



**SIGMA**

**Support for Improvement in Governance and Management**

A joint initiative of the OECD and the European Union, principally financed by the EU

## **MONTENEGRO**

### **PUBLIC EXPENDITURE MANAGEMENT SYSTEM**

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## **Introduction**

The main macroeconomic objectives of Montenegro include an absolute and a relative decrease of the budget deficit as well as a reduction of the level of expenditures in relation to GDP, an increase in employment in the private sector, and a decrease in the number of employees working in the public sector. In the last few years these objectives have remained unchanged.

For the year 2007 the level of consolidated public spending was planned to be 858.8 million EUR, which amounts to 42.9% of GDP. In previous years the level of public expenditure in relation to GDP was higher (in 2004 and 2005 slightly above 45% and in 2006 approximately 43.4%), but it still remains relatively high, especially in comparison to other countries in the region. Therefore, further efforts should be made to achieve the macroeconomic objectives that have been set and to focus in particular on relieving budgetary pressures on the expenditure side.

The year 2006 was the first year when budget surplus was achieved (although the budget was prepared in deficit by 1.7%). The budget for the year 2007 was already approved in surplus by 0.6% of GDP. In comparison with the previous year, the volume of the 2007 budget has increased by 16%, mainly due to the takeover of tasks from the former State Union and to the implementation of laws governing salaries and other earnings of state officials, employees and civil servants.

Public revenues for 2007 are expected to be 909.1 million EUR (8.97% of GDP), which represents an increase of 10.44% compared to the 2006 projections. The expected increase in revenues is a result of positive trends in the VAT collection, international trade and transactions tax, charges, fees and other revenues. The income from taxes shows significantly faster growth dynamics than income from contributions, fees, charges and other revenues.

In 2007 the funds for salaries of the approximately 29.5 thousand employees increased by more than 17% in comparison to the 2006 budget execution, which left the initial goal – to implement the salary laws in a budget-neutral way – unachieved. The funds for salaries planned for 2007 amounts to 179.79 million EUR, or 30.84% of total current budget expenditure, of which the largest part is allocated for financing the salaries of employees in institutions of elementary and secondary education (11.4 thousand employees).

The public expenditure composition is characterised by a low share of investments, which represent approximately 5.1% of GDP (this figure also includes capital expenditures of extra-budgetary funds and local municipalities). In comparison to previous years, the share of investments in the budget has grown (3.5% of GDP in 2006), but it is mainly derived from a budget methodological factor, as the project loans system was for the first time disclosed in the budget. Furthermore, during the year 2006 the limited resources for investments were not entirely used – slightly less than 7% of the funds remained unspent for investment purposes.

### **1. Legal Framework**

The (Organic) Budget Law, which dates from 2001, and the Treasury Regulations, which are issued in accordance with the Budget Law, together govern public expenditure management in Montenegro. Intergovernmental fiscal relations are mainly regulated by the Law on Local Government Finance. No change in the legislative framework has taken place recently.

The Budget Law is relatively general (giving considerable authority to the Ministry of Finance and leaving a great deal of room for interpretation). The law is to a very large extent based on an IMF model organic budget law dating from the mid-1990s. In general, the law as it currently stands is not compatible with the

circumstances in Montenegro, as initially it was not developed to meet the specific needs of the country and it also does not reflect recent developments – including the fact that there is still no legal basis for strategic planning, the Medium-Term Expenditure Framework (MTEF) or programme budgeting.

## **2. Institutional Framework**

The Ministry of Finance (MoF) is divided into six main functional areas, each of which is headed by a deputy minister – treasury; budget; tax and customs; economy, finance, international co-operation, lotteries and gambling; internal audit; and corporate services.

In 2006 – for the first time – a comprehensive activity plan of the MoF was composed (including activities foreseen to be carried out by foreign experts), which was a positive step forward, taking into account the lack of skills and competencies to plan and implement developments in the area and the dependence on foreign experts (although relatively smaller than in other countries in the region). However, the monitoring of the plan was mainly carried out by foreign experts, and no implementation report was produced by the end of the year. It should be underlined here that there is little point in conducting a thorough planning exercise when monitoring and ex post evaluation are not done properly. Therefore, steps should be taken to ensure that the preparation of the plan does not remain a one-time event (for the year 2007 no such plan was on paper yet by the end of March) and that consideration will be given to all steps of the planning cycle. It would be worthwhile to ensure that the plan is still alive during the monitoring phase as well as the assessment phase, which would feed into the preparation process of the next year's plans. We have not been able to analyse how line ministries develop their capacities in the budget process.

