WORKING PAPER

Ministry of Agriculture, Forestry and Rural Development (MAFRD)

Measures to improve fiscal and trade policies in Kosovo agriculture

By

Policy Unit / ASPAUK

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Acronyms

AKA	Alliance for Kosovo Agro-business
CBC	Capacity Building Component
EU	European Union
FYROM	Former Yugoslav Republic of Macedonia
IFDC	International Fertiliser Development Centre
MAFRD	Ministry of Agriculture Forestry and Rural Development
MFE	Ministry of Finance and Economy
SAA	Stabilisation and Association Agreement
UNMIK	United Nations Mission in Kosovo
VAT	Value Added Tax
WTO	World Trade Organisation

Preface

The MAFRD and farming community assert that the current fiscal policy taxes agriculture heavily and unfairly vis-à-vis their competitors. That without some protection being afforded or reduced taxation on agriculture, there is little incentive to invest.

This paper looks at the veracity of this argument. While this argument is strong, changing the fiscal regime should not be seen as the sole solution to the problem of agriculture which includes low productivity, poor technology and poor quality and poor marketing. Making adjustments to the fiscal regime though will encourage investment in agriculture, greater input use and increased productivity - the first steps to greater competitiveness.

A draft paper was circulated within the Ministry of Agriculture Forestry and Rural Development and to key stakeholders in January. Some Comments received on the text have been incorporated into this Working Document. Broader comments have been added as Annex 5 to this working paper.

Is agriculture a special case. The answer is yes, because

1. It is treated like this by all other countries especially the EU with which Kosovo seeks to approximate. Trade in agriculture is already highly distorted.
2. Agriculture is considered a socially strategic sector and protecting agricultural incomes has become an easy to administer social policy.
3. Food security in terms of a nation being able to feed itself is an important strategic consideration.

MAFRD Policy Unit
assisted by ASPAUK

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Executive Summary

Kosovo is severely disadvantaged in agriculture compared to its neighbours with whom it trades. Kosovo's neighbours provide direct subsidies to farmers producing most commodities, have tariffs varying from 15 to 30% to protect their producers from cheap imports and also operate quotas for key commodities. Kosovo on the other hand provides no subsidies and a universal 10% tariff. The government recognizes that encouraging investment in the agricultural sector will be difficult unless the returns form agriculture are as at least as good as those enjoyed in neighbouring territories.

Sixty percent of the population of Kosovo is resident in rural areas. Of this more than 50% derive income from some sort of agricultural activities. Kosovo is struggling to develop its productive sector – mining, agriculture and power sector.

In the agriculture sector the main areas to support are the dairy sector, as livestock is the main focus of small producers and fruit and vegetable, as this makes the best use of the irrigation resource and offers the highest return per hectare.

The Government made a proposal to UNMIK in 2003 to reduce duty on capital goods and raw materials for industry/agro-industry from 10% to 2%. This suggestion has not yet been accepted. For agriculture reducing or even removing duty will not benefit farmers greatly as most of the agricultural inputs come in duty free from neighboring countries and territories. For agriculture, altering the VAT on inputs would have a more dramatic effect.

The MAFRD has analysed the current position and is recommending tax changes that will amount to a loss of revenue to the exchequer of €5 million or 1% of their current revenue collection, but will boost rural incomes by €15 to €25 million, depending on the supply response of farmers. It will also improve employment opportunities in rural areas producing demand for labour – especially in the horticultural sector.

The following 7 measures relating to duty and VAT are therefore made, which together will have a marked impact on agriculture production and employment in Kosovo, and benefit all communities with equal effect,

1. **Abolish Duty and reduce/abolish VAT on inputs for agriculture**
The main inputs into agriculture are fertilizer, seed and agro-chemicals. These constitute from 40% to 60% of the cost of production, depending on the crop being grown. Of this 15% is VAT. Overall, VAT accounts on these agricultural inputs accounts for 7.5% of farmers costs. Removal of VAT would therefore boost incomes and encourage greater output.

   Cost: The loss of income to the treasury based on Customs collection figures for 2003, would be about€4.5 million.

Lost revenue will be partly made up from VAT applied on the increased *consumption* of rural communities.

Benefit: This would benefit all Kosovo farmers – approximately 150,000 households. On the most conservative basis, incomes would increase €17 million. It is more likely that the increase in production encouraged by this measure that incomes would increase more than €25 million.

2. Abolish duty and reduce/abolish VAT on animal Feeds and Concentrates

Feed represents 60% of production costs for livestock, more in the egg production sector. A reduction in feed costs through changes in duty and VAT would have a similar effect in livestock production costs and milk production costs as those for crops. It would contribute to a reduction of cost

Cost: The loss of income to the treasury based on Customs collection figures for 2003, would be about €300,000.

Benefit: This would benefit over 90,000 livestock farmers.

3. Abolish Duty and VAT on Capital Goods for Agriculture and selected agro-processing industries

3.1 Agricultural mechanization is handicapped by the high cost of machinery. The removal of duty and VAT would encourage greater mechanization and boost productivity.

Cost: Tractor imports have been falling due to the high cost and poor investment prospect that agriculture has presented. The tax revenue from imported tractors in 2003 was small - only €37,000.

Benefit: Tractor hire costs would reduce by 7.5% and reduce cost of production for wheat by a further 1.5%.

3.2 For agro-processing industries, the cost of imported packaging has a serious effect on the competitiveness of milk processing and fruit and vegetable production. This relief would only be given to those packaging local product.

Cost: It is estimated that the total duty and VAT paid by milk and fruit and vegetables processors on packaging and imported ingredients is about €250,000 to €300,000.

Benefit: Would be a more competitive product and increased demand for local produce.

4. **Abolish VAT on Irrigation Water**

€12 million was invested in rehabilitation of the main channels of the irrigation schemes. The total area that can be currently irrigated is only 24,000 hectares out of a total area of 55,000 ha, which could be irrigated if the rehabilitation is completed. . The Irrigation Companies are depending on their own resources to finish this rehabilitation. They are struggling to increase the water fee collection from farmers. The total cost to bring 30,000 ha back into irrigation by repairing and rehabilitating the irrigation systems is about €8 million of €266 per hectare.

Cost: In 2004 it is expected that the companies will collect €150,000 in VAT.

Benefit: the irrigation companies would be able to rehabilitate 600 ha a year with the money saved in paying VAT.

5. **Zero rate VAT on essential food commodities: bread, salt, oil and sugar.**

VAT should be withdrawn or applied at a reduced rate on bread, salt, oil and sugar. This measure is seen to help reduce the cost of living for poorer households.

Removal of VAT on milk and milk products was considered, but the major beneficiary would be milk importers, and the Government would loose €3.3 million revenue on VAT applied to these imports.

Cost: These have not been calculated.

Benefit: For the poor people, a high proportion of their budget is food. They would therefore get the maximum benefit. The benefit to the farmer would be small, in the form of more sustained demand.

6. **Payment of Direct subsidies**

Payment of direct subsidies to dairies of 5 cents per litre (as done in Serbia) would cost €300,000 to €500,000 per year. This should be considered also for processors as an alternative to taking off VAT on imported inputs and ingredients which might be difficult to administer.

Economic Distortion

The government has long been advised that tax reduction for one sector will distort the economy and result in misallocation of resources. The fact is that to compete in agricultural trade the distortions that already exist with trading partners need to be taken into account otherwise Kosovo remains a "consumer and remittance society" with no productive base on which to trade. With these incentives in place, investment will be invigorated in this sector and it will lay the foundation for restoration and extension of the agro-processing sector. Together both sectors have a capacity to provide much need employment. Due to the labour intensive nature of agriculture – especially vegetable production, investment in this sector will produce the greatest increase in employment per euro invested.

NEXT STEPS

The government should endorse these measures to send a clear signal to farmers that they are serious in assisting the agriculture sector. These should be presented together with a promise that the government is going to further consolidate support through the development of basic agricultural advisory services to farmers and steering donors to support key elements of the agricultural sector – notably rural finance initiatives, and assistance in improving the marketing and quality of agricultural produce to ensure greater competitiveness.

