Analysis on Tax Justice

Kosovo

CSOs as equal partners in monitoring public finances

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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

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BALKAN MONITORING PUBLIC FINANCES

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CONTENT

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1. TAX SYSTEM

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 did not 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. To add more to that, most of the revenues are provided from the taxation, VAT customs, and excises.[1]

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, moreover, remains progressive, respective to income levels. Yearly income lower than 960 euros are exempted from the given 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 aapplicable 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.[2]

- *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 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

[1] "Strategic Plan of TAK 2015-2020", Tax Administration of Kosovo. http://www.atk-ks.org/wp-content/uploads/2016/01/Plani-Strategjik-2015-2020Eng.pdf
[2] "Strategic Plan of TAK 2015-2020", Tax Administration of Kosovo. http://www.atk-ks.org/wp-content/uploads/2016/01/Plani-Strategjik-2015-2020Eng.pdf

2015. In the recent years Kosovo has reached agreements with many 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.[3]

[3]"Nine Months Financial Report", Republic of Kosovo.
http://mf.rks-gov.net/desk/inc/media/4B97A225-5E73-4A6D-92E0-2F8D61F94804.pdf

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2. NEW FINANCIAL POLICIES IN KOSOVO

In September 2015, the government introduced a 'fiscal package', which 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. However, 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.[4]

2.1. 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, 2016 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. Regardless of 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.[5] Kosovo, according to the World Bank, has a simple tax system adopted, and relatively low tax rates. Through such system, the Tax Administration of Kosovo, TAK, might have it easier to adjust direct taxes for encouraging labor market formality, and meanwhile, increasing both equity and collections. The tax legislation in Kosovo, importantly enough, is established in compliance with international and European Union (EU) standards. Recently, the World Bank's conducted survey suggests that many of their competitors, amongst firms, practice tax evasion, which is not deemed a surprising finding,

[4] "Economic and budgetary effects on fiscal reforms 2015", GAP Institute, June 2015. http://www.institutigap.org/documents/5675_Economic%20and%20budgetary%20effects%20of%20fiscal%20reforms%202015_final.pdf

[5] "The trade impact of Kosovo-EU Stabilization Agreement: An assessment of outcomes and implications", Group for Legal and Political Studies, January 2014. http://legalpoliticalstudies.org/download/Policy%20Report%2003%202014.pdf

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considering that Kosovo ranked alongside Ethiopia and Tanzania, in the Transparency International's Corruption Index, in 2013. Such data, moreover, suggest enormous costs to relate the tax system. Estimates suggest that the country's tax evasion reaches 5 percent of domestically collected VAT and CIT revenues, and 12 percent of PIT revenues. In general, Kosovo's tax burden remains lower than the average tax burden in the region.[6]

To date, Kosovo Government has established a relatively simple tax system, on a non-discriminate basis for all businesses. As a relatively newly established state, Kosovo has managed to create a stable tax system and highly competitive with other countries in the region, considering its low tax rates Kosovo has recently developed a new fiscal policy reform, and as such, it has proposed, for the first time, the inclusion of tax breaks for businesses that invest a specific value, and create a specific number of new jobs. Although the formerly mentioned still remains under discussion, such reform will most likely open up new jobs and stimulate investments.

Although Kosovo's Government has proposed a new tax on dividends, it was not able to further apply such a plan after the business community's opposition. During its 20th meeting, held on March 24th, 2015, the Kosovo Government introduced a set of fiscal adjustments to be executed in the following years. Such adjustments, amidst others, included the amendments of relevant laws on the (i) Value Added Tax (VAT), (ii) Corporate Income Tax, and (iii) Personal Income Tax. Under Article 4 of the Draft Law on VAT,[7] first and foremost, the threshold of VAT is reduced to 30,000 €, and based on the given amendment, any business performing a turnover over 30,000 € per year, shall register for VAT, and pay an additional amount as a result. Kosovo's Budget, however, would gain from such adjustment in the VAT, considering that an increasing number of businesses will be required to pay VAT. The reduction of the VAT threshold from 50,000 to 30,000 will hinder the performance of the newly established and small businesses, even though it is, precisely, the new businesses, that are expected to generate jobs at a bigger scale. The elimination of VAT, on the other hand, on production machinery and raw materials may potentially increase investment on the sector while decreasing production cost. While holding other factors constant, the increased level of VAT in most of the products from 16 to 18%, is likely to increase consumer basket prices and budgetary income. Based on the adjustments

