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KOSOVA BUDGET SYSTEM - POLICIES AND SUSTAINABILITY

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June 12, 2003

ABBREVIATIONS

| | |
|-------|---|
| USAID | United States Agency for International Development |
| UNMIK | United Nations Interim Mission in Kosova |
| SRSB | Special Representative of the Secretary General |
| MEF | Ministry of Economy and Finance |
| EFC | Economic and Fiscal Council |
| IMF | International Monetary Fund |
| BPK | Banking Payment Authority |
| CASE | Centre for Economic and Social Research |
| WIIW | The Vienna Institute for International Economic Studies |
| VAT | Value Added Tax |
| CFA | Central Fiscal Authority |
| PISG | Provisional Institutions of Self-Governance |
| GDP | Gross Domestic Product |
| DLA | Department of Local Authorities |
| EU | European Union |
| FYROM | Former Yugoslav Republic of Macedonia |
| CIS | Commonwealth of Independent States |
| OECD | Organization for Economic Cooperation and Development |
| SME | Small and Medium Enterprises |
| CG | Central Government Budget |
| GG | Government General Budget |
| PIP | Public Investment Program |
| RTK | Radio Television of Kosova |
| KTA | Kosova Trust Agency |
| KPC | Kosova Protection Corps |
| KIB | Kosova Integrated Budget |
| CEE | Central and Eastern European Countries |
| ECA | Eastern Europe and Central Asia |
| CSBE | Central South and Baltic European Countries |
| KEK | Power Corporation of Kosova |
| PU | Public Utilities |
| SOE | Socially Owned Enterprises |
| IDA | International Development Agency |

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EXECUTIVE SUMMARY

1. Since August 1999 important measures have been undertaken to establish segments of the Kosova budget system. Immediately after the war the international community intervened with considerable financial aid, which was of crucial importance in overcoming the consequences of war, rebuilding houses and rehabilitating public infrastructure. UNMIK, with the technical assistance of the IMF and WB applied the German Mark (substituted later by the Euro) as the currency and introduced the first taxes and their administration through the CFA, in conformity with the public investment program through the Department for Reconstruction, and established the Banking and Payment Authority and the commercial banks. After general elections were held the Ministry of Economy and Finance were established and the process of the transfer of budgetary competencies to local government began.

2. So far, budgets have not been properly related to the macroeconomic situation and based on defined priorities that the budgetary policy should follow. The budget has been prepared under the pressure of emerging problems, without any priorities and clearly defined objectives. There is also a need for information on solid macroeconomic indicators and their trends. Such circumstances have made the realistic planning of budget revenues and expenditures more difficult. Also UNMIK throughout this period could not exercise its fiscal authority over the whole territory of Kosova, in particular in the northern part of the country.

3. So far a number of legal documents that regulate the Kosova budget system have been passed. A positive step forward is the Law on Public Finance Management and Accountabilities. However, a modern, efficient and transparent system of budgeting is not yet in place. The existing budget dualisms and the strong asymmetry with respect to effective competencies of PISG and UNMIK generate disagreements amongst the stakeholders involved in budget process. Therefore the above issues should be reviewed and carefully analyzed systematically. A more active and essential role of the government in all the budget procedures, as well as an increased legislative and monitoring role of the Parliament, would improve budget efficiency, transparency and accountability.

4. In examining the developments with respect to tax revenues during 2000-2002, the following trends can be identified:

- The share of budgetary tax revenues to GDP¹ marked an increase from 8.7% in 2000 to 24% in 2002, equivalent to a threefold increase. Compared to other countries in advanced transition, such share is still low, but is near to countries in early transition (former Soviet Union countries: 22.2%). The dynamic of increase of budget revenues was faster than expected and than the dynamic of increase in other countries.
- The tax revenues in 2002 represent an increase of 3.9 times as compared to 2000. The 44% share of VAT to budget revenues and the 28.7% share of excises were the highest ones. Excises should be expanded over domestic products, so as to gradually match the tariffs applied by neighboring countries (in particular the excise on tobacco) and banderols should be applied, which would reduce smuggling and evasion. The high share of tax revenues from

¹ In this report the GDP based calculations rely upon GDP estimated at €1.99 billion (WB, MEF: October 2002) and population of 2 million resident inhabitants in Kosova (Riinvest: December 2002).

incomes and the high share of other taxes show that the current tax structure should be gradually transformed, in order to provide for long-term budget stability.

- There is a high discrepancy between the revenues generated from taxes applied over imported goods and services (that counted for 83.4% of tax revenues in 2002) compared to those applied over domestic products and services (16.6% of revenues). In countries in early transition revenues at the borders furnish only 6.2%. An inappropriate tax structure is implied by the very high share of customs to total tax revenues in Kosova, 16% (2002), as opposed to 9.4% in Albania, 11.2% in Macedonia, 3.5% in Rumania and 2.2% in Bulgaria. Also the share of income tax to overall tax revenues (10.3%) appears very low. This implies that there is room for increasing the managerial capacities in collection of internal taxes (a better collection of domestic VAT should be a priority) in addition to a better coverage of border crossings.
- The business community (65%) during this period considers the customs tariffs and excises high. On the other hand it supports the existing direct taxes.
- The General Budget of Kosova is only based on fiscal revenues. It is incomparable to other countries' budgets as concerns the power to use the privatization funds, in particular for capital investment needs, incomes of the central bank and other incomes generated from government assets (non tax budget revenues).

5. The budget revenue of Kosova is seriously harmed by the existence of the informal economy (informal sector) and the high level of fiscal evasion. Undoubtedly all forms of informal economy directly harm budget revenue, complicate the economic structure of the country, deform the market and competition, discourage the foreign investors and focus the tax obligations on a small group of complying taxpayers, which is burdened with higher tariffs in order to compensate for the budget loss.

6. The WB estimates clearly stated that customs and tax administration has limited human resources compared to other countries' economies. In order to expand the taxation base, it is necessary to first solve the practical difficulties related to tax administration. More tax officers should be hired and trained and the systems of tax management and collection should be further developed. Also the customs administration should be strengthened, better equipped and its controlling mechanisms improved. One of the main tasks of the government is to build a system that would track the tax officers operations and would restrict corruption by the tax officers.

7. The application of a simple linear tax rate system has shown to be practical in tax collection, but unproductive with respect to economic growth. Such system has in particular discouraged the production sphere, agriculture and competition. Therefore in certain cases such as customs duties, differentiated rates can be applied to stimulate investments, development and job creation. An example would be lowering the customs tariffs on capital goods to 2%, in conformity with the program of the Government of Kosova. In addition to providing for adequate administration, so as to prevent abuse of the incentive for trade purposes, such tariff should also be applied to raw materials which are not produced domestically, but are important for the development of the production sector.

8. Currently the budget expenditure neither includes provision for clearing the foreign debt, nor for covering capital expenditures (except one small part) and is reserved for financing some of the functions that are covered by UNMIK and KFOR. With a 20.2 % (2002) and 23.9 % (as envisioned for 2003) share of GDP, the budget is somewhere between the countries with low income and medium income. Consumption expenditure is characterized by a high level of subsidies as a share of GDP (14 % in 2003) and low levels of social expenditures (3.8% of GDP) reflective of the fact that there is not yet in place a system of social security. In the given circumstances it is considered that a 20-22 % share of tax revenues to GDP would have been relatively acceptable in the short-term.

9. In 2002 it has been estimated that of €2.3 billion by donor commitments, around 1.676 million have been spent in capital consumption. By the end of 2002 around 91% of the funds destined for reconstruction were guaranteed, 82% of these funds have been contracted and 69% were spent. During that period the local administrators were not engaged in orienting those investments, therefore they do not have detailed information on where they were oriented. Because of the lack of the budget capacities, a strong support will be required in the future from donors for public investments as well as for better coordination and transparency, because these expensive investments will require considerable current financing from the Kosova Central Budget for maintenance purposes in the future. Current outside Investment support is not costless.

10. One of the important budget challenges is the cumulative cash surplus, estimated at 103 million € during 2002. It results from more taxes being collected from taxpayers, than is being spent, through overestimation of consumption requirements.. This means that budget entities such as SRSG, Government, and municipalities have overestimated their consumption needs and capacities. Such a high level of surplus can impact the Kosovo economy and may lead to a recession.

11. The key issue in building a sustainable budget system is setting priorities in the budget consumption based on a long-term development strategy and medium term programs on public expenditures. Considering (i) the age structure of the population and the needs for modern development in the conditions of globalization, (ii) the need for creating the necessary public infrastructure to support the economic growth and (iii) the need to secure funds for an elementary social security, means that the priorities for the upcoming period will be as follows: (a) The development of the education system; (b) improvement of the public infrastructure and (c) reduction of poverty and providing social care for the poor and old people. The proportion of employees in the education and health sector in Kosova as compared to the overall number of population is below that of the CEE and Central Asian Countries. (Education: Kosova 1.41%, CEE 1.43%; Health sector: Kosova 0.63%, CEE 1.04%). To overcome those needs, the share of the budget to GDP ideally should reach 35%, of which 20% would be secured from taxes, 3-5% from loans and 10-12% from donations.

12. Fiscal decentralization is seen as an important instrument to achieve democratic participation in the process of decision-making thus advancing of accountability and budget transparency. The decentralization should be made to reflect and preserve the integrity of macroeconomic policies, the level of development and efficiency, in determining the expenditure levels.. The decentralization must be developed in harmony with the potentials and the economic preferences of the country, so that it

does not burden tax-payers with new taxes, while central authorities must have detailed information regarding the expenditure levels of the municipalities as well as quality testing and evaluation systems.

13. The budget sustainability of Kosova is of crucial importance not only for financing the necessary functions of central and municipal administrations, and public services, but also to create conditions for sustainable economic development and macroeconomic stability. Room for greater sustainability lies in the control and reduction of expenditure, in particular minimizing the subsidies, an expansion of the taxation base, (including more tax-payers), improvement in the level of tax-collection (in particular of domestic VAT, through better coverage of borders and direct taxes) as well as through improvement of the capacities of the tax and customs administrations. The long-term sustainability of the budget could also be linked with the creation of conditions for economic growth and for the use of other sources of income to finance the public infrastructure. In the situation where there is a high rate of unemployment (38-49%) the basic orientation of economic policies should be the creation of a friendly environment that will attract domestic and private foreign investments as a means for economic growth and reduction of unemployment. Therefore burdening businesses with new taxes would not be recommended.

14. In Kosova the budget subsidies to public enterprises must be drastically reduced because they generate structural budgetary problems, while lowering the motivation of those enterprises for increasing the quality of their operation and service. This problem reflects those faced by several other countries, which are finding it difficult to change the economic systems of the past. This raises the need to create suitable institutional modalities for efficient management of the expenditures and their transparency.

15. Data shows that in Kosova there is over employment in some segments of public administration exists, as compared to other countries. The over employment is seen from both the aspect of the overall number of employed people (Kosova 3.1%, CEE 0.9%) and the overall population number (Kosova 0.67%, CEE 0.45%). These observations raise the need for restricted job openings in the future within government bodies, while new hiring should take place only after analyzing the efficiency of the existing employees.

16. The problems relating to budget transparency, budget surplus, communication with taxpayers and the level of involvement of the PISG in designing budget policies, demonstrate a series of weaknesses in budget management in Kosova. A wider spectrum of issues are expected to be faced in the future, such as free trade and regional economic integration, which require a better involvement of domestic actors in reviewing and implementing such policies. This requires a closer and better approach of the government towards fiscal management, which should lead to fiscal credibility and accountability. Periodic evaluation based on the performance criteria of budget costs by budget entities would be one of the key issues in improving budget management.

RECOMMENDATIONS

1. It is recommended that UNMIK and the Government provide as soon as possible for the necessary operational regulations and procedures for the implementation of the Law on Management of Public Finances and Accountabilities. They should also provide for the regulations that would bring to an end the dual character of the budget, therefore establishing and managing a single integrated budget for Kosova and overcoming the disputes concerning the power sharing over the budget process and management.

Analysis is required to determine whether the new law complies with the need of the transfer of competences to the Government and Parliament of Kosova and pursuant to this, to propose the necessary improvements and amendments to the Organic Budget Law.

2. It is recommended that the Government of Kosova approves as soon as possible the vision and strategy for the long-term economic development of Kosova, on which the medium-term fiscal policy priorities should be based. Therefore, it is necessary to carry out immediately sectional studies (in education, health, public infrastructure, social care and protection). The level of budget expenditure should then be designed in accordance with these studies findings, to optimize the level of economic development and best serve the needs of economic growth.
3. It is recommended that the Government and UNMIK undertake urgent measures for enabling the Statistical Office to publish periodically the basic macroeconomic indicators, which are extremely important for budget planning and management. In the meantime the Ministry of Economy and Finance in cooperation with relevant institutions should carry out a system of surveys that would enable the estimation of macroeconomic indicators as realistically as possible.
4. The challenges of budget sustainability for the medium-term, 2003 – 2005, should be faced by:
 - (a) increasing budget revenue, and
 - (b) increasing the consistency and efficiency of budget expenditure.

Increasing the budget revenues shall be achieved first of all through the following measures:

- Creating a business friendly environment for investment to encourage real economic growth. In this respect it is recommended that consideration be given to the possibility of lowering tax rates which directly impact on economic growth and which may result in increasing levels of taxes collected.
- Increasing the level of tax collection, especially VAT on domestic products and services, excises and direct taxes (tax on property, tax on incomes and, tax on profit).
- Expanding the taxation base through combating fiscal evasion and shrinking the informal economy. Such measures should be associated with

the firm application of laws and a stronger control and supervision by the tax and customs administration.

5. The rationalization and the efficiency of budget expenditures should be built upon the following measures:
 - limiting excessive employment in public administration;
 - applying rigorous procedures and rules to evaluate and monitor the expenditures efficiency and the effects of budgetary process carried out by of budget entities, based on their performance and outputs from the past;
 - bringing the budget consumption to the level of countries with a similar economic development, thus enabling the budget on one side to encourage economic development, and the other side to optimize the covering of the budget consumption needs.

6. It is also recommended that a strategy is developed that would expand the portfolio of budget financing, in particular for public investment through setting up of rigorous borrowing procedures. In addition, borrowing should be based on the economic efficiency criteria, feasibility and sectional studies as well as on the ability of the projects to repay debts and encourage economic growth.

7. Kosovar institutions, civil society and the media should work together to promote the fiscal culture and increase taxpayers' awareness to comply with tax obligations, emphasizing the importance of tax collection in the development and the quality of public services. Therefore the following measures are necessary:
 - (a) To increase the public awareness and exercise positive pressure against fiscal evasion;
 - (b) To raise the institutional culture and the accountability of budget managers toward the taxpayers through the increase of transparency (toward the Parliament, public and the media)
 - (c) To consider the opportunity for preparing a budget guide, which would provide the guidelines and necessary knowledge that would improve the fiscal culture.

1. INTRODUCTION

Since October 2002 the Riinvest Institute for Development Research, with the financial support of United States Agency for International Development, USAID, has been implementing the second phase of the project “Promoting Economic Development through Civil Society”. In the course of the second module of this project the research report “Kosova Budget System-Policies and Sustainability” has been prepared, which will be further discussed at the 9th session of the International Roundtable Forum that will be organized in June 2003.

During the first phase of this project, Riinvest prepared a research report on key issues in the building of the taxation policy in Kosova, with a view to advancing economic development. This report, entitled “Key issues in building a taxation policy in Kosova”, was introduced and discussed at the IRF on June 21, 2001, from which recommendations on improving the taxation policy have been drawn.

In order to review the developments in establishing the taxation policy in Kosova over the last two years, in December 2002 Riinvest organized a Roundtable Discussion and presented a short follow up report. The latest report addresses the achievements and obstacles to developing and implementing the taxation policy in Kosova. It also produces recommendations for overcoming the existing problems that would lead to an increase in fiscal effects.

Despite the fact that fiscal policy issues have been extensively covered by Riinvest research and studies, so far the emphasis has been on taxation policy. The research report Kosova Budget System - Policies and Sustainability gives a wider view of fiscal policy, examining the relationship of the taxation system of Kosova with the efficiency of budget expenditure management, which is aiming to establish a sustainable budget in the future.

1.1. REPORT OBJECTIVE

This research report aims to promote an active debate amongst budget policy decision-makers (the Provisional Institutions of Self-Governance of Kosova and UNMIK) and other Kosovar stakeholders with respect to establishing a sound budget system and policies that would lead to a sustainable budget, as well as transparent and efficient budget management.

The Report aims to address the main macroeconomic problems, the economic growth of Kosova and existing structural problems, such as the high level of unemployment and poverty, difficulties in private sector development, stagnation in the privatization process of SOEs and transformation of the public sector, the high deficit of trade balance and the lack of sound fiscal instruments to support investment. The objective is the evaluation of budget revenue compared to the current level of development and the prospects for economic growth given in terms of GDP, to advance the concepts of program planning and administration by governmental organizations, and strengthening of staff capabilities.

The report objectives have been established from the point of view of examining the Kosova budget system and its management; budget revenue and expenditure; macroeconomic problems and budget sustainability.

The report aims to identify the main budgetary challenges that the government bodies of Kosova are facing, as well as to show some milestones for potential solutions. The long term objectives of the study deal with undertaking the necessary measures with respect to the infrastructure that would create an adequate environment for dynamic economic development, as a basis for providing a sustainable budget. In the short term, the study aims to identify sustainable budget policies dealing with the legal framework, harmonization of taxation rates, the strengthening of the capacities of taxation and customs administration, a widening of the taxation base, a reduction in fiscal evasion and the informal economy, solutions to the issue of the budget surplus, an avoidance of subsidies for public enterprises, a correct evaluation of budget expenditure, budget management, control and audit. Overcoming the conflicts between the PISG and SRSG, integrating the operative budget and capital investment, as well as strengthening the role of the Kosovar Parliament with respect to the budget and its control, are considered to be very important issues.

The report also addresses the role of fiscal decentralization in increasing the fiscal accountability of local government, local government efficiency, as well as the impact of decentralization on the unity of macroeconomic policies, local development and decentralization efficiency, namely achieving effective cost reductions.

The study has also considered other budgetary resources, such as domestic and international borrowing, the use of privatization and alternative incomes in order to repay such loans. The aim is to secure a safer environment for capital investment in Kosova, which to date is not being covered by current taxation revenue.

