SIGMA

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SERBIA

PUBLIC EXPENDITURE MANAGEMENT

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1. Legal and Institutional Framework

The organic budget law is adequate, but fundamental fiscal relations need to be clarified.

Fiscal matters in the Republic of Serbia are regulated by the organic budget law of 2002 – the Budget System Law. This law outlines the preparation, execution, reporting and control of the central government budget, the five extra-budgetary funds and the 145 local self-governments' budgets. Procedures for parliamentary approval of the government's budget proposal are regulated in the Rules of Procedure of the National Assembly of the Republic of Serbia of 2005 (articles 150-154). The 1990 Constitution does not cover fiscal matters, except for article 69, in which it is stipulated that the Republic of Serbia should have a budget showing revenue and expenditure.

The fundamental division of fiscal power between the legislative and the executive could be better spelled out, preferably in the Constitution. Parliament's unambiguous obligation to authorise all revenue, expenditure and borrowing, and the issue of accountability between the executive and the legislative are matters that should be more explicitly treated in legislation. Parallel to this, consideration could be given to a review of the procedures for passing the budget through parliament. According to the Rules of Procedure (article 151), the sectoral committees should assess the budget and submit reports to the Finance Committee, which in turn presents a report to the National Assembly. Based on the Finance Committee's report, the Assembly votes on the budget in one session. To ensure a proper review of the government's budget proposal, a multi-stage voting scheme could be introduced. In order to promote fiscal discipline, such a voting procedure should start with overall fiscal parameters, such as the approval of total revenue and expenditure, and continue with a cascading division into more detailed budget items.

In the event that parliament does not approve the budget before the start of the new fiscal year, the Budget System Law (article 28) provides instructions on how a temporary budget for the first quarter should be executed. In such a case, the Ministry of Finance should repeat the budget for the first quarter of the previous budget year.

The Budget System Law provides an adequate and sufficiently detailed regulation of the budget process. As the development of budget preparation and budget execution progresses (see sections below), it will nevertheless be necessary to update the Budget System Law. Government sector accounting is currently regulated through a government decree. An accounting law for the government sector is under consideration.

There is scope for strengthening parliament's role in fiscal matters.

Fiscal relations in Serbia are characterised by a strong position of the government and a relatively limited involvement of parliament in fiscal affairs. According to the Budget System Law (articles 6 and 25), parliament should approve the state budget and the financial plans of the extra-budgetary funds. Since the budget also includes limits on borrowing and on the total amount of guarantees that can be issued (article 55), parliament formally has to sanction all financial liabilities that the government incurs. Although parliament approves the state budget, it is not in a position to seriously challenge the government's proposal. According to the Budget System Law (article 14), the government should submit its budget proposal to parliament no later than 1 November. Parliament is required to adopt the budget by 15 December. Such a short time frame is not in line with international good practice (for example, OECD Best Practices for Budget Transparency), and gives insufficient time for a proper scrutiny of the budget. In addition, there is limited capacity within parliament to carry out a thorough review of the contents of the budget. The Finance Committee, for example, only has one staff member to prepare material on the government's budget proposal. Parliament's weak capacity to scrutinise the government's budget proposal is an issue that should be addressed.

In accordance with the Budget System Law (article 26), any amendment proposed by parliament that leads to increased expenditure in relation to the government's budget must be accompanied by a corresponding decrease of expenditure elsewhere in the budget or by a proposal for increased revenue.

Significant changes in current-year expenditure require parliamentary approval through a supplementary budget. According to the Budget System Law (article 41), the government has the mandate to make reallocations between appropriations of up to five per cent of the initial figure. More substantial changes must be approved by parliament.

