

### 3.3.1 Public expenditure management

#### *State Union Level*

##### *3.3.1.1 Legal framework*

The competences of the State Union of Serbia and Montenegro are set out in the Constitutional Charter. The *Accounting Law* of the former Federal Republic of Yugoslavia still applies to the financial operations of the State Union, pending the development of replacement legislation.

##### *3.3.1.2 Institutional framework*

Article 11 of the *Decree on the Establishment of Ministries, Organisations and Services of the Council of Ministers* provides, inter alia, for the establishment of a Service for Financing the Competences of the State Union. The Service, which is situated in the General Secretariat of the Centre of Government (see above), is responsible for developing draft acts on annual revenues and expenditures for the financing of the State Union competences in co-ordination with the Member States, and development of the plan for the funds broken down by category of recipient and user.

*The State Union is funded by the Member States*

As required by the Constitutional Charter, the State Union is funded by the Member States (Article 19 of the Constitutional Charter), in practice this means predominately Serbia. For 2003, the total budget amounted to approximately €522.5m and 93.3% of funding came from Serbia. Defence expenditure represents approximately 90 per cent of total expenditures by the State Union.

Accounting for the State Union is currently handled by a small database operated by the US Treasury Budget Advisor in the Republic of Serbia Ministry of Finance and Economy. This database receives data on actual expenditures from the Serbian Public Payments Administration (PPA). In addition, the State Union reports, to the Serbian MoFE, progress on budget execution against its monthly allotments.

The National Bank of Serbia operates the Treasury Single Account for the State Union, as well as for each of the Member States. It also handles all credits and debt obligations of the State Union.

##### *3.3.1.3 Reform Agenda and capacities*

At this stage, the main focus of the State Union administration is to establish the offices and processes necessary to fulfil its statutory functions. There is no reform agenda as such.

##### *3.3.1.4 Assessment*

The institutions of the State Union are extremely weak – intentionally so, since the Constitutional Charter places one of the key sources of power, financing, in the hands of Member States. The Service for Financing the Competences of the State Union is thus reliant on the Serbian MoFE and the PPA for its reporting and budget execution functions: currently, it does little more than aggregate the budget requests of the State Union ministries.

#### *3.3.1.5 Recommendations*

The Service for Financing the Competences of the State Union should be strengthened, at least to the level that it can exercise a typical budget office challenge function on Ministry (especially Ministry of Defence) requests, and undertake expenditure planning so as to facilitate the transfers from the Member States.

#### *3.3.1.6 External assistance*

Currently, technical assistance in the field of public expenditure management is focussed uniquely on the Member States.

Possible areas for technical assistance to the State Union level include:

- Strengthening the Service for Financing the Competences of the State Union. This should encompass:
- General development of the budget system
- Specialist assistance with analysis and development of the Defence budget.

### *Serbia*

#### *3.3.1.7 Legal Framework*

*A modern legal framework exists*

Public expenditure management in Serbia comes under the new Budget System Law, which was adopted in February 2002. This law was drafted with international assistance, mainly from the US, and is consistent with modern budgetary and financial practices; it will need some modification to align it with European practice.

Budgetary processes are now very much under parliamentary control. Following the adoption of the new Budget System Law, uniform standards have been introduced and very significant progress has been made with fiscal reporting.

Greater transparency is also now apparent in relation to public expenditure management, with a range of laws, as well as the Budget Memorandum establishing the principles underlying the 2004 budget and the projections for 2005-6.

### 3.3.1.8 Institutional Framework

The Ministry of Finance and Economy has 11 main departments, including such functions as foreign currency inspection, prevention of money laundering and anti-corruption. There are in addition three separate administrations: the Tax Administration, Customs Administration and the Public Payments Administration (PPA). The central functions, such as budget preparation and treasury, are carried out by relatively small staffs: the entire Ministry has only 65 staff, of which seven are in the Budget Department.

The budget preparation system has settled down well and is becoming routine; fiscal 2004 will be the third consecutive year for which the processes are largely the same. Line ministries are providing substantially greater information than previously. However, the system is still focussed on inputs, and little attention paid to activities. There is as yet no real investment budget, nor is budgetary analysis carried out in any meaningful way.

