

# Economic and budgetary effects of fiscal reforms 2015



## Introduction

In March 10, 2014 Government of Kosovo (GoK) decided that from April 1, 2014 wages and salaries of public administration employees and compensation for pensioners and other social categories will increase by 25%. GoK's decision carried many problems with regard to management of public finance and effects on domestic economy. First, the increase of expenditures for salaries and wages had not been planned in Medium Term Framework 2014-2016 and this indicated macro financial instability.2 Second, the increase would decrease capital investment which is a more growth-friendly category of expense. Third, the increase of wages and salaries together with expenses for highway Prishtinë-Skopje are expected to increase budget deficit above fiscal rule.

In order to balance public expenditure increase with income, Internationally Monetary Fund (IMF) while concluding its visit in Kosovo in March 2015, suggested to the GoK that in addition to increase on excise taxes, it should also consider increasing Value Added Tax (VAT) which would significantly increase budgetary income.<sup>3</sup> On the 20th meeting of GoK, 24th of March 2015, exactly during IMF visit in Kosovo, GoK took a number of decisions with regard to fiscal changes. Among others, these decisions are about the approval of new draft laws of:

- a) Value Added Tax (VAT);
- b) Corporate Income Tax;
- c) Personal Income Tax; and
- d) changes about excise tax on cars, tobacco products, alcoholic drinks etc.4

The purpose of this analysis is to estimate the economic and budgetary effects of the abovementioned laws. Main findings of this

<sup>&</sup>lt;sup>1</sup> Government of Republic of Kosovo, Decision No. 01/176, 10 March 2014, Source: http://bit.ly/1BqCRr1

Ministry of Finance, Medium Term Framework 2014-2016, April 2013, Source: http://bit.ly/1FcgaYf

International Monetary Fund, Kosovo: Concluding Statement of the 2015 Article IV Mission, 30 March 2015, Source: <a href="http://bit.ly/1FccDJt">http://bit.ly/1FccDJt</a>

<sup>&</sup>lt;sup>4</sup> Government of Republic of Kosovo, Decision No. 02/20, Decision No. 03/20 and 04/20, 24 March 2015, Source: http://bit.ly/1bdrmMy



analysis suggest that small and new businesses may be negatively affected due to decrease of threshold of VAT. On the other hand, VAT removal on production machinery and raw materials will decrease production cost and potentially increase investment on production sector. Increase of VAT in most of the products from 16 to 18%, holding other factors constant, is expected to increase consumer basket prices and increase budgetary income. Last, based on previous changes on corporate income tax, the tax on paid or credited dividend may not affect investment level by the private sector.

# 2. Draft law on Value Added Tax

Out of all of the draft laws, the Draft Law on VAT will undergo most changes.<sup>5</sup> First, according to article 6 of the Draft law on VAT, the threshold for VAT decreases from 50,000 Euro, as it is in the current Law, to 30,000 euro. As such, every business that has a turnover greater than 30,000 euro per year will be obliged to register for VAT and pay for the amount in excess of the threshold. Kosovo's budget will benefit from this decrease of the threshold since a greater number of businesses will have to pay VAT. However, this fiscal policy will be burdensome for new businesses, which need fiscal incentives and which have potential to create new jobs.

According to Tax Administration of Kosovo (TAK), the number of businesses that have paid VAT in 2014 has been 14,560. The decision to lower the threshold will increase this number for 1,800.6

Table. 1. The number of businesses that pay VAT before and after the decrease in threshold

						Projected
Year	2010	2011	2012	2013	2014	2015
No. of						
businesses	8,834	9,605	10,556	12,327	14,560	16,360

Another change which is expected to have an opposite effect to that of the decrease in the threshold is the VAT exemption of the following categories of products:

- a) production lines and machinery used in production process;
- b) raw material used in the production process; and

<sup>&</sup>lt;sup>5</sup> Draft Law on Value Added Tax, 20 March 2015, Source: <a href="http://bit.ly/1dsztq5">http://bit.ly/1dsztq5</a>

<sup>&</sup>lt;sup>6</sup> TAK hasn't provided any financial evaluations or data that could be used in delivering an evaluation



### c) IT equipment.

This fiscal policy is expected to create incentives for investments in production and at the same time improve the liquidity of businesses. According to an evaluation by the Ministry of Finances, it will be about 27.6% less costly for businesses to initiate production processes.<sup>7</sup> On the other hand, as for the effects on the budget, the revenues from chapter 84 and 85 will be mostly lowered. The VAT exemption for every product will be carried out by a committee, which is expected to be created based on a Administrative Directive.8 The new law is anticipated to cut procedural obligations as it will no longer require a certificate for import and export in TAK.