[6] Republic of Kosovo, IMF country report", IMF, 2013.
https://www.imf.org/external/pubs/ft/scr/2013/cr13223.pdf
[7] DRAFT LAW ON VALUE ADDED TAX, Republic of Kosovo.
http://www.kryeministri-ks.net/repository/docs/Projektligji_per_tatimin_mbi_vleren_e_shtuar.pdf

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previously made on corporate income tax, the tax on paid or credited dividend may not have an impact on the investment level by the private sector.[8]

Apart from the positive effects on the reduction of prices of specific products, the progressiveness of the VAT is also foreseen to increase the living cost of Kosovo's citizens, which is expected to be reflected in higher budgetary revenues. In order to successfully balance the budgetary needs, along with living costs and economic development, it is highly *recommended* that **(i)** that the VAT threshold should be changed to 50,000, considering it needs to be specified in agreement with the incentives for job creation, **(ii)** also, the category of products benefiting from the VAT reduction, in order to avoid inflation, should also include tomatoes, beans, potatoes, etc., **(iii)** the reduction of VAT rate for raw materials from 8 to 5 percent, so to avoid inflation of the consumption basket, **(iv)** and amongst other, considering the low income level and lack of health insurance amongst Kosovo's citizens, VAT should not be imposed on medicaments, and (v) lastly, the Ministry of Finance, should consider increasing the corporate tax considering its reduction neither stimulated business activity nor diversified budgetary revenues. The Law on the Value Added Tax[9] (No. 05 / l -037) came into effect on September 1st, 2015, which, under Article 26, introduced the reduction rate from 16% to 8 %. An individual, moreover, is required to register for VAT whenever s/he independently carries out an economic activity in Kosovo, aligned with Article 4 of the Law, and whose turnover within a year exceeds the value of 30,000 €[10] (including turnover of supplies exempt of VAT). During the meeting, amongst, other it was decided an upcoming change on VAT's rate, charged with the standard rate of eighteen percent (18%). Despite the first paragraph, under this Article, the reduced VAT rate is calculated and paid at eight percent (8%) for the supply of goods and services, including their import.

The newly established fiscal reform in 2015, has introduced the VAT removal on production machinery, and as such, it has created incentives for production and improved the liquidity of businesses. Moreover, VAT reduction was considered a fair decision, however, placing an 8% of VAT on medical supplies has directly contributed to its price increase. Kosovo must continue to maintain a simple tax system,

[8] "Economic and budgetary effects on fiscal reforms 2015", GAP Institute, June 2015. http://www.institutigap.org/documents/5675_Economic%20and%20budgetary%20effects%20of%20fiscal%20reforms%202015_final.pdf

[9] The Law on Value Added Tax, LAW No. 05/L – 037, Republic of Kosovo. http://www.atk-ks.org/wp-content/uploads/2015/09/LAW_NO._05_L-037_ON_VALUE_ADDED_TAX___ANNEX.pdf

[10] Before the adjustment, the turnover was 50,000 € - data taken from "Economic and Budgetary effects of fiscal reforms 2015", GAP Institute, JUNE 2015. http://www.institutigap.org/documents/5675_Economic%20and%20budgetary%20effects%20of%20fiscal%20reforms%202015_final.pdf

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although much ought to be done in order to combat informal economy and tax evasion, by stepping up the fight against the two and prevent undue influence on the work of the customs and tax administrations. Considering Kosovo's commitments to infrastructure projects and impromptu increases on wages, pensions, etc., especially within pre-election period, Kosovo's fiscal policy is associated with ad hoc decision making with significant budget impact. According to the European Commission, the fiscal framework should primarily aim to discourage and limit such practices from occurring. Kosovo's fiscal framework is composed of debt, expenditure, and deficit rules, and additionally, it lacks viable enforcement and monitoring mechanisms. As such, relevant institutions initially assigned to monitor the process of budget preparation and execution, are characterized with lack of resources and low capacities. [11]

