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IDA/R2017-0131/1

May 1, 2017

Closing Date: Thursday, May 18, 2017
at 6 p.m.

FROM: Vice President and Corporate Secretary

Kosovo – Competitiveness and Export Readiness Project

Project Appraisal Document

Attached is the Project Appraisal Document regarding a proposed credit to Kosovo for a Competitiveness and Export Readiness Project (IDA/R2017-0131), which is being processed on an absence-of-objection basis.

Distribution:
Executive Directors and Alternates
President
Bank Group Senior Management
Vice Presidents, Bank, IFC and MIGA
Directors and Department Heads, Bank, IFC and MIGA

Document of

The World Bank

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Report No: PAD1723

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED CREDIT

IN THE AMOUNT OF EUR 14.3 MILLION

(US$15.27 MILLION EQUIVALENT)

TO THE

REPUBLIC OF KOSOVO

FOR A

COMPETITIVENESS AND EXPORT READINESS PROJECT

April 27, 2017

Trade and Competitiveness Global Practice
Europe and Central Asia

CURRENCY EQUIVALENTS

(Exchange Rate Effective April 1, 2017)

Euro 1 = US$1.0681

FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

BDS	Business Development Services
BETA	Business Environment Technical Assistance
BEEPS	Business Environment and Enterprise Performance Survey
CEFTA	Central European Free Trade Agreement
CIPM	Comité International des Poids et Mesures (International Committee on Weights and Measures)
CMC	Calibration and Measurement Capabilities
CPS	Country Partnership Strategy
CPF	Country Partnership Framework
DAK	Kosovo Accreditation Directorate
DPO	Development Policy Operation
ECA	Europe and Central Asia
EU	European Union
EUROLAB	European Federation of National Associations of Measurement, Testing and Analytical Laboratories
EURAMET	European Collaboration in Measurement Standards
FDI	Foreign Direct Investment
FM	Financial Management
GDP	Gross Domestic Product
GoK	Government of Kosovo
GVC	Global Value Chain
IAF	International Accreditation Forum
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
ILAC	International Laboratory Accreditation Cooperation
IPF	Investment Project Financing
KAS	Kosovo Standardization Agency
KBRA	Kosovo Business Registration Agency
KIESA	Kosovo Investment Enterprise Agency
KMA	Kosovo Metrology Agency
MED	Ministry for Economic Development
M&E	Monitoring and Evaluation

MoF	Ministry of Finance
MRA	Mutual Recognition Arrangement
MTI	Ministry of Trade and Industry
NEET	Not engaged in education, employment or training
NQI	National Quality Infrastructure
NQIC	National Quality Infrastructure Committee
NDS	National Development Strategy
PIU	Project Implementation Unit
PDO	Project Development Objective
POM	Project Operational Manual
R&D	Research and Development
SAA	Stabilization Association Agreement
SBA	Stand-By Arrangement
SC	Selection Committee
SCD	Systematic Country Diagnostic
SECO	State Secretariat for Economic Affairs
SEDPO	Sustainable Employment Development Policy Operation
SEE	Southeastern Europe
SME	Small and Medium Enterprise
SPS	Sanitary and Phytosanitary
SOE	State-owned Enterprise
TA	Technical assistance
TOR	Terms of Reference
T&C	Trade and Competitiveness
USAID	United States Agency for International Development
WB	World Bank
WBG	World Bank Group
WTO	World Trade Organization

Regional Vice President:	Cyril Muller
Country Director:	Ellen Goldstein
Senior Global Practice Director:	Anabel Gonzalez
Practice Manager:	Paulo Guilherme Correa
Task Team Leaders:	Jieun Choi, Blerta Qerimi

KOSOVO

COMPETITIVENESS AND EXPORT READINESS PROJECT (P152881)

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KOSOVO: COMPETITIVENESS AND EXPORT READINESS PROJECT (P152881)

PROJECT APPRAISAL DOCUMENT

EUROPE AND CENTRAL ASIA

Report No.: PAD1723

Basic Information			
Project ID P152881	EA Category C - Not Required	Team Leader(s) Jieun Choi, Blerta Qerimi	
Lending Instrument Investment Project Financing	Fragile and/or Capacity Constraints [ ]		
	Financial Intermediaries [ ]		
	Series of Projects [ ]		
Project Implementation Start Date 30-Sep-2017	Project Implementation End Date 30-Jun-2022		
Expected Effectiveness Date 30-Sep-2017	Expected Closing Date 30-Oct-2022		
Joint IFC No			
Practice Manager/Manager	Senior Global Practice Director	Country Director	Regional Vice President
Paulo Guilherme Correa	Anabel Gonzalez	Ellen A. Goldstein	Cyril E Muller

Borrower: Republic of Kosovo
Responsible Agency: Ministry of Trade and Industry

Contact:	Lulzim Krasniqi	Title:	Chief of Staff
Telephone No.:	38138 20036504	Email:	infokabineti.mti@rks-gov.net

Project Financing Data (in EUR Million)

[ ]	Loan	[ ]	IDA Grant	[ ]	Guarantee
[X]	Credit	[ ]	Grant	[ ]	Other

Total Project Cost:	14.27	Total Bank Financing:	14.3
Financing Gap:	0.00		

Financing Source	**Amount**
BORROWER/RECIPIENT	0.00
International Development Association (IDA)	14.3
Total	14.3

Expected Disbursements (in EUR Million)

Fiscal Year	2017	2018	2019	2020	2021	2022	2023	0000	0000	0000
Annual	0.00	3.64	4.13	5.14	1.29	0.10	0.00	0.00	0.00	0.00
Cumulative	0.00	3.64	7.77	12.91	14.2	14.3	14.3	0.00	0.00	0.00

Institutional Data

Practice Area (Lead)

Trade & Competitiveness
Contributing Practice Areas
Proposed Development Objective(s)
To support product certification for export markets, strengthen the capacity of export-oriented firms and reduce the cost of business inspections.

Components

Component Name	**Cost (EUR Million)**
Component 1: Enhancing Business Environment and Export Readiness	13.78
Component 2: Project Implementation and Coordination Support	0.52

Systematic Operations Risk- Rating Tool (SORT)

Risk Category	**Rating**
1. Political and Governance	High
2. Macroeconomic	Substantial
3. Sector Strategies and Policies	Substantial
4. Technical Design of Project or Program	Substantial
5. Institutional Capacity for Implementation and Sustainability	Substantial
6. Fiduciary	Substantial
7. Environment and Social	Low
8. Stakeholders	Substantial
9. Other	
OVERALL	Substantial

Compliance	
Policy	
Does the project depart from the CAS in content or in other significant respects?	Yes [ ] No [X]
Does the project require any waivers of Bank policies?	Yes [ ] No [X]
Have these been approved by Bank management?	Yes [ ] No [X]
Is approval for any policy waiver sought from the Board?	Yes [ ] No [X]
Does the project meet the Regional criteria for readiness for implementation?	Yes [X] No [ ]

Safeguard Policies Triggered by the Project	**Yes**	**No**
Environmental Assessment OP/BP 4.01		**X**
Natural Habitats OP/BP 4.04		**X**
Forests OP/BP 4.36		**X**
Pest Management OP 4.09		**X**
Physical Cultural Resources OP/BP 4.11		**X**
Indigenous Peoples OP/BP 4.10		**X**
Involuntary Resettlement OP/BP 4.12		**X**
Safety of Dams OP/BP 4.37		**X**
Projects on International Waterways OP/BP 7.50		**X**
Projects in Disputed Areas OP/BP 7.60		**X**

Legal Covenants

Name	**Recurrent**	**Due Date**	**Frequency**
Project Steering Committee	**X**		CONTINUOUS

Description of Covenant

Not later than 90 days after the Effective Date, the Recipient shall establish, and maintain throughout Project duration, a Project Steering Committee.

Name	Recurrent	Due Date	Frequency
Matching Grant Agreements	X		CONTINUOUS

Description of Covenant

The Recipient shall enter into Matching Grant Agreements with the selected SMEs, on terms and conditions acceptable to the Association, before making the matching grants available to the selected SMEs.

Name	Recurrent	Due Date	Frequency
Annual work plan and budget	X		Yearly

Description of Covenant

The Recipient shall prepare and furnish to the Association annual work plan and budget.

Name	Recurrent	Due Date	Frequency
Grants Management Unit	X		CONTINUOUS

Description of Covenant

Not later than 90 days after the Effective Date, the Recipient shall establish, and maintain throughout Project duration, a grants management unit, and has recruited staff satisfactory to the Association to perform the core functions of the unit.

Name	Recurrent	Due Date	Frequency
Independent Selection Committee	X		CONTINUOUS

Description of Covenant

Not later than 180 days after the Effective Date, the Recipient shall establish, and maintain throughout Project duration, an independent selection committee with composition satisfactory to the Association for the matching grants scheme.

Conditions

Source Of Fund	**Name**	**Type**
IDA	Establishment of PIU	Effectiveness

Description of Condition

The Recipient shall establish a Project Implementation Unit ("PIU"), and recruit PIU staff to perform core functions (including Project coordination, procurement, and financial management), satisfactory to the Association.

Source Of Fund	**Name**	**Type**
IDA	Project Operational Manual	Effectiveness

Description of Condition

The Recipient shall prepare and adopt a Project Operational Manual satisfactory to the Association.

Source Of Fund	**Name**	**Type**
IDA	Disbursement condition for matching grants under subcomponent 1.2	Disbursement

Description of Condition

The Recipient has prepared and adopted a Grants Manual satisfactory to Association.

Team Composition

Bank Staff

Name	**Role**	**Title**	**Specialization**	**Unit**
Jieun Choi	Team Leader (ADM Responsible)	Economist		GTC03
Blerta Qerimi	Team Leader	Private Sector Specialist		GTC03
Manjola Malo	Procurement Specialist (ADM Responsible)	Procurement Specialist		GGO03
Jonida Myftiu	Financial Management Specialist	Financial Management Specialist		GGO21

Ifeta Smajic	Team Member	Social Development Specialist	Social Safeguards Specialist	GSU03
Ivana Ivicic	Team Member	Consultant	Environmental Specialist	GEN03
Lisa Lui	Team Member	Lead Counsel		LEGLE
Luis M. Schwarz	Team Member	Senior Finance Officer	Senior Finance Officer	WFALN
Nikola Denchev Kojucharov	Team Member	Economist		GTC01
Tarik Sahovic	Team Member	Senior Private Sector Specialist		GTCEU

Extended Team

Name	**Title**	**Office Phone**	**Location**
Huseyin Ugur	Consultant		
Vinod Goel	Consultant		Washington

Locations

Country	**First Administrative Division**	**Location**	**Planned**	**Actual**	**Comments**

Consultants (Will be disclosed in the Monthly Operational Summary)

Consultants Required?

I. STRATEGIC CONTEXT

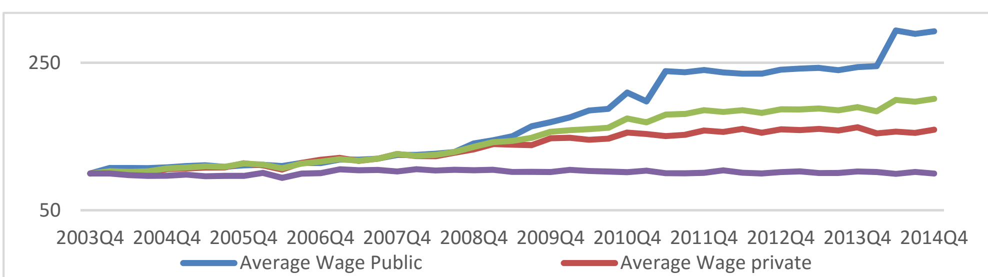
A. Country Context

1. **Since gaining independence in 2008, Kosovo's economy has performed relatively well.** Kosovo is Europe's youngest country; its young population, with an average age of approximately 26 in a country of 1.8 million inhabitants, represents a resource for future prosperity. Kosovo experienced rapid "catch-up" growth in its post-conflict period and remained the fastest-growing economy in the Balkans, averaging 3.4 percent of growth in the years 2008 – 2016. Moreover, economic growth has been largely inclusive, with GDP growth averaging 3.9 percent for the bottom 40 percent of the population.[1]

2. **Despite recent progress, Kosovo remains one of the poorest countries in Europe, and unemployment rates, especially among the youth, remain high.** About 30 percent of its people live in poverty, with 12 percent in extreme poverty.[2] Nearly one-third of young Kosovars are not engaged in education, employment, or training (NEET), and their unemployment rates are particularly high. The unemployment rate was 61 percent among young people (15 to 24 years old) in 2014. It was higher among young women at 71.7 percent, compared to 56.2 percent among young men. Youth from minority communities including Roma, Ashkali, and Egyptian (RAE) typically face additional obstacles in finding employment[3].

3. **The current growth model is not sustainable and will not allow Kosovo to meet its development goals.** Growth from 2008 to 2016 has been driven by consumption, which is fueled by remittances and foreign aid. In 2015, net exports (1.7 percent of GDP) had a negative contribution to growth.[4] Together with high public sector wages, remittances have led to an increase of labor costs in Kosovo. While private sector wages have increased moderately in real terms, labor productivity, measured as GDP per worker, declined (see Figure 1). Labor productivity dropped by 8 percent between 2010 and 2012 relative to a decrease of 6 percent among non-exporters in the Business Environment and Enterprise Performance Survey (BEEPS), suggesting that the environment is more challenging for exporters than for non-exporters.

Figure 1.Wages and Productivity in Kosovo



Source: SCD, Ministry of Finance, and WB staff calculations.

[1]. From 2006 to 2011, the most recent period for which comparable data are available.
[2]. Where national poverty line is €1.72 a day and €1.20 a day or less for extreme poverty.
[3]. Source: Kosovo Labor Force Survey 2015
[4]. For more details on recent economic development see annex 5.

4. **There is, therefore, an urgent need for redirecting the current growth model toward a productivity-driven and export-oriented one.** Higher labor productivity and export competitiveness are particularly relevant, as Kosovo uses the Euro as its currency (and therefore exchange rate fluctuations cannot be used to adjust eventual current account deficits). Foreign Direct Investment (FDI) into the country, already among the lowest in the Southeastern Europe region, is in decline and is mostly directed toward the non-tradable sector, such as real estate. Overall, Kosovo has a narrow and undiversified production base with a large share of the economy in services (56 percent of GDP) and agriculture (16 percent of GDP), which limits the availability of potentially exportable goods.

5. **The Government of Kosovo (GoK) has prioritized addressing Kosovo's declining competitiveness and limited job creation, and has taken important steps in this area.** In January 2016, the GoK approved the National Development Strategy (NDS) for 2015 to 2020, which identifies four priority pillars: (i) human capital and employment, (ii) good governance, (iii) competitive industries, and (iv) infrastructure. Similarly, the GoK approved the Economic Reform Program (ERP) for 2016 to 2018, which prioritizes structural reform issues, supported by a joint dialogue with the EU on economic policy. Additional signs of the GoK's commitment to reforms are the Stand-By Arrangement with the International Monetary Fund (IMF) of EUR 184 million, which was approved by the IMF Board, and Kosovo becoming a candidate country for the Millennium Challenge Corporation (MCC) in 2015.

6. **The GoK is also actively seeking to enhance Kosovo's integration into regional and international communities.** In 2015, the GoK signed the Stabilization and Association Agreement (SAA) with the EU, and it entered into force in April 2016. This first step toward EU integration opens a window of opportunity for a larger reform agenda supported by the EU. Kosovo is also working toward accession to the World Trade Organization (WTO) and other regional trade agreements.

B. SECTORAL AND INSTITUTIONAL CONTEXT

7. **Given its small domestic market (1.8 million people), increased export competitiveness is essential for growth and job creation in Kosovo.** Yet, the country is one of the least internationally-integrated countries in the region, and its exports remain considerably lower than the same in all other countries in Southeastern Europe and comparable small states. Kosovo's exports are concentrated in low value-added items, such as ferro-nickel, which accounts for more than half of total exports. Only about 5 percent of Kosovo's SMEs are exporting, and the survival rate of exporters is low.[5]

8. **The lack of competitiveness of Kosovo's economy is related to a number of factors, including a poor business environment.** Kosovo's landlocked geography and limited transport infrastructure makes it costly to access international markets and increases the cost of intermediate inputs and imports. The business environment is also an important factor. For

[5]. Less than 40 percent of export activities remain active beyond the first year. 14 percent remain active beyond the fifth year.

instance, exporters are 76 percent more likely to report that customs or trade regulations are a constraint (after controlling for other firm characteristics).[6]

9. **Some aspects of Kosovo's business environment have improved significantly in recent years**. This can be seen in the consistent improvement over the last three years in Kosovo's relative standing in the Doing Business Report[7] and in the WB World Governance Indicators, where its score has improved from 2.6 in 2015 to 4.6 in 2016 after adopting a Better Regulation Strategy 2014–2020. Yet a number of policies that support trade and investment need to be improved:

a. **Among the most pressing constraints to investment is the business inspection regime.** Kosovo has the highest number of individual inspections among all its neighboring countries, which poses a significant regulatory and compliance burden on businesses. A lack of coordination and legal overlaps overburden businesses with multiple state inspections. For instance, on average, inspectorates carried out 22 visits a year per firm in Kosovo. The current system is not transparent, provides incentives that increase informality, and disadvantages businesses that comply with the law.[8]

b. **Border inspections are not aligned with international standards and processes, including risk assessment.** A lack of harmonization between inspectors on technical and customs regulations at the border further delays the process of obtaining relevant certifications for trade and sampling. Not surprisingly, customs and trade regulations remain a severe obstacle for firms. Even though there was a major improvement in the *2017 Doing Business Report,* where Kosovo was ranked 51st on the Trading Across Borders indicator, compared to 118th in 2016, it still remains one of the worst performers in the Western Balkans in this area.

10. **The government has initiated a reform of the business inspections system.** The GoK adopted a decision No. 05/138 dated March 22, 2017 to establish a working group on inspections that will prepare the draft law on inspections. The decision includes an explanatory memorandum on the concept and action plan for the inspections reform. The MTI is responsible for chairing the Working Group and coordinating the inspections reform. To enable implementation of the reform, a new Inspection Law was prepared by the GoK in 2015. However, the draft law reviewed by the WBG team was not in line with international best practice or with the recommendations provided by the WBG team to the MTI in 2015. Therefore, the newly established working group will revise the law on inspections and expects to submit it to the Parliament in 2017.[9]

11. **In addition to an improved regulatory environment, firms need to acquire quality certifications and other knowledge necessary to enter export markets – i.e., they need to be**

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[6]. Our analysis based on BEEPS data reveals that, even after controlling for other firm characteristics, exporters are more likely than other firms to report that transportation, the working of the courts, and the customs/trade regulations are constraints to business.
[7]. Kosovo's relative standing in the Ease of Doing Business ranking was 60th in 2017, which is a significant improvement since 2012, when Kosovo ranked 126th among 189 countries surveyed.
[8]. The WB Note 2012 on inventory of inspections revealed 36 business inspections at the central level, and several business inspections at the local level. This includes financial sector inspections, as well as tax and customs. This number is much larger than other neighboring countries (e.g. Bosnia and Herzegovina had 26 inspections and Croatia and Slovenia had 27 inspections prior to the reform). Moreover, the legal framework lacks a clear definition of competencies of the inspection bodies' mandates. In particular, six different inspectorates visited businesses, using time and energy of approximately 22 employees of the firm.
[9]. The Project is not financing the passing of the law but this project and subsequent TA is supporting the GoK with revision of the law and by laws through hiring of consultants. Once the law is approved, bylaws will be drafted.

"export ready". Entering the export market is risky and beset with information problems. To enter export markets, firms generally need to invest in a number of areas, understand the new requirements of new markets, and find new clients in those markets. This is particularly true in post-conflict countries such as Kosovo, where the private sector has been cut off from international markets and information asymmetries are large.

12. **Yet firms tend to underinvest in "export readiness".** Firms tend to underinvest in such activities because the economic benefits are often greater than the returns to the individual firm that undertakes them. There are significant spillover effects where other firms learn from the experience of first movers. Moreover, a large part of this investment is sunk and cannot be relocated to other activities in cases export attempts are not successful. In addition, firms in the region often lack the capacity to develop and present good business plans.

13. **Exports are significantly hampered by the lack of access to product certification and related services at affordable prices.** Exporters cannot use testing reports from domestic laboratories or certificates from domestic product certification bodies when they export their products abroad, such as to the EU, since the accreditation of these laboratories and certification bodies is not internationally recognized. For the laboratories' accreditations to be recognized internationally, the accreditation organization that issued them has to be recognized internationally. Meanwhile, firms that need internationally recognized certifications must obtain them abroad, which increases the cost of Kosovar products. Helping SMEs to improve the quality of their products will improve firms' export readiness.

14. **A minimum requirement for a functional national quality infrastructure (NQI) is that metrology and accreditation organizations must be internationally recognized**.[10] Once these organizations can provide international accreditation to local laboratories, companies will no longer need to travel abroad for testing and certification procedures. Given the small size of the domestic market, establishing various specialized laboratories might not be cost-effective; however, establishing laboratories in key sectors, such as agriculture, livestock, and energy, is advisable and would help reduce the cost of Kosovo's exports. Thus, supporting the National Metrology and Accreditation agencies' efforts to become internationally recognized could reduce firms' costs for certification of products**.**

15. **In the current context three initiatives could help improve Kosovo's competitiveness and export readiness:** (i) increase the availability of a quality infrastructure system that is internationally recognized, at affordable prices; (ii) support businesses' capacity to upgrade products and to export (export readiness) and (iii) reform the business inspection system.

16. **Detailed analyses of each constraint and the role played by other development partners are provided in the Annexes**. Constraints related to exports, business environment, and SME growth are provided in Annex 7. Other development partners' roles in each area are summarized in Annex 8. Table 10 in Annex 7 summarizes the constraints and building blocks for competitiveness and export readiness, and explains whether these are included in this Project or covered by other initiatives.

[10]. In developing countries, 68 percent of firms cited testing and certification costs as an important reason for not exporting. (Tippman and Racine, 2013, "The National Quality Infrastructure: A Tool for Competitiveness, Trade and Social Well-being."

C. HIGHER-LEVEL OBJECTIVES TO WHICH THE PROJECT CONTRIBUTES

17. **The Project contributes to the improvement of export competitiveness and productivity in Kosovo.** The activities planned under the Project aim to enable domestic firms to export more, and to re-allocate resources they now devote to dealing with burdensome inspections and other business environment obstacles to more productive uses.

18. **The Project is aligned with the WBG's twin goals of reducing poverty and promoting shared prosperity and with the Kosovo Country Partnership Framework (CPF) for the period FY2017 to FY2021, as well as the priorities outlined in the Systematic Country Diagnostic (SCD).** The project will contribute to Focus Area I of the CPF, which seeks to enhance conditions for accelerated private sector growth and employment. The project also addresses priorities outlined in the SCD, central premises of which are a gradual rebalancing of growth towards greater competitiveness at home and abroad, and an increase in productivity and employment opportunities.

19. **The Project is expected to contribute to the two key pillars of the new National Development Strategy (NDS) approved by the GoK in January 2016**, namely: (i) good governance and rule of law, which includes better coordination of state inspections; and (ii) competitive industries, which envisages increased funding for promoting Kosovo's enterprises.

II. PROJECT DEVELOPMENT OBJECTIVES

A. PDO

20. **The Project Development Objective (PDO) is to support product certification for export markets, strengthen the capacity of export-oriented firms, and reduce the cost of business inspections.**

B. PROJECT BENEFICIARIES

21. **The Project will directly benefit approximately 150 firms through matching grants, and will indirectly benefit all existing firms in Kosovo, including around 1,500 exporters,** by helping to reduce: (i) the cost of acquiring internationally recognized certifications and product testing, and (ii) the compliance cost of business inspections. The project will also indirectly help protect consumers from low-quality products.

C. PDO-LEVEL RESULTS INDICATORS

22. **PDO-Level indicators are:**

a) Number of products tested at domestic laboratories and certified by product certification bodies that are accredited by an internationally-recognized accreditation agency.

b) Share of beneficiaries of matching grants that increase their export value (amount).

c) Reduction of businesses' compliance costs related to inspections per business.

III. PROJECT DESCRIPTION

A. PROJECT COMPONENTS

23. **The Project focuses on a targeted set of achievable actions selected according to the following criteria**: (i) those prioritized by the government and identified as key drivers of the competitiveness and jobs agenda by the Bank in consultation with the private sector[11]; and (ii) those selected after in-depth consultations with other donors (such as the EU), to coordinate activities and prevent any duplication.[12]

24. **The Project will enhance the business environment and build capacity in the public and private sectors for increased competitiveness.** The project will do this through supporting the national quality infrastructure, reforming the business inspection system, and strengthening export readiness of SMEs. These improvements will lead to increased exports, improved product quality, and reduced cost of business inspections.

