USAID ASSISTANCE IN FISCAL REFORM

THE KOSOVO ECONOMIC RECONSTRUCTION PROJECT

JUNE 2006

This publication was produced for review by the United States Agency for International Development. It was prepared by Development Alternatives, Inc.

KOSOVO

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I. PROJECT DATA

Level of Funding: Phase One: $20 million / Phase Two: $10 million (estimates)

Period of Assistance: Phase One: 1999-2003 / Phase Two: 2003-Present

Types of Assistance:

1. Technical Assistance: (a) resident project team; (b) short-term specialists (c) long-term advisors to specific officials
2. Materials and Equipment
3. Training: (Including extensive on-the-job training, classroom and seminar settings in-country and abroad, and study tours)

Areas of Assistance:

1. Tax Policy and Administration
2. Tax and General Economic Policy Analysis and Forecasting
3. Expenditure Planning, Execution, Monitoring and Control
4. Institutional and Organizational Development
5. Intergovernmental Fiscal Relations and Municipal Government Finance
6. Pension System Design and Implementation

Main Counterparts:

1. Offices of the Minister of Finance and Economy and of the Permanent Secretary
2. Macroeconomic Analysis Unit
3. Budget Office
4. Tax Departments
5. Treasury
6. Audit
7. Municipal Governments' Finance and Property Tax Departments

II. THE PROJECT: BACKGROUND, PRINCIPAL RESULTS AND IMPACT

Introduction

Kosovo is a special, perhaps unique, case in the history of USAID assistance in the fiscal realm. Starting with a blank page at the end of the 1999 war, the Economic Reconstruction Project assisted a new Kosovo government structure in building all the institutions of government fiscal management and setting them into operational motion.

The project is noteworthy for its comprehensiveness. In fact, the fiscal component of the project was just one of four major components, although it is estimated to have consumed approximately one-half of the project's total budget. The fiscal component included each of the main areas of government fiscal management: tax policy and analysis, tax administration, expenditure policy, budget management and control, intergovernmental fiscal relations, and sub-national government finance. Seldom, if ever, has a USAID project addressed all these areas simultaneously.

The following sections briefly summarize the project, its political and economic context, and its key accomplishments in building and strengthening Kosovo's fiscal institutions over the past eight years. This is followed by annexes which address two special areas of project assistance: (i) municipal finance and property taxation, and (ii) pension system design and implementation.

A. *Background and Economic Context of the Project*

At the end of the 1999 war Kosovo gained significant autonomy from Serbia, of which it remains *de jure* a part. By Resolution 1244 of the UN Security Council, a temporary government was set up, headed by a Special Representative of the Secretary General (SRSG). Post-war reconstruction of Kosovo commenced immediately following the war, without awaiting resolution of the sensitive issue of Kosovo's final political status. The overall reconstruction effort was organized under a special UN organization, the United Nations Mission in Kosovo (UNMIK). As reconstruction proceeded, elections in Kosovo were held to provide, first, executive branch leadership and then a legislative branch. Conceptually, authority and control over the institutions of self-governance were to be handed over to Kosovars as the institutions were judged by international authorities to be capable of managing them effectively.

As Kosovo is geographically a part of Europe, the European Union was assigned nominal responsibility for the economic dimension of reconstruction. However, USAID quickly emerged as the donor agency best able to get teams of competent and experienced experts quickly in place and working.

The challenge was massive. It was not just a matter of improving existing but underperforming institutions. Rather, the institutions had to be created, staffed, given statutory and procedural foundations, and operationalized. The Albanian-speaking majority who remained in Kosovo after the war did not include an experienced cadre of technical, professional and managerial specialists ready to take up key positions. Consequently, the technical advisors provided by USAID had to become *de facto* (and sometimes *de jure*) government officials in these institutions at the same time they sought to help Kosovar counterparts prepare to take over. The complex hierarchy of authority in the temporary governance structure added to the difficulty of the task.

