MINISTRY FOR FOREIGN AFFAIRS OF FINLAND

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EX-POST POLICY ASSESSMENT

IMPACT OF TAX REGIME ON FOUR MANUFACTURING SECTORS

(Metal, Textile, Wood and Food Processing)

Prishtinë/Priština, 2014

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LIST OF ABBREVIATIONS

KBRA	Kosovo Business Registration Agency
CEFTA	Central European Free Trade Agreement
CEE	Central Eastern Europe
EU	European Union
FDI	Foreign Direct Investment
FYROM	Former Yugoslav Republic of Macedonia
KC	Kosovo Customs
MTI	Ministry of Trade and Industry of Kosovo
MF	Ministry of Finance of Kosovo
OECD	Organization for Economic Co-operation and Development
SME	Small and Medium-sized Enterprise
TAK	Tax Administration of Kosovo
UN	United Nations
UNDP	United Nations Development Programme
UNMIK	United Nations Mission in Kosovo
VAT	Value Added Tax
WB	Western Balkans

1. INTRODUCTION: OBJECTIVE AND SCOPE OF RESEARCH

The purpose of this policy assessment is to analyze the effect of the tax regime on Kosovo's[1] manufacturing sector during the last decade. More specifically, by focusing on a set of manufacturing industries which were deemed by the Kosovo authorities as having a strategic importance, this study will attempt to first of all determine – based on the available empirical data - whether the tax regime that was in place over the last couple of years has had a negative, neutral or positive effect on the growth of the manufacturing sector.

Since Kosovo does not have the ability to implement a monetary policy, fiscal policy – government revenues and expenditures – remains the only instrument at its hands to stimulate industrial development. Over the last couple of years, high levels of public expenditure (e.g. investments in infrastructure, subsidies, grant schemes, etc.) have stimulated the economy through the increase in aggregate demand, while also improving the pool of physical infrastructure. However, in a market economy, it is the investments of the private sector that play a key role in ensuring sustainable economic growth. Their levels depend, among other things, on the existence of a favourable and competitive business climate that reduces the cost of doing business.

Although many factors play a role in this business climate – starting from the rule of law, the skills of the workforce, interest rates, and all the way to the existence of qualitative public infrastructure – an important role is also played by fiscal incentives, namely the spectrum of tax rates and simulative measures which should aim to simultaneously achieve two objectives: to ensure budgetary and macroeconomic stability while not being a burden for business activity and growth.

The study attempts to retroactively assess the impact of the tax rates that are applicable in Kosovo and the administration of the tax system on the investment climate for the manufacturing sector. It does so by looking at available indicators from a mixture of sources, such as primary data from the Kosovo Tax Administration and the Kosovo Customs, business surveys, other secondary sources and interviews with relevant stakeholders.

It must be noted that there is a great amount of difficulty in isolating the impact of taxes on outcomes such as investments or the general business climate on specific manufacturing sectors. This is because the latter are influenced by a myriad of factors, sometimes even intangible or unquantifiable ones such as cultural norms. There are, thus, substantial limitations to the study and its ability to reach decisive conclusions. Nevertheless, some broad and general inferences and interpretations can be made which will hopefully add value to future policy debates on the development of the manufacturing sector in Kosovo.

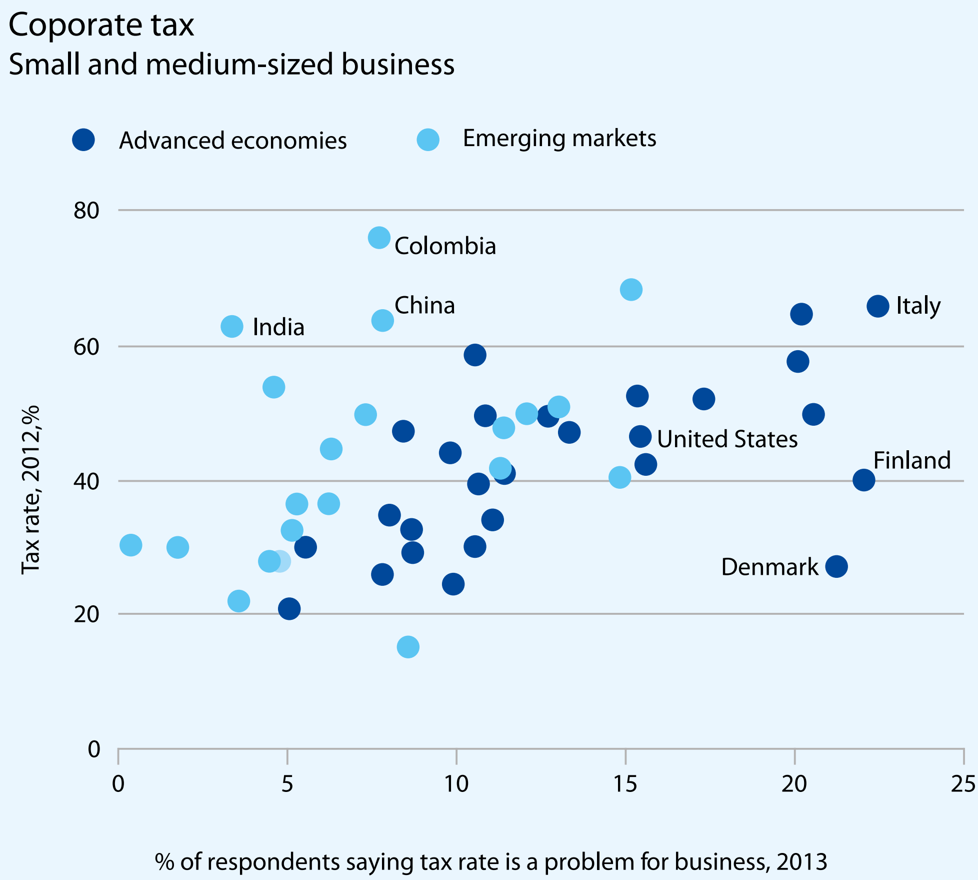
2. CONCEPTUAL REVIEW

Conceptually, the idea that low taxes and fiscal incentives can help the growth of the private sector derives particularly from neo classical economics. It suggests that low taxes allow businesses to keep more revenues to themselves and thus invest in their expansion and competitiveness. Evidence from around the world indicates that there is some direct correlation between tax rates and difficulties in doing business. For example, drawing on data from the World Economic

1 For UNDP, all references to Kosovo in this document are made in the context of UN Security Council Resolution 1244 (1999).

Forums Global Competitiveness Report 2014 – which considers tax rates as one indicator of competitiveness -The Economist magazine recently reported (see Figure 1 below) a moderate positive correlation between higher corporate tax rates and businesses stating that tax rates are a burden for their operations in countries around the world.

Figure 1: Correlation between tax rates and perception of taxes as a barrier to business



Source: The Economist, 2014

There is lack of research on the impact of tax rates on private sector investments and economic development in Kosovo, in the manufacturing sector or otherwise. This is not surprising. For one, the lack of consistent, detailed and reliable data in Kosovo has made any such efforts difficult or even impossible. Kosovo has undergone a process of institution-building only recently and has only now started to accumulate tax records or enterprise surveys that can be used to build longer time series and analyse trends. Secondly, having in mind that Kosovo is transitioning from a socialist, centrally-planned economy to a capitalist, market economy; with a decade of existence as a parallel ineffective state; a devastating conflict in between the transition; and a half-decade rule of international community where the primary concern were human rights, it is not surprising that tax policies and their effect have not been a priority for researchers.

Since there is a lack of evidence from Kosovo on the impact of tax policies on the manufacturing sector, an alternative would be to look at the literature on the Western Balkans and Eastern Europe in general. As the region has passed through similar – albeit less problematic – transition and governance challenges, the literature on the impact of taxes on the manufacturing sector is similarly limited. Hence, we have focused on other dimensions – such as, studies looking at the determinants of FDI, which can be considered as a proxy for the purposes of this study.

Most of the research on FDI determinants tends to focus on institutional quality, the structural composition of the economy, the cost of labour and the state bureaucracy as inner factors, and external factors such as geographical proximity to large markets, EU accession or agreements with the EU, as more relevant factors to attracting FDI and economic development. Tax rates do not appear in the top list of determinant factors for FDI. In most cases they turn out either as statistically insignificant or having a smaller effect than other factors.

Under the framework of Investment Climate Advisory Services of the World Bank Group, James argues that, though debated widely and no clear consensus has been reached, investment incentives, such as tax breaks, have a limited effect on investment and that a favourable investment climate should be a priority for governments[2]. James goes on to argue that although lowering the tax rates help boost FDI, the effect of a good investment climate can be eight times stronger.

Similarly, Matija Rojec and Slavica Penev in a study specifically for attractiveness of Western Balkans for FDI argue that five advantages that Western Balkan (WB) states have are stable macro-economic environment, relatively developed financial system, fast economic growth, relatively low-cost qualified labour, and Stabilization and Association Agreement with the EU and the Central European Free Trade Agreement (CEFTA)[3]. The weaknesses include small domestic markets and low purchasing power of the population, high risk, slow progress in structural and institutional reforms, and inefficient government bureaucracy and high administrative barriers. Based on this research, they argue that the first priority for attracting more FDI is strengthening structural and institutional reform, while specific FDI related policy should only come at a lower priority.

Similar to Rojec and Penev, Saul Estrin and Milica Uvalic[4] argue that gravity model factors do influence FDI inflow in the Balkans. However, in their analysis a "Western Balkans" factor confirms to influence negatively the inflow of FDI. This indicates that the recent political history and the political risks negatively affect FDI. They argue that further institutional development and reform is needed and that announcement and intentions of joining the EU, has a positive influence in the FDI.

A similar result is found by Ines Kersan-Skabic and Edvard Orlic[5] who have studied determinants of FDI inflow in Central and Eastern Europe (CEE) and Western Balkans (WB). They find that tax rates are a statistically significant determinant of FDI inflow in CEE, however they are insignificant for the WB. This may suggest that in the WB there are other constraints which are relatively stronger and that taxes will become a more relevant factor as the countries progress into transition and reach higher levels of economic and institutional development.