Component 1: Enhancing Business Environment and Export Readiness (EUR 13.78M)

25. **Component 1 will contribute to the government's efforts to enhance the business environment and export readiness of firms by modernizing the National Quality Infrastructure, supporting SMEs with export potential, and reforming the business inspections system.** This component will finance the following three subcomponents: (i) improving NQI and supporting its international recognition, (ii) supporting businesses to improve export readiness, and (iii) reforming the business inspections system.

Subcomponent 1.1: Supporting international recognition of NQI (EUR 6.55 million)

26. **This subcomponent supports international recognition of the NQI—identified as a key weakness of the Kosovo NQI system**. The Project will assist the Kosovo Metrology Agency (KMA) and Kosovo Accreditation Directorate (KAD) to become qualified to sign the Mutually Recognized Agreements with International Committee on Weights and Measures, and International Laboratory Accreditation Cooperation/Accreditation Forum, and will support coordination for the sustainability of an NQI system. These efforts will help existing domestic laboratories (and Kosovo's broader NQI system) to be recognized by high-value markets, such as the EU, and thus reduce firms' costs of obtaining internationally-recognized testing reports and certificates.

27. **This subcomponent will finance equipment, capacity building, and IT systems** to: (i) support the KMA to upgrade selected metrology laboratories, train their staff to use the new equipment, and build their capacity to improve traceability and inter-laboratory comparisons—key bottlenecks that KMA must overcome to sign Mutually Recognized Agreements with international organizations;[13] (ii) support the KAD and KAS with IT systems for data interoperability and exchange, which will ensure that relevant agencies can access information about standards and laboratories' testing results, and will ensure that KAD's accreditation of laboratories is in line with international best practice; and (iii) improve coordination for the sustainability of an NQI system

[11] See, for example, World Bank Kosovo SCD 2016, BEEP 2014.
[12]. For more details on partners' interventions, see Annex 6.
[13] Kosovo NQI Needs Assessment, World Bank 2015.

by supporting the establishment of a National Quality Infrastructure Committee (NQIC) with private sector participation[14], and by improving public awareness of international standards and harmonization requirements.

Subcomponent 1.2: Supporting SMEs to improve export readiness (EUR 2.81 million)

28. **This subcomponent will support the establishment of a matching grants program for SMEs with export potential** to assist them in acquiring product certifications and standards, and utilizing business development services (BDS). Matching grants can help address market failures by sharing the cost of making risky investments in these knowledge products and overcoming information asymmetries (for instance, regarding the value of using certifications and BDS).

29. **This subcomponent will finance matching grants for selected SMEs to access consulting services and capacity building** to: (i) fulfill requirements to implement international standards and receive certifications required for export markets; and (ii) increase firm productivity and know-how through the use of BDS. The matching grants scheme will be managed by Kosovo Investment Enterprise Agency (KIESA) under the MTI. KIESA will establish an independent Selection Committee (SC) with member composition satisfactory to the WB team, which will adjudicate applications. The overall design of the matching grants will be governed by a Grants Manual (GM) that will be prepared by KIESA and submitted to the WB for no-objection. An SME needs assessment and available supply capabilities in the market were conducted to inform the design of the grants scheme.

30. **This subcomponent complements the other components of the Project, such as NQI**. While an improved NQI system will reduce firms' costs of obtaining internationally recognized certification and testing, the matching grants will support firms' know-how and ability to meet the requirements of these standards. A complementary TA Project will support i) KIESA's capacity to reach out to firms to encourage their application for matching grants and in implementing the grants scheme, and ii) an impact evaluation of the matching grants. There has been limited analysis of the impact of the various SME support schemes in Kosovo.

Subcomponent 1.3: Reforming the business inspections system (EUR 4.42 million)

31. **This subcomponent supports reductions in the administrative burden on businesses and improvements in the efficiency and effectiveness of inspection services.** The GoK is expected to finalize a new overarching Inspection Law and respective bylaws during the period of Project implementation. The WBG will be supporting the drafting of the new law through the complementary TA, which will help the WBG fully support implementation of this subcomponent. While the GoK is preparing the draft law, it has adopted a concept and action plan for inspection reform, which defines the reform direction and binds the GoK to respect the timeline and activities.

32. **This Project subcomponent will finance equipment, capacity building, and IT systems** to support the effective implementation of the new inspection law by the GoK. Specifically, this subcomponent will finance: (i) an electronic inspector data management system, which will enable a unified electronic platform for inspection planning and coordination of inspection visits, document management of inspection reports, internal and external reporting, data mining, internal audit, analysis, and risk profiling – essentially, all aspects of an inspector's work; (ii) a business inspection interoperability data exchange system, which will enable data exchange among key

[14] Such as metrology, accreditation, standardization, certification, and inspection bodies, as well as laboratories.

institutions to enable risk-based inspections and better business profiling; (iii) equipment for inspectors to conduct field analysis, sampling, and evidence gathering; and (iv) sustainability of the new institutional set-up and capacity building for inspectors. The improvements in the inspection system – especially the risk-based system and improved coordination– will reduce costs to firms and therefore incentives for firms to remain informal.

Component 2: Project implementation and coordination support (EUR 0.52 million)

33. **This component will help to ensure effective implementation of all Project components.** This component will finance goods, services, training, and operating costs to support the implementation and coordination support for the project, *inter alia* by financing: (i) consultants to support project management, fiduciary, and M&E functions for the project; (ii) capacity building for PIU; and (iii) equipment and operating costs necessary for the project implementation.

B. PROJECT FINANCING

34. **The proposed Investment Project Financing (IPF)** will entail the use of IDA funds, with the GoK designated as the Borrower, and will be implemented over five years.

C. PROJECT COST AND FINANCING

35. **Current project financing is estimated to be EUR 14.3 million**. The costings presented in Table 1 below represents estimations based on discussions with the GoK and the MoF's request letter to the Bank on November 9, 2016.

Table 1. Project cost

Project Component	Project cost (EUR)
1. **Enhancing business environment and export readiness (EUR 13.780)**	**13,780,000**
1.1 Supporting international recognition of NQI	6,550,000
1.2 Supporting SMEs to improve export readiness	2,810,000
1.3 Reforming business inspection system	4,420,000
2. Project implementation and coordination support (EUR 0.520M)	**520,000**
Total Project Costs	**14,300,000**
Total Financing Required	**14,300,000**

D. SERIES OF PROJECT OBJECTIVE AND PHASES (IF APPLICABLE)

36. Not applicable.

E. LESSONS LEARNED AND REFLECTED IN THE PROJECT DESIGN

37. **The Project design builds on the lessons learned from projects supporting private sector development in Kosovo and from the region and beyond. Some of the key relevant lessons from those projects include:**

a. **NQI:** Among all similar WBG programs, including those in FYR Macedonia, Albania, Moldova, Croatia, Serbia, Turkey, China and Peru, the projects in Armenia (Trade Promotion and Quality Infrastructure) and in the Kyrgyz Republic (Reducing Technical Barriers for Entrepreneurship and Trade) are most similar to this project, and lessons from these projects have been incorporated in the project design. Key lessons from these operations include the importance of: (i) assessment of the product testing demands and prioritization of key products for establishing testing laboratories; (ii) coordination among relevant stakeholders, including metrology, accreditation, standardization, and inspection bodies, and both private and public laboratories.; and (iii) clear financial flows and staffing plans for improving NQI agencies.

b. **Matching grants:** Key lessons from similar operations emphasize the importance of: (i) private sector participation in the selection committee, management capability, good governance, and cost-effective design, and (ii) appropriate incentives and procedures to ensure success. The design of the matching grants program also takes into consideration a similar grant scheme implemented in Kosovo[15], which provides several lessons related to: (i) adequate staffing capacity of the implementation agency, (ii) importance of an independent selection committee and strategic selection criteria, and (iii) a high demand for BDS but nascent stage of BDS suppliers in Kosovo.

c. **Inspection reform:** WBG experience with similar programs in the Europe and Central Asia (ECA) region highlights that: (i) a clear concept and action plan for reform adopted at the highest levels of government are prerequisites for the reform; (ii) inspection working groups should have a clear mandate, and (iii) strong political commitment and ownership are critical for implementing reforms successfully.

38. **The Project design also incorporates the main lessons learned from the Kosovo portfolio**, more specifically: (i) the need for conducting extensive consultations with key stakeholders in the design phase and defining an active role for them throughout the project implementation (which in this project mostly refers to an active role of the private sector), (ii) technical assistance must accompany financial support, as this enhances the success of interventions in the different sectors, (iii) the need for a well-defined results framework where the data for monitoring indicators can be reported regularly and inform the policy-making process, (iv) retention of a fully devoted, well-trained project implementation team in Government, and (v) the need to ensure frequent missions to support to the supervision of the Project, particularly in the first phase of project implementation.

IV. IMPLEMENTATION

A. INSTITUTIONAL AND IMPLEMENTATION ARRANGEMENTS

39. **The MTI will be responsible for the implementation of the Project.** A Project Implementation Unit (PIU) will be established and be responsible for supporting the MTI in all procurement, financial management, monitoring and evaluation, and reporting on the use of

[15] For instance, the KOSME report found strong need for typical BDS by SMEs. The USAID study on target sectors that extensively analyzed potential for growth, job creation, and value addition for important sector.

Project funds and activities. Policy oversight and strategic decisions affecting the Project will be the responsibility of the Project Steering Committee (PSC), consisting of representatives from the Prime Minister's Office and the Ministry of Finance (MoF). The PSC will be established by MTI and MoF and will provide policy guidance and approval of the annual work plan and budget. KIESA under the MTI will host the matching grants scheme. Based on the new regulation of borrowing funds[16] and depending on the evolution of the capacity in the ministry to implement the project in a timely and rule-abiding manner, the PIU functions could be replaced by public sector employees, conditional on the WBG agreement, based on a capacity assessment to be conducted by the fiduciary team. Implementation support will be provided by the WB throughout the project and will include periodic supervision missions and a midterm review.

40. **The Project Operational Manual (POM) has been prepared and specifies the arrangements for the implementation and coordination of the Project over the five-year period**, with specific information regarding roles and responsibilities of the MTI, PSC, PIU, and KIESA, including preparation of periodic progress reports and updating of implementation plans, as well as details regarding the performance of fiduciary functions.

B. Results Monitoring and Evaluation

41. **Results Monitoring and Evaluation (M&E) will be a key part of the project.** The arrangements to monitor and evaluate this investment loan will be the responsibility of the MTI. Indicators and targets for this operation are specified in the results framework (Annex 1), which will serve as the basis for monitoring and evaluation of progress throughout implementation, both for accountability and learning purposes. The PIU will be responsible for providing — after receiving requisite information from the implementing agencies — semi-annual progress reports to the WB, which will include a section on progress in the performance of the results framework. The POM provides a detailed description of how project activities will be monitored. The project will also finance the design and implementation of: (i) tools to monitor the results framework, and (ii) M&E studies/surveys to establish baselines for project results indicators and measure their evolution during project implementation.

42. **The Project will build on the national M&E system while focusing on strengthening relevant capacities.** The government has an existing M&E system for its programs and interventions. The project will strengthen the government's M&E capacity through the development of an M&E system for MTI. KIESA's performance monitoring of the matching grant scheme will also inform potential changes to the design, scale, and implementation of this activity. An impact evaluation of the matching grants is planned, which will require setting up a process for gathering the necessary information and an adequate evaluation strategy at the early stage of implementation.

[16] New Regulation on Borrowing Funds Management (MoF-No.01/2016) adopted by the GoK in June 2016, aims to establish rules on the management of funds in the projects financed through loans, i.e. sets the internal rules and responsibilities in management of projects' funds in the budgetary organizations, aims at rationalizing the operating expenses in projects, regulates the recruitment of PIU staff and consultants, sets the salary scale for PIU staff, in line with the legislation on civil servants salaries.

C. SUSTAINABILITY

43. **The project is fully aligned with the government's National Development Strategy (NDS) and long-standing agenda on poverty reduction and shared prosperity**. It is expected that the efforts to improve private sector competitiveness will be beneficial for increased exports, jobs and growth in the long term. The innovative interventions to be financed under the project are aligned with the NDS, demonstrating government willingness to strengthen private sector competitiveness. Activities identified as priorities under the project build on existing interventions carried out by MTI and by different donors active in the sector. The project benefit from previous investments and existing capacity that will be enhanced and scaled up.

44. **The sustainability of project outcomes will be supported by technical assistance to implementing entities of each major component.** The proposed interventions will build capacity of various government agencies, such as KMA and DAK. It is expected that, at the time of project completion, capabilities of these implementing agencies would be substantially enhanced and they would be fully equipped to carry out their mandates effectively. Similarly, the project-supported program of regulatory upgrades (such as those aimed at inspection reforms) is expected to be fully completed within the project's lifetime, and would not require incremental government funding beyond the project's closure. Because KIESA will host the matching grants, KIESA would progressively build capacity to manage similar grant schemes after the completion of the Project. The knowledge building of firms through the BDS aims at building longer-term capacity of beneficiary firms, thus contributing to their sustainability and know-how beyond the Project's timeline.

V. KEY RISKS

A. OVERALL RISK RATING AND EXPLANATION OF KEY RISKS

45. **The overall risk for the Project is substantial**.

a. Political and governance risk is rated high, given the fragile government coalition formed six months after the 2014 elections. Ongoing reorganization of ministries and agencies may have implications for the restructuring of KIESA.[17] Moreover, the success of the inspection reform depends upon the GoK's passing and implementing a new inspection law at an early stage of project implementation. The new law is necessary to define the structure of the inspection system, before the Project will be able to finance the purchase of equipment and training to support the new structure. In the current political environment, there is a risk that the new law will be delayed or not adopted, which would reduce the development impact of the inspection component. However, the GoK views the business inspection system as a major constraint to private investment and has therefore made its strong support for reform clear. For instance, the GoK included the drafting of the Inspection Law under the European Reform Agenda. Moreover, the GoK on March 22, 2017 established the working group on inspections and adopted the concept and action plan for inspection reform that lays out a direction and timeline

[17] In July 2016, the GoK announced a reduction in the number of ministries from 19 to 13 (there have been discussions about merging the MTI with the MED) and a reduction in the number of state agencies (currently, 40 or so agencies exist).

for the inspection reform process.[18] A complementary WBG advisory project will support the GoK in drafting the new inspection law, which is expected to be submitted to Parliament in 2017. If the new law is not approved one year after the project effectiveness, the Project will be restructured with respect to subcomponent 1.3.

b. Macroeconomic risk is rated as substantial, given the growth and revenue prospects described in the SCD and risk of budget availability for the MTI during the Project implementation and disbursement. However, the GoK has demonstrated its commitment to ensuring macroeconomic sustainability. For instance, the GoK adopted amendments to the law on war veterans in December 2016 which will significantly strengthen its fiscal position. In January 2017, the IMF conducted joint second and third SBA Reviews and concluded that all macro benchmarks of their program were met.

c. Risk associated with sector strategies and policies as well as technical design is substantial as, although the Project responds to the priority needs of the government, implementation involves several agencies. To mitigate this, the Project specifies detailed implementation arrangements to ensure coordination among agencies, as documented in the POM.

d. Risks related to institutional capacity for implementation and sustainability are also substantial, as the Project will finance activities carried out by different agencies with no experience in implementing WB-financed projects. This risk is expected to be mitigated by setting up a PIU with personnel who will be trained regularly. However, the new Regulation MoF-No.01/2016 on Borrowing Funds Management adopted by the GoK in June 2016 may pose difficulties in attracting qualified personnel who have experience in WB projects because it stipulates that compensation of PIU staff to fall under the civil servants' framework.

e. Fiduciary and stakeholder risk is substantial given the procurement risks associated with matching grants. Moreover, regular coordination of multiple actors is necessary to implement inspection reforms throughout the duration of the Project. To mitigate these risks, the WBG team will support the ministry throughout the Project's lifetime with regular supervision, complementary TA activities, and disbursement, financial management, and procurement training.

[18] The concept and action plan outline the direction and timeline of the inspection reform. Based on these documents, the GoK will initiate work on IT systems and on mapping all regulations and secondary legislation related to inspections.

VI. APPRAISAL SUMMARY

A. ECONOMIC AND FINANCIAL (IF APPLICABLE) ANALYSIS

46. **The project's interventions are designed to address the under-provision and low quality of important public goods and weak supporting public sector institutions in Kosovo.** The project helps to finance: (i) an internationally-recognized NQI system, a public good that is otherwise cost-prohibitive for any private agent to fund on a systemic level; and (ii) reforms to the business inspections system, a public good that normally protects consumers and workers by ensuring firms' adherence to product, labor, and environmental regulations, but which in Kosovo actually imposes outsized compliance burdens on firms due to poorly-coordinated and excessive inspections.

47. **The cost-benefit analysis of the Project's interventions (detailed in Annex 10) suggests a positive economic return based on direct impact channels.** The NPV of the Project as a whole is estimated to be EUR 163 million over the 20-year projection horizon, and the economic rate of return (ERR) is estimated to be 45.9 percent, significantly above the 5 percent real social discount rate used in the analysis. When appraised separately, each of the Project's components is also estimated to have large positive NPVs and ERRs in the range of 43-50 percent (Table 2), suggesting they each make a positive marginal contribution to the Project and are integral to the effectiveness of the overall design. These economic impact estimates are based on a quantification of various direct benefit categories in each component. For the Project's investments in NQI, expected benefits include: (i) the increased export value (amount) added resulting from improvements in firms' foreign market access (due to harmonization of local product/service standards with those of target markets), and their enhanced ability to command a higher export price for their products by upgrading/certifying them to conform to higher-quality international standards; and (ii) the savings from the reduced domestic cost of certifying and exporting products that comes with a stronger NQI system. For the Project's matching grants, key benefits relate to firm profits derived from grant-financed activities. Finally, with regards to business inspections reform, the main benefit comes in the form of reduced compliance costs for firms.

48. **The economic return estimates are consistent in different underlying assumptions.** As a stylized illustration of the magnitude of sensitivities involved, the last column in Table 2 shows the range of ERRs for each Project component that result from a 50 percent upside/downside deviation to the baseline assumptions for key Project impact parameters. Even in the downside case of this fairly large shock—essentially cutting the assumed strength of all Project impact channels in half—the estimated ERR of all Project components, and the Project as a whole, remains comfortably above the assumed 5 percent discount rate. This result gives a significant degree of comfort that the Project's proposed investments are justified on economic grounds even under more conservative assumptions about the magnitude of their economic impacts.

49. **Significant additional indirect benefits not captured in the estimates above can also be expected from positive spillovers of the Project's interventions.** For the NQI reforms financed by the Project, positive externalities from enhanced public health and safety due to protection from low-quality goods entering the market are not easily quantifiable through the economic analysis. For the matching grants program, the estimates of profits and labor productivity gains to beneficiary firms do not capture any multiplier effects or other indirect impacts of the

grant-financed activities, such as the demand boost to firms who are suppliers to the grant recipients. Similarly, the inspection system reforms, beyond helping to reduce firms' compliance costs, is expected to promote a reallocation of their resources to more productive activities, while increasing incentives to formalize, thus indirectly improving their access to markets and finance.

Table 2. Summary of economic cost-benefit analysis

Benefits and costs

*Present value (million US$) **	**Benefits**	**Costs**	**Net benefits (NPV)**	**ERR**	***Sensitivity range*****
NQI upgrading (subcomponent 1.1)	108.2	9.1	99.1	43.5%	*± 15.2%*
Matching grants (subcomponent 1.2)	56.2	4.9	51.3	46.3%	*± 16.5%*
Business inspection reform (subcomponent 1.3)	30.7	7.0	23.7	50.4%	*± 22.7%*
TOTAL PROJECT	**195.1**	**21.0**	**174.1**	**45.9%**	*± 17.2%*

* Estimated over 20-year projection horizon at a 5 percent real social discount rate.

** Range calculated based on 50 percent upside/downside deviation in baseline assumptions for key parameters in each project component.

B. TECHNICAL

50. **The project design conforms to lessons learned and national and international best practices on improving the business environment and export readiness**. Component 1. incorporates good international practices to address market failures and improve the effectiveness and efficiency of government spending in this area, drawing on a long history of WB/IFC work in the region and around the world. Upgrading NQI systems and reform in business inspection processes will help address market failures such as information asymmetry, building on the lessons learned from various analytical reports by donors, government, and the WBG; meanwhile, the Project's matching grants will help offset the high risks firms face when acquiring knowledge to upgrade their capabilities and enter the export market. The Project will add to the knowledge base on what works best to help entrepreneurs through evaluation of the different services provided under the matching grants and their impact on firm growth, exports, and job creation. Performance monitoring of grant recipients to assess intended Project impact, and comparison of recipients' behavior with findings of the WBG's jobs diagnostic (forthcoming) and emerging economic literature will inform the selection criteria and design of the matching grants.

51. **Further, the WBG has broad experience in the activities and components included in the Project.** The WB is seen as a long-term strategic and trusted partner of the GoK in supporting reforms to develop the private sector. While Project design has been largely informed by past and ongoing engagements in the country and best international practices, throughout its implementation, the WBG will bring to bear its technical rigor, resources, knowledge of its staff and experts, its status as an objective third party (especially in mobilizing efforts important for regulatory reforms in which disagreements among ministries and central and local governance can impede results), and its ability to provide long-term financing and address issues systematically.

52. **The proposed Project design is also meant to complement other donors' interventions and ongoing WBG engagements in Kosovo.** Specifically, it will complement WBG engagements like: (i) trade facilitation activities under the Trade Logistics Project (IFC-00599815); (ii) the Kosovo Investment Climate Project (P597287) that concluded in December 2016, which, among other reforms, assisted in improving the business registration processes, licenses and permits, and supported the Kosovo Investment and Enterprise Support Agency (KIESA); and (iii) the design and analytical work for Kosovo Investment Climate II Project (P601638) for business inspection system reform expected to start implementation in FY17.

53. **To ensure timely project effectiveness and implementation, key documents have been prepared and will be adopted by the MTI.** The key documents include: (i) draft Project Operational Manual (POM); (ii) draft Matching Grants Manual (GM); (iii) draft Procurement Plan (PP); and (iv) ToRs for PIU staff.

C. FINANCIAL MANAGEMENT

54. **As part of Project preparation, a financial management (FM) assessment was carried out to determine the financial management implementation risk and to help establish adequate financial management arrangements for the proposed operation**. Bank policies and procedures on FM and disbursement require that the recipient and Project implementing entities maintain adequate FM systems—including accounting, financial reporting, staffing and internal controls, budgeting and planning, flow of funds, and auditing systems—to ensure that they can provide the WB with accurate and timely information regarding Project resources and expenditures. The Project's financial management will be the responsibility of the Division of Budget and Finance (DBF) in the MTI and subordinated agencies. At the time of the assessment, all subordinated agencies in MTI were serviced by the DBF of the ministry. The existing arrangements are considered adequate for Project implementation; however, there are areas that require further strengthening and must be addressed before Project implementation starts, including: (i) the finance unit lacks experience with donor financed projects and knowledge of respective requirements, and is currently working under capacity constraints; this will be addressed by providing support through recruitment of an additional FM specialist as well as continuous training to the FM staff (in the DBF) on Bank FM and disbursement procedures; (ii) documentation of financial management procedures in the Financial Management Manual (FMM) as part of the POM, satisfactory to the Bank, adoption of which will be an Effectiveness Condition, and (iii) documentation of matching grants guidelines and procedures in Grant Manual satisfactory to the Bank, adoption of which will be a Disbursement Condition. The recruitment of an FM specialist, together with other PIU staff, will be an Effectiveness Condition.

55. **The credit proceeds will be disbursed on the basis of the regular Investment Project Financing disbursement mechanism using traditional disbursement methods** such as reimbursement, direct payments, and special commitments. The line ministry's budget would pre-finance Project expenditures for the respective activities, which will later be reimbursed from IDA credit proceeds based on statements of expenditures documenting such expenditures. Other allowed disbursement methods will include direct payment and special commitments.

56. **The risk pertaining to insufficient or untimely budgetary appropriation and allocations is substantial.** To address this, the Project has been included the Annual Budget Law

for 2017 under the Ministry of Trade budget approved in January 2017. Project budget appropriations should meticulously reflect the nature of expected expenditures, programs, source of funding, and implementing agency. Quarterly cash basis IFRs covering all project activities will be submitted for the Bank's review within 45 days from the end of the quarter. The annual audit reports on the Project financial statements would be provided to the Bank within six months after the end of each fiscal year. The audit reports would be made publicly available, as per the WBG Policy on Access to Information.