The government should present this concept to the EFC in April and appoint a technical sub-committee to draft the necessary administrative instructions and policy positions for the next EFC of May. By June the agreed measures can be put into effect.

The government also needs special funds from World Bank European Union to focus on investment in the agricultural sector.

1. Agriculture in Kosovo

More than sixty percent of the population live in rural areas. The majority of these households have one or more members involved in agriculture. Agriculture is characterised by small holder semi-subsistence production with the average size of farm being 3.2 hectares. The number of commercial farms (defined as more than 10 ha) is less than 1% of the total.
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Agriculture accounts for more than 20% of GDP. Of the €500 million spent by central government each year only €2.3 million is allocated to the Ministry of Agriculture Forestry and Rural Development (MAFRD) or ½% of the total. This compares with Serbia where the Ministry of Agriculture (2002 figures) received €122 million representing 3.6% of the budget. The Kosovo government spends about €1.5 per capita on agriculture as against the Serbian government which spends €15.

Agriculture is an important source of future growth. In the long-term there is potential for the development of commercial farming and to restart agro-processing. In the medium term the many small farms play an important social role, providing a safety net for families enabling some sort of subsistence.

2. Tax regime in Kosovo – the logic

Kosovo is a self-governing territory under the administration of the UNMIK. It is a key element of government policy that Kosovo should be a self-financing entity. As UNMIK slowly withdraws itself and it's funding, the government of Kosovo must shoulder a greater burden. To this end, UNMIK has therefore striven to introduce a simple but effective tax structure.

"A strategic goal of Kosovo has been to develop a tax system that will make Kosovo self reliant in its fiscal resources as early as possible. With this in view, a modern tax regime is being developed that is investment-friendly and compatible with the EU. The primary aim is to build a tax regime that is economically efficient (creates the least possible distortion), fair, stable, simple and one that promotes economic growth."[1]

Import duty is charged at a flat 10% ad valorem on almost all goods.[2] Goods coming from Serbia-Montenegro is under Kosovo's current status "internal trade" and therefore not subject to duty. Goods coming from FYROM are generally duty free under a Free Trade Agreement drawn up

[1] Ibid page 16
[2] One exemption is on fertiliser. A temporary exemption has been granted for wheat and wheat seed in Nov 2003, due to the increase in world price and problems of accessing wheat from Serbia.

between FYROM and FRY. Recently, (2003), Kosovo signed a Free Trade Agreement with Albania. Agricultural produce on the Albanian side still retains a high degree of protection.

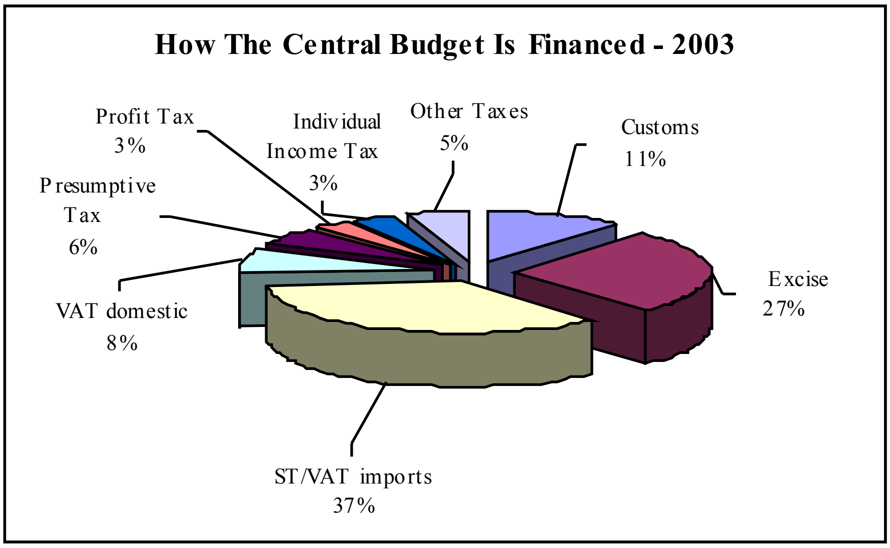
Value Added Tax (VAT)[3] is charged on all imports. The VAT rate is 15% and is charged on the duty paid value of goods at the border. For goods incurring duty, the total tax at the border amounts to 26.5%.[4]

How does this compare with the border tax structure in other competing countries in the region? In competing countries the general picture is one of high tariffs for produce that competes with local production, often imposing duties of 20 to 30%. This helps guarantee a market for local produce. At the same time, low duties on inputs into agriculture help keep prices down. At the same time, certain items are subject to direct or indirect subsidies.

Kosovo's tariff regime makes no distinction between goods for consumption and goods that are inputs into production. This is due to the need for simplicity and enforceability and because of the strong desire by planners not to "distort markets" through a differentiated tax system which favour one sector over another.

The government of Kosovo is highly dependent on the collection of taxes at the border. In 2002 it was planned that 74% of all revenue was to be collected at the border. In a more "normal" economy, border collection of taxes would not exceed 45% and greater reliance would be on taxing economic activity within the territory of Kosovo.

Figure 1 Distribution of revenue by source



Source: Kosovo Central Budget 2003, Kosovo Govt.

[3] VAT is Value Added Tax. This is a tax that can be reclaimed by the business if it is an input in their production process and is charged to the final customer.
[4] Example Value of goods = €100; after duty = €110 x VAT @15% = €126.50 or 26.5% total taxation.

The high volume of imports as against exports has been assisted by the amount of donor funding. This is diminishing sharply. The Ministry of Finance realises that this demands a prudent fiscal policy. It also realises that if internal production is stimulated and "import substitution" is effective, that this will reduce imports and so reduce revenue collected at the border. It is therefore vital that a simple and **effective internal taxation system on economic activity is put in place to compensate.**

In summary, Kosovo is dependent on border taxes in the short to medium term to finance the government budget. In order to make border collection easier and enforceable, UNMIK has favoured a simple, uniform system of taxation allowing almost no exemptions.

This paper focuses on the amount of VAT charged to inputs used in agricultural production rather than duty. This is because most goods are coming in without duty from neighbouring territories and VAT is therefore the most important element.

2.1. Tax on agriculture at the border

Kosovo is a net importer of food. It depends mainly on Serbia for import of wheat and maize; on Hungary, Slovenia and Croatia for import of milk products and for FYROM and Turkey for import of fruit and vegetables. Goods coming from Kosovo's neighbours enter duty free due to i) a Free Trade Agreements (FTA) with Albania, ii) due to Kosovo's trade with Serbia-Montenegro being classed as "internal" under Kosovo's current status and iii) from FYROM, through the operation of a Former Republic of Yugoslavia trade agreement that is annually renewed. Goods from these countries are therefore on an almost equal footing with goods produced in Kosovo being only subject to VAT and a 1% Customs handling charge.

<u>Imported Food:</u>
Imported food reported accounted for €217 million or 22% of the total import bill for Kosovo in 2002[5]. The total VAT tax yield from the import of food was € 32 mill.

[5] Szyremer and Funkhouser , May 2003

Table 1 Kosovo Agriculture Imports and Exports

Imports and Exports 2002 in Millions of euro

	Trade:		Tax yield	
	Exports	Imports	Duty	VAT
General Category of Food	3.8	217.8		32.67
of which:				
Milk/Dairy produce		22.4		3.36
Fruit and Vegetables		24.2		3.63
Wheat & cereal		4.1		0.62
Inputs				
Fertiliser		15.6		2.34
Seed		15.0		2.25
Livestock		4.3		0.65
Total Tax Yield from Inputs			-	5.24
				5.24

Source: World Bank Medium Term Economic Review for Kosovo, 2003
Source: Customs and Excise Kosovo, dbase

Imported Inputs:
Imports reported are mainly for seed and fertiliser, totalling over €30 million in 2002. Fertiliser is not subject to duty. The total VAT yield from imported inputs is about €4.5 million. Animal Feed for 2001 of the value of €1.2 million was imported with a tax yield of €0.2 mill.

