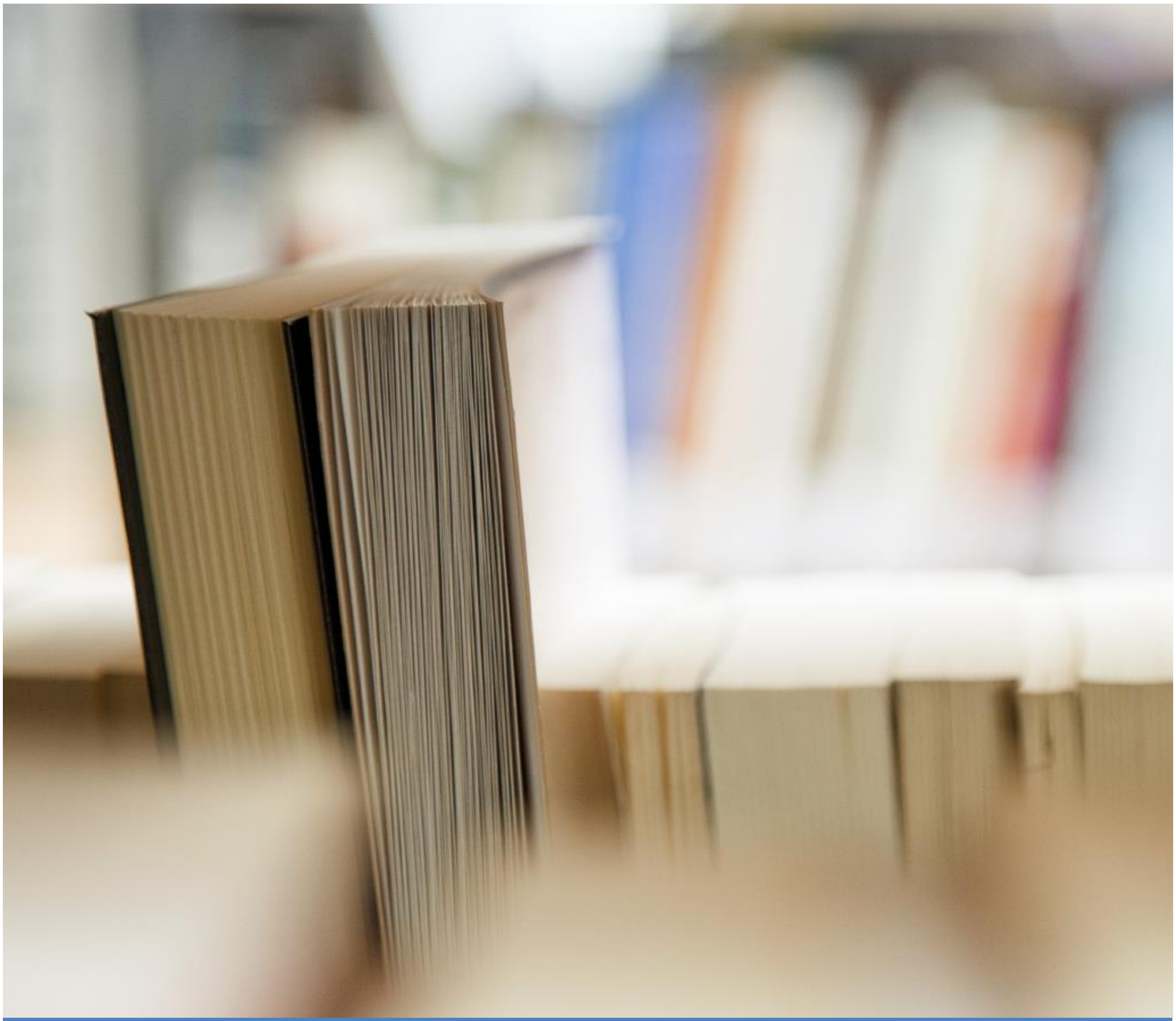

Country briefing

Kosovo

CSOs as equal partners in monitoring public finances

April 2016

BALKAN MONITORING PUBLIC FINANCES
www.wings-of-hope.ba

CREDITS

Authors:
Adea Kondirolli, Project Expert, BIRN (adeakondirolli@gmail.com)

Formatting:
Emina Hasanagić, Administrative Manager, Foundation Krila nade (emina.hasanagic@wings-of-hope.ba)

This document has been produced as a part of the project “CSOs as equal partners in the monitoring of public finance“, which started beginning of 2016 and is implemented by a consortium of 10 organizations from 7 countries and will last for four years.

