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# **Tax Reform in Emerging Transition: Is Kosovo's Government and NGOs Mathematical Economics Rational?**

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## ***Abstract***

*Tax reform in small emerging democracies is difficult to measure what effects is likely to produce due to countries' aggregate political and economic vulnerabilities. If both are taken as remaining relatively stable, then it is easier to discuss what impact the reform introduced may have in the economy and her stakeholders. In absence of a monetary policy, the Government of Kosovo in mid-2008 adopted the changes in tax rates taking effect from January 2009, with the aim to foster economic growth and improve business competitiveness at least in the regional market of the Balkans. This article critically assesses the proposed and approved changes by the Government that were in line with the proposals made by business community Non-governmental Organizations (NGOs), and concludes that this tax reform is not well thought-out and properly analyzed to expect the benefits for which it was too optimistically hoped for, especially in relation to key stakeholders such as the Government's budget, business development, and consumers.*

**Keywords:** Kosovo, Ministry of Economy and Finance, tax reform, business associations, value added tax.

**JEL Classification:** D31, H21, J31, P46.

## **Proposed and approved tax rate changes**

For a long time, a number of NGOs and the overwhelming majority of businesses had identified tax rates in place as the main barrier to Kosovo's economic growth. They considered lowering of tax rates as indispensable towards business development and improving competitiveness. Many proposals by individual NGOs, namely by the organizations defending the interests of business community, were addressed to the United Nations Interim Administration in Kosovo (UNMIK) and the Government of Kosovo. After remarks by the UNMIK that the NGOs should speak with one voice or have their demands jointly addressed, a more unified proposal was made. A document by Investment Promotion Agency of Kosovo (IPAK) entitled "A Proposal for Changing of Fiscal Policies: Investment Incentives" of July 04, 2008 proposed the following tax rate changes: Corporate Income Tax (CIT) to be halved from 20% to 10%, Personal Income Tax (PIT) with a progressive rate to be also halved from 20% to 10% for monthly incomes of over €450, Value Added Tax (VAT) to remain unchanged at a flat rate of 15%. The same document contained the proposals of main NGOs that represent and defend the interests of business community. The Alliance of Kosovan Businesses (AKB) had the following proposals for tax rates: CIT 8%, PIT 8%, VAT 3% and 17%; American Chamber of Commerce (AMCHAM) CIT 7%, PIT 7%, VAT 16%; and, Kosovo Chamber of Commerce (OEK) CIT 7%, PIT 7% and 12%, and VAT 15%.<sup>1</sup> All these three business associations were trying to justify that a sharp decline in the CIT rate would provide greater opportunities for investment in production sector, generate employment, increase tax revenues and the demand for consumption goods, shift away a large proportion of the population from social assistance, and substantially lower fiscal evasion. The NGOs came to a conclusion that such a tax reform would lead to a better general economic welfare.

On July 28, 2008 the Government appears to largely have complied with the demands of these NGOs and the IPAK when it approved the proposal of the Ministry of Economy and Finance (MEF) to change the rates in taxation scheme. The decision was expected to come into force on January 2009 and is now in full force. The MEF's approved proposal had the following tax rate changes: CIT to be halved or decreased from 20% to 10%; VAT will increase from 15% to 16%; excise tax to be increased for several items, among which, tobacco will be charged a new amount of €21 (up from €17) per kilogram; and PIT for salaries in excess of €450 to be lowered from 20% to 10%. Few weeks before this change was proposed and introduced, the three business community NGOs had the following proposals for the PIT rate: AKB 8%, AMCHAM 7%, OEK 7% and 12%.

Before discussing on potential impact and effects of all proposed changes in tax rates, it is worth referring to a report by the International Monetary Fund (IMF) about Kosovo prepared during April 21 – 29, 2008 or before the NGOs and the MEF presented their proposals. The IMF's report appreciated some improvements in fiscal discipline, though it accused the MEF for poor budget planning and weak expertise in spending it. Given Kosovo's limited taxation base, the MEF that the desire to decrease the CIT rate should not go under 15% due to implications it can have for budget revenues. The most serious objection was addressed to insufficient efficiency of the Tax Administration of Kosovo (TAK) for which, urgent improvements were recommended. This sector of collecting tax revenues for Kosovo's budget, was advised to establish a comprehensive system of registering the taxpayers, files and payments. Without a substantial improvement in the presumably outdated IT system, any move to change the tax rates may be very little useful, if not at all. Kosovo's tax system was regarded as relatively good and simple compared to that of the countries in the region.<sup>2</sup> In general, concerns expressed were that without a sound strengthening of the TAK's management and efficiency, the existing taxation system as well as proposed changes, will

neither produce any impressive result nor will lower the very high share of informal sector of the economy for which, the business community NGOs and IPAK were convinced that only lower tax rates will significantly reduced it.

