



Republic of Serbia  
**FISCAL COUNCIL**

**ANALYSIS, VIEWS AND PROPOSALS**

**BUDGET PROCESS IN THE REPUBLIC OF SERBIA:  
DEFICIENCIES AND RECOMMENDATIONS**

December, 2014

## SUMMARY

- *Budget process in Serbia suffers from serious deficiencies – annual budget laws are usually not applied in practice, while medium-term budget limits are not followed at all. Some of the most important deficiencies of the existing budget process are: lack of transparency and accounting of expenditures “below the line” for certain public enterprises and state banks so that they are not visible in the Budget Law, the omission of a large number of (quasi) fiscal institutions and agencies from the regular budget procedures, lack of a functioning central register of employees in the public sector, lack of a monitoring system for arrears and commitments, as well as the absence of a credible framework for managing the budget negotiations at the technical level and separation of costs of existing activities from the new public policy measures. Frequent budget supplements (budget rebalance) during the calendar year are the direct consequence of these deficiencies, while the three year budget limits stipulated by the Fiscal strategy are not respected when allocating resources to individual budget beneficiaries.*
- *Improvements of the budget process will largely depend on the decisive political support and development of human resources and operational capacities, primarily in the Budget Department of the Ministry of Finance. Modest improvement of the budget process in the past decade, despite the significant donor funding in this area, is primarily the result of the lack of a consistent reform vision and the absence of a strong Budget Department in the Ministry of Finance that should manage the budget process and initiate its improvements on the central level. Therefore, the preconditions for establishing a more efficient and more effective budget process include adequate political support, development of human and operational capacities, as well as the adoption of a consistent reform agenda in accordance with the best international experiences and adapted to the Serbian conditions.*
- *The development and improvements of the budget process should be organized within a logical hierarchical sequence – the establishment of an effective budget process on an annual basis and its implementation within a calendar year, gradual transition to a medium-term budgeting in order to increase fiscal predictability, development of the program structure of the budget, and finally, the establishment of budgeting based on the performance indicators, in order to maximize the quality of services that the public sector provides. International experiences show that any attempts to skip any of the phases in the budget process development only lead to counterproductive outcomes. Hence, we can conclude that any attempts to establish the program budgeting and performance indicators in Serbia, in the environment of serious shortcomings of the basic budget functions, will be followed by high risks and dangers that may lead to the absence of the desired outcome.*

**Summarized table: Budget process deficiencies and recommendations**

<b>Problem</b>	<b>Description</b>	<b>Solution</b>
Inadequate coverage of state institutions	There is no register of institutions that are part of the general government.	Republic Statistical Office and MoF to develop a registry of state institutions in accordance with international standards.
	State budget does not cover many relevant agencies and (quasi) budget institutions.	Expand the coverage of the Republic Budget to all relevant institutions of the central government.
Underestimated deficit calculation in the Budget Law	State Budget does not show expenditures “below the line” for the loss-making public enterprises and insolvent state banks.	Harmonize the calculation of the republic deficit with international standards so that it includes “below the line” expenditures and project loans.
	Expenditures financed from “project loans” are not seen or monitored in the regular state budget execution activities.	Expenditures “below the line” must be registered in the Budget Law in a transparent manner.
Absence of systematic framework for budget negotiations at the technical level	Budget calendar is not followed in practice.	Establish a consistent methodological framework for separation of costs of existing activities from the new public policy measures.
	Current system is not able to neither sanction “wasteful” behavior nor reward the “prudence” of budget beneficiaries on the technical level.	Follow the prescribed budget calendar.
	Linear savings are frequently required from all budget beneficiaries, which is not economically optimal.	Make a distinction between the political and technical aspects of the budget process.
Annual budget plans are often not implemented, while multi-year expenditure plans are not followed at all.	Budget rebalances during the year suggest that budget beneficiaries often go above their set expenditure ceilings from the Budget Law.	Increase the responsibility for compliance with the annual Budget Law.
	The three-year expenditure limits prescribed in the <i>Fiscal Strategy</i> are not followed nor do they have any significant impact to the budget process.	Improve technical credibility and political strength of the expenditure limits prescribed in the <i>Fiscal Strategy</i> .
		Establish fiscally consistent framework of medium-term sector strategies.
Inadequate HR and operational capacities in budget departments, especially within the Ministry of Finance	Budget departments of the majority of ministries, especially the Ministry of Finance, are not adequately staffed.	The key and guiding role of the Budget Department of the Ministry of Finance must be recognized in the context of the reform of pay grades.
	There is no central registry of employees in the public sector.	Develop adequate information systems for monitoring employees, arrears, commitments, budget planning and preparation.
	There is no system for monitoring arrears.	Enable decisive political support for the budget process improvements.
	There is no specialized IT system for budget planning and preparation.	
Absence of a clear reform vision in accordance with the best international practice.	Budget process in the past decade was marked by frequent reform wandering.	Develop a reform vision in line with the best international experiences, tailored to the conditions in Serbia.
	Unstable macro-fiscal environment is not favorable for the implementation of systemic reforms of the budget process.	Give priority to the removal of the major deficiencies, before considering more advanced systems such as performance indicators.
	Due to the lack of a consistent strategy, significant donor funds have not produced expected nor sustainable results.	The reform must be led by a strong Budget Department within the Ministry of Finance.

## **Budget process in the Republic of Serbia: Deficiencies and recommendations**

Through this analysis, the Fiscal Council would like to present the main shortcomings and weaknesses of the budget process in the Republic of Serbia, which were not resolved during the previous decade. We would like to point out that in order to have transparent public finances and credible fiscal consolidation that was announced, it is necessary to improve the methodology of calculation of the state deficit and to include “below the line” expenditures, that were accumulated due to insolvency of public enterprises and state banks, and other specific expenditures that are omitted, without any credible reason, from the budget deficit of the Republic. It is also necessary to increase the (incomplete) coverage of public funds at the central government level, through the transparent involvement of institutions that lead the implementation of public policy (such as the Development Fund and various agencies). The aforementioned methodological omissions distort the picture of the state that public finances are in and have far-reaching consequences on the process of fiscal policy implementation in Serbia.

Currently, there is no system in Serbia to track basic budget beneficiary information, such as arrears and the number of employees, nor corresponding software solutions that would improve the budget process. The lack of systematic and consistent control mechanisms leads to irrational allocation of limited budget resources and, in some cases, rewarding of irresponsible behavior of budget beneficiaries. In addition, one of the major problems is the fact that HR capacities in individual ministries, but also in the Ministry of Finance, that are in charge of budget processes – are nowhere near the satisfactory level and in line with the importance and needs of the state. The consequence of such problems is that medium term ceilings of individual budget beneficiaries are not followed, while short-term expenditure frameworks of budget beneficiaries are significantly changed through budget rebalance during the year.

The program structure of the budget and performance indicators that should be introduced in 2015, represent a more advanced way of budget planning and execution compared to the existing system, but they will not eliminate the main deficiencies of the budget process in Serbia. On the contrary, in the case of Serbia, the transition to this model could prove to be very risky, because serious shortcomings of the system were not eliminated beforehand. International experience shows that this particular reform process can be harmful if there are substantial shortcomings of the basic budget system elements. Therefore it would be crucial to remove the major problems in the existing budget process first.

In the first part of our analysis, we presented the main shortcomings and deficiencies of the current budget process and provided some improvement measures. In the second part, we listed the best international experiences in the field of budgetary reforms and pointed out that improvements in Serbia’s budget process must follow a logical hierarchical order. Concluding remarks are summarized in the third part of this document, while the Annex explains the basic definitions and concepts of the budget process.

## **1. Budget process deficiencies and recommendations for improvement**

**The main role of the budget process is to enable efficient and transparent use of public funds in accordance with the selected public policies.** Although there is room for further improvement of the budget process in the segment related to public revenue planning and management of budget liquidity, the biggest deficiencies of the budget process lie in the inefficient process of the allocation of public funds to be made available to budget beneficiaries. Hence, this analysis is dedicated to the current state of the budget process in Serbia from the standpoint of budget preparation, determining the amount of funds allocated to different budget beneficiaries, presenting information on the expenditure of public funds and the effects that these segments have on the fulfillment of the objective of the defined public policies. We are primarily dealing with budget related documents and process at the national level, bearing in mind that the jurisdiction of the Fiscal Council is mainly related to this government level which is otherwise dominant within the general government sector. Many analyzed aspects of the state budget are relevant from the standpoint of the budget process at the local level, while we occasionally look back on the need to harmonize and improve some aspects of the consolidated general government level.