The aim of the project is to improve the transparency and accountability of policy and decision making in the area of public finances through strengthening the role and voice of NGOs in monitoring the institutions that operate in the area of public finances. In this way, the project will strengthen CSO knowledge of public finance and IFIs and improve CSO capacities for monitoring. Additionally, it will help advocate for transparency, accountability and effectiveness from public institutions in public finance. Moreover, this project will build know-how in advocating for sustainability, transparency and accountability of public finance and IFIs. This project will also increase networking and cooperation of CSOs on monitoring of public finance at regional and EU level. Lastly, it will increase the understanding of the media and wider public of the challenges in public finance and the impacts of IFIs.

Key project activities are research and monitoring, advocacy, capacity building and transfer of knowledge/practices and networking in the field of the 4 specific topics: public debt, public-private partnerships, tax justice and public infrastructure.

More information about the project can be found on http://wings-of-hope.ba/balkan-monitoring-public-finance/ and on the Facebook Page Balkan Monitoring Public Finances

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

BALKAN MONITORING PUBLIC FINANCES

www.wings-of-hope.ba

CONTENT

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

EXECUTIVE SUMMARY

Kosovo economy, a case Sui Generis

Kosovo's economy in conventional terms begins in 2008, when the country declared its independence. Thereby, given the very brief history of the youngest republic in the Balkans, most matters including economy, politics and social affairs are projected in the future and have very bleak strings with the past. If this inherent past was to be included in this analysis, it would require a wholly different stance with an enriched anthropological approach, although the core subject here is of macroeconomic nature.

Kosovo is different in other aspects as well, including the fact that its currency as an independent state has been the Euro since the beginning and also Public-Private Partnerships as a concept date back to less than a decade, and even less in practice.

Public debt is so low – less than 13% of the GDP (!) – that it is irrelevant to even talk about it, rather than on "how come is it this low?" Consequently, it must come as no surprise in this analysis that some matters are less present than others – exempli gratia: there is no real business stance or organised reactions in the face of serious government reforms, and the main business associations operate more in the style of conventional NGOs, rather than uniformed lobby structures. However, several business surveys have been included in this analysis.

Kosovo has the youngest population in Europe with a median age of 27 years. It also has the highest emigration rate in the region. According to the Kosovo Statistics Agency, the population of Kosovo at the end of 2014 was estimated to 1,804,944, 15,000 down on the figure for 2013. Considering the birth rate, the agency estimates that about 39,000 citizens left the country that year.

The absolute majority of its population suffers of stark poverty and basically no personal experience in the field with culture and recreation, holidays or other similar 'luxuries'.

Thereby, this resume has a mild twist from its original structure, without violating the spirit of the agreed template and representing a decent macro-analysis.

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

INTRODUCTION

Despite recent improvement in several financial and developmental indicators, Kosovo is challenged by a number of issues, including poverty, high unemployment and an ever-growing trade deficit. While Kosovo economy has been scoring better growth rates than most Balkan countries – 3.5% in 2015 and estimated to 3.7% for 2016 – it is uncertain if this growth has been distributed among its citizens.

The World Bank considers Kosovo the poorest country in the region, as general unemployment is estimated to circa 35%, and with a startling rate of youth unemployment of more than 60%. With feeble domestic production, remittances continue to stand for a key pillar to Kosovo's economy, with 752 million euros of inflows for 2015, which represents an 8.5% increase from the previous year.

As inflation has remained close to zero in the recent years, consumption has been increasing at the expense of an ever-growing trade deficit of 2.3 billion euros in 2015 – an increase of 4.4% from 2014. The government also imposed VAT revisions in mid-2015, labelling the reform as a fiscal package sought to assist both business and consumers. But while a range of products saw VAT slashes or exemptions, arguably benefiting businesses, end-consumer prices didn't lower.

