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Public Expenditure and Institutional Review
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Fiscal Year
January 1 to December 31
Weights and Measures
Metric System

ACRONYMS AND ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>ACC</td>
<td>Anti-Corruption Council</td>
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<tr>
<td>AMS</td>
<td>Administration for Mutual Services</td>
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<tr>
<td>BIAS</td>
<td>Budget Inspection and Audit Service</td>
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<td>CEEC</td>
<td>Central and Eastern European countries</td>
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<tr>
<td>CFIAA</td>
<td>Country Financial Accountability Assessment</td>
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<tr>
<td>CFO</td>
<td>Chief Finance Officer</td>
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<tr>
<td>Consolid.</td>
<td>consolidated</td>
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<td>CPAR</td>
<td>Country Procurement Assessment Review</td>
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<td>DCR</td>
<td>Directorate for Commodity Reserve</td>
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<td>DFID</td>
<td>Department for International Development (U.K.)</td>
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<td>DM</td>
<td>Deutsche Mark</td>
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<td>DSU</td>
<td>Direct Spending Unit</td>
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<td>EAR</td>
<td>European Agency for Reconstruction</td>
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<tr>
<td>EBF</td>
<td>extrabudgetary fund</td>
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<td>EPS</td>
<td>Elektroprivreda Srbije</td>
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<td>EU</td>
<td>European Union</td>
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<td>EUR</td>
<td>Euro</td>
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<td>FMOF</td>
<td>Federal Ministry of Finance</td>
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<td>FRY</td>
<td>FR Yugoslavia</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GFS</td>
<td>Government Financial Statistics</td>
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<td>GOS</td>
<td>Government of Serbia</td>
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<td>Govt.</td>
<td>government</td>
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<tr>
<td>HIF</td>
<td>Health Insurance Fund</td>
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<tr>
<td>IBRD</td>
<td>International Bank for Reconstruction and Development</td>
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<td>IDA</td>
<td>International Development Association</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>ISU</td>
<td>Indirect Spending Unit</td>
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<tr>
<td>LBS</td>
<td>Law on the Budget System</td>
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<tr>
<td>MOD</td>
<td>Federal Ministry of Defense</td>
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<tr>
<td>MOFE</td>
<td>Republic Ministry of Finance and Economy</td>
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<td>MOIER</td>
<td>Republic Ministry of International Economic Relations</td>
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<tr>
<td>MTEF</td>
<td>Medium-Term Expenditure Framework</td>
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<td>MTFF</td>
<td>Medium-Term Fiscal Framework</td>
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<tr>
<td>NATO</td>
<td>North Atlantic Treaty Organization</td>
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<td>NBY</td>
<td>National Bank of Yugoslavia</td>
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<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
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TABLE OF CONTENTS

PREFACE ......................................................................................................................................... VII

1. INITIAL CONDITIONS AND EARLY REFORMS ................................................................. 1
   A. BACKGROUND ................................................................................................................ 1
   B. MACROECONOMIC TRENDS AND MEDIUM-TERM OUTLOOK ................................ 2
   C. RECENT REFORMS ........................................................................................................ 7

2. RESTORING FISCAL SUSTAINABILITY .............................................................................. 11
   A. OUTLOOK FOR PUBLIC EXPENDITURES AND FINANCING .................................... 11
   B. ESTIMATING A SUSTAINABLE FISCAL DEFICIT ....................................................... 14
   C. IS THE SERBIAN GOVERNMENT TOO LARGE? ........................................................... 16
   D. THE NEED FOR FURTHER REFORM ........................................................................... 18

3. FISCAL RISKS BEYOND THE BUDGET ............................................................................ 21
   A. OVERVIEW OF QUASI-FISCAL ACTIVITIES ................................................................ 21
   B. A CASE STUDY OF THE POWER SECTOR .................................................................... 24
   C. POLICY RECOMMENDATIONS .................................................................................... 28

4. ALLOCATION OF PUBLIC SPENDING ............................................................................. 29
   A. ECONOMIC COMPOSITION OF GENERAL GOVERNMENT SPENDING .................... 30
   B. FUNCTIONAL ANALYSIS OF PUBLIC EXPENDITURE ................................................ 39
   C. POLICY RECOMMENDATIONS ..................................................................................... 42

5. PENSION AND HEALTH CARE SPENDING ..................................................................... 43
   A. OVERVIEW .................................................................................................................... 43
   B. THE PENSION SYSTEM ............................................................................................... 44
   C. THE HEALTH CARE SYSTEM ..................................................................................... 49

6. BUDGETARY MANAGEMENT .............................................................................................. 57
   A. FRAMEWORK AND PROCESSES ................................................................................. 57
   B. BUDGET PROCESS IN THE FEDERAL GOVERNMENT ............................................... 59
   C. BUDGET PROCESS IN THE REPUBLIC GOVERNMENT ............................................. 69
   D. SUMMARY OF RECOMMENDATIONS ......................................................................... 86

ANNEX 1: METHODOLOGY FOR ASSESSING FISCAL SUSTAINABILITY... 89
ANNEX 2: FISCAL DECENTRALIZATION IN SERBIA ......................................................... 95
REFERENCES ............................................................................................................................. 103
MAP: SERBIA AND MONTENEGRO ......................................................................................... 109

List of Tables

Table 1.1: FRY - Stock of External Debt, December 31, 2000 .................................................. 5
Table 2.1: FRY Fiscal Operations ............................................................................................. 12
Table 2.2: Serbia: Estimates of the Medium-Term Sustainable Deficit 1/ .................................. 15
Table 2.3: FRY - Selected External Indebtedness Indicators ................................................... 16
Table 4.1: Economic Composition of General Government Operations, Percent of GDP31
Table 5.1: Projection of the Financial Balance of the Serbian Pension System ....................... 45
Table 5.2: Impact on Pension System of Serbia of Amendments to Pension Law .................. 47
Table 5.3: International Comparisons of Health Expenditure ................................................. 50
Table 5.4: Public Health Expenditure in Serbia, YUD million ................................................ 51
Table 5.5: HIF Arrears Receivable and Payable ...................................................................... 52
Table 6.1: Federal Budget Outturn Relative to Approved Budget, 2001 ......................... 65
Table 6.2: The New Budget Calendar ............................................................................ 72
Table 6.3: Consolidated Budget Expenditures, 2001, Approved Versus Actual .......... 76
Table 6.4: Stocks of Arrears of Budget Institutions ......................................................... 77
Table 6.5: Variations in Budget Execution – 2001 In-Year ............................................. 78

List of Figures

Figure 2.1: Consolidated General Government Spending, 2001 ...................................... 18
Figure 4.1: Public Spending on Wages and Salaries ........................................................ 32
Figure 4.2: Public Spending on Non-wage Goods and Services ....................................... 35
Figure 4.3: Public Capital Expenditure ............................................................................. 38
Figure 4.4: Public Spending on Defense .......................................................................... 40
Figure 4.5: Public Spending on Education ....................................................................... 41
Figure 5.1: Employees Pension Fund: Estimated Number of New Retirees Per Year ..... 46
Figure 6.1: Federal Government: Functional Expenditure Allocation, 2001 ................... 60
Figure 6.2: Bifurcated Policy and Budget Process ........................................................... 62
Figure 6.3: Budget Deviation Index ................................................................................ 77

List of Boxes

Box 1.1: Structure of Serbia’s Consolidated General Government .................................... 2
Box 1.2: Serbia’s Anti-Corruption Strategy ..................................................................... 9
Box 3.1: Quasi-Fiscal Activities in Transition Economies ............................................... 22
Box 4.1: Own Funds of Budgetary Agencies .................................................................. 30
Box 4.2: Budget Lending and Onlending ....................................................................... 36
Box 5.1: The Pension System in Serbia ......................................................................... 44
Box 5.2: Minimum Pensions in Serbia .......................................................................... 48
Box 6.1: Criteria for Assessing the Effectiveness of the Budget Process ....................... 58
Box 6.2: Towards Comprehensive Budgeting – The General Balance Table .............. 61
Box 6.3: Financial Management in the Federal Ministry of Foreign Affairs ............... 64
Box 6.4: Ministry of Defense and Military PEM ............................................................... 66
Box 6.5: Use of Budget Normatives ............................................................................... 71
Box 6.6: Administration for Mutual Services: The GOS Accountant .............................. 73
Box 6.7: ZOP – The Central Clearance and Payments System ..................................... 74
Box 6.8: Extra-Budgetary Funds ..................................................................................... 75
Box 6.9: Incorporation of External Assistance Into the Budget ...................................... 79

List of Annex Tables

Annex 1-Table 1: Middle Case: Key Macroeconomic Projections ................................. 90
Annex 1-Table 2: Main Financing Assumptions ............................................................. 91
Annex 1-Table 3: Financing of Serbian Public Sector Deficit 1/ .................................... 93
Annex 2-Table 1: Assignment of Responsibilities ............................................................ 99
Annex 2-Table 2: Tax Structure and Assignment/Sharing System ................................. 100
PREFACE

1. This Public Expenditure and Institutional Review (PEIR) examines the public expenditure management (PEM) system of Serbia and Montenegro. The Review seeks to address key sustainability, allocative, and institutional issues in public expenditure, focusing on the two Republic Governments, and evaluating the decision-making and implementation processes in PEM. The Review aims to support the Governments of Serbia and Montenegro in the formulation and implementation of sustainable fiscal policies that would further market-oriented reforms, support accelerated growth and poverty reduction, and facilitate the reintegration of Serbia and Montenegro into the European and international cooperation framework.

2. The Review was prepared in 2001-2002 with the cutoff date of June 30, 2002. In this period, through a complex process of constitutional change, the Federal Republic of Yugoslavia (FRY) ceased to exist and the union of Serbia and Montenegro was born. Since the future of the Federal public expenditure function was not fully clear at the time of writing, and since FRY was a very decentralized federation, the Review dwells on the Federal issues only briefly - inasmuch as they could be relevant for the new union - and does not attempt to prejudge the shape of union-level public expenditure function. The main focus of the Review is on the public expenditure systems of the two Republics, with this Volume dedicated to Serbia, and Volume Three to Montenegro.

3. Public expenditure policies pursued now by the Government of Serbia (GOS) target fiscal sustainability, and thus differ significantly from the distortionary practices of the previous regime. Since 2000, the Republic Government has made impressive strides in reforming their public expenditure systems. The reform momentum must be sustained if the goals of economic reconstruction and reintegration into the European and global economic space are to be achieved.

4. This report aims to help the Government of Serbia to take its public expenditure reforms further. The three cross-cutting topics of the report are: (i) sustainability of public expenditures; (ii) strategic allocation of public spending, to maximize growth and welfare within fiscally sustainable limits; and (iii) accountability of the public expenditure system, needed to maintain domestic and international support for the reconstruction programs of the Republic.

5. The success of public expenditure reforms depends on several difficult strategic choices. First, there is a need to be realistic in selecting the goals of reform. Aiming to

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1 This Review dwells on the pre-2000 problems only briefly, as these were analyzed in earlier studies. See, for example, World Bank (2001). Federal Republic of Yugoslavia: Breaking with the Past: The Path to Stability and Growth, In 2 vols.
instantly attain the level of sophistication typified by best international practice is not feasible for public expenditure systems which rely on relatively unreformed institutions. Second, quite a number of important reforms have been initiated in the past 18 months. The Government should focus on implementing and deepening the reforms that have already been started rather than on launching many new ones. Third, the best-fit solution must be derived from the existing structures and practices.

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

7. The PEIR is organized around four broad themes: fiscal sustainability, allocative efficiency, pension and health care reforms, and budgetary management. For each broad theme, the report offers a range of recommendations. Volume One features the key recommendations in a summary format; Volumes Two and Three provide detail on measures needed, and on their sequencing. In all three volumes, recommendations are prioritized, with the most immediate and important ones presented first in their respective sections. Typically, the recommendations are split into near-term (to be implemented over the next 12 months) and medium term, to be tackled within the next two years.

8. The Government of Serbia has taken strong ownership of the PEIR agenda, maintaining a dialogue with the PEIR team throughout the preparation of this paper. At the request of the Republic Ministry of Finance and Economy (MOFE), a policy workshop was organized in Belgrade in December, featuring key PEIR themes. In November 2002 the draft PEIR was discussed in a government-wide seminar and a special presentation to the Finance Board of the Serbian Parliament.

9. The PEIR builds upon the more detailed fiduciary and public procurement work undertaken by the World Bank’s Country Financial Accountability Assessment (CFAA) and Country Procurement Assessment Report (CPAR) for FRY. These two reports were prepared simultaneously with the PEIR. The three teams have conducted joint discussions with the Federal and the two Republic Governments, harmonized their recommendations, and jointly disseminated the PEIR and CFAA findings.

10. The PEIR draws its recommendations from the rich knowledge accumulated by international expert teams which support the Government of Serbia in its public expenditure reform drive, and which are sponsored by multilateral agencies such as the IMF, UNDP, as well as the Governments of France, Italy, Sweden, Switzerland, and the U.K. In particular, this paper benefited from exceptional support from the Department for International Development (DFID) of the U.K. Government, which funded consultants
who prepared four background studies — on budget formulation, budget execution, budgetary audit, and public service employment and pay reform. The government of France funded the work of a consultant on health finance.²

11. Volume One of the PEIR provides an overview of the public expenditure reform agenda of the FRY and its two republics. Volume Two focuses on Serbia and includes a brief discussion of the Federal Government issues. Volume Three discusses PEM issues of Montenegro. Throughout the report, the public expenditure problems of the Federal level receive limited treatment, as the contours of the future union were not yet clear at the time of drafting. Similarly, the challenges of fiscal decentralization below the Republic level receive only a brief treatment.³

12. In this volume, Chapter One overviews the initial conditions and the first wave of public expenditure reforms during 2001-2002. Chapter Two discusses key issues in regaining fiscal sustainability; Chapter Three provides further detail on the quasi-fiscal risks, and includes a case study of the electricity sector. Chapter Four presents an allocative analysis of Serbian general government expenditure, with a special attention to spending on public service wages. Chapter Five examines in-depth two major spheres of social expenditures - the pension system and the health care finance. Chapter Six focuses on the budget management challenges. Volume Three has a similar structure.

² With the exception of health paper, these studies focus on Serbia.
³ See Annex Two in this Volume.
1. INITIAL CONDITIONS AND EARLY REFORMS

A. BACKGROUND

1.1 The Federal Republic of Yugoslavia (FRY) was established on April 27, 1992, amid the armed conflict that erupted in the wake of the dissolution of the Socialist Federal Republic of Yugoslavia (SFRY). The FRY consists of two republics, Serbia and Montenegro, with a combined population of 10.6 million, and an estimated 2001 GDP of US$10.9 billion. Serbia accounts for about 94 percent of the FRY’s population and a similar share of its GDP. Since the 1997 elections, the Government of Montenegro adopted an anti-Milosevic stance and remained neutral during the Kosovo conflict. By 2001, Montenegro and Serbia had become two virtually separate economies, and relations between them had moved far from what was laid down in the 1992 constitution.

1.2 After protracted debates on the nature of the future common state, the Basis for the Settlement of Relations between Serbia and Montenegro was signed on March 14, 2002 by representatives of the Federal Government and the two Republics. Under it, the two republics agreed to replace FRY with a looser union called Serbia and Montenegro (SAM). By mid-2002 all three Parliaments – the Federal, Serbian and Montenegrin - have ratified the Agreement, and a special Commission comprised of representatives of the three parliaments began drafting the Constitutional Charter of the new state and the Law on its implementation. These two documents were finalized in early 2003, and adopted, first by the Republic Parliaments of Serbian and Montenegro and then, on February 5, 2003, by the Federal Parliament. The adoption of the new Constitutional Charter marked the end of FRY and the birth of Serbia and Montenegro. The new Charter sets out a general framework for the union, in which Serbia and Montenegro will have some joint institutions, including a unicameral Parliament, a Presidency, and a Council of Ministers, but will operate separate economic, fiscal, and monetary policies. Election of new union-level Parliament would take place soon. Once constituted, the Parliament would then elect the President of the union. The President would propose the Council of Ministers and direct its work. The union Council of Ministers would have five departments: foreign affairs; defense; international economic relations; internal economic relations; and protection of human and minority rights. Serbia and Montenegro would jointly finance these common functions, in proportion to their share in the union’s GDP.

1.3 This Review presents, where possible, the parameters of consolidated general government, embracing four levels of government, including the Federal one. A focus only on the republic and provincial and local governments would understated the size of the public sector, as the Federal Government provides essential public services such as defense and foreign relations. The Federal Government is supported solely by Serbia’s

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4 This figure excludes Kosovo, which remains under U.N. administration according to the U.N. Security Council Resolution UNSC-1244. It is not covered by this report.
revenue base, as there were no transfers from Montenegro to the Federal level. Box 1.1 provides an overview of Serbia's consolidated general government.

**Box 1.1: Structure of Serbia's Consolidated General Government**

In Yugoslavia, Government functions were allocated across four main levels - Federal, republican, provincial, and municipal (see Figure below). Key functions of the Federal government were foreign affairs and defence, with the latter taking up most of the Federal budget. The Republic Government was responsible for fiscal policy, law and order, and sectoral and social policies. Provincial and local governments were responsible for water supply, sanitary services, public transportation, and increasingly for social functions. Annex 2 specifies the assignment of revenues and responsibilities across four levels of government in the FRY.

There exist five extrabudgetary funds on the Republic level - Health, Labour Market, Employees' Pension, Self-employed Pension, and Farmers' Pension. Together these funds constitute about 28 percent of Serbia's consolidated general government spending. Their financing comes mostly from mandatory payroll taxes, with republic budget financing limited to the subsidies for the poor and for the clearance of arrears. The Federal level operated two extrabudgetary funds - Military Pension and Military Health. The following problems inherited from the past decade undermine the efficiency of public resource management: (i) overlapping of functions between the Federal and the Republic level (to be eliminated as a result of the constitutional change); and (ii) centralization of functions at the Republic level, which reflected the centralizing drive of the Milosevic regime. The latter is changing as well, with local governments gradually getting back social protection functions which they performed prior to 1992.

**B. MACROECONOMIC TRENDS AND MEDIUM-TERM OUTLOOK**

1.4 Armed conflicts, international sanctions, and trade shocks resulting from the breakup of the SFRY led to a 50 percent output decline over 1990-1993, and a sharp increase in unemployment and poverty. A slow recovery ensued in 1994 after the end of
hyperinflation, but the re-imposition of international sanctions, supply disruptions, and the destruction of physical infrastructure related to the Kosovo crisis produced a severe output contraction in 1999. High inflation and under-investment depleted the capital stock and led to erratic growth and high structural unemployment. These problems were magnified by distortive fiscal, monetary, and structural policies. Production and trade were hampered by exchange rate distortions, an inefficient external tariff regime, an adverse business environment, and chronically high inflation. Resources were diverted from productive uses through loss-making public enterprises, unaffordable social programs, and bloated government. The public finance system was undermined by extensive quasi-fiscal activities (QFAs). High-level corruption further diverted funds away from vital economic and social goals.

1.5 Nearly ten years of poor economic management and international isolation have left a daunting economic and human legacy. Recorded per capita GDP is about one-half of its 1989 level. Inherited macroeconomic imbalances and external debts pose serious challenges to economic policy makers. Living standards have declined, and the level of absolute poverty is estimated to have doubled since 1990.

1.6 The problems of the Yugoslav economy have been magnified by weak economic policies. Production and trade were severely hampered by a multiple exchange rate regime for the Yugoslav Dinar, as well as exchange surrender and pre-deposit requirements. Overall, foreign exchange policies resulted in overvaluation, currency shortages, and capital flight. The expansion of trade was also hampered by a complex and highly burdensome tariff regime. Chronically high inflation resulting from poor demand-management policies virtually eliminated the possibility for long-term financing. An adverse business climate, which discouraged employment and investment but motivated rent seeking, damaged domestic trade and production. The scope for competition and efficiency was greatly limited by political patronage, costly and poorly-targeted social protection rights, restrictive labor laws, and generally weak property rights. Consequently, for the decade as a whole foreign direct investment was negligible, and the economy remained dependent on debt-creating capital inflows for external financing.

1.7 While most countries in Central and Eastern Europe were developing market economies, the FRY Governments were playing an increasingly interventionist role. For many citizens, the most visible example was the seizure of the household foreign exchange deposits to fund public expenditure. Both budgetary spending and quasi-fiscal activities became increasingly important in the face of declining economic activity and financial resources. Budget interventions aimed to limit the social costs of adjustment but fueled inflation and worked as a brake on growth, resulting in a deteriorating capital stock, slow economic growth, and decreasing employment.

5 Defined here as activities that are not explicitly executed via budgetary mechanisms, but that have, or may have in the future, measurable fiscal implications.
6 The only significant foreign investment was into Serbia Telecom, while new borrowing was largely limited to short-term funding for imports of oil and gas. From an accrual perspective, the accumulation of interest arrears also represented debt-creating financing of the current account deficits.
1.8 Although recorded unemployment increased by 2002 to over 27 percent, the level of adjustment in the labor market was disproportionately less than the decline in output, due to policies that prohibited layoffs. This placed severe financial stress on the enterprise sector, producing huge losses and substantial inter-enterprise arrears. Financing came from directed credit and depressed tariffs of the state-owned utilities, including the power company Elektroprivreda Srbije (EPS). The utilities, in turn, experienced severe financial difficulties, requiring continual bank financing and consumption of the capital stock. The purpose of these interventions was to limit the social impact of the shrinking economic base. In the end, these efforts failed and the poverty rate increased.

1.9 Much of the burden of keeping various sectors of the economy operating fell on the banking system. Despite massive loan delinquencies, banks kept providing financing because they were owned by the enterprises to which they lent. In many cases, banks were instructed by the National Bank of Yugoslavia (NBY) to provide loans to favored industries. Since the loans were seldom repaid, banks were in turn dependent on liquidity financing from the NBY, which contributed to high levels of inflation.7

1.10 Many firms were also subsidized with preferential tax treatment and access to foreign exchange at overvalued official exchange rates. Nonpayment of taxes and social contributions was often the principal means of ensuring that wages would be paid, particularly in the case of firms with limited access to credit.

1.11 The Serbian budget and the social funds remained in the focus of financial stress in the economy. Revenue was lost as a result of extensive tax evasion. Periodically, new taxes and fees were introduced to accommodate growing commitments, but this squeezed more businesses into the gray economy. In the early part of the decade, the Government was probably able to capture a significant inflation tax, but it eventually became negligible with the de-monetisation of the economy. Rather than adjust expenditure to the new resource realities, books were balanced by the buildup of arrears to suppliers, depletion of the public capital stock, and default on external debt. Yugoslavia accumulated billions of dollars in interest arrears and penalty interest, and now lacks creditworthiness in international capital markets.

1.12 Pervasive arrears situation were just one of many factors undermining the viability of the social insurance funds, whose real revenue declined owing to high inflation and falling incomes, while benefits remained unchecked. Payroll taxes were maintained at a very high level, which resulted in substantial tax evasion and dependence of the funds on transfers from the Republic Government and other tax and non-tax revenues, including various earmarked taxes. On the expenditure side, the situation became unsustainable because the benefits were overly generous, designed for a much larger, faster-growing economy, and created commitments that far exceeded the capacity of the system to finance itself through contributions. In the health sector, poor targeting,

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7 Between late 1993 and January 1994 monetary financing of fiscal and quasi-fiscal activities produced in FRY the most severe hyperinflation ever recorded in any country. This wiped out the assets of the banking system, but not the most important liabilities, which were denominated in foreign currency.
operational inefficiencies, and expensive medicines drove up the cost of care to unmanageable levels, contributing to the economy-wide problem of non-payments.

1.13 **External Debt.** During the SFRY period, its Government borrowed heavily to fund development projects and to finance public consumption. As in many other countries during the 1980s, excessive borrowing led to debt crises and restructuring agreements with the Paris and London Clubs. After the dissolution of the SFRY, the debt of the former Yugoslav republics was apportioned according to a formula established by the IMF. At that time, FRY was accorded 36.5 percent of the total amount, or approximately US$6.9 billion. What might have been a manageable burden under normal circumstances, became unsustainable with the economic crisis. A weak debt-carrying capacity further worsened as interest arrears and penalty interest accumulated.

1.14 Table 1.1 shows the stock of FRY’s external debt at the end of 2000, which broadly corresponds with the start of the reforms. Of the US$11.3 billion total, over 83 percent were accounted by arrears, including US$4 billion in interest arrears. Around 90 percent of the principal outstanding consisted of medium- and long-term loans issued prior to 1992. The remainder was comprised of oil and gas trade facilities from Russia and China and short-term credits. The bulk of the longer term debts, or about 60 percent, were owed to the Paris and London Clubs. Nearly 22 percent of the total stock consisted of obligations to multilateral creditors.

**Table 1.1: FRY - Stock of External Debt, December 31, 2000**

<table>
<thead>
<tr>
<th>(US$ million)</th>
<th>Total</th>
<th>Principal Arrears</th>
<th>Interest Arrears</th>
<th>Penalty Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Multilateral creditors</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>IMF</td>
<td>152</td>
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<td>IBRD</td>
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<td>IFC</td>
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<td>EIB</td>
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<td>54</td>
<td>74</td>
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<tr>
<td>Eurofima</td>
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<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Other</td>
<td>40</td>
<td>28</td>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td><strong>Official bilateral creditors</strong></td>
<td>4736</td>
<td>2408</td>
<td>393</td>
<td>1528</td>
</tr>
<tr>
<td>Paris Club</td>
<td>4540</td>
<td>2372</td>
<td>393</td>
<td>1528</td>
</tr>
<tr>
<td>Other</td>
<td>196</td>
<td>36</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Commercial creditors</strong></td>
<td>2864</td>
<td>1370</td>
<td>772</td>
<td>377</td>
</tr>
<tr>
<td>London Club</td>
<td>1997</td>
<td>811</td>
<td>745</td>
<td>124</td>
</tr>
<tr>
<td>Other</td>
<td>867</td>
<td>559</td>
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<td>253</td>
</tr>
<tr>
<td><strong>Short-term debt</strong></td>
<td>1216</td>
<td>501</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

*Note: (1) Excluding approximately US$ 500 million of FRY’s external debt purchased by NBY and other Yugoslav legal entities
Source: National authorities, IMF*

1.15 Serbia’s notional share of FRY’s debt is difficult to determine, but working estimates range from 91 percent to 96 percent of the total stock. Practically all of it is a government liability. This includes debt that has been explicitly contracted or guaranteed by the Federal and Republic Governments, and liabilities arising from the default of banks and enterprises. Nearly 75 percent of the total stock was officially contracted or

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8 In 1992, the authorities froze the banking system’s foreign currency deposits, which became officially recognized as public debt in 1998. It can be argued that since they are denominated in foreign currency, these liabilities constitute a form of external debt. However, they are not treated as such in this report.
explicitly guaranteed by the Federal Government, including most multilateral borrowing and part of the debt owed to the Paris and London Clubs. Because of the troubled state of the bank and enterprise sectors, non-guaranteed debts totaling US$2.9 billion are likely to be removed from the balance sheets of banks, which on-lent these funds to domestic enterprises, and to be transferred to the Republic Governments.

