

Macroeconomics and Monetary Economics**Budget Deficits, Public Debt and
Irregular Receipts: Kosovo case****Lutfi Zharku¹**

Abstract: The aim of this paper is analyze the impact of irregular receipts (one-time receipts such as dividends from public companies and privatization proceeds) in budget deficits that are partially financed by public debt (internal and external) in Kosovo. Kosovo is experiencing both a budget deficit and public debt burden, so it is important to analyze the very beginnings of these tendencies. There is extensive literature on the causes of a budget deficit, its definition and measurement. The literature review method is adopted for this study, and research is refined by including empirical and theoretical studies of budget deficits and public debts. Using this line of reasoning, we have defined and measured special-purpose deficits, so-called “regular” budget deficits that consider only regular receipts and outlays. This analysis leads to the conclusion that irregular receipts used by government to engage in large infrastructure projects and/or politically motivated increases of wage and salary bills and social transfers created future liabilities that had to be financed through public debt. This is a case study of Kosovo. Research has been carried out using primary data drawn from Kosovo’s annual financial reports and annual bulletins on public debt. Budget deficits in Kosovo are results of continuous outlays based on initially high cash balances and irregular receipts that could not be met later by regular receipts. All this was supported by lack of legal infrastructure or fiscal rules for several years. The implications of this paper will be of high importance for policy-makers and academics. This is a unique approach to the issues of Kosovo’s budget deficit and debt.

Keywords: Budget deficit; public debt; fiscal rule; irregular receipts; political budget cycles.

JEL Classification: H6; H62; H63; H68

1. Introduction

Kosovo’s debt history is as young as the country. The new country started with a cash balance of 449.8 million euros (balance on 1 January 2008) equal to 13% of its GDP, with a real GDP growth rate of 8.3% (2007) and no public debt. Another 406.25 million euros have been added to the privatization fund of Kosovo Trust Agency and 279.6 million euros to the Kosovo Pension Saving Trust, and until then,

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no dividend was received by the government from public companies. Thus, cash amounting to about 30% of GDP was idle on the eve of Kosovo independence, while the unemployment rate was estimated to be around 40% and very bad public infrastructure (mainly roads) was considered one of the most serious obstacles to economic growth. Kosovo chronically suffers from large trade deficits, with around 10% of exports covering imports while the balance of deficit payments are being covered by FDI and remittances. There have been about 75,000 civil servants, both in central and local governments, with the lowest average monthly salary in the region of only 230 euros.

Kosovo's debt portfolio was established in 2009 following membership in the International Monetary Fund (IMF) and World Bank (WB) on 29 June 2009, when the country agreed to take over the debt inherited from the former Yugoslavia in the amount of 381.21 million euros as Kosovo Consolidated Credit (KCC) that was split into three installments. To finance budget deficit, Kosovo started issuing three-month treasury bills in 2012. This step was taken only after the country faced liquidity difficulties as a result of continuously running budget deficits since independence and almost depletion of its cash balances.

Table 1. Total debt (million of EUR)

	2009	2010	2011	2012	2013	2014	2015	2016
External debt	249.0	260.4	253.6	336.6	323.8	326.4	371.2	373.8
Internal debt	–	–	–	73.3	152.5	256.5	377.8	480.0
Total debt	249.0	260.4	253.6	409.9	476.3	582.9	749.0	852.8
State guarantees	–	–	–	–	–	10.0	10.0	20.0
Total* Debt / GDP	6.1	5.9	5.3	8.1	8.9	10.7	13.1	14.6
GDP	4,070	4,402	4,815	5,059	5,327	5,567	5,807	5,985

* Source: *Yearly Bulletin 2016 on Public Debt, Government of Kosovo, Ministry of Finance Including state guarantees*

In fact, Kosovo first borrowed externally in 2010 from IMF. From 2011 onward, Kosovo started to borrow from other international financial institutions like International Development Association, Unicredit, Kfw, EBRD, and EIB for specific projects in education, agriculture, health care, road and rail infrastructure, waste and water treatment, central heating, etc. These loans are made regardless of developments in the fiscal sector. The government regularly serviced the external debt.

At first glance, there seems to be no concern about internal public debt. The total debt ratio to GDP is low (14.6%), while internal debt makes up more than half of it. Table 2 shows that Kosovo started to borrow internally in 2012, when according to

the government's annual financial statements, the cash balance at year end was ample and the budget recorded a surplus. However, looking more closely, we notice that the government was not able to service any principal of the internal debt but only the interest, although it continued to run small deficits in 2013-2014 followed by surpluses in 2015-2016. The government refinanced the internal debt by extending the maturity of newly issued treasury bills. The short-term treasury bills (three-month and six-month) were gradually replaced by treasury bills with a maturity of 12 months and two years and later with bonds with three-year and five-year maturity. Neither the annual financial statements nor audit reports show any specific reason for increasing public debt. At the same time, there was no deficit rule to follow.

