

Kosova budgetary sustainability and fiscal policy

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Abstract: Budgeting is the process of governmental resource allocation in order to achieve specific social and economic goals. Since the governmental resources are scarce in most transitional countries, as is the case in Kosova, they need to be allocated based on priority needs, in order to ensure greater efficiency.

In post-war Kosova the primary objectives of drafting policies were concentrated around establishing budgeting systems, collecting revenues by means of the tax system and development of a comprehensive reconstruction programme, it could be said that these goals were achieved within a short period of time. When we take into account the fact that the Central Banking Authority of Kosova (CBAK) is still unable to completely manage the monetary policy, and does this only to a certain extent, and the fact that Kosova until now did not have access to additional foreign financing, these elements make it all the more necessary to be more careful in preserving fiscal sustainability, since the fiscal policy, until now, was the sole means of macroeconomic policies at the hands of the government.

The objective of this paper is to present the proceedings of the Kosova fiscal policy and budgeting during 2000-2007, as well as provide several recommendations which could result in an increased efficiency in fiscal policy by generating budgetary revenues.

Keywords: Budget sustainability, Fiscal Policy, revenues, expenditures, deficit, Kosova

Introduction: Kosova Economy

Relatively poor countries, including Kosova, face the serious problem of establishing a proper economic environment. In countries

like this, it would be merely wishful thinking to expect the private sector to provide such goods and services as: infrastructure, education and healthcare, or in general public services. In Kosova, during a certain period of

time, the government will be the key financial supporter of such goods and services. Therefore, it is crucial to manage the budget in a rational and efficient manner. By all means this is not an easy task, starting from the fact that Kosova faces insufficient budgetary revenues, whereas, on the other hand, the necessity to improve the social and economic welfare of citizens is enormous.

The transitional reforms in Kosova started after 1999, on a fairly low economic base,

downgraded in particular during the 90's. In 1998, the general production of Kosova was dominated by the industry, which was at about 50% of the GDP, whereas agriculture was at only about 20%.

Economic development of Kosova during 2000-2006 was characterized by a small economic growth compared to the fairly low base at the commencement of the transition, as well as generally unstable macroeconomic indicators visible in the table provided below.

Table 1. Some key macroeconomic indicators

	Years				
	2002	2003	2004	2005	2006
Real GDP increase (%)	9.6	8.3	2.1	0.3	3.0
Inflation (%)	3.6	1.2	-1.4	-1.4	0.7
Increase of investments (%)	-9	-7	25.1	-26.0	29.4
Increase of exports (%)	2.2	0.1	-8.7	-11.1	30.3
Increase of imports (%)	-5.6	-4.5	1.0	9.4	13.3
Coverage of imports with exports	2.3	2.4	7.7	6.5	8.1
Transfers (mil. Euro)	341.4	341.4	215.0	281.0	318.0
Foreign assistance (mil. Euro)	897.5	698.7	565.0	491.0	465.0

Source: IMF, Aide Memoire, February 2007

In 2006, the Kosova economy recovered from the stagnation of the preceding year by marking an increase in the real GDP at the rate of 3%. Compared to the increase of 2004, the increase of 2006 was mainly supported by private sector investments. Such investments were supported mostly by banking sector loans and foreign direct investments. It is clear that Kosova needs a higher rate of economic development in order to address the challenges it faces such as financing the public infrastructure, reducing the rate of unemployment as well as the high current ac-

count deficit.

High unemployment rates represent one the greatest concerns for the Kosova economy. Unemployment rates differ from about 30% (IMF, 2004) up to 40% (ESK, 2006). Kosova is the country with the youngest population in Europe, more than half the population is under the 25 years old; therefore much more investment is necessary in order to decrease the rate of unemployment¹.

The high current account deficit also rep-

¹ Central Banking Authority of Kosova (CBAK), Annual Report 2006, Page 15

resents a great concern for the Kosova economy, in 2006 it was at 44.2% of the GDP, which provides for more than a mere concern. The main source of deficit remains the high level of imports, whereas coverage by means of exports is still fairly low, at about 8%.

Fiscal Policy impact on Budget

Bearing in mind the specific situation in which Kosova is, the fiscal policy during the reconstruction phase has had a relatively simple form. The establishment of a functional public finance system in Kosova commenced with the United Nations Mission in Kosova (UNMIK²) and from 2002 it is managed by the Ministry of Economy and Finance. UNMIK had to start from scratch with the design of the tax system, development of a budget and establishment of institutions for the implementation of fiscal policies. Initially, Kosova had a basic tax system, which was based on the collection of revenues at the border (sales tax, customs tax and excise tax), whereas the expenditure structure was still not well defined. Therefore, in lacking own revenues, half the operational expenditures, as well as all capital expenditures were financed by donor grants.

The public sector was the largest sector of the post-war economy; the private sector had just started to develop. Gradually, the public sector percentage of national revenues in Kosova decreased, the private sector developed at an accelerated pace, and the decrease in the period of 2000-2002 realistically

was about 12-13%, whereas in 2003 this sector marked a decrease of about 2.5%. National revenues increased from the base of zero in 1999, with new national taxes such as the profit's tax, presumptive tax, VAT and the Income tax.