1.16 **Pension and health care spending** is another area of fiscal distress. The Serbian pension system currently absorbs 12.7 percent of GDP (on an accrual basis), and is able to meet its legal obligations only as a result of budgetary transfers amounting to 4 percent of GDP. A large expansion in beneficiaries in the past decade, owing to generous eligibility and early retirement criteria, combined with the decline in output and revenue performance, have undermined the viability of the pension system. Likewise, Serbia’s health care system is generating large fiscal deficits. The system is financed out of a compulsory state health insurance system – the Health Insurance Fund (HIF) - and guarantees universal access to a liberal package of health services. The increasingly weak link between contributions and entitlement to services has reduced incentives to pay the contributions. As the economic situation deteriorated, an increasing number of large enterprises were granted exceptions to payment of contributions and the GOS accumulated large arrears to the HIF, which in turn has accumulated large debts to the health providers and to the rest of the economy. These developments were facilitated by low accountability in the delivery and the financing of services.

1.17 Beyond the budgetary sphere, fiscal sustainability was severely jeopardized by quasi-fiscal activities (QFAs) that occurred on both sides of the government’s balance sheet. In the 1990s, cash budgets that were either balanced or had low deficits, concealed large off-budget deficits. With personal incomes rapidly falling, quasi-fiscal activities were used by the government to support the politically and socially sensitive or influential groups and institutions. QFAs were arbitrary and non-transparent, and they undermined market discipline and creditor rights. The fiscal sphere spun increasingly out of control. While insiders could thrive on arbitrage, the less connected and disadvantaged social groups eventually lost out, since they lacked the leverage to distort resource flows to their advantage. Structural reforms in the enterprise and banking sector have brought these hidden deficits into the open.

1.18 Serbia’s enterprise and bank sectors harbor large contingent liabilities. Serbian enterprises emerged from the crisis of the last decade isolated from technological advances and from their traditional markets. The public enterprises lacked market-oriented ownership structures; in the largest of them, political interference was commonplace. The preservation of equity capital was seldom a priority, and managers were accustomed to soft budgets, regular bailouts and continued financing. The outcome was perpetual losses, mounting debts, and payment arrears. By the end of the decade, the problem of non-payments affected all sectors of the economy, with over half of firms not paying their suppliers. Much of the burden of keeping the enterprises operating fell on banks and state-owned utilities. Debts to these sectors accumulated steadily and were

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9 Chapter 5 provides more extensive coverage of these issues.
10 This topic is considered in greater detail in Chapter 3.
seldom repaid, and the banks became dependent on public financial support, particularly liquidity credits from the NBY.

C. RECENT REFORMS

1.19 In less than two years, the Government of Serbia has taken impressive first steps to address this daunting legacy of the past. The reform policies have already brought visible improvements in key economic indicators, and begun to create foundations for a more sustained recovery of output and living standards. This critical start included tax measures aimed at increasing tax revenues while enhancing the efficiency of the tax system. The number of sales taxes was reduced while the average tax rate was raised. Tax collection efforts were stepped up to combat evasion, particularly in connection with sales and excises.\(^\text{1}\) In order to increase tax compliance and encourage hiring and investment, the payroll tax was reduced.\(^\text{2}\)

1.20 Together, the revenue and expenditure measures strengthened fiscal sustainability and began to reduce the stock of expenditure arrears. Fiscal transparency and management were further enhanced with the decision to include the entire defense spending in the Federal Budget and to put the defense budget under civilian control.

1.21 On the expenditure side, despite intense political pressure, wages have been kept relatively constant as a share of GDP. In the Federal administration, a salary freeze was instituted at the January 2001 level of pay, while a wage freeze for the Army was based on the October 2000 level. Defense spending, which is the largest component of Federal spending, continued to decline from its peak in 1999. Legislation has been passed to put the Serbian pension funds on a stronger financial footing. Important steps have been taken by the Serbian MOFE to enhance efficiency and accountability of public expenditure management (PEM). In 2001, fiscal transparency and management were strengthened through the integration of various extrabudgetary programs into the Republic Budget. In 2002, these measures were followed by the establishment of a Treasury and the strengthening of audit procedures.

1.22 Since late 2000, the NBY has terminated the practice of directed bank credits to the economy. Central bank financing of the budget deficits has been limited to a maximum of 0.6 percent of GDP to permit only the short-term closure of budget gaps. In October 2000, the Government and NBY unified the exchange rate and pegged the Dinar to the Deutsche Mark. Early in 2001 this regime was replaced by a managed float, and in 2002 a crawling band was introduced in the context of increasing Dinar monetisation and accumulating foreign reserves. These measures have succeeded to reduce inflation, with the year-on-year retail price inflation rate dropping from 114 percent in 2000 to 39 percent in 2001. In 2002 the inflation rate is expected to be further reduced to around 15 percent, and to subsequently decline to single digits in line with steady adherence to these policies.

\(^{1}\) The Federal coffers also benefited from the simpler sales tax schedule, since sales tax in Serbia is shared between the local, Republic and Federal budgets. The allocation formula is renegotiated each year.

\(^{2}\) The Republic Budget has offset the lost revenue by increasing transfers to the social funds.
1.23 Significant initial progress has been made in reducing the buildup of contingent liabilities. In 2001-2002, electricity tariffs were increased repeatedly and steeply, improving cost recovery in the electricity sector. This is a key step in solving the problem of non-payments throughout the economy, including the taxes owed to the various levels of government. Since late 2000, banks are no longer under government direction to make credits to specific sectors. Bank and enterprise restructuring is advancing rapidly. The liquidation of four large, insolvent banks in early 2002 was particularly important for reducing future fiscal risks. Further reforms in the banking sector will be essential to increase financial intermediation and boost business productivity as well to reduce fiscal risks. The privatization program introduced in 2001 will promote greater liquidity and solvency in the enterprise sector. While reforms in this area are likely to produce short-term fiscal costs due to increased spending on social protection needs, in the long run the risk of large shocks to the budget will be greatly reduced.

1.24 Reforms have begun in the social protection and welfare system, primarily in the pension system, which represents the largest drain on the Republic budget. The Government introduced in late 2001 a set of parametric reforms to the pension system, designed to curb spending and to provide an adequate minimum floor to pensions.

1.25 Possibly the most crucial reforms under way are in the budget management practices of the Republic Government, which views the existing budgeting procedures as lacking strategic dimension, and defines its immediate challenge as deepening the PEM reforms. The start in redesigning its key public expenditure processes and in improving budget management has been impressive. This was done through the integration of various extrabudgetary programs into the budget and a bold inspection of the budget execution in 2000, which led to the prosecution of dozens of officials of the previous regime for the abuse of public funds. In 2002, the Republic began the implementation of the newly adopted Law on the Budget System, including the establishment of a modern Treasury, and took measures that increase the policy content of the budget (extended preparation calendar, chart of accounts consistent with the good international standards). The budget audit procedures are being significantly strengthened.

1.26 Reforms strengthening public sector governance are not confined to budgetary management. The Republic Government has demonstrated commendable vigor in tackling corruption and in prosecuting the abuses of the former regime (see Box 1.2). The Government has adopted a Strategy for Fighting Corruption, and put in place a strong institutional framework to deliver it. Serbia participates in the Stability Pact Anti-Corruption Initiative (SPAI).

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13 Parametric measures are changes to the parameters of the pension system, such as the retirement age and the indexation formula. These reforms are discussed in Chapter 5.


15 These issues are covered in detail in Chapter 6.
Box 1.2: Serbia’s Anti-Corruption Strategy

The Serbian Government’s Strategy for Fighting Corruption, launched in December 2001, is built on the following five principles: (a) creating an institutional framework: an independent and effective judiciary, stricter legislative branch oversight, an independent, effective public prosecutor and internal affairs organs; (b) reform of state administration: establishing standards of professionalism and credibility among public servants, improving the resources available to state administration employees, strict oversight of public revenues, regulation of public procurement and monitored decentralization of public revenues and expenditures; (c) economic reform: market liberalization, macroeconomic stability, reduction of discretionary rights in the supervision of economic activity; (d) increased participation by civil society: increased public awareness of the need to fight corruption, freedom of information, forums for public discussion of draft laws and promoting of the role of media and NGOs in the fight against corruption; and (e) establishment of an enabling political environment: transparency in the financing of political parties and in the property ownership of state officials and prohibition of conflict of interests between state administration officials and employees. Institutional arrangements in place to deliver this strategy are as follows:

- An independent Anti-Corruption Council was established in December 2001 and has been charged with the development of National Anti-Corruption Strategy. The Council advises the Government on legal reform and development and conducts studies of corruption in society. In the first two months of its operation, the Council advised the Government the drafting of several laws, including the Law on the Prevention of Conflicts of Interest, the Law on Financing of Political Parties and the Law on Property of State Officials. The Council also acts as a watchdog, monitoring actual cases of corruption and calling the Government to account for any perceived slippages in its anti-corruption program.

- A High-Level Anti-Corruption Committee, headed by the Prime Minister and comprising several key Ministers and heads of key public agencies, whose role is to steer the implementation of the Government’s anti-corruption program.

- An Anti-Corruption Unit which was set up to act as the headquarters of the anti-corruption initiative in Serbia is strategically located within MOFE. The office coordinates all anti-corruption initiatives, ensures information exchange between the parties involved and assists both Government and NGO anti-corruption initiatives.

- A Regional Network of 26 Anti-Corruption Teams, set up in January 2002, whose job is to protect citizens’ rights from misuse by state officials of their position.

The Republic Government regularly updates progress in anti-corruption activities on its website and publishing targets for outstanding actions. In addition to the new Law on Public Procurement, a recent related achievement is a prohibition against Serbian Government members engaging in business activities. Among the first fruits of this initiative is the promulgation of five laws, which the GOS prepared in the autumn of 2001, comprising a Law on the Final Account of the Budget for the Year 2000 and Report of the Budgetary Audit; a Law on the Budgetary System; a Law on Public Procurement; a Law on Games of Chance, and a Law on Tobacco. Key institutions of the Serbian Government involved in the fight against corruption, including the Ministry of Internal Affairs and the Belgrade District Attorney’s Office, also publish reports of their activities on the government website, including the names of former state officials and employees charged with abuses of power or of making material gain from public office. The Ministry of Internal Affairs reported having brought criminal charges against 209 members of its own staff over Jan.–Oct. 2001.

The Federal Government has not embraced the anti-corruption challenge with the vigor demonstrated by the governments of Serbia and Montenegro.

2. RESTORING FISCAL SUSTAINABILITY

2.1 Serbia has made substantial progress in implementing a strong reform agenda. However, these reforms are just the first steps needed to ensure fiscal and macroeconomic stability. As will be demonstrated in this chapter, fiscal commitments in some areas will necessarily rise with the evolving processes of economic adjustment and international financial and commercial integration. In order to ensure fiscal sustainability, substantial cuts in some areas of public expenditure are required. This chapter presents estimates of the sustainable fiscal deficit in Serbia over the medium to long term and discusses ways to achieve and maintain it.

A. OUTLOOK FOR PUBLIC EXPENDITURES AND FINANCING

2.2 Over the next few years, the level of public spending in Serbia is likely to grow significantly as servicing of foreign debt is resumed and other new expenses are added to the budget. This raises the question of whether the resulting fiscal position will be sustainable without substantial cuts in other expenditures. In the short run, higher deficits can be financed with privatization receipts, foreign grants, and concessional lending. Over the longer term, however, it will be difficult to sustain macroeconomic stability and promote private sector growth without deep fiscal reform. Government expenditure will have to be rationalized in a manner and to a degree that is consistent with the role of government in a market economy. Further reforms of the revenue system, including payroll tax and customs, are needed to enhance efficiency and reduce the burden of taxes on potential investors and employers. These reforms on the revenue side should be accompanied by spending cuts. Otherwise, the currently high deficits may become permanent, fueling inflation, slowing private sector development, and increasing national indebtedness. The greater the gap is between actual spending and what is sustainable, the greater the threat to macroeconomic stability and the greater is the magnitude of adjustment that would eventually be required.

2.3 As shown in Table 2.1, in 2001 realized consolidated Serbian Republic expenditure increased by around 3.5 percentage points of GDP, and consolidated Federal spending declined by 1.2 percentage points of GDP.\(^\text{16}\) Part of the increase in Republic spending reflects the absorption of some items that were previously off-budget. These include the extra-budgetary expenses financed by the own revenues of public institutions. Also, as electricity and gas prices were raised to approach cost recovery in those sectors, additional transfers to poor households, and increased subsidies to enterprises were

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\(^{16}\) The consolidated fiscal accounts of the Republic of Serbia include the Republic budget, five social funds, and local governments. The consolidated Federal accounts comprise the Federal budget and two social funds for the military, and transfers and employer contributions to the Republic social funds. The latter are netted out when the Federal and Serbian government accounts are consolidated together.
needed\textsuperscript{17}. This moved parts of the quasi-fiscal deficit off budget. In the Federal Government, spending declines in 2001 are mostly due to lower military expenditure.

### Table 2.1: FRY Fiscal Operations

<table>
<thead>
<tr>
<th></th>
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<th></th>
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<tr>
<td><strong>YUD billion</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenues and grants 1/2/</td>
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<td>50.0</td>
<td>66.6</td>
<td>7.7</td>
<td>6.9</td>
</tr>
<tr>
<td>o/w grants</td>
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<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
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<tr>
<td>Expenditure &amp; net lending</td>
<td>29.1</td>
<td>49.7</td>
<td>66.4</td>
<td>8.1</td>
<td>6.9</td>
</tr>
<tr>
<td>Goods and services</td>
<td>23.7</td>
<td>31.1</td>
<td>34.4</td>
<td>6.6</td>
<td>4.3</td>
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<tr>
<td>Wages and salaries</td>
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<td>6.7</td>
<td>8.6</td>
<td>1.0</td>
<td>0.9</td>
</tr>
<tr>
<td>Payroll contributions</td>
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<td>6.7</td>
<td>8.6</td>
<td>1.0</td>
<td>0.9</td>
</tr>
<tr>
<td>Other goods &amp; services</td>
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<td>17.8</td>
<td>17.1</td>
<td>4.6</td>
<td>2.5</td>
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<td>Subsidies</td>
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<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
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<tr>
<td>Transfers to households</td>
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<td>7.1</td>
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<td>0.5</td>
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<td>Social funds 3/4/</td>
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<td>7.7</td>
<td>8.7</td>
<td>1.3</td>
<td>1.1</td>
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<tr>
<td>Other non-interest spending 4/</td>
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<td>1.5</td>
<td>3.8</td>
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<td>Interest payments</td>
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<td>1.7</td>
<td>0.1</td>
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<td>0.2</td>
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<tr>
<td>Capital expenditure</td>
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<td>3.8</td>
<td>9.0</td>
<td>0.0</td>
<td>0.5</td>
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<tr>
<td>General reserves</td>
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<td>0.0</td>
<td>2.8</td>
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<tr>
<td>Net lending</td>
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<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Balance</td>
<td>-1.6</td>
<td>0.3</td>
<td>0.2</td>
<td>-0.4</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Percent of GDP</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP of FRY (YUD billion)</td>
<td>358</td>
<td>1.724</td>
<td>978.9</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Memoranda:**

- Local government spending: n.a. n.a. n.a.
- Defense spending: 18.6 28.3 41.4 5.2 4.6 4.2 n.a. n.a. n.a.

Notes: 1/ Federal government accounts include military pensions and health fund, Serbian government accounts include the Republic budget, social insurance funds, and local and provincial governments. Consolidated Serbian tax revenues include the Federal government employer contributions to the social insurance funds and Federal pensions transfers. 2/ Due to reclassification of some revenue and expenditure categories for 2001, full continuity of the series is not possible 3/ Includes military pensions and health funds. 4/ Includes Federal social transfers and employer contributions to Republic social security funds and Federal transfers to local governments.

*Source.* Federal Ministry of Finance (FMOF), Serbia MOFE, and World Bank and IMF staff estimates

2.4 In the Republic Government, the projected expenditure for 2002 includes significantly higher interest payments, capital expenditures, and social spending (Table 2.1). The country is normalizing its relations with external creditors and will resume servicing debt in 2002. Owing to the terms of the recent agreement with the Paris Club, interest payments are likely to increase further in the next few years, and amortization will increase substantially when the grace period ends in the middle of the decade. Long-delayed capital spending needs to increase to upgrade public infrastructure. Given the magnitude of the investment needs, the level of public investment could approach 4 percent of GDP in the next few years. Transfers to households may rise further, to

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\textsuperscript{17} A serious fiscal risk here is that such subsidies will linger on, substituting enterprise restructuring.
mitigate the impact on poverty of utility price increases, and to compensate for the loss of income the households will face due to enterprise and bank downsizing.\textsuperscript{18}

2.5 In 2001, the consolidated Republic deficit was kept to 1.0 percent of GDP, despite the sharp increase in spending. The consolidated Federal accounts were in balance. For the Serbian consolidated budget, tax revenues increased 3.5 percentage points of GDP with the transfer of own revenues of extrabudgetary programs to the budget, the reforms in sales and excise taxes, and improving tax collection. The positive effect of these reforms is expected to continue in 2002, with tax revenues increasing over 2 percentage points of GDP. Current grants from foreign donors will provide an additional 1 percent of GDP. Still, these additional resources will not be sufficient to finance the projected increase in expenditure, and the deficit will rise to 4.5 percent of GDP on a consolidated basis. This gap will be mostly closed by over 1 percent of GDP in privatization receipts and about 3 percent of GDP in foreign loans.

2.6 Like any other investment, however, there are costs and risks associated with this strategy, as well as benefits. The social costs resulting from the efficiency-enhancing restructuring of banks and enterprises, for example, will be offset by increased budget transfers to households. The fiscal impact of these costs will depend on the size and persistence of market distortions and the extent of de-capitalization in the enterprise and banking systems, and the sensitivity of policymakers to social tensions.

2.7 External factors will also play an important role. Normalizing relations with external creditors and opening up to global markets exposes the fiscal accounts to a variety of risks. This is true of both the revenue and expenditure sides of the budget. As Serbia's domestic growth rate is sensitive to global economic developments, fiscal revenues will be affected by external conditions. On the expenditure side, events in international capital markets will affect both the cost and availability of financing. Exposure to these markets via the Republic's large foreign debt, presents a significant risk to both fiscal and macroeconomic stability. Rising interest rates, which are currently below their historic averages in many countries, could have an important impact on debt service and debt-carrying capacity, especially as grace periods expire in the middle of the decade. Should growth be slower as a result of a prolonged worldwide recession or of policy slippage, debt-servicing capacity could deteriorate markedly. Given that soon around 80 percent of the debt will have been rescheduled under the Paris and London Clubs agreements, it is unlikely that, in case of untoward developments, there will be much scope for the new reprogramming of external debt obligations.

2.8 Another risk is that borrowing will once again become a substitute for fiscal adjustment, especially as creditworthiness improves. In Croatia, for example, relatively easy access to international capital markets in the late 1990s temporarily obviated the need for fiscal reform. As a consequence, the country's debt to GDP ratio increased by 25

\textsuperscript{18} Means testing of the social protection systems is weak, and reforms are needed to ensure proper targeting. The projected increase in social spending in 2002 reflects a surge in the numbers of beneficiaries who chose an early retirement option prior to the increase in the retirement age in January 2002. The increase in pensions is also due to indexation of benefits using the old indexation formula, which is based on monthly wage growth, which may have been overestimated.
percentage points of GDP in a few years, and could ultimately reduce access to foreign capital. The large deficits that were closed with easy financing a few years ago, have necessitated a sharp monetary contraction that succeeded in limiting demand growth but put considerable financial pressure on the banking system. Postponement of fiscally sustainable outcomes cannot last for long, and will eventually call for excessively harsh adjustment that may damage growth and lead to increased poverty.

B. ESTIMATING A SUSTAINABLE FISCAL DEFICIT

2.9 An analysis has been carried out for this report to determine the level of the fiscal deficit that is sustainable under different indicative scenarios, which highlight the importance of the growth outlook for fiscal sustainability. Given a strong policy package to develop a stable and robust market economy, and taking into account the accumulated burden of past unfunded commitments and structural distortions in the economy, Serbia can realistically expect steady growth of about 4 percent per annum and single-digit inflation later in the decade. Performance under this indicative “middle-case” scenario would serve as a basis for continued donor support and would invite substantial foreign investor interest. It would allow Serbia to sustain a relatively high deficit in the short run. In the medium term, however, resource limitations will only permit an overall deficit of about 1 percent of GDP. Given projected interest payments on the public debt, this would mean that Serbia would need to maintain a primary surplus of about 1.5 percent of GDP.

2.10 The Impact of Economic Growth. Should economic growth be slower than anticipated, further fiscal adjustment would be warranted to ensure macroeconomic sustainability. Significant policy slippage or a weak supply response to the reforms would cause the economy to grow more slowly. Under this illustrative “lower-case” scenario, significantly less resources would be available to finance the deficit, both from domestic and foreign sources. If the economy were to grow by 2 percent over the medium term the sustainable fiscal deficit could be lower by more than one-half (Table 2.2). This would necessitate an increase in the primary surplus to around 2.5 percent of GDP. Such a change in growth prospects could restrain growth by requiring a reduction in current spending, and/or in capital expenditure. As demonstrated in the 1990s, poor economic and fiscal management could make a tight fiscal situation even tighter and further diminish the prospects for growth.

2.11 Conceivably, a fiscal deficit in excess of around 1 percent of GDP could be maintained if the economy were to grow by more than 4 percent on a sustained basis. Faster growth could be achieved if investment and productivity growth rates were exceptionally rapid. However, owing to the severity of the structural problems confronting enterprises and banks, it is more likely that under a strong restructuring program productivity growth could initially rise strongly and then gradually decline to

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19 The analysis underlying these results is presented in detail in Annex 1. The key tool used to examine sustainability is an accounting framework that integrated the general government and NBY accounts. This permits the analysis of the impact of economic growth, financial developments, and resource constraints on sustainability. Scenarios and outcomes are presented here for illustrative purposes and do not seek to define an optimal macroeconomic framework. This analysis also does not establish monetary or fiscal targets, which would require further analysis and consultation, including with the IMF.
moderate levels. Sustained high rates of productivity and investment growth would require considerably higher investment.

Table 2.2: Serbia: Estimates of the Medium-Term Sustainable Deficit 1/

<table>
<thead>
<tr>
<th></th>
<th>Middle case</th>
<th>Low case</th>
<th>High case</th>
<th>Increase in foreign interest rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall deficit (% GDP)</td>
<td>4%</td>
<td>2%</td>
<td>6%</td>
<td>0.8</td>
</tr>
<tr>
<td>Primary surplus (% GDP)</td>
<td>1.6</td>
<td>2.3</td>
<td>0.6</td>
<td>2.5</td>
</tr>
<tr>
<td>Government savings (% GDP) 3/</td>
<td>3.2</td>
<td>2.9</td>
<td>2</td>
<td>2.3</td>
</tr>
<tr>
<td>Debt service/exports (%)</td>
<td>24.7</td>
<td>31.9</td>
<td>22.2</td>
<td>26.7</td>
</tr>
</tbody>
</table>

Note: 1/ Refers to averages for 2007-2010 2/ Assumes 50 percent of the public external debt is affected, and that GDP grows 4 percent. Other assumptions pertain to middle case scenario. 3/ Capital expenditure is assumed to be maintained at 4 percent of GDP.

2.12 If, as a result of these developments, the Serbian economy were to grow at around 6 percent in the medium term, a deficit of about 2 percent of GDP could be sustained in the long-run. Assuming that domestic borrowing rates and privatization receipts did not change, this level of deficit could be financed with additional foreign borrowing. However, this might not be desirable from a fiscal sustainability perspective. Given the limits to borrowing from official lenders, the alternative would be borrowing on commercial terms, implying shorter maturities and higher variable interest rates. Additional public borrowing would enhance the long run growth potential of the economy only if these funds were employed efficiently. Serbia is already expected to have high rates of public investment throughout the decade. Even higher rates of investment may not yield higher returns, but merely crowd out private investment. And if additional borrowing were used to fund consumption, it would not help raising productivity growth and could decrease government savings. Hence, the economy could conceivably grow faster for a few years with greater borrowing, but such a strategy would eventually result in growth deceleration.

2.13 External Factors. Adverse external shocks, such as a significant slowdown in European import demand, could have a similar effect on the sustainable deficit. Lower exports could make it more difficult to service the external public debt and maintain macroeconomic stability without further fiscal retrenchment. Rising foreign interest rates could also put considerable pressure on the budget. For example, if interest rates were to increase by 50 percent over the remainder of the decade, and assuming that half of the foreign debt were affected, the sustainable primary surplus would need to rise by nearly 1 percentage point of GDP. As global interest rates are currently below their long-run averages, an increase in the Republic’s interest costs cannot be ruled out.

2.14 These indicative scenarios suggest that the current fiscal stance cannot be maintained indefinitely. The sustainable medium-term fiscal deficit is estimated at around 1 percent of GDP. In 2002, the overall fiscal deficit is expected to increase to around 5 percent of GDP (from 1 percent in 2001), with the primary deficit increasing to 2.5 percent of GDP. By the end of this decade, Serbia would need to find fiscal savings of about 4 percent of GDP to maintain a primary surplus of about 1.5 percent of GDP. Since in the coming years more will be spent on investment and economic reforms, interest payments and other outlays could well increase. This means that the aforementioned is a conservative estimate of the magnitude of required fiscal retrenchment. One factor that
could allow Serbia to sustain a higher deficit, however, would be more privatization revenue than is projected in this report. There is a great deal of uncertainty regarding the exact condition of state assets. If these assets prove to have retained substantial value, additional financial resources could be available to the Government to finance spending.

2.15 Debt Sustainability. FRY began to normalize its relations with the international community in late 2000, when key trade and financial sanctions were removed, allowing increased access to funding from international financial institutions and bilateral official and commercial creditors. FRY has taken active steps to restructure its foreign debt, and has achieved considerable progress. Beginning with the clearance of arrears to the IMF, the obligations to multilateral creditors (which account for 22 percent of the total amount outstanding) have largely been rescheduled or fully paid off. Debts totaling US$ 4.5 billion owed to the Paris Club were also restructured in November 2001, providing for a phased 66 percent net present value reduction of the stock of debt contingent upon successful completion of a three-year extended arrangement with the IMF. Serbia is seeking a similar restructuring with the London Club and other commercial creditors.

Table 2.3: FRY - Selected External Indebtedness Indicators

<table>
<thead>
<tr>
<th>Percent</th>
<th>2001</th>
<th>2002-2005</th>
<th>2006-2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt/GDP</td>
<td>107.1</td>
<td>64.1</td>
<td>58.1</td>
</tr>
<tr>
<td>Debt/exports</td>
<td>428.4</td>
<td>250.5</td>
<td>193.9</td>
</tr>
<tr>
<td>Debt service/exports</td>
<td>2.0</td>
<td>11.3</td>
<td>19.8</td>
</tr>
<tr>
<td>Interest payments/GDP</td>
<td>0.4</td>
<td>2.1</td>
<td>2.2</td>
</tr>
<tr>
<td>Public debt service/Budget revenues</td>
<td>5.5</td>
<td>14.2</td>
<td>22.9</td>
</tr>
</tbody>
</table>

Memoranda:

GDP - growth rate        5.5   4    4
Exports of goods and services - growth rate 6.5 12.7 8.1

Sources: World Bank and IMF staff estimates. Separating Serbia’s and Montenegro’s portions of external debt was not possible at the time of study.