1.2. METHODOLOGY

This research project is based on:

- Data and publications from local institutions such as the MEF, the CFA, Riinvest Institute for Development Research, MEF-Macroeconomic Analysis Unit, and the Statistical Office;
- The budgetary position of Kosova in relation to other countries in transition and developed countries is determined by using the comparative method and sources of the IMF, WB, other international organizations and research institutes, and the internet;
- Data from Riinvest surveys has also been used;
- Discussions and meetings have been conducted at some ministries in Kosova, with UNMIK bodies, municipalities and the Pension Savings Trust.
- A study visit has been paid to the Ministry of Finance and the Ministry of Economy of the Republic of Albania;
- A number of brainstorming meetings have been organized with USAID, UNMIK, and MEF experts, and the Riinvest project team.
- A foreign expert (from New Zealand) has been engaged to assist the project and provide his views with respect to international experiences.

The following have been used as sources of information: publications, reports, and data of the MEF, CFA, WB, Institute for Marketing in Gdanjsk, Center for Economic and Social Research (CASE) in Warsaw (Poland), Vienna Institute (WIW) as well as online publications. The report also refers to the results of the Riinvest SME survey (600 SMEs). One chapter of this survey examines the perceptions of Kosovar businessmen on the taxation burden, fiscal evasion, budget transparency and the knowledge of businessmen on the preparation and execution of the budget. In addition the results of other surveys conducted by Riinvest have been used, such as the Household Survey (1250 families), under the Labor Market and Unemployment Project and the survey of 1300 families from different ethnic backgrounds under the Early Warning System Project.

Under recent project activities, the meetings and discussions of the project team with officials and experts of the PISG and UNMIK have been particularly important. A number of meetings have been held with representatives of the MEF, MLSW, Ministry of Education Science and Technology, Budget Parliamentary Commission, CFA, MEF-Macroeconomic Analysis Unit experts, and officials of the Municipality of Prishtina and Lipjan.

In an attempt to produce a wide report, 4 meetings have been organized with USAID experts at the MEF and other macroeconomic experts in this Ministry, and important ideas were exchanged on key issues that were the focus of this study.

In order to learn about similar experiences with respect to budget systems and sustainability from countries in transition, Riinvest paid a study visit to Albania. During this visit, a number of meetings took place with representatives of the Ministry of Finance, Ministry of Economy, university professors and experts from the Private and Public Finance Institute.

In cooperation with USAID, Riinvest engaged a foreign consultant, who assisted and worked together with the project team on budgetary macroeconomic problems and budget sustainability. The consultant finalized the work on-site together with the Riinvest team with a presentation on the experiences of Southeast Asian countries (Malaysia, Vietnam and Cambodia) with respect to budget policies and the macroeconomic management of budgets. He also submitted a fact-finding report at the end of his visit to Kosova. His presentation was attended by a number of participants including USAID representatives, representatives of the MEF-Macroeconomic Analysis Unit and other MEF experts.

Riinvest would like to thank all of them for their comments and support in preparing this Report. However, findings and opinions presented in the report are sole responsibility of Riinvest.

2. THE BUDGET SYSTEM DEVELOPMENT AND MANAGEMENT

2.1. DEVELOPMENTS IN ESTABLISHING THE BUDGET SYSTEM TO DATE²

Immediately after the war in Kosova in June 1999, the focus of the United Nations Mission in Kosovo (UNMIK) was concentrated on securing donations to cover the immediate emergency needs, finance the re-establishment of public administration, the infrastructure and public services. However, in September 1999 the taxation system was introduced and the first tax revenues were collected. Thus a new budget system was established in Kosova under the supervision and administration of UNMIK's Pillar IV and with the technical and financial assistance of the World Bank (WB). In fact, we are dealing with two budgets, established and managed differently: (a) the Kosovo Consolidated Budget (KCB) which provided funds for public servants' salaries and related expenses, using domestic resources (the ratio between revenues from donations and those domestically generated is developed as follows: in 1999, 66%:34%; in 2000, 55%:45%; in 2001, 20%:80%; in 2002, 93%:7%; and in 2003, 93%:7%); (b) the Budget established virtually in total from foreign aid and donations to cover the Program for Capital Investment and Reconstruction.

The administration of both the fiscal and budget systems throughout this period was very strongly influenced by the international administration and was manifested by a slow and gradual process of the transfer of competencies to Kosovar institutions. This process started with the establishment of the initial mechanisms for co-governance (Transitional Council and Joint Interim Administrative Council). The Department of Economy and Finance and the Department for Reconstruction emerged out of 14 established departments (UNMIK 2000/1 Regulation) to manage part of the Kosovo Budget.

UNMIK Regulation 1999/3, dated August 31, 1999, introduced Customs Tariffs (10% rate), Sales Tax (15 % rate), which was later substituted by VAT (also 15 % rate), the presumptive tax, and the tax on services, which together marked the establishment of the taxation system and fiscal administration which were preconditions for collecting budget revenues, and later on for building a functional Budget System.

The Central Fiscal Authority (CFA) was established in accordance with UNMIK Regulations 1999/16, and 2000/7. Prior to the CFA's establishment, the central and local budgets were part of the UNMIK Budget. The CFA was later expanded with new units, including the Treasury Sector, Budget Sector and Macroeconomic Analysis Unit. The establishment of this institutional framework was conducted under UNMIK's umbrella. Regulation 2000/20 established the Tax Administration as one of the first institutions of the Joint Administrative Structures, where local experts were given full competence in applying tax policies and managing taxation procedures.

² Until 1990 Kosova had an autonomous budget of approximately \$0.5 billion. After the repressive Serbian administration was installed in Kosova in 1990, control over the budget was forcefully transferred to Belgrade. More details can be found at: "Economic Activities and Democratic Development of Kosova", Riinvest, 1998, 1999.

So far, several legal documents have been enacted, regulating specific aspects of the Kosova Budget System, including budget revenues and expenditures. Yet, Kosova lacks the formal powers that would provide for a modern, effective and transparent Budget System.

After the establishment of the Provisional Institutions of Self-Government (PISG: Kosovar Assembly and Kosovar Government, December 2001 – March, 2002), it became clear that the overall budget process and budget management needed to be reviewed and systematized. It is evident that disagreements between the stakeholders involved in the budget process (UNMIK and Kosovar/Government and Assembly) are caused in many instances from the duality of the budget. There is an obvious asymmetry in the competencies between PISG and UNMIK, specifically as concerns the CFA, Economic and Fiscal Council (EFC) and SRSG. Neither the Constitutional Framework of Kosova nor UNMIK's Regulations have yet clearly addressed the issue.

In spite of the transfer of powers from UNMIK to the PISG, proclaimed by UNMIK in this aspect through the inclusion of the CFA in the Ministry of Economy and Finance, there are no substantial changes. Already, problems have emerged in planning the budget and managing its execution. The budget surplus from 2002 seems to be as high as almost $\frac{1}{4}$ of the annual budget. Such a high budget surplus on the one hand, and the lack of information on the exact figures on the other speak for weaknesses and problems in budget management and raise the need for a more modern, transparent and sustainable budget system. This surplus is inappropriate at the present time in the presence of high unemployment and low inflation.

Another major problem is caused by the difficulties in exercising UNMIK's Authority in the whole territory of Kosova, particularly in collecting taxes in the Northern part of Kosovo, and generally in enclaves where Serbian Authority is still present in various forms, with intervention from the Budget of Serbia (in providing salaries for teachers, doctors etc).

One of the factors for stagnation in enacting systemic laws in the field of public finance management could be the fact that Kosovo, in contrast to other countries, has two legislative authorities i.e. the Assembly and the SRSG. The Regulation on the Kosovo Consolidated Budget 2002/23 was signed by the SRSG without Kosovar Assembly approval. The Assembly has serious complaints with one article of this Regulation that stipulates a different budget code for Northern Mitrovica, thus leading to specific budget status for this part of the Mitrovica Municipality. These are only some of the examples which show that the current model of budget management in Kosova is producing tension and lacks transparency and efficiency.

2.2. SOME SPECIFICS OF THE KOSOVA BUDGET SYSTEM

The Law on Public Finance Management and Accountabilities³ is structured to secure enough preconditions to establish the budget system in accordance with market economy standards. However, the current status of Kosova and the confusion regarding its competences are negatively reflected in some of the essential articles of this law. The management and decision-making process is complicated and does not provide the necessary symmetry between the powers and responsibilities of different stakeholders involved in the budget system. The role of the Kosovar Assembly and Kosovar Government has been strongly neglected. Even with this law, the Economic Fiscal Council (EFC) has not been properly established within the new system, after the declared unification of the MEF and CFA. The PISG's role is not properly defined in law either.

Regarding the decision-making procedures on budget policies the World Bank Report, among others, specifies that some great challenges must be faced such as: i) Balanced powers between the SRSB and the PISG in budget preparation in order to achieve maximum autonomy and accountability of the PISG; ii) Establishment of strong and accountable relations between the executive branch of the PISG and the Assembly, as well as between the Assembly and the Kosovar people; iii) Consensus must be achieved throughout the budget preparation process, and negotiations must not start at the end of the process.⁴ It is evident that as regards the above mentioned suggestions, further efforts should be made to improve the law, in particular to advance the practices of the application and management of the budgetary process. The Law provides for powers that are separate and potentially duplicative between the EFC and the MEF. This will have potentially serious consequences in the development of a single integrated set of financial policies for Kosova's already-fragmented government.

What could be considered as an important advancement compared to the existing practice is the planning of the budget as part of a midterm fiscal program (three years) based on macroeconomic prognosis, and should be drawn up in cooperation with the IMF and the World Bank (Article 17). We consider this to be very important because the budgets to date (2000-2003) have not been sufficiently related to the macroeconomic situation and the priorities of budget policies. In this respect the fiscal policy, as one of the key instruments for macroeconomic regulation, was not properly based on the current situation. The budget was established in reaction to the emergency needs. There were some real difficulties, especially the lack of solid data on macroeconomic indicators and their fluctuations. This has made the realistic planning of budget revenues difficult and has mainly resulted in budget surpluses. Another problem related to the budget surplus is the lack of organizational capabilities of some ministries and municipalities to manage the allocated sources.

In November 2002 the World Bank published the report: Medium-Term Public Expenditure Priorities of Kosova, which is an important document to use as a base in drafting budget policies. However, some of the projections and goals do not look

³The Law "On Public Finance Management and Accountabilities" was enacted by the Assembly of Kosova on January 23, 2003 and signed by Mr. Michael Steiner, Special Representative of Secretary General in May 2003. All references in title 2.2 of this chapter to the "budget law of Kosova", or "the law" refer to the above document.

⁴World Bank Report: Medium-Term Public Expenditure Priorities of Kosova pg. 93 (October, 2002)

very valid or realistic because new data shows that the level of macroeconomic indicators has not been properly estimated (for example the share of budget revenues in GDP set as a goal for 2005 has already been achieved in 2002).

2.2.1. Some comparative observations

In order to better examine the specifics of the Kosova Budget System, what follows is an analysis of some of the characteristics of this law compared to the respective laws of Albania and Macedonia. Despite the unique characteristics of the Kosova Budget Law, distinguishable from the Albanian⁵ and Macedonian⁶ models, the three models are more similar than different. A similar structure is present in all the models, with chapters regulating the process of budget preparation, budget execution, borrowing, auditing, violations and penalties in a similar way. Also the terminology in the three models is similar and it is not difficult to conclude that the budget laws of Kosova, Albania and Macedonia are based on identical principles.

But what makes Kosova's law different? First of all, a more complicated process of budget preparation. More actors (local and international) are involved in the process of annual budget approval. There is also a more complicated procedure for budget approval than in Albania or Macedonia. These additional complications are not new, if we take into account the unique features of the Kosovar administration structure, separated into reserved and transferred agencies each having transferred and reserved competencies. Moreover, since the beginning of the year 2003 the so-called 'process of transfer of competencies' to local institutions has begun and the current system of competencies is in a state of change. Under these circumstances, a dilemma is raised: will the law on public finance management approved by the Kosova Assembly in January 2003 reflect the changes that will follow the transfer of power, or will it need to be reviewed.

Let us have a look at the following schemes, which present simple illustrations of the budget preparation and budget approval circles in countries such as Albania and/or Macedonia, beside the budget preparation circle in Kosova.⁷

⁵ Law No. 8379 date 29.07.1998 on "Preparation and Execution of the State Budget" (English version used, translated by Anduena Shkurti) available online at: <http://www.minfin.gov.al/vershqip/buxheti/organik.htm>

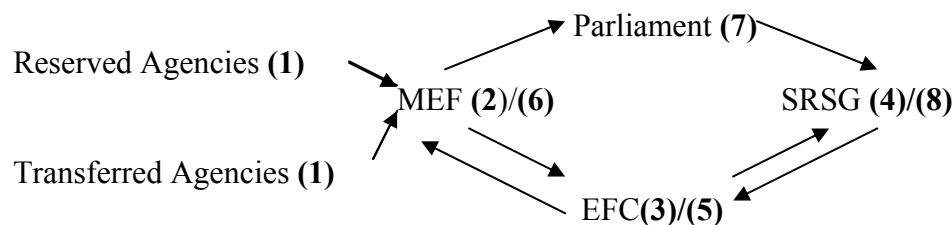
⁶ Law on Budgets ("Official Gazette of the RM" no. 35/01 of May 7, 2001-Unofficial translation in English used) available online at: <http://www.finance.gov.mk/gb/index.html>

⁷ In accordance with the model proposed by the Law on "On Public Finances Management and Accountabilities" (see footnote)

*I. The Circle of Budget Preparation and Approval in Albania/Macedonia:*⁸

Budget Agencies/Institutions (1) → MF (2) → Government (3) → Parliament (4)

II. The Circle of Budget Preparation and Approval in Kosova:



The first scheme is simple. The Ministry of Finance (MF) after having considered the proposals from the budget agencies prepares the draft budget and submits it to the Government. The Government, after reviewing the draft proposed by the Ministry of Finance, submits it for final approval to the Parliament before the beginning of the new fiscal year.

The second scheme (Kosova's case) seems more complicated. The budget agencies submit their proposals for budget funds to the MEF. The latter prepares the budget proposal and submits it to the Secretariat of the EFC. The law stipulates that after reviewing the budget proposal, the EFC "...provides to the Minister of Economy and Finance a register ... in which all the EFC's decisions are recorded." (see: Article 20.5) The law obliges the Minister of Economy and Finance to make the appropriate changes in the budget proposal "in accordance with the register of the earlier decisions of the SRSG, provided by the EFC's Secretariat..." (see article 20.6). while article 20.7 provided for the formal obligation of the government to hand the project proposal to the Assembly.⁹

The above explanation highlights the active role of the EFC in budget preparation and the formal role, or more the sidestepping of the role, of the government in the process. The drafters of the law might have considered the Government's voice exhausted in the course of the MEF's contribution. However, the MEF is not as inclusive a body as the government, therefore the removal of the most important body of the executive from the process makes no sense. Would it make sense if the government formally submits a budget proposal to parliament, without being consulted, or worse without even supporting the proposal? Moreover, a government with formal competency in the process of public revenue preparation and distribution is seriously hampered and its whole activity becomes very formal.

Let us discuss another important aspect of the law, the chapter on borrowing.¹⁰ There is a separate chapter on borrowing in the Kosovar model similar to the Albanian and Macedonian model of law. Undoubtedly this is a positive step forward because for the first time the law provides for the right of the budget institutions of Kosova "to

⁸ Similar scheme is followed in most developed nations around the world.

⁹ Because the Government plays simply a formal role in submitting the Budget Proposal to the Assembly, we have not illustrated it in the scheme II.

¹⁰ See chapter IX of the law entitled: Restrictions in borrowing, grants, lending and capitalization.

borrow or to enter into borrowing agreements” (article 46.1), complying in the meantime with certain conditions. The law itself also includes a list of the financial institutions that can enter into borrowing agreements with Kosova budget organizations (in contrast to what is done in the Albanian and Macedonian cases).

Even in this respect the budget law of Kosova has its own specifics, mostly due to the undefined status of Kosova and its constitutional framework. For example, in contrast to the Albanian and Macedonian models, which use the term “governmental debt”, the Kosovar law does not refer to such “governmental debt”, but to borrowing from budget organizations (see article 46.1), while article 46.4 says that “the total amount of the *public debt* should not exceed 60% of GDP and the deficit should not exceed 3% of GDP”. Thus, while the Albanian and Macedonian versions of the law literally sanction that only the government has the right to borrow/enter into borrowing agreements¹¹, Kosova’s law gives this right to the “budget organization” (article 46.1), with the MEF as the only agent in all borrowing activities (article 46.7). However articles 46.3, 46.4, 46.5 and 46.6 provide for a series of rules, conditions and restrictions that apply in the case of borrowing activities from budget organizations. To start with, it is required that the MEF receives comments by the Banking and Payment Authority of Kosova, Budget Department, Treasury and the Department of Economic Policies within the Ministry and passes these comments to the Government and SRSB (article 46.3). Later on, these two should *jointly* approve the proposed borrowing. (Article 46.5)

From the analysis of the articles of this chapter we can see (beside the undisputable authority of SRSB) a more active role for the Government in examining the budget requests for borrowing, as compared to Government’s role in budget preparation. The role of the MEF in this chapter is properly focused on the preparation of the borrowing proposal (receipt of advices, submission of the advice to the Government and SRSB) or on its role as authorized agent in budget activities, leaving the decision-making part to the Government and SRSB.

The analysis of this chapter’s articles shows that despite the differences in terminology (the law does not explicitly provide for the terms “governmental debt”) this chapter regulates the same kind of borrowing and in a similar way as the “government debt” is regulated by the respective chapters of the Albanian and Macedonian laws. Thus, even in Kosova’s case we are dealing with a debt that counts toward the whole central budget and inefficient management of this kind of borrowing would become a heavy burden for future budgets.

What is unique in Kosova’s case is the joint approval, from both the Government and the SRSB, of the borrowing request. Lack of consensus would lead to an inefficient process of borrowing as described in chapter IX. Not only with respect to borrowing, but also with regard to public finance management in general, the consensus between the executive and SRSB is decisive, therefore there is a feeling that the borrowing process can easily be stopped.