Table 2. Internal public debt (millions of EUR)

	2012	2013	2014	2015	2016
Debt stock	73,31	152,51	256,52	377,78	478,97
New debt issues	73,31	79,20	104,01	121,26	101,19
Service of interest	0,66	1,19	2,50	5,50	7,91
Service of principal	-	-	-	-	-

Source: Yearly Bulletin 2016 on Public Debt, Ministry of Finance

On the fiscal side, the figures did not arouse concern (Table 3). Both total receipts and total outlays showed remarkable increases with low budget deficits, measured as the difference between total receipts and total outlays, while cash balances at year end could be considered acceptable. There were no signs of budget constraints even though the government engaged in large infrastructure projects, increased wage and salary bills and social transfers.

Table 3. Receipts, outlays, deficit/surplus and cash balances (millions of EUR)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Receipts	738	915	989	1.161	1.195	1.313	1.551	1.445	1.463	1.707	1.778
Outlays	657	676	963	1.252	1.288	1.400	1.476	1.512	1.511	1.614	1.763
Deficit/surplus	81	239	26	- 92	- 93	- 87	75	- 66	- 48	93	15
Cash Balance	211	450	476	384	291	204	278	212	164	257	271

Source: Budget Annual Financial Reports for 2006-2016, Ministry of Finance

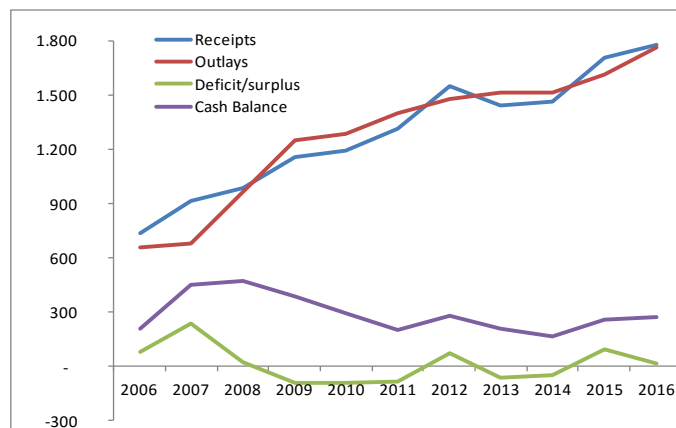


Chart 1. Receipts, outlays, deficit/surplus and cash balances

To gain a better view of the causes of permanently increasing internal public debt, we will read differently the data in the annual financial reports, including audit reports of these statements made by Kosovo National Audit Office and legal infrastructure related to management and accountability of public finances. We will show that in 2012, the government ran the highest yearly budget deficit since independence and faced the risk of being insolvent as a result of accumulated budget deficits since 2008. Among four ways of financing the public sector deficit—printing money, running down foreign exchange reserves, borrowing abroad and borrowing domestically (Fischer & Easterly, 1990)—the only solution for Kosovo’s government was to borrow domestically, which in turn is likely to inhibit growth, as Adam and Bevan (2005) have pointed out.

2. Literature Review

Measurement and definition of fiscal deficit are the starting points to analysing its causes, impact and financing. Leaving aside theoretical debates of three schools of thought concerning the economic effects of budget deficits (neoclassical, Keynesian, and Ricardian (Bernheim, 1898), there are numerous definitions and measures based on the purpose of the analyses. Furthermore, in addition to the economic determinants of budget deficits, political and institutional determinants should also be taken into consideration in the analysis (Barisik & Baris, 2017), as well as limitations of government borrowing. (Hamilton & Flavin, 1986) As Jacobs et al. (2002) point out, each definition highlights a particular aspect of fiscal exposure and can serve a valuable purpose from the viewpoints of investors and policy analysts. The idea is to use a set of different definitions of the deficit to get the full picture of the country's fiscal stance. The determining factor is whether fiscal policy is sustainable in the longer term. This is also in line with Fay and Porter

(2006), who state that calculations on fiscal imbalance and government indebtedness vary depending on which assets, revenues and liabilities are included and how they are valued. The most challenging is Kotlikoff (1986), who states that the deficit is an inherently arbitrary accounting construct that provides no real guide to fiscal policy since the official labeling of something as an asset or a liability is an arbitrary choice that has no general basis in economic theory. However, as Jacobs et al. (2002) state, a comparison between the different definitions of the budget deficit indicated that they do not differ that much in magnitude. In the end, the budget balance is a matter of interpretation and management of fiscal policy. There is no single superior measure of the budget balance, but rather a set of different budget balances measurements, each applicable to specific conditions.

