# ROLE OF PUBLIC FINANCES AS STABILIZING COMPONENTS FOR SUSTAINABLE BUDGET IN THE REPUBLIC OF KOSOVO

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**Abstract:** Within this work, efforts have been made to explore, analyze and address the role and importance of public finances, their functioning in the state, with a special emphasis in the Republic of Kosovo.
Upon the end of the war in June 1999, the Republic of Kosovo has faced serious challenges, which it had to go through. Following the war, from 1999 and 2008, Kosovo was administered by UNMIK. With the declaration of independence in 2008, the Republic of Kosovo has taken over all the responsibilities in the management of public finances where the activity of the state, in connection to the collection of public revenues and the coverage of public expenditures are guided and managed by the Ministry of Finance within the Government of State. According to the Legislation of the Republic of Kosovo, accountability in the management of public money consists of a chain of participants, with each of them being responsible for the achievement of certain goals, and each is accountable to the highest level authority for achieving these goals. The highest authority in this hierarchy is held by the citizens, who are represented by elected members of the Assembly and the municipal governments. The Government, elected by the Assembly, then assigns responsibilities to the ministers for implementing government policies. The latter, under the scope provided for by the applicable rules, further assign powers and responsibilities to senior managers of budget organizations and other users of the public property in accordance with regulations, policies and administrative arrangements.
Based on the Constitution, laws and other legal provisions, the state carries out a series of duties and functions. In order to carry out these tasks, the state needs certain funds where the realization of the funds is intended to be oriented towards the voluntary fulfillment of the lowest cost obligations.
**Keywords:** Public Expenses, Public Expenditure, Budget, Taxes, Procurement.

## 1. INTRODUCTION

Public Finance is nothing more than a sophisticated discussion of the relationship between the individual and the state. There is no better school of training than public finance. This is a quoted statement by the former Czech Prime Minister, Vaclav Klaus.

The issue of public finances is a concern of all governments of different states internationally, regardless of the political, economic system and level or degree of economic development.

With the end of the war in June 1999, The Republic of Kosovo has faced serious challenges that it had to go through. After the war, between 1999 and 2008, Kosovo was administered by UNMIK. With the Declaration of independence in 2008, the Republic of Kosovo assumed all the responsibilities in the management of public finances where the activity of the state regarding the collection of public revenues and the coverage of public expenditures are led and managed by the Ministry of Finance under the State Government.

According to the Legislation of the Republic of Kosovo, accountability in public money management consists of a chain of participants, where each one is responsible for achieving certain goals, and each one is accountable to the highest level authority for achieving these goals. The highest authority in this hierarchy is retained by citizens who are represented by the elected members of the parliament and municipal governments. The Government elected by the Assembly then assigns responsibilities to ministers to implement government policies, who further, within the scope permitted by applicable rules, assign powers and responsibilities, through regulations, policies and administrative arrangements, to senior managers of budget organizations and to other users of public property.

Therefore, the main purpose of this paper is to address how the Government, through public finances, sets rules for collecting public revenues on one hand, and spending of public funds on the other hand for the purpose of increasing public goods and welfare for a better life of its citizens.

The following is achieved through three major functions of Public Finances: the optimal allocation of the sources of funds, which is the key function; redistribution of national income between the sectors of economy, households and businesses; state intervention through economic policies to ensure economic sustainability and stability. The three functions are simultaneously fulfilled and cannot be separated from each other.

The methods applied in this study have general and particular character content, while the research has been has been dealt with in two directions:

1) In general terms, issues related to the meaning, development, functioning, characteristics and role of public finances have been dealt with in the functioning and development of the state, and

2) In concrete terms, financial developments in Kosovo have been reviewed. The study on public expenditures, the way of spending public money, is of crucial importance in this paper.

## 2. PROBLEM FORMULATION AND RESEARCH

The fact that the public goods are provided by the Government to all of its citizens implies that the consumption of a public service, public goods can be used by all citizens at no additional cost.