A study by Džafić et al. meticulously analyses a wide range of factors which are hindering the development of SMEs in Bosnia and Herzegovina. They argue these factors to be the

2 Tax and Non-tax Incentives and Investment: Evidence and Policy Implication. Sebastian James. December 2009.

3 Attractiveness of Western Balkan Countries for FDI. MatijaRojec and SlavicaPenev. 2011.

4 Foreign direct investment into transitioning economies: are the Balkans different?. Saul Estrin and MilicaUvalic. 2013

5 Determinants of FDI inflow in CEE and Western Balkan Countries (Is accession to the EU important for attracting FDI?). Ines Kersan-Skabic and EdvardOrlic. 2007.

main obstacles to the development of SMEs: bureaucracy, the time it takes to implement legal judgments, the issuing of building permits, corruption, lack of financial stimulation/ government support for the development of manufacturing enterprises, the time lapse between a trial date being set and judgment being passed, lack of government measures to stimulate employment, quality of the workforce, quality of road networks, social and health insurance payments, registration of real estate, and quality and costs of telecommunications. Tax rates do not make it to their list.

Vildan Serin and Ahmet Çalıskan[6] use a model that tries to link economic liberalization policies and foreign direct investment. They find that a bigger market size, a more stable political environment, a smaller fiscal burden, a larger trade volume, a freer business environment, lead to an increased inflow of FDI. Part of the freer business environment is the fiscal freedom variable, which measures the fiscal burden and which is argued to be a very important explanatory variable. Of all the studies reviewed[7], Serin and Çalıskan are the only ones to give a strong focus on fiscal freedom.

3. OVERVIEW OF TRENDS IN KOSOVO'S TAX REGIME

The purpose of this policy assessment is to shed light on the ways in which the tax regime in Kosovo has impacted four manufacturing sectors during the last decade (metal, wood, textile and food processing). Such a historical analysis cannot be done without an understanding of the policy context and an elaboration of the history and trends in both of the relevant variables: the tax regime and the economic activity in the aforementioned sectors.

The history of Kosovo's tax system under a free market economy is in fact fairly recent. During the 1990s, the role of the centralized state in the economy was weakening. The formal state was discriminatory towards its citizens and lacked legitimacy, while a parallel state was running with a higher legitimacy but with a very low efficiency at the ground. Both of the 'states' were exerting their tax authority, yet the market flourished in informality. Hence, the tax system was either ineffective due to the illegitimacy of the formal state or working in voluntary basis for the parallel state – and this gap was exploited well by the newly formed informal private sector.

After UNMIK's administration took control of Kosovo, a Central Fiscal Authority was created in November 1999. This institution worked under the framework of UNMIK and was responsible for the overall financial system in Kosovo – tax collection, drafting of the budget of Kosovo, drafting fiscal policy[8]. A few months earlier that year, Kosovo Customs were created which were responsible for the imposition of 10% import tax, excise tax, and a 15% sales tax[9]. The sales tax was applied in the border checkpoints for the import products, as a tax administration for that time was inexistent and even later when it was formed lacked the ability to effectively

6 Economic Liberalization Policies and Foreign Direct Investment in Southeastern Europe. Vildan Serin and Ahmet Çalıskan. 2010.

7 Other studies reviewed but not mentioned in the literature review section include: Do Central and Eastern European Countries Posses FDI Advantages to More Developed Western Countries?.Miroslav Mateev and Ilya Tsekov. 2012. The Present Situation and the Future Perspectives of Foreign Direct Investment in Balkan Region. Arjan Qefalia and Pleurat Rexhepi. 2009 Determinants of Kosovo Trade: A Gravity Model Approach. Florin Peci, Mario Holzner, and Enver Kutllovci. 2010. Business Climate As One Of The Main Determinant Of The Foreign Direct Investment In South. Ylldeze Sokoli, Lavdosh Zaho, and Ina Sokoli. 2011. Risk Assessment And Management In Fdis. A Case Study In The Balkans. NicosSykianakis. 2007. Historical Legacies and Foreign Direct Investment in Bosnia and Herzegovina. Joel I. Deichmann. 2012.

8 UNMIK Regulation No. 1999/16. On the Establishment of the Central Fiscal Authority and Other Related Matters.

9 UNMIK, Regulation No. 1999/3. On the Establishment of the Customs and Other Related Services in Kosovo.

exert its authority. Though the Sales Tax would later change into Value Added Tax, Kosovo Customs continued to gather import tax, excise tax, and value added tax in border checkpoints for practical reasons, as budget collection was reliant on imports and capacities to collect taxes internally were weak.

The Central Fiscal Authority continued its work as the sole institution on the subject of fiscal matters until the Department for Finance and Economy was created. As the capacities of the Department of Finance and Economy got strengthened – and later it would be turned into a ministry – the labour within the department also was divided. Hence, Tax Administration of Kosovo was formed with the sole responsibility of collecting taxes, applying tax laws, and issuing clarifications regarding tax payments.

Thus were set the fundamentals of the fiscal system. New taxes were added – such as tax on hotel, food and drinks services, and tax on property. The tax structure would later be updated and new laws were passed to establish a legal framework for their application. Value Added Tax (VAT) would replace the Sales Tax in May 2001. The new VAT tax was of the same rate as the previous sales tax: 15 percent[10]. Law on Personal Income was passed in 2002, which applied tax rates of 0 percent for annual income up to €600, 10% for income €600 to €3000 euros, and 20 percent for income higher than €3,000 euros plus a fixed rate of €240.[11] The Law on Corporate Income Tax was only passed in 2004 and applied a rate of 20 percent[12].

Throughout this time – from 1999 to present – the tax structure and legislation changed frequently.[13] Most of these changes, however, are not substantial. Tax rates generally stayed the same throughout the years. The only year when significant changes were introduced was year 2009, when corporate tax was reduced from 20 percent to 10 percent. The Personal Income Tax was reduced from a progressive tax ranging from 0-20 percent tax with a total of three brackets, to a progressive tax ranging from 0-10 percent with four brackets, and value added tax was increased from 15 percent to 16 percent.

As far as import taxes are concerned: when the law was adopted for the first time in 1999, the only goods which could enter Kosovo without having to pay for import taxes were goods to be used by international organizations present in Kosovo and diplomatic missions, such as UNMIK, individual embassies, Red Cross and all UN agencies, and vital essentials such as food (fruits, vegetables, milk) and pharmaceutical products.

Currently, the tax system in Kosovo is relatively simple. It includes a corporate tax of 10%, a progressive personal income tax of 0-10%, customs duties at 10%, value added tax of 16%, and excise tax. Other than basic tax incentives – import tax exemptions and VAT exemptions for a few goods and services – there are no major tax incentives foreseen in the laws. In 2013, an Administrative Instruction was decreed by the Ministry of Finance to apply the 'flat VAT' for

10 UNMIK, Regulation No. 2001/11. On Value Added Tax.

11 UNMIK, Regulation No. 2002/4. On Personal Income Tax.

12 UNMIK, Regulation No. 2004/51. On Corporate Income Tax.

13 First of all, taxes were applied and replaced and abolished all together, such as the sales tax which was passed on year 1999, updated on 2000, and abolished later on 2001. Similarly, Presupposed Tax, Tax on Profit, were promulgated in specific laws, such as Regulation no. 2000/29 on Presupposed tax in the year 2000 and Regulation no. 2002/3 on Profit Tax in the year 2002. These would later be updated by other laws, and abolished or incorporated into other laws. Beside tax structure changes, changes were also made in the tax legislation. For example, since its application for the first time in year 1999 as part of Customs of Kosovo, the law on excise tax was passed in 2000, and during the same year it was amended three times. By 2014, Excise Law has changed 18 times. Similarly, import tax since applied for the first time in year 1999, was changed 12 times. Value Added Tax law was passed fist on 2001, and ever since that year, it was changed 7 times.

farmers. This flat VAT allows farmers to sell their products to agro-processing firms without being formally registered as proper firms, so that agro-processing firms can legally buy their products and not pay VAT to farmers. However, this measure offers a solution for small farmers, especially those in between subsistence and commercial farming and not able to properly register their firms and sell their products 'legally'.

However, recent developments regarding free economic zones are preceding changes in tax incentives. The municipality of Gjakovë/Đakovica and Mitrovicë/a have been declared free economic zones by the Kosovo authorities in March 2014[14]. Though it remains unclear what economic incentives will the free economic zones enjoy, Kosovo institutions already decided on tax exemptions for businesses which invest a certain amount and employ a certain number of people.[15] However, these decisions have not yet been approved by the Kosovo Assembly; hence it is not clear if and when they will be implemented.

4. OVERVIEW OF TRENDS IN FOUR MANUFACTURING SECTORS: METAL, WOOD, TEXTILE AND FOOD PROCESSING

Before assessing how the tax regime has impacted the manufacturing sectors, it is important to first of all understand some basic facts about these sectors and illustrate how they have fared over the last decade – namely, whether they have showed signs of growth or decline. This would help contextualize the analysis and the available indicators that are used to explain the causal relation between taxes and economic activity in the sectors.

The four sectors are the biggest manufacturing sectors in terms of economic activity, exports, employment generation and a range of other indicators. A fuller overview of the sectors – including basic firm information, structure of inputs and outputs, markets, human resources, etc. – is provided in the sector profiles that were produced through the Aid for Trade Project by UNDP and MTI.[16]

One of the biggest added values of this paper is the fact that it provides an empirical overview of the sectors' performance for the last eight years. It was assessed how the sectors have fared by analysing import and export data from the database of Kosovo Customs for the period 2005-2013. From the latter, the import and export values for the sectors' goods were retrieved separately for each sector and for each year in the period 2005-2013 (Figures 3, 4, 5 and 6).[17] Import to export ratios for each sector were derived, with the idea that increases in the value of goods exported by domestic firms, and the reduction of the import to export ratio over time, would indicate that the domestic sector has grown during the period.

