

Report No. 23689-YU

Serbia and Montenegro Public Expenditure and Institutional Review

(In Three Volumes) Volume I: Executive Summary

February 2003

Poverty Reduction and Economic Management Unit
Europe and Central Asia Unit



Currency and Equivalent Units
(Exchange Rate Effective as of February 15, 2003)

Currency Units:

Serbia – Yugoslav Dinar (YUD) US\$1.00 = YUD 57.9129

Montenegro - Euro (EUR) US\$1.00 = EUR 0.9311

Fiscal Year

January 1 to December 31

Weights and Measures

Metric System

ACRONYMS AND ABBREVIATIONS

AMS	Agency for Mutual Services (UZP)	MOFE	Ministry of Finance and Economy (Republic of Serbia)
BIAS	Budget Inspection and Audit Service	MTFF	Medium-Term Fiscal Framework
CEEC	Central and Eastern European Countries	NBY	National Bank of Yugoslavia
DM	Deutsche Mark	OECD	Organization for Economic Cooperation and Development
DSU	Direct Spending Unit	PEIR	Public Expenditure and Institutional Review
EAR	European Agency for Reconstruction	PEM	Public Expenditure Management
EBF	Extrabudgetary Fund	QFA	Quasi-Fiscal Activities
EPCG	Elektroprivreda Crne Gore	SAI	Supreme Audit Institution
EPS	Elektroprivreda Srbije	SDF	Serbian Development Fund
EU	European Union	SFRY	Socialist Federal Republic of Yugoslavia
EUR	Euro	Sida	Swedish International Development Agency
FRY	Federal Republic of Yugoslavia	SPAI	Stability Pact Anti-Corruption Initiative
FY	Fiscal Year	VAT	value-added tax
GDP	Gross Domestic Product	YUD	Yugoslav Dinar
GFS	Government Financial Statistics	ZOP	Clearing and Payments Agency
GOS	Government of Serbia		
GOM	Government of Montenegro		
HIF	Health Insurance Fund		
IMF	International Monetary Fund		
ISU	Indirect Spending Unit		
LBS	Law on the Budget System		
MOF	Ministry of Finance		

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INTRODUCTION AND KEY THEMES

1. The Federal Republic of Yugoslavia (FRY) was established on April 27, 1992, amid the armed conflict that erupted in the wake of the dissolution of the Socialist Federal Republic of Yugoslavia (SFRY). The FRY consists of two republics, Serbia and Montenegro, with a combined population of 10.6 million, and an estimated 2001 GDP of US\$11.6 billion.¹ Serbia accounts for about 94 percent of the FRY's population and a similar share of its GDP. Since the elections in late 1997, the Montenegro government adopted an anti-Milosevic stance and remained neutral during the conflict over Kosovo in 1999. By 2001, Montenegro and Serbia had become two virtually separate economies, and relations between them had moved far from what was laid down in the 1992 constitution.

2. After protracted debates on the nature of the future common state, the **Basis for the Settlement of Relations between Serbia and Montenegro** was signed on March 14, 2002 by representatives of the Federal Government and the two Republics. Under it, the two republics agreed to replace FRY with a looser union called *Serbia and Montenegro (SAM)*. By mid-2002 all three Parliaments – the Federal, Serbian and Montenegrin - have ratified the Agreement, and a special parliamentary Commission began drafting the Constitutional Charter of the new state and the Law on its implementation. These two documents were finalized in early 2003, and adopted, first by the Republic Parliaments of Serbian and Montenegro and then, on February 5, 2003, by the Federal Parliament. This marked the birth of Serbia and Montenegro. The new Charter sets out a general framework for the union, in which Serbia and Montenegro will have some joint institutions, including a unicameral Parliament, a Presidency, and a Council of Ministers, but will operate separate economic, fiscal, and monetary policies. Elections to the new Parliament of Serbia and Montenegro would take place soon. Once constituted, the union Parliament would elect the President of the union, who would propose the Council of Ministers and direct its work. The union Council of Ministers would have five departments: foreign affairs; defense; international economic relations; internal economic relations; and protection of human and minority rights. Serbia and Montenegro would jointly finance these common functions, in proportion to their contribution in GDP. Since the cutoff date for this report is June 30, 2002, it dwells on the federal public expenditure issues only inasmuch as they are relevant for the new union, and does not attempt to prejudge the shape of the union's public expenditure function.

3. Armed conflicts, international sanctions, and trade shocks resulting from the breakup of the SFRY led to a 50 percent output decline over 1990-1993, and a sharp increase in unemployment and poverty. A slow recovery ensued in 1994 after the end of hyperinflation, but the re-imposition of international sanctions, supply disruptions, and the destruction of physical

¹ This GDP figure excludes Kosovo, which remains under U.N. administration according to the U.N. Security Council Resolution UNSC-1244, and is not covered by this report.

infrastructure related to the Kosovo crisis produced a severe output contraction in 1999. High inflation and under-investment depleted the capital stock and led to erratic growth and high structural unemployment. These problems were magnified by distortive fiscal, monetary, and structural policies. Production and trade were hampered by exchange rate misalignments, an inefficient external tariff regime, an adverse business environment, and chronically high inflation. Resources were diverted from productive uses through loss-making public enterprises, unaffordable social programs, and bloated government. The public finance system was undermined by extensive quasi-fiscal activities (QFAs).² High-level corruption further turned funds away from vital economic and social goals.

4. Montenegro accelerated its economic reforms in 1998, while in Serbia these reforms were triggered by Federal elections in September 2000, followed by Republic-level elections later in the same year. These elections brought to office reform-oriented governments with a mandate for rebuilding democracy, modernization, and reintegration with the international community. In Serbia, progress since the 2000 elections has been extensive, with major liberalization of prices, foreign trade, and foreign exchange; tax reform; improved privatization and bank restructuring regimes; enhanced transparency in the budget process; and reductions in the gray economy and smuggling. In Montenegro, supported by generous technical and financial assistance from the donors, economic reforms went further in some areas, while in others implementation has been less rapid, in part because of more serious capacity constraints.

5. Both governments view sustainable and accountable public finances as the keystone for broader market-oriented reforms, strong growth and poverty alleviation outcomes, and successful re-integration into the European and global economic structures.³ Since December 2000, a stabilization program supported by the IMF has been in place. In both Republics, reforms affect both the revenue side (simplified tax structure, more efficient revenue administration), and the expenditure side (improved budget management, reform of the pension system, phasing out quasi-fiscal activities). The new Laws on the Budget System (LBS), adopted by Montenegro in 2001 and by Serbia in early 2002, outline further stages of reforms.

6. This Public Expenditure and Institutional Review (PEIR) aims to help the governments of FRY to take their public expenditure reforms further⁴. The report analyzes public expenditure practices and institutions of the two Republics and of the Federal Government, and evaluates their decision-making and implementation processes. The three cross-cutting topics of the PEIR are: (i) sustainability of public expenditures; (ii) strategic allocation of public spending, to maximize growth and welfare within fiscally sustainable limits; and (iii) accountability of the public expenditure system, needed to maintain domestic and international support for the reconstruction programs of the two Republics.

7. The success of public expenditure reforms depends on several difficult strategic choices. First, there is a need to be realistic in selecting the goals of reform. Aiming to instantly attain the level of sophistication typified by best international practice is not feasible for the relatively

² Defined here as activities that are not explicitly executed via budgetary mechanisms, but that have, or may have in the future, measurable fiscal implications.

³ Government of Serbia (2001). *Reform Agenda of Serbia. Funding Recovery: The Need for International Support*, and Government of Montenegro (2001). *Economic Reform and Recovery Strategy*, <http://www.donors.cg.yu>.

⁴ The cutoff date for this report is June 30, 2002. As a rule, it does not cover developments after this date.

unreformed public expenditure systems with limited capacity such as those of Serbia and Montenegro. Both Republic governments have inherited distorted fiscal systems and ineffective budget management practices. Both need to see that the basics are working first, to deliver on the three interrelated goals of sustainability, allocative efficiency, and accountability of their public expenditure systems.

8. Second, the best-fit solution must be derived from the existing structures and practices. For example, Treasuries in Continental European countries differ in some important functions from the Treasuries developed by the Anglo-Saxon countries such as New Zealand, the United Kingdom and the United States, and even in the latter group no two institutions are alike.

9. Third, quite a number of important reforms have been initiated in the past 18 months. The Governments of Serbia and Montenegro should focus on deepening the reforms that have already been started rather than on launching many new ones.

10. Recognizing these strategic choices, the study focuses its recommendations on achieving the best fit with the current characteristics and constraints of the FRY's public expenditure management system. No government can simultaneously reform all aspects of the public spending mechanism, nor are all reforms equally pressing. Consequently, the recommendations of this report are both prioritized and sequenced over the near-to-medium term, which is particularly relevant because of the limited financial and human resources of Serbia and Montenegro. In the same vein, the report is very selective in tackling sectoral issues. In the past decade, distortionary fiscal policies have affected all sectors of the Yugoslav economy, and the agenda for public expenditure reform is very large. The PEIR covers three sectors with the largest impact on the FRY's fiscal stance –pensions, health care, and electricity.

11. Volume One of the PEIR provides an overview of the public expenditure reform agenda of the FRY and its two constituent republics. Volume Two focuses on the Republic of Serbia and the Federal Government, while Volume Three discusses public expenditure management issues of the Republic of Montenegro. Throughout the report, the public expenditure problems of the Federal level receive more limited treatment, as the contours of the future union government were not yet clear at the time of drafting. In the same way, the challenges of fiscal decentralization below the Republic level receive only a brief treatment, and only in the Serbia volume of the report.⁵

12. The report is organized around four broad themes: fiscal sustainability, allocative efficiency, pension and health care reforms, and budgetary management. In both Serbia and Montenegro, the fiscal sustainability theme includes a case study of the electricity sector, which is the largest reservoir of quasi-fiscal deficits. For Serbia, the allocative section also includes a case study of public sector wages.

13. The rest of this section provides a general overview of the four key themes of the PEIR. The next two sections treat the four themes as they apply to Serbia and Montenegro. The Budget management agenda of the Federal Government is discussed separately, due to the specificity of

⁵ See Volume Two, Annex II.

budgetary reform challenges on the Federal level and the different pace of change at this level over the past two years.

14. For each broad theme, the report offers a range of recommendations. Volume One includes the most important recommendations in a summary format, while Volumes Two and Three provide further detail on measures needed in each area and on their sequencing. In all three volumes, recommendations are prioritized, with the most immediate and important ones coming first in their respective sections. Typically, the recommendations are split into near-term (to be implemented over the next 12 months) and medium term, to be tackled within the next two years.

Fiscal Sustainability

15. Fiscal reforms must continue in order to ensure medium-term sustainability, while quasi-fiscal activities must be phased out. The need to sustain the momentum of reform is dictated by the upward pressure on public expenditure driven by the social costs of adjustment, the depletion of public capital stock, and the resumption of external debt servicing. Sustainability cannot be enhanced by a further increase in overall tax rates, since this could damage growth. Consolidation is attainable only via resolute cuts of policy over-commitments. Fiscal adjustment must be expanded beyond the budget system to the broader public sector, which harbors declining, but still large quasi-fiscal deficits.