Provided that citizens live in a society, they are obliged to accept and comply with common rules while respecting coexistence, rules, and the state. This requires the establishment and functioning of the rule of law institutions, control of the institutions for them to be accountable to the citizens for public goods that are publicly received, considering the fact that all citizens have to be equal before the public goods.

The fact that there is no state without a budget and that there is no budget without an adequate system of revenue and allocation, spending of funds to meet the public needs, was the main and reasonable argument for addressing this issue in this book, always considering that the knowledge presented herein can serve not only for the recognition of a period in our development, which cannot be forgotten since it has left its legacy, but it can serve rather in practice for the future development of the society with a view to the advancement of an adequate public finance system with a special emphasis on the collection of public revenues and public expenditures all in the function of the country's economic and social development.

The research question presented is: How will the Government, with a budget management, have an impact in increasing goods, public services for the citizens of Kosovo through Public Finances, respectively public revenues and public expenditures.

## 3. RESEARCH METHODOLOGY

The theoretical study of this study draws on some research in the field of financial industry that addresses and analyzes, with particular emphasis, the issue of public revenues, public expenditures, public procurement, different ways of this field, applicable regulations for governing this field.

In the course of this research I have used the method of deduction as well as methods of comparative analysis. I have used notes and publications from the official websites of the IMF, Macroeconomic and Fiscal Policy Department, MoF, Kosovo Agency of Statistics, Riinvest Institute, KCC and other relevant institutions.

Analytical methods for assessing the efficiency of public expenditures, almost the same methods and techniques are applied in the estimation of public expenditure as applied to other areas of economic analysis, such as the selection method (cost-benefit analysis and cost effectiveness analysis), the optimization method (linear programming method and other research methods). Due to the specific problems associated with public spending, the most appropriate methods for assessing public spending are the Cost-Benefit Method and the Cost-Effectiveness Method.

Unlike the cost-benefit analysis, the cost-effectiveness analysis comparison aims to determine alternative programs that ensure the achievement of a previously defined goal or set of goals that are mutually complementary, at a lower cost. According to this analysis, the goals are not expressed and it does not mean that they should be expressed in monetary terms. The problem of choosing alternative programs can be divided into three ways: a) to choose a program that allows the achievement of the goal or certain set of goals at the lowest cost possible; b) to choose a program which, within the limits of financial resources enables the achievement of the goal or certain set of goals to the greatest extent possible, and c) to choose the program which provides the most favorable ratio between the achievement of the goal or certain goals and committed funds.

## 4. PUBLIC REVENUES

In order to accomplish many tasks and measures that the state is obliged to perform under the constitution, other laws and provisions, there is a need for certain revenues. The funds by which the state meets its state and social needs within its competence are called public revenues. The state revenue system of developed countries with roughly the same incomes per capita differ considerably depending on whether developed countries are more or less oriented on foreign trade exchange, on what the organic composition of their capital is etc. Oil-rich countries revenue systems differ from oil-importing countries. There are three major functions of Public Finances: 1) The optimal allocation of the sources of funds, which is the key function; 2) redistribution of national income between households and businesses as well as between the sectors of economy; 3) Sustainability - state intervention through economic policies when there is an economic imbalance.

### 4.1 FISCAL POLICY INSTRUMENTS THAT THE GOVERNMENT CAN USE TO STIMULATE ECONOMIC GROWTH

The government can lower taxes without reducing spending on government programs, or may increase government spending by keeping taxes unchanged, or may use the increase of government spending and tax reductions at the same time. When the government reduces taxes, individuals and firms have more incomes available and on that basis, they increase spending on consumption and investment that foster growth in production and the economy enters on the growth phase.

Fiscal policy instruments can also be used to lower the high inflation that is a concern for the economy. For example, during a period of rapid economic growth, prices could rise at a very high rate. To bring high inflation to an end or to lower its rate to acceptable levels, the government may decide to use fiscal policy instruments such as tax increases, government spending cuts, or both.

