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Macroeconomic Issues and Fiscal Sustainability

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The following symbols have been used throughout this paper:

. . . to indicate that data are not available;

— to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;

– between years or months (for example, 1998–99 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years (for example, 1998/99) to indicate a crop or fiscal (financial) year.

"Billion" means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

The term "country," as used in this paper, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

Preface

Kosovo is a province of Serbia in the Federal Republic of Yugoslavia that is under temporary UN administration (UN Security Council Resolution 1244). Since the end of the conflict in June 1999, IMF staff have been providing technical assistance to Kosovo to help the province rebuild its economy. The assistance has been channeled toward setting up taxation and budgetary institutions (led by the IMF's Fiscal Affairs Department), a payments and banking system (the IMF's Monetary and Exchange Affairs Department), and, more recently, a statistical framework (the IMF's Statistics Department). The staff have also provided general macroeconomic policy advice, especially in the realm of budget formulation, which is the main focus of this publication. All the staff's work has been carefully coordinated with the World Bank and donor agencies.

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The views expressed are the sole responsibility of the authors and do not necessarily reflect those of the IMF staff, Executive Directors, the UN Mission in Kosovo, or the authorities of IMF member countries.

Acronyms and Abbreviations

BPK	Banking and Payments Authority of Kosovo
CAM-K	EU Customs Assistance Mission in Kosovo
CFA	Central Fiscal Authority of Kosovo
EBRD	European Bank for Reconstruction and Development
EU	European Union
FAO	Food and Agriculture Organization of the UN
FRY	Federal Republic of Yugoslavia
GDP	Gross domestic project
JIAS	Joint Interim Adminstrative Structure
KCB	Kosovo Consolidated Budget
KEK	Kosovo Electricity Company
NATO	North Atlantic Treaty Organization
SC1244	UN Security Council Resolution 1244
UN	United Nations
UNMIK	UN Mission in Kosovo
VAT	Value-added tax

I

Background

This publication analyzes the size and structure of the Kosovo budget and looks at the prospects for the budget to be sustainable in the medium term. To date, fiscal policy has focused on activating essential services and building up capacity to tax and administer budget funds. Capital expenditures for the large reconstruction program have been kept separate from the current expenditure budget and treated as a standalone component of donor support. The initial goals of fiscal policy have been achieved in quick time: budget systems are in place, revenue is being collected, there is a clearer understanding of expenditure needs, and the reconstruction program is in high gear. The challenge now is to develop tax and expenditure policies to ensure that public services are comprehensive, efficiently provided, and financed for the most part from locally generated resources.

Forward-looking exercises are fraught with uncertainties, even more so in the case of Kosovo. In particular, the degree of economic and political autonomy that Kosovo will enjoy in the future will have an important bearing on the structure of the tax system and the extent to which public expenditures remain devolved from the rest of the Federal Republic of Yugoslavia (FRY). Recent political change in the FRY opens up possibilities for moving forward on the issue of Kosovo's status, but there are as yet no firm clues as to direction.

II

Economic and Political Developments

The United Nations has been in charge of administering Kosovo since the end of the conflict that took place in March–June 1999. The UN's mandate comes from Security Council Resolution 1244 (SC1244), which gives the provisional authorities (the UN Mission in Kosovo, or UNMIK) powers to pass regulations that override Yugoslav law. Although local Kosovars are consulted closely in the decision-making process, there is no recognized indigenous government. However, municipal elections in October provided a democratic foundation for local administrative structures.

Policy decisions are guided by the assumption that Kosovo will continue to enjoy considerable autonomy in the future. Nonetheless, lack of clarity about Kosovo's political future complicates the establishment of property rights and narrows policy and institutional options. Economic development is adversely affected by this uncertainty.

Although prewar statistics on the economy are incomplete and unreliable, they paint a picture of an economy that was already in serious decline. Per capita GDP was estimated to be low even by the standards of southeast Europe, and unemployment was very high, particularly among the disenfranchised ethnic Albanian majority. Low-productivity agriculture accounted for about 30 percent of output and the dominant means of employment. Mining and metals processing were other important activities, but they were starved of investment, and production techniques were outdated. More generally, Kosovo's infrastructure was showing the signs of serious neglect and underinvestment.

The economy had also yet to embark on transition to a market economy. Although agricultural land was for the most part privately owned, industry was state or socially owned (the Yugoslav form of worker ownership). Banks tended to direct lending according to political considerations, as opposed to profit motives, and were essentially insolvent. Jobs in the public sector, including key jobs in the industrial sector, were typically reserved for the ethnic Serbian minority, which made up only about one-tenth of the population of roughly 2 million. The majority ethnic Albanians, meanwhile, engaged in extensive gray economy activities and operated separate health, education, and social benefit systems funded through parallel taxes and remittances from the diaspora.

The war provided a further setback to output and the quality and capacity of the infrastructure. Damage to the housing stock was particularly extensive, but the main utilities (power, telecommunications) also suffered considerable damage, as did some of the already dubiously viable industrial concerns. Massive, but for the most part temporary, population flight during the conflict led to the missing of planting seasons in 1999 and the disruption of commerce. The subsequent departure of a large proportion of the ethnic Serbian population left the province with a severe shortage of qualified or experienced workers.

Recovery is well under way, led by a donor-financed reconstruction boom. Shortly after the end of the conflict, donor funds were mobilized to help reactivate the agricultural sector, begin the repair of housing and the utilities, and support incomes through humanitarian assistance. These efforts went hand-in-hand with assistance to set up a rudimentary payments system (Box 1) and to establish budgetary functions and controls. An early decision to legalize the use of the deutsche mark, which quickly became the currency of choice, helped to ensure price stability. So far, disbursements for reconstruction are estimated to have amounted to about US$0.5 billion, and there is at least the same amount in the pipeline established at a donor conference in November 1999.

How far the economy has recovered is difficult to gauge at this stage. By the second half of 2000, agricultural production was estimated to have reached about three-fourths of its preconflict level, construction activity was at a very high level, and some trade-related private services (hotels, restaurants, and retail) were blossoming on the back of aid flows and private remittances from abroad. Industry, however, remained depressed.

Preliminary IMF staff estimates put the level of per capita GDP in 2000 in the range $650–$850 (see Appendix I). The structure of expenditure is highly distorted, with consumption (public plus private) estimated at about 145 percent of GDP and imports over 80 percent of GDP (Table 1). Total investment is also sizable—about 40 percent of GDP—reflecting mainly donor-financed reconstruction. Exports are, to a first approximation, zero. The estimated per capita GDP is below the level in other regional postconflict countries: in Albania, per capita GDP is about $1,000, and in

Box 1. Banking and Payments System

After the conflict, commercial banking operations in Kosovo effectively ceased, and transactions through the local payment bureau system dwindled to a negligible level. To facilitate the modernization and development of payment services and a commercial banking system, two regulations were passed in November 1999, establishing the Banking and Payments Authority of Kosovo (BPK) and legislation for bank licensing, regulation, and supervision. The BPK was assigned responsibility for fostering an efficient and safe system for domestic payments; and the liquidity, solvency, and efficient functioning of a stable market-based banking system.

In keeping with this, the BPK licenses and supervises all banks and nonbank financial institutions operating in Kosovo; maintains a stock of deutsche mark and Yugoslav dinar banknotes and coins; and provides depository and payment services in deutsche mark until sufficient capacity has been developed within the commercial banking system. The overall plan calls for commercial banks in Kosovo to eventually provide payment services cleared through a local clearinghouse and settled on the books of the BPK (deutsche mark transactions) and the National Bank of Yugoslavia (Yugoslav dinar transactions). As soon as sufficient capacity exists within the banking system, teller operations currently performed by the BPK for the authorities in Kosovo will be shifted to commercial banks, and BPK branches and subbranches will be closed.

For now, as the government's bank, the BPK accepts deposits from UNMIK and other official agencies and makes payments on instructions from the Central Fiscal Authority (CFA) and other depositors. All deposits in the BPK have been in the form of cash. Other than holding some cash for safekeeping, the BPK has not at this stage been offering deposit and payments services to enterprises, in order to prevent the BPK from competing with or undercutting the development of the nascent banking sector.

Licensing procedures cover three types of commercial banks: banks with a minimum capital of DM 1 million are allowed to take in deposits in a single currency and provide collection and payments services; banks wishing to make commercial or consumer loans are required to have minimum capital of DM 3 million; banks engaged in underwriting, dealing in debt or equity securities, or providing portfolio management services are required to have at least DM 5 million in capital.