One of the recent developments has been the creation of a donor co-ordination function in the Ministry of European Integration, whose responsibilities include acting as a co-ordinating body for the foreign funds flowing into the state and for the relevant activities carried out using these funds. Even though this is a very positive step forward, it should be noted that in a longer perspective (especially if the scale of foreign funds increases) this function cannot be exercised efficiently outside the MoF and without a strong linkage to the budgeting process. It is not possible to expect rational decisions to be made as to where funds should be allocated if the decision-maker does not know where the needs are or what activities are to be financed using national funds. Such an arrangement also runs the risk of facilitating double-financing and misuse of funds.

### **2.1 Budget preparation**

The budget preparation process is relatively short and very much focused on the next budget year only. The budget preparation process in the government starts in July with the preparation of macroeconomic and fiscal forecasts and ends in November, when the proposal of the Law on the Government Budget is submitted to parliament. The time allotted for parliamentary discussions is therefore quite limited, although the budget goes through a two-stage process, with the Budget Commission scrutinising it prior to the plenary debate. The budget documentation focuses on the budget year only, without providing either comparative data in relation to previous years or current policy impacts on the next year's budget.

The administrative capacity to carry out budget analysis (including the analysis of the financial situation and impacts on the budget of local governments, state enterprises, and extra-budgetary funds) is still rudimentary, however. Considerable efforts are made to gather information, and relevant IT systems are in general quite advanced, but the capacity within the budget preparation process to analyse information is almost non-existent. Furthermore, there is very little knowledge about what the MoF needs to monitor and

what kind of information is required in order to perform these monitoring controls – a situation resulting in a waste of resources at the level of both the MoF and line ministries.

Concerning budget coverage, there are currently three main extra-budgetary funds: Pensions, Health and Employment. The goal is to bring all of the extra-budgetary funds into the budget by 1 January 2008, but there most probably will be obstacles slowing down the process, as none of the necessary impact and risk analyses has been initiated and none of the relevant actions has been taken that would enable this change to be carried out in a smooth and efficient manner.

Recently the budget classification used by extra-budgetary funds was amended to enhance compliance with the overall budget classification of the governmental sector. In addition, changes have been made in relation to the overall budget classification – as from 1 January 2006 a functional classification of expenditures in line with GFS 2001 has been adopted (although, in practice, the methodology of classification of the budget is not entirely in line with GFS and ESA standards).

Another recent development in the area has been the development of a Revenue and Expenditure Entry System (a less expensive application of SAP) to support the budget preparation process. The system also has a connection to the Treasury system, but the link from the Treasury on the actual budget execution figures back to the Revenue and Expenditure Entry System is not yet working. The creation of this link would enable a more solid base for carrying out budget execution analysis for budget preparation purposes. However, the value-added (from establishing the link between the systems) will not be achieved unless the capability to use and analyse the information received is enhanced substantially.

In relation to budget coverage and with respect to foreign funding, it should be noted that, according to the (Organic) Budget Law, external grants are part of the annual budget, although it is estimated that in practice a very small share of these funds end up in the annual budget. This is not just an issue related to budget transparency, but more importantly an issue of whether or not donor funds will be rationally allocated and spent and whether relevant national co-financing will guarantee that financial limitations within the budget framework are taken into account. The related risks are enhanced due to the fact that the co-ordination function for foreign funds does not lie within the MoF and is not connected to the budget process (as pointed out above).

With respect to recent developments, in 2006 the government approved a capital budget concept according to which funds for investment projects are to be allocated from a central fund. Although the approval of the concept is an essential step forward, it might not be the most rational way ahead (especially in the context of MTEF and the shift in the focus of the budget to a more results-oriented approach), as the investment needs should, on the one hand, be derived from the strategic planning exercise and, on the other, take into account related operational expenditure within the overall budget framework. As the budget is only annual, it is difficult to assess the cost of an investment life cycle.