*Fiscal policy is an important part of a country's economic policy, as it includes the policy of securing budget revenues, primarily through collection of taxes, budget spending policy, and public debt management policy*.

Fiscal policy is also used to promote economic security. The distribution of income in a market economy relies on the resources and productivity of individuals. Those with more resources or more productive resources receive more income because they produce more than those who do not own resources or are less productive and receive much less. In this case, it is the government's duty to intervene through various programs to ensure a minimum standard of living for each. The Government drafts two types of programs in the framework of budget drafting.

*First*, programs that increase incomes and standard of living, such as social security programs, unemployment payments, social assistance, etc., and

*Secondly*, programs that eliminate causes of poverty and economic shortages faced by different individuals.

Both of these programs are aimed at helping people by giving them the opportunity of re-training, training and qualification to boost productivity.

**4.2 KOSOVO TAX SYSTEM**

The tax system of a country is a set of laws, rules, norms, procedures and methodologies that become valid from a whole set of institutions and the tax administration.

When it comes to building a new tax system in Kosovo, the created circumstances imposed the commencement of building a simple tax system. The devastated economic and public infrastructure, the demolished businesses and the difficult social situation of the population that Kosovo inherited in the post-war period did not provide realistic opportunities for a rapid building of internal governance structures and consolidation of the economic base and self-financing of budgetary needs. Considering this, during the first post-war phase, the UNMIK mission mainly focused on external donations as the only sources available to finance budgetary needs for the functioning of the public administration, public sectors, reconstruction and maintenance of infrastructure and public services. When it comes to building a new tax system in Kosovo, the circumstances imposed the commencement of building a simple tax system.

It was initially based on sales tax, at a rate of 15%, which was replaced by VAT from 1 July 2001, which also has a rate of 15% and applies to all imports and domestic products to firms with a gross turnover of over € 100,000; presumptive tax at a rate of 3% in gross turnover; service tax at a rate of 10% and customs tax at a rate of 10%. Excises are also applied to various goods, with a prevalence of fuel, cigarettes, alcoholic beverages, refreshments etc. Implementation of the profit tax started on 1 April 2002, while the tax on wages and pension contributions started on 1 April 2002.

TAK's mission is to raise the highest level of voluntary compliance in accordance with the applicable tax legislation, as well as the provision of professional, transparent and effective services to taxpayers.

TAK is responsible for the collection of central government taxes, which includes:

- Value Added Tax (VAT);
- Personal Income Tax;
- Corporate Income Tax;
- Taxes withheld at source;
- Pension Contributions;
- Issuing licences for games of chance

**Requirements for meeting tax obligations**

Persons that perform economic activity, based on tax legislation, are obliged to:

