

## Public Expenditures, Budgetary Sustainability and the Assessment of Management of Public Expenditures in Kosovo

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**Abstract:** Public expenditures are public outlays which competent state organs realize for the purpose of fulfilling obligations of general public interest. They are manifested in different forms and in different social, economic and political areas. Public expenditures produce direct and indirect effects in production and influence consumption and prices. Economic structure and conjunctural courses of one country have an impact on the highness of the public expenditures. Economic and social subsidies present the main instruments for achieving economic and social effects through the policy of public expenditures, whilst in conjunctural economies; the effect of public expenditures is large and is realized through the mechanism of multipliers which are used when the economy is in the state of economic stagnation and recession. After the war, Kosovo built a new fiscal system according to the best international practices. The tax system consists of some taxes, it has a wide spread of tax charges and applies relatively low tax rates. Both budgetary revenues and budgetary consumption have marked certain variations in relation to GDP. Currently, The Kosovo Consolidated Budget (KCB) is completely fulfilled by domestic revenues. It is considered that, even if the budgetary consumption increases up to 30-34% of GDP, this raise will not endanger budgetary sustainability of the country. According to the World Bank assessment (PEFA document- 2006) on the Effectiveness of Management of Public Expenditures in Kosovo, based on the performance of main indicators of management of public finances, the effectiveness of management of public expenditures in Kosovo is relatively satisfactory. According to the draft-document of the World Bank and the Government of Kosovo (PEFA-2008), the quality of management of public expenditures in 2008 has been profoundly improved.

### 1. The meaning and forms of manifestation of public expenditures

Public expenditures are public outlays which competent state organs realize for the purpose of fulfilling obligations of general public interest. Funds that are used for these purposes are gathered from physical and juridical persons in the form of taxes, contributions, fees, loans, customs, etc. Therefore, public revenues and public outlays are closely linked with each other and, hence their treatment should be seen as a causal inter-dependency.

Effects of public expenditures are manifested in different forms and different social, economic and political fields, whose intensity depends on the conjectural courses and the economic structure of a country.

Public expenditures may have multiple effects in production, expressed in direct and indirect forms. Direct impact of public expenditures in production is the result of committing funds for production capacity building, investments in economy (modernization of existing enterprises and building of new ones) and this will directly increase production and consequently increase incomes.

Indirect impact of public expenditures in production has to do with their engagement in the area of education, in the area of health insurance, social welfare, health care, etc, and which will have positive effects in national economies. In one way, public expenditures may have an expansionistic or restrictive impact on the economic courses. Expansionistic impact will happen, for instance, in investments in construction of modern road nets, which will positively impact the development of car industry and income generation from a whole related productive chain of this industry.

Public expenditures may also have a restrictive character in production affecting reduction of production and consequently the GDP. If expenditures are high, then, this means that, in order to fulfill them, a larger portion of GDP should be re-distributed. This re-distribution means that, through taxes and other fiscal revenues, the economic and purchasing power of tax payers will be declined, and consequently with this, purchasing of products will decrease. This then influences the decrease in production, which should adjust to the level of demand, but this also decreases self-financing possibilities of economic subjects respectively their ability to fund expanded reproduction.

Public expenditures affect the consumption level in different ways as well. One of the effects, for instance, we can take the transfer of a certain type of expenditures to those categories of users where the purchasing power did not exist before, or partially existed, for example pensioners, unemployed, etc. As their purchasing power increases, no matter how low their purchasing power may be, the consumption will increase, too.

Effects of public expenditures consumption may also have an impact on the level of prices (they may rise, go down or have a neutral activity). Construction and equipment of health and education facilities, public expenditures for military needs etc, may have an impact of increasing the price of products and related necessary services. These effects may change depending on conjectural courses for certain products. For example, if the need for certain military products increases, the production capacities will broaden and we will have an expansion of those products. This will enhance possibilities of new employments by which the consumption will be

increased, as well as productions and general incomes and vice versa.