Allocative Efficiency

16. Bold measures are needed to rationalize public spending in order to raise its allocative efficiency. At present, the allocation of public funds in both Serbia and Montenegro is both inflexible and inefficient, due to a large non-discretionary component, which comprises public sector wages and interest on debt. Social entitlements - the largest component of consolidated government spending - are also rigid. Public wage expenditures are above the regional averages in both Republics, and in Montenegro their level is among the highest in the region. Interest on debt is rising steeply in both Republics, due to the normalization of their relations with external creditors. Defense spending has been declining in Serbia, but is still at more than twice the CEECs⁶ average. Budget subsidies to inefficient public enterprises have declined over the past few years in Montenegro, and are now low, but in Serbia they are above the regional averages and rising. Spending on maintenance and investment is clearly insufficient to properly maintain the core public assets of both Republics. Cuts in capital spending are still being used to balance the budget in a time of adversity.

17. Of particular relevance is the need to elaborate and implement an effective public sector employment and wage policy. The core wages are low, and the main reason for the high level of spending is the large number of public employees. Salary differentials between highly skilled and unskilled labor are small and do not provide incentives to retain staff with much-needed skills. The current organizational model of public service is not flexible enough to attract the skills the governments need to modernize their public expenditure systems.

⁶ CEECs are Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, FYR Macedonia, Poland, Romania, the Slovak Republic, and Slovenia.

Pension and Health Care Reforms

18. Structural reforms of the social safety net and the health care system must continue to ensure their sustainability. In both Republics, social protection systems are under massive strain from the short-term impacts of restructuring and price liberalization on citizens' incomes and the rise in the number of beneficiaries due to refugees becoming citizens. The health system is facing similar pressure coupled with structural inefficiencies and a lack of accountability and monitoring mechanisms. Serbia has taken initial steps to curb spending on pensions, but both Republics need to implement systemic reforms to contain the fiscal pressures emanating from the pension system. In addition to raising retirement ages, this should include changing the benefit formula to bring benefits in line with contributions; increasing incentives for contribution compliance and for work; and improving the system's equity. On the revenue side, the enforcement of social contributions should be improved. In the health sector it is essential to reestablish the link between payment of contributions and access to the health care, formalize out-of-pocket payments, and increase efficiency through enhanced competition.

Budget Management

19. The comprehensiveness of the fiscal system must be increased further. The FRY operated a highly fragmented fiscal system with off-budget activities obscuring the strategic perspective of public policymaking. Over the past two years, both Republic Governments have taken resolute measures to incorporate all revenues and expenditures into the budget. These reforms should continue. All donor funds, own revenues of government agencies, and privatization proceeds should be brought on budget. Operations of extrabudgetary funds and sub-national governments should be monitored and harmonized with the Republic budget cycle. All public sector policy decisions should be made with reference to their medium-term fiscal implications.

20. Budget formulation needs to acquire a strategic dimension. Weaknesses in the FRY's budget formulation have included: (i) a lack of realism in the macroeconomic analysis on which the budget is based; (ii) a tendency to regard the budget as an administrative tool rather than as an instrument of policy, which resulted in failure to confront strategic resource allocation issues; (iii) a reliance on input-based normatives for budget planning that take little account of available funding; and (iv) an absence of a multi-year perspective. Both Governments are reforming budget formulation, but they are still at an early stage. Significant challenges remain in establishing a framework of policies and priorities to guide the allocation of public resources, in determining revised standards and norms for public service delivery, in developing capacities for monitoring budgetary performance, and in specifying planned outputs and outcomes of the budgetary expenditure.

21. Budget execution should rest upon modern treasury practices and strong commitment controls. Some of the dimensions of budget execution that influence both financial control and service delivery include: (i) control of cash flow; (ii) control of commitments; and (iii) flexibility of resource use by program managers to efficiently deliver services while assuring accountability for financial performance. The existing arrangements provide tight control of cash flow by the Republic and Federal Ministries of Finance, but a process of cash rationing affects this control and has arbitrary effects on suppliers and service delivery units. Adverse effects on government programs could be reduced with a more systematic forecasting of in-year revenues, allowing the

Ministries of Finance to smooth the spending path, and to better integrate cash planning with debt management to assure the timely availability of cash in order to meet spending demands.

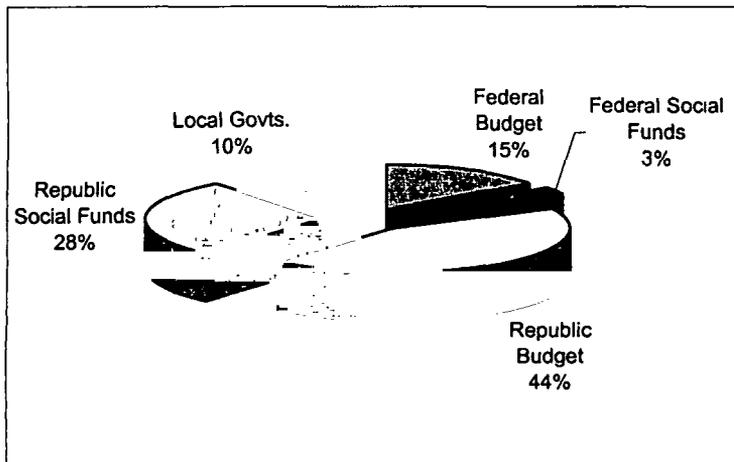
22. The accountability and control framework should be strengthened at all stages of the budget cycle. Strong internal and external audit functions are key to the smooth functioning of the public spending system, assuring integrity in public services and strengthening the credibility of the government. Within the government, strong internal audit should be the key means of management control. Through internal audits, the government is assured that it has procedures and systems in place to minimize the potential for fraud, waste, and abuse of public resources, and that these procedures and systems are operating. At the same time, there exists a need for an independent external audit institution that could safeguard the usage of public funds and the quality and credibility of reported fiscal data.

23. The Federal Government started public expenditure reforms much later than the Republics, and halted them upon the March 14, 2002 Agreement between Serbia and Montenegro. Whatever is the configuration and the size of the new union Government, it should establish high standards for the transparency and accountability of public finances it receives.

SERBIA

24. This report undertakes the analysis of Serbia's consolidated general government, which comprises four levels of government – Federal, Republic, provincial (Vojvodina), and local.⁷ The Federal government is included into the consolidation because it is currently supported by revenues generated solely on the territory of Serbia. The definition of consolidated general government in Serbia also comprises extrabudgetary (social) funds - five on the Republic level - Health, Labor Market, Employee Pensions, Self-employed Pensions and Farmers' Pensions, and two on the Federal level - Military Pensions and Military Health. This presentation excludes public enterprises. Figure 1 presents the structure of general government spending in Serbia, showing the shares of the Federal, Republic, and local government levels and of the social funds.

Figure 1: FRY without Montenegro: Consolidated General Government Spending, 2001
(percent of total)



Source: Federal MOF, Republic of Serbia's Ministry for Finance and Economy (MOFE), and World Bank staff estimates

EARLY REFORMS

25. In little more than two years since it assumed power in 2001, the democratic Government of Serbia has made impressive first strides in addressing the daunting legacy of the past.⁸ Measures were taken to bring diverse extrabudgetary taxes and surcharges on budget and to increase tax revenues, while enhancing the efficiency of the tax system. On the expenditure side, budgetary arrears have been reduced, and public sector wages were kept relatively constant as a share of GDP. The Federal government has cut defense spending significantly. Legislation has

⁷ This definition excludes the province of Kosovo, which is not covered in this report.

⁸ For greater detail, see Chapter 1 of Volume Two.

been passed to put the pension funds on a stronger financial footing by increasing the retirement age and adjusting the rules for indexation.

26. Important steps were taken by the MOFE to strengthen fiscal transparency and management in 2001. This was done through the integration of various extrabudgetary programs into the budget and a bold inspection of the results of budget execution in 2000, which led to the prosecution of dozens of officials of the previous regime for the abuse of public funds. In 2002 reforms accelerated, as the Republic began the implementation of the newly adopted Law on the Budget System, including the establishment of a modern Treasury. The Government has made significant progress in arresting the buildup of contingent liabilities, including via major increases in electricity prices.

27. These fiscal reforms have been reinforced by the prudent policies of the NBY, and have resulted in reducing inflation from 114 percent in 2000 to 15 percent in 2002.

28. Bank and enterprise restructuring is advancing rapidly. The liquidation of four large insolvent banks in January 2002 was particularly important for reining in the future fiscal risks. Last but not least, the Government of Serbia has demonstrated commendable vigor in tackling corruption and in breaking any perceived link to the abuses of the former regime. It has formulated a strategy for fighting corruption, and has put in place a strong institutional framework to deliver it.⁹

FISCAL SUSTAINABILITY

29. Notwithstanding the progress achieved, deeper and faster fiscal reform is needed. Since the end of hyperinflation in the mid-1990s, the Budget's cash deficits have been kept low to limit the inflationary consequences. In part, this was achieved through the accumulation of arrears on external debt and on domestic commitments. This is no longer an option. The momentum remains toward increasing public expenditure. In 2002, consolidated government spending in Serbia is legislated to increase by 6 percentage points of GDP. This increase is caused by several factors: a very positive process of consolidation, in which various quasi-fiscal deficits are being brought on budget; the need to smooth the social pains of adjustment, and to rebuild the public capital stock; and the regularization of Serbia's external debt. The combined effect of these factors is expected to swell the fiscal deficit from 1 percent of GDP in 2001 to about 4.5 percent of GDP in 2002.

30. Current fiscal reforms go a long way toward controlling the growth of spending. However, as Serbia advances its economic restructuring program and opens its economy to foreign commercial and financial interests, the volatility of its revenues and expenditures could increase. While outward-oriented growth strategies offer the potential for substantial improvement in efficiency and growth performance, they also increase the sensitivity of the fiscal accounts to market forces.

31. Fiscal reforms aimed at cutting the level of spending on overscaled social entitlements and on other unaffordable spending items can create a cushion for unforeseen budgetary shocks by raising the share of discretionary expenditure in the budget. Prudent debt management will

⁹ See Box 1.2 in Volume 2 and www.serbia.sr.gov.yu/transition/fighting_corruption.

also be essential for fiscal stability and control, especially for the balancing of the maturity and currency structure of the debt stock. Furthermore, the stability of public expenditure can be enhanced by appropriately funding reserve accounts. In 2002, the Serbian and Federal budgets took a welcome step in this direction, by allocating 0.6 and 0.3 percent of GDP, respectively, into reserve funds.

32. An illustrative analysis has been carried out for this review to determine the sustainable level of the fiscal deficit.¹⁰ With a strong policy effort to develop a stable and robust market economy, and with continued donor support, an indicative middle case scenario suggests that in the second half of the current decade Serbia could sustain a general government deficit on the order of 1 percent of GDP. Under these assumptions, interest payments on public debt would average 2.5 percent of GDP, meaning that Serbia would need to maintain a primary surplus of about 1.5 percent of GDP.