Tax levels in Kosovo are at similar rates with those of other regional economies, with the exception of mainly Serbia and especially Albania in some instances, as the latter scores the highest rates for several taxes. Kosovo has also reached a number of agreements for the elimination of double taxation.

While most of tax income in Kosovo comes from VAT, its recent Stabilisation Association Agreement with the EU – which foresaw slashes or removal of VAT for a number of EU-originated products – not only caused no perceivable decline in customs revenues, but for the first two quarters of 2016, revenues perceived an 18% comparative increase with the same period of the previous year.

The business environment in Kosovo has shown signs of progress, according the World Bank 'Doing Business' index. The country lags behind several regional neighbours though. Surveys conducted with businesses expose a number of issues, which don't relate so much to the legal framework or taxation. Corruption, nepotism and a feeble rule of law are the main issues that negatively impact the business climate, hampering developments in key industries and constituting key areas of concern for local entrepreneurs and foreign investors alike.

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

According to the Transparency International Global Corruption Index, Kosovo scores as the most corrupted country in the region, despite some progress in the recent years.

Public debt is estimated to 12.5% of GDP, a rate of no real concern for the time being.

However, public expenditure continues to show its Achilles' heel in some particular areas. The public sector employs 83,000 citizens or ¼ of the total work force, and 34% of the total public expenditure – 540 million euros – is funnelled to support wages and related expenses in the public sector.

Kosovo is still exploring new ways of development, charting new chapters in its rulebooks and subsequent experience. Public-Private Partnership (PPP), a relatively new reality for Kosovo, saw its introduction in 2008-2009. Just a couple of representative PPP projects have been delivered so far.

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

RESEARCH RESULTS

Gross Domestic Product

Kosovo GDP growth was estimated at 3.5% by the Central Bank of Kosovo – a higher figure than the IMF estimated in its first review of the Stand-by Arrangement with the country. In January, the IMF estimated Kosovo's growth in 2015 was 2.4% – a twofold improvement on the 1.2% growth rate of 2014. The bank set its 2016 GDP growth forecast at 3.7%, while in the first quarter of 2016, GDP growth was estimated at a 3.8%, fuelled mainly by services and trade. In nominal terms, GDP in 2015 was 5.7 billion euros, while GDP per capita for the same year is estimated to 3,400 euro, the lowest in the Balkans.

Public debt

Kosovo’s public debt is estimated to only 12.5% of GDP, according to the central bank, at about 749 million euros in 2015, with an annual increase of 28.5%. Kosovo’s very low public debt has not been a matter of concern, considering recent reports from both the IMF and the World Bank.

Consequently, no relevant debates on the matter have occurred, mainly because currently there is little to debate. The only issue to be monitored for the near future is whether the rapid yearly pace of debt growth will persist in similarly remarkable rates, which would then become an issue for public debate.

Inflation

Kosovo inflation rates have been orbiting around zero in the recent years. ASK estimates that for 2015, inflation accounted for an average rate of -0.5%. The highest recorded inflation rate dates to 2008 at a staggering 9.4% level. However the next year, inflation rated at -2.9%, the lowest rate recorded.

Euroization

The Euro is Kosovo’s national currency since its independence in 2008. Hence there has been no conventional transition from an independent currency to Euro (German Deutschemarks were used as much as the Serbian Dinars before the independence war).

Trade balance

Sluggish growth in production has left Kosovo increasingly dependent on imports, making the trade deficit a major concern. Exports from Kosovo grew by just 0.23% in 2015, accounting for a total export income of 325.3 million euros, according to the statistical agency.

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

Kosovo, meanwhile, imported more than 2.6 billion euros worth of goods in 2015, a 3.8% increase from 2014, resulting in a trade deficit of 2.3 billion euros. According to the Kosovo statistics agency, the country's trade deficit for 2015 was 4.4% higher than the previous year.

Grey economy

In 2014, the Kosovo Ministry of Finances estimated informal economy at 34.4% of GDP, which translated to 450 million euros. While the grey part of economy is widespread to almost every sector and industry, the government acknowledges that agriculture, the main contributor to Kosovo's GDP by 15%, and the country's largest private employer, operates primarily on informal basis.