2.16 If two-thirds debt forgiveness is obtained from commercial creditors and the IMF program is successfully implemented, Serbia’s debt stock will be reduced from over 100 percent of GDP to about 64 percent of GDP on average in 2002 to 2005 (Table 2.3). Similarly, the debt to exports ratio would be more than halved, significantly enhancing debt servicing capacity. However, even with this substantial debt write-off, the debt service burden will gradually rise again to relatively high levels. In the current decade, the debt service to exports ratio will increase from 2 percent in 2001 to an average of around 20 percent in the latter half of this decade. Total debt service as a share of fiscal revenue will evolve similarly. The government should be very cautious about adding more debt to its books, by either direct borrowing or by recognizing off-budget liabilities, as it does not have much headroom in this area.

C. IS THE SERBIAN GOVERNMENT TOO LARGE?

2.17 The levels of consolidated general government revenues and expenditures are over 40 percent and 45 percent of GDP respectively20, and are set to grow further, even despite the rationalization brought about by the “downsizing” of the Federal Government. This rise should not automatically be viewed in a negative light. It reflects, inter alia: (i) on the revenue side, the tax reform of 2001 and the incorporation of own revenues of the

20 Consolidating Federal, Republic, and local levels. In this volume, FRY GDP includes Montenegro.
budgetary agencies, and (ii) on the expenditure side, the bringing of quasi-fiscal activities on budget and the rise in reform-related spending on enterprise restructuring, and the resumption of external debt servicing. These are welcome trends. Nevertheless, the level of general government spending is close to, or exceeds, the levels of public spending in many wealthier countries. Should this be a reason for concern?

2.18 Several studies have demonstrated positive statistical correlation between the income levels and the level of general government spending. However, this merely suggests that richer countries can afford to spend more on public services. There is much less guidance on what is the appropriate size of government spending. There exist no firm indications that a certain overall level of public expenditure can be adequate, or excessive. Much depends on the efficiency of service delivery and the range of socially expected entitlements funded by the government. Some transition countries (e.g., Estonia and Latvia) have lower levels of public revenues and spending to GDP than predicted by statistical models. This may suggest superior efficiency, or merely indicate that the society’s view that it is acceptable for the government to provide narrower range of public services, or both. In some other transition countries low levels of public revenues and expenditures suggest deep structural and institutional problems, such as the failure of the state to collect taxes (this applies to some of the poor countries of the Commonwealth of Independent States). Yet other countries, such as Poland and particularly Hungary, are well above the statistical trend, and have very large governments relative to their income levels. This is not necessarily a symptom of profligate public spending habits. Barbone and Polastri have shown that variables other than income levels (such as socio-cultural traditions) have a much greater explanatory power for the level of spending to GDP. Yugoslavia traditionally had a very extensive social protection system. Expectations of the society (in all ex-SFRY states) that these benefits would continue may be the strongest explanation for the “stickiness” of public expenditure at levels consistently higher than predicted by statistical models. In fact, Serbia has lower public spending levels on a cash basis than any other ex-Yugoslav country except Macedonia, and lower than many of the EU accession countries and such newer EU members as Greece, Spain and Portugal. Still, it is worth noting that Ireland, which has the smallest government among the EU-15, was able to achieve the fastest GDP growth rate in the region in the past 20 years.

2.19 The overall level of public spending cannot be evaluated separately from its efficiency. The following suggests that the efficiency of public spending remains low:

- Duplication of functions across the Federal/Republic levels of government, estimated to cause at least 1 percent of GDP in excessive spending;
- Unsustainable levels of social spending, indicated by substantial, and persistent budgetary support of the social funds;
- Excessive spending in individual categories (e.g., wages and salaries) and functions (e.g., defense);

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- Apparent difficulties in containing the rise in non-discretionary spending related to structural reforms (interest costs, severance pay); and
- Remaining, even if diminishing, budgetary arrears and quasi-fiscal activities.

Figure 2.1: Consolidated General Government Spending, 2001

(percent of total)

Federal Budget 15%
Local Govts. 10%
Federal Social Funds 3%
Republic Social Funds 28%
Republic Budget 44%

Source: World Bank staff estimates.

2.20 Chapters 4 and 5 discuss some of the key areas where efficiency gains can be realized. However, these are feasible only on a disaggregated basis and over medium-term. Unless efficiency concerns are addressed, further increase in public expenditure may have adverse growth consequences.

D. THE NEED FOR FURTHER REFORM

2.21 Notwithstanding the stabilization already attained by Serbia, deeper and faster fiscal reform is needed. It is important to raise domestic savings rates and to prevent private sector crowding out so in order to increase employment and reduce poverty. It is also critical to reduce the vulnerability of the fiscal accounts to shocks from bankruptcies and sudden changes in investor sentiment. Expenditure policy should be reoriented to allow more room for discretionary spending. The size and scope of government may have to be reduced to improve the business climate. Temptation to shift some obligations outside of the budget again should be resisted. The Government must ensure that contingent claims do not build up through explicit guarantees or implicit commitments to bail out distressed enterprises and banks. Better targeting of social programs is needed, to eliminate waste and free up resources to serve the economically vulnerable social groups.

2.22 In the absence of further reform, substantial budget deficits are likely to persist. Revenues are unlikely to increase significantly in proportion to GDP, and could well decline with future tax initiatives aimed at stimulating private enterprise. Tax rates are already high and tend to discourage business investment and the hiring of new employees. The experience with tax evasion suggests that efforts to increase revenues by raising tax rates are not likely to succeed.
2.23 Significant amounts of foreign assistance and privatization revenues will be forthcoming, but perhaps only in the first few years. Foreign donors have endorsed the Government’s medium-term plan for recovery and reconstruction and are likely to continue providing significant amounts of loans and grant-based assistance over the next few years. However, with tightening budgetary conditions in donor countries and their policymakers’ desire to avoid creating aid dependency, it is unlikely that large amounts of assistance can be maintained for long. Moreover, the donor community is under pressure to increase assistance to other, much more distressed regions of the world.

2.24 Privatization revenues could be strong initially, but will taper off later in the decade. Levels projected for 2002 were reached in the first two weeks of the year, and a few very lucrative sales of assets seem probable in the next year or two. Sales of state assets could involve telecommunications, energy, banks and other major assets. However, their depreciation resulting from the lack of maintenance and investment since the early 1990s suggests that revenue from privatization may be limited.

2.25 As mentioned above, borrowing to finance fiscal gaps will need to be managed carefully to avoid over-indebtedness and the crowding of private sector. This will become increasingly important as Serbia advances its economic restructuring program and opens to foreign commercial and financial interests. Greater commercial and financial openness offers to substantially improve efficiency and growth performance. However, outward-oriented growth strategies also increase the sensitivity of the fiscal accounts to market forces. The volatility of revenue and expenditure could grow significantly in the next few years and policymakers will need to prepare a comprehensive risk management strategy. Substantial attention should be paid to the size and composition (e.g., maturity and currency structure) of the stock of public debt.

2.26 Aside from prudent debt management, the stability of public expenditure can be enhanced by appropriately budgeting reserves for unforeseen fiscal shocks, and by increasing the share of discretionary spending in total public expenditure. Reforms of social protection and other areas of public policy will gradually increase the space for discretionary spending and create a cushion for fiscal shocks. These reforms promise to limit the volatility of spending, as well as contain its growth in the long-term.
3. FISCAL RISKS BEYOND THE BUDGET

3.1 Chapter 2 discussed some of the key areas where action is needed to regain fiscal sustainability of Serbia. The budgetary sphere is only one such area. No less important to fiscal stability are measures to rein in quasi-fiscal activities (QFAs). While recent adjustment measures should have helped to control the accumulation of hidden off budget deficits in the FRY, the old stocks of hidden deficits are still high—comparable to the levels of direct external debt—and severely affect the fiscal equilibrium. This chapter analyzes risks coming from quasi-fiscal operations, and includes a case study of the electricity sector, which remains the largest reservoir of quasi-fiscal deficits.

A. OVERVIEW OF QUASI-FISCAL ACTIVITIES

3.2 The Enterprise Sector. One of the first tasks of the new Government in 2001 was to begin tightening financial discipline in the enterprises by stopping directed lending. This was essential to control inflation and to launch the enterprise restructuring process. The Government’s reform strategy provides for the privatization, restructuring, and liquidation of some 4,600 socially-owned enterprise over four years. The GOS has recognized that inter-enterprise arrears and debt offsets weaken contract discipline and produce moral hazard risks. Consequently, in June 2001 a plan was implemented via a Republic Government decree, which eliminate significant portion of inter-enterprise arrears—some YUD 65 billion, or 9 percent of GDP. Firms were to cancel their mutual obligations and to establish binding agreements to settle any remaining balances. A decree also provided for the rescheduling of the tax debts of 200 enterprises over a one-to-three year period. However, given the magnitude of the financial problems in the sector, significant inter-enterprise arrears persist.

3.3 The reform strategy for the Serbian enterprise sector is fraught with fiscal risks. Only some of the enterprises are believed to be ready for privatization without significant restructuring of their debts. Many firms will have to be broken up into smaller, leaner parts with smaller workforces. Other firms will have to be liquidated altogether. The resulting labor redeployment and debt restructuring could have a heavy impact on the budget. In 2002, the first year of this process, the costs are estimated at 0.8 percent of GDP. This includes an expensive precedent-setting agreement with the employees of Zastava, the large automobile manufacturer. Future costs to the budget are highly

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24 In this scheme, redundant employees were offered three options: (i) standard labor market support consisting of 3 to 5 months of severance and 24 months of unemployment benefits; (ii) a lump sum
uncertain, but some estimates can be made on the basis of the labor redundancies calculated for the whole enterprise sector. World Bank staff have estimated that annual costs of deploying redundant workers could be between US$160 and US$180 million per year, or about 1.0 percent to 1.5 percent of GDP. This includes severance payments and unemployment benefits but excludes lost tax revenues.

**Box 3.1: Quasi-Fiscal Activities in Transition Economies**

Quasi-fiscal activities (QFAs) are a major problem in many countries, both developing and developed. QFAs divert public resources in an inefficient and non-transparent manner, undermining accountability and economic growth. Often, as the budget deficit is being brought under control, on-budget subsidies are replaced with quasi-fiscal ones, reflecting the unwillingness and/or inability of governments to deny support to structurally or socially important enterprises, regardless of their performance.

In analyzing quasi-fiscal activities, we follow Polackova and Schick\(^1\), classifying fiscal risks from government obligations into four types: direct explicit, direct implicit, contingent explicit and contingent implicit. Government *direct explicit liabilities* are specific obligations that fall due with certainty and are defined by law or contract. Examples include external sovereign debt; in the longer-term, direct explicit liabilities include legally mandated pension and health expenditures. Government *direct implicit liabilities* represent a political, rather than legal, government commitment that will occur with certainty. They arise as a presumed consequence of public expenditure policies. *Explicit contingent liabilities* represent the government's legal obligations to make a payment if a particular event occurs, such as state guarantees for non-sovereign borrowing. Finally, *implicit contingent liabilities* are those that are not officially recognized until a failure occurs. The triggering event, the value at risk, and the required size of the government outlay are uncertain.

Traditional cash budgeting practices encourage the governments to use quasi-fiscal tools, since the cost of these tools appears to be zero. Thus, quasi-fiscal instruments may appear politically more attractive than cash expenditure items. Transition economies are particularly vulnerable to losses from quasi-fiscal practices, due to less transparent and shifting ownership structures and weak contract enforcement. Hidden subsidies are typically rationalized by social concerns ("raising the utility tariffs to cost recovery levels hurt the poor"), they are untargeted and, as such, waste scarce public resources. Large loss-making enterprises are typically among the largest delinquents on payments to power utilities, effectively discriminating against the new small and medium-sized businesses which typically are the engines of growth and labor absorption. Because they are non-transparent, quasi-fiscal activities fuel corruption, asset stripping and capital flight, and ultimately result in anti-poor redistribution of wealth.

Local governments are an important link in the chain of non-payments. The bulk of budgetary arrears arise at the local level, and local governments typically are less transparent than the central one. Despite the adoption in some cases of legal frameworks supportive of hard budget constraints for local governments, the latter often succeed in negotiating "special regimes" with the central government and continue to run arrears on social expenditures. Nascent financial sectors of these countries also harbor substantial QFAs, usually arising from inflexible exchange regime and directed (subsidized) credit. Attempts to revive the financial systems should go hand in hand with strengthening their supervision regimes and allowing foreign entry.

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3.4 The fiscal cost of enterprise reform will depend on the Government’s commitment to enforcing financial discipline, as well as on the terms of labor redeployment. This will require reasonably quick privatization of poorly managed public and socially-owned companies that could be operated profitably by experienced strategic investors. Often the drain on public resources will need to be stopped through liquidation of unviable business segments or entire companies. Initially, industrial restructuring will

severance of up to DM 4,000 without unemployment benefits; and (iii) the opportunity to join a new affiliated Employment and Training Company where they could get 45 percent of salary for up to four years and retraining or work on community development projects.
require direct government intervention. In the long run, financial discipline and operating efficiency should be enhanced through institutional reforms aimed at strengthening property rights, including the creation of a judiciary that can more efficiently deal with commercial dispute resolution and enforcement.

3.5 Risks From the Banking System. Decades of poor policies, graft, government intervention, and poor corporate governance have left the banking system in very poor financial condition. Loan performance has been extremely low since the early 1990s and many large banks have been kept operating with credits from the NBY. Even after removing the frozen foreign currency deposits and Paris and London Club debts, the net worth of the banking system was a negative DM 4.5 billion (20 percent of GDP) in 2001. Shortly after coming to power, the new GOS developed a strategy to revitalize the banking system. Problem banks were barred from making new loans. The objective was to restore the soundness of the banking system and to avoid the large fiscal costs from the rehabilitation of insolvent institutions, particularly large banks with little systemic importance. In 2001, 19 small banks were liquidated, and in January 2002 four of the five largest deposit institutions were permanently closed, costing the budget about 0.6 percent of GDP in severance payments and full compensation to net depositors.

3.6 Official estimates suggest that the total cost of restructuring the sector will not exceed 1.3 percent of GDP in present value terms, nearly all of which will be paid out of the Republic budget. This includes the costs associated with the banks closed in 2001, the four large banks in 2002, and any other future liquidations or rehabilitations applied to the remaining 57 banks in the system. The costs includes severance payments, deposit insurance, and recapitalization. About 85 percent of this amount will be in liquidation costs, of which more than three-fourths will compensate depositors.

3.7 From an international perspective, these costs seem very low. In fact, these estimates do not capture all costs and are based on an optimistic view of the future costs. Current estimates exclude the debts of the banks to the Paris and London Clubs. If the latter amounts are included, the present value of fiscal cost would be over 60 percent of GDP, which has very substantial cash flow implication for the budget. Approximately 20 percent of interest payments, close to 1 percent of GDP, will be paid to the creditors in a few years. Including repayments, about 3 percent of revenues will go to service these obligations towards the end of the decade. It is also important to note that estimates of future bank restructuring/liquidation costs are based on the assumption that deposit insurance will be limited to YUD 5000 per depositor, as prescribed by law. However, it is not clear whether this limit will be observed. The liquidation of the four large banks in January 2002 has set a precedent for full compensation. Political pressure to protect depositors fully is unlikely to diminish. Owing to the low deposit base of the banking system, this may not present an immediate problem. Over time, however, bank deposits will grow in proportion to assets, and without appropriate measures, fiscal risks could become considerably larger.

3.8 Another potentially important source of fiscal risk may be stemming from the lack of enforcement of existing banking regulation. Partly as a result of weak enforcement of prudential standards, few of the banks meet minimum capital requirements and other prudential guidelines. Serbian banking law requires the application of the Basle Accord standards, but compliance should be strengthened further.

3.9 The Government of Serbia will also need to take care to ensure that the Serbian Development Fund is not converted into a bona fide development bank and that the recently created publicly-owned savings bank will result in genuine value for the economy and will not create new contingent liabilities. The financial condition of the Serbian Development Fund (SDF) was not clear at the time of writing, but there were indications that a significant component of its loan portfolio was non-performing, including loans to enterprises and large credits to the social funds. Hence, the conversion of this institution into a public investment bank could greatly increase fiscal risks. Moreover, such an institution could crowd out private lending and thereby damage the viability and development of the private financial system.

3.10 Structural reforms in the banking sector aimed at creating an efficient and profitable intermediation system will be key to minimizing quasi-fiscal risks. Economic efficiency and sustainability can only be enhanced by a banking system that is based on sound lending practices and the protection of shareholder capital. A profitable, dynamic, and safe banking system will instill confidence in depositors and increase the savings available to finance new investments.

B. A CASE STUDY OF THE POWER SECTOR

3.11 As in many other countries, the largest area of quasi-fiscal activities is the electricity sector. Administrative price distortions existed in this sector well before the Milosevic period, and are still being used to support sensitive industries and social groups. These subsidies have shrunk over 2001-2002, but are still significant, and their fiscal impact is much larger than any on-budget support to the industry. Low controlled electricity prices subsidies are also, by their nature, untargeted and non-transparent, and therefore encourage over-consumption of electricity. Unlike many other countries, in Serbia the subsidization of electricity did not translate immediately into external debt, since electricity is generated mainly on the basis of domestic coal. Still, the forcing of the state-owned power utility EPS to sell power well below the cost of production has led to under-investment and deferred maintenance. The production and distribution facilities are in urgent need of replacement or repair. A network breakdown or an exceptionally cold winter could increase the need for imports and/or emergency maintenance, which would eventually need to be financed from the budget.

3.12 The size of the electricity subsidy can be estimated by the difference between electricity prices in Serbia and its direct generating costs. Internationally, until mid-2002 the average consumer price of electricity is about US$ 45 per megawatt hour (MWh).
The average price in Serbia was just US$21/MWh. In 2002 total electricity demand is expected to be about 30,500 MWh. With a 50 percent price increase in June 2002 factored in, households and firms would still receive in 2002 an implicit subsidy of about US$580 million, or 4.5 percent of GDP. Prior to the steep price hikes of 2001-2002, electricity subsidies have been much larger.

3.13 Prolonged subsidization of downstream industries has put vast financial stress on the power sector, whose revenues were insufficient to cover operating expenses, let alone spending on new equipment and maintenance. Net wages are generally covered, but EPS is often not sufficiently liquid to pay the taxes due on these wages. Arrears to suppliers of products and services accumulated, and commercial arrangements were often based on the willingness of suppliers to tolerate late payment rather on the quality of goods or services provided. In the end, EPS cannot supply high quality power (in terms of voltage and frequency stability). The problems in the sector harm the prospects of downstream industries and limit the productive potential of the economy. Subsidized electricity prices keep production costs down, but they also distort the input mix and make the international competitiveness of Serbian companies dependent on cheap power.

3.14 The principal source of financial stress is the lack of cost recovery in electricity production. Prices are too low to cover expenses and encourage excessive consumption of households and enterprises. The necessary price adjustments, however, are costly to implement and politically controversial. Tariffs cannot be adjusted overnight to full cost recovery due to the economic and social fallout. Full cost recovery can be expected in two or three years. Higher electricity costs can, in fact, accelerate enterprise restructuring.

3.15 The relatively high production costs is another important factor behind the financial problems in the electricity sector. Coal is abundant in Serbia and its unit cost is relatively low. However, the cost of producing electricity is high by international standards. Given the type of technology employed in Serbia, one would expect an average cost of producing a megawatt hour of electricity to be less than US$20. In reality, the average cost is 34/MWh. Two principal reasons account for the additional cost. First, the lignite coal used in Serbia has low calorific value. EPS boilers can be adjusted to compensate for the variations of calorific potential, but due to the lack of timely sampling and appropriate equipment EPS is often unable to make the adjustments. What is gained

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26 Rates differ across geographical areas. In Belgrade, tariffs are between US$18/MWh and US$19/MWh. In mid-2002, the electricity tariffs were increased by 50%.
27 Total electricity output is substantially greater, with the difference accounted mostly by network losses.
28 This estimate makes no allowance for the price elasticity of demand. More research is needed to determine price sensitivity of electricity consumption. Evidence on the household distribution suggests that the responsiveness of consumers to price increases could be significant as prices approach full cost recovery. About 30 percent of electricity consumption is due to just 8 percent of households, many of whom could reduce their reliance on electricity for heating.
29 Over the last decade the electricity subsidy became increasingly important to Serbian households. The average share of electricity costs in total household spending is currently estimated to be 13 percent, and further price increases could significantly squeeze household budgets. To compensate the poorest households for the tariff increases, additional funds were allocated for social welfare in 2002.
30 The focus of this section is on coal-fired power. District heating is gas-based, but supplies only 27 percent of households and is an important source of energy only in winter. This sub-sector is also
from the low price of coal is more than offset by the larger quantity of coal needed per megawatt of electricity output. Also, delays in the removal of the overburden\textsuperscript{31} from mines, destabilize the supply of coal. In the future, the cost of producing electricity is likely to increase further, as the costs of long-delayed environmental cleanup will pile up.

3.16 Costs of production are also kept high by organizational and technical inefficiencies existing throughout the entire power supply chain. Both EPS and the coal mines have substantial surplus labor. In the case of coal production, the problem stems from the policy of granting lifetime employment to people displaced by land acquisitions. EPS employs 63,000 people at an annual cost of US$280 million or 2 percent of GDP. EPS wages are well above the Republic average.

3.17 Inefficiency mainly stems from the public ownership of the electricity companies. The existing ownership structure diminishes the incentives for the managers to control cost, reduce network losses, and protect the value of assets. When these incentives are lacking and cash is short, the overriding concern of managers is the ability to pay wages on time. The state, as owner of the property, fails to ensure that managers protect existing assets and make investments when necessary to ensure service reliability. Until such time as the interests of managers and owners are united in prioritizing high-quality, low-cost service, the growth potential of the economy will be limited and fiscal risks will mount.

3.18 Even with higher electricity prices and reforms that increase productivity, the electricity sector cannot be strengthened without increasing collections and eliminating non-payments in the Serbian economy. Average collection rates are only 75 percent, with households accounting for one-half of collection shortfall. A few favored sectors of the economy are virtually exempt from paying for electricity, costing EPS millions of dollars in lost revenue. Nonpayment is closely related to the general problem of inter-enterprise arrears. Its origins are overstretched balance sheets and distorted cost structures, but it also reflects behavior conditioned by years of tolerance for non-payments.

3.19 The state itself has contributed to the problem by failing to meet it obligations to enterprises and households. Public institutions had the highest rate of delinquency in paying for electricity. The Government often has offset its debts to EPS against tax arrears. This web of nonpayment was legitimized by public participation and by occasional multilateral offsets of debts organized by the Government.

3.20 Fiscal and Economic Implications. A new approach to electricity financing is needed to ensure fiscal sustainability. Without further reform, large quasi-fiscal risks will continue to accumulate in power generation. The lack of maintenance and investment in new equipment threatens a complete shutdown of the system, requiring large, unplanned expenditures for repairing or replacing damaged turbines or other costly equipment. The cost to the budget for a catastrophic failure of the electrical system could reach tens of millions of dollars just to replace a single turbine at a major power plant. An unplanned expenditure of this magnitude could threaten the Serbian Government's ability to fulfill experiencing financial difficulties due to low tariffs and has accumulated significant arrears to foreign gas suppliers. Future reforms must address the imbalances in district heating as well.

\textsuperscript{31} The soil and rock removed in order to dig out the coal.
its other obligations. Electricity policy also can feedback on the budget through the impact on the broader economy.

3.21 Electricity policies also affect important relative prices and distort the incentives they create. When electricity is used as a mechanism to distribute income, energy policies can distort economic decisions and damage prospects for economic growth. Tariffs that do not cover production costs can alter the input mix of companies and reduce the incentive to adopt electricity-saving equipment or to invest into potentially more productive technologies. This tends to damage growth prospects and perpetuate poverty, thereby increasing demands on the budget with fewer resources to fund them. Similarly, households tend to rely more on electricity for heating and to spend less to insulate their homes when electricity is very cheap. This feeds back to the power sector in the form of excessive electricity demand, resulting in greater strain on the system than would occur under a more sustainable energy policy. When cheap electricity is based on coal, as in Serbia, another consequence is environmental degradation. It is only a matter of time before the Government is forced to increase outlays for environmental cleanups.

3.22 On the revenue side, financial problems in the electricity sector lead to a significant loss of tax revenue, including the contributions to the social funds. This also indirectly reflects the impact that EPS has on the financial performance of its suppliers. Since costs are excessively high and electricity tariffs are insufficient to cover all expenses, EPS is frequently illiquid and unable to meet all of its obligations. One way that EPS has coped with the cash shortage is to barter for products and services, including both second- and third-party arrangements. Still, this was insufficient to cover its expenses, and payment arrears have become an important means of financing. In 2001, the stock of tax arrears to the Republic reached approximately US$230 million, or about 2 percent of GDP. Of this amount, approximately 1 percentage point constituted arrears in contributions to the pension, health and employment funds. In addition, EPS had payment arrears of over US$ 200 million to suppliers of equipment and services. These unpaid debts, along with barter transactions, contribute to the lack of liquidity of the enterprise sector and ultimately weaken the ability of all companies to pay their taxes.

3.23 The Serbian power sector's ability to avoid a catastrophic breakdown is testament to the ingenuity and hard work that has been available to keep the system operating, especially considering the damages suffered during the Kosovo conflict. It also a product of the large power generation capacity that was concentrated in Serbia during the former SFRY period. Recent electricity price increases have helped to stabilize the finances of the sector. However, from any perspective, be it financial, technological, or fiscal, the situation remains unsustainable. Supplies of electricity will be available in sufficient quantity and quality when the quasi-fiscal deficits are eliminated and long-delayed capital improvements are undertaken.

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32 This excludes foreign debts contracted by the Federal Government for power generation projects.
33 Prior to 1991, Serbia was the principal supplier of electricity to other ex-SFRY republics.
C. POLICY RECOMMENDATIONS

3.24 The stabilization of the fiscal accounts in Serbia is off to a strong start. Revenue collection has improved while the high payroll tax burden on business has been reduced. Important steps have been taken to reduce excessive expenditure commitments. However, these measures are only the first steps in a long process of reform. Significantly more fiscal adjustment is needed to expand the entrepreneurial space and to lower the entry barriers for new businesses, including reducing still high social taxes, reconstructing public infrastructure, and ensuring macroeconomic stability. Ultimately, progress in eliminating distortions in the overall fiscal system is essential to boost savings and investment rates and to support the growth of the private sector. The PEIR recommends the following specific near-term steps to strengthen overall fiscal sustainability:

- Strengthen the new macro/fiscal unit of the MOFE with a sufficient number of skilled staff. Assign to it the task of identifying/measuring fiscal risks from both on-budget and off-budget commitments. The unit should maintain a multiyear fiscal model that correctly reflects these fiscal risks. By the 2004 budget, strengthen considerably the debt management capacity of the MOFE, and formulate a comprehensive fiscal risk management strategy;  
- Determine the amount of budget reserves needed to minimize the effects of fiscal shocks that could arise from unforeseen circumstances and phase in these amounts as quickly as possible;  
- Refrain from creating new publicly-owned financial institutions, and liquidate the SDF instead of converting it into a public investment bank.

