



SIGMA

Support for Improvement in Governance and Management

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KOSOVO

PUBLIC EXPENDITURE MANAGEMENT SYSTEM

ASSESSMENT JUNE 2007

Introduction

From 1999 to 2002 the Kosovo budget was characterised every year by growing revenue and expenditure and fiscal surpluses. During that period, surpluses occurred because revenue outcomes generally exceeded forecasts and because expenditure was appropriated on a commitment basis and was not fully disbursed by the end of the year. In 2004 a decision was made to move the budget to a cash basis. In the same year the growth in revenue began to slow down. As a result of these factors, the year 2004 showed the first budget deficit of approximately €138 million (equivalent to about 5.5% of GDP). For the year 2007 the budget has been prepared in deficit by €34.2 million.

Total revenues of the Kosovo Consolidated Budget (KCB) for 2007 are forecast to be approximately €682.8 million, of which approximately 85% (€578.0 million) is derived from taxes (border taxes, representing about two-thirds of the total revenue). Donor grants are not included in the consolidated budget.

The above-mentioned factors indicate the strong economic vulnerability of Kosovo's budget, and this will perhaps be even more the case once the issue of Kosovo's status has been resolved.

Budget expenditures are estimated at €717.4 million, of which €553 million is central government expenditure and €164 million the expenditure of municipalities. In comparison to the previous year, budget expenditures in 2007 have increased by approximately 2.5%, while the central government budget has increased by almost 4% since the budget for municipalities has decreased slightly. This decrease results partly from the goal to cut down the number of people receiving their salary from the KCB, which was mainly planned through the relevant reductions in municipalities.

1. Legal Framework

Ultimate legal authority in Kosovo resides with the Special Representative of the UN Secretary General (SRSG), under the terms of United Nations Security Council Resolution (UNSCR) 1244 of 10 June 1999. A consequence of this resolution is that any decision of the Kosovo Assembly must be approved by the SRSG before it becomes operative. The SRSG can also reject or amend any law passed by the Assembly.

Since Kosovo is, legally speaking, part of Serbia under the UN Interim Administration Mission (UNMIK)¹ in accordance with UNSCR 1244, it is not a separate country and does not have many of the prerogatives of sovereign states. However, the situation is evolving as, for example, Kosovo has now received its own international banking code.

According to sections 5.1 (a) and (b) of the Constitutional Framework for the Provisional Self-Government (UNMIK/REG/2001/9 – 15 May 2001), responsibility for economic and financial policy and for fiscal and budgetary issues is vested in the Provisional Institutions of Self-Government (PISG). Public expenditure management is regulated by the Law on Public Financial Management and Accountability 2003/2. This law was amended at the end of 2003, and preparations for further amendments have been underway for over a year, but in May 2007 the law had still not been revised.

2. Institutional Framework

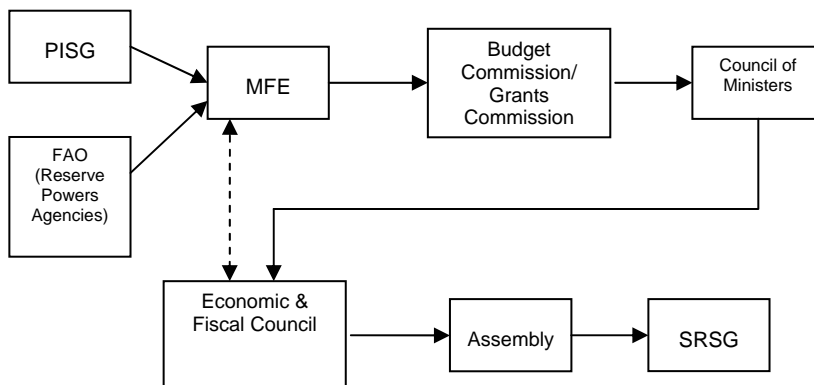
The Ministry of Finance and Economy (MFE) came into being following the abolition of the Central Fiscal Authority (CFA) at the end of 2002. The MFE prepares the budget from budget bids sent in by ministries (in the case of the PISG), by the SRSG for those functions that are reserved powers, and by municipalities. These three elements form the Kosovo Consolidated Budget (KCB).

¹ Since June 1999 the province of Kosovo has been governed by the UN Interim Administration Mission in Kosovo (UNMIK).

