**IMF Staff Visit to Kosovo**

**April 21-29, 2008**

**Aide-Mémoire**

1. **An IMF staff team visited Prishtina during April 21-29, 2008 in the context of continuing technical services authorized in 1999 by the IMF Executive Board.** The mission's principal tasks included a stock-taking of recent economic and policy developments since the previous visit in October 2007,[1] a review of fiscal policy and budgetary execution in 2008, and providing advice to the authorities on a macro framework that could underpin the government's Medium-Term Expenditure Framework (MTEF) for 2008-11. This aide-mémoire elaborates the mission's findings and policy advice.

2. **Kosovo's economic performance has been mixed.** On the one hand, recent revisions to national income accounts point to both much higher gross domestic product (GDP) than previously estimated, and to higher growth rates.[2] The economy expanded at 4½ percent in 2007 on strong domestic demand supported by large flows of remittances and foreign direct investment, a sustained donor presence, and higher deposit-financed credit growth. On the other hand, the expansion was accompanied by an acceleration of inflation. While mostly but not solely reflecting increases in international food prices, inflation rose to 13.2 percent year-on-year in March 2008, exceeding rates in most neighboring countries. The current account deficit remained high, widening slightly to 26 percent of GDP, partly reflecting competitiveness losses.

3. **Fiscal policy was commendably disciplined last year.** Revenue growth of 26 percent was much stronger than expected thanks mostly to buoyant indirect tax receipts (due to fast-growing imports) and to one-time revenues. In addition, fiscal discipline helped keep current spending in line with the budget. However, given line ministries' poor planning and implementation capabilities, over-budgeting of public investment was evidenced by another year of low execution of capital spending. The resulting large surplus in turn swelled the government's bank balance to over €400 million (12 percent of GDP).

4. **Sustained sound fiscal policy, together with persistent market-oriented structural policies, would help achieve a successful transition to sustained employment-creating growth over the medium term.** In the absence of an independent monetary policy, fiscal policy has a key macro stabilization role to play. It also has a significant role to play in restoring competitiveness through targeted improvements in physical and human capital via well-prioritized public investment. Limiting the growth of real current primary spending to a

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[1] Please visit http://www.unmikonline.org/press/reports/aide_memoire_oct2007.pdf for the aide-mémoire of the previous mission.

[2] GDP for the period 2004-2006 has recently been revised by the Statistical Office of Kosovo (SOK), in cooperation with external stakeholders, to address solid evidence of under-reporting of private sector consumption. Preliminary estimates indicate that for the period 2004-2006, nominal GDP averaged €3.0 billion, compared to €2.3 billion previously.

rule-based 0.5 percent per year, together with improved capital budgeting and project monitoring, helps preserve prioritized public investment. A well-conceived public investment program would also need to consider both the limited implementation capacity of line ministries to plan and carry out capital projects and any recurrent cost implications.

5. **The 2008 budget is not consistent with this framework.** Following several revisions to the previous government's already expansionary budget for 2008, real primary current spending is to be boosted further, due in part to the hiring of additional teachers and to higher subsidies to KEK. In turn, real current primary spending is presently set to rise by 8½ percent over last year's outturn, well above the rule-based level. Moreover, public investment is budgeted to reach about €500 million (including a loan to KEK), over three times the 2007 executed level. Attempting to execute so large an increase would result in substantial waste and potentially contribute to inflation (further eroding competitiveness). Moreover, despite buoyant revenues, the government's bank balance would fall to around 3 percent of GDP by year-end, well below a prudent minimum level for Kosovo in present circumstances. A number of factors - including among others cyclical influences, status-related risks, cash management considerations, and potential delays in aid disbursements- argue in favor of maintaining a higher minimum government bank balance in present circumstances.

6. **Given these concerns, the mission urges the government to take remedial steps in the context of a mid-year budget review**. Key measures include:

- **Reducing primary current spending** by €22 million to offset the interim additions to the primary current spending envelope adopted by the previous government. Such a reduction would still accommodate a 4 percent increase in real primary current spending. While the government's decision to curtail ministerial spending on telecommunications, representation, and fuel outlays is a necessary first step, additional measures could include a freeze on filling civil service vacancies, cuts in subsidies to budgetary organizations, or sequestration of non-priority spending.