3.25 The Government needs to further reduce and eventually eliminate the quasi-fiscal deficit in the electricity sector. The PEIR recommends the following priority steps for this sector:

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

3.26 Macroeconomic stability requires the reduction and prevention fiscal and quasi-fiscal deficits. Large public sector imbalances are the result of competing resource demands that cannot be reconciled with the existing economic base. The next chapter will examine in greater detail the structure of public spending, with a view to evaluate its allocative efficiency.

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34 Reform recommendations in this paper are ranked, with the most urgent and important ones coming first  
35 Timelines and other modalities to be recommended in a Poverty Reduction Strategy Paper being prepared by the Serbian Government.
4. ALLOCATION OF PUBLIC SPENDING

4.1 Analysis in Chapters 2 and 3 suggests that a reduction and a restructuring of the public sector is needed. This chapter analyses the allocation of public funds, starting with economic composition of consolidated government expenditures and proceeding to spending on key government functions. The chapter discusses both sectors and sub-sectors where spending could be allowed to expand, as well as sectors also where the level of spending appears excessive, poorly targeted or inefficient. The chapter focuses particularly on the largest non-discretionary spending item – public service wages and salaries. Many other allocative issues (e.g., intergovernmental finance and spending public education)\textsuperscript{36} may be equally important, but, owing to space limitations, these are not covered by the Review in detail.

4.2 The Government of Serbia is fully aware of the necessity of hard choices in allocating expenditures. In formulating its reconstruction program presented at the donors' conference in June 2001, the Government had undertaken an extensive exercise to define development priorities, which have been reflected in the budget's allocative patterns.\textsuperscript{37} Meanwhile, analysis of the allocation of public spending in Serbia is complicated by five problems. First, the traditional budget classification mixed under individual items very diverse economic categories or functions. Second, prior to 2001, Serbia had a very fragmented budget system, with dozens of extrabudgetary revenues earmarked to specific spending purposes. Their consolidation into fiscal reports was incomplete, and time series for individual spending categories are rarely robust. Third, the degree of detail available for the Federal Government is less than for the Serbian Republic Government. This further impedes the consolidation of the consolidated government accounts for the years prior to 2000. Fourth, own funds of budgetary agencies\textsuperscript{38} were consolidated into the Republic budget only in 2002 (Box 4.1). Fifth, while the level of quasi-fiscal activities is drastically lower now compared to the previous government, and the creation of new budgetary arrears has been all but eliminated, the stocks of past budgetary arrears and off-budget liabilities remain, and complicate the allocative analysis.

4.3 The new Serbian Government has taken important steps to address these issues. The 2002 Serbian Republic and Federal budgets were prepared on the basis of the new

\textsuperscript{36} The Review draws here on the Serbia Education Improvement Project (IDA Project No. P075189), and Oliveira, J. (2002).
\textsuperscript{38} Box 4.1 provides greater detail on the own funds of budgetary agencies.
The comprehensiveness of the budget was increased by the incorporation of all extrabudgetary revenues and expenditures in 2001, and of own funds of government agencies in 2002. Apart from the seven extrabudgetary funds (five at the Serbian Republic level and two at the Federal level; see Box 1.1) no public sector agencies are funded outside the budget. These steps have made the Serbian Republic budget more comprehensive and have brought it closer to good international practices. However, disaggregated data series are not available for the Federal Government, which limits the allocative analysis.

**Box 4.1: Own Funds of Budgetary Agencies**

In 2002 own funds of the budgetary agencies were estimated at about 10 percent of the Republic Budget, or 2.4 percent of Serbia's GDP, but for some agencies they are much larger: from one-fifth of the total revenues for the universities to 90 percent for the Republic Directorate for Commodity Reserves (DCR). Typically, these revenues are generated on the same public sector assets that are used to deliver the regular services. For many years, the accountability of own funds was inferior to the regular budget flows. Own revenues are used to pay salary supplements and other benefits, or to fund operations and maintenance. Including this class of public revenues in the regular budgetary procedures raises the transparency of the Budget and its effectiveness as a policy tool. Own funds of budgetary agencies were included in the GOS Budget in 2002, improving its comprehensiveness. This, however, made budget data for 2002 and later years not fully comparable to earlier periods.

**A. Economic Composition of General Government Spending**

4.4 This section provides details on the main economic classes of public spending, concentrating on the 2000-02 trends and discussing key forward-looking issues. The dominant allocative patterns in Serbia are as follows:

- Spending on wages and salaries is substantial at over 9 percent of GDP;
- Spending on non-wage goods and services is lower than in most other CEECs;
- Social transfers are above the regional mean and are closer to countries with a much higher GDP per capita, which raises affordability concerns;
- Subsidies are not negligible at around 2-3 percent of GDP; in 2002 they are budgeted to grow further, which is a worrying trend;
- Capital spending was historically low, pointing to a depletion of capital assets, particularly if viewed alongside with meager maintenance spending; and
- Interest payments were low, but will be rising steadily in the near future.

4.5 The key characteristic of this picture is a large non-discretionary component of public spending which comprises, wages, interest and social entitlements. The latest spending rises occurred mostly in the non-discretionary items (as external debt is being...
regularized, and bank and enterprise reform and privatization lead to layoffs that require large redundancy payments). Expansion of non-discretionary spending is expected to continue in the immediate future. Such rises may be acceptable only if temporary and accompanied by structural reform which promises efficiency gains. Otherwise, the upward drift of non-discretionary expenditures may indicate the persistence of unsustainable policies. Further rise of such expenditures is ill-advised, as it will force the Government to raise taxes, or run higher fiscal deficits.

4.6 Efficiency gains could be sought in the public expenditure system through vigorous structural reform. Hungary offers a good example of public sector refocusing on fewer essential functions. Hungarian general government spending was always high, but declining throughout the past decade, as structural reforms have borne fruit. This has created space for private enterprise, without sacrificing the quality of the key social services. There remains a risk that Serbian Government spending will rise further in the next few years, fueled by one-off inflows such as donor funds and privatization revenues, creating a threat to fiscal sustainability later on. Recent studies on Croatia and Bosnia and Herzegovina suggest that this risk could be real.42

Table 4.1: Economic Composition of General Government Operations, Percent of GDP

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenue and grants</td>
<td>37.4</td>
<td>39.6</td>
</tr>
<tr>
<td>Current Revenue</td>
<td>37.1</td>
<td>37.0</td>
</tr>
<tr>
<td>Tax Revenue</td>
<td>33.7</td>
<td>34.0</td>
</tr>
<tr>
<td>Non-Tax revenue</td>
<td>3.5</td>
<td>3.9</td>
</tr>
<tr>
<td>Total expenditures and net lending</td>
<td>38.8</td>
<td>42.3</td>
</tr>
<tr>
<td>Current expenditures</td>
<td>35.8</td>
<td>40.1</td>
</tr>
<tr>
<td>Goods and services</td>
<td>7.9</td>
<td>6.4</td>
</tr>
<tr>
<td>Wages and salaries</td>
<td>9.2</td>
<td>10.2</td>
</tr>
<tr>
<td>Interest payments</td>
<td>0.7</td>
<td>0.1</td>
</tr>
<tr>
<td>Subsidies</td>
<td>3.2</td>
<td>3.1</td>
</tr>
<tr>
<td>Transfers</td>
<td>14.2</td>
<td>21.3</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>2.1</td>
<td>2.3</td>
</tr>
<tr>
<td>Total deficit/surplus</td>
<td>0.6</td>
<td>-5.3</td>
</tr>
<tr>
<td>Primary deficit/surplus</td>
<td>0.0</td>
<td>-5.2</td>
</tr>
<tr>
<td>Current deficit/surplus</td>
<td>1.3</td>
<td>-3.0</td>
</tr>
</tbody>
</table>

Note: Expenditures are on a cash basis. Albania, Croatia, and Turkey, excluding local governments. FRY GDP includes Montenegro.

Public Sector Wages and Salaries

4.7 The Overall Wage Bill. This section evaluates in detail the largest non-discretionary item – public wages and salaries. Employment and wage issues are central to any analysis of public expenditure. In overall terms, central (Federal plus Republic of Serbia) government wage expenditure in 2001 was close to 9 percent of GDP. This is relatively high, but not unprecedented in the regional context (Figure 4.1). This item absorbs over 22 percent of total consolidated government spending – close to the level in high-income countries of the OECD, and well above the regional average (about 18 percent for 1995-2000). The level of spending on wages and salaries in Serbia displays a

relatively low variance, which suggests that this spending level is protected. The Republic Budget 2002 envisages the same level of spending on this item as in 2001.

4.8 Public Service Employment. Since the core wages are low, the main reason for the high level of expenditure is the number of public service employees. There are around 400,000 public service employees in Serbia - over one-third of the total labor force. The actual wage bill is even higher, since these data exclude temporary workers hired at the discretion of individual ministries, whose salaries are typically funded from the materials budget. Moreover, ministries and indirect spending units are able to supplement from their own funds the salaries specified by government decree. These additional payments are also not recorded in the salaries budget. The overall share of public expenditure used for salaries and additional payouts may be greater than the budget indicates, possibly exceeding 10 percent of GDP.

Figure 4.1: Public Spending on Wages and Salaries (percent of GDP)

Notes: Data for FRY and Montenegro are averages for 1997-2001, for EU and CEEC are averages for 1995-2000. CEECs are Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, FYR Macedonia, Poland, Romania, the Slovak Republic, and Slovenia. Cohesion countries are Spain, Greece, Ireland, and Portugal. FRY w/o MN is FRY without Montenegro.

Source: World Bank and IMF staff estimates

4.9 The wage-setting mechanism used in Serbia is unusual. Individual salaries are determined by multiplying a salary base by two coefficients: the first intended to recognize the qualifications required and complexity of the job, and the second based on

43 This excludes public enterprises (nine in Serbia), which are also part of the public sector, and also excludes employee contributions. Information on established posts or actual employment and salary levels in the public service is not very reliable, as there is no single consolidated source for it, either at the Federal or the Republic Government level. Also, the absence of integration between the establishment and the payroll systems makes it difficult to obtain reconciled and reliable numbers.
individual service. Since June 2001 salaries are calculated on a gross basis, with most allowances incorporated into basic pay.

4.10 Serbia has a traditional model of establishment control, in which departmental organizational structures are agreed with a central unit, and approval is given to a hierarchical staff structure and complement for each department, expressed in terms of authorized positions, each with a designated grade/salary level. In this model the distinction between established and non-established positions is fundamental, not least because it prevents direct spending units from receiving funding for unapproved posts. In Serbia, current establishment levels are unaffordable, and actual staffing levels are often lower than approved levels. For example, the Ministry of Internal Affairs has around 36,000 employees compared with an establishment of 40,453 posts.

4.11 While this approach provides some control over growth in salary costs, it entrenches current employment allocations across ministries, despite variations in the extent of unfilled posts. These variations often reflect skill shortages rather than government priorities. Therefore this approach limits the government’s ability to direct resources and personnel to priority areas and activities. Integration between the establishment planning and budget processes should be improved, so that the number of established posts is in line with resource constraints and expenditure decisions are guided by planning or policy decisions.

4.12 Salary differentials between highly skilled and relatively unskilled jobs are low. For example, the ratio between the average salaries of a judge and a typist in the Supreme Court is less than three. This indicates a systemic problem: while expenditure on wages and salaries is relatively high by international standards, pay policies are not providing adequate incentives to attract and retain needed skills.

4.13 Two distinct processes for the payment of wages and salaries exist in the Serbian public service. In the case of employees of direct spending units it is a relatively centralized process, in contrast to indirect spending units who make their own salary payments, drawing on transfers from their direct spending units. In the case of direct spending units the scope for abuse is limited by controls on wages and salaries at the aggregate level. Controls are also being strengthened through the establishment of a budgetary inspection (see Chapter 6).

4.14 The process for paying salaries to employees of indirect spending units varies according to the direct spending unit (DSU) responsible. Typically, the management of personnel and payroll information is the responsibility of the indirect spending unit. A centralized personnel function does not exist, and direct spending units do not generally have up-to-date employee lists or lists of job functions for “their” indirect spending units. For example, while the Ministry of Education gathers some personnel information from schools, funding for teachers’ wages is based on systematizations made on the

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44 Two terms are common to the budget systems of former Yugoslav republics: direct and indirect spending unit. Direct spending units (DSUs) are the line Ministries, the first level of organizations receiving funds directly from the budget (e.g., Ministry of Education). Indirect spending units are second tier users, those receiving budgetary funds from direct users (e.g. public schools).
assumption that actual employment is equivalent to established posts. While schools will not receive funding for employees above establishment levels, there is no systematic process for checking that actual number of teachers is consistent with systematizations. While most government officials believe ghost workers are only a minor problem, there is significant scope for such workers within current control framework.

4.15 **Policy Recommendations.** Analysis reveals the need to significantly strengthen the capacity of the Government in monitoring employment and wage levels and costs, and in formulating public service employment and pay policy. Pay and employment issues are just one aspect of public service reform and must be addressed in the context of first-order questions about the role of the state and the various levels of government, with important implications for the functions, structure, organization, and process of government. An integrated approach to employment and pay reform would consider three key dimensions of government reorientation:

- The connection between public service management and the government’s financial management systems. Strong links between personnel and budget functions are essential to sound government management;
- Linkages of policies on central public service development with decisions about the devolution and de-concentration of staff, functions, and resources;
- Linkages between central government public service reform and reforms in individual sectors – especially health and education, the largest government employers, to ensure coherent and consistent reform programs.

4.16 In the short run, the following measures could be considered:

- Establish in the MOFE a function of monitoring employment numbers and remuneration levels. This would generate information on current employment and wage structures needed to inform any future employment and wage reforms;
- Formulate an explicit public service pay policy, to enhance its transparency and consistency, and the process for reviewing pay levels and linkages with the budget process. The need for decompressing the salary structure for more highly qualified and skilled posts should be addressed, and consideration given to a performance-related pay formula;
- Consider a two-pronged approach: (i) a high level review that focuses on future direction, priorities, top level management structures, and processes, and (ii) a detailed analysis of organization and staffing for individual ministries and public agencies. A key issue will be to identify the core competencies required in each public agency and a strategy for developing these skills. Developing policy and budgetary analysis capacity will be critical to the successful implementation of a public employment and wage reform.

**Other Economic Categories**

4.17 **Non-wage Goods and Services.** In this category, adding up numbers for Serbia and the Federal Government could be misleading. This would show that the size of this
spending category in FRY without Montenegro is large - close to the region's top levels recorded in the three Baltic countries and Croatia. (Figure 4.2). However, as in most other former Yugoslav countries, it includes the wages of temporary workers. Once this component is subtracted, the picture would be radically different. It is also very different for the Federal and Serbian levels of government. In the Federal Budget, which is dominated by the defense sector, this is the largest single spending item (over one-third of the total). This mostly reflects spending on military hardware and the wages of contract servicemen. The latter component also accounted for most of the decline in this category in 2001. For the consolidated Serbian Government, this spending item is low and falling; it averaged 5.1 percent of GDP over 1997-2001 -- well below CEEC averages. For the Republic, expenses on goods and services may be inadequate to properly maintain public assets. Spending on goods and services was also more volatile than other spending categories, suggesting that the former may have been used as a balancing item at the end of each budget cycle, when unexpected cuts are executed.

Figure 4.2: Public Spending on Non-wage Goods and Services

**Figure 4.2: Public Spending on Non-wage Goods and Services**

*Figure 4.2: Public Spending on Non-wage Goods and Services (percent of GDP)*

**Note.** FRY and Montenegro averages for 1997-2001, CEEC averages for 1995-2000, FRY w/o MN is FRY without Montenegro

**Source:** World Bank staff estimates

4.18 **Interest on Debt.** FR Yugoslavia's interest payments have been low, primarily owing to its default situation of the past decade. Domestic borrowing has been very limited, as the budget's cash deficit was low. A lot of support to politically sensitive constituencies (e.g., social protection, subsidies) was provided off budget, including via directed credit from the National Bank of Yugoslavia. Almost all interest payments were on domestic debt and stood close to one-third of the regional average over the past few years. Only limited domestic financing is envisaged under the stabilization program, while past debt is being rescheduled and new external financing is being provided on highly concessional terms. As a result, interest payments will grow only slowly in 2002-2004. Still this will move Serbia closer to the region's averages, which are about 3 percent of GDP. The Government should not hasten to conclude that there is room to
incur more debt, or to explore sources of commercial borrowing; such decisions should be based upon careful evaluation of its long-term debt-carrying capacity.

4.19 **Subsidies and loans to enterprises.** Budget subsidies go almost entirely to nine large public enterprises (PEs) such as EPS and Yugoslav Railways. These PEs are the largest loss-makers: often, their tariffs are regulated by the Republic Government, and are still used to provide untargeted subsidies to the rest of the economy, including households. About one-fifth of Republic budget subsidies go to agriculture. The Serbian budget also extends a modest amounts of loans to enterprises (Box 4.2).

**Box 4.2: Budget Lending and Onlending**

In 2001, budget loans to enterprises amounted to a modest 1.3 percent of GDP, and were provided almost entirely to EPS, as an emergency measure. Budget loans often appear more attractive to a government than direct subsidies, since they are expected to be repaid. However, experience shows that the recovery of budgetary loans is typically poor, and has high administration costs. Where these funds are lent to inefficient public enterprises, they skew the playing field against more profitable new businesses. MOFs rarely have the institutional capacity to monitor and manage project risks inherent in the budgetary loans, which are often irrecoverable and thus turn into subsidies. Subsidies and budget lending serve similar economic goals, but the former are preferable on a transparency grounds. The same risks are present in on-lent donor funds. Many donors seek special arrangements (dedicated accounts, etc.) for channeling funds, arguing that this will better protect ("ringfence") them. Two main fiscal risks are related to donor funds. One is that any ring-fencing arrangement places the funds outside the budget, and thus decreases the latter's comprehensiveness. Another risk is that while on-lending these funds the government incurs risks typical for a banking institution, which it is equipped to deal with. On-lending may seem an inevitable practice, but the government should be aware of these lending risks. While ample amounts of concessional money may be available in the next few years to increase the capital budget of Serbia, on-lending these funds requires a much stronger risk monitoring and project supervision capacity than is currently available in the MOFE of Serbia. The record of most transition countries with regard to the recovery of on-lent funds is depressing. Contracting this service out to an agent (such as a development bank) rarely reduces the risk. In Serbia's current situation, where creditor right enforcement has been weakened, the government should be wary of building too large an on-lending portfolio, and in any event should take steps to strengthen its risk management capacity in this area. As a starting point, a strict and transparent policy of budget lending and collections should be formulated to prevent such distortions.

4.20 Until 2001, direct subsidies to enterprises were low, averaging just over 1 percent of GDP. This was not an indication of good fiscal practices, as much larger subsidies were provided to public enterprises off-budget, through directed and subsidized credit, exemptions on tax and social contributions liabilities, regulated utility prices and non-enforcement of collection. From this angle, the rise of spending on subsidies in 2001 was welcome as it signaled increased comprehensiveness and accountability of the fiscal system. Some hidden subsidies such as directed lending were discontinued altogether; some are being phased out through structural reforms in the enterprise and banking sectors. In the 2002 budget, subsidies to enterprises jumped further, to 4.1 percent of Serbia's GDP, accounting for about 11 percent of total Serbian budgetary spending. Subsidies are also provided via the Directorate for Commodity Reserves (DCR), which conducts price interventions in key domestic markets, in an attempt to keep the prices of staple commodities, such as wheat, low. This is a sizable operation – it is budgeted for
2002 at about 0.4 percent of GDP. It is untargeted and distorts the markets heavily. It is also conducted primarily from DCR’s own funds, whose transparency is inadequate. In recent years, this Directorate has amassed significant arrears to the farmers (at the end of 2001 exceeded 1.3 percent of GDP). Both on efficiency and equity grounds DCR operations are questionable. On the other side, subsidies to households are low. Households receive budgetary support as direct transfers, which is a good fiscal practice.

4.21 The current level of Serbia’s budgetary subsidies could be acceptable only if (i) there was no pressure to expand them further, and (ii) these subsidies were accompanied by effective structural reform measures. It would be neither feasible nor desirable to increase the proportion of subsidies above the current levels, which can be justified only if they were targeted and provided for a finite period of time needed to liquidate or restructure large publicly owned loss-makers. The costs and benefits of these subsidies should be assessed against alternative uses of budgetary resources.

4.22 Cross-border subsidies amounted in 2000 to 0.1 percent of Serbia’s GDP, but were much higher in earlier years. These subsidies from Serbia were likely to have benefited only one recipient - the Republika Srpska - one of the Entities of Bosnia and Herzegovina. As part of the efforts of the international community to stabilize the region, there is a push to eliminate non-transparent cross-border financial flows.

4.23 Grants and Social Transfers. Serbia’s level of social transfers as a share of GDP is quite high – close to wealthier countries such as Slovenia and Hungary. At the same time it displays high variability if measured on a cash basis. While this may suggest that the Government can cut social spending if needed, the existence of arrears on social spending does not suggest this capacity. For example, the main Republic Pension Fund still carries a large debt to beneficiaries from 1995-96 (about 1 percent of 2001 GDP or one-third of all arrears in the pension system). Vast social obligations cannot be maintained only through compulsory contributions, but have to be propped up with additional budgetary transfers amounting to one-quarter of all budgeted spending in 2002. Supporting the oversized social protection system is a major burden (see Chapter 5).

4.24 Modest grants to local governments in Serbia have been earmarked primarily for reconstruction in the wake of the Kosovo crisis. Even then, transfers to the local level were less than 0.5 percent of GDP. In 2002, the Serbian Republic budget allocated less than 1.5 percent of total spending as grants to local governments, again mostly into a special program for Southern Serbia. The main vehicle for financing the local governments is the annual Law on revenue allocation. Furthermore, the centralization of public spending over the past decade has left local government with few expenditure

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45 Data on these subsidies were not available from Serbia, and were provided by the World Bank team working on Bosnia. Most likely, the source of these transfers was the Federal government. Detailed composition is not available but these subsidies were likely to have funded both civilian and military needs. Similar subsidies were provided by Croatia to the Federation of Bosnia and Herzegovina.
assignments. Chapter 6 (page 78) and Annex 2 provide an overview of the intergovernmental relations in Serbia.

4.25 Capital Spending. Over the past decade, and possibly longer, Serbia was under-investing in public assets, in particular in infrastructure. Until 2000, Serbia's average spending in this category was under 1.5 percent of GDP, which suggests that public capital assets are in dire need of rehabilitation and repair. Only in 2000 capital spending jumped steeply, driven by reconstruction effort in the wake of the Kosovo conflict. In 2001 substantial donor inflows began, directed to reconstruction needs, but were not budgeted. Only in 2002 has a greater share of these inflows been included in the Budget, producing an impressive jump (see Figure 4.3). If planned inflows were to materialize, this would more than double capital expenditure compared to the 2001 outturn. The government rightly believes that a small investment in rehabilitation can yield large benefits, since basic social and physical infrastructure is in place.

![Figure 4.3: Public Capital Expenditure (percent of GDP)](image)

Note: Av. CEEC is a simple average for fourteen CEEC (see note for Figure 4.1). FRY w/o MN is FRY without Montenegro. Data for 2002 are preliminary.
Source: World Bank and IMF staff estimates.

4.26 While the rise in capital spending are positive, two types of risk are associated with it. First, there is a risk of an excessively rigid link between donor funds and capital spending. If external assistance came in at below expected levels, this may force the government to cut capital spending again, merely to balance the budget. Second, the main question must soon become not “how much” but “how efficient” is this capital spending. The quality of projects in the public investment pipeline should be watched.

46 Local governments are funded from their portion of the sales tax, and from several small taxes assigned fully to them. Tax assignments are negotiated yearly. The annual Law on revenue assignment allows much variety in the share of the sales tax that the local governments can retain - from 3 percent (e.g. Community of Obilic) to 95 percent (e.g. Community of Szombor).


48 The largest portion of capital spending is funded from the ring-fenced donor funds. If donor money did not flow in, actual capital spending would be lower. This happened in 2001; hence the difference between the programmed capital spending in 2001 (3.5 percent of GDP) and the actual spending of 1.2 percent.
closely, and the capacity of MOFE to manage the fiscal risks of these projects should be upgraded.

B. FUNCTIONAL ANALYSIS OF PUBLIC EXPENDITURE

4.27. Reliable historical series of general government spending broken down by function are harder to find than economic breakdowns. Serbian MOFE had prepared the first reliable functional breakdown only for 1997-2000; even this covered only the Republic budget, which is less than one-half of general government spending. A functional breakdown of Federal spending is available only for 2000 and 2001. The budget for 2002 was the first (for both Serbia and the Federation) prepared in accordance with the GFS functional definitions. For earlier years attempts to derive government functions by re-interpreting the traditional administrative presentation of the budgets might be misleading: functions are spread across different agencies and levels of government. From the relatively reliable functional presentation of budgets for 2000 and 2001, the following conclusions can be drawn:

- **Spending on general public services** is below the CEEC regional average;
- **Defense spending** is the largest in the region;
- Spending on **public order and safety** does not appear oversized, and may actually be insufficient if the needs to modernize Serbia’s courts and prisons were considered; efficiency concerns are also crucial here;
- **Education spending** is low comparable to other CEECs. Its efficiency is also low, and there exists a distortion toward oversized tertiary education;
- Spending on **pensions and health** is not sustainable; spending on other social protection items is also significant; and
- **Economic affairs** include mostly subsidies to loss-making public enterprises and to agriculture, and should be kept under strict control, as discussed above.

4.28. **General Public Services.** Serbia spends less on this function than most other countries in the region, allocating to it over 40 percent less than an average CEE country. Spending on this function doubled as a share of total spending over 2001-2002. Almost all of this rise is accounted by just one sub-category with the resumption of the servicing of state debt, interest payments account for over half of the spending on this function as compared with negligible levels in past years. With interest payments subtracted, current levels of spending on this function are not far from regional averages.

4.29. **Defense.** In the FRY, defense was the main responsibility of the Federal budget (over two-thirds of the total in 2001). While it is difficult for an outside observer to offer a judgment on an appropriate level of allocations for defense spending, the overall regional trend, as evidenced by PEIRs in several other Balkan countries, has been to reduce this spending. Assuming that the regional security situation continues to normalize, Serbia would be expected to follow other CEEC countries in this trend. Its defense allocations have already come down from the peak levels of the past decade (5-6 percent of GDP). In all countries, including Serbia, a major issue in public defense spending is information access and accountability (see Chapter 6 on budgetary transparency issues). Publicly available information on Serbian defense sector activities
is limited and some of it is unreliable. Many activities are off-budget such as road construction and real estate management. Budgetary spending units in the defense sector also appear to have run up large arrears, particularly on payments to utilities.