USAID's Economic Reconstruction Project was implemented in two phases that roughly followed the two key periods in Kosovo's postwar political development. Phase One (1999-2003) took place in an environment in which UNMIK wielded considerable authority in setting policy and administering government functions. During this period, authority to govern was divided between the UN and local authorities, and USAID advisors occupied positions of direct administrative responsibility in all of the fiscal institutions. Thus the formal relationship between

USAID and the governing authorities of Kosovo did not rest on a traditional bilateral diplomatic agreement.

By 2004, however, the political landscape was changing as local authorities gained greater responsibility over public administration, and as UNMIK began to withdraw from its dominant role in policy and civil affairs. With this change, USAID assistance began to shift from management of the fiscal institutions it helped create to building local capacity to administer those institutions directly. Thus in Phase Two (2003-Present), USAID assistance began to assume the more typical bilateral form, focused on achieving results through the more common channels of discussion, debate and persuasion. During this period, the project focused on "refining and calibrating" the fiscal institutions it helped create, with expatriate experts serving largely as "coaches" to Kosovar technical, managerial and professional experts.

Of course, one negative consequence of the increasing role of local authorities in government fiscal management has been the emergence of rent seeking in its varied forms: patronage, misappropriation, and outright theft and corruption. During Phase One, rent seeking was not a significant impediment for the simple reason that there was limited local administrative authority and opportunity to engage in such activities. This has not been the case in Phase Two.

A further note must be made concerning the economic environment in which the project took place. As the table below shows, Kosovo experienced double-digit GDP growth in the two years immediately following the war, fueled by remittances from Kosovars living abroad and a massive influx of foreign assistance. Government revenues then continued to grow rapidly from 2001 to 2003, both in nominal terms and as a percentage of GDP, as Kosovo's fiscal institutions were created and as major taxes (such as the Value Added Tax, the personal income tax, and corporate income tax) were introduced. Government expenditures during the same period grew more slowly, in large part because spending agencies had just been established and were not operating at full capacity, leading to large cash surpluses. Phase One activities, therefore, took place in an environment which can only be described as benign, even comfortable.

Key Economic/Fiscal Indicators, 2001-2006

	2001	**2002**	**2003**	**2004**	**2005**	**2006**
	Estimate					**Projection**
GDP Growth (%)	16.6%	-2.9%	-1.4%	3.7%	-0.5%	2.3%
Main Fiscal Indicators			*in % of GDP*			
Total Revenues	14.5	22.2	26.2	26.8	28.4	28.0
Total Expenditure	10.8	17.9	24.1	32.8	31.6	30.9
of which: current expenditure	10.5	17.2	22.5	25.4	24.8	24.9
of which: capital expenditure	0.3	0.7	1.6	7.4	5.9	6.3
Current balance	4.0	5.0	3.7	1.4	3.7	3.1
Budgetary support grants	1.9	0.4	0.0	0.2	0.0	0.0
Overall balance after budget support	5.5	4.8	2.1	-5.8	-3.2	-2.8

Source: International Monetary Fund staff estimates, May 2006; Ministry of Finance and Economy.

In Phase Two, however, the economic and fiscal environment has proven more challenging. After 2001, economic growth dropped off as remittances and foreign assistance declined and as planned privatization efforts met with delays. The economic slowdown led to a decline in revenue performance, although improvements in tax administration helped sustain more modest revenue growth. Meanwhile, by the end of 2004, expenditures had reached genuinely unsustainable levels, sparking a serious, broad-based effort to institute expenditure control. Underpinning this problem was the bifurcation of the government budget into “reserved” and “transferred” components corresponding to UNMIK and locally dominated spending agencies, respectively. This unnatural division of resources contributed to an inability at that time to establish a clear and sustainable medium-term fiscal strategy. Thus, transforming and refining the institutions of public expenditure planning and management became a core focus of USAID’s Phase Two assistance.

In summary, by 2004 the economic environment had become much more challenging and USAID advisors needed to execute their responsibilities one step removed from actual decision making.

