



## SIGMA

### Support for Improvement in Governance and Management

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## MONTENEGRO

### PUBLIC EXPENDITURE MANAGEMENT SYSTEM

#### ASSESSMENT MAY 2008

#### Introduction

The Government of Montenegro's main fiscal policy objectives include:

- balancing the state and local governments' budgets for 2008-2010;
- integrating extra-budgetary funds into the state budget and treasury;
- gradually reducing the fiscal burden on the economy by reducing employment related taxes;
- reducing the level of public debt;
- continuing to implement the capital and programme budgets; and
- launching implementation of the medium-term framework for budget spending.

Montenegro's fiscal situation is far better than anticipated some years ago. Public spending has increased rapidly. This is largely due to exceptionally fast revenue increases, which have made it possible to increase both current and capital expenditure. The GDP growth rate has increased since the second half of 2005, driven largely by consumption, but also by investment (the latter mainly related to enterprise credits and foreign investment). However, as is acknowledged by Montenegro's Ministry of Finance, these sources of public revenue (especially the rapid inflow of foreign capital) will not be sustainable in the medium-term.

For 2007 the level of consolidated public spending was planned to be EUR 859 million. However, after faster than expected growth in tax related revenues (mainly VAT), the Government of Montenegro initiated a supplementary budget in which total spending amounted to more than EUR 1 billion.

Both 2006 and 2007 ended with a remarkable surplus; 3.4% and 6.7% of GDP respectively.<sup>1</sup> In both cases such high surpluses were not planned. The public balance will also be positive in 2008, estimated at 0.7% of GDP. However it is envisaged that the macroeconomic forecast published in May 2008 will increase the surplus expectations for the current year.

For the 2008 budget the consolidated public revenues are foreseen to reach EUR 1 282 million and consolidated spending will total EUR 1 264 million.

The Government of Montenegro has used this favourable fiscal situation to reduce the level of public debt both in relative and absolute terms; this is now estimated to be around 30% of GDP. There is government commitment to reduce public debt further. However, this will be increasingly difficult if public revenues do not grow as fast as planned.

Budget revenues are largely dependent on VAT and this dependency will increase further in 2009 and 2010 when the personal income tax is reduced from the current level of 15% to 9% in 2010. This means that the volatility of budget revenues might be extremely high. In recent years this volatility has favoured the

<sup>1</sup> These figures might still change by the end of May 2008, as the GDP time-series are subject to further analysis.

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government; however, a shift to a more negative scenario could occur in under a year. The government has reduced the risk by increasing government deposits and reducing public debt.

The public expenditure composition is characterised by a relatively high share of costs related to salaries of public employees (around 16% of GDP or 30% of public expenditure).

Restitution claims for the compensation of property that cannot be reclaimed by the rightful owners are an additional burden on the budget. However, amended legislation now sets annual limits for the amounts that the government needs to compensate. This means that it is easier to plan the finances needed and also limits the total financial burden to the budget.

In the medium term the government plans to keep current expenditure relatively stable in absolute terms so as to reduce it to 35% of GDP. At the same time the aim is to increase capital expenditure up to 9% of GDP, which will be achieved by financing the government's capital budget as a clear horizontal priority. The share of investments has increased from 3.2% of GDP (2007) to 7.5% of GDP (2008 budget). These figures also include capital expenditures of extra-budgetary funds and local municipalities.

## **1. Legal Framework**

The (Organic) Budget Law (adopted in August 2001 and amended by parliament in November 2007) and the Treasury Regulations (issued in accordance with the budget law) together govern Montenegro's public expenditure management. The scope of the Budget Law covers the government budget and the budgets of municipalities (art 1). Intergovernmental fiscal relations are mainly regulated by the law on Financing of Local Self-Government.