4.30 Looking at the sub-categories within defense spending, a notable feature of the FRY was the large amount of spending on non-wage items, mostly goods and services (about 60 percent of the total defense bill in 2001). To a certain extent this was related to the fact that the military complex included large fixed assets that required sizable maintenance spending. However, the main factor was the classification of temporary servicemen and contractors under goods and services (as described above). If the defense wage bill were adjusted to reflect this classification problem, it would come out as the largest component of defense spending. As Serbia begins to modernize its Army, the wage bill will have to take the largest cuts. In 2001, a large number of part-time servicemen were discharged, and early retirement schemes are in operation for the senior ranks. While anticipated savings in the defense sector from demobilization could be substantial, they would only be realized over the medium term. In the short run, costs of a demobilization would be high, as demobilized servicemen will need retraining.

**Figure 4.4: Public Spending on Defense (percent of GDP)**

![Graph showing public spending on defense as a percentage of GDP over the years from 1995 to 2002.]

Note: Av CEEC is a simple average for fourteen CEEC (see note for Figure 4.1). FRY is Federal defense spending. 2002 data are for legislated budget. Source: World Bank staff estimates.

4.31 Public order and safety has been a republican responsibility. Statistics show that Serbia spends more than the regional average on these activities although the gap is smaller than in the case of defense. This function is also relatively well-protected. While defense spending may be expected to decline in the coming years, there may be increased need for spending to modernize the court system and strengthen the judiciary, in order to improve governance and address corruption. As public order and safety function has

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The Federal MOF estimated Army arrears at over 1 percent of GDP at end-2000, and reported that in 2001 those arrears were almost eliminated. However, GOS sources indicated in mid-2002 that Army arrears were on the rise again.
received less than half of the funding of the defense complex in Serbia, defense savings might be effectively redeployed to finance such improvements.

4.32 **Pension and Health Care** are the largest spending items in the functional classification, accounting for over 1/3 of total consolidated government spending. These two major social functions are analyzed in greater detail in Chapter 5.

4.33 Spending on **education** has been declining throughout the past decade and is now among the lowest in Europe, and comparable to public spending on education in countries with low incomes (Figure 4.5). Wealthier CEECs, such as Slovenia, Poland, and Hungary spend in excess of 5 percent of their GDP on education. This, however, reflects data deficiencies, as reliable information is not available on local government spending on this function. Local governments are responsible for schools’ material costs and repairs while the Republic is footing the education wage bill. Teacher salaries for Serbia have long been below public sector averages, and in 2002 the Republic Government took strong measures to eliminate this gap. Further and wider reforms of this sector are needed. Educational quality is not systematically assessed and performance indicators are not used for policy development, for resource allocation, or for international comparisons. Schools are starved for basic supplies and equipment, and many buildings are past the age that provides normal conditions for learning. The sustainability of higher education is further weakened by the subsidization of obsolete programs, the high cost per graduate, and an inequitable fee structure. Secondary vocational education and training (VET) and higher education do not meet the needs of Serbia’s emerging market economy.

**Figure 4.5: Public Spending on Education**

(Percent of GDP)

Note: Data for FRY and Montenegro are averages for 1997-2001, for other CEEC - averages for 1995-2000. FRY w/o MN is FRY without Montenegro.

Source: World Bank and IMF staff estimates

4.34 The distribution of spending within the education function reveals problems typical for underfunding condition: (i) an excessive share of wages as compared to equipment and materials (in Serbia the former is more than five times larger than the
latter, while in countries with more adequately funded education this proportion is more balanced) (ii) a bias toward tertiary (university) education; and (iii) a lack of performance-oriented criteria for the allocation of educational spending. Tertiary education generates large own revenues, which until 2002 were not properly included in the Republic budgets. The outcome of the system is an oversupply of students with skills that do not make them readily employable.

4.35 Reform of education has been identified by the new Government of Serbia as a priority area. While the Government's reform strategy emphasizes governance issues and sector development outcomes, it also puts these medium-term to long-term goals in the context of the basic sector inputs needed to protect the strengths of the former Yugoslav educational system and to stimulate quality improvement. The first steps in the implementation of this strategy have already been taken for education budget in 2002 almost doubled from the 2001 levels.

C. POLICY RECOMMENDATIONS

4.36 This chapter analyzed the allocation of fiscal resources in Serbia over the past few years and proposed pressures to increase the efficiency of allocation of public funds. The following recommendations can be made for the short term:

- Arrest further rise in the overall public spending, aim to eliminate overlaps and duplication across the levels of government, and prepare selected sector-specific cost-saving strategies (e.g. general public services, defense);
- Complete the transition to GFS, providing the policymakers with tools to correctly measure the efficiency and equity of spending across categories;
- Formulate a medium-term approach to optimize the mix of budgetary spending for the greatest growth and poverty alleviation impact;
- Contain the public service wage bill in real terms as a percent of GDP and begin formulating public service reform; and
- Phase out subsidies to enterprises not targeted to covering the costs of restructuring, while expanding capital spending on the basis of a financially sound medium term plan focused on supporting private sector development.

4.37 Most of the savings and rationalizations, however, are achievable only over the medium-term, and call for the following steps:

- Contain government borrowing, and continue bringing on budget quasi-fiscal deficits, to prevent the new destabilization of the debt situation;
- Initiate military reform aimed at lowering defense spending, and apply some of the savings to strengthen public order and safety;
- Restructure the social protection system.

4.38 The analysis of allocative issues presented in this chapter is extended in the next chapter to the two largest social functions – pensions and health care finance.

5. PENSION AND HEALTH CARE SPENDING

5.1 The preceding chapter summarized the main trends in the allocation of public funds across government functions and economic categories, demonstrating the dominance of social services in Serbia's fiscal system. This chapter takes a closer look at the two main elements of the social sphere - pensions and health care finance. Both are characterized by major structural imbalances and inefficiencies and are a threat to Serbia's fiscal stability.

A. OVERVIEW

5.2 Historically, FRY has maintained a large social protection system, funded and operated mainly at the Republic level. The exceptions are two Federal funds - Military Pension Fund and Military Health Insurance. In the mid-1980s the share of social security and welfare was already close to 33 percent of total public spending. At that time, the economy was stronger and could support most, if not all social programs. Since then social entitlements have proliferated further, justified by the need to reduce hardship, but without due attention to their fiscal affordability. In 2001, various social protection programs (comprising both the Republic and Federal level) accounted for over one-half of general government expenditures in Serbia, or around 19 percent of its GDP.

5.3 Serbia retains the key features of the former Yugoslav social protection system, characterized by a wide range of cash benefits and social welfare services delivered through a comprehensive national network. Republic extrabudgetary funds pay pensions, health and unemployment benefits, while child and maternity benefits and a host of smaller benefits are paid directly from the budget. None of the extrabudgetary funds are viable without budgetary infusions. The social welfare system is poorly targeted and includes some redundant benefits. Excessive centralization at the Republic level negatively affects efficiency of the social protection and security system.

5.4 The Government has maintained social protection as a priority in its 2002 and 2003 budgets. The relatively high resource allocations to these sectors need to be supported by deeper reforms, to improve the efficiency and financial sustainability of the social protection system, and to protect the vulnerable in a more targeted fashion. The Government seeks sustainable solutions to the financing of the public health service as well as to the more entrenched and complex problems of the pension system. In addition, the Government views securing social safety nets for the most vulnerable and

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51 Their position may change as a result of the constitutional transition.
resettlement of refugees and IDPs as its strategic priorities.\textsuperscript{53} This chapter is devoted to the pension and healthcare systems, as these account for the lion’s share of spending on social protection. However, the social welfare system also needs to be reformed, to address significant exclusion errors in targeting, the likely short-term negative social impact of economic restructuring, the new demands generated by price liberalization, and the possible rise in the number of beneficiaries as refugees become citizens. The key issues include: (i) improving the structure of benefits and supporting fiscal sustainability; (ii) enhancing equity and dealing with refugees; (iii) streamlining and strengthening social welfare delivery; and (iv) upgrading staff skills and promoting partnerships with the private sector. Reforms should support the long-run fiscal sustainability of the social welfare system by ensuring that increased future demands on the system can be managed with available resources.

B. The Pension System

5.5 The Serbian pension system is not financially viable. In 2001, it absorbed 12.7 percent of GDP (on an accrual basis), and was able to meet its legal obligations only with the help of budgetary transfers amounting to 4 percent of GDP. A large expansion in beneficiaries in the past decade, owing partly to lax eligibility criteria and partly to the misuse of the pension system to effect early retirements, combined with the decline in output and revenue performance, have contributed to a decline in viability.

Box 5.1: The Pension System in Serbia

Serbia operates a pay-as-you-go pension system with three funds: the Employees’ Fund (the largest fund), the Fund for the Self-Employed, and the Farmers’ Fund. There are 1.6 million pensioners in receipt of three types of pensions: old-age, invalidity, and survivors’ (family) pensions. In addition to pensions, the system pays certain social benefits, the most important of which is the assisted-care allowance, raising the total number of beneficiaries of the system to around 2 million. The two main sources of revenue for the pension system are listed below:

**Payroll contributions:** For employees, the payroll contribution is 19.6 percent of the gross wage (shared equally between the employer and the employees). The self-employed pay 18 percent of the insurance base which cannot be below 50 percent of the average wage. Farmers pay 12 percent of assessed revenues, typically valued at 50 percent of the average wage.

**Budget transfers:** Budget transfers cover: (i) special pension entitlements of certain categories of employees guaranteed under the Federal and Republic laws; (ii) compensation to the Employees’ Fund for the reduction in the payroll tax that accompanied the widening of the tax base on June 1, 2001; and (iii) residual system deficits. The bulk of transfers cover system deficits, as transfers for special pensions are relatively small.

Under the rules prevalent until 2002, pensions were indexed monthly to wages with a 5 percent trigger. Standard retirement age was 60 for men and 55 for women with some categories of employees entitled to old-age pensions earlier, the earliest age being 50. In the Employees’ Fund the average age at retirement (58 for men and 53 for women) was below the statutory age. Farmers and the self-employed are, however, observed to retire later than the statutory retirement age. Amendments to the Pensions Law enacted in late 2001 changed indexation and raised the retirement age (see paragraph 5.13 for more details).

5.6 In the absence of reforms, the pension system was expected to experience growing deficits. At the end of 2001, the Government has introduced a range of parametric measures to contain the level of spending and improve equity in the system.

\textsuperscript{53} Ibidem.
While these changes will reduce the size of the deficit, they will not eliminate it, at least not in the near term. It will be important for the Government to resist pressures to expand entitlements as economic reforms accelerate. Further analytical work is warranted on the longer-term prospects of the system, which should inform the design of pension reforms.

5.7 Owing to the lack of good household survey data, little analysis is possible on the standards of living of pensioner households and the contributions of pensions to overall household resources. The analysis of available data suggests that while pensioners are at no greater risk of poverty than the rest of the population there are sub-groups of pensioners who are extremely vulnerable. Pensioners living alone or in households where the pension is the only source of income fall into this category. Addressing poverty among this group should be one of the key objectives of social protection reforms.

5.8 Financing Needs under no reform scenario. In the no reform scenario, pension system spending was expected to grow (see Table 5.1). The pension system had a deficit of 5.3 percent of GDP in 2001. This was financed largely from the budget (4.1 percent of GDP) and, to a lesser degree, through an increase in arrears (1.2 percent of GDP). The deficit in the system was expected to rise further to 6 percent of GDP by 2005. Looking at the difference between pensions and contribution revenues alone, the deficit in 2001 was 3.3 percent of GDP, and was expected to rise to 4.5 percent of GDP in 2005.

Table 5.1: Projection of the Financial Balance of the Serbian Pension System (Prior to the 2001 Reforms, Percent of GDP, Accrual Basis)

<table>
<thead>
<tr>
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<th>Expenditures</th>
<th>Revenues</th>
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</thead>
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<tr>
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<td>Other Benefits</td>
<td>Others</td>
</tr>
<tr>
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<td>1.6</td>
<td>0.6</td>
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<tr>
<td>2005</td>
<td>11.3</td>
<td>1.4</td>
<td>0.4</td>
</tr>
</tbody>
</table>

Source: World Bank staff projections based on wage, price and GDP growth projections from the Republic of Serbia MOFE.

5.9 The increase in the projected deficit (Table 5.1) is driven primarily by two factors: (i) the net increase in the number of pensioners in the face of unchanged entitlements, and (ii) the lowering of the effective rate of payroll taxation in June 2001. The first factor is a more important determinant of the deficit, as the stock of beneficiaries was

54 The pilot Poverty Survey implemented by the Ministry of Social Affairs in 2002 should go a long way toward remedying this data gap.

55 Projections are based on the assumption that the number of new old-age and survivor pensioners is in line with the trends observed over the last two decades, while the number of new disability pensioners is stable after the sharp decrease in flows observed during the 1990s.

56 The lowering of the contribution rate from 32 percent to 19.6 percent of gross wage for employees along with the expansion of the definition of gross wage to include hitherto untaxed incomes in 2001 was not revenue-neutral and resulted in a lowering of pension system resources. This is reflected in a fall in contribution revenues from 7.4 percent of GDP in 2001 to 6.7 percent thereafter.
expected to grow by over 1 percent per year. Spending on new pensioners alone was projected to rise to 2.7 percent of GDP by 2005.

5.10 The problems of the system are in large part owing to the low ratio of contributors to pensioners, particularly in the Employees' and the Farmers' Funds. The Employees' Fund has seen an absolute fall in the effective number of contributors since 1990; there are currently 1.3 contributors per pensioner. The situation is particularly adverse in the Farmer's Fund where, despite an apparently large number of insured persons, very few effectively contribute to the system. Currently there are 0.5 contributors for every pensioner in this Fund.

Figure 5.1: Employees Pension Fund: Estimated Number of New Retirees Per Year

![Chart showing the number of new retirees per year by type of pension (old-age, disabled, survivors) from 1990 to 2005.](chart)

Source: World Bank staff estimates.

5.11 Adding to the fall in the contributor/pensioner ratio is the large expansion in the number of beneficiaries. Figure 5.1 shows new pensioners per year by type of pension: these numbers have been steadily rising. This is partly due to growing system maturity, and partly due to a stagnant labor market. In the 1980s, disability pensions were the favored route to "early retirement." With a tightening of the criteria in the 1990s, the collection of these pensions has fallen, but there has been an increase in the collection of old-age pensions. The inflow of new old-age pensioners was particularly marked in the run-up to the legislative changes in 1991 and 1997, which significantly curbed entitlements. A similar spike was observed in 2001 in anticipation of the rise in the retirement age. As a result of early retirement, nearly 30 percent of women aged 54 and 45 percent of men aged 59 had the benefit of pensions a year before reaching the statutory retirement age.

5.12 An additional factor behind high pension spending is high replacement rates (the ratio of the average benefit to the average wage). For example, in the Employees' Fund in 1999, the old-age pension more than fully replaced the average net wage. Actuarial calculation shows that, although the contribution rate is high, workers of the Employees'
Fund who retire at the statutory age benefit from a financial return of above 10 percent, which is very generous and is far more than the system can afford. Factors that contribute to this generosity are high accrual rates and the use of the best ten years of earnings (rather than a longer work history) as the basis for pension calculations.

5.13 Recent Developments: Mindful of the growing fiscal burden of the pension system, the Government legislated in late 2001 a set of parametric reforms to the system. These measures were designed to curb spending and to provide an adequate minimum floor to pensions. In particular,

- Retirement ages for men (60) and women (55) were raised to 63 and 58, respectively, with immediate effect from January 1, 2002;
- In tandem, the minimum age at which an old-age pension can be drawn was raised from 50 to 53 years;
- Indexation of pensions was changed from wage indexation to indexation according to the Swiss formula – the average of increases in the cost of living and wages – to be implemented four times a year; and
- The structure of minimum pensions was simplified, so that there is one minimum pension set at 20 percent of the average wage.

Table 5.2: Impact on Pension System of Serbia of Amendments to Pension Law

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
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<td>6.7</td>
<td>6.7</td>
<td>6.7</td>
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<td>11.0</td>
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<tr>
<td>Deficit</td>
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<td>-4.1</td>
<td>-4.3</td>
<td>-4.4</td>
<td>-4.5</td>
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<td>Swiss-Indexation of Benefits</td>
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<td></td>
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<tr>
<td>Pension Benefits</td>
<td>10.6</td>
<td>10.8</td>
<td>10.6</td>
<td>10.6</td>
<td>10.5</td>
</tr>
<tr>
<td>Deficit</td>
<td>-3.2</td>
<td>-4.1</td>
<td>-3.9</td>
<td>-3.8</td>
<td>-3.7</td>
</tr>
<tr>
<td>Rise in the Statutory Retirement Age</td>
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<tr>
<td>Pension Benefits</td>
<td>10.6</td>
<td>10.8</td>
<td>10.6</td>
<td>10.6</td>
<td>10.5</td>
</tr>
<tr>
<td>Deficit</td>
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<td>-3.7</td>
<td>-3.5</td>
<td>-3.5</td>
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<td>Pension Benefits</td>
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<td>10.1</td>
<td>9.7</td>
<td>9.7</td>
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<tr>
<td>Deficit</td>
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<td>-3.5</td>
<td>-3.4</td>
<td>-2.9</td>
<td>-2.9</td>
</tr>
</tbody>
</table>

Source. World Bank staff estimates, based on wage, price and GDP growth projections of MOFE.

5.14 Fiscal Impact of Selected Measures: Table 5.2 presents the impact of selected measures on the fiscal balance of the pension system. It first considers the two measures that provide the greatest saving: (i) changes in indexation, and (ii) changes in the retirement age. Moving from wage indexation to Swiss indexation is expected to curb the growth in benefits expenditure and lower the deficit in the system relative to the no change scenario. The overall saving is at a negligible level in 2002 but rises to 0.8 percent of GDP in 2005. Similarly, increasing the retirement age and the minimum age at retirement will constrain the growth in expenditure and reduce the deficit. Savings from this measure in the first year alone are 0.4 percent of GDP, and rise to 0.81 percent of GDP by 2005.
5.15 The sum of all the measures will reduce benefit expenditure from 10.6 percent of GDP in 2001 to 9.7 percent of GDP in 2005, providing savings of 0.6 percent of GDP in 2002 which rise to 1.6 percent of GDP in 2005 relative to the no change scenario. The deficit of the pension system falls. While these measures reverse the deteriorating trend in fiscal balance, they do not eliminate it entirely.

5.16 Equity: In addition to changing retirement ages and indexation, the amendments simplified the structure of minimum pensions. These changes promise only limited savings, but will play an important role in gradually lowering the replacement rate while providing an adequate floor to pensions (Box 5.2).

Box 5.2: Minimum Pensions in Serbia

Prior to 2002, the structure of minimum pensions was complex, with four levels of 40, 50, 60, and 80 percent of average net wages. Eligibility depended on age, gender, and years of service with higher minimum pensions paid to those with longer contribution histories.

The lowest minimum pension serves an important distributional objective - namely, enabling those with a minimum contribution history to attain a basic minimum standard of living in their old age. The higher minimum pensions (50, 60, and 80 percent of average net wages) reward those with longer contribution records, but the level of the “reward” makes them harder to justify. These minimums, along with other features of the pension system, serve to boost overall replacement rates and weaken the link between contributions and benefits. Nearly 15 percent of pensioners benefit from these higher minimums.

Under the amended Law, the structure of the minimum pension is to be simplified so that there is one minimum set at 20 percent of the average gross wage (which is close to the earlier 40 percent of net wage threshold). In effect, the higher minimum pensions are eliminated. As this change will affect new pensioners, the fiscal impact is likely to be low. However, over time, the change will contribute to a gradual reduction in overall replacement rates and reinforce the contribution principle while at the same time provide an adequate floor to pensions.

Policy Recommendations

5.17 While the Serbian Government has taken many commendable steps to rein in pensions spending, this agenda is unfinished. It is only partly related to persistent fiscal deficits which, as the above estimates suggest, are not likely to be eliminated under the new law. A large stock of pension debt still needs to be repaid. The system suffers from a substantial overhang of previously awarded disability pensions. As the rush for disability pensions at the end of 2001 suggests, there is scope for further improvements in disability certification arrangements. The system also is excessively diversified in administrative terms, with three funds with distinct administrative structures.

5.18 In the short run, it will be important to undertake the following:

- Gradually reduce replacement rates through changes in the benefit formula and through lengthening the wage history used in the pension base calculation;
- Provide further incentives for postponing retirement;

While commendable progress has been made with reducing the stock of arrears (particularly in the Farmer's Fund) and improving the timeliness of payments, there are large debts that date from the economic stabilization of 1994-95. These relate to restitution payments to compensate pensioners for the decline in replacement rate during that period.
• Improve the sustainability of the farmers' pensions;
• Maintain tight control over the granting of invalidity pensions, particularly as the pace of economic restructuring accelerates;
• Expand contribution compliance, particularly among those in the informal economy;
• Expand the contribution base by eliminating all contribution, and unifying contribution rates and bases across all categories of contributors;
• Seek administrative savings through harmonization of operations across the three funds; and
• Improve capacity for modeling of the long-term prospects of the pension system and the evaluation of policy options.

5.19 Over the medium-term, measures are needed to diversify the sources of pensioner income. This will require a concerted program of policy development and institutional strengthening accompanied by legislative action. The Government's recent steps in the area of voluntary pension insurance are welcome. Further evaluation of the scope and feasibility for the introduction of a mandatory funded pillar is warranted.

C. THE HEALTH CARE SYSTEM

5.20 The analysis of Serbian health care is complicated by the dearth of reliable information on the financial flows into and out of the system, and on the degree of efficiency with which these funds are utilized. Even the most basic data (population, overall public expenditure in health) vary strikingly in reports from different government agencies. The challenge is increased by the complexity of the system. This said, public spending on health in Serbia was estimated in 2001 at close to 7 percent of GDP, stable since 2000 and down from the 8.6 percent in 1998. Once estimates of private expenditure are added, total health expenditure reaches around 10 percent of GDP - among the highest in the region, and close to the levels registered by high income countries (Table 5.3). However, per capita expenditure on health is relatively low, ranging from $107 to $67, depending on the population figure used. Even this unreliable information suggests that Serbia's health care system is not fiscally sustainable, and delivers poor quality health care in an inefficient and inequitable way, and thus is in need of considerable restructuring. More in-depth investigation confirms this assessment.

58 Given the complex financial system and the lack of a consolidated health budget, the value of the total public expenditure in health had to be compiled from the sketchy available information and with the help of a series of choices and assumptions (for more details see Couffinhal, A. and Paci, P., 2002). Private expenditure can only be roughly estimated. The lack of agreement on basic indicators for Serbia is serious; even the population figures are disputed. The figure for the total population used by the Public Health Institute (PHI) to estimate utilization and efficiency indicators, is 7.8 million (based on 1991 census), a figure which is consistent with the one presented in the statistical yearbook of Serbia (7.7 million in 1998)

59 The observations referred to in Table 5.3 as "Serbia high" use the lower number for population and the higher estimate for private expenditure (40 percent of the cost of care). "Serbia low" estimate uses the low figure for private expenditure (20 percent) and the high figure for the population.
### Table 5.3: International Comparisons of Health Expenditure

<table>
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<td>7.9</td>
<td>1</td>
<td>8.9</td>
<td>2184</td>
<td>24496</td>
</tr>
<tr>
<td>Germany</td>
<td>7.9</td>
<td>2.7</td>
<td>10.6</td>
<td>2697</td>
<td>26195</td>
</tr>
<tr>
<td>Greece</td>
<td>4.7</td>
<td>3.6</td>
<td>8.3</td>
<td>957</td>
<td>11597</td>
</tr>
<tr>
<td>Netherlands</td>
<td>6.2</td>
<td>2.5</td>
<td>8.6</td>
<td>2139</td>
<td>24920</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>5.6</td>
<td>1.1</td>
<td>6.7</td>
<td>1686</td>
<td>23793</td>
</tr>
<tr>
<td>Middle income countries</td>
<td>2.5</td>
<td>2.6</td>
<td>5</td>
<td>117</td>
<td>1980</td>
</tr>
<tr>
<td>Lower middle income countries</td>
<td>2.3</td>
<td>2.5</td>
<td>4.8</td>
<td>62</td>
<td>1112</td>
</tr>
<tr>
<td>Upper middle income countries</td>
<td>3.4</td>
<td>2.9</td>
<td>6.3</td>
<td>318</td>
<td>4754</td>
</tr>
<tr>
<td>Europe &amp; Central Asia</td>
<td>4.1</td>
<td>1.6</td>
<td>5.7</td>
<td>138</td>
<td>2132</td>
</tr>
<tr>
<td>High income countries</td>
<td>6.1</td>
<td>3.7</td>
<td>9.8</td>
<td>2702</td>
<td>26023</td>
</tr>
<tr>
<td>Europe EMU</td>
<td>6.7</td>
<td>2.3</td>
<td>8.9</td>
<td>2045</td>
<td>22563</td>
</tr>
</tbody>
</table>

Source: World Bank database on health, data for the most recent year available. Data for Serbia are authors' estimates for 2000.

#### 5.21 Financing the Health Care System

Financing the Health Care System takes place via a combination of public finance and private contributions. The cornerstone of the public system is the Health Insurance Fund (HIF), which receives earmarked payroll contributions from employees, employers, self-employed, farmers, and the Pension and Labor Market Funds. In 2000, employees represented nearly 60 percent of the contributors and, with their family members, around 55 percent of the insured, but paid over 80 percent of the contributions. Other large categories of contributors were the pensioners (27 percent) and the farmers (11 percent of contributors and nearly 19 percent of the insured). However, the latter contribute only 1.3 percent of contributions. Transfers from the Republic Government were finance investments via the Ministry of Health, and for covering health care provision for the “vulnerable groups” (from MOFE). The Federal Government is supposed to make transfers for coverage of the refugees. However, in recent years these

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60 There exists a separate Federal Health Insurance Fund for Military Personnel and their families (FMHIF).

61 The “vulnerable groups” are loosely defined to include the long term unemployed, the elderly, the very young, and independent artists amongst others.
transfers have been very limited, so that in 2001 nearly 92 percent of HIF finding has come from contributions. In addition to the revenue of the HIF, public health expenditure includes the budget of the MOH, the health expenditure of the Ministry of Defense and the budget of the Republic Directorate of Properties which covers health facilities. A breakdown of the public health expenditure in Serbia is provided in Table 5.4. Private expenditure on health is pervasive and covers a combination of recently introduced nominal co-payments, services purchased on the limited private market and from the military health facilities, and extensive under-the-table payments.