B. *Outcomes and Impacts in the Project’s Principal Areas of Assistance*

1. Institutional Formation and Development of Ministry of Finance and Economy

As noted above, the project began when Kosovo did not have the institutions required to plan and implement a government expenditure program and to collect the funds to pay for it. For this reason, the technical assistance experts retained to build the institutions played a major role initially in performing the institutions’ operational functions.

The task of developing the Ministry of Finance and Economy (MOFE) and its key functional units focused on nine specific areas: (i) direct support to the Minister and the Permanent Secretary; (ii) macroeconomic analysis and revenue forecasting; (iii) tax policy; (iv) tax administration, including the property tax; (v) budgeting; (vi) intergovernmental fiscal relations, including fiscal decentralization and municipal budget preparation; (vii) treasury; (viii) internal audit; and (ix) procurement.

An external evaluation of the project was commissioned by UNMIK and undertaken in October and November of 2003., The offices of the Minister of Finance and Economy and of the Permanent Secretary were staffed and functioning effectively, though with continuing expatriate advisory and operational assistance. The Minister and his staff performed the tasks appropriate to their respective positions and were becoming increasingly skilled interlocutors with the legislative branch as well as with other cabinet officers. Each of the other eight functions enumerated above was also being undertaken with increasing Kosovar participation, albeit with varying degrees of efficacy.

2. Tax Policy and Administration

a. Tax Policy

USAID’s technical advisors were aware that simplicity of administration would be indispensable to the effective development of tax policy in Kosovo. Accordingly, the advisors recommended a system of seven taxes with few rate gradations, few exemptions and few credits. The tax system was designed to minimize the potential disincentive effects on private production and investment, and distortions in the allocation of economic activity across sectors.

The taxes established with USAID assistance are discussed below. Notably, through 2003 the tax system was producing sufficient revenues to finance all public expenditures. Moreover, despite the sharp rise in government spending and the deterioration of the overall fiscal balance after 2003, tax revenues—at 28.4 percent of GDP in 2005—are still sufficient to fund 100% of the recurrent budget.

<u>Value Added Tax</u>. Value Added Tax (VAT) replaced the sales tax in 2001. VAT is now the most important tax in terms of revenue generation, generating more than 40% of total tax revenue. Its single rate (15%) and relatively high threshold (collected from importers and enterprises with sales of 50,000 euros or more) make it a relatively simple tax to administer as well. Since the VAT's inception, revenue performance has been strong, with average annual growth of 13% in collections, including 25% growth in domestic collections. There is an ongoing effort to revise the existing VAT rules to better harmonize them with the EU's Sixth Directive. Included in these discussions were discussions of reducing the VAT threshold to 30,000 euros along with introduction of fiscal cash machines in an attempt to gain better control over sales and turnover for VAT and corporate income tax purposes.

<u>Excise Taxes</u>. This tax is second only to the VAT in revenue production, having generated in 2005 an estimated 29% of total tax revenue. Like the VAT, it is relatively easy to administer even if it has less to commend it on economic efficiency grounds. The main component of excise tax revenue is a border tax on petroleum products.

<u>Customs</u>. The customs duty is levied at a flat 10% rate and accounts for about 14% of tax revenue. Moreover, the portion of all revenue that is generated by border taxes of one kind or another is believed to be on the order of 70%. If a sharp drop in imports should occur, there could be a correspondingly sharp drop in government revenue. The introduction of comprehensive personal and corporate income taxes should eventually reduce the degree to which the government depends on border taxes for revenues.

<u>Personal Income Tax</u>. When introduced in 2002, the personal income tax was solely a tax on wages. It was envisioned that the tax would later evolve into a tax on the global income of individuals. Starting January 1, 2005, it began to include income from business activities, interest, dividends, rents, capital gains, lottery winnings, copyrights, and all other income that increases a taxpayer's net wealth. The tax continues to follow the original rate structure for wages, with 0%, 5%, 10% and 20% bands (0% for the first 960 euros of annual income).

<u>Presumptive Tax</u>. The presumptive tax was introduced in 2000 as a way to generate quick revenue at a time when businesses still lacked the sophistication to keep sound books and records. The tax was imposed on the "presumed," rather than actual, profit of all entities (3% on turnover). The presumptive tax is gradually being phased out and will be replaced by presumptive tax provisions in the personal and corporate income tax laws.