The senior management and staff of the MFE are largely Kosovar, although the number of foreign experts remains relatively high. A relatively high proportion of staff exercise support functions (e.g. IT).

The Economic and Fiscal Council is also involved in budget preparation, acting as an advisory body to the SRSG and supported by a secretariat. In addition, the Fiscal Affairs Office (FAO) of UNMIK prepares budgetary submissions on behalf of the SRSG and analyses the draft budget prepared by the MFE. The Economic and Fiscal Council Secretariat and the FAO work in close co-operation. Both of these organisations still have a small number of international staff, together with several Kosovars.

There is a complex system for budget preparation and approval, although the MFE is responsible for budget development and preparation. The overall development process is shown below.



The constitutional framework establishes the Budget Commission, which is composed of the Assembly Budget Committee (current membership is according to the number of deputies representing each party), two senior officials of UNMIK and five ministers. The Budget Commission is responsible for reviewing all draft acts that are submitted to the Assembly. It also receives quarterly reports on budget execution.

The Economic and Fiscal Council is chaired by the SRSG and is comprised of three senior UNMIK officials, the Prime Minister and three ministers. The Council may return the draft budget to the MFE with a request to amend it. The SRSG may reject or amend the budget at any stage.

Recently the former budget department in the MFE was reorganised and divided into two departments – one dealing with central budget issues and the other with municipal budget issues. Previously a single unit within the MFE had been responsible for budget development and preparation. Some foreign donor co-ordination has to date been assured by the Treasury.

Final approval of the KCB is the responsibility of the SRSG, who can also reject the draft budget at any stage or request amendments to it.

2.1 *Budget process*

The budget preparation process is complex (partly due to the overall legislative framework and the status of Kosovo). As the Law on Public Financial Management and Accountability has not been modified in the last few years, the main characteristics of the budget preparation process have also remained unchanged .

A Medium-Term Expenditure Framework (MTEF) was approved by the government for the first time in December 2005. This document, covering the period 2006-2008, provided an overview of recent fiscal trends, forecasted the macroeconomic outlook up to the year 2008, and included budget deficit, revenue and expenditure projections. Although it was foreseen that the MTEF would be updated annually, no such document had been approved by the beginning of the 2008 budget process.

The annual budget preparation process starts in the spring, when the first budget circular is issued (for the 2008 budget preparation it was issued on 9 April 2007). The Initial Budget Circular provides instructions and requirements as well as a tentative timetable for the budget preparation process. Although the budget preparation process starts well in time, there is limited time for discussions at the parliamentary level as the budget is not submitted to the Assembly until 30 October.

The budget law is extremely detailed, setting limitations for each institution by department; the budget allocated to each department is divided into programmes, each of which is structured according to the economic classification of expenditures. Together with the annual budget, the number of employees for each department within an institution is also set, leaving basically no room for making necessary management decisions during the year (e.g. moving an employee from one department to another within a ministry). Over 28% of the KCB is dedicated to the wages and allowances of the public administration. Further information on the public service is provided in the assessment report on Public Service and the Administrative Framework in Kosovo.

Even though annual budget expenditures are tightly controlled at a very detailed level, the budget scope is not comprehensive, and a portion of revenues and of expenditures are left out of the process. According to section 10 of the Law on Public Financial Management and Accountability (which specifies what constitutes public money and indicates the sources of public revenue), one source of revenue is represented by grants and gifts from international organisations and foreign governments, which in fact do not flow through the annual budget. The fact that these donor funds are not included in the annual budget decreases the transparency of public expenditure management in Kosovo. More importantly, it is an issue of whether donor funds will be rationally allocated and spent and whether relevant guaranteed national co-financing will take into account financial limitations within the budget framework. The related risks are also increased due to the fact that the lines of responsibility between the various institutions involved in monitoring and co-ordinating foreign aid are not clearly set. There is an EU Assistance Co-ordination Unit in the Agency for European Integration as well as a Donor Co-ordination Unit in the Office of the Prime Minister, but the lines of responsibility between the two have not been set and the staffing of these units seems to be limited.

Given the high involvement of foreign experts in the past, it is unclear to what extent budget offices in line ministries have the capacity to participate in budgeting and in budget execution.