¹¹Albania Law “The *Council of Ministers* shall be solely entitled to borrow from any legal entity or individual in compliance with actual laws or other legal decisions” (Article 35.1). Macedonian Law “Only the *Government* has the right to take loans from any legal or natural entities from the country and abroad in compliance with a law...” (Article 48). (Article 51 of this law rules that “debt include: loans, bonds or treasury bills”).

2.3. FISCAL DECENTRALIZATION

In accordance with regulation 2000/45 on municipal self-government, municipal assemblies are authorized to prepare the municipal budget, which should consist of planned activities and economic management within the fiscal year, including all planned revenue, capital and general expenditure of the municipality.

The law on public finance management gives power over budget activities to the Municipalities through the Finance Executive Director, Treasury Department and Budget Department in accordance with analogous procedures to those applied at the central level. Regarding government transfers, the Grant Commission has been established, and consists of the representatives of the government (Prime Minister, Minister of Economy and Finance and another Minister), the Head of the Budget Committee in the Assembly and representatives of the Municipalities' Association. A new measure is that municipalities will receive grants in accordance with a given formula and a three-year schedule, which leads to better planning and preparation of respective programs (article 59). The municipalities will have accounts in the Kosova Consolidated Fund, in which they will deposit revenue collected from taxes and other municipal fees (article 58).

Such a process for the circulation of municipal revenue/income seems a little complicated. How rational it is (with respect to administrative costs and efficiency) to depose municipal revenue to the consolidated budget, instead of passing it directly to the municipal accounts, should be examined further. During 2002, 24 municipalities were certified to fully manage their budgets. The application of unique accounting and reporting standards will increase the efficiency and the transparency of the management of local budgets. A special contribution in this aspect is the involvement of the municipalities in the Free Balance Project.

Another important component of fiscal decentralization, as well as of the general decentralization of local government, is its cost. In Kosova such an issue is often left aside for no reason, with more emphasis put on the political and ethnical effects of decentralization.

One side of the coin is the efficiency of taxes collected at a local level, such as property tax. The experiences of some countries have shown that the costs of organization, administration and collection of such a tax sometimes exceed its financial benefits. Another issue deals with the expanded local administration as a result of decentralization. This would place the burden directly onto taxpayers through higher tax rates at either central or local levels. Therefore decentralization should be developed in conformity with the economic potential and preferences of the country, while central authorities should keep complete information about municipal expenditure and have adequate systems for its evaluation.

Besides competence in budget preparation, administration and management of budget revenue and expenditure, according to current regulations as well as the budget revenue from government transfers, the municipalities can decide and collect their own revenue from the following sources:

1. Administrative taxes for issuing licenses and other fees determined by the municipalities;

2. Revenue from municipal assets;
3. Property tax;
4. Fines or a certain percentage from fines.

The administration of property tax: The implementation phase of property tax is still progressing slowly. This process should be intensified in order to make this tax one of the main sources of local revenue in the near future. The Draft Law on Immovable Property has been passed by the Assembly, but rejected by the SRSG, with the argument that the Assembly is not authorized to pass this kind of law. Property tax is the only form of taxation so far totally administered by local government. However, in order to make it an important source of local revenue there is a need for a defined framework for rates and burdens countrywide. Because of heavy burdens in some municipalities and the lack of tax collection mechanisms, the overall tax collection for this kind of obligation is still minimal. Furthermore, even the experiences of other countries in transition do not seem very encouraging with regard to the expected contribution of this source in a short period of time.

The administration of taxes and burdens: In accordance with the Administrative Instruction DLA/CFA 2001/1(2), municipalities can make modifications to their system of taxation and burdens. We have already discussed the characteristics of the situation immediately after the war, when municipalities applied wide based taxes, paying less attention to establishing a suitable environment for business development. The Administrative Instruction 2001/1(2) also provides for municipalities to apply taxes and burdens in accordance with the principle of return on expenditure, as well as providing for useful supervision and practical regulations concerning the organization of such a system. The above Instruction also requires the municipalities to submit the revised system of taxes and burdens to the DLA and CFA for approval. Obviously the problems remain not in the system's establishment, but in its implementation. Even though the municipalities started their own revision of taxes and burdens in September 2001, so far only half of the revisions presented to DLA and CFA have been approved. The finalization of this process and the implementation of a new tax system can no longer wait.

2.4. BUDGET MANAGEMENT AND TRANSPARENCY

Important preconditions to establishing a sound budget system and effective budget management require the following:

- A properly defined strategy concerning general priorities and a sound sectoral analysis;
- Funds to implement projects;
- Capable and responsible institutions that would transfer these funds in an efficient manner;
- Program management and budget execution based on analysis of quantitative information regarding the budget spending.

This process requires the establishment of transparent practices for budget management and a sound degree of accountability in the collection of budget revenue and its distribution. A series of sensitive decisions should be taken in setting

priorities (accompanied by rigorous estimation, open debate, competition of needs/projects based on proper sectoral strategies). The public should be educated in order to ensure its active participation in discussions about the priorities. This kind of process would lead to a more realistic budget, also followed by a system of budget monitoring and estimation, so that a higher level of accountability would result in better budget management.

The first steps necessary in establishing this kind of practice have not yet been initiated in Kosova. Discussions on the budget and its managerial practices are not open enough to the public and sometimes, even to important institutions such as Parliament.

Viewed from the aspect of accountability and internal reporting among budget entities and the MEF, the new law on public finance management provides for standards that offer the possibility of responsible and transparent reporting. This law also regulates internal revision. However, in this process, it looks like the chain starts breaking when it comes to accountability to taxpayers, public information and reporting to the Assembly. The obligation for external budget auditing has also been left aside, which should be considered to be a precondition to transparency and accountability.

The level of public information with respect to the Kosova Consolidated Budget and municipal budget is very low. The survey of 600 private businesses shows that only approximately 9% of respondents consider that they are properly informed about budget expenditure, while only approximately 5% are informed on where and how the budget revenue from taxes and customs are distributed.

The budget system and its management should contribute toward the establishment of the concept of a “national budget of Kosova”, which should justify public expectations and increase fiscal culture in general. Also public awareness, as regards their responsibility as a taxpayer, should be increased, notwithstanding transparent policies and the accountability of budget managers toward the taxpayers.

3. BUDGET REVENUE AND BUDGET CONSUMPTION

3.1. THE EXPERIENCES OF TRANSITION COUNTRIES WITH REGARD TO BUDGETS

Economies in transition face many problems with regard to macroeconomic stabilization, and in particular one of the most difficult challenges is balancing the budget. Causes of budget imbalance can be found on both the revenue and expenditure sides.

The first phase of reform in many transition countries was characterized by the collapse of budget revenue. A considerable decline in profit was recorded amongst state owned enterprises in most Central and Eastern Europe (CEE) countries. This decline led to an erosion of the tax base and revenue. On the other side, budget expenditure grew considerably, followed by a change in their structure. In these circumstances, governments have not been that effective in cutting expenditure, at

least not relative to the falls in revenue.¹² Lowering of budget expenditures can be done either by simply spending less money (by cutting budgets, eliminating programs or state institutions, etc.) or by privatizing activities or resources that previously had been funded through the budget, and thus there no longer is the need to spend government money on them.

In terms of the stabilization of their state budget, the governments of these countries embarked on fiscal policy reform and a redefinition of the role of the state in the economy. In this context, redefinition also meant that the state should lower budget expenditure and adjust it according to the model of a market economy.¹³ Fiscal policy reform was to include firstly the imposition of a taxation system that was found to be inappropriate for the newly created circumstances. Most of these countries aimed to introduce similar taxation systems to those in developed countries. Some of them made progress in this respect (Slovenia, Czech Republic, Slovakia, Poland, Hungary and Croatia), by increasing their capabilities in tax revenue collection and providing a relatively high share of revenue to GDP. However, in some other countries that have still not completed their fiscal and tax administration reform, the share of revenue to GDP is low, indicating the problems they are experiencing in revenue collection, which in turn can be explained by a large informal economy, such as Russia and countries of the Former Soviet Union (FSU).

In their attempt to keep the ‘explosion’ of expenditure under control, the governments of less advanced countries in transition changed the priorities of budget expenditure in their program. The share of total expenditure for education, health and social security were increased. At the same time, subsidies for state owned enterprises and expenditure for the military and police services were reduced. For the purposes of maintaining the level of salaries of those employed in administration, these countries exhibit a bias to maintaining the current level of consumption, implying a decline in public investment.

In countries that are at an advanced stage of transition (Croatia, Czech Republic, Hungary, Poland, Slovakia and Slovenia), the share of budget expenditure to GDP is over 40%, whereas in those at a less advanced stage this share varies from 30% to 40% in Estonia, Albania and FYR of Macedonia, to 52.7% in Bosnia and Herzegovina.

In relation to the progress achieved in budget reform in transition countries, the group of countries that are on the way to becoming members of the European Union (EU) are distinguished by their progress in comparison to the rest. Countries joining the EU achieved a balanced budget faster in their first phase of reform than in later stages, when their attempts for stabilization were continually faced with budget deficits (see table 1). Despite this, the recent theory of public finance abandoned the principle of budget balance, and budget deficits as a percentage of GDP are being regarded more and more as a regular phenomenon.¹⁴ Thus in the last three years almost all CEE countries faced this phenomenon, ranging from 11.4% in 1999 in Albania to 1% in 2000 Bulgaria. Active fiscal policies are oriented towards economic and social

¹² See: Nicolas Stern, ‘What Tax Reform is Needed for Fast Economic Development’, Working Paper Series No. 30, CASE-CEU, 1999.

¹³ Progress with Fiscal Reform in Transition Countries, in *World Economic Outlook*, pp. 98-113, IMF, 1998.

¹⁴ See e.g. Dejan Runtevski, ‘Fiscal Burden in the Transition Economies’.

effects. One of the priorities in the agenda of these countries is the program for increasing the efficiency of budget expenditure and decreasing their overall level.¹⁵

Table 1: Budget deficit in selected countries as a % of GDP

| Country/Year | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|----------------|-------|-------|-------|-------|------|------|
| Croatia | -1 | -2 | -3.1 | -7.8 | -5.6 | -6.4 |
| Czech Republic | -0.3 | -1.2 | -1.5 | -0.6 | -3.2 | -2.4 |
| Estonia | -1.9 | 1.8 | -0.2 | -4.5 | -1.1 | 0.3 |
| Hungary | -2.9 | -6.6 | -5.6 | -2.5 | -4.5 | n.a |
| Latvia | -1.6 | 0.6 | -0.7 | -3.8 | -3.3 | n.a |
| Lithuania | -4.6 | -1.1 | -5.4 | -8.1 | -2.9 | n.a |
| Poland | -3.3 | -1.9 | -1.8 | -1.1 | 0 | n.a |
| Slovakia | -1.2 | -4.8 | -4.7 | -3.4 | -3.5 | -4 |
| Slovenia | 0.3 | -1.1 | -0.6 | -0.7 | -1.3 | -1.3 |
| Albania | -12 | -12.5 | -10.4 | -11.4 | -9 | -8.5 |
| B & H | -52.2 | -0.5 | -7 | -7 | -5.5 | n.a |
| Bulgaria | -10.3 | -2.4 | 1 | -0.9 | -1 | -0.9 |
| FYROM | -0.6 | -0.7 | -1.7 | 0.2 | 2.5 | -6.5 |
| Romania | -4.8 | -5.3 | -5.4 | -3.6 | -4 | -3.2 |

Source: IMF Country Reports
EBRD Transition Report

Countries at a less advanced stage of transition are still in the phase of fiscal stabilization, in a ‘battle’ to increase revenue, and their emphasis on fiscal reform still focuses on the revenue side (e.g. Russia and FSU countries). In such countries completion of the reform of the tax system still remains a priority, by eliminating tax exemptions and the variety of taxes on the one hand, and expanding the tax base and reducing the high level of informal economy currently missing from the fiscal system, on the other.

3.2. DEVELOPMENTS IN BUDGET REVENUE

The fiscal policy of a country plays an important role in economic growth. This policy, together with its main components, determines macroeconomic stabilization. Activities that have been undertaken in Kosova during the last four years in building a fiscal policy have produced significant effects in a narrower fiscal sense, because a very high level of budget revenue has been collected from domestic sources. However, these policies, as a precondition for a stable system, have not shown great effects in terms of economic growth and performance, which at this stage is becoming crucial issue.

The tax system in CEE and Baltic countries in the early stages of transition was characterized by a fall in tax revenue as a share of GDP. Another characteristic is the change in dynamics and the share of direct vs. indirect taxes in the structure of tax revenue.

¹⁵ Progress with Fiscal Reform in Transition Countries, 1998, *ibid*.

Table 2: Revenue as a share of GDP in selected countries

| | Budget revenues /GDP | | | | | | Tax revenues /GDP | |
|----------------|----------------------|------|------|------|------|------|-------------------|------|
| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2001 | 2002 |
| Kosova* | - | - | - | - | 9.0 | 17.6 | 16.2 | 24.0 |
| Albania | 18.3 | 16.9 | 20.3 | 21.3 | 22.4 | 23 | 19.4 | - |
| FYROM | 35.7 | 34.8 | 33.3 | 35.4 | 36.8 | 34.3 | 25.0 | - |
| Bulgaria | 31.7 | 30.7 | 38 | 38.7 | 38.7 | 37.7 | 28.8 | - |
| Romania | 29 | 28.6 | 29.7 | 31.9 | 31.4 | 30.5 | 28.3 | - |
| Croatia | 44.3 | 42.5 | 45.6 | 42.8 | 40.4 | 39.4 | 37.3 | - |
| Slovenia | 42.7 | 42.1 | 43 | 43.7 | 42.8 | 43.3 | 39.5 | - |
| Czech Republic | 40.3 | 39.7 | 38.6 | 39.1 | 39.3 | 39.5 | 36.2 | - |
| Slovakia | 43.7 | 41.4 | 39.2 | 40.6 | 38.2 | 35.6 | 30.2 | - |
| Poland | 43.2 | 41.8 | 40.7 | 41.1 | 39.7 | N/a | 33.1 | - |
| Lithuania | 29.6 | 32.6 | 32.7 | 32.1 | 30.3 | N/a | 28.4 | - |
| Estonia | 38.8 | 39.8 | 39.3 | 38.1 | 38.7 | 38.7 | 34.3 | - |

Source: IMF, Country reports
EBRD Transition Report 2001

*Fiscal Unit/Pillar 4, as of April 3 2003.

There is a decline in the share of direct taxes (tax on personal incomes and tax on profit) and contributions for social insurance in the structure of tax revenue. A drastic decline in the share of profit tax is a characteristic of all these countries. This decline is attributed especially to the weak performance of socially owned enterprises, associated with the collapse of enterprise profits and a decline of the tax base.

Some countries such as Croatia, Poland and Slovakia showed a decline from higher to lower tax rates, while in others there is a slow and stable trend of increase in budget revenue as a share of GDP.

GDP estimations for Kosova are of questionable accuracy, given the difficulty in measuring macroeconomic indicators and the limited availability of reliable data, in particular the real value, not only of GDP but also of other macroeconomic indicators.

It is worthy of mention that there are big differences between the sources of total budget revenue in different countries. Such a difference is a result of other non-tax revenue that the central budget has been protected by, e.g. the profits of national banks, privatization revenue, public borrowing and other sources. In Kosova in 2001, the share of total budget revenue to GDP was 17.6%, and the share of taxes and fees was 16.2%. In 2002, the share of total budget to GDP increased to 25%, and the share of taxes to 24%. Tax revenue is overwhelmingly the most important source of total budget revenue in Kosova and increasingly so.

Compared to the following group of countries, Kosova's share of total budget, taxes and fees to GDP for the year 2000, is as shown in the table below:

Table 3: Structure of taxes in industrial and transition countries

| Group countries | Budget/GDP | Taxes/GDP |
|--------------------------------------|------------|-----------|
| OECD countries | 42.9 | 36.6 |
| European Union ¹⁶ | 45.2 | 39.4 |
| CSB ¹⁷ (early transition) | 40.8 | 35 |
| CSB (late transition) | 37.7 | 33 |
| CIS ¹⁸ (early transition) | 29.3 | 24.4 |
| CIS (late transition) | 25.5 | 22.2 |
| Kosova (2002) | 25.0 | 24 |

Source: "Tax reform in Transition" Pradeep Mitra and Nicholas Stern, the World Bank Policy Research Working Paper 2947, January 2003.

Countries of the European Union lead in the share of revenue to GDP. Amongst countries in the early stage of transition, Slovenia, Czech Republic, Croatia and Poland have a higher share of GDP. In 2002 Kosova, measured by the share of revenue from taxes, was at the level of CIS countries in 2000, which belonged to the early stage of transition. The current state of SOEs due to their delayed privatization and weak performance is also negatively influencing the budget revenues.

¹⁶ Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, Sweden, Great Britain.

¹⁷ CSB (Central and Southeast Europe and Baltic): Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia, 'FRY'.

¹⁸ CIS (countries of the former Soviet Union): Armenia, Azerbaijan, Byelorussia, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russian Federation, Tajikistan, Ukraine, Uzbekistan, Turkmenistan.

3.2.1. The structure and dynamics of budget revenue

Budget revenue in Kosova is provided by domestic and foreign (donor) sources. Domestic sources of budget financing were very simple at the beginning. Until July 2001, nearly all taxes in Kosova were applied against businesses, viz. presumptive tax, sales tax, tax on hotel services and beverages, customs duties and excise taxes.