The (Organic) Budget Law was amended last year (and adopted by parliament in November 2007) to better support planned developments in public expenditure management. The main changes related to:

- budget consolidation (previous extra budgetary funds are now part of the state budget and treasury single account system);
- preparations for programme budgeting, including providing more flexibility for the government to shift funds between programmes; and
- incorporating the issues related to public debt fully into the budget law (the law on Debt Contracting and Public Debt Management is no longer in effect).

The existing Treasury Regulation is rather detailed and in some parts resembles a guide rather than a strict regulation. It is also outdated and needs considerable revision by the Ministry of Finance. The legal environment in the area of budget execution will be updated primarily by preparing a new law for public internal financial control (PIFC), according to the PIFC strategy adopted by the government on 27 December 2007. As the new law will most likely be more general than the current Treasury Regulation, there will probably also need to be a review and to issue new secondary legislation for budget execution.

## **2. Institutional Framework**

The Ministry of Finance is divided into six main areas, each headed by a deputy minister: treasury; budget; tax and customs; economy, finance, international co-operation, lotteries and gambling; internal audit; and corporate services. The most relevant areas for public expenditure management are budget, treasury and internal audit.

The total number of staff in these three most relevant areas is approximately 66 (as at the beginning of May 2008). Sixteen of them work in the budget sector, 42 in the Treasury and 8 in internal audit. This staffing is quite modest compared to most European countries. However, vacancies in these sectors form more than 10% of the positions foreseen in the systematisation. The ministry has had difficulty attracting young professionals, as entry salaries are relatively low. Therefore the ministry has started to recruit young trainees and is training them primarily on the job (eight young trainees have already been recruited in the Treasury). An increase in salaries will be vital for keeping the more qualified staff in the ministries. However, it is not clear that using performance-related pay is a good solution, given the generally negative international experiences with that instrument. One development has been the creation of a donor co-ordination function in the Secretariat for European Integration, whose responsibilities include co-ordinating foreign funds

(primarily the Instrument for Pre-Accession, IPA). This is an area where co-operation with the Secretariat for European Integration the Ministry of Finance can improve planning for national co-financing for EU funds.

The Government of Montenegro has also declared its commitment to take more ownership from the European Commission when implementing IPA-funded programmes. In this respect, the Ministry of Finance has initiated preparations for the decentralised management of EU-funded programmes. The decentralised implementation system (DIS) for IPA is closely related to the institutional developments of public expenditure management. This has particular relevance for the Treasury. At the beginning of 2008 the responsibilities among government bodies were decided and the key responsibilities of the Ministry of Finance were also designated. More active development of the IPA administrative system will begin in September 2008.

Our analysis does not intend to describe existing capacities in line ministries and other major budget users; however, the expert consulted for preparing the roadmap for the decentralised implementation of IPA funds highlighted that there is an urgent need to strengthen the co-ordination and analytical capacities of the various ministries before budget preparation and execution can be further decentralised.

## **2.1 Budget Preparation**

The budget preparation process had been relatively short and largely focused only on the next budget year. With the changes to the (Organic) Budget Law, the budget preparation process will start earlier with macroeconomic estimates and proposal for next years sector ceilings discussed in the government as early as May. In June the Ministry of Finance sends a precise circular to budget users explaining the criteria and procedures for the budget preparation process. The budget proposals are sent to the Ministry of Finance by 1 September (instead of 15 September as in previous years). The proposal of the Law on the Government Budget is still submitted to parliament by the end of November, but the government aims to send it in mid-November (this was achieved in 2007 with the 2008 budget proposal). However, compared to other countries the time allowed for parliamentary discussions is still limited, although the budget goes through a two-stage process, with the Budget Commission scrutinising it prior to the plenary debate.

So far no medium-term budget instrument has been used. Since 2007 the Ministry of Finance has produced fairly good quality macroeconomic analysis, which forms a good basis for medium-term macroeconomic and budgetary estimations. In 2008 the plan is to move forward with a mid-term budgetary framework (MTBF) by deciding indicative financial ceilings for all budget users for the following years (2009-2011). The Ministry of Finance intends to allocate the small part of the budget that is flexible (*i.e.* not governed by laws, contracts or other liabilities) based on the government's policy priorities. This will allow basic strategic planning to be incorporated into the budget process. To make even better use of the different sector strategies, they will need to include fiscal impact estimates and direct expenditure plans.