However, the final decisions on the concept also included creating the capital budget unit within the MoF, which is a very positive development, especially taking into account the fact that the initial concept foresaw taking away from the MoF the analysis and approval of capital expenditure projects, which would have created a risk of weaker linkages with strategic planning and with the overall budgetary decision-making process as well as duplication of functions and in the end a less efficient allocation of resources. In overall terms, challenges in two major directions need to be faced. First of all, the share of capital expenditure in the budget should be enhanced (the budget composition needs to be restructured in order to create fiscal space for investment financing, the main source of additional space being the reduction in the number of employees). Second, the prioritisation of funds needs to be made, with the aim of taking into account the needs and development of specific fields of activities in a medium-term perspective (a

functioning strategic planning system would be a prerequisite in this regard) as well as the current expenditure deriving from investments.

However, currently no medium-term budget instrument is operational, although – according to the (Organic) Budget Law – ministries are supposed to submit their expenditure estimates for the next three years. In practice this requirement has not been entirely fulfilled by line ministries. Furthermore, a systematic strategic planning system does not exist, and various strategic documents (for both overall strategies and sectoral or line ministry strategies) do not form a systematic base for budgetary allocation. There are also still very few sectoral plans being prepared. In view of this situation, it is hardly possible to rationally plan a budget in the medium term as there is no overall strategic planning system in place that is linked to budgetary decision-making processes. Furthermore, the activities related to strategic planning are currently very much focused on the planning function, and strategic planning activities are not implemented as an entire cycle, leaving aside monitoring and evaluation (which should feed into the relevant plans being prepared for the next period) of the plans put on paper.

There have also not been any significant results in the area of related programme budgeting activities – a few ministries are officially implementing programme budgeting, but it is not contributing to and linked with the allocation of resources within the budget preparation process. The main recent development has been the establishment of a relevant steering group and a working group, which are actively working. However, in the context of MTEF and programme budgeting, it should be noted that it is not possible to plan a budget for a longer period than that of the planned activities using those funds.

## **2.2 Budget execution**

The Treasury was established in 2002, following the introduction of the Budget Law. Its role includes cash and debt management and the recording and approval of guarantees; it also maintains the Treasury General Ledger Account. Budget execution is carried out through a Treasury system developed under the auspices of the European Agency for Reconstruction (EAR) and based on the SAP R/3 system. Currently, nearly all 75 spending-units are connected to the system.

Although the Treasury's single account has been in operation for some time, bank accounts still exist outside the system, notably for municipalities, creating limitations to cash management. Cash-flow forecasting is still fairly simplistic. Cash-flow plans of budget-users are prepared for the entire year on a monthly basis, and monthly ceilings are set. The ceilings during the budget year are subject to change, but such changes require the permission of the Treasury. In the case of a liquidity crisis, the Treasury could also reject a request, thereby potentially creating constraints for the implementation of activities financed from the budget.

There are also basically no legal restrictions to commitments taken and no related monitoring activity, thus creating a fiscal risk that the government cannot control. Government debt, according to the Budget Law, may be in the form of loan arrangements, short-term borrowing and securities. The terms, conditions and limits on total government debt are established by the annual Law on the Government Budget. In relation to debt management, risks also arise concerning state enterprises, as no real limitations to borrowing exist.

The Treasury is totally responsible for the performance of ex ante control of all payment orders. It performs a formal check that the corresponding underlying controls have been made by line ministries, e.g. to procurement regulations. This formal check demands considerable human resources without providing much value-added. When the internal audit function becomes operational in line ministries to assess the current internal control system, it would be rational to loosen the controls that the Treasury is performing today. The Treasury should then align the development of the strategic planning and programme budgeting

function with the objective of focusing on efforts, together with the other functional areas of the MoF, to monitor the achievement of goals set. The external audit will also provide added-value by assessing the extent to which goals have been achieved.