Table 4: Total government budget revenue (in million €)

| | Tax revenues | | | | Index | | | |
|---|--------------|--------------|--------------|--------------|-------|-----------|-----------|------------|
| | 2000 | 2001 | 2002 | 2003 pr. | 2000 | 2001/2000 | 2002/2001 | 20003/2002 |
| REVENUES | 128.5 | 307.2 | 498 | 491.9 | 100 | 2.39 | 1.62 | 0.99 |
| Tax revenues | 121.5 | 287.5 | 437.4 | 439.2 | 100 | 2.37 | 1.52 | 1.00 |
| Taxes on personal incomes | 6.3 | 32.9 | 45.2 | 52.6 | 100 | 5.22 | 1.37 | 1.16 |
| Profit tax | 0 | 0 | 6.1 | 15.7 | 100 | | | 2.57 |
| Presumptive tax | 4.7 | 29.6 | 30.7 | 27 | 100 | 6.30 | 1.04 | 0.88 |
| Tax on salaries ¹⁹ | 0 | 0 | 8.4 | 9.9 | 100 | | | 1.18 |
| Taxes on food and beverages | 1.6 | 3.3 | 0.1 | 0 | 100 | 2.06 | 0.03 | |
| Tax on consumption | 82.9 | 206.7 | 322.2 | 327.3 | 100 | 2.49 | 1.56 | 1.02 |
| VAT | 63.4 | 129.4 | 196.6 | 203.5 | 100 | 2.04 | 1.52 | 1.04 |
| -Imports(including sales tax) | 63.4 | 118.2 | 169 | 180.5 | 100 | 1.86 | 1.43 | 1.07 |
| -Domestic | 0 | 11.2 | 27.5 | 23 | 100 | | 2.46 | 0.84 |
| Excises | 19.5 | 77.3 | 125.6 | 123.8 | 100 | 3.96 | 1.62 | 0.99 |
| Customs duties | 32.3 | 47.9 | 70 | 59.3 | 100 | 1.48 | 1.46 | 0.85 |
| Non-tax revenues | 5.8 | 21.5 | 33.7 | 24.9 | 100 | 3.71 | 1.57 | 0.74 |
| Revenues of local administration | | 15 | 19.8 | 27.8 | 100 | | 1.32 | 1.40 |
| Adjustments | 1.2 | 16.8 | 7.1 | | 100 | 14.00 | 0.42 | |

Source: Estimations of Fiscal UNIT/Pillar 4, as of April 3, 2003

In July 2001, the introduction of VAT caused the removal of part of the tax on consumers, by replacing the sales tax and a part of the presumptive tax and taxes on services and hostelry. In September 2001, the tax on property was introduced in an experimental form, which was left in the competence of local government. Later, in April 2002, profit tax and tax on personal incomes came into force.

The highest growth in tax revenue was recorded in 2001, when growth exceeded domestic revenue in 2000 by 2.39 times. Also, in 2002 revenue was 62% higher than in the previous year. In 2003, it is estimated that tax revenue will be at the level of 2002. Excise taxes and VAT recorded the fastest growth over this period.

At the same time, there is an apparently disproportionate burden in the current budget between domestic budget revenue and revenue gathered at the border.

¹⁹ Public opinion in Kosova at the beginning of this year expressed its unhappiness concerning the announcement to raise the tax on salaries from 10% in 2002 to 20% 2003. After discussions carried out with the Government, UNMIK, and IMF mission, it was agreed that that the tax rate on salaries should be as follows: there will be no charge for a salary of € 80; salaries from € 80-250 will be charged at 5%; the tax rate for € 250-450 will be 10%; and 20% for salaries over € 450. These differences will cause a loss of € 6 million which it is envisaged will be covered by other taxes. This will also change the planned share of taxes on salaries with respect to budget revenue.

Table 5: Domestic taxes and taxes gathered at the border

| | 2000 | 2001 | 2002 | 2003 |
|-------------------------------------|-------------|-------------|-------------|-------------|
| Profit tax | | | 1.4 | 3.6 |
| Presumptive tax | 3.9 | 10.3 | 7 | 6.1 |
| Tax on salaries | | | 1.9 | 2.3 |
| Domestic VAT | | 3.9 | 6.3 | 5.2 |
| Taxes on food and beverages | 1.3 | 1.1 | | |
| Domestic revenues | 5.2 | 15.3 | 16.6 | 17.2 |
| VAT on imports* | 52.2 | 41.1 | 38.6 | 41.1 |
| Excises | 16 | 26.9 | 28.7 | 28.2 |
| Customs duties | 26.6 | 16.7 | 16 | 13.5 |
| Taxes gathered at the border | 94.8 | 84.7 | 83.4 | 82.8 |
| Total | 100 | 100 | 100 | 100 |

Source: Estimated by Fiscal UNIT/Pillar 4, as of April 3, 2003

* For 2000 and for the first half of 2001 that implies sales tax

Despite a declining trend from year to year of the proportion of domestic taxes to taxes gathered at the border, the current proportion is still regarded as inappropriate. Such a state of affairs is first of all a result of the slack charging of VAT on products and services produced in Kosova, the non-applicability of excise tax on some domestic products, (viz. tobacco and alcoholic drinks) and then, laxity in the implementation of the tax on personal incomes (so far only salaries are taxed) and the very low share of profit tax. The slack charging can also be a symptom of an uneven economic system, rather than only the failure to collect taxes.

Continuation of this trend will endanger budget revenue given the fact that donor revenue sources are significantly diminished, and that consequently imports for investment and reconstruction will diminish as well. Surveys indicate an apparent tendency in the decline of total imports due to the decline of turnover and the purchasing power of the population.²⁰

The likely non-sustainability of the budget can be seen from comparisons with other countries in the table below:

Table 6: Structure of taxes in countries by group

| | Tax revenues | Type of taxes | | | | | |
|------------------------|--------------|----------------------------------|------------------|---|------------------------------|--------------|-------|
| | | Revenues from profit and capital | Social insurance | Taxes on domestic products and services | Taxes on international trade | Property tax | Other |
| OECD countries | 100 | 39.6 | 23.3 | 29.6 | 0.5 | 5.3 | 1.8 |
| European Union | 100 | 36.0 | 26.6 | 31.3 | 0 | 3.9 | 2.2 |
| CSB (early transition) | 100 | 27.5 | 31.5 | 31.7 | 6.2 | 0.7 | 2.4 |
| CSB (late transition) | 100 | 22.5 | 31.6 | 37.9 | 4.3 | 1.3 | 2.4 |
| Kosova (2002) | 100 | 3.3 | - | 13.3 | 83.4 | - | - |

Source: the World Bank documents (data for 2000).

Taxes gathered at the border in OECD countries represented only 0.5% seems very low of total tax revenue. In Southeastern Europe in the early stages of transition they counted for 6.2%, as opposed to the very high share in Kosova of 83.4%. In developed countries, taxes on personal incomes have the highest share, while in transition countries taxes on domestic products and services still dominate the total

²⁰ Riinvest: Survey of 600 NVM, December 2002.

structure of taxes. This might suggest that much of the commerce of Kosova is cross-border, and that Kosova has unique characteristics.

An unbalanced structure of taxes is also evident from the share of customs duties in the total tax revenue in Kosova of 16.7% in 2001 (16% in 2000) vs. 9.4% in Albania, 11.2% in FYROM, 3.5% in Romania and 2.2% in Bulgaria.²¹ The high level of customs duties in Kosova does not encourage economic development, bearing in mind that linear customs tariffs of 10% are being implemented on all imports, whether they are imports of consumer goods or capital goods. The program of the Government of Kosova envisages the lowering of customs tariffs for the import of equipment to be used for investment, but this program has not yet been applied. Moreover, no concrete steps have been undertaken to reduce customs tariffs from the viewpoint of free trade with neighboring countries, in accordance with the process of the integration of economic and trade structures of the EU.

Findings from the survey of private businesses²² indicated that the objection of businesses is not to border taxes *per se* but to tax levels generally. Around 69% considered customs duties to be high and insurmountable, 65.7% considered excise duties in the same way, and 58.1% leveled such criticisms about VAT. There have been similar opinions with regard to customs and excise duties since 2000. Over 50% of SMEs consider direct taxes, such as profit tax, the tax on salaries and contributions for pensions as overwhelming. The findings also showed that firms believe that only 70% of the VAT tax burden falls on consumers with the remaining of 30% falling on firms, due to the price elasticity of demand.

3.2.2. Fiscal Evasion, the informal economy and budget revenue

So far in Kosova there has not been any specific research on the impact of the informal economy and fiscal evasion on enterprises' income and budget revenue. According to Riinvest's research on specific issues of fiscal policy, among the factors that influence fiscal evasion are:

- The incomplete coverage of border crossings and the lack of uniformity of tax tariffs applied at the border.
- UNMIK's acknowledgment of the preferential trade system with FYRM and the misuse of certificates of origin for goods.
- The high level of tax and customs tariffs, in particular the lack of clear regulations in terms of the level of excise tax for imports.

Fiscal evasion takes the form of illegal activities such as bribery, racketeering, looting and unrecorded economic activities that evade tax obligations.

The dimensions and forms of the informal economy (grey economy) differ from one country to another,²³ depending on business conditions, the current economic and political situation, as well as on the level of development and the specific transition

²¹ http://www.worldbank.org/wbi/attackingpoverty/events/Austria_1029DE.../albfiscalpolicy_Eng.htm

²² Riinvest: Survey of 600 NVM, December 2002.

²³ The share of the informal economy in GDP in EU countries was 15.5% in 1995, in former Soviet Union countries 41.8%, in Austria in 2002 it was estimated at 10.6% and 22% in Belgium. In Albania, according to some estimates fiscal evasion reaches 500 million \$. In Serbia and Montenegro, the informal economy is estimated at 25-35% of GDP.

phase that the countries is facing. The following are typical of, but not unique to the Kosovar economy:

- illegal imports
- cash flow outside formal channels
- the use of socially owned enterprises for private interests
- unrecorded business activities in trade, construction, services and other sectors.

The labor market survey conducted with 1,252 households²⁴ showed that at least 20% of Kosovar employees work within the informal sector. The same survey showed that nearly 34% of employees do not pay the tax on salaries. Recent data of the MEF-Macroeconomic Analysis Unit²⁵ indicates a continuous decline in the percentage of enterprises that pay taxes. The share of taxpayers in the overall number of registered businesses at the beginning of 2002 was 46%, which reduced to 33 % by the end of 2002. While at the beginning of 2002 approximately 62 % of active enterprises²⁶ used to comply with tax obligations, by the end of the year the same indicator was reduced to 43%.

In accordance with the Riinvest survey of 600 SMEs, 30.6 % of respondents are assessed as having a low willingness to pay taxes. According to the respondents the main reasons for evading tax obligations are: high tax tariffs (28.7%), lack of proper supervision 27.8%), and lack of a taxpaying tradition (24.8%).

Data of the IMF shows a high share of bribery in firms' revenue. Some countries that have intensive trade relations with Kosova are listed below, where the average value of bribes in 2002²⁷, as a percentage of the average revenue of businesses, is given.

| | |
|---------------------------------|-----|
| - <i>Albania</i> | 3.3 |
| - <i>Bosnia and Herzegovina</i> | 0.9 |
| - <i>Bulgaria</i> | 1.9 |
| - <i>FYROM</i> | 0.8 |
| - <i>Slovenia</i> | 0.8 |

In accordance with the SME Survey, approximately 21% of Kosovar managers think that bribes increase their business costs. In the meantime there is the perception of widespread corruption. The main sources that feed corruption are considered to be the low level of salaries and the lack of institutional mechanisms to combat it. The majority of surveyed businesses think that corruption feeds unfair competition, creates an inadequate business environment and impedes new investment activities. The same sources indicate that around 40% of cash flow is outside the banking system.

Some of the factors that sustain the informal economy are:

- Business relations with companies in countries with a widespread informal economy;

²⁴ Riinvest Institute, December 2002.

²⁵ Source: MEF

²⁶ By the end of 2002 there were 53,986 recorded businesses, 40,485 estimated as active by the MEF, while 17,554 of them paid taxes.

²⁷ IMF: Country Report, no 03/64, March, 2003

- The incomplete establishment of the market system and as yet ineffective economic institutions;
- Heritage of the informal economy created under the Serbian rule;
- The incomplete fiscal system and weak tax supervision;
- Inappropriate economic policies with respect to the private sector development;
- Lack of transparency and control in the socially owned sector and public enterprises;
- The lack of a transparent system in developing fiscal policies and insufficient communication with the public and taxpayers.

The level of the informal economy and fiscal evasion in Kosova, besides the heavy burden of indirect taxes, leads toward an extreme concentration of the tax burden upon complying businesses (those that pay taxes continuously), making these businesses less competitive as opposed to the group that evades tax in a dysfunctional market.

Based on the above analysis we can conclude:

- It is clear that all aspects of the informal economy directly and seriously hamper budget revenue in Kosova, complicate the country's economic structure, distort the market, reduce fair competition and cause a waste of funds.
- The high share of the informal economy discourages foreign investment in Kosova and concentrates tax obligations upon a limited group of compliant taxpayers, who are forced to pay higher tax tariffs in order to compensate for the budget waste.
- Reducing the size of the informal economy remains an urgent issue.

3.2.3. Aspects of transparency and tax administration

Taxpayers' awareness of budget policies and budget transparency in general plays an important role in the preparation and execution of the budget. Riinvest's recent survey of SMEs researched business opinion in the following areas:

- Their knowledge about the reasons for the collection of taxes, and
- To what extent they are informed about budget preparation and execution.

Historically, taxpayers have lived under systems in which little information was given out by the government and hence they had little knowledge about government practices. The surveyed businessmen consider the information level on budget policies and expenditures to be insufficient. Specifically, 50.1% of them think that they are little informed, while 40.9 % of them say that they are "not informed at all" on this issue. These opinions are identical in businesses dealing with either production or trade. It is thought that the fact that the figures on the budget surplus remained unrevealed for such a long time has negatively influenced taxpayers' opinion. Also, the discrepancy in the budget revenue speaks for a lack of transparency. These problems should be overcome in favor of budget efficiency.

Expanding the taxation base, which leads to more taxpayers, is a process closely related to the transparency, simplicity and efficiency of the taxation system. It should be emphasized that the inefficiency of the tax and customs administration, as well as arbitrary administration, are other reasons that keep foreign investors away. Therefore future steps should improve the current level of tax collection and strengthen the tax administration both quantitatively and qualitatively, as well as improving its information technology. Other countries are also facing similar problems²⁸.

The WB's estimates show that the tax and customs administration in Kosova lacks human resources²⁹ compared to other countries. The practical difficulties relating to tax administration need to be solved in order to expand the taxation base. More tax officials should be hired and trained and the systems of managing tax collection should be developed further. The tax administration in Kosova is new and mainly inexperienced. At the local level the old administration (from before the war) has been inherited, which appears very bureaucratic and non-innovative. The low level of collection of property tax supports this observation. Improvements in tax administration are strongly related to a lowering of the turnover threshold for VAT to 25.000 €, a measure that should follow the strengthening of the administration's capacities.

A weak administration paves the way to unequal treatment and encourages tax evasion, which requires a lot of effort to be countered. By the end of this year the tax administration in Kosova will consist of 630 staff, while the customs administration will have 439, 10% more than in 2002. Training and increasing familiarity with new systems will improve the quality at the same time as this quantitative shift is occurring. These measures represent efforts to improve the capacities and efficiency of the tax and customs administrations. Further efforts should be focused on strengthening managerial capacities, in order to properly distribute the tax burden. This measure should increase the willingness to pay tax and would contribute towards better revenue collection.

Future steps in establishing tax administration in Kosova should be focused on achieving the following:

- An increase in the efficiency of tax collection
- Overcoming the bureaucratic environment and instead creating an innovative setting
- Establishing partnerships amongst the government, the private sector and civil society in order to increase the taxpaying culture.

²⁸ From the discussions held at the MF in Albania, insufficient tax personnel, in particular in local administration, was mentioned as one of the main difficulties in tax management in this country.

²⁹ WB: Medium-Term Public Expenditure Priorities, report no 24880, October 2002.

3.3. BUDGET EXPENDITURE

3.3.1. Budget entities and their evolution during 2000-2003

In contrast to other countries, the Kosova budget is distributed amongst three kinds of entities:

- Provisional Institutions of Self-Government (President, Assembly, Government and Ministries);
- Reserved competencies/powers of SRSG;
- Transfers to Municipalities together with revenue from their own sources

In 2000 around 75% of the budget was spent to cover the needs of education, health, social affairs and public services. The rest of the budget was used to finance those entities that still fall under the reserved competencies of the SRSG. In 2001 the expenditure covered by the municipalities own revenue were established as new budget entities, and this expenditure has since followed an upward trend.

Table 7: Share of budget entities in budget consumption

| | 2000 | 2001 | 2002 | 2003 budget | 2001-2002 unspent | 2003 total |
|---|------|------|------|----------------|----------------------|---------------|
| Presidency, Assembly, Government and Ministries | 75% | 64% | 42% | 45% | 32% | 42% |
| Reserved powers (UNMIK) | 25% | 30% | 36% | 27% | 57% | 35% |
| Municipal Transfers | | 5% | 19% | 22% | 6% | 18% |
| Municipal expenditures upon own revenues | | 1% | 3% | 6% | 5% | 5% |
| Total | 100% | 100% | 100% | 100% | 100% | 100% |

Source: Elaborated upon MEF's data

The 2003 budget consumption will reach 701,447,000 €, including 536,000,000 € of the Government General Budget and the 2001 and 2002 unspent funds of 184.6 million €. The share of the SRSG' reserved powers in the current budget would be 35%, instead of 27% as projected, taking into account that under the reserved powers this year 243,391,413 € would be managed (including 104.8 million € from unspent funds, which are expected to be used for the KTA),³⁰ instead of the 138,530,838 € projected in the budget.

The table below indicates a trend of fast independence of the general budget of Kosova from donor sources. A considerable part of non-allocated donations are forwarded as a surplus from year to year, while during the same period budget authorities have not fixed fiscal years.

³⁰ Working material: Kosova Budget

Table 8: Share of donations in total budget revenues and consumption (mil. € and %)

| | 1999 | 2000 | 2001 | 2002 | 2003pr |
|--|-------|-------|-------|------|--------|
| Revenues in general budget | 47 | 290 | 405 | 538 | 532 |
| Domestic revenues | 16 | 129 | 321 | 499 | 491 |
| Total budget donations | 31 | 161 | 84 | 39 | 41 |
| Allocated donations | 5 | 31 | 36 | 27 | 29 |
| Budget consumption | 44 | 234 | 282 | 427 | 702 |
| Donations/budget revenues | 66.0% | 55.5% | 20.7% | 7.2% | 7.7% |
| Donations/budget consumption | 70.5% | 68.8% | 29.8% | 9.1% | 5.8% |
| Allocated donations/budget consumption | 11.4% | 13.2% | 12.8% | 6.3% | 4.1% |

Source: MEF, Fiscal Report, Seminar on Economic Policies, March 23, 2003.