The Ministry of Finance has made considerable progress in consolidating public finances. In the 2008 budget, for the first time all (previously) extra-budgetary funds became part of the state budget. The Ministry of Finance is also planning to consolidate the budget structure and all the spending units have already been grouped under the line ministries. However, it would be premature to delegate the co-ordination of budget preparation to the line ministries during the preparations for the 2009 budget as there is no readiness to analyse and negotiate the proposals of indirect budget users. In most cases there is also no relevant staff in place. Ministry of Finance aims to develop capacity in the ministries gradually and in the first year(s) the discussions over budget proposals will most likely be held in groups (involving the line ministry and the budget users under the domain of the ministry).

The ministry is also continuing with programme budgeting, intentionally taking it forward gradually. In the 2007 and 2008 budgets a small number of budget users had defined functional programmes within the scope of their budgets. For the first time, in the 2009 budget the entire state budget will be described by programmes. However, the changes will not be substantially different, as for many budget users there will be only one programme (*i.e.* all the budget user's activities will be defined as a programme). In some cases there may be two programmes: one for core activities and the second for administrative activities. Nevertheless, this is a step towards programme budgeting and the Ministry of Finance plans to use this to help start developing programmes. As for performance budgeting, it was decided not to set any clear deadlines. For the 2010 budget the ministries will most likely start to describe the most relevant indicators (attached to the programmes), but before budgeting can be really linked with policy objectives some basic capacity for fiscal, economic, social and environmental impact analysis is needed in all line ministries.

In general the 2008 Budget Law is fairly clear and transparent. The need to modify the annual budgets through supplementary budgets is understandable, as the revenue in a small and open economy is very volatile and will remain so in the future.

## 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. Budgets are executed through a Treasury system based on the SAP R/3 system. Currently, nearly all spending units are connected to this system. There are no immediate plans to include the municipalities in the Treasury system, although this has been on the agenda. The municipalities are independent in their budget process; however, the central government has relatively strong authority to control the borrowing by municipalities.

A key recent development has been to merge the extra-budgetary funds into the Treasury system. The process has been slower than anticipated, but nevertheless progress has been made. Two of the five funds (employment and restitution funds) are already part of the Treasury system single account system. Both the pension fund and development fund are to be included in the system during May and June 2008. As the health fund uses accrual-based accounting it has been more technically complicated to integrate it into the Treasury accounting system.

The Treasury is responsible for the *ex ante* control of all payment orders. It checks that the corresponding underlying controls have been made by line ministries. This formal check demands considerable human resources, yet the value-added of this process for regular expenditure is not evident and the Ministry of Finance's internal audit still detects a considerable number of errors. This *ex ante* endorsement procedure will also be applied to the extra budgetary funds once these are included in the Treasury (pension fund, health fund, etc.). Further resources will certainly be needed for this task.

Cash-flow forecasting is fairly simple and so far it has proven to be relatively reliable. Budget-users' cash-flow plans 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 agreement of the Treasury.

As the fiscal situation in Montenegro has been extremely comfortable for the government, the issue of controlling commitments has not been a top priority. So far cash-flow planning has been enough to control the commitments of budget users. This may not be the case when the annual budgets stop increasing every year.

The terms, conditions and limits on total government debt are established by the annual Law on the Government Budget. The capacity in the Treasury for debt management has been a source of concern for many experts due to the lack of written rules and the very small number of staff dealing with the matter.