14 Kosovo Government Decision No. 03/178 dhe 02/178.

15 Kosovo Government Decision No. 07/186

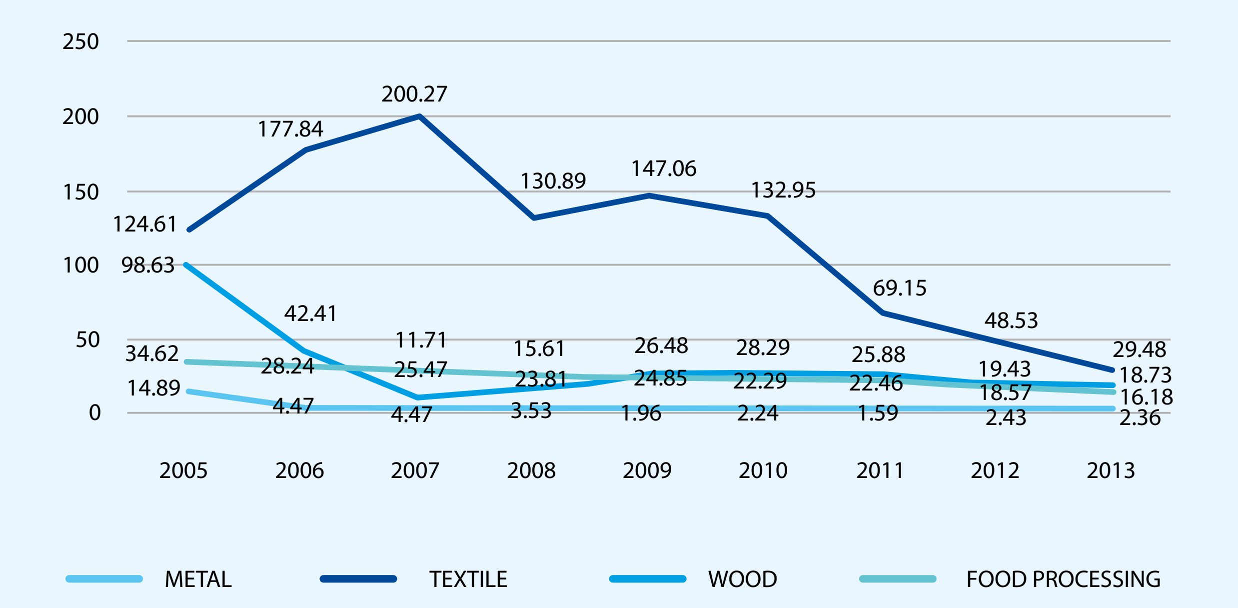
16 Sector Profiles: http://www.invest-ks.org/en/sectoral-studies

17 *Methodological note:* The sectors were defined by clustering goods in accordance with relevant HS 2002 codes. To this end, the **food processing sector** is defined as consisted of the following products: meat; sugar and sugar confectionary; cocoa and cocoa preparations; cereals, flour, starch of milk; pastrycook products; vegetables, fruit, nuts or other parts of plants; miscellaneous edible preparations; beverages, spirits and vinegar; residue and waste from food industries; prepared animal fodder; tobacco. The **wood processing sector** includes: articles of wood; cork and articles of wood and; wooden furniture. The **textile sector** consists of: articles of apparel and clothing accessories, not knitted or crocheted; other textile articles; footwear; headgear. The **metal processing sector** consists of iron and steel; articles of iron and steel; copper and articles thereof, lead and articles thereof; zinc and articles thereof; tin and articles thereof; other base metals – cermet's, articles thereof; tools; miscellaneous; metal furniture; jewelry precious metals.

It must be noted at this point that import and export data are not the best indicator of activity, especially when comparing one sector with another, since some sectors are more export-oriented than others and one might fail to capture increased sales in the domestic market. But lacking other empirical sources with such lengthy historical trend lines, import and export data could be considered as a solid proxy, especially when presented as a ratio between the two, since reductions in imports would reflect import substitution.

Figure 2 below illustrates the ratio of import to export values for the four sectors in the period 2005-2013. It shows that all of the four domestic manufacturing sectors started the period with extremely high sector trade deficits (import to export ratios) which were then reduced significantly over time. The import to export ratio dropped for the metal sector (15 to 2), textile sector (125 to 29), wood sector (99 to 19) and food processing (35 to 16). This is because the average yearly growth rate of exports substantially outpaced the yearly growth rate of imports for all sectors (see Table 1).The data therefore suggests that these domestic manufacturing sectors have been able to export more and/or substitute imports as time passed, which in turn implies that the sectors have expanded over the years. It must be noted, however, that they started from a very low base – namely, that in monetary terms the increase in most cases was small.

Figura 2: Ratio of imports to exports for four sectors (2005-2013)



Source: Kosovo Customs.

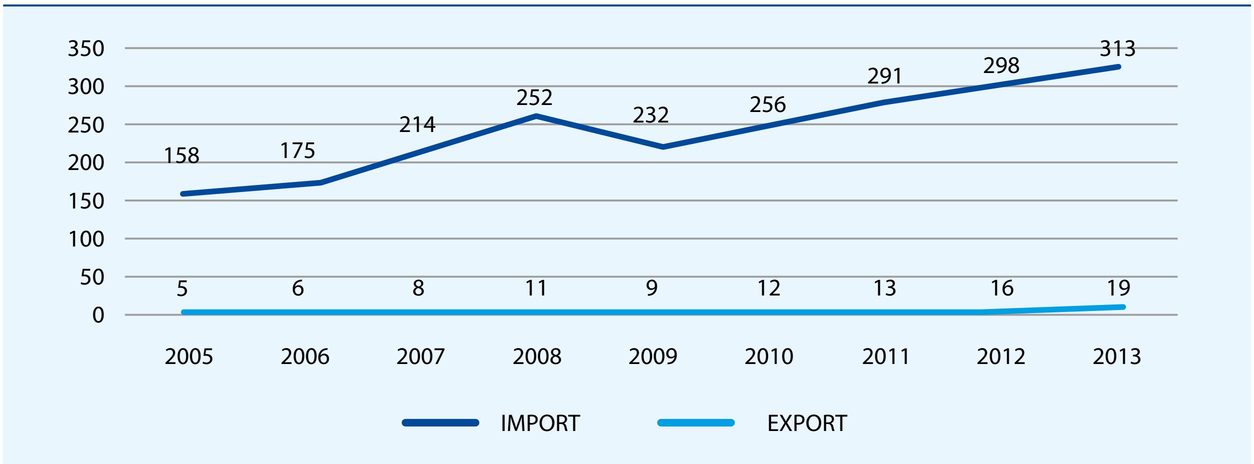
Table 1: Average yearly % changes for imports and exports for four sectors (geometric mean).

Sector	Average yearly % change (Import)	Average yearly % change (export)
Metal	13.4%	42.8%
Wood	9.3%	34.5%
Food	8.9%	19.8%
Textile	10.8%	32.7%

Source: Kosovo Customs.

We turn now to each sector individually to get an idea of the monetary values and the scope of growth within the sectors. The data shows that in the food processing sector (Figure 3) the value of goods exported increased from €4.5 million in 2005 to €19 million in 2013. While domestic demand for imports increased by an average of 8.9% per year, demand for exports increased by an average of 19.8% per year. As Figure 2 illustrates, this reduced the import to export ratio from 35 to 16.

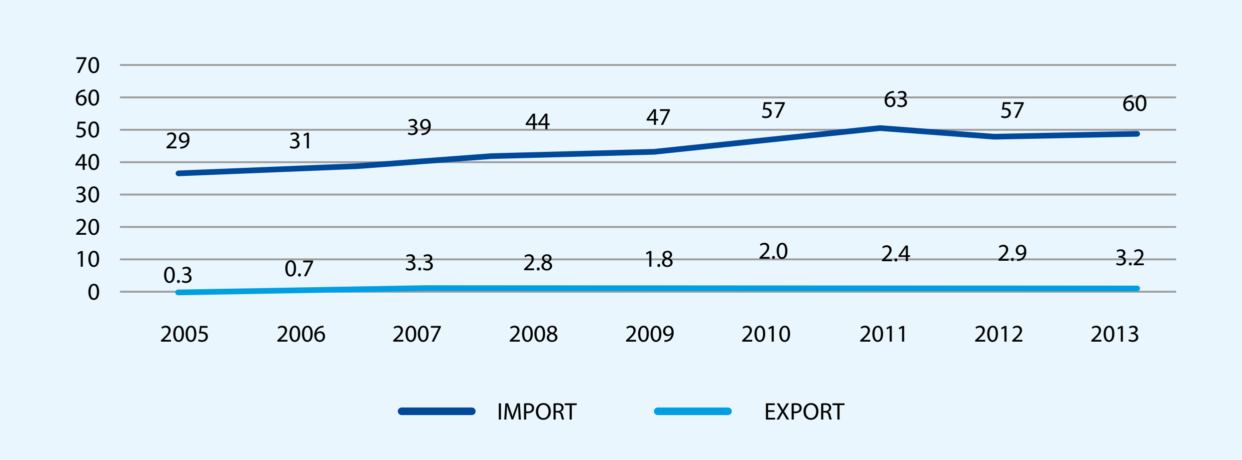
Figure 3: Food processing: Imports and Exports (2005-2013) in million Euro



Source: Kosovo Customs.

The wood sector follows a slightly different trade pattern from the overall trend (Figure 4). The exports curve has a spike in 2007, showing an increase from €0.7 million to €3.3 million, but have since then fluctuated, reaching a slightly lower value of €3.1 million in 2013. Nevertheless, the import to export ratio was reduced significantly as the average yearly growth rate outpaced the growth rate of imports.