The conjecture has also an impact on the type and highness of public expenditures, which either adjust or do not adjust to these conjectural cycles. Therefore, we differentiate three types of adjustments:

- a) Public expenditures which change at the same time with the productive conjecture (cyclic public expenditures), for example, expenditures for goods and services go down along with productive conjecture due to fall of prices and salaries.
- b) Public expenditures which are neutral in relation with the conjecture (non-cyclic public expenditures, for instance, public expenditures for the service of public loans, contracted obligations, pensions and salaries of state officials etc.
- c) Public expenditures which change in an anti-cyclic manner, that is, they behave contrary to the productive conjecture, for example transferable data (compensation for unemployed, expenditures for maintaining the existential minimum and similar).

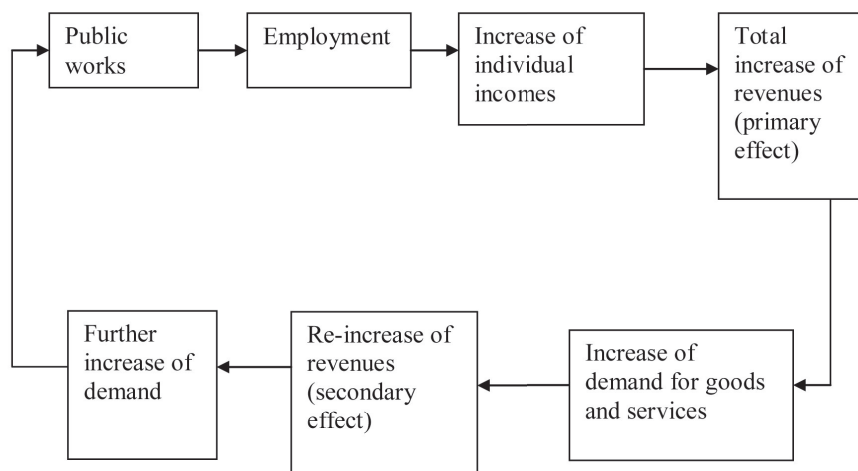
Economic and social effects may be reached by the policy of public expenditures as well, and not only by the policy of public revenues. As the main instruments for achieving these effects are the following: a) economic subsidies and b) social subsidies. a) Economic subsidies may be direct and indirect and their impact is reflected in prices by subsidizing production (where subsidized products would be more competitive in the market and the producer would be more interested in the production), however, the consumption may be subsidized in a manner that

the state would be in charge of compensating the price for certain products dedicated to consumption. b) Social subsidies, which are often called social expenditures, are expenditures in the form of social assistance, scholarships etc dedicated to those who can not afford to cover certain expenditures. These types of expenditures impact production and consumption. An important role in social subsidies play expenditures dedicated to permanent education and perfection, which have positive return effects in production and national revenues. Therefore, it is thought that investments in human resources are the most profitable investments. However, it must be pointed out that social expenditures may have negative effects in saving, investments in employment, productivity, etc.

Effects of public expenditures, in particular, have an impact on conjectural economies, where functions the mechanism of multipliers which are used in circumstances when the economy is in the condition of economic stagnation and recession appears as a hindrance to development. In these cases, the so called conjectural-political investments appear by applying *public works*, where the mechanism of multipliers with its direct and indirect effects may appear as in Figure 1.

A lot of public works are implemented in order to eliminate depression and unemployment, a situation which enables higher employment of workers. With this, more individual incomes are created and therefore, the total of revenues is increased (primary effect of multipliers) and also a new demand for goods and services is created. This has an impact on re-increasing the revenues again (secondary effect of multipliers) and re-increasing the demand (see Figure 1).

Figure 1. Functioning of multipliers' mechanism in creation of revenues and increasing the demand.



In the economic and financial literature, the difference between the so-called active public expenditures and neutral public expenditures can be found, depending on their relation with the socio-economic structure of a country. If public expenditures have changed that structure, they are called active public expenditures and vice versa, if they do not change that structure, they are called neutral public expenditures.