The simplest definition of budget deficit, according to Irwin (2015), could be the difference between spending and revenues, without reference to the government's balance sheet. If defined in terms of changes in the balance sheet, it is measured as the decline in the value of the government's net assets, which is said to be clean, while one that excludes these changes is said to be dirty. A clean deficit is usefully split into a part arising from transactions, which gets most attention, and a part related to "other economic flows". Furthermore, different measures of the clean deficit arise from differences in the assets and liabilities that are recognized in the government's accounting. Within four nested sets of assets and liabilities, the smallest set contains cash and nothing else¹. A clean cash deficit is just the change in the government's cash balance, which is crucial when the government's liquidity is in doubt, but not very informative otherwise. When cash accounting is used, attention is paid to a dirty deficit derived by classifying transactions into groups. Often, financing cash flows are distinguished from operating and investing cash flows, and the deficit is taken to be the sum of operating and investing cash flows, which applies to Kosovo. Blejer and Cheasty (1991) view the conventional public sector deficit as a summary of government transactions during a single budget period—usually one year—without attention to their longer run implications. This deficit requires financing from the government's "ordinary income" rather than from borrowing. However, most widely used is the public sector borrowing requirement (PSBR). Fay and Porter (2006) define standardized or cyclically adjusted budget deficit or surplus, which corrects for the business cycle effect on revenue and outlays (and some other transitory items); a primary deficit that nets out interest costs of servicing accumulated debt; and an operating budget that separates out public capital investment, net of depreciation.

¹ Irwin (2015) identified four nested sets of assets and liabilities, each of which generates its own measure of net assets and hence its own clean deficit. Each set also tends to be associated with certain dirty deficits, as well as certain measures of the debt. These are: cash (C); C and other financial assets (F); F and real assets (R); and R assets and liabilities with respect to all the government's projected spending and revenue under current policy (M).

When it comes to measuring, Meltzer (1992) points out that primary budget deficit—the deficit net of interest payments—is the most relevant measure for the economy. Interest payments are excluded because they are a pure transfer without economic effect. Thus, the standard measure of the deficit is a cash flow measure of the amount that the government has to finance currently. Jacobs et al. (2002) consider that conventional budget balance is not a sufficiently correct indicator to measure the stance of fiscal policy. Along with conventional budget balance that could be measured on a cash or an accrual basis, they analyze an additional 14 balance measures or other fiscal indicators. Also, Blejer and Cheasty (1991) state that conventional measures of the fiscal deficit miscalculate the public sector's true budget constraint and give a misleading picture of the economy's fiscal stance, which is why the budget should be viewed from several angles. Fiscal deficit measures must be specified over three dimensions: 1) the deficit has to be defined for a public sector of a given coverage, 2) the coverage, or size, of the public sector and its composition must be delineated, and 3) the relevant time horizon for assessing the magnitude of the deficit must be identified. To highlight the differential impact of various budgetary transactions (such as investment, import purchase or debt service) on important macroeconomic variables (such as savings, the balance of payments and inflation), policy-makers calculate alternative measures of the deficit, a so-called special-purpose deficit (the current deficit; the deficit measuring the contribution of different transactions to aggregate demand; the domestic deficit; structural and cyclically adjusted deficit and operational deficit). According to Eisner and Pieper (1985) and Eisner (1989), a measure of the real, actual surplus or deficit can be viewed as essentially the sum of three components: 1) the nominal surplus or deficit as currently measured; 2) an adjustment for changes in market value of government financial assets and liabilities due to changing market rates of interest (interest effects); and 3) changes in the real value of net debt due to changing general price levels incident to inflation (price effects). An identical or analogous set of adjustments is appropriate for the high employment budget surplus or deficit. Also, Milesi-Ferreti (1996) point out that the nominal budget deficit (inclusive of interest payments) may be a flawed measure of the actual fiscal stance for several reasons. First, it does not take into account the effects of inflation on interest payments, therefore counting anticipated debt repayment as deficit. Second, in the presence of economic growth, the debt to GDP ratio can be kept constant even if the country is running a budget deficit. Third, seigniorage revenues are not included. Fourth, conventional measures of the fiscal deficit do not correspond to changes of the government's net worth: this implies that privatization proceeds always improve the government's fiscal position by reducing public debt, because the decline in public sector assets is ignored. Finally, contingent liabilities are not explicitly accounted for in the budget. Since the deficit is defined as an arbitrary accounting construct, Kotlikoff (1986) treats government simply as an institution that takes receipts and makes payments, finding nothing to learn about the

underlying economy considering only the size of reported debt. He recommends examining directly the lifetime budget constraints of different generations and asking whether government policies have expanded the lifetime consumption opportunities of older generations at the price of reduced lifetime consumption opportunities of younger and future generations.

In principle, the budget is always and everywhere politically influenced and thus makes the fiscal policy another source of uncertainty. As a consequence, as Fukač and Kirkby (2017) state, expenditures and revenues are subject to random surprises that are unrelated to economic developments. However, the scope of political influence depends on institutional strength. As Shi and Svensson (2006) point out, the strong institutional constraints on politicians in developed countries leave little room for public officials to expropriate public resources for private gains, and the large share of informed voters in these countries renders fiscal policy manipulations less effective. But according to Koszan (2005), the discretionary component appears to be larger for the Western Balkans, where less of the variation in spending is explained by cyclical factors and inertia. Milesi-Ferreti (1996) develops a model based on “fiscal illusion” with opportunistic policy-makers and naive voters. The policy-makers are opportunistic (they care about electoral prospects and not directly about private agents’ welfare) and use fiscal deficits to increase their electoral chances. Voters overestimate the benefit of current expenditure and/or underestimate future tax burdens and therefore do not “punish” politicians for fiscally irresponsible behavior. In the situations of political polarization (mainly reflected in spending priorities between political parties) and electoral uncertainty, there is a tendency for increasing debt, that is, increasing budget deficits, to constrain policy choices of future governments. Alesina and Peroti (1994) share this view, stating that in a nutshell, the idea of fiscal illusion is that the voters do not understand the intertemporal budget constraints of the government. Opportunistic politicians who want to be reelected take advantage of this confusion by raising spending more than taxes to please the “fiscally illuded” voters. Thus, as a result of political influence, Shi and Svensson (2006) confirm that on average, government deficits as shares of GDP increase by almost one percentage point in election years, or on average, the fiscal deficit increases by 22% in election years.