Although the executive is required to submit final accounts to parliament (Budget System Law, articles 63 and 64) no later than 1 July, such accounts are currently of limited value. In the absence of a supreme audit institution, there is no independent statement on the reliability and quality of the accounts provided by the government. Parliament lacks resources to evaluate the contents of the final accounts, and this is a precondition for a meaningful approval. The development of a supreme audit institution has now been put on the agenda and, after lengthy discussions, a law was adopted to that effect in November 2005. Such a development is naturally welcome, but a great deal of efforts and resources will be needed to establish the institution.

Consideration should be given to the integration of extra-budgetary funds into the budget, the elimination of ear-marked revenue and a better presentation of fiscal risks.

The budget is divided into two parts, with the first part containing main fiscal parameters, together with the macroeconomic framework on which the budget is founded. The second part of the budget is made up of appropriations for first-line spending-units – direct budget beneficiaries – and second-line spending-units – indirect budget beneficiaries. All appropriations are classified according to an organisational, functional and three-digit economic classification. Appropriations for investment purposes are included in the budget.

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

In a number of areas, budget-users have the mandate to use revenue collected in connection with activities performed by the organisation to cover expenditure. In addition, the Budget System Law allows for "budgetary funds" (articles 44-47), by means of which taxes and other revenues are earmarked for a special purpose. Since all transactions are executed by the Treasury, and there is a budget classification indicating whether the source of the expenditure comes from the budget or from own revenue, budget accounting is on a full gross basis. The use of earmarked revenues is an obstacle, however, to the process of allocating resources between various objectives in accordance to political priorities.

The budget contains practically no information on fiscal risks. According to the Budget System Law (article 10), the budget should include an assessment of outstanding guarantees and other contingent liabilities. In practice, such information is largely missing from the budget document. According to the same article, the budget should contain a tax expenditure report. Such information has not yet been included in the budget. It should be pointed out that credible estimates of fiscal risks and tax expenditures would require a thorough review of, and decision on, evaluation principles, the development of appropriate models and the access to information currently not provided in the administration.

The budget document is heavily focused on the line-item division of expenditure. This may be adequate to closely monitor expenditure, especially given the relatively undeveloped internal control systems in budget-users. The inclusion of performance-related information could nevertheless make the budget more accessible and could facilitate the evaluation by parliament and by the public of the government's proposed policies and previous years' results.

A medium-term budget framework is outlined in the organic budget law but is only partially applied in practice.

The Budget System Law reflects an ambition to apply a three-year perspective in the preparation of the state budget. Current practice does not yet meet this aim, and revenue and expenditure are, to a large extent, only presented for the upcoming budget year. The implementation of a medium-term budget framework in Serbia should be of high priority as information on government finances beyond the upcoming budget year is necessary to formulate an appropriate fiscal policy. The production of medium-term projections is, however, only meaningful if the administration is able to produce realistic forecasts, and if this information is used in decision-making. A considerable challenge for the Serbian administration is to enhance the capacity to make macroeconomic and fiscal forecasts, both in the Ministry of Finance and in line ministries.

The starting point of the budget preparation process is the production of a budget memorandum, containing a medium-term macroeconomic framework, main fiscal parameters for the upcoming years and information on the government's main policy priorities (Budget System Law, article 14). The memorandum is prepared by the Macroeconomic and Fiscal Analysis Department in the Ministry of Finance, with some degree of input from other departments. The budget memorandum is adopted by the government by 15 May, and should constitute the basis for the continued preparation of the state budget and the financial plans of the extra-budgetary funds. An updated version of the budget memorandum is submitted to parliament together with the budget proposal. Significant improvements have been made in recent years with regard to the comprehensiveness and quality of the information provided in the memorandum. Nevertheless, the memorandum is still plagued by some deficiencies that prevent it from being an effective instrument for guiding the budget preparation process.