### **What the proposed and approved changes aim to achieve and where they can lead?**

It is not difficult to discuss about economics and make good proposals on how to achieve certain goals. Jokes about studying economics at the Pristina University perhaps nowhere were told by non-economists.<sup>3</sup> But to what extent the MEF *et al* proposals were and are in line with encouraging economic growth and welfare? To answer this question, it is crucial to consider one important fact; poverty in Kosovo is widespread. A recent report by the World Bank estimates that around 45% of Kosovo's population lives in poverty line, and close to that percentage is the unemployment rate.<sup>4</sup> These two indicators, however, should not be identified as synonymous despite that they may be strongly correlated. There are people who are employed but fall in the category of poverty due to their very low level of earnings, as there are also people who are jobless and do not belong to the group of those who live in poverty. The latter group may depend on others, e.g. remittances which in Kosovo, by different estimations vary from 10% to 15% of GDP. A further discussion between unemployment and poverty seems not to serve any useful purpose here. What is more relevant to remember is that close to half of Kosovo's population lives in poverty line. Their incomes are mostly spent on everyday consumption goods. Yet, spending the entire incomes in daily consumption may not be sufficient for 15% of the population estimated to live in extreme or food poverty. By increasing the VAT from 15% to 16%, consumption for the poor may become more expensive. The rise of VAT, excluding other factors, is likely to force businesses to raise the prices of consumption goods, the final burden of which will fall on consumers. To sum it up, the new VAT rate further deteriorates economic conditions of almost half of the population, plus

it may bring additional people into poverty line, *ceteris paribus*. The process of castling between the rise in VAT and fall in PIT that the Government thinks will keep sustainability or neutrality in budget revenues, is also not a carefully planned or smart policy.<sup>5</sup> The large number of population which is unemployed does not have regular incomes that the TAK would evidence in her deficient tax register system. What importance for state budget revenues will have the rise or fall in the PIT rate for the people who do not have formal earnings or are not registered with the PIT system? Or, the Government thought that this can be taken as a VAT in consumption?

Sharp decrease in the CIT rate without more detailed analysis is another mistake and hurried decision of the Government having potential implications for budget revenue sustainability. Corporations are entities that have more resources and incomes than the poor and the unemployed. It was constantly overemphasized that the CIT at 20% is very high, and as such, it puts Kosovo in a disadvantageous competitive position against neighboring countries to attract foreign investment. As a matter of fact, the CIT rate in Albania is 20%, FYR Macedonia 12%, Montenegro 9%, and Serbia 10%. However, VAT rate in Albania is 20%, FYR Macedonia 18%, Montenegro 17%, and Serbia 18%. In addition, these countries have other types of taxes that Kosovo has not yet introduced, such as social security contributions that vary from 9.6% in Montenegro to 21.7% in Albania, then, property transfer tax, and so on.<sup>6</sup> The problem is not with higher or lower rate of taxes alone to decide for investors to invest in Kosovo or elsewhere. Foreign investors, apart from the CIT, pay other taxes which, in the neighboring countries appear to be higher. True, lower tax rates are a significant incentive to attract investors, though many studies for transition economies have indicated that this makes sense only if a considerable number of other supportive measures are in place.<sup>7</sup> Also, it is not rational to assume or take it as a clear cut that a sharp reduction in the CIT rate will make foreign investors to invest more or the part that they were eligible to pay to the state under the previous tax rates. It may happen