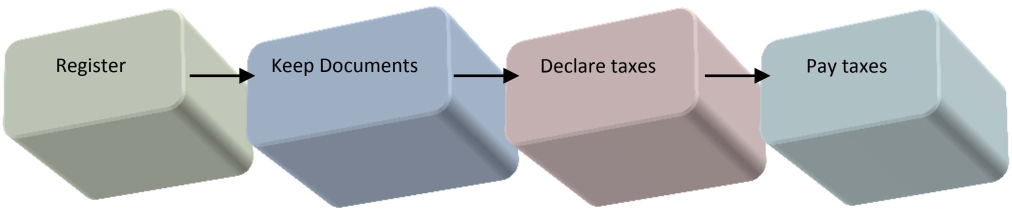


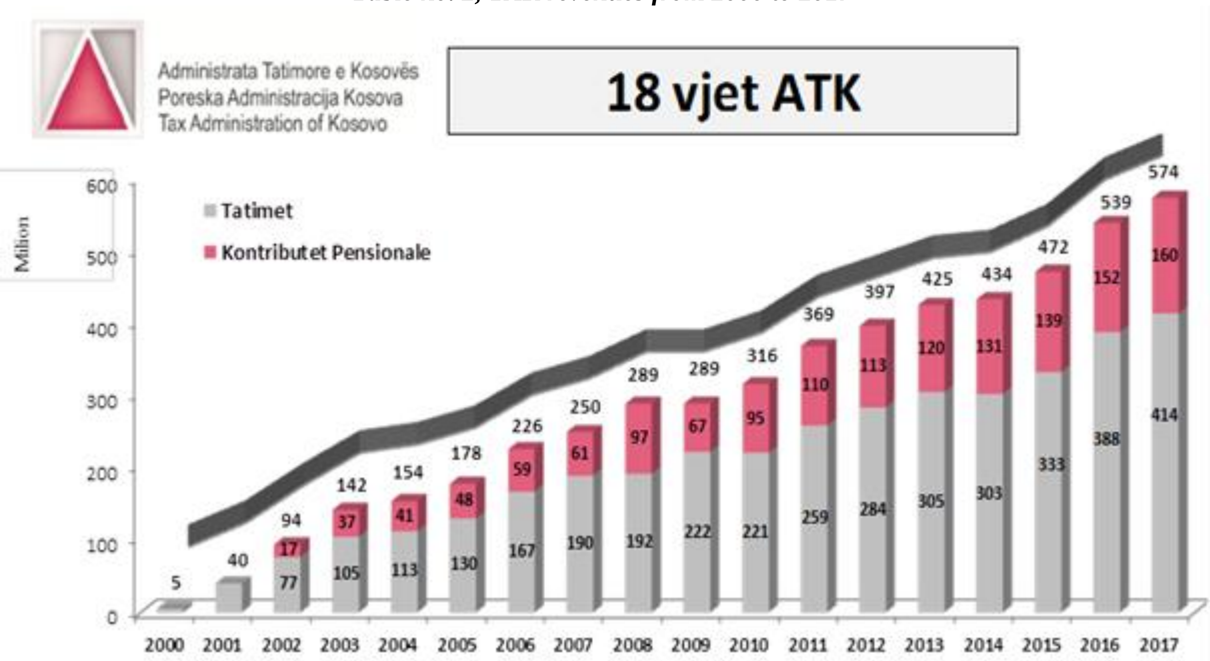

***Figure 1, Requirements for meeting tax obligations***

***Table no. 1, Income by type of tax in TAK***

| Nr. | Lloji i tatimit | Realizimi | | | % e pjesëmarrjes në total | Plani | | % e pjesëmarrjes | Krahasimi | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | 2014 | 2015 | 2016 | | 2016 Rishikim | 2017 | | | |
| | 1 | 2 | 3 | 4 | 5=4/Total | 6 | 7 | 8=7/Total | 9=7/4 | 10=7/6 |
| 1 | Tatimi mbi vlerën e shtuar | 136,939,023 | 153,877,977 | 180,363,400 | 46.7% | 180,324,542 | 193,875,000 | 46.2% | 107.5% | 107.5% |
| 2 | Tatimi i mbajtur në burim | 67,857,126 | 71,848,878 | 80,327,270 | 20.8% | 81,303,159 | 87,876,000 | 20.9% | 109.4% | 108.1% |
| 3 | Tatimi për Bizneset individuale | 33,080,529 | 31,914,269 | 33,161,625 | 8.6% | 38,091,291 | 36,791,000 | 8.8% | 110.9% | 96.6% |
| 4 | Qira ,loto, drejt. Pronsore | 10,499,342 | 13,206,038 | 11,254,117 | 2.9% | 15,283,722 | 12,201,000 | 2.9% | 108.4% | 79.8% |
| 5 | Tatimi në Korporata | 55,318,971 | 61,433,888 | 81,278,873 | 21.0% | 69,997,286 | 89,257,000 | 21.3% | 109.8% | 127.5% |
| | Totali | **303,694,991** | **332,281,049** | **386,385,285** | 100% | **385,000,000** | **420,000,000** | 100% | 108.7% | 109.1% |

Source: MoF-Treasury / TAK-Information Technology

***Table no. 2, TAK revenues from 2000 to 2017***




Source: TAK, 2018.