Table 5.4: Public Health Expenditure in Serbia, YUD million

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health Insurance Fund (HIF)</td>
<td>9,727.1</td>
<td>11,757.9</td>
<td>20,473.7</td>
<td>40,968.2</td>
</tr>
<tr>
<td>HIF's budget, percent of GDP</td>
<td>6.6%</td>
<td>6.1%</td>
<td>5.7%</td>
<td>5.7%</td>
</tr>
<tr>
<td>Republic Ministry of Health</td>
<td>82.2</td>
<td>77.0</td>
<td>60.1</td>
<td>180.2</td>
</tr>
<tr>
<td>Republic Directorate of Properties (health facilities)</td>
<td>60.6</td>
<td>79.9</td>
<td>148.4</td>
<td>300.0</td>
</tr>
<tr>
<td>Health Expenditure of Federal Ministry of Defense</td>
<td>202.0</td>
<td>266.4</td>
<td>494.5</td>
<td>1,000.0</td>
</tr>
<tr>
<td>Federal Expenditure on Health</td>
<td>-</td>
<td>-</td>
<td>0.1</td>
<td></td>
</tr>
<tr>
<td>Additional public revenues of health institutions</td>
<td>1,750.9</td>
<td>2,116.4</td>
<td>3,685.3</td>
<td>7,374.3</td>
</tr>
<tr>
<td>Total Public Expenditure on Health</td>
<td>11,822.8</td>
<td>14,297.6</td>
<td>24,862.0</td>
<td>49,822.7</td>
</tr>
<tr>
<td>Total Public Health Expenditure, percent of GDP</td>
<td>8.1%</td>
<td>7.4%</td>
<td>6.9%</td>
<td>6.9%</td>
</tr>
<tr>
<td>Nominal GDP, YUD billion</td>
<td>146.3</td>
<td>192.9</td>
<td>358.1</td>
<td>724.1</td>
</tr>
</tbody>
</table>

Sources: Federal and Republic authorities, World Bank staff estimates.

5.22 The major weaknesses of the financing system are the evasion of contributions, the resulting pervasive arrears, and heavy reliance on informal out-of-pocket payments. In a system designed to provide universal coverage, where the link between contributions and entitlement to services has grown increasingly weak, the incentives to pay the required contributions for the self-employed, the farmers are minimal. These two categories contribute only 3 percent and 1 percent of total contributions respectively, while the share of GDP derived from the private sector and non-public agriculture are 40 percent and 20 percent. At the same time, as the economic situation deteriorated, an increasing number of large enterprises were granted exceptions to the statutory payment of contributions to the social funds. The Pension and Labor Market Funds fell behind in the payment of their contributions and the Federal and Republic Governments failed to transfer funds. The accumulation of large arrears to the HIF and its contributors became the norm. As HIF revenue declined, informal out-of-pocket payments for the services of public institutions proliferated, reaching an estimated 40 percent of the cost of health care.

5.23 Health Care Provision. HIF finances health care provided through an extensive network of public facilities accountable to and owned by the MOH. Private provision of health care is limited but growing, especially in some such areas as dentistry. The private sector is largely unregulated and staffed primarily by consultant physicians holding full-time contracts in public institutions. The potential for conflicts of interest is clear.

5.24 The health care delivery system has two main weaknesses it: (i) lacks the necessary incentives for an efficient utilization of resources, and (ii) offers an extremely generous package of health services including coverage of treatment abroad, which, is

clearly not affordable, given the current economic conditions. Health care facilities do not have independent budgets and their expenditures are met by the HIF on a reimbursement basis. Staff is nominally employed by the health care facilities but the total wage bill is fully covered by the HIF. The separation of financial responsibilities and decision making resulting from this arrangement creates perverse incentives, reducing the efficiency of the system.

Table 5.5: HIF Arrears Receivable and Payable

<table>
<thead>
<tr>
<th>(YUD million)</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>May 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditure arrears</td>
<td>4 125</td>
<td>5 923</td>
<td>3 429</td>
<td>4 165</td>
</tr>
<tr>
<td>Domestic debt</td>
<td>1 477</td>
<td>5 798</td>
<td>4 812</td>
<td>4 375</td>
</tr>
<tr>
<td>Of which Debt to SDF</td>
<td>933</td>
<td>4 679</td>
<td>4 201</td>
<td>4 130</td>
</tr>
<tr>
<td>Other bank debt</td>
<td>544</td>
<td>1 119</td>
<td>610</td>
<td>245</td>
</tr>
<tr>
<td>Total arrears and debts</td>
<td>5 602</td>
<td>11 721</td>
<td>8 241</td>
<td>8 541</td>
</tr>
<tr>
<td>Arrears and debts as % of GDP</td>
<td>2.9%</td>
<td>3.3%</td>
<td>1.1%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Arrears to HIF from contributions</td>
<td>n a.</td>
<td>777</td>
<td>1,716</td>
<td>3,235</td>
</tr>
<tr>
<td>Net arrears</td>
<td>n a.</td>
<td>10,943</td>
<td>6,525</td>
<td>5,306</td>
</tr>
</tbody>
</table>

Notes: (1) as of the end of November 2001
Sources: HIF and World Bank staff estimates

5.25 Fiscal Sustainability. In the absence for any system of monitoring expenses and enforcing payments, the HIF developed chronic arrears and debts to civilian and military health institutions and the latter run into debt with the rest of the economy. Arrears and debts of the HIF are presented in Table 5.5. Estimates suggest that the HIF’s arrears decreased in 2001, but remained high, at 1.1 percent of GDP. Moreover, arrears to the HIF increased substantially in 2001, leaving net arrears at over YUD 6.5 billion, or slightly less than 1 percent of GDP. In the first few months of 2002 both arrears to the HIF sharply increased while the expenditure arrears picked up again, despite the improvement in the net position.

5.26 Sustainability requires that the gap between HIF revenues and its expenditures be bridged, which calls for either an increase in revenue or a reduction in expenditure or, what is more appealing, a combination of the two.

5.27 Increasing Revenue. In a labor market in with declining formal employment, an increase in revenue is unlikely to come from further raises of the contributions from waged workers and their employers, which already account for over 81 percent of the HIF revenue. The heavy burden already imposed on the waged workers makes it inequitable and inefficient to increase their contribution further. This leaves only a few options open. As the exemptions from contribution payments granted to employers appear to have been eliminated and other social funds appear to have begun to pay their contributions to the HIF more regularly, the focus should shift to: (i) ensuring that the Republic Government transfers adequate funds for the health care of vulnerable groups; (ii) increasing contribution compliance among self-employed and farmers and ensuring that the contribution paid reflects their ability to pay; (iii) formalizing the large out-of-pocket payments.

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63 Information on the debts of the health care facilities was not available at the time of writing.
5.28 The first point raises the issue of the appropriate government contribution. The Republic Government is expected to cover the vulnerable groups by paying per-capita contributions based on the minimum wage. However, there is little understanding of who these groups are and how numerous they are. Similar considerations apply to the commitment of the Federal Government to cover refugees. It is important to keep updated registers of the vulnerable groups and the refugees, to establish a clear link between the size of the transfer and the number of registered vulnerable individuals. In addition, the Republic government needs to transfer these sums to the HIF promptly and in full.

5.29 Reducing the evasion of contributions in the informal and agricultural sectors is integral part of the government drive to reduce tax evasion, but is likely to continue in the medium term, unless a strong link is re-established between contributions and entitlements to services. However, scope for increasing the number of contributors by the self-employed and the farmers clearly exists. Increasing compliance amongst these groups so that their share of contributions equals the share of GDP generated by the respective sectors, could raise HIF revenue by about 35 percent, covering nearly 85 percent of the estimated accumulated arrears for 2000.

5.30 An additional way of increasing the resources going of the public health system is to formalize the extensive private payments. This can be done in a number of ways. The most obvious are to increase the nominal co-payments and to reduce the exemptions. The other would involve allowing for the use of public facilities on a private basis. This is already happening, to a small extent, at least in Belgrade, with the facilities using the extra funding to supplement physicians' salaries. The possibility of allowing doctors to perform private activity in public facilities is also under discussion at the moment. Further progress in this area requires the setting up of an adequate regulatory and monitoring framework which will needs time to develop.

5.31 **Improving the efficiency of the system.** The current gap between revenues and expenditures of the HIF can also be closed by reduce the costs of running the system. The first area of intervention here is the package of services offered, which is extremely generous by international standards and unaffordable under current Serbian circumstances. The move to a graduated system with the HIF bearing full financial responsibility only for an accepted list of basic services would be welcome.

5.32 Another area of intervention is to improve the efficiency with which health care is delivered. Potentially large savings may arise from increased competition in the market for pharmaceuticals. According to the PHI, pharmaceuticals account for 17 percent of HIF expenditure, however, our figure is closer to 11 percent. In addition, a large proportion of private expenditure covers the acquisition of drugs. Estimates of potential savings in this area vary substantially but are considerable. Market liberalization requires two steps: (i) expanding the very limited list of licensed drugs and (ii) making the procurement process more transparent and competitive.

5.33 Overcapacity in the hospital sector appears to be another cause of high spending: both hospital occupancy rate (68.7 percent) and the average caseload per physician (133) are low by international comparison, although the official number of hospital beds per
1,000 population (5-6) is lower than in many transition and OECD countries. By way of contrast, overstaffing of primary care facilities appears to reflect underutilization of the service more than a high number of doctors. Another cause of concern is the very high number of non-clinical staff – such as cleaners, catering assistants, and administrators. However, overstaffing does not appear to have obvious effects on costs. Salaries account for 57 percent of the HIF expenses - a figure that compares favorably internationally, which is due partly to the low wages of the medical profession, and partly to the high share of low-paid non-clinical staff in the wage bill.

**Policy Recommendations**

5.34 The main finding of this analysis is the urgent need to improve the accountability and fiscal sustainability of the health care finance system. Priority actions are:

- Collect adequate baseline data on the financial status of all components of the health care system and on basic performance indicators, based on the current reality of the health care facilities; and
- Set up an adequate mechanism to monitor the development of the system and the flow of funds between its different agents.

5.35 Improving fiscal sustainability will require a number of actions on the revenue side as well as improving the efficiency of the system. On the revenue side the emphasis should be on:

- In preparation of 2003 budget: (i) establish a list of vulnerable individuals whose medical care is to be financed from general taxation via a per capita transfer from the Republic budget related to the minimum wage; (ii) offset the stocks of arrears to and of HIF; (iii) ensure the regular and prompt transfer of funds to the HIF from the Republic budget;
- Take early action of transferring to the HIF the responsibility for annually stamping the “health card” for all categories of covered individuals, upon proof of payment of contributions and/or entitlement. With the implementation of the new Law on Health Insurance (by the end of 2003), limit the financial responsibility of the HIF to the care of individuals with validated health card;
- Formalize the out-of-pocket payments by: for the 2003 budget - doubling the co-payments and reduce the exemptions; for the 2004 budget - agreeing on a graduated co-payment system, with the HIF bearing full financial responsibility only for an accepted list of basic services; and
- For the 2004 budget, set the transfer to the HIF from the Republic budget - to reflect the number of individuals classified as vulnerable - i.e., per-capita contributions equal to 5.95 percent of minimum wage.

5.36 Any action on the cost side will require an accurate analysis of why the utilization rates are low and a forecast of utilization based on realistic growth trends. In the light of these findings, the priority should be the formulation of an action plan for the restructuring of the delivering system. Crucial to this plan are the following measures:
Increase immediately the number of licensed pharmaceuticals by reintroducing drugs with lapsed registration; by the end of 2003 adopt the Law on Pharmaceuticals, and cover pharmaceuticals in the new Law on Public Sector Procurement;

By the end of 2003, prepare a master-plan for restructuring the hospital sector, with particular emphasis on reducing overstaffing, especially among the non-clinical staff;

Increase the capacity for measuring the efficiency of the system and of individual health care providers by: in the short-run - using and expanding the database on prescriptions recently implemented by the HIF; by 2004 - by setting up a more extensive health information system;

When the information described above has been collected, redesign contracts between the HIF and health care providers, to provide adequate incentives for cost containment; and

Adopt a new Health Care Law, to be implemented in preparation for the 2004 budget, to give health facilities responsibilities for manpower decisions and for managing their budget.

5.37 More generally, given the current lack of reliable information, an effective and fiscally sustainable strategy for the health sector in Serbia will require:

- More evidence on the status and performance of the delivery system;
- Adequate information on the financial flows into and out of the HIF and the health care facilities; and
- More accurate estimate of private expenditure on health care and public expenditure on pharmaceuticals.

5.38 An effective way of acquiring information on the delivery system and the financial flows is to carry out an Quantitative Service Delivery Survey which includes, but is not limited to, a facility survey. The World Bank is carrying out this type of surveys in an increasing number of countries. Serbia could benefit enormously from being added to the list. Accurate information on private expenditure can only be acquired with household surveys, and is essential to the development of accurate national health accounts. The Poverty Assessment Survey undertaken in Serbia in 2002 is an important opportunity to acquire this information.
6. BUDGETARY MANAGEMENT

A. FRAMEWORK AND PROCESSES

6.1 Both the Federal and Republic Governments share common PEM processes, with the differences relating primarily to the responsibility of each level of government and the rate of progress in reforms. Until 2002 common PEM features of these governments were as follows:

- A cash-based budget system;
- An input-oriented budget formulation system built around budget normatives set outside of the budget process;
- A one-year budget planning horizon that does not provide a framework for evaluating new or existing multi-year policy and expenditure commitments;
- A decentralized payment system, with significant responsibility for accounting and propriety resting with line Ministries;
- The absence of a formal Treasury system, consolidated treasury fund, and cash and debt management functions; and
- Policy processes separated from the budget process or financing considerations.

6.2 This chapter briefly presents the conceptual framework for evaluating public expenditure systems, followed by a description of the existing budget formulation and execution processes for the Federal and Republic of Serbia Governments, including extrabudgetary funds. This is followed by an assessment of the current processes with recommended improvements. The focus is on the short-term institutional issues that need to be addressed to provide the Government with the tools necessary to undertake sustainable fiscal adjustment.

6.3 The March 14, 2002 Agreement deeply changed the composition of the public expenditure systems of Serbia and Montenegro, significantly reducing the role of the Federal government. Nonetheless, some issues regarding the Federal structure are relevant. First, whatever new structure emerges is likely to be built upon current Federal structures and processes, and thus the review of Federal budget management is still highly relevant. Second, some issues (e.g. defense resource management) will remain relevant for the new union structure, however constituted.

Framework for Evaluating PEM Systems

6.4 A country’s budgetary process has three main objectives: (i) **aggregate fiscal discipline** - allowing budgets to be set consistent with a realistic macroeconomic framework and a sustainable fiscal program, and brought in on target; (ii) **allocative efficiency** - requiring that resource allocations reflect the policies and priorities of the
government’s program; and, (iii) technical efficiency - requiring that resources are utilized efficiently towards the purposes for which they have been allocated. Box 6.1 sets out the features of effective PEM systems relative to these objectives.

### Box 6.1: Criteria for Assessing the Effectiveness of the Budget Process

<table>
<thead>
<tr>
<th>Element</th>
<th>Budget Formulation Features</th>
<th>Budget Execution Features</th>
</tr>
</thead>
</table>
| **Aggregate Fiscal Discipline** | - Multyear macro/fiscal framework used to set public revenue, expenditure and debt policy within realistic economic framework, supporting anticipation of crises, measured restructuring.  
- The total budget envelope should be: (i) explicit and set prior to determining individual spending allocations;  
(ii) consistent with the broader macroeconomic framework; and  
(iii) sustainable over the medium term.  
- Current policies, laws, and normatives and programs reconciled in annual budget to assure affordability.  
- New policies with expenditure or revenue implications adopted during year only if affordable in medium-term framework, sources of financing identified, and supplemental budget approved to finance within budget targets.  
- Budget is comprehensive, accurate, annual, authoritative, and transparent. | - Commitment control system limits commitments to available resources, supporting avoidance of arrears during retrenchment.  
- Treasury cash management further supports matching of expenditures to revenues.  
- Treasury payment system and internal controls support proper payments.  
- Accounting system and Financial Management Information System (FMIS) support comprehensive, timely and accurate information on spending and revenues for government and line ministry management.  
- Fiscal and banking accounts regularly reconciled.  
- Annual accounts closed in a timely manner.  
- Debt management assures sustainable debt policy, timely issuance of debt for cash flow management and reaching the spending target.  
- Internal audit detects and corrects fraud, waste, and abuse; assures integrity of financial information.  
- External audit assures fairness and accuracy of financial reporting, effectiveness of internal audit and control systems. |
| **Allocative Efficiency** | - Expenditure allocations between and within sectors are consistent with government policies and priorities.  
- Sectoral ceilings set early in expenditure process to encourage ministry prioritization.  
- Current policies, laws, and normatives and programs reconciled in annual budget to assure prioritization of resource use, possible program restructuring.  
- Resources are reallocated from lesser to higher priority programs and from less to more effective programs, across and within sectors. | - Commitment and Treasury controls execute the budget as approved.  
- Formal, transparent procedures used to amend budget if necessary.  
- Frequency of FMIS reporting allows management action to correct deviations from approved budget. |
| **Technical Efficiency** | - Budget planning (within resource ceilings and supported via execution of budget as approved) support productivity improvements and management/program development.  
- Budget process supports analysis and review of performance, structure, staffing and organization, policy, normatives.  
- Program classification structure within ministries supports focus on objectives, results.  
- Basic program performance information allows linking of resources with results, pressure for increased efficiency.  
- Program evaluation supports occasional review of program impact, effectiveness. | - Budget execution (commitment and cash controls) limits critical expenditures, but supports flexible resource use at program level (e.g. across non-personnel economic classifications, with respect to seasonal spending patterns) for efficiency (controls are not excessively detailed to prevent management of program).  
- FMIS supports program managers.  
- Civil service system supports quality public staff, flexibility in reallocating staff resources, restructuring workforce.  
- Procurement system supports competitive, efficient, timely contracting.  
- Internal audit may identify options for improved economy and efficiency. |

6.5 Additionally, five general principles of public finance have emerged over the years to guide developments in public expenditure systems. If one or more of these principles are missing, the PEM system cannot be an effective tool for establishing and managing policies, holding agencies accountable for results, and more generally managing the public sector.

- **Comprehensiveness** – all revenue and expenditure, and all government agencies, are included in the budget; and integrated into the PEM system;
- **Accuracy** – actual transactions and flows are recorded;
- **Annuality** – the budget covers a defined period of time (e.g., one year);
- **Authoritativeness** – spending is carried out only as authorized by law; and
- **Transparency** – information on spending is publicly available, on a timely basis, in an understandable or common format.

6.6 Bearing in mind the need for fiscal restructuring and assurance of the social safety net, the criteria for aggregate fiscal discipline and allocative efficiency will be the primary basis for assessing the budget management systems at both the Federal and Republic level. While some attention should be paid to technical efficiency in terms of laying the groundwork, immediate gains are not expected in this area until macro/fiscal stability issues are addressed. The next section describes the Federal budget system (formulation, then execution), followed by an assessment of the system and recommended changes. A discussion of budget management in the Government of Serbia follows.

**B. BUDGET PROCESS IN THE FEDERAL GOVERNMENT**

**Budget Formulation**

6.7 The responsibilities of the Federal Government were narrow, and prescribed clearly in the 1992 Constitution. In practical terms, Federal functions were primarily defense, foreign relations, customs, national courts, and other selected national issues such as the National Geodesic Survey. Most social spending occurred at the republic level, with Federal social spending benefiting primarily military staff. Figure 6.1 presents the composition of consolidated Federal Budget in 2001. The bulk of Federal spending was in defense or defense-related areas (73 percent, including 16 percent in military pensions and health care finance).

6.8 The Federal Government had few own revenues. Over half of Federal revenues were collected at the Republic level and transferred to support Federal expenditures, thus making Federal-Republic coordination extremely important. The union of Serbia and Montenegro will wholly depend on revenue transfers from the two Republics, making this fiscal coordination vital for its survival.

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64 Schack, A. (1999).
65 Analysis of the Federal public expenditure practice is undertaken mainly because it is likely to inform spending operations of the new union. On the other side, the institutions for union-level spending are likely to be scaled down dramatically: for example, there will be no separate Union budget.
6.9 At the Federal level, very little progress in improving budget formulation or execution had occurred until 2002. In developing the 2002 budget, the Federal Ministry of Finance (FMOF) adopted the revised budget classification and budget circular based on guidance from GOS. The FMOF was also examining the issue of establishing a Treasury and a consolidated treasury fund, as well as amending the accounting law to support the new budget classification system introduced by the Republic MOFE in its 2002 budget.

Figure 6.1: Federal Government: Functional Expenditure Allocation, 2001
(percent of total)

Recreation, culture, and religion 0.2%
Health 4.5%
Other social protection 15.7%
Military pensions and health funds 9.7%
Economic affairs 1.9%
Public order and safety 0.7%
Defence 57.5%

Source: FMOF, World Bank staff estimates.

6.10 Budget Process. Formally, the Federal process began in September with a call to Federal budget users to submit requests. This call included inflation estimates to be factored into requests. Budget users prepared requests based on their own priorities and programs, trying to fund all normative laws and expectations, and submitted their requests to the FMOF by October 15. Between October 15 and November 15, FMOF held discussions with the DSUs and submitted its economic policy guidelines for the following year. The economic policy guidelines indicated the expected revenues and public sector pay increases, and generally held the entire public sector to 49.5 percent of social product. The rule of thumb was 9 percent for the Federal Government, 4-5 percent for the Republic of Montenegro, and 35-36 percent for the Republic of Serbia.

6.11 The reconciliation of spending requests with available Federal revenues generally started with prior year budgeted levels, was adjusted for actual spending changes, and then adjusted for specific “policies,” usually expressed in economic classification terms. For example, pay may be uniformly increased by X percent, equipment purchases by Y percent, until the total Federal revenue ceiling had been reached.

66 The Accounting Law was Federal-level, and the Republics were expected to comply with it. Technically, the Republic of Serbia's adopted its new GFS-based budget classification in breach of this Law, but the adoption of the same classification by the FMOF at least tacitly sanctioned the new system.
6.12 A seemingly technical device called the General Balance Table served a critical role in intergovernmental coordination. The General Balance Table specified the percentages of public expenditure for the Federal and Republic Governments (guided by the rules of thumb noted above), and during its preparation there were negotiations with the Republic Governments over relative shares of revenues for each level of government. These discussions occurred primarily at a technical level, but they did inform the policy process and were approved by the Cabinets at each level of Government (see Box 6.2).

**Box 6.2: Towards Comprehensive Budgeting – The General Balance Table**

In contrast to practice in a number of other transition economies, the budgetary process in FRY was more comprehensive, covering the revenues and expenditures of the central government, the local governments and the extrabudgetary funds. Comprehensiveness was achieved through the preparation of the General Balance, submitted to Parliament together with the Federal and Republic budgets.

The preparation of the General Balance was, and remains an important element of the annual budgetary process. In Serbia, a separate unit within the MOFE is responsible for the process, that includes a number of distinct activities:

- Developing forward (budget year) projections for each of the major revenues sources.
- Proposing the distribution of sales and excise taxes between the Federal and Republic Governments.
- For Republics, proposing the distribution of personal income tax and sales tax between the Republic and local Governments. In Serbia, these taxes currently account for around 50 percent of total local government revenues.
- Assessing spending requirements for the social funds, the extent to which these can be met from contributions and the requirement for additional transfers from the Republic budget.

The determination of the Budget Balance has particularly important implications for the Federal Budget, which is limited through this process. For the Serbian Republic Budget, the balance is important because the central government budget is determined as a residual. In recent years, Republic spending programs have been squeezed as resources have had to be made available to cover the deficits of the social funds. In the coming years, increased servicing commitments on foreign debt will also require increased resource allocations to the union level.

Although comprehensive in its coverage, the General Balance is still treated primarily as a mathematical exercise, with little attention being given to the analysis of revenue and expenditure policy issues. This reflects a wider issue of the very limited extent to which the budget is seen as a key instrument in the delivery of Government policy, and highlights the importance of adopting a more strategic approach to budgetary planning.

However, the General Balance was completed on a gross basis, meaning that some expenditures are counted twice. For example, transfers from the Republic Budget to the Health Fund are counted as Republic Budget expenditures, and also as Health Fund expenditures. When calculated on a net basis, the actual spending would be below the levels set in the General Balance Table, providing a conservative bent to spending plans. In 2002, Republic MOFE made an important step by compiling the General Balance for the first time on a net basis.

6.13 After a draft budget had been agreed by the FMOF and federal-level DSUs, the draft was simultaneously reviewed by four Cabinet Commissions prior to its submission to FRY Government. These commissions were: the Economic Board (key economic and development ministries, assistant minister level); the Budget Commission (all ministries, assistant minister level); the Financial System and Public Expenditure Commission (all ministries, minister level); and the Security (defense and interior ministries, assistant minister level). These reviews served to assess overall policy and its reflection in the budget, and to build consensus among technical and policy officials prior to formal submission of the budget to Government. Few changes were reported to emerge from these reviews: the entire process was very consensus-oriented.

6.14 After November 15, the budget was presented to the FRY Government and then to the Federal Parliament. The latter’s role was to adopt the general framework of public spending - the General Balance. The executive had responsibility for the details of the
Budget. Once the Budget was adopted by Parliament, the Serbian and Montenegrin Governments had a framework for development of their own budgets.

6.15 Documents that flowed within ministries, between line ministries and ministry of finance, and between the ministry of finance and the Cabinet were primarily tables of numbers. There was little accompanying explanatory text, no analysis of implications or discussion of options, and no staffing or performance information. Individual ministers were left to analyze the information for themselves and to develop options on their own. The budget was one year, with no multi-year framework or estimation.

6.16 **Policy Process.** The budget process in FRY was notable for the absence of substantive analysis and policy discussions, and of reconciliation of resources with existing laws and norms. This is a reflection of the historical origins of the process, where finance was an annual exercise to fill existing programs and policy was discussed and made operational through other vehicles.

6.17 In SFRY, and to a large extent in the Federal Republic of Yugoslavia, the policy process was conducted to a large extent outside of Government - through the ruling Party, and only modest capacity for policy analysis or development existed within Government. Whatever policy dialogue occurred in Government was conducted outside of the budget process and without reference to expenditure implications (see Figure 6.2). Professional bodies and line ministries developed normatives for sectors, and these were commonly enacted in laws which formed the basis for program operation and budget requests. Line ministries, outside the budget cycle, were responsible for enacting “systematization” decrees that detail the organizational structure and staffing needs of each ministry in order to carry out the laws within its jurisdiction. The compressed budget cycle is illustrative of the absence of policy in the budget process. The budget was only intended to allocate available funds to existing commitments and programs, rather than to serve as a vehicle for rationalizing policy, objectives, laws, and resources, or for seeking the most efficient allocation of expenditures for a given set of objectives.

**Figure 6.2: Bifurcated Policy and Budget Process**

![Bifurcated Policy and Budget Process Diagram]

*Source: World Bank staff.*
Federal Budget Execution

6.18 In the Federal Government, relatively more emphasis was placed on budget execution than on formulation. There was no Treasury, and budget execution (cash management) was performed by the Budget Office of the Ministry of Finance. There was no commitment control system. Each Ministry was responsible for remaining within its budget and cash allocation. No debt management office existed, although foreign obligations were monitored by the FMOF Sector for International Financial Relations and some monitoring of debt obligations occurred in the Budget Office.

6.19 After enactment of the budget, line ministries prepared detailed monthly financial plans indicating revenues and funding needs. These plans formed the basis of monthly transfers from the main revenue accounts to the accounts of the line ministries. The line ministries manage their own accounts and were responsible for ensuring spending occurred within approved budget levels. Line ministries had complete discretion over their own revenues, which were not recorded or monitored by the FMOF.

