

Editors: Mojmir Mrak, Robert Bauchmüller, Paul McClure

# Fiscal Impact Assessment of Structural Reforms

**Case Studies on South East Europe**

BUDGET USERS

ECONOMIC AND FISCAL PROGRAMME

GUIDELINES AND INSTRUCTIONS

# **Fiscal Impact Assessment of Structural Reforms**

**Case Studies on South East Europe**

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# CONTENTS

<b>ABOUT THE EDITORS</b>	<b>xi</b>
<b>ABBREVIATIONS</b>	<b>xiii</b>
<b>PREFACE</b>	<b>xv</b>
<b>INTRODUCTION</b>	<b>1</b>
<b>Chapter 1: Case Study on ALBANIA</b>	<b>5</b>
1. Introduction	7
2. Main institutional features for annual budget and medium-term fiscal programming	8
3. Incorporation of structural reforms' fiscal costs into fiscal programming documents	13
4. Conclusions and recommendations	23
5. Literature and sources	27
6. Appendix	29
<b>Chapter 2: Case Study on BOSNIA &amp; HERZEGOVINA</b>	<b>31</b>
1. Introduction	33
2. Main institutional features for annual budget and medium-term fiscal programming	35
3. Incorporation of structural reforms' fiscal costs into fiscal programming documents	47
4. Conclusions and recommendations	57
5. Literature and sources	61
6. Appendixes	62
<b>Chapter 3: Case Study on CROATIA</b>	<b>69</b>
1. Introduction	70
2. Main institutional features for annual budget and medium-term fiscal programming <sup>1</sup>	71
3. Incorporation of structural reforms' fiscal costs into fiscal programming documents	81
4. Conclusions and recommendations	89
5. Literature and sources	91
6. Appendix	94

<b>Chapter 4: Case Study on KOSOVO</b>	<b>97</b>
1. Introduction	98
2. Main institutional features for annual budget and medium-term fiscal programming	98
3. Incorporation of structural reforms' fiscal costs into fiscal programming documents	102
4. Conclusions and recommendations	106
5. Literature and sources	107
<b>Chapter 5: Case Study on MACEDONIA</b>	<b>109</b>
1. Introduction	110
2. Main institutional features for annual budget and medium-term fiscal programming	111
3. Incorporation of structural reforms' fiscal costs into fiscal programming documents	117
4. Conclusions and recommendations	123
5. Literature and sources	126
<b>Chapter 6: Case Study on MONTENEGRO</b>	<b>127</b>
1. Introduction	128
2. Main institutional features for annual budget and medium-term fiscal programming	129
3. Incorporation of structural reforms' fiscal costs into fiscal programming documents	133
4. Conclusions and recommendations	142
5. Literature and sources	144
6. Appendix	145
<b>Chapter 7: Case Study on SERBIA</b>	<b>147</b>
1. Introduction	148
2. Main institutional features for annual budget and medium-term fiscal programming	149
3. Incorporation of structural reforms' fiscal costs into fiscal programming documents	155
4. Conclusions and recommendations	165
5. Literature and sources	168
6. Appendixes	169

<b>Chapter 8: Case Study on SLOVENIA</b>	<b>177</b>
1. Introduction	178
2. Main institutional features for annual budget and medium-term fiscal programming	179
3. Incorporation of structural reforms' fiscal costs into fiscal programming documents	187
4. Conclusions and recommendations	198
5. Literature and sources	201
6. Appendixes	202
<b>Chapter 9: Case Study on TURKEY</b>	<b>205</b>
1. Introduction	206
2. Main institutional features for annual budget and medium-term fiscal programming	206
3. Incorporation of structural reforms' fiscal costs into fiscal programming documents	213
4. Conclusion and recommendations	219
5. Literature and sources	221
6. Appendix	221
<b>Conclusions</b>	<b>223</b>
1. Relevance of political support	224
2. Fiscal programming and strategic documents	225
3. Fiscal impact assessments of structural reforms	225
4. Role of budget users	227
5. Fiscal policy coordination	228
6. Improving procedures and guiding budget users	229
<b>Annex I: Indication of learning events to serve highlighted needs</b>	<b>231</b>
1. Fiscal policy coordination	232
2. Budget submissions of line ministries	233
3. Enabling environment for effective fiscal impact assessments	234
<b>Annex II: Guidelines for preparation of country case studies</b>	<b>237</b>
Instructions for preparing country case studies	239
Content and structure of country case studies	239
Methodological issues of structural reforms: for use in preparing country case studies	245
<b>Annex III: FIASR Working Group</b>	<b>249</b>
About the Center of Excellence in Finance (CEF)	250
Recent CEF (co)publications	250





# LIST OF FIGURES

Figure I-1:	The linkage between the NSDI and the MTBP cycle	29
Figure I-2:	The programme expenditure process within a year in a budget institution	30
Figure II-1:	The budget preparation process of BiH in 10 steps	43
Figure II-2:	Projected financing of the Strategy of Science Development in BiH	67
Figure III-1:	Linkages among strategic planning documents	72
Figure IV-1:	Planning systems in Kosovo	100
Figure VI-1:	Budget preparation scheme	141
Figure VII-1:	Proposed integrated planning framework	163
Figure VIII-1:	Normative regulation of fiscal and development documents	183
Figure VIII-2:	Schematic illustration of development and budget planning system	190
Figure IX-1:	Budgeting process in Turkey	208
Figure IX-2:	Planning documents in Turkey	213

# LIST OF TABLES

Table II-1:	Issues with the fiscal impact assessment of selected structural reforms in BiH	60
Table II-2:	Total general government expenditure in BiH, 2011	63
Table II-3:	Plan of domestic spending on research and development in RS, 2012–2016	68
Table III-1:	PEP preparation process for the period 2011–2013	75
Table III-2:	Pre-accession Economic Programme approval and implementations	75
Table III-3:	Budget planning process in Croatia	80
Table III-4:	Content of Pre-accession Economic Programmes	82
Table III-5:	Structural reforms	83
Table III-6:	An example of effect estimates of structural reforms	83
Table III-7:	Government strategic program objectives in the period 2010–2012	94
Table III-8:	Linking strategic plans and budgets	96
Table V-1:	Most pressing issues associated with fiscal impact assessments of structural reforms	123
Table VI-1:	Fiscal effects of structural policies: summary based on analysis presented in PEP chapter IV	145
Table VIII-1:	Content of the Budget Memorandum according to regulation and the PFA	189
Table VIII-2:	Structural reforms in Slovenia's Exit Strategy and NRP	193
Table VIII-3:	Individual development planning documents and budget holders	196
Table IX-1:	Matrix of policy commitments: health care and social security	214
Table IX-2:	Display of analytical budget classification	216

# ABOUT THE EDITORS

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Mr. Mrak has more than 20 years of experience in designing and implementing the Slovenian government's policy in areas of international finance and EU accession. In the first five years following independence in 1991, he was the chief external debt negotiator of Slovenia. In addition, he was responsible for the early credit arrangements of Slovenia with the European Bank for Reconstruction and Development and the World Bank. Between 1998 and 2002, he was chief advisor of the Slovenian government on financial aspects of the country's EU accession. Within this framework, he was responsible for negotiations about the financial package of Slovenia's accession. Between 2003 and early 2006, he coordinated the Slovene government's activities with respect to the 2007–2013 financial perspective of the EU, and is currently involved in negotiations about the 2014–2020 financial perspective of the EU.

Mr. Mrak has served as a consultant to numerous international organizations and several governments in South East Europe. He is a CEF Associate Fellow.

**Robert Baumüller** has been working for the CEF since December 2010 as manager of the program on Building Capacities in Policy Design and Implementation (BCPDI), which includes activities that facilitate policy discussions in South East Europe. Among the current activities he manages are the Fiscal Impact Assessment of Structural Reforms (FIASR) project and the Strategic Planning and Budgeting (SPB) project.

Mr. Baumüller holds an MSc degree in Economics from Maastricht University. He has been abroad for several exchange and research visits, for example, to the Warsaw School of Economics, the University of Essex, and the Governmental Research Institute AKF in Copenhagen.

Before moving to Slovenia, Mr. Bauchmüller was a research fellow at the Graduate School of Governance at Maastricht University, while undertaking Ph.D. research in public policy analysis. There he also gained experience in teaching at the graduate and undergraduate levels, and managed capacity building programs in cooperation with UNICEF and the ILO.

**Paul McClure** joined the CEF in April 2012 on an appointment partially funded by the Bank of Slovenia to help scale up support on written communications to finance ministries and central banks across South East Europe.

He is on an external service assignment from the World Bank, where most recently he worked in the Web Program Office to revamp online content dealing with the Bank's research, analytical, and learning activities. He has also served as Chief of Editorial Services at IFC, the World Bank Group arm focusing on private sector development, where he managed the annual report and served as lead editor on news releases, Internet content, and other corporate communications.

His writing, editing, and publishing experience includes positions at the World Bank Office of the Publisher and Congressional Quarterly in Washington, D.C. He also has several years' experience in the teaching of writing at Cornell University, where he earned his Ph.D.

# ABBREVIATIONS

ABC	Analytical Budget Classification
BCPDI	Building Capacities in Policy Design and Implementation (CEF program)
BD	Brčko District (neutral, self-governing administrative unit under sovereignty of BiH)
BiH	Bosnia and Herzegovina
CoG	Center of Government (of Serbia)
DEP	Directorate for Economic Planning (within Council of Ministers of BiH)
DFID	Department for International Development (of the UK)
DSDC	Department of Strategy and Donor Coordination
EDVAP	Economic Development Vision Action Plan
EFP	Economic and Fiscal Programme
EMU	Economic and Monetary Union of the EU
EPAP	European Partnership Action Plan
FBiH	Federation of Bosnia and Herzegovina
FC	Fiscal Council (of BiH)
FDI	Foreign Direct Investment
FIASR	Fiscal Impact Assessment of Structural Reforms (CEF project)
FMF	Federal Ministry of Finance (Ministry of Finance of FBiH)
FSR	Fiscal Strategy Report (of Serbia)
GERD	Gross Domestic Expenditure on Research and Development
GFFBP	Global Framework for the Fiscal Balance and Policy (in BiH)
GFS	Government Finance Statistics
GFSM	Government Finance Statistics Manual (IMF, 2001)
GS	General Secretariat (of the government of Serbia)
HPC	High Planning Council (of Turkey)
IFIs	International Financial Institutions
IMAD	Institute for Macroeconomic Analysis and Development (of Slovenia)
IPA	Instrument for Pre-Accession
LM	Line Ministry

LPFMA	Law on ‘Public Finance Management and Accountability’ (of Kosovo)
MAU	Macroeconomic Analysis Unit (of the Indirect Taxation Authority Governing Board of BiH)
MFT	Ministry of Finance and Treasury (of BiH)
MM	In units of a million
MoD	Ministry of Development (of Turkey)
MoF	Ministry of Finance
MTBP	Medium-Term Budget Programme
MTEF	Medium-Term Expenditure Framework
MTFP	Medium-Term Fiscal Plan (of Turkey)
MTP	Medium-Term Programme (of Turkey)
NPAA	National Programme for Adoption of the Acquis
NRP	National Reform Programme
NSDI	National Strategy for Development and Integration (of BiH)
OECD/SIGMA	Organisation for Economic Co-operation and Development / Support for Improvement in Governance and Management
OSPC	Office for Strategic Planning and Coordination (of Kosovo)
PEP	Pre-accession Economic Programme
PFA	Public Finance Act (of Slovenia)
PFM	Public Financial Management
PFMC	Public Financial Management and Control (of Turkey)
PSDPI	State Development Priorities and Investments (of Slovenia)
RS	Republika Srpska
RSMF	Republika Srpska Ministry of Finance
SEE	South East Europe
SMEs	Small and Medium Enterprises
SPB	Strategic Planning and Budgeting (CEF project)
TCA	Turkish Court of Accounts
TGNA	Turkish Grand National Assembly
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme

# PREFACE

The Center of Excellence in Finance believes that capacity development is an endogenous process: that capacity can only be developed when the effort has strong country ownership. But while our member countries across South East Europe hold the responsibility and decision-making power for strengthening capacity in their public sector, the CEF provides crucial support by facilitating learning.

Developing individuals' capacity can increase the capacity of institutions, which in turn can benefit society as a whole. But people learn most when they are actively involved in the process of learning. This is why the CEF strongly focuses on a participatory approach, one that emphasizes understanding and responding to the learning needs of individuals and institutions.

The country case studies in this volume represent just such an in-depth needs assessment for countries in the region, on an issue that is both critical and insufficiently addressed: how the fiscal impacts of structural reforms are integrated within the budget process. Working closely with Montenegro's Ministry of Finance and with support from the World Bank's SAFE trust fund, the CEF identified authors with the right knowledge to assess the situation and offer recommendations for improvement. The Fiscal Impact Assessment of Structural Reforms (FIASR) project is part of a long-term CEF program, Building Capacities for Policy Design and Implementation. The capacity development needs that the case studies have identified will be addressed through a series of CEF learning events entitled Strategic Planning and Budgeting from 2013 to 2015.

The case studies were prepared by local experts from seven countries of South East Europe that are beneficiaries of the SAFE trust fund, as well as Slovenia and Turkey, in the second half of 2012. Each author describes the country's main institutional features for the annual budget preparation and medium-term fiscal programming, and how fully the costs of structural reforms are incorporated into fiscal programming documents. Each case study concludes by identifying the main problem areas and offers recommendations for addressing them. In examining budget processes as a whole, the studies place a particular focus on the role and capacity needs of line ministries.



Authors or their representatives presented the case studies at a two-day seminar that the CEF convened in October 2012 at the Regional School of Public Administration in Danilovgrad, Montenegro. By bringing together counterparts across the region, the event also played an important role in developing the regional capacity of experts who are involved in strategic planning and budgeting processes. The case studies have been revised and updated to incorporate comments that authors received from their regional counterparts and from international experts who represented European Union member countries, the International Monetary Fund, OECD/SIGMA, and the World Bank at the Danilovgrad event.

The case studies give the CEF's capacity development experts an excellent basis for even deeper needs assessment on the capacity development issues facing institutions involved in strategic planning and budgeting processes across South East Europe. As noted, learning events to address these needs will begin during 2013; beyond the first three proposed in this volume, a more extensive agenda will be defined based on further discussion with beneficiaries. The list of key issues that need attention includes, for example, developing technical capacities for fiscal impact assessment, addressing policy coordination processes, creating an enabling environment for policy making and implementation, and building an understanding of change management processes. These issues are complex and require further involvement of the CEF's Building Capacities for Policy Design and Implementation program. The program is now ready to move from needs assessment to implementation, which will require focus at the highest level and an investment of substantial human and financial resources. Success will demand wide donor involvement and harmonization.

We extend our thanks to all local and international experts who have contributed to the FIASR project. Our particular recognition goes to the authors of the country case studies. Their contribution reconfirms our strong belief that substantial capacity for strategic planning and budgeting already exists in the region. The CEF, in cooperation and coordination with other regional and international institutions, stands ready to further develop this capacity. It is part of our commitment to supporting reform in public financial management and to helping build a stronger, more accountable fiduciary environment throughout the region.

Jana Repanšek  
Deputy Director  
Center of Excellence in Finance

# INTRODUCTION

This publication presents case studies from nine countries of South East Europe, which were prepared by local experts, to examine how the fiscal impact of structural reforms and other sectoral policies is incorporated into annual budgets and strategic macro-fiscal documents. The studies describe the processes that are currently in place and identify areas that can be strengthened through capacity development activities, as outlined in the final chapter. Each of the authors points to the need for better fiscal policy coordination among budget institutions.

Countries of the Western Balkans are on a long, often complex path to EU membership. This process requires substantial adjustments to candidate countries' economic systems, including two important ones that are required by the so-called Copenhagen criteria. The first of these requires that a candidate country be full-fledged market economy, and this has been largely met by the countries in the region. On the other Copenhagen criterion—that a candidate country should be able to sustain its economy amid competitive pressures on the single European market—countries of the region still have a long way to go.

Becoming a competitive market economy is a complex task, not only for (potential) candidate countries but also for many existing EU members. A necessary but not a sufficient condition for a country to become internationally competitive is its macro-economic and fiscal stability. This stability needs, however, to be complemented with appropriate and timely structural reforms. While there is no single, generally accepted definition of structural reforms, it could be said that structural reforms are not an end in themselves but rather a means for boosting sustainable economic growth. Some areas of structural reforms involve significant policy efforts and institutional changes, but are not very demanding from the fiscal point of view, whereas other segments of structural reforms—such as investments in physical infrastructure, human resources, research and development, and social safety net reform—typically pose a significant financial burden for countries' public finances.

Within the context of the EU accession process and to establish a strong and continuous policy dialogue on macroeconomic and fiscal issues, the European Commission requires that candidate countries annually prepare a document—called the Economic and Fiscal Programme for potential candidates and the

Pre-accession Economic Programme for official candidate countries—that outlines consistent macroeconomic and fiscal forecasts over the next three years and estimates the fiscal costs associated with the structural reforms, which are conducive to full compliance with the two Copenhagen economic criteria. These documents reflect preparatory steps for the National Reform Programme and Convergence Programme Reports that EU member states need to prepare.

The CEF is committed to helping its beneficiary countries in responding to such macro-fiscal surveillance requests through a program entitled *Building Capacities in Policy Design and Implementation* (BCPDI). At the initiative of beneficiaries, the CEF has developed this program, with input from the European Commission and the international financial institutions (IFIs). The aim is to build countries' capacities for medium-term macroeconomic and fiscal policy analysis, design, and implementation and to foster stronger internal and external policy coordination for the medium term. The BCPDI program entails three delivery components: 1) training, 2) community of practice, and 3) technical assistance.<sup>1</sup>

In 2013, the Center of Excellence in Finance (CEF) will begin implementing *Strategic Planning and Budgeting* (SPB), a Multi-Beneficiary Instrument for Pre-Accession (MB-IPA) project financed by the European Commission. The SPB project aims to address capacity needs in policy design, implementation, and coordination of three key areas: (i) the medium-term macroeconomic framework, (ii) the medium-term fiscal and budgetary framework, and (iii) the integration of structural reforms' fiscal costs into the annual budgets and medium-term fiscal documents of beneficiary countries. The case studies in this book focus on the third area, the quantification of fiscal costs of structural reforms and into their integration into medium-term fiscal programming documents. They help identify the content of activities for this area of the SPB project, which has been more challenging than for the other two areas.

A number of deficiencies have been observed in the integration of structural reforms' fiscal costs into fiscal programming documents, and the case studies provide a means to gauge these across the region and explore how they can be addressed. There is a lack of consistent inputs by line ministries into annual and medium-term fiscal documents as well as weak linkages among various sections of these strategic documents. Reasons include inadequate guidelines for ministries on how to prepare inputs to strategic documents, a lack of capacity to assess the impact of structural reforms on national budgets, and weaknesses in organizational structures. In addition, challenges in policy coordination include inconsistent procedures, unclear responsibilities or lines of authority, inadequate coordination mechanisms, communication problems, and inconsistencies between central and local government levels. Overcoming such deficiencies should help promote the success of structural reforms through better transparency, accountability, and prioritization of efforts.

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1 For more details on BCPDI, please visit [www.cef-see.org/bcpdi](http://www.cef-see.org/bcpdi).

To address all these deficiencies, the CEF in partnership with the Ministry of Finance of Montenegro initiated a special project—*Fiscal Impact Assessment of Structural Reforms (FIASR)*—for which a financial grant from the SAFE Trust Fund was approved in March 2012. The FIASR project has three main objectives: (i) assessing—via country case-studies—how countries of the SEE region incorporate structural reforms into their national budgets and medium-term fiscal documents, (ii) identifying gaps and policy coordination issues in this process, and (iii) generating a list of issues that can be addressed through learning events within the framework of the SPB project.

For the overall guidance of the FIASR project, a special Working Group was created by the CEF.<sup>2</sup> The group had its kick-off meeting in Ljubljana in April 2012. At the meeting draft, *Guidelines for preparation of country case studies* were adopted as a key component for the project's success.<sup>3</sup> Between May and September 2012, case studies were drafted by national experts from project's beneficiary countries; two other CEF member countries, Slovenia and Turkey, also chose to participate. The national experts received comments on their early drafts from the members of the FIASR Working Group. Country case studies were prepared for nine countries: Albania, Bosnia and Herzegovina, Croatia, Kosovo,<sup>4</sup> Macedonia, Montenegro, Serbia, Slovenia, and Turkey.

The main event within the FIASR project was a two-day seminar (October, 23 and 24, 2012) at the campus of the Regional School of Public Administration in Danilovgrad, Montenegro, co-hosted by Montenegro's Ministry of Finance. The CEF and its partners brought together representatives from the nine countries who wrote case studies to discuss the fiscal impact assessment of structural reforms. The authors or their representatives presented their countries' budget processes and the extent to which these integrate the structural reforms that are championed by line ministries and elected officials. Authors pinpointed challenges and offered recommendations for a more integrated approach; they received feedback from counterparts across the region as well as international experts. The 52 participants brainstormed about the ways capacity development can help, generating ideas that the CEF will take on board for the SPB activities beginning in 2013.

A number of key themes emerged from the discussions in Danilovgrad. Participants agreed that a shared definition of structural reforms is urgently needed throughout the region, and that a close involvement of the European Commission in this process would be beneficial. Line ministries also need more policy capacity as well as guidance, and, in many cases, better skills for assessing the costs of current and envisaged policies, so as to move from preparing mere wish lists to functioning as a fully informed, responsible actor in the decision-making on the fiscal implications of policies. Much more comprehensive

2 For a list of members of this group, see ANNEX III.

3 The final version of the Guidelines is presented in ANNEX II.

4 This designation is without prejudice to positions on status, and is in line with United Nations Security Council Resolution 1244 and the International Court of Justice opinion on the Kosovo Declaration of Independence.

coordination is needed across the government entities involved in annual and multiyear budgeting, with a focus on ensuring that structural reforms have the understanding and support of high-level officials, including politicians. This is particularly relevant at the start of the preparation of fiscal documents, when reforms affect several sectors, as well as in cases where a large number of relevant strategies might lead to policy inconsistencies.

Many participants also highlighted that the coordination of processes associated with preparation of various fiscal programming documents could be significantly improved. Other weaknesses of fiscal documents are linked to a lack of foresight in estimating the fiscal costs of structural reform efforts, poor economic analysis, and inadequate articulation of policy measures. While the case studies identified similar issues in most countries, government sectors vary considerably; hence not all line ministries have the same capacity needs for assessing and measuring the budget impacts of reforms.

When discussing future learning events, participants outlined the main actors and areas that need capacity development and highlighted possible obstacles in the institutional environment. Learning events should develop the capacities of the relevant actors at the political, coordinating, and operational levels of the process; activate trainers within beneficiary institutions to extend and sustain the impact of any training; support the preparation of better guidelines and templates; and facilitate the exchange of good practices. When training public administration officials, it is important to take note of the absorption capacities, staff turnover and motivation, and human resource management at their institution. Technical obstacles might result from a need for translations, limited access to methodology and manuals, weak links with civil society, and a lack of resources.

Following the seminar, authors have been asked to make a final review of their respective country case studies for inclusion in this publication.

## Chapter 1

# Case Study on ALBANIA

prepared by

**Blerta Zilja & Edlira Kalaja**

**Blerta Zilja** is a lecturer in cost and management accounting at the University of Tirana. She graduated from the university's Faculty of Economics in finance and accounting, finished her master's in accounting and auditing, and is pursuing her Ph.D. in public investments appraisal and evaluation. Her research fields include public finance management, cost benefit analyses, decision-making on public investments, and public auditing. She is the author of many scientific articles and participates in international scientific conferences.

She has worked for three years as a budget specialist for public investment management at the Ministry of Finance. Since 2011, she has been an Expert Associate at the Albanian Institute of Science (AIS), engaged in projects on public finance and data transparency. Her articles and studies on the country's budget indicators, economic performance, education sector, and other topics have been published on the Albanian open data website, a project of AIS. She is also a Finance Expert in the Monitoring of Public Finance project of the Open Society Foundation Albania, where she prepared reports on the state's budget preparation and execution, the performance of the Supreme Audit Institution and the Public Procurement Agency, and the reflection of European integration priorities in the state budget.

**Edlira Kalaja** has extensive experience in public finance, especially budgetary programming and policy analysis. For the last seven years she has worked in budget policy analysis at the Ministry of Finance of Albania, also participating in several working groups focusing on budget issues. In the past year she has also contributed as an Associate Expert on public finance projects at the Albanian Institute of Science.

She graduated as an honor student from the University of Tirana, where she received her BSc and MBA degrees, majoring in finance. She is finishing the Ph.D. program at the university, focusing on sustainability of public debt in Albania.

For several years she has been a member of the University of Tirana faculty, teaching finance courses to students of all levels. Since August 2012, she has been a consultant to the World Bank and also holds the position of Country Coordinator for Albania for Europa Re, a company that deals with catastrophe and weather risk insurance for South East Europe.

# 1. Introduction

The budgeting process is vital to getting the full advantage of benefits from public spending given available resources. For this reason Albania has made enormous steps in strengthening budget procedures and reforms, which are nowadays oriented beyond a one-year process, reflecting objectives and policies undertaken by the government. This case study gives a clear picture of the structural reforms undertaken in Albania and how effectively their costs are included in the state budget.

It also tries to identify the bottlenecks of the process and the institutions involved, emphasizing at the same time the progress Albania has made in this area. An important part is dedicated to the problems and issues which should be the future focus for budget institutions responsible for the process and the implementation of reforms.

For this study, the working group focused on the most important structural reforms undertaken over the last 10 years in five sectors: Enterprise, Financial, Human Resource Development and Labor Market, Administrative Services, and Network Industry.

For each case of reform, the group verified whether its cost was integrated in the state budget, analyzing the budgets of relevant ministries, their programs, the Medium-Term Budget Programme documents in relevant years and their accompanying reports, the consolidated fiscal table budget, annual reports of the line ministries and all other budgetary institutions, monitoring reports, reports audit, the Economic and Fiscal Programme documents, and others. Time series were analyzed mainly by program classification, but in some cases functional classification was used.

The main sources of data were taken from the Ministry of Finance, the Institute of Statistics, the Bank of Albania, line ministries and other responsible institutions, sector strategies, and the related legal framework in the five sectors examined, as well as signed agreements with other countries or international organizations. The European Commission's progress reports on Albania and the reports from international organizations, such as the World Bank and UN, were also taken into consideration.

This case study consists of four sections. The first introduces the methodology used for this case. The second introduces the process of budgeting, not only its importance but reforms made during recent years, the legal framework, detailed procedures, and the main actors of this process. The third section focuses on the reforms undertaken in key sectors, institutions, and processes to include the cost of structural reforms in the state budget. The last section gives some conclusions and recommendations for all of the issues treated above.



## 2. Main institutional features for annual budget and medium-term fiscal programming

### 2.1. Legal and other relevant framework

One of the main features in Albania's budgeting process is that the whole system is top-down, meaning that the government firstly determines the level of total expenditures to be allocated among the main policies. The setting of these ceilings is a critical step in ensuring that the process of program expenditure planning is consistent with macro-fiscal stability and the strategic priorities of the government. In this context ceilings are an upper limit of the total amount of money that can be spent, or planned to be spent, for a particular purpose. However, the budgeting process has at the same time some elements that are bottom-up, as the Ministry of Finance (MoF) after analyzing a budgetary request can be flexible in adjusting ceilings of the respective institution.

The perception of the budgeting process changed during 2008, on approval of the new organic law on the budget system.<sup>5</sup> This law specifies in detail the budgetary system in Albania: its structure, principles, the foundations of the budgetary process, intergovernmental financial relations, and responsibilities for execution of the entire budgetary legislation.

This law was the aftermath of the Medium-Term Budgeting Process, which started in 2000 in some pilot institutions and brought several innovations such as: (i) orienting the budgetary process beyond an annual thinking process, (ii) shifting to Programme and Performance Budgeting outputs, (iii) defining clear roles and responsibilities, and (iv) making explicit the linkages of the budget process and policies set by the government. The need for a new law derived from the modernization of the treasury system that started in 2004, establishing a real-time operational treasury system.

A key component of the budgeting process is the Integrated Planning System (IPS), which provides a broad planning framework within which the government's policies and financial planning processes function in a consistent way. The IPS helps the government in harmonizing core processes such as the National Strategy for Development and Integration (NSDI), the Medium-Term Budget Programme (MTBP), European integration and NATO membership, and external assistance. The quality and coherence of these technical processes significantly affect the government's ability to achieve its policy goals and objectives and thus keep its promises to the public.

As part of IPS, an important document in the budgeting process is the National Strategy for Development and Integration (NSDI), which presents the medium- to longer-term policy direction for the government over a seven-year period. The linkages between the NSDI and the MTBP are shown in Figure I-1

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5 Law on the "Management of the Budgetary System in the Republic of Albania" (No. 9936), enacted on June 26, 2008.

in the Appendix. The NSDI is founded on a national vision and a comprehensive set of sectoral and cross-cutting strategies. Sector strategies consider strategic policy commitments from the Government Programme, European and NATO integration requirements, and any major public investment or external assistance priorities.

On the other hand, the law on the 'Management of the Budgetary System in the Republic of Albania' explains in detail the procedure that all government units and special funds should follow during the year. The annual budget procedure itself follows the specific dates set in the organic budget law, followed by the Permanent and Annual Instructions of the Ministry of Finance, which specifies the rules of Budget Preparation and Budget Execution during the year. Those documents are issued by the MoF at the end of February on behalf of the Council of Ministers. The Budget Preparation Instructions is the document which officially begins the first of three rounds of the Medium-Term Budget Planning process, advising budgetary institutions in preparing spending plans.

Additional guidance for preparing the budget is issued in July, starting the second round and requiring appropriate review of plans prepared during the first round. In cases where the ceilings are higher than those of the first round, instructions can specify the products for which these additional resources are given. Other guidelines are prepared to explain the monitoring and execution part of the budgetary process. The third round is a process which must be accomplished by all budgetary institutions at the end of the year, the period in which the ceilings of the first year of the MTBP—the future annual budget—are already set and cannot be changed. This round can be something of a paper exercise, as a result of the short time remaining or problems in the programming.

Guidelines of the Policy Priorities, prepared by the Department for Strategy and Donor Coordination of the Council of Ministers, is another document that helps the budgetary institutions identify new policy priorities that have not been previously funded and that are now a major possibility, so that they can take advantage of resources that may remain available after calculating the costs of existing policies.

Another important step in improving the effectiveness of government's expenditures plans is the process of monitoring, which provides feedback on the implementation of policies. To achieve a successful evaluation of commitments undertaken by ministries, each of them prepares an integrated plan, an annual document that highlights the key MTBP commitments, including European integration commitments, planned legislation, major public investments, anti-corruption measures, and external assistance projects.

Another significant document drafted by the government is the Economic and Fiscal Programme (EFP). As a potential candidate country aspiring to join the European Union, since 2006 Albania has annually submitted this document to the European Commission. It presents Albania's economic and fiscal policies and the main structural reforms with a medium-term perspective. The program outlines also the preparation of institutional capacities to participate in the

economic and monetary surveillance procedures of the European Union by giving a detailed assessment of the current year's economic and financial situation in Albania and articulating the medium-term economic policies and structural reforms to be implemented during the three years for which the document is drafted. The EFP is based on the Budget Law of that year, the Macroeconomic and Fiscal Framework for the next three years, the Medium-Term Budget Programme, the latest Monetary Policy Report, and the Public Finances Strategy. At the same time it is fully in line with the National Strategy for Development and Integration (NSDI). The EFP is approved by the Council of Ministers.

One of the most important principles for the budget process in Albania is transparency, which implies that everyone can read, see, and examine not only the procedures but also the funds allocated to each public institution by using the section for budget documents on the official website of the Ministry of Finance.

## 2.2. Procedures

The following section lists the procedures for preparing the Annual Budget, which is the first year of the Medium-Term Budgeting Programme. All budget institutions strictly follow procedures as set in the organic budget law. In cases where these procedures are not followed, clear sanctions apply. As part of the Integrated Planning System calendar, it is the task of the Minister of Finance—as the main actor in the budget process—to prepare each December the Public Expenditure Management calendar (including detailed deadlines) and to propose it to the Council of Ministers. The calendar is approved as an important element of strategic planning by the Council of Ministers and comes into effect on the first day of each year.

In January, the Minister of Finance prepares a report on macroeconomic assessment and forecast. After approval by a decision of the Council of Ministers in February, the report is sent for information to the National Assembly by March 10. Upon approval by the Council of Ministers, the Minister of Finance approves and issues instructions for budget preparation to authorizing officers of budgetary institutions.<sup>6</sup> All budgetary institutions should provide their budgetary request in line with the proposed format and budget ceilings (comprising the level of wages, other current expenditures, capital expenditures financed from the state budget, and foreign capital expenditures for the next three years). Budgetary institutions are responsible for allocating funds to their program and detailing them according to their needs, following the procedures set by the law and other legal documents.

Under the guidance of the principal authorizing officer, the MoF's Budget Department reviews and assesses medium-term budget requests and additional requests, and prepares a report with conclusions and recommendations for each government unit. This report is presented in hearings held in the MoF

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6 Figure I-2 in the Appendix provides details of the required steps.

with each government unit according to a pre-established calendar. The conclusions of hearings are consolidated into a draft of the Medium-Term Budget Programme, which is later subject to a Council of Ministers decision.

The Council of Ministers revises and approves the draft Medium-Term Budget Programme and its expenditure ceilings in July (the second round of the process). In this round, the MoF prepares another macroeconomic assessment and forecast, from which ceilings are prepared that are then sent to all budgetary institutions. These ceilings might be unchanged from those set in the first round, or might be higher or lower depending on the macroeconomic forecast approved. However, if the overall ceilings remain unchanged, allocation of funds between institutions must be applied according to the budgetary requests prepared by the institutions in the first round of the MTBP, emphasizing the significance that complete budgetary requests have in arguing the importance of reform projects that might be initiated in the near future. In this second round of the process, the budgetary requests fulfilled by all budgetary institutions are mainly focused on the first year of the MTBP, which is nothing less than the annual budget of the following year.

By October 25, the Council of Ministers revises and approves the Draft Annual Budget and the revised Medium-Term Budget Programme. By November 1, the Prime Minister, on behalf of the Council of Ministers, submits the proposed annual budget to the Assembly.

The annual state budget must be approved by December 31 at the budget program level for each general government unit. The Council of Ministers may propose annual state budget approval at a level more detailed than at the program level, in compliance with the principles stated in the budget organic law. The annual budget law and all its components are published in the Official Gazette.

In January, after approval of the annual budget law by the National Assembly, the principal authorizing officer consolidates any changes in the final Medium-Term Budget Programme document. In February, the MoF publishes the final document.

## 2.3. Institutions

The budget process allows all budgetary institutions to be part of the process. Main actors in these procedures are as follows.

- *The National Assembly*: This institution has the right to enact the annual law on 'Budget', after it has followed the necessary enactment procedures.
- *The Council of Ministers*: The Council is one of the main institutions that approve the Macroeconomic and Fiscal Framework and the ceiling for each budget institution after all documents are revised first by the Strategic Planning Committee. The Council is responsible also for approving and coordinating policies as well defining the main policies to be financed.
- *The Ministry of Finance*: The Ministry makes proposals to the Council of Ministers for total expenditure ceilings and MTBP preparation ceilings; carries out the tasks that are necessary for launching the program expenditure

- planning process; revises the entire budgetary request submitted; and prepares the MTBP document and the annual budget.
- *The Ministry of European Integration:* In revising procedures and conducting hearings, the Ministry has a specific role in assessing whether policies that are going to be financed are part of the policies approved by the government in support of EU integration.
  - *The Department of Strategy and Donor Coordination (DSDC):* The DSDC ensures that government expenditures are planned in a way that is consistent with its desired strategic allocation of resources. The DSDC is one of the institutions that participate in the MTBP hearing.
  - *Budgetary institutions:* All budgetary institutions prepare MTBP requests.

At the beginning of the MTBP preparation process, each budget institution is asked to prepare (for each program) the respective Programme Policy Statement, which should include:

- The mission or goals of the central government units
- A description of programs and activities of this unit
- A presentation of program policies (including their goals and objectives)
- Policy standards that shall be achieved by each unit and program
- An explanation of how each program's outputs contribute to achieving relevant policy goals and objectives
- The actual indicators
  - for the two previous budget years
  - budgetary funds planned for the current budget year
  - adjustments made by reallocations
  - approved requests for additional funds
  - the distribution of the total MTBP expenditure ceilings across programs (for the next three budget years)
- The capital expenditures (listed by capital project and program)

In this process, it is important that the policies expressed in the above mentioned Statement are clear, understandable, and periodically revised (on an annual basis) through a process called the *Programme Policy Review*, which should be fully integrated with the other processes.

Designing a reform is a process that takes time and must be in compliance with the NSDI, the Government Programme, European integration, and NATO membership. Each reform must be translated into an Action Plan, costs of which should be reflected in the MTBP of the respective budget institution within the ceilings approved.

### 3. Incorporation of structural reforms' fiscal costs into fiscal programming documents

The rapid developments in Albania necessarily brought about a series of structural reforms to support the vision of the country's development as an open economy. All main sectors were subject to the drafting of regulations, laws, or procedures which aimed to improve the country's economic situation. Most of these reforms were supported from the state budget, while others remained formulated on paper, waiting for funds to be implemented.

#### 3.1. Assessment of the overall framework

##### 3.1.1. Enterprise sector reforms

The most important challenge for Albania was the transition from a closed, completely centralized economy to a market economy under the conditions of free competition. The country implemented many structural reforms toward realization of these objectives, such as privatization, land reform, price liberalization, etc. Albania is nowadays an open economy, with liberal trade and investment, and tries to support the development of local private business and increase foreign investment. Since 1993, Albania has a framework to encourage Foreign Direct Investment (FDI); however, it does not provide specific incentives for foreign investors. Thanks to a favorable business environment, legal conditions, and opportunities opened up by the privatization of state-owned enterprises, Albania has managed to increase the inflow of foreign capital. Many foreign investors have taken part in the privatization of small and medium enterprises (SMEs) and large enterprises in strategic industries, such as banking, telecommunication, and energy. On the other hand, revenues from privatization have served as a good support to reduce the budget deficit and to fund capital expenditures. Further growth of FDI has been achieved through concessions and the establishment of industrial parks and free zones. The state budget has funded research projects in these areas, but the lack of local investments has meant a low standard of services so far. Consequently, interest in these areas has been low.

Despite the evolution in FDI growth,<sup>7</sup> overall this inflow is modest due to the small size of the economy. Problems have come mainly from delays in the completion of reforms in areas such as corruption, tax regulation, infrastructure, energy supply, labor market and human resources, land reform, and construction permits.

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<sup>7</sup> According to UNCTAD and UNDP's *Report on Foreign Investments in Albania, 2011*, page 16, Albania's ranking in Inward FDI Performance Index was 18<sup>th</sup> of 141 countries in 2010, while in 2005 it was 68<sup>th</sup>.

Among these, the land reform has not had adequate support from the state budget. Ongoing changes in the responding institutions or procedures and delays in compensation of former owners have made this issue one of the most problematic concerns for the Albanian society and a major obstacle to development of various economic sectors.<sup>8</sup>

To support economic growth and the business climate, Albania has undertaken many reforms in the tax system by reducing tax norms several times or by enlarging the taxable bases. These measures have served not only to ease doing business in Albania, but have helped also decrease informality and boost tax revenues, which are the main source of budget revenues. For instance, the profit tax rate declined from 23% in 2005 to 20% in 2006, and further to 10% in 2008. The social insurance rate fell from 42.5% before 2000 to 38.5% in 2002, to 29.5% in 2006, to 26.5% in 2009, and further downward since. All these reforms were reflected in the projections of budget revenues of the upcoming year and in the MTBP or the EFP as well.

### **3.1.2. Financial sector reforms**

The financial system in Albania has two main actors that accomplish the supervisory process: the Bank of Albania (BoA) and the Financial Supervisory Authority (FSA). Both seek to guarantee that the operators in the financial sector carry out their financial activity firmly and in accordance with the legal, regulatory and supervisory framework. The BoA supervises the banking sector and other financial institutions, while the FSA focuses on the insurance, securities, and private pensions markets.

The BoA is the central bank of Albania, with the attributes of a modern central bank only since 1992 and the transition of the political system. It has played a key role in maintaining the banking system's soundness by introducing and adopting necessary supervisory, legal, and regulatory measures in response to identified risks. Generally, the entire supervisory process has emphasized measures for enhancing responsibility, rigorously managing banking system risks, and observing prudential norms set by the Bank of Albania. A stable bank system helps the business climate in the country and increases the possibility of funding.

The FSA was established in 2006, as a regulatory and consolidated entity to supervise financial non-bank markets in Albania. It supervises three fields: insurance, securities, and the supplementary private pension scheme. These functions were previously carried out by three different institutions, which led to fragmentation of authority and responsibilities, sharp differences in standards, and inefficient use of regulatory and supervisory skills. The fast development of the overall non-banking financial sector caused an overlapping of

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<sup>8</sup> Access to land in Albania poses a major problem for foreign investors due to various factors, including lack of ownership documents, overlapping claims, and unpredictable court decisions.



these markets' supervisory coverage. That is why a fully integrated supervisory structure is better than a fragmented one. Its main concerns are to protect consumers' interests; to promote sustainability, transparency, and reliability of non-banking financial institutions; and to ensure law enforcement. Meanwhile, the change in the non-banking financial market regulatory and supervisory structure made it necessary also to amend the entire legal and regulatory framework related to different areas of this sector.<sup>9</sup> Among the non-banking financial sectors, the insurance market is the most developed one, while the other two, private pensions and the securities market, are in their early stages.

Another very important institution in the financial market is the Tirana Stock Exchange (TSE). Its mission is to organize and develop the Albanian securities market by creating the most favorable conditions for issuers, investors, and financial intermediaries to exploit the capital market; but until now, no company has registered itself at the TSE to sell its shares publicly. Reforms to make the TSE functional have been put off, making the TSE simply a budgetary institution spending tax-payers' money. This means that the only sources for providing funding for companies in Albania are banks, or stock exchanges abroad.

### 3.1.3. Human resource development and labor market reforms

Albania is a country with a young population, with about 68% aged 15–64 years, the allowed age range for working. A younger population provides a competitive advantage for Albania in domestic and international markets. However, despite broader labor market opportunities, Albania suffers from a high rate of unemployment. The private sector employs most of the labor force, and economic development is considered a way to improve the performance of this indicator. Analyses of unemployment in Albania show there is a direct link between employment and education. In 2009, 53.6% of the registered unemployed had only elementary education, 43.8% had attained a secondary education diploma, and only 2.6% had higher education.<sup>10</sup>

- a) *Education reforms:* Generally, all Albanian governments have declared education one of their priorities. However, if we analyze the funds allocated over the years, Albania ranks among the last countries in the region for education expenditures as a percentage of GDP (around 2.8% in 2011).

To improve the quality of the labor force and increase the chances of better careers, the Albanian society is strongly oriented toward education, especially higher education. The development of this sector has had two phases. During the period 1991–2003, the main concern was to reorganize the education system in line with new developments in the market. Most funds went to the drafting of texts and curricula. Meanwhile, as a result of

9 One of the most important change was the amendment made in 2004 to the law on the 'Activity of Insurance, Reinsurance and Intermediation in Insurance and Reinsurance', which reflected an EU directive about the insurance companies guarantee fund. The directive increased the fund to 3 MM EUR.

10 This data does not include undeclared private work. Source: INSTAT.



high demand for education, many universities were opened throughout the country, supported by the state budget. The most important reform during the second period (2003–2011) proceeded on demand for higher education; while the quotes approved for the public universities were increasing rapidly, this initiative was not supported sufficiently from the state budget for infrastructure and staff. An important reform in higher education was its financing scheme. Since 2007, public universities are autonomous institutions; hence the entire funding for them (other than investments) is allocated in the form of a grant; this is in order to enhance their institutional and financial autonomy. Particular emphasis was given to professional education. The relevant program within the Ministry of Education and Science has received continuous support from the state budget; however, the efforts made to turn it into a successful and effective sector have failed.

- b) *Strengthening social safety nets*: Albania is attempting to implement reforms for strengthening social safety, but not all of them have been successful. Albania has a *pay-as-you-go* pension scheme, which has an absolute dependence of the state budget. Its deficit is becoming a black hole for the budget, mainly due to the high degree of informality and the low number of contributors. In the early years (1993–1996), revenues were rising at a fast pace, averaging 45%. This reflected economic stability following the developments in 1990–1993, when many factories were closed, unemployment rose to alarming figures, and GDP fell drastically. However, contribution figures were low, and the high degree of informality in the years that followed prevented the scheme revenues from maintaining high growth.

After 2000, the need for a radical reform of the scheme became vital. At that time, the market lacked information on the effectiveness of economic activity, private entities, and their employees. The construction industry especially showed a high degree of informality. Markets also saw a discrepancy in the number of licensed firms and the number of those who shed social contributions, and a lower participation in the scheme by workers in the agricultural sector.

Unsatisfactory performance required a change in the contribution rate, which had been at 42.5% since 1993. Considered too high, this led to a distortion of the market, increasingly high evasion, and hiding of actual salary. In 2002, the rate dropped to 38.5%. The negative effect of lower rates was offset by an increase in the number of people involved in the scheme. In 2003, revenues grew by 11% compared with 2002, while in 2004, the negative effects faded away completely, as revenues increased by 16%. In 2006, the contribution rate decreased to 29.5%, accompanied by an even greater rise in the number of people involved in the scheme. However, despite the measures taken, revenues from contributions continue to be low compared to the cost of social insurance, making the scheme very dependent on the state budget. Over the years the growth pace of expenditures has been significantly higher than the growth of revenues. In addition, the pension increases have been fully funded from the state budget. Another important

aspect of the pension reform is the rate's growth over time. Albania has been characterized by a large difference in pension levels between urban and rural areas. To reduce this gap and equalize the areas, in 2012 the government applied a higher growth rate for the countryside's pensions than for the city's. In 2009, for instance, the pensions of urban areas increased by 10% and those of rural areas by 20%. These funds were included in the budget, at the beginning as a contingency fund, administered by the Council of Ministers and reflected in the EFP 2008–2012 document.

However, according to the EFP 2010–2012, one of the strategic priorities is restructuring and reforming the *pay-as-you-go* system to establish a direct connection between the contributions and the pensions. But there are no cost estimations about this policy in the document, and no budget implications.

In the health insurance sector, a key role is played by the Health Insurance Institute (HII). In past years this institution was responsible for providing health services in the country. As contributions collected by the HII are very low compared to its expenditures, also this scheme is steadily financed by the state budget. In 2007 HII began to support primary health care, and in 2009 hospital services as well. These initiatives were associated with an increase of HII funds from the state budget; funds grew from 2.7 billion Albanian Lek in 2006 to 4.6 billion in 2007, and to 20.7 billion in 2011. This means that in the 2007 budget support for the HII grew by 73% compared to 2006, whereas in 2011 it was 7.7 times higher than in 2006.

Another institution that plays an important role in active employment policies is the Ministry of Work, Social Affairs and Equal Opportunities. It carries out its policies through the Labor Market program and aims to strengthen the stability of the labor force, increase workers' productivity, and develop national human resources by strengthening training to increase the skills of the general labor force. Support for this program has been growing steadily, as reflected in the EFP document each year. Furthermore, the Albanian state budget supports also the disabled.

### **3.1.4. Utilities and network industry reform**

Scarce infrastructure has long been a serious obstacle to developing Albania's economy. Hence investments in telecommunications infrastructure have become a priority, especially since 2000. This initiative gets full support from the state budget and other international financial sources. At the same time, increasing investments in road projects has become one of the priorities of the government, absorbing high levels of capital budget expenditures. Regardless of the higher investments in road construction, the government has problems in planning funds for road maintenance, turning billions of Albanian lek in investments ineffective after a short period. Reforms have also been made in the urban water supply and sewerage sector, increasing the level of decentralization and private sector participation. However, the state budget still finances

investments in the sector, mainly in cost recoveries because of the high level of depreciation of the water and sewerage systems, but also through subsidies for operating activities. While the level of investments remains high, the level of subsidies is decreasing each year.

Meanwhile, Albania is trying to develop port and air infrastructure to benefit from its favorable geography. The country has substantially upgraded its Information and Communication Technology (ICT) infrastructure, through the Cross-cutting Strategy of Information Society. Legislation has liberalized the telecoms industry, bringing it into line with the EU regulatory framework for communications, which encourages competition. For this purpose, in 2007 the National Agency for Information Society was set up to accelerate the development of an information society and e-government services.<sup>11</sup> Despite the ICT sector's development in the last few years, there are still important objectives to be achieved, such as country-wide internet coverage and a faster and more reliable network infrastructure. Significant improvements have been made in access to mobile devices as well. A reduction of tariffs, as a result of the regulatory framework implemented by the Authority of Electronic and Postal Communications and thus increased competitiveness, has led the industry to expand rapidly.

Another important development in utilities involves electricity. Albania has numerous problems in this sector, not only in financial terms but mainly in management. Only after 2006 has it been possible to provide uninterrupted power for most of the country; however, net technical losses continue at high levels (about 32% in 2010), and so do the indicators regarding unpaid bills. A continuous power supply improves the business climate, but it has been achieved at a high cost, deteriorating the state budget. Positive developments have been observed mainly after the privatization of the Electricity Distribution Company, but the high level of unpaid bills has made recovery difficult, requiring continuous budget support. On the other hand, the government is giving priority to concessions for hydro-power plants to help develop private sector power production, which is not yet significant for the sector (at only 2–3% of total energy production in the country).

### **3.1.5. Administrative sector reforms**

Albania has undertaken many structural reforms to mitigate procedures and shorten the time to register and license a business. Numerous reforms in the fiscal sector promote economic development as well as facilitate business procedures in payment terms. In 2006 an action plan for regulatory reform was approved by the Council of Ministers, with four pillars: (i) development of a

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11 As a result of technological development, Albania has substantially increased the availability of e-services across most basic government services. Almost 80% of such basic services at the central government level are now accessible as e-services at the first or second level of sophistication (UNCTAD and UNDP's *Report on Foreign Investment in Albania, 2011*, page 36).

regulatory management system (institutions and procedures); (ii) improved quality of existing regulations (reduction of administrative and regulatory barriers); (iii) improved quality of new regulations (through impact assessment of the regulatory framework); and (iv) set-up of a framework for periodic monitoring and assessment of reforms. A loan of 9.3 MM USD to support parts of the action plan was approved by the World Bank.<sup>12</sup> Meanwhile reforms in increasing trade openness and reducing obstacles to the trade of goods and services have been applied thanks to free trade agreements that Albania has signed.

- a) ***Strengthening the legal and administrative framework:*** International organizations and institutions have criticized Albania's hurdles to opening a business. To improve this aspect, the government created two important institutions, the National Registration Center (in 2007) and the National License Center<sup>13</sup> (in 2009). Both are central public institutions reporting to the minister responsible for the economy and functioning as a one-stop shop. This has made it easier to start a business by streamlining procedures, making them simpler or faster by introducing technology, and reducing or eliminating minimum capital requirements. As a result, there have been more registered businesses, financial resources, and job opportunities. The number of days required to open a business in Albania decreased from 41 in 2004 to only five in 2012. Another area that has experienced numerous reforms is tax legislation: among the changes here, the online tax declaration system remains one of the most important steps to facilitate administrative procedures.
- b) ***Trade openness:*** Albania applies a liberal trade regime. Foreign trade was liberalized in 1990 and follows guidelines set by the European Union and World Trade Organization (WTO). Since becoming a WTO member in 2000, Albania has implemented full liberalization of its import-export regime for goods. Imports and exports of commodities are not generally subject to special authorization requirements. Exceptions apply to quotas or control requirements imposed through bilateral or multilateral agreements. At the same time, exports are not subject to any taxes, fees, or other barriers. The Stabilization and Association Agreement (SAA) signed in 2006 contains an interim free trade agreement with the EU, which was implemented in 2009. This is expected to open new opportunities for development of the country. Since 2004 Albania has completed and started to implement a full network of free trade agreements in South East Europe, followed by the liberalization process and the adoption of a joint agreement on free trade. In 2006, the Central European Free Trade Agreement was signed by all parties listed above, and it has been fully operational since November 2007. The liberalization policy has continued with a free trade agreement with Turkey, and another one with the European Free Trade Association states.

12 Fiscal Economic Report 2006–2008, page 34.

13 The NLC aims at improving the business climate, through reduction of administrative barriers regarding free initiatives to conduct economic, commercial, or professional activities, or regarding the use of public goods, guaranteeing at the same time the safeguard of public interests.

All of these measures have been accompanied by assessments of their impact on budget revenues, and the level of revenues from customs duties has decreased. During 1993–2003, revenues from tax offices and customs represented on average 20% of the revenues in the state budget, whereas after the implementation of several free trade agreements, they are only a modest source of state revenues.

### 3.2. Assessment of the institutions

Albania has a top-down, flexible budgeting system, which starts from the Council of Ministers, followed by the MoF (which plays a key role in the entire process), and then by all budgetary institutions. Approval of the National Strategy for Development and Integration has also helped to reflect the cost of structural reforms in the state budget. This document defines the goals and objectives that every sector must follow, serving as a starting point for line ministries to break down and realize their missions. Within the ceiling set by the MoF, the line ministries are free to allocate funds between programs, which helps them in distributing the money according to their needs to achieve structural reforms. However, LMs often encounter difficulties to include all the cost of structural reforms needed in the budget process and their MTBP requests.

The MTBP is the key component for a successful budget, which reflects all the policies of a sector and of LMs. A correct MTBP starts by assessing the mission, the programs needed to fulfill it, and their broad description. Generally, all the budgetary institutions meet these requirements. The problems begin when the institution is asked to define the aim of the program, its objectives, and furthermore the standard of the program policy. These problems stem from the inability of LMs to define policies in cases where there is not a directly responsible person in doing it. A vague definition, especially of the objectives, brings out difficulties in assessing a program's products. That is why many budgetary institutions fail to complete all the fields of the MTBP. The MTBP form proposed by the MoF requires a clear assessment of the policy, objectives, and outputs that will be accomplished in the next three years. The last element (products) is very important, because the LM can provide a product's quantification only if they have made prior estimates of their plans and of structural reforms as well.

Determining the standard program's policy (which is also required to be filled in by the LMs) allows the MoF to judge if the proposed products and their costs meet the standards in comparison with those of other countries. Differences between standards and drafted documents are detected even for the MoF's own MTBP document, which underscores that the quality of submissions is still not at the desired level.<sup>14</sup> Reaching those quality standards will remain a challenge for the MTBP process in coming years. However, despite the difficulties that some budgetary institutions encounter in achieving the

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14 Ministry of Finance, *Project document of MTBP 2012–2014, Phase II*, page 1.

quality requested, some LMs have made considerable progress in drafting a correct MTBP that reflects the costs of the structural reforms. This is mainly the case for ministries with a high level of budget allocated, which at the same time have more human resources, such as the ministries of Public Affairs, Transport and Telecommunication, Interior, and Education and Science.

Although the law or guidelines have clearly defined the responsibilities for each directorate in preparing MTBP requests, this process is mostly handled by the economic directorates of the institutions. Directorates that do not know in detail the entire policies, strategies, or reforms to take place in their institutions fail to comply with the requests of the MTBP as required by the MoF. For example, in defining the costs of products within a program, LMs often focus more on assessment of the costs in the first year without paying the necessary attention to the two years following.

In most cases, even though the LMs may have drafted a reform, the implementation of which requires several years, they fail to deliver accurate financial costs for all years in which the reform is going to take place, even where costs and products are determined in relevant action plans. This makes it difficult for the MoF to evaluate the requests prepared from budgetary institutions. Another problem for the MoF's review is to assess additional requests on the policies and objectives of the institutions that were presented as less important when ceilings were set.

In 2006, the MoF began to implement new procedures for preparing MTBP requests in terms of objectives, outputs, activities, and evaluation of public investments, which was an entirely new methodology for budgetary institutions. These new procedures were necessary to ensure the efficient use of public funds. However, this reform was not accompanied by training of all employees on their role in the process. Since the MoF has continued to help budgetary institutions in preparing the requests, it seems that trainings have been insufficient. On the other hand, LMs have turned this into a routine process, and their commitment to this process could be better.

Another serious problem for the Albanian administration is the frequent change of staff, especially after the change of political direction of the government, hampering effective administration for all budgetary institutions. This has demotivated staff to be committed to a particular duty and perform it with responsibility, because staying in the institution and developing their career are not necessarily related to merit. Another problem remains the recruitment process for public administration, which is mainly accompanied by formal procedures.

Another important issue is the process of preparing the structural reforms themselves. They are often formulated without detailed elements of their implementation and without determining the respective costs for each stage. Consequently, their integration with the budget becomes very difficult.

### 3.3. Assessment of the processes

Despite the budget drafting process being top-down, LMs have the opportunity—within the limit set by the MoF—to reflect the costs of their budgetary reforms in the distribution of budget funds. The MoF does not interfere in the way funds are allocated by LMs, as long as the set limit is applied for capital and recurrent expenditures. However, the MoF remains one of the key links for help throughout the budgeting process.

By determining the number of employees for each central government institution (which since 2011 is defined in the annual budget law) and the accurate assessment of funds for personnel expenditures, the MoF influences both directly and indirectly the implementation of reforms. Based on the legislation in force,<sup>15</sup> it is the MoF and the Public Administration Department (part of the Ministry of Interior) which evaluate and approve requests on establishing new organizational structures, which in most cases coincide with implementation of the reforms to be undertaken.

Overall, Albania has had a persistent lack of coherence between reforms and their translation into budgetary costs, and often the MoF has been blamed for this; despite its role in the whole process of budgeting, the MoF remains an institution that implements laws drafted by legislative bodies. It is the task of each budget institution to analyze the reforms developed in their respective areas to achieve the desired outputs in a cost-effective and efficient way, and within the determined limits.

Another important part of the budget process is the proper definition of capital expenditures. Albania has established new procedures for such expenditures. However, the selection process for investment projects is still not very clear. Despite a clear determination of the priority sectors where the government intends to invest in the next few years, the selection of specific investments is not clearly defined yet. It reflects the political will rather than the result of analysis of the reforms undertaken. Concurrently, the implementation and the deduction in cost of cross-cutting reforms remains a problem, with a consistently low cooperation between responsible institutions. This brings even greater financial implications, because any cooperation that is wrongly timed contributes to funds not accomplishing the mission they were approved for.

To reflect the costs of structural reforms in their budget, all budgetary institutions should start with correct and accurate budgetary requirements. In a budget hearing session with the MoF, they explain the importance of additional requirements in terms of priorities for the future. The MoF considers the budget request of the institution and, along with all the other requirements, submits it to the Council of Ministers. The decisions on additional budget requests presented by budgetary institutions are taken based on macroeconomic forecasts for the following period. However, for the LMs and other independent budgetary institutions, trying to reflect their requests in the annual budgets

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15 Law on 'Competencies of defining wages and bonuses' (No. 10405), enacted on March 24, 2011.



remains the option of parliamentary commissions. Being one of the links that the budget passes through to its final approval, these commissions ultimately decide whether or not to consider the requests.

As mentioned, an MTBP document completed according to all the requirements increases the probability that the budget will reflect the costs of structural reforms. The MoF has noticed a progressive growth in attention to the MTBP process, suggesting that the capacity for managing the process is improving over time.<sup>16</sup>

Another document which is important in summarizing and reflecting the cost of structural reforms is the Economic and Fiscal Programme, which reviews economic and fiscal policies and the main structural reforms to be implemented. More specifically the EFP (i) describes the policy framework for the medium term and spells out the main policy objectives imbedded in the program; (ii) describes the economic developments of the real and monetary sector during the past year as well as presents the medium-term perspective of the economy and articulates the project macroeconomic policy mix; (iii) describes in detail the framework of public finances, paying attention to the income and budget expenses for the medium-term period as well as a treatment of the public debt strategy; and (iv) presents the most important structural reforms which have been or will be undertaken in the fields of entrepreneurship, competition, climate for foreign investment, the labor market, the financial sector, and public administration. The EFP tries to link the budgeting process (starting from the macroeconomic framework) with the structural reforms to be implemented during the budgeting period. Generally, the document focuses on describing reforms without giving details on their implications in the budget. Starting with the EFP 2008–2010, the document has a sub-chapter called *Budgetary implication of the main structural reforms*, though this has very poor information about the reforms addressed (not more than 2–3 reforms) and their costs, whereas the whole document typically mentions only 30 structural reforms.

## 4. Conclusions and recommendations

### 4.1. Conclusions

Albania has significantly improved its budgeting process. It has strengthened budget procedures and the legal framework, setting out clearly the roles and responsibilities of all the stakeholders. Moving to three-year planning, through drafting of the Medium-Term Budget Programme (MTBP), has changed budgeting from an annual thinking process, as well as ensured the link between the budget process and policies set by the government. Achievements from medium-term planning were reinforced even more by the enactment of

16 Ministry of Finance, *Project document of MTBP 2012–2014, Phase II*, page 1.



the law on the 'Management of the Budgetary System in the Republic of Albania', which specifies in detail the budgetary system, its structure, principles, intergovernmental financial relations, and responsibilities for budget preparation and execution.

During the drafting of macroeconomic scenarios, one of the most important elements taken into consideration by the MoF is the reflection of government priorities and of ongoing or expected reforms. This is the first step that attempts to integrate the costs of structural reforms into the budget.

