strategy has not been made available for the public yet. 'The strategy aims to represent, protect the economic/commercial interests of the Republic of Kosovo as well as to attract the foreign investors in Kosovo'- Artan Behrami: Advisor in Ministry of Foreign Affairs, quoted in: 'A do te kete investime?' *Radio Kosova e Lire*, available at: <http://www.evropaelire.org/content/article/24566072.html>.

¹²³ World Bank Doing Business Report 2016

mining sector is considered to be of crucial importance as a short and long-term generator of local employment. However, several legal and social environmental issues relating to poor maintenance, poor management and conflict-induced damages must be addressed in order to attract quality investment in this sector.¹²⁴ In addition, the infrastructure requires major capital injections and technological improvements. A framework for the mining sector should be developed which could be also integrated with the energy, environmental and social strategies. Overcoming these obstacles would pave the way for increased mining operations, which apart from being an employment generator, would also contribute to Kosovo's energy sector and overall economic development.

Kosovo is endowed with a good quality arable land and has recently signed the SAA agreement. As such, the agricultural sector is of crucial importance for economic growth, particularly given its excellent import substitution capacity and ability to attract foreign investment. However, in order to increase the activity in this sector, active associations should be established to provide important and helpful services and present self-sustaining business models for farmers. A starting point would be to increase the budget allocated to the agricultural sector.

Like the mining sector, the agricultural sector requires a transfer of technical knowledge, modern technology, and capital. These investments would directly increase the productivity and production capacity of farms, which, in turn, would contribute to increased competitiveness and positively affect the perception of investors. In addition to the above, offering a variety of incentives tied to core sectors would further influence investors' decisions to invest in these sectors. In the long term, the focus of the government should be oriented towards convincing investors to invest in activities that can significantly benefit economic development and create increased employment opportunities in Kosovo. This would involve orienting investors towards labour intensive and export oriented activities that improve production, export capability, and competitiveness.

KIESA has already identified four core sectors to target, including Electronic Manufacturing Services and Automotive Components, which could generate high employment and export-dynamization capacities. In this vein, government authorities must develop a list of top potential investors, anticipate their needs and demands, and undertake a proactive approach towards creating the conditions necessary for convincing investors to choose to invest in Kosovo. To do this, the government must decrease the difficulties involved with hiring a well educated labour force by adapting and matching the labour supply to the market demands. To increase the competitiveness of the labour force, Kosovo needs to improve the quality of education and provision of skills needed for sectors with large potential for investment. Lack of training facilities and resources which could provide skills for the unemployed has so far deprived the economy from generating the type of skilled workforce needed to meet specific investment and sectoral needs. Hence, the government should increase the competitiveness of Kosovo internationally by modernizing infrastructure (transportation, electric energy, and telecommunications), investing in research and development, improving quality control and certificates, and improving the education system and provision of skills.

Pro-investor policies may help Kosovo to create sustainable private sector growth. FDI incentives and policies in general should be designed to meet the country's economic development objectives and should be equally available/applicable to all serious investors, both foreign and domestic. In order to increase Kosovo's competitiveness for FDI and divert

¹²⁴ World Bank (2004). Kosovo Economic Memorandum', Poverty Reduction and Economic Management Unit. Report No. 28023-KOS.

investments away from other neighbouring countries towards Kosovo, the government needs to consider introducing more comprehensive incentive programs. While Kosovo offers fiscal incentives – import exemptions on certain goods and avoidance of double taxation - they are very scarce compared to the incentive programs offered by neighbouring countries. Therefore, the government should consider enriching the fiscal incentive package by introducing other incentives such as tax holidays for investors, tax allowances and tax havens, or Export Processing Zones. This approach may affect tax revenues, at least initially, but could attract additional investments and an increase of revenue in the long-run. Despite the scarcity of financial resources, Kosovo should also consider offering financial incentives such as subsidies for large projects with high job generation potential, employment stimulation programs, and training incentives. Eligibility for incentives could be based on several criteria, including the number of individuals employed, scale of investment, and, among other factors, export potential and sector orientation. Financial incentives also involve budgetary implications, as the government has to dedicate a special fund for the provision of financial incentives.

It is of great importance to design incentive programs, which would facilitate and complement the above-mentioned actions/measures, that authorities can undertake in order to encourage FDI inflows in Kosovo. Designing efficient and effective incentive programs is a complicated task, especially considering the competition between countries. The failure to design them properly may result in profit and welfare increases for multinational companies rather than for the host country. Given the legal, institutional, and budgetary implications, the government of Kosovo must ensure that the incentives are optimal for attracting investment that can help Kosovo achieve its domestic interests. Thus, policy coordination at various levels of government and prior cost-benefit assessments are necessary to avoid undesirable side effects of new incentive programs. Incentive programs, if they are well-designed and implemented, could enhance the competitiveness and attractiveness of sectors with unique advantages, potentials, and/or natural resources. Therefore, they are an important tool for stimulating export-oriented and employment-generating investments. Lastly, strong and accountable governance is needed to tackle corruption and attract FDI.

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POLICY REPORTS

Policy Reports are lengthy papers which provide a tool/forum for the thorough and systematic analysis of important policy issues, designed to offer well informed scientific and policy-based solutions for significant public policy problems. In general, Policy Reports aim to present value-oriented arguments, propose specific solutions in public policy – whereby influencing the policy debate on a particular issue – through the use of evidence as a means to push forward the comprehensive and consistent arguments of our organization. In particular, they identify key policy issues through reliable methodology which helps explore the implications on the design/structure of a policy. Policy Reports are very analytical in nature; hence, they not only offer facts or provide a description of events but also evaluate policies to develop questions for analysis, to provide arguments in response to certain policy implications and to offer policy choices/solutions in a more comprehensive perspective. Policy Reports serve as a tool for influencing decision-making and calling to action the concerned groups/stakeholders.