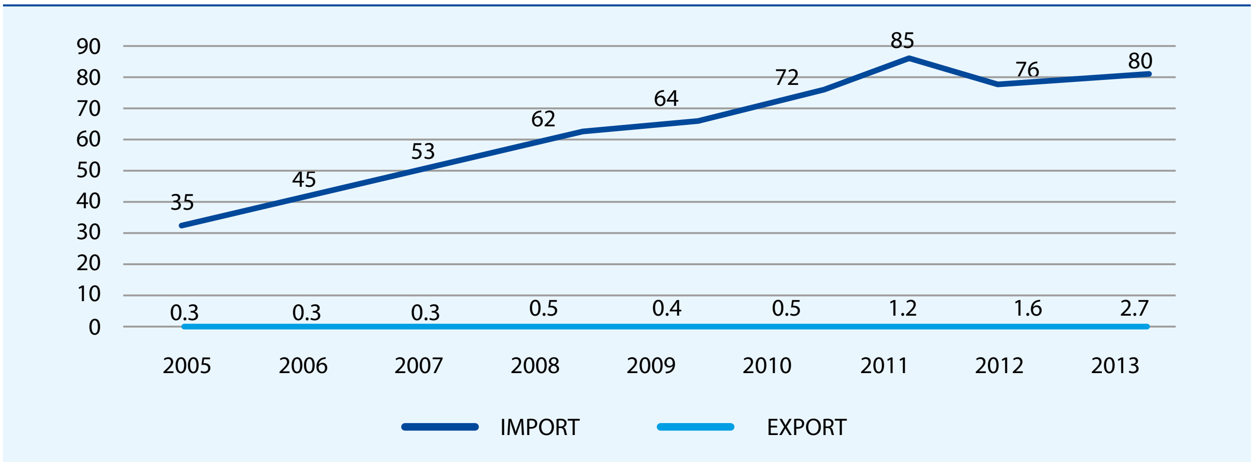
Figure 4: Wood processing: Imports and Exports (2005-2013) in million Euro



Source: Kosovo Customs.

The textile sector (Figure 5) showed the greatest improvement in the trade balance of all of sectors, reducing the import to export ratio from 125 to 29. Nevertheless, the improvement was only recent and seen in the last four years (2010-2013) when the ratio took a steep dive. During this period exports increased from a meagre €0.5 million in 2010 to €2.7 million in 2013 while imports dropped or stagnated after having consistently increased in the previous period.

Figure 5: Textile: Import and Export (2005-2013) in million Euro



Source: Kosovo Customs.

The metal sector can easily be considered the best performing sector in terms of trade balance. Exports values increased dramatically (from a mere €6 million in 2005 to €107 million in 2013) due to the start of operations by an industrial giant (Ferronikeli), albeit with high fluctuations, whereas the import curve follows a more stable upward trajectory. The volatility of exports can mostly be attributed to shifts in global market demand and prices for products such as ferronickel.

Figure 6: Metal processing: Import and Export (2005-2013) in million Euro

Source: Kosovo Customs.

5. PROBLEM ANALYSIS: TAXES AND THEIR IMPACT ON THE FOUR MANUFACTURING SECTORS

What do the import and export data suggest except highlighting that these manufacturing sectors have grown over the years? Most importantly for the purposes of this study, the purpose of which is to identify a causal impact of one variable (taxes), growth implies that the enabling environment has been conducive for it happen, although it does not exclude the possibility that growth could have been greater without inhibiting causes. The enabling environment is influenced by a wide range of factors and it is difficult to ascertain from these data alone the particular role of taxes compared to other variables. There is no visible spike in activity in any sector that could suggest the impact of tax rate reductions (in 2009).

Similarly, the lack of detailed institutional and or other secondary sources makes it impossible to develop a scientifically sound methodology which would capture all of the relevant variables and isolate any statistically significant impact of taxes. Nevertheless, there are some limited indicators which could serve as proxies and which, when analysed in conjunction as pieces of one puzzle, can provide a reasonable explanation on the impact that taxes might have had on the manufacturing sector. We have therefore tried to find possible answers by assessing separately the burden posed by **tax rates** and **tax administration** (with a specific focus on the related issues of **informality** and **enforcement**). To this end we have used as sources and indicators:

a) Kosovo's regional and global comparative standing with regard to tax rates and administration;

b) Quantitative indicators of firm perceptions on tax rates and administration derived from enterprise surveys;

c) Qualitative data from interviews with those familiar with the challenges of manufacturing firms in Kosovo;

d) Tax collection trends from the database of the Tax Administration of Kosovo;

e) Secondary sources and studies conducted by other researchers.

5.1 Assessment of the impact of tax rates

One potential way to assess the degree to which tax rates might have represented a burden for Kosovar manufacturers is to compare these rates with those of other countries in the region and the world, especially those countries or economic blocks that are Kosovo's main trading partners. To this end, smaller tax rates could be considered as being playing a positive role as they would imply that Kosovar firms had lower costs and thus higher degree of competitiveness than their regional and global competitors.

Kosovo was and is in fact quite competitive within the Western Balkans region and the European Union (EU27), since its tax rates fall on the lower bound of the regional ranges. A detailed comparison of tax rates is presented in Table 2, capturing information for three types of taxes: corporate tax, personal income tax, and value added tax (VAT). In the case of VAT, the minimum annual turnover threshold before a firm is obliged to register for VAT is also gathered and compared.

It must be noted, however, that the information in Table 2 presents an overall picture of the tax rates in the region and the EU27; however, it does not account for specific tax policies or incentives such as tax holidays, tax breaks for specified economic sectors, or tax breaks for companies that employ or invest in research and development. Furthermore, the information presented are nominal tax rates which may not necessarily apply universally to all firms. The average tax rate might change depending on tax policies, as mentioned above, and the location of the firm. Given that many countries have economic free zones applying no taxes, the effective average tax rates are certainly different from the nominal tax rates.

The corporate tax rate generally does not differ much across the countries of the Western Balkans. On average, corporate tax in the Western Balkans stands flat at about 10 percent – just like in Kosovo. Serbia and Albania differ slightly with a flat tax rate of 15 percent and a progressive one starting from a roughly 2 percent to 15 percent respectively. An exception to the rest of Western Balkans is Croatia, now a member of the European Union, which applies a corporate tax rate of 20 percent (slightly lower than the EU27 average of 22.75 percent).

Personal income tax affects the cost of labour. The higher the tax rate, the lower the net income for labour and the higher the cost for businesses. Given this relationship, personal income tax level plays a role in determining the competitiveness. With a progressive tax ranging from 0 percent to a maximum 10 percent, Kosovo applies the lowest personal income tax in the region. Most of the other countries compare to Kosovo in the fact that they share a 10 percent tax, however while for Kosovo 10 percent tax is the maximum bound, other countries either have a flat 10 percent tax or start a progressive tax rate from 10 percent.

The Value Added Tax does not vary greatly throughout the countries. From the perspective of potential investors, VAT is not that important if the products that are manufactured are destined for export markets, in which case they are exempt from VAT. It does however impact the cost of inputs. Kosovo has the lowest of VAT rates among the Western Balkans and the EU27. VAT in Kosovo is 16 percent, compared to 20 percent in Albania and Serbia or 25 in Croatia. Montenegro and Bosnia and Herzegovina compare similarly to Kosovo's, with a VAT rate of 17 percent, and the Former Yugoslav Republic of Macedonia (FYROM) with an 18 percent.

It is important to note, however, that most of the countries apply a reduced, or a second level, rate of VAT for certain products of strategic or social interest. Only Kosovo, Albania, and Bosnia and Herzegovina do not apply such a reduced rate of VAT. Another dimension in which Kosovo differs in terms of the application of VAT is its collection at the border by the Kosovo Customs and partially also by the Kosovo Tax Administration. The reasons why this represents a problem for firms will be discussed in subsequent chapters.

Table 2. Comparative table of tax rates for the Western Balkan states and the EU27

			Value Added Tax (VAT)		
			Rate		Minimum annual turnover for mandatory registration
	Corporate Tax	Personal Income Tax	Full	Reduced	
Albania	<8,000,000 = 15%	0-30,000 = 0%	20%		5,000,000
(ALL)	8,000,000-2,000,000 = 7.5%	30,000-130,000 = 13%			
	>2,000,000 = fixed 25,000	<130000 = 23%			
Bosnia and Herzegovina (BAM)	10%	10%	17%		50,000
	>100,000 annual in RepublikaSrpska = 2%				
Croatia (HRK)	20%	12%-40% depending of income level	25%	10%	230,000
FYROM (MKD)	10%	10%	18%	5%	2,000,000
Montenegro (EUR)	9%	0-720 = 9%	17%	7%	18,000
		<720 = 15%			
Serbia (RSD)	15%	10%	20%	10%	8,000,000
Kosovo (EUR)	10%	0-80 = 0%	16%		50,000
		80-250=4%			
		250-450=8%			
		<450=10%			
EU27 (EUR)	22.75%[18]	37.82%[19]	21%[20]	9%	29,535[21]

Source: Deloitte. International Tax Highlights 2014; KPMG. Corporate tax rates table; Eurostat. VAT Gap.

18 http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx

19 Ibid.

20 http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/vat-gap.pdf

21 http://www.vatlive.com/eu-vat-rules/vat-registration-threshold/

The comparative overview suggest that tax rates in Kosovo are very unlikely to have been a serious impediment to growth for the four manufacturing sectors and that they were generally more favourable than in other countries, thus creating, at least from a tax perspective, an advantage over competitors from main trading partners. The argument is reinforced by data from other comparative indices such as the World Bank's "Doing Business Report". The report ranks countries based on a series of indicators, one of which is "Paying Taxes". Kosovo ranks as 43rd globally in this indicator. The comparative table below illustrates that Kosovo has a much lower total tax rate (as a share of profit) – at 15.4% - compared to Europe and Central Asia (38.7%) and OECD countries (41.3%).

Table 3: Kosovo's ranking in "Paying Taxes" indicator in "Doing Business Report"

Indicator	Kosovo	Europe & Central Asia	OECD
PAYING TAXES	**43* (global rank)**		
Payments (number per year)	33	26	12
Time (hours per year)	162	246	175
Profit tax (%)	9.1	9.0	16.1
Labour tax and contributions (%)	5.6	22.6	23.1
Other taxes (%)	0.7	7.0	2.0
Total tax rate (% of profit)	15.4	38.7	41.3

Source: "Doing Business Report 2014." (World Bank)

Another way of assessing the tax burden in Kosovo is by looking at it in a relative perspective compared to other factors in the business environment. The "Doing Business Report" highlights that paying taxes, in relative terms, is one of the lesser problems for Kosovo's businesses. The greatest problems with which firms are faced with are those with the effectiveness and efficiency of institutions, especially of the judiciary – namely, the enforcement of contracts (138), dealing with construction permits (136) and trading across borders (121).