Several factors—the incorrect evaluation of drafted reforms' future financial effects, the failure in implementing the steps every institution has to take for their accomplishment, as well as the timing of their implementation—may lead to wrong calculations and, therefore, undermine the inefficiency of financial resources that are reflected in the respective budgets. The main problem is a lack of coordination between the LMs responsible for implementing reforms, particularly in the case of cross-cutting reforms that involve multiple sectors' priorities. The LM directly linked with the implementation of the reform includes it in the budget, whereas the other LMs may not necessarily set available funds for a reform that is not a priority for their sectors. This non-cooperation means that structural reforms may be initiated but may not be operative if all their components do not align.

The MoF is the main actor in coordinating the budget process, but the LMs themselves settle the objectives of their work within the limits the MoF sets. Regarding the allocations that the LMs make between programs or projects, the MoF may give its opinion or advice, but cannot make decisions. This means that the drafting of the budget is a very good tool in the hands of the LMs to ensure the funding of ongoing or planned reforms. An accurate assessment of costs and an appropriate distribution of available funds in many cases enable the LMs to meet their goals.

To facilitate the budget preparation process by the LMs and other state institutions' budget, the MoF has issued guidelines for the duration of the process. It specifies the rules to follow for budget preparation and execution, as well as for monitoring the process. Together with the guidelines of the Policy Priority—drafted by the Council of Ministers, the MoF, the Department for Strategy and Donor Coordination (DSDC), and the Ministry of Integration—budget institutions have a good basis to identify new priorities which were not previously included in the budget. All of these documents try to ensure that the LMs are distributing funds in accordance with governing policies and priority strategies for the country's development. The control of the MTBP carried out by DSDC, verifying if the planned budget reflects the development priorities and undertaken reforms, also supports this process. Meanwhile, the MoF verifies whether the costs submitted by the LMs are reasonable, justified, and within funding opportunities.

Based on macroeconomic forecasts for fiscal parameters performance and the MTBP, the MoF determines the limit for current and capital expenditure for each budget institution. This gives high importance to the accountability of

MTBP preparation. Being a medium-term plan, it should reflect the costs of all LMs' structural reforms, especially new reforms that will be undertaken within the period. Experience shows that the LMs devote more attention to the first year of the MTBP (as it is the next year's budget) but tend to neglect the next two years. As a result, the cost of ongoing reforms is included and forecasted. But there is no accurate estimate on reforms that will begin in the second or third year of the MTBP, making this one of the main problems in the inclusion and reflection of structural reforms in the budget. There may be several reasons: negligence by the LMs or their institutions, a lack of penalties when the MTBP is not a document completed with accountability and according to the parameters required by the MoF, a lack of vision and insufficient understanding by the LMs of the importance of an accurate medium-term prediction. However, there are also cases where the LMs are aware of the necessity for an accurate budgeting process, but fail in translating the reforms into monetary implications, due to the lack of a clear understanding of the reform or inadequate human resources capacity.

Despite the development of the MTBP as a process that should involve all levels and structures of an institution, requiring the establishment of management teams for every program, it often still ends up being a task for the economic departments of various institutions. Careful budgeting requires time and high commitment from many people, especially the program management team, who know better the reforms that need to be undertaken. The budgeting process requires work, time, good knowledge of program details, goals, objectives, and, as a result, delegating of some of its drafting to other chain actors, who are unable to fulfill budgetary requirements. The instability of the Albanian administration has not helped either, although the government has tried to take measures to improve the situation (especially through the drafting of the civil servants' law and the law drafted for the first time on the Organization and on the Functioning of the Public Administration, which does not yet have cost assessments). The frequent replacement of staff decreases motivation for a demanding set of tasks that may be perceived as "outside" the program's mission, which means that there is little consolidation of the experiences accumulated over the years. All of these factors lead, in most cases, not only to a document that does not meet the MoF requirements, but also to a budget that does not address the costs of structural reforms.

However, while identifying the problems encountered in the continuous inclusion of the structural reforms' costs in the annual budget or other fiscal documents, we should not overlook that the very process of drafting a detailed budget and drafting the MTBP is in its beginnings. Albania started the MTBP draft as a pilot project in 2001, but it became mandatory for all LMs only in 2006, and for the rest of the institutions in 2009. The lack of experience brings many problems, but at the same time, there has been some improvement of quality in budgetary requirements. Those recent efforts show that Albania is trying to improve coordination between structural reforms and the budgeting process.

## 4.2. Recommendations

A good budget starts with a good macroeconomic framework. In this regard the MoF takes into consideration the comments and suggestions that international institutions such as the IMF make, while preparing its macroeconomic framework. Better and more realistic assessments are very important in not distorting the whole process of planning and medium-term budgeting. It is also important that the budgetary institutions have a clear priority list of reforms and projects to be initiated, so that if there are changes in the budget allocated for undertaking them, any cuts in funding might be more easily determined. Otherwise reforms and projects may remain without proper budget funds for a long time. This entails invisible costs that turn into a drain on the budget for many years beyond the stipulated deadlines.

All budgetary institutions that are directly responsible for implementing structural reforms should determine efficient and concrete steps that need to be taken and identify the costs for each case. To achieve this, responsible persons, who have good knowledge of the plans and priorities, should conduct the process. It is also strongly recommended that, while preparing the structural reforms' cost, budgetary institutions analyze cost deviations at the beginning and at the end of the reform, identifying the actors responsible for exceeding the estimated cost and then applying sanctions set in the law. Certainly good estimates and assessment of costs and begin with a proper identification of whether the project itself is a structural reform, and with measuring the opportunity cost of the structural reform that is going to be materialized.

There must be better coordination among the LMs that participate in the implementation of a given reform, despite the fact that the priority level may differ for them. In this case, it is important to ensure that the funds allocated for the fulfillment of a ministry's obligation are associated with the respective estimate in the budget of other institutions, in order to obtain full efficiency on reforms.

LMs' senior officials should increase their attention to the budgeting process and the fulfillment of MTBP according to the MoF requirements. They should ensure that their staff and, above all, the programs' supervisors understand the importance of medium-term programming, give the right timing to budgeting, and do not overlooking any procedures.

LM staff should improve their knowledge of MTBP drafting, as well as how to include the structural costs of reforms in the annual budget. Even though templates have been prepared for each ministry, with concrete cases regarding respective areas that they cover, the submission of budget requests has not been at the appropriate level; on the contrary, it has aimed to be, from year to year, identical with the given instructions. Also, training, in particular for each ministry with a dedicated data set, should be more efficient and training sessions that instruct at the same time specialists or experts of different fields (e.g., transport and health care) should be preferred. This would make clear all the specific elements that an institution should keep in mind. A special training session may be prepared for programs that are considered of key

importance to the mission of the LM or that plan to implement important reforms in the future.

Despite the MoF's key role in this process, it is not involved directly in decision-making. It is mainly the coordinator in the budget organic law, unless the institutions do not submit the budget requirements within the deadline and are subject to administrative fines. Thus, we recommend the attribution of more decision-making competences to the MoF, so that the budgetary requests can be fulfilled at the desired level. At the same time, the ministries themselves should take penalizing measures by identifying the responsible people, but without turning these measures into a punishment system for budgetary institutions or its employees.

Albania needs to increase the sustainability of its public administration, to allow the consolidation of new procedures that it has begun to implement. It needs to invest in training and increasing the knowledge quality of key persons involved in the budgeting process. Exchange of experiences with other governments that have been successful in including the cost of structural reforms in the budget would be very valuable.

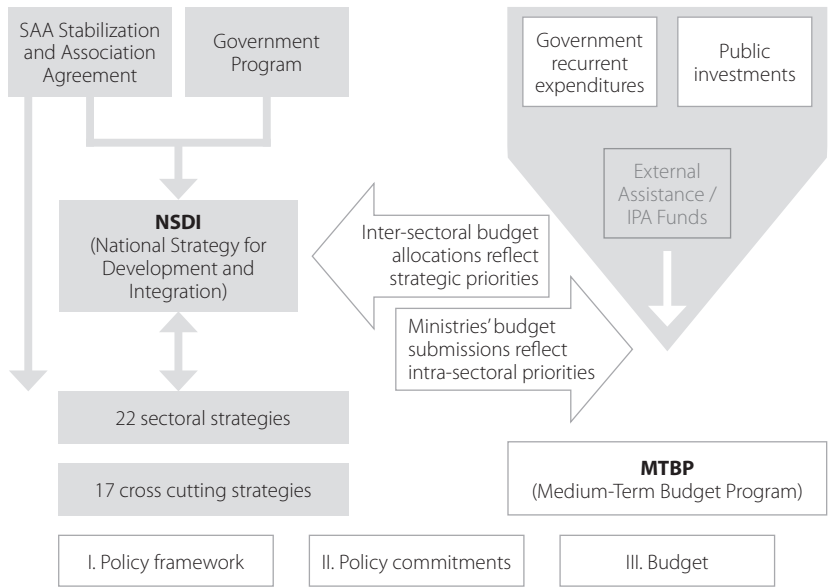
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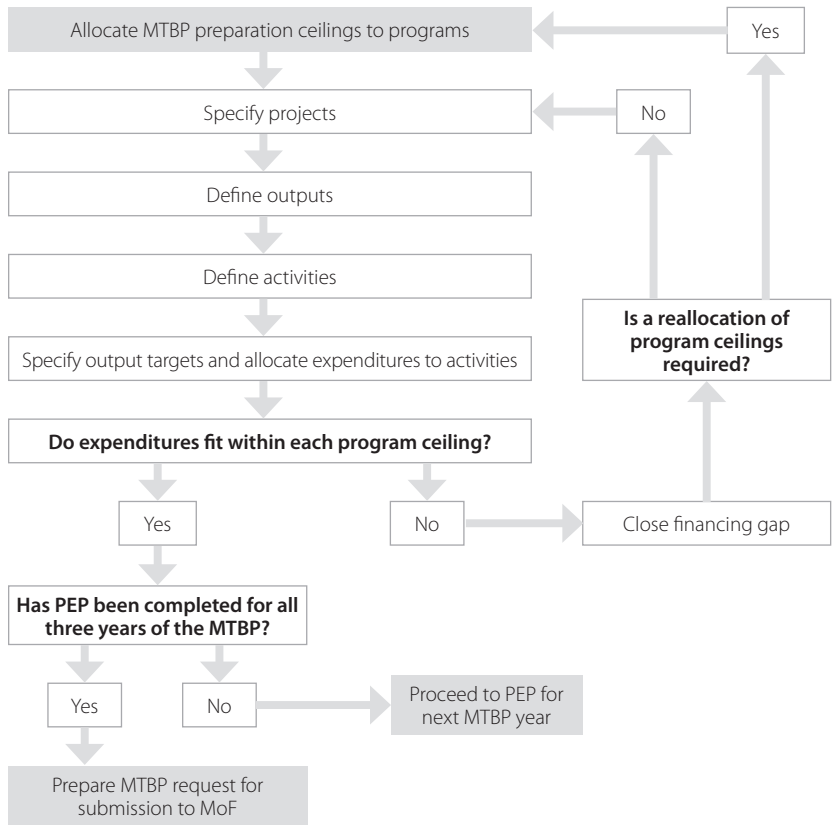
## 6. Appendix

**Figure I-1: The linkage between the NSDI and the MTBP cycle**



Source: DSDC presentation on the implementation of the Integrated Planning System (IPS) and the National Strategy for Development and Integration (NSDI), and the Regional Development Fund's (RDF) Evaluation & Aid Effectiveness, 2012.

**Figure I-2: The programme expenditure process within a year in a budget institution**



Source: Instruction No. 8, March 29, 2012, *Standard Procedures of the Preparation of the Medium-Term Budget Programming*, Annex 5, page 3.

## Chapter 2

# Case Study on BOSNIA & HERZEGOVINA

prepared by

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# 1. Introduction

All of the Western Balkan countries are preparing for European Union (EU) integration. As of August 2012, Croatia is an acceding country, while Former Yugoslav Republic (FYR) Macedonia, Montenegro, and Serbia are candidate countries, and Albania, Bosnia and Herzegovina, and Kosovo are potential candidates. For candidates, fiscal surveillance occurs under Pre-Accession Economic Programs (PEPs), which require the submission of fiscal data to the European Commission (EC) and Eurostat for assessment. The objective is to prepare candidate countries for future multilateral surveillance in the EU and the European Monetary Union (EMU). In PEPs, countries need to define a comprehensive and cohesive medium-term macroeconomic and fiscal policy framework and outline in detail public finance goals and planned structural reforms and their fiscal impact. Within the description of specific policies and reforms, relevant analyses of costing and overall impact should be included, which can essentially be derived from performance-based budgeting (program budgeting). A similar procedure (but without ministerial meeting conclusions) is also applied to potential candidate countries, including Bosnia and Herzegovina (BiH), which are obliged to submit Economic and Fiscal Programmes (EFPs). In essence, EFPs prepare the potential candidate countries for the PEPs that they will have to submit once they achieve candidate status. The EC also evaluates the EFPs, understanding that these countries will need additional time to adhere to accounting requirements and raise the quality of macro-fiscal planning in comparison to candidate countries. Overall economic and fiscal policies are also assessed by the EC in annual Progress Reports for potential candidate and candidate countries, as well as by other international organizations, such as the Support for Improvement in Governance and Management (SIGMA), a joint initiative of the EU and the Organisation for Economic Cooperation and Development (OECD).

Evaluations of the region's PEPs/EFPs and macroeconomic and fiscal policies conclude that structural reforms are generally not well defined and sufficiently linked to the fiscal framework. The report *2012 Pre-Accession Economic Programs of Croatia, Iceland, FYR of Macedonia, Montenegro and Turkey: EU Commission's Overview and Assessments* (June 2012) notes that all programs "fail to identify and analyze in a forward-looking way the structural obstacles to growth as requested by the Commission [and] would in general have benefited from a closer link between reform measures and the fiscal framework".

Similarly, the report *2012 Economic and Fiscal Programmes of Albania and Bosnia and Herzegovina: EU Commission's Overview and Assessments* (June 2012) notes: "The 2012 EFPs reveal that potential candidate countries had difficulties to fully adhere to the requested alignment of their programs and in particular to provide a more forward-looking assessment on external sustainability and growth enhancing structural reforms. ... The structural reforms spelled out in the 2012 EFPs should be further elaborated in order to ensure

a credible basis for future reform agendas. ... In most instances, the presentation of reforms in the EFPs is backward-looking and would benefit from more clarity when explaining future reform plans and their implementation. Moreover, the EFPs would have gained from a more explicit discussion of the links between structural reforms to the macroeconomic and fiscal frameworks.”

The present document is a country case study for Bosnia and Herzegovina. Given the institutional structure of the country, characterized by two autonomous entities with wide competences and the BiH state government with a limited competence (see Appendix 6.1 for a brief overview of the fiscal structure and competences in BiH and Appendix 6.2 for a brief overview of fiscal reporting in BiH), we will assess not only the BiH state level, but also the two entity governments: the Federation of BiH (FBiH) and the Republika Srpska (RS).

BiH (based on the implications from the ECs evaluations) has been evaluated as having the lowest quality among the EFPs/PEPs of Western Balkan countries. The EC assessment of the country’s latest EFP states: “The structural reform agenda presented ... is vague and lacks an overall strategy, presented in a comprehensive and coherent manner. There is significant room for improvement in terms of supporting the reform intentions with specific measures, quantifying their budgetary impact and presenting a timeframe for their implementation.” A brief overview of the reforms mentioned in the 2012 BiH EFP is given in Appendix 6.3.

In section 2, this study outlines the legal basis, institutions, and procedures for annual budget and medium-term fiscal programming at the state, FBiH, and RS levels separately, as well as overall within the preparation of the BiH Economic and Fiscal Frameworks. Section 3 presents the core substance of the case study: a critical assessment of how fiscal costs of structural reforms are being integrated into fiscal programming documents at the state, FBiH and RS levels, as well as for BiH overall. Section 4 gives conclusions and general recommendations stemming from these analyses.

Appendix 6.1 presents the overall fiscal structure in BiH, Appendix 6.2 gives an overview of fiscal reporting in BiH, and Appendix 6.3 lists reforms mentioned in BiH’s 2012 EFP. Appendix 6.4 gives good examples of fiscal impact assessments for budget requests of some budget users in BiH (one example for each of the main levels—state, RS, and FBiH).

The study is prepared on the basis of desk research on the legislation, institutional structure, annual budget documentation, medium-term budget documentation, Economic and Fiscal Programmes, and other overall and sectoral strategic documents adopted by the Council of Ministers and/or entity governments which are relevant for the structural reforms being discussed.

## 2. Main institutional features for annual budget and medium-term fiscal programming

### 2.1. Legal framework

To improve macroeconomic and fiscal coordination, in 2008 the Fiscal Council of BiH (FC) was established through legislation adopted by the State Parliament.<sup>17</sup> According to the law and the Rules of Procedures of the Fiscal Council, the FC is tasked with coordinating the fiscal policy in BiH, including the adoption of the medium-term Global Framework for the Fiscal Balance and Policy in BiH (GFFBP) each year, as the basis for preparation of Medium-Term Expenditure Frameworks (MTEFs) by each government level. The GFFBP needs to include the proposed fiscal targets of the budgets of BiH institutions, FBiH, RS, and the Brčko District (BD)<sup>18</sup>, the proposed macroeconomic projections and the projection of the total indirect taxes and their allocation for the next fiscal year, as well as the proposed ceiling of the borrowing in the various budgets.

The adopted law on the 'Fiscal Council' was a version of the legislation recommended originally by the IMF in 2004/2005. However, in the legislation adoption procedures, several recommended stipulations were deleted, leaving the adopted legislation somewhat vague in terms of the Fiscal Council's competences. In more detail, they are as follows:

- Coordinating the fiscal policy in Bosnia and Herzegovina
- Adopting the proposed document of the Global Framework for the Fiscal Balance and Policy in Bosnia and Herzegovina (GFFBP) by May 31 each year (as the basis for preparation of MTEFs), which should contain the following parameters:
  - proposed fiscal targets for budgets of institutions of BiH, FBiH, RS, and BD
  - proposed macroeconomic projections and projections of total indirect taxes and their allocation for the next fiscal year
  - proposed ceiling of borrowing for budgets of institutions of BiH, FBiH, RS, and BD
- Adopting the proposed short-term and long-term macroeconomic projections
- Monitoring the realization of the set targets and criteria in issuing and executing the budget, as well as taking certain corrective measures and activities
- Establishing full coordination of activities in complying with budgetary calendars in preparing, adopting, executing, and auditing the budgets of institutions of BiH, FBiH, RS, and BD

<sup>17</sup> Law on the 'Fiscal Council', Official Gazette of BiH, 63/08.

<sup>18</sup> Brčko District is a self-governing, neutral administrative unit under sovereignty of BiH that is under international supervision and of both BiH entities: the Federation of Bosnia and Herzegovina, and the Republika Srpska.

- Proposing priorities to improve the public finance sector in Bosnia and Herzegovina

Thus, while the adopted law is vague and leaves space for interpretation, from this list of responsibilities it is evident that it could still provide for much more comprehensive actions and decisions than those actually taken by the FC so far. However, as explained in section 3.1 below, the authorities given to the FC in the law are interpreted differently by stakeholders and government levels across the country. As a result, currently the FC focuses mainly on discussing the BiH institutions' share of revenues and on holding joint discussions with the IMF in regards to the Stand-By Arrangements.

Permanent members of the Fiscal Council are: the Chair of the Council of Ministers of BiH (who, at the same time, chairs the FC sessions), the prime ministers of RS and FBiH, the Minister of Finance and Treasury of BiH, and the finance ministers of RS and FBiH. In addition to the six permanent members, sessions of the FC also require the attendance of the Governor of the Central Bank of BiH and the Governor of Brčko District in their capacity as non-voting observers. Consequently, unlike in most other countries where the FC members are independent experts and academics, the FC members in BiH are all government members and political appointees. In addition, its advisory body (Advisory Group of the Fiscal Council of BiH) also comprises appointees of the prime ministers and finance ministers. The Rules of Procedure require that the Chair of the Fiscal Council convene sessions no less than once per quarter.

With the exception of the Fiscal Council legislation which (albeit vaguely) regulates overall coordination and the GFFBP, each of the four main government levels (BiH institutions and governments of FBiH, RS, and BD) have their separate fiscal legislation and institutions.

### **2.1.1. State institutions**

The legal basis for preparing the annual budget and medium-term budget for the state institutions is the 'Financing of the BiH Institutions',<sup>19</sup> which represents the organic budgetary law for the state level. It the budget calendar for state institutions, which includes both annual budget and medium-term expenditure framework preparation and adoption procedures. By December 31, the BiH Parliament adopts the annual law on the 'Budget of State Institutions and Foreign Debt Servicing of BiH' (total foreign debt servicing for BiH is adopted within the state budget, as stipulated by this law and indirect taxation legislation). By June 30, the Council of Ministers adopts on a rolling basis the Medium-Term Expenditure Framework for the next and the two following years.

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19 Official Gazette of BiH, 61/04, 49/09, and 42/12.

While the budget is adopted by organizational and economic classification, budget requests (for both MTEF and annual budget) also include requests in program format (including performance measures). The law prescribes that program classification is included in budget documentation, which the Ministry of Finance and Treasury of BiH (MFT) submits to the Council of Ministers, the Presidency, and the Parliament, for information purposes at this stage of the reform (as opposed to the budget being adopted in the program format). The state level is the only government level in BiH for which program budgeting information is a part of budget documentation (documents which accompany the budget law in the adoption procedure); other levels do not include this data in their budget documentation.

The law on the ‘Financing of the BiH Institutions’ prescribes the content of the annual budget documentation, which does not specifically include explanation on the effects of structural reforms. However, the law also prescribes that requests submitted by the budget users need to be based on analyses that include cost-benefit analyses, priority analyses, and elements of expected results and objectives.

There is no legislation addressing specifically the subject of structural reforms and their integration into fiscal programming documentation.

### **2.1.2. Federation of BiH**

In FBiH, the legal basis for preparing the annual budget and medium-term budget is the law on the ‘Budgets in FBiH’;<sup>20</sup> the organic budgetary law for the FBiH level. It covers the FBiH government, the entity’s cantons, municipalities, and cities, as well as extra-budgetary funds in FBiH. The law prescribes procedures for the FBiH government and only briefly prescribes that the Federal Ministry of Finance (FMF) also consolidates budget data for lower government levels, based on data which cantons, municipalities, cities, and extra-budgetary funds are obliged to submit to the FMF 15 days before adoption.

Unlike the state legislation, FBiH’s legislation has not been amended to include a more detailed budget calendar or specifically regulate performance budgeting. The legislation vaguely prescribes the adoption of the FBiH MTEF (for three years, as is the case at all levels in BiH) and the annual budget and briefly mentions budgeting for programs. Deadlines for the particular budget steps are sent to the budget users in FBiH within budget instructions (rather than being set in the legislation).

The law prescribes the contents of annual budget documentation, which does not specifically include explanation on effects of structural reforms. The law only briefly prescribes that any legislation which has financial implications has to be explained and justified by cost-benefit analyses. There is no legislation addressing specifically the subject of structural reforms and their integration into fiscal programming documentation.

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20 Official Gazette of FBiH, 19/06, 76/08, 5/09, 32/09, 51/09, 9/10, 36/10, and 45/10.

The law on the ‘Budgets in FBiH’ prescribes that the draft budget documentation includes functional classification of expenditures, based on methodology prescribed by the FMF. However, this methodology has not been clearly defined and functional classification is approximated by the budget users (rather than being a full functional categorization in line with the United Nations Classification of Functions of Government, COFOG).

### 2.1.3. Republika Srpska

The law on the ‘Budget System – Revised Text’ is the core legal act that regulates the process of preparing annual budgets of the RS central government, municipalities, and cities, as well as financial plans of extra-budgetary funds.<sup>21</sup> The law prescribes procedures, responsibilities, and main steps in the budget calendar for their development. It also defines documents for communication in this process between the budget users and the RS Ministry of Finance (RSMF), i.e., instructions for budget users and their requests, as well as the main elements and contents of these documents. The law only briefly mentions the preparation of a medium-term expenditure framework in terms of a “Document” that provides budget projections for a three-year period to be adopted by the RS government and shared with the RS National Assembly. It identifies the Document as the basis for preparation of annual budgets of the RS central government, municipalities, and cities as well as the financial plans of the funds.

Instructions for Budget Users No. 1 and No. 2 are documents distributed to budget users by the RSMF (the State and FBiH also have two annual instructions, in line with reforms started through technical assistance from DFID in 2006–2011). In RS, these instructions provide: detailed information on the budget calendar (in other words, as in FBiH, the detailed budget calendar in RS is not set in the legislation but rather within Budget Instructions); tables with instructions for preparing budget requests for three-year as well as annual budgets; and forms with instructions for submitting information on planned public investment necessary for compiling the Programme of Public Investments. The latter is a document that contains a three-year overview of public investments in RS (Instructions No. 1) and initial budgetary ceilings for budget users and forms for budget requests with instructions (Instructions No. 2).

There is no legislation in RS that directly addresses the subject of structural reforms. The law on the ‘Budget System’ only stipulates that: 1) all budget units when initiating legal acts, agreements, contracts, and other activities must take into account the possibility of their financing in accordance with the funds planned by the annual budget and the MTEF; and 2) every proposal of legal, sub-legal, and other acts must be accompanied by an estimate of financial effects of the proposed acts.

21 Official Gazette of RS, 54/08 – this law replaced the original law on the ‘Budget System’ (Official Gazette of RS, 96/03), and all subsequent amendments and additions to the law (Official Gazette of RS 14/04, 67/05, 34/06, 128/06, and 117/07).

At the time of preparation of this case study, a draft law on the ‘Budget System of RS’ has been put forward for public debate. It includes several new features: it introduces program budget classification as obligatory in the process of budget perpetration; it renames the “Document” into “Medium-term Expenditure Framework” and defines it a bit more clearly; it inserts two additional steps of the budget calendar to regulate the budget users’ participation in development of the MTEFs; and it introduces the Programme of Public Investments into the law.

## 2.2. Institutions

### 2.2.1. State institutions

The following institutions are involved in preparing the MTEF and annual budget of the BiH institutions:

- *The Fiscal Council of BiH* adopts the GFFBP, which includes decisions on overall indirect taxation revenue projections and distribution of the indirect taxation revenues among the BiH institutions, entities, and BD
- *The Ministry of Finance and Treasury of BiH (MFT)* sends Budget Instructions 1, prepares overall projections of the revenues of the state budget, analyses submitted requests for the MTEF, drafts the MTEF, sends Budget Instructions 2, analyses submitted requests for the annual budget, holds consultations and negotiations with the budget users on allocation in the annual budget, drafts the budget, and submits the budget for adoption to the Council of Ministers of BiH
- *The Budget users* (currently 74) submit budget requests for the MTEF and annual budget and hold consultations and negotiations with the MFT on allocations in the budget
- *The Directorate for Economic Planning (DEP)* prepares macroeconomic projections for BiH
- *The Macroeconomic Analysis Unit of the Indirect Taxation Authority Governing Board (MAU)* prepares projections for indirect taxation revenues for BiH
- *The Council of Ministers of BiH* adopts the MTEF of BiH institutions
- *The BiH Presidency* adopts the Proposal of the Annual Budget of BiH institutions
- *The BiH Parliament* (both houses) adopts the Annual Budget of BiH institutions

The process is coordinated by the MFT; however, the Fiscal Council of BiH has a crucial role, since typically neither the MTEF nor the annual budget (as was the case recently) will be tabled at the Council of Ministers of BiH for adoption if the FC has not made a decision on the overall revenue projections and distribution of the indirect taxation revenues among the BiH institutions, entities, and BD.



### 2.2.2. Federation of BiH

The law on the ‘Budgets in FBiH’ is quite vague in terms of the institutions involved in the process of planning and adoption of the entity’s MTEF and annual budgets. It mentions the following institutions:

- *Relevant bodies* (not identified specifically) are supposed to prepare a report on economic and fiscal policies for the current and next three years (in practice, it is not also not clear which institutions prepare these reports for FBiH, if any)
- *The Government of FBiH* adopts Medium-term Guidelines for Economic and Fiscal Policies, which are drafted by the FMF
- *The Federal Ministry of Finance (FMF)* drafts Medium-term Guidelines for Economic and Fiscal Policies, sends instructions on preparation of MTEF budget requests to FBiH budget users (currently 59); analyses proposed financial plans of the budget users and proposes ceilings within the draft MTEF; sends instructions for annual budget requests based on the MTEF; holds consultations and negotiations about budget appropriations with budget users; prepares the Draft Annual Budget of the FBiH Government and sends it to the FBiH Government
- *Budget users* prepare medium-term financial plans (request), which include explanation of financial plan and a plan of development programs that are defined by the MTEF or other acts (not to be confused with program and performance budgeting, which is not specifically included in legislation); prepare and submit annual budget requests to FMF; hold consultations and negotiations about annual budget appropriations with the FMF
- *The Government of FBiH* (Prime Minister) adopts the Draft Annual Budget of the FBiH Government
- *The Parliament of FBiH* adopts the Annual Budget of the FBiH Government
- *Cantons, municipalities, cities, and extra-budgetary funds* submit their budgets to the FMF upon their adoption (the law does not elaborate on how the budgets of lower-level governments are prepared and adopted, nor does it regulate the flow of information on fiscal policies and revenue projections from the FMF to lower levels).

The law has not been amended to include the provisions for the decisions of the Fiscal Council of BiH.

### 2.2.3. Republika Srpska

The following institutions are involved in the process of annual budget preparations and medium-term fiscal programming:

- *The RS National Assembly* holds public debate and adopts the draft annual budget of the RS central government; adopts the annual budget
- *The RS Government* adopts the medium-term expenditure framework; adopts the draft budget of the RS central government and submits it to the National Assembly; adopts the proposal of the central government budget and submits it to the National Assembly; approves financial plans of extra-budgetary funds
- *The RS Ministry of Finance (RSMF)* coordinates the entire process: develops projections of direct tax revenues and other non-tax revenues at RS level; develops the medium-term expenditure framework; delivers this framework to municipalities, cities, and extra-budgetary funds; provides instructions to budget users on drafting annual budgets and receives their budget requests; holds consultations about annual budget appropriations with budget users; sets preliminary expenditure ceilings for budget users' requests; prepares the draft annual budget of the RS central government; reviews the draft annual budgets of municipalities and cities and provides recommendations; suggests changes and additions to the financial plans of extra-budgetary funds; reviews proposals of annual budgets of municipalities and cities and provides its consent to the proposals
- *Budget users* submit budget requests to the RSMF; submit potential objections and hold discussions with the RSMF on proposed budget ceilings
- *Municipalities, cities, and extra-budgetary funds* develop and adopt draft annual budgets and financial plans (according to prescribed budget calendars) and submit them to the RSMF; adopt annual budgets and financial plans and deliver them to the RSMF
- *The Directorate for Economic Planning (DEP)* (develops macroeconomic projections at BiH level) and *Macroeconomic Analysis Unit of the Indirect Taxation Authority Governing Board (MAU)* (develops projections of indirect tax revenues) are BiH level institutions and are not mentioned in the RS legislation related to budgeting process; they are only mentioned in the instruction for budget users

## 2.3. Procedures

While the MTEF and budget preparation procedures as prescribed by the legislation differ at each government level in BiH, procedures for preparation of the MTEFs and annual budgets are in practice generally more aligned to each other than the legislation implies. This was a result of donor-funded technical assistance to all finance ministries in BiH received in 2005–2011 period.<sup>22</sup> However, the recommended procedures were most reflected in the legislation at the BiH institutions level (as outlined above in section 2.2), while this is not the case yet in FBiH and RS.

The main steps of the budget process, which is broadly implemented at all levels, are given in Figure II-1 below.

In terms of the contents of the budget instructions, overall format and requirements for information from the budget users is broadly aligned with best international practices.

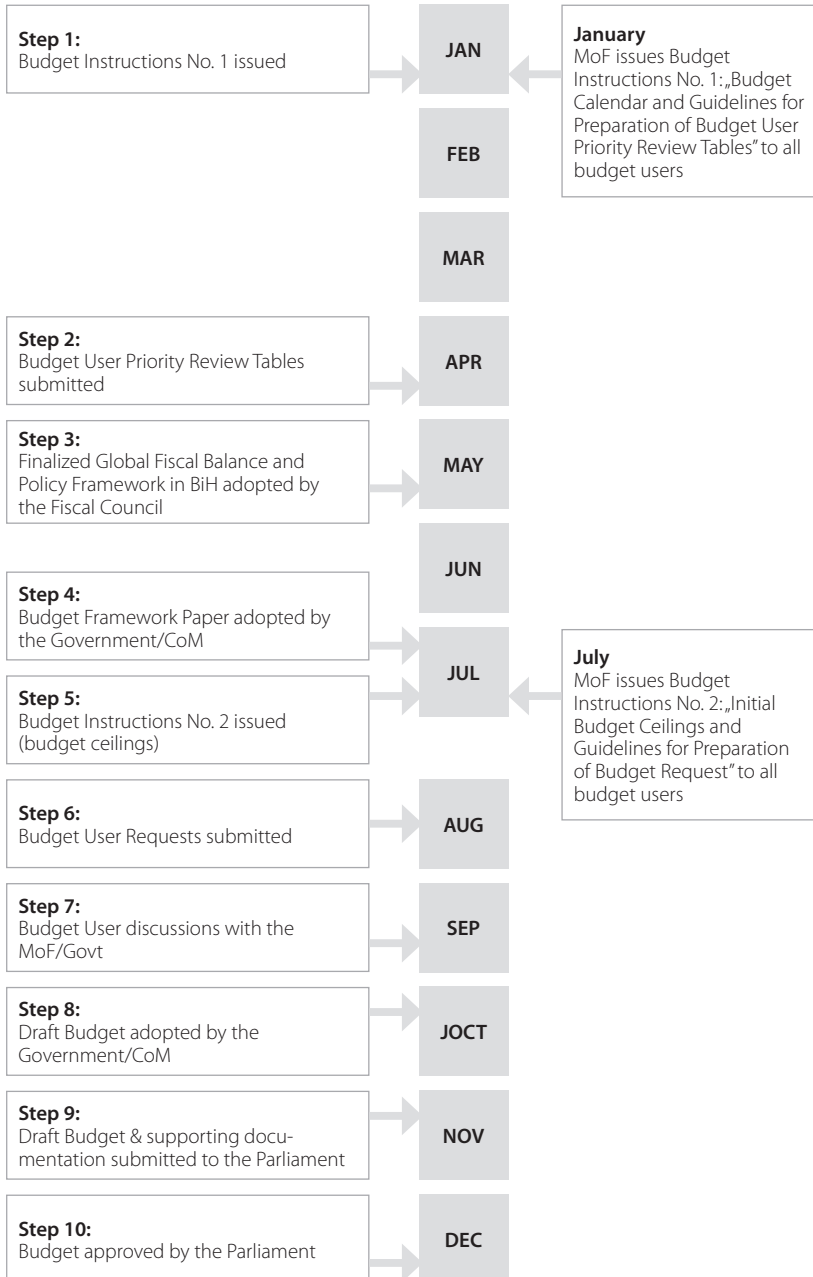
In spring, budget users submit their request for funding for the three-year period—the request for allocations within the Medium-Term Expenditure Framework. This is submitted for five main expenditure categories by economic category (wages, allowances, goods and services, transfers, and capital expenditure) separately for each of the programs. Then, within each program, three types of tables are requested—i) no-policy change budget request, ii) newly proposed priorities, and iii) savings. Finally, performance measures are given for each program (for both the no-policy table and newly proposed priorities)—outputs, outcomes, and efficiency indicators. To simplify the process, only a few performance measures need to be identified for each program. Additionally, each program must list operational objectives (while the strategic objective is defined at a budget user level).

After the adoption of the Medium-Term Expenditure Framework, budget users submit their annual budget request for the next year (based on ceilings defined in the framework) in summer, which also includes the budget request presented in program format with performance measures.

Thus, the current budget instructions are appropriate for budget users to insert the requests for the implementation of sectoral strategies and structural reforms.

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22 *Strengthening Public Expenditure Management project*, financed by the Department for International Development of the UK Government; see [www.javnefinansije.ba](http://www.javnefinansije.ba).

**Figure II-1: The budget preparation process of BiH in 10 steps**

Source: DFID's Strengthening Public Expenditure Project: Manual for the Preparation of the Budget Framework Paper and Annual Budget of the Institutions of Bosnia and Herzegovina (March 2011), [www.javnefinansije.ba](http://www.javnefinansije.ba).

The preparation of the EFP reports, which are sent annually to the European Commission, is not regulated by any legislation or rules of procedures and is performed basically on an ad hoc basis, currently coordinated by the Directorate for Economic Planning (a state institution). The public finance part of the EFPs is prepared by the Sector for the Finance of the EU Programs and Projects within the MFT, based on data and explanations they collect from the entity finance ministries, as well as from the relevant other sectors in the MFT (including the Budget Sector and Public Debt Sector). The fiscal data usually reflects the drafted budgets for the next years and the figures from the MTEF for the two following years. The GFS Unit of the Central Bank of BiH usually also assists by approximating a consolidation of the medium-term fiscal data collected from the budget sectors of the state and entity finance ministries (and the BD Finance Directorate), using approximated GFS 2001 methodology on an ad hoc basis. The next sub-sections outline the procedures at the specific government levels.

### 2.3.1. State institutions

The main steps within the state institutions' budget calendar for preparation and adoption of both the MTEF and the annual budget are defined in the law on the 'Financing of the BiH Institutions', as follows:

1. By January 31, the MFT sends Budget Instructions 1 (instructions for preparation of the Medium-Term Expenditure Framework) to state budget users
2. By March 31, the DEP prepares macroeconomic projections for BiH
3. By April 15, the MAU prepares projections for indirect taxation revenues for BiH (indirect taxation is the only type of tax revenue which is administered at the state level, while revenues are then split among all government levels)<sup>23</sup>
4. By April 15, budget users submit requests based on Instructions 1 (instructions for preparation of the MTEF) for the following three years to the MFT
5. By April 28, the MFT prepares projections of all of the state budget revenues for the next three years
6. By June 15, the MFT prepares and submits the Draft MTEF of BiH institutions (which covers the next three years) to the Council of Ministers, based on the GFFBP adopted by the Fiscal Council by May 15
7. By June 30, the Council of Ministers adopts the MTEF of BiH institutions (which includes ceilings for each budget user)
8. By July 1, the MFT sends Budget Instructions 2 (instructions for preparation of the Annual Budget) to state budget users, with the ceilings adopted by the Council of Ministers within the MTEF of BiH institutions
9. By August 1, budget users submit requests to the MFT based on Instructions 2 (for preparation of the Annual Budget) for the following year (this request is significantly more detailed than the request for the MTEF)

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23 Revenues from indirect taxation comprise around 45% of total revenue of the BiH general government (Central Bank of BiH, GFS data for 2010).

10. The MFT defines the Draft Annual Budget, based on budget user requests and consultations and negotiations held with them
11. By October 1, the MFT revises revenue projections in the Draft Annual Budget of BiH institutions submitted to the Council of Ministers, in case of a revision of macroeconomic or fiscal projections by the DEP and/or the MAU, and subsequent changes of the overall fiscal parameters by the Fiscal Council
12. By October 15, the Council of Ministers adopts the annual budget of BiH institutions and submits it to the Presidency
13. By November 1, the BiH Presidency adopts the Proposal of the Annual Budget of BiH institutions and submits it to the Parliament
14. The BiH Parliament (both houses) adopts the Annual Budget of BiH institutions by December 31

As evident from these steps, at the level of BiH institutions, the processes defined in legislation are synchronized between annual budget preparation and the preparation of the MTEF. However, as mentioned, the preparation of the EFPs is not systematically integrated into the domestic budget preparation cycle (at any level), but proceeds on an ad hoc basis.

### **2.3.2. Federation of BiH**

The law on the 'Budgets in FBiH' is vague when it comes to the timeline for the FBiH MTEF and annual budget preparation, and it seems inconsistent in some parts. The main steps within the budget calendar for preparation and adoption of the MTEF and the annual budget are as follows:

1. By April, relevant bodies (not identified specifically) prepare the report on economic and fiscal policies for the current and the next three years
2. The FBiH government adopts the Medium-term Guidelines for Economic and Fiscal Policies, which are drafted by the FMF in May; these should include medium-term economic and social growth assumptions, basic indications for economic and fiscal policies, revenue and expenditure projections, overall plan for expenditures by budget users, and overall liabilities and debt
3. The FMF sends instructions on preparation of MTEF budget requests to budget users, based on the adopted Medium-term Guidelines for Economic and Fiscal Policies
4. Budget users prepare a medium-term financial plan (MTEF request), which includes an explanation of the financial plan and a plan of development programs with objectives and expected results (not to be confused with program and performance budgeting, which only applies at the state level)
5. The FMF analyzes requests and drafts the MTEF
6. By June 30, the government adopts the MTEF
7. By July 1, the FMF sends instructions to budget users for preparation of requests for annual budget, including the MTEF and expenditure ceilings from the MTEF

8. By August 1, budget users submit annual budget requests to the FMF, including “relevant analyses and explanations”
9. By October 1, the FMF analyzes annual budget requests, holds consultations and negotiations with budget users about the annual budget appropriations, prepares the Draft Annual Budget, and submits it to the government
10. By November 1, the government (Prime Minister) submits the Proposal of Annual Budget to the Parliament, along with the MTEF and the financial plan of extra-budgetary funds
11. By December 31, the FBiH Parliament adopts the Annual Budget

The legislation attempts to synchronize the processes between annual budget preparation and the preparation of the medium-term budget framework. However, the preparation of the MTEF is not defined clearly enough, especially with regards to consolidation of data for lower government levels (cantons, municipalities, cities, and extra-budgetary funds).

### **2.3.3. Republika Srpska**

The preparation of annual budgets for the central government, municipalities, cities, and extra-budgetary funds has been harmonized with the preparation of the MTEF, which contains consolidated information on the RS general government for a three-year period.

The main steps in the budget calendar:

1. The RSMF distributes Instructions No. 1 to budget users; these contain detailed information on the budget calendar, tables for preparing three-year budget requests, and forms for submitting information on the Programme of Public Investments; the goal of this step is to include budget users in the process of preparing the MTEF and collect their initial request prior to compiling it
2. Development of medium-term macroeconomic and fiscal projections by the DEP (macroeconomic projections), the MAU (indirect tax revenues), and the RSMF (direct tax and other RS revenues)
3. Budget users submit three-year budget requests and forms for the Programme of Public Investments to the RSMF, which performs analysis and consultations with budget users as necessary
4. By June 30, the RSMF develops and the RS government adopts the MTEF and the draft Programme of Public Investments (this is the first annual deadline specifically defined in the law)
5. On July 1, the RSMF distributes the MTEF to municipalities, cities, and extra-budgetary funds as well as Instructions No. 2 (which contain information on initial budget ceilings for budget users and tables for budget requests) to budget users
6. By September 1, budget users submit budget requests to the RSMF
7. The RSMF performs consultations with budget users in relation to budget requests and the Programme of Public Investments and sets final expenditure ceilings per budget users

8. Revision of medium-term macroeconomic and fiscal projections (DEP, MAU, and RSMF)
9. By October 15, the RSMF submits the draft budget of the central government to the government; municipalities and cities submit draft budgets to the RSMF, which can provide recommendations for development of their budget proposals; the government adopts the central government's draft budget by November 5
10. By November 15, the government submits the draft budget of the central government to the RS National Assembly, which considers and adopts the draft budget; extra-budgetary funds develop and deliver their financial plan drafts to the RSMF, which is authorized to propose changes and additions
11. By December 1, the RSMF delivers the budget proposal of the central government to the RS government, which adopts the budget the proposal and approves proposals of financial plans of extra-budgetary funds
12. The RSMF submits the proposal of the Programme of Public Investments to the government, which adopts the proposal
13. By December 15, the National Assembly considers and adopts the proposed budget of the central government; cities and municipalities adopt their budgets and deliver them to the RSMF; extra-budgetary funds adopt their annual financial plans

Unlike in FBiH, in RS the municipalities and cities submit the draft budgets adopted by local government councils to the RSMF, based on which the RSMF can issue suggestions for budget proposals.

### **3. Incorporation of structural reforms' fiscal costs into fiscal programming documents**

#### **3.1. Assessment of the overall framework**

##### **3.1.1. The budgetary framework**

General issues in terms of overall budgetary framework applicable to all levels in BiH are as follows:

- *Fiscal management in BiH is hampered by the existence of separate legal frameworks at four government levels (BiH institutions, FBiH, RS, BD), which are not harmonized, as well as by vague legislation which governs the decision-making via the Fiscal Council. A high level of fiscal decentralization, with no legally harmonized methodology for fiscal reporting (see Appendix 6.2), comprises a barrier to monitoring and planning of fiscal policy in BiH. The coordination of fiscal policy is of particular importance given not only a complex fiscal structure, but also given that the country's monetary policy is based on a currency board. To improve macroeconomic and fiscal coordination, in 2008 the Fiscal Council was established through legislation adopted by the State Parliament.*



However, the law is interpreted differently by different stakeholders and government levels, with some believing the FC is entitled only to discuss the state budget and indirect taxation revenues (since they are administered at the state level). As a result, so far the FC focuses on discussing the BiH institutions' share of revenues and holding joint discussions with the IMF about the Stand-By Arrangements. These interpretations are reflected in the GFFBPs adopted so far, whose fiscal part (which should be the main part of the document) does not sufficiently discuss the categories of revenue, expenditure, and financing of all government levels; nor does it explain the policies on which the fiscal positions are based. Structural reforms are not covered in the GFFBPs.

- Since the subject of structural reforms is not addressed or defined in the legal framework at any government level in BiH, discussion on such reforms in the EFPs is mostly an unsystematic, ad hoc exercise in which institutions at each level are asked to submit the explanation of a reform in their realm of activities (for example, the State Agency for Labor and Employment and Entity Labor Ministries for reforms on the labor market, or Entity Privatization Agencies for privatization reforms). As a result of this approach, the lack of definition of structural reforms, and undefined format for explaining the measures and quantifying the targeted outcomes of each reform and its fiscal impacts, discussions of structural reforms in the EFPs are often inconsistent and do not include costing. Consequently, the EC found that the outlined structural reforms in the 2012 EFP lack strategy, timelines, and costing, and are generally not presented comprehensively and coherently.
- Structural reforms are not mentioned or explained in the MTEF and annual budget documentation. In addition, the legislation does not include the preparation of the EFPs (neither the overall document nor the input of different government levels and institutions).
- At the state level, there is a serious lack of political will and general common vision on economic and fiscal direction, which has been reflected in the Draft Development Strategy of BiH not being adopted by the Council of Ministers, but also in serious delays in the adoption of annual state budgets and, since 2009, a lack of timely adoption of the state MTEF by the Council of Ministers (the documents were sent to the Council by the MFT but were not discussed). This has also been highlighted by the EC in the BiH Progress Reports.
- At all levels, there seems to be a lack of political will to improve the inclusion of fiscal effects of structural reforms into the budgeting process. Publicly available budget and MTEF documentation (especially at the entity level) lack sufficient and competent discussion of underlying assumptions, policy plans, and associated risks.
- Budget users at all levels (especially entity levels) lack capacity to substantiate their budget requests and assess the budgetary implications of their initiatives. Although the MTEFs usually report that budget users have improved in filling out the tables related to their requests, considerable capacity improvement of their representatives remains necessary. These are needed in program budgeting and especially in assessing the budgetary implication

of planned initiatives, bearing in mind the lack of experience in this process and the fact that program budgeting is a uniquely complex reform which even in the most developed countries has taken many years, even decades.

Beyond these general issues, which are applicable to all levels, the FBiH framework has serious additional deficiencies:

- Identification of all relevant institutions in the legislation defining the process of preparing and adopting the FBiH MTEF and the Annual Budget. This includes the Fiscal Council of BiH, the DEP, the MAU, and other relevant bodies which should prepare reports specifically on FBiH's economic and fiscal policies for the current and the next three years by April each year.
- Preparation of a consolidated MTEF, which would include data for cantons, municipalities, cities, and extra-budgetary funds. While in practice the FMF used to prepare an approximated FBiH MTEF for all government levels in the 2004–2009 period with a donor's technical assistance,<sup>24</sup> the calendar was never adjusted to facilitate the process for all government levels, including the flow of information and data on fiscal policies and revenue projections from the FMF to lower levels in FBiH and the flow of information and data on budget framework from lower levels back to the FMF. In addition, since 2009, the MTEF for has not been prepared at any level, indicating even further deterioration of fiscal coordination within FBiH and worsened budget transparency, which also implies the lack of real political will to improve the inclusion of fiscal effects of structural reforms into the budgeting process.
- Timelines in the budget calendar have inconsistencies. For example, it is not feasible to expect that an MTEF can be prepared and adopted by June if the FBiH government adopts Medium-term Guidelines for Economic and Fiscal Policies in May and the FMF only then sends the instructions for MTEF requests to budget users. When the need to include lower levels in the process is taken into account, it is even clearer that the budget calendar as legislated in FBiH is not appropriate and needs to be changed.
- Introducing performance budgeting into budget legislation. While in practice the FMF sends budget instructions to budget users with the program budgeting format (with performance measures including objectives, outcomes, outputs, and efficiency indicators), the programs are not included in budget documentation sent to the government or the Parliament. FBiH needs extensive additional donor technical assistance in the area of program budgeting, including training for the FMF staff and especially budget users.<sup>25</sup> The legislation should also be changed to slowly introduce performance budgeting, as was done at the state level.

24 *Strengthening Public Expenditure Management project*, financed by the Department for International Development of the UK Government.

25 It is expected that the EC-financed project on Public Finance Reform—an Instrument for Pre-Accession (IPA) 2010 project—will start by the end of 2012. This project is a continuation of the previous DFID donor assistance in program budgeting, and the beneficiaries will include state and entity finance ministries.

Further deficiencies of the RS framework are the following:

- The overall multi-year budgeting process has been losing quality and transparency in recent years, as reflected by the gradual shortening of MTEF documents, which may also imply a lack of political will for including fiscal effects of reforms. For example, the MTEF for 2012–2015 contains extremely limited explanations of the presented fiscal framework, and most of the text in the document simply paraphrases figures from tables in the document. Therefore, its reader is not able to learn about the underlying assumptions, policy plans, and associated risks taken into consideration when the document was developed.
- Introduction of program-based budgeting and reporting has not been completed. In the budgeting process, the RSMF already requests information from budget users on “outputs,” “expected outcomes,” “efficiency indicators,” and other information needed for compilation of program-based classification. However, tables and accompanying instructions are complex and not sufficiently explained to budget users; they probably need additional review of their design for practical use. A draft law on the ‘Budget System of RS’ foresees inclusion of a program-based budget classification as obligatory in the process of budget perpetration and reporting. This change of legislation is needed to make the collection of program-based information useful and to start disseminating program and performance information to the government and parliament.

### 3.1.2. Assessment of the Overall Strategic Planning Framework

In terms of a strategic planning process, relevant legislation and procedures are not established at the state level.

The Rulebook on Procedures of Council of Ministers<sup>26</sup> prescribes that the MFT should provide an official position on all of the acts (legislation, decisions, and strategies) submitted for adoption to the Council of Ministers by budget users (line ministries and agencies), in terms of the funds needed for the implementation of that act, including the annual work plans of budget users. However, no specific format is prescribed for explanation and quantification by budget users. In practice, some submit acts without the official position of the MFT (though this happens rarely at the state level). In addition, there have been instances of the Council adopting acts which have no position, or even a negative position, from the MFT. The most serious issue is that currently budget users do not properly cost their proposed acts, but typically just note that funds will come from the budget. This is often followed by a vague statement by the MFT which gives a positive position, declaring that the budget user is obliged to plan for the funds in the budgetary procedures, while the funds approved by the MFT will depend on the funds available in the state budget.

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26 Official Gazette of BiH, 22/03.

At the state level, the law on the ‘Council of Ministers’ prescribes somewhat vaguely that the Directorate for Economic Planning (DEP) is responsible for: coordination or preparation and monitoring of implementation of the annual, medium-term, and long-term development strategies.<sup>27</sup> In practice, the DEP led and coordinated preparation of the Draft 2010–2014 BiH Development Strategy and the Draft 2010–2014 BiH Social Inclusion Strategy.<sup>28</sup> The strategies were prepared in a modular format, with separate action plans for each of the government levels (state institutions, FBiH, RS, and BD). The Development Strategy (as well as the Social Inclusion Strategy) was envisaged to be adopted by all of these governments<sup>29</sup>; however, it has been adopted by FBiH and BD, but not by the Council of Ministers or RS. These draft strategies have detailed action plans with activities, responsibilities, and timelines. But the measures and activities are not costed, and the action plan just has a column indicating whether or not funds are available for implementation of a measure. This column is left empty or is filled with *NO* for most of the measures (especially at the state and FBiH levels).

Sectoral strategies are mostly at the entity level, since the state does not have all of the competences, but rather mostly a coordinating competence (see Appendix 6.1 for a brief overview of the state’s competences). The law on the ‘Ministries and Other Administrative Bodies of BiH’ prescribes that the ministries and other administrative bodies prepare strategic documents in their sectors.<sup>30</sup> An overview of the available strategic documents of the institutions at the state level (such as the Science Development Strategy, the Justice Sector Reform, the PIFC Strategy, the Border Security Strategy, and the Strategy for Development of SMEs) reveal wide discrepancies in structure and format as well as the level of integration with budget requests. This is partly explained by the fact that most strategic planning is governed by donor projects, which use varying methodologies.

The law also prescribes that the Council of Ministers submits to the Parliament an annual work plan and an annual report on its work. These are prepared on the basis of the work plans submitted by the ministries and agencies and in practice contain only lists of laws, supplementary legislation, reports related to the EU integration, and other activities and acts which budget users intend to draft

27 Official Gazette of BiH, 30/03, 42/03, 81/06, 76/07, 81/07, 94/07, and 24/08.

28 The DEP has had technical assistance of the EC projects in this process.

29 As was the case with the previous BiH general strategic document, the Poverty Reduction Strategy Paper 2004–2007, which was adopted by all government levels in 2003/2004, and whose preparation was coordinated by the Office of the Chairman of the Council of Ministers.

30 For example, the BiH Ministry of Foreign Trade and Economic Relations is responsible for preparation of strategic documents on economic relations; the BiH Ministry of Communications and Transport is responsible for preparation of strategic documents on international and inter-entity communications and transport; the Directorate for European Integrations is responsible for coordinating strategy for EU integrations; and the Ministry of Civil Affairs is responsible for defining strategies on the international level for all social sector areas –: health, pensions, science, education, labor, employment, culture (see the Official Gazette of BiH, 30/03, 42/03, 81/06, 76/07, 81/07, 94/07, and 24/08).

and implement (most relate to the legal obligations of those budget users, such as drafting of the MTEF, which is an MFT obligation). These documents thus do not show financial implications or the performance measures for the lists of activities.

The MFT requests that budget users align their budget request with annual work plans and relevant strategic documents (general and sectoral strategies) in terms of costs and performance measures. However, significant further improvements are needed, backed by a change in legislation governing the preparation of annual work plans and strategic documents.

In FBiH, the legislative framework for strategic planning was adopted in 2011. The Decree on the Process of Strategic Planning, Annual Planning and Reporting in Federal Ministries<sup>31</sup> defines the procedures for preparing medium-term strategic plans, annual work plans, and annual work reports by ministries. All of the plans drafted must be in line with adopted BiH and FBiH development strategies (both general and sectoral). The decree defines that the Federal Bureau for Development Programming is responsible for coordinating the process of strategic planning and providing technical assistance to ministries, as well as for drafting orientation measures for ministries and compiling overall plans for the government.

While it does not specifically mention the issue of structural reforms, the system for strategic planning set up in the decree represents a significant improvement. It prescribes the structure and template for strategic plans, which are simple, but include both performance indicators (inputs and outputs) and financial impacts (including missing financial resources). The decree also prescribes the formulation of strategic goals, which should be directed towards results and be quantitative. It prescribes that the processes for strategic planning, annual planning, and reporting in ministries have to be entirely aligned with the budgetary process (specific deadlines are given to align with the MTEF—draft medium-term strategic plans have to be prepared and submitted to the FMF by March 31, while final medium-term strategic plans have to be prepared and submitted to the FMF by August 15 each year) and have to be financially viable.

A second decree, the Decree on Preparation, Impact Assessment and Choice of Policies in the Procedures of Preparation of Acts of Federal Government and Federal Ministries, was also adopted in 2011. This covers policies which flow from strategic priorities of the FBiH government. It prescribes that the policies and acts must include quantitative data on fiscal impacts, be financially viable, and be planned in line with the budget process. Its Appendix offers a detailed template for the analysis of prior policies and legal acts, goals and targeted performance measures, risks, and social and fiscal impacts.

These decrees were adopted quite recently, and most of the federal institutions have not used the templates and have not fully applied the prescribed process yet. The 2012 FBiH government work plan does not fully reflect the procedures defined in the decrees (in its introduction, the Federal Bureau for

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31 Official Gazette of FBiH, 22/11.

Development Planning notes that most ministries had difficulties, since this is the first year of implementation). Even those who submitted the plan in the prescribed format either left the fiscal impact column empty or simply entered that funds will come from the budget. In addition, defined performance measures (outputs and outcomes) are weak and mostly relate to the number of adopted acts, rather than actual impact.

It would be beneficial to continue improving the strategic planning process. Significant technical assistance and training is needed in both the FMF and line ministries (as well as in the Federal Bureau of Development Programming) in applying the adopted decrees and improving the process further.

In terms of general strategic documents, in addition to adopted BiH Development Strategies and the relevant Action Plan for FBiH, a 2010–2020 FBiH Development Strategy has been adopted, which is separate but derives from the BiH Development Strategy. However, this document is not detailed enough in terms of fiscal implications and performance measures.

The Rulebook on Procedures of the Government of FBiH<sup>32</sup> prescribes that, when submitting acts to the government, budget users must secure the position of the FMF in respect to the financial impacts. At the state level, no specific format is prescribed to explain and quantify the financial impacts. Here too, there have been instances of budget users submitting acts without the official position of the FMF and of the FBiH government adopting acts which had no opinion or a negative one from the FMF. Budget users at this level also tend to not properly cost the proposed acts, but note that the funds will come from the budget, with a vague position from the FMF.

The law on the ‘Budgets of FBiH’ was amended in 2010 to more specifically prescribe that legislation with fiscal implications cannot be submitted for adoption to the Parliament without prior analyses on needed resources and the way of securing them or (in cases where it is not the proposer of the legislation) without the official position of the government. This amendment resulted from negotiations with the IMF, in the aftermath of fiscally unsustainable legislation in the social and war veteran sector being adopted by the FBiH Parliament.

A plethora of sectoral strategies have been adopted in FBiH (some mentioned in Appendix 6.3). At the state level, an overview of the available strategic documents (such as the Strategic Plan for Health, the Strategic Plan and Development of Energy Sector, the Environment Protection Strategy, or the Strategy for Industrial Policy) reveals discrepancies in structure and format and the level of integration with budget requests.

While broadly consistent (as a result of the reforms assisted by DFID), the FMF’s budget instructions are less specific than those at the state level. Significant further improvements are needed in aligning budget users’ requests with annual work plans and relevant strategic documents (general and sectoral strategies) on costs and performance measures, to build capacity and reflect the decrees on strategic planning.

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32 Official Gazette of FBiH, 37/10, and 62/10.

Republika Srpska does not have legislation that provides closer regulation of the process of developing of strategic plans. Therefore, as in FBiH, strategic plans were developed using differing methodologies and various formats.

The law on the ‘Budget System of RS’ stipulates that any proposed legislation or other act must contain assessment of its budget effects for the subsequent three-year period as well as a proposal on securing the funds for financing of any additional expenditure caused by implementation. In practice, these assessments are made with varying datelines and degrees of precision. Moreover, the financial assessments are often not quantified. There are examples of proposals saying that the required additional financial resources would be provided “from budgets of BiH, Brčko District and entities, international donations and other sources,”<sup>33</sup> or that a draft law will “secure a more rational use of material resources.”<sup>34</sup> However, some proposals do encompass more precise estimates of their financial effects.

### 3.2. Assessment of the institutions

At the overall BiH level, the Fiscal Council is the only joint institution for overall fiscal planning. As noted, the law gives it only vague authority and does not address the preparation of EFPs (later PEPs) in an integrated manner on the basis of the GFFBP. Structural reforms are not mentioned in the FC legislation, nor are they present within the GFFBPs.

At all levels in BiH, finance ministries dominate the fiscal programming process, structural reforms are not officially defined, and there are no guidelines for explaining and operationally integrating structural reforms into fiscal programming. At the state level, the MFT within its instructions specifically requests that budget users include all planned measures from adopted strategic documents (including structural reforms) into their budget requests though explanations and integration within the program budget and performance measures.

In practice, however, since there are no general guidelines either for structural reforms or generally for strategic documents (overall strategies and sectoral strategies) at any government level, there are strong discrepancies among budget users in terms of how they prepare their strategic documents (including all elements—terminology, timeframe, performance measures, and costing) and how they integrate them into their budget requests.