**4.2.1 VALUE ADDED TAX**

For the purpose of Value Added Tax (VAT), the taxable person is any person that is registered, or is required to be registered for VAT, and independently carries out an economic activity on regular or irregular basis, regardless of the purpose or the result of its economic activity.

Value Added Tax (VAT) is a tax on consumption. If seen from the buyer's point of view, it is a tax on the purchase price. If viewed from the seller's point of view, it is a tax on the added value of the product or service.

Any person that meets all the requirements of the definition on taxable person, is required to register for VAT, if within the calendar year exceeds the turnover of thirty thousand euros (30,000€).

VAT is with two rates, the standard rate of 18% and the reduced rate of 8% on the value of imported supplies and taxable domestic supplies, the exclusion of the exempted supplies and supplies considered as exports.

A transaction is subject to VAT in Kosovo, if it is supply of goods or supply of services, rendered against the payment, within the territory of Kosovo, by a taxable person that acts as such. Also, the importation of goods is subject to VAT.

**4.2.2 PERSONAL INCOME TAX**

Personal Income Tax is applicable on all income received by an individual, which is taxable under the Law on Personal Income Tax. Taxpayers are resident and non-resident natural persons, individual business enterprise, partnerships and associations, which receive or create gross income of any source, including wage, business activity, rent, lottery winnings, interest, capital gains, use of intangible property, and any other income that increases taxpayer net value.

The object of taxation for a resident taxpayer is the taxable income with a source in Kosovo and outside Kosovo, while for the non-resident taxpayer it is only the taxable income with a source in Kosovo.

The taxable income for a tax period is considered the difference between gross income received or accrued during the tax period and the deductions allowable with respect to such income.


***Figure 2, PIT taxable income***

Taxpayers with annual gross income over 50,000€ and those who have voluntary opted to be taxed on real income, are taxed by above-mentioned rates, and taxpayers with annual gross income of 50,000€ or less, are taxed with 3% on gross income (for the activities of: trade, transport, agriculture and similar commercial activities) or 9% (for the activities of: services, professional, artisanal, entertainment and similar activities). In addition to tax, these (self-employed) taxpayers are obliged to pay Pension Contributions, too.

The wages of employees are taxed by the primary employer under the following tax rates (0%; 4%; 8% and 10%), and the wages of employees are taxes with 10% by the secondary employer. Any employee, citizen of Kosovo, is obliged to pay 5% from gross income on behalf of Pension Contributions. Also, the principal and secondary employer of the employee, which is Kosovo citizen, contributes with 5% on gross wage of the employee for the pension contributions.

**4.2.3 CORPORATE INCOME TAX**

Corporate Income Tax is applicable on all taxable income of corporations. The taxpayer is considered: a corporation or any other business enterprise with legal person statute under the law in force in Kosovo; The business organization that acts with socially or public owned property; The organization registered as a non-governmental organization; The non-resident person with permanent establishment in Kosovo.

The object of taxation for resident taxpayer is the taxable income from Kosovo source income and foreign source income and for a non-resident taxpayer shall be taxable income from Kosovo sources.

Taxpayer with gross annual income over 50,000€ and those who have voluntary opted to be taxed on real income, are taxed with the rate of 10%, and the taxpayers with annual gross income of 50,000€ or less, are taxed with 3% on gross income (for the activities of: trade, transport, agriculture and similar commercial activities) or 9% (for the activities of: services, professional, artisanal, entertainment and similar activities).

For the taxpayers with annual gross income over 50,000€ and those who have voluntary opted to be taxed on real income, the taxable income for a tax period is considered the difference between gross income received or accrued during the tax period and the deductions allowable with respect to such income.