Table 4: Kosovo's global rankings in "Doing Business Report"

Indicator	Rank
Enforcing contracts	138
Dealing with construction permits	136
Trading across borders	121
Getting electricity	121
Starting a business	100
Protecting investors	98
Resolving insolvency	83
Registering property	58
Paying taxes	**43**
Getting credit	28

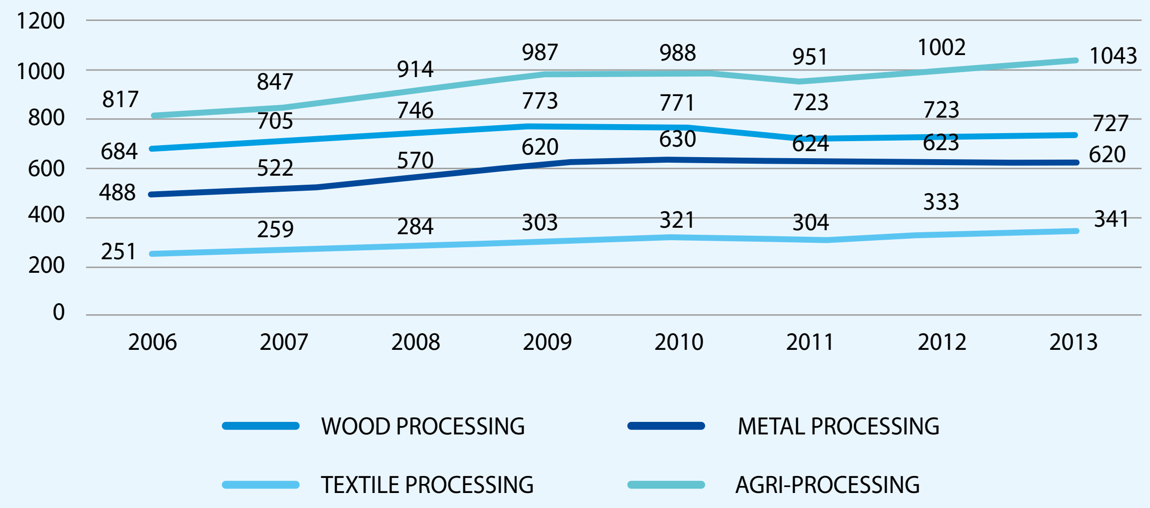
Source: "Doing Business Report 2014." (World Bank)

Another way to assess the tax burden would be to look at tax collection data from the Tax Administration of Kosovo and check whether firm behaviour with regard to tax payments was responsive to changes in tax rates. As the upcoming sections of this report will demonstrate, there is a high degree of informality in Kosovo. If tax rates had been a problem for Kosovo's manufacturers during the last decade, then it would be reasonable to assume that a considerable reduction in the rate – such as the reduction in 2009 of both the ***corporate tax rate*** and the maximum ***personal income tax rate*** from 20% to 10% - would have caused an increase in the number of manufacturing firms deciding to formalize and report revenues to TAK.

Data from TAK (Figures 7 and 8) in fact show that nothing of this kind occurred. The number of firms registering with the Kosovo Business Registration Agency (KBRA) grew at a constant pace and showed no significant spike in 2009 or 2010 which would be consistent with previously informal firms deciding to register after the policy change. New firm registration seemed to be more responsive to general business cycles rather than changes in tax rates. The fact that tax rate changes did not modify the behaviour of manufacturing firms with regard to reporting of revenues was also confirmed by interviews with accounting firms that serve manufacturers as clients.[22]

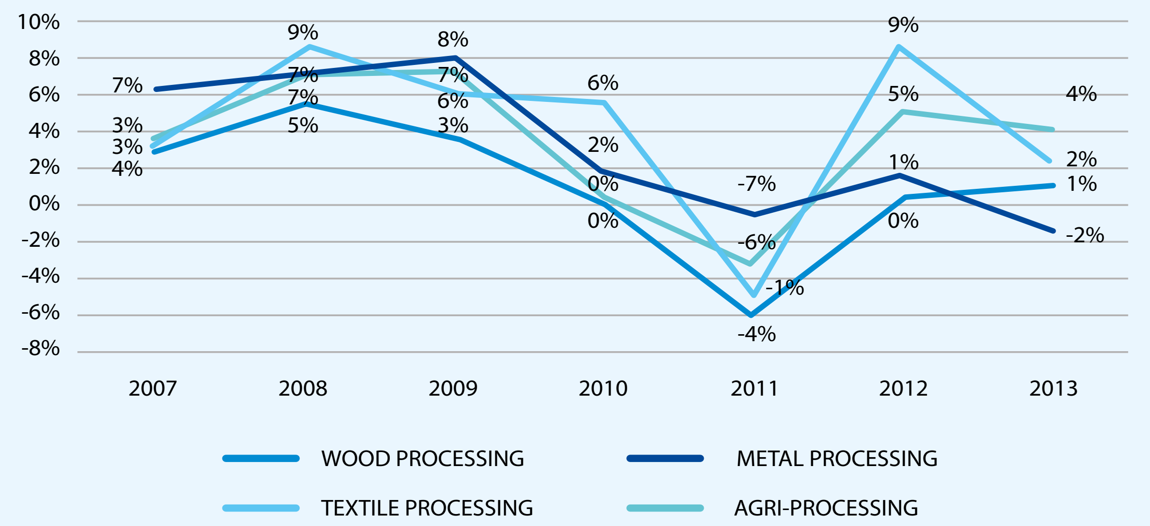
22 Interview with accounting firm working for several manufacturing firms.

Figure 7: Number of firms reporting to TAK



Source: Tax Administration of Kosovo, 2014.

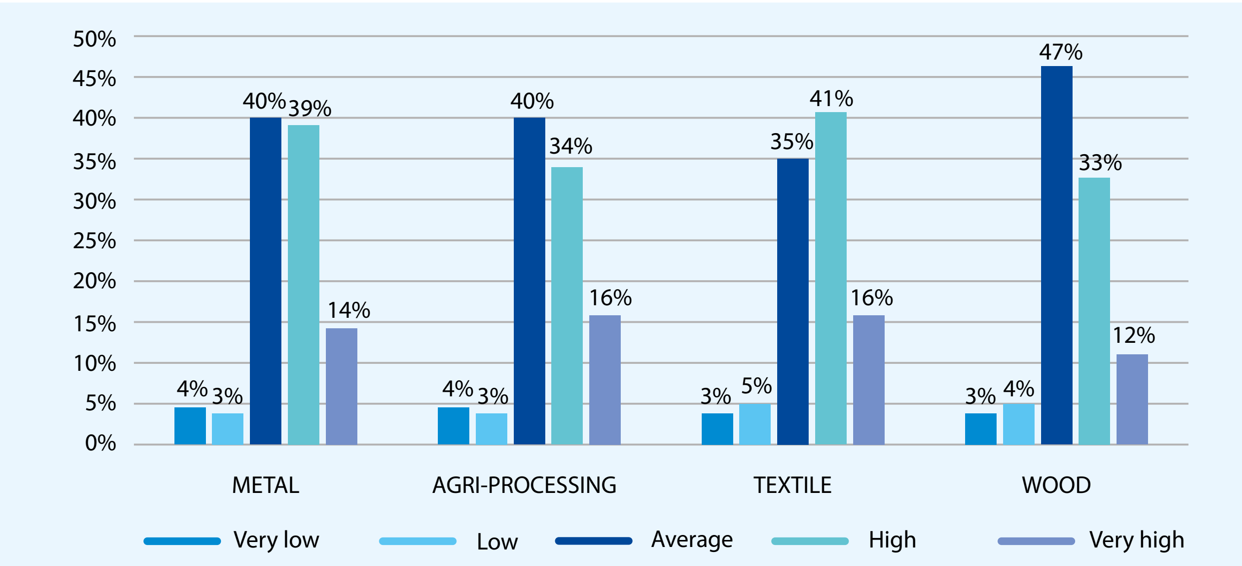
Figure 8: Yearly change in number of firms reporting to TAK



Source: Tax Administration of Kosovo, 2014

Although the data presented thus far provided evidence that tax rates in Kosovo are generally low, and that as such they might not have impacted the manufacturing sectors negatively, this is not a belief shared by the firms themselves. Data from surveys with the four manufacturing sectors suggests that there is a strong tendency for them to find tax rates in Kosovo to be high or very high, which would imply the opposite of what was argued thus far – that in fact taxes have had an inhibitory impact on the sectors' growth. As illustrated by Figure 9 below, only 7-10% of firms in the four manufacturing sectors find tax rates to be very low or low, whereas the remainder find them to be average (35-47%), high (33-41%) or very high (12-16%).

Figure 9: How would you desribe tax rates in Kosovo?



Source: UNDP Survey 2013

It must be noted at this point that perceptions on tax rates are contextual and dependent on the business environment, or even on the broader cultural characteristics of a country. In this regard, perceptions that taxes are high might be the result of the high degree of isolation, misinformation and unawareness that Kosovo businesses might have about tax rates elsewhere, including neighbouring countries. Furthermore, there could also be a cultural element at play, as some cultures simply have a higher predisposition to be vocal in their expression of dissatisfaction, especially in surveys where anonymity is assured. If the data from Figure 1 are taken as an example – the one which illustrates dissatisfaction with tax rates in different countries around the world – improper information and cultural factors could be part of the explanation why some countries with similar tax rates have differing degrees of dissatisfaction.