Transit Tax
Goods travelling through Serbia, Albania or FYROM incur a 5% transit fee from the authorities. Goods transiting through Montenegro pay 3%.[6]

FYROM and Serbia have a cost advantage as sources of inputs as their goods are not subject to Customs Duty and there is no transit fee to pay from goods originating there.

2.2. Tax on Agriculture Inputs – internal

Other inputs used in agriculture that are subject to tax include diesel fuel and irrigation water. Diesel fuel is subject to excise duty of €0.30 per litre and VAT of €0.10; irrigation water is subject to VAT of 15%.

[6] See the Central and Eastern Europe Business Center, International Trade Administration US Dept of Commerce Web-site CEEBIC at www.mac.doc.gov/dutiesandtaxes

Table 2 Other Taxes on Agricultural inputs

in Millions of euro

	Cost	Excise duty	VAT
Irrigation Water [1]	1.00		0.15
Diesel for field activities [2]	1.62	1.62	0.49
		1.62	0.64

[1] Irrigation for 20,000 ha, but in fact less than 50% paid
[2] Diesel based on 30 litres per ha per year and 180,000 ha cultivated

2.3. Tax on Agricultural Income and Outputs

Farmers should pay income tax on their earnings or if registered as a business, corporation tax. Very few are.
At the municipal level, farms should pay a land tax. This has not been collected since the war.
Enterprises with a turnover of more than €50,000 per year should register for VAT and charge VAT on their sales. Again few, if any, farmers are registered. Not being registered for VAT helps keep prices down.

For intermediaries and processors, who are not registered for VAT, there is probably a preference to purchase local produce which has not been subject to VAT. Imported goods are subject to VAT. For the larger firms registered for VAT, they are able to recoup the VAT paid at the border on imports and therefore the cost of using imported foodstuffs is less than for those firms not registered.

3. Tax Regimes of main agricultural trading partners

The tax regimes of neighbouring countries and major trading partners differ significantly with regard to their treatment of the agricultural sector in a number of ways. Firstly, most offer a high degree of protection to domestic production having tariffs from 20 to 30% on competing produce.
Secondly, their governments usually have reduced taxes on agricultural inputs. These reduced taxes may be in the form of reduced duty or reduced VAT. Thirdly, quotas and licences are used to restrict supplies and maintain high domestic prices. Fourthly, there may be direct or indirect subsidies to farmers, to domestic agro-input manufacturers or to agro-processors.

3.1. Tariffs and quotas

Table 3 below shows the different tariff levels applied to inputs and to “sensitive” agricultural produce for Kosovo’s main agricultural trading partners.

Table 3 Import tariffs and quotas for Kosovo's major agricultural trading partners

Comparison of taxes and duties

		KOSOVO	SERBIA	FYROM	SLOVENIA	CROATIA
i	**Value Added Tax**					
	Normal VAT	15.0%	20.0%	22.0%	20.0%	22.0%
	Lower rates applied:					
	Food	15.0%		5.0%	8.5%	?
	Bread and milk	15.0%	0.0%		8.5%	?
	Agricultural Inputs	15.0%	0.0%		8.5%	?
	Irrigation	15.0%	?	?	8.5%	?
	Source CEEBIC on the web http://www.mac.doc.gov/ceebic					
ii	**Duty**					
	Inputs for Agriculutre					
	Raw material and semi-finished goods	10.0%	1%		0 to 5%	0.0%
	Fertiliser	0.0%	5.8%			
	Pesticide	10.0%				
	Soyabean meal	10.0%	5.0%			
	Food competing with local prodcution	10.0%	20-30%	20-30%	?	16-30%
	Meat	10.0%	24.4%	15%-30%		
	Products from fruits & veg	10.0%	28.4%	45.0%		
	Milk and Dairy	10.0%	24.4%	25.0%		
	Wheat and Corn	10.0%	30.0%	15.0%		
	Average trade weighted tariff	6.0%	16.7%	28.0%		
iii.	**Excise duty on fuel**	€ 0.30	€ 0.20		€ 0.28	

Ministry of Fainance Slovania, March 2003.
Discussion in MAFWE Macedonia 2003.
Republic of Serbia, Agricultural Sectgor, World Bank Review, 2003.

The first part of the table shows that general VAT rates are higher in all the neighbouring countries compared with Kosovo. On the other hand they apply lower rates of VAT on food items (to keep prices down for consumers) and on inputs for agriculture. Similarly with Duty, neighbouring countries tend to have lower duties on agricultural (and other raw materials for industry) that are not available domestically. In Serbia, the duty on Soya meal is variable, falling to 5% only when domestic supplies of soybean have been used up. Duties on competing food supplies are high, typically 20 to 30%. Finally excise duty on diesel fuel is considerably higher in Kosovo leading to a cost of fuel 10 to 20% above that of competing neighbours.

Quotas and Licenses

All the competing countries operate a system of quotas on their more sensitive products. The purpose of the quota is to restrict the supply of imports so as to maintain higher price levels that will benefit local producers. For instance Albania, Serbia and FYROM all operate quotas in regard to vegetable oils in order to protect their domestic cooking oil industry.

Subsidies

Subsidies are paid by the government to offset the higher cost of production for a crop or enterprise compared to the foreign competition. Subsidies may be provided direct to the farmer in the form of a payment per hectare, per ton of crop produced or per head of livestock. These subsidies help offset the farmer's costs in production and enable him to be more competitive with imports. Sometime these subsidies are paid to disadvantaged areas within the country, where productivity is lower, such as hill farmers. This is common throughout the Balkans. In Serbia and FYROM production subsidies are given for the following:

Table 4 Quotas and Subsidies

		KOSOVO	SERBIA	MON-NGRO	FYROM	CROATIA	SLOVENIA
1 Quotas							
Wheat and cereals		-	y		y	y	y
Vegetables		-	y		y	y	y
Oil seed crops		-	y		y	y	y
Meat products			y		y	y	y
2 SUBSIDIES							
Milk (€uro cents)	per litre	-	6.0c	8.5c	0.75c	5.5c	
Agricultural Support Measures as percentage of total value of product:							
Wheat	per kg	-	1.0c		1.3c	0.5c	
Maize	per kg	-					
Tomato	per kg	-			0.2c		
Livestock							
Beef (Heifer)	per head	-	€ 92.00				
Sheep (Ewe)	per head	-	€ 9.00				
Horticulture							
Orchard establish	per hectare	-	€ 923				
Vineyard establish	per hectare	-	€ 1,846				

Subsidies may be provided to the processor in order that the final product remains affordable and so that import tariffs are not too high. A subsidy is paid to dairies in Serbia of 4 dinar (€0.06) per litre of milk purchased.

Where the trade protection measures have lead to oversupply of the domestic market, countries often need to sell surplus on the international market. As domestic prices are higher than international prices, surplus can only be exported if the government can provide an export subsidy. For instance, Slovenia dairies purchase 380 million litres of milk annually. Of this 90 to 100 million litres are exported[7]. In 2001 a subsidy of €6.6 million[8] was provided or 6.6 cents per litre.

3.2. Kosovo's major trading partners

Kosovo's main trading partners for inputs for agriculture are Serbia and . According to UNMIK custom records, Serbia is the main source of wheat and cereals for food, animal feed and seed. It is also the main source for fertiliser.

With regard to imports of competing food products, the main competitors and a share in the imports, is given below:

For wheat and cereals:	Serbia (more than 70% of imports)
For Vegetables:	FYROM (25% of imports)
For Milk and milk products	Hungary and Slovenia (70% of imports)

Goods imported from neighbouring countries with which Kosovo has a FTA are not subject to duty. Yet, goods exported to these countries may be subject to quantitative restrictions (quotas), if on their "sensitive" list.