In the classical financial theory, we find demands for neutral role of public expenditures in the socio-economic life of a country and the reasons for such demands are supported by the essence itself (character) of liberal capitalism, according to which, any initiative which is not a private initiative, endangers the development of relations in the liberal capitalism. However, modern financial theory supports the need of an active role of the state in orienting the socio-economic courses of the country as regards public expenditures which, along with other financial instruments, should achieve this goal.<sup>1</sup>

<sup>1</sup> Barbara Jelčić, *Javne Financije (Public Finances)*, Zagreb 2001, 484-492

## 2. Budgetary Sustainability

After the war, Kosovo built a new fiscal system based on the best western experiences. Until 2002, the Central Fiscal Authority within UNMIK operated with the budget, whereas with the establishment of the Ministry of Economy and Finance, the situation changes since the ministry starts to exercise a part of competencies from the area of finances.

The tax system in Kosovo has continuously advanced and with the application of VAT and taxes on personal incomes, taxes start to be displaced on consumers.<sup>2</sup>

The tax base has continuously been broadened and now it includes the largest part of direct and indirect taxes, which is also

<sup>2</sup> In Kosovo, some forms of taxes have been applied, some of which now are not being applied. Tax on hotel industry has been applied since 2000, presumed taxes (July 2000), VAT (July 2001 modified in 2002 and 2004), taxes on salaries (April 2002), taxes on earnings (April 2002 until 31.12.2004 replaced from January 2005), taxes on personal incomes (January 2005), taxes on corporations' incomes (January 2005).

Table 1. General budgetary balance in rapport with GDP (mil. euro)

	2000	2001	2002	2003	2004	2005	2006	2007
Budgetary revenues without grants	124.52	283.14	499.60	586.86	619.20	642.15	712.01	902.98
Budgetary consumption	198.53	264.62	389.91	546.60	749.72	696.13	655.94	673.46
Total balance	-74.01	18.52	109.69	40.26	-130.52	-47.98	56.07	229.52
Incomes/ GDP%	8.28	12.77	22.24	26.09	27.13	29.07	31.64	26.56
Consumption/ GDP%	13.12	11.93	17.36	24.30	32.85	31.53	29.15	19.81
Total balance/ GDPV%	-4.92	1.2	4.88	1.79	-5.72	-2.17	2.49	6.75
GDP/MIL.*	1.504,00	2.217,00	2,246,00	2,249,00	2.282,00	2.209,00	2.250,00	3.400,00**

Source: Financial statement 2000-2007, Departament of Treasury , MEF.

\*IMF Tables 4, 31 May 2006, Aide Memorie

\*\*Department of Micro-economic Policies, MEF,MFE, 2009-2011, Table 2.

a practice of other countries in transition, but businesses still have suggestions to change the tax rates (taxes on earnings, on salaries, etc) and on their linearity. At the beginning of 2009, important reforms took place in the tax system of Kosovo, especially in taxes on personal incomes, taxes on VAT and taxes on corporations for the purpose of stimulating economic development of the country.<sup>3</sup>

Collection of budgetary revenues in Kosovo has marked an improvement since 2000. Table 1 presents budgetary courses in rapport with GDP for the period 2000-2007

General budgetary revenues have marked an increase in participating in GDP since 2000 until 2006 (from 8,28% to 31.64%), while in 2007 they reduced their participation

<sup>3</sup> Tax on earnings is reduced from 20% to 10%, VAT increases from 15% to 16% and taxes on personal incomes (salaries) have been reduced from 20,10,5,0% ,to 10,8,4 and 0%.

to 26.56% due to increased assessment of Gross Domestic Product for this year, although they marked an absolute increase during this year.