Nonetheless, there is some evidence to suggest that one of the most important reasons why manufacturing firms in Kosovo find taxes to be high is because most of them are operating with limited cash flows and sales – essentially at the borderlines of liquidity and perhaps even solvency. Even if tax rates can objectively be considered as normal or low – as the comparative data suggests - they are considered by firms to be high because they eat out from limited profit margins or funds planned for critical investments or costly loan repayments. Survey answers therefore might suffer from a degree of improper guilt attribution. Namely, other factors in the business environment create such great barriers and costs – for example interest rates, most recently 11% on long-term investment loans[23]- that any degree of taxes is found to be high or burdensome.

The argument that taxes are seen as high due to liquidity problems is further reinforced by the fact that a large share of firms underreports their activities or decides to operate informally. A report by the Riinvest Institute finds that the share of informality in the private sector stands at 34% and is higher for manufacturing firms.[24] The Sector Profiles produced by the UNDP on behalf of the Ministry of Trade and Industry also found that firms drastically underreported sales or output data when answering survey questions. In some cases, such as the metal processing sector, the value of total reported inputs by the sector was around double the value of reported outputs.[25]

23 Central Bank of Kosovo

24 Riinvest Institute. "To pay or not to pay" **http://www.fes-prishtina.org/wb/media/Publications/2013/BUSINESS_INFORMALITY__ENG_FINAL.pdf**

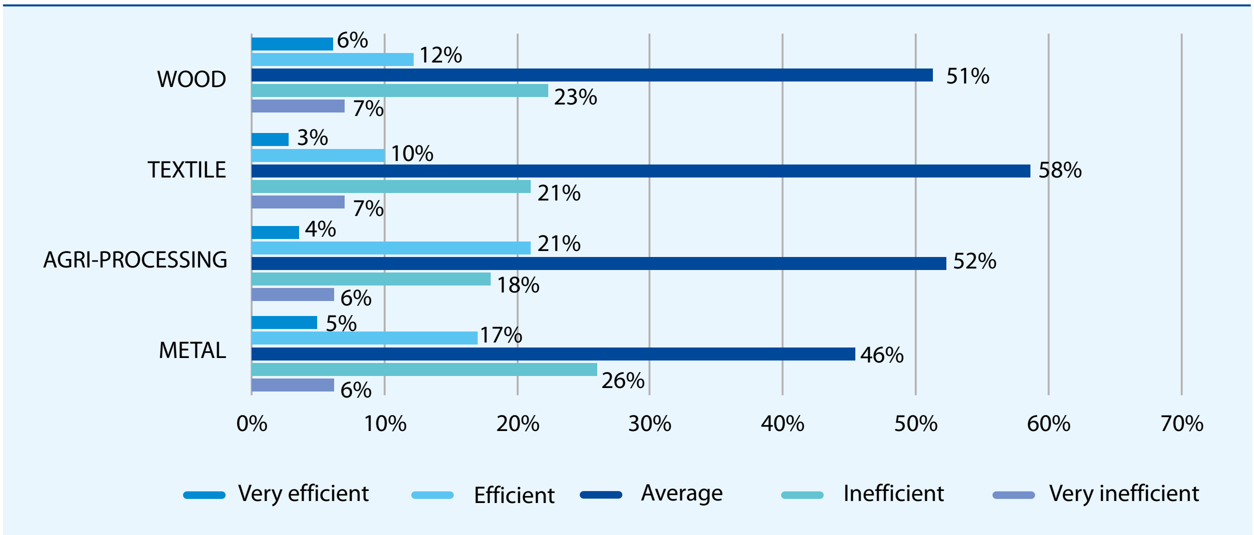
25 Metal Processing Sector Profile

The practice of underreporting sales and its widespread nature was confirmed by interviews with representatives of accounting firms operating in Kosovo and which have manufacturers as clients.[26]Individual examples might not be representative of entire samples, but some might be able to capture and illustrate general trends as to why firms choose to operate informally (except for the obvious reason of "because they can", or poor enforcement by ATK, which will be discussed in the next section). One professional consultant, currently working for a large manufacturer in new project development and with access to its financial records thought that if the company would report its entire revenues flows, "it would not be able to keep afloat".[27] In this regard, informality could be seen as having a positive impact, as it creates breathing space for nascent and fragile companies, giving them time to improve and become more competitive. The negative effects of informality are addressed in the next section.

5.2 Assessment of the impact of tax administration

Data from surveys with the four manufacturing sectors suggest that firms operating in the four sectors have generally similar perceptions with regard to the effectiveness of the two main institutions responsible for administering tax collection in Kosovo – the Kosovo Customs (KC) and the Tax Administration of Kosovo (TAK). As illustrated by Figures 10 and 11 below, the majority of firms state that they have an average level of satisfaction with the two institutions. However, a considerable number of firms are dissatisfied. Dissatisfaction is just slightly higher with the KC than TAK.

Figure 10: How would you best describe the performance of the Kosovo Customs?

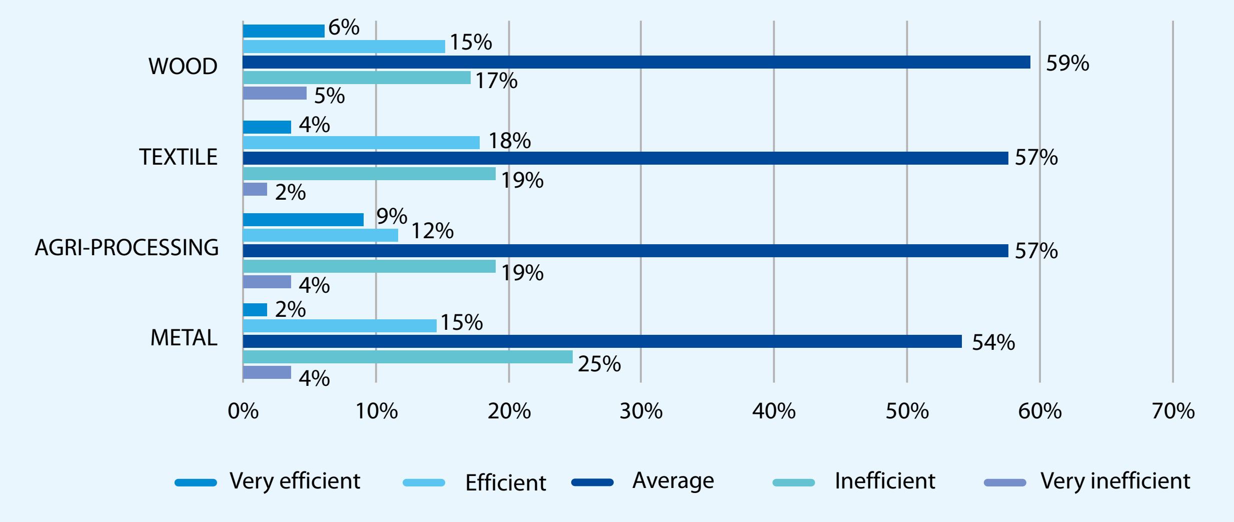


Source: UNDP Survey 2013

26 Interview with businesses.

27 Interview with consultant.

Figure 11: How would you best describe the performance of the Tax Administration of Kosovo?



Source: UNDP Survey 2013

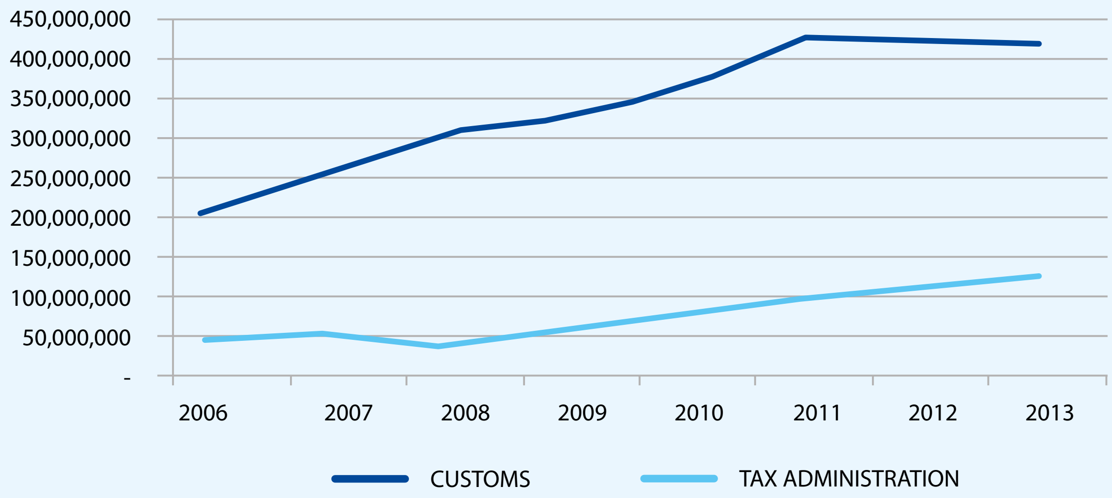
Interviews with representatives of businesses highlighted two key problems with the administration of the tax and customs system in Kosovo and which seem to represent much greater barriers to their business operations than the existing tax or customs rates. These barriers are: a) the collection of the VAT by the Kosovo Customs at the border point, prior to the products being used as inputs or sold and b) the high degree of informality which creates an environment that is conducive for unfair competition or arbitrary and selective punishments by ATK inspectors.

Collection of VAT at the border increased the cost of doing business: The collection of the VAT at the border is by far the number one complaint that was identified during interviews with sector representatives or accounting/auditing firms working for a wide range of manufacturers. As illustrated by Figure 12, in 2013, Kosovo Customs collected €411million on behalf of VAT tax at the border whereas the Kosovo Tax Administration collected €113 million internally. The general perception is that this is a more effective way for Kosovo's institutions to generate revenues, as it is easier for the KC to register goods at the border than it is for TAK to inspect or track sales within Kosovo. In one sense this reflects a failure of institutions to create a reliable system of control and reporting within Kosovo.

Through the VAT collected at the border, Kosovo Customs is able to collect about ¼ of Kosovo's budget, but is doing so at the expense of businesses, by increasing the cost of doing business.