- **Bringing the planned level of capital spending down** to a level consistent with ministries' capacity to plan, execute and monitor projects. With under 5 percent of appropriated capital spending executed during the first 3 months of 2008 (in part due to delays in approving the budget), implementing a more feasible envelope of around €300 million will in any event require additional efforts to improve execution, including through a quarterly monitoring and reporting mechanism accompanied by corrective measures. In this regard, and in order to minimize waste, authorizations should be granted by the Minister of Economy and Finance only to projects that are ready for implementation according to requirements of UNMIK Regulation 2003/17 on Public Financial Management and Accountability.

7. **A revised 2008 budget is a pillar of a viable MTEF 2008-2011, which is in turn the key document to inform donors and investors about the government's development strategy.** The government's medium-term strategy should remain centered on: raising productivity through targeted and prioritized investments in human capital and public infrastructure; maintaining sound fiscal policy founded on low and uniform tax rates,

considerably improved tax administration, prudent growth of current primary spending, and cautious management of the government's fiscal reserves; and encouraging private sector investment by improving the overall business climate.

8. **The mission has prepared a medium-term macro framework in line with the preceding strategy.** Regarding fiscal policy for the period 2009-11**:**

- **Revenue policies:** (i) Consistent with the government's desire to **reduce the corporate tax rate,** the macro framework assumes a reduction of the statutory rate from 20 percent to 15 percent beginning in 2009 to narrow the unhelpful gap with neighboring countries, without the introduction of new tax incentives; (ii) **Excise taxes** on tobacco are assumed to be raised to offset revenue losses; and (iii) It is assumed that serious improvements in **tax administration** begin urgently.

- **Expenditure policies:** (i) Consistent with the fiscal rule, **current primary spending** is assumed to grow by 0.5 percent in real terms from the revised 2008 level noted earlier. Within this projected spending envelope, it is assumed that basic pensions are inflation-indexed as required by law; (ii) **Capital spending** is projected to grow in line with GDP, boosted as well by improvements in ministries' planning and implementation capacities.

- **Domestic financing**: Following an initial drawdown by 3 percent of GDP of the government's fiscal reserves in 2008, the macro framework assumes that, pending greater assurances of reduced risks, the government maintains a precautionary balance estimated at 9 percent of GDP.

**9. The viability of the mission's medium-term fiscal framework hinges, however, on the forceful pursuit of key reforms to tax administration, the civil service, and public financial management:**

- **Tax Administration**: Since the adoption of the Strategic Reform Plan in early 2007, tax administration has improved somewhat, although it remains too weak to keep up with the growth the number of taxpayers. The Tax Administration of Kosovo needs to focus much more on improving the foundations of tax administration, namely establishing sound taxpayer registration systems and processes for tax declaration, filing, and payments. Absent dramatic improvements in these areas, and a significant upgrading of the outdated IT system, any other action will bear little fruit. Both sufficient resources and strong strategic leadership are also essential for achieving reform success. Absent substantial strengthening of tax administration, Kosovo's otherwise comparatively good overall tax system will neither deliver improved compliance nor reduce the scope of informal activity in the economy.

- **Civil service reform:** Long delays in initiating functional reviews of public administration have slowed civil service reform to a crawl. Strong political and institutional commitment are needed. An initial good step would be to redefine the mission of the Ministry of Public Service to focus more on *reforming* public administration than solely on service provision. Two immediate priorities are: (i) Ensuring the independence of SOK; and (ii) Making progress on teacher certification.

In regard to the latter, the goals of the long-postponed teacher certification program need to be clarified, and any budgetary implications need to be made explicit in the MTEF.

- **Public expenditure management:** Capital budgeting practices need to be remedied. The government should begin implementing immediately the main recommendations of the 2007 capital budgeting reviews of the Ministry of Economy and Finance's Budget Department and of the World Bank, including: (i) the separation of allocations for project execution from project preparation; and (ii) a revision to Schedule IV of the annual budget to include total estimated cost of each project in the context of multi-year budgeting, subsequent cost revisions, planned outlays for the current and subsequent two fiscal years, a clear indication of projects' distinct capital, current, and recurrent cost components.