2.2 Budget execution

Budget execution in Kosovo has been fairly low, mainly due to the limited use of funds planned for capital expenditures – approximately one-quarter of these funds have not been used during the budget year. It is not permitted to carry any unused funds over to the next budget year, which provides a potential incentive to carry out inefficient spending towards the end of the year. On the other hand, it also necessitates estimating the funds that will be needed for an investment project that is being implemented but will not be completed by the end of the year, and entering those figures into the following year's budget. However, in the past two years the capacities and procedures for public investment planning have been enhanced, which should also improve the situation during the budget execution phase. Further improvements might include the creation of a possible carryover of unspent funds for investments into the next budget year.

With respect to budget execution, the Treasury within the MFE is responsible for the performance of *ex ante* control of all payment orders – a function which demands considerable human resources without providing considerable added-value. Information about budget execution is produced monthly, quarterly and annually, but the reports are not used as inputs to the budget preparation process, as one of the main incentives for producing the reports is to comply with relevant international standards and good practices. The same situation applies to audit reports, which are produced but not used, and accordingly no decisions within the budgeting process take audit findings into account.

The Treasury is also responsible for the maintenance of financial software. The FreeBalance accounting system, which was installed in the MFE with USAID assistance, is currently operational.

2.3 *Municipal budgets*

The global budget for municipalities in the 2007 budget is made up as follows:

- €136 million as a general grant covering administration, delegated education and health care, and firefighting responsibilities;
- €28 million in own source revenue from fees, charges and property taxes.

The budget preparation and implementation procedures set out in the Law on Public Financial Management and Accountability are fully applicable to municipalities. Municipalities are therefore required to establish procedures that mirror the steps of central government budget procedures. However, there is a separate budget circular for municipalities, according to which it is envisaged that the Grants Commission will determine and approve the amount of intergovernmental transfers as well as the initial budget for each of the municipalities according to complex criteria, based on population, ethnicity, school enrolment, etc.

Funding for primary education and health care is routed through the MFE to municipalities and does not pass through the relevant ministries, whereas some capital expenditures (such as renovation/reconstruction of selected schools or health institutions) are reflected in the budgets of the respective ministries. Education and health grants are provided as block grants, without any specific conditionalities. However, municipalities are not allowed to use these funds for any other purpose, and improvements have also been made (through the establishment of relevant control and monitoring mechanisms at both central and municipal levels) to ensure that the funds will be used accordingly.

Developments have occurred in the installation process of the FreeBalance accounting system in municipalities, and by now all municipalities should have the system in place. Initially it had been expected that the system would be installed in all municipalities by the end of 2003.

One of the recent developments is the goal to transfer the bank accounts of all municipalities to the Central Banking Authority of Kosovo (CBAK) with a view to ensuring effective cash management and increasing interest revenue. According to the Administrative Instruction no. 2007/4 of March 2007, all municipal revenue as from 1 May 2007 is to be collected only in the bank accounts held with CBAK. Municipalities are also obliged to close their accounts in commercial banks as from 1 May 2007 and without prior authorisation from the Director of the Treasury no municipality may open a bank account.

3. Reform Agenda and Capacities

With respect to reform capacities, no significant changes have taken place since the previous assessment, and no steps have been taken to agree on a coherent reform agenda. There have been plans to amend the Law on Public Financial Management and Accountability, but no amendments have been agreed on. However, the two organisations (MFE and UNMIK) responsible for public expenditure management have been working towards full “Kosovarisation” of the process and organisations.

One of the public administration reform priorities is the development of a unitary accounting system in line with international accounting standards, so as to ensure the accurate recording of income and expenditure and to train personnel in using the system.

4. Assessment

The legal framework established in Kosovo for public expenditure management is quite sound as a result of the efforts of foreign experts, but the problems lie in implementation, mainly due to the lack of relevant administrative capacity and of an understanding of the rule of law. Furthermore, it could still be said that in many areas the laws are ahead of the current real state of development, and therefore in many aspects

the legislative framework is not understandable to the officials implementing the acts or to the public in general. This is a situation that could be foreseen to last for the coming years as well.

Another feature characterising the legal framework for public expenditure management in Kosovo is the fact that some legal acts are relatively strict and detailed. However, on the one hand – in part for the reasons mentioned above – these acts are not followed in practice, and on the other, some functions are performed without any legal base. One reason for the low adherence to the rule of law could be that in some areas the legal acts and instructions are less detailed and written in a more normative and less prescriptive way, and this may not be sufficient for staff who are accustomed to a strong, centralised system based on a firm, prescriptive legal base.