6.20 The budget was executed by line item or position, with the FMOF holding budget users accountable for spending to this level of detail. This is more control than necessary for financial accountability and fiscal discipline. In other countries, this level of control has impeded operational efficiency. Ministries responded by maintaining internal reserves of spending authority that could be used to ameliorate FMOF spending authority shortages. Detailed control, decentralized financial reporting systems, and the absence of a strong internal audit or any external audit, created the potential for misreporting of spending in order to appear to meet approved budget levels.

6.21 Cash flow was monitored on a daily basis in the Federal Ministry of Finance. Each day a table was produced showing revenues, transfers and expenditures, and net lending/borrowing for each month of the current year and each day of the current month. The Ministry of Finance prepared a monthly payment schedule of that month’s regular payment dates (salary, pension, and other regular payments). There was no systematic process of forecasting and reconciling revenues and expenditures.

6.22 Formally, cash was managed to ensure the availability of funds to meet the major regular payments, but additional payment requests were considered each day by the FMOF and priority requests were approved. This daily triage opened opportunities for urgent items early in a week to displace more important items later in the week. Payment prioritization should take place on a systematic basis, with the estimated requirement for the month being submitted in advance and commitments being controlled to contain expenditure within the forecasted revenue availability.

6.23 Significant financial responsibility was placed with spending ministries. Box 6.3 summarizes financial management in the Ministry of Foreign Affairs, which always had a relatively strong budget execution system. Efforts had been under way to better integrate Ministries, including the Ministry of Defense and military, into the overall public expenditure system, but the effort stalled pending resolution of the new union agreement and its impact on the Federal agencies.
Box 6.3: Financial Management in the Federal Ministry of Foreign Affairs

The Ministry of Foreign Affairs (MFA) is one of the few Federal Ministries which will remain part of the Union Government. Due to this continuity, its budget management practices are of particular relevance. MFA maintains an automated financial management system, and continuously receives spending information from budget units (primarily embassies). Summary financial statements are prepared on a monthly basis and provided to the Minister. The Ministry has its own team of auditors who review all spending for appropriateness and accuracy. Spending deviations detected during the month or in the monthly reports are followed-up immediately. If budget unit accounting officers are at fault for overspending, they are personally liable for replenishing the overspending. In cases where they are not at fault, the overspending is transferred to that unit's subsequent year budget (with no additional funding provided).

The Ministry is subject to frequent questioning from the FMOF, and formal review from the Federal budget inspectors and Federal foreign currency inspectors. The Ministry of Foreign Affairs provides quarterly spending reports to the FMOF.

In practice, the Ministry maintains an internal reserve of spending authority during the year for ameliorating central cash flow problems or to meet unexpected needs. The MFA Finance Office actively develops policies and programs to improve cost effectiveness, such as limiting personal use of office telephones. The Ministry also has small own revenues generated by embassies, and these are included in the budget. Collections were transferred to the FMOF, which reallocated these to the MFA through the annual budget. The Ministry allocates these back to budget units, though not in accordance with amounts generated by each budget unit.

The Ministry maintains its own property management unit, separate from the Ministry of Justice, for managing property outside the country. The Ministry reports that it always uses competitive procurement, and that central finance office approval is required for all investment spending, regardless of the amount.

Budget formulation is primarily input-based and incremental, starting from prior and current year spending, and adjusting for MOF supplied economic estimates. The Ministry does not receive a budget ceiling from the FMOF. Capital spending is developed in a parallel process, working with the FMOF, their own Legal Office, and the Directorate of State Property. Government approval is required only for items over US$50,000.

Within the MFA, each budget unit is responsible for aligning policy and organization with funding. The central Finance Office deals only with ministerial policy and organization issues, and these are integrated with the budget, usually during execution.

6.24 Auditing. The Federal Government had no Supreme Audit Institution for external audits, and a very small central Budget Inspectorate for internal audits. The Federal Budget Inspectorate consisted of six inspectors, and reported to the FMOF. The Inspectorate followed traditional procedures of checking actual spending for compliance with current laws, primarily a record-review exercise. Little emphasis was placed on the Inspectorate's activities by the FMOF or by the Federal Government, and for much of the past decade the Inspectorate was not allowed to perform its function, or no action was taken on its findings.

How Has the System Performed?

6.25 In terms of aggregate fiscal discipline, the Federal public expenditure management system did relatively well when financial conditions were stable: the

67 Technically, the centralized national payments system (ZOP) did perform some external audit role. The ZOP was extragovernmental, handling all private and public transfers, and did have its own inspectors and auditors. The ZOP reportedly could and did supply some reports to Parliament. With the changing Federal/Republic relations and the transition to a market economy, the ZOP can no longer fulfill this role.

68 The most notable example occurred in 1996, when inspection of the customs service found that over 50 percent of customs revenues had been diverted to unauthorized use. The findings were reported to the Government, but no action was taken.
Federal Government matched revenues with expenses in four of the past five years. The exception was 2000, when the system was able to maintain aggregate spending limits on average, but in-year downsizing without a Treasury and a commitment control system generated significant arrears. For 2000, while both revenues and expenditures exceeded budget, they were within 4 percent of planned levels. For 2001, a net surplus was generated, and arrears for 2000 were cleared; however, in 2002 they have reportedly re-emerged. Table 6.1 presents Federal outturn in 2001 relative to the approved budget.

Table 6.1: Federal Budget Outturn Relative to Approved Budget, 2001

<table>
<thead>
<tr>
<th></th>
<th>Budget</th>
<th>Outturn</th>
<th>Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenues</td>
<td>48,024</td>
<td>49,401</td>
<td>3%</td>
</tr>
<tr>
<td>Total Expenditures</td>
<td>45,874</td>
<td>47,811</td>
<td>4%</td>
</tr>
<tr>
<td>Deficit(-)/Surplus(+)</td>
<td>2,150</td>
<td>1,590</td>
<td>-26%</td>
</tr>
</tbody>
</table>

Source: FMOF, World Bank staff estimates

6.26 In terms of allocative efficiency, policy priorities were generally matched in budget allocations. The limited scope of Federal responsibility, with defense consuming most of the spending, limited the extent of allocative efficiency issues. Defense-related spending declined as a share of total Federal spending from 83 percent in 2000 to 73 percent in 2001. In the future, sectoral allocation issues between defense/foreign affairs and social sectors (primarily Republic expenditures) will overlap substantially with intergovernmental union/Republic allocation issues. Decisions on the amount of revenues to be set aside for the union functions will affect both defense and social expenditure policies.

6.27 Technical Efficiency. There is insufficient analysis or data to make a firm conclusion. The World Bank’s recent procurement review (CPAR) reported that competitive contracting was not general practice throughout the government. The Federal civil service had not been reformed, and personnel costs were a significant part of the Federal Budget. Line ministries’ inability to shift personnel resources to meet changing responsibilities would likely have introduced inefficiency into the system. The daily cash triage, absence of multi-year planning and separate capital budgeting process probably led to sub-optimal resource allocation and higher unit costs. In sum, the Federal system did not favor technical or operational efficiency.

6.28 Comprehensiveness. The Federal budget was generally comprehensive, including own revenues, donor funds, and military pensions and health insurance. All governmental agencies were included in the budget, and their integration into the general public expenditure system was increasing. Work is needed to fully integrate defense and military spending into the PEM processes, particularly external and internal audit (see Box 6.4.). A registry of government agencies should be established to clearly define the public sector and to assure all agencies are indeed on budget.

Federal wages and employer contributions were 31 percent of 2001 Federal Budget recurrent expenses and 43 percent if employer transfers to military pensions were included.
6.29 **Accuracy.** No information was available to assess the accuracy of accounts. The absence of external audits and sufficiently extensive internal audits posed a significant risk of inaccurate spending. The Federal Budget Inspectorate has reported commonly finding errors in accounts, but these were primarily of routine procedural character rather than deliberate misrecording of information.

6.30 **Annually.** Budgets and accounts covered one calendar year (January 1 through December 31).

**Box 6.4: Ministry of Defense and Military PEM**

The Ministry of Defense traditionally operated with a high degree of autonomy in financial management, and the branches of the military with very high autonomy from the Ministry of Defense.

As of September 2001, the Finance Office (budget and financial management functions) was transferred from direct control of the Chiefs of Staff to the civilian Ministry of Defense, now reporting to the Minister. All payments and financial controls were reportedly being integrated into the government-wide systems. The Finance Office reviewed all payments for legality and compliance with established procedures. Ministry own revenues are reportedly be integrated into the budget for 2002. No registry of Ministry- or military owned assets exists or is made available to Government.

Two extrabudgetary funds (EBFs) are associated with the military: Military Pensions and Federal Health Insurance Fund for Military Personnel and their Families. Similar to other EBFs, these are primarily administrative units for paying claims, and they operate under different rules from normal budget users for reporting and accountability.

For capital spending, the Ministry now works with the Ministry of Justice State Property Agency, and reported that it follows competitive tendering procedures. However, the Ministry of Defense performs its own asset management, and this has not yet been integrated into the government-wide system. The extent of military property and business ownership is unclear, and not subject to privatization review. According the World Bank’s 2002 CPAR, two-thirds of military expenditure is spent on non-military goods (e.g. food, property, clothes), but these are not procured using civilian procurement rules.

As in other ministries, budget formulation is incremental and input-based. Capital budgeting follows a parallel process to recurrent spending, but efforts are under way to treat military capital spending like other capital programs.

The absence of a government-wide commitment control system limits the capacity for in-year adjustments, and YUD 3.5 billion in arrears were generated in 2000 (13 percent of total 2000 Federal spending), primarily in pensions and payroll. The Ministry reports that the arrears have now all been paid, and no new arrears are being generated; other government sources indicate that arrears have re-emerged in 2002.

The Ministry of Defense is subject to audit/budget control by the Federal Budget Inspectorate, but this does not extend to the military services, which have a separate audit office. The Federal Budget Inspectorate reviewed civilian Ministry of Defense accounts in 1995, and was again reviewing it in December 2001. In December 2001 as a result of the budget inspection, a General (the former head of the finance office) was going to trial on corruption charges. For the military services, the Chiefs of Staff have a small (2 staff) inspectorate for internal audit. No information is available on their effectiveness.

The Fifth Session of the Supreme Defense Council, held on April 1, 2002, discussed the problems of financing the Yugoslav Army, the organization of the Defense Inspectorate and staff issues within the Army and the Federal Ministry of Defense. Since then, integration of Budget management procedures has stalled pending clarification of the new Union structure.

6.31 **Authoritativeness.** There was no evidence of systemic spending outside the law or budget process, but the absence of a strong internal audit office and total absence of external audits suggests there was high risk of unauthorized spending. Among career public servants, there was a high degree of respect for the law and proper procedures, and

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70 Except transfers to Republika Srpska, reportedly effected by the Federal level – see paragraph 4.22.
the control environment was reasonably strong. A breakdown in the control environment and apparatus occurred during the 1990s at the political level, rather than at the civil servant level.

6.32 **Transparency** of the Federal budget process and finances was inadequate. While the budget was published in the Official Gazette, monthly spending or more detailed reports on budget formulation and execution were not widely available. Very little defense-related spending information was available to Government or the public.

6.33 **Recommendations on Processes and Institutions.** In both budget formulation and execution, there are substantial risks to fiscal sustainability, as discussed below:

6.34 **Budget Formulation.** The absence of a multi-year framework, including the out-year implications of current policies and new policy decisions (current and capital expenses), and the absence of substantive analysis and dialogue integrated with the budget process, were substantial risks to fiscal sustainability at the Federal level, and must still be addressed, despite the significant scaling down of the union government.

- **Recommendation:** The fiscal authorities should draft a multiyear macro/fiscal framework, embodied in a fiscal policy paper\(^71\) prepared early in the budget process, setting the overall macroeconomic and fiscal policy parameters for the budget. Major threats and challenges to the fiscal position of the union over the medium term should be included. (In future years, this could be extended to include ceilings for each sector. At present, these ceilings could be set based on the decisions in the policy paper). The paper should include the current General Balance Table (on a net basis), and be distributed to Republics as well as union Government.

6.35 The budget dialogue between the union and Republic Governments and the draft budget review by cabinet commissions should be strengthened. Future budget preparation discussions with spending ministries should include discussions to harmonize normative laws, policies, and resources.

- **Recommendation:** Fiscal authorities to develop ministry-specific policy papers that include a review of spending trends, past performance (financial and programmatic), any audit findings, and identification of major policy issues. Papers should include summary of the ministry request, and identify several alternate funding options. These papers would proceed to cabinet after adoption of the fiscal framework, and form the basis of cabinet budget discussions.

6.36 The most pressing need is to outline in detail the new union functions vis-à-vis the legacy functions of the Federation, and to retrench or transfer them quickly.

\(^{71}\) For a good example of a fiscal policy paper, see Chapter 3 of Poland’s EU Pre-Accession Economic Program at: http://www.worldbank.org/eca/euenlargement/publications_other.htm#pep
• **Recommendations:** Establish a union Cabinet commission to review legacy Federal functions in light of the new union agreement, and adopt a Cabinet-approved plan for retrenchment or transferring functions. To support this work, the union Government should: develop an inventory of all current government activity, and framework for evaluating what to do with each; provide the commission with full inventory of all Federal assets, properly valued, for decisions on asset disposal or retention; recommend a policy and structure for handling privatization and asset sale revenues, assuring funds are on-budget and properly accounted for;

• **Recommendation:** The revised, GFS-compliant budget classification used in 2002 should be continued. An assessment is needed whether the old Federal accounting law still requires redrafting to support a consistent classification and accounting system across the union and the Republics. In future years, consider adopting a program classification built around major activities in each Ministry. The inventory of activities mentioned above can aid in this effort;

• **Recommendation:** Prepare a modern Law on the Budget System applicable to the union, based on good international practice, fully incorporating all union activities into the budget formulation and execution process, and requiring regular public reports on expenditures in-year and at year-end.

6.37 **Budget Execution.** Absence of a Treasury and commitment control system, debt management office, external audit, and weak internal audit, similarly pose systemic risks to sound financial management and sustainable policy. Daily cash management can undermine budget priorities and opens avenues for corruption and inefficiency.

**Recommendations:**

• Implement a formal treasury function for union expenditures, including commitment control, cash management, and debt management. The immediate cash management situation can be improved if the daily triage for non-scheduled payments were replaced by a weekly triage. This process would be further improved if a systematic method of forecasting revenues and expenditures were developed;

• Develop government-wide asset registry and asset management function; also develop procedures for privatization or asset transfer;

• Develop a strong internal audit system for the union Government, including a central unit in the Prime Minister’s Office and offices in each major Ministry; staffed all such units with sufficient number of well-trained specialists. Fully incorporate all government entities, and all own revenues into the PEM system, including Ministry of Defense and military;

C. BUDGET PROCESS IN THE REPUBLIC GOVERNMENT

6.38 In contrast to the Federal government, the Republic of Serbia has made significant progress in public finance reform since October 2000. These reforms include: the implementation of wide-ranging tax reform; the adoption of new budget system legislation; the development of a realistic macro-fiscal framework and forecasting capacity; the control of contingent liabilities against the Budget; establishment of a Treasury Office and appointment of a Treasurer; the introduction of a new budget classification system and attempt at more rational budget formulation procedures; the thorough auditing of 2000 accounts, the publication of the audit, and follow-up prosecution of identified malfeasance, as well as commitment to similar accountability and transparency arrangements for the accounts of later years. These reforms were in addition to good fiscal discipline and restrained spending in 2001-2002.

General Budget Issues

6.39 In contrast to the Federal structure, an important difference for the Republic of Serbia’s PEM system has much wider scope and is more complex. The consolidated budget in Serbia comprises three distinct elements:

- The Republic Budget, which finances capital and operational spending of government ministries and agencies;
- Local government budgets, comprising the Budget of the Vojvodina Autonomous Province and of the 191 municipalities; and
- The budgets of the five autonomous social funds (see Box 6.8).

6.40 Figure 6.3 shows the relative importance of these elements in the 2001 Consolidated Budget of Republic of Serbia. Total consolidated expenditure over the year was YUD 241 billion (34 percent of GDP), almost 42 percent of which was allocated to spending by the Social Funds.

6.41 New Law on the Budget System. In February 2002 a new Law on the Budget System (LBS) was adopted by the parliament, replacing the 1991 Law on Public Revenue and Expenditure. The new Law reflects current good international practice, emphasizing a number of important principles. First, it reiterates the need for the budgetary process to be inclusive of all public revenues and expenditures, including those of local governments and the Social Funds. Second, it specifically identifies in the budget calendar the development of a strategic budget framework to be approved by the Government prior to the detailed preparation of the annual budget. Third, it requires that budget proposals should be projected forward for a further two years, thereby providing a medium-term context for budget development. Fourth, it provides for the introduction of a functional, or purpose-related, classification for budgetary expenditures, thereby facilitating greater linkage between government policies and programs and resource allocations.

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72 An overview of intergovernmental finance issues is found at Annex 2.
73 Data in this section refer only to consolidated Republic government, and exclude the Federal level.
Budget Formulation

6.42 The first budget formulation cycle based on the new LBS took place in 2002. Prior to this, Republic budget formulation was similar to that described above for the Federal process. It was a bottom-up, needs-based approach related to fulfilling normative laws. The normative laws were enacted outside the budget process and without reference to affordability (see Box 6.5). The MOFE’s role in the budget process was “red-lining”, or capping expenditures to fit available resources. Minimal analysis or policy discussion occurred during the budget process.

6.43 Budget Calendar. The 1991 Law on Public Revenues and Public Expenditure did not specify a detailed budget calendar. During the last decade there has been significant erosion of the budgetary process and of the scrutiny of the Budget by Parliament. As with the Federal budget process, the preparation of the Republic budget followed a highly compressed timetable that has not allowed for adequate analysis of budget issues and policies.

6.44 An important feature of the new budget law is that it allows substantially more time for the preparation of budget proposals by line agencies (2 months); for the review of budget requests by the MOFE and preparation of the draft Budget (2½ months); and for consideration and approval of the Budget by Cabinet and Parliament (2 months). Implementation of this new timetable should help to emphasize the role of the Budget as a key instrument to the realization of government policies and programs. Table 6.2 presents the new budget calendar.
**Box 6.5: Use of Budget Normatives**

Prior to the implementation of the new LBS, the process of budget formulation in Serbia utilized normative budgeting techniques. These involved the use of specified input ratios to which standard unit costs were applied. These normatives were set out in subsidiary legislation and regulations.

An advantage of applying normative budget techniques is their simplicity. Budget determination becomes a simple cost times quantity calculation minimizing the analytical demands on those responsible for preparing and evaluating budget requests. The use of normatives in social protection entitlement programs is unavoidable; however, their mechanical application is likely to contribute to inefficiencies in public service delivery by:

- assuming a fixed production function and thereby removing from program managers the responsibility for introducing innovations that allow for improvements in productivity and in the quality of public service provision;
- providing incentives to managers to increase input use as a means of maximizing their budget allocations;
- reducing budget analysis in line ministries to a process of checking whether norms have been applied correctly rather than challenging the assumptions on which budgets are based and considering alternatives.

There is a further risk of norms being set without adequate recognition of resource constraints or of becoming outdated and inappropriate to present circumstances. This is a significant problem in Serbia and results in budget requests from line ministries having to be substantially cut back. It also carries the risk of spending on social protection entitlement programs, which may be more difficult to cut back, consuming an increasing share of expenditure budget to the detriment of spending on public services and infrastructure.

Approaches to budgeting in other European countries emphasize the analysis of budgets at the program level, the consideration of alternative means of achieving program objectives, and a robust dialogue with the finance ministry over funding levels and performance. Within such a process, legislated norms are replaced by resource allocation guidelines, which themselves are subject to regular review and updating. In the case of entitlement programs, benefit levels tend to be legislated as part of the annual budgetary process so that they can be linked to resource availability and recognize the need to make trade-offs with public spending priorities in other sectors. Such an approach to budget formulation places additional analytical demands on both the finance ministry and line ministries. However, it is particularly relevant to transition economies where governments are faced with a wide-ranging agenda of reforms to public services and entitlement programs in order to improve both the sustainability and efficiency of public spending programs. This emphasizes the importance that governments should attach to the reform of budget planning systems and the strengthening of policy, programming, and budgeting capacities.


6.45 Even prior to passage of the new LBS, modified procedures were adopted for the preparation of the 2002 Republic Budget. These involved the introduction of a more detailed budget classification consistent with the IMF’s GFS classification, and a requirement for budget submissions to be accompanied by a supporting explanation and justification. Ministries were also asked to separately identify in their budget submissions the funding requirements for: (i) continuing existing levels of activity; (ii) on-going activities which could not be covered within existing budget allocations; (iii) planned capital expenditures; and, (iv) new programs. Despite the very tight timetable for preparation of the 2002 Budget, the new procedures resulted in improvement in the quality of budget proposals submitted by line ministries.

6.46 However, whereas the new budget format and information could have been used to more rationally allocate resources to budget users, instead the budget office relied on past practices of modifying economic classification elements from last years’ budget until the 2002 budget targets were reached. This resulted in approved spending levels that did not match the new classification, could not be bridged to requests from budget users, and made it difficult to execute the budget and monitor compliance.
Table 6.2: The New Budget Calendar

<table>
<thead>
<tr>
<th>Date</th>
<th>Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 30</td>
<td>MOFE prepares the Budget Memorandum which sets out the strategic framework for budget development.</td>
</tr>
<tr>
<td>May 15</td>
<td>Medium-term macro-fiscal framework is adopted by the government. Budget Memorandum includes review of fiscal implications of government policies and strategies.</td>
</tr>
<tr>
<td>June 1</td>
<td>Recommended budget strategies and choices, circulated through Budget Memorandum to the Local Governments.</td>
</tr>
<tr>
<td>June 15</td>
<td>MOFE issues Republic Budget Instructions specifying resource ceilings for each budget beneficiary. Finance Department issues Local Budget instructions.</td>
</tr>
<tr>
<td>July 15</td>
<td>Direct budget beneficiaries submit draft budget estimates for Local Budget to Finance Department.</td>
</tr>
<tr>
<td>August 1</td>
<td>Direct budget beneficiaries and Social Funds submit draft budget estimates for Republic Budget to MOFE.</td>
</tr>
<tr>
<td>September 15</td>
<td>Finance Department submits Local Budget proposal to local council.</td>
</tr>
<tr>
<td>October 1</td>
<td>Proposed sector resource allocations are revised and updated.</td>
</tr>
<tr>
<td>October 5</td>
<td>Local Council submits proposed budget to Local Assembly and to MOFE.</td>
</tr>
<tr>
<td>October 15</td>
<td>MOFE submits draft Republic Budget to Government.</td>
</tr>
<tr>
<td>November 1</td>
<td>Government adopts draft Republic Budget and submits it with Budget Memorandum to Parliament.</td>
</tr>
<tr>
<td>December 15</td>
<td>Republic Assembly approves Republic Budget.</td>
</tr>
<tr>
<td>December 25</td>
<td>Local Assembly approves Local Budget. Finance Department submits approved Local Budget to MOFE.</td>
</tr>
</tbody>
</table>

Source: Republic of Serbia MOFE. Key dates are highlighted in bold.

Budget Execution

6.47 Prior to 2003, the Republic of Serbia’s budget execution system operated similar to the Federal system - cash-based, with no commitment controls in place. The execution system was geared towards rationing available cash to meet incurred expenditures.

6.48 In accordance with the 1991 Law on Public Revenues and Expenditures, within two months from the parliamentary approval of the Budget, DSUs submitted detailed financial plans to the MOFE for approval by the Government. The financial plans, which did include own revenues of the line ministries, allowed the budget users to vary the detailed use of the funds authorized within the limit set for each budget position. Once approved by Government, the MOFE control led the DSUs to the financial plan.

6.49 DSUs were responsible for managing their activities within the financial limits set by the budget, and most beneficiaries use the services of the Administration for Mutual Services (AMS) to carry out a number of financial and other functions for them (see Box 6.6). Until October 2001, each DSU had its own account (account 637) with the Clearing and Payments Service of the National Bank of Yugoslavia (ZOP). The MOFE made transfers from the budget account (630) to the DSU 637 accounts to meet approved expenditure. The role of the MOFE was limited to transferring cash to the ministry accounts, and ministries were responsible for paying bills.
Box 6.6: Administration for Mutual Services: The GOS Accountant

The AMS provides support services to ministries and other DSUs. Five divisions of the Agency deal with finance and material, data processing, repair maintenance and administration of buildings, transport, and catering. There are 72 staff in the finance and material division organized into five sub-sections which administer the accounts of all direct budget holders (Ministries, Institutes and Agencies etc.) except the Ministry of the Interior, the Public Revenue Administration and a number of small institutes and agencies.

AMS is responsible for processing and authorizing payments and maintaining a detailed accounting record of all receipts and expenditure. This includes "own" revenues, which from 1 January 2001 have been regarded as budget revenues. AMS records expenditure when invoices are received and hence a modified system of accrual accounting is in use. The ledger for each ministry is continuously updated and summary reports are issued to ministries on request. These show expenditure and receipts from the budget and from 'own' revenues and hence identify arrears.

The finance function of AMS is not seen as a part of a central control system but as a unit providing a standardized financial accounting service to individual budget users and monitoring and other support arrangements in accordance with the budget user's individual requirements. It does not report directly to MOFE on budget execution.

AMS produced a monthly report for each budget holder, comparing expenditure to budget and revenues. Direct spending units use AMS information to supply monthly reports on the financial plan execution to MOFE. Government oversight of budget execution is based on the DSUs' monthly reports. However, there is such a severe MOFE staffing shortage that there is no meaningful analysis of budget execution, identifying larger variations that pose a threat to budget discipline and may require (government) intervention.

In theory commitment control may be undertaken by direct spending units, but it was not done. Direct spending units incurred commitments and were formally responsible for remaining within budget, but expenditure monitoring was carried out by AMS on their behalf.

6.50 The Government took the first step towards creating a single treasury account by closing most ministry accounts in October 2001. Where ministry accounts have been closed, payments are made directly from the MOFE account. This has only been feasible for Ministries where AMS maintain the accounting records. The Ministries that have retained their own accounts are: Ministry of the Interior, the Public Revenues Administration, the Geodetic Institute, and Ministry of Education.

6.51 Cash Flow Management. The control of budget execution by MOFE is restricted to the control of cash flow, with transfers from the main government account limited by the revenues available. Cash flow is monitored on a daily basis in MOFE, which prepares a schedule of major spending items for the month (salary, pension and other regular payments). Each day MOFE produces a table of revenues, transfers and expenditures, net lending/borrowing for each month of the current year and each day of the current month. This provides a basis for responding to the requests from direct spending for cash transfers or payments, but there is no systematic process of forecasting and reconciling revenues and expenditures, or planning ahead for short-term debt issuance to cover anticipated cash flow variations.

6.52 Although in practice cash is managed to ensure the availability of funds to meet the major regular payments, other payment requests from line Ministries are considered
each day by MOFE and priority requests are approved. This daily triage may mean that urgent items early in a week can displace more important items later in that week. Ideally such prioritization should take place on a systematic basis with estimated requirement for the month being submitted in advance and commitments being controlled to contain expenditure within the forecast revenue availability.

6.53 Each type of public revenue (taxes, excise duties, etc.) is paid into a separate government revenue account with ZOP (see Box 6.7) and the daily report from ZOP to MOFE provides a broad analysis of public revenues. Accounting for the main government expenditure account is carried out by MOFE recording the daily revenues (from ZOP) and the transfers and expenditures made (from AMS system).