*The capacity to monitor Local Government Units is weak*

A particular problem is that the unit responsible for monitoring local government units (LGUs) consists of only one person, whilst there are some 160 LGUs requiring monitoring. Very little information is available on the finances of LGUs, which the IMF estimates to be equivalent to 5 per cent of GDP.

**Treasury** The contract with the main contractor for the EU-funded Treasury system was terminated early in 2003 because of non-performance. USAID provided funding for the development of a purpose-built temporary solution which provides cash and commitment accounting. This interim system provides users with a wide range of reports and has met with considerable user acclaim.

The National Bank of Serbia (NBS) established a Treasury single Account (TSA) early in 2002 which, unusually, combined the TSAs of the State Union and of both the Member States. Initially this caused severe liquidity problems for the Member States, but these have now been resolved. It also led to problems in relation to the attribution of revenues, with many incorrectly recorded and consequently transferred to the wrong entity. By January 2003, approximately 80 per cent of revenues were being correctly recorded. The NBS appears to believe that its role of defending the dinar and keeping inflation low takes precedence over providing effective banking services to its clients.

The MoFE originally attempted to implement the IMF treasury model, which relies on a properly functioning banking sector, but quickly realised that this was not feasible in the short term and that there was a

need for ZOP<sup>1</sup> to continue in operation – hence many of its functions were transferred to the newly-established PPA. The ToR for the EAR treasury project now needs to be re-drafted in the light of the changed circumstances prevailing in Serbia. The largest problem remains defence, which, although a responsibility of the State Union level, is handled through the Serbian Treasury. Defence represents approximately 90% of State Union outlays, but it is not managed within the regular Treasury system. However, it will be extremely difficult to bring this within the system before it is required to comply with NATO requirements.

The PPA operates as the ‘back office’ of the Treasury; all payment orders are sent from the Treasury to the PPA for execution, which inputs them into the real-time gross settlement system. Cash flow forecasting is still rudimentary, based on pro-rated expenditures.

The structure and functions of the Treasury are being reviewed (with external assistance). Several options are being considered for splitting off various functions of the Treasury, or creating a separate agency. In the view of its proponents, this would allow staff to be paid more competitive salaries, which would address the problem of recruiting and retaining quality staff, since equivalent functions in the private sector are paid substantially more.

*The PPA is the emanation of the old Payment Bureau (ZOP)*

**Public Payments Administration** The PPA is the current incarnation of the old Payments Bureau (ZOP) without a number of its old functions (inter-bank settlement etc.). It sees itself as being the ‘core’ of the new Treasury, with regional offices throughout Serbia. Apart from handling actual cash receipts, the PPA records all transactions by each level of government (State Union, Republic and Provincial) passing through the Treasury and the TSA. It provides reports to users, although these are not highly regarded, according to the Treasury. The organisation is still in the process of re-inventing itself and creating a new role. The PPA (with external assistance) is looking into the relationship between the Treasury and the PPA, whilst the PPA itself sees the need for resolution of a number of institutional and functional issues, ranging from the reconciliation of apparently conflicting laws, to the definition of budget beneficiaries, use of own revenues, and who should receive the various reports prepared by the PPA. The organisation also sees the need for replacing much of its existing IT infrastructure, as there is a need for it to be more closely linked to the systems of its clients. These changes would also require staff training.

**National Bank of Serbia** As mentioned earlier, the National Bank of Serbia handles the TSA for the State Union, and for the Member States

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ZOP was the comprehensive payments system developed in SFRY which covered the entire country and both the state and “self managed” sectors, as well as some services to individuals. It also exercised functions equivalent to a bank clearing system, taxation authority, statistical service and audit operation.

(dinar transactions only, in the case of Montenegro). The NBS has encountered problems related to gathering data on financial transactions of all government entities, since there are numerous accounts held in the commercial banks that are not reported to the PPA. This causes difficulties when entities make payments from these commercial accounts, as the transactions do not pass through the TSA. The NBS handles all foreign exchange transactions for government and for credit relations with other countries.

The NBS handles all credits and debt obligations of both the State Union and Serbia. It purchases foreign exchange to meet interest and principal repayments, operates the debt registry, including those of individuals which were expropriated by the previous regime. The NBS is also responsible for management of Serbia's Treasury Bills, of which there are approximately the equivalent of €150m on issue at any one time. The Bank finds the cash requirements data provided by the Treasury to be inadequate, and is pressing for more accurate information on expenditures and revenues, in order to be able to forecast liquidity more accurately.