4. Cost of production for major enterprises in Kosovo

Cost of production data has been collected by a number of NGOs working in the different sectors. The data is variable and tends to look at the better farmers rather than the average farmer. International comparison of such data is extremely difficult, because not all the same costs are included. A comparison of costs of production in Eastern Europe is given in Annex 1. It compares costs between Croatia, Poland and Hungary in US$ between1996-98. Added to the table are estimates of cost of production for 2001 for FYROM and Kosovo given in euro. Kosovo appears to be a higher cost producer. One element reducing costs in all the other countries are direct subsidies to the producer. These can vary from 5% to 20% of total cost, depending on the enterprise.

Annex 2 gives an outline of the cropping pattern for Kosovo and cost per hectare breakdown for each crop in terms of seed, fertiliser, labour etc. The total gross margin[9] is calculated on the right hand side of the page in column 'I'; The VAT element in the cost is calculated as 15% on those inputs that

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[7] http://www.uvi.si/eng/slovenia/publications/facts/agriculture/.

[8] Slovenian Business Week April 9th 2001, 15/2001. The WTO report in 2002 that Slovenia does not have any overt export subsidies but does have indirect export support in the form of export finance, guarantees, and promotion assistance is available to Slovenian exporters through a number of programmes and agencies. **Trade Policy Reviews:** First Press Release, Secretariat and Government Summaries, Slovenia 2002 http://www.wto.org/english/tratop_e/tpr_e/tp192_e.htm.

[9] This data needs to be treated with caution as it is an adaptation from different sources. SOK average yields were much lower than for crop budgets developed by NGOs working with specialist farmers.

attract VAT (col 'm'): seeds, fertiliser, agro-chemicals, packing and other materials and irrigation; the final column estimates the total value of VAT (area x VAT per ha: col 'n'). No account is taken of the tax element for mechanisation.

An estimate of duty is not made, as it is assumed that the majority of inputs are coming in duty free from Serbia or. The estimation of VAT is an over-estimate in that it assumes that all seed is purchased and that all irrigation water is paid for. Nevertheless it gives a ball park figure of about €6 million. If VAT is taken out of the cost of production, the cost would reduce on average by about 6 to 7%.

4.1. Key areas for Kosovo

The three key areas of production for Kosovo at present are cereals for human consumption and to support livestock (130,000 ha); vegetable production (20,000 ha), and dairy production (125,000 milking cows producing about190,000 tons of milk)[10]. All of these sectors face heavy competition from imported produce:

Table 5 Kosovo balance of trade in main enterprises

Balance of consumption, production and imports in '000 metric tonnes

	Consumption	Local production	Import
Wheat	380	240 63%	140 37%
Maize	343	220 64%	123 36%
Vegetables	€ 117.00	€ 100.00 85%	€ 17.00 15%
Milk	268	189 71%	79 29%

Source: Wheat and Maize: MAFRD; Fruit and Vegetables – Swiss Fruit & Vegetable Development project; Milk: Swiss Dairy project

1. Wheat and Maize

Serbia is the main source of imports of wheat and maize for Kosovo. Serbia has a comparative advantage in wheat production, but still provides subsidies to wheat farmers amounting to 1 €cent per kg produced.

2. Vegetables

In the eighties, Kosovo was a net exporter of vegetables. Kosovo is now a net importer, importing 10 to 15% of requirements. FYROM is more

[10] Statistics on Agriculture in Kosovo, 2001, Statistical Office for Kosovo, Pristina

competitive along with Turkey for fresh vegetables and fresh fruit[11]. In 2001, Kosovo imported €17 mill of fruit and vegetables.

3. Milk

Kosovo production is for the most part semi-subsistence with typically 2 cows stall fed. Excess milk is sold unpasteurised on the local ("green") market. The Swiss Dairy Cooperation estimates the following breakdown of **marketed** milk and dairy products[12]:

- To Kosovo Dairies	7,500 tons
- To Green mkt (unpasteurised)	67,000 tons
- Imported Dairy products	79,000 tons

Imported milk products make up more than half of marketed produce. A key factor differentiating imported milk from local milk is the packaging, shelf life and quality.

The milk industry is one of the most subsidised in the region. Slovenia pays a base price of 26 €cents to farmers. Farmers usually receive 27 €cents or more. For the same quality, Kosovo farmers receive 25 €cents. The surplus milk from Slovenia is being subsidised with an export subsidy of 6.6 €cents.

4.2. "Supply Response"

A reduction in cost should stimulate greater output. In economic jargon this is called the supply response. Various studies have been done to determine the effect of changes in the costs of production factors on influencing output. Small changes in input prices have little effect on production in Western Europe. This is mainly due to the fact that yields are high and input use is already optimised. In Kosovo, yields are still low due to a low usage of inputs. A small increase (in the correct use) of inputs can have a marked effect on yields. Annex 3 shows a comparison of Kosovo, the UK and Poland wheat production. Kosovo's average wheat yield is 3.5 tons per ha as against Poland with 6.3 tons and the UK with 8.2 tons. Kosovo has the lowest cost per ha, but the highest cost per ton of wheat produced. The cost per ton in Kosovo is €121 as against the UK with €105 and Poland at €82. Although comparing international data is difficult because of different factors included in costings, it indicates that better use of fertiliser and agro-chemicals can increase yields significantly and reduce cost per ton.

Profit margins, or Gross Margins (GM), are modest as shown in Annex 2. A reduction in cost through removal of VAT on the main important inputs can increase gross margins considerably. Although VAT may constitute on average only 7% of total cost, the effect of removal on profit is far greater. The exact effect depends on two factors: The proportion of inputs carrying VAT in total costs, the relative size of the Gross Margin. For

[11] SPHP-K The Market for Fresh Fruit and Vegetables in Kosovo and the Balkan Region, Prishtina, August 2002

[12] KSDP Kosovar: Milk Sector Situation and Prospects Dec 2003

example, for wheat the current GM is €103 per ha. The VAT on inputs is €27. If VAT is no longer charged, this amount will be added to the GM giving a new GM of € 130, or increase of profit of 27%. For Maize the current GM is smaller, therefore the effect will be greater. The GM for maize is €58 per hectare and the value of VAT on Inputs is €25. If the VAT is added to the GM, the new GM is €83 - an increase in profit of 47%.

The effect of removing VAT on seeds, fertiliser and agro-chemicals; on irrigation; and on packaging material for crops is shown in table 6.

Table 6 Increase in Gross Margin due to setting VAT at zero

	Remove VAT On agro-inputs	Remove VAT on Irrigation	Remove VAT on packaging material	Total effect
Wheat	27%			27%
Maize	43%			43%
Vegetables:				
Potato	4%	1%	3%	8%
Pepper	11%	3%	10%	24%
Tomato	8%	2%	7%	17%
Alfalfa	1%	1%*		2%
Estimate overall effect				
On area	2%	15%		
On yields	5%			

Source: See Annex 3: table 2 and 3 for details
Note: * The irrigation charge for alfalfa is based on paying €40 per year rather than €110

Farmers growing maize, wheat and pepper would benefit most.

Assumptions
The effect of reducing or eliminating VAT will have an effect on the amount of inputs used, which in turn will affect the yield. It may also have an effect on the area planted and the cropping pattern. These assumptions are examined below.

Use of purchased inputs such as seed and fertiliser is governed by the price. Lowering the price through lowering or eliminating tax will have a positive effect on demand and so on output of crops. A study in Ghana on the effect of VAT on demand for fertiliser and other agro-inputs[13] estimated that introduction of 10% VAT would reduce demand for fertiliser by 15%, whereas a 10% subsidy would increase demand by 22%.

Increase in Yield
For Kosovo it is assumed that a reduced price of inputs due to removal of VAT would lead to a proportionate increase in its use. To take the

[13] Gyasi, A study on the adoption of improved maize technologies in northern Ghana, SARI, Ghana and Purdue University, Indiana USA
IITA,2003

example of wheat, the yield response of wheat to Nitrogen at the lower end of the yield response curve before it plateaus is estimated at
24 kg of grain per kg of Nitrogen[14]. FAO make an overall estimate of response of 10kg grain to 1kg of N. An increase of expenditure of €13 per hectare (the value of VAT on fertiliser) can increase wheat grain yield by 250 to 300 kg per ha – an increase of about 5% over current yields.