The finance ministries’ focus is on the fiscal programming process, which is not matched by a focus on structural reforms, both because structural reforms are not addressed in the legal framework and more generally because there is no demand for better strategic and structural reform planning by the governments (especially at the level of the Council of Ministers, which does not have an overall strategy adopted at all, while entities do have economic policies).

33 Law proposal on the ‘Organization and Implementation of Census of Population, Households and Apartments in the Republika Srpska’, 2013.

34 Draft law on the ‘Amendments and Additions to the law on Inspections in Republika Srpska’.



On the other hand, most budget users (line ministries and agencies) at all levels lack sufficient capacity and motivation to prepare appropriate policy and fiscal information on structural reforms within their strategic documents' plans and to incorporate appropriate policy and fiscal information on structural reforms within their budget requests.

The budget planning process in FBiH is weaker than at the state level, and the capacities and staffing of the Budget Sector of the FMF and federal budget users are significantly lower. Thus, generally fewer budget users here deliver high-quality budget requests. The law on the 'Budget of FBiH' should be changed to address the involvement of country-level institutions (the Fiscal Council, DEP, and MAU) and to clearly define all of the relevant institutions at the FBiH level (e.g., the Federal Bureau for Development Programming, the Prime Minister's Office, the Fiscal Council of FBiH, which includes canton-level finance ministers, and/or the Association of Municipalities and Cities in FBiH).

In Republika Srpska, the RSMF is also the central institution responsible for the overall process of fiscal programming. This is obvious from the steps prescribed by the budget calendar, where the RSMF coordinates the process, collects budget requests from and negotiates ceilings with budget users, and even provides consent to municipal budget proposals. It is also responsible for compiling MTEF documents and developing medium-term expenditure projections for all government levels in RS.

However, since the information on expected budgetary effects submitted by budget users is of varying reliability and accuracy, it is not clear to what extent the RSMF includes these effects in the MTEF and budget allocation decision-making process. It is important to ensure efficient cooperation between different departments of the RSMF in this process, since they have dissimilar but connected roles. For example, the Department for Budget and Finance is responsible for budget preparation, the Department for Fiscal System for fiscal policy and legislation, and the Department for Macroeconomic Analysis and Policy for economic and fiscal projections. Without efficient inter-departmental coordination it may happen that important information in possession of the ministry is not included in the budgeting process.

The budgetary effects of major reforms (e.g., pension system, contributions, public sector wages) have been, at least roughly, included in the RS MTEFs. However, it is questionable to what extent the fiscal effects of reforms, in which the RSMF does not participate directly, are being included. Such reforms could be structural reforms that have a lower initial budgetary impact or budgetary impacts with postponed effects.

Budgetary users generally lack incentives to provide accurate and sufficiently elaborated information to the RSMF. An important obstacle in this regard is that line ministries often do not have sufficient capacities (or instructions) on how to estimate the budgetary effects of their reform initiatives. Some strategic document proposals have included more appropriate fiscal information, which is probably due to individual initiatives within the ministries or more involvement from the RSMF.



### 3.3. Assessment of the process

It would be beneficial for the Fiscal Council to intensify its work; strengthen its advisory and secretarial bodies; adopt GFFBPs which cover revenues, expenditure, and financing frameworks for all levels; and decide on policies at the state level, while at least broadly agreeing on the overall direction for policies at the entity level (in other words, entities' policies do not necessarily have to be the same, but should be broadly consistent, rather than diverging as in the 2012 EFP, when one entity presented contractionary fiscal policy goals while the other presented expansionary goals). Structural reforms should also be defined and integrated in the GFFBPs, as well as sufficiently explained in terms of impacts and costing.

Once adopted, the GFFBP should each year be the basis for the EFPs that the country sends to the EC, which should also be adopted by the Fiscal Council in order to truly become a strategic document. Furthermore, the FC (and its advisory body) should lead the discussion with the EC on all of the committees and meetings related to economic and fiscal issues. This would address the current problem of EFP preparation not being addressed in the legal framework at any level in BiH, which results in EFPs not being properly viewed as a crucial strategic document of the country, but rather an ad hoc, parallel process. (As noted, the notion of structural reforms is only mentioned for the needs of reporting and negotiating with external institutions—The EC, the IMF and the World Bank—and is entirely missing from the domestic legislation and budget documentation.

At all levels, the organic budget laws should define specifically what strategic documents that address structural reforms should include in terms of definition, format (with guidelines on specific structure, including activities, timeline and responsibilities for implementation, as well as performance measures), and costing. Adoption of all strategic documents should be coordinated with the finance ministries. As noted, these ministries are legally obliged to provide their opinion on acts (legislation, decisions, and strategies) that are submitted by budget users for adoption by the governments and that may have financial implications. But in practice, some acts are adopted without a position from the relevant finance ministry, and budget users often do not properly cost their proposed acts, noting just that funds will come from the budget. Thus, the legislation (and actual practice) should be strengthened to precisely prescribe both the format and necessary quantitative data for budget users to provide when submitting acts (including strategic documents) for adoption, while finance ministries should provide an official position on all strategic documents of the line ministries and agencies, including their fiscal implications. Only strategic documents that adhere to the defined guidelines on format and costing and those for which financial needs and sources have been identified for full implementation should be adopted by the governments.

Along the same lines, instructions sent to budget users by finance ministries (for both MTEFs and annual budgets) need to emphasize more specifically the integration of strategic documents and structural reforms.

Capacity building is needed for finance ministries and especially budget users in strategic planning and in structural reforms and their integration into fiscal processes. The need to improve medium-term strategic planning and budgeting at all government levels has not been sufficiently prioritized. This is reflected by the governments sidelining some of the adopted strategic documents and MTEFs and a lack of policies for development of human capacities in strategic and fiscal planning. Currently, most strategic planning at the sectoral level is governed by donor projects. Hence there are discrepancies in the format of various strategic documents (e.g., the Justice Sector Reform vs. the Border Security Strategy) and in their level of integration with budget requests.

## 4. Conclusions and recommendations

### 4.1. Conclusions

The main weaknesses in programming the fiscal costs of structural reforms in BiH include:

1. Weak coordination of strategic and fiscal planning with a complex fiscal structure, especially at the state level. This structure complicates fiscal management and amplifies the importance of coordination and the work of the Fiscal Council. The MTEF and budget preparation procedures as prescribed by the legislation differ at each government level in BiH, although some harmonization has been achieved under the Strengthening Public Expenditure Management Project (2006–2011). At the state level, the FC is the only joint institution relevant for overall fiscal planning.
2. Lack of political demand for better strategic planning and structural reform planning. The finance ministries' focus is on the fiscal programming process, which is not matched by a focus on structural reforms, since such reforms are not addressed in the legal framework and more generally because there is no demand from the governments and the Fiscal Council.
3. Low general policy coordination capacity. BiH does not have sufficient experience in policy coordination; this process and the fiscal assessment of strategic documentation (and hence also structural reforms) have not been managed on a systematic basis.
4. Lack of orientation when it comes to the methodology for strategic policy planning, including structural reform planning. The notion of structural reforms is only mentioned for the needs of reporting and negotiating with external institutions (the EC, IMF, World Bank) and is entirely missing from the domestic legislation and budget documentation.
5. Preparation of the BiH EFPs is not regulated by any legislation or rules and is performed basically on an ad hoc basis.
6. Domination of fiscal programming process by finance ministries at all levels is coupled with a lack of guidelines to help budget users explain and

operationally integrate structural reforms into the fiscal programming process.

7. While there have been improvements, all finance ministries and especially line ministries and agencies still need to strengthen their capacities. Most strategic planning at the sectoral level is driven by donor projects.
8. In addition to capacity limitations, the FBiH legal framework has serious additional deficiencies in identifying relevant institutions in preparing and adopting the MTEF and the Annual Budget, preparing a consolidated MTEF to include data for cantons, municipalities, cities, and extra-budgetary funds. It has an inconsistent timeline and there is also a need to introduce performance budgeting into budget legislation.
9. Additional weaknesses that affect RS: there are signs that the transparency of the budgeting process and the quality of MTEF documents have deteriorated; the introduction of program-based budget planning and reporting has not been completed and requires changes in legislation; and the existing, simple information requirements are often not appropriately met by budget users due to lack of capacity, adequate instructions, or motivation.

## 4.2. Recommendations

Possible measures to address the weaknesses of the process of programming fiscal costs of structural reforms in BiH:

1. Given that the coordination and fiscal assessment of structural reforms has not been done on a systematic basis in BiH, it would be beneficial to present to the Fiscal Council and state and entity governments different models and EU best practices for programming the fiscal costs of structural reforms, including the legislative framework, institutions, and procedures. This could facilitate country-wide discussion on this issue and provide momentum for legislative and institutional changes to improve this process.
2. For strengthening overall fiscal coordination in BiH, the legislation and the work of the Fiscal Council should be revised to define more concrete responsibilities for the FC in overall fiscal coordination for the country (including adoption of high-quality GFFBPs and EFPs), since currently the FC is a major bottleneck for substantially strengthening the overall process.
3. The legislation and the work of the FC should also regulate the preparation of the EFPs (later PEPs) in an integrated manner on the basis of the GFFBP.
4. Strategic policy documents (including structural reforms, which should be treated like any other strategic policy document) can be improved generally through the legislation and rulebook for the FC (in prescribing the information contained in the GFFBP and EFP/PEP), and more specifically by legislation at each government level, making sure that the definition and format of structural reform planning is broadly harmonized to enable consolidation and compilation for the purpose of GFFBP and EFPs

(later PEPs). It is essential that the issues of planning for strategic documents (including structural reforms) are endorsed by the governments in some way—be it through legislation, or (more appropriately) through a decree, procedures and methodology. In essence, this should be a manual providing a clear definition and terminology for strategic policy documents and, more specifically, for structural reforms (which are simply a type of strategic policy documents). It would provide guidelines for explaining and quantifying the targeted outcomes of a policy or reform and its fiscal impacts. In other words, this manual should specify the content and format of strategic documents, including main terms such as strategic goal, output, outcomes, performance measures, as well as provide a template for costing (including aspects that need to be taken into account for direct and indirect, short- and long-term effects). The methodology has to be in line with the budget planning templates (with similar terminology and definitions for strategic and operational objectives and performance measures) to ensure that sectoral strategies (including structural reforms) are easily translatable into the budget planning process. Instructions sent to budget users by finance ministries (for both MTEFs and annual budgets) also need to emphasize the integration of fiscal effects of the strategic documents and structural reforms. The strategies and structural reforms should be defined and integrated in the GFFBPs and subsequently EFPs, as well as sufficiently explained in terms of impacts and costing.

5. Capacity building is needed for all finance ministries (in particular at the FBiH level) and especially for budget users in strategic planning and structural reforms and their integration into the fiscal processes. Activities to improve the coordination with such focal points might include: (i) developing adequate templates for preparing inputs, (ii) putting in place more structured procedures for input preparation, (iii) organizing learning events for focal points and other staff at the line ministries in skills of medium-term fiscal and economic planning.
6. The law on the ‘Budget of FBiH’ needs to be changed to address the involvement of country-level institutions (the Fiscal Council, DEP, and MAU) and to clearly define all relevant institutions. In addition, the legislation needs to clearly define the process, as well as provide realistic and comprehensive timelines for preparing a consolidated MTEF with data for cantons, municipalities, cities, and extra-budgetary funds. There is also a need to introduce performance budgeting into budget legislation.
7. A wider public debate on the significance of a well-developed budgeting process would be beneficial at all levels. This would help put more political weight (and thus resources) on improving medium-term budgeting, especially at the level of budget users. Legislative introduction of program-based budgeting needs to be completed to shift some focus in the planning process from inputs to outputs. This needs to be followed with better developed instructions and improved capacities of line ministries’ focal points.

Below is a table with a rough general overview of some pressing issues and problems associated with the fiscal impact assessment of selected structural reforms in BiH (comments generally pertain to all government levels—competence for the listed reform areas is primarily at the entity level).

**Table II-1: Issues with the fiscal impact assessment of selected structural reforms in BiH**

Area of structural reforms	Overall framework issues	Issues emerging from institutional features	Issues emerging from procedures and processes
<b>Reforms of the enterprise sector</b>	The methodology of fiscal impact assessment of structural reforms has not been regulated and thus the strategic documents underpinning reforms in the enterprise sector have been developed in different formats and include varying degrees of fiscal assessment (from none to highly detailed assessment).	A large number of institutions have been involved in reforms of the enterprise sector and many lack capacity and motivation to estimate fiscal impacts of proposed reforms and actions.	There are no prescribed procedures for fiscal impact assessment of structural reforms except the legal obligation to include estimates of financial effects in the acts proposed by budget users. Thus large discrepancies in the quality of assessment appear between different acts related to reforms in the enterprise sector.
<b>Financial sector reforms</b>	Fiscal impact assessment of potential negative developments in the financial sector has not been produced (at least publicly).	An ad hoc working group was created to deal with crisis-related problems within the financial sector at RS level (Fiscal Standing Committee for Financial Stability), but its role has not been sufficiently defined.	Coordination among the institutions responsible for safeguarding the stability of the financial sector (and thus for assessing potential requirements for budgetary support) has not been satisfactory.
<b>Human resource development &amp; labor market reforms</b>	Although fiscal impact assessments of some large reforms, e.g., pension systems, have been developed (primarily in RS), it is not clear how fully the results have been included into medium-term budget plans.	Domestic institutions participating in design of strategic reforms lack sufficient capacities to independently estimate fiscal impacts of the proposed reforms.	There is no systematic solution. Ad hoc working groups are usually formed for developing large reform strategies, such as the pension system reform.
<b>Utilities &amp; network industry reforms</b>	There are no comprehensive strategic documents encompassing medium-term plans and financing requirements in these sectors.	Key public institutions in these sectors have not demonstrated capacity to perform detailed medium-term planning of financial requirements. IFIs play highly important financing role in these sectors, e.g., road and highway construction.	Assessments of fiscal requirements related to construction of physical infrastructure are subject to frequent changes stemming from arrangements with IFIs and private investors.

Area of structural reforms	Overall framework issues	Issues emerging from institutional features	Issues emerging from procedures and processes
<b>Administrative &amp; other reforms</b>	There are no strategic documents outlining medium-term policy plans and expected results in terms of improving the entity's international competitive position.	Reforms in this area affect a large number of public institutions and require their coordinated action, e.g., simplifying the procedures for registration of new businesses or obtaining construction licenses.	Reforms have lacked domestic initiative and have been mostly carried out or initiated by foreign-financed projects, e.g., the Regulatory Guillotine, the Regulatory Impact Assessment.

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## 6. Appendixes

### 6.1. Overview of the fiscal structure

The general government in BiH has a uniquely large number of autonomous parts, which complicates fiscal management.

Indirect taxation is at the state level, while the entities levy various direct taxes, and within the entity of FBiH, each of the 10 cantons has a mandate to make tax legislation. This is reflected in the fiscal structure of the country and the way in which competencies and responsibilities are distributed across the levels of government (state, entity, cantons, and municipalities).

According to the GFS 2001 data for 2011 (consolidated and published by the Central Bank<sup>35</sup>), out of the total BiH general government expenditure of around 5.52 billion EUR, the state institutions had a share of around 8%<sup>36</sup> of total expenditure of general government in BiH; FBiH had a 58% share (including the FBiH government, 10 cantons, 80 local government units, as well as extra-budgetary funds and road directorates); RS had a 32% share (including RS government, 65 local government units, as well as extra-budgetary funds and road directorates); while Brčko District (BD) had a 2% share (including BD government and extra-budgetary fund<sup>37</sup>).

35 Note that the Central Bank GFS data excludes foreign financed projects which do not go through budgets.

36 Note that total foreign debt servicing for BiH (which is basically entirely entity and BD debt) is adopted within the state budget (as stipulated by the law on 'Financing of BiH Institutions', and indirect taxation legislation).

37 This Case Study does not examine BD level, due to its low share in total general government sector in BiH.

**Table II-2: Total general government expenditure in BiH, 2011**

	BiH			Federation of BiH					Republika Srpska				Brčko District
	Structure (total) %	Total	State institutions	Total	Government	Cantons	Municipalities	Funds	Total	Government	Municipalities	Funds	
<b>Total Expenditure</b>	100	5522	497	3256	639	900	232	1541	1719	774	203	799	104
<b>Wages and Allowances</b>	28.6	1706	329	850	121	590	101	37	486	355	109	22	41
<b>Goods and Services</b>	17.9	1068	92	791	34	116	65	576	146	52	54	40	39
<b>Interest</b>	1.4	82	53	47	43	3	2	2	35	24	7	4	0
<b>Subsidies</b>	3.5	206	0	128	59	44	13	12	73	65	8	0	5
<b>Grants</b>	0.1	3	1	4	141	33	31	2	0	146	0	0	0
<b>Social Benefits</b>	37.1	2214	22	1285	241	114	19	911	889	131	26	733	18
<b>Other Expenditures</b>	5.0	298	7	192	34	71	67	20	95	59	33	3	50
<b>Capital Expenditures</b>	6.6	394	20	173	7	25	48	93	191	25	64	101	10

Note: Expenditures in MM EUR. – Source: Government Finance Statistics Data of Central Bank of BiH.

Main authorities at the state level include foreign affairs, defense, state security (through agencies such as the Border Police, the State Investigation and the Protection Agency, the Intelligence and Security Agency, the Directorate for Coordination of Police Bodies), agencies related to EU integration (such as the Institute for Standards, the Institute for Intellectual Properties, the Veterinary Office, the Competition Council, the Anti-Corruption Agency), the State Judiciary, Election Committee, and coordinating ministries and agencies for other sectors (e.g., the Ministry of Civil Affairs has Sectors for Education, Social Protection and Pensions, Health, Science, and Culture and Sport). In RS, education, health, local judiciary, and local police are all at the RS government level. In FBiH, cantons take over most of this expenditure.

BiH GDP for 2011, as published by the State Statistics Agency, is 13 MM EUR, making the total BiH general government expenditure as consolidated by the Central Bank of BiH (CBBH) at 42.4% of GDP. However, the CBBH data does not include estimates of foreign-financed projects which are not recorded in the budgets. The IMF includes these foreign-financed projects and estimates



that the overall general government expenditure in BiH is at around 49 % of GDP (total expenditure is estimated to be around 400 MM EUR higher in the IMF's projections than in the Central Bank projections).

In Bosnia and Herzegovina, authorities present macroeconomic and fiscal data in the EFPs based on expenditure-based GDP, while the IMF's data is based on production-side GDP. The expenditure-based GDP is around EUR 1.7 billion, or 14 % higher than production-based GDP (both published by the BiH Statistics Agency, but the expenditure-based GDP is published as unverified statistic). In addition, the BiH authorities do not include estimates of foreign-financed projects, escrow accounts, and some road directorates in the fiscal data shown in the EFPs. Consequently, the BiH EFP shows total general government expenditure of BiH at only around 41 % of GDP.

## 6.2. Overview of fiscal reporting

The state MFT does not consolidate fiscal data for the country; this is despite the fact that the law on the 'Ministries and Other Administrative Bodies of BiH' prescribes that the MFT's competences include compilation, distribution, and publishing of the consolidated general government fiscal data. Neither does the State Statistics Agency consolidate fiscal data for the country.

The Central Bank of BiH publishes consolidated execution data for all government levels on an annual basis, in line with the Memorandum of Understanding between the Agency for Statistics of BiH and the Central Bank. However, quarterly consolidation by the Central Bank excludes municipalities and road directorates. Furthermore, it provides only a statement of government operations (not a statement of other economic flows, balance sheet, or sources and uses of cash). Due to a uniquely large number of fiscal units in the general government whose administrative data is not in line with the GFS 2001, the Central Bank's consolidation is an extensive task; hence annual data is published with a six-to-seven-months lag.

The MAU consolidates monthly administrative fiscal execution data for revenues and expenditures, excluding financing. There are no legal requirements for the government units to report to the MAU.

However, as a result of a requirement within the Stand-By Arrangement with the IMF, a coordinating group with the task of collecting and consolidating fiscal statistics from all government levels in BiH was formed by the Fiscal Council in 2009, chaired by the MAU. The basic quarterly reports for the purpose of monitoring the Stand-By Arrangement have been published on a quarterly basis. As monthly data is published in MAU bulletins, this data is not fully in line with GFS 2001 (nor with the European System of Accounts 1995) and is basically developed with the format needed for the IMF's monitoring. In addition to some issues of data coming in late from the lower government levels, the published data includes only revenues and expenditures, and not financing. Furthermore, not all government levels are included (e.g., road directorates

are excluded), while foreign-financed projects and off-budget spending from escrow accounts are also left out.

In 2010, the IMF provided short-term technical assistance to all finance ministries to ensure that the bridging of the reports from administrative Charts of Accounts to GFS 2011 is done properly. That technical mission, which prepared new bridging tables and proposed a harmonized reporting template, noted a lack of coordination between stakeholders in the reporting process and stressed that, while stakeholders from all government levels recognize the need to harmonize, a concrete approach has not been agreed upon. They also noted a lack of capacity and resources in some government units, particularly in FBiH.

Both the Central Bank and the MAU only publish historical execution data, while budget plans and the medium-term outlook are not officially consolidated. For drafting the Global Frameworks of Fiscal Balance and Policies, the MAU has attempted to consolidate the data from Medium-Term Budget Frameworks submitted at government levels, using the same format as the administrative quarterly reporting (excluding financing, road directorates, foreign-financed projects, and off-budget spending from escrow accounts).

It would be beneficial to establish a methodology, responsibilities, and deadlines for the process of fiscal data consolidation and reporting for the whole general government sector of BiH. An EC-financed project, *Capacity Building for the Compilation of Accounting Data within the Scope of General Government and Public Finance Statistics*, has recently been initiated and should aid these efforts.

### **6.3. Overview of reforms mentioned in the Economic and Fiscal Programme**

The 2012 EFP of Bosnia and Herzegovina (BiH) was adopted by the Council of Ministers with a two-month delay on March 21, 2012.

There is no overall policy vision specifically outlined in BiH EFP as in other EFPs/PEPs. The EFP outlines that growth in 2012 (at 2.1%) is expected to come from private consumption and investments with a negative contribution from the external sector, while additional growth in 2013 and 2014 (at 4% and 4.8% respectively) is expected from more intense export growth. The increase of electric energy production is also expected. A strong increase in FDI is projected, in the electricity sector, Oil Refinery Brod, and petrol stations. A decision of the FBiH government is cited, stating that renewal and construction of electricity and energy systems (renewable sources) will primarily be based on funds from electricity generating companies and international financial institutions' (IFIs) loans, while construction of thermal power plants will be based on foreign direct investments. In 2012–2014, stronger FDI is expected due to ongoing privatization, primarily in the oil and energy sector, including mining.

In the public finance section, there is no outlined strategy on the country's overall position. The EFP only states that the crisis worsened the fiscal position in 2009, while the recovery in 2010 coupled with the Stand-By Arrangement

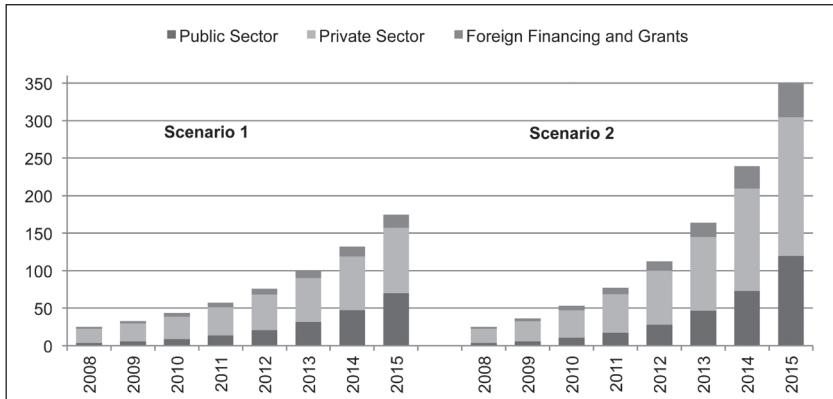
with the IMF helped reduce the deficit (according to IMF data, the 2010 deficit was 4.5%, while the EFP cites a deficit of only 2.1%, partially due to the fact that not all parts of the fiscal sector are included in the EFP: escrow account transactions, foreign-financed projects that do not go through budgets, road directorates). In terms of structural reforms, the EFP briefly mentions that the reforms identified in the IMF Stand-By Arrangement have been initiated.

The EFP is not fully cohesive and coherent in terms of suggested policies in the broader macro-fiscal framework. Detailed policies and activities are missing to back up some of the targeted goals, while details in terms of the cost and impact of proposed policies are also mostly missing.

## **6.4. Examples of fiscal impact assessment for budget requests of some budget users**

### **6.4.1. State level (BiH institutions) example—Science Development Strategy**

The science and research system in BiH is decentralized across government levels. Its main competence is at the entity and BD level, with the state level having limited competence in research policy through the Ministry of Civil Affairs (MoCA), which represents the country in international scientific and technical cooperation activities. In 2009, the framework law on the ‘Scientific and Research Work Basis and Coordination of Internal and External Scientific and Research Collaboration’ was adopted by the State Parliament, and the MoCA prepared the *Strategy of Science Development in BiH* (SSD). The law defines multi-level coordination in this area in BiH, while the SSD sets out actions for implementing the law, with priorities for and the main focus of the policy up to 2015. The SSD attempts to provide data on current financing within the situational analysis. It also provides data on future financing. The strategy first makes assumptions and calculations on projected GDP growth in BiH for the period it covers. It then prepares two scenarios for resources committed to science and research development in total and by government levels in BiH. The analysis includes costs per employee in science and research. Finally, the strategy gives overall projections of costs by source (public sector, private sector, and foreign financing and grants) as shown in Figure II-2.

**Figure II-2: Projected financing of the Strategy of Science Development in BiH**

Note: Budget figures in MM KM. – Source: Strategy of Science Development (SSD) in BiH.

While the costing in this strategy may not be detailed enough and notwithstanding the problems (including in financing) during the implementation phase, the SSD is an example of a strategic document which includes some projections of financing needs, responsibilities, and schedule.

#### 6.4.2. Republika Srpska example—GERD

The financial plan of Gross Domestic Expenditure on Research and Development (GERD) in RS is a good example of fiscal impact assessment of a new policy, it is part of the Strategy for Scientific and Technological Development of RS 2012–2016 that relates to domestic spending on research and development. Table II-3 below summarizes the financial plan for GERD which was incorporated into the strategy's Action Plan.

This financial plan corresponds to the figures from the RS MTEF that present the planned spending for research and development by the Ministry of Science and Technology and other budget users. However, additional notes in it stipulate that the final level of budget funds earmarked for this purpose in the period 2013–2016 will be determined through the budget instructions (to be provided to budget users) and a list of policy priorities adopted annually by the RS government. Therefore, the financial plan represents a framework while the pace of its implementation will depend on annual decisions of the government.

**Table II-3: Plan of domestic spending on research and development in RS, 2012–2016**

	2010*	2011	2012	2013	2014	2015	2016	Total 2012- 2016
<b>GDP</b>	8.3	8.8	9.2	9.7	10.4	10.9	11.4	
<b>Spending</b>								
<b>GERD</b>	20.8	24.0	29.5	36.0	42.5	50.0	57.0	215.0
<b>GERD</b>	0.3	0.3	0.3	0.4	0.4	0.5	0.5	
<b>Sources of funds</b>								
<b>RS budget for research and development**</b>	8.8	8.8	9.1	12.5	15.4	19.5	22.3	78.8
<b>RS budget for research and development (% GDP)</b>	0.1	0.1	0.1	0.1	0.2	0.2	0.2	
<b>Others for research and development</b>	12.0	15.2	20.4	23.5	27.1	30.5	34.7	136.2
<b>Others for research and development (% GDP)</b>	0.2	0.2	0.2	0.2	0.3	0.3	0.3	

Note: Spending figures in MM KM. – \* Based on data of the Statistical Office, and estimates of the Ministry of Science and Technology and the Ministry of Finance. – \*\* Funds from budgets of the state and local governments that are related to the budgets of the Ministry of Science and Technology and the Academy of Sciences and Arts, (in part) intended for financing research and development and determined by the Budget Framework Paper. The height of budget funds allocated to research and development in other ministries and local governments (including research projects in their sectoral responsibilities) is dependent on the analysis that preceded the development of scientific and technological development of Serbia— projection in the table may hence differ. Data on expenditures on research and development needs to be related to public funds (and not directly to the Ministry of Science and Technology and/or the Academy of Sciences and Art) as accurately as possible. – Source: Action Plan of Strategy for Scientific and Technological Development of RS 2012–2016.

### 6.4.3. Federation of BiH example—Environment Protection

The FBiH Environment Protection Strategy 2008–2018 is an example of a strategic document for which the Action Plan includes an estimated cost for each measure and activity. This strategy is comprehensive and includes various aspects of environmental issues.

The Action Plan is prepared as a detailed table for different environment components (e.g., air, lands, waste) which identifies the legal and institutional framework, the planned implementation period, and responsible institutions for implementation of each measure and activity. For each of the measures and activities, needed financial resources were estimated, with a potential source of funding identified, including where possibilities may be available for foreign financing.

Since the preparation of the strategy, given fiscal space reduction partially due to the crisis, further prioritization of the measures has been performed taking into account available funding. This is done within the FBiH medium-term expenditure framework preparation process to ensure consistency between budget planning and the strategy's prioritization and implementation.

## Chapter 3

# Case Study on CROATIA

prepared by  
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# 1. Introduction

The main goal of this paper is to determine how the fiscal costs of structural reforms are integrated into the medium-term budget framework and annual budget of Croatia. The additional goal is to identify the main dilemmas in coordinating the integration of structural reforms into the medium-term budgetary framework and the budgetary process, as well as to indicate problems that need to be analyzed in future learning events in countries that are still developing their budgetary strategic planning.

Sources used for implementing the objectives of the research include primary and secondary publications, reports and working materials of the Croatian government, the Ministry of Finance (MoF) and relevant line ministries, as well as books, scientific articles, and papers dealing with strategic planning and the budgetary process. The research is mainly based on the analysis of primary and secondary materials of the government and the Ministry of Finance, and interviews with representatives of the MoF.

This paper analyzes the Croatian National Budget from 2000 to 2012, with emphasis on the period after 2010 when the government adopted its first strategy program. The objective is to explain the connection between strategic documents and the budget. The analysis used the Budget Law, the Fiscal Responsibility Act, and subordinate legislation such as regulations governing the budgetary classification. In order to present an authentic practice, and point out the potential problems in the implementation of strategic planning, we used the strategic plans of the MoF and three line ministries (LMs): Sea, Transport and Infrastructure; Environment and Physical Planning; and Science, Education and Sports.

The paper is divided into four parts. After the introduction, the second section explains the legal framework, institutions, and processes of strategic planning of the budget in the medium-term fiscal framework. The third is dedicated to analysis and evaluation of how the fiscal costs of structural reforms are integrated into planning documents, such as the medium-term budgetary framework and budget. The fourth section presents conclusions and recommendations.

Apart from the annual Pre-accession Economic Programme document for the EU, the concept of structural reforms is summarized or explicitly stated in the planning and strategic documents of the government. Since 2000, the government has stated that it is necessary to implement structural reforms in a number of economic and fiscal areas of public administration, restructuring and privatization, and reconstruction of the transport sector (e.g., roads, rail). In short, the general platform for structural reforms in the economic system has been based on a significant reduction of the state's role in the economy, providing more space for private entrepreneurship and improving management of the state finances. However, the costs of structural reforms are included in

the pre-accession EU programs, and expenditures for individual programs are included in the medium-term budgetary framework and budget but not clearly outlined in the strategic planning budget documents.

## **2. Main institutional features for annual budget and medium-term fiscal programming**

The main aim of this section is to provide information on the institutional framework and processes for annual budget planning within the medium-term fiscal framework.

### **2.1. Institutional framework**

The framework and objectives of the Croatian economic policy are defined in the government's policy documents. These are: the Strategy of Economic Development for the period 2006 to 2013, the Economic and Fiscal Policy Guidelines (first produced in 2005), and the Pre-accession Economic Programme (PEP, prepared annually since 2004). These documents are produced in the process of consultation between government authorities, the business community, and trade unions; and they represent the basis for economic policy in the medium term.

In 2005 the government's Central Office for Development Strategy and Coordination of EU Funds prepared the Strategy of Economic Development, which is the main strategic document that defines the priority areas for action in the area of economic policy. All other strategic documents associated with it take into account its specific objectives, the current situation, and the assessment of possible changes in the environment.

Since 2005, the Economic and Fiscal Policy Guidelines provide a three-year fiscal framework for implementing the government's objectives and measures and represent the first step in the process of budgetary planning. Since 2006, the guidelines include limits of expenditures for the ministries. However, the adoption of the Strategy of the Government for the 2010 to 2012 period, and of the Economic and Fiscal Policy Guidelines for the same period (using the established expenditure limits for each budgetary user), for the first time established a strong link between priorities and the budget, and integrated strategic planning in the three-year budgetary framework.

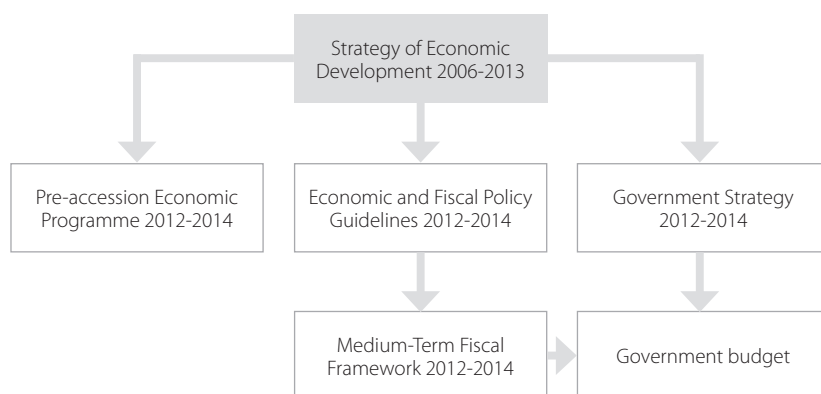
The PEP, relying on these two documents, defines the macroeconomic and fiscal framework for the next three-year period, the priority areas of government policy, the order of these priorities, as well as specific measures for the successful implementation of structural reforms in the economy. In 2004 the government produced the first PEP for the period from 2005 to 2007 with a plan of structural reforms.



### 2.1.1. Evolution of strategic planning

The government's strategy for the period of 2010–2012 marks the beginning of the strategic planning process in Croatia. This document provides an overview of priorities by sectors because it is based on the strategic plans of ministries. Prior to 2010 Croatia had developed sectoral planning documents, but unfortunately, these strategic documents often contain only descriptions of the content of reforms and provide no interconnection between those reforms and the budget that is supposed to ensure their implementation.

**Figure III-1: Linkages among strategic planning documents**



The PEP documents since 2005 contain the matrix of implementing measures and an elaboration of the structural reforms and activities to be implemented. In the appendixes of the PEP, the statistical supplement, there are estimates of the fiscal impact of major structural reform measures for the two-year period and projects financed from EU funds; a matrix evaluates the success in implementing the measures set out in the PEP from the previous period.

In March 2008 the government adopted a Public Administration Reform Strategy 2008–2011, which identified the need to introduce methods of strategic planning and definition of strategic priorities. One of the reasons for the adoption of the Strategy is the European Commission's 2007 report on Croatia's progress, which noted that Croatia needed to strengthen the link between strategic planning and budgeting.

The strategy for improvement and modernization of the state treasury 2007–2011 is a strategic document that highlights the methods and aims for modernizing the budgetary process to introduce and maintain fiscal discipline. The strategy introduced strategic planning, multi-annual budgets, and more flexibility in executing the state budget with a focus on achieving results, not only indicating the funds spent.

In mid-2008 the government and the Parliament approved a new budget law (which came into force on January 1, 2009). The act introduced a number of

changes, such as a multi-year budget framework, which along with the budget for one fiscal year also requires projections for the next two years.

The Strategy of Government Programmes was based on the strategic plans of ministries and other government bodies. Under the new Budget Act (Official Gazette, 87/08), this strategy is prepared annually and includes goals and priorities for the next three years. The strategy for the period 2010–2012 for the first time linked the strategic and budgetary planning and clearly defined goals and priorities that should be implemented through government programs. Strategic plans have provided an overview of sectoral goals, whereas strategies of the government have secured the allocation of budgetary resources to the 12 major goals (which are further elaborated in the 46 specific goals) that will achieve the greatest impact in priority areas (see Table III-7 below).

The importance of strategic planning was also recognized in the Fiscal Responsibility Act (Official Gazette 139/10). It provides that the head of the budgetary user each year prepares a statement of fiscal responsibility for the preceding fiscal year. With this statement, the budgetary users' heads confirm that they will provide legal, functional, and purposeful use of resources and the efficient and effective functioning of financial management and control within the funds provided in the budget.

The decree on the preparation and delivery of the statement of fiscal responsibility and report on the implementation of fiscal rules (Official Gazette, 78/11) prescribes the form, content, procedures, and deadlines for preparing and submitting the statement. The budget head gives a statement on the basis of a completed questionnaire on fiscal responsibility, which gives an indication on the progress of preparing and publishing strategic plans, and linking them to the state budget.

### **2.1.2. The present state of strategic planning**

In 2012, most of the relevant ministries prepared a strategic plan for the period 2013–2015. In July 2012 the government also produced a Strategy of the Government Programme for the period 2013–2015. The main strategic programs were transferred to the budget planning process, in which programs, activities, and projects were quantified and funds for their implementation ensured. The relevant ministries have established goals, priority programs, and projects, to be nominated by the government and the MoF for consideration and adoption.

The methodology of strategic planning is improving every year. In the cycle of development of strategic plans for the period 2013–2015, the emphasis is on reviewing performance indicators and ways to achieve specific objectives. Work has continued on the determination of risks that may affect the achievement of the goals set. The Strategy of the Government Programme's implementation has been provided through the achievement of 12 general objectives. It has included operational programs that are funded from the EU pre-accession programs, and expanded the scope with the Cohesion and Structural Funds;

thus, the strategy emphasizes that the EU funds and programs financed with them are an integral part of the state budget. In the State Budget for 2013 (and projections for 2014 and 2015), funding for the implementation of programs is planned within the limits of total expenditures as determined by the government. In July 2012, the government adopted the Economic and Fiscal Policy Guidelines for the period 2013–2015. The guidelines have not changed the basic strategic priorities and objectives that are aligned with the strategy of government programs.

In practice, there is a problem in connecting the PEP with the Government Strategic Programme and with the Economic and Fiscal Policy Guidelines. These weaknesses are mostly the inability to clearly identify the structural reforms, calculate their cost, and transfer this to the budget by program.

The process of producing the PEP starts with the EC invitation and continues through formal meetings of a working group consisting of staff of various ministries and other government bodies who have a coordinating role with the MoF. The formal process of the PEP takes about four months. It starts in September, when the government appoints a committee for coordination of the PEP, consisting of representatives of the MoF and relevant ministries (see Table III-1).

The elements contained in the PEP are not taken into account in preparing the budget, but neither are the dynamics of the planning and implementation of the state budget taken into account in preparing the PEP. Preparing the PEP in the system of public finance has become an exercise in preparing the national reform programs. The PEP conducts cost estimates, revenue estimates, and the net financial impact of structural reforms, but without clearly defining structural reforms and methodologies. The process of drafting and adopting the PEP has not progressed at the same pace as preparation, planning, and approval of strategic plans and budgets of Croatia. Thus, from 2004 to 2007 the government approved the PEP in the November and December of the year preceding the year of PEP implementation (e.g., PEP was enacted in December 2005 for the period from 2006 to 2009). However, from 2008 to 2011 the government approved the PEP at the beginning of the year in which the *de facto* implementation started.

**Table III-1: PEP preparation process for the period 2011–2013**

	Activities	Responsible institutions	Start	Finish	Duration (days)
1	1 <sup>st</sup> meeting of the coordination body	MoF and LMs' representatives	Sep 13, 2010	Sep 13, 2010	1
2	Define working group	LMs' representatives	Sep 13, 2010	Sep 17, 2010	5
3	1 <sup>st</sup> working group meeting	MoF and LMs' representatives	Sep 20, 2010	Sep 20, 2010	1
4	Data collection and the first PEP working draft	MoF and LMs' representatives	Sep 20, 2010	Oct 18, 2010	21
5	2 <sup>nd</sup> working group meeting	MoF and LMs' representatives	Oct 22, 2010	Oct 22, 2010	1
6	Finish of the working draft of PEP		Oct 22, 2010	Nov 3, 2010	9
7	2 <sup>nd</sup> meeting of the coordinating body	MoF	Nov 9, 2010	Nov 9, 2010	1
8	Review of the PEP first draft	MoF	Nov 10, 2010	Nov 17, 2010	6
9	Meeting—identification of necessary changes for the PEP update	MoF and LMs	Nov 18, 2010	Nov 18, 2010	1
10	PEP update	MoF	Nov 19, 2010	Nov 24, 2010	4
11	Editing the final PEP version	MoF	Nov 24, 2010	Nov 26, 2010	3
12	MoF sends the PEP to the line ministries		Nov 29, 2010	Nov 29, 2010	1
13	Opinion of proposal of responsible ministries on the PEP		Nov 30, 2010	Dec 3, 2010	1
14	Final editing		Dec 6, 2010	Dec 8, 2010	3
15	MoF sends final the PEP to the government for discussion and approval		Dec 10, 2010	Dec 10, 2010	1
16	PEP English translation		Dec 10, 2010	Jan 3, 2011	1

**Table III-2: Pre-accession Economic Programme approval and implementations**

Approval	Oct. 2004	Dec. 2005	Oct. 2006	Oct. 2007	Jan. 2009	Jan. 2010	Jan. 2011	Feb. 2012
Period of implementation	2005-2007	2006-2008	2007-2009	2008-2010	2009-2011	2010-2012	2011-2013	2012-2014

In July 2013, Croatia is scheduled to become a new EU member state. With membership there is a need to develop two key documents that replace the PEP. These are the National Reform and Convergence Programmes. In 2012, the Ministry of Regional Development and EU Funds will start coordination and preparation of the National Reform Programmes. Depending on the contents of the document, all relevant government bodies will participate in its preparation.

The MoF in cooperation with the Croatian National Bank will coordinate the process of developing the Convergence Programme, with other relevant government bodies assisting when necessary. The government should submit both documents to the European Commission by the beginning of April 2013. From 2013 Croatia will need to present the National Reform Programme in the same time frame as all other EU member states. This will change the annual calendar, as the PEP was prepared by the beginning of the year whereas the National Reform Programme (NRP) will need to be presented in April each year.

## **2.2. The role of budgetary institutions in preparing the budget and medium-term fiscal framework**

The Ministry of Finance is responsible for preparation and implementation of the government's fiscal policy. One of its main tasks is effective management of public finances, which has to ensure overall fiscal discipline that is essential for macroeconomic stability. Measures include strengthening fiscal controls, improving inter-sectoral allocation of resources, and ensuring greater flexibility to effectively manage and develop the performance accountability system.

There are two key strategic umbrella documents in which the government defines structural reforms. The first is the PEP, and the second is the Strategy of Government Programs. Both documents are for the medium term.

The MoF played a leading role in introducing the strategic planning process. Paragraphs of the Budget Act provide that the MoF, in collaboration with the Central Office for Development Strategy and Coordination of EU Funds, annually compiles instructions for making strategic plans for the three-year period, collects existing strategic plans, and creates the Strategy of Government Programs for a three-year period and recommends it to the government. In this process, the main role has been played by the MoF, while the role and involvement of the Central Office for the strategy was extremely small. The Central Office was abolished in 2012, with its role taken over by the Ministry of Regional Development and EU Funds, which plays a major role in drafting the National Reform Programme.

In the process of developing strategic plans, ministries and other government agencies have a crucial role. They are obliged to publish strategic plans on their official websites.

According to the calendar set out in the Budget Act, the MoF drafts at the end of May the Economic and Fiscal Policy Guidelines. Guidelines are based on the Strategy of Government Programs for the three-year period ahead and get

adopted by the government. In recent years, the adoption of the guidelines has moved to the end of July or beginning of August. All key indicators provided by the guidelines (including the limits set by the government) are then transferred into instructions for drafting the state budget. When receiving those instructions, budgetary users prepare their proposals of financial plans, within which they autonomously decide on the allocation of funds to programs, activities, and projects in their jurisdiction. In preparing the plan for their programs, project activities must comply with the limits set for the overall level of spending. In practice, ministries usually are not satisfied with the allocated limits. They may ask the government to change the limit but with an explanation provided, which the government may accept on the basis of its reasoning.

By October 15, the MoF drafts the state budget for the fiscal year and the projection for the next two years and submits these to the government. The government determines the proposed budget and projections by November 15, and submits them to the Parliament for approval. By the end of the year the Parliament adopts the annual budget and projections for the next two years.

### **2.3. Procedures for preparing budget and medium-term program framework**

The process of preparing the budget and the medium-term budgetary framework is determined by the provisions of the Fiscal Responsibility and Budget Act. The act has introduced fiscal rules to be followed when preparing the budget and projections for the three-year period. Its provisions determine the methodology for preparing the national budget.

The budget planning process begins with the drafting of the strategic plans of ministries and other state bodies. To ensure a uniform and balanced approach to the development of strategic plans, the MoF annually compiles instructions for their preparation. Based on the strategic plans, the government drafts the Strategy of Government Programs for the three-year period.

The first cycle of strategic planning began in 2009, with the creation of strategic plans for the period from 2010 to 2012; budget users made strategic plans for the three-year period for the first time as well. The MoF has realized the importance of defining the quality framework of the strategic plan, and the budgetary users were asked to identify a vision and mission, connecting these with the general and specific objectives and indicating the ways to realize them.

Analysis of strategic plans for 2010–2012 showed that the second cycle of developing strategic plans should begin by analyzing the current situation. Budget institutions determined whether general and specific goals and ways to achieve them are well-defined or require further work. On the basis of information obtained by analyzing the current state, budgetary users have, in explaining specific goals and ways to achieve objectives of the strategy, described the current situation and identified performance indicators. In the second cycle of strategic planning, 2011–2013, the MoF conducted further analysis and determined performance indicators.

The strategic plan identified two types of indicators: outcome and output indicators. This was the first step in establishing a system of responsibility for setting goals and ways to achieve them. The allocation of budgetary resources to achieve goals will have the greatest impact in priority areas.

In the cycle of strategic planning for 2011–2013, the MoF has established a system for monitoring and reporting on the success of goals and ways to achieve those defined in the strategic plan. Establishing such an accountability system has been further bolstered by naming the persons responsible for monitoring the implementation of the strategic plan at the level of each specific goal and a particular way of accomplishing it.

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**Box 1: Relationship between strategic planning and budget development**

It is important to achieve the interconnection of strategic planning and the budgeting process. The strategic plan defines the action lines of the budgetary institutions, while the budget defines programs, activities, and projects and provides resources for implementation. Programs in the budget are associated with the objectives of the strategic plan. Linking specific objectives of the strategic plan with programs in the budget, ways to achieve the strategic plan with the activities, and projects in the budget has created a connection that allows monitoring of the implementation and achievement of objectives. In the second cycle of strategic planning, institutions have linked goals and ways to achieve the strategic plan with programs, activities, and projects from the state budget through the binding table. In this cycle, the link between the strategic plan and the state budget is presented (see Table III-7 in the Appendix). These tables are included in the strategic plan.

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The third cycle of strategic planning, for 2012–2014, began with the introduction of the risk management process. This involves the identification and assessment of risk, treatment, and monitoring and reporting on risk management. Due to the complexity of the process, attention is focused on identifying and risk assessment.

In the most recent cycle of strategic planning, the Strategy of Government Programs was developed for 2013–2015 (and adopted by the government in July 2012) with the following strategic objectives: (1) macroeconomic and economic stability; (2) optimal environment for development of a competitive economy; (3) balanced regional development; (4) strengthening social justice; (5) protection, preservation, and promotion of health; (6) promotion of knowledge, excellence, and culture; (7) environmental protection and development; (8) a competitive agri-food and fisheries sector; (9) improving the competitiveness of tourism, affirming Croatia as one of the leading international tourist destinations; (10) strengthening the rule of law; (11) maintenance of public and national security at the highest level; and (12) further strengthening the international position of Croatia and the preservation of national identity.

As these are strategic and long-term goals, they do not change from year to year; but their ranking indicates the priorities for the forthcoming medium term, which should be reflected in the limits established by the Government in the Economic and Fiscal Policy Guidelines.

The Strategy of Government Programs defines key objectives and priorities of the government for a three-year period and is the basis for producing the Economic and Fiscal Policy Guidelines. Content of the guidelines is defined by the budget. The guidelines include: goals and tasks of economic and fiscal policy in the medium-term macroeconomic projections; the priorities of fiscal policy; the determinants of revenues and expenditures of the general government (including the distribution of the total state budget expenditure for the three-year period head for each budget user); and the anticipated changes in public debt and related management strategy. The existence of budget limits supports planning the budget according to strategic objectives and government priorities. The guidelines describe strategic objectives and reforms of the government in the same manner as the Strategy of Government Programs.

By the end of June of a given year, the MoF prepares instructions for drafting the state budget. These include the basic indicators of the economic and fiscal policy, development methods, and timelines for the state budget. Based on the limits and guidelines, budgetary users develop their budget proposals for the financial plans. With the financial plans, users decide on the allocation of funds to their programs. An integral part of each financial plan is an explanation, which shows program budget guidance, the emphasis on outcomes that selected programs intend to establish, and performance indicators to achieve the objectives.

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**Box 2: Contents of the budget users' explanation of the financial plan**

Draft financial plans for the budget users include: a) a summary of the scope of the budget user's programs; b) legal and other bases for the programs; c) the objectives, strategies, and programs to document long-term development; d) outcomes and indicators on which the calculations and assessments of resources necessary to implement the program are based; e) a statement of the goals achieved and the results of a program based on performance indicators of the budgetary user in the previous year; and f) other explanations and documentation.

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In 2009, the Budget Act introduced a multi-year budget framework, and obligated the MoF to prepare a draft budget for the fiscal year and a projection for the next two years. Up to October 15, the MoF submits to the government a draft budget and projections. By November 15, the government discusses and adopts the draft budget and projections, and sends them to the Parliament for debate and adoption.

The goal is to establish a medium-term budget framework (projections are not binding), which would ensure that the budget documents carefully explain how the estimates of budget items and perennial estimates are associated with estimates from previous years. From 2010, the state budget is passed in a less detailed level because the ministries and other government agencies want to provide more flexibility in the execution of the budget and financial plan.



**Table III-3: Budget planning process in Croatia**

	Activities	Responsible institution	Deadline
1	Prepare instructions for the preparation of strategic plans for the three-year period and submit to budget users	MoF and Central Office for Development Strategy and Coordination of EU Funds	March 15
2	Develop strategic plans for the three-year period and deliver it to the MoF	Budget users	April 15
3	Prepare government programs for the three-year period proposed by the government	MoF and Central Office for Development Strategy and Coordination of EU Funds	April 30
4	Adopts the Strategy of Government Programs for the three-year period	Government	May 15
5	Drafts the Economic and Fiscal Policy Guidelines proposed by the Government for the three-year period ahead	MoF	May 31
6	Approves the Economic and Fiscal Policy Guidelines	Government	June 15
7	Provides instructions for drafting the state budget budgetary and extra-budgetary users	MoF	June 30
8	Submit the draft financial plan to the relevant ministry	Budget users	July 15
9	Deliver consistent financial plan proposals to the MoF	Responsible ministries	July 31
10	Prepares the draft budget for the fiscal year and the projection for the next two years, submits these to the Government	MoF	October 15
11	Determines the budget proposal and projections, passes them to the Parliament	Government	November 15
12	Adopts the budget for the next fiscal year and the projections for the next two fiscal years	Parliament	End of the year

### **3. Incorporation of structural reforms' fiscal costs into fiscal programming documents**

The main aim of the third part of this paper is to assess the integration of the fiscal costs of structural reforms into the medium-term and annual fiscal program.

#### **3.1. Evaluation of the overall fiscal system programming and the fiscal costs of structural reforms**

Until 2002 there were few strategic documents in the public sector. Since then government bodies have created over 200 national strategies, programs, plans, and similar documents from sectors including statistics, health, agriculture, forestry, fisheries, livestock economy, environmental protection, social policy, science and education, transport, tourism, consumer protection, national minorities, computerization, security, and defense. However, these documents often present the strategic planning documents of one ministry or other government body without indicating a clear interface or hierarchy with other such bodies. The implementation of these strategies in a number of cases was led exclusively by the procedures of individual institutions.

The introduction of a strategic planning process has aimed to connect the existing strategic documents and the budget as an instrument of their implementation. Strategic plans, which were developed for the first time in 2009, did not replace the existing strategic planning documents and functions, but were based on existing documents in a way that takes into account the objectives, but also changes in the environment (e.g., reduced financing, different priorities). To direct ministries and other state authorities to the development of strategic plans, instructions for making strategic plans for the three-year period were issued. In addition to the instructions, the MoF provides technical assistance to ministries and other government bodies by organizing group workshops and individual consultations.

Throughout the period there was no clear explanation of the term “structural reforms,” the dynamics of their implementation, and in particular the assessment of their fiscal impact. The concept of structural reform is more present in the PEP, which gives an estimate of the fiscal impact of the reforms and analyzes steps in their implementation. Structural reforms and their cost estimates are less present in the Economic and Fiscal Policy Guidelines and the Strategy of Government Programs, but they need to integrate and connect with the medium-term budgetary framework and budget. Thus, the state budget programming approach was enforced in 2010 (although the budget program classification had been in force since 2002). On the basis of the Budget Act, the MoF (Official Gazette, 87/08) announced new rules on budget classifications (Official Gazette, 26/10).

The 2007 PEP provides a matrix which elaborates on structural reforms through specific measures to be implemented. In the PEP's statistical annex, there are estimates of the fiscal impact of major structural reform measures outlined in the two-year period and projects financed from EU funds, as well as a matrix that evaluates the success in implementing the measures set out in the funds allocated from the previous period.

**Table III-4: Content of Pre-accession Economic Programmes**

Year	2004	2005	2006	2007	2008	2009	2010	Feb. 2012
Time period	2005- 2007	2006- 2008	2007- 2009	2008- 2010	2009- 2011	2010- 2012	2011- 2013	2012- 2014
Current economic develop- ments (framework and objec- tives of economic policy)	+	+	+	+	+	+	+	+
Macroeconomic program (current macroeconomic trends)	+	+	+	+	+	+	+	+
Public finance	+	+	+	+	+	+	+	+
Structural reforms	+	+	+	+	+	+	+	+
Matrix (economic policy) implementing measures	+	+	+	+	+	+	+	+
Supplement								
Assessment of the effects of fiscal structural reforms		+	+	+	+	+	+	+
Fiscal Effects projects financed from EU funds		+	+					
Statistical Appendix		+	+	+	+	+	+	+
Matrix on the implementa- tion of reforms in the previ- ous program								

Source: Pre-accession Economic Programmes.

The PEPs justify targets, measures, and activities in each of the priority areas of structural reforms (see Table III-5) and state the fiscal effects of their implementation (Table III-8 in the Appendix).

**Table III-5: Structural reforms**

<b>4.2.1 Entrepreneurship sector</b>	4.2.1.1 Market competitiveness and state aid
	4.2.1.2 Privatization
	4.2.1.3 Railway restructuring
	4.2.1.4 Ship-building restructuring
	4.2.1.5 Energy
	4.2.1.6 Small and medium size entrepreneurship
	4.2.1.7 Public-private partnership
<b>4.2.2 Financial sector</b>	4.2.2.1 Banking sector
	4.2.2.2 Non-banking sector
<b>4.2.3 Labor market</b>	4.2.3.1 Employment incentives
	4.2.3.2 Social security system
<b>4.2.4 Agriculture</b>	
<b>4.2.5 Public administration reform</b>	
<b>4.2.6 Other reforms</b>	4.2.6.1 Knowledge-based society
	4.2.6.2 Health care reform
	4.2.6.3 Judicial reform
	4.2.6.4 Environment protection

Source: Pre-accession Economic Programmes 2012–2014.

Fiscal impacts are related to the allocation of budgetary resources for implementing specific measures, and provide information on financing from loans and funding assistance from the European Union. The PEPs list total costs in the medium term to implement certain structural measures, as well as net outflows from the budget.

**Table III-6: An example of effect estimates of structural reforms**

	2011	2012	2013	2014
<b>Overall fiscal impact assessment</b>				
A Implementation				
<b>B Net direct impact on budget</b>	<b>-1,105.3</b>	<b>1,154.8</b>	<b>497.7</b>	<b>263.3</b>
B1 Direct impact on revenue	319.1	168.5	-122.2	128.9
B2 Direct impact on expenditure	-1,424.5	-986.3	-619.8	-134.4
<b>I Entrepreneurship sector</b>				
Net direct impact on budget	<b>-236.6</b>	<b>86.8</b>	<b>-0.6</b>	<b>-0.4</b>
Direct impact on revenue	11.8	20.9	-21.9	1.0
Direct impact on expenditure	248.4	-65.9	-21.3	1.5
<b>1 Market competition and state aid</b>				
Implementation				
Net direct impact on budget	-0.5	-0.6	0	-0.0
Direct impact on revenue	-0.4	4.0	7.5	0
Direct impact on expenditure	0.1	4.6	7.5	0.0

	2011	2012	2013	2014
<b>2. Railway restructuring</b>				
Implementation				
Net direct impact on budget	370.7	547.4	228.1	82.6
Direct impact on revenue	88.1	9.2	231.6	91.6
Direct impact on expenditure	-282.6	-538.3	3.5	9.0
....				

*Note: Expenditure figures in MM HRK. – Source: Pre-accession Economic Programmes.*

In the PEP the government emphasizes the most important measures that will have a fiscal impact in the coming period, primarily from the reduction of subsidies (railways, shipyards, agriculture, etc.), concerns about the stability of the social security system (legislative changes aimed at eliminating differences between “new” and “old” retirees), and so on. The PEP estimates the total net impact of implementation of structural reforms; for example, in the medium term of 2010 to 2012, the net increase in budgetary allocations averages around 0.04% of GDP. Budget revenues related to some of these measures will record an average growth of 0.03% of GDP, while expenditure will grow by 0.07% of GDP.

Unfortunately, the approach through which the PEP deals with structural reforms and their cost is not present in the Economic and Fiscal Policy Guidelines. These are a technical document which specifies the goals of economic and fiscal policy in the medium term, macroeconomic developments, and public debt in the medium term. The guidelines also survey key strategic objectives of the government’s strategy in focusing on certain major activities and projects to be implemented by individual ministries, but without providing a clear overview of structural reforms. This reflects the lack of a systematic approach to planning and structural reforms. The civil servants who are largely responsible for writing policy documents do describe further improvements in their scope, but without instructions and goals set by higher-level management. One of the main problems is a lack of vision in the organization, establishing priorities and the manner of implementation of structural reforms at the level of political decision-makers (i.e., on the government level).

However, basic technical knowledge in assessing the fiscal impact of legislation and policy documents does exist. Since 2005, ministries are required to estimate costs and benefits of the implementation of laws and regulations proposed for adoption, and since 2007 they develop and evaluate the effects of planning documents (e.g., strategies, policies, national programs) as the suggestions of these acts may affect the preparation of proposed regulations and provide guidance and a framework for future government work.

Regarding fiscal impact assessment of capital projects, the Budget Act (Article 45) prescribes that state budget users may assume commitments for investment projects only after expert assessment has been completed and the investment project’s justification and efficiency have been evaluated. Some

budget users are following this procedure. However, for a more systematic approach, it is necessary to prescribe methodology. Although the Budget Act envisages that the government will prescribe that methodology by a decree, the MoF has yet to draft one.

The reasons for the relative low transmission of goals for implementing structural reforms should be sought in the existence of a large number of strategic documents at ministries, which are sometimes not well aligned in content and time frame (see Box 3).

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**Box 3: Strategic objectives of the Ministry of Sea, Transport and Infrastructure**

The Ministry of Sea, Transport and Infrastructure establishes a specific objective 5.3: The development of the transport system. This specific objective is related to the overall objective of economic development. However, defining the general goal stemmed from more time and scope, with uncoordinated policy documents. These are:

- Transport Development Strategy (Official Gazette, 139/99)
  - National program for railway infrastructure, 2008–2012 (Official Gazette, 31/08)
  - Strategy of river transport, 2008–2018 (Official Gazette, 65/08)
  - Medium-term plan for the development of inland waterways and inland ports, 2009–2016
  - Pre-accession strategy of the Croatian maritime (2005)
  - National strategy for the transport sector under the Instrument for Structural Policies for Pre-Accession (2004)
  - Law on the ‘Ratification of the Agreement between the Croatian Government and the European Commission amending the Financing Agreement for a multi-year Operational Programme’
  - “Transport” for Community assistance from the Instrument for Pre-Accession Assistance under “Regional Development” (Official Gazette, 11/10)
  - National Programme for the Protection of Civil Aviation (Government adopted at the session of February 4, 2010)
- 

Most of the existing government sector strategies need to be updated because they are time-inconsistent and sometimes have only a short study period—usually up to three years. New strategies should be developed for a seven-year period, more like the Ministry of Tourism’s strategy 2013–2020, which is aligned with the EU financial perspective. The current economic strategy covers strategic objectives by 2013.