Kosovo firms rank "practices of competitors in the informal sector" as the single biggest constraint to their business growth: 57.8 % of the Kosovo firms, compared to 8.2% in Estonia, 8.6% in Slovenia, 11% in Montenegro, 16.1% in Serbia, 19.9% in Albania and 34.8 in Macedonia. Kosovo also stands out with the number of years – 0.3 years – that firms reported operating without formal registration (BEEPS, 2013).

Kosovo authorities have taken a range of actions to address this issue, including amplified audits and inspections, as well as encouraging measures for citizens to ask for VAT invoices from businesses and deliver those to the tax administration so they can be refunded part of the VAT.

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

SOCIAL INDICATORS

Poverty

According to official, yet outdated data from the Kosovo Statistics Agency (ASK), 29.7% of Kosovo citizens were considered poor, while extreme poverty accounted for 10.2% of the population in 2011. No new dedicated evaluations on poverty have been carried out by ASK in the following years.

A survey by ASK on household budgets, indicates that welfare of the population in 2014 scored lower than in 2012 and 2013. The survey shows that 72% of Kosovars cannot afford a week of holidays outside their homes; 60% don't have the means to cover an unexpected spending of 500 euros; recreational expenditure does not exceed 1% of the total budget; whereas 88% of expenditure goes for basic expenses such as food, housing, clothing and transport.

The World Bank estimated in 2015 that Kosovo is the poorest country in the region.

Unemployment

ASK estimates unemployment at more than 35% of the work force while youth unemployment is higher than 60%. According to the World Bank, inadequate education is a key obstacle to reducing poverty in the country, estimating that 2/3 of the poor have less than middle education.

Gini coefficient

One basic indicator of the distribution of income and wealth is the Gini coefficient, a measure of statistical distribution defined as a ratio of values between 0 and 1. A low coefficient indicates more equal distribution, as opposed to a higher one. According to the World Bank, Kosovo's Gini coefficient in 2005 was an estimated 0.30, while in 2013 (most recent estimate available) it accounted for 0.27.

Remittances

Remittances are a key source of development for the Kosovo economy and in combating poverty. Many Kosovar families rely mainly on remittances in facing the core of their yearly expenses and for future investments, including education and new housing or vehicles.
The bank estimates that 752 million euros of remittances entered Kosovo in 2015, representing an 8.5% growth compared with remittances in 2014. Remittances increase also reflects continued emigration.

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

TAX JUSTICE

Taxation in Kosovo

Value Added Tax in Kosovo is 18% and comparable with similar rates – slightly higher or lower – of other Balkan countries (differences account for a maximum threshold of 2% for respective countries).
Personal Income Tax in Kosovo is progressive, related to respective income levels. Yearly income lower than 960 euros are exempted from this tax; starting from 960 euros and up to 3,000 euros the tax is 4%; from 3,000 euros to 5,400 an 8% tax is imposed; and yearly income over 5,400 euros are subject to a 10% personal income tax, which is the highest applicable rate. This rate is comparable with those of Bosnia and Herzegovina and Macedonia (10%), and Montenegro (9%). It is significantly lower than Serbia (15%) and Albania (23%).

Corporate Tax in Kosovo is 10% of respective income. A same rate of corporate tax is encountered in the cases of Bosnia and Herzegovina, Macedonia and Bulgaria.

Tax institutions

Tax Administration of Kosovo (ATK) is an executive authority that implements tax legislation with full autonomy, although integrated in the Ministry of Finances. In 2015, VAT constituted for the highest share of tax revenues, 46.3% of the total at about 154 million euros – a 12.4% increase from 2014.
Revenues from Personal Income Tax scored about 103 million euros, a 2.8% increase from the previous year. Corporate tax revenues registered more than 74 million euros – an increase of 13.4% from 2014.
Kosovo Customs are the main contributor in the state budget. Customs revenues in 2015 were about 952 million euros, with a 80 million euros increase from 2014. During the first two quarters of 2016 tax revenues scored over 457 million euros, an 18% increase from the same period of 2015.

Double taxation treaties

In the recent years Kosovo has reached agreements with a number of countries for the elimination of double taxation, including Macedonia, Turkey, the United Arab Emirates, Great Britain and Northern Ireland, Albania, Slovenia, Czech Republic and Hungary.