To avoid as much as possible the political motivation of budget deficits, fiscal rules are considered one of the solutions, being designed to constrain fiscal policy. (Grembi et al., 2016) Fiscal rules have become an important institutional requirement for many countries in balancing their budgets. (Luechinger & Schaltegger, 2013) Even more, fiscal rules are introduced to increase confidence in fiscal policy, lower costs of public borrowing and ensure the sustainability of public debt. (Badinger & Reuter, 2017) According to Poterba (1996), budget rules provide a form of self control for political actors, while Gronex (2009) defines budget rules as a permanent constraint on fiscal policy, typically defined in terms of an indicator

of overall fiscal performance. As a result, fiscal rules are usually differentiated by the type of fiscal indicator that they target, with the budget balance rules being most common, followed by debt rules, expenditure rules, and, far behind, revenue rules. (Guerguil et al., 2017) In general, there are two most used rules: the fixed deficit rule and the capital borrowing rule, often called a “golden rule.” The fixed deficit rule allows public consumption to be financed by deficits, whereas the golden rule allows the government only to run deficits if they are used to finance investments in the public capital stock. Analyzing growth and welfare effects of budget rules, Gronex (2009) points out that the crucial difference between the two rules is the development of the growth rate of public investment. The golden rule leads to an immediate jump in the rate of growth of public capital and also a higher growth rate in the long run. Under the fixed deficit rule, this growth rate slightly falls in the medium run while maintaining the same value in the long run. According to Poterba (1996), budget rules may provide a mechanism for constraining the discretion of politicians when they would prefer a larger budget deficit in the current period than they would have agreed to in a previous period. The anti-deficit tight rules accompanied with limits on government borrowing induce smaller deficits and more rapid adjustment of taxes and spending to unexpected fiscal shortfalls. Concerning the effect size, Heinemann et al. (2018) state that deficit rules on average reduce the primary deficit between 1.5% and 1.2% of GDP.

Dur et al. (2000) analyzed the effects of fiscal rules on public investments if budget deficits are politically motivated. Policy-makers behave “fiscally irresponsibly” when public debt can be used by the party in office to influence the next period of policy-making. When parties has sharply different preferences, the one in office has an incentive to accumulate debt and spend more on its preferred public goods at the expense of future public consumption. Policy-makers have a tendency of running up budget deficits for strategic purposes that yield socially sub-optimal outcomes. However, political parties would unanimously agree on binding debt rules, some level of budget deficit that prevents strategic use of public debt. In this respect, Kosovo has been taken few measures to limit the “fiscally irresponsible” behavior of policy-makers. Thus, following wage and salary bill increases during the election process at the end of 2010, the budget law for 2011 contained specific provisions saying that “no transfer of any Budgetary appropriation may be made into the Expenditure Category of Wages and Salaries from another economic category without the prior approval of the Assembly.”¹ Along with this, a provision has been included not allowing any employee to be paid through the goods and services category, which was a very common practice. The wage and salary bill again showed to be politically the most influenced budget category and that’s why (and based on IMF Staff recommendation for introduction of a rules-based framework to

¹ Article 14.4 of law no.04/L-001 on budget of Republic of Kosovo for year 2011, dated 31 March 2011.

guide public wage decisions) an amendment has been made to the law for management and accountability of public finances that limits wage increase beyond nominal GDP growth rate¹. There has been also efforts to “discipline” the capital investments, in particular large infrastructure projects, from being (ab)used by the party in office for election purposes. For instance, to prevent the government from running budget deficits and thus creating future liabilities, the budget law for 2013 included a provision saying that “funds for construction of Highway 6 will be allocated when the bank balance achieves the level of three hundred million (300,000,000) Euros.”² However, this provision was not included in the law on budget for 2014, and the contract on Highway 6 (in the amount of 600 million euros, equal to 11% of the GDP) was signed shortly after the national elections of 2014. Within the law for management and accountability of public finances in July 2013, for the first time, a fiscal rule has been adopted limiting the budget deficit to 2% of GDP³ applicable as of the 2014 budget. This deficit rule was further clarified and advanced at the end of 2015.