Compared to the countries in the region, Kosovo possesses a simple tax system and relatively low tax rates. Nevertheless, the inefficiency of Tax Administration of Kosovo, TAK, has triggered many businesses to evade taxes, which in turn means lower revenue for the government's coffers, and more importantly, the former has the tendency to hinder competition amidst businesses. As such, by not collecting taxes as required by the given law, encouraging favoritism in businesses related to the powerful authorities, TAK has converted into an institution that is directly influencing the non-loyal and anti-competitive behavior in Kosovo's market. Encouraging certain businesses to avoid paying taxes makes them in turn more strengthened compared to regular businesses. The lingering institutional and other structural shortcomings related to corruption and the rule of law have put downward pressure on overall competitiveness and productivity growth, restraining the emergence of a more vibrant environment for further development. While countries in the region provide fiscal incentives for new bones, and especially, for new investments, the Kosovo's government still lags on compiling an Administrative Instruction, which enables the newly-created businesses and those conducting new investments, get exempted from tax duties for several years. This, consequently, is one of many issues triggering the lack of foreign investments in Kosovo.

According to the World Bank, there is a perception amidst firms that a significant portion of their competitors perform tax evasion. Considering that Kosovo is ranked alongside Ethiopia and Tanzania in Transparency International's 2013 Corruptions Perceptions Index, the observation that many given firms' competitors evade taxes is not a surprising finding. However, such finding has large costs to the

[11] "2017 Economic Reform Programmes of Albania, the former Yugoslav Republic of Macedonia, Montenegro, Serbia, Turkey, Bosnia and Herzegovina and Kosovo*", European Commission, June 2017. https://ec.europa.eu/info/sites/info/files/ip055_en.pdf

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tax system. ***Tax evasion*** is likely comprised of5 percent of domestically collected VAT and CIT revenues, and 12 percent of PIT revenues. The World Bank surveyed nearly a quarter of firms in the Large Taxpayers' Unit (LTU), including some medium sized firms, questioning their perceptions on their competitors' tax paying behavior. According to their answers, CIT and domestic VAT evasion from large, formal firms alone cost the government at least 5 percent of collections annually, and around 12 percent of PIT collections. The yielded results, moreover, suggest that evasion is responsible for between 15 and 25 percent of the tax gap, which has been estimated at about 35 percent of actual collections.[12]For the private sector, the given tax behavior pose large implications, ranging from extra – and probably unpredictable – costs to doing business, which in turn may arguably hamper investment growth; encouraging firms to perform tax evasion and escape penalties when caught, which in turn contributes in harming economic development; and the practice of evading taxes and remaining unpunished for such behavior hurts other firms entitled to be more productive and more able to benefit the given sector. To add more to that, tax collection is reduced as a result of some firms performing tax evasion. Such reduction, consequently, should be compensated by higher taxes for firms that are compliant with given tax regulations. Additionally, given firms – which remain in compliance with enforced tax regulations, may be unwilling to pay taxes when their competitors are actually dodging taxes. According to the conducted survey, those politically-involved firms are more prone to escape and avoid severe penalties for tax evasion, which arguably points to significant high-level collusion in tax evasion. To avoid a downward spiral into non-compliance, such high-level collusion would require robust mechanisms of enforcement. As such, if we could capture all the taxes (by stopping tax dodging or tax competition), more services could be provided to the citizens by the state. For instance, the revenues collected as a result of tax evasion reduction could benefit the Kosovo's social assistance scheme ("AsistencaSociale"), which remains the only cash social protection program in the country – specifically designed to reduce poverty amidst the working age population. In 2015, the given budget-financed guaranteed minimum income program benefitted around 26,000 families, or more specifically 107,000 individuals.[13]

[12] Republic of Kosovo; Kosovo Public Finance Review; International Bank for Reconstruction and Development/ The World Bank, June 2014. https://openknowledge.worldbank.org/bitstream/handle/10986/20756/ACS93510WP0P130IC00Final0Kosovo0PFR.pdf?sequence=1&isAllowed=y

[13]KOSOVO TECHNICAL ASSISTANCE REPORT— ENHANCING SOCIAL PROTECTION CASH BENEFITS; IMF, May 2016. https://www.imf.org/external/pubs/ft/scr/2016/cr16123.pdf

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CONCLUSIONS AND RECOMMENDATIONS

As such, Kosovo, along with the recommendations listed above, should also deliberately consider:

- Improving parliamentary oversight capacities in properly evaluating budget planning and execution, including the evaluation of fiscal risks and take first steps towards establishing an independent fiscal body.

- Strengthening tax administration by enhancing the quality and quantity of tax inspectors, improving risk assessment segments, applying random audits to assess areas for improvements in risk assessments, and, amongst other, increasing efforts to combat tax evasion.

REFERENCES

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