### **3.2. Budget institution participation in the process of structural reform and fiscal documents**

The MoF has, in technical terms, ensured that all conditions are in place for analysis of the fiscal costs of structural reforms, as well as for strategic budget planning and directing the development of strategic plans. However, the government is supposed to provide the central impetus for clearly profiling strategies and the time to coordinate and harmonize the process of strategy development, reflecting the state strategies and the potential costs of structural reforms in each sector.

Strategic documents, laws, and regulations do not contain a clear and comprehensive definition of structural reforms. True, the PEPs do mention structural reforms in several places, but only in the broader sense of the need to implement fiscal consolidation.

Beside the definition, there is no sufficiently defined methodology for assessing the cost of structural reforms. In the process of preparing the PEPs, the MoF has not received from the European Commission any guidelines or methodological instructions that could enable it to carry out, quantify, and evaluate the fiscal costs of such reforms, estimate revenue for their implementation, and evaluate the net fiscal impact.

This deficiency was evident in the pre-accession negotiations under Chapter 22. However, this problem has not been given much attention because other negotiating criteria have been more pressing.

The lack of a glossary and methodology has directly influenced the quality and content of pre-admission assessment of the fiscal impact of structural reforms.

In developing cost estimates of such reforms, the MoF's Department of Macroeconomic Analysis focused only on revenue estimates, whereas the estimates of expenditure relied on the line ministries. The estimate of structural reforms looked like a paper exercise and not a real, serious evaluation based on deeper analysis and a pre-established analytical and methodological framework.

In short, there remain two parallel and uncoordinated processes, because the line ministries and the MoF professionals who are involved in the development of strategic planning of the budget are not participating in the development of PEPs. In this process only staff of the MoF's Department of Macroeconomic Analysis participated.

Due to the absence of clearly defined terms for structural reforms or a methodology of estimating the costs and the net effect, it has not been possible to develop any ex post indicators of the implementation of targets set, so no ex post analysis of the implementation of structural reforms exists.

Composing a strategic plan represents a technically demanding assignment for employees of the ministry, and it has to be performed as a basis for creating a budget. Strategic planning of the budget is a demanding assignment that prevents employees of the ministry from collecting data for PEPs, composing relevant information on expenses, and estimating the net effects of structural reforms.

Costs related to structural reforms are an unknown (and abstract) concept in ministries, which are often short on expert employees (especially senior employees) who fully understand the problem. The MoF will have to do most of the work in estimating the costs of structural reforms. It will have to define the concept, create a methodology for cost estimates, connect estimates with existing strategic documents, and organize many workshops to explain the concept and model of the cost estimate of structural reforms.

### 3.3. Quality assessment of transferring the costs of structural reforms in the government's fiscal program

Key barriers for integrating the costs of structural reforms in the government fiscal program are a lack of vision and goals for structural reforms, and ways to implement them, especially when this includes multiple institutions and needs coordination at a level of government that is not organizationally resolved.

The Fiscal Responsibility Act established rules for strengthening fiscal responsibility. The first regulates liabilities over the plan. For every budgetary user, if liabilities are created with a maturity beyond the level envisaged in the state budget of the financial plan, in the next budget year the amount is reduced by the amount of liabilities created above the level envisaged in the state budget.

The second rule relates to assessment of the fiscal impact of legislation, one of the key instruments of good fiscal management and budget planning. Serious assessment of such impact was introduced in 2005. The government has taken a decision which prescribes the content of the standard methodology for assessing financial performance. This decision was made pursuant to government rules. Although the obligation to report estimates of the financial effects of proposals of different regulations was already in place, this projection is submitted as an attachment to the text of proposed regulations and is mainly indicative, without any financial implications for the budget.

A decision about the form of standard financial impact assessment and implementation of proposed regulations is closely linked with the program classification of the state budget, which has improved control of these mechanisms for the MoF. Determining the costs and benefits of the implementation of certain laws and regulations through programs, activities, and projects was largely transferred to the responsibility of the central government bodies as bearers of the program. In parallel, awareness and responsibility of the government for the financial consequences of adopting a regulation increased.

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#### Box 4: Statement on the assessment of fiscal impact

The process to make a statement on the assessment of financial impact:

- The applicant shall complete the form and submit it to the Ministry of Finance at the same time as indicated by the proposed regulation to the manifestation of the relevant ministries, in accordance with the rules of procedure.
  - MoF reviews the testimony and enters its comments.
  - After the adoption or acceptance of objections, the applicant submits the response to the opinion of the MoF.
  - This is followed by the final statement of the MoF.
  - The statement from the MoF shall be submitted to the government and its working bodies. This will enable the participants of these meetings to consider the fiscal performance, which may cause the application of certain regulations on budgets in the decision-making process.
-



An amendment to the Rules of the Government in June 2007 expands the scope of the fiscal impact of the implementation of regulations. The government in 2008 adopted a new decision on the standard methodology for estimating fiscal impact. Proposed laws, ordinances, regulations, and laws passed by the government, and proposed to the Parliament cannot be adopted without an opinion from the MoF on the assessment of the fiscal impact. This places emphasis not only on making a statement assessing the fiscal impact, but on strengthening the role of the MoF in this procedure. One of the objectives of this act is to provide and maintain fiscal discipline. An estimate of the financial effects of the application of laws and regulations anticipates future changes in the level of public expenditure in the planned macroeconomic framework. At the beginning of the budgetary process, the MoF sets limits of the amount of financial plans of the ministries. To better determine the limit, the MoF must have information about the cost of implementing laws, regulations, and strategic documents in the coming years.

Since 2009 the MoF has had a key role in developing strategic planning of the budget in the medium term and translating structural reforms into the budget planning process. It has led efforts to quantify and analyze the fiscal impact (cost) of structural reforms. Relevant ministries and spending agencies have adopted the practice of strategic planning and the transfer of strategic plans in preparing their budgets, based on a large number of workshops, both group and individual, that the MoF has held over the past few years.

The strategic planning process has been successfully linked to the goals and priorities of implementing the PEPs. Planning of programs and projects financed from EU funds was done in parallel until 2010, when it became an integral part of the budget. Thanks to the reform of budgetary classifications, introduced by changes in the rules on classification and chart of accounts, the system has been fully completed. The budget has moved from a system of records to the management of public finances.

Although program classification was introduced in 2002 at the central and local levels of government, until the introduction of strategic planning there was no program-based budgeting. Planning by program is primarily understood as a grouping of expenditures in various activities and projects, and then linking them into programs. Looking into the planning process was focused primarily on the type and amount of the costs, not the program's results. So the process of budget execution focused exclusively on the discrepancy between planned and actual values. The results of the program and its impact on quality, efficiency, and effectiveness in delivering public goods and services were rarely monitored.

Changes to the program classification began in 2009, reducing the number of programs from 410 to 341; and further rationalization continued in 2010, when the number dropped to 185. By reducing the number of programs and connecting them with the goals of the Strategy of Government Programs, the transparency of the national budget has increased, allowing better monitoring of their implementation. Along with the general and special part of the budget, the explanation of the financial plans of budgetary users is becoming an important part of the budget.

In the budgetary system of Croatia, two types of indicators have been developed: output and outcome. Output indicators relate to produced goods and services that are created by various activities. Outcome indicators provide information on the effectiveness, long-term results, and social and economic changes that are developed in achieving specific goals. Through an annual report on the execution of the state budget for the second year, in over 1,000 pages, the results of the implementation of programs, activities, and projects are being explained.

The European Union has recognized the importance of integrating the monitoring and reporting of budgetary processes: see EC/Euratom regulation 1605/2002 of June 25, 2002. The European Commission has mandated that for all fields of activity covered by the budget, goals have to be set that are specific, measurable, achievable, relevant, and time-defined. Achieving these goals for each activity is monitored through performance indicators. Every administrative body that is authorized for spending budgetary funds must submit this information to the budgetary authority.

## **4. Conclusions and recommendations**

### **4.1. Conclusions**

The process of strategic planning and budgeting in Croatia, which focuses on linking strategic priorities with the budget as a whole, can be assessed positively. In technical terms, a system of strategic budget planning has been initiated in the practice of public finance, and has created the institutional requirements and procedures for monitoring the fiscal effects of laws, regulations, and measures of the government and the state budget. In addition, the system of strategic budgeting includes performance indicators for the set goals and targets the implementation of government programs. The Fiscal Responsibility Act identified the procedures for prudent management of public funds. In short, it can be concluded that all necessary procedures are established and that in this process the MoF has played a key role in creating and linking strategies and strategic plans of the government with the annual budget and the medium-term fiscal framework.

This process still has certain weaknesses. For example, the Economic and Fiscal Policy Guidelines determine the limits of the financial plans of the ministries and other state bodies. However, no distinction is made between limits of the basic budget, the budget reflecting costs of existing policies, and the budget that accounts for any policy changes, which may be necessary in implementing a medium-term budget framework. It is obvious that there are problems that are not technical in nature and that primarily relate to a lack of clear vision encompassing the essence of structural reforms, which should be presented to the political leaders (government). Potential problems lie in coordinating and

providing clear guidance on the prioritization of structural reforms and the timing for developing strategies, so that individual sectors can recognize and quantify the necessary structural reforms and establish the financial resources for their implementation.

The government has, through the PEPs, tried to extract from existing budgets the sector activities in which Croatia has carried out structural reforms. Thus, in the PEP there is a list of sectors and measurable statements of the costs of structural reforms and their impact on the budget. Unfortunately, such a statement was not in the Economic and Fiscal Policy Guidelines or in other budget documents. The problem is that different organizational units and professionals of the MoF work on the strategy of the government, the guidelines, and the PEP.

There is no clear definition of the concept of structural reforms. This is confirmed by examining the content of strategic documents, laws, and ordinances. The PEP in several places mentions structural reform, but only in the broader sense of the need for fiscal consolidation.

Apart from the definition, there is no sufficiently clear methodology for assessing the cost of structural reforms. In preparing the PEP, the MoF has not received any guidelines, methodological instructions, or terminological reasoning from the European Commission that could be used to quantify and evaluate the fiscal costs of structural reforms, the revenue needed for their implementation, and their net fiscal impact.

## 4.2. Recommendations

At the beginning of the process of developing the strategy, the government should clearly define the term and content of structural reforms. For Croatia, these are associated with the same or similar reform priorities as those established at the EU level.

It is necessary to establish a clear methodology to estimate the fiscal costs of structural reforms and assess their net effect. Determining the methodology is equally important for current and capital expenditures.

A developed system of strategic budget planning is the basis for estimating the cost of structural reforms and their impact. It is very important to coordinate the process of drafting economic development strategies, the National Reform Programmes, Strategies of Government Programs, and the Economic and Fiscal Policy Guidelines.

The government needs to adopt a national program of reforms that are consistent with the financial perspective of the European Union. The national reform program, as a strategic umbrella document, should be linked to the budget and medium-term fiscal outlook.

It is necessary to ensure continuous training of staff in the relevant ministries so that they can develop effective strategies and related documents, in particular training in the technical aspects of calculating the costs of structural reforms.

The government needs to coordinate the entire process of creating new sectoral strategies where necessary so that it can clearly distinguish the costs of existing and new programs that are related to some of the planned measures in implementing structural reforms.

For the implementation of the medium-term budgetary framework, it is necessary to distinguish between limits for the basic budget, the budget that reflecting costs of existing policies, and the budget that accounts for any policy changes.

The government should improve coordination and provide clear guidance on the prioritization of structural reforms, as well as the timing for developing strategies, so that individual sectors can recognize and quantify the necessary structural reforms and establish the financial resources for their implementation.

The whole process requires constant education of administrative and professional staff working on strategic and planning documents. Continuing education is especially needed for the application of the guidelines, the adoption of methodologies, and instructions for preparing a plan of structural reforms and assessing their costs.

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## 6. Appendix

**Table III-7: Government strategic program objectives in the period 2010–2012**

<b>General objective 1: Macroeconomic stability</b>	
Specific objective 1.1.	More efficient management of public finances
Specific objective 1.2.	More efficient collection of fiscal revenues
Specific objective 1.3.	Strengthening the capacity to use EU funds
<b>General objective 2: Optimum environment for the development of a competitive economy</b>	
Specific objective 2.1.	Enhancing the competitiveness of business entities
Specific objective 2.2.	More developed, more competitive and more flexible labor market
Specific objective 2.3.	A more efficient way to use national resources
<b>General objective 3: Strengthening the rule of law</b>	
Specific objective 3.1.	Judicial reform
Specific objective 3.2.	Combating corruption and organized crime
Specific objective 3.3.	Strengthening the protection of human rights and freedoms
Specific objective 3.4.	Strengthening legal certainty in economic transactions and real estate
Specific objective 3.5.	Improving the capacity and improving the quality of public services and administration
<b>General objective 4: Promoting knowledge, excellence, and culture</b>	
Specific objective 4.1.	Sustainable quality of the educational system and the development of sports
Specific objective 4.2.	Developing science as a driver of long-term social and economic development
Specific objective 4.3.	Excellence of the scientific system
Specific objective 4.4.	Continued development of the information system
Specific objective 4.5.	Development of cultural and artistic creativity
Specific objective 4.6.	Achieving an optimal model of protection and preservation of cultural good
<b>General objective 5: Balanced regional development</b>	
Specific objective 5.1.	Fostering the competitiveness of Croatia's regions
Specific objective 5.2.	Sustainable development of the less developed regions
Specific objective 5.3.	Developing a transport system
Specific objective 5.4.	Sustainable development of water management
<b>General objective 6: Strengthening social justice</b>	
Specific objective 6.1.	Insurance available to protect and improve the quality of life of vulnerable groups
Specific objective 6.2.	Economic empowerment of families, children, and young people
Specific objective 6.3.	Enhancing the dignity of Croatian soldiers in the society

Specific objective 6.4.	Strengthening the social security of workers and coordination of social protection of the unemployed minimum
Specific objective 6.5.	Developing a sustainable pension system
<b>General objective 7: Croatian positioning as one of Europe's leading tourist destinations</b>	
Specific objective 7.1.	Developing and promoting the tourism product, destinations
Specific objective 7.2.	Effective promotion of tourism products and services
<b>General objective 8: Competitive agri-food and fisheries sector</b>	
Specific objective 8.1.	Farm enlargement and agricultural land work
Specific objective 8.2.	Improving market mechanisms for selling agri-food and fisheries products
Specific objective 8.3.	Health protection of humans, animals, and plants, and the protection of consumers' interests
Specific objective 8.4.	Improving the quality of life in rural areas
<b>General objective 9: Further strengthening the international position of the Croatia</b>	
Specific objective 9.1.	Accession to the European Union
Specific objective 9.2.	Strengthening bilateral and multilateral international cooperation
Specific objective 9.3.	Further profiling of Croatia as a reliable partner on the international stage as a full member of NATO
<b>General objective 10: The police and armed forces in the service of citizens</b>	
Specific objective 10.1.	Improving the system of prevention, detection, and prevention of crime
Specific objective 10.2.	Increasing road safety
Specific objective 10.3.	Develop border security
Specific objective 10.4.	Developing an integrated national security
Specific objective 10.5.	Maintenance of international military and police cooperation
Specific objective 10.6.	Improving priority readiness of the armed forces
<b>General objective 11: The protection, preservation, and improvement of health</b>	
Specific objective 11.1.	Accessible health care
Specific objective 11.2.	Developed system of health care quality
Specific objective 11.3.	Protecting the interests of public health
<b>General objective 12: Environmental protection and development</b>	
Specific objective 12.1.	Environmental protection and effective management of the environment
Specific objective 12.2.	Protection and nature conservation
Specific objective 12.3.	Arranging inventories, accurate and reliable information on the situation in the area, and purposeful use and planning
Specific objective 12.4.	Improvements in the areas of housing, municipal management



Table III-8: Linking strategic plans and budgets

The overall objective	Special objectives	Program in the state budget	Way to achieve specific goal	Activities and projects in the state budget	Output indicators
Transport system development	Developed transport infrastructure	Development of railway transport securities and lift infrastructure	Maintenance and modernization of railway infrastructure and cable cars, traffic regulation, and construction of new railway lines	<b>A 57003</b> Maintenance of rail infrastructure and traffic regulation	Mileage overhaul, modernized and newly built railway lines
			Investment in rail infrastructure through projects co-financed from EU pre-accession structural funds	<b>K 761009</b> Modernization and construction of railway infrastructure	Renewed kilometers of railway in the Operational Programme for Transport Okučani-Novska
				<b>K 761003</b> lifts development	Restored control network per kilometer railroad anticipated operational program Okučani-Novska
					Number of approved final report on contract

## Chapter 4

# Case Study on KOSOVO<sup>38</sup>

prepared by  
**Bernard Nikaj**

**Bernard Nikaj** is a public policy and management professional with expertise in public financial management, economic development policies, and public administration reform. He currently serves as the Senior Political Adviser and Chief of Cabinet to the Deputy Prime Minister for Economy and Minister of Trade and Industry of the Republic of Kosovo. He also teaches management and entrepreneurship at the University of Prishtina.

Prior to holding these positions, Mr. Nikaj worked as an independent consultant on economic and social sector reform projects, advising the governments of Kosovo and Kyrgyzstan. He was also engaged in a number of initiatives with civil society organizations, working on projects that applied technology for social change and projects promoting entrepreneurship and open culture.

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<sup>38</sup> This designation is without prejudice to positions on status, and is in line with United Nations Security Council Resolution 1244 and the International Court of Justice opinion on the Kosovo Declaration of Independence.

## 1. Introduction

This paper outlines the current situation regarding the legal framework, institutions, and processes involved in Kosovo's budget process and their capacity to assess the fiscal implications of structural reforms.

While Kosovo has seen significant progress both politically and economically in the last couple of years, the capacity building of its institutions has remained a challenge. During preparation of this report it has become obvious that despite a good legal framework, Kosovar institutions still lag behind in the process of fiscally assessing the impact of structural reforms. Furthermore, the research has shown that the institutions in Kosovo should initially spend more effort in defining the structural reforms being undertaken as well as fully establish sound long- and medium-term strategic planning as a prerequisite for a functioning yearly budget process and fiscal impact assessment. To do that, full political support is required, not only to satisfy external pressures but to also ensure fiscal sustainability as a prerequisite for the country's sustainable economic growth.

Important steps in this direction have been taken lately. Budget impact assessment has been made mandatory for every piece of new legislation; there is also an administrative procedure and yearly calendar for approval of new strategic documents. Nonetheless, better coordination between relevant actors is needed; the Ministry of Finance and the Office of the Prime Minister are especially crucial in this process.

Finally, as this report will highlight, the capacity of the public administration to cope with the process and take on board new tasks remains limited. The government has to become serious about public administration reform as a prerequisite for moving forward on the path to the EU. Technical assistance by the EU, the IMF, and others should be utilized to facilitate this process.

This report is organized as follows: first we will look at the legal framework, processes, and institutions involved in the budget planning process, then we will critically assess these in regard to fiscal impact assessment of the structural reforms being undertaken by the government. Lastly, some conclusions and recommendations will be given.

## 2. Main institutional features for annual budget and medium-term fiscal programming

This section outlines the legal framework, institutions, and procedures for budget planning in Kosovo. As Kosovo is a young country that is going through a rapid process of state building and integration, its legal framework is quite dynamic. However, for the purposes of this paper, only the latest context is outlined, not including the changes historically and those that are planned.

## 2.1. Legal basis for medium-term and annual budgeting

The overall framework for the medium term and annual budget planning processes in Kosovo is based on the law on ‘Public Finance Management and Accountability’ (LPFMA; 03-L-048) and subsequent amendments, namely 03-L-221 and 2012/04-L-128.

Besides the general guidance it provides, the LPFMA enables the Ministry of Finance (MoF) to issue yearly budget circulars instructing budget organizations on the specifics of budget planning. Article 20 of the LPFMA provides specifics that: “The Minister shall have the authority and responsibility to issue, in accordance with paragraph 3 of this Article, budget circulars to any and/or all budget organizations providing instructions on the development of the Kosovo Budget.”

The number of circulars and the specifics can be decided and issued by the MoF. The legal provisions outlining the process of medium-term and budget planning apply equally to the central level and the municipal level, even though due to the status settlement proposal the municipalities in Kosovo have a higher degree of independence in planning their budgets (UN Security Council, 2007).

## 2.2. Institutions involved in the budget process

According to the LPFMA, the Budget of Kosovo is prepared by the MoF, namely its Budget Department, in cooperation with line ministries, municipalities, and other independent agencies. Before this budget enters into force it has to have been approved by the Parliament before December 31 of the previous year.

As the budget is a policy statement besides the mechanics that are outlined in the LPFMA and taken care by the MoF, it involves a number of institutions that set policy or coordinate the process of setting it. In Kosovo these are the Office for Strategic Planning and Coordination (OSPC) at the Office of the Prime Minister and the Ministry of European Integration (MEI). While OSPC is in charge of preparing the strategic documents issued by the government, such as the strategic objectives of the Medium-Term Expenditure Framework, national and sectorial strategies (where available), and other strategic documents, the MEI is in charge of coordinating the process of European integration through its European Partnership Action Plan (EPAP).

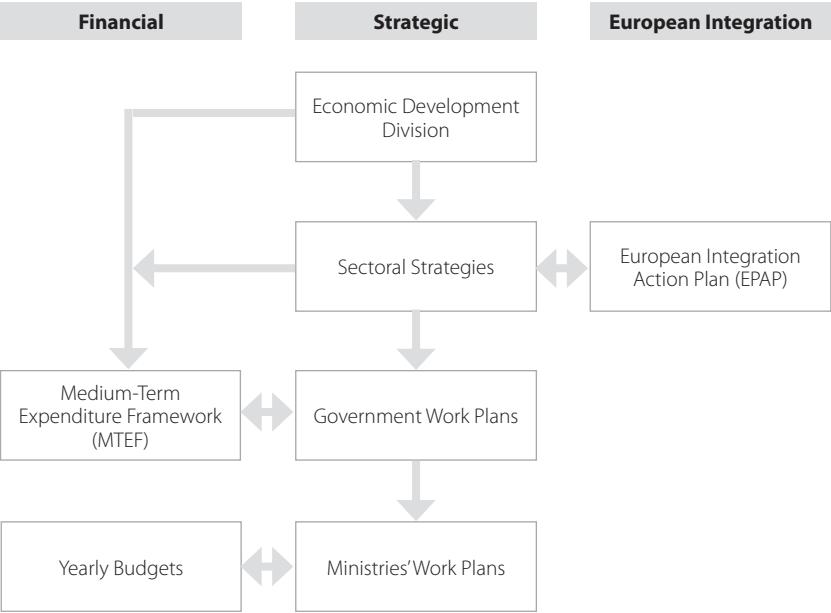
In addition, recently each ministry has created an EU Integration and Policy Coordination Office to lead in coordinating the policy planning and EU integration processes. These offices serve as points of contact to OSPC and MEI in line ministries.

### 2.3. Procedures and process

The overall planning process in Kosovo is organized across three main pillars (as shown in Figure IV-1):

- Strategic planning
- Medium-term and yearly budgeting
- European integration

Figure IV-1: Planning systems in Kosovo



It is the interaction between these three processes that defines the quality of policy planning and implementation.

In April 2011 the current government approved the Economic Development Vision, which outlined five priority areas of development: infrastructure, public companies, agriculture, the business environment, and human capital. This is the first time that a government in Kosovo has approved a long-term strategic vision to guide policy development and implementation. Following approval of this vision the government approved the Economic Development Vision Action Plan (EDVAP) detailing the concrete actions which should be undertaken to implement the development vision. Besides the EDVAP, specific ministries and sectors approve their own sectoral strategies, which have to be coordinated with the OSPC. Starting in 2012 the OSPC has introduced a yearly process for strategy preparation and approval. Every year the government approves a list of strategies to be prepared during the following year. This is similar to the Legislative Strategy, which outlines the laws to be prepared and submitted to the Parliament each year.

At the same time the LPFMA requires that the Medium-Term Expenditure Framework (MTEF) be presented to the Parliament before April 30 each year. This is prepared based on a standard practice and is a rolling exercise covering a period of three years. The MTEF process kicks off every year with the issuance of the first budget circular, which sets out high-level ceilings and overall strategic objectives, for the government as a whole and each budget organization individually.

Following approval of the MTEF by the Parliament, the MoF continues with yearly budget planning, which usually proceeds through issuing the second budget circular, which sets out instructions and provides firmer ceilings than the first circular. This process is followed up with budget hearings between the MoF and individual budget organizations to address eventual over-the-ceiling requests or justify their current budget requests. Depending on the situation, the MoF can issue subsequent circulars until the final budget is submitted to the Parliament; according to LPFMA, the budget has to be submitted on or before November 1. Following submission to the Parliament, the budget goes through the same procedure as any other law. It is first addressed in the Commission on Budget and Finance and then sent for the first reading in a legislative session; following approval it goes back to the Commission for eventual revision before being sent for the second and final reading. Between readings and while at the parliamentary commission, the budget can change depending on the hearings with budget organizations and negotiations between the government and the commission.

Usually the budget document consists of two parts:

- The general narrative outlining strategic priorities and general macroeconomic trends of the economy
- Budget Tables presenting:
  - overall data on revenues and expenditures
  - expenditures by budget organization and expenditure category (salaries, goods and services, capital investments, and transfers and subsidies)
  - capital investment projects by budget organization
  - expenditures at the municipal level

At this point, since this paper looks at fiscal impact assessment, it is important to mention the process of approving new laws. Based on the Regulation on the Government Operation (2011), each institution preparing legislation is obliged to prepare a budget impact assessment for such legislation. This consists of a form outlining the changes to budget categories, e.g., staffing, goods and services, capital investments and subsidies and transfers. This form is then sent to the MoF, which is obliged to approve, discuss, or require changes to the form within 15 days of submission.

Finally, the last process in the planning cycle is the process related to European Union accession. Kosovo, similar to other countries of the Western Balkans, is part of the European integration process since the Zagreb Summit of 2000, when the Stabilization-Association Process (SAP) process began for the

region. This process aims for an accelerated stabilization and transition to a market economy, promotion of regional cooperation, and prospects of EU integration. This process was further enhanced by the Thessaloniki Summit (June 2003), which included Kosovo in the framework of the SAP; also, a concrete prospect for Kosovo was proclaimed with the EC Communication in April 2005 on the *European Future for Kosovo*, which outlined the commitment of the EU to Kosovo.

In implementing the SAP for the Western Balkans, including Kosovo, in June 2004, the European Council endorsed the European Partnership for Kosovo, the first instrument to determine the key short- and medium-term priorities to be addressed by Kosovar institutions to support European integration. With a view of addressing these priorities, the government of Kosovo endorsed the first European Partnership Action Plan (EPAP). Since then, this key EU integration strategic document is revised annually, and it provides the main foundation of the Kosovo's path towards the European Union.

Between March 2003 and October 2009, the main instrument of political dialogue between the government of Kosovo and the European Commission was the "Stabilization-Association Tracking Mechanism". In November 2009, an EC Communication for the European Council and Parliament entitled *Kosovo – Fulfillment of the European Perspective* enhanced the process by launching the Stabilization-Association Process Dialogue (SAPD), within which there are an annual plenary meeting, eight sector meetings (or sub-committees), and two "horizontal" meetings: Dialogue with Civil Society and the joint Monitoring Committee (monitoring implementation of EC assistance). Apart from these, the Communication opened the way toward visa liberalization dialogue, the signing of a trade agreement between Kosovo and the EU, extension of independent market measures, and advances in cross-border cooperation.

However, the preparation of the EPAP does not follow a set calendar, and the timing of its preparation has varied from year to year. One of the main challenges remains the full integration of EPAP into the other two planning cycles in the government of Kosovo.

### **3. Incorporation of structural reforms' fiscal costs into fiscal programming documents**

This section provides a critical assessment of the laws, regulations, institutions, and process outlined in section 2, looking specifically at the inclusion of structural reforms and their fiscal impact within the existing framework.

Before we look deeply into the ways that laws, institutions, and processes enable the fiscal assessment of structural reforms, it is useful to see if there is a definition of structural reforms in use by the government of Kosovo.

For the purpose of this case study, the definition of structural reforms put forward by the European Commission has been used. According to it, structural reforms can be classified as those involving the enterprise sector, the financial sector, human resource development and labor markets, utilities and infrastructure development, and administration.

In Kosovo there is no official definition of structural reforms, nor is the term mentioned in any of our planning documents. However, if the EC definition were applied to reforms outlined in the EDVAP, most of the reforms being undertaken in Kosovo would fall into the category of structural reforms. This means that while the reforms in Kosovo are not specifically identified as structural reforms in the planning documents, they could be treated as such.

### **3.1. Assessment of the overall framework**

Kosovo enjoys a good legal framework, though it never gets fully implemented in practice. As we have seen from section 2 above, in most areas Kosovo's legislation is fully in line with the best European and international practices. This is not an accident, since the institutions and the legal framework has been built with heavy involvement and support from international organizations.

Nevertheless, due to our undefined relations with the European Union, there is a different level of adherence to the requirements and standards set out for pre-accession and candidate countries. Combined with an inexperienced public administration and political elite, the context is conducive to behavior that sees fiscal impact assessment as secondary to the need to "get things done".

The approval of the EDVAP has moved strategic planning aspect a level up, but has failed to establish a concrete definition of structural reforms and their fiscal impacts. A quick look at the document will show that beyond the capital projects that are easy quantifiable, there are no costs associated with actions addressing reform objectives. This is mainly due to lack of interest from a number of ministries to properly address the fiscal impacts of the proposed measures.

A typical example of this failure to integrate the fiscal impact assessment of structural reforms into the budget and planning process is the last major structural reform undertaken by the government, the increase of salaries of public sector employees in 2009. This increase was announced by the government just a few days before general elections were to be called, creating a huge impact on the budget of Kosovo and forcing the IMF to stop the Stand-By Arrangement signed with the government a couple of months earlier. All of this happened within a couple of weeks after the official budget planning process had been completed.



### 3.2. Assessment of the institutions

The assessment of institutions involved in the process of fiscal impact assessment could be separated in two levels:

- Decision-making or coordinating level (MoF, OSPC)
- Line ministries and agencies

These two levels differ, both in terms of capacity and in terms of preparedness and will to adhere to rules and procedures.

The budget planning process, including the fiscal assessment of the reforms, is heavily influenced and driven by the MoF, especially its budget department. This situation is typical of most countries in the region. Furthermore, the MoF is one of the more technically competent ministries in the government, due largely to high level of technical assistance provided through USAID- and EU-funded projects (FRIDOM Project, 2009a). At a similar level of competence stand both OSPC and the Ministry of European Integration, each being led by highly educated and competent civil servants.

However, in most line ministries and agencies the situation is not comparable. There is a high turnover of staff, and the technical skills and competences are not on par with the leading institutions of the process. This creates a situation where the MoF is leading the process and the majority of followers are not completely sure why they are doing what they are doing (FRIDOM Project, 2009b).

A typical example of the disconnect between the first level of institutions and the rest of the agencies is the relationship between the government of Kosovo and the IMF. After the halt of the Stand-By Arrangement program, Kosovo was put on a staff-supervised status. During this period the MoF handled most negotiations with the IMF. Due to this, whenever there was some new initiative or request from agencies, they were regularly told “No, because the IMF doesn’t allow it.”

Besides this disconnect, another concern in terms of institutional functioning has to do with the cooperation between the MoF and the Office of the Prime Minister, especially the OSPC. Besides providing their inputs at the beginning of the process of MTEF formulation, there is little or no involvement by OSPC in the rest of the process.

Finally, a new element brought to the institutional scene of structural reforms is the Ministry of Economic Development, which was created recently. Since MED’s portfolio covers the privatization of public assets, they should be involved in the process of strategic planning, formulation, and fiscal assessment. This stands partly true at the time of this writing.

### 3.3. Assessment of the process

Despite the existence of documents and guidelines, there is no systematic strategic planning system in place, and various strategic documents (for both overall strategies and sectoral or line ministry strategies) do not form a systematic base for budgetary allocation. Even though the approval of the EDVAP has injected some strategic planning into the overall operation of the government, not all the actors involved in the planning and execution process have followed it. Thus, there is no clear definition of structural reforms in the medium term.

Furthermore, the budget department currently does not have the responsibility to assess the budgetary impacts of various strategies, which will likely lead to a situation where many of the approved strategies will never be implemented due to a lack of budgetary resources. In view of this situation, it is hardly possible to rationally plan a budget in the medium term, as there is no overall strategic planning system in place that is linked to budgetary decision-making processes. In the context of the MTEF and program budgeting, it is not possible to plan a budget for a longer period than that of the planned activities using those funds.

Another important consideration is the budgetary impact assessment of new legislation. This process used to present a real challenge to both the MoF and the Parliament and has been addressed in the past few years. However, it still requires capacity building in both the MoF and the line ministries. A good example of progress in this regard is the new law on 'Public Health', which was held back for a number of months until all the actors involved could agree on the fiscal impact that it will have.

Regarding yearly budgets, it should be noted that the current budget calendar has not yet been followed in practice (the new LPFMA came into force in 2008); also, the budget preparation calendar that was initially set has not in the past been entirely followed. In 2008 the MTEF was approved only on June 12, causing a delay in the issuing of the first budget circular, which gave budget organizations only 17 days to prepare and submit their budget proposals. Since then the MTEF approval has come in line with the deadlines set out in the LPFMA; nevertheless the coordination between MTEF and yearly budgets remains a challenge. A proof of this is the amount of in-year transfers each year, which proves that the budget planning is far from being properly developed and implemented. All this is partially linked to the lack of proper strategic planning in place across all line ministries and agencies, notwithstanding the creation of new Offices for EU integration and Policy Coordination which remain uninvolved in the overall budget process in line ministries.

Although the LPFMA in general is rather detailed and sets very explicit requirements for the content of a budget proposal, it does not specify rules and regulations for the budget preparation process. The law gives considerable freedom to the Minister of Finance in the budget process, as it does not determine the roles and responsibilities of the MoF (e.g., there is no requirement for budget negotiations being held nor any requirement for the MoF to assess

budget proposals). Furthermore, no comprehensive methodology has been worked out for preparing and assessing budget proposals as well as evaluating the budgetary impacts of legal acts and strategic documents; such an assessment is needed even more now that the number of budget users and the size of the annual budget have increased. The focus in reviewing budget proposals is on determining whether various requirements (mainly stemming from the budget circulars) have been fulfilled. The obligation to assess the budgetary impacts of all new pieces of legislation has been set, but this rule is not always followed and does not apply to strategic documents at all.

The law does not regulate the budget process in the Assembly—it is only stated that the Minister of Finance has the right to receive adequate notice of, and participate in, any hearing held by an Assembly committee regarding any aspect of the proposed Kosovo Consolidated Budget or the proposed law on ‘Appropriations’.

In overall terms, the capacities to both prepare budget proposals and analyze these proposals needs further strengthening.

## 4. Conclusions and recommendations

It is clear from this study that all the pieces required to establish a sound budgeting system are in place in Kosovo. However, there is still the need to turn legislation and procedures into practice. It would be fair to summarize the current situation as follows:

The government of Kosovo should prepare a more specific definition of structural reforms that it plans to follow. This would allow for better fiscal impact assessment and incorporation in the overall planning and budgeting process.

Medium-term planning is still in its infancy. This constrains any sort of long-term planning, especially in terms of fiscal impact assessment of the structural reforms being undertaken in the economy.

Political priorities take precedence over budgetary and strategic prudence. It should be noted that any kind of fiscal discipline is a result of external pressures rather than rational realization of the need for fiscal prudence.

Administrative capacity in line ministries is insufficient to properly analyze and present the fiscal impact of the reforms being undertaken. This creates a mismatch between what happens in the center (MoF) and in the line ministries.

Closer cooperation between Strategic Planning Office in the Office of the Prime Minister and the Budget Department of the MoF would ensure better performance during the budget process.

The fiscal impact assessment of new legislation should be strengthened at both the MoF and line ministries. Technical assistance should be sought from both the EU and IMF to better prepare the civil service in preparing such assessments.

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## Chapter 5

# Case Study on MACEDONIA

prepared by  
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**Tatjana Arsova** is a Macedonian national. She holds an MBA from the Maastricht School of Management. She formerly worked for the Ministry of Finance in Macedonia, where she spent 14 years in the International Finance and the Budget departments, focusing on EU-related issues and organizations, especially to establish new structures for decentralized management of EU pre-accession funds and regulations and to build the institutional and administrative capacity for sound financial management. She also served as Head of the Working Group for adoption of the *acquis* on regional policy and coordination of structural instruments. She participated as a member of several EU and international bodies and organizations.

Since 2010, she has been working as a free-lance consultant, mainly in projects financed by the EU, Agency for International Cooperation (GIZ), and UNDP. Recently, she has been engaged in the Western Balkans region and other countries as an expert in projects focusing on EU funds management, EU-driven reforms of public administration, strategic planning and programming, public finance management and coordination of EU-funded research while working at Macedonia's South East European University. She has also delivered lectures and trainings in EU-related topics and worked as an international expert for the governments of Albania, Azerbaijan, Montenegro, Poland, Romania, Slovenia, Turkey, and other countries.

# 1. Introduction

Fiscal impact analysis of structural reforms is a tool for connecting budget planning and economics by estimating the public costs and revenues that result from structural reforms. The fiscal impact of structural reforms represents the effect of new investment, construction, employment, population, school enrollment, and other changes on a government's budget.

The benefits of fiscal impact analysis can be very impressive. At the most basic level, these analyses bring a realistic sense of the costs of a reform into the budget planning discussion. They can provide an objective screen so that all parties in the reform process have a clearer understanding of the likely results. Moreover, the analysis helps decision-makers link planning with the national budget.

One of the top priorities of the government of Macedonia is becoming a member of the European Union and NATO. Part of preparing for membership is meeting the Copenhagen economic criteria to have a "functioning market economy," which requires a number of structural reforms and their effective incorporation into the process of annual budgeting and multiannual strategic planning. The process of accession includes also the alignment of the national legislation with EU legislation and adoption of the EU *acquis*.

Macedonia has been dedicated to this process for more than 12 years, first as a potential candidate country and since 2005 as a candidate country. To better plan and implement all the reforms deriving from accession to the EU and beyond, Macedonia has introduced multiannual fiscal strategic planning since 2002.

The structural reforms that are well planned in line with the above priorities are part of the government's annual programs, agreed with the European Union within the Pre-accession Economic Programme, which is updated each year and discussed and agreed with the EU. In addition, the structural reforms that Macedonia implements are in line with the objectives of the Lisbon Strategy and Europe 2020 Strategy.

However, the costs of the structural reforms which the government is planning and implementing are not easy to estimate and incorporate into the annual budget and the multiannual fiscal strategies, considering the nature and complexity of the reforms, the national and international economic situation, and the institutional constraints.

The main structural reforms that Macedonia has agreed on with the EU in the PEP 2012–2014 are the following: continuous improvement of the business climate, support to entrepreneurship and SMEs as factors for dynamic growth and reduction of unemployment, improvement of human capital, strengthening the link between demand and supply, and support to exports. In addition, there are reforms to create a smaller, more efficient public administration, to increase legal stability, to enhance the supervisory capacities of the regulatory bodies, and to increase agricultural productivity.

The Ministry of Finance has created a mechanism for all the budget users to estimate and incorporate the cost of the structural reforms they are planning to implement into their annual budgets. However, the practice has shown that the capacities of the budget users to estimate these costs, and the level of coordination of the all the costs on a national level, need to be improved.

For this purpose a study was carried out in order to:

1. Assess how Macedonia incorporates structural reforms into its national budget and medium-term fiscal documents
2. Identify gaps and policy coordination issues and problems in this process
3. Generate a list of issues that can be addressed through learning events

The methodology used in this study mainly includes analysis of the legal framework; national budget documents; the multiannual fiscal strategy; the Pre-accession Economic Programme (PEP); the strategic plans of the line ministries; reports and evaluations by the World Bank, the IMF, and the EU; and other relevant documents.

In addition, preparing this study involved discussions and exchange of views with relevant stakeholders, as well as the drawing of conclusions based on prior analysis of the process of incorporating the fiscal costs of the structural reforms into the national annual and multiannual fiscal planning documents.

## 2. Main institutional features for annual budget and medium-term fiscal programming

### 2.1. Legal and other relevant framework

Macedonia has a comprehensive legal framework for annual budget programming as well as multiannual fiscal planning. The framework for the annual budgets is provided by the following legal acts, in order of priority:

- *The Budget Law* is a basic legal act that provides the procedures for preparing, adopting, and executing the budget of Macedonia, the budgets of the local self-government units, and the city of Skopje.
- *The law on the 'Budget Execution'* is adopted every year and provides a legal base for budget users to use the budget funds for the relevant year.
- *The government decree on 'Strategic Priorities'*: According to Article 15 of the Budget Law, the government issues this decree each year by April 15 for the following year. The strategic priorities as a number of initiatives and goals are incorporated in the budget of the budget users and funds through government programs and sub-programs. The budget users prepare three-year strategic plans that incorporate the programs, activities, and strategic priorities of the government, as well as their own goals and objectives.
- *Government decree on 'Maximum approved allocations'*: The Ministry of Finance (MoF), as a basis of the fiscal strategy, proposes to the government



the maximum approved amounts for the budget users and the funds for the following three fiscal years. According to Article 18 of the Budget Law, the government adopts the decree on the maximum approved amounts by end of May each year.

- *Government decree on 'Macroeconomic Policy'*: Each year, the government adopts this decree, which serves as a base for fiscal planning.
- *Budget circular*: According to the Article 19 of the Budget Law, the MoF issues guidelines for preparing the budget circular every year by June 15 for the budget users on the basis of an adopted fiscal strategy and within the maximum approved allocations.
- *Rulebook on 'Classification of Revenues'* is a by-law that derives from Article 38 paragraph 2 of the Law on Budget, where the Minister of Finance issues the classification of the revenues.
- *Rulebook on 'Classification of Expenditures'*: According to Article 13, paragraph 3, the Minister of Finance issues the classification of expenditures.
- *Fiscal implications form*: It is important to mention that Article 26 of the Budget Law requires an estimation of the fiscal implications when budget users propose laws and other legal acts to the government; they are obliged to submit a form that estimates the fiscal implications.
- *Plan of the development programs*: According to Article 21 of the Budget Law, budget users prepare a plan for programs for development in compliance with the guidelines for the budget circular and submit it to the government for approval, at the latest by July 15 each year.

## 2.2. Other relevant documents

*The Fiscal Strategy*: According to Article 16 of the Budget Law, the MoF prepares a fiscal strategy for the medium term, proposing the trends and the goals of the fiscal policy and establishing the amounts allocated for the main categories of estimated revenues and the allocated expenditures for the period. The fiscal strategy is adopted by the government by May 31 of each fiscal year. It covers the basic economic assumptions and guidelines for preparing the draft law, the estimate of the revenues, expenditures, and financing of the budget for the next fiscal year as well as the medium term of three years, and other relevant information.

*The Government Operational Programme 2011–2015*: This document gives an overview of all the planned activities and projects that the government has foreseen for this period based on the adopted strategic priorities.

*Strategic Plans of the Budget Users*: These plans cover a three-year period and represent a multi-purpose document in compliance with the strategic priorities of the government as well as with the National Programme for Adoption of the Acquis (NPAA) and are thus indirectly in line with the PEP. Strategic plans are part of the integrated budgeting system and directly connected to the budget estimations.

*Public Investment Programme 2011–2013.* The document covers sectoral development policies and priority infrastructure projects which are included in the 2008–2012 Government Operational Programme.

*Pre-accession Economic Programme:* According to the established practice for multilateral fiscal supervision, Macedonia prepares a PEP for a two-year period. The document represents a preparatory step for the Convergence Programme that EU member states prepare within the Stability and Growth Pact. As an EU candidate country, Macedonia is preparing to integrate into the European economic and monetary union and has become a part of the multilateral fiscal supervision in this context.

According to the above list, Macedonia has established a solid legal base for national priorities for structural reforms and their integration into the budget planning process, both annual and multi-year.

*Operational Milestones within the High-Level Political Dialogue between EU and Macedonia:* This is a very important set of guidelines for accession-driven structural reforms and the basis for preparing and revising the NPAA, which sets the priority areas for reforms.

*National Programme for Adoption of Acquis:* This is an annual, comprehensive document submitted to the EU for planning integration activities, encompassing also structural reforms. It gives an overview and detailed analysis of the activities per chapter of the *acquis*, including legal acts, institutional reforms, the current state of affairs, and short- and medium-term planning. Most importantly, it provides an overview of the budget allocations per government programs structured in EU *acquis* chapters for the medium term. Thus, all the allocations for structural reforms that are accession-driven can be detected from the NPAA.

## 2.3. Institutional set-up for budget preparation

The government is responsible for adopting the draft annual budget and submitting it to the Parliament. The government is also responsible for adoption of the decrees on strategic priorities and on maximum approved expenditures, the plans for development programs of the budget users, and the three-year Fiscal Strategy. The budget is adopted by the Parliament upon a proposal by the government.

The institutions responsible for annual budget preparations and medium-term fiscal programming documents are:

- MoF and its relevant departments
- Budget and Funds Department
- Department for Macroeconomic Policy
- The budget users (line ministries, funds, municipalities)

The MoF is responsible for preparing the draft budget according to Article 29 of the Budget Law.

*The MoF's Budget and Funds Department handles budget process management, including preparation of fiscal strategy and budget circulars and harmonization with the budget users, on the basis of which the draft budget is prepared for discussion and adoption by the Parliament. In addition, the department monitors and analyzes the budget execution by the budget users, on the basis of which it prepares their respective budget reallocations and expansions. It is in charge of the fiscal implications arising from all legal acts and by-laws, decisions, and information of the government. In the course of the fiscal year, the department also prepares the annual report of the Budget of Macedonia.*

*The MoF's Macroeconomic Policy Department is indirectly involved in budget planning because it outlines and monitors the implementation of macroeconomic policy and prepares monthly, quarterly, and annual reports and documents, including the PEP and the National Development Plan. The department prepares short- and medium-term projections on the main macroeconomic indicators (GDP, inflation, employment, wages, etc.), which are used as inputs when planning government policies within the competence of the MoF, and within the scope of operations of the other ministries and institutions.*

Budget users: according to the Budget Law, the first-line budget users belong to the executive government and judicial institutions, i.e., the central government, the funds (road, health, and pension funds), the municipalities, and other users that have obtained public functions by law. All of these institutions are responsible for preparing a budget request to be submitted to the MoF. They are also responsible for preparing the Plan for Development Programmes in line with the Guidelines. According to the Budget Law, the municipalities and funds are responsible for preparing a budget request too.

## **2.4. Adoption and preparation of the budget and the fiscal strategy**

To detect the main strengths and weaknesses in connecting the fiscal implications of structural reforms with fiscal programming documents, and to screen the coordination activities that take place during the preparation of these documents, the process is divided into a preparation and an adoption stage.

### **2.4.1. Preparation stage**

This stage is regulated by Chapter II of the Budget Law addressing the “Preparation of the Budgets”. It prescribes in detail the process of preparation and coordination, and the hierarchy in decision-making. The bases for preparing the budget are the strategic priorities of the government, the Fiscal Strategy, the draft strategic plans of the budget users, and the priorities of the municipalities.

The Minister of Finance is responsible for preparing and submitting the budget to the government. For municipalities, mayors are responsible for preparing and submitting budgets to the Municipality Council.

The government adopts the strategic priorities each year by April 15; these then have to be incorporated into the budgets of the budget users. The budget users prepare three-year strategic plans which include programs and activities for achieving the government's strategic priorities.

The three-year Fiscal Strategy is prepared by the MoF; its Budget and Funds Department manages the process. The strategy establishes the main assumptions and goals for the fiscal policy as well as the estimated amounts for the main categories of revenues and expenditures. It covers also the main reform expenditures in the section dedicated to projected expenditures.

The next step in budget preparation is the proposal from the MoF to the government for the maximum approved allocations for the following three years for the each of the central government budget users and the funds. The government approves the maximum amounts by the end of May each year.

On the basis of the Fiscal Strategy and the maximum approved amounts, by June 15 each year the Ministry of Finance issues to budget users the guidelines for preparing budget requests (the budget circular). The head of each budget user, in turn, forwards the budget circular to the second-line budget users. The MoF also provides the budget circular to the mayors of municipalities by the end of September.

The budget circular contains the following elements:

- Macroeconomic projections as adopted in the Fiscal Strategy
- Strategic priorities as adopted by the government decree
- Maximum approved amounts of expenditures
- Guidelines for preparation of the draft budgets

The head of each budget user is responsible for allocation of the maximum approved amounts of expenditures to the second-line budget users according to the strategic priorities and the plan for development programs.

This activity is followed by preparation of a plan for development programs: budget users and funds do so by July 15 and municipalities by November 15.

Budget users submit their budget requests to the MoF by September 1. The request contains:

- The strategic plan of the budget user
- The public procurement plan
- The approved plan for development programs
- The plan for planned and actual employment

The next step is the adjustment of the budget requests; the MoF checks the compliance of the budget requests with the issued guidelines and carries out the necessary adjustments. The proposed budget is submitted to the government for approval together with a report on non-compliance with the guidelines for each budget user, i.e., the requested amounts are indicated together with the proposed amounts by the MoF. In case of correction of the macroeconomic indicators, the government adopts corrected maximum approved allocations.

Of central importance for this study, budget users are obliged to estimate the fiscal implications of every proposed legal or other act to the government and to fill out a special form. If those estimations exceed the maximum allocated amounts of expenditures, or if they decrease revenues and are adopted after the budget of the relevant budget user for the current year, the exceeded amount is calculated in the budget for the following year of that budget user. In exceptional cases, if after adoption of the budget for the current year, it is necessary to assume some liabilities, the source of financing must be stated as well. The same applies to the fiscal implications that exceed the budgets of the municipalities, i.e., the source of financing must be stated in such a decision for amendment of the maximum approved amounts.

### **2.4.2. Adoption stage**

The draft budget is submitted by the MoF to the government each year by November 1. The budget is composed of three sections. The General section includes total revenues, total expenditures and other costs of the budget for the fiscal year, as well as the global projections for revenues, expenditures, and costs for the following two years. The Special section covers the plan of the allocated amounts of the budget users and the funds by programs, sub-programs, and items for the fiscal year. The Development section covers the plans of the development programs; these contain medium-term projections of the allocated funds by budget users, programs, and sub-programs, years of implementation, and sources of financing.

The government submits the draft budget to the Parliament for adoption by November 15; the Parliament has 20 days for discussion and adopts the budget by December 31 at the latest. The budget is presented to the Parliament by the Minister of Finance. In the adoption procedure, each increase in proposed allocations has to be followed by a suitable reduction of other proposed allocations. The contingency amount cannot be reduced due to other increases of allocations. In the event the budget is not adopted within the lawfully provided deadlines, the Parliament adopts a decision on temporary financing by the end of March; it can extend the decision for temporary financing if necessary.

## **2.5. Synchronization of preparation processes**

The processes for preparing the annual budget documents and medium-term budget programming documents (as well as the PEP) are synchronized in the following way:

1. The budget, the Fiscal Strategy, and the PEP are all prepared by the MoF. The Funds Department, which is responsible for the budget and fiscal strategy preparation, cooperates closely with the Macroeconomic Policy Department, which is responsible for the macroeconomic policy and PEP preparation during the preparation of the budget and vice versa, under the supervision of the Minister of Finance.

2. The budget, the Fiscal Strategy, and the PEP are based on the same government priorities for economic policy and thus on fiscal and monetary policy.
3. When adopting the budget, the Fiscal Strategy, and the PEP, the responsible government bodies and institutions are consulted with the opportunity to comment and to confirm compliance with the Government Strategic Priorities:
  - The Operational Programme of the Government
  - Strategic Plans of the Line Ministries
  - EU integration priorities and commitments

On the other hand, during preparation of the PEP, the same consultation takes place, managed by the Macroeconomic Policy Department. Therefore the PEP contains in its annexes a list of institutions responsible for preparing the PEP and a list of institutions from which an opinion was requested.

We can conclude that the process of preparing the PEP enables the linking of the strategic planning to the budgeting process and a clear vision of medium-term priorities and commitments, taking into consideration the Government Operational Programme 2011–2015, NPAA, the Stabilization and Association Agreement, and the national sectoral strategies.

### **3. Incorporation of structural reforms' fiscal costs into fiscal programming documents**

#### **3.1. Assessment of the overall framework**

The Macedonian system of overall fiscal programming is not perfect, but it is to a large extent coordinated in terms of the definition of structural reforms and in connecting the reforms from the strategic level to the annual budget estimation level.

The key element in the entire system, which in practice integrates the definition of structural funds and helps coordinates on priorities, is the guidelines issued by the MoF to the budget users for preparing the budget circular. The guidelines list the proposed government programs and sub-programs, which budget users are obliged to use in the classification of their budget requests. The proposed government programs are based on the established government strategic priorities, the Operational Programme, and also the agenda for structural reforms as presented in the PEP and agreed with the EU.

As an illustration of how structural reforms are defined and linked to the strategic planning level and EU integration commitments to the budget estimation level, please find below:

- The list of government priorities
- The list of policies addressing Priority 1 from the Operational Programme

- The list of structural reforms agreed with the EU and presented in the PEP as relevant to government priorities
- The list of proposed government programs in the guidelines for the budget circular

The structural reforms agenda reflects the strategic priorities of the government,<sup>39</sup> which are the following:

1. Increased economic growth and employment, as a precondition for increasing citizens' standard of living and improving quality of life;
2. Integration of Macedonia into the EU and NATO;
3. Uncompromising fight against corruption and crime and efficient implementation of law by undertaking deep reforms in the judiciary and public administration;
4. Maintenance of good inter-ethnic relations based on the principles of mutual tolerance and respect and implementation of the Ohrid Framework Agreement; and
5. Investment in education, science, and information technology as elements of a knowledge-based society.

For example, according to the Government Operational Programme 2011–2015, Priority 1 is addressed by the following policies:

1. Stable macroeconomic and fiscal policies
2. Tax and customs policy
3. Improvement of the business climate and competitiveness
4. Investment promotion
5. Support of small and medium enterprises

According to the PEP (2012–2014), and taking into account the identified priorities and challenges to the economic policy, the following are the key areas in the structural reform agenda for the period 2012–2014 which address Priority 1:

- Continuous improvement of the business environment
- Support to entrepreneurship and SMEs, as main promoters of dynamic economic growth and unemployment reduction
- Promoting human capital
- Ensuring a stronger link between supply and demand on the labor market
- Increased export support and promotion
- Creation of efficient, effective, and professional public administration
- Strengthening legal safety and supervisory capacities of the regulatory bodies
- Increasing agricultural productivity

The guidelines for the budget circular also indicate the following programs and sub-programs which encompass above listed strategic planning:

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39 Source: Government Decree on 'Strategic Priority', 2012.

- Economic development
- Economic promotion
- Promotion of business activities
- Investment in rail infrastructure
- Technological industrial development zones
- Support to SMEs
- Support to investment promotion

Further, the three-year strategic plans of the line ministries foresee policies, activities, measures, and projects for each government priority, which are grouped in the government programs as indicated in the budget circular. Subsequently, the indicators from the strategic plans relevant to measure the plans of the budget users have to correspond to those of their budget request.

The definition of structural reforms is not completely the same in terms of its wording across the documents that are analyzed in this study, but the structural reforms defined in the PEP as well as in the Macedonian Budget and Fiscal Strategy are contributing to the same strategic goals. The figures presented in the PEP correspond to the figures presented in the budget, because they are derived from it.

### **3.2. Assessment of the institutions**

The core institution in the fiscal programming process, both on an annual and multi-year level, is the Ministry of Finance. Its role is very specific because the documents that the MoF prepares and submits to the government for approval represent a framework for determining and guiding the activities of the other state institutions, especially from a financial point of view. These documents include the Strategy, the Macroeconomic Policy, the Public Debt Management Strategy, the Budget, the Public Investment Programme, and the PEP.

In addition, the MoF within its competences provides control and supervision of financial and fiscal management from the legal and financial aspects of spending. The specificity of the MoF derives also from the competences related to public procurement and the battle against organized crime, corruption, money laundering, and terrorism.

Moreover, the MoF includes in its organizational structure the government official responsible for decentralized management of EU pre-accession funding, the National Authorizing Officer, the Head of Operating Structures, and the Programme Authorizing Officer. Thus the MoF leads on sound financial management of Instrument for Pre-Accession (IPA) funding which derives from the financial agreements signed between Macedonia and the EU.

However, structural reforms in Macedonia are very closely directed by the Prime Minister's Office, rather than the MoF. While the Prime Minister is involved in creating and monitoring the implementation of structural reforms on a regular basis, the MoF is not a lead institution in these areas. Instead, the MoF monitors the implementation of the budget from a fiscal point of view,



which is in effect indirect monitoring of the implementation of the structural reforms. In Macedonia there is a Deputy Prime Minister for economic issues, who coordinates economic reforms under the supervision of the Prime Minister.

In addition, there is a Commission on Economic System within the government which is composed of the core ministers responsible for structural reforms. The Commission is tasked to discuss and propose solutions to the government in terms of introducing, improving, strengthening, or in some cases eliminating reform activities. It also discusses and proposes solutions to the government related to the strategic planning documents, as well as the PEP.

Budget users, on the other hand, have their own departments for budgeting. These prepare and submit the budget requests (budget circular) to the MoF, according to the guidelines issued each year and based on their sectoral strategies and strategic plans, which in turn reflect government priorities and EU-related commitments.

The costs of structural reforms presented in the budget users' requests are linked to the measures and activities in their strategic plans and the indicators stated there. These estimations tend to be quite realistic, but, perhaps inevitably, there is a tendency of fitting into the maximum approved allocations. As noted above, budget users are also obliged to estimate the fiscal costs whenever they propose a new legal act to the government.

The situation in estimating the fiscal costs deriving from any new legal act is not so good. Specifically, in calculating costs, budget users mainly reflect the costs for new employment, purchase of equipment, building or providing premises that the act will impose. Hence the perception of the fiscal implications is very narrow and not comprehensive.

Naturally, the capacity and response to this requirement among budget users are not even. Some budget users are more responsible and try to fill in the form for fiscal implications when proposing a new law with estimations as accurate as possible. Moreover, there is a recent trend of not presenting the fiscal cost estimations in the form due to the very intensive working agenda of the government and the line ministries and funds.

Recently, even though there is a lawful obligation (the Budget Law), the budget users, due to the lack of human resources for estimating the costs of the structural reforms that they are proposing, do not estimate costs at all or, as noted, present very indicative figures that represent a narrow perception of the fiscal implications.

Besides the lack of human resources and the tight working agenda that derives from the political commitments related to EU integration (NPAA, Milestones for the High Level Political Dialogue with the EU, etc.), certainly there is a lack of knowledge in some budget users and a need for capacity improvement in how to calculate the fiscal implications.

The commitment to implement the NPAA puts a lot of pressure on the line ministries, which are responsible to amend or prepare new legislation within their respective competences. In addition, the national reform agenda imposed

by the government is extremely intensive, which makes the capacity to dedicate staff to estimation of fiscal implications even less likely. Macedonia is a relatively small country, and the human resources in its public administration are rather limited.

While it can be concluded that capacity for estimating the fiscal implications of structural reform measures in the budget planning process does exist within the budget users, it can be further strengthened in terms of how to make calculations more precise and to reflect the entire implications of these measures.

### **3.3. Assessment of the processes**

Policy coordination on the fiscal impact of the structural reforms, and the reflection of this in fiscal programming documents, is the responsibility of the MoF.

As noted above, the MoF has a leading, specific role in policy coordination from a fiscal point of view. Besides preparing the annual budget, it prepares the macroeconomic policy and submits it to the government for approval. The assumptions of the macroeconomic policy are used for the budget preparation.

Preparing the Fiscal Strategy is also a responsibility of MoF's Budget and Funds Department. The strategic plans of the line ministries are also submitted to this department. Thus, the link between the policies that foresee structural reforms and the reflection of the costs of those structural reforms is carried out by the MoF in the course of preparing various strategic documents.

It is a multi-dimensional coordination, first in the vertical hierarchy of the priorities, starting from the top priorities—e.g., government priorities, macroeconomic policy, commitments to the EU integration process—and in the horizontal coordination of sectoral strategies and structural reform measures reflected in such strategies as well as the programs of the line ministries and funds.

However, the core process of policy coordination takes place in preparing the strategic plans of the line ministries. The vertical hierarchy of priorities is imbedded in the strategic planning of the line ministries, and thus vertical coordination is applied by the MoF.

While horizontal coordination is mainly a responsibility of the MoF (which has the global picture of the line ministries' programs, macroeconomic policy, and the public investment program of the government), the horizontal policy coordination happens through the preparation of all fiscal programming documents.

As an illustration, the annual budgeting process is carried out through continuous consultation with the line ministries. The MoF organizes meetings with each of the ministries to discuss their budget requests. In addition, the preparation of the Fiscal Strategy is also carried out through horizontal coordination, first within the relevant departments of MoF, and later with other relevant institutions. As noted before, the preparation of the PEP is a responsibility of the Macroeconomic Policy Department within the MoF, which means the process

of coordination is carried out by the MoF. However, many government institutions are involved in its preparation, and opinion is sought by many other institutions as annexed to the PEP.

As regards the instructions that the MoF issues to budget users for estimating fiscal costs, the MoF is very much interested in the detailed quantification of the fiscal costs and tends to seek as much information as possible from the budget users so that it can coordinate for decision-making on the basis of priorities, i.e., to be able to prepare the budget without disrupting the vertical coordination of priorities. The tendency of the MoF is to instruct the ministries and the other budget users to prepare their budget requests based on their already prepared strategic plans and, when quantifying their fiscal implications, to use the same indicators as in the relevant strategic plans. However, we have uneven capacity across the budget users in capacity to estimate the fiscal implications.