The banking system nevertheless remains extremely thin. At end-2000, the commercial banking system consisted of only one institution (Micro Enterprise Bank), which is partially capitalized by the European Bank for Reconstruction and Development (EBRD). It operates five branches and has taken in about DM 170 million in deposits. So far, most of these deposits have been invested abroad, with lending in Kosovo amounting to about DM 5 million. License applications have been received from seven other would-be banks. However, most of these institutions have encountered major problems in raising the necessary capital, and in some cases the owners do not satisfy background requirements laid out under the licensing regulation.

Table 1. GDP, National Income, and Balance of Payments, 2000

	Millions of Deutsche Mark	Percent of GDP
Gross domestic product	**3,000**	**...**
Consumption	4,380	146
Private	4,078	136
Public	303	10
Investment	1,161	39
Foreign	756	25
Domestic	405	13
Exports	0	0
Imports	2,540	85
Reconstruction	680	23
Energy	54	2
Humanitarian	312	10
Food and agriculture	155	5
Equipment	21	1
Emergency assistance	136	5
Households	104	3
Health	21	1
Education	10	0
Dutiable imports	1,496	50
Declared	823	27
Other	673	22
National income	**4,512**	**150**
GDP	3,000	100
Private remittances from abroad	1,200	40
Humanitarian assistance	312	10
Balance of payments		
Current account	–1,029	–34
Trade balance	–2,540	–85
Remittances	1,200	40
Humanitarian assistance	312	10
Financed by		
Donor grants for current spending[1]	272	9
Reconstruction aid	756	25

Sources: Central Fiscal Authority (CFA); UNMIK Departments; Food and Agriculture Organization (FAO); and IMF staff estimates.
[1]Includes budgetary assistance, off-budget financing, support for electricity imports, and change in cash balances of CFA.

Bosnia and Herzegovina it is about $1,100. Kosovo per capita GDP would be only about half the level in Bulgaria, the former Yugoslav Republic of Macedonia, and Romania and well below levels in the more advanced transition economies of central and eastern Europe. The level of national income in Kosovo would greatly exceed GDP because of the sizable humanitarian aid and private remittances. These transfers bridge the wide trade deficit.

Macroeconomic policy instruments and options are extremely limited. As a result of the decision to legitimize the use of the deutsche mark and other foreign currencies, there is no independent monetary or exchange rate policy. The dinar remains legal tender and is accepted for paying taxes, customs duties, utility charges, and other compulsory payments. But in practice it has all but vanished as a medium for transactions. A prohibition on public borrowing ensures that the budget has to be balanced.

III

Fiscal Structure and the 2000 Budget

Given Kosovo's unique circumstances, fiscal policy currently takes a rather rudimentary form. UNMIK had to start from scratch in designing a tax system, developing a budget, and creating the institutions to implement its policies (Box 2). At present, Kosovo has a basic tax system that relies mostly on tax collection at the border (sales tax as well as customs and excises), while the structure of expenditure has yet to become fully comprehensive. In the absence of domestic financing instruments, donor grants are financing about half of the recurrent budget, as well as all capital outlays.

Kosovo's first budgets for the final four months of 1999 and for 2000 focused on essentials such as reestablishing the provision of basic goods and services, a minimal welfare net, and the rehabilitation of utilities. With the help of World Bank technical assistance, expenditures were drawn up on the basis of a needs assessment, although due regard was also given to resource constraints in the design of the key programs in the areas of education, health, and welfare.

At the same time, with the help of European Union (EU) and IMF technical assistance, UNMIK moved rapidly to establish border tax collection. However, it was recognized at the outset that it would take time to establish revenue streams, given limitations in administrative capacity and the many gaps between border posts. In the meantime, donor grants were to supplement local revenues for financing recurrent expenditures, with the explicit assumption that such grants would be on a declining path as the local tax base was developed. The budgets focused only on recurrent spending. The capital budget was drawn up separately, was based on reconstruction needs, and was financed in full by donors.

After initial problems, the execution of the recurrent budget has been commendable. At first, UNMIK encountered problems in both establishing the flow of tax revenue and in carrying out planned expenditures. On balance, spending shortfalls predominated, and the budget generated a cash surplus in the final months of 1999. As holes in the border were plugged (mostly by establishing border posts with Montenegro) and experience with payments and procurement procedures improved, tax and spending were brought up to planned levels during the course of 2000 (Tables 2 and 3).

The composition of revenues and expenditures has, however, diverged in places from budget plans. On the tax side, revenues have been boosted by windfall gains in car imports, which have offset generally weak customs and excises at the beginning of the year and the postponed introduction of some domestic taxes, including the income tax. On expenditures, utility subsidies have been much larger than planned in part because of bill collection difficulties as well as problems of overstaffing in the electricity company. There have also been problems in reducing staffing to budgeted levels in the education and health sectors, although the wage bill is estimated to have been below the budgeted amount. Expenditure overruns have been offset by shortfalls in procurement—in some cases compensated for by off-budget provision of goods in kind from donors, notably for pharmaceuticals and education equipment—and in spending on social assistance. Over-

Box 2. Administrative Structures

The removal of Kosovo's autonomy and centralization of public administration in Belgrade during the past decade created an institutional vacuum in Kosovo. Essential functions, such as the management of public resources, either did not exist or existed in a rudimentary form. A parallel budget system financed by voluntary contributions from the Kosovar diaspora was created in these years to ensure the provision of basic public services for the ethnic Albanian majority. However, by the summer of 1999, neither the official nor the parallel system could serve as a substitute for formal budgeting.

While initial spending had to be organized in an ad hoc fashion, UNMIK adopted at end-1999 an IMF technical assistance blueprint for the Central Fiscal Authority (CFA), which assumed the functions of a ministry of finance. Fiscal operations are also performed by municipalities and public utilities.

Central Fiscal Authority

The CFA is responsible for the financial management of the Kosovo Consolidated Budget (KCB), which consists of general government activities, municipal services, and public enterprises but excludes the UNMIK budget. The CFA formulates the overall fiscal strategy by executing its main functions:

- budget preparation and monitoring;
- execution of budgetary transactions through the treasury single account and their financial control, including procurement procedures;
- design of tax policy;
- control of tax and customs administration—the latter executed by the European Union Customs Assistance Mission in Kosovo (CAM-K); and
- internal audit.

Municipalities

Kosovo has 30 municipalities, which currently are financed by transfers from the central government (about DM 20 million in 2000) but also by illegally levied taxes, including from the exploitation of natural resources (in particular, quarries). A recent regulation laying the groundwork for future local self-government envisages the devolution of major services such as health and education. However, while explicit in assigning expenditures, the regulation limits municipal revenue to a few instruments that would be insufficient to cover the envisaged devolution of expenditure.

Public Utilities

Kosovo Electricity Company (KEK) is currently a huge drain on public finances because of net operating losses (reflecting nonpayment of electricity bills, but also overemployment) and the need to complement domestic electricity production by imports to offset outages caused by the rehabilitation of the power stations. Budgetary subsidies are estimated at about DM 50 million in 2000 and are supplemented by additional off-budget donor support for imports of about DM 40 million. With the rehabilitation work expected to be completed in the course of the year, subsidies and import support are expected to decline to about DM 50 million in 2001. Subsidies to other utitilies are budgeted at about DM 12 million for 2001.

Table 2. Budget Summary, 2000 and 2001[1]
(Millions of deutsche mark)

	2000			
	Budget	Budget revised[2]	Provisional estimate	2001 Budget
Total resources	393	399	441	500
Revenues	223	210	242	338
From imports	163	144	222	236
Donor grants	170	189	199	162
Expenditure	423	429	431	500
Wages	166	172	163	182
Change in cash reserves[3]	–30	–30	10	0

[1]Does not include donor-financed reconstruction, which accounts for all capital spending.
[2]The initial budget was revised in March to reflect new costs associated with the implementation of the Joint Interim Administrative Structure (JIAS) and a more pessimistic outlook for local revenues.
[3]A positive sign denotes an increase in cash reserves.

all, required donor budget support was close to the requested amount.

Total government expenditure levels are temporarily quite high because of the large foreign-financed reconstruction program. Data on off-budget spending are less reliable than those on the spending controlled by the CFA. Nonetheless, the IMF staff estimate that capital spending in 2000 is currently some 75 percent higher than the recurrent budget (Table 4). Adding in some identified off-budget spending items pushes spending up to about 40 percent of GDP. Not included in spending are the accrued costs of servicing potentially large liabilities for existing pensions and debt service. Also not included are the cost of humanitarian aid (which should be largely exhausted by end-2000), defense (provided by NATO), and foreign assistance in running the civil administration.[1]

Excluding capital spending, expenditure levels in Kosovo are not high by international standards. On-budget recurrent spending in Kosovo amounts to about 14 percent of GDP, compared with an average 20–23 percent of GDP in low- and middle-income countries with which Kosovo might reasonably be compared (Table 5 and Figure 1). However, most of the difference can be accounted for by the exclusion from the Kosovo budget of defense and debt service—which make up about 6 percent of GDP in typical low- or medium-income countries. Expenditure-to-GDP levels are much higher in typical transition economies, including the economies in the region, but it is well known that such economies have bloated public sectors.