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

New financial *policies* in Kosovo

In September 2015, the government introduced a 'fiscal package', which basically reduced or exempted VAT on a range of products. While the general VAT rate rose from 16% to 18%, a range of products and raw inputs received a reduced VAT of 8%, while other products were totally exempted from VAT. Especially raw materials for the food industry (grain, flower and other products) received significant cuts, including reduction of VAT in water supply and electricity services as well as IT products. The government said the changes were intended to ensure cheap prices of key items for families in need.

But, according to the Kosovo Statistics Agency, the impact of the VAT changes on real prices of key household products was negligible, being that for the timespan September 2015 – April 2016, inflation rates recorded minor fluctuations above or below the zero level, marking an average of practically 0%. Since several products received reduced VAT or were entirely exempted, while general end prices remained the same, Kosovo businesses may have indeed benefited, but consumers did not.

Stabilisation Association Agreement impact on taxes

Despite a predicted impact on customs revenues from the Stabilisation and Association Agreement, SAA, with the EU, the reality in field showed that no serious revenues reductions manifested. The agreement entered in force on April 1 after being signed in October 2015. Much of it concerns scrapping customs tariffs on a range of products, and consequently Kosovo customs announced that in the first quarter since its implementation, the SAA had cost Kosovo customs 5 million euros in revenues.

Despite the SAA scrapping customs fees, the customs service declared that revenues rose by 18% compared to the same period in 2015, thus practically erasing the potential effects of tariffs reductions.

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

CORRUPTION VS DEVELOPMENT

Corruption perception

According to Transparency International Global Corruption Index for 2015 which covers 168 countries, Kosovo and Albania are classified as the most corrupted countries in the region.

Kosovo, which the previous year was in the 110th place, in 2015 was ranked 103rd with 33 points, like Ethiopia and Moldova. But despite progress, Kosovo is ranked behind countries in the region, including Albania, scoring the highest level of perceived corruption.

Doing Business in Kosovo

In its 2016 Doing Business report, the World Bank ranked Kosovo in the 66th place out of 189 countries. According to the World Bank, Kosovo has made continued efforts to improve its business environment. Compared with other countries in the region, Kosovo stands much better than Albania (97th place) and Bosnia and Herzegovina (79th place), but it does poorer than Serbia, Macedonia and Montenegro. In the 2012 Doing Business report Kosovo was ranked in the 126th place.

The 2016 'After Care' survey from the Kosovo Chamber of Commerce with 250 foreign direct investors, showed most are content with their business results in Kosovo. However, when asked to explain their main obstacles, they mentioned corruption, nepotism, unfair competition and weak rule of law.

Public employment expenditure

While nepotism plays a crucial role in appointment in public employment, alongside corruption cases – which have been documented via a series of media reports – Kosovo's situation with the state being the main employer is a matter of serious concern.

About 540 million euros, or 34% out of the total public expenditure, is funneled to support wages and related expenses in the public sector. About 83,000 citizens are employed in the Kosovo public sector with an average monthly salary of 440 euros, which is the double of private sector average wage.

At the time (2014) the employed in the public sector equaled 1/3 of those in the private sector, and constituted ¼ of the total work force, accounted for 302,000 people. The latter constituted a source of concern from the IMF in its concluding statement of the 2015 Article IV Mission.

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

Prior to the 2014 elections, authorities significantly increased public wages and benefits, and "met the fiscal rule only with deep cuts in much-needed capital spending", said the IMF. "Growth in Kosovo should ultimately come from the private sector. Limiting public sector wages would enable private companies to compete on more equal terms when it comes to attracting skilled workers," the IMF said.

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

INFRASTRUCTURE AND RELATED PUBLIC INVESTMENT

Transport

The biggest road infrastructure investment in Kosovo is the "Ibrahim Rugova" highway connecting it with Albania. It cost a total of 1 billion euros amid controversies about the very high costs. Two other major road projects are under way: (i) "Arber Xhaferri" highway connecting Prishtina with Skopje, estimated at a total of 600 million euros, and (ii) Prishtina-Gjilan highway at 260 million euros.