3. Budget Review

Kosovo’s budget is run on a cash basis, as a traditional form of government accounting. (Irwing, 2015) As mentioned, till July 2013 there was no legal restriction on budget deficits. Yet, there was no legal clarification of what budget deficit means and how it should be measured. Thus, the government’s fiscal stance was followed based only on the cash balance (the difference between total receipts and total outlays), and it was publicly accepted as a budget deficit/surplus. As pointed out in the literature review, this principle does not give a real picture of public finance performance but is crucial for the government’s liquidity.

Table 3 shows that both outlays and receipts experienced a real boom following independence (in particular, the capital investments). In spite of year by year improvements of taxes and fees and other non-tax revenues, total payments permanently exceeded total receipts. In this sense, the crucial problem seems to be overestimation of revenue capacity or overly optimistic revenue assumptions. Maintaining high budgetary payments was possible because of high initial cash balances and some of the “other revenue” items (dividends from public companies

¹ Law no. 05/L-063 dated 14.12.2015 on amending and supplementing law no. 03/L-048 on public financial management and accountability amended and supplemented by laws no. 03/L-221, no. 04/L-116 and 04/L-194.

² Article 20 of law no.04/L-165 on the budget of Republic of Kosovo for year 2013, dated 13 December 2012.

³ Law 04/L-194 on amending the law on management and accountability of public finances no. 03/L-048 provides that “no law on budget allocations shall include a total deficit that exceeds the level of 2% of forecasted GDP” (article 22.1.A), 12 July 2013. This law was applicable when the 2014 budget was being adopted.

and proceeds from privatization being the main portion). When these “other revenue” items ended, the financing gap had to be closed by internal borrowing.

To analyze the causes of the budget deficits that led to public debt, we will start with the annual financial reports on Kosovo's consolidated budget. The reports, based on cash accounting, represent receipts and outlays and cash balance at the end year. However, during the period 2008-2016, there was no consistent form of reporting, particularly within receipts. Until 2013, no distinction was made between taxes, custom duties, or fees, and all of these were simply recorded as taxes. Furthermore, “own source revenues,” grants and aids, borrowings, deposit funds, fines, tariffs, royalties, interests, one-time privatization proceeds and other receipts were separately recorded. During 2014-2016, the item “taxes” was split into direct taxes, indirect taxes and non-tax revenues. The item “other receipts” has gathered the rest of the receipts while separate recordings of grants and aids and borrowing continued. Within outlays, there are four main categories: wages and salaries, goods and services and utilities, social transfers and subsidies and capital investments. The debt service, lending to public companies and other outlays are also separately recorded. The difference between total receipts and total outlays is reflected in the cash balance. Following adoption of the fixed deficit rule (2% of GDP) in July 2013, the budget deficit started for the first time to be reported only for fiscal year 2014 and on. Considering the fixed deficit rule of 2% of GDP to be too tight, and to make room for more capital investments, a new fiscal rule that excludes from the primary deficit both spending of the privatization agency and spending from own source revenues carried forward was adopted by the end of 2015 within the amendments of the law on management and accountability of public finances.¹

Following Blejer and Cheasty's (1991) reasoning on special-purpose deficits, we will calculate an alternative measure of the budget deficit. For this purpose we will “revise” both receipts and outlays and define budget deficit as a difference between total “regular” receipts and outlays. “Regular” will mean receipts and outlays that are permanent, non-discretionary, with no significant variation from year to year, and on which relies fiscal policy. Regular receipts exclude borrowings, grants and aids and one-time receipts such as privatization proceeds and dividends from public companies. The simple reason for excluding these receipts from the regular one is that they do not meet the criteria mentioned above: they are discretionary financing, can vary significantly from year to year and usually are one-time receipts and their inclusion as regular revenue leads to inappropriate confidence in their permanence and the sustainability of the government's policy stance. As happened in Kosovo, they had to be replaced by government borrowing at a certain point. In the same way, regular outlays will not include lending to public companies (the dividend is

¹ Law 05/L-063 on amending the Law on management and accountability of public finances no. 03/L-048 amended with the laws no. 03/L-221, no. 04/L-116 and no 04/L-194 dated 14 December 2015.

also excluded from regular receipts) because they also do not meet the “regular” criteria, nor they are operational budget expenditures. In our analysis we will include “net dividend” as an “irregular” receipt that is measured as gross dividend received minus lending to public companies plus repayment of loans. Normally, the expenditures financed by borrowings will not be included in the outlays. Thus, after revising total receipts and outlays, we will arrive at the “regular” budget deficit as a special-purpose deficit.

3.1. Budget Receipts

To follow fiscal developments that resulted in high budget deficits, the total receipts will be revised and grouped in two categories: 1) “regular” receipts such as taxation (collected from customs and tax administration) and own source revenues (collected from municipalities and central government) and 2) “irregular” receipts such as grants and aids, dividends from public companies, capital receipts (privatization fund) and other receipts, excluding public borrowing.

Table 4 and Chart 2 show remarkable increases of the “regular” receipts (tax and own source revenues) during the period, thus confirming the consolidation of both fiscal agencies (tax and custom administrations) as also pointed out by Koszan (2015). No single year shows a declining trend. The main increases were recorded during 2009-2011 (post-independence) and during 2014-2016, which is characterized mainly by fiscal consolidation measures (increasing the VAT standard rate from 16% to 18% and introduction of new reduced rate of 8%). Prudent fiscal policy recommends that all budgetary outlays should be projected based on these revenues.