D. PROCUREMENT

57. **Procurement for the Project will be carried out in accordance with the WB Procurement Guidelines**. Specifically, procurement will be carried out in accordance with "Guidelines: Procurement of Goods, Works, and Non-Consulting Services under IBRD Loans and IDA Credits & Grants by WB Borrowers," published in January 2011 and revised in July 2014; and with "Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits & Grants by WB Borrowers," published in January 2011 and revised in July 2014, and with the provisions of the Financial Agreement. "The WB Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credit and Grants", dated October 15, 2006, and revised in January 2011, will also apply to this project.

58. **Considering the risk encountered under implementation of Kosovo's Business Environment Technical Assistance (BETA) Project (P088045 – completed in 2012), as well as the country risk, the procurement risk is considered high.** The Bank, together with other development partners, has been providing support to the GoK in mitigating the risks through continued dialogue and provision of fiduciary workshops and training activities.

59. **Key risks identified during the procurement capacity assessment include**: (i) weak capacity in the MTI in preparing ToRs or technical specifications for some of the required consulting services or contracts to be procured; (ii) lack of experience on conducting procurement activities using WBG Guidelines; (iii) poor quality of TORs and technical specifications that may lead to delays in contract implementation; (iv) lack of expertise that may lead to delays in completing evaluation of bids and proposals; and (v) delays in procurement processes due to lack of coordination between internal departments at MTI and delays in contract awarding due to complaints. Another risk identified was the enactment of Regulation of MoF No. 01/2016, "On borrowing funds management", which stipulates that PIU's staff will be hired and paid based on the legal framework applied to civil servants.

60. **To mitigate these risks the following elements have been incorporated into the Project**: (i) a clear division and segregation of duties are agreed upon and reflected in the draft POM; (ii) the Bank will provide support to the PIU through fiduciary workshops and training activities; (iii) the Bank will closely monitor the application of the new Regulation of MoF and evaluate its implication for the quality of PIU staffing; (iv) the Bank will, through a complementary TA project, support the GoK's capacity building in critical reforms (inspections, NQI) and assist with the preparation of ToRs for critical pieces of work; and (iv) the Bank will conduct prior review of key packages and post review of selected contracts during the supervision mission.

E. SOCIAL (INCLUDING SAFEGUARDS)

61. **The Project does not include civil works or any other activities anticipated to cause involuntary land acquisition. OP/BP 4.12 is not triggered**. Under subcomponent 1.2, the Project envisages support to SMEs in form of matching grants to strengthen their ability to meet required export standards and business development potential. The Grant Manual will specify that businesses that may require involuntary displacement of existing occupants or economic users of any plot of land, regardless of its current ownership, or loss of or damage to others' assets will be excluded from grant support. The GM will outline the social due diligence requirements of OP 4.12 and provide guidance for screening grant applicants on property rights issues.

62. **The Project is gender informed.** In Kosovo, lack of employment opportunities is a major driver for entrepreneurship among both women and men. However, women are less likely to start a business than men, as illustrated by self-employment figures. According to the Kosovo 2015 Labor Force Survey, more than a quarter of Kosovar men were self-employed vs. 13.6 percent of women. Women in Kosovo continue to face considerable challenges to entrepreneurship participation due to lack of access to finance (exacerbated by low property ownership), unbalanced domestic responsibilities (including childcare), and inadequate skills.[19] Efforts to increase women's labor force participation and employment, as well as entrepreneurship, need to increasingly originate from the private sector. The Project will contribute to narrowing the gender gap in entrepreneurship participation by encouraging female-headed enterprises to apply for support under the matching grants (subcomponent 1.2). Specific activities aimed at meeting this objective include providing gender-sensitive export readiness information as a part of matching grants promotion events and sharing targeted information about the matching grants specifically with organizations supporting female entrepreneurs in Kosovo. The gender distribution of Project SME support will be monitored throughout Project implementation to allow for informed targeting of interventions and gender-disaggregated evaluation of the matching grants benefits (see indicator 8 in the results framework). In addition, the project will contribute to increased employment of young entrepreneurs in Kosovo by improving the business environment and providing direct support to SMEs.

63. **Citizen engagement.** During the process of designing the Project, consultations were conducted with multiple stakeholder groups, including relevant state agencies and business associations. During implementation, beneficiary feedback/grievance mechanisms will be an integral part of the matching grant scheme operation, in order to allow applicants to inquire about the selection procedure (e.g., criteria, timeline) and to submit comments and complaints. The efficiency of the mechanism's response to submitted comments/grievances will be monitored (see results framework). Improvements in business inspection services will be evaluated by means of a user survey at the beginning, middle, and end of the Project. The survey will be sample-based and targeted at staff in relevant inspection bodies, and will seek to evaluate the impact of Project interventions on simplicity and effectiveness of inspection procedures. The results of the survey will be shared with relevant stakeholders, such as the Ministry of Trade, Chamber of Commerce, business associations and so on, to inform them about the impacts of the inspection simplification

[19] Kosovo: Gender Gaps in Education, Health and Economic Opportunities. (2012). World Bank Group

process (see results framework).

F. ENVIRONMENT (INCLUDING SAFEGUARDS)

64. **The Project is classified as a category C project.** The Project focuses on enhancing the business environment and opportunities through reform of national services (inspection), and provision of matching grants to SMEs for soft services, such as acquisition of certification and standards as well as business development services. No civil works of any kind will be financed by this Project. There may be equipment purchase, but no works related to their installation are foreseen.

65. **The Project will support all exporting sectors through a matching grant scheme; including those that may be in polluting industries or located in areas that lack adequate pollution abatement infrastructure.** The GM will, therefore, along with exclusion criteria and within the environmental compliance guidelines, set additional requirements on the final users of grant funds (applicants) to confirm compliance with Kosovo's environmental legislation. Project activities must not aggravate existing impact and/or environmental conditions. Priority in financing will be given to companies already conforming to some type of recognized sectoral environmental set of standards, practices and techniques, such as EU Best Available Techniques Reference Documents, or EMS norms, such as ISO 14001. For information collection, a compliance questionnaire will be developed by the Borrower as a part of the guidelines for determining Applicants' compliance with environmental regulations. Matching grants applications with activities that might cause significant change in pest management practices or land use will not be approved, nor will ones listed in the WB exclusion list.

66. **Project contribution to adaptation to climate change:** Expected impacts of climate change on Kosovo's economic, sociological, and natural conditions include increased exposure to droughts, floods, and forest fires, and consequently ecosystem degradation, reduction of ecosystem services and resources availability, and new forms of pollution. Improvements in the business environment and export readiness introduce the possibility of achieving a higher social standard, improved income and economic stability, and access to better health services, which can all improve general resilience to climate change effects. The international recognition of the Kosovo Metrology Agency (KMA) will make internationally recognized testing reports and certifications more accessible to firms. The standardization of products and production processes has the potential to lead to: (i) efficient use of resources and reduced pressure on increasingly scarce water resources and energy (obtained mostly from fossil fuels in Kosovo); and (ii) improved product quality to comply with markets abroad, which may include using less polluting substances in production (for example, dyes in textiles), resulting in reduced impact on the environment.

G. OTHER SAFEGUARD POLICIES

67. **Administrative and implementation issues related to OP 7.50 Projects in Disputed Areas might occur due to the fact that Republic of Kosovo is not recognized as an independent state by its immediate neighbor, Republic of Serbia.** The location of sub-projects (in subcomponent 1.2) is still unknown. It may include Northern Kosovo, which also does not recognize the National Government of Kosovo and where there is limited accessibility for the

representatives of the Republic of Kosovo as well as the WB team. However, LEGEC concluded that, based on several agreements and accords signed in 2012 and 2013, OP 7.50 would not apply. Risks associated with the problem of implementation because the Bank team and PIU have limited access to the North of Kosovo needs to be recognized and addressed. In order to address the language barrier and ensure that Northern Kosovo is also included the Project, documents will be translated into three languages.

68. **Communities and individuals who believe that they are adversely affected by a WB supported project may submit complaints to the Project-level grievance redress mechanism or to the WB's Grievance Redress Service (GRS)**. The GRS ensures that complaints received are promptly reviewed in order to address project-related concerns. Project affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the WB's attention and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the WB's corporate Grievance Redress Service (GRS), please visit http://www.**worldbank**.org/GRS. For information on how to submit complaints to the WB Inspection Panel, please visit www.inspectionpanel.org.

ANNEX 1: RESULTS FRAMEWORK AND MONITORING

Country: Kosovo

Project Name: KOSOVO: COMPETITIVENESS AND EXPORT READINESS PROJECT (P152881)

Results Framework

Project Development Objectives

PDO Statement

To support product certification for export markets, strengthen the capacity of export-oriented firms and reduce the cost of business inspections.

These results are at	Project Level

Project Development Objective Indicators

		Cumulative Target Values				
Indicator Name	Baseline	YR1	YR2	YR3	YR4	End Target
Number of products tested and certified at domestic organizations that are accredited by an internationally recognized accreditation agency (Number)	0	0	0	0	100	200
Share of beneficiaries of the matching grants program that increase their export value (Percentage)	0	0	0	20	30	50
Reduction in annual inspection compliance cost per business	0	0		5		15

(Percentage)						

Intermediate Results Indicators

Indicator Name	Baseline	Cumulative Target Values				
		YR1	YR2	YR3	YR4	End Target
Kosovo Metrology Agency (KMA) becomes a signatory to Mutual Recognition Arrangement (CIPM MRA) of the international metrology system (Committee on Weights and Measures (CIPM) (Text)	NO					YES
Kosovo Accreditation Directorate (DAK) becomes a signatory to a MLA or MRA with international accreditation organizations ILAC and IAF (Text)	NO					YES
Participations of KMA in international inter-laboratory comparisons (Number)	0	0	0	2	5	10
Private capital mobilized through matching grants program (Amount (EUR))	0	0	486,000	1,248,000	2,340,000	2,340,000
Number of firms financed through matching grants program (Number)	0	0	30	80	150	150
Number of firms with female owner financed through matching grants program	0	0	3	8	15	15

(Number - Sub-Type: Breakdown)						
Percentage of grievances about the SME grant scheme that were responded to (Citizen Engagement) (Percentage)	0	0	0	80	80	90
New law on inspection is adopted by the Parliament (text) (Text)	NO	Concept document for the law is endorsed by Council of Ministers	Law submitted to Parliament for approval	YES	YES	YES
Number of inspectorates within government body (Number) (Number)	36	36		33		15
Number of inspection visits per firm each year (Number)	22	22		20		16
Number of user survey results about the business inspections system were shared in public (Number)	0	1	0	2		3

Indicator Description

Project Development Objective Indicators				
Indicator Name	Description (indicator definition etc.)	Frequency	Data Source / Methodology	Responsibility for Data Collection
Number of products tested and certified at domestic organizations that are accredited by an internationally recognized accreditation agency	Number of products tested and certified at domestic organizations that are accredited by an internationally recognized accreditation agency. From 2011 to 2014, Kosovo exported an average of approximately 2,370 products.	Annual	Customs Agency and DAK	Project Implementation Unit (PIU)
Share of beneficiaries of the matching grants program that increase their export value	The increase in the export value is measured as the change in the firm's nominal value of exports (in Euro) relative to the most recent financial reporting period prior to the receipt of the matching grant. For the percentage of total beneficiaries' calculation, in any given year, only firms for which at least 12 months have passed since first grant disbursement are included.	Annual	Kosovo Investment and Enterprise Support Agency	KIESA/PIU
Reduction in annual inspection compliance cost per business	Direct inspection compliance cost for firms is defined here as the labor cost of compliance, measured in monetary terms as the staff time devoted to inspection multiplied by the average wage of the employees involved. Based on data from the 2012 business inspection survey, the baseline annual compliance cost value is estimated at EUR 220—assuming 4 of the firm's workers (with an average annual salary of EUR 350) are involved in each of the 22 inspection visits, with each visit	Biannual	Business Survey; Central inspectorate data	PIU

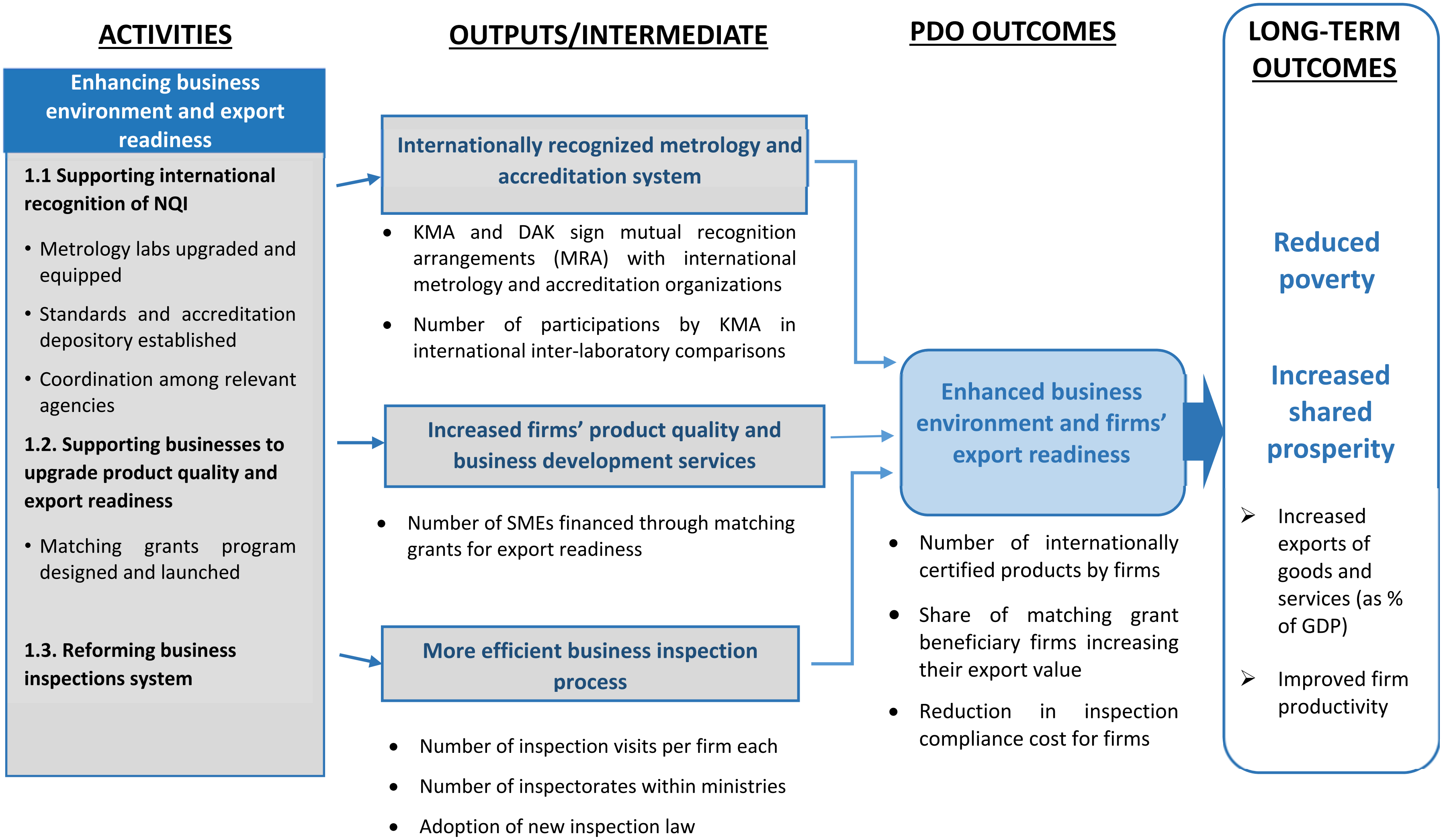
	taking approximately 1.25 hours (or 0.15 business days).			

Intermediate Results Indicators

Indicator Name	Description (indicator definition etc.)	Frequency	Data Source / Methodology	Responsibility for Data Collection
Kosovo Metrology Agency (KMA) becomes a signatory to Mutual Recognition Arrangement (CIPM MRA) of the international metrology system (Committee on Weights and Measures (CIPM)	Internationally recognized metrology system. Kosovo Metrology Agency (KMA) becomes a signatory to Mutual Recognition Arrangement (CIPM MRA) of the international metrology system.	Continuous	CIPM MRA database	PIU
Kosovo Accreditation Directorate (DAK) becomes a signatory to a MLA or MRA with international accreditation organizations, ILAC and IAF	DAK becomes a signatory to a MLA or MRA with international accreditation organizations, ILAC and IAF by end of the Project.	Continuous	ILAC or IAF database	PIU
Participations of KMA in international inter-laboratory comparisons	Number of times that KMA participates in international inter-laboratory comparisons.	Annual	Kosovo Metrology Agency (KMA)	PIU
Private capital mobilized through matching grants program	Private financing committed by recipients of matching grants as part of their agreed “matching” contribution.	Annual	KIESA	KIESA/PIU
Number of firms financed through matching grants program	Number of firms receiving direct financing from matching grants program. Female-owned firms are defined as those registered with a female as the principal owner or those firms that have more than	Annual	KIESA	KIESA/PIU

	50% of shares owned by a female.			
Number of firms with female owner financed through matching grants program	Number of firms receiving direct financing from matching grants program. Female-owned firms are defined as those registered with a female as the principal owner or those firms that have more than 50% of shares owned by a female.	Annual	KIESA	KIESA/PIU
Percentage of grievances about the SME grant scheme that were responded to (Citizen Engagement)	This indicator tracks grievances about the matching grants scheme and the percentage of those grievances that are responded to.	Annual	KIESA	KIESA/PIU
New law on inspection is adopted by the Parliament (text)	This indicator tracks the various stages/milestones of the process for passage of a new inspection law.	Continuous	Project Progress Report; Official Gazette of Kosovo	PIU
Number of inspectorates within government body (Number)	Number of inspectorates within ministries to be reduced from 36 to 15 by end of Project.	Biannual	Business survey; Central Inspectorate Data	PIU
Number of inspection visits per firm each year	This refers to the number of distinct visits by inspectors. One inspection process may require multiple visits.	Biannual	Business survey; Central inspectorate data	PIU
Number of user survey results about the business inspections system were shared in public	This refers to the number of surveys conducted and shared publicly through publication on MTI website.	Biannual	Business survey; Central inspectorate data	PIU

ANNEX 2: RESULTS CHAIN



ANNEX 3: DETAILED PROJECT DESCRIPTION

1. **The project aims to strengthen the capacity of select public institutions in Kosovo that contribute to improving exports and private sector competitiveness.** Rather than attempt to address all competitiveness and export constraints, the Project focuses on a targeted set of achievable actions selected according to the following criteria: (i) those prioritized by the government and identified as key drivers of the competiveness agenda by the Bank in consultation with the private sector; and (ii) those selected after in-depth consultations with other donors (such as the EU), to coordinate activities and prevent any duplication.

2. **The project seeks to improve the business environment and export readiness of firms by upgrading national quality infrastructure, supporting small and medium enterprises (SMEs) with export potential, and reforming the business inspections system.** Increasing productivity, improving product quality, and reducing cost for business inspections are vital steps for improving business environment and export readiness of firms in Kosovo. Kosovo is one of the least integrated countries in the region and shows very low export performance (export-to-GDP ratio is only 18.4 percent, and survival of exporters is low). Exports are significantly hampered by lack of adequate national quality infrastructure (NQI). Meanwhile, there is an urgent need to support growth of SMEs by helping them to improve the quality of their products and services and tap into regional value chains. Matching grants will share the costs as firms make risky investments in knowledge products to improve their export readiness. In addition, Kosovo has the highest number of individual inspections among all its neighboring countries, which poses a significant regulatory and compliance burden on businesses. This project will finance the following three subcomponents: (i) improving NQI and supporting its international recognition, (ii) supporting businesses to upgrade product quality and export readiness, and (iii) reforming business inspections system.

Component 1. Enhancing Business Environment and Export Readiness

Subcomponent 1.1: Supporting the international recognition of NQI (EUR 6.55M)

3. **This subcomponent supports the government of Kosovo in upgrading the NQI system and obtaining international recognition of key NQI institutions.** Specifically, the project will support (i) the Kosovo Metrology Agency (KMA) in becoming qualified to sign mutual recognition agreements of the international metrology system (Committee on Weights and Measures)—CIPM MRAs; and (ii) the Kosovo Accreditation Directorate (DAK) to sign mutual recognition agreements with the International Laboratory Accreditation Cooperation (ILAC MRAs), and with the International Accreditation Forum (IAF). With the help of these agreements, Kosovo's metrology and accreditation agencies will gain international recognition, and the output of any accredited organization in Kosovo (i.e., all NQI institutions of Kosovo) will be recognized by Kosovo's trading partners.

4. **The WB conducted an NQI needs assessment in Kosovo in 2016**. The lack of international recognition of the NQI system helps explain Kosovo's weak export performance despite its proximity to EU markets. Kosovo's top export items are light manufacturing (textiles, processed wood products) and food products. There are several product-testing laboratories in Kosovo which test these products for certification. However, exporters cannot use testing reports from domestic laboratories or certificates from domestic product certification bodies when they

export, as the accreditation of these laboratories and certification bodies is not recognized internationally. For existing laboratories to receive international recognition they must be accredited by organizations that are themselves internationally accredited. A functional and internationally recognized NQI will help to lower the cost of product development and manufacturing, thus enhancing the competitiveness of Kosovar products. In addition, a well-functioning NQI system serves to protect consumers against low-quality and noncomplying goods. Therefore, the NQI system is considered a public good.

5. **Specifically, the project will finance equipment, IT systems and capacity building to address the following issues:**

6. **Support to KMA.** The project will upgrade selected metrology laboratories and provide necessary testing equipment and training to KMA staff to use the procured equipment. The project will also build capacity of KMA staff to improve traceability and inter-laboratory comparisons — identified as key KMA bottlenecks — so it can qualify to sign MRAs with international organizations. Planned activities include:

- Increasing measurement capability through (i) temperature and humidity controls for at least two laboratories; (ii) modernizing measurement equipment (such as humidity, dimensional measurements, chemistry, biology/health, time, and frequency) for both existing and new laboratories; and (iii) training laboratory staff to use the procured equipment.
- Establishing and sustaining traceability through support of international calibration and comparison processes for the metrology system.
- Supporting Kosovo's application to the European Metrological Institutes (EUROMET).
- Supporting KMA to be able to sign CIPM MRA and show competence by declaring CMC entries in the CIPM MRA database.

7. **Support to DAK.** The project will finance DAK's IT system for data interoperability and exchange, which will ensure that relevant agencies can access necessary information, such as standard requirements and testing results of accredited laboratories. The project will also support capacity-building activities for DAK to support future accreditation of measurement laboratories and certification bodies in line with international best practices. Planned activities include:

- Organizing inter-laboratory comparisons and proficiency testing for accredited laboratories so that existing accredited laboratories can be accepted internationally, and future accreditation of measurement laboratories can be done according to international standards.
- Supporting DAK to be able to sign mutual recognition agreements of international accreditation organizations ILAC and IAF.
- Supporting training for DAK in international methodologies.
- Supporting DAK with IT infrastructure in order to protect accreditation information.

8. **Support KAS (Kosovo Standardization Agency).** The project will finance KAS infrastructure to help ensure relevant agencies can access necessary standards. The project will

also fund capacity-building activities to enable KAS to support future development of Kosovar standards. Planned activities include:

- Supporting KAS with a controlled room for storing written standards.
- Supporting KAS with IT infrastructure in order to protect Kosovar standards in electronic form.

9. **Coordination.** To ensure the sustainability and continued development of the NQI system, the project will support the establishment of the National Quality Infrastructure Committee (NQIC), in which the private sector will participate. The NQIC will support coordination among relevant stakeholders, including metrology, accreditation, standardization, certification, and inspection bodies, and both private and public laboratories. The project will also improve public awareness of international (e.g. EU) measurement and harmonization requirements. The project will finance market surveillance activities and ensure goods marketed in Kosovo are suitably monitored and controlled. Planned activities include:

- Supporting institutional development of NQI organizations by providing training to relevant technical staff and by hiring international consultants.
- Supporting a public awareness campaign to increase knowledge about NQI among stakeholders.

Box 1. Kosovo NQI Needs Assessment, WB, 2015-16

Kosovo NQI needs assessment was conducted by WBG in 2015-16 and identifies areas where Kosovo's NQI system needs urgent support; it provides a medium-term plan to ensure sustainability of the overall NQI. The findings are summarized below:

National Quality Infrastructure (NQI) is at an early stage of development. Most NQI agencies, such as metrology and accreditation, are under the MTI, while other ministries participate in market surveillance through inspections in relevant areas. Legal infrastructure is in place but is not properly implemented due to weak physical infrastructure and staff capacity. There is an urgent need to upgrade selected laboratory equipment and to increase staff capacity. Figure 2 demonstrates how the overall NQI system works in Kosovo.