33. Should economic growth be slower, greater fiscal adjustment would be warranted to ensure sustainability. For example, if the economy were to grow only 2 percent over the medium term, this would necessitate an increase in the primary surplus to around 2.5 percent of GDP. On the other hand, more rapid growth could be achieved if investment and productivity growth rates were exceptionally rapid. If the Serbian economy were to grow at around 6 percent over the medium term, a deficit of about 2 percent of GDP could be sustained. Assuming that domestic borrowing rates and privatization receipts did not change, this level of deficit could be financed with additional foreign borrowing. However, additional public borrowing would only enhance the long run growth potential of the economy if borrowed funds were employed efficiently and the costs of carrying debt were contained.

34. Adverse external shocks, such as a significant slowdown in European import demand, could significantly damage growth. Lower exports would make it more difficult to service the external public debt and to maintain macroeconomic sustainability without further fiscal retrenchment. Rising foreign interest rates could also put additional pressure on the budget. These external shocks would require an increase in the primary fiscal balance to maintain sustainability.

35. **Size of the government.** Over the past three years, the levels of Serbian consolidated government revenues and expenditures have risen. In 2002, they are projected to exceed 40 percent and 45 percent of GDP respectively.¹¹ This is driven, *inter alia*, by the tax reform of 2001 and the incorporation of own revenues of budgetary agencies, the bringing of quasi-fiscal activities on budget, the rise in reform-related spending on enterprise restructuring, the resumption of external debt servicing, and the reduction in the stock of arrears. These are all positive trends. Nevertheless, the level of public spending by the Republic and Federal Governments combined exceeds that of many wealthier countries.

36. Several studies have demonstrated a positive correlation between income levels and the level of general government spending. This, however, merely suggests that richer countries can afford to spend more. There is much less guidance on what is the appropriate size of government

¹⁰ For greater detail, see Volume Two, Chapter 2 and Annex 1.

¹¹ For details of consolidation, see para. 24.

spending. Yugoslavia traditionally had an extensive social protection system, and expectations of the society in all ex-SFRY states that social benefits would continue may be the strongest explanation for the “stickiness” of public expenditure at high levels. Serbia also has lower public spending levels on a cash basis than all other ex-Yugoslav countries except Macedonia, and lower than many of the EU accession countries. These considerations are no reasons for complacency. The following structural characteristics of public spending suggest that its efficiency may be low: (i) duplication of functions across the Federal/Republic levels of government, estimated to be “worth” over 1 percent of Serbia’s GDP; (ii) apparent excessive spending in individual categories (e.g., public wages) and functions (e.g., defense), and (iii) remaining budgetary arrears and quasi-fiscal activities.¹² The first of these concerns is being addressed in the course of the constitutional reform; other concerns are being tackled via sector-specific programs. Gains from restructuring will come only in the medium term. Further significant increases in public expenditure could have adverse consequences for long-term growth and private sector development, and the reintegration of the gray sector into the official economy.

37. **Quasi-Fiscal Activities.** Long-term fiscal sustainability is undermined not only by budgetary deficits. Off-budget (quasi-fiscal) activities could be even more problematic, since they are much less transparent. In Serbia over the past decade, quasi-fiscal deficits were much larger than cash deficits of the budget. Massive quasi-fiscal activities were carried out via the social funds and public and socially owned enterprises and banks. The stocks of quasi-fiscal liabilities are not well measured, but may be comparable to the level of direct external debt. The Government of Serbia is aware of these risks and has taken bold steps to cut the flow of QFAs, by privatizing, restructuring, and/or liquidating of public and socially owned enterprises and banks, and by putting the social funds on a stronger financial footing. These measures should continue. However, bringing quasi-fiscal items on budget could entail short-term costs.

38. QFAs in the **electricity sector** are by far the largest. Administrative price distortions existed in that sector well before the 1990s and are still being used to support politically and socially sensitive industries and social groups. This has led the sector to under-invest and to defer maintenance, while its clients have incentives to over-consume electricity. Revenues of the Serbian power utility EPS up to mid-2002 still do not cover its operating expenses, let alone funding new equipment and maintenance. EPS often cannot pay its social taxes and also accumulates arrears to suppliers.

39. The government has begun to address these issues. In 2001, nominal electricity prices were doubled and in mid-2002 there was another 50 percent increase. Full cost recovery can be reached within two years, but the relatively high cost of producing electricity is a major constraint. Limited prospects for competition, public ownership of the electricity sector, and the lack of regulatory oversight weaken the incentives to control costs, reduce network losses, and protect the value of assets. Even with higher electricity prices and reforms that increase productivity, the electricity sector cannot be strengthened without increasing collections and eliminating the web of non-payments in the Serbian economy.¹³ Further measures are needed in

¹² On the other side, Ireland, which has the smallest government among the EU-15, registered over the past 20 years the fastest GDP growth rate in the group. Chapter 2 in Volume Two provides greater detail on these topics.

¹³ Average collection rates in 2002 were 75 percent. Government often fails on its own obligations to EPS.

the financial, structural, technological, institutional and fiscal spheres to stabilize the finances of the sector.

40. **The PEIR recommends** the following specific near-term steps to strengthen the overall fiscal sustainability:

- Strengthen the new macro/fiscal unit in the MOFE with sufficient number of skilled staff. Assign to it the task of identifying/measuring fiscal risks from both on-budget and off-budget commitments. The unit should maintain a multiyear fiscal model that correctly reflects these fiscal risks.
- Build the debt management capacity of the newly established Treasury, and formulate a comprehensive fiscal risk management strategy;
- Determine the amount of budget reserves needed to minimize the effects of fiscal shocks from unforeseen circumstances and phase in these amounts as quickly as possible;
- Refrain from creating new publicly owned financial institutions.

41. With regards to the electricity sector, **the PEIR recommends** to:

- enforce collections, disconnect non-payers, eliminate barter and offsets as methods of payment for electricity, and end the accumulation of arrears to EPS originating from budgetary institutions;
- establish an independent regulatory body with a mandate to raise electricity tariffs to full cost recovery levels, and ensure that electricity production costs are cut, particularly the wage bill, to achieve efficient production and to allow EPS to finance investment and maintenance; and
- target compensation for electricity price increases on poor households.¹⁴

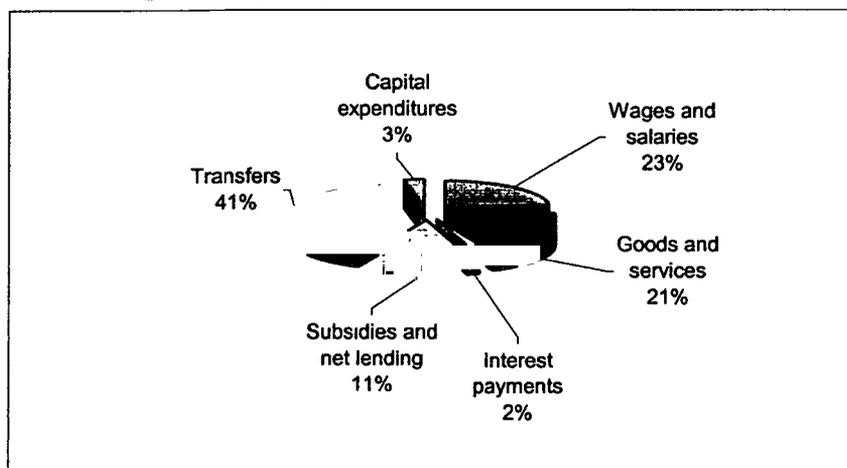
ALLOCATION OF PUBLIC SPENDING

42. The key characteristic of the allocation of public funds in Serbia is its large non-discretionary component, comprising wages, interest on debt, and social entitlements. The economic classification of general government spending is shown in Figure 2. In the near future, these rigid components of public spending are likely to rise further, as external debt is regularized and bank and enterprise reform generates the need for higher social support payments. The rigidity of public spending can only be mitigated via structural reforms that deliver cost reductions and efficiency gains.¹⁵ The key risk categories are discussed below.

¹⁴ Timelines and other modalities will be outlined in a forthcoming full Poverty Reduction Strategy Paper.

¹⁵ For further details, see Volume Two, Chapter 4.

Figure 2: FRY without Montenegro: Government Spending by Economic Category, 2001
(percent of total)



Note. General Government consolidation comprises Federal, Republic, and local budgets, and Republic and Federal social funds.
Source. FMOF, MOFE, and World Bank staff estimates.

43. **Public Sector Wages.** Federal and Republic Government wage expenditures combined are close to 10 percent of Serbia's GDP, absorbing over 23 percent of total spending. This is above the CEEC average by about one percentage point of GDP. These numbers exclude temporary workers, whose salaries are funded from the goods and services budget. As core wages are low, the main reason for the high level of spending is the number of public employees. Salary differentials between skilled and unskilled staff have been growing but are still low, suggesting that wage policies do not provide incentives to retain much-needed skills. Public employment mechanisms assure overall control over costs, but entrench current employment allocations and limit the Government's ability to re-direct personnel to priority areas. There is a need to reform the system and policies for determining employment and wage levels.

44. Spending on **non-wage goods and services** is generally in line with the regional comparators. However, as in most other former Yugoslav countries, it also includes the wages of temporary workers. Once adjusted for this component, this spending category is low, and may signal levels insufficient to maintain public assets.

45. **Budget subsidies and loans** are significant at 3-4 percent of GDP. While the average level of subsidies in Serbian budget is not very different from the regional averages, the latter have declined by about one-half over 1998-2001, while in Serbia subsidies to enterprises are on the rise. They go almost entirely to nine public enterprises that are the largest loss-makers. Until 2001, most subsidies were not on budget. The rise of allocations for subsidies in 2001-02 could mean that a larger amount of subsidies is provided through the budget and less flows through off budget channels, which improves accountability. Still, the current level of budgetary subsidies appears excessive.

46. With regard to **budgetary loans to enterprises**, the experience of other transition countries has shown that such loans have poor collection rates and high administrative costs. Governments rarely have the capacity to monitor and manage risks of these loans. Often, funds

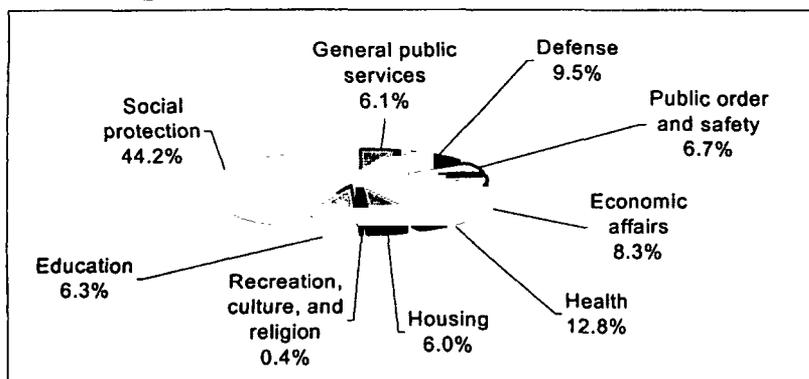
are lent to inefficient public enterprises at subsidized interest rates. This discriminates against more dynamic private start-ups with no access to such loans.