that they transfer their entire profit, and they are free to do so under the provisions to expatriate the profit, to their accounts abroad as it happened in Albania with pyramid schemes that brought about the collapse of the state. If the state collects more taxes from corporations, then it can invest the same in public goods or use it alternatively in projects of general welfare, the effect of which will obviously be observed. The shortcomings in the case under consideration, rely on well grounded and justified remarks for the TAK and the MEF in planning, managing and spending the budget. It has been reported and frequently made public in the media that many foreign companies operating in Kosovo have over €40 million unpaid taxes. There are foreign investors as well as domestic businesses that do not pay taxes. All were released from fines and penalties for hiding taxes by a decision of the MEF, just after the new tax rates were approved. The tax amnesty was applicable until 2009. How much further the Government wants to encourage them? To think that halving the tax rate makes the taxpayer honest that s/he will voluntarily come to pay, is wrong. Even if the CIT was to be reduced to 5%, the taxpayer will never pay whenever it has the opportunity to do so. Collecting taxes is not a desire or incentive on the side of entities eligible to pay – it is an obligation enforced and executed by the state. A popular proverb in the United States says: “If someone has died while being asleep, s/he probably has been dreaming about being prosecuted and punished by the state authorities for not paying taxes”. But the Government of Kosovo does not have difficulties in making the budget ends meet. The grave concern is with the way how the budget is spent and not used. As of 2007, the cumulative budget surplus was around 40% of total budget of the same year. Collected but not spent revenues left many deficiencies in providing public goods and services.

The Government takes the problem of reforming the tax system as a basic concept from the textbooks of economics and thinks it can work as it is written there. In the Government’s view, a decline in the CIT rate should encourage or bring foreign investors in who would invest and employ more

people, then reinvest the profit, employ additional people, and pay more taxes to the state that would subsequently cause budget revenues to rise. All these were probably to result in higher economic growth rate and better welfare. This chain effect may only work under the assumption if other factors are taken as constant, which in Kosovo, more than in any other European country, are less likely to remain.

What is expected to happen from the Government's new tax rates or castling between the VAT and the CIT is more or less known. This system aims at further increasing of income differences between the very few rich by making them richer, and the very large proportion or almost half of the population in poverty even poorer. The rise in income differences is a significant limitation factor in economic growth and development in transition economies.<sup>8</sup> The problem becomes more severe for those economies facing massive unemployment rate and widespread poverty such as Kosovo. The Government seems not to have properly calculated as what it wants to achieve in a nascent independent country at the time when it needs more resources to finance her expenditures, provide a better environment for businesses and cope with ongoing deterioration of economic conditions of the population, whose very low purchasing power constrains business development and growth. Economic growth rate estimated at 3% in 2008 was generally considered too small for inroads to change the current socio-economic situation. The Government's projected economic growth rate with unreliable data at 6% for 2009 has been moderately called by many economists as too optimistic, and in extreme form as a political propaganda. The politicians too often fail to understand that economy is the biggest politics for the state. It appears that the Government is not interested to make the state stronger with the tax changes it made. These changes to some extent are not castling but twaddling scheme.



## **MEF and the TAK continue to misinform taxpayers**

The MEF and its department of tax revenue collection – the TAK never wanted to correct a technical error and wrong information they were and still are transmitting to businesses and the population on the VAT rate of change. This (on purpose or who knows for what reason) mistake has persisted from the day when the MEF proposed the change and the Government approved it on July 28, then on December when the Assembly of Kosovo voted the changes in tax rates. The government authorities and high ranking officials reported and the media broadcasted the rise of VAT from 15% to 16% as an increase of only 1%. The same belief is present among them even today and may be in the future. As such, it was not correct then, neither is today nor it will ever be in the future. Here is a simple argument with elementary school mathematics that an increase in the rate of VAT from 15% to 16% or by one percentage point, is an increase precisely by 6.67%:  $1/15 \times 100 = 6.67$ . If an item before tax has a price of €100 and the consumer buys it in the shop increased by VAT at 15% or with a total price of €115, the buyer pays the seller and this one to the TAK the sum of €15 as VAT. From January 2009, the same item will cost: €100+16% VAT = €116. Instead of €15 that the buyer has been paying by the end of 2008, s/he will pay €16 or €1 more, which is 6.67% more.<sup>9</sup>

### Example:

If a book has a price of €20 and the reader buys it with VAT included at a rate of 15% or €3, then total price of the book is €23. The price of the same book from January 1, 2009 becomes: €20+16% VAT (or €3.20) = €23.20. Comparing the book's price with VAT in 2008 and 2009, the overall increase in price is €0.2 or 20 euro cent. Expressed in percentage terms, total price is  $0.2/23 \times 100 = 0.87\%$ . One may think that this is what the Government, MEF, TAK, NGOs, businesses and the citizens thought when being informed about a 1% increase in VAT. Let us remind once again: the Government did not introduce or adopt any price reform, but the change in the VAT rate. The

Government is only interested in the tax rate of those products which from 15% has increased to 16%. What was this increase when implemented in the case of the book just mentioned? Instead of €3, the TAK will now collect €3.20 as a VAT, or  $0.2/3 \times 100 = 6.67\%$  more. That is how much more the businesses will have to pay and how much more the TAK will collect. That is all about the “confusion” and irrational mathematics in calculating the rise in the VAT rate from 15% to 16%.