At the sector level, poor control of the quality of imported inputs and lack of quality infrastructure for testing make fruits and vegetables producers less competitive in Kosovo. The situation in the fruits and vegetables sector is somewhat improved, but costs are still high as there are no accredited laboratories for necessary tests. Due to poor quality control, Kosovo has no access to EU markets for dairy products. A similar situation exists with non-food products. For instance, industrial metrology and market surveillance do not function properly, as there is no single central coordinating contact point. Private sector participation in testing facilities is weak, due to the large investment required for those facilities, which is further discouraged by the lack of an internationally recognized NQI system.

- Supporting KMA and DAK to obtain international recognition will lead to recognition of existing domestic laboratories (thus the whole NQI of Kosovo) by high-value markets, such as the EU. KMA is the weakest area of the overall NQI system. Currently, KMA does not perform its fundamental duties, such as traceability for accredited measurement labs, inter-laboratory comparisons, and proficiency testing for accredited laboratories. It is required to improve physical infrastructure for (i) temperature and humidity controls; and (ii) measurement equipment, such as humidity, dimensional measurements, chemistry, biology/health, time, and frequency, for both existing and new laboratories. Moreover, no laboratory in Kosovo is accredited by an internationally recognized accreditation organization, which creates extra costs related to customs formalities and transportation costs for businesses that seek compliance with international standards, as they must find accredited certifiers in other countries. Establishing physical and electronic depositories for standardization and accreditation would also support DAK to achieve international recognition.
- Coordination among NQI agencies. The lack of coordination among NQI agencies is an additional burden for firms. For instance, lack of harmonization between inspectors on the technical side and customs regulations at the border further delay the process of obtaining relevant certification/clearances for imports and exports. To ensure coordination and reduce the knowledge gap among various stakeholders, the project will also provide training to relevant stakeholders and improve a public awareness campaign for international certification and standards requirements. Meanwhile, the existing EU project, Free Movement of Goods, will complement these efforts by supporting the legal framework for institutional set-up.
- Market surveillance. Currently, there is no central coordinating contact point for market surveillance and the market surveillance inspection lacks capacity, while technical regulations that are based on EU directives are put in action without the necessary infrastructure for proper implementation. Finally, certification, especially product certification, is extremely weak. There is an urgent need for enhancing market surveillance activities and overall coordination of all NQI processes, such as testing, and analysis capability of various organizations, so goods marketed in Kosovo are suitably monitored and controlled.

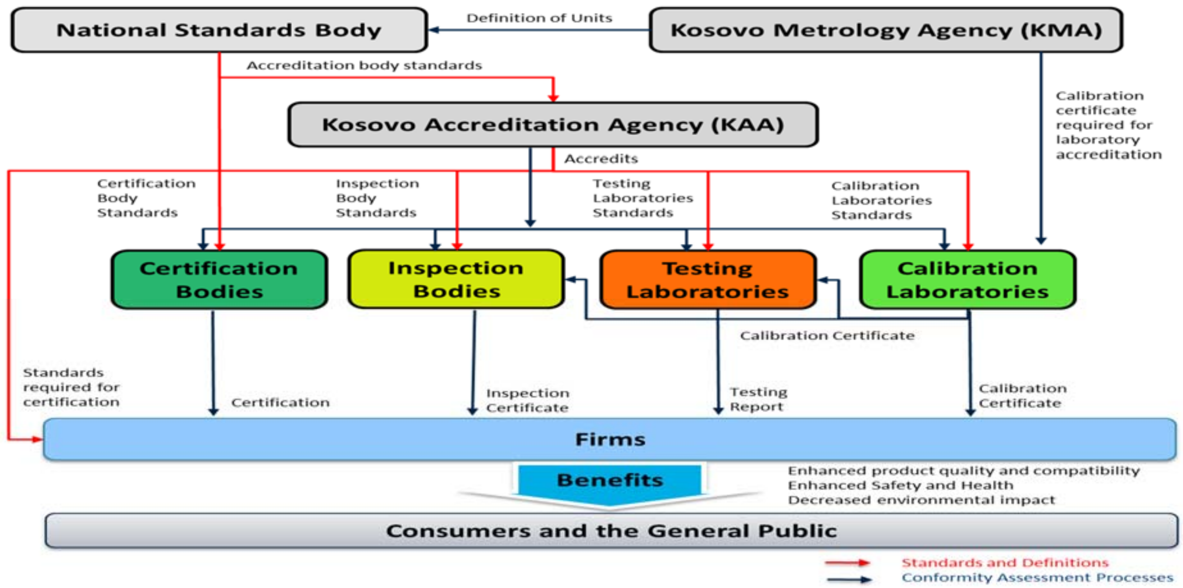
Institutional development of NQI in Kosovo

- Along with the availability of new equipment, suitability of buildings for high-level measurements, and acquiring new skills and experience through technical assistance, success and sustainability of Kosovar NQI depend on the following interventions:

- Metrology and accreditation organizations should be converted from purely ministerial agencies to financially self-sufficient, semi-autonomous institutes to maintain impartiality as well as to raise sufficient revenues for their operations.
- KMA should work as an industrial-academic organization rather than as purely a service provider. It should be involved in the creation of know-how (both scientific and industrial), rather than just the implementation of know-how created by others. To achieve this, KMA should cooperate with universities and industries.
- KMA operations should be moved to the new facilities constructed years ago at the outskirts of Pristina, after the installation of a better acclimatization system for mechanical laboratories. Unused space in that facility should be rented for private testing laboratories on a fixed time basis.
- Some gaps in staffing should be filled by MSc or PhD students, some of whom can be hired by KMA after they receive their degrees.
- KMA staff income should be based on performance rather than a fixed salary, as the latter provides no motivation to increase the effectiveness of KMA.
- KMA and DAK staff should work together within the National Quality Infrastructure Committee (NQIC) to assess the needs of NQI and to propose solutions for existing and potential problems.
- To assist KMA and DAK in their operations and to provide necessary input for critical decision-making processes, a nongovernmental KOSLAB should be established (similar to CROLAB of Croatia, MAKLAB of Macedonia, and TURKLAB of Turkey). This organization will interface between laboratories in Kosovo and relevant public organizations, such as KMA, DAK, and various regulatory bodies. KOSLAB will seek membership in EUROLAB, the relevant European organization.
- To create a central source for know-how needed by the industry in the areas of quality assurance, quality and environmental management, conformity assessment procedures and processes, a Kosovo Society of Quality (or Kosovo Quality Association) should be established as a nongovernmental organization (NGO), similar to the Bosnia and Herzegovina Quality Association, Croatian Society for Quality, or Slovenian Association for Quality and Excellence. This organization should also assist KIESA in export promotion, especially regarding the rules and regulations used in foreign markets. It will also provide a platform for the exchange of information and experience between quality managers of participating organizations. A national quality award can be used to trigger constructive competition among producers and service providers. The European Foundation for Quality Management (EFQM) offers a sound model and experience in this area.

Source: Authors. The overall framework is provided in Quality Systems and Standards for a Competitive Edge, World Bank 2007.

Figure 2. National Quality System in Kosovo



Subcomponent 1.2: Supporting SMEs to improve export readiness (EUR 2.81M)

10. **This subcomponent will establish a matching grants scheme to co-finance the acquisition of standards and certifications, and accessing Business Development Services (BDS) by SMEs with export potential.** SMEs will be supported in: (i) implementing standards and receiving certifications required for export markets, and (ii) accessing BDS, to better prepare them to test and enter the export market.

11. **The matching grants will help SMEs mitigate the effects of information asymmetries and overcome the high fixed cost of export entry.** In situations where there is little integration, as in Kosovo, SMEs often under-invest in efforts for export entry because they underestimate their gains. The economic gains exceed the private gains captured by the investing firms because there are spillover effects when other firms observe the first movers. The matching grants scheme will support firms with export potential to acquire product certifications and standards, and utilize BDS, such as export market research and export promotion, with the purpose of assessing markets and testing demand for products in new markets, which are identified as key constraints for export entry and scaling up of Kosovar SMEs.[20] Previous IOM engagement showed that there are growing local BDS providers as well as a pool of international consultants in the region, which could meet the needs of this project. The project will also indirectly help build the BDS market and strengthen providers. The success of beneficiary firms will trigger other SMEs to access to similar services and export destinations.

12. **The matching grants subcomponent complements the NQI subcomponent of the Project**. While an improved NQI system will reduce firms' costs for obtaining internationally

[20] SME needs assessment 2014

recognized certification and testing, the matching grants will support firms' ability to meet these standards.

13. **Governance:** The matching grant scheme will be implemented by KIESA, which will establish a small grants management unit with two key staff within 90 days after project effectiveness as an extension of the PIU. The grants management unit will have at least two key staff, such as Grants Coordinator and M&E Officer, who will work directly with the financial and procurement specialists in the PIU. The audit will follow the overall project audit requirement. An independent Selection Committee (SC) will adjudicate applications. Hiring of key personnel in the grants management unit and in the SC would be supervised by WB and no objections will be raised to the ToRs created or to individuals hired.

14. **Grants Manual:** The overall design and execution of the program will be governed by the Grants Manual (GM). A draft is already prepared and will be finalized by KIESA. Adoption of the GM to the satisfaction of the WBG and establishment of the selection committee are disbursement conditions for the EUR 2.3M earmarked for beneficiary firms under subcomponent 1.2. Selection criteria focus on the investment's impact on the applicant firm's growth, exports, and profitability. Performance monitoring of grant recipients to assess the intended Project impact, and comparison of recipients' behavior with findings of WBG jobs diagnostic (forthcoming) and emerging economic literature[21] will inform amendments to the GM. The GM will provide guidelines for areas that the grants will not finance, such as specific activities that could potentially have a negative environmental effect. The GM would also include mechanisms for addressing potential applicant complaints. If implementation deviates from the applicant's original proposal, KIESA, in consultation with the SC, will decide whether to accept a revised implementation proposal or decline the applicant's request. The final disbursement for eligible expenses will be made upon review and approval of a progress report submitted by the applicant in accordance with the provisions of the grant's Financing Agreement. The review and approval of the report will take approximately two weeks to complete and may be subject to an on-site monitoring visit. The MGP will not provide financing for proposals that are already funded by other grants schemes operating in Kosovo.

15. **Design:** The size of this activity is EUR 2.81 million, with administrative costs (including the hiring of key personnel, compensation for an independent selection committee and cost for outreach and communication) of about is EUR 0.47 million. Approximately 150 firms are expected to benefit. An active outreach program will be used to encourage female entrepreneurs to apply. Priority will be given to firms in strategic sectors identified by MTI (e.g. food products, ICT, wood, and textiles), but would be open to firms that show export potential in any sector. A complementary TA Project will support KIESA's capacity in their outreach efforts and in implementing the grants scheme. An evaluation of the matching grants, to be conducted by KIESA, will be supported by the advisory project.

16. **Grant size:** Grant size will vary but will be capped at is EUR 46,800 for any individual firm. Applications from individual firms or consortia of firms, such as business associations, will

[21] See, for example, World Bank Kosovo Systematic Country Diagnostic 2016 (forthcoming), Business Enabling and Enterprise Performance Survey (BEEPS) 2014.

be accepted through a series of calls for proposals. Detailed criteria and procedures for the grants will be included in the GM, which will provide comprehensive information on the governance of the program.

Box 2. Previous matching grants in Kosovo and Analytical Underpinnings

A matching grant program funded by EU and executed by IOM had an overwhelming response and is strong evidence of the need for more direct support for businesses. Business development services (BDS), though available in Kosovo, are in their nascent stage. Hence, there is minimal risk of this activity crowding out the private market; in fact, a grant program provides great impetus for the growth of the nascent BDS industry. The program objective was to generate market demand for BDS of a general nature (accounting; diagnostic of problems such as SWOT analysis; management consulting; legal support; training of SME personnel; and purchase of business software).

Various analytical reports by donors, government, and WBG underpin the program. WBG experience with similar programs in the ECA region will inform its design. Of the number of similar WBG programs, the project in Armenia (Trade Promotion and Quality Infrastructure) most closely parallels this project, and lessons from Armenia have been incorporated in the project design. Key lessons emphasize the importance of (i) private sector participation, management capability, good governance, and cost-effective design and delivery, and (ii) appropriate incentives and procedures to ensure success. The design of the matching grants also takes into consideration similar grants schemes implemented in Kosovo, which provide several lessons related to: (i) concerns of implementation agency capacity, (ii) need for an independent selection committee and strategic selection criteria, and (iii) high demand for but nascent state of BDS in Kosovo.

Insights from the IOM matching grant and the BDS program of KOSME in Kosovo will be utilized in the project design. The KOSME report found strong need among SMEs for typical BDS. The USAID study on strategic sectors that extensively analyzed potential for growth, job creation, and value addition, as well as other analytical reports and stakeholder consultations from previous missions, uncovered a very strong need and demand for certification (ISO 9001, market certifications, food safety and organic certifications) for firms. These findings have informed the design of the matching grants.

Findings of SME need assessment in representative sectors are presented in Annex 7.

Subcomponent 1.3: Reforming business inspections system (EUR 4.42M)

17. **This subcomponent will help to reduce the administrative burden for businesses**. A well-designed inspections system can create a “win-win” solution for all concerned parties. If the underlying legal requirements are well-targeted and well-designed, their enforcement creates benefits, reduces costs, and fosters accountability and due process, thus enhancing social welfare. However, if the inspection system is poorly designed, it is an excessive burden for businesses and creates opportunities for corruption and abuse. The latter diminishes the trust citizens and businesses have in their governments, regulators, and authorities. Recent studies of administrative barriers to investment carried out by the WBG and other organizations in many countries have found that government inspections for compliance with legal obligations can cause substantial problems for businesses, including disruption of business activities and risk of unpredictable sanctions. Typically, such problems are not confined to single sectors: patterns are often seen across the public sector, through departments and inspectorates responsible for taxes, safety, customs, sanitation, environment, and consumer and labor protection.

18. **The government has undertaken measures to reform the business inspections system.** The GoK through the decision No. 05/138 on March 22, 2017 established a working group that will analyze and prepare the recommendations and concept document on the draft law on inspections, which is expected to be submitted to the Parliament during 2017. The decision

attaches an explanatory memorandum that reflects the concept and action plan for inspections reform. Through this decision, the Ministry of Trade and Industry has been appointed as the coordinator of the reform and chair of the working group. The working group will be composed of the General Secretaries of the relevant ministries or their authorized representatives. The initial draft law on inspection prepared by the GoK in 2015 was not in line with the international best practice and the recommendations provided by the WBG team to the MTI in 2015. With the WBG's support, the GoK developed the concept and action plan for inspections reform. The working group will work on redrafting the Inspection law and expects to submit it to the Parliament in 2017. The GoK has added Drafting of the General Inspections Law to the 2017 European Reform Agenda, which shows the government's strong commitment to achieving this reform.

19. **The Project will finance** (i) an electronic inspector data management system, which will enable a unified electronic inspection platform for inspection planning and coordination, inspection controls/visits, inspection checklists, file/document management of inspection reports, internal and external reporting, data mining, analysis and risk profiling — basically all aspects of an inspector's work; (ii) a business inspection interoperability data exchange system, which will enable data exchange among different institutions, facilitating risk-based inspections, better business profiling, and reduced informality; (iii) equipment for inspectors to conduct field analysis, sampling, and evidence gathering; and (iv) sustainability of the new institutional set-up and capacity building for inspectors.

20. **The success of this component depends upon the proper sequencing of the activities and the GoK's strong commitment to institutional change.**

f. The GoK has approved the concept and action plan for inspections reform.

g. The GoK will prepare the New Inspection Law, which is expected to be submitted to the Parliament during 2017. Adoption of this Law will lead to changes in the institutional set-up and ensure full implementation of the Inspections Reform, as specified in the aforementioned concept and action plan. The complementary advisory project will also support the MTI in the drafting of this law.

h. While the new law is being finalized, work on mapping all regulations and secondary legislation related to inspections will be initiated, which will enable the GoK to immediately begin the process of making the necessary amendments once the new law is passed. The WBG team, though the complementary advisory project, will assist the GoK in the horizontal review of over 150 regulations.

i. Drafting of the New Inspection Law and the review of regulations will be monitored by the working group on inspections led by the Ministry of Trade and Industry with oversight from the Prime Minister's Office.

j. Simultaneously, the Project will begin work on an electronic inspector data management system, as specified in the aforementioned concept and action plan. Specifically, work on IT due diligence (for both E-inspector system and inspection data interoperability) will be initiated as soon as Project implementation starts. This will set the stage to tender the E-inspector, inspection data interoperability processes and hardware as soon as the New Inspection Law is enacted.

k. For the E-Inspector system to produce the desired benefits for businesses, two more activities are required, namely establishing business inspection interoperability and equipping inspectorates. Business inspection interoperability will enable different institutions (tax, customs, KBRA, inspectorates, food safety agencies, municipalities and the respective ministries) to engage in data exchange. The Project will support equipping inspectorates for field analysis, sampling and evidence gathering. This will enable mobility of inspectors and increase work quality.

l. The Project will provide a year-long capacity building program with hands-on training, including sharing knowledge about EU practices[22.]

[22] A new and overarching Inspection Law and respective bylaws will be prepared by GoK and will enable implementation of the Inspections Reform. The Project is not financing the passing of the law.

Box 3.Key Challenges in Kosovo's Inspections System

The 2012 inventory of inspections in Kosovo conducted by WBG identified key challenges in the inspection system.

Too frequent inspections and too many inspectorates. The inventory revealed that Kosovo has the highest number of individual inspections in the neighbors. Kosovo's inspectorates are regulated by some 150 different regulations and governed by over 10 agencies. Inspectoral bodies lack the resources (human, financial, and equipment) to enforce the laws and bylaws that fall under their jurisdiction, thus leading to their inconsistent interpretation and application. Also, there are significant overlaps among inspections. There is no unified inspection procedure across agencies, nor joint inspection planning, and no subordination between the national and local levels. All of the above increases compliance costs, creates significant burden to business (22 inspector visits per business per year), and reduces the efficiency of inspections. Businesses are subject to nontransparent inspections (no publicly available inspection checklists, so no inspectors adhere to the checklist during inspections, no advance notice of visits, and no proper complaint process).

Weak coordination. The current organization of inspections leads to widespread lack of coordination between inspectorates. The legal framework lacks a clear definition of the competencies of inspection bodies' mandates, which increases overlaps and redundancies for businesses, which must undergo multiple inspections for the same requirement. Duplications of mandates leads to unnecessary business inspections by competing inspection bodies, thus increasing business costs and undermining trust in the overall inspection system. There is no data exchange among inspection agencies, and no risk-based profiling and inspections.

Informality. Currently, there is no internal control over inspectors, and there is poor accountability of inspectors for wrongdoing. Sanctions for inspectors and businesses for noncompliance, underreporting, and informality are negligible and enforced unevenly. There is no data exchange between agencies. Poor business appeal mechanisms, a cumbersome process of enforcement of inspectors' decisions and lack of trust in inspection services lead to widespread noncompliance (and thus informality).

In summary the challenges to Kosovo's inspections system include:

Poor capacity of inspectors (and in some cases lack of adequate number of inspectors); inspections are not equipped and lack budget.

No unified electronic inspection data system; no data exchange between inspections.

No risk-based inspections.

Poor internal control over inspectors; poor accountability of inspectors for wrongdoings.

Poor business appeal mechanism and enforcement process of inspectors' decisions. Lack of transparency in inspection processes; lack of business advocacy and outreach.

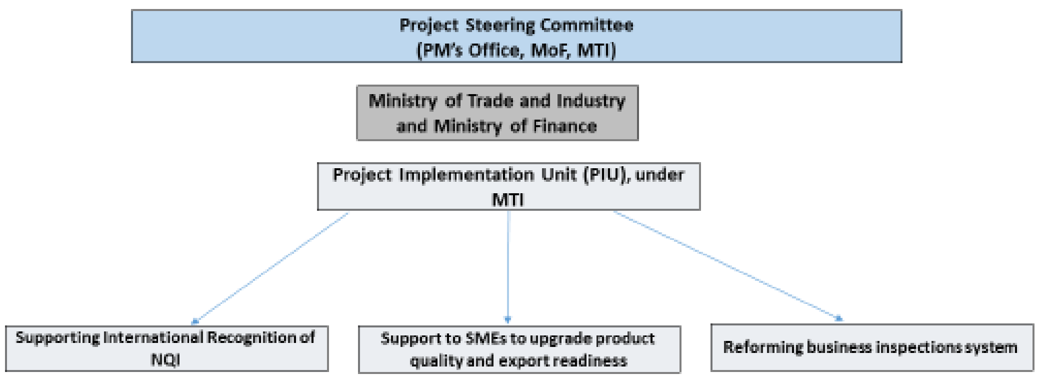
Component 2: Project implementation and coordination support (EUR 0.52M)

21. **This component will ensure effective implementation of all Project components.** This component will finance a Project Implementation Unit (PIU), which comprises of consultants to support project management and coordination activities, technical implementation, procurement, safeguards, financial management, and project monitoring and evaluation (M&E).

ANNEX 4: IMPLEMENTATION ARRANGEMENTS

1. **The MTI will implement the project over a five-year period.** Project Implementation Unit (PIU) would be established to ensure correct implementation of the Project. The PIU will be responsible for procurement, financial management, coordination, monitoring and evaluation, and reporting on the use of project funds. Policy oversight will be the responsibility of the Project Steering Committee (PSC), consisting of representatives from the Prime Minister's Office, the Ministry of Finance (MoF), and the MTI, who will provide policy guidance, and review and approve the annual work plan and budget (See Figure 3). Implementation support will be provided by the WBG throughout the project via periodic supervision missions and a detailed midterm review.

Figure 3. Implementation Arrangements



Institutional Arrangements

2. **Responsibility for adherence to all WB safeguards requirements regarding the final users of funds under the Project lies with the MTI.** Since project components are subject to safeguard policies, the capacity for management and supervision of environmental project elements of the MTI and the PIU will need to be enhanced, as MTI does not have experience implementing WB environmental safeguard policies and procedures. A person responsible for environmental issues will be identified at MTI and appropriate training on WB safeguard policies and procedures and other identified topics will be carried out by the project environmental specialist as needed.

Financial Management

3. **A financial management (FM) assessment was carried out to determine the FM implementation risk and to establish adequate FM arrangements for the proposed operation.** Bank policies and procedures on FM and disbursement require that the recipient and Project implementing entities maintain adequate FM systems—including accounting, financial reporting, staffing and internal controls, budgeting and planning, flow of funds, and auditing systems—to ensure that they can provide the Bank with accurate and timely information regarding Project resources and expenditures. The existing arrangements are considered adequate for Project implementation; however, there are areas that require further strengthening and need to be

addressed before Project implementation starts: i) the finance unit lacks experience with donor financed projects and knowledge of relevant requirements, and are currently working under capacity constraints - this will be addressed by providing support through recruitment of an additional FM specialist as well as continuous training to the FM staff (in the BFD) on Bank FM and disbursement procedures; (ii) documentation of financial management procedures, including internal controls, as part of the POM (a draft is already prepared); (iii) documentation of matching grant scheme guidelines and administration procedures (a draft is already prepared). FM risk is assessed as Substantial.

Use of the country systems

4. **The Project would rely extensively on elements of Kosovo's public FM systems, including (i) planning and budgeting, (ii) internal control, (iii) flow of funds and payments, and (iv) accounting and reporting.** Kosovo has participated in a number of detailed reviews of its public financial management (PFM), among them a series of central government PEFA assessments (2007, 2009, and 2015); a municipal PEFA (2011); a country fiduciary review (2012); annual EU-SIGMA reviews; and other analyses by the World Bank. The various reviews have plotted the significant progress Kosovo has made in improving PFM. The Country Fiduciary Assessment conducted in March 2012 showed that key strengths include the sound legal framework, the integrated central Treasury system, and an increasingly effective external audit office. The strengths are offset by limited professional capacities and gaps in implementation. There is considerable scope for improving budget planning and preparation, internal financial control, audits, debt management, and capital investment management. The authorities are aware of these limitations, and progress is occurring with support from international bodies. Lagging areas include (i) limited coordination of budgets, MTEF, sector plans, and budget ceilings; (ii) budget preparation that is not fully linked with Treasury systems; and (iii) FM control and audits that are not fully effective.

5. **MTEF and the Annual Budget Law are the two main documents presented for assembly review and approval.** Public FM in Kosovo is highly centralized in relation to budget policy and institutional control. The annual budget at the beginning of 2016 covered 16 ministries, 8 agencies, approximately 30 independent institutions, reserved powers, and 38 municipalities (although 3 municipalities only partially participate) - excluding resources and activities funded by Serbia.