Use of improved seed can increase yields for wheat by 20 to 30% and improves the response to fertiliser. A 15% increase in use of improved seed would increase yields about 4.5% overall.

Use of agro-chemicals in Kosovo is quite limited at present. The marginal rate of return therefore to increased use should be high. Currently only €40 is spent per hectare in cereals.

This is a theoretical computation. In practice farmers will not increase input usage proportionate to their current use but in accordance with need. Nevertheless it serves a purpose in calculating the yield and income effect of the proposed tax changes.

Similarly with vegetables, increase use of good seed, fertiliser and agro-chemicals can increase yields substantially. For the sake of simplicity, it is assumed that the overall increase in yield will be 15% across the board – see section 5 for cost benefit analysis.

<u>Increase in area</u>
Increase profitability will encourage greater use of land. As land in Kosovo is in short supply and farms are small, the increase in land cultivated will be very small. The current area cultivated is 281,000 ha with 22,000 ha fallow. It is assumed that there is no change in the area cultivated or the cropping pattern as a result of changes in taxation.

4.3. Capital goods in agriculture

So far, the argument has concentrated on the taxation on inputs in production and not looked at taxation on capital investment in agriculture. During the 1999 war a large number of tractors were looted or damaged. Despite post-war aid and repair a cumulative lack of investment in agriculture during the nineties means there is still a backlog of new investment required. All agricultural machinery is imported, mostly from outside the FTA countries, therefore 10% duty and 15% VAT is incurred. Partly because of the taxes and duties, there has been a reluctance to invest in farm equipment.

In order to encourage investment in Kosovo, the Government (PISG) had put forward a proposal to reduce import duty on all capital goods and raw

[14] Mackenzie and Tazureau (1997) quoted in IFA, UNEP: Mineral Fertiliser and the Environment

materials from 10% to 2%[15]. VAT was to stay intact. This was discussed within the Economic and Fiscal Council. The argument against was that it would distort the investment climate and lead to a misallocation of resources as reduced taxation on some commodities is a form of protection. Another proposal is to lower duty to 6% and raise VAT by 1% to compensate for the revenue loss.

The counter argument to this is that without some sort of incentive, it is difficult to get investment in Kosovo. Given that other countries give incentives as a matter of course, Kosovo puts itself at a strategic disadvantage.

5. Previous attempts to reduce tax in agriculture

Because the Ministry has no budget to subsidise, it has taken the attitude that to level out the trade playing field, taxes and VAT should be reduced on inputs. Various representations have been made over the past 3 years.

5.1. Ministry of Agriculture presentations

The Department and later the Ministry of Agriculture have made three concerted efforts to get a reduced taxation on agricultural inputs and on capital goods. Lost revenue was to be made up from an increase in excise duty on beer and wine. With the exception of fertiliser, where no duty is applied, these efforts have met with little success – see chronology in Annex 4. Most recently (September 2003), duty has been temporarily waived on wheat seed due to the steep rise in wheat price in that year and the restriction on importing from Serbia.

The Alliance for Kosovo Agribusinesses, with assistance from the IFDC, put forward a case in 2001 for the exemption of import duty on agricultural inputs, animal feed and for a temporary period of between 3 and 5 years. It argued that the agricultural trade policies in place and planned are somewhat (sic) inconsistent with regional and western experience studied.

A paper commissioned by IFDC in October 2001[16] looked in particular at the effect of VAT on agricultural production. It made comparison with best practices in other countries – especially within the EU. The paper fully appreciated and endorsed the aims of the CFA in trying to have a simple and effective tax system and made its proposals accordingly. It recommended to exempt, or better still, zero rate from VAT, specific agricultural inputs and unprocessed agricultural products. In particular fertiliser, seeds, animal feed, crop protection agro-chemicals, vet medicines and unprocessed food.

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[15] EC Customs Assistance Mission in Kosovo, "*Draft Regulation on Import of Raw Materials and Capital Goods to 2%*" CAFAO-UNMIK, 2002

[16] **Tax Reform and Agricultural Policy Priorities, limitations, Options**, Dr. Maciej Grabowski, for IFDC and KADP, Oct 2001, Prishtina, Kosovo

6. Policy Options

MAFRD policy is to increase farm income and productivity. This should be done with minimum loss of government revenue in the short term and with minimum, or no loss, of consumer welfare. At the same time, due thought must be given to the broader objectives of government. What impact would the removal of taxes on agricultural inputs and capital equipment have on other sectors?

- Is Agriculture a special case?

  The argument of this paper is that it is treated as such by all other countries which necessitate Kosovo to follow suit in order to trade on an equal basis.

- Will revenues be made up by taxation on increased economic activity in the sector?

  The inputs to agriculture are taxed, and it is this that MAFRD seeks to remove. The products of agriculture are hardly taxed. VAT is charged on all products where businesses have an annual turnover of more than €50,000. Most agricultural produce is traded from small farms to small shops and so does not attract VAT. Income tax is similarly not collected from small farms.

  Increased farm incomes will result in increased spending on non-food consumer goods on which VAT is charged. The amount of increase though will be small.

- Will this be a permanent subsidy to the sector?

  These measures would be in place for at least the medium term. Much depends on the terms of trade with neighbouring countries and their reduction in protection, and other opportunities in the Kosovo economy.

The following policy options are proposed by the MAFRD:

A. Abolishing/reducing VAT and Duty
   I. on inputs for agriculture (cultivation)
   II. on animal feeds
   III. on capital goods for agriculture
   IV. on Irrigation Water

B. Imposing Tariffs and quotas
   V. on imports for key competing products - milk
   VI. seasonally on imports on fruit, vegetables and eggs
   VII. Compensate for high fuel costs in mechanisation

Each policy option is evaluated on its effect on production and farm income, effect on trade, effect on tax collection and effect on consumer welfare. The effect on production and farm incomes is based on the SOK data given in Annex 2 showing current production levels, input usage yields.

I. Abolish Duty and VAT on main inputs for agriculture
on imported seed, fertiliser and selected agro-chemicals.

Beneficiaries
The total gross margin to farmers for field crops is calculated at €55 million. Of this, €4.5 million represents VAT on seeds, fertiliser and agro-chemicals. The abolition of VAT would therefore raise the total gross margin to farmers by 8%. It is expected that at a minimum, farmers would respond by increasing input usage to the current level of expenditure. That is, input usage would increase by 15% for seeds, fertiliser and agro-chemicals. It is calculated that the combined effect of this would be to increase yields by 10%. The abolition of VAT on fertiliser, seed and certain Crop Protection Chemicals would result in a total increase in Gross margin from €55 million to €72 million, an increase or €17 million.

The effect of reduced cost of maize and fodder will reduce the cost of animal production and so milk production as fodder is a major cost of production (up to 60% of total cost). The effect on the dairy industry should be to reduce the total cost by 0.7 euro cent per litre.

Abolishing duty on packaging would benefit vegetable farmers. However it is difficult to distinguish packaging for agriculture only, and therefore difficult to apply.

Loss of Government revenue
The government would lose revenue at two points:

- On the inputs. The total estimate of VAT charged given in Annex 2 is €4.6 million.
- Increase in production of cereals, vegetables and fodder should reduce the imports for these items. This should not effect overall revenue generation as VAT lost at the border should be recouped by VAT produced internally, although as pointed out above, internal collection will be considerably less. Import duty lost will be minimal as trade displaced is mainly with countries with which Kosovo does not impose duty.

Improved Record of imported inputs
As there will be no incentive to under-invoice, the Customs should be able to get a good picture of what agricultural inputs are imported into Kosovo.

Consumer Effect
There will be no effect on consumers as price levels for food will not be affected.

Trade Relations
There will be no effect on trade relations as no tariffs or quotas are being applied.