Following the new VAT rate, a likely immediate increase in prices by 0.87% may force businesses to price their products higher because they will now pay an increased tax by 6.67% to the state. Apart from this burden which will fall on consumers, businesses have two alternatives to cover the loss. One is to increase sales and reduce costs. The other would be to partially go in informal sector in order to survive competition in the market. Businesses typically strive to avoid paying or hide taxes, whereas the duty of tax authorities is to keep them in check and bring into formal sector. Kosovo has the highest share of informal sector in Europe. Given the “expertise” of the TAK, the MEF, their local advisors paid by USAID/Bearingpoint as contractors with no accountability whatsoever, it can be argued that in Kosovo there are more businesses paying taxes than the TAK deserves to be paid.

A logical question arises: why all these concerns for a technical error in calculation that the TAK continuously, on purpose or accidentally, is selling to the media, businesses and the citizens? There is only one simple answer – the VAT is the main tax revenue for Kosovo’s budget. In 2007, VAT accounted for 35% of all budget revenues. Yet, for 2009 it is projected to rise to 44%. The share of excise taxes in total budget revenues in 2007 was 21%. Although the MEF maintained that this indirect tax along with the VAT will cover the difference in revenues lost by lower rates of CIT and PIT, the contribution of the tax in question – the excise tax is projected to increase by only four percentage points to represent 25% of the 2009 Kosovo’s budget revenues.<sup>10</sup> Since the VAT is the largest contributor to the budget, it should be viewed

from another perspective that deserves more attention. Kosovo's trade deficit is amazingly large where, the value of exports in 2007 covered only 10% of total imports, a figure projected to slightly improve to around 14% by the end of 2009. According to official data, foodstuffs and beverages dominate total value of imported goods, in the overwhelming majority of which VAT was collected. Taken the VAT revenues in total, over 85% of them were collected on imported with the rest on goods and services produced at home.<sup>11</sup>

Last but not least remark. The Government after approving the rise of VAT, signed the memorandum with the United Nations Development Programme (UNDP) to reach the Millennium Goals, an event which was given a great publicity in the media, in particular to one of the eight Millennium Goals – *to halve the proportion of people living in poverty line by 2015*. Despite the rhetoric by the Government itself to be deeply committed to this and the rest of the Goals, the new tax reform adopted involving the rise of VAT is the first step off the track or backwards in the short to medium term as the year 2015 is not far.

## **Conclusions and remarks**

Tax reform in emerging democracies and transition economies often involves two scenarios preceding a faster consensus: first, poor expertise and practice in policy making characterized by knowledge constraints; and second, more professional and diversified thoughts enabling better decisions. The case of Kosovo's Government and the business community NGOs discussed in this article, is an example of the first scenario. When the thoughts are similar for complex issues such as tax reform without detailed analyses and profound justification for the final decision taken and put into operation, discrepancies emerging from actual results and those expected, to a large extent can be blamed on how policy reforms were prepared and adopted. Business associations do not seem to sufficiently defend the interests of the entities they represent, except talking about the problems and make superficial proposals

instead of more active lobbying to exercise pressure to the Government for their demands. It is not quite clear whose interests the Government is defending in economic affairs when it has conflicting objectives in tax policy reform. As the decision to rise the VAT rate was centralized and ignored concerns of small businesses and the consumers, so is the determination of few larger businesses with direct ties to the Government to lower the rates of CIT and PIT – to centralize the power in the hands of the few or a tiny small group interest by marginalizing and pushing into deeper poverty the army of the unemployed and the poor.

Tax reform in Kosovo is more difficult to be designed, implemented, monitored and measure their expected impacts. If the system has a limited number of taxes in place, a thorough and detailed investigation which tax rates to lower and/or increase is not an easy decision to be made when it requires a consensus between the players involved and affected. It is more preferable if the decision to reform is dependent on what attainable goals wants to reach with available resources. The goals should be distinguished from desires or emotional feelings and the likely effect what actual system in operation can have.