47. Serbia's level of **social transfers** as a share of GDP is high, and close to that of much wealthier countries, which raises affordability concerns. The actual level of social transfers displays high volatility, suggesting serious sustainability problems.¹⁶

48. **Capital Spending.** Over the past decade, and possibly longer, Serbia was under-investing in public assets. As a share of GDP, this category was less than half the regional average. It was also volatile, suggesting its use as an in-year balancing item. Only in 2000 was there a rise in capital spending, related to the post-conflict reconstruction. In 2001, substantial donor funds went into extrabudgetary capital spending, but budgeted capital expenditure dropped sharply. In 2002, significant rises are budgeted again, reflecting both increased reconstruction needs and moving more investment projects on budget. Despite these positive trends, cuts in capital spending are still used to balance the budget in adversity, particularly if donor aid were to come in at below expected levels, which is what happened in 2001. It also should be noted that as capital spending rises, concerns about its efficiency need to take center stage.

49. Reliable historical series of spending by government function (see Figure 3) are harder to compile than by economic category.¹⁷ From the relatively reliable functional presentation of budgets for 2000-02, the following conclusions can be drawn.

Figure 3: FRY without Montenegro: Government Spending by Function, 2001
(percent of total)



Note: consolidation of Federal and Republic budgets and social funds. Data for local governments by function were not available.
Source: World Bank staff estimates.

50. Spending on **general public services**¹⁸ is more than 20 percent above the regional average. This mostly reflects the burden of interest payments on external debt, which now account for over half of the spending within this function as compared to very low levels in the 1990s. Other components of spending on this function are not far from regional averages.

¹⁶ These issues are discussed in the next section of this volume, and in Volume Two, Chapter 5.

¹⁷ Due to the data deficiencies, the foregoing discussion excludes local government spending, which is believed to be heavily weighted towards general services.

¹⁸ These comprise primarily own expenses of government bodies and the servicing of government debt.

51. **Defense** spending has declined from very high levels of 1998-1999, but is still well above the regional averages. The regional trend has been to reduce spending on defense. Assuming that the security situation will continue to normalize, Serbia should be expected to follow other CEECs in reducing its defense allocations.

52. **Public order and safety** spending is slightly above the regional comparators. It will need to be adequate to combat crime and improve the judiciary system. Reflecting this need, levels budgeted for 2002 are well above the trend of recent years.

53. **Education** spending has been declining throughout the past decade. It bottomed out in 2001, reaching one of the lowest levels for the region, even if local government spending is included¹⁹. Teacher salaries dropped well below public sector averages, schools were starved for basic education supplies and equipment, while many school buildings were past the age that provides normal conditions for learning. In 2002, the Republic Government acted strongly to revert the decline of public education. It aligned teacher wages with the public sector averages, and increased capital spending.

54. To arrest an undesirable further rise in the overall public spending and to increase its efficiency, **the PEIR recommends** the following short-term measures:

- Complete the transition to the GFS-based²⁰ budget classification, providing policymakers with an effective tool to assess the allocative efficiency of spending;
- Identify sub-sectors where low maintenance spending is particularly harmful to the value of public assets, and increase maintenance spending on these items;
- Program only the subsidies to SOEs that defray the social costs of restructuring, and grant these only if a beneficiary is making a demonstrable progress under a realistic restructuring plan towards improved performance;
- Identify capital investment programs crucial for long-term growth, and protect this spending, with due attention to its efficiency; and
- Specify approaches to reducing military expenditures, including the costs of redeploying military personnel; where feasible, apply some of the savings to strengthen the public order and safety function.

55. With regards to public sector employment and wage policy, **the PEIR recommends** that in the near term the MOFE develop the capacity to monitor employment numbers and remuneration levels in all direct spending units (DSUs).²¹ This would generate the information on current employment and wage structures as a foundation for reforms. Over the medium term, the MOFE should formulate an explicit public service pay policy, to enhance the transparency and consistency of public service remuneration and the process for reviewing pay levels and

¹⁹ In Serbia, the Republic Government is primarily responsible for paying teacher salaries, while local governments are contributing with repair and maintenance expenses. Sufficiently detailed data for local government spending were not available to determine the size of their contribution to the sector.

²⁰ Government Financial Statistics (GFS) is a statistical standard for presenting government financial information endorsed by the IMF and adopted by many of its member countries.

²¹ Two terms are common to ex-SFRY budget systems: direct and indirect spending units. Direct spending units (DSUs) are the agencies receiving funds directly from the budget (e.g., Ministry of Education). Indirect spending units (ISUs) are second tier users, receiving funds from direct users (e.g., public schools).

linkages with the budget process. In formulating the pay policy, the need to decompress the salary structure, and give consideration to performance-related pay should be addressed. A high level review that focuses on future direction, priorities, and processes should be combined with a detailed analysis of the organization and staffing of individual public agencies, identifying their core competencies and attracting the right skills to them. Once the relevant information on public sector employment is available, a strategy for administrative reform should be formulated and implemented.

SPENDING ON PENSIONS AND HEALTH CARE

56. As was noted in the previous section, social protection programs account for close to 45 percent of the FRY's consolidated public expenditures. The two most important of these programs are pensions and health care, the responsibility for which rests largely with the Republics.²²

57. The Serbian pension system faces serious sustainability challenges. It currently absorbs 12.7 percent of GDP (on an accrual basis), and is able to meet its legal obligations only with the help of budgetary transfers amounting to 4 percent of GDP. In the absence of reforms, the pension system's deficit will grow further. Aiming to contain the level of spending and to improve equity in the system, the government introduced in late 2001 a range of parametric measures,²³ which will reduce the deficit but will not eliminate it entirely. Deeper structural reforms are essential to bring the system back into balance. Preparation of these reforms should be supported by analytical work exploring the fiscal costs of different reform scenarios. It will be important for the government to resist pressures to expand costly social entitlements as reforms accelerate.

58. To contain spending while improving both incentives and equity in the pension system, **the PEIR recommends** to deepen the reforms in the short-term via:

- Changing the benefit formula to bring entitlements more in line with contributions (e.g. through lowering the pension accrual factor, and increasing the wage history used to calculate the pension base);
- Improving the certification of disability (by reducing temporary disability provisions and tightening eligibility, particularly in relation to the initial assessment);
- Improving incentives for postponing retirement, by disallowing retirement with years of service and/or raising the pension reduction factor for early retirees;
- Reducing the costs and improve the administrative efficiency of the pension system, through administrative rationalization of the system (in line with the experience of other ex-SFRY countries). Duplication of costs and administrative procedures associated with the three pension funds should be addressed; and
- Strengthening contribution compliance, and expanding the contribution base by harmonizing contribution rates and bases across all categories of contributors, and eliminating all contribution exemptions.

²² Greater detail is found in Volume Two, Chapter 5.

²³ Parametric reforms change the parameters of the system (e.g. retirement age, indexation formula).

59. Over the medium term, the PEIR recommends considering reforms aimed at diversifying the sources of pensioner incomes. These should be preceded by a program of institutional development (particularly of the financial sector and capital markets) and capacity building (particularly for regulation), if funded pensions are to be considered.

60. Serbia's health care system is in need of considerable restructuring. In its current format it is not fiscally sustainable and delivers poor quality health care in an inefficient and inequitable way. Inefficiencies are particularly evident in the level of overcapacity of the hospital system and the high number of non-clinical staff, such as cleaners, catering assistants, and administrators. Inefficiencies arise from the lack of adequate incentives for cost minimization, separation of financial responsibilities held by the Health Insurance Fund (HIF), and decision-making on staffing and salary levels, which rests with the Ministry of Health; the highly protective and oligopolistic nature of the market for pharmaceuticals; and the lack of accountability and monitoring capacity at all levels of the system. The heavy reliance on informal out-of-pocket payments and on the often illegal imports of pharmaceuticals are among other major weaknesses of the current system.

61. The low efficiency in the health care delivery is one factor why the system is not sustainable. Others are the limited resources available to the HIF, the near universal coverage the system provides, and too generous entitlements. The per capita contributions to the HIF in 2001 were in the range of US\$41-US\$52, which is very low by CEEC standards.²⁴ This is the result of economic crisis, which reduced the number of contributors and the earnings on which the contributions were calculated, widespread evasion among farmers and the self-employed,²⁵ failure of the Republic and Federal governments to transfer funds to fully cover the cost of treatment of vulnerable groups,²⁶ and large arrears on transfers from other social funds to the HIF.

62. Given this combination of factors, the very comprehensive health care package that the HIF offers is not affordable. Formal employment is unlikely to increase substantially in the short to medium term and the evasion of contributions in the informal and agricultural sectors is likely to continue unless a strong link is established between contributions and entitlements to services. The heavy burden already imposed on the waged workers²⁷ makes it inequitable and inefficient to further increase their contributions. This leaves the following options:

- Ensuring the transfer of adequate resources to cover the cost of health care for pensioners, the unemployed, and the vulnerable groups;
- Increasing formal out-of-pocket contributions for access to health care;
- Reestablishing the link between contributions and access to the health care;
- Reducing the package of services financed by the HIF; and
- Increasing the efficiency with which these services are provided.

²⁴ The range is due to the different estimates of the population covered used by the Public Health Institute and the HIF.

²⁵ In 2000 farmers and self-employed made only 3 percent and 1 percent of total contributions respectively, while GDP shares generated by the non-public agriculture and the private sector were 20 percent and 40 percent.

²⁶ This category includes refugees and IDPs, but is not clearly defined. See recommendations further in the text.

²⁷ In 2000, waged workers accounted for 55 percent of the insured, but made over 80 percent of the contributions paid.

63. Given the high HIF deficits over the past years, a combination of these options would be required.²⁸ All of the options have important potential implications for the equity of financing and delivery of health care services.

64. To increase HIF revenue, **the PEIR recommends** the following priority steps:

- Transfer to the HIF the responsibility for annually stamping the “health card” for all categories of covered individuals, upon proof of payment of contributions and/or entitlement. With the implementation of the new Law on Health Insurance, limit the financial responsibility of the HIF to the care of individuals with valid stamp of health card;
- Establish a list of vulnerable individuals whose medical care is to be financed directly from general taxation via a per capita transfer from the Republic budget related to the minimum wage;
- Undertake a netting operation on the stocks of arrears payable and receivable of the HIF;
- Ensure the timeliness of budgetary transfers to the HIF; and
- Formalize the out-of-pocket payments by increasing the co-payments and reducing the exemptions.