Figure 12: VAT collections by Customs and TAK

	CUSTOMS	TAX ADMINISTRATION
2006	210,608,000.00	44,474,000.00
2007	254,760,000.00	49,480,000.00
2008	304,398,000.00	37,699,000.00
2009	327,288,000.00	51,015,000.00
2010	360,697,000.00	67,991,000.00
2011	418,779,000.00	94,317,000.00
2012	417,864,000.00	98,911,000.00
2013	410,989,000.00	113,661,000.00



Source: Kosovo Customs and Tax Administration of Kosovo

Interviews with business representatives highlighted that the collection of the VAT at border points creates great liquidity problems for firms, as they have to pay a large amount of cash up front without even having used the goods that they purchased for their business operations. This is particularly problematic having in mind the fact that most firms are in a difficult position with cash flows and operating at the limits of liquidity and/or solvency. And it is especially problematic for new firms, essentially creating a great entry barrier, thus also damaging competition. Paying the VAT at the border blocks a large amount of capital that would allow firms to invest or hire more workers.

Informality created grounds for anti-competitive and arbitrary measures by tax authorities: The second greatest problem with the administration of the tax system that was highlighted during interviews, and which is also confirmed by other sources, was the issue of informality and tax evasion, which creates space for arbitrary measures from tax inspectors and thus for anti-competitive practices. The general perception is that tax administrators are aware that most firms underreport their activity. This creates space for abuse, as more powerful and well-connected businesses might use tax inspectors to inflict damage on competitors, knowing that they are vulnerable. In the survey conducted by Riinvest Institute on informality, on a scale from 1-10, businesses gave a score of 4.6 on the question of whether tax inspectors can be bribed or misuse their authority, which suggests that there might be considerable instances of such abuse.[28]

28 Riinvest Institute. "To pay or not to pay" **http://www.fes-prishtina.org/wb/media/Publications/2013/BUSINESS_INFORMALITY__ENG_FINAL.pdf**

Some examples that were pointed out during interviews with businesses might illustrate the nature of the problems faced by those who find TAK to be inefficient or very inefficient. One interviewed accounting firm told the example of two neighbouring and competing businesses, one of which was operating in complete informality and the other paying some taxes albeit underreporting sales. Ironically it was the latter that received a visit from tax inspectors and was forced to shut down due to fines.[29]The fact that informal competition is a great barrier to businesses is also confirmed by most business surveys conducted in Kosovo over the last years.[30]

Informality mainly results due to weak enforcement by TAK: Informality exists not only because many firms have an incentive to engage in it, but also because tax collecting institutions are inefficient in collecting taxes. Historical data from TAK illustrate not only the high degree of informality within the four manufacturing sectors that are the subject of this study, but also the high degree of responsiveness to better enforcement. For example, the graphs in Figure 13 which illustrate tax collection trends for three types of taxes (corporate tax, personal income tax and VAT) for the firms operating in the four manufacturing sectors. It is clearly visible from the graphs that the introduction of fiscal devices in 2009 by Kosovo institutions dramatically increased the collection of VAT, which in turn shows how much sales had been underreported and how much of an impact better enforcement can have in reducing informality.

Figure 13: Metal Processing

	2006	2007	2008	2009	2010	2011	2012	2013
VAT	386,209	396,484	755,112	544,811	410,217	1,513,011	1,074,001	916,170
PERSONAL BUSINESS TAX	147,193	204,320	208,367	214,396	249,906	262,780	264,834	247,530
CORPORATE TAX	581,955	370,949	243,682	96,744	821,120	734,994	343,431	238,188

29 Interview with businesses.

30 See for example UNDP's Human Development Report 2012 ("Private sector and employment") or the sector profiles produced by UNDP-MTI.

Figure 14: Textile

	2006	2007	2008	2009	2010	2011	2012	2013
VAT	78,808	74,384	59,095	109,904	82,302	566,706	337,201	454,246
PERSONAL BUSINESS TAX	93,873	125,686	120,414	125,473	135,993	156,875	140,776	153,462
CORPORATE TAX	27,021	32,589	44,696	52,517	100,575	128,613	98,377	124,294

Figure 15: Wood processing

	2006	2007	2008	2009	2010	2011	2012	2013
VAT	220,239	155,118	152,600	233,899	192,980	486,902	348,657	428,021
PERSONAL BUSINESS TAX	262,713	283,886	297,106	291,754	353,997	329,988	333,348	338,010
CORPORATE TAX	86,491	68,300	79,461	104,661	88,223	183,529	97,527	133,841

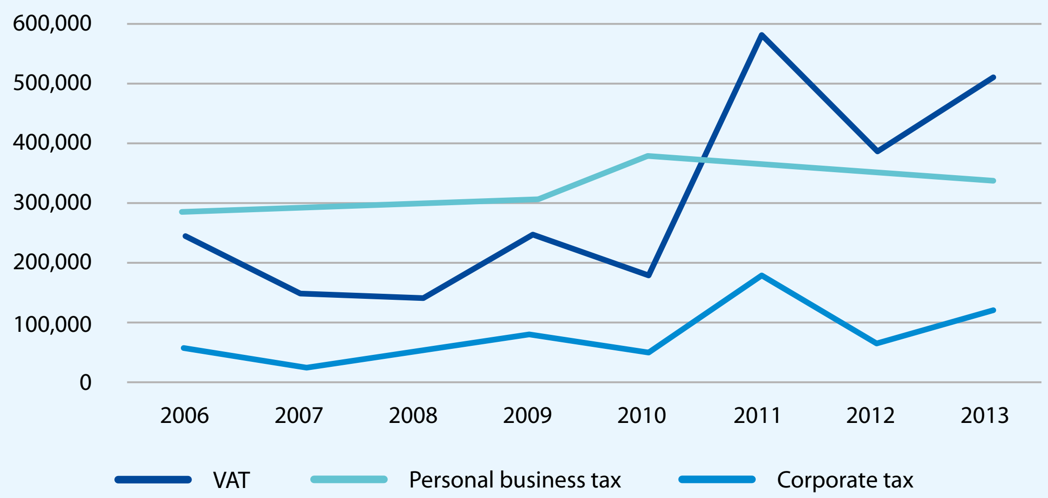
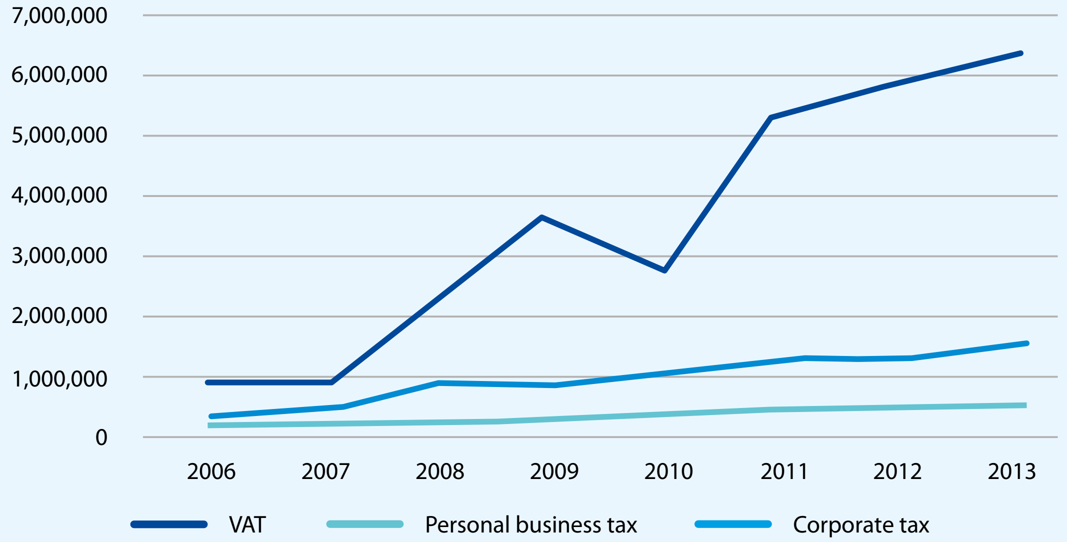


Figure 16: Agri-processing

	2006	2007	2008	2009	2010	2011	2012	2013
VAT	943,070	1,085,281	2,095,138	3,046,092	2,764,153	5,540,946	6,046,433	6,179,852
PERSONAL BUSINESS TAX	426,142	440,162	528,895	441,737	488,885	594,813	602,834	555,091
CORPORATE TAX	432,719	531,602	1,222,004	1,021,145	1,162,072	1,552,814	1,381,056	1,692,888