II. Abolish DUTY and VAT on Animal Feeds

Most animal feed is imported from neighbouring territories so no duty is applied. If VAT were abolished this would have the effect of driving down the price of locally produced feed and so push down the price of oil seed crops which currently account for a very small area – less than 500 ha and for which Kosovo probably does not have a comparative advantage.

Beneficiaries:
It would reduce the cost of meat production and milk production as feed accounts for 60% of cost.

Loss of Government Revenue
Import of animal feed in 2001 was €1.2 million yielding a revenue from VAT of nearly €300,000.

III. Abolish DUTY and VAT on Capital Goods for Agriculture

Tractors and farm equipment; processing equipment for the dairy industry and other agro-processing equipment, attract VAT at 15% and import duty at 10%. For those registered for VAT, the VAT is refundable but passed on to the consumer. For small farmers (which is almost all farmers in Kosovo), there is no way to recoup the VAT, it is therefore built into their costs.

After the 1999 war, efforts were made by government and donors to rehabilitate and replace damaged tractors and farm equipment. There is still a need for further replacement and investment. Import of tractors outside of these programmes has been small.

Beneficiaries
Allowing tractors and farm equipment to be purchased duty and VAT free reduces the cost by 26.5%. This would reduce tractor hire costs by 7.5% and reduce gross margins for wheat by 1.5%.

Use of tractors is not confined to farmers though and tractors might be purchased for building and general transport purposes rather than just agriculture.

Loss of government revenue
Tractor imports in 2001 were valued at €860,000. In 2002 at €431,000. The revenue generated from taxes was €225,000 and €37,000 respectively. A relatively insignificant sum.

IV. Abolish VAT on Irrigation Water

The Irrigation Companies are struggling to re-establish themselves. None of them are as yet irrigating the full area that they were designed to irrigate, due to the cumulative effect of lack of maintenance for 13 years. Some rehabilitation work has been completed, but more needs to be done. Charging VAT at the full rate at this stage is likely to delay and impede the rehabilitation effort.

Beneficiaries:
The farmers on the irrigation schemes will pay 15% less for water. The irrigation companies should be able to recover a higher proportion of water fees invoiced.

Loss of Government Revenue
The actual area irrigated in 2003 was about 13,000 ha. If 60% of farmer paid for their water, the total VAT collected would be about €80,000. In 2004 it is expected that 23,000 ha are to be irrigated. The VAT forgone, on the same basis would be about €150,000

V. Impose Tariffs on imports for key competing products – milk

Milk is a key product as it is a major source of cash for most small farm households. At the moment only a small proportion (5%) of milk is sold to dairies, most is sold un-pasteurised onto local markets (green markets), where farmers get a better price. Demand for milk on the Green market is considered inelastic. Therefore an increase in supply will just push prices down. Any increase in production by farmers will need to be sold to Dairies where lower prices obtain – 25c as against 30c. The Dairies are squeezed on the supply side by high cost of collection and a high cost of milk and on the market side, by relatively cheap imported products.

Table 7 Consumption of Dairy Produce ('000s tons)

	Local	Imported
Commercially traded	7.5	79
Green (unofficial market)	167	

The "commercial market" for manufactured milk and milk products is dominated by imports accounting for 90% of the "commercially traded milk". The imported milk is produced under conditions where subsidies are given to farmers, dairies or exporters. For instance in Slovenia subsidies were given to their dairy exporters of 6.6 cents per litre, or nearly 20% .

The effect of an increase of tariff by 10% to 20% would increase the combined VAT and tax from 26.5% to 38% an increase of 11.5%. This would raise the price for imported dairy produce and provide a stimulus for local dairy manufacturers.

Government Revenue effect
The increase in price would lead to an increase in revenue in the short term but in the longer term imports should be expected to decline due to increase production in Kosovo.

Consumer effect
Higher prices for imported dairy produce and higher prices for local dairy produce may result on poorer consumers resorting more to the green market dairy products. The elasticity of demand for milk is fairly low, so a price increase will not see a matched reduction in demand.

Trade Effect
As Kosovo prices rise it might be that milk will start coming from Serbia as Serbian milk is not subject to duty, but does enjoy a 6 cent subsidy from the Serbian government.

VI. Impose seasonal quotas on imports of fruits, vegetables and eggs

Fruit and Vegetable production is characterised by short periods of very high production. Prices are pushed down in these periods. Unrestricted imports at the main harvest period can drive prices down further. All neighbouring countries exercise some protection measures in the form of seasonal tariffs and/or quotas for their fruit and vegetables. All except Kosovo. A similar protection is suggested for eggs.

Some measure of protection would encourage investment in the industry and buoy incomes.

Revenue effects
Temporary Tariffs are relatively easy to administer and tend to deter imports. The loss in revenue would be fairly small as it would mainly effect FYROM which competes in the major crops that Kosovo grows.

VII. Compensate for high fuel costs in mechanisation

Kosovo has the highest price for diesel fuel in the region charging 30 €cents excise duty per litre. Neighbouring Serbia charges on 20 €cents. With increased mechanisation, this reduces cost competitiveness. In Western Europe, farmers have access to “red diesel”, which has a considerably reduced excise duty (in UK farmers pay half the price for diesel that normal businesses pay).

The Kosovo Customs are actively looking at the possibility of introducing such a scheme into Kosovo. Diesel for tractors would be sold at a reduced or zero excise duty.

7. Policy Preference

Does Kosovo have a comparative advantage in agriculture?

- Probably in fruit and vegetable production based on an effective irrigation system.
- With Dairy, Kosovo does not have a comparative advantage over countries with large dairy farms high yields and low costs. The dairy industry has been supported throughout much of Europe for social reasons. Most small farmers have dairy cattle and they are a source of protein for the family and regular income from sales of small quantities of milk or cheese. Most countries have a policy to protect these small farmers in the short to medium term whilst encouraging the more productive farmers to enlarge their herds and increase productivity.

What is the best way for Kosovo to protect its agriculture? Through tariffs or subsidies or both?

- The region is moving towards free trade. Kosovo's tariff system is currently simple and closer to the longer free trade principle than any of its neighbours. It is difficult to raise tariffs when neighbouring countries are reducing theirs.
- Tariffs will increase prices for consumers
- Direct subsidies to farmers in the form of acreage payments or subsidies per kg of produce produced are expensive to administer and would require the MAFRD to expand its budget greatly. The government is keen to keep government expenditure to a minimum.
- Reduction in selected VAT and duties is a subsidy to the agriculture sector by reducing costs. This would mean some small reduction in revenue to the government of probably €4 to €5 million. The stimulus in production though would result in increased incomes of at least €16 million which would increase investment in the sector and increase consumption and revenue from taxation on consumption.

8. Conclusion

Kosovo is a mainly agricultural economy. The industrial economy that existed in the past has largely collapsed. Kosovo in the future will need to develop industry, as the land cannot support the population in full-time farming.

Farm sizes are small, as in most of the West Balkan region. Over time, it is expected that Kosovo will follow the regional trend with the number of people actively engaged in agriculture declining and farm sizes increasing. At present only 17,000 out of 180,000 rural households constitute farms with more than 5 hectares and only 3,000 with more than 10 hectares.

Policy in the region recognises this and different countries have encouraged the development of commercial farming and consolidation of small farms. All the neighbouring countries in transition have recognised the need to ensure some minimum standard of living to their farmers and have had a policy of import tariffs to maintain price levels, and subsidies to ensure adequate incomes are received by farmers. Comparison has been made with the Cost of production and subsidies available in Serbia and FYROM and other neighbouring countries.

Under current conditions it is unlikely that agriculture will attract investment. The costs of production in Kosovo are generally higher than that of neighbours due to a lack of subsidies.
Changing taxes in order to ensure a more profitable agriculture is not sufficient to change agriculture, but it is a precondition to attract investment. The MAFRD also recognise that equally important are to the need to develop effective rural advisory services, finance for agriculture and measures to improve marketing for farmers. All measures they are actively developing.