Of the main economic categories of expenditure, social transfers and the wage bill are on the low side by international standards. Welfare and social security spending is noticeably below that in transition countries and somewhat below that in middle-income countries—primarily because of the absence of payment of public pensions. Instead, Kosovo's welfare system focuses on the provision of means-tested social assistance to the neediest families.[2] Until now, such assistance has been augmented by sizable off-budget humanitarian assistance. The

[1] The extra cost of replacing foreign administrators with locals at Kosovo budget wage levels would, however, be modest.

[2] See World Bank, "Kosovo: Building Peace Through Sustained Growth" (Washington, November 1999).

Table 3. Recurrent Budget, 1999–2001[1]
(Millions of deutsche mark, unless otherwise indicated)

	1999 Sept.–Dec.	2000 Budget	2000 Budget revised[2]	2000 Provisional estimate	2001 Budget
Total revenue	31	223	210	242	338
Tax revenue	30	197	180	234	304
Customs	9	38	35	61	45
Excises	2	21	18	36	83
Sales taxes (including VAT)	20	104	91	125	138
Payroll taxes	...	15	15	0	0
Other	...	19	21	12	38
Nontax revenue	1	27	30	8	34
Total expenditure	87	423	429	431	500
Education	32	116	116	111	118
Health	17	81	81	69	92
Defense and public order[3]	...	56	56	55	77
General public services	14	15	19	25	30
Social assistance	9	83	83	66	85
Other	14	73	75	106	99
Subsidies	...	32	32	63	55
Energy[4]	23	23	49	13	13
Other[4]	...	9	9	14	42
Municipalities	...	19	19	19	28
Other	...	22	24	24	16
Balance	–56	–200	–219	–189	–162
Financing	56	200	219	189	162
Donor financing[5,6]	85	170	189	199	162
Change in cash reserve[7]	29	–30	–30	10	0
Memorandum items					
Total revenue, excluding grants (percent of GDP)	...	7.4	7.0	8.1	9.6
Total expenditure (percent of GDP)	...	14.1	14.3	14.4	14.2
Identified off-budget expenditure[6]	...	...	17	24	15
Equipment	...	...	5	5	...
University hospital	...	...	8	8	...
Other	...	...	4	11	...

Sources: United Nations Mission in Kosovo (UNMIK); and IMF staff estimates.
[1]Does not include donor-financed reconstruction, which accounts for all capital spending.
[2]In April 2000 a revised budget added DM 6 million for the Joint Interim Administrative Structure (JIAS), responsible for the administration of Kosovo since February 2000.
[3]For 2000, includes DM 20.7 million for the Kosovo Protection Force.
[4]For 2000, subsidies to the Kosovo Electricity Company (KEK) and for water/public heating increased by DM 25 million and DM 5 million, respectively. Increases reflect in part delays in reducing redundant staff.
[5]For 2000, includes dedicated donor support of DM 17.7 million for the Kosovo Protection Corps.
[6]Does not include support for electricity imports, estimated at about DM 40 million each in 2000 and 2001.
[7]A positive sign denotes an increase in cash reserves.

Table 4. Integrated Budget, 2000
(Percent of GDP)

Revenue	8.1
Expenditure	40.4
Current spending	15.2
Budget expenditure	14.4
Off-budget expenditure	0.8
Capital spending	25.2
Balance	–32.3
Financed by	
Donor reconstruction grants	25.2
Budget support grants[1]	6.3
Off-budget contributions	0.8

[1]Includes changes in cash reserves.

overall budget sector wage bill is low by international standards because employment levels are for the most part lean (there are some exceptions, including in health and education) and because some functions (for example, military personnel, police, judges) are not fully developed. Nonetheless, wage rates for government workers are high in comparison with those in a broad range of transition economies when they are corrected for average productivity levels in the economy (Figure 2).[3] On a functional basis, spending on health and education is broadly in line with that in other countries.

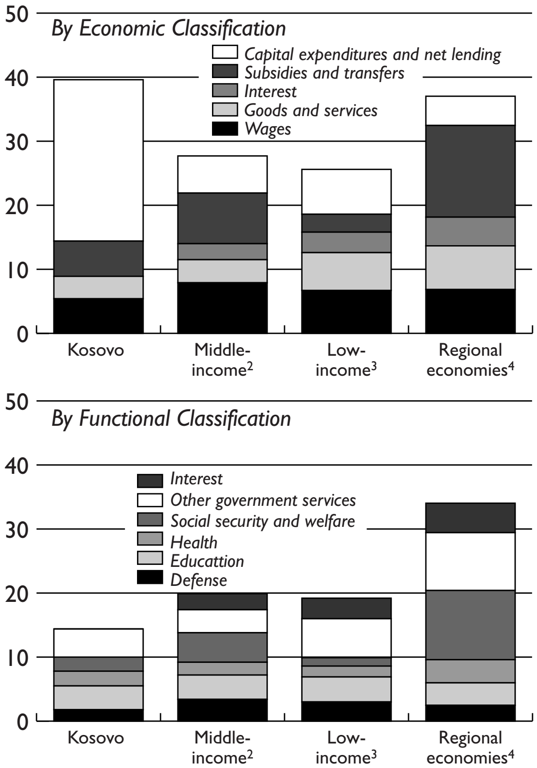
[3] Wage rates are also reportedly much higher in Kosovo than in the rest of the FRY.

Table 5. Selected Countries: Government Expenditures
(Average as percent of GDP)

	Kosovo[1] 2000	Albania 1998	Bosnia and Herzegovina 1999	Bulgaria 1998	Croatia 1998	FYR Macedonia 1999	Romania 1999	Middle Income[2]	Low Income[3]
Expenditures by economic type									
(including net lending)	14.4	30.7	53.4	36.9	30.0	37.7	37.7	27.7	25.6
Current expenditures	14.4	25.5	46.5	34.2	25.2	35.1	34.1	21.9	18.6
Goods and services	8.9	10.2	30.9	16.5	16.4	12.4	11.8	11.5	12.6
Wages[4]	5.4	6.2	6.8	8.7	9.6	9.3	5.0	7.9	6.7
Other goods and services	3.5	4.0	24.1	7.8	7.0	3.1	6.7	3.6	5.9
Interest	0.0	7.8	2.0	4.4	1.4	1.6	5.5	2.5	3.2
Subsidies and transfers	5.5	7.5	13.7	13.3	7.4	21.1	15.4	7.9	2.8
Capital expenditures	0.0	5.2	6.9	4.0	4.8	2.6	2.9	4.7	6.0
Net lending[5]	0.0	0.0	0.0	–1.4	0.8	...	0.1	1.1	1.0
Expenditures by function[6]	14.4	30.7	...	41.3	29.9	37.7	35.7	26.7	26.3
Military and civil defense	1.8	1.2	...	2.7	5.3	2.4	3.6	3.4	3.0
Education	3.7	3.0	...	3.8	3.4	4.0	3.3	3.8	3.9
Health	2.3	1.7	...	3.6	0.6	6.1	3.0	2.0	1.7
Social security and welfare	2.2	7.4	...	11.6	5.8	13.6	10.6	4.6	1.3
Housing	0.6	1.3	...	1.7	1.9	0.0	1.7	1.1	0.7
Economic services	2.6	0.3	...	1.0	...	2.0	0.5	5.7	6.4
Other government services[7]	1.2	8.1	...	12.7	...	7.9	7.4	3.6	6.1
Interest	0.0	7.8	...	4.4	1.4	1.6	5.5	2.5	3.2
Number of countries								26	11

Sources: IMF, *Government Finance Statistics Yearbook* (Washington, various years); and IMF staff estimates.
[1]Budget 2000, subsidies and transfers include unallocated contingency reserves.
[2]Barbados, Botswana, Chile, Colombia, Costa Rica, Cyprus, Dominican Republic, Egypt, El Salvador, Fiji, Hungary, Islamic Republic of Iran, Jordan, Malta, Mauritius, Morocco, Panama, Paraguay, Peru, Romania, Swaziland, Thailand, Tunisia, Turkey, Uruguay, and Zimbabwe.
[3]Burkina Faso, Cameroon, Ghana, Kenya, Lesotho, Malawi, Mali, Sierra Leone, Sri Lanka, former Zaïre, and Zambia.
[4]Military wages included in other goods and services for Bosnia and Herzegovina in 1999.
[5]Data unavailable for the former Yugoslav Republic of Macedonia.
[6]Does not include lending minus repayments.
[7]Services provided by Ministries of Agriculture, City Planning and Construction, Development, Economy, and Information, the Bureau of Statistics, and nonclassified expenditures.