Meanwhile, budgetary consumption showed variations from year to year and the lowest participating in GDP was in 2001(11.93%) whereas the highest in 2004(32, 85%) of GDP.<sup>4</sup>

High budgetary expenditures in Kosovo in 2004 and the lack of revenues to follow the trend of expenditures which were covered by budgetary accumulation of previous years imposed the need for a better control of

<sup>4</sup> In some countries in transition, participation of budgetary consumption in GDP in 2006 was as follows : Albania 28.4%, Bulgaria 35.3%, Macedonia 33.7%, Latvia 37.5%, Rumania 32.1%, Croatia 47.7%, Serbia 42.1% : Source : EBRD Country Report 2008 based on the data of state authorities of each country.

budgetary consumption in 2005 in order not to cause high deficit and long term budgetary unsustainability.<sup>5</sup>

Also, the highest negative general balance was in 2004 (-5.72%) while the highest positive balance was in 2007(6.75%).<sup>6</sup>

Currently, the Kosovo Consolidated Budget is entirely fulfilled by domestic revenues. Around 75% of tax related revenues are realized in boundaries and 25% from internal taxes. The intention of institutions is to change this relation for the purpose of long term consolidation of budgetary sustainability.

Creation of participatory rapport of budgetary revenues in GDP with around 30% would provide budgetary sustainability even in the case of the increase of budgetary consumption up to the level of 30-34% of GDP. However, in such cases, measures of budgetary control should be increased for the purpose of increasing the effectiveness of budgetary expenditures.

In Table 2 ,due to accuracy of the data, they have been presented as per the rate of realization of budgetary allocations for the period 2003-2007. The data indicate that the category of wages and salaries had the highest coefficient of spending budgetary allocations for this period (97,45%), then the category of subsidies and transfers (95,22%), goods and services (91,53% ) and the lowest coefficient of spending budgetary allocations was realized in the category of capital expenditures (71%). Overall, the general coefficient

<sup>5</sup> Report of December, 2004, IMF

<sup>6</sup> It is worth mentioning that the data on the highness of GDP differ, depending on the source of information. After calculations and analysis, we have estimated the presented data as more sustainable.

of using budgetary allocations was 87, 09% or annual average coefficient of using budgetary allocations was 76, 25%. Looking at it from the aspect of the level of budgetary expenditures, such realized level (87, 09%) is significant in the institutional building aspect as well. From 2002 and onwards, a new reality was created in Kosovo, entirely new in the institutional, political, economical, financial aspect. Kosovo built its institutions, and today we have a consolidated fiscal and budgetary system, a consolidated education and health system, a social system administered and controlled, although there is a lot to be done in order to treat different categories of society in the aspect of social welfare; a public administration almost completely new has been built, many economic, infrastructural, order and safety aspects have been taken into consideration etc. All budgetary requests in these areas have been covered by the Kosovo Consolidated Budget as of 2003. However, given these meaningful aspects of public funding, a higher level of using budgetary allocations is required, taking into consideration developmental needs of the country and, particularly implementation of capital projects. Analyses show that many indicators have influenced the low level of using budgetary funds in the category of capital expenditures and we will mention just few of them:

- budgetary planning;
- managerial problems;
- preparation of projects, especially capital projects;
- public procurement procedures;
- lack of necessary training of administration (despite achieved results);
- system of payment (cash payment, especially for larger projects);
- insufficient capacities of economic operators;

Table 2. Coefficient of budgetary allocations for the period 2003-2007. Economic classification (mil. euros)

	Wages and salaries	Goods and Services	Subsidies and Transfers	Capital Expenditures	Municipal Expenditures	Reserve	Total
<b>2003</b>							
Allocated							
Budget	148,97	183,61	135,77	130,64	-	42,87	641,81
-Realized							
Budget	145,70	175,50	129,95	93,10	-	2,35	546,60
<b>2004</b>							
-Allocated							
Budget	191,66	216,59	207,51	311,69	-	9,84	937,69
-Realized							
Budget	184,41	188,31	185,50	187,44	-	3,96	749,72
<b>2005</b>							
-Allocated							
Budget	198,68	157,69	215,58*	165,57	-	7,36	744,88
-Realized budget	194,60	142,88	213,85*	144,88	-	-	696,13
<b>2006</b>							
-Allocated							
Budget	209,45	142,43	163,40	189,95	20,15	1,93	727,31
-Realized							
Budget	206,98	134,33	157,99	138,38	18,37	-	656,05
<b>2007</b>							
-Allocated							
Budget	216,44	145,17	161,51	221,19	19,21		763,52
-Realized							
Budget	208,92	132,88	154,55	159,21	17,90	-	673,46
Total							
Budget :							
-allocated	965,20	845,49	883,77	1.019,04	39,36	62,00	3.814,86
-realized	940,61	773,90	841,54	723,61	36,27	6,31	3.322,24
Coefficient of Realization of allocated Budget	97,45%	91,53%	95,22%	71,00%	92,14	10,17	87,09% or Annual average 76,25%

