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SERBIA

PUBLIC EXPENDITURE MANAGEMENT SYSTEM

ASSESSMENT MAY 2008

For the year 2007 the level of consolidated public spending in Serbia was estimated to be 997.3 million RSD, which amounts to 40.6% of GDP. The deficit for the year 2007 is estimated to be 0.5% of GDP and the prognosis shows a deficit of 0.6% in 2008 and for the years 2009 and 2010 a surplus of 0.5% and 0.6% of GDP respectively.

The fiscal policy of the government in the medium term aims to cut public spending as a share of GDP by 2.0 percentage points and to improve the fiscal balance by 1.2% of GDP compared to the levels in 2007. In order to achieve the goals of the fiscal policy, the main measures for reducing public expenditures are foreseen to be the following (in comparison with the year 2007):

- reducing public investments by more than 10%;
- reducing subsidies by 5%;
- freezing the real level of wages.

Although the fiscal policy is aimed in a desirable direction (according to the fiscal strategy presented in the budget memorandum of November 2007), the impacts and risks related to the implementation of these measures on macroeconomic developments as well as on the administrative capacity of the public sector remain unclear. Furthermore, there is no justification or argumentation for the measures taken and no analysis of alternatives considered. It should therefore be concluded that most probably there is a need to improve the process of setting the fiscal strategy (including the capability to conduct impact analysis) and to increase the transparency of budget documentation in that respect.

1. Legal and Institutional Framework

Fiscal matters in the Republic of Serbia are regulated by the organic budget law of 2002 – the Budget System Law. The law has since been amended a few times. Recently a draft amending the law was prepared and presented to the National Assembly. The main changes proposed were related to creating preconditions for the management of EU funds, also with respect to medium-term budgeting as well as programme budgeting. However, the bulk of the amendment proposals were focused on specifying the provisions of the current law. The draft was discussed and met with general approval but was not adopted before the dissolution of the National Assembly decided in March 2008. The conditions under which parliamentary discussions will resume once a new National Assembly has been elected are unknown, as this will depend on the agenda of the future government. Since no serious political opposition was noticed in the recent debate, the risk seems to be limited to additional delays in the procedure.

The Budget System Law outlines the planning, preparation, adoption, execution, accounting, reporting and control of the central government budget, the budgets of autonomous provinces and the budgets of local self-governments as well as the preparation and adoption of the financial plans of extra-budgetary funds. The law provides an adequate and sufficiently detailed regulation of the budget process. As the development of budget preparation and budget execution progresses (see sections below), it will nevertheless be necessary to update the law.

Procedures for parliamentary approval of the government's budget proposal are regulated in the Rules of Procedure of the National Assembly of the Republic of Serbia. The 1990 Constitution does not cover fiscal matters, except for article 69, in which it is stipulated that the Republic of Serbia should have a budget showing revenue and expenditure.

1.1. Fiscal Relations and the Role of Parliament

Fiscal relations in Serbia are characterised by a strong position of the government and a relatively limited involvement of parliament in fiscal affairs. According to the Budget System Law, parliament should approve the state budget and the financial plans of the extra-budgetary funds. Since the budget also includes limits on borrowing and on the total amount of guarantees that can be issued, parliament formally has to sanction all financial liabilities that the government incurs.

A few of the most influential provisions related to the role of parliament have remained unchanged over the past few years:

- In accordance with the Budget System Law, any amendment proposed by parliament that leads to increased expenditure in relation to the government's budget must be accompanied by a corresponding decrease of expenditure elsewhere in the budget or by a proposal for increased revenue.
- In the event that parliament does not approve the budget before the start of the new fiscal year, the Budget System Law provides instructions on how a temporary budget for the first quarter should be executed. In such a case, the Ministry of Finance should repeat the budget that had been approved for the first quarter of the previous budget year.
- Significant changes in current-year expenditure require parliamentary approval through a supplementary budget. According to the Budget System Law, the government has the mandate to make reallocations between appropriations of up to five per cent of the initial figure. More substantial changes must be approved by parliament.