Figure 1
Selected Countries: Government Expenditure
(Simple averages; percent of GDP)[1]

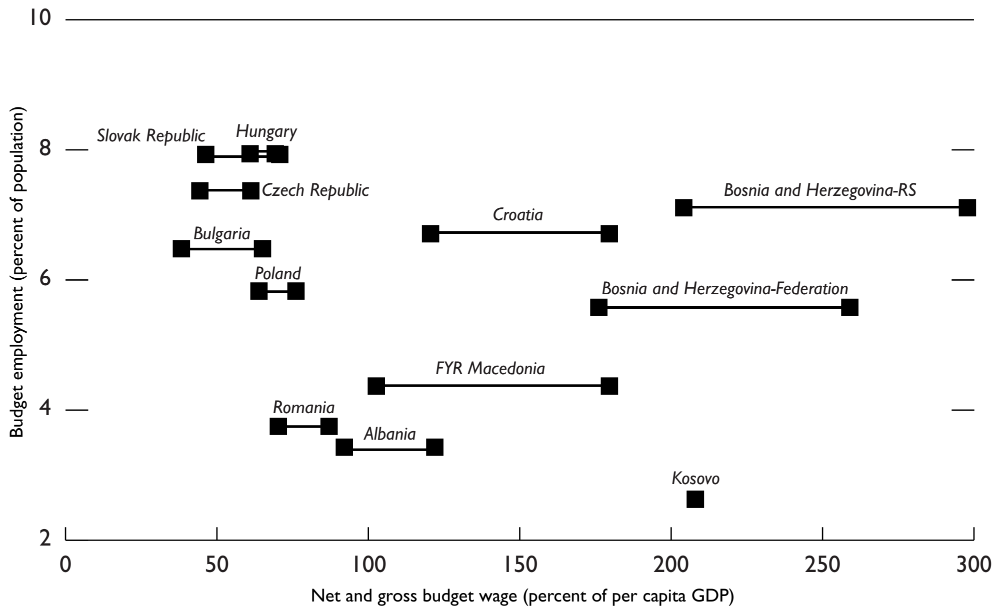


Source: IMF staff estimates.
[1]Middle- and low-income countries based on IMF, *Government Finance Statistics Yearbook* (Washington, various years).
[2]Barbados, Botswana, Chile, Colombia, Costa Rica, Cyprus, Dominican Republic, Egypt, El Salvador, Fiji, Hungary, Islamic Republic of Iran, Jordan, Malta, Mauritius, Morocco, Panama, Paraguay, Peru, Romania, Swaziland, Thailand, Tunisia, Turkey, Uruguay, and Zimbabwe.
[3]Burkina Faso, Cameroon, Ghana, Kenya, Lesotho, Malawi, Mali, Sierra Leone, Sri Lanka, former Zaïre, and Zambia.
[4]Albania, Bulgaria, former Yugoslav Republic of Macedonia, and Romania.

At this stage, Kosovo's tax base is very small by regional standards. Although the revenue-to-GDP ratio varies considerably across countries in the region, Kosovo's ratio at 8 percent is only 40 percent of that in Albania, which stands out as a low revenue raiser (Table 6). Kosovo's revenue base compares even more unfavorably with states of the former Socialist Federal Republic of Yugoslavia, which would have shared with Kosovo a similar tax system before the breakup of Yugoslavia began in the early 1990s. For example, Bosnia and Herzegovina—which endured a much longer conflict than Kosovo—has, at 47 percent, the highest revenue ratio in the region. Other transition countries raise between 30 and 45 percent of GDP in revenues—roughly 4–6 times more than Kosovo.

Kosovo's weak revenue performance is to a large extent due to its rather basic tax instruments. Almost all revenues in Kosovo stem from imports, which are subject to a uniform tariff, a sales tax, and excises; the domestic economy, in contrast, escapes virtually untaxed (Box 3). Tax rates are not low, but substantial exemptions on basic consumption goods depress collections. Conspicuously absent in Kosovo are taxes on incomes, including social security contributions. These are a substantial source of revenue to fund programs such as pensions in the former Yugoslav republics, where surviving payments systems from the old regime play an important role in forcing collections: social security contributions amount to about 15 percent of GDP in Bosnia and Herzegovina, for example. In Kosovo, however, the breakdown of the payments system (which had been centralized in Belgrade) and the widespread collapse of the state sector made the collection of income tax and social security contributions initially infeasible after the conflict. Efforts to collect revenues on incomes have only restarted tentatively, with some limited presumptive taxes on businesses. Official business and income taxes have to compete with illegal "parallel" taxes collected by local administrations and extortionists. In some cases, such taxes exert a substantial burden on local businesses, and their elimination is a major challenge.

Figure 2
Selected Transition Economies: Budget Employment and Net and Gross Budget Wages[1]



Sources: IMF staff estimates.
[1]The two observations for each entry denote net and gross budget wages.

Table 6. Selected Transition Economies: Revenues as a Share of GDP[1]

	Total Revenue	Nontax Revenue	Tax Revenue	Income and Payroll Tax	Corporate Tax	Sales, Turnover or VAT	Excises	Import Duties	Social Security Taxes	Other Taxes
Kosovo	**8.1**	**0.3**	**7.8**	**0.0**	**0.0**	**4.2**	**1.2**	**2.0**	**0.0**	**0.4**
Albania	18.6	3.6	15.0	0.2	1.1	4.7	1.2	2.7	3.9	1.2
Bosnia and Herzegovina	46.8	3.9	42.9	3.8	0.8	11.3	5.2	5.9	14.6	1.3
Bulgaria	33.1	7.6	25.5	2.6	4.0	7.1	2.3	1.9	7.1	0.4
Croatia	44.1	2.5	41.6	3.6	1.5	13.6	4.5	3.5	...	...
Czech Republic	33.6	1.5	32.1	2.0	2.8	6.9	3.8	1.0	14.8	0.8
Hungary	37.9	5.0	32.9	5.2	2.0	7.8	3.2	2.3	10.6	1.8
Macedonia, FYR	39.0	2.9	36.2	...	...	5.4	7.2	3.7	13.0	...
Poland	36.7	3.3	33.4	6.8	2.8	7.7	3.9	1.7	10.4	0.1
Romania	30.4	3.5	26.9	5.9	...	4.8	1.5	1.4	7.3	...
Slovak Republic	45.0	6.1	38.9	5.6	4.5	8.2	3.4	1.8	14.4	1.0
Slovenia	42.6	2.5	40.1	6.7	1.1	13.0	0.3	2.2	14.1	2.8

Sources: IMF, *Government Finance Statistics Yearbook* (Washington, various years); and IMF staff estimates.
[1]Average share of GDP during 1996–98, excluding Romania (1996–97), Bosnia and Herzegovina (1998–99), and Kosovo (2000).

Box 3. Tax Policy: Status and Outlook

Current Tax Structure

Kosovo has a basic tax system that collects revenues mainly from imports. Imports are subject to a 10 percent uniform tariff (with the exception of agricultural and medical products and humanitarian goods), a 15 percent sales tax (same exceptions apply), and excises on alcohol, tobacco, and petroleum goods as well as soft drinks and some electronic goods. To begin taxing the domestic economy, UNMIK introduced a 10 percent hotel, food, and beverage tax on the gross receipts of hotels and restaurants, and a presumptive tax on businesses (with a flat-rate and a second-tier tax on turnover for larger enterprises).

Tax Policy in the Future

While taking into account the practical limitations of the economic situation, Kosovo should lay the groundwork for a coherent long-term tax policy as the economy recovers and administrative capabilities increase. The following is based on technical assistance provided by the IMF and describes the main issues and next steps for improving the current system and further extending it to the domestic economy while taking into account the tax systems of neighboring countries.

Customs Duties. The major issue relating to customs duties is the treatment of trade with the former Yugoslav Republic of Macedonia (exempt under a free trade agreement) and Montenegro (exempt because this trade is considered internal trade within the Federal Republic of Yugoslavia). The best option would be to levy a uniform tariff for goods regardless of origin. However, if this option is politically not feasible, the status quo should be maintained, but customs would need to develop further its capabilities in determining the origin of imports. Alternatively, tariffs could be abolished and sales tax rates adjusted to compensate. Since the food exemption (from the customs duty and sales tax) has lost its justification with the resumption of trade after the emergency situation, the Central Fiscal Authority (CFA) has drafted a resolution to eliminate this exemption by mid-2001.