10. **The improved competitiveness implicit in the revised macro framework will only materialize if underpinned by appropriate structural policies and reforms.** The mission welcomes the authorities' intention to proceed cautiously with any social initiatives to ensure they do not endanger fiscal sustainability and do not have adverse economic impacts. Labor market flexibility is a key ingredient to restoring competitiveness, but it is seriously threatened by the premature labor law sent recently to the Assembly. The mission understands that the draft law is being returned once again to government for assessment of its economic and budgetary impacts. The draft pension law continues to threaten fiscal sustainability and labor market flexibility, and its progress should be halted. The mission again urges the government to take much needed command of pension legislation initiatives by setting up a working group, with appropriate assistance from Kosovo's development partners, to draft a concept paper on pension reform. The draft health insurance law would be costly for the budget and enterprises without addressing the fundamental flaws in the health delivery system. There is broad consensus among stakeholders that the law should be returned to government for revision, pending a concept paper on a reform strategy for the sector. Against a backdrop of multiplying and uncoordinated plans for social programs (war martyrs, early retirement benefits to Trepca miners, pension claims of former contributors to the ex-Yugoslav pay-as-you-go scheme, separation benefits from the dissolution of the Kosovo Protection Corp, a draft unemployment law that would establish costly benefit schemes, and forgiveness of electricity bills for some social classes), the government urgently needs to develop a strategy for social benefits that is less prone to ad hoc decisions and is viable in Kosovo's social and economic circumstances.

11. **Energy sector reform, despite being a long-standing high priority for Kosovo, still needs to be defined.** Continued lack of reform progress in this area would endanger economic growth and have serious budgetary impacts. After receiving close to €500 million in donor assistance and substantial budgetary support since 2000, KEK's ability to supply electricity remains highly variable due to the dilapidated condition of generation and distribution. Subsidies of around 1¾ percent of GDP continue to be needed due largely to poor billing and collection rates, the lowest in the region at 42 percent of supplied power. In addition, slow progress in mining development threatens the near-term supply of lignite, and has in part contributed to delays on the Kosovo C project. The government needs urgently—in close consultation with the World Bank and other donors active in the sector—to decide

on a strategy and to take initial concrete steps both to demonstrate its resolve and to jump start the sector's development.

12. **Maintaining the soundness of the banking sector continues to be a high priority.** The independence of the Central Banking Authority of Kosovo (CBAK) remains an important priority of the authorities. The mission notes the commendable process by which a qualified Kosovar was recently appointed to head the CBAK. In appointing new members of the CBAK Board, the government is urged to continue to respect qualification and eligibility requirements set out in the CBAK regulation. In the immediate future, the authorities will need to be guided by international best practices in revising the CBAK regulation to refine its principal objectives, and to ensure its continued autonomy, accountability, and good governance. Also important is safeguarding the banking sector through proper supervision, including by developing risk-based supervision and continuing to improve stress-testing. Finally, the mission also recommends that the authorities avoid moving forward prematurely with certain initiatives, in particular the creation of a deposit insurance system, given the current structure of the banking sector and the absence of a viable emergency funding source.

13. **On the basis of the policy framework outlined above, the medium-term macroeconomic projections paint a picture of steady growth and improved competitiveness.** Real growth is projected to average five percent in 2008-11 compared to about 2 percent in 2001-07. Enhanced competitiveness, enabling import substitution and export growth, will prove crucial to restoring a more sustainable current account deficit, projected to decline from 34 percent in 2008 to 22 percent in 2011. Maintaining wage and price flexibility, in particular in the context of an expected donor withdrawal, will be important for holding inflation below levels in Kosovo's trading partners. Overall, the economy is projected to become more self-sustainable, supported by a high investment ratio of 30 percent of GDP and an improving domestic saving rate.

**14. The mission strongly urges the government to consider the recommendations elaborated in this aide-mémoire as it moves forward with finalization of a mid-year budget review and an updated MTEF 2008-11.** A summary of the mission's recommendations is reported in Table 2. Fund staff remain fully engaged and look forward to continuing the constructive dialogue that has marked the current mission. In concluding this aide-mémoire, the mission wishes to thank the authorities for their hospitality and the highly professional and open discussions that have taken place during the visit.