The fundamental division of fiscal power between the legislative and the executive could be better spelled out, preferably in the Constitution. Parliament's unambiguous obligation to authorise all revenue, expenditure and borrowing, and the issue of accountability between the executive and the legislative are matters that should be more explicitly treated in legislation.

Although parliament approves the state budget, it is not in a position to seriously challenge the government's proposal. According to the Budget System Law, the government should submit its budget proposal to parliament no later than 1 November. Parliament is required to adopt the budget by 15 December. Such **a** short time frame for parliamentary discussion is not in line with international good practice (for example, OECD Best Practices for Budget Transparency), and gives insufficient time for a proper scrutiny of the budget. Therefore, time limitations and parliament's weak capacity to scrutinise the government's budget proposal are issues that should be addressed.

In general, there is scope for strengthening parliament's role in fiscal matters – over the past few years no significant changes affecting the role of parliament have been made.

1.2. Scope and Transparency of the Budget and Quality of Budget Documentation

Budget documentation is heavily focused on the line-item division of expenditure. However, the content of the budget documentation as it is constitutes a limiting factor to the role of parliament. The budget is divided into two parts, with the first part containing main fiscal parameters; the second part of the budget is made up of appropriations for first-line spending-units – direct budget beneficiaries – and second-line spending-units – indirect budget beneficiaries. All appropriations are classified according to an organisational, functional and three-digit economic classification. Appropriations for investment purposes are included in the budget. In general the structure of the budget is very detailed, especially in terms of economic classification. This may be adequate to closely monitor expenditure, especially given the internal control systems in budget-users that are still to be improved. The inclusion of activity-related and/or performance-related information could nevertheless make the budget more accessible and could facilitate the discussions in parliament and by the public of the government's proposed policies and previous years' results, provided there is enough awareness in Parliament to address these issues with benefit.

However, some ministries also have their budget divided according to a programmatic structure. In the 2008 budget this is the case for five ministries that were the pilots in the programme budget development initiative, which started in 2006 while preparing the budget for 2007 with the support of a technical assistance project. For the budget year 2008 the annual financial statements should also include a report on outputs on the programme budgets, and during the budgetary year 2008 budget implementation within pilot ministries should also follow the programmatic structure. However, it should be pointed out that currently the programmatic structure does not work and is not understood or seen as a supporting mechanism for the management.

Another recent development is the creation of a National Investment Programme (NIP), a kind of separate envelope for the funding of investments within the budget but which does not include all of the investments financed from the budget. The scope of the NIP budget is proposed by the macroeconomics unit, while the investment projects funded from the NIP budget (based on proposals of line ministries) are decided by the NIP Office, headed by a minister without portfolio.

The initiative to bring the funding of investments more into focus is welcome, but the mechanism that has been created reduces budget transparency, creates grounds for possible double financing and cannot work as a logical basis for budgetary decision-making (mainly due to the fact that decisions on the use of funds are not being made within the budget process and that decisions on what to finance from the investment budget affect the rest of the budget and vice versa). Furthermore, there is a fundamental contradiction between the initiatives of programme budgets and the mechanism that has been created to allocate funding for investments. In view of this (and especially in the event that the use of foreign funds increases), it would be rational to harmonise the management of NIP with the budget process, and finally to completely merge this procedure into the standard budget process.

The five social security funds – covering pensions and disability insurance, health care, and unemployment – constitute separate budget entities with their own revenue sources from social security contributions. Budget preparation for the extra-budgetary funds is regulated in the Budget System Law, and largely follows the procedures for preparing the state budget (see section below). The financial plans for the funds are submitted alongside the budget for parliamentary approval. Consequently, parliament has a full presentation of all expenditure and revenue affecting the central government's net lending. The funds are nevertheless not fully self-financed, and there is a significant transfer of funds from the state budget. Given the government's subsidiary responsibility for the financial commitments of the extra-budgetary funds, **there are strong arguments to consider a consolidation of these funds into the budget.**

According to the Budget System Law, the budget should include an assessment of outstanding guarantees and other contingent liabilities and also contain a tax expenditure report, but such information has not yet been included in the budget. It should be pointed out that credible estimates of fiscal risks and tax expenditures would require a thorough review of, and decision on, evaluation principles, the development of appropriate models and the access to information currently not provided in the administration. Furthermore, while preparing the budget documentation basic principles are not followed – e.g. no comparative information is provided with respect to the previous year's budget and no information on either the estimations of the previous year's budget outturns or the justifications for main discrepancies.