<u>Corporate Income Tax.</u> Introduced in 2002, the corporate income tax replaced the presumptive tax for larger businesses (sales over 50,000 euros, which is also the VAT threshold) and for certain other businesses that are required to maintain more formal books and records. A new corporate income tax law that took effect on January 1, 2005 expanded application of the tax to all corporations in Kosovo. The new tax imposes a rate of 20% on net income, which is low in comparison to rates in place in many parts of Europe.

Property Tax. Since the property tax was implemented across Kosovo in 2003, municipal property tax administration, along with public acceptance of the tax, has become institutionalized in the fabric of municipal own source revenue for 27 of the 30 municipalities. Progress in expanding that revenue mechanism is described in Annex 1, attached.

b. Tax Administration

In developing the tax system in Kosovo, the project also laid critical foundations for effective tax administration. During Phase One, the Central Tax Administration was established with the basic organizational layout, personnel, systems and procedures necessary for administering the taxes described above. For its IT needs, in 2000 the Tax Administration installed Canada's Standard Integrated Government Tax Administration System (SIGTAS) to control taxpayer records, returns processing, bank reconciliation and management information.

During Phase Two, significant advances were achieved in tax administration. First, responsibility for tax administration was fully transferred to local officials, including the office of Director, reflecting marked improvements in the capacity and professionalism of local tax officers. In 2005, a new Tax Administration Law based on international "best practice" standards was promulgated. The law provides for stricter sanctions against tax evasion; stronger powers for collection; clear protections for taxpayer rights; and, a code of ethics to guide the conduct of tax officials.

The SIGTAS system, which has been in place for six years, continues to improve in efficiency as users gain experience and as enhanced modules are added. In addition, despite initially poor performance in collecting unpaid taxes, significant strides have been made in the collections area. A vigorous effort is underway to rationalize the collections effort and to use the powers of lien and levy when necessary.

Unfortunately, since 2004 corruption and other forms of rent-seeking have surfaced in the operations of the Tax Administration. Among others, patronage in hiring, collusion with certain taxpayers, and extortion of others have been detected. These problems have been addressed through a serious internal integrity campaign supported by the USAID project.

3. Economic and Policy Analysis and Forecasting

In the MOFE the critical revenue forecasting function was placed in the Macroeconomic Unit. The analyses of the unit are of great importance in the Ministry's efforts to propose fiscal policies that are compatible with broader economic goals. Similarly, it is essential to be able to make plausible forecasts of macroeconomic outcomes in order to make sound estimates of the revenue that will be available to finance the budget.

The expatriate-led team that headed this unit in the MOFE performed excellently, and in extraordinarily difficult circumstances (e.g., little availability of plausible data; inexperienced supporting analysts). It is a tribute to this unit that other parts of the Kosovo Government as well as international organizations such as the IMF, the World Bank and the UN have relied for their own analyses on MOFE's data and analyses. Whether the high level of performance can be sustained depends on solving the problem of attracting and/or training skilled professional analysts, and on encouraging them to stay in the government. By mid-2006, a new local staff had been hired and their training commenced.

4. Expenditure Planning, Execution, Monitoring and Control

With USAID assistance, all aspects of expenditure planning, execution, monitoring and control had been put in place. Following are a few highlights of accomplishments in this area.

Unified Budget/MTEF. USAID assistance helped with the development of a unified budget. Specifically, the distinction between "reserved" and "transferred" parts of the budget has now been eliminated. Budgets are now developed with formally structured interactions between all budget actors, and in the context of a medium-term expenditure framework (MTEF) which takes full account of the forward projections of low revenue growth. This provides a framework sufficient to control future spending plans and to limit the growth in public sector employment. Without these strict limitations, future spending obligations would be difficult to control. USAID advisors provided critical coaching to local counterparts through a series of budget cycles and through a number of organized training programs that contributed to improvements in local capacity to manage the budget development process.