The change which is expected to have significant effects in the consumer's basket and in Kosovo's budget revenues is VAT progressiveness. Comparing with the previous law, where the VAT rate was 16% for most of the products, in the new draft law the rate is expected to be raised to 18%, which amounts to an increase of 13%. An equally important change is the decreased rate of VAT to 8% in several product categories, such as:

- a) food (rice, flour, bread, milk, eggs etc.);
- b) public services (electricity, waste collection, heat); and
- c) pills and medical instruments

In order to measure the effect of these fiscal changes in consumer's basket, GAP Institute has taken prices per unit in February 2015 of a number of representative articles and services published by Kosovo Agency of Statistics (KAS).

Based on weight used by KAS, these products comprise around 33% of the consumer's basket. Accurate measures of the effect of VAT in prices are difficult to obtain, especially considering the fact that the decrease in the price of electricity and VAT removal on production inputs may lead to a decrease in prices of domestic products; however, holding everything else constant, consumer's basket will experience an increase in prices up to 1%.

The price of bread, as a product that makes up for 2.75% of the consumer's basket, is expected to decrease for 2 cent, the price of milk for 6 cent, the price of oil for 8 cent, the price of 30 eggs for 17 cent, whereas electricity's price will decrease for 0.5 cent per

<sup>&</sup>lt;sup>7</sup> Ministry of Finance, Interview with Semra Turbedar and Berat Havolli, 24 April 2015.

<sup>&</sup>lt;sup>8</sup> Ibid



kilowatt hour. If a family spends on average around 500 kilowatt hours of electricity per month, then it will save around 2.5 euro each month from the reduction in VAT.<sup>9</sup>

On the other hand, the price of meat as an important product is expected to increase for 9 cent per kilogram. Other food products that are expected to become more expensive are potatoes, tomatoes, and beans. Likewise, the prices of other products such as coffee, tea, sugar will also increase. Fuel derivatives which comprise around 3% of the consumer's basket (a larger portion than bread) will experience an increase in prices for 2 cent per liter. Lastly, the prices of luxury goods, such as cigarettes and beer, will experience a double increase due to the excise tax increase for these products. For instance, if a citizen up to now has paid 24 cent as excise tax for a liter of beer, from now on s/he will pay 39 cent which is an increase of 60%. Whereas, for a package of cigarettes s/he will pay 6 cent more from the increase in the excise tax and 4 cent more from the increase in VAT (in total, the price will increase for 10 cent). 10

Table 1. Effects on prices of VAT changes

Items	Unit of Measure	February Prices 2015 (old VAT)	Prices with New VAT	Difference
Rice	1 kg	1.31	1.22	-0.09
Wheat flour	1 kg	0.39	0.36	-0.03
White bread	500 gr	0.35	0.33	-0.02
Boneless cattle	1 kg	6.39	6.5	0.11
Beef meat	1 kg	7.24	7.36	0.12
Chicken meat	1 kg	2.61	2.66	0.04
Milk (carton)	1 lit	0.92	0.86	-0.06
Yoghurt	1 lit	0.92	0.86	-0.06
Eggs	30 pieces	2.48	2.31	-0.17
Oil	1 lit	1.09	1.01	-0.08
Bananas	1 kg	1.2	1.22	0.02
Potatoes	1 kg	0.35	0.36	0.01
Tomatoes	1 kg	1.41	1.43	0.02
Beans	1 kg	2.7	2.75	0.05
Non-spicy	1 kg	1.83	1.86	0.03
Sugar	1 kg	0.64	0.65	0.01

<sup>&</sup>lt;sup>9</sup> Ministry of Economic Development, Annual Energy Balance Of Republic Of Kosovo For The Year 2015, December 2014, Source: <a href="http://bit.ly/17YNZn3">http://bit.ly/17YNZn3</a>

<sup>&</sup>lt;sup>10</sup> Assumption: A package of cigarettes has 20 cigarettes and has the price of Marlboro brand

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Ground coffee	1 kg	7.07	7.19	0.12
Tea	1 kg	5.32	5.41	0.09
Mineral Water	1.5 lit	0.32	0.33	0.01
Beer	0.5 lit	0.54	0.55	0.01
Cigarettes - Ronhill	1 pack	1.29	1.31	0.02
Cigarettes - Marlboro	1 pack	2.25	2.29	0.04
Electricity	1 kwh	0.074	0.07	-0.01
Firewood	1 m <sup>3</sup>	38.09	38.75	0.66
Petrol	1 lit	1	1.02	0.02
Diesel	1 lit	1	1.02	0.02

As ATK does not possess any database which separates VAT revenues based on items, calculating the effects of lower VAT on revenues of TAK is not possible. 11 However, based on the data sent by the Customs and based on the revenues of the year 2014, the net effect of the reduction of the VAT for some items on Customs' revenues is expected to be 5 million euro. 12 The categories of the items that are expected to have the highest effect on the reduction of the revenues are: oils and fats for cooking, milk, flour, wheat, corn etc.

On the other hand, the increase in the VAT on all other products from 16 to 18% is expected to increase Customs revenues by circa 51 million euro, plus 4.2 million euro in revenues because of the VAT on medical supplies by 8%. <sup>13</sup> In addition, the collected VAT by TAK is expected to increase by around 17 million euro.