The category of “irregular” receipts recorded high fluctuations. Its main components were “one-time” receipts such as dividends from public companies and privatization proceeds. It is not their one-time character that raises concern for the budget, but rather (ab)use by the government that creates long-run liabilities. As Koszan (2015) points out, these cyclical revenues and one-off receipts from privatization increased the appetite for spending, especially in the run-ups to elections, thus resulting in surging government expenditures, particularly on public wages and pensions and ambitious infrastructure projects, as was the case in Kosovo. The highest level of “irregular” receipts was reached in 2009 and amounted to 219.3 million euros (included the dividend from Kosovo Telecom in the amount of 200 million euros) or 19.3% of total receipts for that year. The “irregular” receipts almost completely ceased in 2016, amounting to only 15.9 million euros or 1.7% of total receipts for that year. In total, during the period 2008-2016, dividend receipts amounted to 463.8 million euros,¹ while privatization proceeds amounted to 116.5 million euros. Thus,

¹ During the same period, the government loaned Kosovo Energy Company the amount of 192.54 million euros, of which the company repaid only 18.71 million euros.

financing expenditures based on unrealistic revenues could be continued only by relying on internal public debt.

Table 4. Regular and irregular receipts (millions of EUR) and their ratios (%)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Regular receipts	718	892	928	941	1,030	1,218	1,241	1,247	1,337	1,450	1,608
Irregular receipts	19,6	23,0	60,9	219,3	142,1	89,8	142,9	114,6	12,1	91,1	15,9
Regular receipts (%)	96,5	96,2	93,0	80,7	87,6	93,0	89,5	91,3	98,8	94,6	98,3
Irregular receipts (%)	3,5	3,8	7,0	19,3	12,4	7,0	10,5	8,7	1,2	5,4	1,7

Source: Recalculated data based on Budget Annual Financial Reports

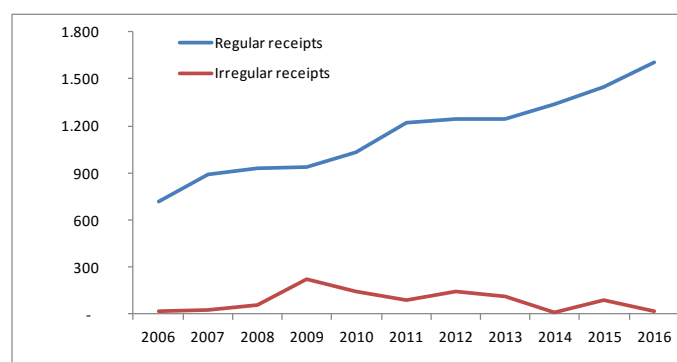


Chart 2. Regular and irregular receipts

3.2. Budget Outlays

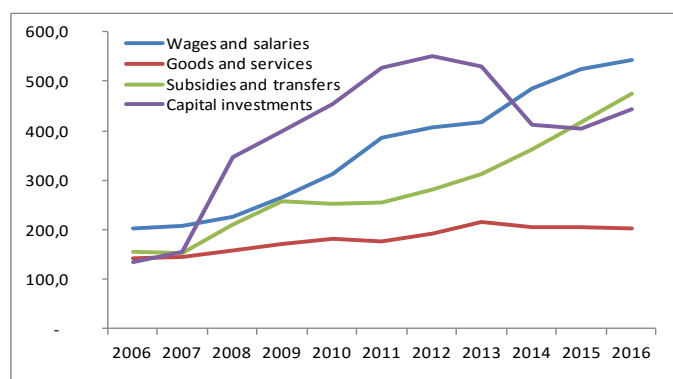
In general, the budget deficits in Kosovo are consequences of continuous discretionary increases of outlays that could not be met by receipts. To determine the impact of different outlay categories on the budget deficit, we will briefly analyze behavior of each separately as shown in Table 5 and Chart 3 for the period 2008-2016. It is obvious that goods and services was the only category with stable and permanent increases (139%). However, they had to be slightly cut (for 5%) during 2014-2016 due to increases of the wage and salary bill and social transfers. On the other hand, capital investment, which is much needed due to poor public infrastructure in Kosovo, wages and salaries and social transfers and subsidies showed high variations that could only be explained by political budget cycles. Thus, large capital investments and politically motivated increases in the wage and salary bill and social transfer are considered main causes of lasting budget deficits.¹

¹ IMF Staff Report 2015 Article Consultation drew attention to the worsened composition of the budget.