Financial Reporting by Treasury. A Reporting Unit was established within the Treasury and is responsible for comprehensive financial reporting, including monthly, quarterly and annual reports on budget execution. In 2005 the government's financial statements, which were previously prepared by an international advisor or a professional accounting company, were produced independently by local Treasury staff. All budget organizations also produced their own financial statements in 2005, based on administrative instructions issued by the Treasury. The implication of this is that Treasury has led the way in ensuring transparency in the execution of the Kosovo budget. The quality of Treasury reporting has enabled complex strategic fiscal planning (i.e. MTEF) that is based on detailed current and historical fiscal analysis. Moreover, improvements in Treasury reporting have increased the level of public debate on fiscal issues, including within politics and media.

Recalibration of the Organizational Structure of the Treasury. In 2005, a Kosovar local was appointed as Director of Treasury, replacing the USAID advisor who previously held this position. The terms of reference for the new appointment gave the new Director control over key elements in management of Treasury (budget execution, personnel, etc.). Previously, external interference and rent seeking in issues such as procurement and staffing were significantly constraining development of the Treasury. The Director has taken a strong position on issues such as control of expenditure on salaries, and has reinforced the role of an independent Treasury in ensuring that public expenditure is made within the constraints of the approved budget.

Treasury Accounting. A Reconciliation Unit was established, and in 2005 financial statements were fully reconciled. In addition, a Cash Management Unit was established and Treasury now manages budget allocations based on detailed cash flow plans. Local staff are now managing these functions, following training from international advisors. As a result, Treasury's ability to manage increasingly scarce fiscal resources has rapidly improved.

Financial Management System/FreeBalance. Kosovo now has a comprehensive, uniform financial management system, based on the FreeBalance platform. It is "comprehensive" in the sense that the system enables a wide range of financial management elements (i.e. from revenue to assets) and that data from all institutions is in the system. All budget organizations and all major revenue agencies are now connected to the system and are using FreeBalance to record all transactions. In this sense, the system has become a "one-stop shop" for fiscal information. The system is "uniform" in that it now enables comparison of accounting data at all levels of government and between all institutions. The financial management system is also a "real time" system. In effect, this means that the tools are in place for best practice in financial management and that there is real transparency—which, for example, enables meaningful external auditing of budget organizations to commence.

III. FACTORS OF SUCCESS

Kosovo's institutions of fiscal administration began only in 1999. Yet they are operational, and their operations reflect policy choices that are broadly effective in mobilizing tax revenue, managing expenditures and in reinforcing broader economic policies and objectives. We turn now to a consideration of the key factors in the project's success.

1. <u>Relationships among USAID, the Kosovo Government, Expert Advisors and the International Community</u>. According to the independent evaluators in late 2003, several institutional relationships played an important role in the success of USAID assistance. First was the relationship of expert advisors to the government institutions to which they were tasked. In the earliest stages of the project, the temporary governance structure gave expatriate officials and advisors extraordinary authority over the kinds of policies and institutions that were established. In most cases, the key expatriates shared very similar views of what constituted international "best practices" with respect to fiscal administration. Thus these elements of the "Kosovo Government" bought in fully to the conceptual views recommended by the expert advisors. Second was the relationship between the USAID Mission and the expert advisors. USAID officials recognized that the expert advisors had the concentration of specialized technical expertise to provide the necessary support. USAID project officers provided excellent management oversight and stewardship of the contract, but did not attempt to intrude upon or second-guess the conclusions of the technical experts. Third, the relationship between the advisors and their host government counterparts was appropriate in most cases and did not generate resentment or sabotage inclinations on the part of counterparts.

<u>Subsequently</u>, with the transfer of authority from expatriates to Kosovars, many of the advisors who initially directed the key fiscal institutions became those institutions' "coaches." They consequently had a very high level of credibility among local counterparts. Finally, the project implementation could not have been possible without sustained cooperation among the key members of the international community in Kosovo, including UNMIK, IMF, World Bank and the European Union, especially during the course of Phase Two.