During the budget year, the Treasury is also allowed — with the approval of the Cabinet — to reallocate budget appropriations by up to 10% of the amount approved by the Law on the Government Budget (this figure was 5% before the amendment of the Budget Law). Subject to approval by the Ministry of Finance, spending units can also reallocate the funds by up to 10% (it was 5% in previous years). However, they are not permitted to carry any unused funds over to the next budget year, and this encourages inefficient spending towards the end of the year. But more importantly this is a matter to consider in the case of investments (perhaps Capital Budget) and even more so for the national co-financing of IPA programmes, where there are tendencies for considerable delays in implementation.

Although mentioned also in the National Programme for EU Integration, moving towards accrual accounting is not an immediate priority for the Ministry of Finance.

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. A large part of the expenditure is related to routine transactions, therefore financial planning has not been very demanding.

The regulatory environment for budget execution needs considerable updating and revision. Since the Budget Law was amended, updating the Treasury Regulation has also been on the Ministry of Finance's agenda. However, the work has been postponed to the second half of 2008 when the new law on PIFC will have been prepared by the Ministry of Finance. This new law will also provide the necessary framework for

budget execution. In addition to revising the legal framework for Treasury and internal audit, more detailed daily procedures for cash and asset management need to be developed.

From 2008 the financial accounts will be presented to the government in May. This means that parliament will address the financial conclusions of the previous year before dealing with the budget for the following year. Presenting the financial accounts to parliament is the only formalised and overall obligation of the government when reporting to parliament. Detailed monthly analyses are nevertheless carried out within the Ministry of Finance.

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

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. However, the following topics are on the agenda:

- consolidating public finance, introducing the necessary changes to complete the integration of the previous extra-budgetary funds into the Treasury system;
- making significant reductions to the tax burden on employment (personal income tax will be reduced from 15% to 9% and there are less extensive reductions also foreseen for social taxes);
- limiting current expenditure in order to reduce the “fixed” part of the budget;
- increasing expenditures for the capital budget;
- introducing the first steps for a medium-term budgetary framework;
- giving a stronger co-ordinating role to the line ministries (consolidating the budget structure), and decentralising functions from the ministry of finance;
- developing the basic structure for programme budgeting (performance budgeting will be introduced in the medium-term future); and
- introducing a law on public internal financial control and revising staff guidelines on budget execution.

The Organic Budget Law addresses good governance procedures and the implementation of accountability approaches, as does the PIFC policy paper approved by the government on 20 December 2007. Managing the change to managerial responsibility outlined in the PIFC policy paper will require time and technical capacity, long-term political commitment and effective arrangements. Special attention should be given to change management in particular, and the need to change working methods in order to achieve the objectives spelled out in both the organic budget law and the PIFC policy paper. Administrative decentralisation does not mean losing control, but it does require different structures and guidelines for devolving authority and responsibility. Furthermore it requires follow-up procedures for budget execution, including follow-up reporting. The lack of a coherent reform strategy for expenditure management raises the risk that the areas of budget preparation and execution will be developed without sufficient phasing of activities, or the necessary co-ordination between them.

### **4. Assessment**

The management of the Ministry of Finance has started to implement a number of different reforms but, as this commitment has not been made within a Montenegrin strategic development context, medium-term sustainability has for years been less than external counterparts had expected. One reason for slower implementation and occasional resistance to reform might be the intensive donor activity in the country. The presence of so many initiatives at the same time has exceeded the absorption capacity of the Montenegrin ministries (in addition, most short-term projects seek to achieve very ambitious medium-term objectives).

There is no formalised process for budget reforms, including linkages to budget execution, *e.g.* no strong and relevant components for financial management and control and internal audit. So far developments in budget reform and public internal financial control (PIFC) have been generally independent of each other.

The government has established a sound legislative starting point for the further development of new budgeting initiatives (*e.g.* mid-term budgetary framework, programme budgeting) and of the PIFC system.

The legislation in place creates a structure for managerial accountability and provides basic rules for authorising, executing, accounting and controlling financial transactions.