6. **Budget execution is controlled by setting allocation limits, which are based on forecasts of available resources and the individual needs of the spending institution, with due regard for seasonality of revenues and expenditures.** The Treasury manages allocations through the year and controls budget execution and cash management based on the cash plan submitted by the budget organizations themselves. The Kosovo Financial Management Information System (KFMIS) is an important tool in executing the budget. In general, internal control procedures are well-understood. The Treasury is serviced through the Single Treasury Account (STA) with the Central Bank of Kosovo (CBK), through which all government revenues and expenditures are recorded. Reconciliations between CBK and Treasury records are performed on a daily basis. The financial information is entered into the KFMIS, which produces reports. Records and information are produced, maintained, and disseminated to fulfill decision-making

control, management, and reporting purposes as needed. Budget execution reports are organized by structure of the budget and present fund balance commitment on a monthly and quarterly basis for each category.

Implementing agencies and the financial management staff

7. **Project financial management will be the responsibility of the Division of Budget and Finance (DBF) in the MTI and its subordinate agencies.** At the time of the assessment, the ministry and the subordinated agencies in MTI were serviced by the MTI's DBF. The DBF will be responsible for Project planning and budgeting, commitment and payment request, verification of supporting evidence, and reporting. The division follows policies and procedures established by the Law on Public Financial Management (LPFM) and financial rules on public fund expenditure. The division is serving a large number of programs and subordinated agencies, and while the proposed operation will be implemented through MTI's budget, an additional FM specialist will be recruited as part of the PIU to support MTI's DBF on complying with additional requirements from the Bank. Such support will consist of preparation withdrawal applications, compiling planning and budgets, support for preparation of the interim financial report, support in Project audits, ex ante controls on payment documents, and post review, as applicable; correspondence with the Bank, advising on Project FM matters, and financial contract monitoring. Roles and responsibilities of the FM specialist and those of the finance and budget division are defined in the draft POM. The FM specialist recruitment process will be monitored by the Bank team. Recruitment of the FM support will be a Project Effectiveness Condition.

8. **Budgeting.** The mechanisms for budgeting and opening the budget (release of funds) are considered adequate for the needs of the proposed Project. The budget instructions issued by MF would guide the implementing ministry's budget planning and execution processes. These instructions provide nominal ceilings for the various budget categories at the planning stage and approved allocations for the budget execution stage. To facilitate reporting and planning activities, a unique Project code would be assigned, and all Project activities would be captured by this code. The approved procurement and implementation plan would be the basis for the draft of the forecast. Project budgets and forecasts would reflect inputs from the technical departments and agencies involved with the Project. These budgets would form the basis for allocating funds to Project activities and, after expenditures are paid, for requesting funds from the Bank.

9. **The ministry's budget would pre-finance Project expenditures for the respective activities, which will later be reimbursed from IDA credit proceeds based on quarterly financial reports documenting such expenditures.** Given characteristics of the pre-financing mechanism, the risk pertaining to insufficient or untimely budgetary appropriation and allocations is substantial. To address the above, a realistic Project budget and forecast should be included in the Medium Term Expenditure Framework (MTEF) and the Annual Budget Law, beginning in the year the Project is expected to become effective.

10. **Internal controls.** The MTI will maintain an effective internal control system to ensure that Project expenditures are properly verified and authorized, supporting documents are maintained, accounts are reconciled periodically, and Project assets, including cash, are safeguarded. General government regulations for processing transactions and approving contracts

exist; however, there are areas, such as subsidies and transfers proposed under the Project (matching grants), for which financial rules are not provided in detail in existing regulations. A Financial Management Manual (FMM), part of the draft POM, elaborates the FM, disbursement, and internal controls policies and procedures, and is intended to guide staff and minimize the risk of errors and omissions, as well as delays in recording and reporting. These written standards also clarify segregation of duties and responsibilities, including level of authority and clear control over funds and assets; and they ensure timely and accurate financial reporting. The adoption of POM would be a *project effectiveness condition*. A draft POM has been prepared and discussed with the Bank team during the project appraisal and negotiation. The MTI's DBF has no experience with implementation and financial requirements of the matching grants schemes, as prior similar schemes have been implemented outside the budget system. Previous similar schemes have been implemented by MTI/KIESA through IOM. A draft Grants Manual (GM) has been prepared, and will be further elaborated and finalized as a condition of disbursement of component 1.2. The GM describes financial management requirements of the matching grants, which are not provided in the existing PFM legislation and program manuals, and on establishing clarity on roles and responsibilities during implementation.

1. **Key internal controls and procedures that need to be in place with respect to matching grants mechanism should include *inter alia*:**
    a) clear description of eligibility criteria for beneficiaries;
    b) clear description of eligibility criteria for activities;
    c) procedures relating to evaluation and selection of grants, including determining and describing responsibilities for this process;
    d) procedures relating to the budget mechanisms and timely transfers of funds to beneficiaries;
    e) procedures and processes of monitoring of grants implementation, including reporting on the use of funds and technical progress and maintaining appropriate accounting records and supporting documentation;
    f) procurement process for the grants.

11. **Accounting system.** Project financial records (budget appropriations, allocations, commitments, and actual expenditure) would be maintained by the MTI in the KFMIS (free balance system) on a cash basis**.** The effective use of KFMIS would enable the generation of financial reports. The Project chart of accounts would be based on the KFMIS. Project funds would be accounted separately and identified by the unique Project code. However, the existing chart of accounts does not enable recording of Project expenditure by activity. KFMIS is able to generate Project reports by the nature of expenditure, institution, and program. The FM specialist would be required to maintain parallel contract monitoring financial data. The data would be cross-checked periodically to KFMIS generated statements.

12. **Financial reporting.** Based on Project financial information maintained by the implementing ministry, the Interim Unaudited Financial Reports (IFRs**)** would be prepared on a quarterly basis, containing at least the following: (i) statement of sources and uses of funds (with

expenditure classified by disbursement category), (ii) statements of sources and uses of funds (with expenditure classified by component), (iii) contract monitoring, and (iii) KFMIS budget execution reports. The IFRs would be submitted for Bank review within 45 days from the end of the quarter. Annual project financial statements would be prepared for project and will be based on IPSAS cash basis. The financial statements would cover the government's fiscal year, which coincides with the calendar year. The functional and reporting currency is Euro. The format and content of IFRs has been confirmed and will be part of the POM. Support will be provided by the FM specialist in preparation of IFRs.

13. **Audit.** The Project's financial statements, as described above, would be audited annually by independent auditors, under terms of reference acceptable to the Bank. The Project would be audited under the existing auditing arrangements in Kosovo, whereby the MoF contracts out an independent audit firm to audit all WB–financed projects. WB procurement procedures would be followed for the selection of the auditors. The annual audit scope would be extended to include a relevant sample of matching grants. The audits of the Project financial statements would be financed from Project resources. The audited financial statements shall be presented to the Bank no later than six months after the end of the fiscal year and would be made publicly available in a timely manner acceptable to the Bank.

Table 3. Financial Management Action Plan

Action	Completion date
Finalize and adopt POM	Project effectiveness condition
Finalize and adopt Grants Manual	Disbursement condition for the provision of the matching grants (EUR 2.34M) to the beneficiary firms under subcomponent 1.2
FM specialist hired (1 headcount)	Project effectiveness condition.
Provide training in FM and disbursements to finance staff in MTI	During project life.

Disbursements

14. **The Project would be financed entirely by an IDA credit.** The credit proceeds will be disbursed on the basis of the regular Investment Project Financing disbursement mechanism using traditional disbursement methods: reimbursement, direct payments, and special commitments. The GoK's preferred method of disbursement is reimbursement of funds prefinanced from the budget to finance Project expenditures. The other preferred methods are direct payments and special commitments to third parties (consultants, suppliers, and contractors).

15. **All payments would be made by the MTI from their own sources of funds, and no designated account would be needed.** The FM specialist would prepare all relevant documents

in support of applications for withdrawal. MTI and MoF authorized official would act as authorized signatures.

16. **Bank funds disbursed using the reimbursement method would be documented by a Statement of Expenditures, evidencing eligible expenditures in such form and substance as specified in the Disbursement Letter.** Upon receipt of each application for withdrawal from the credit account, the Bank shall, on behalf of the recipient, withdraw from the credit account and deposit into the single Treasury account an amount equal to the amount requested.

17. **For direct payments, the Bank would require copies of the original documents evidencing eligible expenditures in such form and substance as specified in the Disbursement Letter.** Records include such documents as invoices and receipts or a SOE summarizing eligible expenditures paid during a stated period. MTI is required to maintain original documents evidencing eligible expenditures, making them available for audit or inspection. These documents should be maintained for at least two years after receipt by IDA of the audit report and for a period required by local legislation.

Table 4. Expenditure Categories

Category	**Amount of the Credit Allocated** **(expressed in EUR M)**	**Percentage of Expenditures to be Financed** **(inclusive of Taxes]**
(1) Goods, works, non-consulting services, and consultants' services for the Project, except for the Matching Grants extended under component 1.2	[EUR 12M]	100%
(2) Matching Grants	[EUR 2.3M]	100%
TOTAL AMOUNT	[EUR 14.3M]	

18. **Procurement under the proposed Project will be carried out in accordance with the World Bank's Guidelines:** "Procurement of Goods, Works, and Non-Consulting Services Under IBRD Loans and IDA Credits & Grants by World Bank Borrowers" (January 2011, revised July 2014) and "Guidelines Selection and Employment of Consultants Under IBRD Loans and IDA Credits & Grants by World Bank Borrowers" (January 2011, revised July 2014), and the provisions stipulated in the Legal Agreement. The World Bank Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credit and Grants dated October 15, 2006 and revised on January 2011, would also apply.

19. **The various procurement actions under different expenditure categories are described in general below.** For each contract to be financed under the FA, the various procurement or consultant selection methods, the need for pre-qualification, estimated costs, prior review requirements, and time frame have been agreed between the Borrower and the Bank in the Procurement Plan (PP).

20. **Advertisement**s: A General Procurement Notice (GPN) is prepared and will be published in UNDB on-line. Specific Procurement Notices (SPN) will be published for all International Competitive Bidding (ICB) and National Competitive Bidding (NCB) procurement as well as for all consulting services contracts as required under the respective procurement and consultants' guidelines.

21. **Debarments**: The Recipient will respect debarment decisions by the Bank and will exclude debarred firms and individuals from the participation in the competition for Bank-financed contracts. Current listing of such firms and individuals is found at the following web site address: http://www.worldbank.org;/debarr

22. The procurement procedures and SBD to be used for each procurement method, as well as model contracts for works and goods procured is described in the Project Operational Manual.

Assessment of the Agency's capacity to implement procurement

23. **The Bank team carried out an assessment of MTI's procurement capacities in June 2016.** The assessment took into consideration the current capacity of the ministries, including a review of the organizational structure as well as the necessary interaction between MTI staff responsible for procurement as per their respective components. The assessment concluded that (i) MTI has demonstrated some knowledge of procurement concepts and practices in a previous project financed by WB but the former PIU is no longer in place and there is a limited legacy of that knowledge (ii) MTI should form a PIU to help with procurement activities throughout the project; (iii) the PIU must be staffed with a seasoned procurement consultant with possibly previous experience in WB guidelines (iv) and (v) a number of actions need to be taken by the MTI in order to address the upcoming procurement challenges, such as establishing of PIU, preparation and regular update of the Project Operational Manual and other related manuals and preparation of the Procurement and Implementation Plan.

24. **In view of the specific additional workload and to mitigate one of the main procurement risks,** the Bank recommended increase in procurement capacity as foreseen in the Procurement Plan through staffing of the PIU with a procurement expert who is experienced in the procurement of Works under Bank-financed projects.

Table 5: Summary Risk Assessment

ITEM	RISK	MITIGATION
1	(a) Potential risk of delays in the implementation of the project due to the complexity of procurement processes and decision-making that involves different government agencies. (b) Enactment of Regulation of Ministry of Finance No. 01/2016 "On borrowing funds management" may result in lack of interest from experienced procurement consultants.	Assignment of a dedicated procurement expert for the project; (b) Selection of a consultant experienced in procurement of works under Bank-financed projects; closer monitoring by the bank of the hiring process (c) Preparation of a POM that will include a procurement section detailing procurement arrangements, an independent complaint handling mechanism, and contract management; (d) Review of TORs to ensure selection of qualified consultants;(e) Fiduciary training to staff; Publication of procurement notices and contract award information as required by the Bank Procurement and Consultant Guidelines, including publication on the relevant agency's website.
2	Insufficient contract monitoring and contract management skills.	Complaints received regarding procurement and contract management process shall be recorded, sent to the Bank for information and addressed promptly and diligently; up-to-date procurement records shall be maintained.
3	The PIU might be initially overwhelmed with the number or size of contracts to procure.	Recruitment of a qualified procurement expert experienced in the Procurement of Works under Bank Guidelines. Early training and training by doing.
4	Feasibility and Design studies do not provide all data to permit early drafting of Design bidding documents, construction/rehabilitation documents	TORs to focus on design parameters for construction and rehabilitation works contracts; all TORs subject to the Bank's prior review.
5	Insufficient number of qualified and capable contractors (local).	Advertise contract opportunity widely and set realistic qualification criteria.
6	MTI could come under political and/or commercial pressure related to the outcome of bid evaluations and contract awards and are inclined to disregard provisions regarding	Bank team will follow early collaboration between Consultants and clients closely and will attempt to intervene to resolve or remove obstacles hindering implementation

	evaluation procedures or reluctant/slow to make decisions	
7	Bidding approach (many equipment and works contracts) require update of procurement knowledge on ICB/NCB under goods and works bidding documents on the part of procurement unit which has no such experience at present.	Intensive training by Bank staff to prepare MTI responsible staff. Detailed POM
9	Late or slow start of the Project due to MTI being preoccupied with many other matters or having new priorities	(a) TORs for critical assignments should be drafted and cleared by the Bank after Bank approval and related Request for Expressions of Interest published; (b) Proposed shortlists for these critical assignments and draft RFPs should be submitted to the Bank before project effectiveness; (c) Close monitoring of MTI by the Bank team. MTI's PIU to submit monthly/quarterly progress reports.

25. **The initial procurement risk has been rated high** due to both the increase in the number and size of contract to be procured, and the country and sector environment. Procurement risk is expected to stay high during the first two years. The complex country environment and the potential risk of interference in the procurement process are likely to remain valid concerns during the life of the project. The Bank will maintain close oversight via its staff in HQ and Pristina Office. Prior review of all major contracts in agreement with the thresholds given at the end of this Annex will be carried out by the Bank team.

26. **A Project Operational Manual (POM) has been prepared** by the MTI. It defines the steps, service standards, responsibilities and accountability of team staff and management for carrying out project activities. In addition, technical staff from MTI and KIESA could be appointed as members of the evaluation committee, depending on the expertise required for the procurement package to be reviewed.

27. **Procurement Plan (PP) was agreed during the Project negotiation**, and will be made available on the MTI website. It will be made available on the Bank's external website (without cost estimates). The PP will be updated by the PIU in agreement with the Project Team annually or as required, to reflect actual project implementation needs and improvements in institutional capacity.

28. **The PIU will use the Bank's new Procurement Planning and Tracking System (STEP)** which will help the Bank and the borrower to streamline the procurement processes. In this setting,

hands on training will be provided to the procurement consultant and other members of PIU as needed.

Frequency of Procurement Supervision

29. In addition to the prior review supervision to be carried out by the Bank team, the capacity assessment of the Implementing Agencies recommends supervision missions of procured activities every six months during first two year of implementation, and once every subsequent year.

30. **Post reviews** will be carried out regularly with a minimum sampling of one in ten.

31. **Procurement methods and thresholds**: The FA will define the methods available for various procurement actions. Thresholds for procurement methods and prior review requirements are indicated below on the basis of the Bank's assessment of the capacities of the agency responsible for procurement. The procurement plan specifies whether each procurement action will be subject to prior or post review. It has been agreed that if a particular invitation for bid (IFB) is comprised of several packages, lots or slices, and invited in the same invitation for bid, then the aggregate value of the whole package determines the applicable threshold amount for procurement and also for the review by the Bank.

Table 6. Expenditure Category

Category	Contract Value(US$)	Procurement Method	Bank Prior Review
Civil Works	>= 5,000,000	ICB	All >/=US$5 million contracts
	< 5,000,000	NCB	
	<200,000	Shopping	
	NA	DC	All
Goods	>= 1,000,000	ICB	All >/=US$500,000 contracts
	<1,000,000	NCB	First contract
	<100,000	Shopping	First contract
	NA	DC	US$50,000
Consultant Services	NA	QCBS, QBS, FBS, LCS and CQS*	**>/= US$ 200,000; all SSS** **>/=US$100,000 for IC**
	NA	SSS	
	NA	IC	
Notes:	ICB – International Competitive Bidding NCB – National Competitive Bidding		

DC – Direct Contracting QCBS – Quality and Cost Based Selection QBS – Quality Based Selection FBS – Fixed Budget Selection LCS – Least Cost Selection *CQS – Selection Based on Consultants' Qualification below $300,000 depending on the nature of assignment SSS – Single (or Sole) Source Selection IC – Individual Consultant selection procedure NA – Not Applicable

32. **The prior review thresholds will be periodically reviewed and revised as needed during the Project implementation** based on implementation of risk mitigation measures, reports from procurement post-reviews, and improved capacity of the implementing agency.

33. **The procurement planning under the grants scheme will be governed by the provisions of the POM.** The procurement chapter of the POM will cover all procurement aspects such as procurement implementation arrangements; procurement planning and reporting; procurement methods and thresholds; responsibilities of procurement staff and evaluation committees; and procurement process, including contract monitoring, procurement control procedures, and complaints-handling procedures.

34. **Procurement under the project will include the following categories: goods, non-consulting services and consulting services.** Goods will include equipment for laboratories, machinery, IT hardware and software, office equipment, and the like. Consultant services will include technical assistance to support the design and implementation of project activities. The threshold for procurement methods and Bank prior review applied for procurement are mentioned in the Procurement Plan. The procurement thresholds may be adjusted during the project implementation to reflect the increased capacity of the implementing agencies.

35. **Record keeping and filing.** The PIU will keep procurement documentation safe and filed at their premises for each contract funded under the project

Social (including Safeguards)

36. **The Project is gender-informed.** Gender inequality in Kosovo is among the highest in the region. According to the Kosovo 2014 Labor Force Survey, only 21.4 percent of women participated in the labor market, compared to 61.8 percent of men. Female labor force participation in neighboring countries is on average 44.0 percent. At the same time, unemployment in Kosovo is higher among young women (71.7 percent) than among young men (56.2 percent). Women's employment is concentrated in areas such as education and health, predominantly in the public sector. Women in Kosovo continue to face considerable challenges to entrepreneurship participation due to lack of access to finance (exacerbated by low property ownership), unfair competition, and informality. The share of female entrepreneurs in Kosovo is 11 percent, about

one-third of the regional average. Efforts to increase women's labor force participation and employment, as well as entrepreneurship, need to come increasingly through the private sector.

37. **The Project will seek to narrow the gender gap in private sector entrepreneurship** by encouraging female-headed enterprises to apply for support under the matching grant scheme (subcomponent 1.2). The gender distribution of Project SME support will be monitored throughout Project implementation to allow for informed targeting of interventions and gender-disaggregated evaluation of SME scheme benefits. Furthermore, the Project's beneficiary feedback mechanisms will be gender-informed.

38. **Citizen engagement:** Design of the Project included consultations with multiple stakeholder groups, including relevant state agencies and business and professional associations. During implementation, beneficiary feedback will be an integral part of the design of subcomponent 1.2: Support for SME development; subcomponent and 1.3: Reform of business inspections services. The SME support scheme will include a feedback/grievance mechanism to allow applicants to inquire about the selection procedure (that is, criteria, timeline) and to submit comments and complaints. The efficiency of the mechanism to respond to submitted comments/grievances will be monitored (see results framework). Improvements in business inspection services will be evaluated by means of a user survey at the beginning and at the end of the Project. The survey will be targeted at staff in relevant inspection bodies and will seek to evaluate the impact of Project interventions on simplicity and effectiveness of inspection procedures. The results of the survey and will be shared with relevant stakeholders, such as the Ministry of Trade, Chamber of Commerce, Business Associations, to inform about the impacts of the inspection simplification process.

Environment (including Safeguards)

39. **Responsibility for adherence to all safeguards requirements defined in the Grant Manual regarding the final users of funds under the subcomponent 1.2 lies under the MTI.** MTI will prepare environmental regulation compliance and good practices guidelines that includes a questionnaire as an addendum to the Grant Manual (GM) which will also be used as a part of the Application package. Based on the information provided by applicants, MIT will evaluate their compliance with national regulation, impact of activities as well as evaluate any additional good practices (EMS systems or BAT conformation). The GM is a subject of Environmental and Social Safeguards Specialists' approval.

World Bank Grievance Redress

40. **Communities and individuals who believe that they are adversely affected by a World Bank (WB)** supported project may submit complaints to the Project-level grievance redress mechanisms or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address project-related concerns. Project affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's

corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

ANNEX 5: IMPLEMENTATION SUPPORT

1. **The innovative approach of the operation**, the engagement with multiple stakeholders, and significant technical assistance will require intensive implementation support throughout the project's lifespan and be particularly high in the initial stages of the project. This will include periodic supervision missions and a detailed midterm review. The midterm review will, among other things, analyze progress toward achieving all of the results indicators and determine where adjustments are needed. The composition of the Bank's implementation support team will require a mix of local and international technical experts. This blend of staffing will ensure an appropriate balance between local knowledge and responsiveness and global expertise. The proposed team composition and expected time allocation are described in Table 7. The implementation supports proposed focuses on implementing the risk mitigation identified in the risk section, specifically:

- **Complexity**: Experts in different domains will be mobilized to provide advice and share best practices in activities related to component 1: NQI, inspections, and matching grants.
- **Coordination**: The core team will closely monitor project implementation to promote coordination and detect possible lack of communication and delays in implementation. Moreover, the team will strive to maximize the benefits of the Bank's involvement in other sectors and periodically convene with stakeholders related to work in these other sectors.
- **Financial management**: During implementation support, the Bank's financial management specialist will support the PIU, and routinely review the project's financial management capacity, including but not limited to accounting, reporting, and internal controls.
- **Procurement**: The Bank's procurement specialist will work closely with the PIU to build capacity and support them in the periodic procurement activities.

Implementation Support Plan

2. **Key Bank team members** involved in implementation support will be based in Washington, DC and in the Kosovo Country Office to ensure effective implementation support. The core team is expected to conduct four formal implementation support missions during the first year of implementation, including field visits. After the first year, the frequency of the implementation support missions is expected to be reduced to two to three missions a year, and maintained throughout the project. Detailed inputs from the Bank team are outlined in Table 7.

- **Technical inputs.** (i) Technical experts to support the elaboration of TORs (consultant and non-consultant services); (ii) field visits to follow the operational enhancements; (iii) technical assistance to activities in component 1 (for example, review of the legislative reforms for NQI and inspection reforms, support capacity of NQI institutions and KIESA); and (iv) the organization of workshops to share best practices and support the evaluation agenda.
- **Fiduciary requirements**. The Bank team identified capacity-building needs to strengthen financial management capacity and improve procurement management in the context of World Bank operations. Support will be provided from the Bank office in Pristina. Formal implementation support of financial management reports and procurement will be carried out semiannually, while prior and post review will be carried out for contracts specified in the Procurement Plan (PP) as required.

- **Safeguards.** The WB team will closely monitor adherence to safeguards requirements.

3. **The project will require the following implementation support in the first year**. The Implementation Support Plan will be revised after the first year of implementation:

Table 7. Required Project Supervision

Skills Needed	***Number of Staff Weeks***	***Number of Trips***	***Comments***
Economist (co-TTL)	10	4	TTL oversees entire operation and supervises technical and fiduciary aspects.
Private Sector Specialist (co-TTL)	16	0	TTL oversees entire operation and supervises technical and fiduciary aspects.
Senior Private Sector Specialist	10	4	Senior expert will provide guidance for the implementation of NQI reforms.
Private Sector Specialist	10	0	Expert will provide overall support in Kosovo to the implementation of the inspection reforms and matching grants.
Procurement Specialist	5	0	Procurement specialist will support the PIU on related issues.
Financial Management Specialist	3	0	FM specialist will support the PIU on related issues.

4. **The team has designed a complementary TA Project to supplement the Project though the WBG executed advisory services.** During implementation of the operation, the team will continue exploring possibilities for synergies with other donors by arranging the supplementary financing that can provide additional advisory services to facilitate the implementation on selected areas of this operation. In addition, the team will leverage the ongoing WBG advisory services, namely Regional Project on Investment Climate and Agribusiness Competitiveness, and Regional Tax Simplification Project.