It is expected that after 2003, budget expenditure will be covered 100% by its own revenue. In addition, during this period Kosova has used huge amounts of donations designated for Investments and Public Reconstruction under the Midterm Redevelopment and Reconstruction Program, which consisted of \$2.3 billion for the period 1999-2003.

3.3.2. Current and capital expenditure

It is hard to discuss the real dimensions of budget expenditure while Kosova does not cover capital expenditure, the repayment of outside loans and the total management of budget expenditures, so far as some of them are under the reserved powers. For the moment Kosova is not spending on defense, (excluding funds for KPC), while the pension scheme has just begun to be implemented. Thus, the share of current consumption in GDP is not as a result of normal conditions. However, even in these circumstances General Budget Expenditure has greatly increased in Kosova since 2000.

From the point of view of the Kosova Consolidated Budget, which covers the consolidated budget and PIP, budget expenditure is as follows:

Table 9. Current and capital expenditure of KIB as share of GDP (in million €)

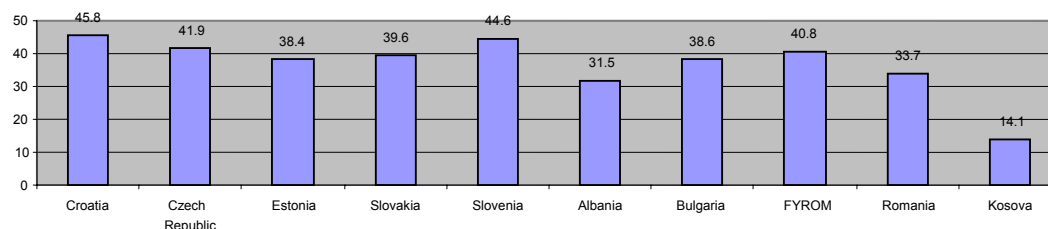
| | 2000 | 2001 | 2002 | 2003 |
|-------------------------------|-------|-------|-------|-------|
| Total expenditure | 885.8 | 860.2 | 807.2 | 815.7 |
| Current expenditure | 234.5 | 274.7 | 367.1 | 455.5 |
| Capital expenditure | 651.3 | 585.5 | 440.1 | 360.2 |
| Estimated GDP | 1.414 | 1.747 | 1.990 | 2.163 |
| Total expenditure/GDP in % | 62.6 | 49.2 | 40.6 | 37.7 |
| Current expenditure /GDP in % | 16.6 | 15.7 | 18.4 | 21.1 |
| Capital expenditure /GDP in % | 46 | 33.5 | 22.9 | 16.6 |

Source: Fiscal Unit/Pillar IV, as of April 2003

The proportion of total expenditure in the integrated budget to GDP varies from 62.6% in 2000 to 40.6% in 2002, while in 2003 it is intended to be around 38%. The increase in revenue from domestic sources and capital investments based on donations, has had a decisive impact on these trends. In the meantime, the share of current budget expenditure in GDP appears to be at a much lower level, varying from 16.6% in 2000 to 21.4% in 2002 (the same figure is expected for 2003). Such expenditure levels are low when compared to other countries in transition and neighboring countries.

From the point of view of the Government General Budget of Kosova, public expenditure, compared to other countries is illustrated by the following table.

Figure 1: Share of Public Consumption as a percentage of GDP for 2001



Source: IMF, Country reports
EBRD Transition Report 2001
Kosova: Fiscal Unit/Pillar 4 as of April 3, 2003

The share of the Government General Budget to GDP in 2001 was 14.1 %, in 2002 it reached 20.3%, while in 2003 it is expected to reach 23.9%. It should be emphasized that the Kosovar budget is financed mainly from its own sources, while only around 4% of it is financed from foreign donations, **as opposed** to the situation in other countries which use other budget sources and have at the same time a huge budget deficit. During these years budget expenditure has been lower than budget revenue, thus causing a huge surplus in Kosova.

Current expenditure

During the last few years the expenditure on salaries and per diems has been kept at a constant share in GDP, approximately 6.5% (6.6% in 2002). The share of expenditure on goods and services (materials, travel costs, equipment supplies and inventories for administration) in GDP has been marked by an upward trend from 5.1 % in 2000 to 7.7% in 2002. During these years 4.7% of GDP has been designated for subsidies and transfers.

Capital expenditure (Public Reconstruction Investments Program)

1/3 of around 1,676 million euro, spent on capital expenditure up to the end of 2002, is dedicated to public services, while 1/5 is for reconstruction of houses destroyed during the war. These investments have supported trade, industry, agriculture, transportation, the infrastructure, education, science, culture and the establishment of democratic institutions.

Table 10: PIP 1999- July 2002

| | Dedicated | Contracted | Spent |
|--|---------------------|---------------------|---------------------|
| Countries (33) ³¹ | 1,050,262.91 | 971,380.23 | 784,117.46 |
| European Union and international organizations ³² | 1,054,812.68 | 936,267.07 | 732,748.18 |
| NGOs | 148,955.38 | 148,433.14 | 143,296.52 |
| Donations in total | 2,254,030.97 | 2,056,080.44 | 1,660,162.16 |
| Kosova Consolidated Budget | 46,089.73 | 34,374.41 | 28,172.78 |
| II. Total PIP | 2,300,120.70 | 2,090,454.85 | 1,688,334.94 |

Source: MEF, Kosova General Government Budget 2003 (April 16, 2003, internal working draft)

³¹ The United States alone has provided around 12%, equivalent to 230 million euro.

³² The EU share is 37%, equivalent to €757 million.

Up to the end of 2002, nearly 91% of dedicated funds were provided for reconstruction, 82% has been contracted and 69% has been spent. The expenditure under PIP in 2000 and 2001 accounted for around 50% of GDP, while in 2002 it accounted for around 40% of GDP. It is thought that in 2003, public expenditure will count for 37% of GDP. The investments carried out in Kosova under PIP will be followed by continuous expenditure to maintain the constructed (or reconstructed) objects.

3.3.3. Budget expenditure on economic categories

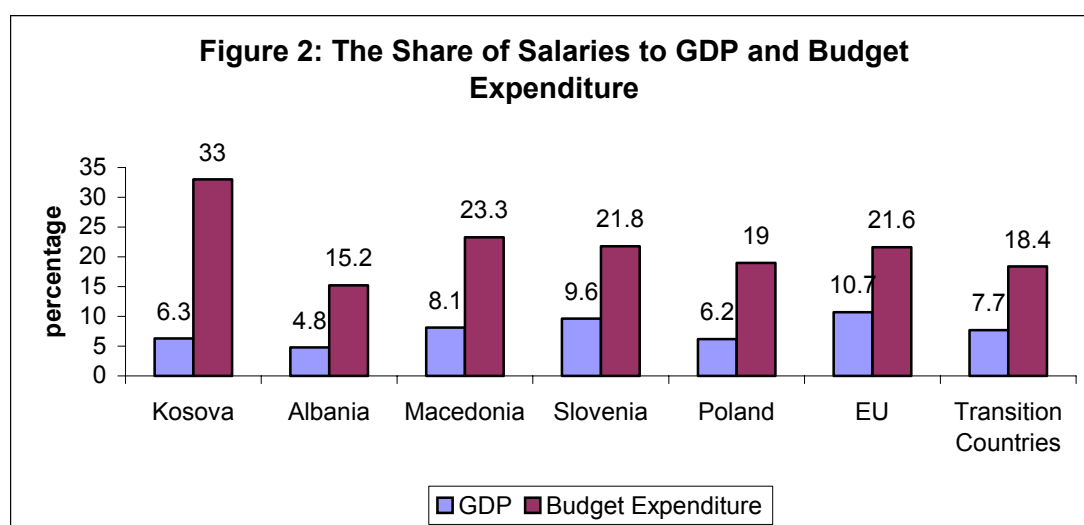
The share of salaries in budget expenditure has declined from 42% in 2000 to 29% in 2003. A similar downward trend accompanies the subsidies and transfers, which have reduced from 33% to 20% during the same period. On the other hand, there has been an increase in the share of capital expenditure, in compensation for the reduced foreign donations.

Table 11. Budget Expenditure on economic categories 2000-2003(million €)

| | 2000 | 2001 | 2002 | 2003 |
|-------------------------|---------------|---------------|--------------|---------------|
| Salaries and per diems | 85.30 | 107.30 | 131.4 | 148.40 |
| Goods and services | 49.65 | 66.60 | 121.3 | 153.25 |
| Capital expenditures | | 6.60 | 62.1 | 80.20 |
| Subsidies and transfers | 67.45 | 65.20 | 87.5 | 104.60 |
| Reserves | 1.00 | 0.10 | 0 | 30.45 |
| TOTAL | 203.40 | 245.80 | 402.3 | 516.90 |

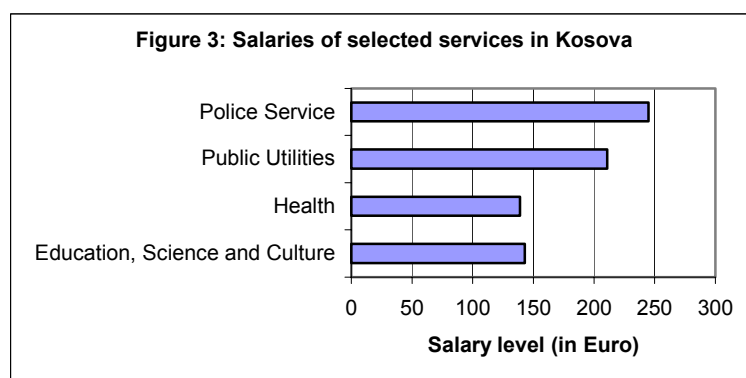
Source: Elaborated by Fiscal Unit/Pillar 4, April 3, 2003

Expenditure on wages/salaries and per diems in 2002 accounted for 33 % of total budget expenditure, equivalent to 6.6 % of GDP. In EU countries the same indicator accounts for 10.7% of GDP, which means 21.8% of total budget expenditure. Compared to other countries, Kosova is above the threshold with regard to the share of salaries in budget expenditure, and below with regard to the share in GDP.



Source: WB. Medium-Term Public Expenditures Priorities, report no. 24880, October 2002

In accordance with the funds dedicated for salaries in the general budget of Kosova in 2003 and the number of employed people up to the end of the year, the following average salaries are foreseen (broken down into sectors):



Source: General Budget of Kosova (2003)

The very low level of salaries, constant during 2002 and 2003, in the health sector (the average is 139 euro), and education (143 euro), is of a great concern. The overall average salary has marked an increase from 152 € in 2002 to 162 € in 2003, which amounts to a 6.6% increase.

Kosova is facing a really disadvantageous employment structure and a high level of unemployment. The unemployment rate is estimated at 49%, or 39% if we include seasonal employees in agriculture. Under these circumstances, there is a trend to soften this problem through jobs in the state sector, in particular in government bodies and organizations. It is estimated that in 2002 in Kosova 430,000 persons were employed in the private sector, government bodies, the sector administered by the KTA and in agriculture, in addition to informal employment (20%). The Kosova Consolidated Budget covered the salaries of 65,187 employees, which account for 15.2 % of the total number of employed people. The employees in the education sector account for 6.5 %, while those in the health sector for 2.9%. Compared to Central and Southeast European Countries, employment broken down by sectors is as follows:

Table12: Public sector employment as % of overall employment

| | Central Admin. | Education | Health | Police | Local Govern. |
|-------------------------------------|----------------|-----------|--------|--------|---------------|
| Kosova (2002) | 3.1 | 6.5 | 2.9 | 1.3 | 1.3 |
| CEE (Central and Eastern Europe) | 0.9 | 2.9 | 2.1 | 0.6 | 0.9 |
| ECA (Eastern Europe & Central Asia) | 1.3 | 3.3 | 2.4 | 1.4 | 1.3 |

Source: WB (2000 data)

Riinvest (Data on Kosova- Labour market report)

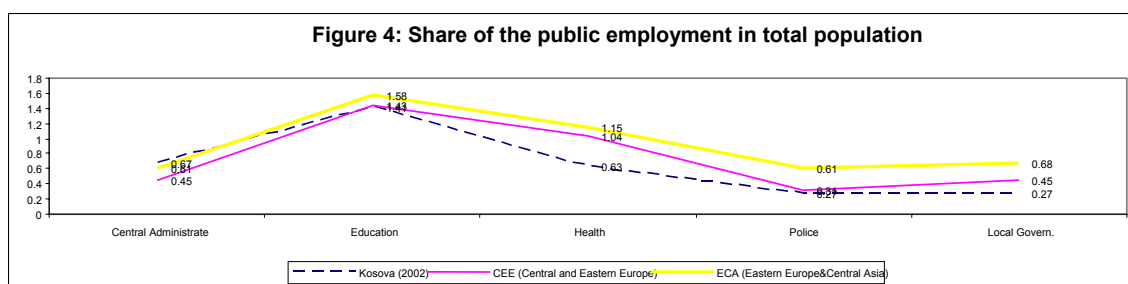
The ratio of employment to population in Kosova, compared to the average figures in Eastern European and Central Asian countries is as follows:

Table13: Public sector employment as % of population number

| | Central Administration | Education | Health | Police | Local Govern. |
|-------------------------------------|------------------------|-----------|--------|--------|---------------|
| Kosova (2002) | 0.67 | 1.41 | 0.63 | 0.27 | 0.27 |
| CEE (Central and Eastern Europe) | 0.45 | 1.43 | 1.04 | 0.31 | 0.45 |
| ECA (Eastern Europe & Central Asia) | 0.61 | 1.58 | 1.15 | 0.61 | 0.68 |

Source: WB (2000 data)

Riinvest (Data on Kosova- Labour market report)



The above comparisons show the disadvantageous position of employees in education and central administration in Kosova, compared to other countries in transition in Central and Eastern Europe, as well as in Central Asia

The above indicators do not reflect the high rate of overall unemployment in Kosova compared to other countries, the high numbers of young population enrolled in different levels of education (some 500,000), the small number of health employees per inhabitant and a local government not yet decentralized. Therefore, taking into account the big picture in Kosova, it would be inappropriate to conclude that the number of employed people in education and the health sector has exceeded budget goals.³³

Table 14: Employment by function and government level

| | Public employment | | | | Employment Index | | | |
|-----------------------------------|-------------------|-------|-------|---------|------------------|-----------|-----------|-----------|
| | 2000 | 2001 | 2002 | 2003pr* | 2000 | 2001/2000 | 2002/2001 | 2003/2002 |
| Overall consolidated government | 56971 | 62409 | 65187 | 74928 | 100 | 1.10 | 1.04 | 1.15 |
| Central government | 52082 | 57473 | 59741 | 69453 | 100 | 1.10 | 1.04 | 1.16 |
| Municipal assemblies | 4889 | 4936 | 5446 | 5901 | 100 | 1.01 | 1.10 | 1.08 |
| Overall administrative government | 18597 | 20351 | 24387 | 28568 | 100 | 1.09 | 1.20 | 1.17 |
| Central Government Bodies | 10708 | 11457 | 13466 | 15870 | 100 | 1.07 | 1.18 | 1.18 |
| Municipalities | 4889 | 4936 | 5446 | 5901 | 100 | 1.01 | 1.10 | 1.08 |
| Health | 10582 | 13558 | 12630 | 13671 | 100 | 1.28 | 0.93 | 1.08 |
| Education | 27792 | 28500 | 28170 | 32689 | 100 | 1.03 | 0.99 | 1.16 |
| Police | 4475 | 3958 | 5475 | 6797 | 100 | 0.88 | 1.38 | 1.24 |

Source: WB

* 2003 Budget

The data on employees in the government sector clearly shows a rapid increase in the number of central administration bodies. In 2003 the number of people employed will be 48% above the number in 2000, and 38% higher than in 2001. The number of people employed in the health sector will increase by 29%, while those employed in education will increase by 17%. As can be seen from the above chart and table, the number of people employed in central administration in Kosova is above the average for Central and East European countries, as well as for Central Asian countries, while in sectors such as education and health, it is below the average.

A more realistic indicator can be drawn by comparing public sector employment with the overall population. This analysis shows that Kosova is consistent with average thresholds in countries with respect to employment in central administration, while it

³³ WB: Report no. 24880, p. 34, October 2002

is below the average with respect to education, the police force and local government. Thus the following should be put in place:

- A well-thought out employment policy for central government administration, focused more on increasing the quality of the personnel rather than increasing the overall numbers employed.
- Implementation of employment policies in education, health, police and local administration consistent with the increase in GDP and economic growth.

Goods and services constitute 30% of budget expenditure and 6.1 % of GDP, as opposed to the average figures of 18.5% and 7.7% in other countries in transition, and 19.5% and 9.6% in EU countries respectively.

Capital expenditure in the general budget in 2002 amounted to 15% of the budget and 3.1 % of GDP, as opposed to 11% and 4.5% respectively, as average figures for countries in transition, and 8.2% and 4% respectively, as average figures in the EU. In the meantime, it is expected that capital expenditure will increase soon. The WB estimates that 85 million € are needed each year to maintain the objects constructed by donors. Current budget expenditure cannot cover these needs without putting at risk other vital functions. A possible alternative would be to transfer part of the funds stemming from privatization and use them for this purpose.

Subsidies and transfers in 2002 represent 22 % of the budget and 4.4% of GDP. These figures are much higher than the respective average figures in transition countries (4.8% and 2%) and in EU countries (3% and 1.5%). Such subsidies have mainly been provided for KEK, Treçpa and central heating. Part of such subsidies have been used to cover the shortcomings in the organization in these entities, mainly the failure to collect debts from consumers, the mismanagement of funds and inadequate policies for capital maintenance. According to all indicators, such expenditure appears to be very high and unstable, thus necessitating the need for substantial changes to current policies.

3.3.4. Budget expenditure by function

If current trends continue, general budget expenditure in 2003 will show an increase of 19.4%, while in 2004 and 2005 slighter increases are expected, 6% and 7.5% respectively. In 2002, education, health and social care had a share of 50.3% in general budget expenses, equivalent to 10.2% of GDP.