In the period of 2000-2001, expenditure levels in Kosova, excluding capital expenditures, were not high compared to international standards. Based on the assessments of the IMF in Kosova, budgetary expenditures during this period represented about 14% of the GDP, which compared to the average of regional countries at the rate of 20-23% is considerably lower. Therefore, bearing in mind the fact that the proportion between expenditures and GDP is much higher in the regional countries, it can be said that Kosova in this period led a diligent and restrictive fiscal policy.

The budget of 2002 marked an important period in the transition phase for Kosova. From 2002 Kosova was to be governed by newly-elected institutions: the Assembly, President and Prime minister. About 93% of 2002 budgetary revenues were financed by national revenues, marking a considerable transition toward a budget that is completely financed by means of own revenues.

For the first time in 2003 the budget of Kosova did not contain any donor support. This was an important transition compared to the budgets of the preceding years when the budgetary support donations played an important role in the financing of governmental services. In 2003 the main budgetary revenues continued to be revenues from imports (customs) of Kosova, which represented 72%

² United Nations Mission in Kosova

of governmental budgetary revenues.

During the period of 2000-2003 governmental revenues increased dramatically as a result of application of new taxes and greater efficiency in tax collection. Based on the World Bank data, during this period, total revenues increased from 17 to 45% of the GDP value, whereas the budgetary surplus represented on average 3.5% of the GDP value. As a result of this, at the end of 2003 cash reserves at about 25% of the GDP value were collected.

In 2004 expenditures continued to increase with a high rate and consequently a budgetary deficit emerged which was covered by the surplus of the preceding years. It is worthwhile noting that Kosova is heavily dependent on revenues collected at the border, even though this dependency had started to decrease. Such dependency is high compared to international standards and reflects great dependability of the country on imports. Taxes at the customs comprised 90% of the revenues collected in 2000. This percentage decreased to 70% in 2004, and continued to decrease to 67% in 2005 and 61% in 2007.

The Kosova budgetary revenues in 2005 were 614.4 million Euros. Customs taxes, as mentioned above, comprised the largest portion of budgetary revenues or 67.4%, direct internal taxes were at 12.1%, indirect internal taxes were at 9.1%, whereas non-tax revenues represented 13% of total budgetary revenues.

Total expenditures of the Kosova Consolidated Budget (KCB) in 2005 marked the amount of 710.2 million Euro. They were

higher compared to the total revenues of the same year by 15.5%; however, they were lower by 5.1% compared to the total expenditures of 2004. Most KCB expenditures comprised of subsidies and transfers at 28.8%, salaries and wages 26.8%, capital expenditures excluding enterprises at 21.6% and expenditures for goods and services at 20.5%.

Kosova budgetary revenues also continued to grow in 2006, and reached the amount of 684 million euro, which was by 11.5% higher compared to the 2005 revenues. By reaching the amount of 485 million Euros, customs taxes marked an increase by 7.1% compared to 2005, however as part of total revenues, marked a decrease from 67% to 64%. A factor contributing to the increase of the volume of customs taxes could be the increase of the volume of imports (by 11.4%) which could have partially been affected by Free Trade Agreements (FTA's) with Albania and the FYROM, from which imports have marked an increase by 28.7% and 18.4% compared to 2005. A substantial increase was marked in 2006 in the collection of internal taxes (29%); they increased from 127.2 million Euros in 2005 to 164.1 million Euros in 2006³.

Compared to the budgetary revenues, total Kosova Budget expenditures in 2006 marked a decrease by 8.7% compared to 2005. The decrease in budgetary expenditures of 2006 resulted from the decrease of subsidies and transfers by 27.3%. The KCB expenditure structure continues to remain the as the one of 2005, whereby most expenditures are absorbed by salaries and wages (32%), which is also evident in Table 1.

³ CBAK, Annual Report 2006, page 23

Table 2. Kosova Consolidated Budget 2003 – 2006, in million Euros

	2003	2004		2005		2006 Projections	
Total revenues	589.7	601.3		614.4		684	
Taxes	520	533.2		534.6		604	
Customs taxes	424.9	430.0	71.5%	414.5	67.4%	485	
Direct internal taxes	66.5	62.0	10.3%	74.1	12.1%	121	17.7%
Indirect internal taxes	40.3	46.1	7.7%	55.7	9.1%	81	11.8%
Non tax revenues	68.9	68.1	11.3%	79.8	13%	80	11.7%
Total expenditures	542.6	748.5		710.2		692	
Current expenditures	506.4	579.5		546.8		559	
Salaries and wages	145.7	184.2	24.6%	190.7	26.8%	199	28.8%
Goods and services	173.9	187.7	25.1%	145.4	20.5%	146	21.1%
Subsidies and transfers	184.5	203.7	27.2%	204.8	28.8%	209	30.2%
Reserves	2.4	4.0	0.5%	6.0	0.8%	6	0.87%
Capital expenditures excluding enterprises	36.2	168.9	22.6%	153.4	21.6%	139	20.1%
Total balance	47.1	-147.2	- 19.7%	-95.8	- 13.5%	-9	1.3%
Budgetary support grants	0.0	4.3	0.6%	0.0	0%	0.0	0%

Source: Kosova: Balance of payments, 2001-2006, IMF staff assessments.