**5. PUBLIC EXPENDITURE**

Public expenditures serve for financing, namely for meeting the public needs of the country. They enable and ensure the performance of duties from the competence of the country and its bodies, defined by constitution, law and other provisions. Public expenditures have the following two characteristics:

- public expenditures serve for meeting social needs and for public interests, and
- public expenditures are done with money.

Public expenditure is spending in money made by the state and other public-legal entities to meet the general needs and for public interests.

Public expenditures are closely related to public revenues because public revenues are the source of public expenditure funding. Public needs, in a historical perspective, have always increased with the increase of state functions.

There are three economic policy objectives that are implemented through the budget:

1. Determination of public goods (services) for citizens. Since the market does not operate perfectly, some of the goods and services are derived as public services. These are: for example, protection, construction of highways, services for maintaining public order, etc. For this reason, a significant amount of money must be taken from the private sector on behalf of the state to enable the latter to produce these public goods by choosing their best combination, wherever needed more and wherever less.

2. Redistribution of welfare/income. Since living is done within the same social environment, there should be a redistribution of welfare among different regions of the country, from a more developed region to a less developed one (through subsidies and various grants); from the younger ages to the elderly (through the payment of pensions) and from the rich to the poor (through social services).

3. Sustainability. This is a continuing state obligation to ensure that the desired level of employment is combined with the low level of inflation.

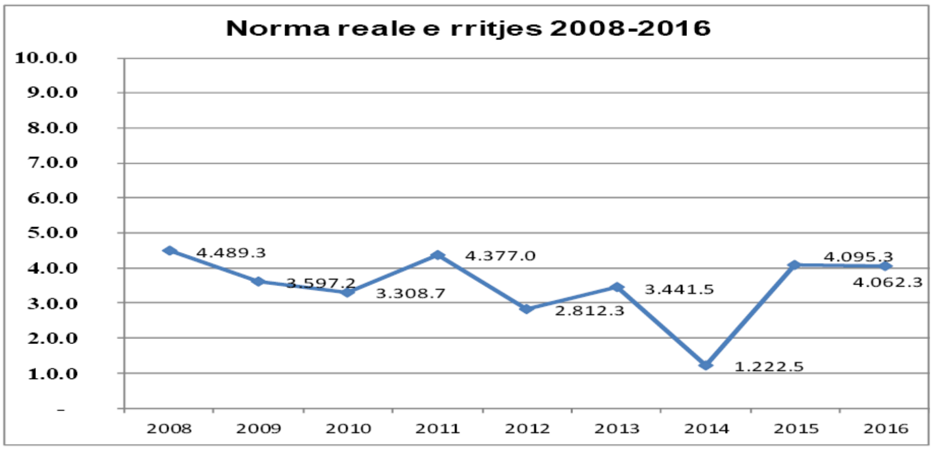
**5.1 GENERAL REVENUES AND EXPENDITURES, COMPARATIVE ANALYSIS FROM 2014 TO 2019**

***Table no. 3, Total Revenues and Expenditures, in million Euros (000 €)***

| Description | 2014 | 2015 | 2016 | 2017 | 2018 Proj. | 2019 Proj. |
|---|---|---|---|---|---|---|
| Total revenues | 1,345 | 1,470 | 1,634 | 1,725 | 1,793 | 1,892 |
| Tax revenues | 1,162 | 1,269 | 1,410 | 1,512 | 1,576 | 1,671 |
| Non-tax revenues | 171 | 188 | 212 | 201 | 205 | 209 |
| Donor grants | 12 | 13 | 12 | 12 | 12 | 12 |
| General Expenditures | 1,480 | 1,564 | 1,732 | 2,001 | 2,063 | 2,158 |
| Current expenditures | 1,058 | 1,149 | 1,221 | 1,273 | 1,309 | 1,346 |
| Capital Expenditures | 411 | 404 | 500 | 723 | 753 | 810 |
| Grant Expenditures | 11 | 13 | 12 | 12 | 12 | 12 |
| Year-end Balance Sheet | 102 | 201 | 335 | 355 | 361 | 342 |
| GDP | 1.8% | 3.6% | 5.5% | 5.5% | 5.4% | 4.8% |
| Deficit as % of GDP | -2.3% | -1.4% | -1.6% | -1.5% | -1.5% | -1.1% |

Source: Budget for 2017

***Figure 3, Real growth rate***




Source: Kosovo Agency of Statistics, GDP 2008 - 2016, October 2017.