5. **Implementation support will be provided by the Bank throughout the project's lifespan**. This will include periodic supervision missions and a detailed midterm review roughly 1.5 years after project effectiveness. The midterm review will analyze progress toward achieving all of the results indicators, and determine where adjustments are needed. The project is expected to have one co-TTL based in headquarters and the other co-TTL based in the Pristina office. It will also have a mix of local and international technical experts assigned to the components, to ensure a balance between local knowledge and responsiveness and global expertise.

ANNEX 6: RECENT ECONOMIC DEVELOPMENTS

1. **Kosovo's real GDP grew by an estimated 3.6 percent in 2016, driven by consumption and investment-driven recovery in domestic demand[23].** Despite the ongoing political crisis caused by the agreement between Kosovo and Serbia from Brussels on August 25th on establishment of Association/Community of Serbian-dominated municipalities, and agreement on border demarcation with Montenegro, both strongly opposed by opposition in Kosovo, the economy grew at a solid 3.6 percent in 2016, with positive contributions from consumption (4.5 percentage points) and investment-driven recovery in domestic demand (2.2 percentage points). Net exports, however, subtracted 3.1 percentage points from growth – the better performance of travel services exports could not match that of imports as domestic demand for consumption and investment goods increased. Consumption growth was mainly through private consumption, driven by remittances and an increase in public wages and pensions, whereas the public sector contributed negatively to growth. Investments were fueled by public investments in the highway to Macedonia, a 20 percent growth in investment lending, and by growing FDI inflows, especially in the second and third quarter as reflection of political stability at the time.

2. **Deflation averaging 0.5 percent in 2015 helped the poor, although poverty rates remain the highest in the region.** Decline in fuel and food prices had a major impact, resulting in domestic deflation. Lower education costs also contributed, resulting from an earlier government policy that included lower accommodation prices for students. Deflation is expected to help the poor, even though food price declines were most pronounced later on in the year. Economic growth in the past years has been largely inclusive, averaging 3.9 percent a year for the bottom 40 percent of the population compared to 2.4 percent for the top 60 percent. Nevertheless, as of 2011 about 30 percent of Kosovars still lived below the national poverty line of EUR 1.72 a day, and about 12 percent were living in extreme poverty, on less than EUR 1.20 per day.

3. **The current account deficit widened from 10.4 percent of GDP in 2015 to 11.5 percent in 2016** due to an increase in the trade deficit by 3.2 percent y-o-y, though it remained flat as a share of GDP. Driven by domestic demand, imports grew by 6.7 percent y-o-y. On the other hand, exports of goods fell by 4.6 percent y-o-y as a result of lower prices of base metals.

4. **Declining FDI inflows weighed down the financial account balance in 2016**. Net FDI fell by 34.4 percent y-o-y at the end of November because FDI inflows declined by 29.2 percent (likely signaling the start of saturation in diaspora demand for real estate and financial intermediation services), and outflows of equity investment and fund shares went up 25.7 percent. Real estate, rentals, and business activities continued to attract the most FDI in 2016. FDI related to the Brezovica Ski resort did not materialize in 2016, lowering projected growth.

5. **The financial sector performed well in 2016 and was liquid, sound and profitable.** Loans grew by 10.4 percent y-o-y with loans to households growing faster (14.7 percent) than loans to businesses (8.3 percent). Loan to deposit ratio was 77 percent. Non-Performing Loans (NPLs) declined to 4.9 percent by end-year, continuing last year's trend. Although deposit rates have declined to 1 percent, deposits have grown by 7.2 percent.

[23] World Bank Group, Western Balkans Regular Economic Report No.11, Spring 2017.

Outlook

6. Economic growth in Kosovo is projected to reach 3.9 percent in 2017, with investment as its main driver, followed by consumption. Investments are expected to be the main drivers of growth, contributing 2.7 pp. Consumption is expected to contribute 2.3 pp, fueled by higher disposable incomes. Net exports are projected to subtract about 1.1 pp from growth, however, because of fast growth in imports driven by investment and consumption, and weak exports of goods due to a small export base. Investment growth will cause the CAD to widen slightly in 2017–18. The recent launch of the SAA with the EU is expected to act as an incentive to boost FDI in the medium term. The recent amendment to the fiscal rule stating that certain types of IFI would not be counted for deficit target purposes, opened up room for investment in strategic sectors and is expected to increase public investment. Kosovo's positive economic outlook is, however, subject to risks. Among the main downside risks is the sensitive political situation in the North and the demarcation dispute with Montenegro. Should these risks intensify, they would disrupt Kosovo's economic agenda. On the upside, better absorption capacity of the public investment projects could lead to slightly higher growth, especially in 2017, but lower growth in 2018 due to a higher base. The positive economic forecasts depend on growing FDI inflows. To counterbalance these risks, reform priorities should be to shift the sources of growth toward tradable sectors, increase domestic productivity, engage and employ youth, address corruption, improve environmental sustainability, and address the constraints in the energy sector.

ANNEX 7: EXPORT, BUSINESS ENVIRONMENT, AND SME GROWTH

Exports and Access to Markets

1. **With its small domestic market (1.8 million population), increased exports will be essential for Kosovo's economic growth and employment.** With its very narrow production base that reflects the low level of domestic productivity, Kosovo will need to rebalance its growth model to one that places greater reliance on increased productivity at home and improved competitiveness abroad to achieve higher and sustainable growth through more exports, diversification of exported goods and destinations, and increase in value addition in exports.

2. **However, Kosovo's firms are not taking full advantage of the large EU export market on their doorstep, particularly in areas other than raw materials.** Export markets are not diversified, with the top five export destinations accounting for 53.1 percent of Kosovo's exports of merchandise in 2015 (top 5 export destinations in 2015 India 14.5 percent, Albania 12.4 percent, FYR Macedonia 10.3 percent, Serbia 9.9 percent and Italy 6.0 percent)). Product concentration is also high, with only one product, ferro-nickel, accounting for almost 50 percent of total exports.

Table 8. Kosovo's Revealed Comparative Advantage (2004–13)

Type	Exports 04/05	Share 04/05 (percent)	RCA 04/05	Exports 12/13	Share 12/13 (percent)	RCA 12/13	CAGR
01-05 Animal				286,671	0.1	0.08	
06-15 Vegetable	2,066,223	16.3	6.2	4,288,187	2.2	0.69	10
16-24 Foodstuffs	1,187,525	9.4	3.29	7,853,506	4.0	1.27	27
25-27 Minerals	2,378	0.0	0	14,672,860	7.4	0.35	198
28-38 Chemicals	182,529	1.4	0.16	1,013,434	0.5	0.05	24
39-40 Plastic / Rubber	316,692	2.5	0.58	8,761,371	4.4	1.01	51
41-43 Hides, Skins	841,850	6.6	9.47	10,244,176	5.2	8.65	37
44-49 Wood	106,434	0.8	0.26	2,384,848	1.2	0.53	48
50-63 Textiles, Clothing	106,555	0.8	0.17	15,505,625	7.9	2.02	86

64-67 Footwear	264,767	2.1	2.51	408,992	0.2	0.26	6
68-71 Stone / Glass	72,867	0.6	0.19	10,270,141	5.2	1.48	86
72-83 Metals	3,144,575	24.8	3.3	100,737,540	51.0	7.35	54
84-85 Mach/Elec	3,886,224	30.6	1.09	13,610,007	6.9	0.29	17
86-89 Transportation	294,656	2.3	0.22	3,819,403	1.9	0.21	38
90-97 Miscellaneous	206,300	1.6	0.27	3,236,025	1.6	0.29	41
98-99 Special				250,122	0.1		

Source: Authors' calculations based on UN Comtrade. Systematic Country Diagnostic 2016.

3. **Manufacturing has the potential to generate income and exports if it can reach export-orientation similar to ECA averages.** Kosovo shows clear comparative advantages in metals, hides and skins, textiles, and moderate comparative advantage in foodstuffs. Meanwhile, Kosovo is losing its comparative advantage in vegetables, footwear, and machinery and equipment. Less than 40 percent of export activities that are initiated in a given year remain active beyond the first year, and only 14 percent remain active beyond the fifth year. Foodstuffs, metals, minerals, and stone- and glass-related export flows show higher chances of survival, while machinery and equipment, and textiles show substantially lower chances of remaining active past the first year. A number of factors related to soft and physical infrastructure are impeding export growth and dynamism. The manufacturing subsectors that are most engaged in exporting are furniture, food, and garments. For example, 63 percent of furniture manufacturers in Kosovo export. Garments are also targeted to external markets, albeit to a lesser degree: 40 percent of garment producers export, and their exports account for 50 percent of total sales. Among furniture producers, by contrast, while 62 percent export, only 15 percent of their sales are from exports; the remaining 85 percent are destined for domestic consumers.

4. **In the manufacturing sector, exporting firms are larger than non-exporters and employ more of both skilled and unskilled workers.** The proportion of skilled workers is markedly lower in Kosovo compared to the ECA average, but has increased significantly since 2009. Using wage levels as a proxy for comparing job quality, exporters on average pay higher wages than non-exporters (exceptions are furniture and other manufacturing). Kosovo's median manufacturing wages tend to be higher than ECA averages, although this comparison likely masks important interindustry differences. Skilled manufacturing workers tend to be concentrated in the garment, nonmetallic mineral, and food processing subsectors; but, whereas garment manufacturing has a high skill ratio equal to 2.6, food and nonmetallic mineral producers employ

relatively more unskilled workers (with skill ratios averaging 0.6 and 0.7, respectively, which are lower than ECA averages).

Table 9. Size of Exporting vs. Non-exporting Manufacturing Firms (Number of Full-Time Employees)

Year	Exporting status	Kosovo			ECA		
		Employees	Skilled employees	Unskilled employees	Employees	Skilled employee	Unskilled employees
2009	Non-exporter	19	6	13	48	26	25
	exporter	35	10	28	244	92	77
2013	Non-exporter	30	14	17	33	23	15
	exporter	50	25	25	110	63	44

Source: Data from World Bank enterprise surveys for 2009 and 2013. Systematic Country Diagnostic 2016.

5. **The services sector in Kosovo is also a major source of exports and has outperformed most regional peer countries.** Total services exports in Kosovo in 2014 represented 70 percent of total exports above all peer countries, with Albania and Croatia as the nearest comparators, with services exports at slightly over 60 and 50 percent of exports, respectively. Services exports continued to grow by 11 percent (same as merchandise exports) in 2015 and represent an important source of export diversification for Kosovo. Exports of travel services as well as communications, computers, and other services has driven Kosovo's commercial services export performance. In 2011, export growth reached a level more than 3.5 times that of 2005, before declining in 2012. Travel services contributed significantly to this growth, while communications, computers, and other services were responsible for the decline in 2012. Communication, computers, and other services also achieved strong growth, more than quintupling their value since 2005 (from US$38 million to US$203 million).

6. **Exports are significantly hampered by lack of adequate national quality infrastructure (NQI).** In Kosovo, quality infrastructure institutions are understaffed, lack financial resources, and have difficulty obtaining international recognition. In the absence of benchmarks, firms do not have standards that they aspire to reach to improve their competitiveness. Also, export markets do not have confidence in Kosovar goods as they lack adequate certification and do not meet required standards. Quality infrastructure is not only needed to increase the value generated by increased exports - it is also needed to protect the Kosovar market against the influx of low-quality products. Improving quality infrastructure will help Kosovo to prepare for EU accession and to be compliant with WTO rules. Additionally, this will help encourage local companies to produce goods that may substitute for imports.

7. **Kosovo's unresolved political status raises specific challenges for trade**. As a small and landlocked economy, connectivity plays a critical role for the economy's successful integration into regional and global markets. However, Kosovo ranks 118th for trading across borders according to the 2015 Doing Business report - one of the poorest performances in Europe. This is

due to a number of factors. While Kosovo is part of the Central European Free Trade Agreement (CEFTA) together with seven other countries from Southeastern Europe, and although the government of Kosovo implements the agreement, some CEFTA member countries still do not recognize Kosovo's institutions. Also, fewer than the required two-thirds majority of UN member states represented in the General Assembly have accepted Kosovo's statehood. Specifically, by the end of 2014, Kosovo has been recognized by 108 UN members, including 23 of the 28 EU member states. In addition, despite its proximity to important markets, Kosovo can be marginalized due to the lack of direct access to the sea and dependency on transit through other countries. Being landlocked also makes it costly to access markets to compensate for its small domestic market—a situation that increases the cost of intermediated inputs and imports.

Business Environment and SME Growth

8. Scaling up existing firms, rather than establishing new ones, is key to increasing the number of jobs in the private sector. In the past 18 months (June 2012 to December 2014), 24,178 firms have been created—the equivalent to 20 percent of the total employment number. Meanwhile, those created firms keep their size small and do not scale up their businesses even when it is profitable. More than 98 percent of businesses are family-owned or micro, small, and medium-size enterprises (MSMEs).[24] Therefore, efforts focusing on firm survival and growth should be prioritized for job creation.

9. There is strong evidence of loss of competitiveness from the perspective of unit labor costs. While private sector wages have increased moderately in real terms, their increase was substantial once scaled with a measure of productivity. This is even more apparent when public wages, which increased almost threefold since 2003, are brought into the picture. Decline in manufacturing labor productivity drove an overall decrease between 2010 and 2012. Labor productivity decreased by 6 percent between 2010 and 2012 for all firms in the sample of the Business Environment and Enterprise Survey (BEEPS).[25]

10. The overall decline in labor productivity was driven by the manufacturing sector, which saw average labor productivity decline by 12 percent during 2010 to 2012. In contrast, productivity in the retail sector increased by 7 percent. The overall decline in labor productivity is reflected in firms with varying characteristics. Both old and young firms (in existence for fewer than seven years) faced productivity declines during 2010 to 2012; small and medium-size firms both faced productivity declines; sole proprietors and publicly traded firms both faced productivity declines; and all but two regions (Ferizaj and Gjilani) faced productivity declines. Moreover, exporting firms saw a decline in labor productivity of approximately 8 percent over 2010 to 2012,

[24]. UNDP

[25]. The dataset analyzed is a two-wave panel, with firm data from 2010 and 2012. The set contains a total of 202 firms in the 2012 survey and 262 in the 2009 survey. Ten of these were identified as having unreliable responses for some questions in the survey, and were therefore removed from the sample for much of the analysis presented. In terms of economic sectors, the sample includes 69 manufacturing firms, 31 retail firms, and 26 wholesale firm, 50 firms producing other services, and 12 construction firms (4 firms are not categorized by sector). Of the analyzed firms, 30 export while 162 produce nontraded goods and/or services. It is estimated that they are good representatives derived from the stratified sampling (three layers: firm size, sector, and region). On the other hand, however, they are just 0.5 percent of the total population in the economy, judging from the information from Kosovo's Structural Business Statistics. The data are available from: http://www.enterprisesurveys.org/.

compared to a decline of 6 percent for non-exporters, suggesting a more challenging environment for exporters than for non-exporters (especially those producing no tradable (see the table 1.1. in the main PAD).

11. **There is limited evidence suggesting an employment shift in higher productivity sectors.** The annual Household Budget Surveys show that, from 2010 to 2013, those in the bottom 40 percent have tended to move out of agriculture and into construction, trade, and manufacturing. The shift out of agriculture and into construction is most dramatic in the poorest quintile, where agriculture's share of employment dropped from 35 to 20 percent, and construction's share increased from 27 to 34 percent. Smaller but still significant increases for workers in the bottom 40 percent are observed in manufacturing (8 to 11 percent) and trade (13 to 19 percent).

12. **During project preparation, the team interviewed a number of firms in different sectors, which are potentially profitable but do not scale up their businesses.** Their constraints, as mentioned above, are summarized as (i) small domestic market, which discourages firms from scaling up their businesses; (ii) low export opportunities; (ii) lack of know-how and finance to upgrade quality and enter into exporting; (iii) weak business environment; and (iv) lack of high-quality labor.

13. **The main impediments to business expansion in Kosovo are lack of access to markets and to know-how.** To access European markets, companies must often design and produce new products and ensure the quality of the ones they produce. SMEs in Kosovo face challenges both in developing new products as well as in certifying products they already produce. Secondly, lack of experience in marketing and sales makes it difficult for Kosovo's companies to find contracts in European markets. Finally, to be able to produce larger quantities when they can get larger export contracts, SMEs need finance to expand, and they find it difficult and expensive to borrow.

14. **Efforts are necessary to increase integration of Kosovo's private sector into the global value chains** by taking a holistic approach to trade and investment policy and anchoring supportive policies in a strategic framework. Administrative barriers make it unnecessarily difficult for Kosovo's firms to take advantage of its proximity to the EU. Kosovo's firms face export costs that are higher than in other Southeastern European countries as well as the second-highest import costs in the region. Kosovo's business environment is unlikely to motivate significant investment unless a number of policies are in place to address constraints and reduce costs.

15. **SMEs find it difficult to develop new products and to certify the quality of products they already produce.** New product development is essential, especially to capture export markets. There are insufficient designers and production engineers in Kosovo. Most companies do not have dedicated product research and development functions. In the food processing sector, fragmented land ownership limits the ability of processors and aggregators to deliver sufficient quantities of primary agricultural products at uniform quality standards. Inputs vary greatly in quality, and suppliers to processors and aggregators are not adequately monitored. Further international food safety and quality certifications are needed. In the wood processing sector many companies have certified quality assurance systems (such as ISO 9001), but lack important sector-specific standards such as the chain of custody certification from certified and sustainably managed forests.

16. SMEs in all sectors cite issues with marketing and sales as a hindrance to access to export markets. Most companies do not have dedicated sales management and lack knowledge of export markets and of how to promote their products. Export promotion is usually done through fairs, and these costs are challenging for companies. Companies also lack sustainable connections to export buyers and wholesale and retail chains in the EU, resulting not only in lack of sales opportunities, but also limited knowledge of product demand trends. Even in the internal market, local companies find it difficult to compete with imports. Poor design and quality of packaging is cited as a negative in competing with imports, even if domestic product quality is equal or superior.

17. Domestic companies face difficulties in competing successfully in local and international markets. According to a recent survey by the Kosovo SME Promotion Program, only about 5 percent of SMEs in Kosovo are currently exporting. Policies to encourage and support growth of micro enterprises and exporting firms should be prioritized. These firms could be supported to improve the quality of their products and services and tap into regional value chains. Moreover, most of the growth in the SME sector happens in the micro enterprise (businesses with fewer than nine employees), which are the most vulnerable, have the most difficulties with access to finance, and benefited the least from support schemes by the government or donors.

18. Low competitiveness has led to a very weak private sector and poor economic vitality of SMEs. An unfavorable business environment and the low level of competitiveness have constrained private sector activities and impeded reductions in the high level of unemployment, poverty, and income insecurity. To date, the productive base in Kosovo's economy has remained narrow and undiversified, with large agriculture (16 percent) and service (56 percent), limited manufacturing (12 percent), and very small tradable sectors; more than 98 percent of businesses are family-owned micro, small, and medium enterprises (MSMEs). The challenges are reinforced by an unfavorable business environment, weak governance, a deficit in quality infrastructure, and poor access to finance by firms—especially SMEs—all of which stifle their growth prospects.

19. Informality is a significant problem in Kosovo, with approximately one-third of workers engaged in informal employment. Analysis of firm-level data reveals that the percentage of firms that are severely affected by competition from informal firms is one of highest in the world. Furthermore, a comparison with other countries in the region reveals that this level is the highest in the region. Typically, these are workers in small firms, unpaid family workers, and self-employed people in either small firms or nonprofessional occupations. By this definition, about 35 percent of workers are in the informal sector in Kosovo. Again, by the same definition, more than half of workers in the formal sector in Kosovo are public sector employees, and more than 40 percent work for large firms. On the other hand, informal workers are more likely to be young, male, with little education, and from rural areas.

20. Due to lack of coordination and legal overlaps, businesses in Kosovo are overburdened with multiple state inspections and market surveillance. The current system in Kosovo is not transparent, lacks a risk-based approach, is prone to corruption, and poses significant burden to business. The system itself is not efficient in performing its main duty to protect public health and safety (excluding financial/tax/customs inspections that collect government revenues), and needs to be reformed. Similar problems exist in the area of market surveillance, during which technical inspections are used for production and services provided. Instead of improving the product or protecting consumers, these technical inspections harm production by increasing costs and slowing it down. In addition to multiple uncoordinated and overlapping technical inspections, inspections without appropriate testing and analysis infrastructure are meaningless and give rise to corrupt practices.

21. **The legal framework for inspection lacks a clear definition of competencies of the inspection bodies' mandates as well as the resources to allow these bodies to enforce the relevant laws and bylaws.** An analysis done by the WB Business Environment Technical Assistance Project in 2013 found approximately 40 inspectorates at the central level in Kosovo and 4 to 5 at the local level. These inspectorates are regulated by approximately 80 to 90 different laws and many more sublegal bylaws. Most laws have no or few details on the responsibilities and rights of inspectors and businesses subject to inspection. Overall, this makes the recourse or appeal process unclear and uncertain. In most cases, inspectorates do not know the extent of their budget; sometimes this is because they function as part of ministries. Even in cases when inspectorate bodies are organized as separate agencies, budgets are small and mostly dedicated to inspectors' salaries (approximately 70 percent of the budgets); a few operational activities; and overhead expenditures like electricity, paper, and gas. Overall, inspectorates lack scientific infrastructure like laboratories and research centers. No study has been done on the extent of the resources that are used, what resources would be needed to fulfill inspectorates' obligations, or how the resources available could be used more efficiently.

SMEs' Specific Constraints in Selected Sectors

22. **SME constraints and challenges inhibiting growth are found mostly in the area of access to markets due to lack of information and contacts in this area, product quality and certification, workforce skills, and lack of access to finance.** The WB team has interviewed firms in representative sectors. Other donors, such as USAID with Empower Private Sector Project, also conducted a thorough analysis on the constraints, challenges, and needs of SMEs in Kosovo in five main sectors. The results are summarized below.

23. **Wood Processing.** The total sector size is 600 to 1,500 companies. The major challenges and needs of SMEs in this sector are as follows:

- *Marketing and sales:* Promotion is limited. Most companies do not have dedicated sales management. They lack knowledge of export markets and of how to promote their product to them, and lack sustainable connections to export buyers. Some firms complained that the agents that they do have access to (for both domestic and export markets) are ineffective.
- *Product development:* New product development is an essential in this industry. There is a lack of designers and production engineers. Most companies do not have dedicated product research and development functions.
- *Product certification:* Many companies have certified quality assurance systems (such as ISO 9001), but not important sector-specific standards such as chain of custody certification from certified sustainably managed forests. Lack of EN and CE Mark certifications was also noted.

- *Workforce skills:* Companies express difficulties in finding workers who are ready-to-go upon graduation from VET schools. They have specific ongoing needs for higher-level skills such as CNC machine operators, design and graphics experts, and marketing and sales professionals. Companies feel disconnected from the VET system. Kosovar youth are unaware of good employment opportunities in their industry, and are not encouraged by their families to enter VET schools and vocational training centers.
- *Finance:* They lack access to working capital finance. Long-term equipment finance is limited and expensive. Export finance per se is limited.

24. Apparel and Leather. The sector size is about 180 companies. The major challenges and needs of SMEs in this sector are as follows:

- *Marketing and sales:* Promotion is typically through fashion shows, word of mouth, personal contacts, sometimes the internet, and occasional trade shows. Promotion costs are challenging to most companies. Most companies do not have dedicated sales management.
- *Product line expansion/skilled designers:* Lack of good designers to constantly renew the product line—as is essential in apparel and leather—and to expand it.
- *Finance:* Lack of working capital finance, and limited equipment finance. Difficulty in approaching banks. Lack of significant expansion/growth capital.

25. Food processing. The sector size is about 800 companies. The major challenges for business expansion of SMEs in this sector are as follows:

- *Marketing and sales:* Limited contacts/access to big wholesale and retail food chains in the EU, resulting not only in lack of sales opportunities but also limited knowledge of product demand trends. There is also lack of knowledge about how to connect and promote products to these buyers. Prior development assistance efforts for joint promotion in exporting are criticized as lacking long-term strategy. Poor design and quality of packaging is also cited as a negative in competing with imports, even if domestic product quality is equal or superior.
- *Product development, quantity, and quality:* Fragmented land ownership limits the ability of processors and aggregators to deliver sufficient quantities of primary agricultural products at uniform quality standards. Primary products vary greatly in quality, and suppliers to processors and aggregators are not adequately monitored. Contractual relationships between processors and out growers are underdeveloped. Investment in new product development is limited. Further international food safety and quality certifications are needed.
- *Advanced skills:* Processors cited inadequate collaboration mechanisms with agriculture/ technical schools, and a lack of expertise required for higher-quality, higher-value production.
- *Finance:* Lack of working capital finance; lack of risk/growth capital required to expand operations significantly as required to finance out growers and additional processing equipment to aggregate and deliver larger quantities.