Table 15: Budget consumption by function

| | 2002 | 2003 | 2004 | 2005 |
|---------------------------|--------|--------|--------|--------|
| Education | 77741 | 80465 | 81660 | 85273 |
| Health | 57657 | 59639 | 56974 | 59895 |
| Social care | 66797 | 82600 | 109015 | 108857 |
| Public order and security | 48647 | 63044 | 65440 | 64381 |
| Economic Affairs | 30601 | 48363 | 51733 | 72704 |
| Other government expenses | 120631 | 182748 | 152702 | 165381 |
| | 402074 | 516859 | 517524 | 556491 |
| Average increase | | 28.50% | 6.0% | 7.50% |

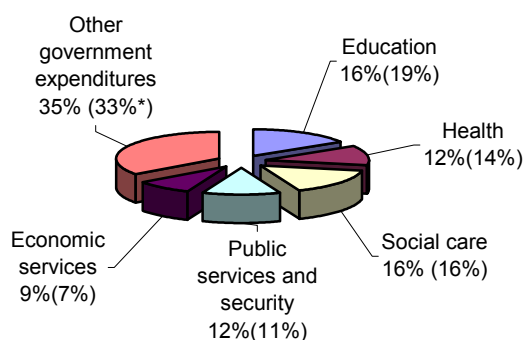
Source: MEF Kosova General Government 2003 Budget (April 04, internal working draft)

Expenditure on education includes transfers for elementary and secondary education, (3/4 of such expenditure), expenditure for the University, student center, institutes, special schools, the national library, teacher training, etc. The share of education expenditure in GDP in 2002 was 3.9%, while in 2003 it is expected to be 3.7%.

Health expenditure includes transfers for primary care (28 % of total health expenditure), as well as expenses for university clinics, regional hospitals, public health institutions, the pharmaceutical program, minority health program, etc. In 2003 this sector represents 11.5 % of general budget expenditure and 2.8% of GDP.

Social care - The basic pension scheme, which includes around 100,000 persons (35€ each), accounts for 55 % of expenditure (or 2.09% of GDP), while social assistance is 35% (or 1.3 % of GDP). The whole sector accounts for 16% of general expenditure and 3.8 % of GDP.

Figure 5: Government General Budget of Kosova by function, 2003



*Data in brackets indicates the share in 2002

The MEF's projections suggest a decrease of the share of such areas of 5% up to 2005, in particular in education and health, while the social care indicator will be improved.

Public order and security. In 2003 (as in 2002), public order and security will make up 12 % of general budget expenditure, whereas its share of GDP will increase from 2.4 to 2.9%. This includes all expenditure for the police service, the courts, the judiciary and correctional institutions.

Other government expenditure includes all the expenditure outside the above sectors, such as those relating to the Assembly, Presidency, Prime Minister's Office, Ministry of Finance, Ministry of Public Services, Ministry of Environment, customs, other public institutions and all expenditure under the reserved powers of the SRSG (excluding expenditure for public order and security). All the above mentioned expenditure in 2002 accounted for 35% of general budget expenditure.

The structure of such expenditure can be better understood if we compare it with relevant expenditure or groups of expenditure in other countries. The Government general budget expenditure of Kosova in 2002 is compared with the budget expenditure of OECD countries, countries in transition in Central and Southeast Europe and former Soviet Union countries in the table below. (Data refers to 2000).

Table 16: Functional structure of public expenditure

| Countries | GDP per capita (PPP US\$) | Total Expenditure | | Education | | Health | | Social Welfare | | Public order, security | |
|-----------|------------------------------|-------------------|--------|-----------|--------|--------|--------|----------------|--------|------------------------|--------|
| | | GDP | Budget | GDP | Budget | GDP | Budget | GDP | Budget | GDP | Budget |
| OECD | \$26,200 | 42.4 | 100 | 5.3 | 12.5 | 5.4 | 12.7 | 15.6 | 36.7 | 1.2 | 2.7 |
| CSB | \$9,300 | 41.9 | 100 | 4.8 | 11.6 | 5.2 | 12.3 | 14.0 | 33.3 | 2.3 | 5.5 |
| CIS | \$3,850 | 29.1 | 100 | 4.3 | 14.9 | 2.2 | 7.6 | 7.8 | 26.9 | 1.5 | 5.1 |
| Kosova* | € 1,050 | 20.2 | 100 | 3.9 | 19.3 | 2.9 | 14.3 | 3.4 | 16.6 | 2.4 | 12.1 |

Source: GFS, IMF staff reports (World Bank Policy Research Working Paper 2946, January 2003)

* Kosova 2002

As we can see from the above data, Kosova differs from countries in transition and developed countries with regard to the high share of expenditure for public order and security. There is also a huge disproportion in terms of the low share of expenditure on social welfare. Undoubtedly, this low share refers to the lack of basic instruments of social security, the low level of pensions and social assistance and the lack of benefits for the unemployment.³⁴ A common disadvantage is observed in the health sector in both Kosova and CIS countries. The position of the education sector in Kosova in 2003 remains similar as in less developed transition countries.

4. THE BUDGET AND MACROECONOMIC PROBLEMS

The current socio-economic situation in Kosova is characterized by a very high unemployment rate, a strong dependency of the economy and expenditure on imports, a decrease in inflation (stable prices), a reduction in donations, the reduced presence of foreign governmental and non-governmental organizations, as well as a slow privatization process. Under these circumstances it is necessary to analyze fiscal policy and its relation with macro-economic problems. The very low level of inflation, with a tendency toward deflation could lead to the reduction of nominal budget revenues. The decline of foreign donations and of the overall international staff in Kosova will reduce imports, investments and general expenditure, and as a consequence even the tax revenues generated from these sources. The delay in the privatization process is pushing SOEs into a more disadvantageous position with respect to their normal operations and compliance with tax obligations. In addition, the development of the private sector is showing signs of stagnation. It is already a well-known fact that Kosova lacks a general strategy for economic development.

So far the emphasis has been on emergency needs in respect to budget/tax generation issues. In the longer term we need to shift to the “drivers” of economic.

The critical factors for generating economic growth in the Kosova case are:

- Investment levels and ratios to GDP
- Savings levels and ratios to GDP
- Human capital and links to health and education
- Infrastructure
- Stability in Political situation
- Macro Economic stability or predictability, etc.

³⁴ During the preparation of this report we held discussions at the Ministry of Labour and Social Welfare and proposed the initiatives wanted by the Minister in providing assistance to job seekers. Also other concerns have been expressed regarding the delicate social problems that the Ministry is facing.

GDP

In Kosovo in 2002 the GDP per capita was estimated at around 1000 €. However, as the table below shows, there is no common estimation on the GDP rate, even with respect to GDP per capita. The IMF mission, in its February report, notes that “Currently, the national account statistics compiled by MEU are mainly based on limited surveys and anecdotal evidence on the relevant macroeconomic variables, and IMF staff and projections, which is inadequate to provide a firm basis for macroeconomic analysis”. This is due to the lack of consistent and abundant data upon which this indicator would be examined. Under these circumstances our analysis on this indicator is based on WB estimations.

| Estimations on GDP (million €) | | | | | | |
|--------------------------------|------|------|------|------|------|------|
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
| WB* | 1414 | 1747 | 1990 | 2163 | 2339 | 2530 |
| MEF** | | 1757 | 1992 | 2197 | 2364 | 2545 |
| MEF*** | 1353 | 1629 | 1714 | 1712 | 1768 | 1857 |

*WB, Medium-Term Public Expenditure Priorities, Oct. 2002

**Economic Policy Department: Papers prepared by the Economic Policy Department, Prishtina, October 2002

*** Janusz Szyrmer and Magdalena Tomczynska, March 24, 2003

As a result of the above-mentioned reasons, Kosovo will face great challenges in developing its budget system. The main challenges are related to macroeconomic sustainability and sustainable public services based on increased efficiency.

The lack of analysis on the impact of the existing fiscal structures on the macroeconomic situation, in both the short and long term, causes great concern. Currently there is no development strategy and there are no defined priorities with respect to development and budget expenditure.

In this direction the greatest challenges are:

- a. The relation between GDP, the budget and economic growth;
- b. How to manage the budget surplus;
- c. The definition of priorities on budget expenditure implying or involving difficult decisions in a situation where there is a lack of resources;
- d. The impact of decentralization, or what is the optimal level of decentralization from the fiscal-budgetary point of view?

The WB in the Medium-Term Public Expenditure Priorities (Oct. 2002) document, amongst others, predicts the following economic and budgetary developments in Kosova:

- In the period 2003-2005, GDP could be expected to grow by an average of around 5%. This increase is mainly implied from very strong private sector performance, a projected decrease in the inflation rate from 10% to 3 % by 2005, and the continued inflow of foreign diaspora remittances.
- Local fiscal revenues are expected to reach 23% of GDP in 2005 compared to 9% in 2000.
- The public spending to GDP ratio in 2005 would count for 30%; with 1/3 of public spending covering public investment needs and 2/3 current spending. This would be appropriate, because in this period a number of functions that should normally be financed by the budget are covered from other sources, due to the presence of KFOR and UNMIK.
- Public investment needs (in accordance with the scenario of the 5% increase) are estimated to decrease from 35% of GDP in 2001 to 10 % in 2005. Also, a fall in private investment is expected, due to the insecure environment as a consequence of the undefined final status for Kosova.
- Due to the decrease in foreign financial aid, a fall of imports to GDP in the coming years is expected, from 122% in 2002 to 50% in 2005. A decrease in the export of services due to the declining presence of internationals and an increase in the export of goods because of structural reforms is also expected.
- Based on current examinations it is estimated that donors' spending accounts for 1/3 of GDP, therefore an eventual 10% decrease in donors' spending would result in a 3.8% decrease in GDP. However, such dependency would gradually decline as Kosova becomes independent of donor's aid.
- The financial gap should be filled from donors' funds and public borrowing. The projected overall need for funds for the period 2003-2005 in Kosova is some 810 million €. More than half of such funds are expected to be delivered by the remaining part of, and previously agreed, donations.

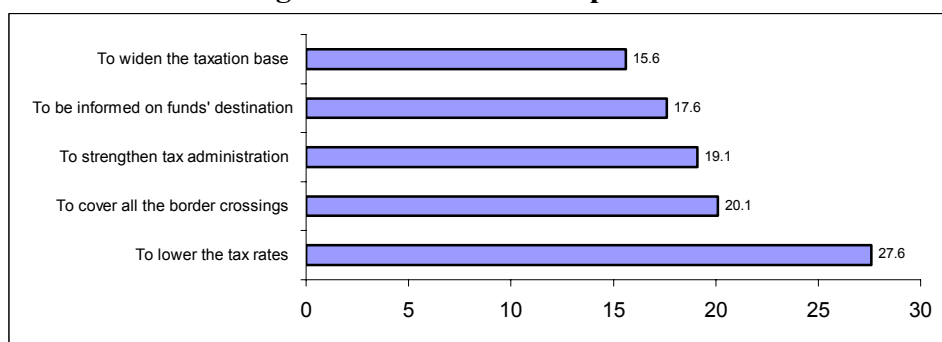
4.1. THE RELATIONSHIP BETWEEN GDP, THE BUDGET AND ECONOMIC GROWTH

As a result of the situation in Kosova, with its high unemployment rate, low level of GDP, and the poor performance of socially owned and public enterprises, transformation of the taxation structure should be linked to measures formulated to speed up economic development. Therefore the taxation policy should be designed to stimulate businesses and job creation. First of all, the taxation system should provide for a proper balance of supply and demand in goods and services, in order to better allocate resources and bring about economic efficiency. This is hard to achieve in the current situation, due to the low level of economic development and the high level of poverty (nearly 50% of the population lives on the threshold of poverty). Accordingly a thoughtful approach is needed with respect to taxation. Taxes should fulfill their purpose to establish the necessary public infrastructure as a precondition for economic growth, but they should also provide for the redistribution of revenue in favor of a poor population.

The IMF Mission in January 2003 acknowledged that the share of taxes to GDP (estimated at around 22%) is comparable to the same indicator in countries with similar level of revenue. Considering the poverty threshold, the Mission considered that poor countries can have a lower share of taxes to GDP than more developed countries. Tax revenue should reflect the increase in GDP. Therefore the tax dynamic should follow the dynamic of real GDP increase.

In accordance with the SME survey (of 600 SMEs), businesses consider the following to be effective as measures to improve tax collection:

Figure 6: Measures to improve tax collection



The respondents believe that high taxation rates have become a serious barrier to private sector development, as yet unconsolidated in Kosova. If we take into account profit tax, presumptive tax, excises, customs and the part of VAT that business declare and which is not paid by consumers because of demand inelasticity (some 30% of VAT), the result is that in 2003 nearly 64% of the tax burden would fall on businesses. The same indicator was nearly 30% in Albania in 2001, and 20% in Poland in 2002.

In 2002 the share of tax revenue to GDP was around 25%. This shows that taxation policies should be reviewed and tax rates made compatible with the low level of development and GDP, through an expansion of the taxation base, which would lead to an overall increase in the number of taxpayers. Such an approach would narrow the informal economy and fiscal evasion, and lead to a better functioning of the market and to fair competition.

4.1.1. The Kosova Integrated Budget

The share of the integrated budget to GDP has followed a downward trend throughout the years because of both: a) high donor investments, in particular in reconstruction; and b) an increase in GDP. This share is expected to decrease from 62.6% in 2000 to 30% in 2005. In addition to such a decrease, substantial transformations have occurred with respect to this indicator. While the share of donations to GDP in 2000 was 45% and the share of domestic budget expenditure was 14%, it is estimated that in 2005 the share of domestic budget expenditure will be 22.5 %, and the share of donations only 7.5%.

Table 17: The share of expenditure and revenue to GDP (in %)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|--------------------------------|-------|-------|-------|-------|-------|-------|
| Integrated Budget expenditure* | 59 | 46 | 42 | 37 | 32 | 30 |
| Domestic revenue** | 9 | 18 | 25 | 24 | 23.1% | 21.8 |
| General Budget expenditure | 14 | 15 | 21 | 23.9 | 22.5 | 22.5 |
| GDP | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

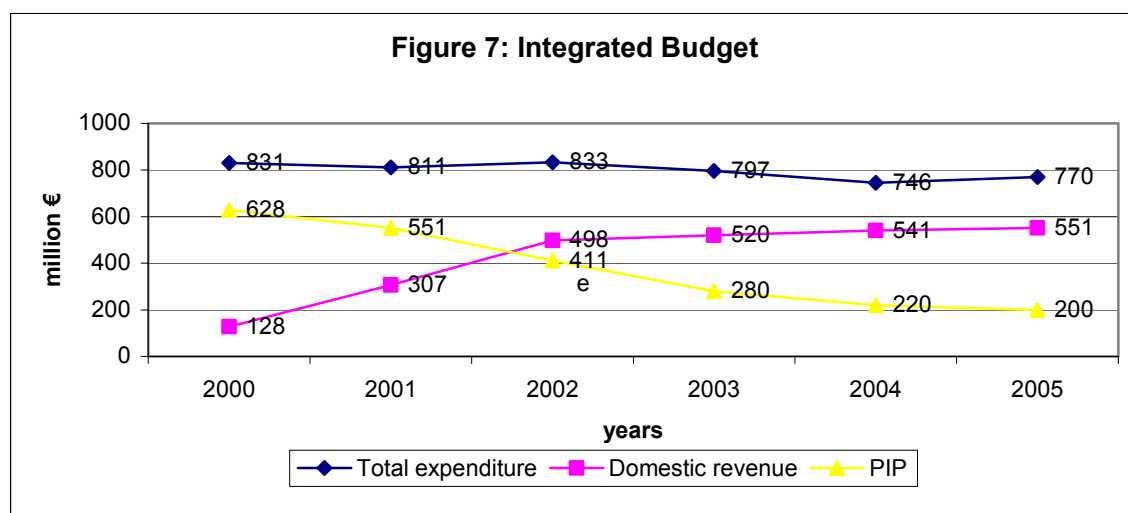
Source:

* WB data

**Kosova–macro&fiscal, Janusz Szyrmer and Magdalena Tomczynska, March 2004 (Refer 10/2003, March 26, 2003)

Donations will be an important source for fulfilling public investment needs, even during the current period. The share of domestic sources to Integrated Budget will increase from 15.5% in 2000, to 65.2% in 2003, and it is expected to reach 71.6% in 2005.

The relationship between the Integrated Budget, domestic budget revenue and donations, which contribute to the Public Investment Program (PIP), is given by the following figure:

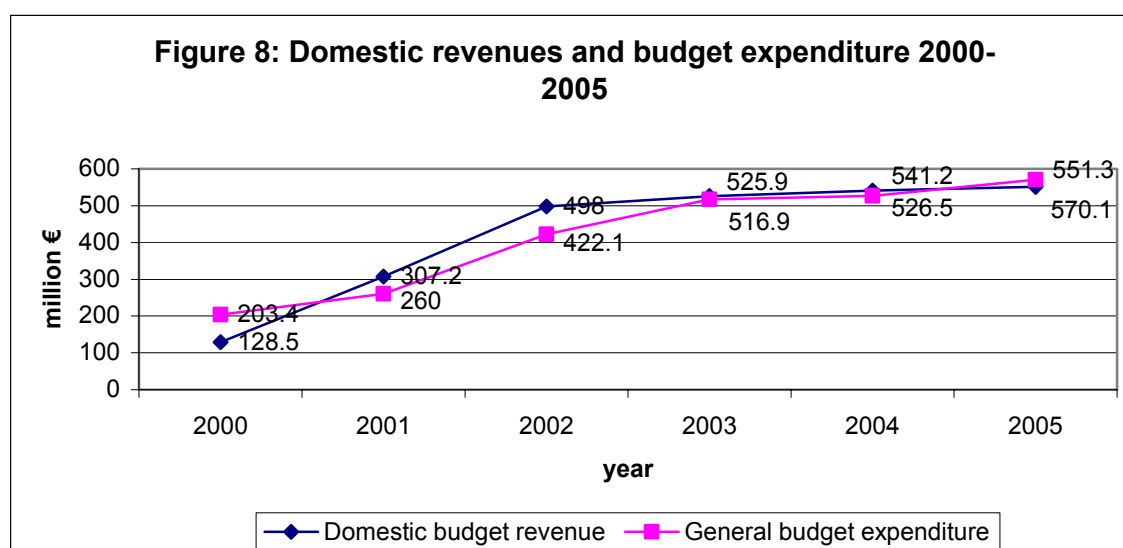


In 2002, own or domestic revenues started to exceed the donors' funds designated for public investment in Kosova. A considerable decrease in donations in the coming years is also expected.