2. <u>Comprehensiveness of the Project's Scope</u>. The project wisely addressed both taxation and expenditure planning and execution. Often, a discussion of taxes leads to undue emphasis on the income distribution implications of a tax, ignoring the reality that the expenditure side is usually a better vehicle for realizing social and income distribution objectives than the tax side. Including both sides of the fiscal system helped avoid this pitfall. In Phase Two the project became even more comprehensive in scope, as key advisors were placed in the Assembly and the Office of the

Prime Minister. This has been essential in helping local leaders shape policy and promulgate high quality legislation.

3. Simplicity as the Hallmark of Project Recommendations. A tax that applies to all or most persons with income, at one or just a few rates, and with few exemptions or credits, is a simple tax. Its administration is also simple, as there is less need to detect efforts to qualify for a lower rather than a higher rate, or to qualify falsely for a credit or an exemption. Because the work of assessing liability and finding the taxpayers is more straightforward, the cost of administration, and the cost of compliance, is lower. Moreover, the urgency of the need resulted in the project focusing on the fundamentals first. For example:

(i) In the short-term, a "good" budget was defined as a balanced budget. Such refinements as cost/benefit analysis were delayed.

(ii) An immediate wage tax was adopted rather than wait for the more sophisticated personal income tax.

(iii) For Treasury, cash management and debt management were postponed.

4. Quality of the Technical Experts Provided by USAID. According to the external evaluators, USAID had found a good balance between the quality of experts, equipment and other inputs into a project, and the cost of the project. When providing technical assistance at such a high level as cabinet officials who have policy making responsibility, it was felt to have been economical to get the best qualified, most internationally prominent experts available. Policy experts were required from the start, since high level government officials take such persons far more seriously than more junior, and less expensive, experts. Moreover, by and large, the compensation rate of a more expensive expert in fiscal administration was judged by the evaluators to have reflected the greater value of his or her production.

5. Close Involvement of USAID Leadership in Critical Aspects of Ongoing Policy Formulation. In particular issues, especially some of the sensitive issues involving rent seeking during Phase Two, USAID leadership was willing and able to play an activist role. This was often a critical factor as many important issues that will have a strong bearing on the technical assistance effort were initially perceived by counterparts as essentially political in nature.

6. The Blank Page. In Kosovo's immediate, post-conflict environment, there was no malfunctioning fiscal management mechanism and no tax structure (with inevitable "winners" and "losers") in place. Thus, building the institutions and policies was able to take place without resistance from the entrenched interest groups.

Annex 1. USAID Assistance in Municipal Finance and Property Taxation

The current system of municipal finance was established in 2001 and 2002 when responsibility for delivering major services such as elementary and secondary education and primary health care was devolved to municipalities. The revenue system envisaged two sources of financing for municipalities: (i) transfers from the central budget in the form of grants, and (ii) municipal own-source revenues. The level of grants was to be determined during the budget planning process on the basis of objective formulas. A statutory foundation for the system of grant calculation and distribution was established in the Law on Public Financial Management and Accountability through decisions approved by the Grants Commission.

Pursuant to the Law on Public Financial Management and Accountability, the Grants Commission holds regular monthly meetings, called by the Minister of Finance and Economy. The Law also specifies the membership of the Grants Commission, including the Prime Minister, the Minister of Finance and Economy, another Minister appointed by the Government, the Chair of the Budget Committee of the Assembly, and three representatives of municipalities nominated by the Association of Kosovo Municipalities and approved by the Government.

Through the budget development process in 2005, the MOFE undertook efforts to strengthen the system of intergovernmental financing. The medium-term municipal budget strategy approved by the Government in 2005, as well as other strategic documents such as the most recent MTEF, committed provision of 22.5% of projected annual central budget revenue to municipalities in a form of grants. This share is intended to remain constant over the medium term, with the main objective being to provide for relative stability in intergovernmental transfers.

The system of intergovernmental transfers includes three categories of grants: an unrestricted general grant, a special purpose education grant, and a special purpose health grant. The main criteria for each of the grant distribution mechanisms are: objectivity, fairness, and transparency.