Excises. To improve compliance for excise taxes, the major excises on petroleum products, alcoholic beverages, and tobacco products will be converted from ad valorem to specific levies. Once the stock of cars is registered, UNMIK could consider an annual tax on cars since this would be easy to administer and could yield substantial revenues.

Wage Tax. A draft of a 15 percent wage tax is under review.[1] This tax will ensure greater equity between employees receiving wage income (and not currently taxed) and those entrepreneurs, such as repairmen, professionals, and various service providers, who pay (or should pay) the presumptive tax and whose income is primarily labor or earned income.

Value-Added Tax. The CFA has drafted the legislative framework for a 15 percent valued-added tax (VAT) to expand the sales tax to domestic goods with a view of its implementation on July 1, 2001. A major impetus to extending the sales tax to the domestic economy is to ensure that exports are not burdened by VAT charged on imports used to produce the exports. The VAT will replace the sales tax currently paid by importers and will apply to a limited number of domestic taxpayers in order not to exceed administrative capacities.

Profit Tax. As the last pillar of Kosovo's tax system, a profit tax should be imposed on business profits, measured by taking into account all legitimate costs of producing income. Because many Kosovar enterprises have been crippled by years of underinvestment and the recent war, the profit tax is not likely to be a major revenue raiser in the early years. Its introduction should thus have lower priority than introducing a VAT or wage tax.

[1] Implementation of the wage tax has been delayed, in part because it appears that local employees of international organizations would be exempt from this tax pursuant to the UN Convention on Privileges and Immunities. The current draft excludes UN local hires, thus raising political problems of fairness of treatment.

IV

The Path Toward Self-Sustainability

Kosovo needs to make budget decisions with a clear view to achieving a sustainable fiscal position. The objective should be to avoid the need for sharp expenditure adjustments in the future, when external financing sources are likely to dry up. Although donor support for reconstruction might continue for several years, as it has in Bosnia and Herzegovina, donors have repeatedly stressed that support for recurrent expenditure will need to decline substantially in the next few years. In the short term, this will constrain spending options as increases in tax revenue replace declining donor grants. In the longer term, a fully sustainable fiscal position would require all expenditures—including the three big off-budget items, investment, defense, and debt service—to be financed mainly from local revenues and, perhaps, a modest level of borrowing. Moving along a path that prepares for such an eventuality is entirely consistent with the "considerable autonomy" principle underlying the UN's SC1244.

The priorities for ensuring that budgets are on a sustainable path are thus to diversify the tax system and contain expenditure growth through careful review of spending needs. In this context, the low tax-to-GDP ratio indicates considerable potential for raising revenues in the future; but at the same time there will be pressures to expand social spending, including to cover payment of pensions.

On *tax policy,* IMF technical assistance has outlined a sequenced plan for improving existing tax instruments and introducing new ones (see Box 3). The main steps are as follows.

- In the immediate term, to strengthen existing tax collections by raising excise duty rates (particularly for petroleum products) and converting them to specific duties, reducing exemptions from import and sales taxes, and further improving border administration.
- During 2001, to introduce a VAT and wage tax. To capture domestic sales, it is proposed for initial administrative purposes that the VAT be levied only on large taxpayers. The VAT would also replace the sales tax levied currently on imports. The proposed initial rate is 15 percent. Allowing for taxpayer education, the VAT could be in place by mid-2001. A wage tax could in principle be introduced before then, although UN unwillingness to tax its local hires has become a stumbling block because it raises political questions of fair treatment.
- Beyond 2001, to extend the tax system to incorporate taxation of profits.

On *expenditure policy*, the key issues are:

- To maintain a lean public sector and avoid pay increases that could undermine Kosovo's competitive position.
- To prevent the budget becoming a magnet for industrial subsidies—a mistake made in other transition economies, which have found it difficult to keep state enterprises at arm's length, with a resulting high and inefficient resource cost. The main subsidies on Kosovo's budget at present go to the electricity company, KEK. These subsidies, which are sizable, should be phased out quickly (which will require KEK to be restructured) in order to accommodate new demands for public spending.

- To avoid commitments on public pensions that cannot be honored in the future. Since broad entitlements for the aged are unlikely to be affordable until tax or social security systems are more developed, the best approach for now appears to be to continue alleviating poverty for all segments of the population through a targeted, and perhaps enhanced, social assistance program. Before pension entitlements from the old system are paid, financial responsibility (which has a political dimension) needs to be established, claimants identified, and ongoing financing secured.
- To ensure that integrated planning takes place for financing the rising maintenance cost of the public investment under the foreign-financed reconstruction program. Maintaining the revitalized public infrastructure will require shifting budget priorities.

At the same time, Kosovo will need to continue building an efficient intergovernmental structure. Whereas a recent UNMIK regulation has set out the broad structure of municipal government, detailed expenditure responsibilities and the associated financing through a system of transfers and taxes (shared as well as local) have yet to be spelled out. Given the small size of Kosovo, and its further fragmentation into some 30 municipalities, there is a case for keeping decentralized taxing powers to a minimum, although an early start could be made in introducing local property taxes, a typical staple of local government. Ensuring that there are sufficient controls and incentives in place to prevent fiscal indiscipline at lower levels of government will be a major challenge. At the central level, the formal integration of current and capital budgets would help with budget planning. Current good practices of transparent fiscal accounting for recurrent expenditures (up-to-date information is posted to the CFA website) should continue and be extended to the consolidated budget and to the budgets of the municipalities.

2001 Budget

The 2001 budget aims to make progress toward self-sustainability by focusing on revenue raising and containing overall expenditure growth. Assuming that tax administration improves further and that planned taxes are introduced, revenue is expected to increase by 40 percent to DM 338 million. Assuming a wage freeze and that employment is reduced toward the originally budgeted levels for 2000, on-budget expenditures are estimated at DM 500 million, or some DM 70 million above the expected 2000 outturn. Much of the increase reflects higher costs from expanded public services, expansion in the welfare budget to make up for a withdrawal of humanitarian aid and to pay disability payments to veterans, and allocations for capital maintenance and some investment. Donors are being asked to provide about DM 160 million in financial support in 2001. They would then be financing about one-third of recurrent expenditures compared with almost a half in 2000.[4]

There are, however, considerable risks that could require downward flexibility in expenditures if sufficient donor financing is not forthcoming. In particular, the projections assume the introduction of a VAT by mid-2001, which is ambitious given the need for taxpayer education.[5] The VAT is projected to raise DM 30 million on domestic value-added in 2001. The tax projections also assume continuation of the strong underlying performance of border collections seen since the first quarter of this year. And, while the assumptions do not build in undue optimism—suggesting that there may be upside potential as well—collections have been buoyed by special factors (car imports) and slowed toward the end of 2000. All this suggests that, in order to provide maneuverability on expenditures, it will be important to enforce the intended wage freeze and carry out reductions in employment in some budget sectors. Strong efforts will also be needed to contain subsidies to the utilities by eliminating overstaffing and improving bill collection.

Beyond 2001

An examination of fiscal sustainability requires looking beyond the near term, an exercise that is necessarily highly uncertain in the case of Kosovo. Accordingly, this section looks at longer-term scenarios for the fiscal accounts. For analytical purposes, it is assumed that Kosovo remains an au-

[4] In addition, donors are providing direct support (about DM 40 million in each of 2000 and 2001) to the electricity company to import electricity.

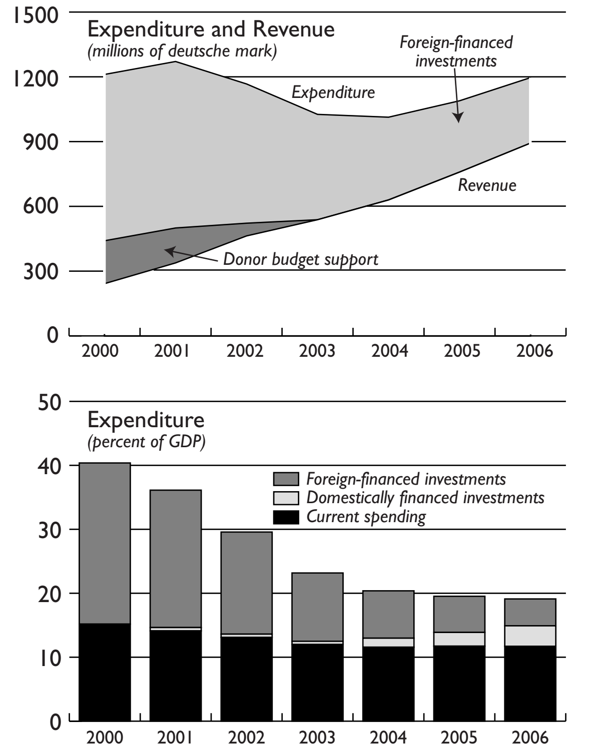
[5] Plans to introduce a wage tax in 2001 are currently suspended. However, the tax would not be expected to raise much revenue in 2001.

tonomous economic entity. The main scenario assumes real GDP growth of 10 percent a year, inflation of 2 percent a year, the full implementation of the IMF staff's tax policy proposals, and the ending of donor support for the recurrent budget in 2003. At that point, foreign-financed reconstruction would already be on a sharp decline. Alternative scenarios examine the sensitivity of the fiscal accounts to lower growth and to delays in introducing tax instruments. More details can be found in Appendix II.