**In the first part of the analysis, we provide more details for the description of the deficiencies and weaknesses of the current budget system in the Republic of Serbia.** Some of the main deficiencies include the lack of adequate definition of the general government sector, inadequate coverage of public institutions at the central state level, no systematic framework that would manage budget negotiations at the technical level, the lack of a monitoring system for arrears and commitments of budget beneficiaries, insufficient level of compliance with financial plans during the budget year, low institutional capacity and insufficient staffing capacities in the budget sectors of the line ministries, especially the Ministry of Finance, the lack of specialized IT system for the budget preparation and planning, lack of credible information on the number and qualifications of the budget beneficiaries' employees, and the lack of progress regarding transparency and insight into the fiscal statistics and indicators.

### ***1.1. Inadequate coverage of institutions within the state sector***

**Contrary to the legal provisions, Serbia still doesn't have a definition or a register of entities and institutions that are part of the general government sector.** The Budget System Law (Article 8) requires that the Ministry of Finance and the Statistical Office of the Republic of Serbia shall establish the inventory of (budgetary and extra-budgetary) entities, in accordance with international standards, that are part of the general government sector and that this inventory shall be updated/checked every year. However, the official inventory of institutions that are part of the general government sector still doesn't exist, although the initial deadline for its establishment was April 1, 2011. The absence of the inventory of public institutions that are part of the general government sector undermines the credibility of fiscal statistics and budgetary process, since it is necessary to monitor and consolidate financial results of individual entities, in order to obtain credible estimation of the overall fiscal performance of the public sector.

**The coverage of public fund beneficiaries at the central government level is incomplete.** As there is no inventory of entities that are part of the general government sector, there is also no official inventory of public fund beneficiaries that belong to the central government level. Coverage of those entities involved in the annual Budget Law of the Republic

of Serbia is incomplete, since there is a large number of agencies and institutions, that by their nature belong to the central government level, and that are not covered in the state budget. These are entities that implement important economic policy measures (the Development Fund), agencies that are closely associated with the executive authorities at the national level (National Agency for Regional Development, Republic Housing Agency, Agency for Accreditation of Health Care Institutions of Serbia, Road Traffic Safety Agency, etc.), as well as those regulatory agencies whose responsibilities are defined at the national level (Energy Agency of the Republic of Serbia, Securities Commission, Regulatory Agency for Electronic Communications and Postal Services (RATEL), Regulatory Authority of Electronic Media, etc.)<sup>1</sup>. In accordance with the international practice, it is necessary to define a comprehensive inventory of public funds' beneficiaries at the central state level, while the budgets of these institutions should be included in the state budget and their financial plans should form an integral part of the budget documents (as it is currently done with the financial plans of the institutions of mandatory social insurance). On the operational side, it is necessary to improve the transparency of financial plans of these institutions and enable the Treasury to adequately supervise their execution. Even more so as the discretionary spending of some of these agencies in the previous period generated negative reactions of the public which affects the integrity of the budget process as a whole.

**Incomplete coverage of relevant institutions at the central level provides opportunities to avoid binding fiscal rules and mandatory austerity measures.** Those institutions that are not adequately covered or reflected in the budget process framework at the national level, and whose business is in (direct or indirect) control of the government, can undermine and render meaningless the introduction of fiscal rules and austerity measures at the national level. One of the goals of the fiscal rules from 2010 was to limit the wage bill of the public sector, including the state budget. However, when the budget for 2012 was adopted, the Government decided to circumvent the wage bill ceiling, so the program of (temporary) employment of 1,700 agronomists was formally implemented through budget funds under the control of the Ministry of Agriculture – to avoid formal increase of the wage bill defined in the Budget Law. The Fiscal Council pointed out this problem in December 2011 in the document “Evaluation of the Fiscal Strategy Report and Draft 2012 Budget Law” (page 12).

**The non-transparent operations of public enterprises are a huge problem for the efficiency and sustainability of public finances.** Public enterprises (in principle) are not part of the general government sector (for more details see Annex). However, the performance of many public enterprises is associated with the state budget – losses of public enterprises are often, directly or indirectly, covered from the state budget (see Section 1.2 of this paper), while the jurisdictions or the way of financing of some public enterprises contain the elements inherent to the public sector. Hence, there is a possibility, and the need, to establish a closer and more transparent relationship between the state budget and the operations of certain public enterprises. For example, PE Corridors of Serbia is financed (practically) only by loan proceeds for the construction of major transport investments, while these loans will be repaid from the state budget in the coming years. The question arises whether, in order to have a better and more

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<sup>1</sup>Some agencies that are directly financed from the Budget, such as the Anti-Corruption Agency or the Agency for Environmental Protection, are covered by the state budget. However, the state agencies that are (predominantly) financed through fees, taxes or by selling their services are usually not included in the regular budget procedure. From the fiscal standpoint, the difference between these institutions is formal rather than substantive, because both groups of agencies are financed from legally prescribed fiscal levies.

transparent control, the finance of the PE Corridors of Serbia should be integrated into the state budget, since it is related to budget spending for construction of transport infrastructure which is a public good<sup>2</sup>. Also, during previous years an increased number of quasi-budget institutions was noticed, often in the form of public companies, such as PE Nuclear Facilities of Serbia or PE Center for the Promotion of Science. The financial positions of these public enterprises are clearly unsustainable without some form of fiscal resources – whether through mandatory payment of fiscal taxes, loan proceeds that are borrowed by the Republic of Serbia or through direct budget transfers. Hence, it is necessary to identify the most efficient way to show the financial resources of these institutions in a transparent way within the budget process framework, since these are institutions that are obviously dependent on budgetary resources (or will certainly become dependent in the following period)<sup>3</sup>.

**Own revenues of indirect budget beneficiaries are not monitored or adequately controlled within the budget process.** Indirect budget beneficiaries, primarily schools and faculties, generate large amount of own revenues (renting gyms, tuition fees, etc.). These revenues and their spending are not tracked within the current budget process<sup>4</sup>. The Budget Law of the Republic of Serbia, starting with the supplementary budget in 2012, formally provides an assessment of indirect budget beneficiaries' own revenues, but the realization of these revenues is not monitored during the year<sup>5</sup>. Furthermore, the presented estimated revenues and associated expenditure on this basis – are inconsistent. Moreover, in the 2014 Budget, own revenues based on the “transfer among budget beneficiaries at a different government level” are estimated at 8.9 billion dinars, while the budget section for the Ministry of Education contains plans for significantly higher expenditures in primary and secondary education based on these revenues – over 12.5 billion dinars. Also, preliminary analysis and benchmarking of the estimated resources in the Budget Law with the data from the final accounts suggest that the own revenues of indirect budget beneficiaries are actually twice the size of the formal assessments that are included in the national budget – about 30 billion dinars of own revenues in the Budget Law compared to 60 billion dinars of reported revenues in the final accounts.

**The lack of adequate monitoring of (own revenues of) indirect budget beneficiaries adversely affects the transparency and efficiency of the budget process in the Republic of Serbia.** We will mention one of the most remarkable examples that are well known in the general public. The example is related to the discretion of hospitals and health centers (which are

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<sup>2</sup>Also, the establishment of the National Investment Plan (NIP) in 2006 reversed the transparency of the budget process in the area of capital expenditures, since the members of the National Assembly, when declaring their vote, do not have any information on specific projects that will be financed from the NIP, but they only vote on the total amount of funds. The Government subsequently decides on the specific projects and the use of these funds, together with the line ministry, which degrades the whole purpose of the Budget Law.

<sup>3</sup>Before these institutions are included into the formal budget process, it would be possible to carry out a detailed analysis of their responsibilities and see whether it would be more efficient, in some cases, to shut down some of these institutions and transfer their jurisdiction to related institutions that already exist in the public sector.

<sup>4</sup>The possibility for the budget beneficiaries to generate their own revenues is not problematic in itself, but the use of the funds on that basis should be adequately monitored, while, from the practical standpoint, it would be good to analyze the optimum approach for the integration of this aspect of public expenditure into the regular budget process.

<sup>5</sup>The monitoring of the direct budget beneficiaries whose own revenues are integrated into the regular state budget execution was enhanced during the budget rebalance in 2012. However, similar efforts in the case of indirect budget beneficiaries have so far failed to materialize.

not formally indirect budget beneficiaries of the state budget, but are under the jurisdiction of the Health Insurance Fund) to allocate their own source revenues. In 2012, the Minister of Health at the time, went public with the information that 13.600 people were employed in the health sector without the permission of the Ministry and the HIF<sup>6</sup>. The largest share of funds for hiring additional workers in health care sector had to come from the co-payments and other own revenues of medical institutions, and it is obvious that there is no adequate and efficient budget control over these funds – since the law states that own revenues of health institutions can be used to improve health services, but cannot be used to hire employees without the approval of the Ministry and the HIF.