Recommend
Setting VAT at zero or at a much lower rate than the current 15%. It has the advantage of being transparent and simple to administer. Although it may “distort” investment towards agriculture, it will not distort investment within agriculture.

Higher Tariffs on milk and milk products can overcome the lack of subsidy available for Kosovo Dairies as against those of competitors, but will encourage imports from Serbia. A system of direct subsidies to Dairies might be considered (see Annex 5: comments from Fiscal Authority Office (formerly the Central Fiscal Authority)

Seasonal tariffs on fruit and vegetables would help safe-guard this nascent industry. A similar approach can also be taken with eggs. Further work needs to be done to define the crops, the period and quota limits.

Next Steps
1. Carry out Cost of Production Studies (MARCH)
2. Develop input-output models to determine growth prospects for different crops under different cost conditions. (APRIL)
3. Put the arguments laid out here to the government and to UNMIK (FEB and MAY).
4. Adjustments made in Taxation and Tariffs (JUNE/JULY)

* * *

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ANNEXES

1. Comparative Gross Margins of East European Countries

2. Gross Margins for Major Crops in Kosovo

   2.1 Gross Margin per hectare: showing change in GM if VAT removed

   2.2 Gross Margin per hectare: showing change if yield increases 10%

3. Comparison of Wheat production Cost: UK, Poland and Kosovo

4. Chronology of Past Efforts to Change Policy

5. Comments Received on First Draft

Annex I

Comparative Gross Margins of East European Countries

	1996-98 data (1)				2001 data	
	US cents/kg …………………………….				€/kg	€/kg
	Croatia	Poland small farm	Poland large farm	Hungary	*Macedonia (2)*	Kosovo (3)
Wheat	7.8	6.0	4.7	8.0	8.0	11.0
Maize	4.7	5.1		6.0	8.0	10.0
Barley		5.7	3.7		7.0	
Oat	6.8		4.8			
Apple	18.3			11.0	12.0	
Strawberry	49.3					
Olive	13.3					
Potato	7.5	1.8	1.6	8.0		7.0
Cabbage	2.5				7.0	
Paprika	10.3					
Pepper					15.0	16.0
Sweet pepper				27.0		
Tomato				7.0	15.0	13.0
Sugar beet	6.4			2.0		
Sunflower				19.0		
Soya	16.0					

Source: FAO study

1 Impact of Structural Adjustment Programmes in CEE (Budapest 2000)
2 Macedonia figures from Agricultural Policy Analyst Unit of Ministry of agriculture report 2003
3 Kosovo figures prelim. estimates from SOK 2001 data

Note: This compares different data sets which are not necessarily derived in the same manner. The data for Eastern Europe is in US dollars and refers to the years 1996 to 1998, whereas the data for FYROM and Kosovo is in € and refers to 2001.
The exchange rates are roughly comparable.

Annex 2: COST OF PRODUCTION IN KOSOVO: GROSS MARGIN ANALYSIS

Area and Cost of production.

			Total cost: in euro per ha									Cost per kg			
	a	b	c	d	e	f	g	h	i	j	k	l	m	n	o
	Area planted 2001		Seeds	Manure	Inputs Fertiliser	Agro-chem	Mechanis	Labour	Pckg	Irrig	Total cost	**Cost per kg**	VAT Element	VAT as % cost	VAT 000s €
	Ha	yield/kg													
Grurë/wheat	74,062	3,365	78	50	100	40	100				368	**€ 0.11**	€ 0.008	8%	2,099
Misër/Mazie	58,193	3,398	50	50	100	40	80	30			350	**€ 0.10**	€ 0.007	7%	1,437
Other cereals	17,000	3,382	64	50	50	40	90	30			324	**€ 0.10**	€ 0.006	6%	340
Patate/Potato	5,215	13,551	50	50	150	80	200	200	200	110	1,040	**€ 0.08**	€ 0.006	7%	400
Speca/Pepper	3,707	9,178	100	100	200	80	104	420	350	110	1,464	**€ 0.16**	€ 0.012	7%	405
Domate/Tomato	1,653	13,718	250	100	200	100	150	400	450	110	1,760	**€ 0.13**	€ 0.011	8%	239
Perime të tjera / Other veg	10,000	7,969	100	100	200	80	104	420	350	110	1,464	**€ 0.18**	€ 0.014	7%	1,092
Jongjë / Alphalpha	23,553	3840			50		100			40	190	**€ 0.05**	€ 0.003	6%	276
Kuttura të tjera foragjere/Mixed forage	88,000	2745			50		100				150	**€ 0.05**	€ 0.004	8%	1,030
Total area	281,383	61,146	692	500	1,100	460	1,028	1,500	1,350	480	7110	**€ 0.12**	€ 0.000	0.09%	7,317

Source : SOK Agricultural Statisitcs of Kosovo,MAFRD

Source: SOK Agricultural Statistics, SOK, 2001. For area and yields.
Cost of production data adapted from MAFRD, Anadrini, Swiss Project for Horticultural Promotion

Annex 2

Gross Margins

1. Gross Margin per hectare: Showing change of GM if VAT removed

	Per hectare						
	Price per kg a	Area b	Yield c	Revenue d (a x c)	Cost e	GM f (d-e)	Total GM €mill g (b x f)
Wheat	0.14	74,062	3,365	€ 471	€ 368	€ 103	7.64
Maize	0.12	58,193	3,398	€ 408	€ 350	€ 58	3.36
Other cereal	0.12	17,000	3,382	€ 406	€ 350	€ 56	0.95
Potato	0.15	5,215	13,551	€ 2,033	€ 1,040	€ 993	5.18
Pepper	0.21	3,707	9,178	€ 1,927	€ 1,464	€ 463	1.72
Tomato	0.19	1,653	13,718	€ 2,606	€ 1,760	€ 846	1.40
Other veg	0.19	10,000	10,000	€ 1,900	€ 1,760	€ 140	1.40
Alphalpha	0.19	23,553	3,840	€ 730	€ 260	€ 470	11.06
Mixed forage	0.19	88,000	2,745	€ 522	€ 260	€ 262	23.02
Total		281,383					55.72

2. Gross Margin per hectare: Showing change of GM if yield increases 10%

	Price per kg	Area	Yield	Revenue	Cost	GM	Total GM €mill
Wheat	0.14	74,062	3,702	€ 518	€ 368	€ 150	11.12
Maize	0.12	58,193	3,738	€ 449	€ 350	€ 99	5.73
Other cereal	0.12	17,000	3,720	€ 446	€ 350	€ 96	1.64
Potato	0.15	5,215	14,906	€ 2,236	€ 1,040	€ 1,196	6.24
Pepper	0.21	3,707	10,096	€ 2,120	€ 1,464	€ 656	2.43
Tomato	0.19	1,653	15,090	€ 2,867	€ 1,760	€ 1,107	1.83
Other veg	0.19	10,000	11,000	€ 2,090	€ 1,760	€ 330	3.30
Alphalpha	0.19	23,553	4,224	€ 803	€ 260	€ 543	12.78
Mixed forage	0.19	88,000	3,020	€ 574	€ 260	€ 314	27.61
Total		281,383	-				72.68
Increment		-					16.97

Annex 3

COMPARISON OF WHEAT PRODCUTION COST: UK, POLAND AND KOSOVO
Gross Margins without overheads
in €

	PER HECTARE						PER TONNE					
	Kosovo		UK		Poland		Kosovo		UK		Poland	
Yield (tons/ha)		3.8		8.22		6.3		3.8		8.22		6.3
Inputs												
Seed	€	70.0	€	70.1	€	51.9	€	18.4	€	8.5	€	8.2
Fertiliser	€	110.0	€	150.7	€	112.6	€	28.9	€	18.3	€	17.9
Sprays	€	40.0	€	176.1	€	132.8	€	10.5	€	21.4	€	21.1
Labour	€	80.0	€	182.1	€	55.7	€	21.1	€	22.2	€	8.8
Power and machinery	€	160.0	€	282.1	€	164.7	€	42.1	€	34.3	€	26.1
Total	€	460	€	861	€	518	€	121	€	105	€	82

Estimate for Kosovo from Table 2, including imputed values of labour and manure
Poland and UK estimates from Pamela Gladwin Study (2001/2)

NOTE: Comparison is difficult in these circumstances as cost of production are derived in different ways, some imputing costs such as family labour and farmyard manure and others putting only the cash purchase costs.