The main scenario suggests that an early exit of donor budget support would impose tight limits on spending. Following on the assumed strong recovery in GDP and the broadening of tax instruments, revenue growth is projected to average about 25 percent a year in 2001–06, bringing the revenue-to-GDP ratio up toward 15 percent. Even so, the arithmetic straitjacket of eliminating donor recurrent budget support implies that current expenditures would grow on average by little more than 5 percent a year up to 2003, or about 3 percent a year in real terms (Figure 3 and Table 7). This would imply fairly tight restraint in view of likely new demands on the budget for capital maintenance, more comprehensive social benefits, and the effects of demographic trends.[6] After 2003, continuing revenue growth would not be offset by declining donor support, implying scope for more rapid growth in spending that, for illustrative purposes, is assumed to be partly allocated to topping up declining externally financed capital spending. On a consolidated basis, current spending would level off by mid-decade at close to 12 percent of GDP and capital expenditure at 7–8 percent of GDP.[7] It is assumed that more than half of capital spending would continue to be financed by foreign donors.

The extra room for spending in the medium term could easily be eaten up by the need to incorporate in the budget some potentially big-ticket items (defense, debt service, or pensions). For example, even

Figure 3
Kosovo: Medium-Term Scenario



Source: IMF staff estimates.

a small defense force might cost on the order of 2 percent of GDP a year, and debt service, assuming debts were not repudiated, could add 1 to 2 percent of GDP.[8] On pensions, old liabilities might have to be serviced, and there could be considerable pressure for a new, more comprehensive pension scheme. The latter could become a substantial burden on the budget if coverage were broad and conditions for reestablishing social security contributions remained difficult. For example, paying a pension equal to only 30 percent of the average budget wages (currently, DM 275 a month) to 12 percent of the population would amount to a transfer cost of about 5 percent of GDP in the medium term. While this would be modest by the standards of many public pension schemes, and there would likely be some offsetting savings on social assistance, the cost would put a heavy strain on contribution rates (or

[6] Demographic analysis is rather speculative, but an increase in the number of school-aged children is expected in coming years. Emigration could also raise the dependency rate and put pressure on the fiscal accounts in the absence of an ability to tax remittances from overseas workers and to properly means-test dependents.

[7] Note that budget wages are not grossed up for income taxes in the consolidated presentation. If this were done, gross expenditure levels would be about ¾ of 1 percentage point of GDP higher, although the overall budget constraint would be unchanged.

[8] Based on the order of magnitude that Bosnia and Herzegovina is paying.

Table 7. Main Fiscal Scenario
(Millions of deutsche mark; percent of GDP)

	2000	2001	2002	2003	2004	2005	2006
Revenue	242	338	463	538	630	759	918
	8.1	*9.6*	*11.7*	*12.1*	*12.7*	*13.6*	*14.7*
Expenditure	1,211	1,271	1,167	1,026	1,013	1,089	1,196
	40.4	*36.1*	*29.6*	*23.2*	*20.4*	*19.5*	*19.1*
Current spending	455	497	517	531	575	654	733
	15.2	*14.1*	*13.1*	*12.0*	*11.6*	*11.7*	*11.7*
Budget expenditure	431	482	502	516	560	639	718
	14.4	*13.7*	*12.7*	*11.6*	*11.3*	*11.5*	*11.5*
Off-budget expenditure	24	15	15	15	15	15	15
	0.8	*0.4*	*0.4*	*0.3*	*0.3*	*0.3*	*0.2*
Capital spending	756	774	650	495	438	435	463
	25.2	*22.0*	*16.5*	*11.2*	*8.8*	*7.8*	*7.4*
Foreign-financed	756	756	630	473	368	315	263
	25.2	*21.5*	*16.0*	*10.7*	*7.4*	*5.6*	*4.2*
Domestically financed	0	18	20	22	70	120	200
	0.0	*0.5*	*0.5*	*0.5*	*1.4*	*2.2*	*3.2*
Balance	–969	–933	–704	–488	–383	–330	–278
	–32.3	*–26.5*	*–17.8*	*–11.0*	*–7.7*	*–5.9*	*–4.4*
Financing	969	933	704	488	383	330	278
Donor budget support	199	162	59	0	0	0	0
Foreign-financed reconstruction	756	756	630	473	368	315	263
Off-budget donor contributions	24	15	15	15	15	15	15
Change in cash reserves[1]	10	0	0	0	0	0	0
Memorandum items							
Nominal GDP (million of deutsche mark)	3,000	3,519	3,948	4,430	4,970	5,577	6,257
Real GDP growth (percent)	...	15	10	10	10	10	10
Inflation (percent)	...	2	2	2	2	2	2

Sources: Central Fiscal Authority (CFA); and IMF staff estimates.
[1]A positive sign denotes an increase in cash reserves.

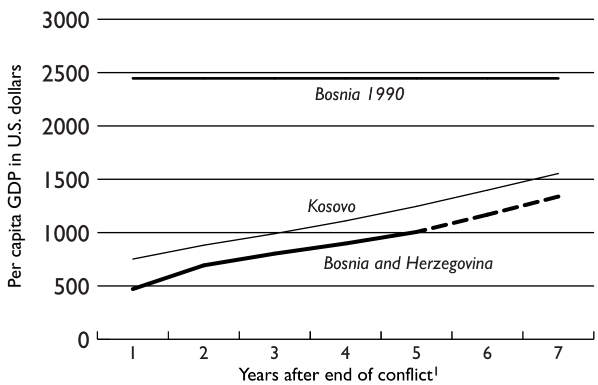
more likely would require substantial subsidization from the budget) if it were introduced before there was a recovery of taxable employment.[9] A pay-as-you-go scheme could also build up problems for future generations.

Although the parallels should not be drawn too closely, comparison with the postwar experience in Bosnia and Herzegovina provides a benchmark for the scenario. Three main points arise.

- First, the growth path assumed in the scenario is not out of line with what happened in Bosnia and Herzegovina after 1995 (Figure 4). In keeping with its much weaker starting point, Bosnia's economy enjoyed a somewhat larger postwar "bounce" than is expected in Kosovo, but thereafter the growth rates in the Kosovo scenario are similar to Bosnia's in the late 1990s. While it could be argued that, under UN administration, Kosovo has the potential to implement reforms in a more coherent fashion and hence enjoy a faster pace of catching up to prewar levels—Bosnia's per capita GDP is still estimated to be only about half what it was in 1990—the complexities of Kosovo's political situation provide a counterweight to op-

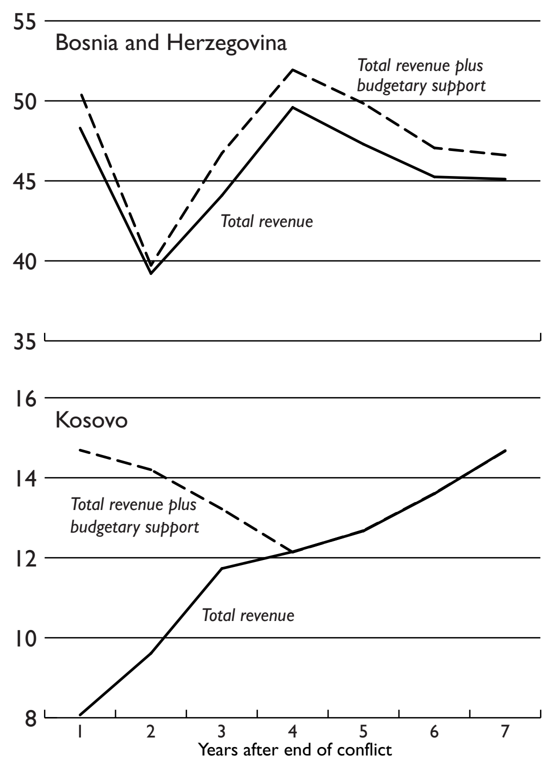
[9] Note that the scenario described in Table 7 does not incorporate social security contributions.