**The state budget doesn't provide (any more) the information on the extent of tax expenditures.** Tax expenditures represent the loss of tax revenues due to tax exemptions or tax credits such as, for example, a VAT refund in the case of purchase of the first apartment, a tax incentive savings in voluntary pension funds or tax credits for various forms of investments in the case of profit tax. Tax expenses are actually (hidden) budget subsidies to particular segments of the economy and/or population. International practice provides many examples where interest groups use tax expenditures to lobby for their interest, since it is a less transparent form of state aid compared to direct subsidies that are visible in the budget and that are voted in the Parliament. In order to increase the transparency of the budget process in this segment, the Budget Law in 2010 included, for the first time, (rather rudimentary) estimate of the loss of public revenues on the basis of various tax exemptions. However, instead of trying to improve the review of tax expenditures, this part of the Budget Law was abolished in the 2013 Budget (also, estimates of tax expenditures were not included in any other relevant report, such as the Fiscal Strategy). Therefore, it is necessary to pay attention, in the following period, to this segment of the budget process and to include the estimates of tax expenditures, as detailed as possible, in the regular budget documents<sup>7</sup>.

## *1.2. Underestimated deficit calculation*

**The official calculation of the deficit in the Budget Law is not in accordance with international standards and it significantly underestimates the actual deficit at the national level.** In financial jargon, financial transactions “below the line” are those transactions that do not affect the fiscal deficit, or transactions that do not affect the financial value (the difference between assets and liabilities) of the state sector<sup>8</sup>. For example, if the state decides to take a new loan in order to repay an existing loan, this would be defined as a financial transaction “below the line” that does not influence the deficit nor does it change the current state of public debt<sup>9</sup>. Also, if the state increases the capital of a solvent bank (for example, Komercijalna banka) this is a transaction “below the line”, since this is the way for the Government to increase the value of

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<sup>6</sup><http://www.novosti.rs/vesti/naslovna/aktuelno.290.html:365788-Gde-se-krije-13600-zaposlenih-u-zdravstvu>

<sup>7</sup>In the fall of 2012 and especially 2013, the Government significantly reduced the prescribed scope of tax expenditures through elimination of (inefficient) tax exemptions for profit tax. Ironically, these positive effects cannot be seen transparently due to the aforementioned exclusion of tax expenditures from the Budget Law for 2013.

<sup>8</sup>Transactions that affect the deficit are colloquially referred to as “above the line” transactions.

<sup>9</sup>If the new loan is more favorable than the existing one, in the coming years the state will decrease deficit based on the lower expenditure on interests, that are recorded “above the line”. However, at the time of the transaction, the deficit and public debt remain unchanged.



its financial assets. There are, however, transactions that look like they are “below the line”, but essentially represent “above the line” expenditures that should be included in the deficit calculation. A typical example of these transactions is the example of state loans to students or farmers where the repayment level in the past years has been extremely low. In fact, those were hidden subsidies that are classified “above the line” according to international standards, and that increase the deficit. For many years, the Budget Law has been following international practice in this segment and the costs of such programs are properly included in the deficit calculation. In the past few years, however, there have been two major categories of below the line transactions: repayment of guaranteed loans of loss-making public enterprises and recapitalization of insolvent state banks, which are not transparently shown in the Budget Law and which are ignored when calculating the deficit, without any justification.

**Unregistered “below the line” expenditures represent a large and growing burden on the public finances of Serbia.** As mentioned before it is (predominantly) the expenditure on two grounds: 1) various forms of recapitalization of insolvent state-owned banks and 2) expenditures for the repayment of loans that were taken by public enterprises, with a state-guarantee, (mostly loss-making enterprises) and are no longer able to repay them. Expenditures on these grounds were not that big until 2011-2012, when they started growing significantly. Between 2011 and 2012, “below the line” expenditures were predominantly caused by the collapse of state-owned banks – (New) Agrobanka and the Development Bank of Vojvodina. After that, funds were also set aside for the Privredna banka Beograd, and through supplementary budget in 2013, additional resources were allocated for the recapitalization of Postanska stedionica and Dunav osiguranje. As of 2013 and 2014, the Republic of Serbia started to set aside more funds for the repayment of loans of loss-making state enterprises, such as Srbijagas, that have been covering losses in the previous years through state-guaranteed commercial borrowing. Issuing Government guarantees to loss-making companies so that they can borrow from commercial creditors is a form of hidden subsidizing of these companies, since it is clear that most of them are not able to repay their loans, which then means that these loans have to be repaid directly from the budget.

**Unrepresented and unaccounted “below the line” financial expenses in 2014 reached a total of about 60 billion dinars, or more than 1,5% GDP.** As discussed, “below the line” expenditures are actually hidden losses of public enterprises and insolvent business operations of state-owned banks from the previous year. Hence the “below the line” expenditures will not be eliminated in the short term, but will require a period of four to five years to repay these hidden losses from the previous period. The data on existing and potential “below the line” expenditures are scarce (which is actually one of the problems), but it is known that the total guaranteed debt of Srbijagas is around 700 million EUR, while the debts of Zelezara Smederevo (steel company) are estimated to around or over 250 million EUR. A rough calculation based on these scarce data indicates that (at least) 1% GDP will be needed in the coming years in order to service these “below the line” expenses.

**Remediation of loss-making state-owned enterprises and the end of practice of covering their losses through state guarantees and “below the line” expenses is the key prerequisite for fiscal consolidation.** Projections of the Fiscal Council show that the success of fiscal consolidation and stabilization of the public debt shall critically depend on the radical shift

in public enterprises. They need to stop creating losses and transferring them to the tax payers<sup>10</sup>. In order to eliminate the “below the line” expenditures in the next four to five years, it is necessary to immediately stop issuing new state-guarantees to loss-making companies. However, despite some announcements that this unsustainable practice will be abolished, during 2014 the Republic of Serbia has continued to issue guarantees at the same pace. In 2014, for example, Srbijagas received 75 million budget loan “above the line” and around 150 million of “below the line” expenditure was used to service commercial debts of this company. In addition, a new guarantee, of around 160 million EUR was approved to Srbijagas, which is an example of hidden financing of loss-making company in the next heating season. Through “below the line” expenditures, this guarantee will become budget expenditure in several years, and Srbijagas will not be able to service that newly formed debt. If this practice continues, the “below the line” expenditures in the coming years will be much higher than the estimated 1% GDP, which will thwart the fiscal consolidation plans. Since the identification of a problem is the first step towards its resolution, it is necessary to transparently express these “below the line” expenditures so that MPs (and taxpayers) when voting on the Budget Law could be fully aware of the huge losses in the sector of public enterprises and state-owned banks whose management needs a radical reform in the future.

**The lack of transparency of the “below the line” expenditures is manifested in two ways – they are not only excluded from the official deficit calculation, but the majority of these expenditures is not registered in the Budget Law.** Through a thorough analysis of budget rebalance for 2014, it can be seen that the Government will allocate 4.8 billion to recapitalize Postanska stedionica and 4.7 billion dinars for recapitalization of Dunav osiguranje. These amounts (unjustifiably) are not included in the deficit calculation, but the Budget Law at least contains the information on the amount that is planned for these purposes. Other below the line expenditures are even less known and visible. Thus, for example, the Budget Law does not provide any information about the resources that will be spent in 2014 for repayment of guaranteed debt of Srbijagas. The Fiscal Council indirectly estimated the costs of servicing the guaranteed debt of Srbijagas in 2014, and that amount is around 15 billion dinars. It is, therefore, crucial to significantly improve the transparency of the Budget Law and to clearly show and quantify all “below the line” expenditures, as it was done in the case of Postanska stedionica and Dunav osiguranje.

**The calculation of the national deficit needs to be harmonized with international standards, and it also needs to be harmonized in various official documents of the Government of Serbia.** International standards were properly included in the drafting of the Fiscal Strategy for 2014 and the deficit calculation included the expected 60 billion dinars of “below the line” financial expenses for activated guarantees of public enterprises and remediation of solvency of state financial institutions. However, during 2014, fiscal statistics in other public documents of the Government of Serbia and the Ministry of Finance have not been upgraded to follow international standards and deficit calculation that was announced in the Fiscal Strategy. As mentioned above, the Budget Law for 2014 does not provide information on these expenditures, nor are they included in the official calculation of the state budget. In addition, monthly reports of the Ministry of Finance on the expenditure of public funds do not

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<sup>10</sup>For more details see “Fiscal Developments in 2014 and the Basic Recommendations for the Budget Rebalance and Medium-Term Adjustment 2015 – 2017”, July 31, 2014.

provide any information on the financial expenditure “below the line”. These deficiencies should be removed as soon as possible, so that the public is fully aware of the scope of the hidden losses of public enterprises and the threat they represent to successful implementation of fiscal consolidation<sup>11</sup>.