It is worth noting that traditionally, the MoF has the best capacity in this area. For example, whenever the MoF proposes a new amendment to the tax laws (such as changes in tax rates) it makes estimated projections for the revenues in the budget, based on relevant models for estimation. And when a reform is proposed by the MoF which has fiscal implications on the expenditure side of the budget, it also estimates the change in costs based on assumptions that are directly reflected in the budget preparation.

This traditionally good capacity in estimating the fiscal implications of the reforms proposed by the MoF comes from the nature of its competences, its responsibility to prepare all the relevant fiscal documents, as well as its long years of direct cooperation with the IMF, the World Bank, the EC, and others in producing various reports. Specifically, the arrangements that Macedonia had with the IMF in previous years contributed to the capacity development of the MoF, as a focal point for surveillance by the IMF together with the Central Bank.

Certainly, the budget circular proposed by the MoF can be further improved and thus seek more detail from the budget users. But the main problem in Macedonia is not the instructions from the MoF, which are quite comprehensive and can be further improved. Instead, the problem in estimating the fiscal implications of some reforms measures proposed by budget users stems from:

- The complexity of impact that a reform measure can cause
- The inability to foresee all the relevant implications
- The lack of capacity of some budget users
- Limitations in the availability of funds, with a tendency to fit into the maximum approved allocations
- The instability of the international economic situation, which can affect the domestic economy

To illustrate these points, refer to Table V-1 below, which presents some structural reforms areas and the associated problems in estimating fiscal impact.

**Table V-1: Most pressing issues associated with fiscal impact assessments of structural reforms**

Area of structural reforms	Overall framework issues <i>(Sub-section 3.1.)</i>	Issues emerging from institutional features <i>(Sub-section 3.2.)</i>	Issues emerging from procedures and processes <i>(Sub-section 3.3.)</i>
<b>Reforms of the enterprise sector</b>	Clearly defined structural reforms, integrated in fiscal programming docs	Lack of human capacity in the Ministry of Economy	Lack of detailed model and instructions for estimating overall impact of structural reforms on the budget revenues and expenditures both in annual and multiannual fiscal programming documents.
<b>Financial sector reforms</b>	Clearly defined structural reforms, integrated in fiscal programming docs		same as above
<b>Human resource development &amp; labor market reforms</b>	Clearly defined structural reforms, integrated in fiscal programming docs		same as above
<b>Utilities &amp; network industry reforms</b>	Clearly defined structural reforms, integrated in fiscal programming docs	Lack of human capacity in the Ministry of Economy and Transport	same as above
<b>Administrative &amp; other reforms</b>	Clearly defined structural reforms, integrated in fiscal programming docs	Lack of human capacity in the Ministry of Administration and Information Society	same as above

## 4. Conclusions and recommendations

### 4.1. Conclusions

Macedonia has been in a global reform process for many years. It is one of the main characteristics of the country and reflects the reality of our everyday life, both for citizens and for those responsible to introduce and implement reforms on the government side. During the last 20 years, reforms sometimes have intensified or slowed down, depending mainly on the political context. We can rightly say that in the last several years Macedonia has lived under a very intensive reform agenda implemented by the government. These reforms require political will and great effort for coordination, implementation, and monitoring as well as substantial resources and planning.

Certainly, most of the structural reforms that are under implementation in Macedonia are driven by EU integration and based on the political commitments to the EU. However, bearing in mind that reforms are made to improving

the lives of people living in our country, the current government also undertakes structural reforms that are beyond the agreed reform agenda with the EU, including in the health sector, education, economic reforms (taxation, social contributions), transport, and infrastructure.

Throughout the years, Macedonia's government has built very competent public administration bodies and institutions for coping with the challenges coming from implementation of the reforms and the assessment and planning of resources required to achieve their goals. The long process of preparing for integration with the EU has helped considerably in this.

The Stabilization and Association Agreement that Macedonia has had with the EU for around 12 years, the joint Stabilization and Association Agreement bodies for monitoring the process, our EU candidate status for seven years, all the political commitments for adoption of the *acquis*, agreed reforms under the PEPs, the other reporting activities, and so on—all of these have helped the country develop its public administration capacity in general to be able to cope and cooperate with EC services on a technical level.

In addition, the structural reforms that are currently implemented and planned in Macedonia are widely accepted by the general public, which voted for the program of the ruling party in the last elections; all the current structural reforms are reflected in that program. The political will is well ensured, and therefore the reforms are being smoothly implemented.

However, we cannot neglect the importance of precise estimation of the impact of the structural reforms in the multiannual and annual budgeting processes and their integration into the multiannual fiscal documents, including the PEP.

Considering the complex nature of the structural reforms, Macedonia's effort to better organize institutions in estimating the fiscal impact of reforms and integrate this into the budgeting process has been quite successful and well-coordinated, though with certain shortcomings.

The lead institution in the budgeting process is naturally the MoF, which has a responsibility to collect as much as possible realistic estimations of the fiscal costs of proposed structural reforms by the line ministries, issuing every year the instructions and assisting the government in its decision-making on whether to finance certain structural reforms during the budget preparation and adoption process. In addition, the MoF prepares the three-year Fiscal Strategy using the input provided in the strategic plans of the line ministries as well as the PEP.

For their part, the line ministries and municipalities are obliged by law to follow the annual instructions issued by the MoF for estimating their budgets. In addition, they are obliged to prepare three-year strategic plans which serve as a basis for the government's Fiscal Strategy. Also, the Budget Law provides that all budget users who propose a new legal act must estimate its fiscal implications. The line ministries also participate and provide comments and opinions where necessary in the preparation of the PEP.

However, despite well-developed capacities, there are some constraints to the process. The main weakness in the process is the lack of the human

capacities for detailed impact assessment when proposing a structural reform, both a lack of knowledge in some ministries and municipalities as well as in shortage of staff due to the very tight reform agenda.

Another constraint worth noting is the limited availability of funds for some structural reforms. During the budgeting there is always a tendency to fit into the maximum allowed allocations for the relevant year, and therefore the realistic estimation of the impact of certain structural reform is often missing.

Lastly, there is not a detailed model on fiscal impact assessment of structural reforms in the budgeting procedure provided in the instructions issued by the Ministry of Finance that will achieve compliance with the requirements of the templates provided in the PEP.

Institutions that present a major bottleneck for substantially strengthening this process are mainly those that have an ambitious reform agenda, that are newly created, or that implement reforms that are very costly to the budget while the positive impact of the reforms they are implementing (such as increases in revenues) is indirect and not immediate. Therefore, they either lack capacity or cannot make direct arguments for a revenue increase to back up the costs of the reforms they are proposing; thus they either reflect reduced costs or a narrow perception of the costs in their budget requests. This makes the work of the MoF more difficult as well as the decision-making of the government more complicated.

## 4.2. Recommendations

To achieve better integration of structural reforms' fiscal costs into Macedonia's annual and medium-term fiscal programming documents, some very practical steps need to be taken.

Firstly, the capacity for budgeting in some line ministries has to be increased in terms of human resources, including the number of staff as well as training of the appointed staff.

Secondly, one possible solution can be improving the instructions issued by the MoF for the budget users' requests by including templates and models for calculating the fiscal implications of structural reforms, similar to the one that is created on the basis of the Budget Law for proposing new legal acts. In other words, the model already exists in Macedonia, but needs to be improved and included in the annual and multiannual budgeting and fiscal planning process. Also, those models can be linked with the PEP templates.

Thirdly, we need an exchange of experience with countries that are more advanced in this process. This could be within the framework of some special projects in the form of seminars, workshops, or conferences, where Macedonian relevant officials can exchange experiences and learn more sophisticated technical models for annual and multiannual budgeting.

Lastly, some tailor-made learning events for the focal points and other staff at the line ministries and municipalities in medium-term fiscal and economic planning could be very beneficial for refreshing their knowledge and increasing their skills in annual and multiannual planning.

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## Chapter 6

# Case Study on MONTENEGRO

prepared by  
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Between 1999 and 2011, she worked for the Privatization Council, the Institute for Strategic Studies and Prognoses, the World Bank, and the government of Montenegro in advising, research, and management functions. In April 2011, she was appointed Deputy Minister of Finance, responsible for the Sector of Economy Policy and Development. Among other tasks, the sector prepares macroeconomic and fiscal revenue projections as well as all analytical documents needed either in annual budget preparation or for medium-term programming documents, including Montenegro's Pre-accession Economic Programme.

She is a member of special United Nations Economic Commission for Europe (UNECE) teams for Public Private Partnerships, Innovation, and Competitiveness Policies; the Intergovernmental Committee on Economic Cooperation of Montenegro and China; and the Economists Association of Montenegro. She has taken part in a numerous economic and scientific conferences and study visits, and has published scientific working papers (both nationally and internationally) on economic policy design and analysis.



# 1. Introduction

## 1.1. Background

Since its establishment as an independent sovereign state in 2006, Montenegro has been exposed to numerous challenges. It has had to establish all the institutions of a sovereign state while also working to achieve macroeconomic stability, a prerequisite for intensifying structural reforms, and thus for sustainable economic growth. The current advanced stage of transition—characterized by institutional reforms—is closely interlinked with the country's EU accession process. In December 2011, Montenegro obtained EU candidate country status, and in September 2012 the actual accession negotiations were expected to begin.

As in all other transition countries, the process of transition and accession to the EU has been associated with significant structural reform expenditures. This includes expenditures for internal strengthening of institutions that are important, either for smooth functioning of the market economy, or for improving the country's international competitiveness, mainly by improving its physical and human resource infrastructure. For achieving both objectives, the country has had to allocate significant public funds. As a rather small proportion of these funds is provided through EU pre-accession assistance and other sources of multilateral and bilateral assistance, a large majority of funds for structural reforms has had to be provided from domestic public sources, and this means primarily from the national budget.

Over the last decade a lot of interest has been expressed on various sides—national governments, the multilateral financial institutions, analytical sources—about the subject that could be broadly described as fiscal costs of structural reforms. The European Commission, for example, requests that EU pre-candidate and candidate countries provide in their annual Economic and Financial Programs (EFPs) or Pre-accession Economic Programmes (PEPs) an estimation of structural reforms' fiscal costs and to integrate these into their three-year fiscal projections.

As there has been no generally accepted methodology for measuring the fiscal costs of structural reforms, and taking into account that this is a strategically important segment of any country's fiscal expenditures, the Center of Excellence in Finance (CEF) has embarked, with financial assistance from the SAFE trust fund, on a project, Fiscal Impact Assessment of Structural Reforms (FIASR), that has the following three objectives: "(i) assessing—via country case-studies—how countries of the SEE region incorporate structural reforms into their national budgets and medium-term fiscal documents, (ii) identifying gaps and policy coordination issues in this process, and (iii) generating a list of issues that can be addressed through learning events" within one of the forthcoming projects of the CEF.

The CEF has prepared guidelines for preparation of country case studies (see ANNEX II), including this study for Montenegro. The guidelines have aimed at ensuring a high level of methodological consistency among contributions prepared by authors from various countries.

## **1.2. Objective of the case study and its methodology**

The overall objective of this document is to present for Montenegro how the fiscal costs of structural reforms are being integrated in the country's annual budget and medium-term fiscal documents.

In more specific terms, the document aims at, first, presenting the institutional framework and the processes for integrating fiscal costs of structural reforms into fiscal programming documents, such as the annual budget and the PEP, and second, providing a critical assessment of this framework as well as of these processes.

Preparation of the document has been based on the author's experiences on the subject, especially in the context of the EFP and PEP documents. The author has also carried out interviews with individuals from various institutions that have been directly or indirectly involved in programming the fiscal costs of structural reforms.

## **1.3. Outline of the case study**

Following closely the structure suggested in the guidelines, this study has, in addition to this Introduction, three main sections. Section 2 describes basic features of the annual budget and medium-term fiscal programming, especially the legal basis for preparation of various fiscal programming documents, the institutions taking part in these processes, and the procedures applied. Section 3 provides a detailed and critical assessment of how fiscal costs of structural reforms are being integrated into fiscal annual and medium-term fiscal programming documents. The final section—Conclusions and Recommendations—contains main conclusions about Montenegrin experience in these areas and recommendations for improvements.

# **2. Main institutional features for annual budget and medium-term fiscal programming**

## **2.1. Legal and other relevant framework**

In Montenegro, three types of fiscal programming documents are prepared each year. They include: (i) *Guidelines for Macroeconomic and Fiscal Policy*, (ii) the *Annual Budget*, and (iii) the *Pre-accession Economic Programme*.

The first two, which can also be called “domestic documents,” have their legal basis in the Budget Law. Articles 21 to 26 of this law stipulated the responsibility of various institutions involved in this process and the sequence of activities that has to be followed in preparing the two documents.

In line with the provisions of the Budget Law and the practice established over the years, the *Guidelines for Macroeconomic and Fiscal Policy*—prepared each year in April—is a kind of a background or framework document on the basis of which annual budget preparation starts. It contains macroeconomic and fiscal revenue projections for the current year and the following three years and the key economic policy orientations for the forthcoming period. The document typically consists of the following three chapters: Economic Framework, Macroeconomic Trends (analysis of recent trends and mid-term projections of main macroeconomic indicators), and Public Finances (analysis of recent fiscal performance and mid-term projections of main fiscal indicators).

The second fiscal programming document prepared each year under the Budget Law is the *Annual Budget*. This document is based on upgraded macroeconomic and fiscal revenue projections—it is prepared in September with January–August data. The document typically consists of the following two parts: the law, and an explanation of the law. The law prescribes limits for expenditure units, while the explanatory part provides the macroeconomic and fiscal mid-term framework as the basis for expenditures planning.

In addition to these “domestic” fiscal programming documents which have a legal basis in the Budget Law, Montenegro prepares, in the context of its EU accession process, another fiscal programming document, the *Economic and Fiscal Programme* and *Pre-accession Economic Programme*.<sup>40</sup> The main objective of this document is to articulate the macroeconomic and fiscal forecast of the country for the forthcoming three years and to integrate structural reforms into these forecasts. In Montenegro, preparation of EFPs/PEPs has not been formally integrated into the Budget Law or into any other legal act. Their preparation is based on the political commitment of the Montenegrin authorities vis-à-vis the EU. This annual document represents the analytical backbone for regular communication between the government of Montenegro and the European Commission in the area of macroeconomic and fiscal developments.

## 2.2. Institutions

*Ministry of Finance:* This is the key institution for preparation of all three fiscal programming documents in Montenegro, specifically through two of its sectors—the Budget Sector and the Sector for Economic Policy and Development. The overall division of responsibilities between the two as related to macroeconomic and fiscal forecasting, annual budget preparation and execution, and macroeconomic and fiscal analysis is roughly the following:

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40 Official EU candidate countries are asked to prepare PEPs, while potential candidate countries prepare EFPs.

- *The Sector for Economic Policy and Development* is responsible for preparing and regularly updating macroeconomic and public finance revenue forecasts that are needed in the context of annual budget preparation. In addition, the Sector acts as the *de facto* government focal point for economic analyses and is thus responsible for preparation and/or coordination of various economic policy documents. With respect to the three regular fiscal programming documents, the Sector has within its mandate (i) drafting the Guidelines for Macroeconomic and Fiscal Policy, (ii) drafting the analytical document supporting the submission of the annual budget to the Parliament, and (iii) coordinating preparation of the PEP. The sector is also responsible for many other economic policy documents that are prepared on an *ad hoc* basis. A good example is preparation of the National Development Plan that is currently underway.
- *The Budget Sector is responsible for overall budget preparation as well as budget execution*, for which it uses forecasts received from the Sector for Economic Policy and Development and the Guidelines for Macroeconomic and Fiscal Policy.

*Other institutions:* In the context of annual preparation of the three fiscal programming documents, the Ministry of Finance (MoF) has numerous contacts with line ministries (LMs) through negotiations for the annual budget law, and with LMs and other institutions in accounting structural reforms' costs. All of these institutions are asked to provide their inputs in various stages of budget preparation:

- In February, LMs and other budget recipients are invited by the Budget Sector to provide their capital budget requests for the following year. The capital budget is planned and executed through two budgetary units: the Directory for Public Works and the Directory for Transportation.
- In May, after the adoption of the Guidelines for Macroeconomic and Fiscal Policy by the government, the Budget Sector sends out the budget memorandum asking the LMs and other budget recipients to submit their budget requests for the following year.
- In autumn, in the context of PEP preparation, the Sector for Economic Policy and Development asks the LMs and other budget users to provide their inputs on the structural reforms planned for the forthcoming three years. Within this framework, the institutions are also asked to provide their assessment of fiscal costs associated with implementation of these reforms.

### 2.3. Procedures

The procedure for preparation and adoption of both “domestic” fiscal programming documents is determined in the Articles 20 to 24 of the Budget Law. Here is the summary of this procedure:

- In February, the MoF asks the LMs and other budget users to submit their capital budget requests for the following year (Article 20)

- In March, the government sets economic policy priorities for the following year (Article 20)
- In April, the government adopts the Guidelines for Macroeconomic and Fiscal Policy, which incorporates fiscal projections (revenues and expenditures) for the forthcoming three years (Article 20)
- In May, based on the orientations contained in the Guidelines for Macroeconomic and Fiscal Policy, the MoF sends the budget memorandum to LMs and other budget users (Article 20)
- In July, LMs' responses on the budget memorandum are received by the MoF (Article 21)
- In October, the MoF submits the annual budget for the forthcoming year to the government (Article 23)
- In November, the government submits the annual budget for the forthcoming years to the Parliament (Article 24)

In contrast to the procedure for preparation of the two “domestic” fiscal programming documents, the procedure for EFP/PEP preparation does not have a legal backing. Nevertheless, over the years Montenegro has put in place a good and well-functioning procedure for preparation of this document. According to the European Commission's request, an EFP/PEP for the year  $N$  has to be submitted by January 31 of that year, and it should contain a macroeconomic and fiscal forecast for the period between the year  $N$  and  $N+2$ .<sup>41</sup>

In Montenegro, activities of preparing an EFP/PEP for the year  $N$  typically start in July of the year  $N-1$  with the working group that is appointed by government and responsible for drafting the document. The working group—led by the deputy minister of finance heading the Sector for Economic Policy and Development—consists of representatives of institutions from within the government structures (LMs) as well as institutions outside these structures, such as the central bank, the statistical office, and independent macroeconomic institutions. The role of the LMs within this working group is primarily to provide inputs related to the country's structural reforms and to assessment of their fiscal costs. The first draft of the document is usually prepared in early December of the year  $N-1$  and is submitted for government approval before the end of that year.

In early years of EFP preparation in Montenegro, the procedure was rather poorly coordinated with the annual procedures for preparing the two “domestic” fiscal programming documents. This resulted not only in sub-optimal consistency across the documents but also in an unnecessary extra workload for the ministry's staff working on these projects. With the 2010 internal reorganization of the MoF, two important objectives have been achieved for the preparation of fiscal programming documents. First, the two parallel procedures of preparing documents—one for the two “domestic” documents and another for

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41 For example, the 2012 PEP had to be submitted by January 31, 2012, and had to contain macroeconomic and fiscal forecast for the years 2012 to 2014.

the EU-requested EFP document—have been integrated into one. Over the last two years, preparation of the Montenegrin PEP has *de facto* been integrated into the “domestic” fiscal programming exercise. Now, the same macroeconomic and fiscal forecasts are used for preparing the country’s annual budget and its PEP for the forthcoming period. At the same time, the capacity of the government for making independent and high-quality macroeconomic and fiscal forecasts has been significantly strengthened.<sup>42</sup>

### 3. Incorporation of structural reforms’ fiscal costs into fiscal programming documents

#### 3.1. Assessment of the overall framework

As presented in section 2 above, structural reforms and the fiscal costs associated with their design and implementation are supposed to be an integral part of each of the three fiscal programming documents that are regularly prepared in Montenegro. Unfortunately, looking at the subject in more detail, it becomes obvious that this integration is rather a formal one and pretty vague in substance terms. The reasons are numerous and can be classified into the following three areas:

- *Conceptual problems associated with the definition of structural reforms.* As noted in the guidelines for preparing the FIASR country case studies, there is no generally accepted definition of structural reforms. If there is no clear definition of the phenomenon, hence it is not possible to measure very accurately its fiscal costs. In Montenegro, we have started to quantify the fiscal costs of structural reforms only recently in the context of the EFP/PEP.<sup>43</sup>

As far as the definition of structural reforms is concerned, Montenegro for the time being uses in its fiscal programming documents the European Commission’s working definition. According to that, structural reforms consist of: (i) corporate sector reforms, (ii) financial sector reforms, (iii) human resource development and labor sector reforms, (iv) utilities and network industry reforms, and (v) administrative and other reforms.

This is a rather pragmatic classification based on areas of reforms and not on criteria whether the reform contributes to economic growth. The common characteristic of structural reforms should be that they represent an instrument for boosting aggregate demand, providing a basis for

42 When Montenegro first became an independent sovereign state, the government did not have the institutional and human capacities for macroeconomic forecasting and therefore relied either on the forecasts prepared by international financial institutions—especially the IMF—or the central bank.

43 The first assessment of fiscal impact of structural reforms in Montenegro was done in EFP 2010–2013.

sustainable economic growth. Structural reforms in essence increase a country's productivity and competitiveness. If a particular reform does not contribute to economic growth, it should not be classified as a structural reform. In other words, structural reforms should be output- and objective-oriented. In our recent PEPs, structural reforms are classified within the framework of the five areas of reforms as suggested by the Commission, and then, within each, specific outputs and objectives have been articulated (see PEP Appendix 1).

People who work on analyses of structural reforms, assessment of their costs, and recommendations for structural reform measures usually put more emphasis on historic action than on reviewing a structural reform in the context of its primary goal or the context of other structural reforms. For example, privatization could reduce employment in the short term, but also increase productivity and open new working places in related sectors over the long term, decreasing public consumption and increasing public revenues. Or, changing tax policy through an increase of value-added taxes could be a beneficial measure for short-term public revenues, but could also affect, among other consequences, the interest rates for credits and total consumption, and lead to a smaller tax base. Lack of a comprehensive, objective-oriented definition of structural reforms negatively affects the consistency of such assessments. The question is: what is the quantitative fiscal impact of these reforms?

- *Problems with the quantification of fiscal costs of structural reforms.* The lack of a credible and internationally comparable definition of structural reforms is by itself an important obstacle for credibly quantifying their costs. A major operational problem we faced in preparing our recent PEPs is the methodology to identify and estimate the costs of these reforms once they are articulated. Currently, this is done through a table that presents the impact on public revenues, impact of public expenditures, and total net fiscal impact of each measure in certain structural reforms classified by the EU criteria mentioned above. What seems to be a possible framework for quantifying financial inputs for structural reforms is the economic classification of budget expenditures, i.e., their classification on (i) salaries and wages, (ii) goods and services (other than salaries), (iii) subsidies and current transfers, and (iv) capital expenditures. Of, course, only a larger or smaller portion of budget expenditures under each of the four expenditure groups could be classified as the fiscal costs of structural reforms. As there is a complete lack of methodological guidelines which would allow identification of those budget expenditures within each of the four groups that would meet structural reform test, it is left to individuals to make this classification, and thus to quantify the fiscal effects of structural reforms: for example, how salary expenses could be classified for people contributing to structural reforms.
- *Weak human capacities in identification and calculation of budget expenditures for structural reforms.* The staff in LMs is often not qualified and/or motivated enough to be a good counterpart for submitting appropriate

information and data to the MoF. Without clear definitions, methodology, and requirements it is difficult to motivate or require civil servants to learn, upgrade, and implement specific technical methods of measuring the fiscal impact of structural reforms. There has sometimes been a situation where people did not see a clear difference between a structural reform and an infrastructure project, providing the impact of both activities. Except the PEP, there are no other requirements for delivering a specific methodology for including structural reforms expenditures in budget planning. Establishing clear tasks and procedures, as well as a specific, consistent methodology for all budget users and structural reform creators would require trainings and capacity building in both the MoF and LMs. This would enable a systematic assessment of structural reforms expenditures to become an integral part of public finance programming.

- *Lack of a political commitment to a more systematic measurement of structural reforms' fiscal costs.* In addition to the two sets of obstacles above for measuring the fiscal costs of structural reforms—both of which have a conceptual and methodological character—structural reforms often have also a strong political dimension. For example, such reforms, especially those ones involving large capital investment, are typically of a long duration. As investments of this kind have to be included into medium-term fiscal programs, they in effect limit budget flexibility for politicians. Also, some structural reforms involve policy measures that are not politically attractive, either because they are expected to raise opposition from various stakeholders and/or because they are expected to bring positive results only over a longer period than a political cycle. These and perhaps other similar reasons explain why there is often no sufficient commitment at the political level for introducing a more systematic insight into the fiscal costs of structural reforms or for using such a tool to improve the design of economic policy measures and instruments as well as to monitor their implementation.

### 3.2. Assessment of the institutions

*The Ministry of Finance* and its role in measuring fiscal costs of structural reforms:

- The MoF is expected to serve as the coordinator of fiscal programming and take a methodological lead in measuring the fiscal costs of structural reforms. As noted above, two of its sectors have a role in obtaining data about the fiscal costs of structural reforms, but there might be some inconsistency here. The Sector for Economic Policy and Development is the one that drafts documents containing data about these costs, but it is the Budget Sector that enters into a dialogue with the LMs and other budget users with respect to their capital budget requirement (in February) and budget memorandum (in May).
- The fiscal costs of structural reforms are not in the immediate interest of the part of the MoF—the Budget Sector—that is responsible for budget



preparation. It is this Sector that comes into the contact with LMs and other budget users on quantifying these costs. For this Sector, the information may be interesting but not critical in the context of budget preparation. Except in the fields of fiscal policy, improvement of the business environment, and financial stability, the MoF is not the creator of structural reforms in Montenegro, although it has the most professional capacity in implementing methodologies to evaluate their costs. There is potentially a strong coordinating and operational role for the MoF in the fiscal assessment of structural reforms.

- For the time being, rather poor instructions to the LMs and other budget users on measuring the fiscal costs of structural reforms mean we do not have a promising basis to get a good response from them. The main issue is not the willingness of people involved in the process, but the lack of a definition of structural reforms and a methodology for their fiscal impact assessment.
- The capacities of both the Sector for Economic Policy and Development and the Budget Sector in measuring the fiscal costs of structural reforms should be strengthened. The Sector of Economic Policy and Development could become a stronger coordinator in measuring structural reforms' fiscal impact and achieving consistency based on clear definitions and methodology. That impact on the fiscal side and on economic growth could be analyzed through the annual budget documents and the PEP. As the Sector for Economic Policy and Development was formed only two years ago, it has a particular focus on building capacity and analytical skills of staff. The Budget Sector, which has direct communication with budget staff from LMs, could request the fiscal impact of structural reforms at the beginning of budget preparation process, following procedures initiated by the Sector for Economic Policy and Development.
- It is important that the Sector for Economic Policy and Development become operationally involved in preparing the part of the budget memorandum (issued in May) that would require submission of data on structural reforms. It would make sense to establish a law-based requirement for fiscal assessment of such reforms. Having this included in the annual budget law would require more commitment from policy makers and staff participating in the process at operational level. This would highlight the need to solve problems at the measurement stage and help improve the "ways of thinking" when initiating and planning structural reforms or their specific measures and projects.

*Line ministries* and other budget users' role in measuring the fiscal costs of structural reforms:

- LMs in Montenegro are not set up to respond effectively to potential demand from the MoF in the area of structural reforms. Often this is done by budget departments without involving people who know the substance. Circulars that are sent to LMs in the context of annual budget and medium-term budget preparation are answered by the staff responsible for accountancy issues. They typically do not have a policy overview. It is simply not possible that a budget person in a line ministry will be able to make a classification of budgeted expenditures that determines which are associated with structural reforms and which are not.
- LMs do not have a focal point to aggregate and communicate their structural reform inputs to the coordinator and/or simply do not understand the overall context of the procedures and the relevance of their inputs. Structural reforms are mainly part of sectoral strategies, which usually are not consistent.<sup>44</sup> The impact of one structural reform in a given period of time in most cases does not align with assumptions about another sector's structural reform. A systemic approach to reforms' fiscal impact implies identifying, nominating, and building the capacity of focal points. Instead of accounting people, the staff responsible for policy coordination or the cabinet should be the focal point. They should be briefed regularly about the general framework of fiscal programming documents and the importance of structural policy inputs that they are asked to provide within this context. The way forward is through preparation of the National Development Plan (NDP) for Montenegro 2013–2016,<sup>45</sup> which provides a development path in the context of the EU Strategy 2020. Preparation of the NDP identified people that are dealing with structural reforms in LMs and convened them with counterparts from other ministries and agencies. It forced them to think about structural reforms not as a “wish list” but to bring them to a broader level, providing impact (economic, fiscal, and social) of all aspects of Inclusive, Smart, and Sustainable growth. The NDP, updated every third year, and the PEP, updated every year, are laying the groundwork for further capacity building at the MoF and LMs in fiscal assessment of structural reforms.
- Some line ministers are obligated to inform the government periodically about planned structural reforms and their realization in the fields of education, health, the labor market, and the pension system. The costs of those reforms are given only as an indication, through defining the sources of financing. It is a good overview of the main systemic changes in the long run, but without an assessment of their fiscal impact.

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44 Montenegro currently has around 50 relevant strategies.

45 NDP for Montenegro 2013–2016 is being done for the first time and will be submitted to the European Commission at the beginning of the next year as candidate country obligation.

### 3.3. Assessment of the processes

The process of collecting the fiscal costs of each structural reform is not very high on Montenegro's political agenda. It has been done, by and large, on an ad hoc rather than systematic basis, which affects the consistency of “domestic” fiscal documents and those done to meet EU requirements. A brief explanation of the process of determining the fiscal impact of these reforms follows:

- As previously said, the first fiscal assessment of structural reforms was done to meet an EU requirement in 2010, through the EFP. The coordinating body has been Sector for Economic Policy and Development in Ministry of Finance since 2011. Improvements have taken place, mainly in identifying structural reforms and raising awareness that they produce fiscal impacts, rather than in creating a systemic method whose results can be an integral part of decision-making.
- Information on mid-term structural reform expenditures are collected on the basis of EU tables. The coordinator of the Structural Reforms<sup>46</sup> chapter of the PEP gives instructions to sub-coordinators of five sub-chapters.<sup>47</sup> The time period of impact observation is  $t+3$  years. The fiscal impact of structural reforms' measures and projects for the next year ( $t+1$ ) is defined by the annual budget law. That is why the assessment is final after the Parliament adopts the annual budget law for the next year. The impact for the rest of the period (years:  $t+2$  and  $t+3$ ) is an indication for budget preparation for year  $t+2$ , which starts in the February of the next year. This information is included in official fiscal indicators (balance, debt) for the medium-term period that is presented to the domestic and international public.
- The tables are filled out by each team member that covers a relevant sub-chapter. These people are staff of the MoF, LMs, and institutions in charge of certain sectors that are of interest for the PEP. They are the main link between LMs and other institutions and the MoF in evaluating structural reform costs. The structural reforms tables in the PEP provide fiscal effects—positive, negative, and net—of each measure or project through which a structural reform is being implemented. The members of EFP/PEP teams that fill the tables are also the authors of related texts on structural reform. The process of collecting information from LMs and other institutions faces difficulties, ranging from poor understanding of the concept and definition of structural reforms, to their correct identification, to cost evaluation and their distribution in the medium term. Therefore, it is not realistic to expect responses of a good quality.

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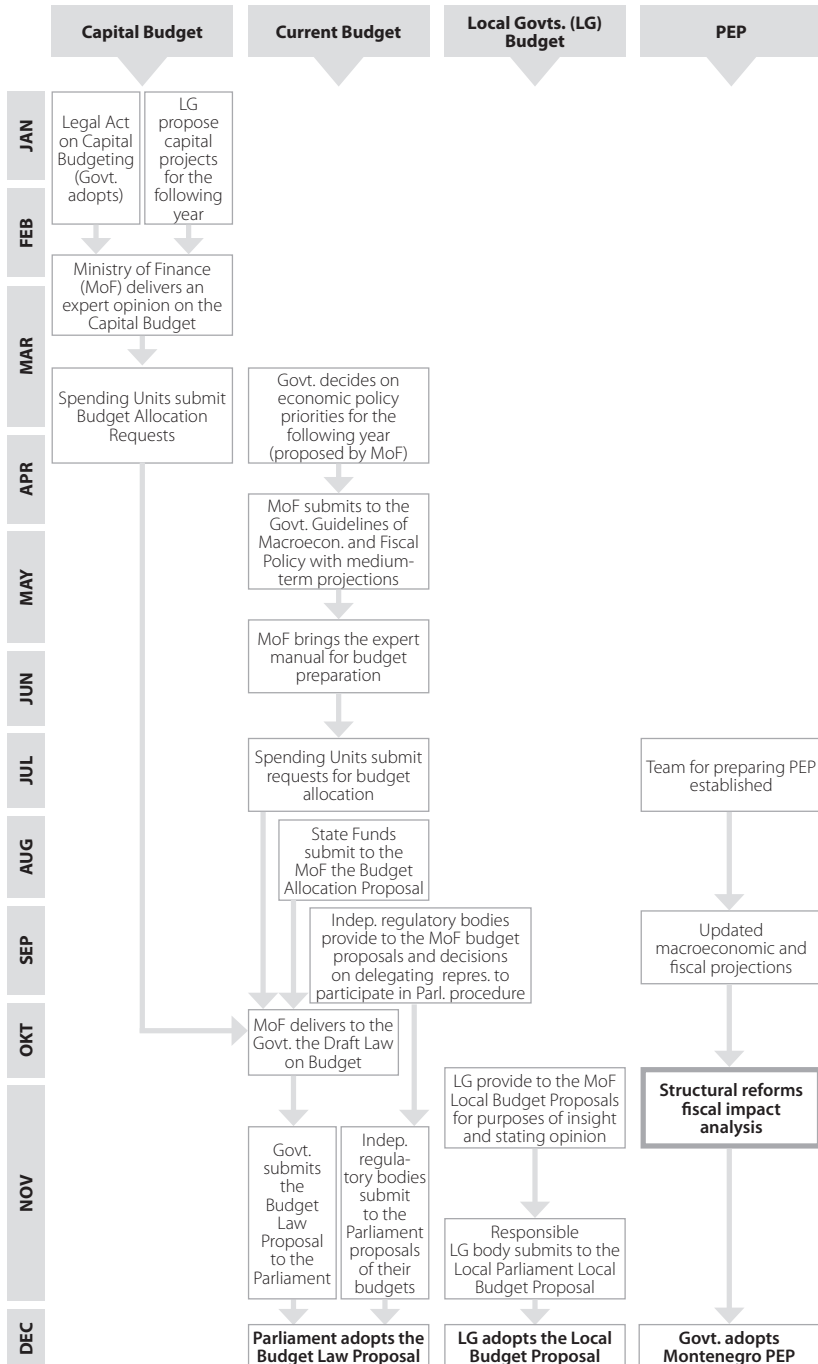
46 The person is formally in charge of structural reforms in the Cabinet of the Prime Minister, having responsibility to follow the realization of structural reforms and inform the government about it.

47 There could be more fields of structural reforms depending on the EU outline for a certain year, e.g., regional development, agriculture, protection of environment, etc.

- The total net impact of structural reforms' expenditures on mid-term public finances is input for the EFP/PEP team members who are responsible for Chapter III of the document, regarding the fiscal framework. The public expenditures, including structural reform costs, are based on macroeconomic and public revenue forecasts, representing the final step in providing figures for the medium-term fiscal framework.
- The coordinator of the PEP in the MoF assures the paper's internal consistency. The MoF presents the draft of the EFP/PEP to the government, providing opportunity for line ministers to discuss and improve the consistency of the document. The presentation of the fiscal impact of structural reforms is one of the three most important chapters. After government approval, the PEP is submitted to the EU as the official macroeconomic and fiscal framework for the medium term, and then evaluated by EU experts.
- Institutions often assign too little priority to consistency between the final PEP and the "domestic" fiscal documents. The PEP is merely considered as indication of fiscal documents and government plans, and can therefore be changed freely from year to year. It is a significant problem in Montenegro to integrate systemically structural reforms' costs into the fiscal documents. There is no formal obligation for an accurate quantification of structural reforms' fiscal costs in the context of annual and medium-term fiscal programming by the MoF. There is also a lack of staff capacity in the LMs and other budget users and institutions that are responsible for coordinating the process.
- The problems above were more intensive prior to 2009. Increasing requests from the EU and the need for solutions generated the idea of seminars on general guidelines and the work plan for writing the PEP. Introductory EFP/PEP seminars have become a good practice in providing better consistency among contributors from LMs and the MoF. These are an opportunity to have all participants in one place listening to presentations of the PEP outline as an EU document and receiving templates with instructions for contributors as the basis for three months' work. At the seminars, macroeconomic and fiscal teams, as well as structural reform teams, start work by delivering the first theses on which their texts will be based. Seminars and meetings that gather the MoF and evaluators of structural reforms' costs, and provide clear instructions and procedures, have improved the fiscal assessment of structural reforms in Montenegro. This is a good first step in creating a systemic integration of structural reforms' costs into the medium- and long-term fiscal framework.
- The fiscal impact of reforms, measures, and projects in Montenegro is evaluated by filling out a Fiscal Form when submitting proposals for government adoption. Since fiscal impacts of structural reforms are not extracted in the Fiscal Form, it is hard to know which portion of total fiscal impact is related to them. However, this form could be used as a first and obligatory step in measuring the fiscal impacts of structural reforms. It would be part of a formal procedure for government adoption, official and recorded,

raising the assessments to a more obligatory level than now. Of course, analyses and figures need people, methodology, and procedures, which brings us again to the need for capacity building.

- How are the realization of structural reforms and their actual fiscal impact in Montenegro analyzed and estimated in comparison to the original plans? The process of following the realization of structural reforms started with EFPs, as a requirement from the EC. Every structural reform analysis starts with paragraph explaining: what promised structural reforms' measures and projects from last year's EFP were realized during the previous year (or to what extent). We have retained this practice in the PEPs, since it makes for a more responsible approach to what should be "promised" to the European Commission. The drawback of this approach is that it does not make a direct comparison of last year's planned and actual fiscal costs for structural reforms, just a new evaluation of positive-negative-net fiscal effects.

**Figure VI-1: Budget preparation scheme**

## 4. Conclusions and recommendations

### 4.1. Conclusions

Conclusions regarding fiscal programming issues:

- The basis for preparation of fiscal programming documents is well established: the Budget Law for the two “domestic” documents, and the EU accession commitment for the PEP.
- Structural reforms are one of three pillars of Montenegro’s economic growth and development.<sup>48</sup>
- The MoF is responsible for preparation and coordination of the three fiscal programming documents. After its 2010 internal reorganization, the institution is adequately organized to perform the role of focal point for measuring fiscal costs of structural reforms in Montenegro.
- LMs and other budget institutions have become aware of need for fiscal assessment of structural reforms and are integrated into the process.
- Procedures are well established either in the Budget Law (for “domestic” documents) or through practice (for the PEP); in recent years, the two previously parallel procedures have been integrated into one.
- Montenegro’s obligation to submit the PEP to the EU has spontaneously created the need for organizational and technical solutions for measuring the fiscal impact of structural reforms; it has created new needs and problems to be resolved.
- The PEP working group is working as a team that puts effort into better evaluation of structural reforms’ costs and their impact on the fiscal framework.

Weaknesses in assessing the fiscal impact of structural reforms in Montenegro:

- No clear definition of structural reforms. Montenegro for the time being uses in its fiscal programming documents the European Commission’s working definition. According to that structural reforms consist of: (i) corporate sector reforms, (ii) financial sector reforms, (iii) human resource development and labor sector reforms, (iv) utilities and network industry reforms, and (v) administrative and other reforms.
- Problems with quantification of structural reforms. This has been done through the fiscal programming documents’ table that presents the impact of structural reforms on public revenues and expenditures and the total net fiscal impact of each measure or project within a given structural reform. But we lack methodological guidelines which would allow identification of the budget expenditures within each of the four groups that would meet the structural reform test, hence it is left to individuals to make this classification, and thus to quantify the fiscal effects of structural reforms.

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48 The two others are: fiscal consolidation and improvement of business environment.

- The issue is a low political priority. There is no sufficient commitment at the political level for introducing a more systematic insight into the fiscal costs of structural reforms, primarily because mid-term project planning limits budget flexibility for politicians and because such policy measures are not always politically popular.
- No formal obligation for measuring the fiscal impact of structural reforms in annual budget planning. The fiscal costs of structural reforms in Montenegro are only an indication for the next year's budget.
- Weak human capacities and low motivation for measuring the fiscal impact of structural reforms. The staff in LMs is often not qualified or motivated enough to be a good counterpart for submitting appropriate information and data to the MoF.
- A lack of focal points and coordinators of structural reforms in LMs and other budget users. There is no coordinator to aggregate and communicate structural reform inputs and build understanding of the overall context of the procedures and the relevance of their inputs.

## 4.2. Recommendations

Montenegro needs a systematic approach to fiscal assessment of structural reforms. Institutionally there are the basic preconditions. The following recommendations focus on creating a system of clear definitions, procedures, and methodologies related to structural reforms' cost measurement in order to identify, quantify, and monitor their realization through the regular budget planning process. This could be achieved only through regulatory changes and strong capacity building for sector staff who are already participating in the general costs assessment process for structural reforms:

- Guidelines for definition of structural reforms (output based; programming budget);
- Formal integration of structural reforms' fiscal impact assessment into regular procedures related to adoption of budget documents by government;
- Formal integration of fiscal assessment of structural reforms into the process of annual budget planning, with clear requirements and procedures based on political will;
- A systematic approach implies identifying, nominating, and building the capacities of focal points and coordinators in an annual process of assessing the fiscal impact of structural reforms;
- Concrete methodology and guidelines for measuring fiscal costs of these reforms (input-based);
- Trainings and seminars to MoF and LMs (budget and structural reform staff) in conceptual and fiscal impact aspects of structural reforms;
- Workshops and presentations to high-level government officials to raise awareness of the importance of fiscal impact planning of structural reforms as part of policy formulation;



- Building capacities of the MoF's Sector for Economic Policy and Development to conceptualize and coordinate on structural reforms;
- Building operational capacities of the MoF's Budget Sector to integrate structural reform fiscal costs analyses into budget processes;
- Recognizing the PEP's Structural Reforms and Public Finance Team, with representatives from the MoF and LMs, as the main intra-governmental team tasked to strengthen measurement of the fiscal costs of structural reforms.

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## 6. Appendix

**Table VI-1: Fiscal effects of structural policies: summary based on analysis presented in PEP chapter IV**

	2011	2012	2013	2014
<b>4.1. ENTERPRISE SECTOR</b>				
<b>4.1.1. PRIVATIZATION</b>				
<b>4.1.2. COMPETITION, STATE AID AND PUBLIC PROCUREMENT</b>				
<b>4.1.2.1. Competition</b>				
Net effects				
Revenues				
Expenditures				
<b>4.1.2.2. State aid</b>				
<b>4.1.2.3. Public procurement</b>				
Net effects				
Revenues				
Expenditures				
<b>4.1.3. BUSINESS ENVIRONMENT AND TAX POLICY</b>				
<b>4.1.3.1. Improvement of business environment</b>				
Net effects				
Revenues				
Expenditures				
<b>4.1.3.2. Small and medium-sized enterprises sector</b>				
Net effects				
Revenues				
Expenditures				
<b>4.1.3.3. Tax policy</b>				
Net effects				
Revenues				
Expenditures				
<b>4.1.4. NETWORK INDUSTRIES</b>				
<b>4.1.4.1. Energy</b>				
Net effects				
Revenues				
Expenditures				
<b>4.1.4.2. Transportation</b>				
Net effects				
Revenues				
Expenditures				
<b>4.1.4.3. Telecommunications</b>				
Net effects				
Revenues				
Expenditures				

	2011	2012	2013	2014
<b>4.3. LABOUR MARKET</b>				
Net effects				
Revenues				
Expenditures				
<b>4.4. AGRICULTURE SECTOR</b>				
Net effects				
Revenues				
Expenditures				
<b>4.5. ADMINISTRATIVE REFORMS</b>				
<b>4.6. OTHER REFORM AREAS</b>				
<b>4.6.1. DEVELOPMENT OF KNOWLEDGE SOCIETY</b>				
<b>4.6.1.1. Education</b>				
Net effects				
Revenues				
Expenditures				
<b>4.6.1.2. Research and development</b>				
Net effects				
Revenues				
Expenditures				
<b>4.6.2. PENSION SYSTEM REFORM</b>				
Net effects				
Revenues				
Expenditures				
<b>4.6.3. HEALTHCARE PROTECTION</b>				
Net effects				
Revenues				
Expenditures				
<b>4.6.4. SOCIAL PROTECTION</b>				
Net effects				
Revenues				
Expenditures				
<b>4.6.5. ENVIRONMENT</b>				
Net effects				
Revenues				
Expenditures				
<b>4.6.6. REGIONAL DEVELOPMENT</b>				
Net effects				
Revenues				
Expenditures				
<b>NET BUDGET EFFECTS</b>				
<b>TOTAL REVENUES</b>				
<b>TOTAL EXPENDITURES</b>				

Source: Table format of the PEP for Montenegro 2011–2014.

## Chapter 7

# Case Study on SERBIA

prepared by  
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She holds a BA in English language and literature and is a PRINCE2-certified project manager and an accomplished translator and interpreter.

# 1. Introduction

The purpose of this study is to assess the status of the system and processes of integrating fiscal costs of structural reforms into the medium-term fiscal documents and annual budgets in Serbia. The assessment is being undertaken to explore how to address the observed deficiencies of the process.

The objectives of the study are to assess how countries of the SEE region incorporate structural reforms into their national budgets and medium-term fiscal documents, to identify gaps and policy coordination issues in the process, and to generate a list of issues that can be addressed through learning events within the framework of the Strategic Planning and Budgeting project.

The study begins with an overview of the legal frameworks regulating medium-term fiscal programming and preparation of the budget in Serbia, with emphasis on the law on the 'Budget System' and the Budget Memorandum. Although in 2011 the Budget Memorandum was replaced by the Fiscal Strategy Report (FSR), these are essentially the same documents. This text mainly refers to the practices of development of the former, as the FSR has been produced for the first time in the circumstances of a distorted budget calendar with severe delays.

The next segment provides information on the main institutions participating in medium-term fiscal programming and budgeting, including the Ministry of Finance (MoF), the Cabinet, budget beneficiaries, and the Parliament.

The subsection entitled Procedures attempts to provide an insight into the budget preparation process, starting with development of medium-term fiscal and macroeconomic forecasts and annual budgets in the context of budget calendar. It also provides a snapshot of the content of budget instructions and submissions by first-line budget users.

The third section assesses the overall fiscal programming system, especially how it addresses the issue of structural reforms' fiscal costs. It finds that little has been done so far in terms of collecting and incorporating information of the fiscal impact of structural reforms into medium-term fiscal programming documents and annual budgets. It provides a brief description of a chapter in the Budget Memorandum presenting information on the status of structural reforms and the EC's assessment of the quality of information presented. In terms of presenting costs of structural reforms, the information shown is not immediately transparent due to the present structure of the budget, which still presents information according to the line item division of expenditures. The paper provides an excerpt from the 2011 budget that is by no means extensive in terms of coverage of ministries or expenditures. It is, rather, intended to provide an illustration of how costs of some structural reforms are shown in the budget.

The next subsection assesses how institutions are addressing their present capacities to request and process the information on structural reforms' costs and their need for further reform. The assessment points out that there is a

need to advance the reform of program budgeting as part of the overall strategic policy planning framework and to develop capacities for various types of analyses, so that the costs of structural reforms and other policies can be appropriately analyzed and incorporated in the relevant documentation.

The assessment of the processes that follows is presented in the context of the country's overall capacity for policy coordination, notably the absence of an integrated planning and budgeting framework and a top-down approach. This section provides information on attempts to move toward an integrated approach and the efforts of the Centre of Government (CoG), however modest. It describes the content of budget instructions, including the attempt to request the costs of policies (new and ongoing).

The final section offers conclusions and recommendations. Recommendations focus on the need to recommence reform of budgeting practices in the MoF; to advance reform of the CoG by introducing tools and mechanisms for coordination and consultation; and to introduce unambiguous terminology, clear procedures, enforcement of legislation, and comprehensive trainings to suit the needs of stakeholders in the overall policy and budgeting process.

## **2. Main institutional features for annual budget and medium-term fiscal programming**

### **2.1. Legal framework**

The Constitution provides reference to Public Finances and the Law in Part 3, Section 2, Articles 91 (Taxes), 92 (Budget), 93 (Public Debt), 94 (Balanced Development), 95 (National Bank of Serbia), and 96 (State Audit Institution). Part 4, covering Competences of Serbia, has as an Article 11 on the “control of legality of managing resources of legal entities; financial audit of public finances; collection of statistical and other data of public interest”.

Fiscal issues, medium-term forecasting, and budgeting in Serbia are regulated by the organic law on the ‘Budget System’, first adopted in 2002. The law regulates the planning, preparation, adoption, execution, accounting, reporting, and control of budgets of all levels of government and formalizes the multi-annual budget process that better embraces the medium-term expenditure framework (MTEF).

When it was adopted, this law introduced comprehensive, systemic changes in the management of public finances in Serbia. It consolidated the budget system; introduced rules for planning, preparation, and execution of budgets for all levels of government; and established the Treasury and Administration for Public Payments (later merged into the Treasury Administration). This law laid the foundations for further advancement of the PFM system in Serbia, but has also provided experts and the general public with valuable insight into the sources and amounts of collected revenues and incurred public expenditures.

Clearly, the solutions and implementation of the law on the 'Budget System' did not yield the expected results in all aspects. However, it cannot be disputed that it launched an era of more efficient and more transparent public finances.

The law was amended numerous times, and in 2010 a new law was adopted, mainly for technical reasons, i.e., to consolidate all the changes that had occurred over the course of seven years. The new law does not bring forward systemic changes but acknowledges those introduced earlier: introduction of a mid-term framework for expenditures in the national budget to increase the predictability of public finance for budget beneficiaries, while at the same time preventing cyclical expansion of current expenditures; introduction of medium-term planning as a prerequisite for implementation of strategic development projects; conditions for using development aid from EU and management of such aid by Serbian authorities. The main changes introduced by the new law are provisions on fiscal responsibility aimed at strengthening fiscal discipline over the medium term and enhancing the long-term sustainability of public finances in Serbia; it replaces the Budget Memorandum with a Fiscal Strategy Report and changes the budget calendar to accommodate preparation of the FSR.

The fiscal responsibility provisions aim at consolidation of public finances based on a multi-annual budgetary process and a set of fiscal rules. The legislation stipulates a medium-term deficit target of 1% of GDP and public debt (excluding restitution) below 45% of GDP. Public sector wages and pensions are capped at 8% and 10% respectively, over the medium term.

The latest changes of the law on the 'Budget System' adopted in late 2010 (Article 27d: paragraph 8) stipulate that the Fiscal Strategy Report shall contain the fiscal implications and analysis of economic policies and structural reforms. This provision has not been enforced to date.

In terms of impact assessment requirements, the Rules of Procedure of the Government also stipulate that any draft regulation forwarded to the government for review and adoption must be accompanied by a regulatory impact assessment. In the event that the sponsoring ministry deems such assessment unnecessary, they are obliged to provide a written explanation of the circumstances justifying their position. Unfortunately, this requirement is rarely observed, if at all.

For several years, Serbia has been presenting the EFP to the European Commission, as a part of its obligations as a potential candidate country. Given that it only became a candidate in early 2012, Serbia has not yet prepared the PEP. The EFP is essentially an abbreviated version of the Budget Memorandum and contains information on the macroeconomic policy goals and guidelines, structural policy guidelines for the medium term, projections and trends, the fiscal framework and risks, the public debt management strategy, and a section on structural reforms. In terms of integration into the overall budgetary process, it could be said that this document is a result of the existing process and procedures, as it is entirely derived from the Budget Memorandum. It is prepared by the Department for Macroeconomic and Fiscal Analysis and sent to the EC by the end of January each year.

Medium-term fiscal programming is done as a part of the budget preparation process, which involves determining the macroeconomic framework, preparing the Memorandum on the Budget and Fiscal Strategy Report, holding budget hearings, and preparing the annual budget for presentation to the Parliament. The Ministry of Finance liaises with all direct budget beneficiaries and local governments during the process.

The memorandum was prepared by the Macroeconomic and Fiscal Analysis Department in the MoF, with some input from other departments. According to the law on the 'Budget System', the memorandum had to be adopted by the government by May 15, and should constitute the basis for continued preparation of the state budget and the financial plans of the extra-budgetary funds. An updated version of the memorandum should be submitted to the Parliament together with the budget proposal. The amended budget system law introduced new deadlines and several new stages in the process of approval and adoption of the FSR. The network calendar is presented in Box 1 below.

The Memorandum on the Budget and Economic and Fiscal Policy for the next and subsequent two years (Budget Memorandum, replaced by the FSR) and the Annual Budget are the two main documents produced as part of the budget process. Over the years the Budget Law and the rationale it contained has become ever more comprehensive and detailed. The content of the law has been extended to include EU development assistance including funds for co-financing of projects and programs supported by the Instrument for Pre-Accession Assistance (IPA), as well as implementation of cross-border cooperation programs funded by the EU. The Budget Memorandum has been used as a basis for development of the EFP that was submitted annually to the EC, with a chapter on structural reforms.

In addition, in line with the Budget Law and the Guidelines for Budget Preparation, the budget beneficiaries are supposed to conduct medium-term quantification and assessment of effects of new policies and national investment priorities.

## 2.2. Institutions

*The Ministry of Finance* manages the budget preparation process, developing the medium-term forecast, preparing the Fiscal Strategy Report, issuing budget instructions, negotiating with the direct budget beneficiaries, developing the draft budget, and handling budget execution and accounting and reporting (through the Treasury Administration). Two key departments concerned with budget preparation are the Macro-Fiscal Analysis Department and the Budget Department. Both are understaffed and have for years been responding to numerous pressures and attempting to reach the fiscal targets.

*Direct and indirect budget beneficiaries, OCSI and lower levels of government* provide inputs in various stages of the budget process. In the early stages, as the law stipulates, they are obliged to provide inputs for determining the priority funding areas. In earlier years, this was when they submitted their inputs to the



MoF regarding structural reforms for the Budget Memorandum. Direct budget beneficiaries are represented in the annual budget, whereas indirect ones are normally subordinate to them and not visible in the budget. Direct budget beneficiaries constitute the ministries, agencies, services, and special organizations of the government, as well as directorates, institutes, the judiciary, the Parliament, the President, and administrative districts. They are represented by chapters and sub-chapters in the annual budget. The current estimate of the total number of budget beneficiaries in Serbia, both direct and indirect, is around 9,000.

*Organizations of compulsory social insurance:* Social security funds dealing with pensions and disability insurance, health care, and unemployment constitute separate budget entities, with their own revenue sources from social security contributions. For purposes of budget classification and accounting they are treated as a separate level of government, and their financial plans are not shown in the budget in entirety. The financial plans of these organizations are submitted to the Parliament together with the budget so that the legislature has a full view of all expenditure and revenue of the central government, but the amounts shown in the budget are only those transferred for the purpose of financing the funds' shortfalls. These amounts are represented as transfers to another level of government under classification code 464.

*The Cabinet* is fully involved in the budget process. It reviews and adopts the Budget Memorandum, the Fiscal Strategy Report and macro-fiscal projections and its revised version; it reviews the draft budget and forwards the budget bill to the Parliament. The role of the government in budget preparation is far more influential than that of the Parliament.

*The Fiscal Council* was established in 2011 as an independent body in charge of monitoring and improving fiscal accountability by conducting an independent analysis on fiscal policy as presented in the Fiscal Strategy Report. So far its impact on the budget has been quite limited.

*The Parliament* has a relatively limited role in fiscal affairs in Serbia. It approves the annual budget and financial plans of the organizations of compulsory social insurance and formally sanctions financial liabilities of the government by providing its consent to the limits of borrowing and the total amounts of guarantees that can be issued. The law stipulates that should the Parliament propose any amendments that may lead to an increase of the expenditures in the proposed budget, such amendments must be accompanied by a proposal to decrease expenditures elsewhere or a proposal to increase revenue. In the event that the Parliament does not approve the budget before the start of the budget year, the government must come up with temporary financing based on the first quarter of the previous year. Should any substantial changes to appropriations be required during the budget year (such that they exceed the 5% that can be sanctioned by the MoF), the Parliament must approve them by adopting a supplementary budget.

*The General Secretariat of the Government (GS):* as part of its overall reform agenda and obligation to modernize current practices and become a focal point of policy coordination at the Centre of Government, the GS has started

strengthening policy planning capacities in the line ministries (LMs) and special organizations and services of the government. It has recently assumed a leading role in creation of a wide empirical base, using data submitted by LMs to facilitate the alignment of the sector strategies and policies with the available budgetary funds. Despite relatively modest results so far in collecting impact assessments and performance indicators, the efforts of the GS can contribute significantly to the eventual introduction of program budgeting in Serbia.

Within the scope of this effort the GS has been requiring the executive branch of the government to develop inputs for the Annual Government Plan (policy proposals) for the medium term in the form of programs and projects. It has also required them to provide aggregate financial information for programs and projects, by sources of funding. The quality of submissions is largely contingent on two main factors: strategic priorities that are supposed to be defined by the government on the basis of their four-year program at the start of each annual planning cycle, and the timing and reliability of the budget ceilings set by the MoF. These top-down elements are still missing from the overall process.

This effort constitutes one segment of the overall intention to introduce and enforce an integrated planning system that will entail close cooperation between the CoG and the MoF. These efforts are partly in response to recommendations in 2011 from OECD/SIGMA that will be detailed later in this study.<sup>49</sup>

## 2.3. Procedures

The process is regulated by the Budget Calendar,<sup>50</sup> an integral part of the law on the 'Budget System.' The calendar has undergone considerable changes in the second most recent amendment, to allow sufficient time for preparation of the Fiscal Strategy Report. Given that it had largely affected the actual process of development of budget beneficiary submissions and the budget itself, some of the deadlines have been pushed back subsequently. The process starts with collection of inputs from budget beneficiaries regarding the "priority funding areas including the medium-term public investment priorities," development of a forecast of relevant macroeconomic parameters, and a specification of fiscal objectives for the medium term. This initial phase results in an FSR containing a medium-term macroeconomic framework, the main fiscal parameters for the upcoming years, and information on the government's main policy priorities. The MTEF is instrumental in setting the budget beneficiary ceilings that comprise a part of the FSR.

The FSR is prepared by the MoF's Macroeconomic and Fiscal Analysis Department. The deadline for its adoption is June 15. Until the recent changes of the law, the deadline for adoption of the Budget Memorandum was May 15, which allowed more time for budget beneficiaries to prepare their submissions. The revised FSR, containing information on financial and other effects of new

49 OECD/SIGMA Assessment of Serbia, 2011.

50 The Budget Calendar is presented in Appendix 6.1.

policies and taking into account the macroeconomic framework updated after April 15, is adopted by the government by October 1 and forwarded to the Parliament by October 15. The FSR is the basis for preparation of financial plans of budget beneficiaries and subsequent preparation of the budget.

According to the new budget calendar, the budget instructions are disseminated to the budget beneficiaries on July 5, with submissions due by September 1. This significantly shortens the period for development of submissions compared to the earlier budget calendar, which stipulated the issuance of the circular on June 1.

The Budget Instructions<sup>51</sup> include a general introduction with an overview of main fiscal rules; an overview of the main economic assumptions and fiscal trends and constraints, including the forecast of key macroeconomic indicators for the following year; clarification of the ceilings; guidelines for planning and presentation of individual categories of expenditures, in line with the ceilings, by organization and expenditure category; instructions on how to prepare justification of individual requests; and detailed technical instructions on how to complete the enclosed forms.

The budget submissions should contain the financial requests of the first-line budget users for their activities over the forthcoming year. These are presented in spreadsheet format and accompanied by a narrative justification of all requests. This text is supposed to serve as a basis for development of the annual budget explanation that is mandatorily submitted to the Parliament together with the budget, and should also be based on medium-term plans (operational) that the ministries produce over the planning cycle. It is presently not known to the author to what extent the narratives and medium-term plans are used in devising the overall budgetary justification, as the latter is not available.

October 15 is also the date when the MoF forwards the draft budget to the government. The latter is obliged to adopt the bill by November 1 and send it to the Parliament for deliberation and adoption no later than on December 15.

The annual budget is still developed and presented according to the line item division of expenditures. It consists of two parts<sup>52</sup>: a general section with key fiscal information, and a detailed one with information about expenditures of the direct budget beneficiaries. The detailed section presents financial plans of direct budget beneficiaries in line with the division of fiscal power between the legislative, executive, and judicial branches.

Appropriations are presented in line with the uniform budget classification, used for both preparation and execution of the budget and consisting of organizational, functional, and economic classification, and classification of the sources of funding. Five “pilot” ministries have their budgets presented according to the programmatic structure. However, not even the program budgets of the pilot ministries provide sufficient information about the details of the activities. A sample program budget of one ministry is provided in Appendix 6.1.