Figure 4
Kosovo and Bosnia and Herzegovina: Postconflict GDP per Capita



Sources: Central Fiscal Authority (CFA); and IMF staff estimates.
[1]Covers the first seven years after the end of the war in Bosnia and Herzegovina (1995) and the Kosovo conflict (1999). Projections for Kosovo cover 2000–06. The seven-year period for Bosnia and Herzegovina includes staff estimates for 1996–99 and projections for 2000–02.

Figure 5
Kosovo and Bosnia and Herzegovina: Revenue and Budgetary Support[1]
(Percent of GDP)



Sources: CFA; and IMF staff estimates.
[1]Covers the first seven years after the end of the war in Bosnia and Herzegovina (1995) and the Kosovo conflict (1999). Projections for Kosovo cover 2000–06. The seven-year period for Bosnia and Herzegovina includes staff estimates for 1996–99 and projections for 2000–02.

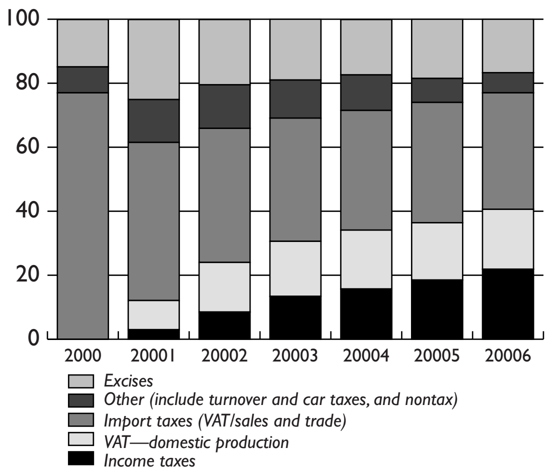
timism.[10] Furthermore, the foreign-financed reconstruction effort is not expected to be as large or as sustained as it has been in Bosnia.

- Second, donor budget support (including soft loans) was initially lower as a percent of GDP in Bosnia and Herzegovina than in Kosovo, but it has persisted beyond the horizon allowed in the Kosovo scenario (Figure 5).
- Third, donor support is proportionally much more important to Kosovo than it is to Bosnia and Herzegovina, where it has hovered around 5 percent of total revenues. This reflects the much stronger tax base in Bosnia made possible by the survival of institutions such as the payments system and, at least for now, by more clearly defined borders for collecting taxes on imports than is the case in Kosovo. By implication, the elimination of budget support would impose a proportionately much bigger strain on Kosovo's expenditure than it would in Bosnia and Herzegovina.

[10]Statistics on GDP in Bosnia and Herzegovina, both pre- and postwar, are extremely imprecise. Reliable estimates of prewar per capita GDP in Kosovo are not available. However, before the breakup of the former Yugoslavia, Kosovo was considered poorer than the republics of Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia, and Montenegro.

Kosovo's expenditure constraints would be more severe if the economy were to grow less strongly in the medium term or if there were delays in implementing tax measures. For example, if real GDP growth were limited to 5 percent a year—not a disaster scenario—there would be no room for an increase in current expenditures in real terms in 2001–03 if donors insisted on removing budget support by 2003. Nor would the pickup in expenditure growth after 2003 be as strong as in the higher-growth scenario, implying that the squeeze to accommodate new programs or to incorporate off-budget items would be much tighter. The constraints on expenditure would also be much tighter if there were delays in introducing new taxes, given that it takes time for revenue from new taxes to build up (Figure 6). For example, if the VAT

Figure 6
Kosovo: Medium-Term Revenue Composition, 2000–06
(Percent of total revenue)



Sources: CFA; and IMF staff estimates.

and wage tax were postponed by 12 months from their planned implementation dates, the revenue- and expenditure-to-GDP ratios could be as much as 1 percentage point lower by mid-decade. There would, of course, also be a tight squeeze in 2001.

At the same time, there is potential for more positive outcomes that could alleviate some of the constraints on expenditure. First, tax revenues could prove to be more buoyant in the future, taking into account their low starting level and factoring in the potential for improving tax administration. Assumptions about the success of the wage tax in particular err on the conservative side, and under the main scenario the tax-to-GDP ratio would, by mid-decade, still be below the current level in Albania. There would also be some scope to further broaden tax instruments and raise marginal rates. Second, in the medium term Kosovo will likely have alternative financing sources, including domestic borrowing. A sustainable borrowing level could in principle alleviate the spending constraint by a few percent of GDP. Third, donors may be more generous to Kosovo than assumed.

V

Conclusions

A number of conclusions emerge from the analysis.

- The UN has made a good start in budget implementation, and an important step toward budget self-sustainability appears to be in train for 2001. However, a small tax base and the expectation of rapidly diminishing donor support for recurrent spending imply a very tight constraint on expenditure, especially in light of pressures to expand the scope of the budget and, eventually, shoulder some large off-budget items.
- Policies to foster economic growth are essential for ensuring that the constraints on expenditure are not unbearable. Because growth will hinge on private sector development picking up the running as the construction boom eases, an appropriate enabling environment is crucial. This means placing immediate priority on finding workable, albeit perhaps temporary, solutions to property rights problems and putting in place—and enforcing—modern commercial codes and regulations.[11] Private sector development will go hand in hand with a deepening of the banking system. Maintenance of law and order and a lessening of ethnic tensions are also essential ingredients.
- Delays in diversifying the tax system should be avoided. Revenues from new taxes build up over time, and the authorities need to jump-start efforts to solve administrative problems.
- Caution should be exercised against introducing spending programs that carry long-term commitments. Ensuring there will be a sound base of social security contributions to fund social programs such as public pensions is an obvious example.
- Phasing out donor budget support by an early date would be quite stringent.

[11]UNMIK has in this regard drawn up a White Paper on private sector development, and draft commercial regulations are awaiting approval.

APPENDIX I
Estimating GDP

Although technical assistance from the IMF's Statistics Department is helping to define a program to regularize the collection and reporting of statistics, reliable estimates will depend on data from upcoming surveys. Until then, estimates of the size of the economy of Kosovo are based on partial information, potentially unreliable observations, and some educated guesswork.

The IMF staff's estimate of GDP presented in Table 1 is based on the expenditure approach. The main data sources and assumptions underlying the estimate are as follows.

- *Private consumption* is based on an August 1999 survey of 500 households conducted by RIINVEST, a local think tank, which estimated daily average consumption at $2.57. For 2000, this estimate is rounded up to $2.75. As well as humanitarian aid, private remittances from abroad provide significant support for consumption. Informal estimates put the number of remitters at about 200,000 making an average monthly remittance of DM 500–1,000. At the low end of this range, total private remittances would amount to some $570 million in 2000, or roughly $1,500 a year per family living in Kosovo.
- *Public consumption* is estimated from information on the execution of the central budget for 2000. No estimate is factored in for the value of services provided by the parallel system that continues to function at the local level, although this is partly picked up in the estimate of private consumption.
- Donor-financed capital projects account for most *investment*. Based on information from the UNMIK Department of Reconstruction, *foreign-financed reconstruction* inflows for 2000 are estimated to be $360 million (DM 750 million), of which about $250 million is for rehabilitation of housing and other buildings. *Private sector investment* is estimated at about half this amount on the assumption that housing reconstruction is matched by a large local effort—although this is largely guesswork because there are no systematic surveys. Private investment would amount to about 30 percent of private remittances, consistent with anecdotal evidence that a significant part of money sent home from abroad is used for house construction.
- *Imports* are estimated from a variety of sources. First, import duty receipts are consistent with $390 million in dutiable declared imports for 2000. To correct for underinvoicing, smuggling, and delays in establishing border points, this number is augmented by 80 percent, a factor based on experiences from other economies in the region—particularly Bosnia and Herzegovina—bringing total dutiable imports to $710 million. Second, based on discussions with the Department of Reconstruction, donor-financed reconstruction inflows are assumed to have a 90 percent (nondutiable) import content. Third, electricity imports are estimated at $26 million in 2000. Fourth, based on information from the UN Food and Agriculture Organization (FAO) and donor groups,

imports of humanitarian assistance for 2000 are estimated at about \$150 million. Such assistance comprises food aid (wheat and wheat flour) (\$60 million); agricultural assistance and supplies (\$15 million); emergency social welfare (\$50 million);[12] and donations of equipment (\$10 million), medical supplies and essential drugs (\$10 million), and education materials (\$5 million). Total imports add up to \$1.2 billion.

- Based on customs data, *exports* are expected to amount to less than \$1 million in 2000, reflecting limited online productive capacity. There is, however, reportedly some unrecorded two-way trade taking place with the rest of the FRY.