**Another source of underestimated deficit within the Budget Law is the fact that expenditures financed from “project loans” are not included.** Project loans mean spending credit proceeds of multilateral international institutions (World Bank, EBRD, EIB) and bilateral partners (China, Azerbaijan), which were approved to specific beneficiaries, for specific purpose. These are the beneficiaries that, by their nature, belong to the central government level and therefore, in accordance with international standards, should be included in the annual Budget Law at the national level. All the more so since the Republic of Serbia is a formal borrower in these “project loans”<sup>12</sup>. The Ministry of Finance does not monitor the implementation of project loans within the regular monthly monitoring of budget execution (Table 2, available on the website of the Ministry of Finance), and the evaluation of the execution of these proceeds is included in a wider report of the Ministry of Finance (Table 4). The calculation of the deficit in the Budget Law should therefore be extended to include deficits that arise due to the implementation of project loans, which are estimated at about 20 billion dinars in 2014. In operational terms, the monitoring of implementation of funds from the project loans needs to be harmonized with the regular budget procedure<sup>13</sup>.

### *1.3. The absence of a systematic framework for managing the budget negotiations at the technical level*

**The efficiency of the budget negotiations at the technical level largely depends on the possibilities of a credible separation of budget expenditures for the current policy from the funds required for new activities.** The Ministry of Finance should have adequate information about the baseline that each budget beneficiary needs in order to perform the existing scope of activities, and to clearly separate the costs of existing public policies from the costs of new programs that the Government wants to implement. Otherwise, the budget beneficiaries have a motive to exaggerate the amount of funds that is allegedly needed to fund the existing activities to ensure more funds for discretionary spending and implementation of its priorities, instead of the proclaimed Government measures. This problem of the so-called bottom-up budget pressures is present in Serbia, where a large number of budget beneficiaries exaggerates the amount of funds they need to finance their (existing) activities in order to provide for themselves the most favorable starting position for negotiations with the Ministry of Finance. This leads to a negative selection - the Ministry of Finance gets these exaggerated budgetary requests from some beneficiaries and realistically planned budgets from other beneficiaries, but the Ministry does not

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<sup>11</sup>Expenditures “below the line” must be included in the calculation of the official national deficit in the same manner in which it is currently done in the case of expenditure for the “acquisition of financial assets in order to fulfill public policy”.

<sup>12</sup>Project loans also include the infrastructure projects that are funded through bilateral loans from China and Azerbaijan.

<sup>13</sup>If the implementation of project loans cannot be integrated into the regular budget procedure in due time, for example, due to the legal provisions of the bilateral credit arrangements, then the calculation of the deficit in the Budget Law certainly could be increased for the estimated amount of these funds in the next year (similarly to the way the Budget Law includes a tentative assessment of own revenues of indirect budget beneficiaries, even though these revenues are not monitored in the regular budget procedure).

have the information which requests are exaggerated and which are realistically projected. Since the total requests of budgetary beneficiaries (largely) exceed the available funds, the most common outcome is proportional reduction of all budget requests, whereby people who planned their budgets adequately and responsibly are being punished, while the beneficiaries that have resorted to exaggerating their expenditures are rewarded.

**The lack of systematic and consistent mechanism for assessing the costs of financing the existing activities of budget beneficiaries is one of the key deficiencies of the budget process.** In late 2013, the technical mission of the International Monetary Fund (IMF) analyzed the degree of the budget process development in Serbia and concluded that, in the process of adjusting the financial needs of budget beneficiaries and the volume of available public resources, there is no consistent and credible framework for the separation of budgetary costs of the existing activities from the costs of new public policy measures<sup>14</sup>. The absence of this mechanism creates negative incentives to budget beneficiaries to exaggerate the amount of funds needed to finance current activities. Due to the lack of credible information, the Budget Department of the Ministry of Finance is unable to resolve the problem of exaggerated requests of budget beneficiaries at the technical level, and these requests significantly exceed the available public funds. The solution to this technical problem is therefore often resolved in the political field – budget beneficiaries that exaggerate in their requests the most and/or those who have the greatest political influence get the most from the budget process. The final result is that the Government is unable to have efficient implementation of its proclaimed policy (i.e. top – down budgeting) because the budget beneficiaries appropriate for themselves a large share of the funds that were supposed to be used to fund new Government programs.

**The statutory budget calendar is most often not followed in practice.** The Budget System Law stipulates that the budget process should begin in mid-February when the instructions are to be sent to the budget beneficiaries for proposing priority areas of funding. Although in practice the instructions to budget beneficiaries are (usually) promptly sent, the IMF (2013) concluded that the information received in this phase of the budget process practically doesn't have any influence to the final content of the budget – due to the previously mentioned problem of separation of the costs of existing from new policies, and the fact that the prescribed (indicative) limits for individual budget beneficiaries are not respected. The absence of adequate information and results in this (first) phase of the budget process undermines the efforts invested in determining the priorities of public spending, as well as the credibility of plans that are presented later in the Fiscal Strategy. Although the budget calendar stipulates that the Government shall submit the Draft Fiscal Strategy to the Fiscal Council by the end of April, this deadline has not been met in the previous three years (for various reasons). Therefore, the Fiscal Strategies were usually drafted at the end of the year, together with the Draft Budget for the coming year. Failure to comply with the budget calendar further damages the credibility of the budget process and contributes to the situation where budget beneficiaries usually spend more than the amount that was prescribed in the Budget Law – which then required budget revisions during the year.

**The absence of a credible framework for managing the budget negotiations at the technical level also prevents successful introduction of medium – term budgeting.** The aim of the medium term budgeting is to expand the budget horizon from one to the next few years in

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<sup>14</sup>For more details see the IMF technical paper for Serbia “Strengthening the Budget Planning and Budget Realization Process”, December 2013 (hereinafter: *IMF, 2013*).

order to ensure greater predictability and stability of fiscal policy and efficient spending of public funds in the medium term. The selected measures of public policies often do not show their full economic/fiscal effect in the current calendar year. A typical example is the constant increase of certain budget expenditures at the end of the calendar year that minimally affect the budget deficit in the current year, but it permanently deteriorates the budget position in the coming years<sup>15</sup>. Adequate medium term budgeting is an important instrument in fiscal consolidation, which usually requires savings plans for a period of several years – in order to avoid one-off proportionate reduction of all/most public expenditures where, instead, necessary savings are achieved in the dominantly least productive and/or least desirable forms of public expenditure. However, a prerequisite for a successful medium term budgeting is a credible framework for the projection of budget expenditures that finance the existing public policies, for which we have stated that it still hasn't been established<sup>16</sup>. Serbia made the first steps towards medium term budgeting in 2010, when the following practice was introduced: the Fiscal Strategy, annual report formed in the Ministry of Finance and adopted by the Government, prescribes annual ceilings for public funds that will be made available to different budget beneficiaries (at the level of budget sections) over the next three years<sup>17</sup>.

**Medium term ceiling of individual budget beneficiaries, which are prescribed in the Fiscal Strategy, are not followed in practice.** As of 2011, the Fiscal Strategy of the Government of Serbia sets annual ceilings (limits) on funds that should be made available to individual budget beneficiaries (at the level of budget sections) in the next three years. However, the prescribed limits are not legally binding and have not been respected in practice in the past couple of years; during the preparation of the annual Budget Laws, which do have a legally binding character, many budget beneficiaries received more funds than the prescribed limits in the Fiscal Strategy. This is due to technical and political reasons. On the technical side, the above mentioned absence of a credible framework for projecting the costs of existing activities undermines the credibility of annual limits from the Fiscal Strategy. From the political standpoint, it is obvious that the Fiscal Strategy, although it is an official document of the Government of Serbia, doesn't have the credibility to significantly affect the fiscal plans of line ministries. It seems that the Fiscal Strategy is perceived as a mere compliance with legal formalities by the Ministry of Finance, and not as one of the key documents for the planned management of fiscal policies<sup>18</sup>. Both of the above mentioned deficiencies need to be eliminated so that the medium-term budgeting could be applied in practice.