The total education grant is distributed on a per pupil basis adjusted for factors that determine per pupil costs. The World Bank formula for the assessment of fiscal needs is used in order to determine per-pupil costs for each municipality.

The total health grant and the general grant are distributed on a per capita basis.

Increasing spending pressures and a projected decline in the growth of revenues over the medium term demand a municipal budget process that assist municipalities in targeting expenditures to the highest priority areas. To address this challenge, municipal budget process reform was initiated in 2006 with the introduction of several modifications:

- initiation of a multi-year budgeting approach;
- introduction of annual cash based budgets;
- implementation of the first stages of program budgeting;
- introduction of a consolidated Public Investment Program; and
- mandatory public budget hearings.

Apart from intergovernmental transfers from the central level of government, municipalities rely heavily on own-source revenues in order to finance municipal functions. Considerable efforts have been undertaken by project advisors to develop incentives for improved municipal own-source revenue mobilization.

The following table shows the increase in total property tax revenue collected by the 27 (out of 30) municipalities that administer the tax.

Year	Total PT Revenue	Difference from Prior Year	% Increase Over Prior Year
2003	€ 3,482,889	N/A	N/A
2004	€ 5,518,261	€ 2,035,371	58%
2005	€ 6,683,554	€ 1,165,293	21%
2006 (Jan-May)*	€ 2,687,746	€ 394,869	17%

*Figures for 2006 compare revenue to Jan-May 2005.

Commensurate with ever-increasing property tax collections, compliance has also shown steady improvement. Property tax revenue was 22% of the total assessment in 2003; 44% in 2004; and 53% in 2005. This can be attributed to public acceptance of the tax and a gradual recognition of the linkage between paying property taxes and the public benefit. In fact, in 2006 several municipalities decided that public sentiment towards the market-based property tax was sufficient to accept a small increase in tax rates. The result is an additional €1,555,389 in the total property tax assessment over 2005, for a total assessment of €14,235,002 in 2006.

The most significant development in 2005 was the design and implementation of the Property Tax Incentive Grant. The Incentive Grant operates according to a predetermined set of criteria. At the beginning of the year, the tax rates and collection rates for each class of property in each municipality is compared with the average tax rates and collection rates in order to determine the "revenue effort" of the municipalities. Municipalities that collect more property taxes in the current year than they did in the previous year qualify to receive a portion of their Incentive Grant allocation. Municipalities that meet or exceed their targets receive their full allocation plus a portion of the undistributed funds from municipalities that fail to match their previous year's revenue performance.

The Minister of Finance and Economy saw the value in the Incentive Grant and was convinced of the soundness of the methodology. The Grants Commission approved its implementation and every municipality immediately began working towards achieving their revenue targets. For the first time, a comprehensive set of statistics on real estate assessment, taxation and collections for each property class in each municipality was collected and analyzed.

The Incentive Grant had a tremendous effect on 2005 collections. By the end of the year, over 6.6 million euros was collected, a 20% increase over 2004. Given the rate of collections prior to implementation of the Property Tax Incentive Grant, it seems clear that the increased revenue effort of the municipalities is responsible for approximately 500,000 euros in additional revenue collected in the last six weeks of 2005.

Annex 2. USAID and Pension Reform in Kosovo

During 2001-2003, a fundamentally new pension system was designed and implemented in Kosovo with design leadership from the USAID project. The system has three components, or "pillars." Following is a discussion of each of these pillars.

Pillar I. Pillar I is constitutes an old-age "basic pension" (paid to all Kosovars 65 years of age and older) and a disability pension, both of which are funded from general revenues rather than an earmarked wage tax. This pillar helps avoid high payroll taxes since there is no wage-based "social contribution." It enables near universal coverage in an environment where only a small share of the population earns formal wage income. And, it adheres to a principle of clear division of roles, where Pillar I ensures poverty avoidance and Pillar II serves as the main vehicle for savings. In contrast to the previous Yugoslav pension system, which only covered roughly half of the elderly population over 65, the new system quickly achieved almost universal coverage.