26. **ICT.** The sector size is 100 to 200 companies. The major challenges and needs of SMEs in this sector are as follows:

- *Workforce:* Inadequate numbers (and high turnover) of well-trained programmers or even graduates with basic IT skills, preventing the pursuit of larger outsourcing contracts. Cooperation between universities and VET institutions to supply these skills is underdeveloped.
- *Finance:* Lack of proactive product development and R&D. This is primarily due to the lack of risk/growth capital or the up-front investment that such research and development and testing of new products and applications entails.
- *Marketing and sales:* Companies lack dedicated marketing resources and need more connections to buyers in Western markets, both direct and through agents.

27. **Tourism.** The size of this sector is difficult to measure. The major challenges and needs of SMEs in this sector are as follows:

- *Tourism development policy*: More than most other sectors, tourism needs overall policy and budgetary support, because national-level promotion substantially benefits everyone in the sector but is beyond the resources of any given company. Participants are highly critical of the lack of such support by Kosovo's government. There is no national tourism organization (NTO) that would design and manage a basic country marketing campaign. Tourism law is still not finalized; there is no active national-level marketing, and a lot of basic tourism infrastructure is inadequate—roads, signs, tourism site services, maps, litter management, pollution control, national park definition, and designation and protection of national historical and religious monuments.
- *Workforce:* Tourism lacks professional workforce training. There is no education or training institution specifically devoted to the hospitality and tourism sector.
- *Standards:* Kosovo's tourism service providers have been slow to adopt internationally recognized standards for sustainable tourism practices or for accommodation.
- *Finance:* The sector is considered risky, and many service providers are smaller SMEs that have difficulty attracting bank finance that they could use to promote and improve their products.

ANNEX 8: ROLE OF OTHER PARTNERS IN THE AREAS OF PRIVATE SECTOR COMPETITIVENESS

WB/IFC

1. **The WB team is coordinating closely with relevant donors engaged in private sector competiveness issues.** The team has held technical discussions with the EU to coordinate potential areas of engagement for the Instrument for Pre-Accession Assistance (IPA) 2016. The team has also met with USAID, GIZ, and UNDP. It was discussed that the proposed project will not finance activities that other donors are financing, or planning on financing, but will complement them as needed. The project will work in close collaboration with key actors engaged in competitiveness issues and any other potential actors in the sector to ensure full and effective collaboration and maximize synergies in the implementation of the project.

2. **The Kosovo Investment Climate Project was implemented by the WBG's Trade & Competitiveness (T&C) team on behalf of IFC to simplify business regulations and enhance investment policy in Kosovo.** The project started implementation on January 2013, and completed in December 2016. The advisory support linked in a programmatic manner investment policy work, business regulatory and industry-specific work to maximize impact. It addressed key shortcomings in the country's investment climate with the aim of unlocking the potential of domestic and foreign investment. Activities have focused on the following areas:

- Supporting the drafting of the legal framework that regulates permits and licenses.
- Publishing online portals for permits and licenses at the central level and in four municipalities.
- Streamlining procedures throughout the horticulture value chain.
- Supporting the introduction of Regulatory Impact Assessment in policy making.
- Improving and simplifying business registration procedures.
- Supporting the strategic thinking and legal framework regulating investment policy and simplifying legal impediments for foreign investment.
- Working on improving investor-after care and the coordination between the government and the private sector.

3. **The team has designed the Investment Climate II (601638) project, a follow-up of the above mentioned WBG executed Kosovo Investment Climate Project as technical assistance to MTI** to complement the Competitiveness and Export Readiness Project. State Secretariat for Economic Affairs (SECO) has confirmed US$2.3M to support this advisory work. Leveraging this advisory work with the Project would increase chances of project success and ensure that the competitiveness agenda is fully supported through different WBG instruments.

4. **The Kosovo government provides direct support to both individual farmers and agriculture** SMEs through a grant scheme that is financed by different donors such as the WBG, DANIDA, and the EU. The total financing for individual farmers in 2015 was EUR 23 million. The matching grants scheme to SMEs is concentrated in the following areas:

- Investing in physical assets in agricultural economies for farmers and SMEs. The minimum value of the grants is EUR 10.000, and the maximum value is EUR 120,000. Public support is 60 percent of eligible costs. The total budget for this activity in 2015 was EUR 11 million.
- Investments in physical assets in the processing and marketing of agricultural products. Minimum value is EUR 30,000; maximum value is EUR 400,000. Intensity of public support is 50 percent of eligible costs. Total budget for 2015 was EUR 5 million. The World Bank Agriculture and Rural Development Project contributes to this fund.

EU

5. **EU has an active project on Free Movement of Goods** from 2014 to 2016. This project provides technical assistance for the main stakeholders who participate in the implementation of free movement of goods, in particular those related to product safety and quality infrastructure. Overall, assistance is conveyed through provisioning of expert support in engaging and strengthening Kosovo legislation and practices of free movement of goods through the confirmed EU principles and rules. It provides necessary training for professionals and much-needed awareness on this topic for the general public. The project will help Bodies of the NQI for Standardization and Accreditation to join relevant European and International organizations and complete their service portfolio, and support Kosovo Metrology Agency (KMA) to build their capacity to meet their current needs and the local economy in industrial and legal metrology.

6. **The EU supports a matching grants project for MSMEs with the MTI implemented by IOM.** This engagement started in February 2014 and is continuing through August 2016. The amount of the project was EUR 4 million, out of which EUR 3 million was disbursed to businesses, and EUR 1 million was spent on administration costs. The aim of this activity is to improve capacities of MSMEs to upscale production in an efficient and sustainable way that is in line with European Standards and Practices. The grant was divided into two lots: (i) for micro companies—minimum EUR 10,000 and maximum EUR 25,000, covering 55 to 85 percent of cost; and (ii) SMEs—minimum EUR 60,000 and maximum EUR 200,000, covering 40 to 75 percent of cost.

7. **The EU matching grant scheme is targeted at the MSMEs that operate in manufacturing and processing of materials, including agriculture, and service sectors are eligible to apply (excluding agro-processing).** To the extent possible, the focus of grant support was on engaging "productive" enterprises offering real opportunities for import substitution, reinforcing domestic production, and consequently reducing import needs and/or export activities. The scheme was open to all sectors, but there was special interest in services, ICT companies, textile, leather, wood processing and furniture, metal processing, renewable energy, automotive components, mines and minerals, and agriculture (excluding agro-processing).

USAID

8. **USAID EMPOWER Private Sector Project has the overarching goal of job creation as a tool to achieving sustainable economic growth for Kosovo.** The project works closely with firms and individuals from carefully selected growth-ready sectors to help them identify and connect to market opportunities, increase productivity, upgrade management and workforce skills, and expand access to finance. Through its activities and interventions, EMPOWER Private Sector addresses high levels of poverty and unemployment, overdependence on imports, and an

underdeveloped export sector. The activities started in July 2014 and will span over five years. One of the components of the project provided matching grants to companies in five sectors: Apparel, Wood Processing, ICT, Renewable Energy, and Tourism. The total amount disbursed was about EUR 2 million, with 70 companies benefiting. The maximum amount of matching grant to date was EUR 75,000.

KOSME—Kosovo Program for SME Promotion

9. This program was implemented at the Ministry of Trade and industry and funded by the governments of Austria and Switzerland. It lasted for three years and is closing in 2016. One component is a Voucher Counseling Scheme (VCS), organized and established to assist SMEs with consulting and training services. Business Consultants Council reorganization is supported including qualification, training, and CMC certification of consultants. The Voucher Counseling Scheme supports the development of enterprises by providing subsidized counseling services (up to 10 consultancy days) in these fields: Management /Strategic Planning, Finance, Marketing and Promotion, Human Resources, Public Relations, Electronic Engineering and IT, and Quality Standards. However, the evaluation of the program has not been conducted.

UNDP

10. UNDP is implementing the Aid for Trade Project with its main partner, the MTI. It started in April 2012, and closed in July 2016 with total financing of EUR 1.5 million. It provided direct support to businesses in Southern Kosovo and Mitrovica. Nine hundred businesses benefited from direct coaching, trainings and networking events, and 163 local businesses were promoted through online platforms. It also supported farmers in the Southern region and Northern municipalities, where two milk collection points and milk processing facilities were established.

EBRD

11. The EBRD provides support to companies through its Business Advice Program by matching them with qualified local consultants. It provides up to 50% financing depending on the size and location of the enterprise and the type of advice needed. The engagement lasts approximately four to six months, and the advice covers specialized areas of expertise, including strategy, marketing, organization, operations, technology, engineering solutions, quality management, financial management, energy efficiency, and the environment. Through quality management advice, the EBRD enables companies to gain access to know how in implementing different international standards, but doesn't provide financial support for product testing or obtaining certifications. There are about 130 consultants in Kosovo, and the program has supported approximately 500 companies so far. EBRD has capacity to support 7-100 companies on an annual basis and its engagement is limited to working with the same consultant 20 times. Based on the discussion with EBRD team, there is potential to support up to 50 more companies annually.

Swiss Development Cooperation

12. The Swiss Development Cooperation is funding the Promoting Private Sector Employment Project. It includes a component with direct support to business through an Opportunity Fund of approximately US$700,000, mainly in the areas of food processing and tourism.

ANNEX 9: CONSTRAINTS AND BUILDING BLOCKS FOR COMPETITIVENESS

Table 10. Main Constraints and Building Blocks for Competitiveness and Export Readiness

Constraint	Covered in Project	Covered elsewhere
Access to international markets	Yes: NQI for acquiring internationally recognized quality infrastructure system and matching grants to co-finance firms' product quality upgrading.	
Infrastructure and trade logistics	No	T&C IFC Trade Logistics Project
High regulatory burden/informality	Yes: Inspection system reform	No
Investment climate (excluding inspection reforms)	No	IFC, USAID, and GIZ for licenses and permits reforms
Relevancy/Uncertainty	Yes: Matching grants will support SMEs' export entry and quality upgrading, which have high sunk cost and high risk for investment.	Credit Guarantee Fund (KFW, USAID, and SIDA), EBRD/EU future program focusing on micro or large-size firms
Know-how	Yes: Matching grants will address market failure resulting in underinvestment in know-how (through BDS) in Kosovo, where firms and individuals' private returns are less than the overall social returns to the knowledge investment.	

ANNEX 10: ECONOMIC AND FINANCIAL ANALYSIS OVERVIEW

1. **The Project aims to enhance competiveness in Kosovo through a combination of interlinked infrastructure, services, and financing activities.** This annex examines the market failures and rationale for each of the Project's interventions and provides a detailed cost-benefit analysis of their anticipated economic impacts.

I. RATIONALE FOR PUBLIC INTERVENTION

2. **The project's interventions are designed to address the under-provision and low quality of important public goods in Kosovo.** Specifically, the Project helps to finance:

a) **An internationally-recognized NQI system:** The NQI system is considered a public good because it helps to address several imperfections in the market for quality standards. For example, leaving metrology to markets alone can lead to the under-provision of standards, particularly in countries such as Kosovo that lack a strong tradition of industry associations. It can also lead to over-provision of standards, which can have negative economic effects. Supporting the National Metrology Institute's efforts to become internationally recognized will significantly reduce the costs associated with certification of products by firms since, due to the availability of laboratories with accreditation recognized internationally, companies will no longer need to travel abroad for testing and certification procedures.

b) **Reforms to burdensome business inspection:** A system for business inspections is a public good that helps protect consumers and workers by ensuring firms' adherence to product, labor, environmental and other regulations which they may not otherwise have the incentives to self-enforce. However, Kosovo's system, characterized by poorly-coordinated and excessive inspection, leads to outsized compliance burdens on firms and drains their resources. It is a suboptimal outcome with deadweight loss for the economy. Reforming the system would help enhance the benefits of this public good.

II. ECONOMIC COST-BENEFIT ANALYSIS

3. **The economic analysis here extends a step beyond the PDO outcomes measured in the results framework, aiming to quantify some of the broader economic impacts in the next stage of the results chain.** In this sense, the project's key PDO outcomes (e.g. products certified by firms) serve as intermediate inputs into this framework for valuing the magnitude and cost-effectiveness of their broader economic impact (Figure 1). The model underpinning this valuation is presented below.

4. **Due to the cross-cutting nature of many of the project's activities and the multitude of associated impact channels, this model restricts itself to estimating only the direct benefits.** The estimates presented here should therefore be viewed as a lower bound on the scale of overall project benefits, as they do not capture potential second-order effects and externalities, many of which are difficult to define in scope and magnitude. The objective of this analysis is to provide a general sense of whether the likely magnitude of direct project benefits is broadly commensurate to the project's overall costs.

5. **The benefits are estimated on an incremental basis relative to a "no-project" counterfactual scenario.** For each component, this entails defining a counterfactual set of outcomes that would have materialized without the Project's intervention. While this is difficult

to predict, the general premise is that: (i) in the absence of NQI upgrading (and catalytic grant financing for firms to leverage this enhanced NQI), Kosovo's export growth would continue to be stunted by the limited ability of domestic exporters to obtain internationally-recognized certification for their products; (ii) burdensome business inspection processes would continue to impose outsized compliance costs on firms and hamper their productivity. The specific assumptions underpinning these differences between the "with-project" baseline case and the counterfactual "without project" scenario are detailed in the sections below.

Framework parameters for the analysis

6. **This analysis employs a bottom-up cost-benefit model to estimate the expected net present value (NPV) and economic rate of return (ERR) of the project's various interventions.** To be economically acceptable, a Bank-financed project must meet two conditions: (a) the expected NPV must be positive and/or the ERR higher than the assumed discount rate, and (b) this NPV and/or ERR must be higher than or equal to that of mutually acceptable Project alternatives. Each project component should be appraised on the basis of its marginal contribution to assess the value of its inclusion in the Project. For this reason, all the Project subcomponents are appraised separately, as they represent distinct activities.[26]

7. **Since many of the proposed activities and reforms will not be completed until the last two years of the project, a 20-year projection horizon is used so as to capture their payoffs beyond the 5-year project period.** All monetary values are expressed in terms of real 2016 US$ or EUR. The real social discount rate used to calculate present values of cost and benefit flows is assumed to be 5 percent, derived from a Ramsey formula that uses international averages for the pure time preference and marginal utility of consumption elasticity parameters, and a Kosovo-specific estimate of expected per consumption growth.[27]

NQI upgrading (subcomponent 1.1)

8. **The primary direct benefit targeted through the Project's support for international recognition of Kosovo's NQI system is an expansion of Kosovo's exports, particularly for products and markets where the lack of internationally-recognized certification has previously proven to be a binding constraint on growth.** Of course, the benefits of an internationally-recognized NQI system extend beyond this export channel. Among other things, it helps safeguard public health and safety by preventing low-quality imports from flooding the domestic market. It also fosters improved firm productivity by providing more accurate measurement and testing infrastructure for new product development (i.e. improved R&D efficiency). However, these are second-order effects where the timing and magnitude of impact

[26]. While there is a strategic link between the NQI upgrading activities (subcomponent 1.1) and the matching grants program (component 1.2), the grants target a much narrower set of beneficiaries with a stand-alone cost and delivery mechanism for reaching these beneficiaries. This warrants a separate appraisal of their cost-benefit trade-off.

[27]. The social discount rate reflects the opportunity cost of capital from an inter-temporal perspective for society as a whole—i.e. the social view of how future benefits and costs are to be valued against present ones. According to Ramsey (1928), under constant relative risk aversion, the real social discount (r) can be expressed as $r = \beta+\varepsilon*\sigma$, where β is the pure time preference rate, ε is the elasticity of the marginal utility of consumption, and σ is the expected growth rate of per capita consumption. Most empirical cross-country estimates suggest an average value of 1 for β, and 1.5 for ε (see Lopez 2008). The expected growth rate of real per capita consumption (σ) in Kosovo is set at 2.5 percent, the average projected growth rate for the 2015 to 2020 period according to the IMF's latest World Economic Outlook (October 2015). Substituting these parameters into the Ramsey formula yields a social discount rate of approximately 5 percent (1+1.5*2.5).

and the number of potential beneficiaries is extremely difficult to quantify. They are thus considered beyond the scope of this analysis and the limits of what is practical to estimate with a bottom-up modeling approach.

Benefits

9. **International recognition of Kosovo's NQI system provides both a supply and demand-side boost to Kosovo's exports.** From the demand perspective, the impact can be modeled as a function of two main effects: (i) the *pure quantity effect*, which refers to the increased real quantity of goods that Kosovo can now export to key trading partners who previously were not able or willing to purchase these products due their lack of internationally-recognized certification; and (ii) the *quality effect*, which represents the rise in the unit value[28] of Kosovar products resulting from their upgrading to conform to higher-quality international standards. On the supply-side, the NQI benefit to exports stems from transaction costs savings related to: (i) the lower cost to export, since internationally-recognized product certification reduces information asymmetries between buyers and encourages more streamlined testing and inspection procedures at borders; (ii) the reduced cost of product certification, since firms no longer have to travel abroad to obtain this certification. These lower transaction costs encourage more Kosovar producers to seek certification for their products and bring them to export markets.

(a) Additional domestic export value added generated

10. **Collectively, the quantity and quality effects of NQI upgrading contribute to a higher value of Kosovo's exports over time, as compared to the counterfactual no-project scenario.** This value difference between the two scenarios represents the incremental contribution of the NQI component to the overall project return. The estimation strategy for this benefit stream involves defining the scope of export products that will be most affected by the NQI upgrading, the pace at which these various products will become certified once Kosovo's NQI system is internationally recognized, and the magnitude of the demand response by Kosovo's key trading partners to newly-certified products. The key assumptions required are:

a) **Scope of affected products.** The focus in this analysis is only on goods exports, as services are less likely to be affected by the nature of the NQI improvements the Project is targeting, which focus predominantly on metrology and the testing and certification of tangible goods. As of end-2015, Kosovo's goods exports amounted to EUR 303 million.

b) **Number of exporting firms and products exported**. Currently, only around 5 percent of Kosovar firms' export, selling approximately 2,400 different products[29] (or around 2 products per firm). In the no-project scenario, these ratios are assumed to remain constant, resulting in a slow upward drift in the number of exporters as the total number of firms in Kosovo grows over time. As discussed earlier, the Project's NQI upgrading is expected to encourage additional firms to bring their goods to the export market: the assumption is an additional 1 percent of total firms each year for the five years after the NQI upgrading is completed (i.e. year 4 of the project).

[28]. The unit value is defined is the price per unit of quantity and is frequently used a proxy for product quality. It is distinct from the export price, which represents nominal rather than real price movements.
[29]. According to customs data based on the HS 6-digit classification system.

c) **Growth in product certification.** Only around 15 percent of Kosovo's exported goods are estimated to be currently recognized by internationally-certified bodies, the byproduct of firms who paid the premium to obtain their product certification abroad. Once the NQI system is internationally recognized, this share is expected to grow rapidly. The Project is targeting over 100 products to be newly-certified each year in the first few years, and triple that rate over the longer term. This results in around 30 percent of Kosovo's goods exports being certified 10 years after the start of the Project, and nearly 60 percent in 20 years' time.

d) **Export demand elasticity to certification.** This is the key parameter shaping the strength of the "quantity" effect, as it determines the degree to which foreign demand for a given Kosovar product will increase after that product is certified by an internationally-recognized body. The baseline assumption here is a 20 percent increase for exports to the EU (i.e. an elasticity of 1.2) and 5 percent (elasticity of 1.05) for non-EU markets. The rationale is based on the observation that Kosovo's goods exports to non-EU markets have been growing fairly rapidly in recent years even in the absence of certification, whereas export growth to the EU has been much more tepid. Apart from the growth struggles in the EU in recent years, this reflects Kosovo's restricted market access to the higher bar for quality standards in the EU, a bar Kosovo is explicitly trying to meet through this NQI upgrading. Once achieved, it should unleash a stronger demand response from the EU than from other markets.

e) **The certification quality "premium".** This parameter relates to the *quality effect*, and captures the aforementioned notion that firms will need to invest a certain amount of resources to bring their products up to the point where they can meet international certification standards. This quality upgrade should be reflected in the unit value of the product, conservatively assumed to be 10 percent higher for certified products than for non-certified products.

11. **Taken together, these assumptions result in a significant estimated impact of the Project on certified goods exports:** an annual gross export value by year 10 that is double the level in the "no-project" scenario, and nearly four times larger by year 20. From the perspective of the Kosovar economy, however, the net economic benefit of these additional exports is not their gross value but their *domestic value added*, which subtracts out the value of imported production inputs (i.e. the foreign value added). Assuming the import content of Kosovo's goods exports is 30 percent[30], the incremental domestic value added of exports over the 20-year forecast horizon is estimated at EUR 453 million in present value terms, an average of around 0.5 percent of GDP per year. This calculation assumes the same growth path for *non-certified* goods exports for both the "with-Project" and "without Project" scenarios.[31]

(b) Transaction costs savings

12. **The cost to export in Kosovo—at around US$1,750 per shipping container—is the highest in the Western Balkans according to the latest Doing Business Report (2016).** As mentioned earlier, the upgrading of Kosovo's NQI is expected to help reduce this cost, initially due to the mutual recognition agreements with key trading partners (helping to reduce information asymmetries between buyers and sellers), and progressively more over time by encouraging the

[30] Since data for Kosovo is not available, the assumption is based on the average import content of exports for EU-28 countries, which is around 30 percent based on the OECD's statistics on Trade in Value Added (2011).
[31] The growth rates for non-certified goods exports are set equivalent to the average forecasted growth for Kosovo's real goods exports in the IMF's latest Staff Report (January 2016) for Kosovo's Stand-by Arrangement Program with the Fund.

streamlining of inspection and export procedures. This dynamic is captured as a cumulative 30 percent reduction in Kosovo's cost to export (based on international experience of NQI reforms in other countries), realized over a period of 5 years, beginning in year 4 of the project, when the first major phase of the NQI upgrading is completed. This results in savings of EUR 65.5 million in present value terms over the 20-year forecast horizon, relative to the baseline, "no-Project" counterfactual where Kosovo's cost of export is assumed to remain unchanged.

13. **As far as the cost of certification, a recent World Bank diagnostic of Kosovo's NQI found that seeking product certification abroad was, on average, around 4 times costlier on account of fees paid to foreign assessors, and costs related to transportation, accommodation and other incidentals.** Once Kosovo's NQI becomes internationally recognized, the savings to exporting firms from being able to obtain product certification more cheaply domestically are projected to amount to roughly EUR 9.7 million.[32]

14. **Combining the incremental export value impact of NQI upgrading with the associated transaction cost savings, the estimated present value of the incremental *direct* benefits of this Project component amount to US$564 million.** However, this benefit stream must be adjusted to reflect the fact that well-functioning and internationally-recognized NQI system will not result singlehandedly from this Project's activities, but will also rely on critical complementary NQI investments from other donors and the private sector (e.g. expanding domestic testing laboratory capacity, etc.). In other words, only a portion of these projected benefits of an upgraded NQI system can be attributed to the Project. Since the overall cost of NQI is estimated at EUR 33 million, and the Project is financing only EUR 6.5 million, the Project-specific "benefit factor" is set at 20 percent, bringing the PV of project-specific benefits down to EUR 106 million.

Costs

15. **The costs of the NQI upgrading component consist of:** (i) the investments in equipment and TA to help upgrade laboratories, establish a standards and accreditation depository and the capacity for traceability and inter-laboratory comparisons, and train relevant staff; (ii) the recurring operating and maintenance costs of running the various NQI facilities beyond the project period; and (iii) the share of overall Project implementation support costs (i.e. project management and M&E) costs devoted to the NQI component, assumed to be 50 percent given the relative magnitude of its undertaking. Collectively, these costs amount to US$7.6 million over the 5-year project period, and US$9.1 million in present value terms over the full 20-year projection horizon.

Overall return and sensitivity analysis

16. **When the total present value of NQI upgrading benefits is netted against the PV of expected costs, the result is a highly-positive NPV of US$104 million for this group of project components** (Table 10). The implied economic rate of return (ERR) is 44.4 percent, well above the assumed 5 percent social discount rate. What is relevant here is not the precise numbers but

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[32] While the cost of certification varies greatly depending on the product, the approximation used for the estimation here is based on a range of costs for CE marking (a basic certification needed to sell products in the European Economic Area, or EEA), the average of which is around €5,000 (including laboratory testing, calibration, certification and inspection). Relative to this cost of obtaining certification abroad, the domestic cost in Kosovo once the NQI reform is completed is assumed to be 4 times cheaper, or €1,250.

rather the finding that expected benefits exceed costs by a rather large margin.