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<sup>15</sup>A striking example in the case of Serbia is the extraordinary pension increase by 10% in November 2008. This increase did not have a significant impact to the 2008 budget at the time of adoption, since it only referred to the last two months of 2008, however, it has significantly deepened the budget deficit in 2009 and in subsequent years.

<sup>16</sup>Another prerequisite for the implementation of medium-term budgeting is the existence of quantified medium-term sector plans and/or medium-term development strategy, in order to be able to adequately implement the prioritization of public expenditure in the medium term. Also, when adopting new laws, it is necessary to improve the credibility and accuracy of the assessment of fiscal effects of the proposed legal solutions. Currently, the opinion of many laws contains the sentence stating that the proposed law “has no financial impact on the budget”, though proposed laws often affect the fiscal position of the country.

<sup>17</sup>Until 2011, Fiscal Strategy was called the “Memorandum on Budget and Economic and Fiscal Policy”.

<sup>18</sup>For example, public debates and/or adoption of Fiscal Strategy in the National Assembly would contribute to a greater political credibility of the projections and the limits prescribed in this document.

#### **1.4. The lack of the system for monitoring basic information such as arrears and staffing levels**

**There is no system for monitoring arrears of budget beneficiaries in Serbia.** Although the Ministry of Finance and the Treasury Department collect reports on the status of arrears of individual budget beneficiaries, these reports can't be considered as comprehensive (since they do not cover all budget beneficiaries, especially in the area of indirect budget beneficiaries) nor are they entirely reliable since there is no credible system that would verify the information submitted by the budget beneficiaries. Also, the (partial) information on arrears of budget beneficiaries are not systematically integrated into the budget process<sup>19</sup>.

**The lack of adequate monitoring system for budget beneficiaries' arrears damages the financial discipline within the public sector and impedes the smooth functioning of the economy.** In these circumstances, budget beneficiaries often have the motive to assume obligations that exceed their available funds, since without a comprehensive centralized monitoring of arrears it is very difficult to impose adequate sanctions on such forms of irresponsible fiscal behavior and lack of financial discipline. Creation and accumulation of arrears not only makes economic activity in the country difficult, but it is also a source of serious budgetary risks – when the burden of financing arrears exceeds the financial capabilities of individual budget beneficiaries, these costs are transferred to the state budget and taxpayers. Such examples were common in recent years, such as when the state took over 300 million EUR of arrears and debts of the PE “Putevi Srbije” in 2010, the republic program of refinancing arrears of local governments in 2012, the state takeover of arrears in the health sector in 2013 and the like.

**There is no proper register of employees in the general government sector in Serbia.** Expenditure on staff costs represents the dominant source of costs for the largest number of budget beneficiaries. Hence the adequate control and planning of these expenditures is of great importance for the efficiency of the overall budget process. However, the analysis conducted by the Fiscal Council showed that expenditures for employees in 2009 – 2012 was constantly growing faster (by about two percentage points per year) than what was prescribed through the statutory indexation of wages. We identified the lack of an adequate central register of employees in the general government sector as one of the main reasons of poor control of expenditures for employees and we suggested the need for a systemic resolution of this problem<sup>20</sup>. In early 2013, the Ministry of Finance initiated activities to develop a central register of employees in the general government sector<sup>21</sup>.

**The Central Register of public sector employees has not yet been completed and the system is not integrated into the rest of the budget process.** As of October 2013, the public funds' beneficiaries submit the reports on their staffing levels (on different grounds) to the Ministry of Finance. However, to this date, they haven't published official and exact information

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<sup>19</sup>In addition, the system for monitoring assumed commitments (which will require spending of budgetary resources in the future) is not adequately established within the existing budget process.

<sup>20</sup>For more details see “Proposed Measures of Fiscal Consolidation 2012 – 2016, Chapter 7, May 2012.

<sup>21</sup>In 2003 – 2004, a register and system of centralized payment of salaries for public administration employees (close to 30.000 employees) was developed within the Treasury Administration. After that, with certain difficulties, this register was expanded and employees in the primary and secondary education were included as well.

on the number of employees in individual institutions and beneficiaries of public funds. As in the case of reporting on arrears, the issue of comprehensiveness and credibility of submitted data on employees is present here as well. Therefore, in the future period, a systematic solution to the central register integrated into the budget process framework should be developed – in order to adequately centralize/unify the payment of wages (for the majority) of employees in the general government sector, similar to what was done in the public administration sector ten years ago. Otherwise, there is a risk that the scope and quality of information on the number of employees submitted by the public funds' beneficiaries will reduce over time (there are some indications that budget beneficiaries are becoming less eager to send monthly reports on their staffing levels, compared to the initial response when this project started in October 2013)<sup>22</sup>.

### *1.5. Inadequate staffing and operational capacities*

**Budget departments of the beneficiaries of public funds are often faced with a shortage of qualified professionals.** Examples from everyday practice, as well as various analyses made during the year, indicate that the budget departments with the majority of public funds' beneficiaries are not adequately staffed<sup>23</sup>. Due to the lack of adequately skilled budget experts, systemic shortcomings of the budget system (which was discussed in the previous section) are even more pronounced.

**The lack of HR capacity is particularly pronounced in the case of the Budget Department of the Ministry of Finance.** The quality of the budget process of every state largely depends on the strong and professional budget department in the Ministry of Finance that develops and improves the budget process and centrally monitors budget departments of other line ministries and other budget beneficiaries. However, the Budget Department of the Ministry of Finance of the Republic of Serbia has been working for many years with a shortage of staff and has been facing huge challenges to retain those qualified professionals who often leave to work in budget departments of other ministries, administrations or agencies – that are able to provide them with better working conditions. We can give an example of the capital budgeting, in view of the chronically poor execution of public investments in recent years. In September 2014, the Group for Capital Investments in the Ministry of Finance had only one employee, which certainly cannot be considered appropriate for managing this important segment of the budget process. In addition, adequate planning and budgeting of capital expenditures is of great importance in times of economic crisis that hit Serbia, and the necessary reduction of current public spending in the coming period<sup>24</sup>.

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<sup>22</sup>Adequate coverage of employees in the public sector is additionally burdened by inconsistent classification of expenditure so that, for example, expenditures for employees in scientific institutions are presented in the budget as public expenditure on goods and services (account 42) and not as expenditure for wages and salaries (account 41). Also, the indirect budget beneficiaries (which we mentioned are inadequately supervised in the current budget process) financed, from own revenues, more than 20 billion dinars of expenditure for employees in 2013.

<sup>23</sup>For example, Mr. Dusan Vujovic highlights the lack of HR capacity as a serious limiting factor for further improvements of the budgetary process (see the study on “Effective Use of Performance Indicators in Planning and Budgeting in the Public Sector”, USAID Business Enabling Project, April 2012).

<sup>24</sup>For more details about the possibilities for a more productive execution of public investments in Serbia in the following period, see the Fiscal Council report “Public Investments in Serbia: Growth Incentive in Fiscal Consolidation”.

**Staffing problems that the Budget Department of the Ministry of Finance is faced is a striking example of inadequate evaluation of employees within the public sector.** Since the Budget Department of the Ministry of Finance is the “operational center” which manages and improves the overall budget system in the Republic, as well as supervise the functioning of the budget sectors of other state institutions, it is clear that the structure of wages in the state sector must ensure that working conditions in the Budget Department of the Ministry of Finance are better than the conditions that other budget departments in the rest of the country provide. Otherwise, the Budget Department of the Ministry of Finance will not be able to hire adequate staff or to retain the best professionals in the field of the budget system – which will then affect the overall development and improvement of the budgetary system of the Republic of Serbia. It is therefore crucial to solve this problem in the context of the announced reform of pay grades in the public administration in Serbia.

**The budget planning process in Serbia is not supported by specialized software tools.** Given the complexity of the budget process, which in the case of the Republic of Serbia includes almost 200 direct budget beneficiaries and 4,000 indirect budget beneficiaries, most countries rely on specialized software solutions in the preparation and development of the state budget. Specialized software tools are largely automated and facilitate the coordination of data of a large number of participants in the budget process, enabling storage and monitoring of relevant indicators and statistics, comparative analysis between different budget beneficiaries, as well as the analysis of one beneficiary over time. However, the budget preparation process in Serbia does not rely on specialized software solutions, but relies solely on basic Excel spreadsheets, thus increasing the administrative burden of the Budget Department and preventing operational improvements in the form of process automatization and implementation of advance benchmarking analyses<sup>25</sup>.