Together with the annual budget two reserve funds are also being established – a permanent reserve and a current one. The Permanent Budget Reserve is used to cover expenditures incurred due to unforeseen circumstances (e.g. national disasters), while the Current Budget Reserve is used to finance any kind of legal acts approved by the government within the budget year. While the need for a reserve like the Current Budget Reserve is understandable in a rapidly changing and developing environment, it should be noted that the present system increases fiscal risks and reduces the transparency of the budget (also taking into account the fact that parliament is not provided with information on the entire plan of activities for the next financial year since the launch of new activities can be financed from the budget during the budget year without parliamentary approval). It should also be pointed out that the use of the reserve constitutes an unexpected and unplanned pressure on the next year's budget. Efforts should be made to create working procedures and improve administrative capacities (both at the level of line ministries and in the Ministry of Finance) for carrying out impact assessments of new legal acts or amendment proposals. These basic factors should be in place and operational before the more sophisticated developments of the financial management system are initiated.

Therefore, challenges remain in terms of improving the quality and transparency of budget documentation.

1.3. Budget Preparation Process

Budget preparation is to a large extent an incremental bottom-up process heavily focused on a division of expenditure into line items, with limited attention given to performance-related aspects. The process starts with a forecast of relevant macroeconomic parameters and a specification of fiscal objectives for the medium term. This initial phase culminates in a budget memorandum, containing a medium-term macroeconomic framework, main fiscal parameters for the upcoming years, and information on the government's main policy priorities. The memorandum is prepared by the Macroeconomic and Fiscal Analysis Department in the Ministry of Finance, with some input from other departments. According to the Budget System Law, the budget memorandum has to be adopted by the government by 15 May, and should constitute the basis for the continued preparation of the state budget and the financial plans of the extra-budgetary funds. An updated version of the budget memorandum should be submitted to parliament together with the budget proposal.

Once the Ministry of Finance has finalised the draft budget, it is submitted to the government for approval. By 1 November the government is required to submit the proposed budget to parliament. Parliament approves the budget, in a single voting session, by 15 December at the latest. The preparation and approval of the budget is summarised below.

Budget Preparation and Approval in Serbia

30 April	Minister of Finance proposes a budget memorandum with main macroeconomic parameters, fiscal policy and main government priorities for the upcoming three-year period.
15 May	Government adopts the budget memorandum.
1 June	Based on the budget memorandum, the Minister of Finance issues instructions for the preparation of budget proposals
1 August	Direct budget beneficiaries and extra-budgetary funds submit their budget proposals to the Ministry of Finance.
1 October	The budget memorandum is updated with the most recent macroeconomic projections.
15 October	Minister of Finance submits the draft Law on the Budget and draft decisions on financial plans of the extra-budgetary funds to the government
1 November	Government adopts the budget and submits it to parliament.
15 December	Parliament adopts the budget.

Even though the budget preparation calendar is set by the Budget System Law, in the past few years it has not been possible to fully follow the calendar. For example, in 2007 due to the late formation of the government, the Budget Law was adopted by parliament on 23 June. The budget memorandum for the year 2008 was issued on 5 July and the budget instructions followed on 16 July, as opposed to the original budget timetable of 15 May and 1 June respectively. Budget proposals were submitted by all budget beneficiaries to the Ministry of Finance by 21 September, as opposed to the budget preparation calendar date of 1 August.

However, significant improvements have been made in recent years with regard to the comprehensiveness and quality of the information provided in the budget memorandum. Nevertheless, the memorandum is still plagued by some deficiencies that prevent it from being an effective instrument for guiding the budget preparation process.

