

MEDIUM TERM MACROECONOMIC BACKGROUND TO THE BUDGET FOR 2005

The summary position for 2005 is that given various assumptions:

- *the total of resources from the domestic economy before any policy changes in 2004 and available to the Budget is estimated to be of the order of Euro 627 millions, or about 37.0 per cent of GDP as constructed. This total represents a real increase of 1.3 to 2.0 per cent as compared with the figure as planned for 2004*
- *the direct effect of proposed policy initiatives to be introduced in 2004 would reduce revenues by about Euro 4.5 in 2004 and Euro 9.5 in 2005. These changes would also be expected to have a beneficial effect on the development of the relevant sectors in the economy.*

A general caveat is that Kosovo as yet, has no officially authorised system of national accounts. Information quoted for the budget can be accepted as being reliable. Close collaboration with the IMF during recent Missions to Kosovo, has revealed the difficulties in producing reliable estimates for the growth of GDP and its major components. Although the figures produced here reflect broad agreement, discussions between the Fund, SOK and the Ministry of Finance are still continuing in this respect.¹ In the Statistical Office (SOK) and elsewhere, work is in hand to address this deficiency.

I Real Growth

As a matter of principle, the productive capacity of an economy depends on inputs of labour skills, capital investment and the degree of technical advance including organization and management of the factors available.

(i) Labor Supply

Although there is no regular official census of population, other sources of information suggest that the Kosovo population² is of the order of 1.9 million for 2004. The economy is characterized by significant population movements, with numbers of people temporarily residing abroad, especially during the winter season. The average rate of population growth is expected to range between 1.5% and 2% annually during the next five years.

¹ The Ministry (MEPD) and SOK are appreciative of the Mission team for its efforts to assist local staff and Advisers in the joint effort to improve the statistical basis for economic and other assessments.

² Defined as Kosovo permanent residents, annual average.

Table I Population ('000)*

	Permanent Residents	Seasonal Workers Abroad	Total Population
2002	1735	135	1870
Laur 2003	1755	137	1892
2004	1775	139	1914
2005	1792	143	1935
2006	1809	146	1955
2007	1824	148	1972

*Estimates MFPD

The current level of the active population (working age: 15 – 64 years of age³) is around one million persons. The annual average rate of growth of the population of working age over the next five years is estimated to be around 2.5%. This translates into at least 25,000 new working places needed each year to accommodate this labor force growth.

The total number of gainfully employed is currently estimated at 330,000 persons, out of which only 45% (or 150,000 persons) are officially employed and contribute to budget revenues as registered income tax payers. It is expected that the number of officially employed will be increasing by only a few thousand per year. Agriculture is probably the main potential employment generation sector in both the official and subsistence economy.

A high unemployment rate could be at least as high as 50 per cent during the winter months; perhaps somewhat lower during the summer period, remains as one of the most important problems through 2004 – 2007.

In summary, the prospects for growth of the effective labour force are modest. Assessed in terms of medium term potential, a figure of between 1.25 and 1.75 per cent per annum is taken to be a reasonable assumption.

(ii) Investment

A variety of sources suggest that investment by the private and public sectors together with donors, amounted to about 40 per cent of GDP between 2002 and 2003. Much of this investment has been in residential and other construction activities. The evidence,

³ Labor market definitions adhere to those adopted by the International Labor Organization.

although limited but re-enforced by the recent crisis, suggests that these sectors are still expected to dominate.

Table II Gross Investment as a percentage of GDP*

	Private	Public	Donors	Total
2002	37.4	3.3	7.6	40.6
2003	30.2	7.8	2.6	35.7
2004	28.8	14.5	2.1	36.6

*Estimates and Projections MEPD, IMF

(iii) Productive capacity

Based on the above, some simple calculations suggest that the underlying rate of growth of productive capacity for Kosovo is around 4.0 per cent per annum. However, this figure certainly is speculative and should be set in a range of alternative and possibly equally plausible estimates. It is interpreted best as a trend growth rate that the economy could be expected to converge over a period of time.

Table III provides a *working illustration* of the path to which both nominal and real GDP might tend to converge. It is to be stressed again, however, that the profile given, is based on limited information, and judgemental factors. It should be interpreted best as a working assumption. It is seen that the path of inflation is set at zero and reflects an assumed inflation in the EU of roughly 2.0 per cent being offset by downwards pressure on costs and prices in the domestic economy.

Table III GDP Growth (annual average %)*

	2002	2003	2004	2005	2006	2007
Nominal GDP	21.2	3.8	3.9	4.0	4.0	4.0
GDP Deflator	:	-0.5	0.0	0.0	0.0	0.0
Real GDP	:	4.3	4.0	4.0	4.0	4.0

* Estimates/Projections MFE/IMF

II Summary Overall Revenue Projection

A first broad overall summary is provided in **Table IV** below. It is seen that given the assumed rate of growth of nominal GDP and the revenue figure as shown in the 2004 Budget plan, the share of total revenues in 2005 has declined a little. It is emphasized that the revenue estimates are based on the current tax legislation and do not take into account

any consequential effects arising from expenditure changes from the end of 2003/early 2004.

In part this is a reflection of the joint effect of an increase in domestic economy taxes and a slight decline in taxes collected at the border. Imports are assumed to decline but remain very high as a share of GDP (currently, close to 70 per cent of all taxes are collected at the border).