Firstly, overall fiscal parameters, such as central government revenue and expenditure and central government and general government net lending, are presented in the memorandum. It is, without a doubt, positive that the government's ambition is indicated. As the budget is not prepared in accordance with overall ceilings in functional or organisational terms, it is not possible, however, to translate the fiscal parameters into useful restrictions. Secondly, doubts can be raised as to the quality of the macroeconomic projections. Aside from the limitations caused by yet undeveloped forecasting models and a general lack of data of high quality, the reciprocal effects between fiscal policy and macroeconomic development are not fully taken into account. There are arguments for a more systematic organisation of macroeconomic forecasting rounds so as to take into account the macroeconomic effects of proposed policy. Thirdly, although the budget memorandum contains a medium-term framework, the budget is only prepared in a one-year perspective. According to the Budget System Law, the budget proposals that budget-users submit to the Ministry of Finance should contain information on the two fiscal years beyond the upcoming year (article 17). These projections should then be consolidated into the government's budget proposal, and parliament should be presented with a full picture of the development of government finances in a three-year perspective (article 10). In practice, the budget is still prepared strictly on a one-year basis, and there is no medium-term information on individual appropriations or revenue items in the budget-users' proposals or in the government's budget bill.

The budget process does not promote fiscal discipline.

Budget preparation is to a large extent an incremental bottom-up process heavily focused on a division of expenditure into line items, with limited attention given to performance-related aspects. The process starts with a forecast of relevant macroeconomic parameters and a specification of fiscal objectives for the medium term. This initial phase culminates in a budget memorandum, which also includes the government's main policy priorities. Based on the memorandum, the Ministry of Finance distributes instructions for the preparation of budget proposals to approximately 50 first-line budget-users and to the five extra-budgetary funds. These instructions contain macroeconomic assumptions to be used in the calculation of revenue and expenditure, the government's main policy priorities for the upcoming period, technical instructions on how to prepare the budget proposal and an indicative ceiling for operative expenses. Expenditure items – such as salaries, subsidies and grants and the purchase of equipment – are not included under the ceilings. Furthermore, budget-users are not prohibited from proposing expenditure above the ceilings. In accordance with the instructions, the first-line budget-users submit to the Ministry of Finance budget proposals that include expenditure for subordinate second-line budget-users. The proposed expenditure is divided into three parts: 1) baseline assessment of operative expenditure; 2) proposal for new, un-financed initiatives; and 3) expenditure for the purchase of fixed assets. There is no formal restriction on the expenditure a budget-user is allowed to propose, and there is generally a need for intensive negotiations between each of the first-line budget-users and the Ministry of Finance in order to reduce overall expenditure to levels that are consistent with the fiscal objectives outlined in the memorandum. Once the Ministry of Finance has finalised the budget proposal, it is submitted to the government for approval. By 1 November the government is required to submit the proposed budget to parliament. Parliament approves the budget, in a single voting session, by 15 December at the latest. The preparation and approval of the budget is summarised below.

Budget preparation and approval in Serbia

30 April	Minister of Finance proposes a budget memorandum with main macroeconomic parameters, fiscal policy and main government priorities for the upcoming three-year period
15 May	Government adopts the budget memorandum
1 June	Based on the budget memorandum, the Minister of Finance issues instructions, including a ceiling on operative expenditures, for the preparation of budget

	proposals from first-line budget-users and the extra-budgetary funds
1 August	First-line budget-users and extra-budgetary funds submit their budget proposals to the Ministry of Finance
1 October	The budget memorandum is updated with the most recent macroeconomic projections
15 October	Minister of Finance submits the draft budget and the budgets of the extra-budgetary funds to the government
1 November	Government adopts the budget and submits it to parliament
15 December	Parliament adopts the budget

The institutional arrangements in the budget preparation process, where budget-users' expenditure proposals are not restricted by firm ceilings, may lead to a deterioration of government finances, as the Ministry of Finance is unable to restrain pressure for increased expenditure. Considering the limited resources of the Budget Department, with a current staff of only 22 persons, the difficulties in ensuring financial discipline in the current institutional environment should be obvious. Since budget-users have the incentive to overestimate earmarked revenue so as to motivate increased expenditure, there is also the risk of increasing deficits. In order to provide stability to the budget process, promote fiscal discipline and ensure sustainable public finances, consideration should be given to a reorganisation of the institutional arrangements in the preparation and approval of the state budget, with the introduction of clear top-down elements. The devolution of budget preparation functions to line ministries and budget-users presupposes a well-developed capacity to produce credible estimates of administrative expenditures, as well as the cost of programmes, and a sufficient capability of the Budget Department to scrutinise these figures. Attention should be given to the continued development of expenditure forecasting in the Serbian Government administration.