Firstly, overall fiscal parameters, such as central government revenue and expenditure and central government and general government net lending, are presented in the memorandum. It is, without a doubt, a positive step to indicate the government's ambitions in the memorandum. However, as the budget is not prepared in accordance with overall ceilings in functional or organisational terms, it is not possible to translate the fiscal parameters into useful restrictions since there is no information provided about limitations divided by budget-users. The institutional arrangements in the budget preparation process, where budget-users' expenditure proposals are not restricted by firm ceilings, may lead to a deterioration of government finances, as the Ministry of Finance is unable to restrain pressure for increased expenditure. In order to provide stability to the budget process, promote fiscal discipline and ensure sustainable public finances, consideration should be given to a reorganisation of the institutional arrangements in the preparation and approval of the state budget, with the introduction of clear top-down elements.

Secondly, doubts can be raised as to the quality of the macroeconomic projections. Aside from the limitations caused by forecasting models that are yet to be developed and a general lack of data of high quality, the reciprocal effects between fiscal policy and macroeconomic development are not fully taken into account. There are arguments for a more systematic organisation of macroeconomic forecasting rounds so as to take into account the macroeconomic effects of proposed policy.

Thirdly, although the budget memorandum contains a medium-term framework, the budget is only prepared in a one-year perspective. According to the Budget System Law, the budget proposals that budget-users submit to the Ministry of Finance should contain information on the two fiscal years beyond the upcoming year. These projections should then be consolidated into the government's budget proposal, and parliament should be presented with a full picture of the development of government finances in a three-year perspective. In practice, the budget is still prepared strictly on a one-year basis, and there is no medium-term information on individual appropriations or revenue items in the budget-users' proposals or in the government's budget bill.

The implementation of a medium-term budget framework in Serbia should be on the agenda, as information on government finances beyond the upcoming budget year is necessary to formulate an appropriate fiscal policy. **The production of medium-term projections is only meaningful, however, if the government and its administration are actually planning activities in a strategic (medium-term) time frame** and are able to produce realistic forecasts of the strategic plan's financial impacts, and if this information is used in decision-making. A considerable challenge for the Serbian administration is to enhance the capacity to make macroeconomic and fiscal forecasts, both in the Ministry of Finance and in line ministries. However, it should be emphasised that, in a rapidly changing and unstable (political) environment, it is unrealistic to expect the medium-term budgeting initiative to work in practice.

1.4. Budget Execution

The state budget, the financial plans of the extra-budgetary funds, and the budgets of local self-government units are executed by the Treasury through a treasury single-account system. Since the merger in August 2005 of the Treasury with the Public Payments Administration (PPA), budget execution has been fully managed by the Treasury. The creation of a single organisation responsible for all treasury-related functions has improved the conditions for a secure and efficient management of government funds.

The Treasury performs detailed control of all payment requests to ensure that the detailed line-item classification of the budget is complied with, that monthly cash apportionments are not exceeded, and that sufficient liquidity is available in the treasury single account to execute the payment. At the same time, the Treasury also registers all transactions in the treasury general ledger (see below for a discussion on government sector accounting). Through the centralisation of budget execution, a stringent control of transactions is possible. One of the recent developments has been the creation of a new treasury system, which has been fully and solely in use since 1 January 2008.

The management of liquidity in the Serbian administration has improved with the creation of a unified Treasury under the Ministry of Finance and the development of a treasury single account that includes all budget entities. Nonetheless, the availability of liquidity continues to be a problem, and the Treasury is forced to resort to cash-rationing on a regular basis. Since the inflow and outflow of cash to the government do not coincide on a daily, or even weekly, basis, the Treasury has to take into account its cash position before approving a payment. To some extent, this problem can be circumvented by cash planning, where payments have to be registered beforehand to allow the Treasury to assess the necessary liquidity to cover all financial obligations. The Treasury aims to address this issue through the use of a commitments ledger as part of the new treasury system, in which financial obligations become visible to the Treasury when entered. Such a ledger should facilitate the Treasury's cash planning. For the moment it is too early to assess the extent to which the administration can take advantage of the new treasury system and improve the situation regarding cash management. In the longer term, the access to financial markets where short-term liquidity positions can be managed is a precondition for efficient financial management.