In addition, looking at other pieces of legislation, it is obvious that the international community has not sufficiently co-ordinated its efforts to ensure a coherent style throughout the Kosovar legal framework so as to make it comprehensive, consistent and transparent. Despite all previous problems, the legal tradition in Kosovo was based on continental European law; there is now a certain mixture of continental and common law institutions (commissions/agencies, etc.). This has – for certain institutions – resulted in a lack of real accountability and of real enforcement mechanisms due to incompatibility between the different systems. This situation could lead to the subjective interpretation of legislation, while leaving other necessary parts of the legal framework unregulated.

In overall terms, the capability of both preparing budget proposals and analysing these proposals is weak. Furthermore, proper impact analysis on new pieces of legislation or on amendments to legislation is lacking. This situation creates a risk that once the legal act has been adopted, additional needs for financing will emerge, which have not been planned for in the budget or in the legal act; although such additional actions may be approved, they will not be implemented due to the lack of financial resources.

In the event that the status of Kosovo changes, additional budgetary pressures will emerge. The financial impact assessment of transition responsibilities has started. However, to keep the fiscal position of Kosovo solid and the budget deficit under control, it can be foreseen that substantial budgetary as well as staff restructuring will have to be undertaken.

In general the IT systems supporting various functions are well developed. However, due to the lack of administrative capability, all of the possible merits of these systems are not used, since the capability to analyse data on both the budget preparation phase and the execution phase is lacking.

The Medium-Term Expenditure Framework (MTEF) and the Public Investment Programme initiatives are contributing to more transparent fiscal management. However, during the past year some drawbacks have been faced in this regard, as an updated MTEF has not been prepared.

Following the establishment of the UNMIK administration in late 1999, public expenditure management in Kosovo was handled almost entirely by international experts. As noted above, the main influence to date has been from US sources rather than from European practice. In addition, the MFE is still heavily reliant on assistance from international organisations, although this assistance is being withdrawn.

Currently, there are also weaknesses in implementing the legal acts in force, including the provision of the budget coverage required by the Law on Public Financial Management and Accountability.

Strategic planning is in its very early stages, limiting the further development of the MTEF. There are also shortcomings in staff skills to analyse budget proposals during budget preparation. Furthermore, the information provided by audit reports and budget execution reports is not being used as input into budgetary decision-making.

5. Recommendations

- Before taking further steps along the lines of activity-based budgeting, staff skills to implement current legislative requirements should be improved.
- Furthermore, steps should be taken to enhance budget coverage, especially in relation to donor funds. The two units responsible for donor co-ordination should be adequately staffed and their remits should be properly defined to ensure that donor funds are effectively brought together into the budget preparation process for the Kosovar consolidated budget.
- In order for the Medium-Term Expenditure Framework to fully work, the general principles for strategic planning should be worked out and regulated to ensure relevant competencies and development of capacities.
- Responsibilities within budget preparation processes should be simplified and processes streamlined. The responsibility lines between the central budget department and the municipal budget department should be clearly established.
- The budgeting process should start to use various reports as input information in relation to budget execution information from the previous year.
- Further support to the Ministry of Finance and Economy and to ministries and municipalities will be required, especially in the area of strategic planning and its linkages to budget preparation but also in capacity-building for budget analysis, as the level of international assistance decreases. Strategic planning is important for internal needs but also crucial for enabling the use of EU assistance. Increasing analytical capacity is, among other factors, critical in safeguarding the resources invested in IT systems, as the administration must be able to use the information acquired through these systems for the investments to be worthwhile.

6. External Assistance

As indicated above, USAID has provided considerable assistance since late 1999 to the Central Fiscal Authority and to the Ministry of Finance and Economy (Budget Department, Treasury Department, Tax Administration and Macroeconomic Department). This assistance is gradually being withdrawn, and functions are being handed over to Kosovars.

The EAR funded a project to assist the MFE in developing budget preparation. The project, which started in January 2005 and ended in January 2007, focused on capacity-building, mainly in relation to public investment planning. The EAR is also funding the second phase of the project, which will last for two years. The purpose of this second phase is to ensure that the Public Investment Programme process, including its performance budgeting component, will be engrained in the annual budget process in a sustainable way.

The World Bank has also provided assistance in the public expenditure management area. A World Bank project aimed at increasing the administrative capacity for budgeting is currently being implemented. The project focuses mainly on the MFE and four key budget organisations: Labour and Social Welfare, Health, Kosovo Trust Agency, and Transport and Telecommunications.