17. **The fairly high margin of return in this baseline case implies ample scope for different benefit flows to fall short of their forecasted values and still deliver a positive overall return, but the underlying sensitivities are also large.** This is particularly true of the expected additional export value—the largest benefit category. Lowering the rate of increase in share of firms assumed to begin exporting as a result of the NQI upgrading (from 1 percent per year in the baseline to 0.5 percent) reduces the NPV of export value benefits by EUR 39.3 million and the ERR by around 9 percentage points. A similar magnitude of sensitivity relates to the assumed increase in the number of products recognized by internationally-certified bodies as a result of the Project. For every 100 fewer additional products assumed to be certified each year over the projection horizon, the estimated NPV declines by EUR 44 million and the ERR by 7 percentage points.

18. **For expected savings in export and certification transaction costs, the key determining variable is the assumed reduction in the cost to export as a result of the NQI upgrading.** The sensitivities involved are lower here, however—changing the assumed decrease in the export cost by 10 percentage points alters the NPV of this benefit category by EUR 1.9 million and the ERR of the overall NQI component by just 1 percentage point.

19. **Despite the potentially large individual impacts of downside deviations in these various benefit categories,** even in a scenario when they all materialize collectively to a significant degree—for instance, no assumed increase whatsoever in the share of exporting firms, 200 fewer additional products assumed to be certified each year over the projection horizon (relative to the baseline), and only a 10 percent decrease in the cost to export (compared to 30 percent in the baseline) - the overall estimated NPV of the NQI upgrading component is still a positive US$3 million and the ERR of 8 percent continues to exceed the cut-off discount factor.

Table 11: Summary of cost and benefit flows of NQI upgrading subcomponent (baseline)

BENEFIT FLOWS (million USD)

		Project year						
Component	**PV***	**1**	**2**	**3**	**4**	**5**	**6-10**	**11-20**
Additional domestic export value added	$483.67	0.00	0.00	0.00	1.95	4.16	107.05	902.54
Savings in cost of exporting	$69.51	0.00	0.00	0.00	0.62	1.91	26.50	108.05
Savings in cost of certification	$10.39	0.00	0.15	0.15	0.44	0.40	5.03	12.97
TOTAL BENEFITS	**$563.57**	**0.00**	**0.15**	**0.15**	**3.02**	**6.47**	**138.58**	**1023.57**
ADJUSTED BENEFITS**	**$112.71**	**0.00**	**0.03**	**0.03**	**0.60**	**1.29**	**34.64**	**255.89**
COSTS (million USD)								
	PV*	**1**	**2**	**3**	**4**	**5**	**6-10**	**11-20**
Investment costs	**$5.99**	**0.06**	**1.42**	**2.63**	**2.68**	**0.21**	**0**	**0**
Laboratory acclimatization system	$1.69	0	0	1.00	1.00	0	0	0
Laboratory equipment	$3.46	0	1.33	1.33	1.33	0	0	0
Standards and accreditation depository	$0.12	0	0	0.05	0.05	0.05	0	0
Traceability and inter-laboratory comparisons	$0.21	0	0	0.08	0.08	0.08	0	0
Public awareness campaign	$0.16	0	0.06	0.06	0.06	0	0	0
Institutional development and training	$0.36	0.06	0.03	0.10	0.16	0.08	0	0
Recurring operational & maintenance costs	**$2.84**	**0.00**	**0.00**	**0.00**	**0.00**	**0.30**	**1.60**	**3.20**
Laboratory acclimatization system	$0.89	0	0	0	0	0.10		
Laboratory equipment	$1.78	0	0	0	0	0.20	1.00	2.00
Standards and accreditation depository	$0.06	0	0	0	0	0.0	0.04	0.08
Traceability and inter-laboratory comparisons	$0.10	0	0	0	0	0.0	0.06	0.13
Implementation costs	**$0.24**	**0.06**	**0.06**	**0.06**	**0.06**	**0.06**	**0.00**	**0.00**
TOTAL COSTS	**$9.06**	**0.12**	**1.47**	**2.68**	**2.74**	**0.57**	**1.60**	**3.20**
NET ADJUSTED BENEFITS	**$103.65**	**-0.12**	**-1.44**	**-2.65**	**-2.13**	**0.73**	**33.04**	**252.69**
Economic rate of return (ERR)	44.4%							

* Calculated at a social discount rate of 5 percent.

* Adjusted for Project's partial contribution to overall NQI system upgrading and achievement of international recognition, using benefit factor of 0.2.

<u>**Matching grants (subcomponent 2.2)**</u>

20. **The Project's matching grants program intends to provide grants to Kosovar SMEs to help firms enhance their export readiness and potential by acquiring the necessary certifications and complying with the quality standards needed to access export markets; Around 150 firms in total are expected to benefit from the matching grants.** The grants will average around EUR 15,635 in size. Absent this matching grants scheme, it is assumed firms would not be able to finance the expansion of their exports to a similar degree.

Benefits

21. **The incremental economic impact of the export development grant is estimated as the *increase* in beneficiary firms' profits that it helps to generate.** The increase is measured relative to the expected evolution of the same firm's profits in the counterfactual scenario where it did not undertake grant-financed activities.

22. **For the counterfactual case, the starting level of annual profits for a beneficiary firm**

is set at EUR 50,000, the average for medium-sized firms in Kosovo, which are expected to be the main candidates for these matching grants. Thereafter, profits are assumed to increase at the rate of real GDP growth over the projection horizon.[33] Relative to this path, financed activities that result in a new product being brought to the export market are assumed to boost the firm's profit growth by 20 percent per year (for a period of 3 years), beginning in the third year after the grant is received to simulate the approximate time it takes for this export development to materially impact the firm's sales. For activities financed that expand the export values of a currently-exported product, the assumed profit boost is only 10 percent per year for 3 years. Under these parameters, the present value of incremental profits generated by the 50 grant beneficiary firms over the projection horizon is estimated at US$19 million. This does not capture any multiplier effects or other indirect impacts of the grant-financed innovations, and should thus be viewed as a lower bound on the range of potential benefits.

23. **The costs of the impacts generated by the matching grants program fall into four categories:** (i) investment costs, (ii) operating costs, (iii) implicit costs, and (iv) implementation costs. Investment costs include the grant awards themselves (EUR 2.3 million over the 5-year project period) as well as the required matching contribution from the private sector, estimated at EUR 2.3 million over 5 years assuming up to 50 percent match rate. Operating costs (EUR 0.4 million over the 5-year project period) relate to the expenses of administering each call for grant proposals, including paying for expert reviewers and the panel of judges, as well as the dedicated program of technical assistance and mentoring provided to grant applicants. Implicit costs reflect the opportunity cost of the time firms have to dedicate to prepare grant proposals—assumed to be equivalent to 5 percent of the grant amount sought. Finally, 20 percent of total project implementation support costs are attributed to the matching grants component, as it will require significant effort on the part of the implementing agency (KIESA) to organize and execute the various calls for proposals as well as monitor the subsequent activities of grant recipients. In total, the present value of these three categories of costs is estimated at EUR 4.6 million.

Overall return and sensitivity analysis

24. **Netting the estimated benefits against the expected costs results in a positive NPV of EUR 48 million for this matching grants component, and an implied ERR of 46.3 percent, above the assumed 5 percent real discount rate (Table 12).**

25. **The sensitivity of these estimates relates predominantly to the assumptions for the profit increase of export development grant beneficiary firms.** For every 5 percentage point shift in the annual firm profit increase assumed to come from export improvements, the NPV of the matching grants component changes by EUR 19 million and the ERR by roughly 11 percentage points. A breakeven scenario where the NPV of the entire component falls to zero and the ERR converges to the assumed discount rate would require the annual profit growth rate resulting for export improvements to be only around 3 percent (only one-tenth of the baseline value). Deviations of such magnitude are fairly low-probability, suggesting a significant safety buffer in the estimated return of the matching grants component.

[33]. Real GDP growth is set at 5 percent, the estimated long-term potential growth rate of Kosovo's economy.

Table 12: Summary of cost and benefit flows of matching grants subcomponent (baseline)

BENEFIT FLOWS (million USD)

		Project year						
Component	**PV***	**1**	**2**	**3**	**4**	**5**	**6-10**	**11-20**
Additional profits from existing exports	$17.66	0.00	0.00	0.00	0.09	0.35	7.90	25.89
Profits from newly-exported products	$38.52	0.00	0.00	0.00	0.18	0.72	17.18	56.69
TOTAL BENEFITS	**$56.18**	**0.00**	**0.00**	**0.00**	**0.27**	**1.07**	**25.08**	**82.58**

COSTS (million USD)

	PV*	**1**	**2**	**3**	**4**	**5**	**6-10**	**11-20**
Investment costs	**$4.27**	**0.00**	**1.00**	**1.67**	**2.33**	**0.00**	**0**	**0**
Public grant awards	$2.13	0	0.50	0.83	1.17	0.00	0	0
Private matching contribution	$2.13	0	0.50	0.83	1.17	0.00	0	0
Operating costs	**$0.43**	**0.00**	**0.17**	**0.17**	**0.17**	**0.00**	**0.00**	**0.00**
Administrative costs	$0.17	0	0.07	0.07	0.07	0	0	0
TA for grant participants	$0.26	0	0.10	0.10	0.10	0	0	0
Implicit costs	**$0.11**	**0.00**	**0.03**	**0.04**	**0.06**	**0.00**	**0**	**0**
Management burden of preparing grant proposals	$0.11	0.00	0.03	0.04	0.06	0.00	0	0
Implementation costs	**$0.10**	**0.02**	**0.02**	**0.02**	**0.02**	**0.02**	**0**	**0**
TOTAL COSTS	**$4.90**	**0.02**	**1.21**	**1.90**	**2.58**	**0.02**	**0.00**	**0.00**
NET BENEFITS	**$51.28**	**-0.02**	**-1.21**	**-1.90**	**-2.31**	**1.05**	**25.08**	**82.58**
Economic rate of return (ERR)	46.3%							

* Calculated at a social discount rate of 5 percent.

Business inspection reforms (subcomponent 3)

26. **The objective of the business inspection system reform targeted by the Project is to streamline the business inspections process in Kosovo and reduce the compliance burden imposed on firms, as well as the implementation burden on authorities in charge of inspections.** Without Project support, a "business-as-usual" scenario is assumed as the counterfactual, where existing compliance and administrative burdens would persist throughout the forecast horizon.

Benefits

27. **The cost savings to businesses and government authorities (both in terms of monetary expenditures and time foregone) from the reduction in compliance and administrative burdens associated with inspection represent the main direct benefits of this Project component**.[34] Meanwhile, there are also a variety of potential indirect benefits, including, *inter alia*: stronger and more efficient enforcement of labor standards and regulations, leading to better treatment of workers and improvements in their productivity; and increased incentives for firms to formalize and thus gain improved access to markets for their goods and services and financing for investments. In this analysis, the focus is on the cost savings benefits, as these are the most direct and predictable impacts of the inspection system reform and the most practical to quantify.

[34]. Although part of the savings are financial in nature, they are an economic benefit in the sense that they represent extra resources that both the private and public sectors may use to make new investments, hire people, and potentially raise their productivity.

(a) Compliance cost savings to businesses

28. **In broad terms, direct inspection compliance costs for firms can be defined as the sum of the two components: (i) *financial costs*, including official fees and taxes paid to local authorities and expenses related to lawyers, accountants, consultants, travel, and other items that are necessary to complete official procedures; and (ii) *labor costs*, which are expressed in monetary terms as the staff time devoted to inspection multiplied by the average wage of the employees involved.** From an economic-cost benefit perspective, the first component (financial costs) is not factored into the analysis, as it represents a transfer of funds between inspected firms to the public sector and other firms, and is thus not a *net* benefit to society as a whole. For the estimation of savings in the labor cost of inspection compliance, the calculation assumes the following impact of the Project on several key underlying variables:

a) **Share of businesses inspected.** As part of the inspection system reform, the movement towards a more risk-based inspection approach should help reduce the number of registered businesses requiring inspection. The expected reduction in the inspection rate (defined as the number of business inspected as a percentage of the total number of registered businesses) is assumed to be a cumulative 10 percent over 3 years, beginning in year 3 of the Project after the new inspection law has been passed and the new inspection systems are operational.

b) **Frequency of inspection visits:** According to a business survey conducted in 2012 as part of an impact assessment for inspection reform in Kosovo,[35] the average firm received an average of 22 inspection visits per year. This is expected to be reduced by 30 percent over the life of the Project (to around 16 visits), in line with the Project results framework target.

c) **Average staff time devoted to each inspection visit.** Based on the business survey, the average firms devote 27.4 hours of time to inspection over the course of the 22 inspections visits, which works out to roughly 1.3 hours per visit, or 0.15 days. This is expected to be cut by around a third by the end of the Project.

29. **Based on an average daily employee salary of EUR 17[36] and an average of 4 employees occupied by the inspection during each visit,[37] these assumptions result in a reduction of the labor compliance cost of inspection from EUR 10 per visit, at present, to EUR 7 by the end of the 5-year project period.** Over the course of the 20-year projection horizon, factoring in the expected reductions in the share of businesses inspected and the frequency of inspections, the estimated present value of cost savings to businesses is EUR 25 million. As part of the inspection reform supported by the Project, reductions in the imposition of excessive fines on firms are also expected. As in the case of inspection fees, however, the savings related to these fines are not considered, as they represent a transfer between firms and the government rather than an economic benefit to society.

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[35]. World Bank 2012. "Impact Assessment: Reform of the Inspections System in Kosovo."

[36]. According to the latest Structural Business Survey (2014) published by the Kosovo Agency for Statistics, the average employee salary in the private sector was €350 per month, which works out to €17 per day over the average of 20 working days per month.

[37]. The World Bank business survey (2012) reported that 6 different inspectors visit each business per year, occupying the time of approximately 22 employees of the business. This works out to around 4 employees per inspector (22/6), and assuming each visit consists of only one inspector, it also implies 4 staff are occupied per inspection visit.

(b) Administrative costs savings to government

30. **For this benefit category, the impact of the Project comes through the targeted reduction in the number of inspectorates in Kosovo and the introduction of an E-inspection system.** This leads to both lower personnel cost (due to less total inspectorate staff) and lower operating costs of conducting inspections (due to more efficient file/document management, reporting, data mining and analysis resulting from the new electronic systems). The Project target is to reduce the number of inspectorates from 36 to 15. With roughly 15 employees working in each inspectorate, each paid an average of EUR 400 per month, this results in a present value of EUR 1.3 million in benefits over the projection horizon from lower personnel costs and higher productivity of remaining inspectors over the projection horizon, relative to the counterfactual "no-Project" scenario where all 36 inspectorates remain in operation. Meanwhile, operating costs per inspection are expected to decline by a cumulative 25 percent over the project period, leading to a further EUR 2.9 million (in present value) in benefits to the government.

Costs

31. **The present value of overall costs for this component is estimated at EUR 6.6 million**, consisting of the Project's EUR 5.2 million investment in equipment and TA to support the inspection systems reform,[38] recurring expenditures for operating and maintaining the new inspection system beyond the project period, and 30 percent of overall Project implementation support costs.

Overall return and sensitivity analysis

32. **In total, the combined present value of expected benefit flows from the inspection system reform is estimated at EUR 28.7 million over the 20-year projection horizon.** When netted against the present value of EUR 6.6 million in costs, this results in a positive NPV of EUR 22.2 million for this component, and an implied ERR of 50.4 percent, well above the assumed 5 percent real discount rate (Table 13).

33. **These estimates depend heavily on the assumptions regarding the reduction in the share of businesses inspected and the frequency of inspections visits.** For instance, for every 10 percentage point change in the assumed cumulative reduction of the frequency of inspection visits, the NPV of the overall business inspection component falls by EUR 1.9 million and the ERR by 4 percentage points. A halving of the assumed percent reduction in the share of firms inspected as a result of the reform (from 10 percent to 5 percent) would have a broadly similar impact on the NPV and ERR. Meanwhile, a 50 percent *smaller* reduction in the average firm staff time devoted to inspection would have a slightly larger impact—EUR 4.2 million on NPV and 8 percentage points on the ERR. While the parameter deviations described above are not unrealistic, even if they are combined or doubled in magnitude, they would still not be enough to erase the highly positive estimated NPV and ERR of this component.

[38]. This includes €75,000 in TA for legislative reform and institutional setup and €748,993 for improving inspections services and upgrading their capacity. This TA is not part of the Project budget, but is essential to the effectiveness of the business inspection reform and will be financed through the WBG's advisory project in Kosovo.

Table 13. Summary of cost and benefit flows of inspection subcomponent (baseline)

BENEFIT FLOWS (million USD)

		Project year						
Component	**PV***	**1**	**2**	**3**	**4**	**5**	**6-10**	**11-20**
Compliance cost savings to firms	$26.24	0.00	0.00	0.98	1.89	2.51	12.91	27.82
Administrative cost savings to government	$4.48	0.00	0.04	0.13	0.29	0.44	2.24	4.72
TOTAL BENEFITS	**$30.72**	**0.00**	**0.04**	**1.10**	**2.18**	**2.94**	**15.15**	**32.54**

COSTS (million USD)

	PV*	**1**	**2**	**3**	**4**	**5**	**6-10**	**11-20**
Investment costs	**$4.82**	**0.59**	**1.35**	**1.49**	**1.09**	**1.09**	**0**	**0**
Legislative reform and institutional set-up	$0.16	0.09	0.09				0	0
E-inspector system	$0.92	0.30	0.60	0.10			0	0
Inspection data interoperability	$0.90	0.20	0.40	0.40			0	0
Equipping inspections	$2.30		0.26	0.79	0.79	0.79	0	0
Improving inspection capacity	$0.72			0.20	0.30	0.30	0	0
Recurring operational & maintenance costs	**$2.04**	**0.00**	**0.00**	**0.00**	**0.10**	**0.10**	**1.16**	**2.32**
E-inspector system operation	$0.56				0.05	0.05	0.25	0.50
Inspection data interoperability	$0.56				0.05	0.05	0.25	0.50
Inspection equipment maintenace	$1.36						0.66	1.32
Implementation costs	**$0.14**	**0.03**	**0.03**	**0.03**	**0.03**	**0.03**	**0.00**	**0.00**
TOTAL COSTS	**$7.00**	**0.62**	**1.38**	**1.52**	**1.22**	**1.22**	**1.16**	**2.32**
NET BENEFITS	**$23.72**	**-0.62**	**-1.35**	**-0.42**	**0.96**	**1.72**	**13.99**	**30.23**
Economic rate of return (ERR)	50.4%							

* Calculated at a social discount rate of 5 percent.

Overall Project

34. **Under the baseline input parameters for each component appraised, the overall project delivers a positive NPV of EUR 163 million and an ERR of 45.9 percent** (Table 14), with most of the net benefits materializing after the 5-year Project period, consistent with the timeline of implementation in which most of the planned reforms and upgrades will not be completed until the later stages of Project.

35. **This estimated economic return of the Project (and its constituent components) is quite large in comparison to the assumed discount rate, but so is its variability.** In this sense, the range of potential ERR outcomes is more instructive than the individual point estimates. As a stylized illustration of the magnitude of sensitivities involved, Figure 4 shows the range of ERRs for each Project component that result from a 50 percent upside/downside deviation to the baseline assumptions for key Project impact parameters.[39] Even in the downside case of this fairly large shock—essentially cutting the assumed strength of all project impact channels in half—the

[39] This applies to variables expressed in both percentage and level terms. For example, if the assumed Project impact within a component is a 10 percent increase in a given benefit category (e.g., profits of firms receiving Project matching grants), this is varied to either 5 or 15 percent to generate the downside/upside scenarios; if the impact is expressed in level terms—for instance, 100 new certified products, as in the case of NQI upgrading—this is varied to 50 or 150. For any given Project component, this shock is applied to all key impact parameters (i.e., those discussed in the component analysis sections above) to demonstrate the combined effect of strengthening/weakening multiple impact channels.

estimated ERR of all project components, and the Project as a whole, remains comfortably above the assumed discount rate. This result gives a significant degree of comfort that the Project's proposed investments are justified on economic grounds even under conservative assumptions about their magnitude.

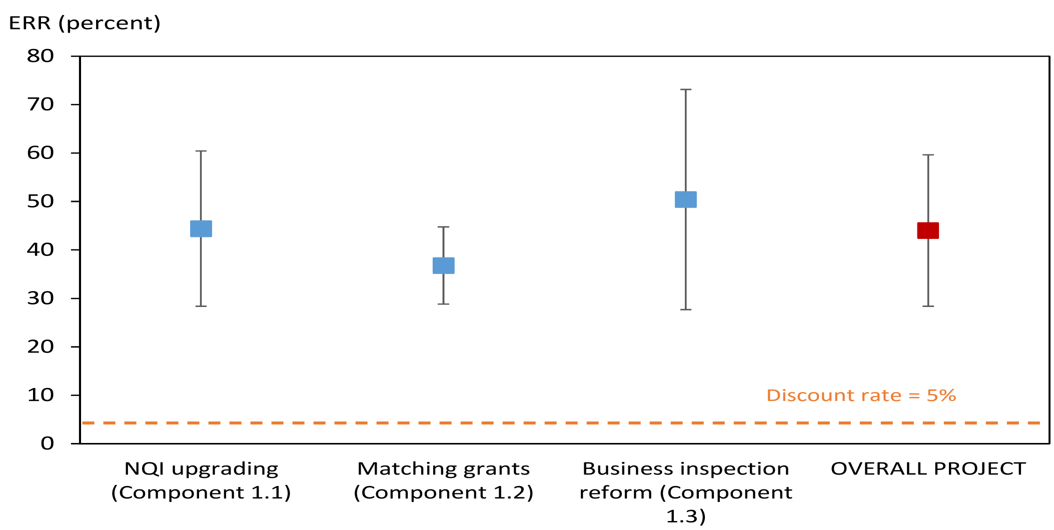
Table 14. Summary of overall Project costs and benefits (baseline)

BENEFIT FLOWS (million USD)

Component	PV*	Project year 1	2	3	4	5	6-10	11-20
NQI upgrading (Component 1)	$108.21	0.00	0.01	0.01	0.60	1.28	26.91	196.00
Matching grants program (Component 2)	$56.18	0.00	0.00	0.00	0.27	1.07	25.08	82.58
Business inspection reform (Component 3)	$30.72	0.00	0.04	1.10	2.18	2.94	15.15	32.54
TOTAL BENEFITS	**$195.11**	**0.00**	**0.04**	**1.12**	**3.04**	**5.29**	**67.14**	**311.12**
COSTS (million USD)								
Component	**PV***	**1**	**2**	**3**	**4**	**5**	**6-10**	**11-20**
NQI upgrading (Component 1)	$9.06	0.12	1.47	2.68	2.74	0.57	1.60	3.20
Matching grants program (Component 2)	$4.90	0.02	1.21	1.90	2.58	0.02	0.00	0.00
Business inspection reform (Component 3)	$7.00	0.62	1.38	1.52	1.22	1.22	1.2	2.3
TOTAL COSTS	**$20.97**	**0.76**	**4.07**	**6.10**	**6.54**	**1.81**	**2.76**	**5.52**
NET BENEFITS (NPV)	**$174.14**	**-0.76**	**-4.02**	**-4.99**	**-3.50**	**3.48**	**64.38**	**305.60**
Economic rate of return	45.9%							

* Calculated at a social discount rate of 5 percent.

Figure 4: Range of outcomes for estimated ERR of Project components



ANNEX 11: KOSOVO GENDER FILTER

	Activity	Plans: Yes	Plans: No
i.	Consult with social/gender experts on Project Development Objective, components and scope to identify (i) potential gender-specific activities and include the findings in the project documents and results framework and (ii) potential experts or partners for implementation support on gender.	X	
ii.	Ensure that both men and women are included in consultations on project interventions, and women's voice is not missing from policy dialogue (e.g. field visits to get feedback from both men and women in communities impacted by the project). The team will consider having a women-only consultation when relevant.	X	
iii.	Integrate gender assessment into project survey/data collection with an objective to obtain gender-disaggregated information with minimum costs.	X	
iv.	Include a share of female beneficiaries in the monitoring indicators. Obtain gender-disaggregated data through surveys and socioeconomic monitoring to identify project impacts on both male and female.	X	
v.	Consider social safeguards aspects for female and male specific impacts, differences or benefits.		X
vi.	Document gender-based outcomes and include reporting on gender targets and activities in the regular project implementation reports, and share the findings with gender experts and all interested.	X	
vii.	Conduct gender awareness event for the client bringing experiences from other countries and successful programs. Work with counterparts on integrating the gender equality perspective in sector policy design and services.		X
viii.	Ensure the project activities are consistent with the overall national gender action plan and considered an integral part of achieving the broader national gender goals.		X
ix.	Seek other donor's experience/ existing practices of mainstreaming gender into the sector operations in Kosovo.	X	
x.	Increase female/male awareness of sector specific issues.	X	