#### *3.3.1.9 Reform agenda and capacities*

Serbia has made dramatic progress in the reform of its public expenditure management systems in a very short period of time. This progress has also taken account of the needs of the administration, as well as the demands of donors, and has been well managed. Although much remains to be done, it is clear that the senior management of the Ministry of Finance and Economy welcome reform and are willing to pursue implementation. The reforms so far undertaken provide a sound basis for further improvement. Whilst there does not appear to be a coherent reform programme as such, the MoFE is moving at a rapid pace towards harmonisation with good European practice.

#### *3.3.1.10 Assessment*

**Strengths** The main strength of the MoFE is its willingness to embrace reform. This has resulted in substantial progress being made in a very short period of time, and with the reforms becoming well-bedded within the Ministry.

**Weaknesses:** The MoFE has a core of highly motivated staff, many of whom came from the Diaspora and who returned following the change of regime. However, unless salary reforms are introduced rapidly, these staff may leave and the Ministry would lose a substantial investment in human capital. The salaries of some staff are being supplemented directly by the UNDP. This is, in any case, a practice to be avoided, but it also increases the risk of precipitating departures once the supplementation scheme stops.

#### *3.3.1.11 Recommendations*

The Ministry of Finance and Economy is in need of modernisation. As a minimum, the following are required:

- Establishment of a budgetary analysis capability;
- Establishment and staffing of suitable systems to monitor local government finances;
- Computerisation (hardware and software) of MoFE, as an adjunct to the development of the Treasury System.
- The National Bank of Serbia needs to:
- Improve the management of government accounts;
- Improve the overall cashflow forecasting system, in consultation with the Treasury and the PPA;
- Establish suitable audit mechanisms.

Further development of the treasury function is needed:

- Resolution of a number of institutional and functional issues between the Treasury and the PPA;
- Definition and procurement of suitable IT tools for the PPA;
- Improvement to the cashflow forecasting system within the Republic of Serbia administration.

#### *3.3.1.12 External assistance*

The US Treasury Department has resident Budget, Taxation and Debt Advisors in the MoFE. The EAR is currently funding a consultancy to examine the future relationship between the PPA and the Treasury and to propose a range of options. The MoFE has engaged the French Trésor to act as its agent in reviewing this consultancy. The UK DfID has a macro-economic project in the MoFE and USAID funded the development of the interim treasury system and continues to fund its maintenance. In addition, USAID has paid for the provision of a credit rating by Standard and Poor's.

The MoFE would benefit greatly from a twinning arrangement (in either Budget Preparation or Treasury) with one of the new Member States, to ensure that the further development of its systems and processes are aligned with good European practice.

*Montenegro<sup>2</sup>**3.3.1.13 Legal Framework*

*The legal framework is in line with international standards*

Public expenditure management in the Republic of Montenegro is governed by the Budget Law, which dates from 2001, and the Treasury Regulations, which are issued pursuant to the Budget Law. These were developed with the assistance of external advisors and are in line with the views of the international financial institutions.

*3.3.1.14 Institutional Framework*

The Ministry of Finance (MoF) is divided into two main areas: one responsible for budget preparation and the other for treasury functions.

**Budget preparation** Budgetary procedures are enforced by the Ministry of Finance and generally well followed by line ministries. The Macroeconomic Department, which consists of three staff, developed forecasts for the 2004 Budget year and the following two years. The budgetary forecasts were approved by the Government in July 2003, and the Budget Instruction issued to ministries included the overall budgetary target, as well as targets for individual ministries. Following receipt of the budget requests from line ministries, the draft budget is prepared by the five staff of the Budget Department and any modifications then discussed with ministries, before submission to the Government. The draft budget is generally submitted to the Assembly before the end of November, although it is scrutinised by the Budget Commission beforehand. The draft budget is published in the official journal prior to approval by Parliament. Budget analysis is, however, still rudimentary.

The MoF is piloting activity based budgeting in the Ministry of Transport and the Prisons Unit of the Ministry of Interior Affairs. The pilot is to be extended to the remainder of the Ministry of Interior Affairs, as well as the Ministries of Agriculture, Culture, Education and to the courts, during 2004.