65. Over the medium-term, other revenue enhancing measures should include:

- Implementing a graduated co-payment system, with the HIF bearing full financial responsibility only for an accepted list of basic services; and
- Setting the budgetary transfers to the HIF at the level which correctly reflects the number of vulnerable individuals.²⁹

66. As efficiency enhancing measures, **the PEIR recommends** the following near term actions:

- Increase the number of licensed pharmaceuticals by reintroducing drugs with elapsed registration. Cover pharmaceuticals in the new Law on Public Procurement, and aim to adopt the new Law on Pharmaceuticals;
- Prepare a master-plan for restructuring the hospital sector with particular emphasis on reducing overstaffing; and
- Strengthen the capacity for measuring the efficiency of the system and of individual health care providers. In the short-run, do this by expanding the new HIF database on prescriptions. In the medium-term, set up a more extensive health information system. Once information is available, redesign current contracts between the HIF and health care providers, to create stronger incentives for cost containment.

²⁸ Furthermore, the stock of HIF debts inclusive of the debts to financial institutions at end-2000 was equivalent to 57 percent of its annual budget.

²⁹ This transfer should be sufficient to cover the per-capita contribution requirement equal to 5.95 percent of minimum wage.

67. The new Law on the Health Care, to be implemented in time for preparation for the 2004 budget, should give the health facilities responsibilities for manpower and budget management decisions.

REFORMING BUDGET MANAGEMENT

68. Serbia has only recently emerged from the legacy of poor policy choices. It has made a good start in redesigning its key public expenditure processes and in improving budget management. Its government views the existing budgeting procedures as needing strategic dimension, and defines the deepening of the Public Expenditure Management (PEM) reforms as its priority challenge.³⁰

69. Improvements in Serbia's budget management mechanism are most pressing in two areas: institutional arrangements and the stewardship of resources. In terms of institutions, the budget is not comprehensive and decisions are made without a clear picture of the overall public finance position. This leads to sub-optimal budget outcomes. In budget execution, the issue of comprehensiveness also arises. Without a complete picture of in-year spending trends, the government cannot take corrective action in a timely manner. Decisions are currently taken within a one-year framework, which can generate future fiscal imbalances and can inhibit the successful resolution of current fiscal imbalances. A multi-year perspective needs to be integrated into budget analysis and decisions. Related to both comprehensiveness and a multi-year perspective, policy is not integrated with the budget. In several sectors policy commitments exceed the resources available. Laws that set policies and normatives do not reflect the availability of resources.

70. The key institutions for budget execution that determine whether the government's budget and policy are implemented and fiscal targets are met are lacking. These key institutions are: a well-developed Treasury, including cash management and commitment control functions, to assure that targets are met and policies are implemented; and a robust, systematic audit of public accounts to assure accountability. There is presently no external audit of the executive, and internal audit does not have the resources to safeguard the integrity of public finances.

71. The **stewardship** perspective is also important, since it directly affects the credibility of the government, the success of reform programs, and the efficiency of public spending. In most OECD countries the finance ministry, through its responsibility for overseeing the planning and management of public expenditure, plays an important role in the co-ordination of the processes of government policy and program development across all sectors. In Serbia, this role has in the past not been emphasized, and the budget has been seen primarily as an administrative exercise. The MOFE traditionally took responsibility for the oversight of only the state budget, rather than the consolidated budget – a role only the Republic MOFE is positioned to take. How decisions are taken and funds expended during the year does matter, including the spending of funds off-budget (e.g. for bank restructuring) or non-transparent financing arrangements.³¹

³⁰ Government of Serbia. Reform Agenda of Serbia: Funding Recovery. The Need for International Support, June 2001. Budget management is discussed in greater detail in Volume Two, Chapter 6.

³¹ For further details, see paras. 118-119 in this volume, and Volume Three, Chapter 5.

72. **Comprehensiveness.** The budgetary process needs to be comprehensive of all public revenues and expenditures. Through the preparation of the General Balance Table, the budgetary process in Serbia already has one tool that integrates the revenues and expenditures of the Republic Government, local governments, and the social funds. Until 2002, this table was presented only on a gross basis,³² and similar comprehensive approaches do not extend to budget and fiscal analysis or management in-year.

73. Furthermore, the budgets of the local governments and the social funds are not subject to the similar levels of strategic review as the Republic budget. For 2001, local governments exceeded their budget by 12 percent, which adversely affected the Republic budget. Funding requirements for local governments and EBFs need to be considered within the broader framework of inter-sectoral and sectoral policies and priorities. The importance of this review will grow as decentralization progresses.

74. Finally, the government has started to receive substantial external financial assistance. Because such resources are supporting public expenditure, and in the case of credits and loans will incur future debt servicing costs, it is important that they be treated as an integral element of the budget framework. Capital projects entail operating and maintenance expenses that must also be factored into the budget to assure that these carrying costs can be sustained, and that capital spending decisions support the sectoral policy objectives. **The PEIR recommends** the following measures:

- In the short-term, continue using the General Balance Table (on a net basis), and increase its analytical content; over the medium-term, integrate this table into a fiscal policy paper, which the MOFE should prepare at least annually;³³
- Over the medium-term, enhance the comprehensiveness of the budgetary process by including within the fiscal framework a more thorough analysis and review of the social fund and local government spending, and all external aid projects.

75. **Multi-year Perspective and Integration of Policies with Resource Allocations.** A multi-year perspective is important for setting the overall fiscal policy of government, and for considering specific policies, laws, and funding decisions. Taking decisions on a one-year basis frequently leads to unexpected future fiscal crises. Moreover, reviewing current spending policies in a multi-year context can illuminate potential crises and thus permit intervention to avert them. **The PEIR recommends** that the MOFE:

- Take prompt actions to introduce a three-year budget planning horizon, in order to provide a medium-term framework within which line ministries can formulate their expenditure programs;
- Over the medium-term, adopt a more strategic approach to public expenditure planning that links sector policies and program priorities with planned program outputs and outcomes and budgetary resource allocations; and develop capacities in

³² Meaning that flows between parts of the fiscal system are not netted out, thus overstating its overall size.

³³ For an example of a fiscal policy paper, see Chapter 3 of Poland's EU Pre-Accession Economic Program, at: http://www.worldbank.org/eca/euenlargement/publications_other.htm#pep.

the MOFE and line ministries' to monitor budget performance and planned program outputs; and

- To support these reforms, promptly initiate measures to upgrade the Budget office staff skills in the MOFE itself and in the line ministries, EBFs, and local governments by: (i) adopting a strategic plan and mission statement defining the new role of the budget office; (ii) developing staffing plan for the office; and (iii) initiating recruitment and training for staff.

76. **Treasury Function.** A Republic Treasury was established in Serbia in Spring 2002. It needs time to develop full functionality. Current cash management practices (triaging payables) deliver effective cash outflow control, but undermine budget policies, adversely affect suppliers and service delivery, and often lead to arrears. Measures to improve Treasury operations are urgently needed to better meet fiscal targets, support program service delivery, and gather better information for control and analysis. Through the full implementation of the Treasury, budget oversight will be improved to allow in-year management of spending, and budget classification will be enhanced to support transparency and to introduce performance orientation. Both spending ministry and MOFE capacities must be enhanced for Treasury operations.

77. A major risk to fiscal sustainability in the short term is the closure of Clearing and Payments Service (ZOP), the central payments system, before a Treasury and a revenue administration are fully functional.

78. **The PEIR recommends the following short-term actions:**

- Introduce commitment controls into spending earlier in the expenditure chain, thus reducing the potential for the generation of arrears;
- Make budget execution and accounting more comprehensive by incorporating all DSUs into one accounting and payment system. This could be built around the current Agency for Mutual Services (AMS) accounting system, with AMS potentially being located in the new Treasury Office; and
- Improve budget execution oversight through regular publication of in-year consolidated reports showing actual expenditures, arrears, and cash flows.

79. **Over the medium term, the PEIR recommends that the MOFE:**

- Improve cash management with (i) more systematic forecasting of within-year revenues, allowing the MOFE to plan a smoother path of spending, as well as to better integrate cash planning with debt management to assure timely debt issuance and availability of cash to meet spending demands, and (ii) replacing of the present daily triage by a weekly triage, which would smooth the cash allocations, eventually moving toward quarterly allotments within which line ministries operate;
- Improve transparency and performance orientation of spending by adopting program classification within ministries. The MOFE should work with line ministries to identify major programs within each ministry; a budget classification should be jointly developed that accurately captures the objectives of programs. Later, outcomes for the programs should be identified to further build the link between inputs and objectives/outcomes; and

- Upgrade the DSU financial management capacity by appointing a Chief Financial Officer in each DSU, responsible to the MOFE for financial management.

80. Furthermore, a prudent approach should be adopted for the closure of the Clearing and Payments Service (ZOP), while fiscal adjustment is underway and capacity in revenue administration and treasury operations is being built.

81. **Audit.**³⁴ Effective external and internal audits maintain the integrity of financial management and the accountability for the use of public resources, and help assure that government policies are effectively carried out as presented in the enacted budget. Serbia has no external audit function, while the internal audit (budget inspectorate) is severely under-resourced and lacks modern approaches. Nonetheless, the internal audit was effectively used in 2001 to review fiscal year 2000 spending, though with temporary additions to its staff. While an external audit will take longer to implement, **the PEIR recommends** that the Government takes the following near-term steps:

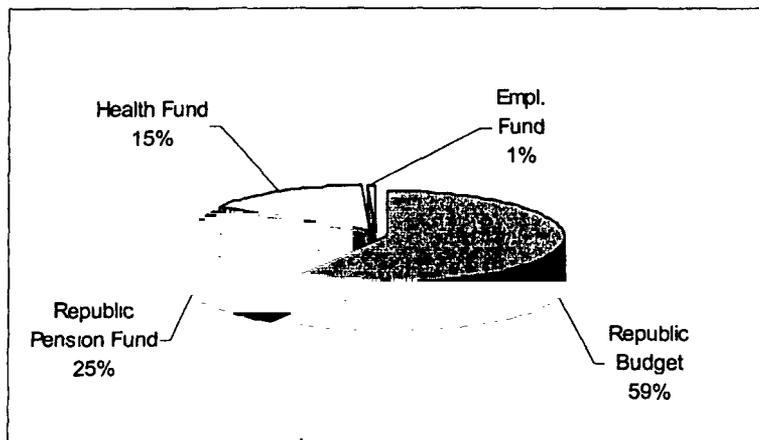
- Strengthen significantly the internal audit at the MOFE, in line with the new LBS, building on the existing budget inspectorate. In the medium-term, develop the audit function within DSUs; and
- Continue work with Parliament in identifying external audit models and make a decision on an appropriate model for Serbia.

³⁴ Accountability and audit are also discussed in *FRY Country Financial Accountability Assessment*, and *FRY Country Procurement Assessment Review*, published by the World Bank simultaneously with this report.

MONTENEGRO

82. The key themes in public expenditure reform in Montenegro differ somewhat from those in Serbia, primarily because of the earlier start and faster pace of public finance reform, the more limited local institutional capacity to sustain the reform process, and the resulting greater dependence on external support, both financial and human. Another specific aspect of Montenegro's fiscal system is the phasing out of ties with the Federal Government over the past four years. Figure 4 presents the structure of the consolidated central government spending.³⁵

Figure 4: Montenegro: Consolidated Central Government Spending, 2001
(Percent of Total)



Note: Republic budget consolidated with social funds. Data on local government spending are not available.
Source: World Bank staff estimates.