Kosova budgetary revenues in 2007 marked 891.4 million euro, they were higher by 155 million Euros compared to the budget approved for 2007 at the beginning of the year. Revenues collected at the border, at 61%, continued to comprise the largest portion of total revenues and are 51 million euro higher compared to the preceding year. ¹Whereas internal tax revenues comprise 19% of the total revenues with an increase of 23 million Euros compared to the preceding year. Tax revenues at the border during 2007 have increased visibly, mainly as a result of additional measures undertaken by the ¹ Department of Treasury and Macroeconomics, MEF, Draft Law for the Kosova Consolidated Budget for 2008

toms in the increased levels of border control. This stimulation norm has provided considerable effects.

Kosova budgetary expenditures at the end of 2007 marked 662 million Euros, meaning that they were visibly lower compared to the revenues. During this period, expenditures for salaries and wages marked 208.5 million Euros, thus they were higher compared to 2006.

Although there are efforts to decrease expenditures for goods and services, based on the IMF data for 2003, still these expenditures were higher in Kosova compared to several regional countries, which is evident from the following table.

Table 3. Percentage of expenditures for goods and services on 2003 total expenditures

Country	Expenditures for goods and services
Kosova	26%
Slovenia	18%
Bulgaria	18%
Croatia	15%
Bosnia and Herzegovina	13%
Albania	9%

Source: Country Report, IMF (2003 data)

From the data presented above it is evident that within the framework of regional countries included in the table in 2003, Kosova had the largest participation of expenditures for goods and services in total expenditures. Naturally, there were attempts to decrease expenditures for goods and services to the benefit of capital expenditures.

Fiscal Evasion also represents an evident problem for the Kosova budget, because the Kosovo budget is smaller by a large portion of public revenues. Insufficient research was conducted in Kosova in order to identify the magnitude of the informal economy. Based on the World Bank data of 2002, the average participation of the informal economy on GDP in 23 European countries in transition was 38% (the highest levels were marked by Bulgaria – 36.9%, Bosnia and Herzegovina – 34.1%, Albania – 33.4% and Croatia – 33.4%). With OECD countries the level of the informal economy on the same year was 16.7%, among which the highest percentage was marked by Greece (28.5%) and Italy (27%), whereas the lowest was marked by the USA (8.7%) and Switzerland (9.4%).

Conclusions: Reality has shown that the use of fiscal policies in Kosova has had an insufficient impact. The reason is that on the one side governmental expenditures are low due to the limited budget, whereas

governmental demand is much higher than what the budget can cover. On the other side, Kosova budgetary revenues are collected mainly from taxes that are collected at the border, about 70% and the remainder are collected within the country, consequently at around 30%. Revenues from the border are collected through the customs tax, VAT and excise taxes, whereas own revenues of municipalities are much lower than those collected by the central government and are mainly ensured by means of the property tax, duties and levies collected at the local level, revenues from interests, road taxes and mine taxes. The collection rate of taxes at the local level in 2005 was only 40% of the budgeted revenues. Therefore, the local authorities need to work in increasing the collection rates of local taxes such as the VAT, property tax, income tax etc. Moreover, they need to work in increasing the tax base and decreasing the informal economy. On the contrary to the situation in Kosova, the OECD countries have the highest participation rate of fiscal revenues from: the income tax at 23%, contributions on social insurance at 22%, turnover tax at 16%, whereas the participation of customs in these countries in 2002 was at about 11%.

When we bear in mind the fact that Kosova until now did not have access to external financing, as well as not having had a monetary

policy, such elements make it all the more necessary to dedicate more attention to preserving fiscal sustainability. The fiscal policy, until now, was the sole macroeconomic tool at the hands of the government. Countries in transition usually face problems in maintaining a sustainable fiscal policy during development stages as they undertake expansive fiscal policies that cause problems in terms of budgetary deficits. Therefore, Kosovo as a country in transition which aims at EU membership should be careful with budgetary deficits, bearing in mind the fact that one of the main criteria for EU membership has to do with keeping the budgetary deficit under 3% of the GDP.

There are various methods in which fiscal policies could assist in the collection of budgetary revenues of a country. In the case of Kosovo, it is recommended that budgetary revenues are ensured through such a tax structure in which the tax base would be very broadly defined and have as few exceptions as possible. This makes it possible to keep tax rates at a low level, by decreasing the demotivation to work, spend, invest or save. With regards to budgetary revenues, it is important for governmental programs to be designed in such a manner so as to support the operation of the private sector – by fostering conditions that are favourable to economic growth and employment.

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