**Establishing strong HR and operational capacity depends on the decisive political support for improving transparency and efficiency of the budget process – which often had deficiencies and shortcomings in the previous decade.** The aforementioned example of nontransparent hiring of 1,700 agronomists in 2012 or the changes in the accounting treatment of debt based on the Treasury bills in 2011, were not the result of weak HR capacities, but of a conscious political intention to circumvent the legal, fiscal rules that prescribe the control of the wage bill and the public debt, respectively<sup>26</sup>. It is therefore important to have a strong and unequivocal political support for improving transparency and efficiency of the budget process, as well as for respecting of the fiscal responsibility rules. This support is necessary not only to establish a strong and adequate staffing capacities, but it is also necessary so that budget departments are able to resist any pressures to circumvent the legal norms and good budget practice – which was common in recent years.

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<sup>25</sup>Ironically, several years ago, donor funds were used to develop a software tool for budget preparation, but it is not being used, among other things, due to the fact that certain technical solutions are not adequately developed.

<sup>26</sup>Changed accounting treatment of T-bills at the end of 2011 was clearly not in accordance with international standards, which was later confirmed by the State Audit Institution.



## 2. The Sequence of Development and Improvement of the Budgetary System

**It is not possible to skip a logical hierarchical order of improvement and development of the budget process.** Thus, for example, it is unrealistic to expect the establishment of a meaningful medium-term budget framework if, as in Serbia, there are major systemic deficiencies in the preparation of annual budgets, such as the lack of a credible framework for separating the costs of existing activities from the new measures. Also, if the current budget process is not transparent enough and does not provide basic information on the staffing levels or arrears at the level of budget beneficiaries (see section 1.4.), or if the budget process does not involve a substantial segment of (quasi) budgetary institutions (section 1.1.), it is unlikely that advanced methodologies such as budgeting based on performance indicators will produce the expected results. In this part of the paper, we are looking into some more advanced stages of the budget process, such as program budgeting and performance indicators, as well as the conditions to be fulfilled in order to introduce more advanced budget process that would produce expected results.

**Line item budget becomes program budget through disaggregation of the functional classification of budget expenditures on individual programs and project.** The Budget Laws that provide the information on individual budget beneficiaries, separate allocated funds based on the functional and economic classification, and provide insight into the sources of financing of public expenditures – in technical jargon these are called “line item budgets”. If in addition to the aforementioned information, the Budget Laws also break down public expenditures into program activities and projects, they are called “program budgets”. Annual Budget Law provides information on the economic and functional classification of expenditures of individual budget beneficiaries, while there is a possibility to have a more detailed classification of expenditures by programs and projects (for more details see Annex). During 2006, for the first time five ministries started to organize their budgets (pilot programs) in accordance with the program structure, which was first shown in the 2008 budget. During 2013, only seven of the 54 budget sections were fully covered by the program structure. The Budget System Law requires that as of 2015 all beneficiaries, both at the national level and at the level of local governments, must draft and execute their budgets in accordance with the program structure.

**The program structure complements the content of the Budget Law, but most of the information is already available within the existing line item budget.** The information presented in the program budget is the result of the budget process and the negotiations on the planned activities, projects and programs of budget beneficiaries. In recent years, the level of the information that is available to the public has considerably increased – the Budget Bill for 2014 included 300 pages with information about the plans and programs of budget beneficiaries, while this information was detailed in 400 pages in the case of the 2012 budget<sup>27</sup>. Adoption of the program budget structure enables the existing information on the activities of budget beneficiaries to be systematized in a uniform way. Therefore, we can conclude that certain expectations of the general and professional public that the transition to the program budget represents a radical change in the existing budget process are unfounded.

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<sup>27</sup>For example, the Budget Law (without the additional explanations) usually contains 170 – 180 pages. The Budget Bills, including the annex with plans and programs of budget beneficiaries, are available at the website of the National Assembly of the Republic of Serbia.

**The budget process based on the performance indicators of public spending is the highest stage of the budget system development.** The objective of establishing performance indicators is to improve the quality and efficiency of public services. This reform direction in practice requires an increase of decentralization of the budget process in which the efficiency of individual budget beneficiaries is assessed based on the selected/relevant performance indicators of budget funds that were spent. However, it is important to bear in mind that the development of appropriate and relevant performance indicators is a very challenging task. Performance indicators should quantify the degree of fulfillment of the declared goals of public policy, on the basis of spent budget funds.

**There are a number of challenges and dilemmas when attempting to implement the indicator based budgeting in practice.** The degree of fulfillment of public policies cannot always be adequately quantified, either due to conceptual reasons or practical reasons like the lack of statistical data, it is often the case where several state bodies are in charge of the implementation of one goal of the public policy, poor results in implementing public policy may be due to inefficient use of public funds, but they can also be the consequence of unforeseen circumstances beyond the control of relevant institutions, there is often a significant time gap between the expenditure of public funds and the tangible results of public policy (prevention of diseases, for example). Hence the development of the budget system based on performance indicators can be a very challenging task, which in the case of individual budget beneficiaries cannot be resolved in a technically satisfactory way in terms of increasing the number of information of the existing budget process.

**The budget process is inherently a political process.** Even in countries that have attained the highest (technical) stage of development of the budget system and adequate and impartial performance indicators, it is important to bear in mind that the decisions that are made on the basis of indicators are of political nature. For example, suppose that performance indicators clearly show that a hospital in city A is far more efficient than the hospital in city B. One of the possible outcomes would be to close the hospital in city B and transfer its funds to a more efficient hospital. However, the alternative outcome is an increase in budget funds for hospital in the city B in order to improve its capacities and efficiency, since the option of closing down a hospital and forcing people to travel to another city for treatment is politically unacceptable. It is, therefore, important to bear in mind the inevitable political dimension of the budget process since many technical weaknesses of the current budget process, which we described in the second part of this paper, are often being attributed to political causes in the general public.

**PEFA (*Public Expenditure and Financial Accountability*) brings together leading international institutions and donors in the area of public finance management.** Specifically, PEFA includes the European Commission, the World Bank, the International Monetary Fund, as well as bilateral donors such as the UK, France, Switzerland and Norway. The aim of PEFA is to synthesize the best international practices in the field of public finance management and to provide guidelines for improving the budgetary process, so that the national reform and donor funds are used in the most productive manner, since the low efficiency is a common problem of donor funded projects in many countries<sup>28</sup>. In the context of improving the

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<sup>28</sup>Problems with the performance of donor funded projects are not closely related to the area of the budget system, but are more general in nature. It is the economic “principal - agent” problem – bilateral and multilateral donors want to support reforms in developing countries, and they (usually) do so by engaging foreign experts in these areas.

budgetary system of Serbia, PEFA study from 2013 (“Good Practice Note on Sequencing PFM Reforms”, author Jack Diamond), is very important, and we will quote extensively its findings and conclusions in this part of the paper (hereinafter: PEFA).

**PEFA emphasizes the need to work out the sequence of reform activities.** “Some reform measures are a technical prerequisite for the implementation of other measures, so in practical reality, it is usually impossible to undertake all reforms simultaneously, so we must prioritize.” “In order to be successful in PFM reform, there is little choice but to attempt to *conceptually* define a desirable sequence of reforms”... “In the absence of a broad vision, more detailed reform efforts, and the associated donor support, will tend to be band-aid, quick-fix, dealing with symptoms, and difficult to sustain”. (PEFA, page 10)

**PEFA shows that technical reasons, and the experience of developed countries with advances budget systems, strongly suggest the following sequence of reform: 1) establishment of an effective budget process on an annual basis, 2) a shift from annual to medium-term budgeting, 3) establishing a program classification of expenditures and 4) introduction of performance indicators for budget funds.** “The most advanced PFM systems have evolved in stages to meet different [public] policy requirements. First, traditional budgets focused primarily on financial compliance, or fiscal control. Then they moved from annual budget planning to medium-term planning to assure greater macroeconomic stability and fiscal sustainability. Subsequently, PFM systems moved to performance budgeting or “result-based” PFM systems to improve service delivery and effectiveness in attaining [public] policy objectives. This was achieved by adopting more decentralized [public finance] management systems with associated changes in corporate governance arrangements in the public sector” (PEFA, page 14).

**PEFA indicated that if the above mentioned hierarchical sequence is not followed or some reform steps are skipped, it can be dangerous and the final outcome may be counterproductive.** “Accepting the logic behind this hierarchical approach, it would not be advisable to move to detailed sequencing of reform actions that conflict with the country’s top-level priorities. For example, it does not make sense to begin developing a medium-term budget framework (MTBF) when there is insufficient basic financial compliance to enable a country to successfully execute an annual budget. Similarly, introducing program budgeting or moving to “results-based” reforms when one cannot ensure financial compliance, or overall stability in aggregate resource envelopes, does not make sense, and could prove counterproductive. *To sum up: it is not likely to be possible to get reform sequencing right if the overall reform priorities are wrong.* (PEFA, page 15).