EARLY REFORMS

83. The legacy of poor economic policies during the SFRY period, together with sanctions that have also affected Montenegro, have weakened its economy and undermined fiscal sustainability. Soon after the 1997 elections, the new government moved toward more dynamic market mechanisms. Steps were taken to stabilize prices and to eliminate trade distortions. In 2000 the customs tariff structure was simplified and the average tariff rate was cut to less than 3 percent. The introduction of the Deutsche Mark as legal tender helped to reduce inflation from over 100 percent per annum in 1999 to 12 percent in 2002.

84. Given the absence of a monetary and exchange rate policy, the government's attention turned to the fiscal sphere. One of the first steps towards fiscal stabilization was a significant

³⁵ Comprising the Republic budget and the social insurance funds. Local government is excluded due to data limitations.

increase in the administered prices of electricity, which reduced relative price distortions and improved the still fragile financial position of the state-owned power company, EPCG. In 1999 the government introduced strict limits on bank lending, in order to stabilize the banking system and to reduce risks to the budget.

85. In 2001-02, reforms accelerated. Prices of basic foodstuffs were liberalized. New measures were instituted to target social assistance and child allowances to the poorest. Significant steps have been taken to restructure the enterprise sector, and to create a sound banking system, including the establishment of the core central bank functions. A comprehensive set of regulations is being set up to govern the licensing provisions, financial reporting and performance requirements for commercial banks. A bankruptcy and liquidation law was passed, defining the triggers and procedures for actions on insolvent banks. Many important reforms in public financial management were initiated.³⁶ On the revenue side, two packages of tax laws aim to rein in tax evasion through improved tax administration and collection, and to expand the revenue base. In 2003, the government expects to further boost the collection of indirect taxes by introducing a VAT.

FISCAL SUSTAINABILITY

86. Notwithstanding the progress made in many areas, the agenda for reform is at an early stage across all sectors. Adjustment is required to eliminate distortions in the enterprise, banking, and other sectors. In 2001, the budget deficit amounted to 5 percent of GDP (before grants), only slightly higher than planned, but the actual allocation of spending across major categories deviated considerably compared from the legislated amounts. The prioritization of wages and other consumption commitments in the budget has turned capital expenditure into a residual item. The deterioration of public capital stock has resulted in lower quality public service, possibly large contingent liabilities, and arrested growth.

87. The finances of the social funds reflect an unpredictable and weak link between their principal sources of funding and the legislated benefits. Contributions do not fully cover expenditure commitments. The sustainability of the social protection and welfare system is further undermined by tax evasion, exemptions from taxes, and unstable contributions from the Republic budget. As a consequence, the main insurance funds often depend on excises, taxes, import duties, and foreign grant assistance. Without these additional sources of funding, the Pension Fund would have had a deficit of over 5 percent of GDP in 2001. The situation of the Health Fund is worse, since its financial position depends on transfers from the Pension Fund for the health care of the pensioners.

88. Fiscal pressure on the social funds and the Republic budget is likely to increase significantly in the near future without further reforms. The tendency to increase spending in accordance with the growth in revenues is institutionalized by laws and practices governing the system of entitlements, particularly the social insurance schemes. Budgetary pressure is also likely to increase over time as new commitments are brought into the Republic budget. In 2002 Montenegro began making contributions for its share of the FRY's external debt service payments. Interest payments are projected to rise from 0.1 percent of total spending in 2001 to 4.8 percent in 2002. Over time, debt service will increase substantially as grace periods on

³⁶ A detailed analysis of these reforms is presented in Volume Three, Chapter 1.

restructured debt expire and new debts are serviced. More resources will also be needed to mitigate the social costs of bank and enterprise restructuring. In 2002, these costs are budgeted at about 0.7 percent of GDP. Given the magnitude of the financial problems existing in these sectors, claims on social assistance programs are likely to increase in the near future.

89. Fiscal sustainability could also be challenged by the decline of external grant financing. Both the Republic budget and the social funds are now critically dependent on concessional foreign financing, particularly grants from the EU and USAID. Foreign grants in 2000 totaled 9 percent of GDP, and in 2001-02 they will average about 3.0 percent of GDP, closing about 60 percent of the fiscal gap. This level of fiscal support is unlikely to continue indefinitely. Foreign donors are wary of creating aid dependence, while competition for grant resources is growing internationally. Future financial assistance will be more closely tied to policy performance. Given that grant support will tend to decline and spending will tend to rise in the future, Montenegro is left with few policy options with which to ensure fiscal sustainability. Recent experience suggests that measures to increase revenue alone are not likely to close large fiscal gaps. In 2001 efforts to improve tax collection produced only modest results. The burden of taxation is already high, and tax evasion could limit the efficacy of attempts to boost revenue.

90. As new commitments come on budget, Montenegro will need to substantially reduce spending in other areas, and to improve its budget management. As it is often socially costly and politically difficult to reduce the role of government in the economy, it is often tempting to delay expenditure adjustment or use the debt creation to offset the eventual loss of grant assistance. To some extent this is already happening. Net domestic borrowing was 2 percent of GDP in 2001. As relations with foreign creditors become normalized, Montenegro may gain access to foreign lending on relatively hard terms. In the absence of adjustment, excessive reliance on such non-concessional funding could pose long-term risks to the Republic's creditworthiness.

91. The current fiscal stance suggests that deficits in the order of 4.5 to 5.0 percent of GDP,³⁷ before grants, would persist without substantial policy reform. In the not too distant future such deficits will not be sustainable, as the resources available to finance them will diminish. The situation could be further aggravated by excessive debt accumulation. In 2001, Montenegro launched its first Treasury bill issue. Given that the domestic investors currently accept only very short maturities, Montenegro may have to roll over a stock of very short-term debt, which would compound very quickly.

92. An analysis was undertaken for this review to determine the level of fiscal deficit that is sustainable.³⁸ Assuming that private sector crowding out is minimized, and that the public debt to GDP ratio is stabilized at around 35 percent of GDP, the sustainable fiscal deficit, including the central government and the social insurance funds, should be on the order of 2.5 percent of GDP by the end of the decade. In the short term, the deficit can be higher, but over time macroeconomic stability requires that the long-term sustainable rate be not exceeded. This means that the primary balance will need to improve from -4.8 percent of GDP in 2001 to -0.5 percent

³⁷ GDP estimates used here equal 1.25 times the IMF estimates of net material product (NMP), which excludes of the "non-material" sphere, including education, culture, public health, banking, insurance, government services, and defense. The Authorities estimate that GDP is 25 percent larger than NMP.

³⁸ For greater detail, see Volume Two, Chapter 2.

in 2010. As some expenditures will increase, including debt service and capital spending, this requires even deeper cuts in other expenditures.

93. **Quasi-Fiscal Activities.** As in Serbia, the broader public sector is still being used by the Government of Montenegro to provide hidden subsidies to politically sensitive enterprises and groups. Not only are these hidden subsidies unaffordable; they discriminate against more efficient new businesses and thus hamper growth. Prospects for private sector development would improve with the elimination of these quasi-fiscal deficits and with enhanced financial discipline.

94. In this context, the restructuring of the enterprise and financial sectors needs to be managed carefully to avoid the transfer of major liabilities to the budget. In the short run this calls for privatization, forced liquidation, and other means of corporate restructuring. In the long run, sustained efforts to strengthen the regulatory, supervisory, and judicial frameworks to ensure contract enforcement, creditor rights and proper financial standards will be required. While Montenegro is already in the process of establishing the proper statutory framework in the banking system, capacity to supervise institutions and to enforce prudential regulations needs to be enhanced.

95. The severe financial imbalances of the Montenegrin electricity sector have important implications for fiscal sustainability. The Republic's power company, EPCG, operates with tariffs that do not cover its costs fully; its collection rates, while rising, are still low. As a consequence, it postpones the much-needed maintenance and system upgrades. EPCG effectively subsidizes both households and state-owned enterprises, such as KAP - the Republic's aluminum producer. EPCG must also cope with unstable coal supplies, which are due to the financial, technical, and organizational problems of the coal mines. In 2001-02, these problems led to the failure to meet demand during the winter months. An unreliable electricity supply distorts business incentives and leads companies to purchase backup generators rather than to undertake electricity-saving investments. Households use subsidized electricity for heating and have few incentives to conserve it. All this exposes the Republic budget to the risk of significant losses.

96. Revitalizing banks and businesses should continue, as it is crucial for reducing unemployment and alleviating poverty, as well as for ensuring fiscal sustainability. In the electricity sector, improving fiscal performance and ensuring stable supplies of electricity calls for reform measures to improve resource management and productivity. To lower the risks of the reform strategy, **the PEIR recommends** the following short term steps:

- Limit new debt issuance to contain debt service costs and to avoid the crowding out of private borrowers. This should be done soon, and retained until significant improvement of the Republic's debt carrying capacity;
- Establish a fiscal risk management function at the MOF;
- Raise electricity tariffs to cover operating and debt service costs, improve financial management at EPCG to cut supply costs, implement a collection policy to reduce barter and offsets, and audit the accounts of EPCG; and
- Promptly increase maintenance spending at EPCG, and consider selected key investments for 2003.

97. For the medium term, the **PEIR recommends:**

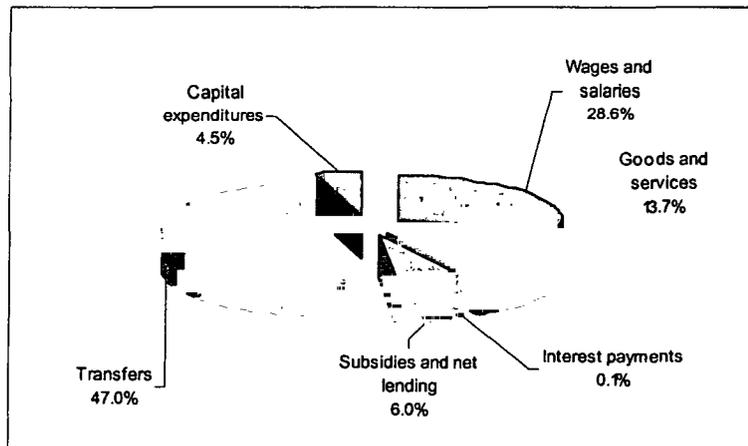
- further develop the fiscal risk monitoring function in the MOF, begin preparing a fiscal risk statement annexed to the annual Republic budget;
- reorganize the coal mines that supply EPCG to reduce waste and boost productivity, possibly including private sector participation; and
- reduce KAP's dependence on low tariffs and diminish the risks it poses to the public finances.