51 The BSL Article regulating the content of the Budget Instructions is provided in Appendix 6.2.

52 Law on the ‘Budget System’, article 28.

### **3. Incorporation of structural reforms' fiscal costs into fiscal programming documents**

#### **3.1. Assessment of the overall framework**

There is no definition of structural reforms. The processes and procedures for collecting inputs for medium-term fiscal programming and budget preparation do not provide clear instructions (if any) on how to present information and costs for structural reforms and other government policies. There are still no structured mechanisms in place to collect information on new policy priorities.

Although the law stipulates an obligation to present the fiscal impact of structural reforms and other policies in the Budget Memorandum/FSR, nowhere does it provide a definition of structural reforms. Furthermore, in implementing the legislation, the instructions for submission of funding priority areas and/or structural reforms do not contain sufficiently clear guidance to budget beneficiaries as to how to develop and present the requested information.

Budget preparation is still an incremental, bottom-up process heavily focused on a division of expenditure into line items, with limited attention to performance-related aspects. The expenditures presented in the detailed part of the budget must contain the costs of implementing structural reforms; however, these costs are merged with others belonging to the same economic classification level and are rarely emphasized by way of explanation of the structure of appropriations.

#### **3.2. Structural reforms in the Budget Memorandum**

This section will discuss how structural reforms are represented in the Memorandum on Budget, Economic and Fiscal Policies for 2011 with the projections for 2012 and 2013. This was the last Budget Memorandum published before introduction of the FSR; it contains essentially the same information, including details mandated by the latest amendments of the law that had introduced provisions on fiscal sustainability. This Memorandum provides the most up-to-date information on the state of play in implementing structural reforms, and will be used to illustrate the type of information presented. The structure, type, and quality of information contained there do not differ from the previous years' Memorandums and can be considered a sufficiently representative example of how structural reforms are dealt with in Serbia's medium-term fiscal programming document.

The collection of information on structural reforms was coordinated by the MoF's Department for Macro-Fiscal Analyses and Projections, working with relevant stakeholders in the design and implementation of the policies. The process normally started with the MoF issuing a letter to all relevant Ministries,

asking them to present an update on the implementation of structural reforms with a realistic plan and objectives for the upcoming period. Since, as a rule, the letter itself did not specifically ask for assessment of future fiscal implications, the submissions returned did not provide these data. Instead, the data in the Memorandum pertains only to historical information, e.g., of completed privatizations and implemented measures. However, the absence of data on the fiscal impact of structural reforms in medium-term fiscal programming documents and, subsequently, the budget is not only due to an absence of clear instructions and enforcement of existing legislation, but also the fact that in past years there has been a severe delay in implementing structural reforms.

Chapter IV of the Memorandum contains information on structural reforms for the period 2011–2013 and is organized in two sub-sections, the first giving a general overview of the reforms of the real, financial, and state sectors, and the second outlining future trends of sectoral reforms.

The first sub-section starts with an introduction on the progress of implementing structural reforms, noting that the global economic crisis had slowed the implementation of economic reforms in 2009, but also anticipating that the pace would pick up. It emphasizes that privatization and creation of a competitive environment and conditions for free market competition are of key significance for long-term economic growth and macroeconomic stability. Listing the key economic reforms to be implemented in the following three-year period, it moves on to describe the state of play and intentions for specific areas of structural reform. For the real sector, it discusses the general direction in which reforms will be carried out—improving the business environment (abolishing unnecessary laws and improving others to reduce the administrative burden on the economy, adopting new legislation to strengthen corporate management, resolving ownership and restitution issues, continuing anti-corruption activities) and an increased role for the private sector (finalizing the process of privatization, corporatizing all major state-owned companies, restructuring large public enterprises, and reducing state subsidies over the medium term).

It then provides details of privatization of socially owned enterprises (e.g., the number of companies sold through 2010, the price, investment) and the plans to sell remaining ones. It does not, however, provide a list of companies to be privatized, nor the schedule or impacts of privatization. The section on privatization and restructuring of public enterprises outlines plans to continue restructuring of Serbian railways, roads, postal services, telecom, JAT Airways, utility companies, etc., over the medium term. The same approach is applied to describing the liberalization of infrastructure, protection of competition, incentives to export, and development of SMEs. More details are provided on the situation in the financial sector, particularly the banking sector, where Serbia has made the most progress. The rest of the chapter presents information in a similar manner, with historical data on progress to date, a narrative description of the significance of reforms in individual areas, and Serbia's intentions over the three-year period.

As noted, the Budget Memorandum has provided a basis for the Economic and Fiscal Programme, and the chapter on structural reforms is required in the EFP. In fact, the EFP is a somewhat shortened version of the memorandum, with almost identical information on structural reforms, both in terms of quality and comprehensiveness. The same constraints involved in development of the memorandum's section on structural reforms apply to the EFP.

Upon reviewing the EFP, the EC stated that the program was “generally comprehensive and sufficiently detailed, and had covered the main areas of structural reforms carried out over the previous period”. The most notable deficiency was the fact that the presented information was solely narrative and was not accompanied by any cost-benefit analysis, impact assessments, or implementation schedules. In the 2011 Occasional Paper addressing the quality of the Serbian EFP for 2011–2013, the EC noted:

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The programme outlines a comprehensive structural reform agenda covering a wide range of areas in the public domain, which aim to foster economic restructuring, enhance competition, stimulate employment and rationalise social spending. In particular, broad consensus has been reached regarding the need to advance structural reforms in support of industrial sectors at the high value-added part of the productive chain, which will attract FDI, bolster export expansion and create job opportunities. However, roadmaps and timetables for the implementation of the most important reform measures over the medium term, as well as assessment of their budgetary impacts are largely missing. Reforms that are crucial for enhancing the role of private sector and may also have sizeable budget effects, such as enterprise restructuring and privatisation as well as creating a business-friendly environment, are long overdue and need to be tackled without further delay.

As regards the structural reforms framework, the presented information is comprehensive. It confirms the policy priorities but does not provide detailed roadmaps and timing for reform over the [medium term]. It does not specify the features of the adjusted pension and healthcare systems. The absence of cost/benefit analyses and implementation schedules hinders the evaluation of the fiscal sustainability of the structural reforms. To reinforce confidence in their medium-term economic and fiscal programme, the authorities will need to spell out a convincing and comprehensive implementation strategy to enhance growth, competitiveness and employment.

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As a result of these observations, Serbia's EFP for 2012 seems to have improved. Although the content is still largely narrative and the information quite similar to the previous year's memorandum, the document provides some information on the likely impacts that specific measures may have. For instance, from improvements of the health care system (i.e., improving the collection of all contributions paid by self-employed persons) savings in the budget could amount to approximately 0.9% of GDP; improvements in the education system are expected to yield savings of up to 0.1% of GDP; reform of the social welfare system would result in savings of 1.2% of GDP; and so on. The document includes a table with the fiscal implications of the proposed measures. However, given that it lists the IMF and the World Bank as sources, the numbers seem to have been derived from these international recommendations, rather than actual collection of data from the ministries.

The linkage between the annual budget document and the memorandum is not as strong as it could be. Although the MTEF in the memorandum allows the establishment of budget ceilings, the translation of these ceilings into Line Ministry budgets that are fully reflective of a policy framework (developed through sector strategies and an integration of investment and recurrent expenditures) has yet to be developed. In technical terms, key reasons are the absence of program budgeting and a link between strategic plans and budgets. Since the budget is still presented according to the line item division of expenditures using the budget classification (economic, functional, organizational, sources of funding), it is not easy to identify the expenditures allocated for implementation of specific structural reforms. Until recently, the MoF was reluctant to further advance any substantial reforms of the budgeting process, particularly by introducing a program budget. This situation seems likely to change with the arrival of the new minister, who has started implementing numerous changes after coming into office.

The Budget Memorandum and the EFP present data based on an optimistic scenario. The medium-term fiscal strategy projects a gradual reduction of the general government deficit from 4.3% of GDP in 2012 to 2.9% in 2014, based on an expenditure-led adjustment. In 2011, the general government deficit was almost unchanged at 4.6% of GDP; however, the downward revision of the 2011 GDP changes ratios to GDP, notably increasing deficit and debt (over 5% and 45% respectively).

The situation is further aggravated by the considerable 2011 tax revenue shortfall of more than 2 percentage points compared to 2010 (value-added and personal income taxes, particularly).

As noted, there has been a lack of commitment to implementing structural reforms. Both the Budget Memorandum and the EFP announce structural adjustments in health care, education, and social welfare, which are expected to curb public spending. In cumulative terms, the planned reforms are estimated to foster savings of around 1% of GDP over the next three years, but they offer no action plans and deadlines for implementation nor any fiscal effects.

Overall the macroeconomic, social, and political conditions are quite fragile, and the government has been directing most of its efforts to reaching (or staying close to) fiscal targets and maintaining a reasonable degree of social stability.

The allocation of budget funds is still largely incremental. In terms of dynamics between the MoF and the budget beneficiaries during the budget process, the beneficiaries' submissions are typically inflated (ask for more than needed, to get enough), whereas the MoF is trying to keep expenditures within the available constraints. Also, ministries with significant political influence tend to get almost all they ask for, thus diminishing funds available for the rest of the budget, while the MoF is forced to make cuts across the board wherever possible to stay within the deficit target and partly accommodate the expenditure needs. This often leads to some budget beneficiaries being unable to finance their commitments, even in situations where their submissions were presented realistically and based on detailed quantifications of future obligations.



The table presented in Appendix 6.5 contains excerpts from the 2011 Budget. The few ministries chosen are those in charge of major structural reforms of the real sector and public enterprises (ministries of economy and regional development, infrastructure, and telecommunications) or research and innovation (ministry of science). The list of ministries is not comprehensive, nor does the table give all of the expenditures for the selected ministries; information presented serves only to illustrate how funds are presented in the budget.

Sector strategies are prepared for all key sectors, but in the absence of a functioning MTEF, they do not include costing of investments and recurrent expenditures. Structural reforms are largely represented in numerous sectoral and national strategies, but few of these contain cost-benefit analysis or assessment of fiscal impacts, despite the explicit legal requirements.

A study of the 74 strategies (national and sectoral), commissioned by the General Secretariat of the Government in 2010, highlighted numerous deficiencies in the quality of information presented.<sup>53</sup> The study analyzes strategies developed in the period 2001–2010 and their recommendations for improvement of the strategic framework. These documents cover the following areas: economy and finance; infrastructure (information and communication technology, energy, transport); agriculture, forestry, and environment; employment, social welfare, and health; education, science, youth, and sport; public administration, judiciary, and human rights; and defense and foreign policy.

The analysis considered all aspects and mandatory elements of the strategies, and among other observations it pointed out that two-thirds of the strategies contain schedules and timelines (action plans) for implementation, whereas about 70% of the strategies do not contain any cost assessments. In terms of impacts, 50% of the documents analyzed contain qualitative analysis of the impacts, whereas only a small proportion present quantification of the impacts of proposed measures.

A key recommendation was that a strategic document could become operational only once a close link between strategic measures and the budgeting process is established. This requires a systemic change in the budgeting process, but also additional training of civil servants to build their capacities for developing analyses and assessing economic impacts of policy measures as well as the overall process of policy development and project management.

It is only when policy and planning are effectively established, and translated into expenditures that reflect priorities, that the Serbian MTEF will reflect both the bottom-up and top-down features of an effective and functioning MTEF. The current MTEF emphasizes the top-down element, whereas the lack of an overall policy-based budget, notwithstanding the pilot program budget in five ministries, ensures that it remains only a partial MTEF.

The absence of general government consensus on the need to address the weaknesses of the overall planning and programming system—so as to achieve both fiscal sustainability, effective design of economic policy measures, and

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53 The number of strategies is continuously growing and currently exceeds 112.



better practices in line with recommended European and international models—hinders further progress towards including the fiscal costs of structural reforms in the budget documents.

Most donor support, including from the EU, is implemented through programs and projects. Planning, adoption, implementation, and monitoring and reporting of these are taking place largely outside of the government system, and parallel structures are created for these purposes (particularly for management of EU funds). Donor projects normally use the parallel systems managed by the Deposit Insurance Agency, which itself is outside of the government system. Financial information on donor programs and projects is insufficient for budgeting and reporting purposes.

### **3.3. Assessment of the institutions**

The MoF, as the “owner” of the fiscal programming and budget preparation process, has yet to develop capacity and procedures for incorporating the fiscal impacts of structural reforms into budget documents. Its two key units, the Macro-Fiscal and Budget departments, are severely understaffed and have been responding to the external pressures from the spillover of financial crisis and attempts to meet fiscal targets. Little attention has been given to changing and reforming budgeting practices, or to introducing and enforcing mechanisms that will enable early debate on policy priorities based on relevant analyses.

During the first five years of economic transition, which started in 2001, Serbia made significant progress in achieving macroeconomic stabilization and advancing structural reforms and reforms in public financial management as championed by the MoF. However, the political gridlock since 2006 has prevented further progress on the structural front and further budgetary reforms.

Since 2007, virtually no reforms have been carried out by the MoF. The government has been focusing on addressing and alleviating external and internal pressures caused by the financial crisis and other factors, and it has faced severe budgetary constraints. It has mainly dealt with reaching the fiscal targets, striving to remain within the limits of forecasted deficit, and shaping fiscal policy to change the structure of public expenditures towards increasing investments, improving fiscal discipline, and limiting overall public expenditures. It is thought that fiscal pressures will reach their peak in mid-2012 and that the new government will be able to seek more long-term solutions for continuing budgetary and fiscal reforms. Additional impetus for implementing these reforms can be found in the improved prospects for EU membership, as Serbia was granted candidate status in March 2012. Thus, better management of public funds becomes a key tool for more efficient use of public resources over the medium term.

Fiscal sustainability over the medium term will largely depend on further implementation of structural reforms (particularly of pension, health, and education systems and the public enterprises) and the re-launch of the

comprehensive reform of the budget system, including the introduction of program budgeting and of an integrated policy planning and budgeting system.

The MoF faces a severe problem of limited capacities as well as partial loss of leadership resulting from reorganization in the pilot ministries. This has meant poor expert and institutional support for introducing program budgeting. This reform, begun in late 2005 and introduced initially in five pilot ministries in the 2008 budget, gradually slowed, then stopped altogether. The quality and structure of the program budgets themselves, as well as the process of introducing them, has been the subject of many assessments and criticisms. Although the first attempts to introduce program budgeting were far from perfect, they still entailed rather reliable information about inputs and created a fairly solid basis for further improvement of data and methodology.

However, the introduction of program budgeting has not started in parallel with development of the MTEF and the development and implementation of an integrated policy planning and budgeting system. Instead, it was viewed as a standalone exercise, with efforts mainly focused on developing budget preparation instructions, programmatic classification, and IT tools.

The budget circular does not accommodate clear presentation of the fiscal impact of government policies, and in general the policy development and budget preparation processes take place independently of one another. The budget circular does refer the budget beneficiaries to the Rules of Procedure of the Government that stipulate the obligation for public administration bodies to submit plans containing the “goals and operations of the Government, as well as goals and operations of the public administration bodies, and the expected results within the constraints of the budget funds” and to coordinate these plans with their budget submissions. However, this is as far as the integration of policy and financial planning goes at present.

The appropriations in the budget document surely contain expenditures for financing of structural reforms; however, in some cases these are merged with other expenditures planned under the same economic classification code, and at best, are clarified only in a brief explanation of the appropriation.

Limited capacities in the financial departments of line ministries are also an issue, as these limitations can significantly affect their capabilities to perform the necessary assessments and analyses of policies aimed at addressing the goals and long-term priorities of the ministry and the government.

However, in 2006 the LMs started receiving external technical support through a project that strived to develop the government’s methodologies and skills, through training, in the area of project, strategic and operational planning as well as monitoring and reporting. This effort was initially designed to provide assistance to both the MoF and the LMs in introducing program budgeting. The initial response of the LMs was encouraging, and their rate of response in submitting plans in the early years was quite impressive. Over the years, however, as the MoF failed to utilize the support and its results, the interest and motivation of the LMs have dwindled. Nevertheless, more than 500 civil servants across all ministries have been trained to develop operational

and strategic plans. Interest has picked up again when the General Secretariat started to require that ministries develop their inputs for the Annual Government Work Plan in line with the above-mentioned methodologies.

### **3.4. Assessment of the processes**

There are no processes and procedures for systematic incorporation of fiscal costs into Serbia's fiscal programming documents. In terms of overall policy coordination, Serbia has little experience. This has been the subject of criticism from the EU based on assessments carried out by OECD/SIGMA.

The essence of policy coordination is to assure that proposals from specific ministries are prepared in line with an appropriate process and with the government plans and priorities, and that they are not contradictory with other plans. This function naturally belongs to the General Secretariat because of its link to the Prime Minister and the collective role of government sessions in policy-making, and because the Centre of Government is normally already responsible for annual planning, which is the main output of integrated planning.

The GS has a central role in specifying, promoting, and using tools to increase policy coherence. It is responsible for establishing, updating, and enforcing procedures for preparing and submitting proposals to the government. It must be able to provide policy coordination, analysis, and advice so as to facilitate the flow of high-quality information to the sessions of the government, and to ensure that the majority of conflicts, especially technical ones, are resolved before items reach the government.

One of the roles of the GS is to establish procedures for policy analysis. While the ministries are in charge of developing and preparing proposals, the GS is in charge of defining the rules for presenting these to the government: the types of supporting information and analysis that submissions need to include. The GS normally prepares instructions to ensure that the most important issues are addressed in a short summary in the required format. This is intended to unify the process of preparation and facilitate easier review of the proposals.

Within this function, the GS role is to ensure that sectoral and cross-sectoral issues have been considered; that the ministries' proposals are accompanied by relevant analyses (fiscal, economic, environmental); to ensure that these are in line with the government's strategic and budgetary priorities and that any disagreements between ministries are resolved prior to the government sessions; and that the Prime Minister and committee chairs are briefed on all issues forwarded to the government for decision.

The government has been working to modernize the GS as the central focal point of policy coordination. Despite the efforts, progress in this area remains slow. OECD/SIGMA 2011 observes that "The government should establish more top-down elements to its policy planning by introducing a clearer strategic planning process that sets out the main objectives of government policy. Line ministries, following those main objectives, should prepare their own strategic plans with objectives and timescales including an assessment of the

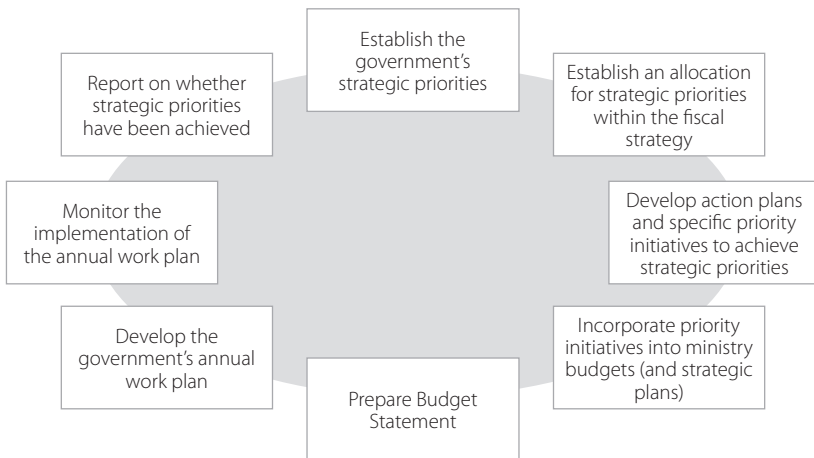
resources that will be required. It is important to ensure that the main policy priorities of the government are driving the administrative work plans of the government and ministries. With a more top-down approach and right timing, the work plan of the government could serve as key strategic input to the budget planning process and also as a tool to better integrate the agendas of the political and administrative leadership.”

In response to the assessment quoted above, the GS has commissioned the development of an integrated policy planning methodology and model, which would ensure that all relevant institutions (LMs and special organizations) are able to plan and implement policies supporting the government’s strategic priorities.

The purpose of the methodology is to define the integrated strategic planning system of the government, to specify the stages in the planning process, and to spell out the roles and responsibilities of the key bodies involved. The methodology integrates the strategic planning and the budget processes through a set of logically linked activities and timelines that ensure the setting of the government’s strategic priorities and the fiscal framework, establishing links to the budget and the ministries’ medium-term (strategic) plans and translating these into the Government Annual Work Plan.

An interpretation of the proposed integrated planning framework by the General Secretariat is provided in the figure below.

**Figure VII-1: Proposed integrated planning framework**



Source: General Secretariat, 2012.

In the current system, instructions sent by the MoF to the LM on quantification of structural reforms and other policies remain quite unclear and ambiguous. In earlier years, responses returned by the budget beneficiaries, when asked to provide updates on structural reforms, were merely narrative descriptions of the state of play. Today, the forms sent out do not mention structural

reforms or policy priorities, and instead, require budget beneficiaries to express their financial requirements by “purposes”.

The legal requirement to present the fiscal impacts of structural reforms and other policies is not consistently enforced. The ministries may be implicitly expected to provide such information; however, in instances when they fail to do so, no additional effort is made to ensure their delivery.

In 2011 the Budget Department of the MoF issued instructions for submission of the priority funding areas. These consisted of elaborate spreadsheets and requested details of expenditure; however, they provided little explanation of requirements and used confusing terminology, requiring budget beneficiaries to present the quantification of (what essentially should have been) policy priorities, including strategic reforms, by calling them purposes. The term “purpose” has been used to denote not only policy priorities but also programs, projects or similar (for the majority of non-program ministries). Furthermore, without a ceiling, even indicative and based on previous years’ medium-term forecasts, the instructions limited the budget beneficiaries to a maximum of five programs and priorities. The entire process was conducted without a common understanding (in the MoF itself) of its purpose or expected results. The data collected yielded varied results, which could not have been adequately evaluated as the initial requirements were so confusing.

Based on the analysis of chapters on structural reforms in earlier years’ Budget Memoranda, the LMs seem to have a fairly good grasp of the concept and definition of structural reforms. However, despite the fact that it is legally mandated, the MoF has not yet devoted due attention to devising procedures for incorporating the fiscal impacts of structural reform in budget documents, and this particular issue cannot be addressed at present.

Furthermore, the requirement of the Rules of Procedure of the Government are not enforced where they stipulate that new policy proposals and legislation, as well as new strategies, are to be accompanied by relevant analyses, such as fiscal, policy, and regulatory impact assessments.

Some ministries do carry out impact and cost-benefit analyses at their own initiative while developing their sector strategies, but these instances are also quite rare and are not represented in the budget documentation in a transparent manner.

There are no government-endorsed rules or methodologies and/or trainings designed to provide the LMs with appropriate knowledge, tools, and skills to carry out the required analyses. Some attempts have been made, but they are isolated, ad hoc, and far from sufficient; these have mainly been initiated externally, by technical assistance projects.

## 4. Conclusions and recommendations

### 4.1. Conclusions

The capacity and procedures for effectively integrating structural reforms' fiscal costs into the budget are yet to be developed.

Budget preparation in Serbia remains an incremental, bottom-up process heavily focused on appropriations, 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 Fiscal Strategy Report (formerly the Budget Memorandum), containing a medium-term macroeconomic framework, main fiscal parameters for upcoming years, and information on the government's main policy priorities. The FSR is prepared by the Macroeconomic and Fiscal Analysis Department in the MoF, with some input from other departments. By law, the FSR has to be adopted by the government by June 15 and should constitute the basis for continued preparation of the state budget and the financial plans of the extra-budgetary funds. An updated version should be submitted to the Parliament together with the budget proposal. Once the MoF has finalized the draft budget, it is submitted to the government for approval. By November 1, the government is required to submit the proposed budget to the Parliament, which approves the budget, in a single voting session, by December 15 at the latest.

Although the MTEF in the FSR allows for establishment of budget ceilings, the translation of these ceilings into LM budgets that are fully reflective of a policy framework, developed through sector strategies, and integrating investment and recurrent expenditures, has yet to take place. It is only when policy and planning are effectively established, and translated into expenditures that reflect priorities, that the Serbian MTEF will reflect both the bottom-up and top-down features of an effective and functioning MTEF. The current framework emphasizes the top-down element, but the lack of an overall policy-based budget (notwithstanding the pilot program budgeting in five ministries) ensures that it remains only a partial MTEF.

Planning and budget formulation is weak and as a result limits both allocative and technical efficiency in delivering services that reflect government policy. There is need to improve planning and budget formulation in LMs to fully reflect policy priorities established through the MTEF. Specific attention needs to be directed at formulating costed sector strategies and improving the overall capacity to implement the investment cycle, starting at the identification of project possibilities and continuing through the selection of projects for execution linked to individual ministries' priorities. The consequence of these weaknesses is that resource allocation linked to ministerial priorities is ineffective, and the center allocates the budget as it sees fit rather than through an allocation based on sector expertise. Transparency under these circumstances is doubtful.

As long as policy-making, planning, and budgeting continue to take place independently of each other, it will be impossible to direct resources to budget priorities. Presently budgeting is considered an annual funding exercise, rather than a policy-based one, and the unpredictability of funding is one of the main factors that contribute to poor performance of the public sector. In the absence of effective decision-making processes, policy-making and planning are disconnected from one another and from budgeting, and they are not shaped as they should be by resource availability or by strategic priorities. Hence there is a persistent discrepancy between needs and the availability of funding, and the annual budget process remains a mechanical process of allocating funds to keep things afloat.

All of these efforts clearly require a sufficient number of skilled staff both in the MoF and the center of government, but also in the LMs. However, key problems in this area include understaffing, resistance to change among existing civil servants, and relatively low salaries that present an obstacle to hiring new, adequately skilled staff. Retention is an issue as well, not only because of the low remuneration levels but also because of relatively high politicization, which results in staff turnover when the government changes.

## 4.2. Recommendations

The capacity for reform must be enhanced. Changes must be based on clearly defined objectives, with an emphasis on clear allocation of roles and responsibilities of various actors in the PFM process and on creation of proper cooperation and coordination mechanisms, to ensure unambiguous setting of responsibilities.

The Public Expenditure and Financial Accountability (PEFA) assessment has pointed to weaknesses in policy and planning and, as a result, in budget formulation, which still focuses on aggregate expenditures rather than a distribution to spending agencies that reflects their policies and plans. Strengthening control by improving accounting systems, internal audit, and internal control is important, but without the expenditure being fully focused on service delivery, expenditure will be limited in terms of effectiveness and efficiency. While there has been a pilot project in introducing program budgeting to five ministries, this has not been as effective as it should be and requires not only greater involvement from the MoF in ensuring the budget is reflective of policy and plans but also from the GS and Cabinet in ensuring that there are integrated policies and plans to convert to expenditures through the budget. Such a reform can only be implemented over a number of years, but the basic building blocks of a budget law, a defined budget calendar, medium-term resource envelop estimation, and setting of ceilings are in place.

Program budgeting should be introduced in all ministries. The existing processes and procedures should be critically assessed, and the methodology should be revised and aligned with good budgeting practices. Capacity



should be developed in both the MoF and budget beneficiaries, and program budgeting should be rolled out. This should, over time, ensure stronger links between the Budget Memorandum and the budget and a clearer presentation of the fiscal costs of all major policy measures, including structural reforms. The budget preparation documentation and the budget itself should be changed to increase transparency and clarity of information in all stages of medium-term fiscal programming and the budget preparation process, so that the fiscal impacts of structural reforms can be appropriately presented. The budget should be reformed, and program budgeting should be rolled out to all budget beneficiaries, so that programs may reflect not only the costs, but also the objectives and progress of structural reforms over the medium term.

The government should enhance coordination at the preparation stage to ensure consistency of fiscal, monetary, and structural policies. There is a need for clear allocation of roles and responsibilities between the GS, as the focal point of policy coordination, and the MoF. For this to happen, institutional reforms must be accelerated and pursued in both institutions.

Existing legislation should be enforced and amended as needed to ensure that impact assessment is mandatory. Any and all ambiguity regarding the definitions of structural reforms, policy impacts, and funding priorities must be removed, and proper explanations of the concepts should consistently be applied.

Capacities across all ministries should be built to develop the required analyses. Training programs, both locally and in international training centers, should be designed to equip the relevant staff with knowledge and skills required to adhere to the requirements. Ideally, a technical assistance program should be designed for the MoF to assist the relevant staff in absorbing the new functions.

Introducing an integrated policy, planning, and budgeting system will enable that expenditure programs are driven by policy priorities and disciplined by budget realities. A key to this is having an effective center of government/GS and an effective MoF, as well as associated institutional mechanisms that facilitate the making and enforcement of strategic priorities and resource allocation decisions based on sound analyses within the budget constraints. The strategic plans of the ministries should be fully reflected in the budget, once program budgeting is introduced.

The MoF and GS must prepare an initial framework that contains a review of the economic and fiscal situation and prospects, aggregate fiscal targets for the period, and the key strategic and policy issues, and that proposes sector allocations to budget beneficiaries. Coordination between the MoF and the GS is particularly important to generate a joint submission to the government at the beginning of the cycle and to collaborate in the review of the proposals from government bodies.

It will also improve budgetary outcomes over the long run to introduce the top-down element by way of strategic priorities which include the



implementation of structural reforms, to establish an appropriate mechanism for presenting required information, and to insist that the required information on fiscal impacts be presented without exception.

The envisaged links between the government planning and budgeting processes are presented in Appendix 6.6.

Furthermore, appropriate mechanisms that promote consultation and debate should be introduced. Such mechanisms will ensure that the overall medium-term fiscal programming and budgeting procedure take place within the context of strategic decision-making, so that the budgetary decisions are based on the most cost-effective policy options. To develop these consultation mechanisms, technical procedures need to be established and enforced to ensure that policy proposals are adequately debated on the basis of their merits, founded on analyses, before submission to the government.

Decision-making needs to be underpinned by resource availability: this involves introducing mechanisms that translate political vision into strategic policy choices within an affordable financial envelope. This is achieved not only by introducing appropriate legislation, but also by introducing institutional mechanisms that ensure the transparency of the costs and benefits of competing policies, mainly by further strengthening of the MTEF. Therefore there must be capacity at the MoF and the CoG/GS to evaluate policy options coming up from the ministries and ensure they fall within the aggregate fiscal constraints.

Existing legislation should be enforced and, where appropriate, amended to describe the roles and responsibilities of the ministries, including the type of analyses that must be performed (cost-benefit, policy impact assessment, regulatory impact assessment, etc.) and the discussions of policy proposals and fiscal impacts of structural reforms that should take place in crucial stages of the budget process.

Templates for preparation and submission of inputs should be developed and the procedures well-structured and clearly explained. All relevant actors, above all those in the MoF, should be appropriately skilled and trained to assume their (new) roles in fiscal planning. In LMs, effective use of the tools requires procedures and capacities to develop policy and legislative proposals of high quality. Specifically, the procedures need to address inter-ministerial and stakeholders' consultations, and there must be capacity to base proposals on valid analysis based both on ex ante assessment of the impacts of proposals, and periodic ex post assessment of results.

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## 6. Appendixes

### 6.1. Budget calendar (according to Article 31)

The preparation and adoption of the budget and financial plans of organizations for mandatory social insurance are carried out according to the budget calendar, as follows:

*Calendar for the Republic of Serbia level:*

- By February 15, the Minister of Finance issues instructions for submission of priority areas of financing, including the medium-term public investment priorities

- By March 15, direct beneficiaries of the budget shall furnish the Ministry with the proposals for determining priority areas of financing for the budget year and the two following fiscal years (in accordance with the instructions referred to above)
- By April 15, the Minister shall forward a Fiscal Strategy Report to the government for preliminary review, which shall contain economic and fiscal policies of the government and projections for the budget year and following two fiscal years, and shall be prepared in cooperation with the relevant ministries and institutions in charge of economic policy and system
- By April 25, the government shall issue its consent to the Minister to prepare a draft Fiscal Strategy Report, which shall contain specific decisions on priority areas of financing including the medium-term public investment priorities
- By April 30, the Minister shall forward the draft report to the Fiscal Council
- By May 15, the Fiscal Council shall issue its opinion on the draft report
- By June 1, the Minister shall forward the proposal of report to the government for adoption
- By June 15, the government shall adopt the report and forward it to the National Assembly for review
- By June 30, the National Assembly shall forward its comments and recommendations on the report to the government
- By July 5, the Minister shall issue Budget Preparation Instructions
- By September 1, direct budget beneficiaries and organizations of compulsory social insurance shall submit their proposals of medium-term and financial plans to the Ministry
- By October 1, the government shall adopt the revised Fiscal Strategy Report (upon proposal of the Minister), with the information on financial and other effects of new policies taking into account the macroeconomic framework updated after April 15
- By October 5, the government forwards the revised Fiscal Strategy Report to the National Assembly
- By October 15, the Minister sends a draft Budget Law to the Government, which includes draft consents to the financial plans of organizations of compulsory social insurance, together with the financial plans of the organizations for compulsory social insurance
- By November 1, the government shall adopt the proposed Budget Law and shall forward it to the National Assembly, together with the proposed consents (decisions) to the financial plans of the organizations for compulsory social insurance and the financial plans of the organizations for compulsory social insurance
- By December 15, the National Assembly shall adopt the Budget Law and the Decisions approving the financial plans of the organizations for compulsory social insurance

## 6.2. Content of the budget instructions

### *Instruction for the Preparation of Budget of the Republic of Serbia*

Following the adoption of the Memorandum, the Ministry shall furnish direct beneficiaries of the budget with the instruction for the preparation of medium-term and financial plans for the preparation of the budget.

The instruction referred to in Paragraph 1 shall contain:

- Basic economic assumptions and guidelines for the preparation of the draft financial plan of the budget beneficiary and draft budget
- Ceilings for the draft financial plans of direct beneficiaries of the budget for the budget year, with projections for the following two fiscal years, determined by the medium-term expenditure scope from the Memorandum
- Guidelines for the preparation of medium-term plans of direct beneficiaries of the budget
- Guidelines and requests for exposition, medium-term quantification and assessment of effects of new policies and investment priorities
- Procedure and schedule for the preparation of the budget and financial plans of its direct beneficiaries
- Guidelines on the style in which the beneficiaries shall present expenditures and outflows in the draft financial plan

## 6.3. Draft financial plan of direct beneficiaries of the budget

According to the instruction for the preparation of the draft Republic budget and medium-term plans, direct budget beneficiaries shall prepare a draft medium-term and financial plan.

Draft financial plan indicated in paragraph 1 hereof shall consist of the following:

- Expenditures and outflows for a three-year period, presented according to budget classification;
- A detailed written explanation of the expenditures and outflows as well as sources of financing.

Draft financial plan of a budget beneficiary shall be submitted in the amount equal to the scope of funds of the first year of the medium-term expenditure framework, defined in the Memorandum.

Parts of the draft financial plan referred to in paragraph 2 of this Article shall consist of a written explanation, comprising also an exposition, medium-term quantification and assessment of effects of new policies and investment priorities, based on the Instruction for the Preparation of the Budget of the Republic and medium-term plans of beneficiaries of the Republic of Serbia funds and financial request.

## 6.4. Costs of structural reforms in the budget for 2011 (excerpt)

Chapter	Subchapter	Function	Economic classification	Description	Budget funds	Additional sources	Total funds
				<b>MINISTRY OF ECONOMY AND REGIONAL DEVELOPMENT</b>			
		<b>410</b>		<b>General economic and commercial affairs and labor related affairs</b>			
			424	<b>Specialized services</b> The amount of 508.2 MM RSD in this appropriation is allocated to the Agency for Foreign Investments and Promotion of Export; the amount of 305.2 MM RSD is appropriated for the Privatization Agency; the amount of 26.0 MM is appropriated for Accreditation Body and the amount of 9.0 MM for other specialized services.	848.4		848.4
			451	<b>Subsidies to public non-financial enterprises and organizations</b> Funds in this appropriation are planned for the Program of Credit Support to economy through the Development Fund, and the allocation and use of these funds will be done in accordance with special legislation of the government.	3,100.0		3,100.0
			454	<b>Subsidies to private enterprises</b> These funds will be used for Greenfield investments in accordance with the Decree on Conditions and Manner of Attracting Direct Investments	2,700.0		2,700.0
			621	<b>Acquisition of domestic financial assets</b> The funds within this appropriation are intended for earmarked loans for incentives for production and exports; for subsidized loans for liquidity, subsidized loans for investment and consumer loans for purchase of domestic products according to the special government program implemented through the Development Fund; for investments of special significance (FIAT car company, and other); other incentives to domestic economy (programs of subsidized sale of domestically manufactured busses, program of replacement of old buses and trucks with new ones; program of subsidized sale of domestically manufactured tractors, trucks and construction machines; program of subsidized housing construction; incentives to productions and overhaul of railroad vehicles etc.); for recapitalization of the Serbian Export Credit and Insurance Agency and its crediting and insurance of exports; the use and allocation of funds will be made according to the special act of the government.	19,780.0		19,780.0

Chapter	Subchapter	Function	Economic classification	Description	Budget funds	Additional sources	Total funds
		412		<b>General Labor Related Affairs</b>			
			464	<b>Transfers to organizations of compulsory social insurance</b> This appropriation is allocated for active employment measures implemented through the National Employment Service, and the allocation and use of funds will be made according to the special act of the government.	3,900.0		3,900.0
		473		<b>Tourism</b>			
			621	<b>Acquisition of domestic financial assets</b> The funds in this appropriation are intended for enhancing the quality of hospitality supply by individuals, small and medium enterprises operating in tourism by means of favorable loans through the Development Fund, and the use and allocation of these funds will be made according to the special act of the government for establishing and financing of businesses and public enterprises for development of tourism in Serbia and touristic destinations in line with the Strategy for Development of Tourism.	2,010.0		2,010.0
22				<b>MINISTRY FOR INFRASTRUCTURE</b>			
				<b>Transport</b>			
		450		<b>Subsidies to public non-financial enterprises and organizations</b>	16,040.6		16,040.6
			451	The funds of this appropriation are planned for the public enterprise of the "Serbian Railroads" and the use and allocation of the funds will be made according to the special act of the government.			
23				<b>MINISTRY OF TELECOMMUNICATION AND IT SOCIETY</b>			
				<b>Communication</b>			
		460		<b>Subsidies to public non-financial enterprises and organizations</b>	325.0		325.0
			451	Use and allocation of the funds will be made according to the special act of the government.			
25				<b>MINISTRY OF SCIENCE AND TECHNOLOGICAL DEVELOPMENT</b>			
				<b>Primary Research</b>			
		140		<b>Subsidies to public non-financial enterprises and organizations</b>	233.0		233.0
			451	Use and allocation of the funds will be made according to the special act of the government.			

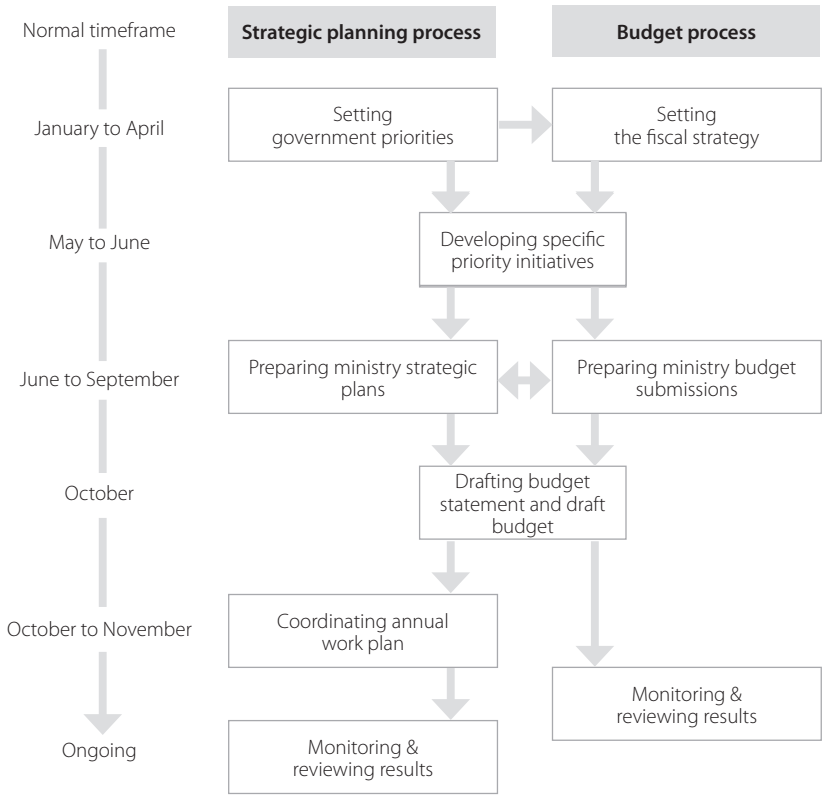
Note: Budget figures in MM RSD. – Source: 2011 Annual law on the 'Budget of the Republic of Serbia'.

## 6.5. Program budget of the Ministry for Public Administration and Local Government (excerpt)

Chapter	Subchapter	Function	Economic classification	Description	Budget funds	Additional sources	Total funds
64	110	0601		<b>MINISTRY OF PUBLIC ADMINISTRATION AND LOCAL GOVERNMENT</b>			
				<b>Executive and legislative bodies, financial and fiscal affairs and external affairs</b>			
				<b>Coordination and monitoring in the area of state administr. and local government</b>			
				<b>development of policies and control</b>			
		0601-01	411	wages and salaries	88.5		88.5
			412	social contributions payable by employers	16.0		16.0
			413	compensations in kind	0.6		0.6
			414	social assistance benefits to employees	2.3		2.3
			415	reimbursable costs to employees	3.8		3.8
			416	awards to employees and other special expenditures	0.0		0.0
			421	continuous costs	4.2		4.2
			422	costs of travel	4.0		4.0
			423	contracted services	141.3		141.3
			424	specialized services	0.0		0.0
			425	current repair and maintenance	1.4		1.4
			426	costs of material	9.9		9.9
			462	grants to international organization	12.6		12.6
			463	transfers to other levels of government	100.0		100.0
			482	taxes, mandatory fees and penalties	0.8		0.8
			512	machinery and equipment	13.0		13.0
				<b>sources of funding for program 0601-01:</b>			
			01	budget revenues	398.4		398.4
				<b>total for program 0601-01:</b>	<b>398.4</b>		<b>398.4</b>
		0601-02		<b>severance benefits to employees in public administration bodies</b>			
			414	social assistance benefits to employees	115.0		
				<b>sources of funding for program 0601-02:</b>			115.0
			01	budget revenues	115.0		
				<b>total for program 0601-02:</b>	<b>115.0</b>		<b>115.0</b>
		0601-03		<b>State examinations for employment in the public administration bodies</b>			
			423	contract services		31.9	31.9
			426	materials		0.2	0.2
				<b>sources of funding for program 0601-03:</b>			
			04	own source revenues of budget beneficiaries		30.5	30.5
			13	unallocated surplus from earlier years		1.5	1.5
				<b>total for program 0601-03:</b>		<b>32.0</b>	<b>32.0</b>

Note: Budget figures in MM RSD. – Source: 2011 Annual law on the 'Budget of the Republic of Serbia'.

### 6.6. Relationship between strategic planning and budget process



Source: General Secretariat, 2012.





## Chapter 8

# Case Study on SLOVENIA

prepared by  
**Helena Kamnar**

**Helena Kamnar** is Advisor to the President of the Republic of Slovenia on economic and social policy, with 35 years of working experience, mainly in the field of public finance. Twelve of those 35 years she worked at the Ministry of Finance.

She began her career at the ministry as Assistant to the Minister, continuing as Advisor to the Government and later being promoted to Director General. Her responsibilities included the budget system, preparation of the budget, and the budget execution. She was appointed by the government to the position of State Secretary at the Ministry of Finance for two terms.

She also worked as a professor of political economy and management at the High School of Economics in Ljubljana. Subsequently she was in charge of health insurance policies at the Ministry of Health. She then held the position of Senior Advisor at the Court of Audit of the Republic of Slovenia and was dealing with the performance audit system. Between her terms as State Secretary at the Ministry of Finance, she spent four years as Vice Rector at the University of Ljubljana responsible for economic affairs. In 2010, she was appointed for Secretary General of the Government. She was also a member of the Negotiating Team for Accession of Slovenia to the European Union.

# 1. Introduction

The objectives of the case study are to assess how Slovenia incorporates structural reforms into national budgets and medium-term fiscal documents, to identify gaps and policy coordination problems in this process and to offer recommendations for better integration of structural reforms' fiscal expenditure into the country's annual budgets and medium-term fiscal documents.

The study includes three parts. In the first, I describe the legal and organizational framework for the preparation and adoption of annual budget and two medium-term fiscal documents, the Budget Memorandum and the Program of State Development Priorities and Investments (PSDPI). Special attention is given to the changes in budget preparation procedures and the new program structure of the state budget, which were introduced in 2010. I will portray functions and responsibilities of all institutions involved and the link between the budget and procedure for preparing medium-term documents. Slovenia is obliged to prepare also two additional medium-term documents and to submit them to the European Commission. It is therefore necessary to include them in the description of procedures.

The second part is the core of the case study and provides a basis for conclusions and recommendations. I provide a critical assessment of how fiscal expenditure of structural reforms is being integrated into annual and medium-term fiscal programming documents. The section includes three sub-sections. In the first, I assess the overall fiscal programming system, especially from the point of view of how the system addresses the issue of structural reforms' fiscal expenditure in the budget. I will consider the need for a clear definition of structural reforms, the political will for assessing the fiscal impact of specific policy measures, and what coordination takes place between domestic fiscal programming and external surveillance programming. In the second sub-section I will assess how successful are the institutions involved in the process of fiscal programming. In the third I will look at the processes for incorporating structural reforms' fiscal expenditure into the country's fiscal programming documents, as well as the quality of these processes.

In my evaluations I will use the findings of the Fiscal Council and the Court of Auditors, which audited the budget preparation procedure. I will evaluate the two documents mentioned above, two European medium-term documents, and the budget for 2011 and 2012.

In the last section I offer conclusions about the objectives of overall assessment of incorporating structural reforms into the budgets and medium-term fiscal documents, and identify gaps and policy coordination issues in this process. I will also offer some recommendations that would contribute substantially to better integration of structural reforms' fiscal expenditure into the annual and medium-term fiscal programming documents.

When using the term "structural reforms," I refer to policies in the following areas, as defined by the European Commission: reforms of the enterprise

sector, financial sector reforms, human resource development and labor market reforms, financial sector reforms, utilities and network industry reforms, and administrative and other reforms.

## 2. Main institutional features for annual budget and medium-term fiscal programming

Each year, Slovenia draws up budgets for the two upcoming financial years,  $t+1$  and  $t+2$ . The two draft budgets are adopted by the Parliament in November of the year  $t$ . After one year it is usually necessary to amend the draft budget for the financial year  $t+2$ , so Slovenia simultaneously prepares draft changes of the budget for the upcoming financial year and the draft budget for the following financial year. The preparation procedures are the same. During an election year, the  $t+2$  budget is not prepared, nor are the  $t+1$  changes of the budget. This procedure includes annual budgeting for two consecutive years on a rolling basis. Slovenia creates two annual budgets every year. It is expected that this would contribute to overall budgetary discipline. It limits the line ministries to bring forward requests for budget expansion for the upcoming budget year in the annual budget negotiations. As the budget for the upcoming year has been adopted during the previous budget cycle, only a limited set of changes can be considered. These changes have to be motivated by macroeconomic developments or by adjustments of general fiscal policy. Further, it is expected that this approach gives an incentive to line ministries to cooperate in reform initiatives.

### 2.1. Legal and other relevant framework

The preparation of medium-term fiscal documents, the state budget and the municipality budgets, social funds and financial plans of indirect budget users<sup>54</sup> is regulated by the Public Finance Act (PFA). The government has adopted the Regulation on Documents on Development Planning and Procedures for Preparing the State Budget,<sup>55</sup> and the Ministry of Finance (MoF) also issues guidelines on preparation of financial plans of indirect budget users of state and municipalities and a set of rules that form the methodological basis for preparing budgets. Moreover, the MoF adopts a special guideline for budget

54 Indirect budget users consist of those units of the general government that have the legal status of an agency, fund, or public institute, and have been founded by either the state or the municipalities and are being indirectly funded (based on the contract with the competent ministry) from these budgets. Budget funding is not crucial for the status of indirect budget users; what is crucial is its legal status.

55 In the fall of 2011, the government proposed to the Parliament to adopt amendments to the PFA and a special law to govern the development planning of the state. Due to the early elections, neither of the laws got enough support to start the parliamentary procedure. The new government has not yet brought them into procedure.

planning (the budget manual) every year. In the period 2004–2011, the areas dealing with real assets of state and municipalities and with state capital assets were excluded from the PFA. These are now governed and regulated by the law on ‘Real Assets’, which states, similar to the former PFA, that the government is obliged to present the plan for managing real assets in a financial year to the Parliament along with the draft budget. According to the law on ‘Managing Equity Investments’, the plan of buying and selling state equity investments is no longer part of the budget documents.

The listed measures describe the preparation process for the national fiscal and development documents, but not the documents for EU purposes. The regulation only establishes that the national and EU documents must be in alignment.

The PFA establishes the content and procedure of preparing a draft budget and also the medium-term fiscal frameworks. It does not regulate<sup>56</sup> the connection of national budget documents to the European documents; however, it establishes the content of a draft budget or budget documents that the government must present to the Parliament. These documents are the Budget Memorandum; the budget with explanatory notes; the program of selling real estate assets for the upcoming year; the financial plans for social funds,<sup>57</sup> public funds, and agencies founded by the State; and draft laws that are necessary for budget implementation. It also establishes the documents that need to be presented by mayors to municipal councils along with the municipal draft budget and the program of selling municipal financial assets. The PFA also establishes the content of the regulation issued by the Minister of Finance for preparation of the yearly budget, the content of financial plans of direct budget users<sup>58</sup> which forms a special part of the budget,<sup>59</sup> and the relations between the MoF and all other actors at the stage of draft budget preparation.

All indirect budget users that are funded from the budget must prepare financial plans based on the platform ruling the state budget, and these institutions have to adopt their plans in a 60-day period after the budget has been adopted.

The statutory provision, dealing with Budget Memorandum, focuses on medium-term planning. The Memorandum is a government act introducing fiscal and other policies in the next four-year period. The law establishes the

56 The planned amendment of the PFA in 2011 included introducing the European Semester into the preparation procedure and envisaged a two-stage procedure of parliamentary budget adoption. Due to the early elections, the procedure did not pass in the Parliament.

57 The term *social funds* refers to the National Health Insurance Fund and National Pension and Disability Insurance Fund.

58 A direct budget user is a state or legislative body, holding the financial plan in the specific part of budget.

59 The State and Municipal budgets consist of three parts: a general part, showing revenue and expenditure with regard to the economic structure; a special part showing only expenditure with regard to the institutional, program, and economic structure; and a plan of development programs, where the expenditures are shown as specific projects and regulations with regard to the source of funding and each year for the entire period of their implementation.

content of the Memorandum; the regulation, however, adapted the content to the new European criteria regarding medium-term planning.

The most important medium-term planning document, envisaged by the regulation but not by the PFA, is the PSDPI, representing the medium-term operationalization of the Strategy of Development in Slovenia.<sup>60</sup> With this document the government establishes priorities for development policies. It also includes the National Reform Programme (NRP), ensuring the connection with the Europe Strategy 2020 and the Stability and Growth Pact. The PSDPI specifically defines and financially evaluates the priorities in regard to all developmental policies,<sup>61</sup> including some specific ones. The policies consist of evaluated priorities in the form of programs, sub-programs, activities, measures, projects, envisaged structural and institutional changes, and defined indicators. The PSDPI is the basis for preparing the medium-term fiscal scenario, the Budget Memorandum, and draft budget. It is prepared using logical framework matrices introducing measures and projects, evaluated implementation deadlines, and responsible institutions. For every measure or project, the purpose, goal, indicators, results, and a financial plan are defined. The measure or project has to incorporate assessments of direct effects; a connection with the goals of sub-programs, programs, and policies; and a cost estimate for implementation.

The government development policies must be consistent with each other and mutually supportive; they should be formed on the basis of macroeconomic evaluations and prognoses and should consider the outcomes of evaluations made. The policies need to be consistent with the budget, and the measure and project need to be consistent with fiscal capacities. When preparing the draft budget, the NRP can include measures and projects listed in the logical framework matrix.

The paramount instrument for integrating and linking medium-term planning, structural reforms, and yearly budgets is a result-oriented program budget, which was first used in preparing the budget for 2011. The essence of the new budget approach is to directly link expenditure planning with goals and activities for achieving them. This stimulates more thorough goal setting. Due to the restriction on the total amount of expenditure allowed by the fiscal rule, this approach further introduces the evaluation of specific measures.

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60 This is the strategic, long-term state document which is prepared using long-term projections and covering a minimum period of 7 years. The Strategy defines the vision and goals of development, strategic orientations, and development policies and their priority areas. It also incorporates a goal development scenario, which evaluates key development indicators that could be achieved with optimal establishment of strategic orientations and effective implementation of development policy priorities. Every year the government supervises the implementation of the Strategy.

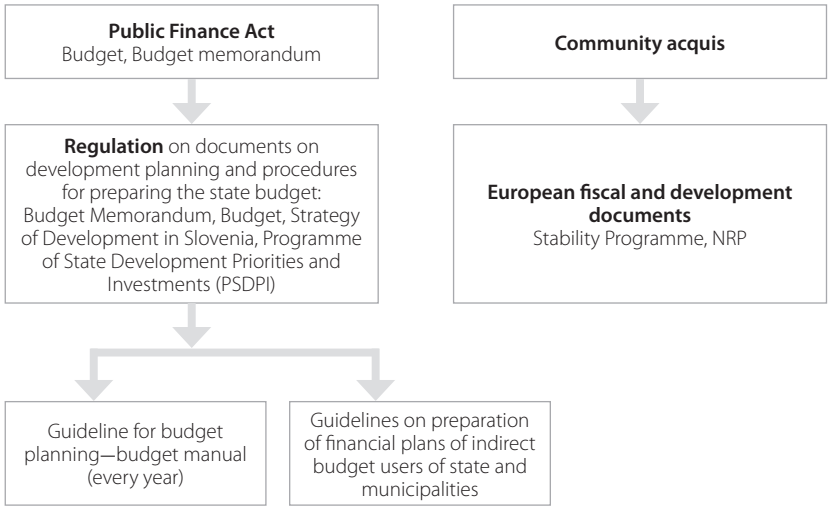
61 The government development policies incorporate a range of programs, which link horizontally the activities aimed at meeting developmental goals and international commitments made by the state. The program structure of the budget also derives from development policies, which are further classified as programs, sub-programs, and activities. The program structure is defined and managed by the special rule of the Minister of Finance; however, at present it is still not adapted to the real structure used in the budget.

It increases the focus on deciding which measures within specific policies can support development most effectively, launching the evaluation process for programs implemented so far, which in turn leads to termination of unsuccessful and ineffective programs. This is the basis for determining the structure of fiscal expenditure. The new budget approach also increases responsibility on the question of entering new financial obligations with new laws without prior agreement as to which program's budget will be cut. The new approach is expected to increase the efficiency and performance with which public money is spent.

The new program budget structure is based on the analyses of all development, strategic, and implementation documents in Slovenia, their goals and established indicators, and realized expenditure of state budget in the last decade. The principal program structure is based on 11 development policies (entrepreneurship, research and development, labor market, education, culture, transport, environment, energy, social development, health care, and agriculture), three state-forming policies (national security, national defense, and foreign policy), governance of public administration systems, and management of public debt. Policy sets are divided into programs and sub-programs, to which the needed resources and program indicators for monitoring efficiency and effectiveness are linked. For each specific policy there is one minister responsible, who also ensures coordination between cooperating ministries that have programs within the same policy.

The regulation also establishes the fiscal rule which the government needs to respect when preparing the medium term fiscal framework and yearly budgets. The fiscal rule provides controlled growth of government expenditure and fiscal balance in the medium term, which does not depend on cyclically determined fiscal revenue. It is set to limit expenditure, and the form of restriction is consistent with the EU rules (see Appendix 6.1 for the specification of the applied fiscal rule). However, its practical implementation is insufficient, as pointed out by the Court of Auditors. Setting the limit of fiscal expenditure for the next four years is the first decision the government makes after launching the budget preparation procedure.

**Figure VIII-1: Normative regulation of fiscal and development documents**



## 2.2. Institutions

The *Institute for Macroeconomic Analysis and Development* (IMAD) prepares projections of macroeconomic aggregates for the current financial year and the following two years as well as a medium-term scenario incorporating projections for the current year and the following three, taking into account economic policies in force during their preparation. Alongside the basic projection, IMAD also prepares an alternative scenario assuming the realization of key risks to the basic projection. When there is a reasonable prospect, IMAD prepares, along with the basic projection, a scenario of possible effects of the envisaged amendments to economic policies. It prepares a projection of economic trends twice a year—in spring and fall—presenting this to the government and publishing it.

The *Ministry of Finance* has a leading role in maintaining common fiscal discipline, in governing and coordinating the budget preparation procedure and other documents, and in ensuring and providing legal and technical support to the procedure. The MoF projects budget revenue; analyzes the effects of tax law changes; sets the safety limit and suggests the acceptable level of budget deficit, applying the Maastricht criteria; ensures the sustainability of public finance with regard to the aging population; and prepares general (macro) economic and fiscal analysis, analysis of sensibility to changes of some macroeconomic assumptions, and risk analysis. It prepares the Budget Memorandum and the Stability Programme and coordinates the budget process.



*The Ministry of Economy*<sup>62</sup> is in charge of the PSDPI coordination process and prepares the final document. For the purposes of its preparation and monitoring and for preparing the budget, the government constitutes policy-based work groups, each led by the respective minister as coordinator. The work groups produce and prepare logical framework matrices. The government also appoints a head orientation group for harmonization and coordination of the state's development planning, which is conducted by the Ministry of Economy.

*The Policy Coordinator* is the minister who is responsible for achieving general goals on a specific policy by coordinating, monitoring, and orienting the policy's work group.<sup>63</sup> Based on the amount of funding assigned to a specific policy, the coordinator ensures a corresponding adjustment of goals and indicators, while the proposers of the financial plans synchronize the contents within the policy. The final result of a work group is a proposal of cutting budget expenses in programs, sub-programs, and among the proposers of the financial plans; this represents the basis of the second government budget session.

*The proposers of the financial plan*<sup>64</sup> are determined in the PFA and are always direct budget users; in most cases this is a set of ministries in a narrower sense, coordinating the functioning bodies. The law also provides a few distinctive features. The proposers, due to their competences, responsibilities, and rights, are the main partner of the MoF and the work groups, while other budget users rarely join the debate directly. In the budget preparation procedure, proposers are responsible for informing all direct budget users of the relevant issues concerning and influencing financial plans' preparation as well as for providing, within their competences, a suitable level of cohesion of financial plans.

*Direct budget users* are responsible for planning, managing, and controlling their financial plans, which form an integral part of the budget. They design and implement government policies, and they handle the preparation and implementation of sector or development policies and their respective budgets, within the framework provided by the government. This also means they design financial plans of the indirect budget users after the work groups finish their work.

*The government* is the center of decision-making. It adopts the main macroeconomic platform for budget preparation, the medium-term fiscal framework, and fiscal goals; provides priorities and other political platforms; and

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62 Until the most recent elections in 2011, Slovenia had a special minister for European Affairs and Development. In 2012 this function was partially assumed by the Minister of Economic Development and Technology, the Minister of Foreign Affairs, and the Minister of Finance.

63 A specific policy covers programs performed within different LMs and other direct budget users. In the past, the coordination of various program holders of the same policy was performed by the MoF in the budget preparation process; now, coordinators of specific policies are appointed to coordinate goals and programs on policy levels.

64 As an illustration, the Supreme Court proposes the financial plan for all state courts; the Supreme Court being at the same time also a member of the work group on the "Policy of Institutions of Legal State, Freedom, and Security", despite the fact that every court is a specific direct budget user. For the 56 municipalities, which have the status of direct budget user, the financial plan proposer is the Ministry of Justice and Public Administration.

decides on the budget preparation schedule and the organizational structure for preparing the NRP and the budget. The government also joins the process of budget preparation when faced with disputes between the MoF and policy coordinators or line ministries. Ultimately, it adopts the draft budget.

*The Parliament* adopts the state budget. In the adoption phase it can propose increasing expenditure on a specific matter only if it simultaneously proposes cutting expenditure (by the same amount) in another area or if it proposes other measures for increasing income. The proposals for cutting expenditure, however, must not affect budgetary reserves or additional debt. The Parliament does not adopt medium-term documents (the Memorandum, the Stability Programme, and the National Reform Programme); these are merely introduced to the Parliament.

### 2.3. Procedures

The budgetary process starts in early spring. By the end of March, the MoF prepares the report on achieved goals and results for the past year and informs the government. Every two years by April 15, the Minister of Economy prepares a report on development policies and informs the government; this report evaluates the efficiency of the policies, programs, and sub-programs financially as well as in terms of achieving goals.

By the end of April, the government sets the fiscal rule, which establishes the limit of government expenditure for the current year and the following three years (the first two years are fixed, the second two are indicative). The MoF and the IMAD revise the evaluated growth value of potential GDP by the end of April and end of September each year. If macroeconomic indicators deteriorate and potential GDP is undervalued, it will be necessary to launch the fiscal consolidation process. In this case, the government may amend the parameters of the fiscal rule and subsequently the limit of public expenditures.