Changes in tax rates for a certain development direction are an easy task of the Government. However, there is one task still remaining a significant challenge for the Government itself and that is, improving the TAK's performance. Kosovo is in the process of becoming the newest member of the IMF and subsequently of the World Bank. The IMF's remarks addressed to the Government about urgent improvements in the TAK's efficiency were not ignored. And what improvements occurred since then until the tax reform entered into force nine months later? The TAK increased "efficiency" in another segments – it continued to misinform the taxpayers about the amount of money they have to pay after increasing the VAT rate from 15% to 16%. A change between percentages indicates ratios, not differences.

## Endnotes:

<sup>1</sup> IPAK (2008), A Proposal for Changing of Fiscal Policies: Investment Incentives, manuscript, July 04, 2008, Government of Kosovo, Pristina.

<sup>2</sup> International Monetary Fund – IMF (2008), Aide Memories of the IMF Staff Mission to Kosovo, April 21 to 29, 2008, Washington D.C.: IMF

<sup>3</sup> One of these is a fictional and bizarre one according to which: “a man was run over by the train, his body remained on the rail, whereas his head was sent to hospital. After two years, the body went to hospital, picked up the head and became more complete, then got the idea to go and finish his studies in economics!” in Western countries, it is a completely different perception about economics and society’s most important part – the economy.

<sup>4</sup> World Bank (2007), *Kosovo Poverty Assessment: Accelerating Inclusive Growth to Reduce Widespread Poverty*, Vol. 1, Report No. 39737, Poverty Reduction and Economic Management Unit of the World Bank, Washington D.C.: World Bank.

<sup>5</sup> Castling is a term in the game of chess to denote a special move between the king and either of the original rooks of the same color. It can be castling short when it involves the rook on the right, and castling long that moves the rook on the left.

<sup>6</sup> Available at: <http://www.doingbusiness.org/exploretopics/payingtaxes/>, accessed on December 25, 2008.

<sup>7</sup> To name some of them: geographical proximity to developed countries, political and economic stability, the state of infrastructure, methods of privatization, purchasing power of the population, trade openness, accession to the EU, institutions, rule of law, low labor costs, abundance of natural resources, political risk and uncertainty, and many more. See among others, Campos, N. F. and Kinoshita, Y. (2003), Why Does FDI Go Where it Goes? New Evidence from the Transition Economies, Working Paper No. 228, IMF, Washington D.C.; Bos, J. and van de Laar, M. (2004), Explaining Foreign Direct Investment in Central and Eastern Europe: An Extended Gravity Approach, Working Paper No. 8, De Nederlandsche Bank, Amsterdam; Brada, J. C., Kutan, A. M. and Yigit, T. M. (2004), The Effects of Transition and Political Instability On Foreign Direct Investment Inflows: Central Europe and the Balkans, Working Paper No. 729, the William Davidson Institute, University of Michigan; Carstensen, K. and Toubal, F. (2004). Foreign direct investment in Central and Eastern European countries: A Dynamic Panel Analysis, *Journal of Comparative Economics*, Vol. 32, No. 1, pp. 3–22.

<sup>8</sup> The studies confirming this trade off include a long list, few of which are: Milanovic, B. (1995), Poverty, Inequality, and Social Policy in Transition Economies, Policy Research Working Paper No. 1530, Policy Research Department, Washington D.C.: The World Bank; Barro, R. J. (2000), “Inequality and growth in a panel of countries”, *Journal of Economic Growth*, Vol. 5, No.1, pp. 5–32; Byung- Yeon, K. and Pirttilä, J. (2006), “Political Constraints and Economic Reform: Empirical Evidence from the Post-communist Transition in the 1990s”, *Journal of Comparative Economics*, Vol. 34, No. 3, pp. 446–466.; and Sukiassyan, G. (2007), “Inequality and Growth: what Does the Transition Economy Data Say?”, *Journal of Comparative Economics*, Vol. 35, No. 1, pp. 35-56.

<sup>9</sup> The motivation to give publicity this real change never reported or ignored by the authorities, came after a question asked to the Author of this article by a sole proprietor after the Government approved the rise in the VAT rate. “I have a small shop and I pay €1,000 on average for VAT per month. By this increase of 1% I will be paying an extra €10 from January 2009. That is not much but it is still an extra burden given that I hardly manage to keep this shop in business. What is your opinion?”, asked the sole proprietor. “In addition to that €10, you must pay another extra €57 per month. Tax authorities and your accountant must tell you that now and they probably will”, was the answer of the Author.

<sup>10</sup> MEF (2008), *Semiannual Macroeconomic Bulletin*, Issue 1, Macroeconomic Department, MEF, Government of Kosovo, Pristina.

<sup>11</sup> Ibid.