During the budget year, the Treasury is also allowed – with the approval of the Cabinet – to reallocate budget appropriations by up to 5% of the amount approved by the Law on the Government Budget. Subject to approval by the MoF, spending-units have the possibility of changing the use of funds amounting to up to 5% of their total allocations. They are not permitted to carry any unused funds over to the next budget year, which encourages inefficient spending towards the end of the year.

In overall terms, expenditure planning is quite accurate and revenue forecasting conservative rather than optimistic. However, with respect to expenditure planning, accuracy is achieved to some extent through strict monthly cash control rather than through a sound and (performance-oriented) budget preparation methodology.

The annual financial reports are audited by the Supreme Audit Institution. The Law on the Execution of the Budget is currently being prepared and presented to parliament, but it is still in its early stages, as the capacity to analyse budget execution is weak. Furthermore, in general, various reports (including the Law on the Execution of the Budget and audit reports) are not systematically used as an input to budgetary decision-making. However, an important step forward towards performing this analysis has been taken, and the annual Law on the Government Budget is no longer presented together with the Law on the Execution of the Budget.

### **3. Reform Agenda and Capacities**

The economic policy and objectives set under the economic reform agenda were aimed to serve as the starting point for preparation of the 2007 budget. Although significant reforms have been carried out and further developments are foreseen in various areas related to public expenditure management, there is still no comprehensive reform strategy for expenditure management. Therefore, in many respects the sequencing of various development activities is not sufficiently rational to enable fruitful reform results. In overall terms, it has to be concluded that it is crucial to create systems and procedures for the further logical integration of the various functions of public finance.

### **4. Assessment**

The management of the MoF has embraced reform but, as this commitment has not been made within a Montenegrin strategic development context, medium-term sustainability could be undermined. The MoF is continuing to put in place necessary changes, but development activities are mostly donor-driven and not always logically integrated into Montenegrin realities.

In general there is a lack of transparency, mainly concerning the scope and coverage of the budget as well as the budgeting process. The cash management function is also lacking. Some functions performed within public expenditure management are ahead of the relevant legislation while, at the same time, a number of reforms are taking place without proper co-ordination. With regard to administrative capacity, one of the main weaknesses is the limited analytical capacity, in relation to both budget preparation and budget execution. The latter also results from the fact that, with the implementation of various developments in public expenditure management, the related institutional and organisational changes (including the reorganisation of personnel) have not kept pace with the demand. As a result, a substantial number of staff

have tasks that do not contribute to the essential functions of public expenditure management and at the same time not enough staff are available to contribute to the implementation of reforms.

Another example of the donor-driven reform activities for which there is low local foundation is the relatively new performance-oriented budgeting that has been introduced. The linked implementation of the budget requires different skills and competences compared to the previous crude input-based budget system. The MoF has also relied heavily on external consultants for much of its expertise, but as much of this aid is now being withdrawn, the pace of reform, as well as its sustainability, could be adversely affected in the medium term unless strong initiatives and co-ordination are provided on the local side to increase the capacity.

## **5. Recommendations**

In overall terms, stronger ownership should be taken by the local administration, and attempts should be made to co-ordinate the various reforms in a meaningful manner within the entire public expenditure management context. It would be worthwhile to develop a comprehensive budget reform agenda (which would cover the entire public expenditure management cycle), while firstly and most urgently focusing on strengthening strategic planning so as to enable further developments in the areas of programme budgeting and medium-term budgeting. Adequate skills and competences that are necessary for staff should be identified and further developed, in particular with regard to monitoring budget implementation compared to budget plans.

## **6. External Assistance**

The major donor in the area has been USAID, but its assistance is decreasing; financing is currently assured until July 2008. USAID has been giving assistance mainly in the areas of taxation and public expenditure, debt management, municipal finance, programme budgeting and MTEF.

The European Agency for Reconstruction (EAR) has focused its assistance on areas where it considered that an impact could be achieved and where local teams would be present and receptive. The main focus of EAR has been on the budget sector, but it has also financed components in the development of the Treasury. Currently a project on implementation of reforms in budgeting and salary systems is being carried out and will last 18 months in total, until 31 May 2008.

The US Treasury has been providing assistance in capital budgeting, programme budgeting and cash management, but this aid will terminate in July 2007.