Furthermore, with respect to budget execution, consideration should be given to allowing less stringent rules for carrying the funds over to the next budgetary year in order to avoid the so-called "December fever". For example, in 2007 the level of expenditures in December was approximately 79% higher than the average of the previous 11 months and almost 60% higher than in November. Up to a certain level the higher expenditure levels at the end of the year are justified (e.g. due to tendering processes), but current execution figures indicate a clear motivation for budget-users to make use of all available funds by the end of the year so that they are not lost (even if these funds are not needed to cover expenditures of the current year and are used, for example, as pre-payments of expenditures in the next budgetary year).

The major issues in the budget execution phase have remained unchanged in the past few years, with one of the main problems being cash management.

1.5. Accounting and Reporting

The Treasury is responsible for keeping a record of all transactions executed from the treasury single account. In this treasury ledger, there is a full documentation of all payments according to an organisational, functional, six-digit economic and source-of-financing classification. The budget and accounting classification, based on the IMF General Finance Statistics (GFS) 86, has not been changed in the past few years.

In addition to the treasury ledger, first-line budget-users are required to keep accounting records of their own operations and the operations of subordinate second-line budget-users. Through such accounts, it is possible for budget-users to make a more detailed division of the chart of accounts for the public sector, and, consequently, to satisfy the requirement for specific information.

The Treasury produces reports on the execution of the budget, which are presented to the government within two weeks of the end of each month. Currently, direct budget beneficiaries are required to submit annual reports to the Treasury by 31 March; an end-of-year report should be produced and presented by the Ministry of Finance to the government by 20 June. This report also includes the end-of-year accounts for the extra-budgetary funds. By 15 July, the government should submit the consolidated final accounts to parliament.

The Budget System Law also requires the government to submit an external audit report together with the final accounts. Although the executive is required to submit final accounts to parliament, such accounts are currently of limited value. In the absence of an operational supreme audit institution, there is no independent statement on the reliability and quality of the accounts provided by the government. Parliament lacks resources to evaluate the contents of the final accounts, and this is a precondition for a meaningful approval. Therefore there is also a lack of support from the external audit function to budgetary decision-making in general.

2. Assessment, Reform Agenda and Capacities

In overall terms the capacity for reform needs to be enhanced and a clear strategy for financial management system reform needs to be developed and approved, putting an emphasis (among other issues) on clarifying the roles and responsibilities of the various entities in the financial management process and on creating proper co-operation mechanisms. The strategy would include an assessment of the current state of play in this area, and would set concrete goals and targets as well as planning measures to achieve the targets set. The existence of a reform agenda is especially needed, as currently strong emphasis should be put on setting effective co-ordination mechanisms within the administration so as to avoid duplication of activities and to ensure the setting of clear responsibilities. Emphasis should also be placed on sequencing the activities for reform – the ambition and calendar of activities should be determined in proportion to the relative (political) instability in the country.

The reform process should continue, as financial management in Serbia is still some way from good European and international practice. Understaffing remains a problem in many key areas, and the relatively modest remuneration of civil servants is an obstacle to recruiting and keeping competent staff. In addition, the politicisation of the administration, notwithstanding the quality of most of the staff in place, is an additional factor affecting staff turnover whenever political power shifts.

3. External Assistance

Reform in the area of financial management is supported by technical assistance projects. A project for the development of a financial management and information system for the Treasury was financed by the European Agency for Reconstruction (EAR). The implementation of the system started as from 1 January 2008, although it was initially foreseen to begin a year earlier (namely in January 2007). Following the development of the financial management and information system, relevant capacity-building to enable the administration to use the system will be required. EAR is also financing a project aimed at developing budget preparation, with a special objective of introducing programme budgeting. To better assess the preconditions for performance-oriented budgeting in the Serbian administration, the project has focused on a limited number of pilot ministries. The objective of the project is to better link government policies to actual expenditure and to increase the efficiency of public expenditure. The project was initially foreseen to terminate in July 2008, but a request for extension until December 2008 has been made.

The World Bank has supported a wide range of issues related to the development of public expenditure management. Bilateral support in the area of financial management has included a DFID-financed project aimed at developing capacities for producing medium-term macroeconomic and fiscal projections.

The US Treasury has financed an advisor to the Ministry of Finance.