**PEFA explains that the establishment of the program budget and performance indicators is the last, highest level of development of the budget process that requires successful fulfillment of a number of preconditions and cannot be rushed.** This is a “two-stage process: firstly, as a precondition, a policy relevant program structure needs to be

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Since the developing countries often lack adequate local experts with the necessary knowledge and experience, and the fact that donors themselves are not technically skilled in the field of finance reform – the degree of supervision of the consultants’ work is usually not satisfactory. Adequate professional supervision in these cases is additionally challenging due to the fact that reforms tend to produce visible results after few years, long after the donor project ends. Mentioned (in)efficiency of donor funded projects have been known for many years since the problems with donor development projects in African countries, in the 1960s and 1970s.

introduced and successfully operated; and, secondly, this program structure must then be used to measure the performance and enforce the accountability of budget managers. If the process is to be successfully completed both stages of the [budget] reform should be introduced in a phased way that can be expected to take a considerable period of time” ... “Even when successfully operating a program-based budget system, this final move [of the budgeting based on performance indicators] requires some important preconditions to be put in place” ... “Managers need to be responsible for the results of spending at the level of individual programs. To make this possible, managers need to have greater flexibility in spending, leading to a higher degree of decentralization of the budgetary process” ... “Allowing a greater delegation of authority to budget beneficiaries requires assurances of their internal controls, their ability to forecast accurately, to budget realistically, to cost programs comprehensively, and to manage their programs efficiently”. (PEFA, 2013, page 22 – 24).

**PEFA suggests that the reform priorities that determine the order of the general strategy of reform should be the same for all countries.** In particular, it is about reform priorities which include: compliance with financial plans during one year, improvement of fiscal stability and sustainability through medium-term budgeting and improvement of efficient service delivery in the public sector. “With this strategic view, specific reform actions can be taken to achieve a top-level priority – that should be determined based on country circumstances. At this lower level [of individual reform activities] there is no universal ideal sequence for the reforms.” (PEFA, page 7).

In the following paragraphs, we will analyze the extent to which it is necessary to introduce program budgeting and performance indicators, as of 2015 in Serbia in accordance with the best international practice and the PEFA suggestions.

**A large number of preconditions that PEFA identified as the essential elements of the introduction of program budgeting and performance indicators are not met in the case of Serbia.** Specifically, in the second part of this study, we saw that the annual budget process suffers from a number of deficiencies and weaknesses – regular budget process does not involve a large number of quasi-budget institutions whose business operations seriously affect fiscal performance, the level of information available in the case of individual budget beneficiaries is very low and does not include data on the number of employees or the stock of arrears, and also there is no consistent framework for managing the budget negotiations at the technical level. Taking into account the aforementioned weaknesses of the budget process, it is not surprising that the medium-term budget framework in Serbia exists only formally on paper, in the Fiscal Strategy, while the medium-term budgeting is not applied in practice<sup>29</sup>. International experiences from PEFA, therefore, suggest that the introduction of program budgeting and performance indicators at this stage of development of the budget process in Serbia carries a high degree of risk and uncertainty.

**Although the initiatives and efforts to move to the program budgeting have been present in Serbia since 2005, the progress towards meeting the preconditions for the**

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<sup>29</sup>Technical adviser to the International Monetary Fund for Serbia in the period 2009 – 2012 hence advised that in terms of reform efforts, “the introduction of medium-term budgeting should be given advantage compared to the establishment of program budgeting” (Pal Ula, “The Medium-Term Budgetary Framework and Setting the Expenditure Ceilings”, January 2012).

**successful implementation of the program budgeting was modest.** During the past decade, a large number of donor projects aimed at improving the budget process in Serbia, often with more or less focus on the introduction of the program budgeting. However, due to the above mentioned weak HR capacities of the Budget Department in the Ministry of Finance, the coordination between the local activities and various donor projects was weak, and there was no consistent direction of reform in terms of PEFA recommendations and, therefore, “wandering reform” was a common occurrence. This is why the concept, methodology and responsibility for implementation of the program budgeting has changed often. Initially, the Budget Department in the Ministry of Finance was responsible for the development of the program budgeting, then that responsibility moved to the Treasury, then in the General Secretariat of the Government of Serbia and finally back to the Budget Department in the Ministry of Finance. The structure of the programs has been significantly changed over the years. The initial program classification from 2008 included 26 primary program areas. Changes over the years have resulted in the draft program classification from 2013 with 17 program areas. After the technical mission of the International Monetary Fund (IMF, 2013) indicated that the draft program classification from 2013 is not comprehensive and does not follow a hierarchical structure that is essential in the process of analytical results consolidation – program areas were revised and reorganized again.

**Plans for the introduction of program budgeting and performance indicators, both at the level of the state budget and at the local level, starting from 2015 is very ambitious, having in mind the international practice and the previous experience in Serbia.** PEFA proposes the introduction of performance indicators only after the program classification is successfully implemented and developed. Bearing in mind the aforementioned wandering in terms of adequate organization of the program classification in previous years, it seems that there is a significant risk of new revisions of the program classification in the following period. In addition, the problem is that the state budget and local governments are transferring to the program classification in parallel in the same year, as international practice shows that an adequate program classification first needs to be introduced and developed at the central level before introducing the program budgeting for local governments (IMF, 2013). Parallel implementation of the central and local levels of government complicates the problem of coordination and the development of adequate program structure, since it is necessary that the classification of programs at the central and local levels are consistent, in order to allow consolidation of overall expenditure of the general government.

**We conclude that there are substantial risks that positive effects of the introduction of program budgeting and performance indicators at this stage may not be produced (and that this process may even lead to counterproductive outcomes).** As mentioned before, the annual budget process suffers from a number of shortcomings and weaknesses, while medium-term budgeting is not implemented in practice. These two elements, however, are the key preconditions for the successful introduction of program budgeting and performance indicators, as the top-level stages of the budget system development. “Attempting to leapfrog this hierarchy in the top PFM priorities will likely lead to unsuccessful reforms”. (PEFA, page 7).

**We can identify several potential risks of counterproductive effects.** From the operational standpoint, the introduction of program budgeting and performance indicators represents a significant administrative burden for the relevant budget sectors which already lack HR capacity, especially in the key Budget Department of the Ministry of Finance. This can have a (further)

negative impact on the dynamics and possibilities of solving the most basic and most important shortcomings of the budget process, such as the absence of a large number of quasi-budgetary institutions or the absence of a credible framework for managing the budget negotiations at the technical level. From the social perspective, there is a risk that the general public (wrongly) perceives the introduction of the program budgeting as achievement of international standards of transparency of the budget process and the pressure to improve key areas of non-transparent budget system may decrease, such as the lack of data on the number of employees, a large number of quasi-budgetary institutions and their finances, the expenditures “below the line” and business operations of loss-making state-owned companies, arrears, etc. Also, the consistent implementation of the budget process based on performance indicators implies decentralization and allocation of responsibilities to the budget beneficiaries – which could increase the scope of counterproductive spending of funds, in view of the extremely low operational capabilities for effective monitoring and prevention of fiscally irresponsible behavior of budget beneficiaries.

### 3. Concluding remarks

**The budget process in Serbia suffers from a number of shortcomings, weaknesses and lack of transparency.** Some of the most relevant shortcomings include the omission of a significant number of (quasi) budgetary institutions from the regular budget procedures at the national level, the lack of information on employees of individual budget beneficiaries, as well as the absence of a system for monitoring arrears and commitments. The absence of a credible framework for managing the budget negotiations at the technical level (costs of existing activities compared to the expenditure on new measures) undermines the effectiveness of the annual budget process and prevents the introduction of the medium-term budgetary framework. The non-transparent (lack of) showing expenditures “below the line” and their omission from the official deficit calculation conceals huge losses that were created in the previous years by state-owned enterprises, including insolvent state-owned banks.

**Budget system reform should follow international experience and logical hierarchical order: 1) establish effective compliance with financial plans within the annual budget, 2) set up an effective medium-term budgetary framework and 3) determine the structure of the program budget and performance indicators.** Consistent monitoring of this sequence is necessary in order to ensure the success and sustainability of reforms. Also, from the aspect of fiscal consolidation, the most significant savings can be achieved just by improving basic budgetary functions, such as the implementation of a credible framework for budget negotiations at the technical level or introduction of the central register of the state sector employees. The development of an adequate register of employees is of paramount importance since the expenditure for employees are a dominant item of expenditure in all budget beneficiaries, as well as the fact that all the preliminary analyses suggest irrational redundancies in the state sector. It is important to notice that the announced introduction of program budgeting and performance indicators is followed by some serious risks and the possibility of counterproductive outcomes, since the current system does not allow for efficient compliance of basic budget functions on the annual basis, as well as the fact that medium-term budget framework does not work in practice<sup>30</sup>.