Annex 4

Past efforts to change policy

Date	Action
Nov 2000	**Memo from Co-head DoA to Co-head CFA** Proposals to remove customs duties (but not sales tax) from: 1. Seeds 2. Listed Agro-chemicals 3. Farm machinery 4. Plastic sheeting for green houses 5. Listed Veterinary products *Fertiliser was at that time exempt.*
March 2001	**Alliance of Kosovo Agri-Business** Discussion paper prepared: "Proposed removal of customs duty on specific agricultural products"
Oct 2001	**IFDC & Kosovo Agribusiness Development Program**
	Paper prepared by Dr Maciej Grabowksi: "Tax Reform and Agricultural Policy: Priorities, Limitations and Options". *Made case for lower border taxes that would allow greater agricultural growth and in the long term higher budget revenues. Also noted that many developed countries charged little or no VAT on agricultural sector inputs.*
Sept 2002	**Memo from MAFRD to Central Fiscal Authority / Ministry of Finance** Proposed a 3 year duty exemption for: 1. Agricultural Inputs 2. Animal Feed 3. Wheat 4. Raw material for food industry – packaging, bottles and labels 5. Agricultural machinery and spare parts It was also suggested that loss of revenue from these items could be made up with increased excise duty on beer and wine.
Dec 2002	Proposals made in **CBC Farm Rehabilitation project** on Macro-economics: - Removal of Custom Duties on seed, cattle semen, plant protection, veterinarian equipment, capital goods and machinery for agric. - Increase excised duty on beer and wine. Beer from 15c/l to 25c/l ; wine from 25c/l to 35c/l - Introduction of 10% seasonal duty on certain veg. - Removal of VAT on new agric machinery and equipment - 3-tier VAT system: 5% for food products; industrial 15%; luxuries at 25% - Domestic protection – time bound to help re-establish processing market in Kosovo: - Improving compliance and transparency in trade agreements - Encouraging harmonisation with EU: market economy and regulatory environment. - Reduce risks to reduce interest rates
Oct 2003	**Proposal made to MFE** 1.Suspend the duty on Wheat, Wheat seed and Flour. *Taking into consideration the increase in world price of wheat and Serbia suspending exports of wheat as of July 2003 due to high domestic prices* 2. Also to abolish Duty and VAT on all agricultural inputs The first proposal accepted and went into force on up to next year.

Annex 5

COMMENTS RECEIVED ON FIRST DRAFT

The MAFRD Policy Office are grateful for the valuable contributions received from other members of staff and from institutions outside the Ministry.

This Working paper is essentially a quick revision and correction of the Draft that was put out in January. Some comments require considerable work in order to address them properly and will be incorporated in a Final Draft to be completed in May 2004.

Ministry of Finance and Economy

1. Need for Further in-depth Analysis

    The argument regarding the imbalance in support to agriculture in Kosovo compared to that of neighbouring territories/countries was acknowledged. The method of analysis was, on the whole accepted. On the other hand, it was felt that there was a need for better Cost of Production data on which to base the projections and the need for a <u>Cost of Production survey</u> to proceed as soon as possible in order that the analysis could be strengthened.

    If farmers' income increase due to increased production, what will be the effect on their consumption pattern and will it result in more indirect tax being paid from increased consumption?

    It was noted that nearly all farmers were outside the income tax net, and that much of the traded produce was also not subject to VAT. Therefore an increase in production will not obviously result in an increase in revenue.

    Alternative Revenue sources should be looked at to compensate for the projected loss to the Treasury.

2. Income Distribution

    The MFE argued that subsidising one sector of the economy was an "economic distortion", attracting investment into a sector that was being made "artificially attractive".

    The MAFRD argument is:

    - *that all agricultural sectors in trading partners are distorted by support measures. Therefore to compete it is necessary to have equivalent support measures.*
    - *that support to agriculture has a social function. Most poverty is in rural areas and support to agriculture enables people on the margin to some income.*
    - *While "supporting" agriculture can be seen to slow down the process of "modernisation of the sector", in as much as modernisation is a process allowing the number of small farms*

to diminish and larger farms to emerge, it is a process that requires an equal growth in opportunities outside agriculture.

3. Taxation system is well established

   The taxation system is well established. It is broadly based and rates are generally lower than those in neighbouring countries. The main **concerns** that MFE would have on the proposed policies from a tax administration perspective are:
   - If a tax exemption is made for agriculture there will be no way back. It will become a permanent expectation – a right! The MFE would therefore like to see a time limitation (sunset clauses) clearly built in.
   - How easy will it be to assess the effect of these tax changes? MAFRD statistics are not at present good.
   - Other interest groups will plead the same "special case" status and ask for similar reliefs.

4. Budgetary Implications

   Whilst the paper looks at probable loss of revenue it does not look at measures to make good this loss. The MFE in its Medium Term Forecast envisages the demands of the budget increasing and the ability to raise revenue flattening off. In particular foreign donor funds are expected to fall and remittances, after an initial spurt of investment are expected to fall. The MFE is therefore reluctant to reduce taxation unless they can feel reasonably certain that it will be made up in some way.

5. Technical issues:
   a. The Draft referred to "abolishing" VAT. From a tax administration point of view and in order to operate sunset clauses, it should be zero-rating. That is, VAT is still chargeable, but is set at zero.
   b. The Draft only mentions changes to Taxation as a means of assisting the sector. This is only one of a number of support measures. If the tax measures are taken alone, they will not necessarily have the desired effect without these other measures – notably rural finance, advisory services and measures to free the market for land.

Ministry of Agriculture and Rural Development

The MAFRD Senior staff meeting endorsed this document and also debated adding further recommendations:

VIII: Take VAT off Major Food commodities

Purpose: to encourage increased consumption and as a "social measure" as poorer people spend a greater proportion of their money on food. The food items to be relieved of tax would be milk, bread, salt, oil and sugar.

Comment
Impact on production: as demand for food is relatively inelastic, it will not result in a greatly increased demand.
Impact on revenue: not costed yet.

IX: Remove VAT on Firewood and Seedlings

This was suggested by the Forestry Dept. in order to reduce the pressure on Kosovo forests. Making it cheaper to import firewood should result in lower prices and it being less economic to cut illegal firewood in Kosovo.

The question of seedlings needs to be investigated further. Would taking VAT off of Seedlings make an appreciable difference to the planting rate or to the profitability of forestry?

Comment
Impact on production: not estimated.
Impact on revenue: not costed as yet

X: Consideration be given to protecting the Wine Industry

Comment
This document has not looked at the Wine Industry or its need for protection. It is appreciated that FYROM spends €8 million per year protecting its wine industry, but it already had some comparative advantage. It is not thought that the wine industry in Kosovo requires any particular protection over and above that outline in this document

Customs and Excise

Customs appear to have no foreseeable problem with the proposals. They would like to be furnished with a list of the items that would be treated differently and would like the list to be restricted to important items only.

Customs asked if MAFRD wanted to take VAT off animal imports.
Comment : Livestock imports are competing with domestic production, so no, the VAT would remain on imports.

Economic and Fiscal Secretariat
The EFS reiterated that changing VAT will “distort” the economy. Whereas they recognised the special problem with agriculture and the manner in which it is treated in other countries, is the use of taxation the best tool?

Zero-rating VAT or abolishing VAT is not favoured. A lower rate, say 5% might be more acceptable.

Tariffs on milk might be difficult to apply. It might be better to pay direct subsidies to dairies in order to level the playing field.

Cost implication: If a 6 cent subsidy were given per litre as in Serbia, then 7.5 million litres would cost € 450,000. Milk production could quite easily triple production with current under-utilised capacity and therefore cost €1.5 million per year.