The benefit is tied to the cost of a basic monthly food basket, based on official government statistical surveys, in order to contain long-term costs with a real anchor. This has been an important fiscal achievement, given the East European context: Unlike other countries in the region, where pension expenditures are eating up an increasingly large share of GDP due to aging populations and political inability to control benefit rates, in Kosovo the basic pension is tied to the food basket, so state pension expenditures as a share of GDP should decline over time, assuming the economy in the long run grows faster than the impact of demographic changes. Furthermore, pensions are paid through the banking system rather than through the postal service, reducing administrative costs. And, the disability pension is narrowly focused on total and permanent disability, ensuring that scarce resources are well focused on the truly disabled.

Pillar II. Pillar II of the system is a mandatory, defined-contribution, savings pension program. The program requires all working, habitual residents of Kosovo to contribute 5% of gross salary, matched by a 5% employer contribution. Contributions and records are managed by the Kosovo Pension Savings Trust (KPST), an independent body established solely for the purpose of administering the savings pension system. The KPST invests pensioners' assets abroad through major European asset managers. There are no legal requirements or restrictions on overseas or domestic investment, though high standards are set for the security of instruments, which at least for the initial years have led the KPST governing board to invest outside Kosovo. Collections are centralized to minimize administrative fees. KPST participants' asset levels are shown in the following table, having reached a level of 7.6% of GDP in 2006.

Pillar II Asset Levels, 2002-2006

Date	Assets Under Management (euros)
December 31, 2002	8.6 million
December 31, 2003	34.8 million
December 31, 2004	79.9 million
June 15, 2005	106.4 million
May 31, 2006	170 million

The following data show the level of coverage provided by the savings pension system to date. The new contributory pension system has high coverage, at least of workers in the formal sector (i.e., those who pay personal income taxes).

Pillar II Contributor Trends, 2002-2006

Date	KPST Employers[1]	KPST Employees[2]	Taxpaying Employees
December 2002	278	87,333	
June 2003[3]	401	97,217	
December 2003	11,262	144,977	
June 2004	13,622	158,224	135,578
December 2004	14,993	168,718	
June 2005	40,735	236,278	163,829
June 2006	-	206,000	129,213

*The numbers for taxpaying employees are annual averages for 2004 and 2005, and the first-quarter preliminary average for 2006. KPST contributors include some who are exempt from income taxes (e.g., working for a donor or below the PAYE threshold).

The KPST has performed well to date. Net real investment returns were positive by the second full year of operation, in contrast to many systems in the Eastern European region that continued to yield negative returns for the first three to five years after implementation, partially due to high administrative fees. Administrative fees charged have been low by regional standards, at 1% of assets, compared to combinations of asset and contribution charges in other countries that add up to higher net amounts.

Pillar III. Pillar III of the system provides for supplemental, voluntary, individual or employer-sponsored pension schemes. The Banking and Payments Authority of Kosovo (the BPK—Kosovo's equivalent of a central bank) licenses and regulates all third-pillar pension schemes. The BPK also regulates the KPST.

The reform has achieved a number of important policy outcomes. Labor taxes and contributions have been kept low to reduce labor-market distortions. The PAYE pillar is fiscally sustainable over the long term and leaves enough fiscal room for other important needs-based social programs. Coverage greatly expanded to nearly all the elderly population, whereas the old Yugoslav system reached only approximately half of Kosovo's elderly. Funds under Pillar II are securely invested, according to international best practices, and already are returning positive real net returns to participants, with comparatively low administrative fees. The foundation for supervision of mandatory and voluntary funded pensions is strong, with effective transparency requirements. The system now is comprehensively implemented, having wrestled with issues of collection, recordkeeping, IT systems, and information reconciliation processes

[1] Includes self-employed.
[2] This data reflects the number of employees (including self-employed) for whom valid IDs have been received. It represents the number of participant accounts that have been opened in the KPST database. Contributions have been received for additional individuals for whom ID has not yet been received or validated. In this case, contributions are tracked using dummy IDs in a temporary account.
[3] Prior to the Phase Two expansion of coverage.