Also, an important segment of Kosovo railways is scheduled to undergo a major upgrade via a 195.5 million euros EBRD loan.

Concerning road infrastructure, IMF has expressed concerns that there is a tendency in Kosovo to over-invest in new capital stock and under-invest in the maintenance of roads and other infrastructure, partly because maintenance spending gets crowded out by other political priorities. Maintenance expenditure has been falling in recent years both in monetary value and as a ratio of the capital stock.

Road maintenance budget is less than half of neighboring Serbia or Bosnia Herzegovina on a per capital basis. The IMF and World Bank have suggested increasing road user charges and vehicle registration fees to ensure sufficient funds are available for road maintenance in the medium to long term.

Energy

98% of the country's electricity generation comes from two outdated, inefficient, and highly polluting lignite power plants. Power outages still occur in some areas when demand is high. About 50% of companies in Kosovo have identified access to electricity as a major obstacle, compared to 6% in Montenegro, 8% in Serbia, and 10% in Bosnia Herzegovina.

The Kosovo Electricity Corporation (KEK) is considering a 500 MW power plant project, financed by the private sector, which would reduce the supply shortfall and substantially improve energy efficiency. However, expert voices from the local and international organisations have warned of hikes of electricity prices for end consumers – business and households – and have also accused the government of turning a blind eye to more sustainable green solutions.

Also, this year Kosovo and Albania finished works on a 400-kilovolt electricity transmission line that will connect the two countries – dubbed as the "Energy highway". Work on the interconnection hub

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

between Kosovo and Albania started in 2014, financed in both countries by the German Development Bank and the entire length of the line in the two countries is 251.5 km.

PUBLIC-PRIVATE PARTNERSHIP (PPP)

PPP experience in Kosovo is tardy and it only commenced in 2008 (independence) when the government announced its directive to support the implementation of PPPs as a way to stimulate investment in public infrastructure and ensuring public services. A dedicated law (No.03/l-090) on “Public-Private-Partnerships and Concessions in Infrastructure and the Procedures” followed suit in 2009. A dedicated unit and an inter-ministerial committee on PPPs were also established.

Since then, Kosovo has been able to develop and conclude two relevant PPP transactions: (i) A complex transaction for the Prishtina International Airport and; (ii) the public transport services in the Municipality of Peja – with a combined capital stock of 1.7% of GDP at the end of 2014. Another PPP for urban waste processing in the Municipality of Suhareka is in the process to being concluded.

According to the IMF, Kosovo has not yet made extensive use of Public-Private Partnerships, but several projects are planned. However, several projects at the general government level are in development, either at the feasibility or contract procurement stage, with an estimated construction cost of about 1.5% of GDP. The IMF stresses that the great majority of these projects are expected to be fully funded by users, with no guarantees from the government.

PPP regulations

Public-Private Partnership in Kosovo can be processed through concessions or public contracts with a private partner. While typically they stand for an agreement between public and private operators, the given infrastructure is financed, partially or entirely by the private partner.

Risks are accordingly divided between partners, taking into account the party which holds a better position in managing each individual risk. In Kosovo PPPs are a public procurement tool, which focuses in the payment for the successful delivery of services (transferring the performance risk to the private partner), and the agreements are output/performance-oriented (as opposed to the traditional input-oriented delivery of public services).

According to the IMF, the fiscal costs and fiscal risks associated with PPPs are neither systematically assessed nor reported. All PPPs have to submit annual reports to the PPPC, but these reports include only limited information on fiscal risks. The PPP unit does not assess and estimate the fiscal risks of existing projects (e.g., related to termination clauses) as well as for projects in the pipeline (e.g., risks

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.

related to availability of land), and does not proactively identify potential mitigation measures in the event of the realization of such risks.

This is particularly important in the case of Kosovo, given the increasing number of PPP projects in the pipeline and the absence of legal ceilings to the overall government exposure to the risks that may arise. In addition, the legal framework does not include provisions for the accounting of PPP related assets and liabilities according to international standards, nor provisions to report any data on PPPs in the budget and the annual financial statements.

This project has been prepared with the financial assistance of the European Union. The content of the document is the sole responsibility of the project partners and can under no circumstances be regarded as reflecting the position of the European Union.