\*Includes additional 22.mil.euros borrowings for KEC and Airport

Source: Financial statements 2003-2007, Departament of Treasury, MEF, and processed by the author.

- the lack of obey of law in cases of misuse of law by the budget organizations and by contractual economic operators.

### 3. Assessment of effectiveness of management of public expenditures

Assessment of effectiveness of management of public expenditures in Kosovo is supported by the System of Finance Management in Kosovo (SFMK).

The System of Finance Management in Kosovo (SFMK) is quite advanced and it has been implemented for registration, management and reporting on the budget, in all phases of its execution. The financial management

system is uniform, fast, flexible, and comprehensive and allows access to the data of all budgetary agencies, as well as comparison of those data at all levels and institutions. According to World Bank Assessment of the main indicators of management of public finances in Kosovo, it results that the effectiveness of management of public expenditures in Kosovo is relatively good. Below, we will present the assessment of financial management of public expenditures for the year 2006 based on the documents of the Government of Kosovo (MEF) and the World Bank, known as the PEFA document, whereas for 2008 based, on the draft-document of the Government of Kosovo and the World Bank.

Table 3. Main indicators of assessment of management of public expenditures in Kosovo for 2006 and 2008

	INDICATOR	2006	2008
	<b>Budget Credibility</b>		
1	Total of expenditures' flow as compared with the approved budget	N/A*	C
2	Content of expenditures' flow as compared with the approved budget	N/A**	A
3	Total of revenues' flow as compared with the approved budget	A	A
4	Fund and monitoring of debt payment expenditures	D+	B
	<b>Transparency and comprehensiveness</b>		
5	Classification of Budget	D+	A
6	Inclusion of information in the budgetary document	D	B
7	Dissemination of governmental reported activities including donors' funding	A	A
8	Transparency and inter-governmental fiscal relations	A	B+
9	Supervision of fiscal risk	C+	C+
10	Public access to key fiscal information	A	B
	<b>Policy based budget</b>		
11	The rule and participation in the annual budgetary process	B+	B
12	Long term perspective in the fiscal policy, planning and budgeting	D+	B
	<b>Anticipation and control of expenditures' execution</b>		
13	Transparency of obligations and commitments of taxpayers	B+	B
14	Effectiveness in registration of tax payers and tax assessment	C	D+
15	Effectiveness in collection of taxes	B	D+



16	Effectiveness of cash flow planning, management and monitoring	B+	A
17	Registration and management of cash debt and guaranty	A	A
18	Effectiveness and control of the payroll	D+	D
19	Competitiveness, value of money and controls in procurement	D+	B
20	Effectiveness in internal controls	C+	B
21	Internal Audit Effectiveness	C	C+
	<b>Accounting, registration and reporting</b>		
22	Deadlines and regularity of calculated balances	B	B+
23	Reliability of the source of information obtained from units that provided services	D	D
24	Deadlines, quality and distribution of executive reports during the year	B+	A
25	Deadlines of audit financial statements, submitted to the Assembly	A	A
	<b>Revision and internal audit</b>		
26	Purpose, nature and implementation of the reports of external auditor	D+	B
27	Annual budgetary review in the Parliament	B+	B
28	Review of the external audit report in the Parliament	D	C+

*\*Due to changes in the budgetary principles that display this indicator in accordance with standard criteria of PEFA, this indicator has not been assessed. If we consider the deviations of 2005, then the assessment for this indicator will be B.*

*\*\*as in \*but the assessment might be D.*

**Source:** Public Expenditure and Financial Accountability (PEFA) Assessment Report, Government of Kosovo and World Bank, April 2007, supported by DFID, EAR, IMF, USAID and PEFA 2008, Draft document of the Government and the World Bank.