The government takes note of the yearly report on development, prepared by the IMAD, at the first government budget session at the latest. For this session, the Ministry of Economy, in cooperation with the policy work groups, prepares cohesive sub-programs, programs, and policies with expressed and evaluated priorities, and alerts the government regarding the gap between the limit of government expenditure and needs, as expressed in the logical framework matrices.

By May 15, the first government budget session is held, proposed by the Minister of Finance, where he presents the draft Budget Memorandum. In the first budget session the government:

- Adopts the orientations for amending the Budget Memorandum, which will be adopted in September
- Establishes the PDPSI for the fiscal period
- Sets the limit of government expenditure by stating the goal level of national debt and deficit or surplus for the next four years
- Decides on the cutting of government expenditure up to policy levels for the next two years and another two (indicative) years

With government decisions from the first budget session in mind, work groups start final adjustments of the expenditure structure. The harmonization process is finalized five days prior to the second budget session at the latest. The work groups propose well-balanced cutting of budget expenditure for the next two years on the level of programs and sub-programs.

The second budget session is held by the end of June. This is when, proposed by the MoF, the cutting of expenditure on policy, program, and sub-program levels and on the level of proposers is decided upon. The cutting is determined for a four-year period, though as noted the last two years are indicative.

Based on the decisions from the first session, the MoF provides a guideline for preparing financial plan proposals, which is distributed among the financial plans' proposers. They also prepare the explanatory notes, whose content must connect to the logical framework matrix. The development program expenditure is planned according to a classification of program structure, specific projects and measures, financial sources, and specific years within a fixed period of project and measure implementation. To include projects and measures in the plan, the regulation establishes special conditions. The proposers of financial plans revert to the MoF with their plans by August 15, unless the government provides a different deadline. When preparing financial plans, the proposers bear in mind the draft Budget Memorandum and basic economic platform and assumptions, cutting of expenditure as established by the government, and the guidelines for budget preparation.

The proposers of financial plans must be in compliance with social funds, public funds, public institutes and agencies founded by the state, and other subjects that are funded from the state budget. All mentioned entities must prepare financial plan proposals with respect to the platform of the Budget Memorandum. By August 30 the following entities must provide relevant ministries with financial plan proposals: health fund to the Ministry of Health; pension fund to the Ministry of Labor, Family, and Social Affairs; public funds and agencies founded by the state to the relevant ministries. By September 10 the ministries must provide the MoF with financial plans, which are shown along with the draft budget first to the government and then to the Parliament, although they are not a matter of adoption.

By September 20, the MoF provides the government with all relevant budget-related documents to be adopted; by October 1 the government gives these to the Parliament. During the Parliament's budget adoption period, the government may, if it finds it necessary, prepare an amended draft budget, considering the fall projection on economic trends.

Within 40 days of the Parliament's adoption of the state budget, the proposers of financial plans must prepare and amend explanatory notes on their financial plans, synchronize these with the adopted budget, and send them to the MoF. The work groups revise and amend the logical framework matrices and coordinate them with the adopted budget. The Ministry of Economy prepares a revision of logical framework matrices, and the MoF revises the explanatory notes on financial plans, which it publishes within 60 days of implementation of the budget.

### 3. Incorporation of structural reforms' fiscal costs into fiscal programming documents

This section evaluates the normative and organizational framework for budget preparation in medium-term fiscal documents, including its practical implementation. I will try to determine whether the structural reforms in medium-term documents are clearly and transparently planned and how effectively they are later incorporated into the yearly budget. In my evaluation I will draw on the following medium-term documents: Slovenia's exit strategy 2010–2013, the Stability Programme – Amendment 2011 and 2012, the National Reform Programme 2011–2012 and 2012–2013, the Budget Memorandum 2011–2012, and the budget for 2011 and 2012.

#### 3.1. Assessment of the overall framework

Key weaknesses in the regulation on medium-term documents preparation and budget preparation are:

1. *The normative regulations are not coordinated and do not address all relevant issues regarding the changes in the external and internal environment (EU requirements, the change in state administration, the organizational structure in budget preparation, the new program budget structure).*

In 2010 the government adopted a new regulation to overcome the weaknesses of the existing system and provide a normative framework for program budget preparation to be more results-oriented. New features include: creating development policies, establishing development priorities, forming goals and measuring results, and linking development documents with the program budget. The regulation also set a new organizational framework for coordinating development policies and program budget preparation: a head development planning group, a fiscal policy group, and work groups for specific policies. The aim is also to link national and European fiscal documents, which demands coordination of all documents; the linking mechanism is the national reform program which is thus an integral part of the Stability Programme as a PSDPI.

The budget preparation procedure, as defined in the PFA, does not describe activities in the same way as the new program approach to budget preparation (new program classification of expenditure, introduction of logical framework matrices, budget preparation work groups, and the fiscal rule).

The regulation and the PFA are not consistent on preparation, content, and adoption of the Budget Memorandum. The PFA states that the government must adopt the memorandum in April; later (in September) it can adopt its changes and amendments along with the draft state budget, if during budget preparation significant changes occur in economic development assumptions, orientation of economic and fiscal policy, content, or scope of the budget. The

regulation, however, requires that the government adopt a draft Budget Memorandum in the first budget session along with guidelines for its amending. It also states that the government must adopt the Budget Memorandum in September.

There are discrepancies in the memorandum's content as well. The regulation establishes the content much more thoroughly and on a larger scale than the PFA. It requires that the content be similar to that of the Stability Programme and at the same time provide a link to PSDPI and the program budget. It calls for a chapter on priorities and structural changes, which should form a strong enough link to the budget itself.

Table VIII-1 on the following page illustrates the differences in content of the memorandum as outlined in the PFA and in the regulation. The non-alignment of legal acts, which does not permit a transparent and consistent procedure, is a common concern of the Court of Auditors in their revision.

Since the PFA needs to be adapted to fit the new circumstances, the former government proposed its amendment along with the act on development planning so as to synchronize the entire procedure with the European semester and thus ensure better linkage between domestic and EU medium-term fiscal documents as well as the national strategic documents. Surprisingly, even with evident need, and especially because of the set fiscal rule, neither of the acts received sufficient support in the Parliament in 2011. Whether this was due to the lack of political will to cope with the circumstances or due to attempts to discredit the previous government should become clear when the current government puts both acts into parliamentary procedure.

The system of development and budget planning that the acts would ensure, and that is now more or less regulated by the regulation, is shown in Figure VIII-2 on page 190.

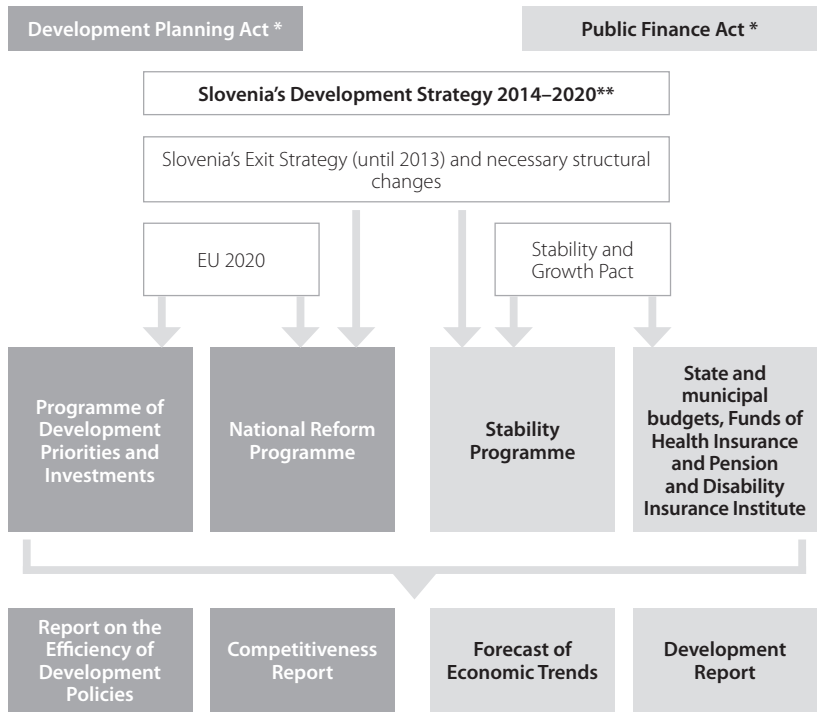
**Table VIII-1: Content of the Budget Memorandum according to regulation and the PFA**

Regulation	Public Finance Act
Assumptions on economic development in the current and following two years and development scenario for the next two years, based on the economic estimate and projections prepared by the IMAD, the Bank of Slovenia, the EC, and the OECD	Assumptions on economic development for the current and the following year, and a goal development scenario for the next three years
The limit of fiscal expenditure as set by the fiscal rule	
Basic orientation of economic and fiscal policy	Basic orientation of economic and fiscal policy
Evaluation of income and cost to the state budget and municipalities, the Pension and Disability Insurance Institute (ZPIZ), the Health Insurance Institute (ZZZS), and the consolidated accounts in public funding (economic classification) for the current year and the next three years	Evaluation of income and cost to the state and municipalities' budgets and all public funding accounts
Evaluation of medium-term or long-term sustainability	
Evaluation of the risks to realization of the proposed fiscal scenario	
Envisaged changes in state property and the property of municipalities, state debt and the debt of municipalities	Envisaged changes in state and municipal property and state, municipal, and public debt
Global overview of state budget commitments that would only be realized in the next years,* and policy of planning development program	Global overview of state budget commitments that would only be realized in the next years, and policy of planning development program
Economic and fiscal measures needed to realize the fiscal scenario	
Priorities, transformed into policies and appropriate structural changes	
Global evaluation of budget expenditure with regard to program classification to policy levels, programs, and sub-programs for the current and the next three years	

Source: Regulation, PFA.

\* Revenue and expenditure are portrayed in the budget and in the final budget account using the cash flow principle. The accounting also keeps record of commitments (made with contracts or other documents), which stand for the commitments in the next period.

**Figure VIII-2: Schematic illustration of development and budget planning system**



Note: \*enforcement in 2012, \*\*enforcement in 2014. – Source: National Reform Programme, 2011–2012, April 2011.

2. *The Budget Memorandum and the Stability Programme provide a fiscal framework using different methods, causing the results to differ, which in turn confuses the public.*

Looking at the content, the Memorandum and the Stability Pact are quite similar. But they use different methods in their data sections. The Memorandum illustrates the situation and projections of fiscal categories in the four public finance budgets (state and municipality budgets and both social insurance funds) using the GFS methodology, based on the cash flow principal. On the other hand, the Stability Programme shows fiscal categories in the state sector and converts financial categories based on the cash flow principle to the accrual principle as determined by the European System of Accounts 1995 methodology. Both documents have to be coordinated, but without the (unknown) translating table it is very hard to see why the categories differ and decide how to examine coordination of both documents. Though the MoF webpage has published methodological explanatory notes regarding both methods used, they can only be found in the Reporting of Government Deficits and Debt Levels in accordance with Council Regulation (EC) No. 479/2009.

3. *The Stability Programme is amended annually for the needs of the European Commission. The Budget Memorandum, on the other hand, being the core document for the Slovenian public, remains unchanged for a longer period of time, and often its content does not fit the reality quite soon after the budget has been adopted.*

Let us examine the case of the 2011 and 2012 budget. Both were adopted at the end of 2010 and were grounded in the macroeconomic projections from the fall of 2010. Both budgets had to be amended as revenue projections have been assessed based on a too-optimistic macroeconomic scenario. The amending budget of 2011 foresaw a good percentage of the GDP of lower revenue and expenditure than originally planned, with the same deficit and the same new debt. The amending budget for 2012, however, foresaw revenue lower by 2% of GDP, expenditure lower by almost 3%, a reduced deficit by 1%, and an increase of debt by 3% of GDP. According to the numbers, major shifts and changes occurred in fiscal aggregates and fiscal policy, and yet the government left the entire Memorandum unchanged. Thus the Memorandum has become an outdated document. It does not reflect actual macroeconomic projections and fiscal policy; nor does it form the basis for the budget and the amending budget.

There is also inconsistency between the Memorandum and the Stability Programme. The spring correction of the Stability Programme creates a great offset from the valid Budget Memorandum.<sup>65</sup> The main reason for this is the time difference in the documents' creation. While the Memorandum is created in spring or fall of a given year, the Stability Programme is amended in the following April. The basis for the first document is macroeconomic projections in the fall, the basis for the latter the macroeconomic projections in the spring. In recent years this deviation has become more and more evident, since the projections are considered higher-risk.

4. *On the national level, the term "structural reform" applies to the reforms concerning pension, health, and long-term care systems.*

Using the EU definition, structural reform also includes other measures and reforms of economic policy and institutional adaptation. The following documents deal with structural reforms: Slovenia's exit strategy, the NRP, the Budget Memorandum, and Stability Programme.

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<sup>65</sup> The same remark has been made by the Fiscal Council in their report from April 2012. It says that: "Slovenia writes strategic documents for the EU. On April 14, 2011, the Government prepared three documents, for the purposes of the EU, which establish Slovenia's fiscal policy for 2011–2015. These three documents are as follows: (1) National Reform Programme 2011–2012; (2) Stability Programme, Amendment 2011; and (3) Medium-Term Fiscal Framework (for the Stability Programme preparation). The main document is the Stability Programme 2011. The strategic document for Slovenia's public—the Budget Memorandum 2010–2011—remains unchanged."



The NRP is the key document for structural reforms planning and applies to a two-year period. Its content is provided to the EU and is adjusted to fit the EU's growth strategy for the coming decade: Europe 2020. Slovenia prepared the first program in 2011 for the period 2011–2012 and included a financial estimation of the measures under individual programs (see Attachment 1), which form the program structure of Slovenia's budget. The budget for 2011 and 2012 incorporated structural and other growth measures equivalent to a quarter of yearly expenditure. This year's program for 2012 and 2013, however, does not provide a financial estimation.

Structural reforms are not explicitly introduced in the Stability Programme, since this is the domain of the NRP, but there is an evaluation of the impact of some measures and reforms on economic growth. The most recent Stability Programme concluded that in the event of realization of some planned measures and reforms (tax incentives for research and development, reducing administrative barriers by 25%, gradual improvement of educational structure, and reduced tax rate for legal persons), the GDP in 2020 would increase by 1.9%.<sup>66</sup> The impact on growth of other measures and reforms included in the NRP is also assessed. The Budget Memorandum incorporates priorities as well as structural reforms and other measures crucial for realizing the fiscal scenario and other goals that have been set. The measures are introduced under policies and main programs, with goals and assumed and expected indicators. Since priorities and key measures are introduced under individual policies, which at the same time form the program structure of the budget, a direct link with the budget is made. As said before, this year that link is not present because the memorandum did not adjust to the amending budget. Also, an assessment of the macroeconomic impact of all measures planned has been made. The assessment is illustrated under the GDP (and individual elements of the GDP) for the next three years.

The Exit Strategy is a combination of economic policy measures, structural reforms, and institutional adjustments. Its goal is long-term sustainable economic growth. The guideline for creating economic policy measures is the fiscal consolidation that could be achieved by reducing expenditure. This is only possible if the scope of fiscal expenditure is determined and the fiscal rule is established, along with the structure of fiscal expenditure based on the state development priorities. The priorities aim at creating new employment and knowledge, stimulating and creating innovative business, increasing employment levels, activating and training of individuals, development, transportation, and energy infrastructure. A gradual transformation to an environmentally efficient, low-carbon society is horizontally present within all priority measures. The document has an appendix that thoroughly covers all planned measures including a financial evaluation for the 2010 budget.

Table VIII-2 compares specific structural reforms and other measures in the Exit Strategy and the NRP.

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66 The evaluation uses a Dynamic Stochastic General Equilibrium Model (DSGE).

**Table VIII-2: Structural reforms in Slovenia's Exit Strategy and NRP**

Slovenia's Exit Strategy, 2010–2013	National Reform Programme, 2012–2013
<p><b>Economic policy reforms and measures</b></p> <ol style="list-style-type: none"> <li>1. Consolidation of public finances: <ul style="list-style-type: none"> <li>– The fiscal rule and complying with stability and growth program</li> <li>– Measure aimed at achieving fiscal consolidation</li> <li>– Additional measure for state debt reduction</li> </ul> </li> <li>2. Priority measures in project for achieving development goals <ul style="list-style-type: none"> <li>– Adjustment of the cohesion policy</li> <li>– Coordination of financial instruments</li> <li>– Adjustment of guarantee instruments, protection scheme instruments, and other forms of state assistance</li> <li>– Rehabilitation of bad bank investments</li> </ul> </li> <li>3. Strengthening the elements of safe flexibility <ul style="list-style-type: none"> <li>– Labor costs and social security</li> <li>– Employment policy and the labor market</li> </ul> </li> </ol> <p><b>Structural reforms:</b></p> <ol style="list-style-type: none"> <li>1. Changes to the pension system</li> <li>2. Changes to the system of long-term care</li> <li>3. Changes to the system of health activity and health care (insurance)</li> </ol> <p><b>Institutional adjustments:</b></p> <ol style="list-style-type: none"> <li>1. Public institutions and public administration</li> <li>2. Transportation and energy infrastructure for an efficient environmental and climate policy</li> </ol>	<p><b>Macroeconomic measures for fiscal stability</b></p> <ol style="list-style-type: none"> <li>1. Implementation of differentiated and growth-friendly fiscal consolidation</li> <li>2. Clear signaling to the fiscal markets about fiscal stability</li> <li>3. Reducing tax in favor of the economy</li> <li>4. Decent and fair pensions</li> <li>5. Operational efficiency of managing capital investments</li> </ol> <p><b>Planned reforms and measures</b></p> <p><b>I. Smart growth</b></p> <ol style="list-style-type: none"> <li>1. Elimination of the credit crunch</li> <li>2. Increasing the competitiveness of the most creative</li> <li>3. Domestic and foreign investment support</li> <li>4. Internationalization of economy</li> <li>5. Setting the facilities must not be an obstacle for investments</li> <li>6. Reduction of regulated profession</li> <li>7. Digitalization of economy and society</li> <li>8. E-business of state administration</li> <li>9. Voluntary membership in chambers</li> <li>10. Strengthening investments in research and development</li> <li>11. Higher-quality and more rational education system</li> <li>12. Improving the attraction of vocational education and training</li> <li>13. Improving quality and efficiency of higher education</li> </ol> <p><b>II. Inclusive growth</b></p> <ol style="list-style-type: none"> <li>1. Safe flexibility</li> <li>2. Reforms for youth and the elderly</li> <li>3. Human capital investments</li> <li>4. Improved efficiency of the employment service and active employment policies</li> <li>5. New social and intergenerational dialogue</li> <li>6. Transparent and just system of social support and a more efficient activation of the receivers</li> <li>7. Development of contemporary social services by supporting the system of public work</li> <li>8. Coordination of vocational and family life</li> <li>9. Accessible, high value, and autonomous health care</li> <li>10. Improving the situation of the Roma minority</li> </ol> <p><b>III. Sustainable growth</b></p> <ol style="list-style-type: none"> <li>1. Mitigation and adaptation to climate change and improving air quality</li> <li>2. Efficient management of water and other natural sources</li> <li>3. Closing substance gaps to create a recycling society</li> <li>4. Measures to support sustainable growth</li> <li>5. Responsible self-supply of energy</li> <li>6. Mobility of commodities and passengers</li> <li>7. Using competitive and environment-friendly farming to ensure sufficient and safe food supply</li> </ol>

Source: Exit strategy and NRP.

5. *The preparation mode and responsibility of the NRP and the Stability Programme are not normatively regulated.*

By adopting the new European growth strategy, Europe 2020, member states committed themselves to report to the EC annually about reforms and implementation of measures which would help them achieve common goals. With introduction of the European semester, reporting on planned reforms and measures (NRP) has been coordinated with reporting on measures for fiscal consolidation (Stability Programme). The means and goals are united, yet both documents must provide the appropriate measures. As instructed by the EC, measures in the NRP should be clear and measurable. Structural measures should, when possible, include evaluations of impact on major macroeconomic indicators. NRP should provide measures that directly contribute to the realization of EU 2020 main goals, respect priority tasks of the annual growth review, and correspond to the principals of integrated guidelines. In accordance with stronger coordination of economic, structural, and fiscal policies, the NRP forms an integral part of the European semester. It should provide a link between integrated guidelines and priority areas of annual growth review and overview, and it should be coordinated with the annual cycle of monitoring, using which the Commission adopts specific recommendations (Appendix 6.3). The NRP 2012–2013 has two parts, the macroeconomic section and the plan of reforms and measures, which further classifies measures, under the logic of the Europe 2020 strategy, to smart, inclusive, and sustainable growth.

Given that the NRP is the key document for preparing the budget, the Budget Memorandum, and the Stability Programme and that it forms an integral part of the PSDPI, it is necessary to regulate its preparation normatively.

6. *Medium-term fiscal documents are not adopted in the Parliament, but are government documents.*

The Parliament takes note of the European documents, yet it does not decide upon them. The memorandum is thus also only a memo to the Parliament. I believe that documents which commit us to European institutions on our future actions, or to planning national development, fiscal interventions, and economic and social development should be a matter of parliamentary decision-making, particularly because some sector strategies are also adopted by the Parliament.

### **3.2. Assessment of the institutions**

Until 2012, the function of preparing the budget and medium-term development documents was shared between the MoF and the Government Office for European Matters and Development. The MoF was in charge of preparing the budget and budget documents, while the Office was in charge of preparing the PSDPI and, within the program, the logical framework matrices that were

the basis for budget planning. The Office in cooperation with the MoF prepared background and a budget program structure proposal, and together they provided professional support to the ministries and work groups on priorities and budget coordination. The NRP was prepared by the Government Office for Development, the Stability Programme by the MoF. This distribution of tasks did not fully conform to regulation but was operational. After reforms of the state administration, activities related to development planning have been assumed by the Minister of Economy.

The Minister of Development also led a special group of ministers for coordination of development planning and economic policy measures, focusing on the most important structural reforms and other measures that had a greater impact and effects.

Work groups play an important role in shaping the PSDPI and budget preparation. They are led by ministers—coordinators, who are in charge of individual policies. Ministers address general political goals, while on the other hand the cooperating ministries and other state bodies address goals at lower levels. Specific and general goals are hierarchically ordered from the sub-program upwards, and this is the basis for establishing priorities. The bases for planning development policies are analysis, projections of economic trends, and long-term projections performed by the IMAD and other independent institutions. Development policy planning also takes into consideration the comments and evaluations made by the Fiscal Council.

The preparation procedure of structural reform, development, and budget documents is executed in a more decentralized manner than in the last decade. The responsibility for preparing priority tasks, structural reforms, and other measures is dispersed as well. The MoF is no longer the lead coordinator of individual budget users' financial plans; this role was taken on by ministers in charge of individual policies. The MoF, however, is responsible for revenue, macroeconomic proportions, maintaining fiscal discipline and policy on debt, and guarantees management. The allocation of funds is thus in the hands of policy holders and the Minister of Development.

The organizational structure described has been in effect since 2010, so there are still some issues of implementation. Knowledge of result-oriented budgeting is not sufficient. We need a good normative framework, a lot more learning, and more awareness that the approach is right and can lead to good results. Reforming state administration will not be beneficial to the continuation and consolidation of the process, but it will probably help set the roles of individual actors, especially the ministries of development and finance, in a clearer perspective.

The Court of Auditors would agree. They comment on the fact that the budget preparation procedures were not executed in the prescribed way regarding deadlines and individual actors' competences. They also remark that the cooperation of the MoF and the former Government Office for development was not sufficient, with tasks not consistently distributed. Regarding the work groups, it concludes that members were more or less pleased with the results

of their work despite the fact that some groups' work was not reflected in the adopted budget; yet some work groups lacked substantive discussion. A survey of work group members showed a lack of understanding of new budget preparation concepts and confirmed that the change in the mindset is not fully realized yet.

**Table VIII-3: Individual development planning documents and budget holders**

Development planning documents	Prepared by	Inclusion of civil society
<b>Slovenia's Development Strategy</b>	Prepared by the government office in charge of development (until recently the Ministry of Development and Technology) and the IMAD	Professional associations, councils, and other working bodies that are appointed by the government or ministers as consulting bodies take part in the preparation and monitoring procedure of the development policy documents, and they may propose an initiative for its preparation or alteration.
<b>PSDPI</b>	Prepared and coordinated by the government office for development (until recently the Ministry of Development and Technology) in cooperation with ministries and government offices via work groups under specific policies	
<b>Other development planning documents</b>	Prepared by the ministries and government offices in their field of work and coordinated with the government office for development (until recently the Ministry of Development and Technology)	
<b>Programming cohesion policy</b>	Preparation of operational programs for receiving European funds is done by the government service for local self-autonomy and cohesion policy development (until recently the Ministry of Development and Technology) government offices.	
<b>Budget Memorandum</b>	MoF and IMAD	
<b>Financial plans of social funds, agencies and public funds</b>	Social funds, agencies, public funds in cooperation with the ministries	
<b>Budget</b>	MoF in cooperation with other ministries and other financial plan proposers.	

Source: Regulation, Government Office for Development and European Affairs (SVREZ, 2011).

### 3.3. Assessment of the processes

With the PFA of 2000, Slovenia has designed a modern fiscal and budget system. It produces an economic classification of fiscal expenditure which needs to be followed by all units of the state sector, and thus it provides sufficient data to serve as a basis for preparing the medium-term fiscal framework. The same law established a uniform procedure for the financial planning and reporting of all units in the general government sector. For budget expenditure it developed a program classification, which turned out to be a very useful tool for priorities planning and for linking planned measures and actions, structural changes, and budget expenditure. At the same, the Budget Memorandum is a document which guides government policy in the next four-year period and has been used for the last two decades, though its content has gradually altered and adapted to new circumstances and needs.

Indeed, the Budget Memorandum has been the document ensuring so-called goal scenario planning for many years, and it establishes structural reforms as well as other relevant measures that help realize the goal scenario. Whereas in the past, the structural changes and measures planning was performed through direct cooperation of individual departments with the MoF and the IMAD, the new procedure provides the same cooperation in the process of forming the PSDPI and continues with the budget procedure within the work groups led by relevant ministers. Some coordination weaknesses occur as work groups initiate their work under the coordination of the Ministry of Development and finish it under the coordination of the MoF. Professional help also comes from two sources—help in designing the logical framework matrices from the Ministry of Development, the data basis and information support from the MoF.

Shaping structural reforms should be based on analysis of the current situation and identification of weaknesses. In a normative sense, yearly reporting on reform efficiency and performance within specific policies is established, but the reporting concept is new, so its quality and usefulness cannot be evaluated yet. It is the lack of evaluations of current reforms and measures that hinders replacing them as needed and thus increases fiscal expenditure. Decisions made regarding structural changes are based on the assessments of line ministers, who focus on evaluating the current situation and finding optimal solutions, using more or less thorough situation analysis. Due to incomplete assessment of the situation, often in a rush (especially in times of crisis), structural reforms are planned on a much too general level, and there are also weaknesses in establishing clear goals and finding adequate indicators for evaluating them. Although the commitment to development and budget planning procedures is clearly established, there are still some weaknesses, especially in establishing adequate indicators for evaluating results and quantifying goals; however, the situation is improving after the implementation of the new budget approach. The new legislation also requires that for every legislative change or amendment a calculation of exact financial effects and an evaluation of other

impacts on the economy, living standards, and the environment should be made. Unfortunately, despite long years of practice, the situation in this area is not improving fast enough.

The guidelines provided to the line ministries and work groups from the ministries of development and finance are sufficiently clear, thorough, and understandable, especially in the budget preparation procedure. The main shortcoming involves macroeconomic frameworks, where required macroeconomic aggregates are not always available. This is mainly a drawback for other units of the state sector that are also part of the budget procedure. The guidelines on shaping structural reforms and other measures planning often lack precision, hence the planning can vary, as can be seen in individual documents. Some reforms and measures are introduced on a highly detailed level, others on a rather general level; and sometimes the introduction of a reform is presented by the same legal document that is supposed to establish the reform.

When implementing new features in development and budget planning, a lack in staff is evident, in the MoF as well as in line ministries. This is partly a result of restrictive employment policy and partly of an unsuitable organizational structure of individual departments for new needs. It is a common concern that further reduction in public sector employment would increase the problem further, unless major organizational changes are made, which was also the aim of the last reorganization of the government. Regardless of the staff-related issues, what is crucial is to make education and training for employees far more intensive so that they can implement new procedures and understand the concepts.

Given the increased level of fiscal control and a more synchronized growth strategy on the EU level, the scope of documents demanded by the EU is growing, and the content is getting more and more advanced. Despite the fact that the normative frameworks demand and provide document synchronization, it is not yet sufficient. This is mostly due to uncoordinated timing of the documents' creation, unreliable projections of macroeconomic aggregates, and inappropriate organization and weak capacities of the MoF staff in charge of development planning.

## **4. Conclusions and recommendations**

### **4.1. Conclusions**

In 2010 Slovenia introduced some new features into the process of budget and development planning. A new program document, the PSDP, and a new program budget structure are envisaged. Both could establish a good connection between structural reforms and the budget. These features have been implemented as a pilot for three years. In the current year another change in the program budget structure occurred; while the main principles of the new

approach have been preserved, a new PSDP cannot be found on the government web page. The current system of budget and development planning, with additional improvements, is a good enough mechanism, enabling the transfer of structural reforms into the budget.

Organizationally, it has to be emphasized that the changes in the budget and development planning process have been adapted to the organizational structure of the previous government. A special minister without portfolio, in charge of development, definitely affected the proposed changes and especially the pace of their implementation. The fact that the Minister of Development also dealt with the coordination of all structural reforms and thus ensured a tight link between development planning, structural reforms, and the budget, cannot be ignored. The new government incorporates the Minister of Development function into the Ministry of Economy. The fact that he heads an important portfolio indicates that he will most likely not deal with development planning as intensively as the former minister without portfolio. A look at the organizational structure of the Ministry of Economy shows that development planning became part of the cohesion policy and that a person who could horizontally link structural reforms in the government is nowhere to be seen. This presents a great risk of slower growth in this field than previously expected. Since the legal setting at the moment is not precise and consistent enough to ensure a well-functioning process of preparing specific documents and interlinking them, I see the risk being much higher. The functions of the ministers of finance and economy in the government are thus of great importance, as is their interest in continuing the procedure so as to establish an adequate framework, thus ensuring the stability of procedures and a precise distribution of tasks and competences among specific holders of the process.

The new coordination system for specific policies has limited the power and role of the MoF in designing and especially in aligning budgets. Some ministers have not assumed a big enough role or, especially, an unbiased one in the process, although they can design the content of goals and regulations and the attached money within specific policies. The relations between the Minister of Finance and the specific policy coordinator are not clearly set because there is practically no dialogue envisaged between them.

In the medium-term fiscal documents, structural reforms are poorly presented, in their content and effects. One of the most important questions that would therefore have to be addressed is the decision-making on structural reforms that are incorporated into specific budgets. Currently, the Parliament does not make decisions on structural reforms; it only adopts laws that concern finalizing reforms, as well as the budget. It would be wise to make the Stability Programme and the NRP part of the parliamentary decision-making prior to adopting the budget. In this way, the whole range of reforms needed to realize the goals that we set would be presented on the spot to the Parliament and the public. Maybe this would make structural reforms easier to implement, since there would be a (vague) consensus about required changes in several areas, at once. At the same time, interest groups (e.g., civil society, syndicates)



would enter the coordination process of specific reforms at an earlier stage, which could also contribute to a faster pace of reaching consensus on a specific reform.

Lastly, it is necessary to limit the number of medium-term fiscal and development documents and ensure that timing and content align between the domestic and European documents. In this way, the transparency of the administration will be increased and the work load decreased.

To conclude, I present key findings, which have been thoroughly dealt with in section 3 above.

### **Weaknesses in normative regulation**

- The rules are not coherent and do not address all relevant questions that the changes in the external and internal environment have invoked (EU requirements, the change in public administration, the budget preparation organizational structure, the new approach to program budget preparation).
- The Budget Memorandum and the Stability Programme give us a medium-term fiscal framework using different methods, so the results are different, which confuses the public.
- The Stability Programme is amended annually for the purposes of the European Commission; the Budget Memorandum as the main document for the domestic public stays the same for a longer period of time, so its content often does not fit the reality soon after the budget has been adopted.
- The preparation mode and the responsibility for preparing the NRP and the Stability Programme are not normatively regulated.
- Medium-term fiscal documents are not an adoption matter in the Parliament; they are government documents.

### **Weaknesses in implementation**

- The implementation of medium-term programming and budget planning does not comply with the normative regulation entirely. There are differences in time, content, and managers of specific tasks.
- The PSDPI is not prepared on the basis of the development policies efficiency report.
- The PSDPI and the NRP are not directly interlinked.

### **Organizational weaknesses**

- The head of PSDPI, NRP and other development planning, programming for use of European funds, and regional planning, is the Minister for Economic Development and Technology, who is at the same time the holder of two development policies.

## 4.2. Recommendations

### Proposals for amending the normative regulation

We need an amendment to the PFA which would include development and budget planning. All regulations should be coordinated with it. The time frame for preparing national and EU documents should be coordinated. This would also ensure content consistency. The Budget Memorandum should include a conversion table that would enable the comparison of fiscal categories between the memorandum and the Stability Programme. The Stability Programme and the NRP should constitute an integral part of the memorandum. It should be ensured that the Budget Memorandum is amended annually as well, along with the Stability Programme and the amending budget.

Normative regulation should include a clear definition of structural reforms, consistent with the one used by the EU in its document. The procedure and responsibility for preparing the NRP and the Stability Programme should also be normatively regulated. The NRP, the Stability Programme, and the Budget Memorandum should become a matter of decision-making in the Parliament.

### Suggestions for improved procedures

Procedures, deadlines, and contents should be well respected and considered; that is why they should be written clearly and in detail; non-compliance should be sanctioned. The efficiency report should form the basis for setting priorities and measures, so the content should be envisaged carefully. A sufficient informational support should be established for the preparation of both documents, to ensure their direct link.

### Suggestions for improved organization

The minister in charge of a specific development policy cannot efficiently perform horizontal tasks, which is why the competence should be given to the IMAD—a government office under direct jurisdiction of the premier that has acquired knowledge and experience with preparing similar documents.

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## 6. Appendixes

### 6.1 Fiscal rule limiting fiscal expenditures

The regulation defines the fiscal rule as providing the limit of fiscal expenditure; this is determined by the formula:

$$G_{t+1} = G_t \times (1 + g^*)$$

The nominal growth of government expenditure ( $g^*$ ) is determined as:

$$g^* = g_{trend} - u \times (b_t - b^*) - v \times (f_t - f^*)$$

Whereas:

- $G_{t+1}$  = government expenditure for the following year (EUR)
- $G_t$  = government expenditure assessment for the current year (EUR)
- $g_{trend}$  = arithmetic average of the past 3 years, the current year, and forecasts for the next 3 years at a nominal growth rate of the potential GDP (%)
- $b_t$  = evaluation and assessment of the consolidated gross debt of the wider state for the current year (% of GDP)
- $b^*$  = goal level of consolidated gross debt of the wider state (% of GDP)
- $f_t$  = assessment of the primary fiscal balance for the current year (% of GDP)

- $f^*$  = goal level of the primary fiscal balance for the current year (% of GDP)
- $u$  = the velocity of reaching the goal level of consolidated gross debt of the wider state, with values between 0 and 1
- $v$  = the velocity of reaching the goal level of primary fiscal balance, with values between 0 and 1

The potential GDP is estimated using the method of production function, which is the official method in the EC.

The parameters  $b^*$ ,  $f^*$ ,  $u$  and  $v$  are established in the Budget Memorandum for a two-year period.

## 6.2. Evaluation of structural reforms, NRP 2011–2012

Selected priorities and policies	2011		2012	
	Structure in %	in MM EUR	Structure in %	in MM EUR
<b>Smart growth</b>	45.6		42.2	
Entrepreneurship and competitiveness		268.9		211.6
<i>including the B balance sheet (financial assets and liabilities account)</i>		<b>537.7</b>		<b>226.0</b>
Higher education, science, technology, and the information society		695.0		658.9
Education and sports		373.2		397.3
Culture		18.2		20.4
Governance of public administration systems		29.6		31.1
Institutions enforcing the rule of law, freedom and security		10.8		10.7
<b>Inclusive growth</b>	30.2		29.4	
Labor market		30.1		329.2
Social security		564.8		564.3
Health security		30.5		31.6
Sustainable growth	24.1		28.4	
Transport		344.8		400.8
Energy		52.1		59.8
Agriculture, forestry, fisheries, and food		193.3		160.5
Environment and spatial planning		148.4		274.2
<b>Total amount</b>		<b>3.058.7</b>		<b>3.150.4</b>
Total in % of the total national budget (A balance sheet)	26.3		28.5	
<b>TOTAL (including the B balance sheet)</b>		<b>3.327.6</b>		<b>3.164.9</b>

Source: National Reform Programme (NRP) 2011–2012, April 2011.

### 6.3. EC recommendations for the NRP

The European Commission recommends for the 2011 NRP:

- To achieve the goal for the deficit in 2011, and to support the goal for the deficit in 2012 with specific measures, to consistently perform the necessary consolidation, and to adopt additional measures for prevention of possible deviations; and thus to apply structural measures for restricting and reducing expenditure, and eliminating noted insufficiencies, and to prepare a more committed medium-term budget framework
- To take necessary measures to ensure long-term sustainability of the pension system while simultaneously assuring a decent level of pensions; to increase the employment rate of older population with late retirement through further development of active policies regarding the labor market and lifelong learning measures
- To take additional measures in the banking sector, when required, for strengthening the balance sheet and capital portfolios, in order to increase the loans flow to the real economy
- To take measures for reducing the imbalance of rights and obligations ensured on the basis of employment contracts with indefinite or fixed-term duration; and to revive attempts for solving the issues of a parallel labor market, which evolved as student labor market
- To establish a system for projecting the knowledge, skills and competences that are needed to form a responsive labor market; and to evaluate service performance of the Employment Service, specifically with regard to vocational orientation and advising and consulting services
- To rationalize regulated occupations and to increase the administrative capacity of the Office for the Protection of Competition to improve the business environment and attract investments

## Chapter 9

# Case Study on TURKEY

prepared by

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# 1. Introduction

In the realm of fiscal management, Turkey has carried out many reforms since the beginning of the 21<sup>st</sup> century. Because macroeconomic performance was impaired by a number of structural shortcomings during the 1990s, the government has put special emphasis on management of the economy. The macroeconomic strategy and the structural reform agenda have supported each other. Since the crisis of 2001, fiscal policy is a cornerstone of Turkey's macroeconomic strategy, as are fiscal reforms. The government has firmly committed to the reforms which are seen crucial by international organizations such as the IMF, the World Bank, and the OECD. Turkey's EU accession processes also have accelerated the reform effort, and international institutions have supported the process in many ways. However, there is still much to be done to achieve the goal of a fiscal system that ensures accountability, transparency, and the effective and efficient collection and utilization of public resources.

This study will describe the basic features of the Turkish fiscal framework, especially the legal basis for preparing various fiscal programming documents, the institutions taking part, and procedures. An assessment of how fiscal costs of structural reforms are being integrated into fiscal annual and medium-term fiscal programming documents will be provided. The final section will offer conclusions and recommendations.

## 2. Main institutional features for annual budget and medium-term fiscal programming

### 2.1. Legal and other relevant framework

The Turkish budget system was re-regulated to achieve a more transparent, accountable and sound fiscal management system. This transformation was inspired by best practices and international experiences.<sup>67</sup> Main parts of the transformation that have been completed include widening the coverage of the budget, improving preparation and execution, and increasing capacity to assess performance; enhancing accounting standards, procurement procedures, and audit functions; and introducing modern and transparent public liabilities management practices.

While there are other specific legal arrangements, the public fiscal management system in Turkey has been transformed by four main laws. The first and most important is the law on 'Public Financial Management and Control' (PFMC; No. 5018), which was enacted in 2003 and fully in force by 2006. By

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67 European Commission Regulations; IMF Code of Good Practices on Fiscal Transparency, 1998; and projects that are implemented with WB, OECD, and other twinning partners of government institutions provide valuable support.

setting the main framework of the fiscal management system, it established principles and merits, multi-year budgeting, the budget scope, budget execution, performance management and strategic planning, internal control, accounting, and monitoring and reporting.

The second important fiscal legislation is the law on ‘Regulating Public Finance and Debt Management’ (No. 4749), enacted in 2002. This law set the main procedures and principles, eliminated various disorganized legal arrangements on debt management, increased unity, determined predefined strategies for debt management, increased transparency with the help of standard reporting, and set boundaries for contingent liabilities.

The third legislation is the law on ‘Public Procurement’ (No. 4734), enacted in 2002, which regulates the public procurement system. Effectiveness, transparency, and competitiveness were increased, and a new institution, the Public Procurement Authority, was established.

The final important legislation deals with external audit, which is regulated by the law on ‘Turkish Court of Accounts’ (No. 6085), enacted in 2010. The Turkish Court of Account (TCA) performs audit activities (both regular audit and performance audit) on behalf of the Turkish Grand National Assembly (TGNA). This institution also has judiciary functions on public accounts and fiscal transactions.

## 2.2. Procedures and main documents

The constitution of Republic of Turkey and the PFMC Law establish the legal basis for the state budget. The PFMC Law makes provisions on the basis and structure of the budget, preparation principles, and budget implementation; it defines legal principles as well.

Pursuant to Article 16 of the law, the multi-annual budget preparation process begins with the adoption of the *Medium-Term Programme (MTP)* by the Council of Ministers. This document includes macroeconomic policies, principles, and basic economic figures as targets and indicators, and is prepared by the Ministry of Development (MoD, formerly the Undersecretariat of State Planning Organisation). This program is prepared for three years and annually updated. The annual process of budget preparation takes place according to a fixed timetable (see Figure IX-1 below).

The Medium-Term Programme roughly determines public policies and practices and also directs resource allocation in this framework. As a kind of road map to enhance predictability for both the public and private sector, the program also contributes to confidence and stability by ensuring that recent improvements in social and economic fields are maintained on a solid grounding. The objectives and priorities of the program are taken as a basis while preparing the budgets of ministries and institutions and making administrative and legal regulations, as well as in decision-making and implementation processes of the institutions.

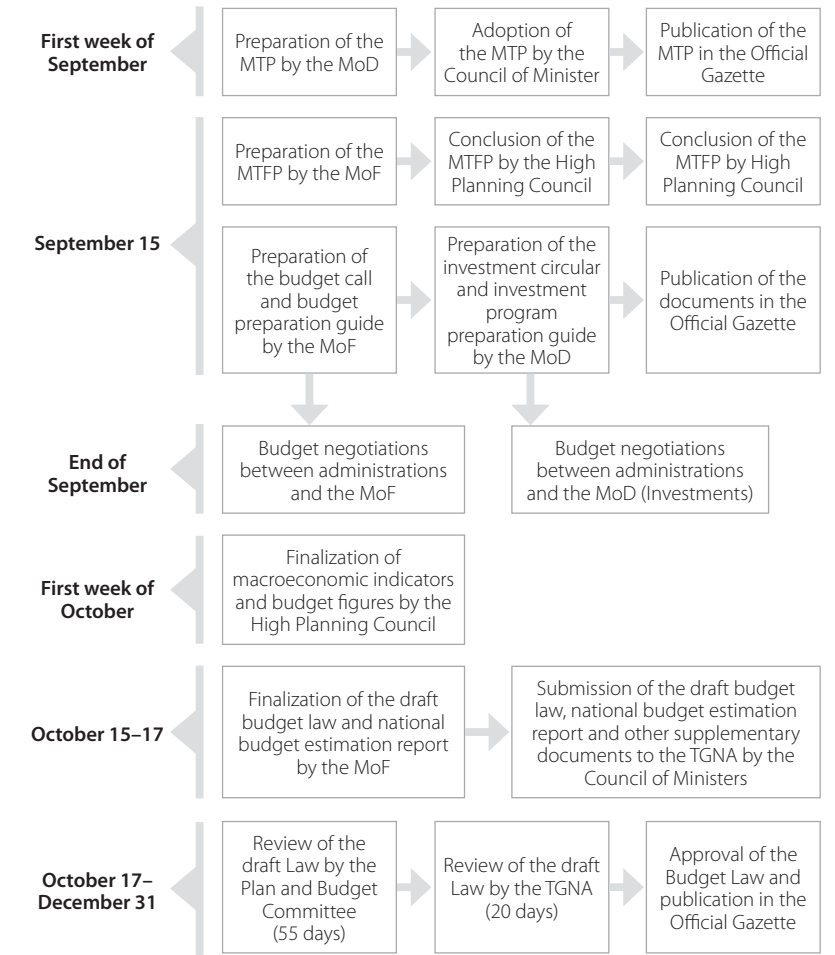
The program, which provides a dynamic structure and has a three-year perspective, is reviewed every year by taking into account annual implementation



results and changes in general conditions. Program implementations and external developments that could affect it are monitored and assessed effectively. The MoD is responsible for monitoring and evaluating the implementation based on objectives and priorities stated in the program, as well as for providing the Council of Ministers with relevant information.

The second document issued in the budget preparation process is the *Medium-Term Fiscal Plan (MTFP)*. This includes targeted deficit and borrowing positions, total revenue and expenditure estimates for the following three years, and appropriation proposal ceilings for public administrations as consistent with the MTP. The MTFP is prepared by the Ministry of Finance (MoF), finalized by the High Planning Council by September 15, and published in the Official Gazette.

**Figure IX-1: Budgeting process in Turkey**



General and special budget administrations determine their institutional priorities within the limits defined in these two documents and prepare their budgets accordingly. The expenditure targets in the MTFP are based on the medium-term inflation target of the MTP. The targets can be adjusted according to macroeconomic developments and political priorities. This also provides a certain flexibility to accommodate unexpected macroeconomic developments and maneuvering space for the MoF in subsequent negotiations with ministries and agencies in the budget process.

After publishing the MTP and the MTFP, to guide the preparation process of the budget proposals and investment programs of the public administrations the MoF prepares the *Budget Call* and the *Budget Preparation Guide* as its supplement, while the MoD prepares the *Investment Circular* and the *Investment Programme Preparation Guide* as its supplement. All of these are published in the Official Gazette by the end of September. The two guides include the ways and methods to be followed, technical details and standards, as well as forms to be used in budget preparation.

The following are taken into consideration while preparing revenue and expenditure proposals:

- Basic figures together with principles and procedures determined in the MTP
- Appropriation ceilings determined by considering the *development plan*, *annual program* priorities, and *strategic plans* of the relevant institution.
- The multi-annual budgetary framework in compliance with the *strategic plans of the public administrations*
- The *performance program of the administration*

In the framework of the principles stated in the budget preparation guide and strategic plans, public administrations prepare their budget revenue and expenditure proposals accompanied by a statement of reasons and send these to the MoF by the end of September after they are signed by their competent authorities. The investment proposals of public administrations are submitted for evaluation to the MoD within the same period. Public administrations follow a participative approach and ensure that the appropriation requests of decentralized units are reflected in the proposals.

Public administrations within the scope of the special budget prepare their revenue proposals for the following three years apart from their expenditure proposals and send them to the MoF's General Directorate of Budget and Fiscal Control (GDBFC) by the end of September. Revenue proposals for the general budget are prepared by the MoF. Expenditure proposals are prepared in line with the institutional, functional, and economic classification system (analytical budget classification) set by the MoF, whereas revenue proposals are prepared according to the economic classification. Budget revenue and expenditure proposals are accompanied by the statement of reasons and signed by their competent authorities.

Regulatory and supervisory agencies that are provided in Chart (III) annexed to the PFMC Law prepare and submit their budgets directly to the

Turkish Grand National Assembly by the end of September. They send a copy to the MoF to be annexed to the draft Budget Law of Central Government, and send their investment proposals to the MoD to be associated with the Investment Programme.

Budget proposals prepared by line ministries and institutions are finalized by the MoF's GDBFC. It scrutinizes their proposals, considering their compliance with principles and standards stated in the budget call and budget preparation guide and the adequacy of the legal grounds and economic reasons for appropriation requests. The MoF and MoD work in close cooperation in this phase.

In the following phase, the MoF, the MoD, and the Undersecretary of Treasury finalize macroeconomic indicators, budget figures, and text of the draft budget law for the High Planning Council (HPC) meeting in the first week of October.

After the HPC meeting, the MoF, the MoD, and the Undersecretary of Treasury finalize the draft budget law and other related documents and submit these to the Council of Ministers. According to the Constitution of the Republic of Turkey (Article 162), the Council of Ministers shall submit the central government budget draft law and the report containing the national budgetary estimates to the Turkish Grand National Assembly (TGNA) at least 75 days before the beginning of the fiscal year.

The following documents shall be attached to the draft Budget Law of Central Government (to be considered in budgetary debates in the Parliament):

- Budget memorandum, including Medium-Term Fiscal Plan
- Annual economic report
- Schedule of public revenues renounced due to tax exemptions, exceptions, reductions, and similar practices
- Public debt management report
- The last two years' budget realizations and the next two years' revenue and expenditure estimates from public administrations within the scope of general government
- Budget estimates of local administrations and social security institutions
- List of public administrations, other agencies, and institutions that are not within the scope of the central government but subsidized from the central government budget

After the draft budget law is submitted to the Parliament, its Plan and Budget Committee scrutinizes the draft budget law technically, and work carried out in this committee is to be completed within 55 days. The committee debates each budget proposal of administrations within the central government budget individually. The draft law is sent to the General Assembly of the Parliament once it is approved and adopted after necessary amendments are made, together with a committee report including amendments and annexes. The committee also discusses the final accounts of the previous year in the same period.

The debate on the draft budget law in a plenary session of the TGNA starts with a speech by the Minister of Finance and continues for up to 20 days. After

the budget is debated as a whole, the text of the central government budget draft law is debated in terms of its articles, the revenue and expenditure charts are debated in terms of public administrations, and the draft law is voted on as per its sections. During budgetary debates, as per Article 162 of the Constitution, members of parliament are not allowed to make expenditure-raising or revenue-decreasing proposals. Budgetary debates in the plenary session are completed once the revenue budget and other articles of the draft law are debated and voted.

Upon completion of budgetary debates in the plenary session, the whole budget is put to an open vote. The draft law adopted by the Parliament is sent for approval by the President. As per Article 89 of the Constitution, the President is not allowed to send the budget law to the Parliament to be debated again. The Central Government Budget Law approved by the President is published in the Official Gazette before the beginning of fiscal year and enters into force on January 1.

The Annual Public Investment Programme, which covers all public investment projects, is published in the Official Gazette just after the Budget Law of General Government in January. This document covers the entire public sector, meaning that beyond the central government budget it includes such items as investments funded by state-owned enterprises, the Iller Bank, the social security institutions, and the local governments (projects totally or partly financed by foreign sources). In this document, project-based distribution of investment appropriations of institutions is characterized by parameters such as total costs, previous cumulative expenditures, and current year allocation. The responsibility for the investment budget is shared by the MoD, the MoF, and the Treasury.

Turkey has prepared the Pre-accession Economic Programme (PEP) and submitted it to the European Commission since 2001. The PEP is prepared under the coordination of the MoD with contributions from relevant ministries and institutions, and is adopted by the decision of the High Planning Council. The PEP is prepared within the scope of the Ninth Development Plan (2007–2013), based on the MTP and the Annual Programme. The document includes an evaluation of recent economic developments in the Turkish economy and the world economy, macroeconomic forecasts for fiscal policies, and forecasts and analyses regarding budget and debt management. It also contains assessments of developments in structural reforms, budgetary impacts, and the reform agenda.

### **2.3. Institutions**

*The High Planning Council (HPC)* is composed of a Deputy Prime Minister and seven Ministers under the presidency of the Prime Minister. The MoD provides secretariat services for the Council. The HPC is responsible for the macroeconomic forecast, prepared by the MoD. The HPC adopts the Medium-Term Fiscal Plan, which contains the expenditure targets for the central government excluding regulatory and supervisory agencies. At the end of the budget formulation process, the HPC decides on remaining points of difference that

have not been solved in bilateral contacts between the MoF, MoD, and the line ministries.

*The Ministry of Finance (MoF)* has overall responsibility for fiscal policy, including budget preparation, medium-term fiscal programming, budget execution, revenue collection, reporting, and accounting. It also bears the responsibility for coordination and harmonization of public internal financial control. Within the MoF, the General Directorate of Budget and Fiscal Control (GDBFC) bears the main responsibility for coordinating the budget process.

*The Ministry of Development (MoD)*, formerly the Undersecretary of State Planning Organisation, is responsible for preparing the Development Plan (long-term: the existing plan is seven years), the MTP, the Annual Programme, and the Annual Public Investment Programme. For the latter purpose, the MoD analyzes and assesses the investment proposals of ministries and agencies and performs cost-benefit analysis. It is also responsible for the Pre-accession Economic Programme that is submitted to the European Commission. The tasks of the MoD also include macroeconomic modeling and forecasting, scenario analysis, and costing of entitlement programs. It serves as the secretariat of the High Planning Council. It also has expertise in the area of regional development and regional policy, and it monitors and analyzes the results and effectiveness of regional policies.

*The Undersecretariat of the Treasury* is an agency reporting to the State Minister within the Prime Minister's Office. It is responsible for cash management, short and long-term debt management in local and foreign currency, relations with international financial institutions, and monitoring of the activities of state-owned enterprises and extra-budgetary funds.

*Strategy Development Presidencies (SDPs) and Departments (SDDs)*, which are the financial services units in the line ministries and other budgetary institutions, are in charge of the development of strategic plans, performance programs, and accountability reports as well as the preparation of budgets based on the performance budgeting approach.

*The Turkish Court of Accounts* performs an ex post audit of administrations under the general government on behalf of the Turkish Grand National Assembly. It also prepares General Accountability Report, External Audit General Evaluation Report, and General Conformity Statement.

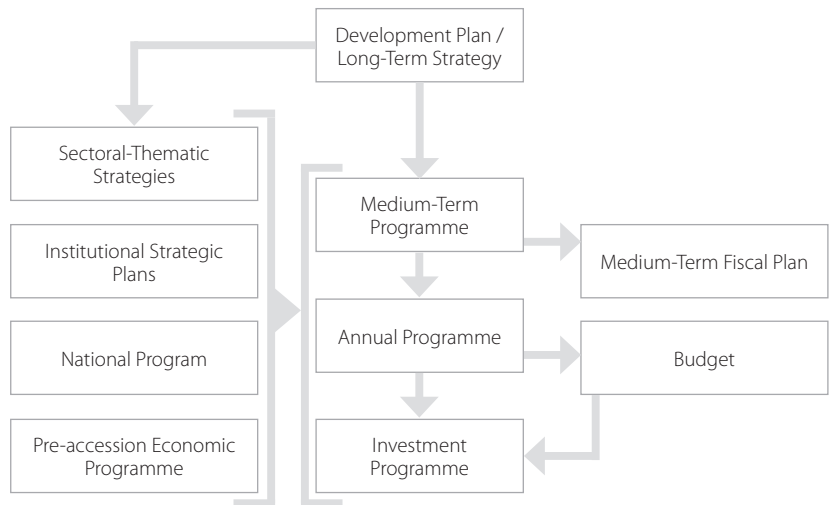
*The Plan and Budget Committee of Turkish Grand National Assembly* is a special committee that deals with the budget process and the evaluation of the final accounts. This committee also evaluates documents attached to the draft budget law and final accounts.

### 3. Incorporation of structural reforms’ fiscal costs into fiscal programming documents

Turkey’s fiscal management architecture has changed considerably in recent years. These structural changes in fiscal management have been carried out in parallel with the fiscal consolidation process and have been accelerated by the EU accession process. Structural changes and transformation are internalized by national plans, government programs, and other medium- and short-term policy documents. For example, the Ninth Development Plan of Turkey (2007–2013) has formed the basis for necessary documents in the EU accession process like the PEP and the Strategic Coherence Framework, as well as for other national and regional plans and programs, primarily the Medium-Term Programme and sectoral and institutional strategy documents. Sectoral and thematic policies and priorities have been considered under these axes and are interrelated to serve the same strategic objective. In line with this understanding, the Ninth Development Plan was designed as the basic strategy document that would contribute to the EU accession process. Therefore, the Plan period was determined to be seven years, bearing in mind the EU fiscal calendar.

The MTP and the Annual Programme’s planning period follow the axes and strategic objectives of the Ninth Plan, which also determine targets, policy objectives, and how measures of programs are monitored. The main policy documents and their interaction are shown in Figure IX-2 below.

**Figure IX-2: Planning documents in Turkey**



Medium-term or annual programs do not separately identify the impact of existing and new policy measures, although the effects of new policies are briefly explained in these documents. MTPs and annual programs incorporate policies and priorities of sectoral-thematic strategies and institutional strategic plans.

The structure of PEPs allows them to present the net effect of reforms on the budget, as the following example from the PEP shows.

**Table IX-1: Matrix of policy commitments: health care and social security**

	2010	2011	2012	2013	2014
<b>1. Health Transformation and Social Security Reform Project</b>					
A. Implementation Profile	---	---	---	---	---
B. Net Effect On Budget	89.7	79.0	84.0	80.2	78.7
B.1. Direct Effect on Budgetary Revenues	100.0	100.0	100.0	100.0	100.0
B.2. Direct Effect on Budgetary Expenditures	10.3	21.0	16.0	19.8	21.3
<b>2. Avian Influenza Project *</b>					
A. Implementation Profile	---	---	---	---	---
B. Net Effect On Budget	-4.2	-5.8	-2.1	---	---
B.1. Direct Effect on Budgetary Revenues	---	---	---	---	---
B.2. Direct Effect on Budgetary Expenditures	4.2	5.8	2.1	---	---
<b>Total Net Budgetary Effect</b>					
A. Implementation Profile	---	---	---	---	---
B. Net Effect On Budget	85.5	73.2	82.0	80.2	78.7
B.1. Direct Effect on Budgetary Revenues	100.0	100.0	100.0	100.0	100.0
B.2. Direct Effect on Budgetary Expenditures	14.5	26.8	18.0	19.8	21.3

*Note: Budget figures in MM EUR. – \* Project is being carried out with World Bank and European Union funds. – Source: The table is derived from Republic of Turkey Pre-accession Economic Programme, 2012–2014.*

The budgetary framework in Turkey gives an opportunity to assess the net budgetary effect of new and existing commitments. The net effects of major structural reforms on budgets are published in national documents.

At the beginning of the budget process, budget and investment preparation guides give responsibility to the strategy units (which are responsible for budget preparation on behalf of spending units) to fill out the separate forms for new appropriations demanded in statements for budget proposals. Budget users prepare their proposals for budget revenue and expenditures in the framework of strategic plans, the principles stated in the budget preparation guide, and ceilings in MTFPs. Budgets are prepared using the fourth level of the economic classification, using an electronic platform called *e-bütçe* that they access online.

The performance programs of institutions cover cost of actions under performance objectives. In case of a change in appropriations, public administrations revise their performance programs accordingly. There are three versions

of performance programs: proposal, draft, and final, as in the budget. The resource requirements of an administration as specified in the performance program should be equal to the resources available in any version.

Performance programs are submitted to the Plan and Budget Committee of TGNA at least three days prior to debates on an institution's draft budget. Institutions (minister, undersecretary, or highest administrator of the institution) are also responsible for publishing their performance programs to the public in January, after these are adapted to the budget. But as stated above, national documents do not report the total fiscal cost of structural reforms explicitly.

The Annual Public Investment Programme, which covers all public investment projects, also has detailed information. In this document, project-based distribution of investment appropriations of institutions is characterized by parameters such as total costs, previous cumulative expenditures, and current year allocation. New investment projects can be monitored via this document.

A strong top-down budgeting system and relatively disciplined fiscal management generally do not give institutions the opportunity to spend more than their ceilings. New appropriation needs that stem from new policy initiatives are covered within the ceilings determined via MTFP. But on the other hand, there is flexibility in terms of changing the ceilings from the negotiation and evaluation period with the MoF and the MoD until the TGNA's plenary session. This flexibility in ceilings is related to general economic conditions and priorities of the government.

Strategic planning, the performance-based budgeting concept, and more transparent fiscal management have all created new incentives to policy makers and other stakeholders to see the impacts of policies. The new output-oriented concept, strategic planning and performance-based budgeting, is described in Article 19 of PFMC law (see Appendix). The elements of the performance budgeting system—strategic plans, performance programs, budgets, accountability reports, and other necessary items—constitute sub-areas of the system already built up. But there are problems to be solved to get an effective system. Some of these will be addressed in the following part of this study. Full implementation of performance-based budgeting seems to be operational in terms of monitoring expected outputs and the cost of programs.

Another tool in the PFMC law is the requirement of impact analysis for draft laws which influence revenues and expenditures.<sup>68</sup> As an auxiliary to this rule, since 2006 regulatory impact analysis has been required for preparation of

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68 PFMC law on 'Draft laws that Influence Revenues and Expenditures', Article 14: In the preparation of draft laws that may cause an increase in public expenditures or a decrease in public revenues and thus impose a liability on public administrations, the public administrations within the scope of central government shall calculate the financial burden by the draft law of a minimum period of three years and within the framework of medium-term program and fiscal plan, and shall attach it to the draft laws. The draft laws on social security shall also include actuarial calculations of at least 20 years. In addition, the opinion of the Ministry of Finance, and that of the Undersecretariat of State Planning Organisation or the Undersecretariat of Treasury, according to its relevance, shall be attached to these draft laws.



legislative arrangements. In contrast with the rules, there are less than 20 regulatory impact assessments attached to the draft legislative arrangements.