Table IV Total Resources Available to the Budget 2005 (Euro mill)*

	2003	2004 Planned	2005	2006	2007
Nominal GDP	1,580	1,641	1,706	1,774	1,845
Imports % GDP	155	137	124	110	102
Border Taxes	413.6	422.5	419.6	420.1	421.7
Per cent of Total Revenues	70.1	68.2	66.9	65.4	64.4
Total Revenues	589.8	619.3	627.0	642.0	654.0
% GDP	37.3	38.0	36.7	36.2	35.4

* Estimates/Projections MFE

The summary position for 2005 is that given the various assumptions, the total of resources from the domestic economy before any policy changes in 2004 and available to the Budget is seen to be of the order of Euro 627 millions, or about 37.0 per cent of GDP as constructed. This total represents a real increase of 1.3 to 2.0 per cent as compared with the figure as planned for 2004.

III Detailed Revenue Analysis

At the macroeconomic level expectations relating to domestic demand, both public and private, are of importance. Overall, it is of significance to note that *general budget expenditure has been the primary factor stimulating domestic economy expansion since the first quarter of 2001*. There is a strong relation between public spending and tax revenue collections. We expect a continuation of significant public sector spending, including housing, reconstruction and infrastructure works, spending of the accumulated government cash surplus, and spending of already committed donor funds. However, imports are the tax base for around 65 - 70% of total tax revenues and these are expected to grow at a more moderate rate than in previous years, perhaps flattening out around 2006. This is expected to lead to a gradual stabilization in revenue collections.

The recent disturbances in Kosovo probably has disturbed the pattern of revenues and it is preferred to wait on more recent information before forming a firm view on the evolution through 2004.

IV The Effects of Proposed Fiscal policy changes:

As noted above, the baseline forecast is based on current tax legislation. However, progress in domestic taxes administration; namely, the effects of the introduction of the New Customs Code, and improvements in tax compliance, have been built into the forecast in order to reflect an expected positive effect on revenue collections.

Currently, *three* sets of tax/customs policy initiatives are under consideration for introduction in 2004.

- a. a reduction in the customs tariff for selected capital goods and selected raw materials
- b. abolishing VAT on agriculture inputs
- c. abolishing VAT on agriculture capital goods

It is estimated that the *cash revenue* impact of the proposed policy changes; namely, customs duties foregone and VAT would be around 4.5 million euro in 2004. In 2005 annual budget cost is estimated at around 9.5 million euro per year. **Table V** shows the possible impact effects of these changes on ex ante revenues as projected.

One must stress that the revenue effects shown in **Table V** are “first round” cash or impact effects. Thus the possible effects on behaviour of the economy are not incorporated. These cash effects are estimated for 2005 also but not extended further. For future years one must expect that the behaviour of the economy will change as it adjusts to the introduction of the policy initiatives.

After financing from a (World Bank) provided Budget Support Grant and ignoring any claims for re-construction total cash resources available to the Budget for 2004 is 612 million euro. The continuing effect of these policy changes through 2005 in cash terms, reduces total revenues from 627 millions to 620 million euro.

Table V Mid Term Budget Revenue Projection 2005 – 2007, million euro

	2000	2001	2002	2003	2004	2005	2006	2007
Euro million	Actual				Budget Plan	MTBR Projection March 2004		
Tax revenue	121.5	270.7	444.3	520.9	533.2	538.8	547.1	554.8
Domestic taxes	6.3	45.4	76.0	98.1	110.7	119.3	127.0	133.1
Income taxes	6.3	32.9	48.2	63.0	68.4	73.9	78.3	81.4
Corporate Income taxes	6.3	32.9	38.9	47.8	52.2	56.4	59.8	62.1
Presumptive tax	6.3	32.9	31.1	19.3	18.1			
Profit tax	0.0	0.0	7.8	28.5	34.1			
Personal Income taxes	0.0	0.0	9.4	15.2	16.2	17.5	18.5	19.3
Taxes on consumption								
VAT Domestic	0.0	12.5	27.8	37.4	44.3	47.4	50.7	53.8
VAT Domestic refund				-2.3	-2.0	-2.0	-2.0	-2.1
Border taxes	115.2	242.1	364.5	413.6	422.5	419.6	420.1	421.7
Sales/VAT Imports	63.4	116.9	169.0	180.6	193.5	189.7	193.5	197.4
Excise	19.5	77.3	125.6	171.4	158.0	164.6	161.3	158.1
Customs	32.3	47.9	67.5	72.3	80.0	75.9	76.6	78.0
Other taxes (offenses & penalties)	0.0	0.0	2.5	2.6	3.0	4.0	4.1	4.1
VAT Imports refunds				-13.4	-12.0	-14.7	-15.4	-15.9
Discrepancy	0.0	-16.8	3.8	9.2				
Non-tax revenue	6.9	21.5	35.5	45.3	52.1	53.9	57.6	60.2
Municipal own source revenue (MOSR)	0.0	15.0	19.8	23.6	34.0	34.4	37.1	39.0
TOTAL REVENUE	128.4	307.3	499.6	589.8	619.3	627.0	641.8	654.0
Tax/Customs Policy Initiatives effective in July 2004								
Reduced customs tariff from 10% to 0% for selected raw materials and selected capital goods (as per draft proposal)					-2.5	-5.0		
Abolished VAT on agriculture inputs*					-2.0	-4.6		
Abolished VAT on agriculture capital goods*						-0.04		
Total Revenue loss (estimate)					-4.5	-9.6		

TOTAL REVENUE AFTER POLICY INITIATIVES						614.8	617.4	641.8	654.0
External Financing									
Budget support grants	120.6	41.1	18.1	0.0		4.3	0.0	0.0	0.0
TOTAL REVENUE AFTER FINANCING	249.0	348.4	517.7	589.8		619.1	617.4	641.8	654.0

Note: * Preliminary estimates according to the Ministry of Agriculture, Forestry, and Rural Development

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