# Other Fiscal Changes

During the abovementioned meeting of March 23, 2015, the GoK also approved the amendments on the Law on Corporate Income Tax (CIT) and the Law on Personal Income Tax (PIT).

Since January 2009, the tax rate on corporate income in Kosovo has decreased from 20% to 10%. A year later, the GoK by the new law

<sup>&</sup>lt;sup>11</sup> To carry out the evaluation, GAP Institute has sent formal requests to: Tax Administration of Kosovo and Kosovo Customs

<sup>&</sup>lt;sup>12</sup> The exact number for all commodity codes cannot be calculated, since the Ministry of Finance did not specify the commodity codes that benefit from the reduction of the VAT  $^{13}$  GAP Institute projection based on the Customs' revenues from VAT in the year 2014

<sup>&</sup>lt;sup>14</sup> Law no. 03/L-113 On Corporate Income Tax, 18 December 2008, Source:



on CIT has removed the tax on dividends paid from resident and non-resident taxpayers, while the rate tax rate on corporate income remained 10%.<sup>15</sup>

In the new draft law on CIT, the GoK has restored the 10% tax on dividends, while the tax rate on corporate income has remained unchanged from the law of 2010 (10%).<sup>16</sup> It is important to note that tax on dividend is withheld at the time of payment or crediting. So in case that shareholder decides to reinvest the dividend, the legal entity is exempt from paying the tax. In principle, this increases the capital investments and generates employment. But a study conducted by UNDP, which surveyed four biggest producing industries, has found that the decrease in CIT from 20 to 10% has not had any effect on the increase of the said industries.<sup>17</sup> Therefore, it is not expected that this change in the law to have an effect on increasing investments by companies working in Kosovo.

Even though the tax on dividend might not have any effect on businesses, this tax ensures equality between people whose income is based on salaries from which taxes are withheld based on the law on Personal Income Tax and those who generate revenues from dividends.<sup>18</sup>

The effect this change in law will have on the budget has not been analyzed, because according to the TAK this effect is dependent on many factors: the number of shareholders that work in Kosovo, the value of the shares, the level of reinvestments etc.<sup>19</sup>

The Law on Personal Income Tax (PIT) does not have any substantial changes regarding the tax rate. Some of the main amendments to the law are as follows:

- a) the maximum of training expenses exempted from the tax has increased from one thousand to three thousand Euros, if that training is done abroad;
- b) the allowed representation expenses have decreased from two to one percent;

#### http://bit.ly/1FdWDqm

Law no. 03/L-162 On Corporate Income Tax, Chapter 22, Article 7, 01 February 2010, Source: <a href="http://bit.ly/1AHsNc0">http://bit.ly/1AHsNc0</a>

Law no. 03/L-162 On Corporate Income Tax, Chapter 22, Article 7, 01 February 2010, Source: <a href="http://bit.ly/1AHsNcO">http://bit.ly/1AHsNcO</a>

<sup>17</sup> UNDP Impact of Tax Regime on Four Manufacturing Sectors, November 2014, Source: <a href="http://bit.ly/1QpOozr">http://bit.ly/1QpOozr</a>

<sup>&</sup>lt;sup>18</sup> Ministry of Finances, Interview with Semra Turbedar and Berat Havolli, April 24 2015

<sup>&</sup>lt;sup>19</sup> Tax Administration of Kosovo, Reply by email, 06 May 2015



c) the allowed charity expenses have increased to 10% etc.

# 4. Conclusions and recommendations

Based on the findings of this policy brief, the reduction of the VAT threshold from 50,000 to 30,000 euro is expected to encumber small businesses, which generate jobs at a bigger scale. On the other hand, the elimination of the VAT on the production lines and inputs may promote investment in production and reduce the prices of domestic products in the domestic as well as international market. Despite the positive effects on the reduction of prices of some products, the progressiveness of the VAT is expected to increase the living cost of the people of Kosovo. This increase of the living cost is going to be reflected in higher budgetary revenues. However, with the purpose of balancing the budgetary needs, economic development, and living costs, GAP institute recommends:

- The VAT threshold needs to be specified in agreement with the incentives for creating new jobs, and for this reason it needs to return to 50,000 euro;
- In order to avoid inflation, the category of products benefiting from the cut in VAT needs to be expanded with products such as: potatoes, tomatoes, beans etc.;
- In order to avoid inflation of the consumption basket, the VAT for inputs needs to decrease from 8 to 5%;
- Taking into account income level and lack of health insurance among citizens, medicaments need to be exempt from the VAT like it was before;
- Given that the reduction of the corporate tax did not have an
  effect on increasing the business activity, and with the
  purpose of increasing and diversifying budgetary revenues,
  the Ministry of Finance needs to consider possibilities of
  increasing the corporate income tax.





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