Table 1. Kosovo: Main Indicators, 2005-12

| | 2005 Est. | 2006 Est. | 2007 Est. | 2008 Proj. | 2009 Proj. | 2010 Proj. | 2011 Proj. | 2012 Proj. |
|---|---|---|---|---|---|---|---|---|
| **Real growth rates (in percent)** | | | | | | | | |
| GDP | 2.0 | 3.9 | 4.4 | 6.7 | 5.6 | 4.6 | 4.2 | 4.1 |
| Contribution of foreign assistance to GDP growth | -1.4 | -1.3 | -0.6 | 1.4 | 1.1 | -1.4 | -1.4 | -1.3 |
| Private sector disposable income | 4.5 | 2.4 | 2.4 | 8.5 | 5.0 | 5.5 | 4.7 | 5.0 |
| Private sector consumption | 8.0 | 4.2 | 5.4 | 3.8 | 3.9 | 3.6 | 3.6 | 3.6 |
| GDP per capita | 0.6 | 2.4 | 3.1 | 4.9 | 3.8 | 2.8 | 2.4 | 2.4 |
| Private consumption per capita | 6.5 | 3.0 | 4.2 | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 |
| **Price changes (in percent)** | | | | | | | | |
| CPI (annual average inflation) | -1.4 | 1.5 | 4.2 | 8.4 | 2.0 | 0.9 | 0.6 | 0.2 |
| Dec-on-Dec inflation | 0.7 | 2.0 | 10.4 | 2.5 | 2.4 | ... | ... | ... |
| GDP deflator | -1.7 | 0.2 | 3.4 | 4.8 | 2.1 | 1.6 | 1.1 | 0.7 |
| Real effective exchange rate (CPI-based; annual average change) | -5.0 | -2.8 | -0.1 | ... | ... | ... | ... | ... |
| Real effective exchange rate (CPI-based, end of period) | -5.5 | -1.3 | 3.6 | ... | ... | ... | ... | ... |
| **General government budget (in percent of GDP)** | | | | | | | | |
| Revenues | 21.1 | 23.0 | 26.9 | 23.2 | 22.2 | 22.1 | 22.3 | 22.3 |
| Expenditures | 24.2 | 20.5 | 19.6 | 23.9 | 23.0 | 22.5 | 22.1 | 21.6 |
| *Of which: Capital and net lending* | 5.1 | 3.5 | 2.9 | 6.5 | 6.8 | 7.3 | 7.6 | 7.8 |
| Current balance | 2.0 | 6.0 | 10.2 | 5.8 | 6.1 | 6.8 | 7.8 | 8.5 |
| Primary balance | -3.1 | 2.5 | 7.3 | -0.7 | -0.7 | -0.5 | 0.2 | 0.7 |
| Overall balance (including notional interest payments) | ... | ... | ... | -1.7 | -1.6 | -1.3 | -0.5 | 0.0 |
| **Savings/investment balances (in percent of GDP) 1/** | | | | | | | | |
| Domestic savings | -14.9 | -14.3 | -14.0 | -15.3 | -13.4 | -9.8 | -7.0 | -4.5 |
| Remittances | 9.2 | 11.6 | 12.9 | 11.7 | 10.9 | 12.0 | 13.1 | 14.2 |
| Net factor income | 1.3 | 1.4 | 2.0 | 1.0 | 1.1 | 1.2 | 1.3 | 1.5 |
| National savings | -4.4 | -1.2 | 0.9 | -2.6 | -1.5 | 3.4 | 7.4 | 11.1 |
| Investment | 21.4 | 23.0 | 27.2 | 30.9 | 28.9 | 29.8 | 29.5 | 29.6 |
| Current account | -25.7 | -24.3 | -26.3 | -33.5 | -30.3 | -26.4 | -22.1 | -18.5 |
| Foreign assistance 2/ | 12.3 | 10.3 | 8.9 | 9.2 | 9.4 | 7.4 | 5.9 | 4.7 |
| Current account balance (after foreign assistance) | -13.4 | -14.0 | -17.4 | -24.2 | -21.0 | -19.1 | -16.2 | -13.9 |
| **Main aggregates (in millions of euros)** | | | | | | | | |
| GDP /3 | 2,977 | 3,099 | 3,343 | 3,739 | 4,029 | 4,280 | 4,509 | 4,728 |
| GDP per capita (in euros) | 1,438 | 1,476 | 1,573 | 1,729 | 1,832 | 1,914 | 1,982 | 2,044 |
| GNDI per capita (in euros) | 1,589 | 1,668 | 1,806 | 1,949 | 2,052 | 2,166 | 2,268 | 2,364 |
| Workers' remittances 4/ | 274 | 359 | 431 | 438 | 439 | 514 | 590 | 670 |
| Foreign assistance 2/ | 403 | 355 | 340 | 386 | 418 | 361 | 312 | 264 |
| Direct contribution of foreign assistance to GDP | 179 | 171 | 170 | 185 | 187 | 166 | 147 | 128 |
| Population (in thousands) | 2,070 | 2,100 | 2,126 | 2,162 | 2,199 | 2,236 | 2,274 | 2,313 |