**The success of the budget reforms in the coming years will largely depend on the decisive political support and the HR and operational capacity building in the line budget departments, primarily in the Budget Department in the Ministry of Finance.** Positive experiences from other countries show that strong budgetary departments in the Ministries of Finance are the key to successful implementation of budget reforms that, aside from the fact that they need to follow the above mentioned hierarchical sequence, they also must be tailored to local circumstances and specificities. Weak HR capacities of the Budget Department in the Ministry of Finance were not able to provide adequate implementation of basic budgetary functions in the previous years, nor were they able to manage reforms that would establish more advanced functions, especially in turbulent macro-fiscal conditions, frequent elections and changes to the organizational structure of ministries. Hence, the considerable resources of

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<sup>30</sup>In the context of fiscal consolidation, it is important to remember that the main goal of the program budget and performance indicators are not budget savings, but improvement of the quality of public services. In addition, low quality of public services in Serbia is currently dominantly determined by the lack of adequate sector strategies, such as the lack of sustainable health sector reform strategy, the lack of rationalization plan for the system of elementary schools or the lack of precise strategy of allocation of jurisdiction between the central and local government level.

various donor projects were spent in an uncoordinated and often unproductive way, usually without establishing sustainable and permanent improvements<sup>31</sup>. Strengthening HR and operational capacity of the Budget Department of the Ministry of Finance, in a systematic and sustainable manner, is, therefore, one of the operational priorities of fiscal consolidation and the first necessary step towards creating a more efficient and more effective budget process in the Republic of Serbia<sup>32</sup>.

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<sup>31</sup>Unlike the domestic practice in the last decade, Bojan Pogacar emphasizes that all budgetary reforms in Slovenia were initiated and guided by the Ministry of Finance and the Budget Department (Presentation “Slovenian Experiences”, Conference on the reform of the budget process, Belgrade, August, 2012).

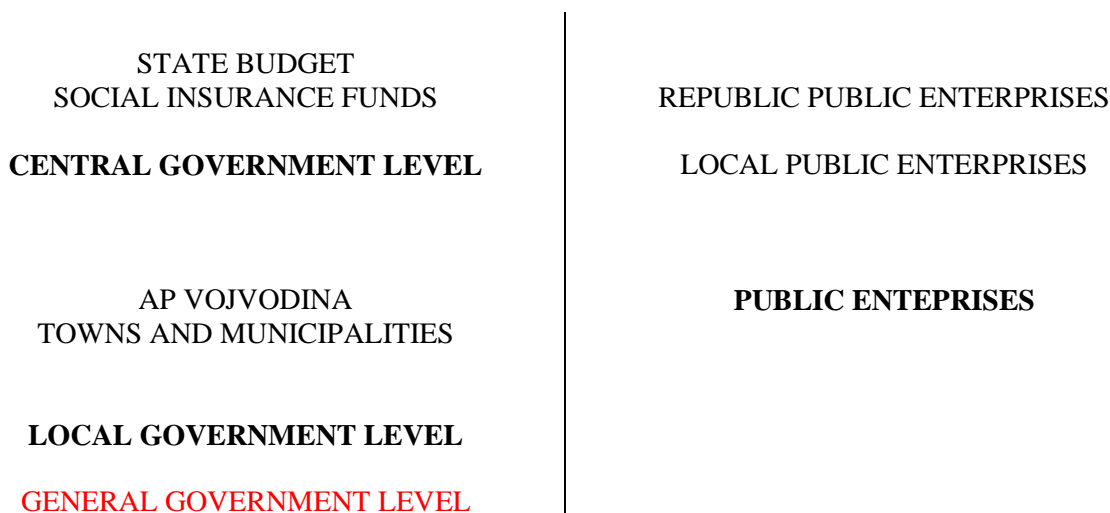
<sup>32</sup>In parallel, the reform and strengthening the capacity of the Tax Administration should be the operational priority of fiscal consolidation on the budget revenue side.



## ANNEX: DEFINITIONS AND TERMS

*The Budget System Law regulates the use of public funds at all levels of state administration in the Republic of Serbia.* The Budget System Law defines the nature of public revenues and expenditures, as well as the coverage of the general government sector which consists of the central level (Republic, mandatory social insurance organizations) and local level (municipalities, cities and autonomous provinces) authorities. The Budget System Law has the nature of an organic or an umbrella law that defines the guidelines for drafting of annual Budget Laws that define how the public funds will be spent during one calendar year, at both the national level budget and the local level budgets (local governments and the provinces) and financial plans of mandatory social insurance organizations. Figure 1 provides a schematic representation of various entities that make up the consolidated general government sector in the Republic of Serbia.

**Figure 1. Structure of the public sector and general government sector**



### PUBLIC SECTOR

Note: Public sector includes banks and other financial institutions in majority state ownership. The National Bank of Serbia is also part of the public sector.

**The Budget Law defines the expected public revenues in the (next) calendar year, how these collected revenues will be allocated and the method of financing (if any) the budget deficit.** Figure 2 shows a segment from the Budget Law of the Republic of Serbia for 2014, which describes the use of public funds earmarked for the National Assembly of the Republic of Serbia. The Budget Law presents five elements that describe the spending of public funds – 1) budget beneficiary to whom the funds are earmarked, 2) functional classification of funds, 3) program classification of funds, 4) economic classification of funds and 5) sources of funding.

**Figure 2. Part of the 2014 Budget Law of the Republic of Serbia, page 61**

Section	Head	Function	Program	Project	Ec.classification	DESCRIPTION	Total amount
1	2	3	4	5	6	7	8
<b>1</b>		<b>110</b>				<b>NATIONAL ASSEMBLY</b>	
						<b>Executive and legislative bodies, financial and fiscal affairs and foreign affairs</b>	
					411	Salaries, allowances and compensation of employees (wages)	363.829.000
					412	Social contributions paid by employer	64.205.000
					413	Benefit in kind	2.000.000
					415	Compensation of costs for employees	8.000.000
					417	Flat rate allowance for MPs	150.000.000
					421	Fixed costs	300.000
					422	Travel costs	137.000.000
					423	Contracted services	500.000
					482	Taxes, mandatory taxes, fines and penalties	1.000
					483	Fines and penalties according to the court decisions	1.000
						<b>Sources of financing for function 110:</b>	
					01	Budget revenues	725.836.000
						<b>Total for function 110:</b>	<b>725.836.000</b>
						<b>Sources of financing:</b>	
					01	Budget revenues	725.836.000
						<b>Total:</b>	<b>725.836.000</b>

Information on *budget beneficiaries* that receive public funds in that calendar year is presented in Column 1 (Section) and Column 2 (Head). Over the past few years, the republic budget distributed total amount of funds into 54 *Sections*, where many sections were further distributed into budget beneficiaries within *Heads*.

*Functional classification* (Column 3) describes the basic purpose for which the public funds are used. Financial classification follows a comparable international United Nations' COFOG classification, which includes ten basic functional purposes: 01 – General public services, 02 – Defence, 03 – Public order and safety, 04 – Economic affairs, 05 – Environmental protection, 06 – Housing and community amenities, 07 – Health, 08 – Recreation, culture and religion, 09 – Education, 10 – Social protection.

Public revenues can be additionally distributed, within the functional classification, into selected public policies to *program classification* (Column 4) and individual projects (Column 5). Unlike the functional COFOG classification that is internationally defined, each country separately defines and determines the program classification and classification of individual projects.

Public expenditures can also be classified based on the *economic classification* of how the funds are spent. In this segment, the Budget Law follows the IMF's GFS classification that implies the following forms of public spending: 41 – Compensation of employees, 42 – Purchase of goods and service, 44 – Interest repayment, 45 – Subsidies, 46 – Donations and transfers, 47 – Social insurance rights, 48 – Other expenditures, 50 – Expenditures on non-financial assets.

Finally, the Budget Law provides information on *sources of financing* of expenditures of budget beneficiaries. The most common source of financing are budgetary resources (code 01), but some budget beneficiaries also have access to their own revenues (code 13), donations from

international organizations (code 06) and the like. Every single line within the Budget Law which defines the use of public funds for a specific purpose is called *the budget appropriation*.