Recently, at least in the area of budgeting, the reform agenda seems to be more comprehensive, even with a more comprehensive reform programme, and the agenda seems to be reasonably prioritised. In addition, the management of the Ministry of Finance is well committed to their medium-term plans. Capacity to carry out budget analysis has been significantly strengthened during the last two years. This includes capacity for macroeconomic forecasting, and analysing the financial situation and impacts on the budget of local governments, state enterprises and extra-budgetary funds. Capacity-building has been less about increasing the number of staff and more about developing staff working methodologies and skills in the Ministry of Finance. The capacity-building has been mainly focused on the Ministry of Finance and less on line ministries. In the Ministry of Finance, skills have been built “on the job”, thanks to frequent interaction with external experts (*e.g.* while preparing the macroeconomic forecasts).

There is still a need to harmonise the relevant plans for developing financial management and control and internal audit in the area of budget execution. This harmonisation should in principle take place within the context of preparing the law on PIFC (the first draft has already been developed).

There is no real need for extensive financial support from the EU to budget and Treasury activities. There is enough existing support to continue current initiatives. However, there are a few more recent initiatives that might require stronger support from the EU, especially for the preparation of methodologies, procedures and capacities for fiscal impact assessment. Wider regulatory and strategic impact assessments (such as economic, social, environmental impacts) will also need support further down the line. These are essential areas to be developed for well-functioning performance budgeting (along with others, such as strengthening the national statistical office, Monstat).

## **5. Recommendations**

- Continue existing government plans to increase the long-term sustainability of public finances, whilst also taking further steps to reform the system of public sector salaries and preparing a detailed reform plan for optimising skills and the number of public employees, not only in the Ministry of Finance but also in line ministries.
- Continue with the current step-by-step approach to developing the public expenditure management system. For better communication and co-ordination it would be worthwhile preparing a good overview (ideally in the form of a work plan) for co-ordinating the different activities of budget and Treasury.
- Take steps to prepare the necessary methodologies and capacity for fiscal impact assessments in the Ministry of Finance, line ministries and other major budget users. In the medium-term developments in the areas of regulatory and strategic impact assessment also need to be planned for. Co-operate with Monstat to develop regular statistics to support the needs of ministries and also various sector policies. These will be preconditions for future developments in performance budgeting.
- Revise the Treasury Regulations according to the unofficial plan — *i.e.* by the end of 2008. However these revisions should be done within the framework of the law on PIFC (scheduled to also be finished in the second half of 2008). As this law is to be a framework law, a comprehensive set of accompanying regulations are also needed. Increase the transparency of the Treasury’s work to develop in further detail the procedures for both cash and asset management.
- The Ministry of Finance should analyse, in co-operation with the EC Delegation in Podgorica and the USAID team, those USAID activities which are coming to an end, and identify which areas require additional support if they are to become sustainable.

## **6. External Assistance**

The major donor in the area of public expenditure management in Montenegro has been USAID, but its assistance will be cut from June 2008, with minor phasing out activities continuing until September 2008. USAID has mainly been supporting taxation and public expenditure, debt management, municipal finance, programme budgeting and MTBF. The last USAID project concentrated on improving fiscal and financial

management, and thus dealt primarily with the Ministry of Finance. Some activities still to be delivered by the USAID project include a progress report on debt and cash management operations in the Ministry of Finance and a proposal for a general costing methodology for spending units to use when preparing budget requests.

The European Agency for Reconstruction (EAR) has focused its assistance where it considered that an impact could be achieved and where local teams exist and are receptive. EAR's main focus has been on the budget sector, but it has also financed components in the development of the Treasury. One project, on reforming budgeting and salary systems, is being extended until April 2009. Its focus is on further developing macroeconomic analysis capacity for integrating sector policies into the budget process and to calculate the fiscal impact of the proposed salary reform.

Recently GTZ has also been asked by the Ministry of Finance to support the preparations for programme budgeting. This will be a follow-up to a previous US Treasury project which ended in July 2007. This new project is not likely to be very extensive.