Source: Fund staff estimates.

1/ Savings/Investment balances of the entire economy, i.e., the domestic sector and the donor sector.
2/ Total foreign assistance excluding capital transfers.
3/ GDP has been increased in March 2008 based on the revision of private household consumption for 2004 to 2006 by about EUR750 million each year.
4/ Including pensions from abroad.

## Table 2: Key Recommendations from IMF Staff Visit (April 21-29, 2008)

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|---|---|
| **1. Fiscal Policy: 2008 Budget (Mid-Year Budget Review)** | |
| **Current Spending** | Reduce current primary spending by € 22 million. |
| **Capital Spending** | Revise the spending envelope to a level compatible with the government's capacity to implement effectively and efficiently the capital spending program.<br>Government approves the main short-term measures to reduce over-budgeting, as detailed in the 2007 MoEF Budget Department report and in the *Policy Note on Public Investment Management* (World Bank). |
| **Fiscal Reserves** | Establish a prudent level of bank balances. |
| **2. Medium-Term Fiscal Policy (Medium-Term Expenditure Framework)** | |
| **Current spending** | Increase current primary spending by 0.5 percent in real terms, in application of the fiscal rule (MTEF 2008-2010, Section 1.2 on *The Policy Framework*, page 3). |
| **Capital spending** | Increase prioritized capital spending in a manner consistent with needed improvements in ministries' planning and implementation capacity.<br>Government approves the medium-term measures to reduce over-budgeting detailed in the 2007 MoEF Budget Department report and in the *Policy Note on Public Investment Management* (World Bank). These would include: separate allocations for project preparation and execution; revise Schedule IV to include total estimated cost of each project and their yearly phasing, a clear breakdown of the capital and current cost component of projects, and the recurrent cost implications of each project in future years. |
| **Fiscal Reserves** | Maintain a prudent level of bank balances. |
| **Tax Policy and Administration** | Reduce the corporate income tax rate and offset revenue losses via an increase of the excise tax on tobacco.<br>Revise the Tax Administration Strategic Reform Plan with a view to increasing its focus on the basic strategic objectives. |
| **3. Structural Reforms** | |
| **Social Policies and Spending** | Refrain from drafting any law that would increase labor costs without careful analysis of its impact on economic competitiveness.<br>Develop a concept paper (White Paper) on Pension Reform and incorporate its findings and recommendations into a new draft of a Pension Law.<br>Develop a Health Care and Financing Reform Paper and incorporate its findings and recommendations into a new draft of the Health Care and Financing Law. |
| **Civil Service Reform** | Change the mission of the Ministry of Public Services (MoPS) to focus on the delivery of public administration and civil service *reform*.<br>Establish the Statistical Institute of Kosovo's independence from the MoPS via legislation. |
| **General** | Establish an inter-ministerial and stakeholder working group to develop strategic objectives and key policy decisions of new laws before legislation with important economic and budgetary implications is drafted.<br>Enforce qualification and ineligibility requirements for key public sector posts. |
| **4. Financial Sector** | |
| **Central Banking** | Develop a central banking law ensuring its independence and autonomy, accountability, and good governance. |
| **Other** | Avoid the introduction of the Deposit Insurance System at this juncture. |