ALLOCATION OF PUBLIC SPENDING

98. Incomplete budget comprehensiveness, and the existence of a large extrabudgetary sphere, which is less transparent than the Republic budget, complicate the analysis of the allocation of public spending. A large part of donor money is spent outside the budget, and is not reported. Pre-2000 data are not fully comparable with the recent past, owing to the existence of multiple exchange rates prior to 2000. Furthermore, the budget has run up significant arrears, which makes cash spending an inadequate gauge of allocative patterns. With these limitations in mind, the key allocative patterns in Montenegro can be tentatively described as follows:

- Spending on **public sector salaries** is above 12 percent of GDP - higher than in almost any other CEEC. The real wage bill is even higher, since reported data exclude temporary workers, funded from the goods and services budget;
- Spending on **non-wage goods and services** was low if corrected for the wages of temporary workers, and may be insufficient to properly maintain public assets. This spending is volatile, suggesting its use as a balancing item;
- **Social transfers** are above the regional mean and closer to economies with a much higher GDP per capita. This raises affordability concerns;
- **Subsidies and net lending to enterprises** were about 2.6 percent of GDP in 2001, or about 6 percent of total spending – significantly lower than in Serbia. Subsidies (1.2 percent of GDP in 2001) go to public and socially owned enterprises such as EPCG. In 2002 they are budgeted to rise, which may be disturbing unless a strong enterprise reform is implemented. In addition, budget lending to enterprises reached 1.4 percent of GDP, more than doubling compared to the legislated levels. Interest rates on budget loans are below inflation, with the budget absorbing the difference;
- **Capital spending** was low at 2 percent of GDP (1999-2001). In addition, substantial levels of capital spending were funded by international donors outside the Republic budget, and little data are available to determine whether total capital spending was adequate and how efficient it was; and
- **Interest payments** have been very low but will jump to 2 percent of GDP in 2002. They will continue to rise in the future, constraining the fiscal space.

Figure 5: Montenegro: Economic Composition of Government Spending, 2001
(Percent of Total)



Source: Montenegro MOF, World Bank staff estimates.

99. The non-discretionary component of public spending (wages, social entitlements, and foreign interest payments) dominates the picture. It is set to grow further, as external debt is regularized and bank and enterprise restructuring increase the need for social support. These rises would be acceptable if accompanied by structural reforms delivering efficiency gains. Otherwise, the ongoing upward drift of non-discretionary spending could signal the continuation of the unsustainable policies of the recent past.³⁹

100. Key patterns in the functional distribution of Montenegro's general government spending are as follows⁴⁰:

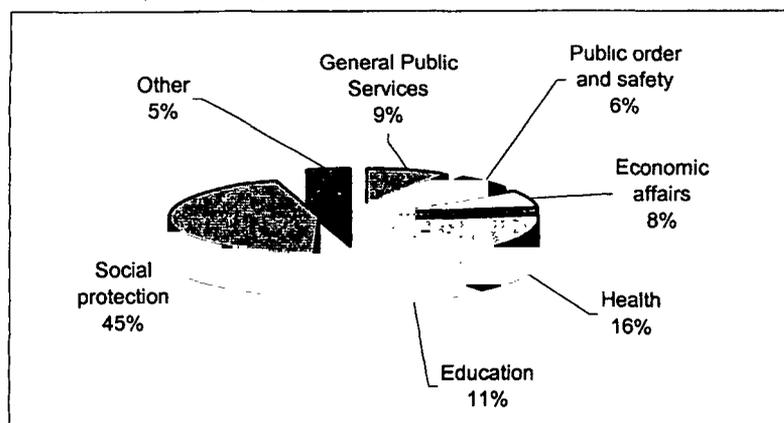
- The two largest functions are **social protection** (including pensions) and **health**, together accounting for 61 percent of central government spending;
- Spending on **general public services** was close to 9 percent of the total in 2001 – a rather high level of spending on administration (interest payments were still negligible in that year). The bulk of this spending was for administrative costs of the Government;
- Recorded **public order and safety** spending is in line with regional comparators⁴¹; and
- **Education** spending is large - about 11 percent of the total, which is comparable to wealthier countries. Efficiency problems have been documented in this sector.

³⁹ Further details are found in Volume Three, Chapter 3.

⁴⁰ As in the presentation of the economic classification above, local government is excluded. The shares presented in the chart are based on planned outlays.

⁴¹ In 2001-2002, several foreign observers noted that the numbers of police were quite high compared to Montenegro's population, possibly higher than in any other European country.

Figure 6: Montenegro: Structure of Government Spending by Function, 2001
(Percent of Total)



Notes. Data are for the legislated 2001 budget and consolidate Republic-level spending (incl. social funds) Outturn data for 2001 in functional breakdown and data for local governments are not available.

Source: Montenegro MOF, World Bank staff estimates.

101. **The PEIR recommends** that the government consider the following near-term measures to rationalize the allocation of public spending:

- Complete the transition to GFS classification, to allow informed decisions by the authorities on the allocation of public funds;
- Freeze the public service wage bill in real terms, formulate a medium-term public service reform program aimed at reducing this wage bill;
- Tie subsidies and budget loans to public enterprises explicitly to defraying the costs of restructuring, and formulate a medium-term program of phasing out these subsidies and loans altogether;
- Identify sectors where spending rationalization offers the most significant savings and formulate specific programs for them (e.g., for general public services);
- Review the allocation of spending within the education function, formulate measures to improve the efficiency of this spending and its adequacy to the needs of the reforming economy;
- Bring all aid-financed capital spending on budget; and
- Identify key public investment activities and protect them with due attention to their efficiency.

SPENDING ON PENSIONS AND HEALTH CARE

102. The Montenegrin **pension system** is unsustainable, with legal obligations toward pensioners and other beneficiaries well in excess of contribution revenues. The system deficit⁴² in 2001 was on the order of DM 110 million, or 5.6 percent of the Republic's GDP. The Government is projecting the deficit to fall in 2002 to 4.3 percent of GDP, but this is heavily dependent on improvements in contribution compliance, which may be hard to achieve. The Government itself is not in full compliance with its contribution obligations.

⁴² Defined here as the difference between all legal obligations of the Pension Fund (including non-pension benefits and pensioners' health contributions) and contribution revenues (for greater detail, see Volume Three, Chapter 4).

103. The main factors underlying the pension system deficit are: (i) a sharp decline in the ratio of contributors to beneficiaries to the current level of 1.4; (ii) overly generous benefit provisions (with average replacement rates around 90 percent, and higher for old-age pensions); and (iii) historical factors which allowed the structural imbalances to persist, with system deficits being met with Federal transfers that ceased in 1998. The short-term remedies used to date to meet the deficit (reliance on additional taxes and/or budgetary support and donor assistance) are not sustainable. Recent measures to make the subsidy to the pension system more transparent by replacing “redirected” funds⁴³ with an earmarked subvention from the budget to the Pension Fund are a step in the right direction. The PEIR recommends that for the 2003 budget the Republic Government:

- Implement measures to replace all hidden subsidies with explicit ones; and
- Undertake systemic reforms to limit the growth of pension spending, including measures to (i) raise the retirement age and the effective age at retirement, (ii) change the benefit formula to bring benefits more in line with contributions, and improve incentives for work and compliance; (iii) change the indexation so as to move away from full wage indexation, and (iv) improve the certification of disability pensioners.⁴⁴

104. In the medium term, the Government may wish to encourage the diversification of sources of pension income by introducing privately managed mandatory and voluntary funded pensions. Such measures should be carefully planned, so as to be consistent with the macroeconomic and balance of payments position of the economy, the ability to finance transition costs, and the institutional capacity for implementation.

105. The structural problems of Montenegro’s health care system are the high level of arrears and debts accumulated by the system, the lack of an adequate incentive structure, and the close to universal coverage, with increasingly weak links between contributions and entitlements to services. Coupled with declining employment, stagnant wages and contributions, and a liberal package of services, these problems have led to a large accumulation of debts on the part of the Health Insurance Fund (HIF) and the health facilities. On the delivery side the generous health care package is unaffordable in the current economic situation and the separation of financial responsibilities and decision making - resulting from current contract arrangements - creates perverse incentives, which reduces efficiency in the system. To improve the sustainability of the health care system, the PEIR recommends that the Republic Government takes the following near term steps:

- Create a list of “vulnerable individuals” entitled to receiving health care financed out of the Republic budget and transfer to the HIF annually a sum equivalent to the contributions these individuals would have paid had they received the minimum wage;

⁴³ These are mostly customs duties, which legally are due to the Federal Government and were redirected to the Montenegro Pension Fund after the Federal Budget discontinued making its transfers in 1998.

⁴⁴ Many of these measures have already been included in the draft Law on Pensions approved by the Government in mid-2002.

- Discontinue exceptions from the payment of contributions by companies in financial difficulties and enforce the timely payment of contributions by all employers; and
- Formalize the out-of-pocket payments into co-payments to be paid to the HIF or directly to the health care facilities, reflecting the provisions of the draft law currently under discussion.

106. In the medium-term, the Government should transfer responsibilities for collection of health contribution for pensioners and the unemployed from the other social funds to the HIF; and improve the accountability by setting up an adequate health information system to monitor the financial status of all components of the health care.

107. Previous sections have considered sustainability and allocation issues, both economy-wide and with regard to the two largest components of the social safety net. Sub-optimal outcomes of Montenegro's public expenditure are also related to the its budget management practices. The following section assesses these and offers reform recommendations.

REFORMING BUDGET MANAGEMENT

108. Montenegro has made tangible progress in public expenditure management reform, especially in passing new laws, but does not have fully operational institutions and tools to manage its fiscal situation. Key missing pieces include: a multi-year perspective; a comprehensive budget; an integration of policy into budget formulation; comprehensive commitment controls; budget monitoring and stronger auditing in budget execution; a general approach of stewardship for all public finances; and a communication strategy to support the fiscal reforms. Montenegro's key challenge is to complete the implementation of the PEM reforms already initiated.

109. A multi-year fiscal framework for the 2001 donor conference was produced outside the MOF and on an ad hoc basis. Maintaining a one-year perspective often leads to spending reductions that may be least difficult politically but that may also be the most damaging over time, such as cutting capital investment and maintenance spending. Moreover, a multi-year framework far more accurately reflects the true implications of today's decisions and helps to avert future fiscal crises and to maintain a sustainable fiscal balance.

110. **The PEIR recommends** that in the near term the MOF develop a systematic multi-year public revenue and expenditure envelope, based on conservative growth and public revenue assumptions, government spending estimates that fully reflect current legal and policy commitments, and realistic financing expectations. This work could be initiated with the development of a three-year fiscal model comprising both the Republic budget, the social funds and the local governments,⁴⁵ and all policy commitments such as the clearance of budgetary arrears, social enterprise and bank restructuring, normalization of external debt servicing, and reform of the social safety net and health care systems.

111. For the medium-term, **the PEIR recommends** that the MOF:

⁴⁵ Inclusion of local governments in the comprehensive framework should not be viewed as a constraint on their fiscal autonomy, but as an analytical tool. This inclusion reflects the fact that any adverse developments in the broader public sector may affect the fiscal sustainability of the Republic.

- Prepare regularly a fiscal policy paper, discussing options for bringing fiscal balance to government accounts; use this paper to inform the Cabinet on the multi-year situation, to educate the public and the Government policy officials about the fiscal situation and available public choices, and to build consensus for the necessary retrenchment measures; and
- Begin developing a mechanism to produce multi-year cost estimates for new policy proposals, and to ensure that these costs are included with the proposals when presented to the Cabinet, including information on whether these costs are affordable over the medium term.