It should be emphasized that so far local actors have been in an inferior position with regard to the involvement and evaluation of donations for public investment. There is a lack of necessary information and estimates on the feasibility of specific investment projects. It should be noted that some projects have been highly expensive and will require additional funds for maintenance and additional financing from the local budget. Under these circumstances there is a need for a common evaluation of priorities and the effects of donations. These funds should ideally be used for the most needed objects and in the most efficient way.

4.1.2. The General Budget of Kosova

The General Budget of Kosova is expected to reach sustainable revenue and spending in the forthcoming period. That would mark the period when a complete balance will be achieved between budget revenue and spending as shares of GDP. The share of budget revenue to GDP will reach 23-24%, which would be equivalent to the share of budget expenditure.



It should be emphasized that the actual 2003 budget far exceeds the budget based on current budget revenue for the year. The budget is expected to be 701.8 million € which, in addition to the current budget, includes the previous years' unspent funds and the following³⁵:

- specified donors' grants amounting to *29.4 mil. €*,
- agreed funds from all the organizations, transferred from 2002 *147.1 mil. €*, and
- municipal revenues transferred from 2002 *10.2 mil. €*

Based on the data and facts presented above, it could be concluded that there is little room to place a further burden on businesses without seriously hampering investment and job creation. Therefore the recommended share of tax revenues to GDP should be 20-22%, at least in the short term. In the future as income levels rise this percentage can be reviewed, depending upon then current expenditure needs.

³⁵ MEF: Fiscal actualities and the report on the analysis of developments, March 2003.

4.2. THE BUDGET SURPLUS

In accordance with the data of the Secretariat of the Economic and Fiscal Council³⁶ in December 2002, the unspent budget revenue was made up from 256,666,000 € in the Banking Authority of Kosova and 32,360,000 € in the Commerz-Bank, which account for a total of 289,026,000 €. It is estimated that from these funds 103,222,000 € represents the budget surplus. Such a level of surplus is equivalent to 5.2% of GDP. It is considered that during 2002 an average of 280 million € was collected from taxpayers and kept unspent in bank accounts, which could have a negative impact on economic activity and lead to recession. The UNMIK administration views such a surplus as a technical issue. According to UNMIK officials the surplus is a result of the fact that the Kosova budget cannot go into a deficit, thus it cannot be zero balanced at the end of the year.³⁷ The surplus is also considered to be the result of the lack of experience, in particular of the lack of a governmental program management tradition and a long-term strategy in Kosova. Also, the surplus is seen as an achievement of the tax and customs administration and of the satisfactory contribution of local taxpayers to the budget. Notwithstanding these views, it is clear that more funds are collected from taxpayers than can be absorbed on the basis of current governmental actions.³⁸ This means that budget entities such as the UNMIK, the Government, and Municipalities have either overestimated their needs, or demonstrated lack of capacities for efficient use of allocated funds. Such a high level of surplus will most likely have an impact on the Kosovar economy and can lead to recession.

This conclusion is supported by the fact that the unspent funds of budget entities (central government bodies) amounted to 127.8 million € by the end of 2002, while at the end of 2001 it was 10.5 million €³⁹. This situation is a result of the overestimation of projected expenditure by all the budget organizations: the Parliament, Government, President's Office, ministries, municipalities and the reserved powers of UNMIK. A budget surplus of 17.5 million €⁴⁰ has also been acknowledged during the first quarter of 2003, estimated as the difference between revenue and expenditure at the end of this period.

³⁶ Secretariat of Economic and Fiscal Council, Ref No: 10/2003, 20.03.2003

³⁷ Notes from the discussions with officials of EFC, May 13, 2003.

³⁸ Although it seems that there is an accelerated rate of spending in 2003 compared to 2002.

³⁹ In 2002, out of the agreed funds, KTA left unspent more funds (69.7 million €) than other bodies, followed by the Ministry of Public Services (8.6 million €), the Ministry of Health (6.4 million €), Ministry of Education, Science and Technology (7.3 million €), Kosovo Police Service (5.3 million €), and municipalities (8.6 million €).

⁴⁰ MEF: Fiscal actualities and the report on the analysis of developments, March 2003.

The Kosovar Case Study

Associate Professor Kenneth E Jackson said that after coming to Kosova, he learned about the economic situation, with its high level of unemployment, low rate of inflation and high budget surplus. He found such a situation unique in terms of both economic theory and practice. He also stated that he thought the case of Kosova would be 'a good case study', likely to be taught in business schools.

Associate Professor Kenneth E Jackson, Auckland University in New Zealand held a presentation on "Budgetary Policy and Macroeconomic Management in Transition: a South East Asian Perspective" Prishtina May 14, 2003.

(Dr. Jackson came to Kosova to work at Riinvest as a foreign consultant under the terms of this project).

The basic requirements that need to be addressed in order to solve this problem are: a) a real examination of budget expenditure from the competent authorities, as well as proper management and control; b) specific budget revenue, i.e. tax and customs tariffs, based on the criteria of examined budget expenditure; c) an economic destination of the budget surplus; and d) using surplus funds effectively in the short term, so that when those funds are exhausted and when the regularly-appropriated funds and the spending activities of the government achieve a balance, that there are no fiscal emergencies caused by organizations which have become accustomed to having surpluses but now facing leaner times. In order to soften the economic consequences of the budget surplus and inadequate budget management, such funds should be used to stimulate economic development and capital investment, which provide long-term benefits. It would be inappropriate to deliver the surplus to those budget entities that created it, because such a measure would stimulate irrational budget expenditure, or produce an increased budget for expired expenditures, which would lead to long term consequences on the budget. Also as stated, the MEF's emphasis during 2004 budget formulation process will be to work closely with spending agencies in order to ensure more effectively that they have the capacity to spend the funds that they are requesting.

4.3. PRIORITIES FOR BUDGET EXPENDITURE

Budget expenditure priorities should be built upon the long-term development strategy and medium-term public expenditure programs. So far this aspect has been lacking in budget management. An important basis can be found in the World Bank document **Medium-Term Public Expenditure Priorities (Oct. 2002) and the MEF Program**. However, even here the priorities are not based upon the specific conditions in Kosovo. Setting priorities and their application in annual budgets should be conducted based on long-term visions and objectives, as well as on global and sectoral analysis. So far, this has been not the case in Kosovo.

However, to produce a clear idea of priorities, the following factors should be taken into account: a) the population age structure and the need for modern development in the context of globalization; b) the need to provide for public infrastructure that would encourage economic growth and create a friendly business environment; and c) the need to provide for funds for basic social care.

- a) The development of the education system through an increase in the opportunities for young people to benefit from this system, and the transformation of such a system into a more efficient and contemporary one, are basic preconditions to develop young people with entrepreneurial potential (the most important resource). Therefore a decrease in the share of budget expenditure for education would be unproductive in the long-term and should be reconsidered. Effective targeting of educational expenditure is, however, to be encouraged, as is the case in any areas of expenditure.
- b) Improving public infrastructure (roads, telecommunication, energy sector, business and urban areas) of both national and local importance, is a precondition to the increase in foreign and domestic investment and economic growth.
- c) Social care should be targeted to the most vulnerable categories and should be used to cover the most basic needs.

The projected and identified budget resources for the upcoming period appear unlikely to provide for education, health and social care. In contrast to some optimistic observations that may be drawn from a simple comparison of salaries in education and the health sector with those in neighboring countries, the situation in Kosovo appears worse, especially if we take into account the high level of unemployment and the strong dependence on salaries. Thus it is inappropriate to regulate the level of salaries in education and the health sector by reducing the excessive employment.⁴¹ This scenario seems more appropriate for regulating employment in public administration. Some estimates indicate that over employment in public administration reduces the efficiency of this sector and places an unnecessary burden on budget expenditure. For the period up to 2005, the MEF projections on budget distribution by function appear as follow:

⁴¹ In Kosovo there is one teacher per 20 pupils in elementary schools and one teacher per 17.5 pupils in high schools. Compared to other countries the same indicators respectively are: Czech Republic 19.7 and 13.1; Germany 19.8 and 15.2; Hungary 10.9 and 11.2; Poland 12.7 and 15.5; Slovenia 18.3 and 13.2.

Table18: Budget distribution by function

| | 2002 | 2003 | 2004 | 2005 |
|------------------------------|-------|-------|-------|-------|
| Education | 19.3 | 15.6 | 15.8 | 15.3 |
| Health | 14.3 | 11.5 | 11.0 | 10.8 |
| Social care | 16.6 | 16.0 | 21.1 | 19.6 |
| Public services and security | 12.1 | 12.2 | 12.6 | 11.6 |
| Economic issues | 7.6 | 9.4 | 10.0 | 13.1 |
| Other government spending | 30.0 | 35.4 | 29.5 | 29.7 |
| | 100.0 | 100.0 | 100.0 | 100.0 |

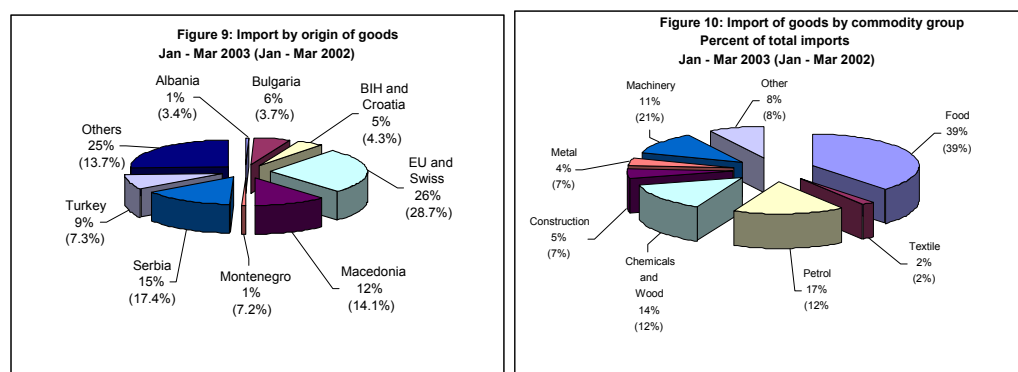
Source: MEF, Kosova General Government Budget 2003 (April 16, 2003, internal working draft)

4.4. THE REPERCUSSIONS OF FREE TRADE AND IMPORTS ON BUDGET REVENUE

a. Free trade agreement

Kosova is characterized by a very high trade deficit. Exports are at a low level, while the import of goods, raw materials and services still remains very high. In 2002 imports reached 988.7 million €, while exports were only 27.3€, which means that imports are covered by exports by only 2.76%.

A great deal of import comes from the European Union countries, sometimes followed by Serbia (15%), Macedonia (12%), Turkey (9%), etc. As can be seen I the graph below, 28% of imports are from Macedonia, Serbia and Montenegro which do not bear customs burden. Under such circumstances free trade agreements with neighboring countries would put Kosova in a disadvantageous position. Under such agreements Kosova would lose considerable revenue from customs, with no benefit in return because of the low level of exports.



Source: MEF (Unit for Macroeconomic Analysis) and Customs service

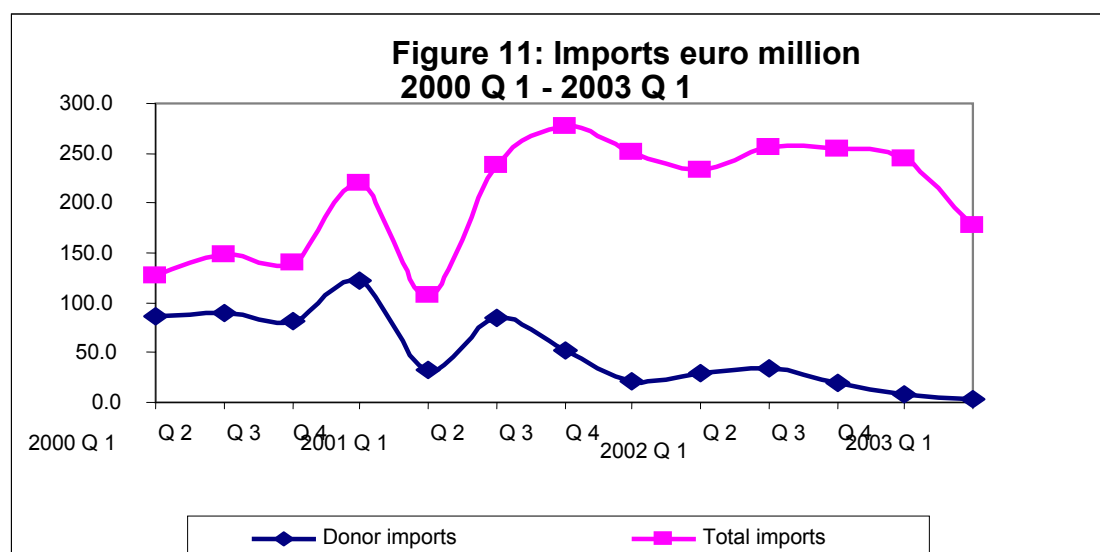
At the beginning of this year, negative trends can be observed in import, as opposed to the last three years which showed an increase in import. Hence in the first quarter of this year import was lower by 24% comparing to the same period of 2002.

Table 19: Import trends (in million €)

| | First quarter 2002 | First quarter 2003 | First quarter 2003/2002 |
|---------------------|-----------------------|-----------------------|----------------------------|
| January | 80.9 | 48.6 | 0.60 |
| February | 70.8 | 50.9 | 0.72 |
| March | 81.6 | 77.9 | 0.95 |
| Total first quarter | 233.3 | 177.4 | 0.76 |

Source: MEF (Unit for Macroeconomic Analysis) and Customs service

It is especially evident the drastic decline of import by donors. In March of this year, the share of donor imports in total import was 1.8% comparing to 16.2% in 2002 or 32.8% in 2001 or 61% in 2000, in the same month of the year.



Source: MEF (Unit for Macroeconomic Analysis) and Customs service

Import structure is mainly dominated by food items, petrol, chemical and wood products. It is worrying the halving of import of machinery in total import from 21% to 11% during this period.

From current imports, around 270 million € are estimated to be imports for investment goods related to construction materials and equipment.⁴² It is estimated that imports for equipment amount to 70 million €. Taking into account that so far customs tariffs are not applied to imports entering from Serbia and Montenegro, and that only a one percent tariff is applied to imports from Macedonia, it can be concluded that the decrease in customs tariffs from 10% to 2% for capital imports will be substituted by other taxes.

On the other hand, fiscal policy should examine the alternative resources that should be used to soften the problems that are expected once imports decrease.

⁴² Janusz Szyrmer and Ed Funkhouser: Kosovo Economy in 2002, May 8, 2003

5. BUDGET SUSTAINABILITY

Kosova's budget sustainability is of essential importance, not only to finance the necessary operations of public administration and public services, but also to create conditions for sustainable economic development and macroeconomic stability. In this respect, proper measures are needed in two directions:

- (1) Creating conditions for the sustainable growth of budget revenue; and
- (2) Rationalization of expenditure and improvement in budget management.

5.1. CREATING CONDITIONS FOR THE SUSTAINABLE GROWTH OF BUDGET REVENUE

Up to now, considerable measures have been undertaken to increase budget revenue. We have observed tax increases in revenue as a share of GDP faster than the international administration expected. Also, several measures have been undertaken which have enabled the transfer of some tax burdens from businesses to consumers. However, the overall structure of budget revenue increase is still not built upon a sustainable basis. In relation to this, an effective approach is needed for:

- a) Creating conditions for sustainable growth
- b) Expanding the taxation base
- c) Improving the level of tax collection
- d) Improving the capacities of tax administration
- e) Creating conditions to use other revenue sources to finance public infrastructure.

We consider that further capacity for the stabilization of budget revenue relies upon undertaking measures to strengthen the management of the tax administration, in particular that of customs duties, combating corruption in the tax and customs administration and greater control at the borders.

5.1.1. Creating conditions for sustainable economic growth

Stabilization of long-term economic growth is an essential condition to providing higher budget revenue and long-term budget sustainability. Post-war economic growth in Kosova has gone through an impressive resurgence of economic activity (especially in trade, construction and services), high GDP growth rates in 2000 and 2001, and an apparent decline in the economic growth rate in 2002 with a real fear of entering into a recession in the coming period 2003-2005. This indicates that despite the evident success in overcoming the consequences of war during the emergency phase of reconstruction, real progress in creating conditions for sustainable development have not been made.

Therefore, the main issue is to urgently improve economic policies and the business environment. In conditions of high unemployment (38-49%), the key orientation of economic policies is to create a friendly business environment for domestic and foreign private investment as a source of economic growth and to reduce unemployment. As presently operated, the three key policies are at the disposal of managing macroeconomic regulation: (i) taxation policies; (ii) trade policies; and (iii) business financing, are not operated in a manner likely to best address this need.

In terms of taxation policies, it is obvious that there is no more room to increase fiscal obligations against businesses without jeopardizing their development. The orientation should be towards a relative, and possibly absolute, lowering of burdens to businesses in financing the budget. This applies in particular to taxes that make capital investment expensive.

In the financing domain, there should be an increase in available credit for medium and long-term productive investment through the increase of security to implement guarantee instruments and the building of relationships between Kosovar and foreign banks and international financial organizations to support SME financing.

With regard to trade policies, it is essential to avoid administrative and political barriers for Kosovar exports, namely in neighboring countries.

Another component with similar importance for the creation of an appropriate business environment is law enforcement and the creation of a secure environment for businesses and protection of property. Also, it is worth to consider the possibility of using the budget surplus to invest in capital goods which can help stimulate the economy over the medium and long terms.

5.1.2. Expanding the taxation base

Despite the inappropriate structure of direct taxes vs. those charged to expenditure, priorities concerning budget sustainability lead to measures which would effectively impact:

- the implementation of excise taxes on selected domestic products and services,
- the lowering of the VAT threshold in order to apply it to a greater number of firms,
- the maximum elimination of tax and customs duty exemptions (especially for NGOs), and
- the application of tax on total incomes to citizens for the longer term.

In the short-run, it is important to set up the basis of a sustainable legal framework, in order to strengthen the economy and increase the capacities of the tax administration.