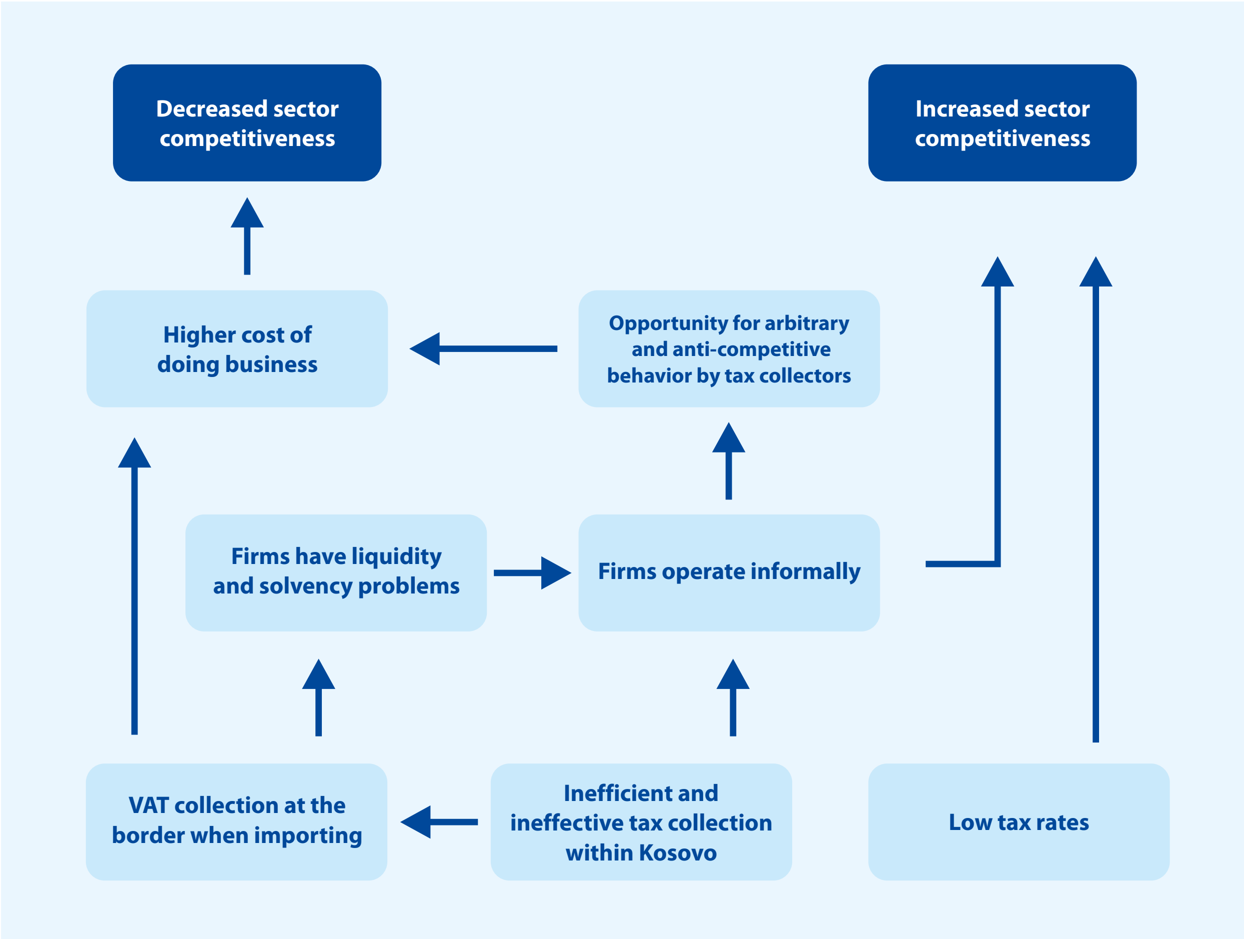


Source: Tax Administration of Kosovo, 2014.

6. PROBLEM DEFINITION: GRAPHICAL ILLUSTRATION

The empirical data presented in the previous sections suggest that the four manufacturing sectors have grown during the last decade, but there is no way to directly measure the direct impact of the tax regime, whether positive or negative. Nevertheless, there is no compelling evidence to suggest that tax rates have had a negative effect, whereas factors related to tax administration have had a mixed impact. A high degree of informality enabled by poor enforcement of tax collection actually gave firms critical breathing space for growth. But it also caused several problems that increased the already high cost of doing business – including here, critically, harming competition between and within sectors, since not all firms evade taxes to the same extent. The structure of the problem is presented in the form of a problem tree in Figure 14.

Figure 17: Graphical illustration, problem tree.



7. CONCLUSION: POLICY IMPLICATIONS

This paper used whatever empirical data that was available to assess the impact of the tax regime on the development of four manufacturing sectors in Kosovo: metal, wood, textile and food processing. These four sectors have grown over the last decade, albeit starting from a very low base. However, they still faced many constraints and barriers which increased the cost of doing business and thus decreased their competitiveness in increasingly integrated regional and global markets. Generally, the conclusion that can be drawn from the data is that in relative terms, factors related to taxation were not the main determinant in decreasing the competitiveness of Kosovar manufacturers. The main problems rest elsewhere and are related to the cost of financing, cost and quality of the workforce, etc. Nevertheless, there are a couple of important issues that were identified in this research which should be highlighted and which could be addressed from the perspective of tax rates and administration to support the expansion of these four manufacturing sectors. In broad terms, two main policy implications that stand out are:

a) Tax rates are not high, but they could be reduced even further or even eliminated entirely through tax-holidays

Evidence suggests that tax rates in Kosovo are low compared to other countries in the region or in Europe. But most Kosovar manufacturers still find them to be high, mainly because they operate in an environment where the cost of doing business is already high. They are thus driven to informality, which among other adverse effects, such as lower opportunities to get credit, also makes them vulnerable to tax officials' arbitrariness and extortion, creates conditions that are conducive for unfair competition, and further increases their cost of doing business.

One possible solution to this problem could be to reduce tax rates[31] to a minimum or even to introduce tax holidays for sector firms by eliminating tax payments entirely for a certain period (eg. five or seven years) while taking extra measures to ensure that they nevertheless register with TAK and report their revenues, which would formalize them in the long-run. Another option would be to link such stimulus packages to the already initiated process of establishing Economic Free Zones, which would also create conditions for sector clustering.

Certainly, the optimum-time span of tax holidays, the scope of the beneficiaries and their criteria should be explored in more detail as part of future studies – as the scope of this study is limited. But what could be confidently stated for the four sectors that are part of this study is that such measures could lead to several positive developments. Most importantly it would give firms sufficient breathing space to address other barriers in their business environment and would allow them to formalize and thus reduce the risks of any arbitrary and anti-competitive actions from tax inspectors.

There is also some reason to believe that such a measure could be fiscally feasible if applied only for these sectors. The total value of taxes collected from the four sectors represented a very small share in the general pool of revenues collected by TAK. As illustrated by Figure 15, only about €11 million in taxes (personal, business or corporate) were collected from all four sectors in 2013. Figure 16 shows that revenues from these four manufacturing sectors represent a mere fraction of the total revenues that TAK gets from corporate tax, personal income, business tax and VAT combined. For example, in 2013, while taxes collected from the four sectors stood at €11 million, the total collected from these taxes in Kosovo was €231 million.

Taxes from these sectors represent a mere 4.4%of the total taxes collected by TAK. It could perhaps be reasonable to assume that the VAT share paid to the Kosovo Customs through the collection at the border by the manufacturing sector is the same as the share paid to TAK. If extrapolated from the total amount of VAT collected by the Kosovo Customs (€410 million), the share of 4.4% would entail payment of taxes of about €16.5 million, thus putting the total tax bill for these four manufacturing sectors (excluding Customs duties) at about €28 million per year. That is still a fraction of the total revenues in Kosovo's budget of about €1.5 billion.

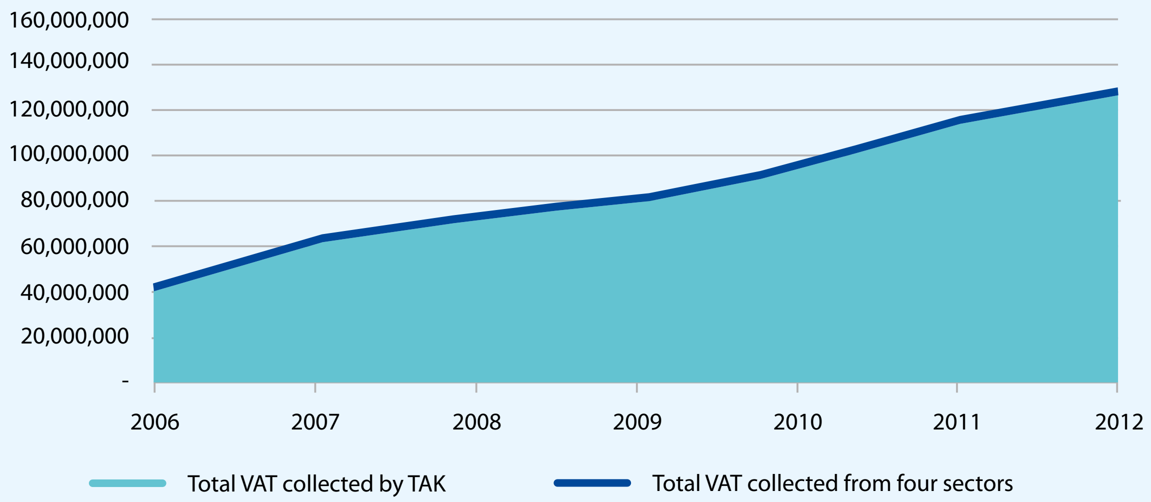
31 The mandate of this paper is not to recommend to whom tax reductions would apply – namely, whether only to the four sectors, to all manufacturing firms or to all businesses. It merely suggests what such a reduction would imply for the four sectors.

Figure 18: Total tax collection for all four sectors, by type of tax

	2006	2007	2008	2009	2010	2011	2012	2013
VAT	1,628,325	1,711,267	3,061,945	3,934,707	3,449,651	8,107,564	7,806,291	7,978,288
PERSONAL BUSINESS TAX	929,921	1,054,052	1,154,783	1,073,360	1,228,780	1,344,455	1,341,791	1,294,093
CORPORATE TAX	1,128,185	1,003,439	1,589,842	1,275,067	2,171,990	2,599,948	1,920,392	2,189,210

Figure 19: Collection of corporate tax + personal business tax + VAT by TAK, total and four manufacturing sectors

	2006	2007	2008	2009	2010	2011	2012
Total VAT collected by TAK	47,772,000	58,783,000	59,023,000	75,825,000	95,008,000	121,439,000	129,581,000
Total VAT collected from four sectors	1,628,326	1,711,267	3,061,945	3,934,707	3,449,652	8,107,565	7,806,292



b) It is critically important to strengthen TAK's capacities for tax collection

The existence of a high degree of informality suggests that the capacities of the Tax Administration of Kosovo to collect taxes are weak. That is why the Kosovo budget relies on the Kosovo Customs to collect VAT at the border, as it is easier to capture goods there than when they enter Kosovo. Nevertheless, VAT collection at the border is blocking valuable capital from businesses facing liquidity constraints and operating in an environment where the cost of doing business is already high. One possible solution could be to assign to the Kosovo Customs the role of only registering the entry of goods, which would then allow TAK to track and compare reported imports with the firms' financial statements and collect the VAT after the point of sale. This could entail, for example, the development of a joint information sharing software between TAK and the Customs. Better administration of the tax system would also be critical to avoid abuse in case any special incentives are developed (such as special tax reductions) or to prevent anti-competitive and arbitrary measures by tax collectors against specific firms.

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