112. Comprehensive Budget. It is difficult to achieve spending targets, and policy objectives, or manage fiscal risk without a comprehensive picture of planned spending. The General Balance Table prepared by the MOF includes Republic and Social Funds' balances, and most own revenues of DSUs. This provides a relatively comprehensive picture of the public sector. But some donor financing and own revenues remain off budget, and the comprehensive perspective of the General Balance Table is not carried forward into the state budget. Capital spending is reflected in the budget with only one line per project. It is important to reflect capital projects in the sector or program to which they apply to improve transparency as well as incentives for sound sectoral policies. **The PEIR recommends** that the MOF takes the following near term measures:

- Continue using the General Balance Table, present it on a net basis, and incorporate it into the fiscal policy paper mentioned above;
- Incorporate as quickly as feasible all international aid into the budget, to provide a comprehensive picture of the fiscal situation and the resources devoted to each sector; and
- Begin setting sectoral spending ceilings early in the budget process, and guide the spending ministries to develop their programs and budgets, both capital and recurrent, strictly in line with these ceilings. The spending ministries themselves must seek the mix of inputs (salaries, capital) that will most efficiently achieve their objectives.

113. Integrating Policy with Budgets. Budget formulation is still being viewed narrowly as a finance function, with policy commitments and programs established outside this process, with little reference to financial implications. **The PEIR recommends** that in the near term:

- Policy issues are brought into the budget formulation discussions between the MOF and DSUs, as well as into the Cabinet review of the budget;
- As part of their budget requests, spending ministries identify of normatives or other laws that may not be fulfilled under indicative funding levels, and state whether the normatives or other laws need to be amended to avoid incurring liabilities or to improve the linkage of resources and policy; and
- The MOF develop the capacity to price new legislation and policies before the Cabinet considers and the Parliament votes them, and state whether the new proposals are affordable in the medium term.

114. **Comprehensive Budget Execution, Commitment Control and Budget Monitoring System.** It is difficult for a government to manage spending and reach fiscal targets without a comprehensive picture of actual spending during the fiscal year. It is also difficult to manage spending if there are no means during the year to control the rate of spending by government programs at a level that will meet the annual budget target. Simply triaging payables to available cash is too late in the process, and allows arrears to accumulate. Implicit in this notion is the hard budget target. Progress has been made in this regard through the interim Treasury system, but the process should be completed and comprehensive spending must be limited to the approved budget levels rather than to the normative output level. This may entail changing some laws to clarify the normative as the target, with achievement constrained by available resources.

115. The MOF needs some means of controlling commitments as well as monitoring the comprehensive government fiscal position during the year. This is particularly needed for identifying spending trends which, if left unchecked, would lead to arrears. **The PEIR recommends** that in the near term the MOF:

- Put in place a commitment control system⁴⁶;
- Until a Treasury system and a commitment control system are fully developed, collect monthly spending reports from DSUs, including all extrabudgetary funds, in a standard format that allows identification of where spending problems are occurring; and
- Produce for the Minister and for the Cabinet monthly summary tables of fiscal position, with projections to year-end, with problem areas identified.

116. Over the medium-term, **The PEIR recommends** that all DSUs, including the social funds, be fully integrated into the Treasury system, together with their own funds.

117. **Audit.** A very minimal capacity in internal audit exists within the MOF. In lieu of an external audit, the Government makes use of a private independent audit. These measures provide some assurance of the integrity of financial accounts, but there remains an institutional need for regular review of budget user records and accounting practices to ensure the integrity of the financial management system, to assure that funds are used as approved and that they are in compliance with new laws and procedures. **The PEIR recommends** that in the near term:

- The MOF fully develops an internal audit function, building upon the budget inspector function; and
- The Government and Parliament begin exploring external audit models and take steps to develop an appropriate external audit capacity.

118. **Stewardship and Responsibility.** Generally, a broader role and set of responsibilities for the MOF is required. The MOF must assume the role of steward of public resources, counterbalancing the line ministries' inclinations to overspend. The MOF has a role in enforcing approved government decisions on spending, monitoring compliance with decisions, and actively managing the public finance system and its development. Good financial management is also the responsibility of all spending units. Each government entity should be accountable for the

⁴⁶ See Volume Three, Chapter 5.

resources it spends, with the MOF setting standards and monitoring performance. This must be clearly communicated to all spending units.

119. The government and the MOF must take pains not to do what is expedient to meet a momentary crisis. Seeking expedient expenditure cuts, such as in investment or maintenance spending, does not remove the structural imbalances or provide a permanent reduction in spending. Engaging in non-transparent financing arrangements for selected companies undermines both the public expenditure system and government credibility. Taking decisions outside the budget process without reference to financing consequences also undermines confidence in the government and the budget process. Expedient choices may be the path of least resistance at the moment, but they delay the necessary adjustment of the public and private sectors. The MOF has an important role in advising policy officials on the consequences of their actions and in developing appropriate options for pursuing government objectives.

120. **Communication Strategy.** An often under-emphasized dimension of budget management practices is a communication strategy. It is critical to the success of reforms, in terms of allaying fears and misunderstanding regarding proposals and educating citizens on the current problems, the options for change, and the reasons for choosing a certain course of action. Beyond educating officials and politicians, an active communications strategy assists government staff that implement reforms to better understand these reforms and thereby to more successfully implement them. Such a strategy helps citizens, the civil society, and businesses to adapt to change and to work with, rather than against the new direction. The PEIR recommends that the Government initiate promptly regular dialogues with the public to prepare any significant steps necessary to assure the fiscal health over the medium term.

KEY ISSUES IN FEDERAL BUDGET MANAGEMENT

121. This section focuses on the budget management issues of the Federal Government. Other broad themes of fiscal sustainability, allocative efficiency and of pension and health care reform, inasmuch as they concern the Federal Government, are addressed in the Serbia section of the summary (paras 22 ff.).

122. **Overall Assessment.** In terms of aggregate fiscal discipline, the Federal PEM system faced mounting problems. In the nineties, it matched revenues with expenses; however, in 2000, in-year downsizing without a Treasury and a commitment control system generated significant arrears. They were cleared by the end of 2001, only to re-emerge in 2002. In addition, large off-budget arrears are reported in the defense sector. Allocative efficiency issues were of lesser concern, since defense consumes about three-fourths of Federal budget.

123. With regard to technical efficiency, there is insufficient analysis or data to draw a firm conclusion. However, the World Bank's CPAR indicated that procurement performance might be poor.⁴⁷ The Federal civil service is not reformed, and personnel costs are a significant part of the Federal budget.⁴⁸ The absence of multi-year planning and the separate capital budgeting process probably led to sub-optimal resource allocations and higher unit costs. In sum, the Federal budgetary system did not favor technical or operational efficiency.

124. The Federal budget was generally comprehensive, including own revenues, donor funds, and military pensions. Most federal agencies were included in the budget, and their integration into the general public expenditure system was increasing over the past years. However, defense spending was never fully integrated into the PEM processes, and a registry of government agencies was lacking, which did not allow to clearly define the public sector and to assure that all elements are indeed on budget. With regard to the budget execution practices, the absence of a Treasury and commitment control system, a debt management office, and an external audit, as well as a weak internal audit, posed systemic risks to sound financial management and sustainable policy.

125. No information is available for gauging the accuracy and authoritativeness of Federal accounts, but the absence of external audits and the need for more extensive internal audits suggest a significant risk of inaccurate or unauthorized spending. Among career public servants, there was a high degree of respect for the law and for proper procedures, and the control environment seems reasonably strong. A breakdown in the control environment and apparatus

⁴⁷ The World Bank's *Country Procurement Assessment Review* observed that competitive contracting was not general practice throughout the Federal Government.

⁴⁸ Wages and employer contributions were 32 percent of 2001 Federal budget recurrent expenses -- 45 percent if employer transfers to military pensions were included.

occurred during the 1990s at the political level, rather than at the civil servant level. The transparency of Federal budget was inadequate: while the budget was published in the Official Gazette, monthly spending and other detailed reports on budget formulation and execution were not widely available. Very little information on defense-related spending was available to the broader executive, and even less to the public of Serbia.

126. **Recent reforms and outlook.** In the last years of its existence the Federal Government had started public expenditure reforms, but upon the March 14, 2002 agreement between Serbia and Montenegro they have stopped. Whatever structure emerges as the successor to the Federal Government, it will need to maintain high standards for the transparency and management of public finances it receives, no matter how modest is their size, assuring the credibility and integrity of the new union. Currently, the Serbian and Montenegrin governments envisage that the future union Government will use Republic-level core services in Treasury, procurement, accounting, and internal and external audit. While it is still difficult to envision how such structure will function in practice, broad principles of accountability, efficiency and transparency should be maintained for public funds spent at the union level no less forcefully than at the Republic level.

CONCLUSION

127. Notwithstanding the degree of fiscal stabilization already attained in Serbia and in Montenegro, deeper reforms are needed. Expenditure policy should allow more room for discretionary spending, but with the proper controls in place. Significantly more fiscal adjustment is needed to expand the entrepreneurial space and to lower the entry barriers for new businesses. Of particular importance are reform measures in the electricity sector. Better targeting and reform of social programs is needed to eliminate waste and to free up resources to serve the economically vulnerable. The pace of change in budgeting practices should be accelerated. Finalizing budget consolidation will prevent the fiscal pressures in the broader public sector from hurting the budget. Mechanisms must exist to cut back policy over-commitments and to measure the efficiency of each spending item. Strong follow-through is needed in budget execution and financial controls, through the implementation of an effective Treasury and independent budget audit institutions.

128. Unless further fundamental improvements are made to the processes for formulating public policy, allocating resources, and implementing budgets, economic recovery in Serbia and Montenegro will be fragile and short-lived. Both Republics have stated their intention to begin preparations for eventual EU accession. This should provide further impetus to expenditure reform, as they will have to meet the Maastricht fiscal responsibility criteria. Eventually, complying with the *acquis communautaire* could require an increase in spending in such areas as education, environmental standards, and transportation. Since the two Republics will carry a large external debt (even after a highly concessional rescheduling), the scope for slowing fiscal reform is simply not there.

129. Several risks bear close monitoring. One is limited capacity, which warrants extra attention to the choice of reform priorities and to sequencing. Another is fiscal decentralization, which calls for caution in balancing the responsibilities with revenues, delivery capacities and proper accountability arrangements at each level of government. Risks may arise from the large non-discretionary component of public expenditures and the impracticality of increasing public revenues further. Insufficient accountability of public spending calls for capacity strengthening in audit and financial management. On the revenue side, attention is needed to strengthen the revenue administration regime.

130. Public expenditure management reform is a medium-term challenge, requiring a robust budget process and unwavering follow-through in formulating and implementing sustainable macro/fiscal and sectoral policies. The other two volumes of this Review provide a more detailed examination of the key areas in which reform is needed, and discuss the necessary steps for delivering a sustainable and efficient fiscal system over the medium term.