In the current situation, the following are the areas where improvements can be made:

- a. The proportion between domestic taxes and those gathered at the border can be improved through an increase in the efficiency in gathering domestic taxes, without sidestepping the role of border taxes, and
- b. Adjusting the proportion between direct and indirect taxes, where tax on property, personal income tax (expanded to other incomes) and profit tax, would have a special role,
- c. To lower customs duties for the import of machinery and equipment needed for investment from 10% to 2%. Any subsequent decline in fiscal revenue **could be offset** by an expansion of the VAT base.

5.1.3. Improving the level of tax collection

There are three types of taxes about which the effects of their non-accomplishment has been observed. The initial effects of the collection of the tax on property are modest. Collection of the tax on salaries is also not satisfactory. Domestic VAT, according to its level of collection, stands below all expectations. Positive trends in the collection of these taxes would not only have positive fiscal effects, but also would improve the structure of the budget by increasing the share of direct taxes and improving the proportion of the fiscal burden between the economy and citizens.

5.1.4. Improving the capacities of the tax and customs administration

The reform of the tax administration refers to a wide range of activities, mechanisms, and specific actions related to:

- organization of the tax and customs administration,
- managing the tax system and procedures

Within the capacities of tax administration there lies the opportunity for wide range implementation of VAT through a lowering of the threshold of gross turnover, plus efficiency in collecting this tax on domestic turnover of products and services, and greater control and efficiency in collecting taxes, customs duties and excises at border crossings. Private sector development will bring with it new demands on the tax administration, not only with regard to expanding the taxation base but also for the classification of products and services. Hence there is a need for an administration which is sufficient in number, prepared and well-trained. In this sector, as opposed to other sectors, there are reasons for increasing the number of employees, which would be positively reflected in a harmonization of the capacities of the tax administration with its duties.

Procedures for estimation, collection and registration of taxes to be paid should also be strengthened. For the purposes of more efficient management of the increase in the number of taxpayers, most of which come from SMEs and citizens (and experience so far has shown that it is not easy to tax them), the tax administration should implement better identification procedures and an efficient information system.

In those countries less advanced in the process of transition, inadequate personnel, weak training, low salaries and lack of equipment all contributed not only to low moral and weak management practices, but also to the erosion of tax collection. Countries of less advanced transition (such as Kosova) are still characterized by relatively unfair tax burdens, inappropriate regulations, and in general an inadequate level of delivery of public services. Therefore, one of the most important duties to be addressed by the Government is the creation of a system to detect incorrect tax estimations and to prevent corruption amongst tax officials, including selective monitoring and audit.

5.1.5. Fiscal culture

The causes of fiscal evasion that have been identified so far continue to jeopardize fiscal revenue. Here we should emphasize those causes which are related to various legal, administrative and organizational issues, the asymmetry in customs duties with neighbouring countries, the ineffective scrutiny of border crossings, and the informal economy with all its characteristics and the consequences it has for fiscal effect and equality in the market. Of special importance in the fight against evasion is the need to undertake measures to cultivate a fiscal culture which would be oriented towards taxpayers fulfilling their fiscal liabilities, and towards budget expenditure plans which are more efficient, rational and effective in budget spending. Important instruments to this end are: curricula, public media, special publications, direct communication with taxpayers, audit, control and accountability of legal institutions, the publication of tax guides for firms and citizens.

5.1.6. Creating conditions to use other revenue sources to finance public infrastructure

The Government Budget cannot not use a broader portfolio of budget sources outside tax revenue, foreign budget donations and non-tax revenue, due to the unresolved status of Kosova. Other countries have a broader portfolio of sources that ensures they can more easily overcome the needs of the budget. Being limited to only domestic budget sources will not be sufficient to cover even the basic needs of the budget, which are increasing all the time as foreign donors leave, plus economic growth will trigger additional needs. There are significant reasons why the budget of Kosova should use the following sources:

- a proportion of proceeds from the privatization of socially owned enterprises (rent of land);
- donations for capital investment
- public, domestic and foreign debt (borrowing); and

These sources should be used, first of all, to cover the need for capital investment in Kosova.

Also, there should be an assessment of the improvement of situation in education, especially higher education, and health that could be brought about by the building of a sustainable participation system of their financing by those who use these services.

a. Proceeds from privatization

Participants in the International Conference “Privatization of Socially Owned Enterprises (SOEs) and the Reform of Public Utilities in Kosova”, held in June 2002 in Prishtina and organized by Riinvest, considered that it is quite irrational to freeze the proceeds from the privatization of SOEs in the KTA account. It was emphasized that freezing the funds generated from the sale or liquidation of SOEs can contribute to economic recession at a time when unemployment is very high. The participants shared the view that these proceeds should not remain frozen but should be activated for development purposes through the creation of a Privatization Fund. In line with this issue, it would be reasonable for the Government of Kosova each year to determine a percentage from these proceeds and their destination (building public infrastructure or maintaining capital investments which are currently carried out by

foreign donors). The orientation of these funds as a part of Kosova's budget for capital investment will not have implications on the ownership change of these funds, but they will be transferred into assets that would serve all the citizens of Kosova.

In this way part of the tax revenue will be saved, which is actually being lost due to the liquidation or transformation of socially or publicly owned enterprises as fiscal entities.

b. Donations and borrowing

Donations: In this phase of the reconstruction of Kosova, and in the context of mobilizing capital investment, issues that are related to the building of a borrowing policy are considered critical. In the forthcoming period, the donor community will diminish its support for the economic development of Kosova. For the period 2003-2005 this community has pledged to provide donations in the amount of €450-500 million, or less than 25% of the donations that were available between 2000 and 2002. A decline in donations will endanger the opportunities for overcoming disproportions and consolidating operational and capital expenditure for the integrated budget.

Public Investment Program. Over the period 2003-2005 €933 million is expected to be financed from external sources (€ 700 million) and domestic financing (€233 million).

Table 20: Capital investments made by donations (million €)

| | 2003 | 2004 | 2005 | 2003-2005 |
|---------------------------|------|------|------|-----------|
| Public Investment Program | 220 | 130 | 90 | 440 |
| Identified financing | 280 | 220 | 200 | 700 |
| PIP balance | -60 | -90 | -110 | -260 |

Source: The World Bank

As the table shows, €440 million have been identified from donor sources, while an additional €210 million are needed and should be distributed to accomplish the Public Investment Program.

The use of domestic revenue in supporting the Public Investment Program remains a critical issue, despite the progress made in building Kosova's budget and the increase in domestic sources. This trend should be regarded from the perspective of the functioning of free trade in the region and the inclusion of Kosova in this international agenda as well as from the aspect of export and import trends in the future. These trends will have an impact on the creation of Kosova's budget and its capacity to foresee a part of public investment in public services and infrastructure and the covering of operational expenditure.

In this situation, Kosova should undertake public borrowing to meet public investment needs, but not the needs of current budget expenditure. The experience of borrowing for current budget expenditure has proved harmful for budget stability and sustainability in some countries in the region. The borrowings were: a) foreign, and b) domestic.

Foreign borrowings: In order to meet public investment needs, the Government of Kosovo and UNMIK⁴³ are discussing the possibilities of borrowing, even under the conditions of the unresolved status of Kosovo. The IMF is recommending a careful policy of borrowing, through the commitment to limit the contracting and guaranteeing of debts pursuant to the conditions of the IDA, which ensures a sustainable burden with debts in the medium and long-term⁴⁴. The mission of the IMF has taken into consideration these sources for the budget of 2004. The involvement of public enterprises in using these sources is conditional upon the plans for their restructuring. Any borrowing by public enterprises is considered by the IMF as direct borrowing from the budget. To overcome these obstacles and limitations, it is necessary first of all to:

- build a sustainable mechanism to facilitate the access of Kosovo to international credit in order to finance the private sector and public infrastructure. Building such a mechanism would compensate the decline of international donations and create favorable conditions for sustainable economic growth;
- in the Law on Management of Public Finances and Responsibilities (Article 46) promotes the opportunity of including budget organizations in activities that allow borrowing. It takes into consideration the limitations of the Euro zone on public borrowing, especially the requirement that total public debts should not exceed 60% of GDP of the previous year, and the deficit should not exceed 3% of GDP. According to this Law, only the Government and SRSG have the authority to approve proposed borrowings;
- consensual financing according to the conditions of the IDA or contracting credit tranches with other international governments and organizations (Islamic Bank for Development in the amount of \$30 million, and the Saudi Development Fund in the amount of \$30 million.
- Any borrowing should be preceded by a development strategy and sectoral and feasibility study which proves that the loan can be paid back by project generated revenues.

Realization of these operations will positively affect the creation of a more favorable international financial environment able to generate external qualitative sources of finance to support public investments and projects, including projects directly related to SME development.

Domestic borrowing: The development of borrowing policies should be carried out with priorities. The deposits of the population that are currently being held in commercial banks represent an important potential. These financial sources could be borrowed by the government for the purpose of capital investment. No interest rate is being paid by the banks on current deposits, therefore providing an appropriate interest rate for them (above the interest that the banks actually provide), close to the interest rate in the European financial market, would increase the number of depositors and hence these resources could be used for a long term capital investments.

⁴³ According to Resolution 1244, UNMIK can undertake international borrowing on behalf of Kosovo, while Kosovo according to her Constitutional Framework can use the provision of BPK's revenue. It has been agreed to build a strategy for borrowing for medium-term development and borrowings can commence in 2004.

⁴⁴ Declaration of the IMF Mission on the occasion of the visit made to Kosovo, January 15-28, 2003.

5.2. THE RATIONALIZATION OF EXPENDITURE AND THE IMPROVEMENT OF BUDGET MANAGEMENT

The rationalization of expenditure in relation to the redefined role of the government means lowering and adjusting expenditure according to the forms of a market economy, through continuous attempts to keep the level of aggregate expenditure with respect to GDP as low as possible. Priority should be given to:

- a. The avoidance of subsidies for public enterprises (especially the KTA)
- b. The rationalization of public administration and its cost effective computerization

Accountable institutions, UNMIK, the Parliament and the Government should advance the process of determination of budget expenditure, to make sure that it is planned on a realistic basis, can be examined and is controlled, and that expenditure policy is built upon economic opportunities and capacities that Kosova possesses as well as opportunities for domestic and foreign liquid loans. Short-term sustainability of the budget is linked especially to budget expenditure performance, where budget accountability has the central role.

5.2.1. Avoiding subsidies

As part of the program for the reconstruction of Kosova, the donor community had mobilized great resources to revitalize public services.⁴⁵ The high share of capital investment to revitalize and maintain the thermal power plants of KEK should be mentioned. In addition to donations, considerable resources were also used from Kosova's Consolidated Budget, and from the part reserved for the SRSG. Budget surplus has been used for these purposes, in the absence of full budget transparency. To explain the commitment of these resources (the budget surplus) in public services, especially in KEK, the following circumstances should be considered:

- UNMIK and its Pillar IV is accountable for the investment and management of the power generation sector in Kosova;
- There has been no efficient management;
- There has been a reluctance to recognize legal issues concerning public enterprises;
- The low level of writing off debts and the lack of financial sustainability in public services;
- Continuous distortions in the operations of these services, in particular power and water supplies;
- The lack of vision to overcome this situation and the reluctance to solve the problem through restructuring with the participation of the private sector.

In these circumstances, the operation of public utilities is strongly dependant upon external financial sources while the services delivered are of poor quality and are very expensive. Subsidies were used to compensate the inefficient management and that is why restructuring and liberalization have not taken place.

⁴⁵ Within the sources committed by the EU, over the period 1999-2002 public services have had the following share in capital investments: power generation and other public services €331.0 million or 40%; transport and infrastructure €53.0 million or 6.4%, and water supply and environment protection €43.0 million or 5.2%. Compared to total capital investments, investment in public services accounted for 29.68% in committed resources, 28.5% in contracting resources and 29.30% in resources spent.

Maintaining subsidies out of a strategy for the development of power generation can have a negative impact on the uncontrolled increase of consumption and cause disregard of the need to increase power generation efficiency. In the case of power generation, this will negatively impact the accumulation of debts and irregularities in payments by consumers. Another shortcoming is that subsidies in Kosovo are not focused on the poor and do not have any social basis. In a market economy, when the consumer pays the full price of electricity and other public services (which are very high) it is unreasonable to pay them once again as a taxpayer. Obviously, the consumer cannot take the burden of the shortcomings and mismanagement of UNMIK, the KTA, KEK and other public organizations. The experiences of other countries, where the abandonment of the previous economic system was more difficult, indicate that subsidies for state owned enterprises became an unavoidable burden for their budget stability, and that is a good lesson for the situation in which Kosovo currently finds itself.

Discussion on how to use budget surplus is not preceded by relevant analysis and expertise on the current situation and realistic needs, nor an identification of the barriers to increasing financial sustainability.

In the budget of 2003 it is expected that €23 million will be dedicated for subsidies, out of which the greatest amount will go the Trepça Corporation. That would be affordable if we do not take into account another €75 million from the budget surplus allocated to the KTA, without specifying for what purpose. This makes the share of subsidies in the total budget (including surpluses) in 2003 14%. This indicates that there is a lack of clear definition between budget surplus, subsidies in the form of investment and efficiency of public services. For equity purposes the full market price for good and services should be paid by all with any subsidy going to assist the poorer consumer by raising their income level to cover the higher costs, rather than using budget revenues for public enterprise subsidies.

Table 21: Subsidies in the budget of 2003

| | |
|---|--------------------|
| Power (electricity) | 3,000,000 |
| Water Supply | 1,000,000 |
| Administration and Management of SOEs | 860,112 |
| Trepça Mines | 12,590,000 |
| Central Administration Services | 1,599,888 |
| UNMIK Railways | 2,084,000 |
| Radio and Television | 2,000,000 |
| Total KTA | 23,134,000 |
| KTA (surplus of 2001, 2002*) | 77,037,010 |
| Total Subsidies | 100,171,010 |
| Share in Total Governmental Budget | 14.3% |

Source: Kosovo Consolidated Budget, 2003

*The Kosovo General Government 2003 Budget (internal working draft)

Subsidies in other countries⁴⁶ show a declining tendency with respect to GDP and there are more subsidies for expenditure and the special use of public services. In the case of Kosovo, continuing to spend budget resources (especially the budget surplus – considering them as resources not gathered from taxes) to subsidize the managerial

⁴⁶ Budget subsidies (their share of GDP in 2001 by countries was as follows: Bulgaria 1%, Albania 1.3%, Romania 2.1%, Poland 2.4%.

and organizational failures of public utilities, will directly jeopardize budget stability on the one hand, and will harm other public services such as education, health, science, social welfare, pensions, and taxpayers themselves on the other.

Supporting public organizations with budget resources is reasonable only if budget entities are not harmed, and on a credit basis, if the opportunities to pay back the credit are examined, considering not only the resources required but also those that are lent as subsidies (without the compliance of taxpayers and their legal representatives in the Parliament of Kosova). Also, there should be an acceptance of the critical views of the IMF which calls for a profound restructuring of these enterprises in order to limit the continuous losses that they are making, not only for themselves but also for the government. The IMF mission recommends the creation of a separate unit within the MEF to monitor the execution of a budget for the main public enterprises. They claim that only a strategy for their restructuring would lead to the creation of financial sustainability that would save the public funds of the country.⁴⁷

5.2.2. The rationalization of public administration

Further steps should be taken to address the over employment in the civil service and the problem of inefficiency, while strengthening the quality but avoiding the erosion of salaries. Bearing in mind that the analysis so far has showed that there is over employment in governmental institutions compared to other countries, and given the budget constraints, there is an urgent need that before increasing the number of employees in public services, a sectoral analysis should be carried out which would prove the reason for such an action.

⁴⁷ Mission statement of the IMF on the occasion of the visit to Kosova, January 15-28, 2003.

5.3. IMPROVEMENT IN THE BUDGET MANAGEMENT PROCESS⁴⁸

A clear process for identifying long-term aims should assist in achieving a transparent process and accountability in making strategic choices between competing projects and services. The overriding aim is for the Government, through its budgetary procedures, to act as efficiently as possible and to provide a good infrastructure for the development of the emerging small business sector, which appears to have the potential to be a dynamic force in the economy. The larger sectors, with monopolies, either natural or produced by regulation, need careful management and reform. The guiding principal is to encourage competition and for the Government to clearly and transparently provide for goods and services with a public good element to them. This need not mean that the State provides them by producing them itself, but that any subsidies that are needed to ensure their provision are made clear, preferably through income transfers rather than direct production subsidies.

The use of fixed multi, e.g. two or three-year, limits as part of the Government's fiscal management approach could help in demonstrating fiscal credibility and good fiscal management. Policy review should be an ongoing task. This will be limited by the availability of trained staff and good information flows. To begin with the process will be quite a basic one, subsequently developing as data and technical ability improves. Other low-income countries with poor information flows and a lack of technical expertise have at least started in this direction. The idea being that once the concept is put in place it can then be developed as conditions allow. The current budgetary policy in Kosova appears unlikely to be sustainable and certainly likely to prevent progress in achieving efficiency improvements.

5.3.1. Fiscal Credibility and Fiscal Responsibilities

A careful appraisal of the approach to expenditure will help to achieve sustainability of the budget, even if there is a significant collapse in revenue, for example from a move towards freer trade. Expenditure levels are far more within the control of the Government than revenue streams, which will fluctuate with changes in the level of economic activity. This will help to achieve the sort of fiscal responsibility required of those seeking to join regional groupings under the stability pact and will have benefits in a developmental sense.

With any fiscal management approach, over time a number of issues will arise which necessitate a need to rethink the policy objectives and their respective priorities. In the initial phase this is likely to be more frequent than for a mature economy, thus suggesting medium term reviews at two-year intervals rather than three, which are common in such structures in mature economies. Whatever the time-frame, there is a challenge in revising the approach so as to address issues in ways that are consistent

⁴⁸ Kenneth E Jackson's report, May 2003.

with the fiscal management policy and aim: to achieve fiscal credibility. The policies and projects may alter in priority but the approach and evaluation techniques remain consistent. Allocating scarce resources amongst competing priorities will always involve an element of friction. It is important to be clear about how changes to the Government's fiscal management approach in terms of re-prioritization fit into the wider fiscal picture. A pragmatic response to particular expenditure demands in times of perceived crisis is unlikely to lead to good fiscal management.

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