## 6. CONCLUSIONS AND RECOMMENDATIONS

In the absence of monetary policy instruments, fiscal policy remains the only instrument available to the Government of the Republic of Kosovo to promote private sector investment. Therefore, a sound and prudent fiscal policy is required, which is of crucial importance for maintaining macroeconomic stability, especially when considering that fiscal policy in Kosovo is the main instrument of economic policy.

Total revenues over the medium term in the coming years are planned to increase at an average annual rate of 3% to 5%. The largest contribution to revenue growth is from tax revenues, i.e. revenues collected internally, while the increase in total revenues is foreseen to be stopped from one-time revenues because most of the enterprises are privatized, the Post is expected to be privatized in the near future and there seems to be no good performance of revenues in the current situation. The appropriate tax system and favourable business environment are the most important pillars for the sustainable development of the private sector in the country. In this regard, fiscal policy reforms include VAT differentiation, VAT threshold reduction, exemption of production lines and machinery from VAT, exemption from VAT and customs duty of key inputs of sectors with competitive priority, and functionalization of industrial and technological parks within which the provision of various tax incentives is foreseen.

Due to the efficiency, economization, the creation of facilitations for businesses, the stoppage of prolonged procedures in the future over a period of three years, it is recommended to establish a single Revenue Agency, where the merging of the Tax Administration of Kosovo and Customs would occur, in accordance with the legislation and best practices of EU countries, and the support from the International Monetary Fund. Provision of fiscal facilitations in primary agricultural production, processing, storage and trading of agricultural products as well as incentive credit and subsidy measures and improvement of public infrastructure. Increase the fund for subsidies and grants gradually; cooperation with development partners for developing the agriculture sector. Also, the small and medium enterprises should set up a mechanism for eliminating legal barriers and reducing red tape and set up a mechanism for credit guarantee. Promotion of tourism, as a sector with high development potential. Tourism development will have a direct impact on several areas such as: production, increase of income, the development of economic activities, hospitality, transport, trade, cultural institutions, increase of employment, increase of the living standard level, increase of investments improvement of the balance of payments.

In the framework of social policies, social welfare and cross-social solidarity, the Government should engage in strengthening the market economy and economic development as a key tool for reducing poverty and unemployment, also by providing cross-social solidarity through income redistributive economic policies. Social policies will ensure the financial stability and sustainability of the mandatory contributions scheme.

According to the fiscal framework of the European Monetary Union (protocol of the Excessive Deficit Procedure-EDP - Annex of the Maastricht Treaty), EU member states and Eurozone countries have to build sound policies in public finance management by applying these criteria: a) the general government deficit must not exceed 3% of the GDP and b) public debt must not exceed 60% of the GDP. Under these criteria, Kosovo needs to keep control of its budget deficit and not exceed 3% of the GDP and thus the criterion of the European Monetary Union EDP Protocol would be fulfilled. Budget implementation (execution) in Kosovo needs to be improved. Effective control of expenditures in each stage of the budget cycle (ex-ante, internal, external control, etc.); adequate budget monitoring at each stage of the expenditure cycle (commitment, verification and payment); strengthening of the internal control system (internal audit) in expenditure agencies. A good procurement system in Kosovo would have an impact on eliminating negative phenomena (corruption and mismanagement) in the management of public expenditures by expenditure agencies and it would have an impact on increasing budget savings.

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