Table 5. Budget outlays (millions of EUR)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Wages and salaries	203,8	208,5	227,1	264,4	311,4	385,0	407,7	417,1	485,2	525,0	543,7
Goods and services	143,0	144,9	158,1	171,0	182,2	176,9	190,9	215,5	205,0	205,5	202,1
Subsidies and transfers	155,4	153,0	209,8	256,9	252,7	256,2	280,1	312,9	361,2	418,1	474,7
Capital investments	133,2	154,8	347,1	400,4	455,3	528,2	550,2	529,2	411,4	403,9	443,6

Source: Budget Annual Financial Reports, Ministry of Finance of Kosovo

**Chart 3. Budget outlays**

Wages and salaries almost tripled during the period (261%). Although we do not disagree about the need to increase the low average salary, two cases show typical political behavior of these expenditures. In both cases, wages and salaries were increased just before or following national elections. The 2011 wage and salary bill increased by about 24% after the national elections of December 2010. The second one occurred in 2014, when the wage and salary bill was higher by 16% (IMF, 2015) than in 2013 running up to and following national elections in June 2014.¹

Subsidies and transfers more than tripled during the period (310%). The composition of social spending has significantly changed, with pension and social assistance increasing in relative size. Only 7% of benefits are allocated based on economic welfare. Almost two-thirds of benefits are for age, health-care, and family benefits, while close to 30% are for war-related benefits (IMF, 2018). Table 5 shows the main increase (152%) was recorded during 2014-2016 as a consequence of reviews of social schemes and war benefits.

¹ To avoid these “political” increases of wage and salaries (and based on IMF staff recommendations for introduction of a rules-based framework to guide public wage decisions), an amendment has been made to the law on public financial management and accountability that limits wage increases beyond nominal GDP growth rate (law no. 05/L-063 dated 14.12.2015 on amending and supplementing law no. 03/L-048 on public financial management and accountability amended and supplemented by laws no. 03/L-221, no. 04/L-116 and 04/L-194).

Capital investments are much needed for economic development of the country. Public investment induces an increase in the rate of return to private capital and thereby stimulates private investment expenditure. (Aschauser, 1989) Thus, following independence in 2008, the government engaged in a very ambitious program of capital investment that focused mainly on road infrastructure (construction of two new motorways, Routes 6 and 7). Capital investments more than doubled in the first year of independence and continued substantially to increase (14-16% per year) for several years, reaching the highest level in 2011-2012 (11% of GDP). But the increasing trend was sharply stopped in 2014 as a consequence of high increases in the wage and salary bill and subsidies and social transfer. Capital investments were cut by about 30% even though the government had signed the contract for the new motorway (Route 6) from Prishtina to Macedonia. Its level was kept at about 7% of the GDP during 2014-2016 due to budgetary adjustments. Since then, capital investments were permanently below the level of wages and salaries and subsidies and social transfers, confirming worsening of the composition of the budget. Thus, one of the main drivers of economy growth was sacrificed to keep the budget deficit within the legally determined limit of 2% of the GDP.

3.3. “Regular” Budget Deficits

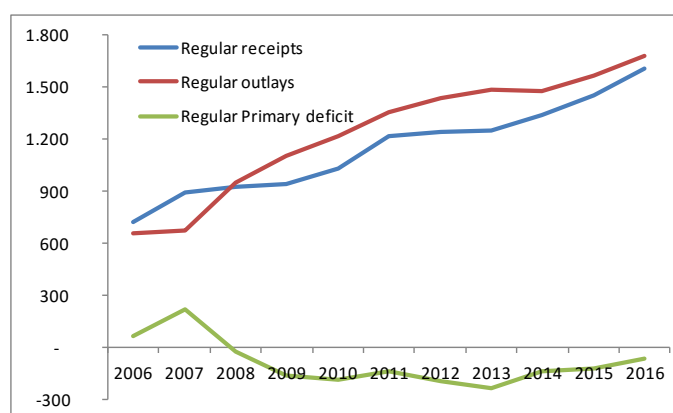
As mentioned, officially reported figures based on cash accounting do not tell the real fiscal status. The data in Table 4 show a gap of no concern between total receipts and total outlays. However, now the picture is different viewed from the point of “regular”¹ receipts and outlays. Table 6 and Chart 4 show regular receipts could not meet regular outlays in any year from 2008-2016. They were permanently below the outlay level even though their increase was high and continuous (180%). But regular outlays grew much more (249%). It is obvious that the government has been running permanent and growing “regular” deficits since independence. In particular, the regular primary deficits were high for five consecutive years (2009-2013), keeping the level almost constantly above 4% of GDP, except in 2011. The primary budget deficit reached its highest level in 2013, amounting to 239.1 million euros or 4.7% of GDP. At the end of 2016, the total accumulated deficit amounted to 1.282 billion euros, about 40% of which was financed through internal borrowing. There was no single year with a budget surplus, and fiscal adjustments started only in 2014 after the deficit rule was adopted in mid-2013.

¹ “Regular” as being revised according to the criteria set above.