**Budget execution/treasury** A Treasury Ledger System (TLS) is being developed under the auspices of the EAR. As with Croatia and FYROM, this is based on the SAP R/3 system and is being implemented by the same company in all three instances. The system became operational in January 2003 and there are now 22 spending units directly connected to it. There has been good user reaction to the system and the reporting available from the system. However, the system as currently implemented does not support commitment accounting. A further

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The official currency of the Republic of Montenegro is the Euro (€), Law on the Central Bank of Montenegro as amended July 2003, whilst that of the Republic of Serbia is the Yugoslav Dinar.

problem is that the extra-budgetary funds (Health, Social Security etc.) use a different chart of accounts from the government, making consolidation for reporting purposes complex and subject to error.

*Some line ministries still have several bank accounts despite the existence of a TSA*

Although the Treasury Single Account (TSA) has been in operation for some time, the Ministry of Labour and Social Welfare still has several bank accounts outside the system and this causes some difficulties with the bank reconciliation process.

The Treasury was established in 2002, following introduction of the new Budget Law. Its role includes cash and debt management, recording and approval of guarantees. Montenegro has only very recently become responsible for handling its own debt portfolio; this was previously managed centrally in Belgrade. As Montenegro represents 5.88 per cent of the GDP of the State Union, this is the proportion of the debts of the former Federal Republic of Yugoslavia that Montenegro has inherited. In addition to these debts, there are some €150m in debts owed to the private sector, which must be repaid over the next 14 years. Cashflow forecasting is still fairly simplistic and the links with the other players in the process – the Macroeconomic Department, the main revenue collection agencies, and the Central Bank of Montenegro – need to be strengthened. The cash rationing system used to pay the Government's suppliers is also adding to the stock of arrears, and this could become a problem in future years.

The short-term debt instruments available to the Treasury are limited to 28-day and 56-day Treasury Bills, with about €15m on issue at any one time. A recent improvement resulted from the decision to allow banks to hold up to 25 per cent of their Statutory Reserves in T-Bills. The Central Bank of Montenegro is prohibited from lending to the Government.

**Central Bank** Cash payments are handled by the Payments' Institute (ZOP<sup>3</sup>), which is a part of the Central Bank of Montenegro. The reform of ZOP is currently underway, with government transactions outside Podgorica being handled by the commercial banks. The transformation envisaged is similar to that carried out in Serbia, with the ZOP acting as the mechanism by which Government payments are inserted into the banking system, and which handles receipts and expenditure accounting. The ZOP still handles the revenue-sharing at source arrangements, which the commercial banks are not capable of performing.

Unlike most central banks, the Central Bank of Montenegro cannot finance itself from seigniorage, as the currency of Montenegro is the Euro, and the Central Bank is not permitted to issue its own currency. Alternative mechanisms for funding the Central Bank will need to be developed.

### *3.3.1.15 Reform agenda and capacities*

The MoF has a well-developed reform agenda, developed with international consultants, which foresees the further development of activity-based budgeting, development of internal and external audit capacities, extension of the capabilities of the TLS and enhancement of public debt management capacities. The Central Bank is also undergoing significant reform, in line with the requirements of a market economy.

### *3.3.1.16 Assessment*

**Strengths** The management of the MoF has embraced reform and is continuing to put in place necessary changes, sometimes against internal inertia. Once these reforms are in place, they are generally welcomed and this should assist the Ministry in the continuation of its reform agenda. There are several dedicated and influential staff within the MoF who have been instrumental in furthering the reform process.

**Weaknesses** The MoF has, until recently, relied heavily on external consultants for much of its expertise. Many of these have now been withdrawn and this could adversely impact the pace of reform.

### *3.3.1.17 Recommendations*

- Cashflow forecasting mechanisms need to be strengthened and improved. The capacities of the Budget Department should be strengthened;
- The Debt Management function of the MoF should be enhanced.

### *3.3.1.18 External assistance*

USAID has funded a major Economic Reform Project within the MoF. However, all the advisors have recently been withdrawn from the MoF following a disagreement on procedure. The EAR funded Managing Government Expenditure Project came to a successful conclusion in July 2003, whilst the EAR funded computerisation of the Treasury is also drawing to a successful conclusion.

The MoF may also benefit from a long-term twinning arrangement in either the Budget Preparation or Debt Management Departments.