In the sections below, problems faced in the framework of fiscal management will be mentioned. The problematic areas derive from several reports and studies on the Turkish fiscal system.

### 3.1. Assessment of the overall framework

Turkey has an analytical budget classification (ABC) that is compatible with ESA95 (European System of Accounts). The functional classification is consistent with the United Nations Classification of Functions of Government (COFOG), and the economic classification is consistent with the IMF Government Finance Statistics Manual 2001 (GFSM). Budgets are produced according to this classification. However, programs cannot be specified separately in the classification. The cost of any program, project, or activity cannot be specified under a single item in the budget. It is also not possible to specify the outcomes of programs in the ABC. Because of the characteristics of the ABC, it is difficult for stakeholders (TGNA, TCA, and the public) to assess expenditures according to separate programs.

**Table IX-2: Display of analytical budget classification**

	Institutional				Functional				Financing	Economical			
LEVEL	I	II	III	IV	I	II	III	IV	I	I	II	III	IV
CODE	XX	XX	XX	XX	XX	X	X	XX	X	XX	X	X	XX

There are lots of planning and programming documents in Turkey, and this inflation of documentation has created administrative burdens. It also has created ambiguity in linking strategic plans to higher-level policy documents; performance programs to strategic plans; and budgets, accountability reports, and detailed expenditure programs to performance programs. There have been attempts to merge some documents and establish clear links between them, but these attempts have not become policy objectives yet.

Performance programs and budgets are prepared and submitted to the related administrations and the Parliament as separate documents. Therefore, appropriations are expressed via two different classifications. On one hand, appropriations are presented under the cost of activities in performance programs. On the other hand, budget proposals use the analytical budget classification and are negotiated institution by institution. Regulation for performance budgeting requires administrations to identify goals, targets, programs, activities, and costs via unit costs of activities, whereas the analytical

budget classification does not enable the allocation of appropriations to individual programs, which makes it difficult to calculate program costs or relate appropriations directly to programs or targets. In other words, the performance program structure is aligned around a results-based perspective, while budgets cannot be expressed with this structure.

### **3.2. Assessment of the institutions**

Both strategic planning and performance budgeting concepts are relatively new in Turkey. These new tools of administration require time for adaptation. As the groups responsible for coordinating the planning, programming, budgeting, and reporting processes, besides other responsibilities in line ministries and in other spending units, the Strategy Development Presidencies (SDPs) and Departments (SDDs) have crucial importance for the new fiscal structure of Turkey. They have been established in all public administrations covered in the PFMC Law. Strategic Development (SD) units and are in charge of system and internal control issues. For the sake of the newly established fiscal system, these units need to be supported by sufficient and highly qualified personnel.

There are some coordination problems between SD units and other operational units of spending agencies. SD units are directly attached to the highest administrator of the agency in order to overcome such coordination problems. Nevertheless, they still have problems in coordinating with other units.

The TGNA has relatively limited time for both draft budget and final accounts and supplementary documents. According to the Constitution and the PFMC Law, only 75 days are dedicated to evaluation and debate on budget and final accounts with their related documents. Of this time, 55 days are spent in the Plan and Budget Committee phase, with the remaining 20 days spent in the plenary session of the TGNA. The time dedicated to debates cannot easily change because the timeline for budget negotiations in the Parliament is set by the Constitution. But the effectiveness of the debates can be improved.

The TGNA has 18 standing (specialized) committees, but there is only one dealing with budget and other legislation affecting expenditure or revenues. The budget bill is not presented or deliberated in other committees of the Parliament. However, members of other committees can participate in the discussion of their respective areas. The Plan and Budget Committee has 40 members, currently 25 from the governing party and 15 from the opposition. Committee members are often former civil servants or academicians with experience in economic and fiscal issues.

The quantity and quality of permanent staff serving the TGNA on budget issues is limited. It is important to increase the capacity of staff serving the Plan and Budget Committee; existing staff generally deal with daily organizational issues rather than budget analysis.

The external audit authority of Turkey, the Turkish Court of Accounts, was reorganized by Law No. 6085 in 2010. This relatively new regulation imposes new duties on the organization. Secondary legislation and a new organizational

arrangement will need to be issued and enforced for the Court to be able to perform audits in line with EU practices and international audit standards. After full implementation of regulations aiming to strengthen the operational capacity of TCA, this institution will be guiding public agencies and fostering policy-makers sufficiently.

### **3.3. Assessment of the processes**

In the initial version of the PFMC Law, the budgeting process was set to begin at the end of the May with publication of the MTP. But from 2006 there were deviations from the formal calendar, which caused improper and ineffective implementation and preparation of policy documents. After changes in the PFMC Law in 2011, the time-frame constricted significantly. The last date for publication of the MTP is now the first week of September. Postponing the beginning of the process from May to September tightens it even more than in previous years. Without doubt this time-frame will influence the effectiveness of documents and quality of outputs.

As stated above, performance programs and budgets are separate documents but produced in the same time frame. Therefore the linkage between these documents should be enhanced. The quality of performance programs and consistency of these programs with institutional strategic plans and national and sectoral plans has vital importance. The link between planning and programming documents needs to be improved. In order to strengthen the link between these documents and improve their quality, the time-frame, preparation and reporting methodology, and responsibilities all need to be reorganized.

The IT infrastructure of these organizations also needs to be developed to produce more programmatic and output-oriented fiscal results. Existing systems such as the e-budget and other monitoring systems are not producing sufficient results for the evaluation of whole programs.

There are new initiatives to increase the effectiveness of IT-based systems such as the e-budget. For example, new modules have been introduced within the e-budget for monitoring and evaluation of performance. This improves alignment with general principles of performance monitoring and evaluation of programs, enabling display of activity reports and results of monitoring and evaluation.

## 4. Conclusion and recommendations

Institutions for medium-term fiscal planning are relatively strong: there are clear and stable fiscal objectives, a detailed medium-term budget framework, and a movement towards greater performance orientation in policy making. But on the other hand, some required implementations still exist in terms of developing institutions.

The Grand National Assembly should play a more active role in the government's fiscal strategy and take a top-down approach to approving an annual budget and scrutinizing the results of budget consistent with that strategy. To play this role, the analytical capacity of the Parliament's staff needs to be developed.

The Plan and Budget Committee is a major actor on the demand side of fiscal reports. But it has limited time and access to analytical resources to analyze the budget and final accounts. Discussion and voting on the budget takes place on an institutional basis using a first-level institutional and functional classification. A programmatic approach needs to be developed in this phase with the Parliament. In this respect institutional performance programs and draft budgets can be merged.

Involving parliamentary standing and sectoral committees in the budgeting process will improve spending agencies' accountability and ownership of the programs. This will also provide effective reporting on the fiscal costs of programs.

There is a strong motivation to improve the functioning of TNGA in the parliamentary process of budget-related issues. There are still efforts and debates on: 1) the creation of two permanent sub-committees of the Plan and Budget Committee with separate responsibilities for the budget process and the evaluation of the final accounts, 2) a larger participation of sectoral committees, 3) improvement of the research capacity of the Parliament, and 4) a larger participation of civil society in the budget process. Proposals for strengthening the parliamentary process need to be put in an action plan.

The TCA, the responsible institution in assessing fiscal reports and implementation results on behalf of the Parliament, has a relatively new legal base. This institution needs time to accommodate new roles and functions. It is expected to make a positive contribution to the output-oriented new system. Statements of general conformity, financial and performance audit reports, evaluation reports on financial statistics, and other instruments will add to the quality of information produced in the fiscal realm.

The general framework, from long-term planning to annual policy documents, seems to be consistent and robust. The Development Plan, the Medium-Term Programme, the Medium-Term Fiscal Plan, the Annual Programme, the Budget, the Annual Public Investment Programme, and sectoral-thematic strategies form the national-level documents, while institutional strategic plans, performance programs, and accountability reports form the institutional-level

documents. Simplification of planning procedures, adjustment of their time periods, and stronger integration with other planning documents would make the budget process more transparent and efficient, and would reduce the administrative burden.

Budgets and related fiscal documents are produced, published, and submitted according to an analytical budget classification, which express institutional and economic information in a detailed way. However, programs cannot be specified separately using this classification. The cost of any program, project, or activity cannot be specified under a single item in the budget. Budget proposals and related documents could be made more operational with minor adjustments in the ABC system. Programs, especially those implemented by more than one institution, could be monitored more easily. Both the Parliament and the accounting authority will be able to monitor separate programs, and it will be easier to scrutinize the performance of institutions.

A move to more program-based budgeting, reducing the number of legally binding appropriations (about 35,000 line items) to more manageable numbers, will improve monitoring of costs and outputs. The government should introduce a program classification into the budget with 3–5 programs per ministry. This arrangement will also facilitate a more policy-based discussion of budget priorities and make it easier for members of parliament and other stakeholders to focus on value for money.

As noted above, the medium-term budgeting time frame has been constricted beginning in 2011. It is expected that the curtailed time frame will reduce the quality of institutional budgetary implementations, because there will be less time to prepare sufficient performance budgets. At this point two different policies can be advised. First, the time frame should be rearranged as per the original PFMC Law, giving more time to line authorities. Second, it would help to adjust the sequence and content of documentation and work done by relevant authorities. The existing rearranged time frame resembles the previous annual budgeting process which the government used to implement before the PFMC law.

A medium-term budgeting framework, strategic planning and performance budgeting, and other related fundamental elements are well established in Turkey. The quality of economic and fiscal documents is improving over time. Further improvements are expected in the future as part of the learning process from the implementation of reforms.

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## 6. Appendix

*Strategic Planning and Performance Based Budgeting*, according to the PFMC law 5018, Article 9

Devising a mission and vision for the future work of each public administration within the framework of development of plans and programs entails the following elements:

- adopting of the relevant legislation and basic principles
- determining strategic goals and measurable objectives
- measuring performances according to predetermined indicators
- monitoring and evaluating this overall process
- assuring that strategic plans are prepared in a cooperative manner

To assure sufficient quantity and quality of public services, public administrations shall base their budgets and their program- and project-based resource allocation on strategic plans; annual goals and objectives; and performance indicators.

The Undersecretariat of State Planning Organisation is authorized to determine the strategic planning calendar and the public administrations that are in charge of preparing strategic plans, and to set out the principles and procedures to link strategic plans with development plans and programs. Public administrations prepare performance programs that include activities and projects to be carried out, as well as their resource requirements, performance targets, and indicators.

Public administrations shall prepare their budgets on a performance basis and in concordance with the mission, vision, strategic goals and objectives included in their strategic plans. The Ministry of Finance is authorized to define the procedures and principles on making the budget compatible across its users. This framework of procedures and principles, states the performance indicators (in line with strategic plans) and the activities to be carried out by the budget users, as well as other issues related to performance based budgeting.

The performance indicators shall be jointly set between the Ministry of Finance, the Undersecretariat of State Planning Organisation, and relevant public administrations; and shall be included in the administrations' budgets. Performance audits of the indicators are carried out under this framework.

# Conclusions

A key topic for public financial management in South East Europe (SEE)—but one that has received comparatively little attention—is the process of by which EU candidate and potential candidate countries incorporate structural reforms into their national budgets and medium-term fiscal documents. Attention to this issue is particularly important for them as they want to establish an effective policy dialogue with the European Union on the strength and sustainability of their medium-term macroeconomic and fiscal frameworks. Hence, the CEF, in close cooperation with the Ministry of Finance of Montenegro and with support from the SAFE Trust Fund, has asked experts across the SEE region to assess the process in their countries. The resulting case studies provide a thorough investigation into the capacity gaps and policy coordination issues that impede this process in the seven Western Balkan countries, Slovenia and Turkey.<sup>69</sup> In drawing conclusions on the insights and recommendations that these efforts have produced, the CEF has also been able to pinpoint issues that can be addressed through future learning events (see ANNEX I).

In their rich description of strategic planning and budgeting systems, authors showed that their countries are making significant progress in their public financial management, as reflected in an incremental move to medium-term planning and budgeting, which in turn allows public funds to be allocated with a stronger emphasis on performance measures. However, when comparing government sectors across countries, a very diverse picture evolves, with some countries being further ahead than others, and some budget users having stronger capacities than others. Whatever the level of progress, the initial steps need to be strengthened, which requires intensified and sustained capacity development efforts. The following conclusions can be drawn from the case studies without any judgment of a particular country or the author's assessment of it.

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<sup>69</sup> In addition to the issues put forward in the case studies, the following conclusions are augmented by notions that have been substantiated in a discussion of the case studies with beneficiaries at a seminar organized by the CEF and co-hosted by the Ministry of Finance of Montenegro at the Regional School of Public Administration in Danilovgrad, Montenegro, on October 23–24, 2012.



## 1. Relevance of political support

Economic transition, EU integration and the impact of the recent economic crisis underscore the importance of implementing structural reforms in the SEE region. Because of the impact on vested interests, policymakers often give little political priority to structural reforms. Nonetheless, the case studies show that such reforms have been more successful to date in some SEE countries than in others. In many cases, the structural reforms are implemented due to political pressures rather than an evidence-informed policy decision. This can lead to a concentration of public funds with the politically more powerful ministries, even if they do not carry out the most important policies and reform projects. This may leave insufficient resources for other ministries to carry policies and reform projects that could actually be more critical for the long term.

The fiscal impact assessment of structural reforms could help make policy decision and the prioritization of projects more transparent. For that reason, new legislative proposals typically need to be accompanied by an assessment of their fiscal impacts. However, as most of the case studies stressed, policymakers are often not sufficiently committed to assessing the expected fiscal impact of envisaged structural reforms or to assuring enough attention to detail, which can undermine competent discussion of policy plans and their underlying assumptions and associated risks. In such cases, reform projects are put forward in a trial-and-error manner, potentially posing severe consequences on public finances, especially if short-term gains are over-emphasized and long-term costs are neglected.

Even where the necessary technical procedures and legislation are in place to assess the fiscal impact of structural reforms and integrate this information in the relevant documents, sufficient political support and direction from higher level is needed to make the system work by assuring a supportive, enabling environment for public administration officials to carrying out their assessments. Some of the country cases stress that parliaments play a crucial role in checking governments' structural reform plans, but they tend to lack sufficient technical skills to discuss the financial implications of such plans. Countries with limited resources may experience additional difficulties to assure political support for an encompassing fiscal impact assessment approach. Difficulties may arise also due to heavy involvement from donors, as donors and their projects may be uncoordinated or may allocate funds to bigger reform projects outside of the budget process.

## 2. Fiscal programming and strategic documents

Moving toward performance-oriented policymaking and introducing medium-term policy frameworks has helped public authorities improve their macro-fiscal accountability, and transparency and use public funds better by prioritizing expenditures. This shift has been accompanied by the preparation of numerous strategic documents by various government agencies. In many countries, a rapid proliferation of strategies has actually undermined their main aim—to promote transparency and accountability. Hence, as the case studies note, some countries have begun reconciling and consolidating their strategic documents. Even so, in most cases the preparation of strategic documents for domestic purposes and EC surveillance has remained disconnected. Typically the countries closer to EU accession demonstrate a somewhat closer integration of their strategic documents, although such alignment remains imperfect even for some EU member states. The countries farther from EU accession also tend to be farther from systematically integrating the preparation of strategic documents with the budget process. In such cases, EU surveillance reports often remain from ad hoc exercises.

The EU's economic surveillance requires an annual update: this is the Economic and Fiscal Programme (EFP) for potential candidates, and the Pre-accession Economic Programme (PEP) for candidates. Both documents shall describe the countries' medium-term macro-fiscal frameworks and include the fiscal impact assessments of structural reforms, with EFPs being less extensive than PEPs. The European Commission's reviews of the EFPs/PEPs reveal a number of problematic issues in terms of the quality. The amalgamation of these reports, which involve a substantial number of stakeholders, can produce inconsistencies: for instance, ambiguous levels of detail for various report sections and inconsistent use of statistics standards, e.g., when accounting for structural policies. Such inconsistencies can derive, for example, from an undifferentiated reproduction of some sections from previous years' reports or a reporting format where in which form dominates over content.

## 3. Fiscal impact assessments of structural reforms

The importance of realistically assessing the fiscal impact of structural reform, with full accounting for the short and medium term, seems straightforward. A good assessment of fiscal implications might in particular help budget users in their budget negotiations. However, budget users often fail to provide adequate quantification of the medium-term fiscal implications of their policies and reform projects, both under unchanged macro-fiscal conditions (the baseline scenario) and through assumptions about potentially changing conditions (alternative scenarios). There are cases in which such scenario analyses turn out to be technically too complex and thus of limited use for policymakers.

However, in most cases, budget users either fail to provide costs scenarios or offer only weak or insufficiently updated information.

Budget users' fiscal impact scenarios often fall short because of insufficient in-house capacities to make technical assessments of policies and reform projects, or a failure to cooperate with outside research bodies that do have such capacities. Some of the case study authors stress that the methodology to be applied for assessing the cost of structural reforms is not sufficiently clear in the first place. Evidently capacities are stronger among budget users that bear a heavier share of the public budget, such as line ministries in charge of bigger capital investment projects, social welfare programs, or market regulations with substantial fiscal implications. Technical requirements also vary widely according to the policy or reform project that is to be assessed: some can be assessed somewhat more easily (e.g., those linked to capital and current expenditures) while others require intensive analysis of the likelihood of changing scenarios and are thus very sensitive to the macroeconomic forecasts they are based on (e.g., those linked to new legal acts). Some of the case studies demonstrate that cross-cutting reform projects in particular tend to be only partly assessed, as the attention given to assessments of their fiscal implications depends very much on the priority each involved budget user assigns to it.

Fiscal impact assessments are relevant to EU reporting, adoption of new legislation, and the budget process. As evaluations of EU surveillance reports show, descriptions of structural reforms efforts are often not properly accompanied by their fiscal implications. Newly proposed legislation on structural reform projects usually needs to provide some assessment of fiscal implications, which, however, also often results in imprecise and incomplete estimates. By comparison, the fiscal impact assessments that are implicitly needed to prepare budget submissions and discussed within the budget preparation process (for example, in the negotiations of ceilings and hearings on budget requests) are likely to be the most developed. Through this process, less comprehensive fiscal impact assessments (with more budget users failing to provide realistic estimates) make it more likely that budget ceilings will need to be renegotiated, possibly across different budget users.

The ministry of finance (MoF) typically guards the overall budget vis-à-vis ceilings. It guides budget users in making their budget submissions, checks submitted budget requests, and thus also probes the plausibility of fiscal impact assessments of structural reforms. In doing this, it tends to be more pessimistic about the medium- and long-term fiscal implications, whereas budget users tend to provide more optimistic scenarios. However, budget users are better informed about their policies and reform projects; it is in their direct interest to make a strong argument for the benefits of their policies and reform projects, and correspondingly always to have at hand a good assessment of their fiscal implications.

## 4. Role of budget users

In discussing the role of budget users in the fiscal impact assessment of structural reforms, the case studies mainly refer to line ministries (LMs), especially those that manage a bigger share of the budget—institutions that may face a bigger need to develop related capacities. Other budget users, such as, for example, public agencies, are also required to assess the fiscal impact of their work, but are not typically managing structural reforms with substantial budget relevance. Nonetheless, the problematic issues in including the fiscal impact of structural reforms when preparing the budget may apply to any budget user, including the ministries of finance themselves.

The case studies confirm that capacities vary considerably across budget users. This may be due to different technical skills needed to assess the policies and reform efforts of specific budget users, as well as variation in size and experience of different budget teams. Technical capacities may also be determined by the level of responsibility that budget users assume in discussing their budget beyond merely preparing an administrative budget for the MoF. Some budget users have moved further ahead in assessing the costs of current and envisaged policies, with a shift from preparing mere wish lists to functioning as a fully informed and responsible actor in the decision-making on the fiscal implications of policies. LMs (and other budget users) have decision power about the projects and reforms they carry out; their influence in the budget system empowers them to assure the best resources for their activities.

Yet, many budget users still are a long way from such an active role in the budget process. Often they neglect the importance of providing accurate and timely information, whether because of insufficient vision, or problems in internal coordination, technical skills, articulation of policy measures, or commitment to prudent financing. Capacity issues tend to be more severe if there is not a sufficient enabling environment in the budget institutions. The case studies highlighted the importance of senior-level staff (i.e., committed middle managers and top leadership) in providing a stimulating environment that encourages constant updates of internal procedures, offers the freedom to make improvements, invests in the staff's capacities, manages staff effectively, and consolidates institutional knowledge. Accordingly, there is a considerable need to create awareness among senior-level officials of the importance of preparing strategic budgets, to deepen their understanding of the crucial role their institutions play in this process, and to develop their capacity to better communicate the fiscal costs of their policies and reform projects.

Even if budget users are well integrated in the annual budget process and the preparation of strategic documents, they often are not organized in a way that enables them to respond appropriately, e.g., in making a distinction between structural reforms and infrastructure projects, or having focal points to communicate relevant information internally and externally. The case studies stressed the importance of recruiting relevant experts to support the

process, ensuring more independence of the process from executive authorities, and improving the policy coordination not only with external partners but also internally among various departments. Often the departments that have the best skills for responding to budget requests do not have sufficient authority or capacity to coordinate within their own institution. While budget users need to strengthen their policy capacity, they also need better guidance and management.

## 5. Fiscal policy coordination

The MoF has the responsibility to assure that decision-making is underpinned by resource availability. It therefore coordinates and guides the process of preparing the budget and related strategic macro-fiscal documents. It helps set priorities and limits for expenditures (ceilings), coordinates across budget users, guides them in responding to budget requests (through instructions), controls and discusses the budget submissions (through hearings), and assures that spending remains within preset ceilings. While these roles are clear, the case studies highlight a number of issues that hamper MoFs in effective coordination of fiscal policies.

Typically, MoFs are less informed than budget users about the content of policies and reform projects that are discussed during the budget process, whereas budget users place less attention on the financial consequences of their activities. As a consequence, the MoF tends to expect higher fiscal costs from reform projects, whereas budget users tend to underestimate costs, especially those in the longer term. Regular consultation and an effective flow of information between the MoF and budget users are essential to overcome this difference in focus between the two sides. Good policy coordination processes are particularly relevant when structural reforms involve several budget users.

The case studies provide a diverse picture of policy coordination in SEE countries. A crucial aspect is the role of coordinating functions or bodies—some case studies call them “focal points”—that facilitate agreement across levels and are a core discussion partner for other domestic authorities, the EC, and IFIs on macro-fiscal issues. Some countries already have working groups of such focal points that gather relevant information within their respective institutions and communicate it with other authorities (e.g., the MoF) in preparing the annual budget and strategic documents, including assessments of the fiscal impact of structural reforms.

Effective working groups are characterized, for example, by leadership from a senior-level staff who assures consistency across the key documents, and a comprehensive introduction of new group members to the relevant processes. Having too many focal points can make responsibilities less clear and can slow and complicate working group efforts, but on the other hand, having responsibilities too concentrated can make a group highly dependent on the skills and

motivation of a few people, or sometimes just one person. Some countries have already established better overall capacity to coordinate policies; they tend to be less in need of setting up focal points. However, most countries discussed in the case studies have significant scope for improving coordination, both among the budget institutions themselves (the MoF and budget users), and with the government (i.e., the Cabinet) and the Parliament (including its budget and sectoral committees).

As noted, most case studies found that MoFs still face problems with fiscal coordination. Many MoFs still face non-compliant budget users that show little interest in reflecting the costs of reform efforts and pay little attention to performance aspects; as a result, extensive budget renegotiations may become necessary and the quality of strategic documents may turn out to be weak. For example, when MoFs fail to assure an appropriate quality of EFP/PEP reports, it is often due to budget users providing only narratives on structural reforms, with financial information that is incomplete, outdated, or unrealistic, or completely absent. In some cases the MoF's monitoring system is not yet sufficiently developed to monitor budget users' programs and their performance, making it difficult to identify non-compliance. In other cases the MoF is restricted to a mere commenting role, with little authority to penalize non-compliance.

## 6. Improving procedures and guiding budget users

The case studies also show that guidelines and procedures devised by the MoF play an important role in assuring the quality of budget submissions and inputs for strategic documents. Effective guidance facilitates a an understanding of why the input of budget users is relevant for preparing sound macro-fiscal frameworks and why these frameworks in turn are important for the budget users, as well as the basics of what is expected from budget users and when they need to submit their input. The common practice is to establish (with a by-law) the annual budget calendar, to prepare written budget instructions, and to arrange meetings with budget users. However, the case studies highlighted that in many cases these practices need improvements; as examples, the budget calendar is often not aligned with the preparation of strategic documents (leading to ad hoc or parallel procedures), formats or templates provided are insufficient or imprecise, and meetings between the MoF and budget users are not very productive. In addition, the MoF can help budget users by simplifying procedures, reducing the administrative burden, and assisting in their capacity development (e.g., by providing learning events).

When requesting input on the fiscal impact of structural reforms, however, the first question to be answered is how the reforms are being defined. The case studies stress that there is a lack of such definitions.<sup>70</sup> It is also essential

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70 See also ANNEX II for a discussion of the definition of structural reforms, in line with documents of the European Commission.

to differentiate how far different types of structural reforms may have fiscal implications at all. Authors highlight that ambiguity on what is considered a structural reform may also reduce the consistency of the EU reports that their countries submit. They strongly emphasize the need for an intensive exchange, including with the European Commission, to come to clearer definitions. The MoF needs to play a leading role in assuring budget users' shared understanding of which definitions and terminology are to be applied.

## ANNEX I

# Indication of learning events to serve highlighted needs

The case studies provide a detailed assessment of problematic issues and capacity deficits that could be addressed through future learning events, and thus they successfully fulfill the FIASR project's main objective. Accordingly, the CEF is proposing three learning events (see below) that it will design and deliver in close cooperation with international experts in the coming months within the Strategic Planning and Budget project. The learning events will be complemented by capacity development activities for officials from ministries of finance and other budget users to strengthen beneficiary countries' macro-fiscal frameworks, as reflected in their EU surveillance reports. The learning events will have a multi-beneficiary character to ensure an exchange of good practice across South East Europe; regional expertise will be activated to sustain capacity development outcomes. The CEF encourages beneficiaries to come up with complementary initiatives that serve the specific needs of their country.

The learning events (two workshops and a high-level seminar / policy dialogue) will provide an optimal start for addressing the needs identified for beneficiaries in South East Europe, supporting better fiscal policy coordination and discussion of the fiscal impact of structural reforms—an area that, while vitally important, has been little addressed so far. However, the preparation of a more extensive training agenda is needed, and this will require an extended exchange between international experts and beneficiaries, with deeper assessment of the issues and capacity needs in beneficiary countries. For instance, an area that might warrant further attention is how technical capacity needs to differ by sector as line ministries assess the fiscal impact of their structural reforms and policies. The CEF is committed to facilitating this process over the long term and to helping address the capacity development needs that are identified, in close cooperation with international donors and partners.



# 1. Fiscal policy coordination

## 1.1. Description of learning event

In a workshop on *Fiscal Policy Coordination*, the CEF will address the problematic issues in policy coordination between ministries of finance and other budget users (in particular budget-intensive line ministries) in jointly preparing annual budgets and strategic macro-fiscal documents. Ministries of finance are responsible for fiscal policy coordination; they draft the macro-fiscal frameworks and guide budget users in submitting their inputs.

Challenges in policy coordination include inconsistent procedures, unclear responsibilities or lines of authority, inadequate coordination mechanisms, communication problems, inconsistencies between central and local government levels, and a lack of ownership in providing the required inputs. Overcoming such deficiencies can help promote a successful implementation of structural reforms through better transparency, accountability, and prioritization of efforts.

## 1.2. Learning objectives

The workshop's primary objective is to enhance fiscal policy coordination among budget institutions, and thus aims to enhance the capacity of ministries of finances in coordinating among stakeholders. It aims to promote:

- identification of the key stakeholders in coordinating fiscal policies
- mutual understanding and joint ownership of strategic planning and budgeting processes
- integration of procedures to prepare the annual budget and strategic documents
- a shared sense of urgency to overcome ambiguous responsibilities and reconcile different interests
- a dialogue on strategies to assure budget compliance
- application of adequate monitoring and evaluation measures
- exchange of good policy coordination practices (e.g., working groups and focal points)
- transparency and better information flows among stakeholders

### 1.3. Target audience

The workshop targets mid-to-senior level officials working at MoFs (and other coordinating institutions) who integrate the input from budget institutions into the annual budget and strategic macro-fiscal documents (e.g., the intermediate and final authors of EFP/PEP reports). Mid-to-senior level officials working in line ministries (and other budget users) who provide such input (e.g., program managers, planning and financing experts, and heads of relevant departments responding to MoF requests) are also kindly invited to attend the workshop.

## 2. Budget submissions of line ministries

### 2.1. Description of learning event

In a workshop on *Budget Submissions of Line Ministries*, the CEF will address the often weak quality of budget submissions from budget institutions (in particular budget-intensive line ministries).

When budget users submit their assessment of the fiscal impact of their policies, programs, and reform projects to the MoF, they need to provide the most relevant, consistent, and current figures that are needed to generate a comprehensive medium-term plan. This includes an assessment of the expected costs as well as benefits of each public program, with clear prioritization and management of expenditures, as well as a strategic adjustment of policy developments during the budgeting process and a constant monitoring of the performance of sectoral programs.

Today there are inconsistent inputs from line ministries (and other budget users) into annual budgets and strategic macro-fiscal documents, as well as weak linkages among various sections of these strategic documents. Reasons include poor guidelines on how to prepare budget submissions and inputs for strategic documents, a lack of capacity to assess the fiscal impact of policies and envisaged structural reforms, and ambiguity about the way the costs of structural reforms are defined and should be assessed. Regularly updated and reasonable submission guidelines and templates, clear methodology and definitions, as well as strengthened capacities in the internal budgeting processes of budget users are needed to make their cooperation with ministries of finance more effective.

At the end of the workshop, participants will have a handbook with guidelines and templates of budget submissions. Participants will be aware of the basic applications of the required methodology for strategic planning and budgeting in order to produce inputs into annual budgets and strategic documents.

## 2.2. Learning objectives

The primary objective of the workshop is to strengthen budget users' capacity to respond to their MoF's budget requests. It aims to promote:

- guidance for better preparation and discussion of budget submissions (i.e., updated budget instructions, better templates, simpler formats, clearer definitions for budget submissions, more productive hearings)
- enhanced understanding of operations and concrete methodology to assess the fiscal impact of envisaged policies and structural reforms
- agreement on procedures to prepare annual budgets and strategic documents
- mutual understanding of the importance of good macro-fiscal frameworks in preparing for EU accession
- enhanced inter-sectoral cooperation in assessing the fiscal impact of cross-cutting policies and structural reforms
- exchange of good practice to assure realistic fiscal impact assessments

## 2.3. Target audience

The workshop targets at mid-to-senior level officials in line ministries (and other budget users), who provide input for the preparation of the annual budget and macro-fiscal strategic documents (e.g., program managers; planning and financing experts; heads of relevant department, responding to MoF requests). Mid-to-senior level officials of MoFs (and other coordinating institutions) who integrate the input from budget institutions into budgets and strategic documents (e.g., the intermediate and final authors of EFP/PEP reports) are also kindly invited to attend the workshop.

# 3. Enabling environment for effective fiscal impact assessments

## 3.1. Description of learning event

In a high-level seminar and policy dialogue on what entails an *Enabling Environment for Effective Fiscal Impact Assessments*, the CEF will raise awareness among senior-level managers and top representatives of budget institutions of the importance to sustain and deepen progress on capacity development in fiscal policy coordination and budget submissions. Participants will identify unaddressed capacity needs and discuss options to assure such an encompassing capacity development strategy for budget institutions.

### 3.2. Learning objectives

The primary objective of this high-level seminar and policy dialogue is to assure a comprehensive strategy for developing budget institutions' capacities to better inform policy-making on the fiscal costs of current policies and envisaged structural reforms. It aims to promote:

- joint ownership of strategic planning and budgeting processes
- a shared sense of urgency to overcome ambiguous responsibilities and reconcile different interests
- identification of related unilateral and multilateral capacity development activities
- awareness of the importance of strategic planning and budgeting as part of policy formulation
- mutual understanding of the importance of good macro-fiscal frameworks in preparing for EU accession
- recognition of the importance of providing an enabling environment for capacity development
- identification of unaddressed issues in the fiscal policy coordination and impact assessment of current policies and envisaged structural reforms
- a mandate to design and deliver a comprehensive agenda of capacity development activities
- support in identifying options to fund and implement this capacity development agenda

### 3.3. Target audience

The high-level seminar and policy dialogue targets senior level officials and high-level representatives of budget institutions (in particular budget-intensive line ministries and ministries of finance) who are in charge of the process to integrate the fiscal impact of current policies and envisaged structural reforms into annual budgets and strategic macro-fiscal documents.



## ANNEX II

# Guidelines for preparation of country case studies

**About these guidelines:** This document guided authors in preparing country case studies as part of the FIASR project. Following the guidelines will help ensure a higher level of methodological consistency among contributions prepared by authors from various countries.

Below you will find the background on the FIASR project, including its time-frame and who is involved. This is followed by key contacts, deadlines, and detailed guidance on content and structure of the case study document. A final section provides essential background information on methodological issues for discussing structural reforms and classification of fiscal expenditures.

**The FIASR project:** *Fiscal Impact Assessment of Structural Reforms* (FIASR) is a project initiated in 2011 by member institutions of the Center of Excellence in Finance (CEF).<sup>71</sup> The CEF's recent evaluations of strategic planning and budgeting processes across South East Europe (SEE) have indicated a need to strengthen institutional capacities in the region for integrating fiscal costs of structural reforms into countries' annual budgets and medium-term fiscal documents.

FIASR helps prepare the ground for *Strategic Planning and Budgeting* (SPB), a Multi-Beneficiary Instrument for Pre-Accession (MB-IPA) project which the CEF proposed to the European Commission and is now developing, with expected launch in late 2012. SPB aims to address capacity needs in policy design, implementation, and coordination of three key areas: (i) the medium-term macroeconomic framework, (ii) the medium-term fiscal and budgetary framework, and (iii) the integration of structural reforms' fiscal costs into the annual budgets and medium-term fiscal documents of beneficiary countries. FIASR focuses on the third area. In contrast to the other two areas, for SPB the content of learning events on the third area still needs to be identified and articulated, and country cases studies will provide a basis for this.

71 FIASR Beneficiary countries are Albania, Bosnia & Herzegovina, Croatia, Kosovo, Macedonia, Montenegro and Serbia. Experts and practitioners of non-beneficiary countries from the SEE region (i.e., recently acceded EU member states, Moldova and Turkey) will be invited to join at their own expense.

A number of deficiencies have been observed in the integration of structural reforms' fiscal costs into fiscal programming documents, and the case studies will provide a means to gauge these across the region and explore how they can be addressed. There is a lack of consistent inputs by line ministries into annual and medium-term fiscal documents as well as weak linkages among various sections of these strategic documents. Reasons include inadequate guidelines for line ministries on how to prepare inputs to strategic documents, lack of capacity to assess the impact of structural reforms on national budgets, and weaknesses in organizational structures. In addition, challenges in policy coordination include inconsistent procedures, unclear responsibilities or lines of authority, inadequate coordination mechanisms, communication problems, and inconsistencies between central and local government levels. Overcoming such deficiencies should help promote the success of structural reforms through better transparency, accountability, and prioritization of efforts.

Assessments of beneficiaries' strategic planning and budgeting processes across the SEE region, done by the European Commission's Directorate General for Economic and Financial Affairs (DG ECFIN), show that there is a need to strengthen (potential) candidates' capacities, especially in line ministries, to integrate the fiscal costs of structural reforms into medium-term plans and budgets.<sup>72</sup> The FIASR project is also in line with the EU's 2020 strategy for growth, to help countries in SEE that aspire to join the European Union in implementing the *acquis* and in promoting economic and social reforms to fulfill the Copenhagen criteria.

In partnership with the Ministry of Finance of Montenegro, the CEF has received funding from the SAFE Trust Fund to support FIASR. The trust fund, which focuses on Strengthening Accountability and the Fiduciary Environment, is administered by the World Bank on behalf of the European Commission and the Swiss Government. In March 2012, it approved a grant for the CEF to deliver the FIASR project to beneficiaries in the Western Balkans. The grant will be complemented by in-kind contributions from beneficiaries. Project activities will also be open to experts and practitioners of non-beneficiary countries in the SEE region at their own expense.

The FIASR and SPB projects are part of the CEF's Building Capacities in Policy Design and Implementation (BCPDI) program; see [www.cef-see.org/bcpdi](http://www.cef-see.org/bcpdi) for further information.

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72 See, for example, assessment reports of the EC's DG ECFIN on the *2012 Economic and Fiscal Programmes of Albania, Bosnia and Herzegovina: EU Commission's overview and country assessments* (EUROPEAN ECONOMY Occasional Papers 97), and of the *2012 Pre-accession Economic Programmes of Croatia, Iceland, the Former Yugoslav Republic of Macedonia, Montenegro, Serbia and Turkey: EU Commission's overview and assessments* (Occasional Papers 98).

**FIASR objectives:**

1. Assessing—via country case-studies—how countries of the SEE region incorporate structural reforms into their national budgets and medium-term fiscal documents
2. Identifying gaps and policy coordination issues in this process
3. Generating a list of issues that can be addressed through learning events within the framework of the SPB project

**Project timetable:** FIASR is scheduled to be completed by the fourth quarter of 2012, so that its outputs can be fully integrated into the SPB project's implementation. The final event of the FIASR project—a two-day seminar—is scheduled for October 23–24, 2012.

**Overall guidance:** A special FIASR Working Group created by the CEF had its kick-off meeting in Ljubljana on April 2, 2012, and agreed on country case studies as a key component for the project's success [see list of Working Group members in ANNEX III].

## Instructions for preparing country case studies

The FIASR country case studies are intended to provide clear, well-documented examples that demonstrate the specific issues countries face in incorporating structural reforms' costs into their national budgets and strategic planning documents.

Collectively, the case studies will provide a comprehensive synthesis of real-life cases that are backed up by data and policy analysis. Country case studies require the author to think through a number of key issues and to assess their appropriate resolution by evaluating pros and cons of different policy options and strategies.

[...]

## Content and structure of country case studies

The country case study should include the following main sections, with an overall length of about 15 pages of main text.

- *I: Introduction*
- *II: Main institutional features for annual budget and medium-term fiscal programming*
- *III: Incorporation of structural reforms' fiscal costs into fiscal programming documents*
- *IV: Conclusions and recommendations*
- *Literature and sources*
- *Appendixes*



Guidance below offers a check list of issues, questions, and potential problems to be addressed by the case studies. This list is not exhaustive: each author is invited to include other issues he or she deems essential to a comprehensive document. At the same time, the check list touches on a number of problem issues that are under consideration for the region as a whole. Bearing in mind significant differences in institutional features and processes as well as in overall capacity for programming the fiscal aspects of structural reforms, authors are expected to use these Guidelines as a general framework for their text preparation.

One general methodological point on the definition of fiscal programming documents should be clarified. The focus of country case studies is on how fiscal costs of structural reforms are being integrated into two types of fiscal programming documents: *first*, into annual budgets, and *second*, into medium-term fiscal documents. This latter category consists of documents prepared exclusively for “domestic purposes,” such as a medium-term expenditure framework (MTEF), a “spring” and “autumn” fiscal programming report, as well as documents prepared in the context of EU integration, such as EFP/PEP documents of EU candidate countries and other (forthcoming) surveillance reports of EU member states.

## Section 1: Introduction

This brief introductory section (about 1 page) should:

- familiarize the reader with the subject matter
- articulate the key objectives of the case study
- present methodological features of the study as well as sources of information used in its preparation
- outline the structure of the text by main sections

In the introduction, the author may add, in line with section 4.1 of this document, a short description of the main structural reforms that have been recently addressed or are planned to be implemented in the near future in his/her country.

By reading only the Introduction, the reader should know what he/she can expect from the case study. The text should be written to catch the reader’s attention.

## Section 2: Main institutional features for annual budget and medium-term fiscal programming

The section (about 3 pages) should be composed of the following three sub-sections.

*Sub-section 2.1 (Legal and other relevant framework)* should provide information about the legal basis (laws, by-laws, decrees, etc.) or other relevant basis for the preparation of annual budgets as well as medium-term fiscal programming documents, such as MTEF and EFP/PEP. Particular attention should be

put on identification of the legal acts and decisions that explicitly or implicitly address the subject of structural reforms and their integration into fiscal programming documents. Have there been any legal or other documents adopted that deal with this subject? If yes, please explain.

*Sub-section 2.2 (Institutions)* should make an overview of all the institutions that are involved in the processes of (i) annual budget preparations, and (ii) medium-term fiscal programming documents. Typically, the process is coordinated by the Ministry of Finance, while line ministries and/or other budget recipients are asked to provide inputs at various stages. In some countries, other types of institutions are systematically involved, such as prime ministers' offices or governmental institutions responsible for macroeconomic and fiscal revenue forecasting.

*Sub-section 2.3 (Procedures)* should provide basic information on the processes through which fiscal programming documents are prepared. An important issue here is whether (and, if yes, to what extent) the processes are synchronized between annual budget preparation and the preparation of medium-term fiscal programming documents. Is the preparation of medium-term fiscal programming documents that regularly need to be submitted to the European Commission (EFP/PEP/...) systematically integrated into the budget preparation cycle of "exclusively domestic fiscal programming documents"?

### **Section 3: Incorporation of structural reforms' fiscal costs into fiscal programming documents**

This section (about 8 pages) presents the core substance of the country case study and is expected to provide a basis for conclusions and recommendations. Its objective is to provide a critical assessment of how fiscal costs of structural reforms are being integrated into fiscal annual and medium-term fiscal programming documents. For each of the sub-sections, the Guidelines have sketched a number of key concerns that have been identified during preparation of the FIASR project. It should be underlined that these propositions are neither exhaustive nor necessarily correct for each individual country. But authors should refer to these in preparing the document, to help gauge how accurate they are for the region as a whole.

The section is recommended to include at least the following three sub-sections.<sup>73</sup>

*Sub-sections 3.1 (Assessment of the overall framework)* should provide an assessment of the overall fiscal programming system, especially from the point of view of how the system addresses the issue of structural reform's fiscal costs. Based on the Working Group's observations, we ask authors to consider whether the following circumstances apply in their country:

- *Vague definition of structural reforms* impedes addressing them in operational manner, i.e., to integrate them systematically into fiscal programming process

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<sup>73</sup> Additional sub-sections, if deemed appropriate by the author, are welcome.

- *Lack of political will* obstructs systematic insight into fiscal costs and thus effective design of economic policy measures
- *Wrong perception of external surveillance programming* as labor-intensive by-product of domestic fiscal programming
- *Disconnected coordination of domestic fiscal programming* (embedded in national legislation) and external surveillance programming (based on political commitments)—sometimes two different sets of figures presented for the same programming period

*Sub-sections 3.2 (Assessment of the institutions)* should assess how (un)successful various groups of institutions (Ministry of Finance, line ministries, other institutions involved in the process) are in introducing structural reforms in a systemic manner into fiscal programming documents. Based on the Working Group's observations, we ask authors to consider whether the following circumstances apply in their country:

- *Ministry of Finance's typical dominance in fiscal programming processes usually not matched by sufficient interest for structural reform aspects*, despite organizational and human resource advantages for it to be the leading institution in the process
- *Line ministries generally lack sufficient capacities, motivation, overview of procedures, and effective policy coordination* to submit appropriate policy and fiscal information on structural reforms as requested by Ministries of Finance (i.e., in circulars for medium-term budgeting)

*Sub-section 3.3 (Assessment of the processes)* should assess any existing procedures for a systematic incorporation of structural reform's fiscal costs into a country's fiscal programming documents, as well as the quality of these processes. Based on the Working Group's observations, we ask authors to consider whether the following circumstances apply in their country:

- *Countries have rather little experience in policy coordination*, and, within this context, in coordinating structural reforms and assessment of their fiscal costs; the process has been by and large done on an ad hoc rather than systemic basis
- As Ministries of Finance are not particularly interested in a detailed quantification of structural reform's fiscal costs; hence their *instructions sent to the line ministries and other budget users in the context of annual and medium-term fiscal programming exercises tend to be unclear or incomplete*
- *Line ministries typically do not have a sufficiently clear understanding of the concept and definition of structural reforms* and, therefore, it is not realistic to expect them to provide high-quality responses
- *Parallel, not systematically integrated procedures* to generate domestic and EU fiscal programming documents that result from a lack of sufficient institutional capacities, poor retention of qualified staff, or issues of decision

authority and/or prioritization in particular on behalf of the coordinating institution, e.g., the Ministry of Finance

The following table may be useful to case study authors in making a rough, first overview of the most pressing issues and problems associated with the fiscal impact assessment of structural reforms in their respective countries. The questions outlined above may provide a good starting point. For discussion of the areas of structural reforms, please reference “Methodological Issues” in the last section of this document.

**Table: Identification of most pressing issues associated with fiscal impact assessment of structural reforms**

Area of structural reforms	Overall framework issues <i>(Sub-section 3.1.)</i>	Issues emerging from institutional features <i>(Sub-section 3.2.)</i>	Issues emerging from procedures and processes <i>(Sub-section 3.3.)</i>
Reforms of the enterprise sector			
Financial sector reforms			
Human resource development & labor market reforms			
Utilities & network industry reforms			
Administrative & other reforms			

Section 4: Conclusions and recommendations

This section (about 3 pages) should be composed of two sub-sections.

*Sub-section 4.1 (Conclusions)* should provide the author’s conclusions about the first two objectives of the FIASR project—*overall assessment of how countries of the SEE region incorporate structural reforms into their respective national budgets and medium-term fiscal documents, and identification of gaps and policy coordination issues in this process*. More specifically, conclusions should be presented about (i) how the country is organized for effective integration of structural reforms’ fiscal costs into its fiscal programming documents; (ii) what is the role of the Ministry of Finance, line ministries, and other relevant institutions in this process; (iii) what have been identified as the main weaknesses within the process of programming fiscal costs of structural reforms (e.g., absence of a political will, weaknesses in the bureaucracy, lack of clear orientation with respect of methodology, etc.), and (iv) which institutions present the major bottleneck for substantially strengthening this process.

*Sub-section 4.2 (Recommendations)* should offer recommendations that would contribute substantially toward better integration of structural reform's fiscal costs into the country's annual and medium-term fiscal programming documents. More specifically, recommendations are expected to identify instruments for achieving this objective as well as the target groups of such assistance.

A possible solution to line ministries' organizational issues with budget submissions, for instance, might be to identify, nominate, and build the capacity of individuals who serve as focal points. This may imply that they would be briefed regularly about the general framework of fiscal programming documents and the importance of structural policies inputs that they are asked to provide. Activities that help to improve the coordination with such focal points might include the following: (i) development of templates for preparing inputs, (ii) putting in place more structured procedures for input preparation, (iii) learning events for the focal points and other staff at the line ministries in skills of medium-term fiscal and economic planning.

Bearing in mind the third objective of the FIASR project—to *generate a list of issues that can be addressed through learning events within the framework of the SPB project*—the recommendations are expected to focus on these types of activities.

## **Literature and sources**

The author should make clear references to all those pieces of the literature (academic, other) and information and data sources (official documents, interviews, etc.) that have been used in the process of country case study preparation. These references should be made both in the respective part of the text as such as well as in this separate reference section.

## **Appendixes**

In the appendixes, the author may put tables, figures, or documents that for various reasons (length, specific character, etc.) could not be integrated into the main text but that support the country case study. Preferably appendixes should not be more than 10 pages.

## Methodological issues of structural reforms: for use in preparing country case studies

In the context of preparing country case studies, two methodological issues associated with the term “structural reforms” need to be clarified. One is the concept and definition of structural reforms that is being applied. The other deals with the classification of fiscal expenditures related to structural reforms.

### Concept and definition of structural reforms

There is no single and generally accepted definition of structural reforms. In general, it could be said that structural reforms are or at least should not be considered an end in themselves but rather a means for boosting sustainable economic growth. Various institutions have their own distinct approach in defining what constitutes structural reform, and this depends at least partly on each institution’s goals and objectives.<sup>74</sup>

For the purpose of these Guidelines, the European Commission’s concept of structural reforms has been taken as a point of departure. According to this concept, articulated partly in guidelines for Economic and Fiscal Programme (EFP) and Pre-accession Economic Programme (PEP) preparation and partly in some other documents of the European Commission, such as annual progress reports, structural reforms include:

- *Reforms of the enterprise sector:* A high share of a private sector activities, allocation of resources in a decentralized manner and according to market principles, and absence of loss-making enterprises are key features of a functioning market economy. Enterprise sector restructuring is clearly at the very heart of the transition process toward a market economy. The key characteristic of this process is the ownership transformation from a publicly dominated to a privately dominated economy. The process typically consists of three sets of activities: (i) introduction of financial discipline and competition in the enterprise sector, (ii) private sector development through both privatizations of state-owned firms and promotion of new private firms, including small and medium enterprises (SMEs), and (iii) restructuring of enterprises in both, pre- or post-privatization periods.
- The overall objective of enterprise sector reforms is to increase the country’s international competitiveness. The concept distinguishes between competitiveness at two levels: at the enterprise sector level, its ingredients, for example, include investments in labor productivity, and research

<sup>74</sup> International organizations differ in their definitions of structural reforms: the IMF (WEO, 1994) puts more emphasis on the role of market forces, the OECD (Political Economy of Reform, 2009) on resource allocation in the economy, the G-20 (Seoul Declaration, 2010) on global demand and the World Bank (WDR, 1997) on macroeconomic adjustments that include measures directed at poverty alleviation, private sector development and building institutional capacities.

and development; while at the national level, international competitiveness includes elements, such as macroeconomic stability, legal system, tax system, labor market, costs and access to finance, corruption and crime, state aids, support to specific sectors, support for foreign direct investment (FDI), SME development, etc.

- *Financial sector reforms:* The main objective of the financial sector within a national economy is to channel savings towards productive investment. In contrast to a planning economy, where the allocation of resources is done through a centralized mechanism of planning, the market economy performs this process via the financial sector. It is therefore a typical ingredient of a functioning market economy. There is no market economy without a well-functioning financial system. While the development, stability, and health of the three segments of the financial sector—banking, insurance, and capital market—are of key importance to avoid macroeconomic disequilibria and even crises, the sector is also instrumental for boosting and sustaining economic growth. Financial sector reforms are typically associated with prudential and regulatory changes as well as with improvements in the supervision of the financial sector.
- *Human resource development and labor market reforms:* A sufficient supply of human capital, at an appropriate cost, is of crucial importance for a country's sustainable economic growth. Labor market reforms typically focus in two areas: (i) reforms aimed at improving the quality of the workforce and its innovation capacity through efforts in the sectors of education (school enrollment at different levels, lifelong education) and research and development, and (ii) reforms aimed at strengthening the social safety net, including active employment policies as well as pension and health sector reforms.
- *Utilities and network industry reforms:* A poor level of physical infrastructure as well as weaknesses in the utilities sector have often been identified as important hindrances to countries reaching their overall development potential. A sufficient amount of physical infrastructure (energy supply, telecommunications, transportation) at an appropriate level is of crucial importance for mitigating these deficiencies and strengthening the country's international competitiveness in the future. Reforms in these areas are basically of two kinds: (i) institutional reforms aimed at restructuring the utilities and network industries, and (ii) investments in physical infrastructure.
- *Administrative and other reforms:* This segment of structural reforms includes all those administrative and other reforms (not already addressed above) that contribute to a country's sustainable growth based on its strengthened international competitiveness. Typically, these reforms include policy measures aimed at (i) increasing trade openness, (ii) reducing obstacles to trade in goods and services, (ii) stimulating FDI, (iii) improving market entry and exit mechanisms (crucially important for elimination of payment discipline problems, which are especially destructive for SMEs,

for reducing inter-company arrears and bad debts, and for state aids), and (iv) strengthening the legal and administrative framework, including for SME development.

As evidenced from the above elaboration of structural reforms, some areas involve significant policy efforts and institutional changes, but are not very demanding from the fiscal point of view. On the other hand, some other segments of structural reforms—such as investments in physical infrastructure, human resources, research and development, and social safety net reform—typically pose a significant financial burden for countries' public finances.

## **Classification of fiscal expenditures related to structural reforms**

The classification of public finance expenditures is important to policy formulation and for identifying resource allocation among sectors, activities of the government, and the level at which performance should be assessed. The best-known classification systems are:

- (i) The *functional classification* developed by the United Nations, known as Classification of the Functions of the Government (COFOG)
- (ii) The *economic classification* developed by the IMF, known as Government Financial Statistics (GFS), which has a focus on measuring expenditure inputs
- (iii) The *programmatic classification*, which has a focus on measuring expenditure outputs and outcomes

A *functional classification* organizes government activities according to their purposes (e.g., education, social security, housing, etc.). It is independent of the government organizational structure. A functional classification is important in analyzing the allocation of resources among sectors. A stable functional classification is required to produce historical surveys of government spending and to compare data from different fiscal years.

In contrast, an *economic classification* of expenditures is required for budget analysis. Issues such as the share of wages in government expenditures, and the weight of transfers to public enterprise, for example, are crucial. At the very least, the economic classification must be fully consistent with the GFS economic classification of government expenditures. The object and line-item classification is more or less an economic classification, but should in many countries be revised or reorganized to be compatible with the GFS economic classification.

For the purpose of these Guidelines—which focus mainly on budget analysis issues—the economic classification is the more appropriate analytical tool to measure expenditure inputs. They can be classified into one of the following categories:

- *Wages and salaries*: Covers wages and salaries of public sector employees (including social security and pension contributions made for them by their



employers)—in their total amount or in their appropriate proportion—that are explicitly or implicitly needed to implement structural reforms.

- *Goods and services (other than salaries and wages)*: Covers expenditure for those material costs and various groups of services, including investment maintenance, that are explicitly needed to implement structural reforms.
- *Subsidies and current transfers*: Covers those subsidies and current transfers that are directly associated with the implementation of structural reforms.
- *Capital expenditures*: Covers those capital expenditures that can be classified as important for structural reforms.

However, while the economic classification offers information on the inputs, it does not assist in identifying whether the structural reform objectives are being met. Input-based classification systems offer a lot of information on what has been spent but very little on what is being achieved. In order to measure progress in achieving reform objectives it is also necessary to monitor performance, and in doing so, typically a *programmatic classification* accompanied by relevant performance indicators and target needs to be introduced. More advanced countries are now also appropriating by program rather than the traditional, economic line item-based appropriation structure that had been the norm.

Program budgeting classifies expenditure by types of service and objectives, rather than—as in traditional budgeting—by types of inputs. Appropriating by program and monitoring performance allows for analysis on how much money is being directed at achieving particular outputs and outcomes (i.e., results) and helps budget decision-makers assess the benefits and efficiency of programs relative to their costs. To assess the impact of structural reforms it will be necessary to introduce a programmatic approach to the reform process. The need for a programmatic classification has been recognized by most countries in South East Europe, although further work is needed in most of them to fully introduce a functioning program classification to the budget planning and execution process.

ANNEX III

FIASR Working Group

First Name	Last Name	Institution	Job Title (and Department)
Taşkın	Babaoğlu	Ministry of Development (State Planning Org.), Turkey	Planning Expert
Robert	Bauchmüller	Center of Excellence in Finance	Project Manager
Werner	Deenen	Ministry of Finance, The Netherlands / EU Twinning Macedonia	Medium Term Expert / PIFC Expert
Helena	Kamnar	Office of the President, Slovenia	Advisor to the President
Erhan	Karacan	Ministry of Development (State Planning Organization), Turkey	Planning Expert
Klaas	Klas	OECD/SIGMA	Senior Adviser
Dirk-Jan	Kraan	International Monetary Fund	Regional Public Financial Management Advisor
Ivana	Kunić	Ministry of Finance, Croatia	Head of Section for Capital Project Evaluation, Budget Analysis Department
Jean-Christoph	Maur	World Bank	Senior Economist
Paul	McClure	Center of Excellence in Finance / World Bank	CEF Visiting Fellow / World Bank Senior Communications Officer
Mojmir	Mrak	Faculty of Economics, Ljubljana, Slovenia	Professor of International Finance / CEF Associate Fellow
Brian	Olden	International Monetary Fund, Fiscal Affairs Department	Deputy Division Chief
Jana	Repanšek	Center of Excellence in Finance	Deputy Director
Tijana	Stanković	Ministry of Finance, Montenegro	Assistant Minister for Economic Policy and Development

*Note: Some group members were involved only in part of the project, e.g., in successfully initiating it.*

## About the Center of Excellence in Finance (CEF)

The Center of Excellence in Finance (CEF) was established in 2001 by the Slovenian Government on the initiative of its Ministry of Finance and in close cooperation with counterpart ministries across South East Europe (SEE). CEF member countries are Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Macedonia, Moldova, Montenegro, Romania, Serbia, Slovenia, and Turkey.

The mission of the CEF is to promote awareness of international standards and best practice in public financial management and central banking by organizing specialized learning events, encouraging knowledge sharing and research, and providing technical assistance.

With extensive knowledge of the region's learning needs, the CEF has become a leading training institution for capacity development in the region. The CEF provides tailor-made learning programs that aim to be practical and applicable to the professional challenges that finance officials and central bankers face on a daily basis.

The CEF designs programs to address reform developments and related needs in its member countries—in line with the latest trends and standards in public financial management and central banking.

For more information about the CEF and its programs, please visit the webpage: [www.cef-see.org](http://www.cef-see.org).

## Recent CEF (co)publications

WB/CEF. (2009). *Pension reform in Southeastern Europe: Linking to Labor and Financial Market Reforms*. Holzmann, R., MacKellar, L., and Repanšek, J. (eds.). Washington, D.C.: The World Bank.

CEF. (2010). *From Tolar to Euro*. Bole, V., MacKellar, L. (eds.). Ljubljana: Center of Excellence in Finance.

With fiscal space limited in South East European economies, this book is very timely. Structural reforms remain crucial to unlock growth in the region, but they frequently entail budgetary costs. Assessing and managing these costs requires a strengthening of capacity, as well as a better integration with budgetary projections and EU planning documents. This volume draws very skillfully on case studies from across the region to explore the operational challenges that this entails, including the need for capacity-building in line ministries as well as ministries of finance. Its conclusions distil important lessons, and offer a practical guide for policy-makers as they approach these problems. The book fills a gap in our understanding of public financial management, and it deserves a wide readership.

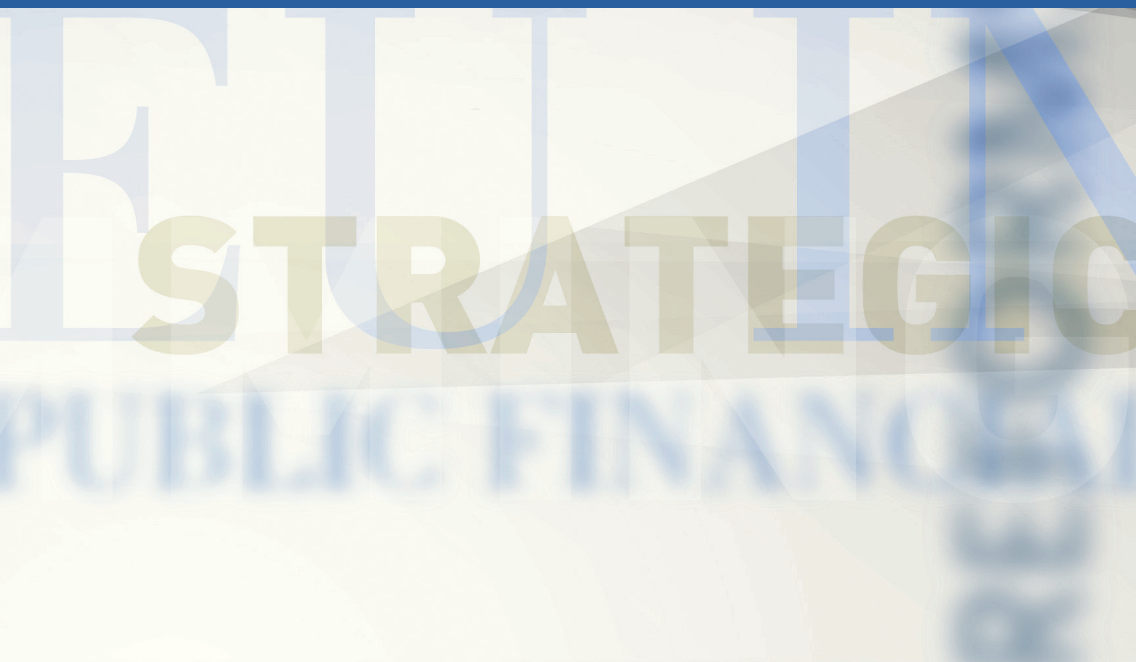
**Max Watson**

Visiting Fellow and Coordinator of South East European political economy studies, European Studies Centre, St Antony's College, Oxford

This book is an invaluable resource for those who are seeking to understand how essential structural reforms in South East European countries are coordinated with fiscal planning processes. Written by those who have been intimately involved with the reforms, the book offers key insights into the challenges that have been overcome and those that still remain. I think it is a great achievement.

**Brian Olden**

Deputy Division Chief, Fiscal Affairs Department, International Monetary Fund



Ministry of Finance  
Montenegro