Table 6. Regular budget deficit (millions of EUR)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Regular receipts	718	892	928	941	1.030	1.218	1.241	1.247	1.337	1.450	1.608
Regular outlays	657	673	953	1.107	1.216	1.358	1.438	1.486	1.476	1.569	1.678
Regular Primary deficit	61,2	218,4	- 24,5	-165,7	-185,3	-139,7	-197,7	-239,1	-139,3	-119,9	- 70,5
Interest	-	-	-	0,74	9,00	8,78	10,08	11,48	12,46	17,33	19,21
Regular Deficit	61,2	218,4	- 24,5	-166,4	-194,3	-148,5	-207,8	-250,6	-151,8	-137,3	- 89,7
Pr.Def. to GDP ratio (%)			- 0,71	- 4,27	- 4,55	- 3,17	- 4,11	- 4,73	- 2,62	- 2,15	- 1,21
Nominal GDP		3.461	3.883	4.070	4.402	4.815	5.059	5.327	5.567	5.807	5.985

Source: Recalculated data based on Budget Annual Financial Reports

**Chart 4. Regular budget deficits**

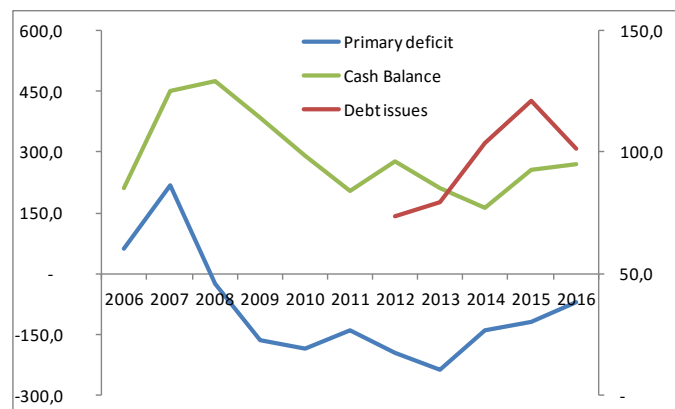
4. Financing of “Regular” Budget Deficit

Internal borrowing, as the only financing solution for the government, started in 2012, i.e., in the fifth year of independence following serious liquidity difficulties (in 2012, along with the first internal debt, a second installment disbursed from IMF in the amount of 93.64 million euros helped stabilize cash balances). Table 7 and chart 5 show that public debt is directly a consequence of falling cash balances (the lowest level since 2007) and high regular budget deficits (the cumulative budget deficit at year end 2011 was 515.2 million euros). Due to high and politically motivated expenditures in wages and salaries and social transfers, the budget deficit persisted, although at a lower scale. This high level of regular outlays was mainly based on “irregular” receipts. Thus, continuously decreased “irregular” receipts had to be replaced with public debt if outlays were to be kept on a high level. As a logical consequence, the lower budget deficit was accompanied by higher public debt.

Table 7. Financing of regular primary deficit (millions of EUR)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Primary deficit	61,2	218,4	- 24,5	-165,7	-185,3	-139,7	-197,7	-239,1	-139,3	-119,9	- 70,5
Debt issues							73,3	79,2	104,0	121,3	101,2
Cash Balance	211,0	449,8	475,5	383,9	290,8	203,6	278,2	211,8	163,5	256,5	271,2

Source: Budget Annual Financial Reports and recalculated primary deficit

**Chart 5. Financing of regular primary deficit**

In total, during the period 2008-2016, the regular primary budget deficit reached about 1.282 billion euros. The financing of this regular primary budget deficit was made through internal public debt in the amount of 479 million euros, external public debt (IMF) in the amount of 187 million euros, public company net dividends in the amount of 290 million euros, privatization proceeds in the amount of 117 million euros, reduction of cash balance in the amount of 179 million euros and from dedicated and non-categorized revenues in the amount of 30 million euros. None of these items, excluding public debt, is regular: not permanent, vary significantly year after year and are one-time receipts. At the same time, since a significant part (37.4%) of deficit is financed by internal public debt, it is likely to be growth-inhibiting. (Adam & Bevan, 2005)

5. Conclusion

The government of the independent Kosovo started with ample cash balances and small budget surpluses based on cash accounting reporting. However, badly needed capital investment forced the government to engage in very ambitious capital projects (mainly road infrastructure) based on overly optimistic revenue estimation mainly in the category of “irregular” receipts (dividends from public companies and privatization proceeds). Although the budget deficit initially was caused by large capital investments, it was worsened by “politically” motivated increases of the wage and salary bill and social transfers and subsidies. This was supported by lack

of legal infrastructure that limits budget deficits and public debt. Thus, for several years, the government ran up budget deficits that were underestimated and not known to the public. Faced with liquidity issues as a result of falling cash balances, the government resorted to internal public borrowing as the only choice. Internal public debt grew constantly, but no principal debt has been serviced—only interest has been paid thus far. To ease the debt burden, the government is extending its maturity gradually by replacing short-term treasury bills with long-term treasury bills and bonds.

As a recommendation, governments should engage in large capital projects only after having secured financing sources based on “regular” revenues and/or borrowings. The “irregular” budgetary items should be considered temporary sources regardless of their size, and governments should refrain from creating long-term liabilities based on their doubtful permanence. To avoid “politically” motivated budget deficits, there should be clear legal rules that limit the government’s use for electoral purposes of public resources while in office by increasing budget deficits, public debt and nominal wage and salary bills and social transfers.

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