Taken together, the above information implies GDP for 2000 equal to \$1.4 billion, or DM 3 billion. With the population of Kosovo estimated to be currently 1.9 million, per capita GDP is thus about \$750. This would be about twice as high as a much-quoted preconflict estimate based on official Yugoslav data by the independent research group RIINVEST. However, the earlier estimate probably grossly undervalued GDP. Among other things, it was based on the concept of gross social product, which neglected value-added from services, and likely undervalued the contribution of the ethnic Albanian majority. Taking into account the size of private remittances and official funding for reconstruction, budgetary support, and humanitarian aid, national income would amount to DM 4.5 billion, equivalent to \$1,130 per capita.[13]

The estimate of GDP is subject to a sizable degree of uncertainty. Given its large relative size (136 percent of GDP), the estimate is particularly sensitive to different assumptions about private consumption. For example, if daily consumption is increased to \$3 from \$2.75 (only about 10 percent greater), per capita GDP would rise to about \$825, assuming no offsetting upward revision to imports. Such a higher figure might plausibly go with a higher estimate of private remittances, which in turn might argue for a somewhat higher level of private investment. However, there is also significant likelihood that GDP is overestimated, through either an underestimation of unrecorded imports or perhaps an unwarranted rounding up of daily consumption levels.

[12] Includes monthly food baskets valued at DM 80. With the introduction of means testing, the share of families receiving emergency assistance declined from about 60 percent at the beginning of the year to about 20 percent by July 2000.

[13] No allowance is made for debt service, which in principle is accruing and would lower this estimate somewhat.

APPENDIX II
Medium-Term Fiscal Scenarios

The main medium-term scenario summarized in Table 7 depends on assumptions about macroeconomic developments and policies on taxes and expenditures. The scenario treats Kosovo as a continuing autonomous economic entity.

Macroeconomic Assumptions

Under the main scenario, real GDP is projected to grow by 10 percent a year on average through 2006. Such growth would be a little above the rate seen in Albania following episodes of internal conflict, but a little below the rate seen in Bosnia and Herzegovina, which suffered a longer and more devastating conflict than Kosovo. Annual inflation is projected to be about 2 percent, assuming that Kosovo continues to use the deutsche mark or euro. Implicit in the growth projection is a strong private sector performance that would return agricultural production rapidly to at least preconflict levels and allow the industrial sector of the economy to recover much of its lost share in output. The importance of the construction sector would decline as the reconstruction boom eases.

Consistent with this broad pattern of growth, domestic saving would have to rise as a share of GDP to assume more of the burden of financing investment in the medium term. Specifically, the scenario assumes that private consumption growth is 2 percentage points below that of incomes, which in turn would be growing slower than GDP because (1) income support from humanitarian aid drops off; (2) remittances from abroad are assumed to grow in line with more slowly growing foreign income levels; and (3) income growth from rapidly rising employment is attenuated by relatively modest real wage growth (3 percent a year).[14] As a result, private consumption declines in the scenario from 136 percent of GDP in 2000 to 100 percent of GDP by 2006 (Table 8). Total investment also declines as a share of GDP because private sector investment does not compensate for the dropoff in foreign-financed reconstruction investment in the medium term.[15] The reduction in domestic expenditure as a share of GDP is compensated by an improvement in the trade balance: exports begin to emerge with the recovery of private sector industry and agriculture, reaching 7 percent of GDP by 2006, while the share of imports is sharply reduced. The projection for net exports is cross-checked with the assumed financing from remittances, donor support, and a small amount of inward foreign direct investment.

Under the alternative lower-growth scenario, Kosovo's real GDP is assumed to expand by about 5 percent a year. Behind the scenario is an assumed slower pace of private sector development and less buoyant employment growth. As a result, GDP is about 21 percent lower than in the main scenario by 2006. However, for the same absolute levels of remittances and external donor support, the drop-off in consumption, investment, and imports relative to the main scenario would be less than this.

[14] Taxable employment income, however, would grow much more rapidly as workers are integrated into the formal economy.

[15] The scenario assumes the current pipeline of reconstruction support is refreshed, but at a lower level than before.

Table 8. Main Scenario: Expenditure as Percent of GDP

	2000	2001	2002	2003	2004	2005	2006
Consumption	146	132	125	119	116	112	109
Public	10	9	9	8	8	8	8
Private	136	123	116	111	108	104	100
Investment	39	34	29	25	23	24	24
Public	25	22	17	11	9	8	7
Private	14	13	12	13	14	16	17
Net exports	–85	–67	–54	–44	–39	–36	–33
Financed by							
Reconstruction aid	25	22	17	12	9	7	5
Budget support	9	5	2	0	0	0	0
Humanitarian aid	10	3	0	0	0	0	0
Remittances	40	36	34	32	30	28	26
Foreign direct investment	0	0	1	1	1	2	2

Revenue Projections

The revenue projections assume that the tax policy program outlined in Box 3 is fully implemented. The macroeconomic assumptions, together with some specific assumptions about tax compliance, combine to define the evolution of the tax base. The key specific assumptions are outlined below.

Wage Tax

The projection assumes that only 20,000 workers in the private sector will file the tax in 2001.[16] This number might appear rather low, but unemployment in Kosovo is high, and experience in neighboring Albania points to major difficulties in capturing wage income accurately. Not only are there many evasion schemes, which are difficult to detect for an inexperienced administration, but the absence of a well-functioning payments system will make withholding not an option. Over the medium term, the number of workers filing for the wage tax is projected to increase to 130,000 in 2006 owing to improvements in tax administration and development of the banking system. Private sector wage levels are assumed to be the same as in the public sector. Although anecdotal evidence points to monthly wages substantially above DM 1,000 for some workers, particularly in the construction sector, there are many other workers (for example, in agriculture or factories operating at minimum capacity) who earn less than budgetary wages or at least are not paid regularly.

[16]Note that the wage bill in the scenarios is calculated net of wage tax payments.

Profit Tax

Projections for the profit tax are the most difficult, given a lack of coherent information on the corporate sector. However, since many enterprises are crippled by years of underinvestment and the recent war, the profit tax is not likely to be a major revenue raiser in the early years. The scenarios thus make the ad hoc assumption that revenues from the profit tax are DM 10 million in 2002—the year of its introduction—and from then onward are related to GDP growth, with an elasticity of 1.7 in 2003 and 1.2 thereafter.

Value-Added Tax

Projections for the VAT are based on the value of dutiable imports and on calculations of the domestic VAT base on the basis of preliminary business registration data. It is assumed that the VAT, which will be limited initially to large taxpayers, will be extended to the medium-sized businesses in 2003, resulting in an increase of the tax base by 60 percent. The VAT base is projected to grow with nominal growth in the manufacturing and trade sectors.

While the projection of the VAT collection from imports is straightforward, a key parameter for the calculation of the domestic VAT component is how much VAT is creditable from the import stage.

With exports negligible, it is assumed that about 50 percent of the domestically produced value-added has to be credited for imports and that this amount will increase to more than 60 percent with the extension to the retail sector and an increase in exports.

Excise Taxes

Petroleum products. Consumption of petroleum products is assumed to increase in line with a weighted average of real consumption growth (0.75) and real GDP growth (0.25). The specific excises are adjusted from DM 0.4 per liter of gasoline in 2001 to DM 0.45 in 2005 and from DM 0.30 per liter of heating oil and diesel in 2001 to DM 0.35 in 2005.

Spirits. The tax base grows in line with private consumption. The specific tax rate is adjusted from DM 2.0 per 100 percent of alcohol in 2001 to DM 2.3 in 2005.

Beer. The tax base grows in line with private consumption. The rate is adjusted from DM 0.30 per liter in 2001 to DM 0.35 in 2005.

Cigarettes. The tax base grows in line with private consumption. The rate is adjusted from DM 0.08 per package in 2001 to DM 0.12 in 2005.

Customs Duties

Customs duties depend on import growth. The estimated average tariff rate (7.2 percent in 2000) is assumed to be unchanged in the medium term.

Vehicle Tax

The stock of vehicles is estimated at 250,000 by the car registration office.

Expenditure Projections

In the scenarios, recurrent expenditure is constrained by the projected revenue envelope to eliminate donor budget support by 2003. In the main scenario, this implies about 5 percent nominal growth (3 percent real) on average for 2001–03. With declining donor support no longer a drag on resources, and tax revenues continuing to rise quickly, spending constraints ease thereafter. For the purposes of the scenario, it is assumed that about half of the increase in revenues after 2003 is allocated to recurrent spending and the remainder to capital spending. Consistent with the macroeconomic scenario, foreign-financed capital spending declines sharply as a percent of GDP from 2001 onward.