Budget execution provides a satisfactory control of transactions, but liquidity constraints continue to be a problem.

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

The Treasury performs detailed control of all payment requests to ensure that the detailed line-item classification of the budget is complied with, that monthly cash apportionments are not exceeded, and that sufficient liquidity is available in the treasury single account to execute the payment. At the same time, the Treasury also registers all transactions in the treasury general ledger (see below for a discussion on government sector accounting). Through the centralisation of budget execution, a stringent control of transactions is possible.

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

Accounting and reporting

The Treasury is responsible for keeping a record of all transactions executed from the treasury single account. In this treasury ledger, there is a full documentation of all payments according to an organisational, functional, six-digit economic and source-of-financing classification. In addition to this purely cash-based accounting, work is being conducted to include accounting information on selected financial obligations and depreciation on investments for operational purposes. Such a modified cash basis has not yet been introduced, however. The budget and accounting classification is based on the IMF General Finance Statistics (GFS) 86.

In addition to the treasury ledger, first-line budget-users are required to keep accounting records of their own operations and the operations of subordinate second-line budget-users (Budget System Law, article 61). Through such accounts, it is possible for budget-users to make a more detailed division of the chart of accounts for the public sector, and, consequently, to satisfy the requirement for specific information. Deviations between treasury accounting and budget-users' accounting are, reportedly, not a problem. Nevertheless, it should be possible to produce accounting information that meets the demands of both the central and decentralised levels through one single-accounting system.

The Treasury produces reports on the execution of the budget, which are presented to the government within two weeks of the end of each month. An end-of-year report should be produced and presented to the government by 15 May. Such a report also includes the end-of-year accounts for the extra-budgetary funds. By 1 July, the government should submit the consolidated final accounts to parliament (Budget System Law, article 64). The Budget System Law (article 65) also requires the government to submit an external audit report together with the final accounts. As pointed out above, the absence of a supreme audit institution seriously diminishes the value of the government's final accounts.

2. Assessment, reform agenda and capacities

The capacity for reform needs to be enhanced.

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

3. Recommendations

Besides strengthening the capacity of the Ministry of Finance, which is key to any further reform process, including the ownership of such a process, the Serbian authorities must endeavour to finalise the reform of the Treasury administration, improve the budget forecasting system, and further develop the analytical capacity of the Budget Directorate in the Ministry of Finance. All of these tasks constitute priorities in addition to the various suggestions made above.

4. External Assistance

Reform in the area of financial management is supported by a number of bilateral and multilateral technical assistance projects. A project financed by the European Agency for Reconstruction (EAR) is currently involved in the development of a financial management and information system (FMIS) for the Treasury. The implementation of the system is expected to begin in January 2007. Parallel to the development of a financial management and information system, methodological and legal changes may be required. Relevant training within the administration will be necessary. EAR is also financing a project aimed at developing budget preparation, with a special objective of introducing programme budgeting. In order to better assess the preconditions for performance-oriented budgeting in the Serbian administration, the project has focused on a limited number of pilot ministries. The objective of the project is to better link government policies to actual expenditure and to increase the efficiency of public expenditure.

The World Bank has supported a wide range of issues related to the development of public expenditure management and is currently financing assistance by two advisors on budget preparation issues. Bilateral support in the area of financial management includes a DFID-financed project aimed at developing capacities for producing medium-term macroeconomic and fiscal projections. The US Treasury has financed an advisor to the Ministry of Finance.