The letters A,B,B+,C,C+,D,D+ ,indicate the level of assessment of the quality of assessed indicator beginning from A-that indicates the highest assessment of the quality of indicator's performance to D-which indicates the lowest assessment of the quality of the indicator's performance. The letters with the sign + show that the indicator has substantial improvement, aiming to be categorized in the assessment with the letter in front of the sign. For example, if the indicator has been assessed with B+ then this indicator is very close to reaching the assessment level of the letter A and similarly.

By analyzing all these indicators, according to the established criteria and

standards on budgetary policies and budgetary credibility, budgetary transparency, control on execution of expenditures, accounting, registration and reporting, internal and external audit of public expenditures, it can be concluded that the management of public expenditures in Kosovo in the post war period is quite credible and transparent, *however, it requires annual evaluation of indicators' performance in order to maintain and improve their sustainability.*

Moreover, the management of public expenditures is a financial category and extremely sensitive managerial activity that is threatened by mismanagement and misuse of budget.

#### 4. Results

Public expenditures in Kosovo introduce one of the most important components of financing public consumption, stimulating economic development and functioning of the institutions of the country.

► The fiscal system has been built according to the best international practices, but the fiscal policy, although it has undertaken some reforms recently, still has a character which is mainly fiscal and not sufficiently developmental.

► The coefficient of implementation of the budget, still low, especially in capital expenditures (71% in the period 2003-2007)

► Budgetary consumption is within the permissible limits and, for the moment, is not endangering the budgetary sustainability (See Table1)

► Participation of public expenditures in GDP in Kosovo in the period from 2000-2007 was 22% distinctly lower than in the European Union countries with (42.8%), or with the OECD countries (42.9%)

► Budgetary deficit/surplus, from 2005 Kosovo has budgetary surplus (Table1).

► Assessment of management of public expenditures in Kosovo-relatively on satisfactory level.

#### 5. Conclusions

The successful management of public expenditures in Kosovo will have a tremendous impact on economic growth. Kosovo is currently facing with the situation of overcoming the transitional phase of economic development. The use of internal funds for building the economic, education, health infrastructure will have an impact on the decrease of the unemployment as well, which is estimated to be around 40% of the work force, decrease of the poverty and extreme poverty level, which is estimated to be at 18% of the total population in Kosovo.

Competent institutions in Kosovo should improve even more their performance especially as regards collection of fiscal revenues, fight against fiscal evasion, fair allocation of public funds and successful implementation of investment projects, financed by these funds. Moreover, the increase of the level of transparency through the mechanism of control and oversight over the government (through the Parliament) will result in the improvement of the quality of budgetary indicators by which is made the assessment of the effectiveness of the management of public expenditures in Kosovo. According to World Bank document (PEFA), drafted in 2007, it is estimated that the effectiveness of the management of public expenditures in Kosovo is relatively good. This assessment was also made in 2008 and the data indicate that, in comparison with 2006, this year has marked improvements in the performance of indicators measuring the quality of management of public expenditures.

#### ABBREVIATIONS

1. **GDP** – Gross Domestic Production

2. **UNMIK** – United Nations Mission in Kosovo

3. **VAT** – Value Added Tax

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|---|---|
| 4. <b>MEF</b> – Ministry of Economy and Finance         | 9. <b>PEFA</b> – Public Expenditure and Financial Accountability      |
| 5. <b>IMF</b> – International Monetary Fund             | 10. <b>EAR</b> – European Agency for Reconstruction                   |
| 6. <b>MFE</b> – Mid-term Framework of Expenditures      | 11. <b>DFID</b> – Department for International Development            |
| 7. <b>KEC</b> – Kosovo Energy Corporation               | 12. <b>USAID</b> – United States Agency for International Development |
| 8. <b>SFMK</b> – System of Finance Management in Kosovo |   |

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