Box 6.7: ZOP – The Central Clearance and Payments System

In the former Federal Republic of Yugoslavia, ZOP was a division of the National Bank and a Federal institution. ZOP provided a national payments clearance system, as well as performed the functions for the Government of revenue collection and statistics. ZOP also maintained some audit capacity.

The ZOP revenue function was critical for Government. All legal entities were required to have ZOP accounts, and payments could only be made through the ZOP system. ZOP thus knew the revenues and account balances for all businesses, and would automatically deduct appropriate taxes and transfer these to Government. This automated system provided high tax compliance for official accounts. It did not capture gray or black market activity.

Unlike the Former Yugoslav Republic of Macedonia or Croatia, ZOP in Serbia and Montenegro does not provide the accounting database or perform the accounting function for Government. ZOP did however, provide revenue reports to Government, though not for individual budget users.

6.54 Budget Reporting. Reporting on budget execution was limited. The 1991 Law on Public Revenues and Expenditures required that the "Budget Balance Sheet", including a report on the execution of the Budget, is submitted to the Government by 28th February of the following year. In practice, this report has also been submitted to the Parliamentary Economic and Finance Commission. The absence of quarterly and half-yearly reports on Budget implementation was identified as a weakness by the Commission.

6.55 The new LBS specifies more frequent and regular reporting on expenditures, commitments, cash payments from the budget, suspensions of program spending (if over 45 days), and other reports that will provide a comprehensive picture during the year of the evolution of public finances.

Budget Management in Extrabudgetary Funds

6.56 Extrabudgetary fund administrators have few degrees of freedom in budget formulation or execution. Unlike more discretionary programs of government, EBF budget formulation is not about directly planning of projects and programs, but about projecting expenditures. Budget formulation is primarily taking last years actual expenditures, and modifying them for inflation, known demographic or behavioral trends, and changes in laws governing benefits. Policy formulation for these types of programs involves designing changes in reimbursement rates or eligibility (regulations and laws).
Box 6.8: Extra-Budgetary Funds

Extrabudgetary funds in the former Yugoslav Republics share common characteristics:

- Laws set benefit levels, eligibility for benefits, and contribution rates, and sometimes operational matters (in the Health Insurance Fund may be required to contract with all providers);
- The Fund administrators generally operate as collection and bill payment operations, rather than program managers or policy analysts;
- Funds often have little or no audit or compliance role (health funds tend to be the exception);
- The policy function for the Fund is performed by a parent Ministry, which frequently reviews annual Fund budget submissions;
- Budgets are prepared in a formulaic approach, since the key parameters are essentially fixed from the Fund perspective.

Fund administrators have few levers to manage spending. Among the few general strategies available are:

- Maintain high revenue collections;
- Delay new eligibility determination (if under their control) or review eligibility of current beneficiaries;
- Strengthen audits for ineligibility, fraud, or abuse (if possible);
- Delay payment of benefits (generating arrears).

Most common are maximization of revenue collection and delay of payment.

Common structural weaknesses in extrabudgetary funds include:

- Legislated benefit or eligibility changes without increases in contribution rates;
- Risk of ZOP transformation with no prior improvement in Fund capacity to collect;
- Exemptions of companies or industries from paying contributions;
- Non-fund Government bodies with influence over fund benefits or eligibility (in health, Ministries of Health may be responsible for new capital investments that lead to higher recurrent costs for the Fund, or for new drug approvals that expand demand; for disability programs, non-Fund bodies may determine and reassess eligibility);
- Governing Board structures that function poorly and do not adequately represent Fund management interests to Government;
- Government failure to pay contributions for civil servants and disadvantaged groups.

6.57 For budget execution, there is little that EBFs can do to improve their in-year budget performance (see Box 6.8) Administrators do not have the freedom to change benefits or eligibility, and are left with administrative devices to control cash flow, such as delaying payment of bills. However, well-managed EBFs in other countries do proactively manage spending through administrative means that are at their disposal. For example, in Hungary’s Health Insurance Fund, the Director General cracked-down on miscoding of inpatient treatments, threatening disciplinary action to hospitals and physicians that were actively miscoding. Prior to the crack-down, it was common practice to code all births as “complicated,” earning a higher reimbursement rate from the Fund. After the crack-down on miscoding, “complicated” deliveries declined from over 90 percent to the regions’ average.

6.58 For the MOFE, the risks of EBFs include shortfall of collections which have to be compensated with budget transfers, EBF own debt issuance to cover liquidity problems, and the risks of having to bail-out EBFs in arrears. The MOFE must manage these risks and closely monitor EBF expenditure trends.

6.59 Equally important for the MOFE is the overall management of the public expenditure system. Experience from many countries suggests that as cash resources for the government budget become tight, there is a tendency to transfer functions to and expand benefits of EBFs or local governments without commensurate increase in resources and authority. Additionally, where Republic budget cash flow is short, it can
seem an easy solution to reduce Republic payments to the EBFs or local government, since they would still carry-out the mandated tasks and functions - effectively a forced loan from the EBFs or local government to the Republic. It is advisable for the MOFE to closely monitor to functional assignments of EBFs and local governments and related legislation. This is a broader role for the Ministry of Finance than traditionally, but an important example of the stewardship responsibility that only the MOFE can play. The practical aspect of such monitoring falls on the budget reporting system, and can be achieved through aggregate fiscal reports, as well as through MOFE review and costing of all legislation prior to enactment by Parliament -as provided for in the new LBS.

Subnational Governments

6.60 At present, budget management in subnational governments is very basic. They function more as administrative arms of the Republic Government. However, the responsibilities and performance expectations of subnational governments are growing (Table 2.1). The Republic of Serbia has started decentralization of fiscal responsibilities and powers to local governments, reversing the centralization trend of the past ten years. In February 2002 a new Law on Local Self-Government (LLSG) was passed, redefining the administrative structure, responsibilities and rights of local governments. However, a number of challenges remain to be addressed: (a) the scope of decentralization and the degree of fiscal autonomy; (b) the sequencing and speed of reform implementation; and (c) basic incentive mechanisms. Theses challenges are discussed in details in Annex 2.

6.61 The capacity of subnational governments to manage their finances, as well as the scope and speed of decentralization and incentives of the spending system, all carry risks to the Republic Budget. As with the EBFs, the MOFE will need to closely monitor fiscal trends on the subnational level and actively manage the risk posed by excessive subnational spending, borrowing and other such activities. Recent experience from Argentina, Turkey and other countries illustrates the costs of neglecting these issues.

How Has The System Performed?

6.62 In terms of aggregate fiscal discipline, the Republic of Serbia’s PEM system has had mixed results. As shown in Table 6.3, for 2001, the Republic Budget was brought in very close to plan, and would have been brought in just below plan except for net lending to insolvent banks which increased expenditures during the year. No arrears were incurred, partly due to the accumulation of extrabudgetary arrears. Less successful were local governments and the extrabudgetary funds, particularly, the Pension Funds.

<table>
<thead>
<tr>
<th>Item</th>
<th>Budget</th>
<th>Actual</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Republic Budget</td>
<td>129,369</td>
<td>132,339</td>
<td>1.02</td>
</tr>
<tr>
<td>Local Government</td>
<td>27,989</td>
<td>31,396</td>
<td>1.12</td>
</tr>
<tr>
<td>Pension Funds</td>
<td>72,874</td>
<td>79,399</td>
<td>1.09</td>
</tr>
<tr>
<td>Health Fund</td>
<td>38,513</td>
<td>39,459</td>
<td>1.02</td>
</tr>
<tr>
<td>Total</td>
<td>274,102</td>
<td>286,468</td>
<td>1.04</td>
</tr>
</tbody>
</table>

Source: MOFE, Republic of Serbia.
Due to the performance of the comprehensive PEM system including EBFs, was poor. Arrears were generated each year in 1997-2001. Their stock reached 2.8 percent of GDP in 1997, peaked at 8.7 percent of GDP in 1999, and then declined to 4.4 percent of GDP in 2001. Table 6.4 displays arrears for Republic budget institutions between 1997 and 2001.

Table 6.4: Stocks of Arrears of Budget Institutions

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001 (end Oct.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Serbian Republic</td>
<td>0.2</td>
<td>0.9</td>
<td>2.8</td>
<td>1.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Pension Funds</td>
<td>2.4</td>
<td>3.9</td>
<td>3.5</td>
<td>2.7</td>
<td>3.2</td>
</tr>
<tr>
<td>Health Insurance Fund</td>
<td>0.0</td>
<td>2.1</td>
<td>2.3</td>
<td>3.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Labor Market Fund</td>
<td>0.0</td>
<td>0.0</td>
<td>0.1</td>
<td>0.3</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Source: MOFE, Republic of Serbia

Between 1997 and 2000, the ratio of budgeted to actual total revenues has been 99 percent. This strong showing masks considerable variation in individual revenue categories. This was to some extent explained by the of the Central Payment System (ZOP), which quite efficiently collected revenues. This may change as Serbia transitions away from ZOP towards private payment systems and voluntary tax compliance.

The fragmented nature of the execution system, with EBFs operating outside normal budgeting procedures, as well as absence of a commitment control system, contributed to these mixed results.
In terms of allocative efficiency, i.e., whether the PEM system executes the budget in accordance with Government policies as established in the approved budget, the Republic's PEM system has performed less well.

The variability between approved and actual budgets by functional or administrative classifications gives some sense of allocative efficiency. Figure 6.3 illustrates budget volatility for fiscal year 2000. For 2000, individual direct spending units' expenditure varied between 10.5 percent and 277 percent of budget. Eight were below 80 percent, 12 were above 120 percent. On a functional classification basis, for 2001, average variation between approved and actual expenditures was 30 percent, ranging from 239 percent above budget to 22 percent below. This significant variability can be attributed to poor budget formulation, including absence of multi-year planning, and budget execution operating on a cash rationing basis unrelated to budget priorities.

In terms of technical efficiency, as with the Federal system reviewed earlier, there are no detailed numbers on costs per unit of service delivered, or comparative procurement costs. However, three budget positions common to most direct spending units (salaries, material costs and specific purposes) are indicative of the funding variability faced by an average administrator. The performance is very uneven as Table 6.5 based on transfers from the budget 630 account to 5 December 2001 shows. Such resource variability is all but guaranteed to adversely impact program effectiveness and service delivery. Moreover, the recent Bank CPAR did a survey of pharmaceutical prices for commonly purchased drugs, and found potential cost savings of 26 percent if competitive bidding procedures had been used.

### Table 6.5: Variations in Budget Execution – 2001 In-Year

<table>
<thead>
<tr>
<th>Total Budget</th>
<th>Payments to 05/12/01</th>
<th>Net underspending as of 05/12/01</th>
<th>Percentage used</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries</td>
<td>34,552</td>
<td>29,873</td>
<td>4,679</td>
</tr>
<tr>
<td>Material Costs</td>
<td>4,972</td>
<td>2,724</td>
<td>2,248</td>
</tr>
<tr>
<td>Specific Purpose</td>
<td>6,511</td>
<td>6,048</td>
<td>463</td>
</tr>
<tr>
<td>Total</td>
<td>46,036</td>
<td>36,639</td>
<td>9,397</td>
</tr>
</tbody>
</table>

Source: MOFE, Republic of Serbia.

The pattern of payments may have been distorted by the practice of cash rationing. Whatever the cause, the practical effect is that budget formulation and budget execution are substantially unrelated to each other. This is not a satisfactory basis for service delivery.

Overall Assessment of the Budget Formulation Process

The key to successful budget execution is a realistic budget, which implies a managed balance between revenues and expenditures and allocations of resources consistent with the required program or service delivery. This balance must be addressed at the budget setting stage, not left to be dealt with on an ad hoc basis during budget execution. Otherwise, actions taken to manage cash flows will adversely affect government services, waste resources, and undermine development efforts.
6.71 While some of the negative outcomes typical for Serbia are explained by policies of the previous regime, they also reflect underlying weaknesses in PEM characteristic of the former centrally planned economies. These included: (i) a consistent lack of realism in the macroeconomic analysis on which the budget was based resulting in planned levels of public spending that were unsustainable; (ii) a tendency to regard the Budget primarily as an administrative tool rather than as an instrument of government policy which resulted in the failure to confront strategic resource allocation issues; and (iii) a continued reliance on legislated input-based normatives for budget planning which had long since become outdated and which took little account of likely available funding levels.

6.72 The Government elected in late 2000 has begun to address these issues. Considerable progress has been made in restoring the aggregate fiscal discipline and predictability that are essential pre-requisites to sound budget management. However, the reform of budget formulation is still at an early stage, and significant challenges remain in: (i) establishing a framework of policies and priorities to guide the allocation of public expenditure resources; (ii) specifying the planned performance (outputs and outcomes) of budgetary expenditure; (iii) determining revised standards and norms for public service delivery; and (iv) developing capacities for monitoring budgetary performance.

Box 6.9: Incorporation of External Assistance Into the Budget

Currently Serbia is receiving substantial inflows of international assistance. The Development Assistance Coordination Unit (DACU) in the Ministry of International Economic Relations (MOIER) estimated total disbursements of external assistance at US$ 780 million for 2002, of which 47 percent was to be provided as financial assistance (budget support and public investment) and 53 percent as in kind payments (humanitarian assistance, commodity aid, technical assistance, and project assistance administered directly by aid agencies).

While external assistance represents a major resource flow to the Government, it is only partially reflected in the budget. In the 2002 Budget total external financing is estimated at YUD 3.5 billion (US$ 46.2 million), of which YUD 2.7 billion (US$ 35.9 million) represents budget support. Thus, 22 percent of external assistance is not currently reflected in the Budget, considerably reducing the comprehensiveness of the Budget and resulting in significant spending falling outside of the government's procedures for ensuring accountability in the use of public resources. Ensuring full incorporation of external assistance into the Budget poses a number of practical issues and problems:

- First, experience from other countries has shown that it is often difficult to set up workable systems and procedures for recording “in-kind” expenditures in the Budget. In Serbia this is likely to prove a temporary problem as the level of grant assistance (often provided “in-kind”) can be expected to diminish rapidly over the coming years. It is therefore probably not practical to seek to bring such expenditures into the Budget.

- Second, the arrangements for the management and administration of financial assistance for public investment projects differ markedly from those for domestic resources, and budget staff in line ministries do not currently regard such resources as part of the ministry budget. Consequently, although the Budget Instructions for 2002 requested line ministries to provide details of planned expenditure on externally financed projects, this elicited only a very limited response. This suggests that there is a need to use the information available from DACU on project financing agreements and planned disbursements as a basis for agreeing with line ministries a list of projects for which estimates should be included in the Budget.

- Third, a significant share of external financing is provided to autonomous public corporations and there is a need to consider to what extent this should be reflected in the Budget. If the financing agreement is with the Government with a provision for on-lending or on-granting of the resources then this resource transfer should be fully reflected in the Budget. If the agreement is with the public corporation, but is guaranteed by the Government, then it should be reflected in the Budget as its contingent liability.

In developing future Budgets, the MOFE should take steps to ensure that all external financial assistance being provided for public investment is fully reflected under the relevant line ministry. Achieving this will require close co-operation between MOIER and the MOFE.

6.73 The rest of this section considers some of the issues central to the establishment of an effective and strategic budget planning process. These include: (i) the comprehensiveness of the Budget; (ii) the time horizon for budget planning; (iii) realism in budget development; (iv) linkage with government policies and strategies; (v) transparency and accountability in budget formulation; and (vi) institutional capacities for budget development.

6.74 Comprehensiveness of the Budget Process. The budgetary process needs to be comprehensive of all public revenues and expenditures if the government is to exercise effective fiscal management. Through the preparation of the General Balance, the budgetary process in Serbia already has one tool that integrates revenues and expenditures of the Republic Government, local governments and the social funds.

6.75 In two aspects the comprehensiveness of the budgetary process could be further improved: (i) MOFE monitoring EBF and local government spending trends, and broadly managing the financial risks; and (ii) the budgetary operations of local governments and of the social funds should be subject to similar levels of strategic review as those of the Republic Budget. At present the MOFE undertakes only a limited analysis of local government and social fund budgets, even though these impact significantly on the overall fiscal framework and on the resources available to the Republic Budget. For 2001, local governments exceeded their budget by 12 percent, and the Employee Pension Fund by 9 percent, adversely affecting the Republic Budget. Funding requirements for local governments and EBFs need to be considered within the broader framework of inter-sectoral and sectoral policies and priorities. A more thorough analysis of issues relating to social fund operations and inter-governmental finance should be a central element of the budgetary planning process. With respect to local governments, the issue is not to second-guess their budgets, but to take the annual budget as an opportunity to review trends in local government spending and potential problems for the Republic, as well as review the balance between Republic and local government revenues and responsibilities and potential imbalances or performance issues that need to be addressed. The importance of this review for local governments will grow as decentralization progresses.

6.76 The Government is receiving substantial external assistance. To the extent that this is providing general budget support, it is already being included in the Budget. However, a major element is being provided to support investment in the rehabilitation and development of public infrastructure and services, and this is not yet included in the Budget (Box 6.9). Because such resources are supporting public expenditure, and in the case of credits and loans will incur future debt servicing costs, it is important that they be treated as an integral element of the budget framework. Moreover, capital projects will entail operating and maintenance expenses that must be factored into the budget in a multi-year prospective framework to assure these carrying costs can be sustained.

Recommendation: The comprehensiveness of the budgetary process should be further enhanced by: including within the budget framework: (i) more thorough analysis and review of social fund and local government
spending programs and trends; and (ii) all projects financed through external grant and traditional credit/loan agreements.

6.77 **Time Horizon for Budget Planning.** A fundamental weakness of the budget formulation process in Serbia was that it has lacked a medium-term outlook. Given the instability of recent years, a single year horizon to the Budget was all that could reasonably be achieved. However, as macroeconomic and fiscal discipline are restored, indicative targets for budgetary expenditures should be projected over the medium-term, recognizing that the public spending implications of government policies and programs are typically spread over a number of years. A multi-year time horizon in the planning of public expenditure aggregates would provide greater predictability to line ministries in the planning of their annual budgets. The new budget law anticipates this requirement by specifying that estimates of revenue and expenditure be provided for both the budget year and the subsequent two years.

**Recommendation:** The MOFE should progressively introduce a three-year time horizon for budget planning in order to provide a medium-term resource framework within which line ministries can plan the reform and restructuring of expenditure programs.

6.78 **Realism in Budget Development.** Serbia has begun to make significant progress towards developing a realistic multi-year framework for budget development. The 2001 Budget fiscal targets have been largely achieved, and thus has been consistent with the Government's wider policies for macroeconomic stabilization and controlling inflation. Sustaining this progress will require the MOFE to further strengthen its capacities for macroeconomic and fiscal analysis.

6.79 In other respects, however, the budgetary process continues to lack realism. The failure to set indicative sector resource ceilings prior to the preparation of line ministry budgets leads to budget submissions being presented substantially in excess of the likely available funding. These initial estimates have to be cut back by the MOFE, often with minimal discussion with the line ministries concerned. As a consequence, real process of budget development takes place after the Budget has been approved, when line ministries prepare their financial plans, showing how they intend to utilize resources.

**Recommendations:** (a) Develop a realistic and contestable medium-term macro-fiscal framework should be as the starting point for the preparation of the annual budget. This will require the strengthening of macroeconomic forecasting and management capacities within the MOFE.

(b) Consistent with the macro-fiscal framework, set realistic sector resource ceilings within which line ministries can develop their expenditure plans.

6.80 **Linkage With Government Policies and Strategies.** The Budget should be one of the most important tools through which the implementation of government policies is realized. The annual budget formulation process is a natural vehicle for integrating government policy with the resource allocation decisions that give them effect, as well as
with the responsible organization for implementing the policy and program and underlying statutes. In Serbia, this is not yet the case and the process of budget formulation continues to be treated primarily as a mathematical exercise of balancing revenues and expenditures. Budget preparation is incremental and inertia-driven. For example, the Budget Instructions have traditionally provided guidance as to the level of increase to be applied to the main economic expenditure items (e.g. wages), and have included detailed lists of the standard costs to be used in constructing the Budget. This process emphasizes on-going activities, regardless of effectiveness.

6.81 Expenditure planning focuses on management of inputs, with little attention being given to the objectives, outputs and outcomes of public expenditure, let alone to issues of efficiency and effectiveness of public services or their contribution to achieving government policies.

6.82 The Budget is presented in a highly aggregated form that, in most sectors, provides very limited information on how the resources allocated to line ministries and agencies will be distributed between the major programs in the sector.

6.83 The Budget documentation provides little discussion of the underlying revenue and expenditure policy issues and choices that should provide the base for the development of the Budget.

Recommendations: (a) A more strategic approach to public expenditure planning should be adopted that links: (i) sector policies and program priorities; with (ii) planned program outputs and outcomes; and (iii) budgetary resource allocations. Greater emphasis should be given in the budget formulation process to the specification of planned program outputs and the identification of outcomes.

(b) Capacities should be developed within both the MOFE and line ministries for the monitoring of budget performance and of planned program outputs.

6.84 Institutional Capacities for Budget Development. In most western countries the finance ministry, through its responsibility for overseeing the planning and management of public expenditure, plays an important role in the co-ordination of the processes of government policy and program development across all sectors. In Serbia, this role has in the past not been emphasized, and the Budget has been seen primarily as an administrative exercise. This is reflected in the small size of budget planning offices and their limited influence within line ministry structures, as well as in the background of budget staff, which typically emphasizes accounting and bookkeeping skills. In line ministries there is little linkage between policy and budgeting functions, while the role of the MOFE in facilitating policy co-ordination through the budgetary process is not yet widely recognized. There will be an increasing need to upgrade the budget office staff training and skills in the MOFE and budget offices of line Ministries (and EBFs and local governments). While a medium to longer-term issue, options for expanding training opportunities and upgrading skills should be explored now.
6.85 Budget execution is not only about effective financial control, cash and debt management, but also about supporting efficient delivery of services within the approved resource envelope. Some of the dimensions of budget execution that influence both financial control and service delivery, and that are issues in Serbia, include: (i) control of cash flow; (ii) control of commitments; (iii) accountability and transparency; and (iv) flexibility.

6.86 **Cash Flow Control.** The present arrangements provide a tight control of cash flow by MOFE. However, this control is achieved by cash rationing that has arbitrary effects on suppliers and service delivery units. In other countries suppliers subject to uncertain payment commonly react by increasing prices to reflect the increased risk of delayed payment or non-payment. Some of the adverse impact of cash rationing on suppliers can be reduced if guidelines and priorities for determining cash allocations and priority of invoice payment were developed and published. Adverse effects on government programs could be reduced with a more systematic forecasting of current year revenues allowing the MOFE to plan a smoother path of spending, as well as better integrate cash planning with debt management to assure timely debt issuance and availability of cash to meet spending demands. Smoother cash allocations would also be possible if the present daily triage was replaced by a weekly triage.

6.87 **Commitment Control.** Currently there is no systematic control of commitments. There is ad hoc commitment control by budget users depending on individual circumstances although this control is vitiated by the uncertainties introduced by cash rationing. For example, the Directorate of Property lets contracts for construction in stages so that liabilities can be tailored to anticipated cash resources. This process is likely to result in increased contract costs. By controlling commitments – an earlier stage in the spending chain – the lag in actual effect on cash outlays is longer, but there is less likelihood of running arrears, and greater support to programs in delivering goods and services of on-going activities. Moreover, it is not likely that all budget positions pose the same risk to fiscal balance. Some, such as personnel, do have longer-term implications (civil service rules on redundancy, as well as pension payments), are larger shares of the budget, and deserve tighter commitment control. Others, such as travel, are less problematic from a MOFE government-wide perspective, and need less attention.

6.88 **Accountability and transparency.** Neither all direct spending units, nor all transactions, are included in the AMS accounting system. Overall financial management and reporting would be improved if all direct spending units were included in the same system. This would also contribute to development of a single treasury system.

6.89 Reports on budget execution are only published in the annual report on the accounts. The only regular consolidated report is that produced by the MOFE on the cash flows from the “630” account. Although direct spending units submit monthly reports to MOFE and ZOP produces semi annual reports for each legal entity these are not published and the limited staff resources in MOFE do not allow for any practical scrutiny of these reports.
6.90 Transparency could be improved by the regular publication of a consolidated report showing actual expenditure and arrears as well as cash flow. Public access to such information could partly compensate for the limitations of MOFE scrutiny.

6.91 Flexibility in resource application for improved service delivery. The present budget classification allows some flexibility to budget users in the deployment of resources. Although the detailed financial plans are approved by the government, users are free to transfer amounts between detailed lines within the same budget position. With relatively few positions for each budget user this gives considerable flexibility. However, there is no virement between positions and this could well inhibit changes in resource mix which could improve productivity.

6.92 The contribution budget execution can make to the efficient delivery of approved services is presently limited by the lack of program structure in budget classification. Over time, it would be beneficial for MOFE to work with line ministries to identify major programs within each of them, and work to develop a budget classification for the ministry that accurately captures the objectives. Later, outputs or outcomes for the programs could be identified to further build the link between inputs and objectives/outcomes.

6.93 Personal accountability. The necessary counterweight to flexibility is personal accountability for results. As discussed above under flexibility, one barrier to improved service delivery is the limited management discretion in applying resources. For many budget users the process of budget execution is one of administration not management. In other words the purpose is simply to obey the rules, not to be responsible for the outcomes. Only if there is some capacity for the exercise of discretion in organizing the way in which programs are delivered will the process of management be developed with consequent improvement in the efficient delivery of services.

6.94 A precondition to relinquishing detailed centralized control over the use of resources is the establishment of measures or indicators of performance against which the use of budgeted resources can be judged. To achieve accountability not only for the use of budget resources but also for service delivery, initial steps should be taken to link them. Initially a Chief Financial Officer (CFO) should be appointed by each DSU who would be accountable to the MOFE for budget execution. The CFO would agree quarterly budget allocations with MOFE and manage the commitments of the DSUs to conform to that allocation. Within the user organization the process of devolving management responsibility would be linked to budget accountability to the CFO. As measures of performance are developed the detailed, centralized internal control of resource use could be eased.

6.95 Internal Audit. Within the framework of improved flexibility of resource application by program managers and greater accountability for results, MOFE and Cabinet require some assurance that the fundamental accounting, reporting, record-keeping, procurement, and other rules of the resource management system are functioning. Moreover, Government needs some means of monitoring whether its
policies are being implemented, and if government programs are operating effectively. An internal audit function provides such support to Government and MOFE.

6.96 At present, MOFE has limited capacity in budgetary inspection and focuses exclusively on compliance audit. Budgetary inspection in direct budget beneficiaries, social funds and other public sector agencies is even weaker. There is no tradition of systems audit or the use of post hoc sample audit techniques.

6.97 Internal audit is a broader concept from the traditional function of budget inspector in Serbia. Internal auditing is a review and appraisal activity that is organized within an organization. Internal audit is a service to the Government, and a means of management control. Through internal audits, the Government is assured that has procedures in place to minimize the potential for fraud, waste, and abuse of public resources, and that such procedures and systems are operating. Internal audits role is determined by Government, and may properly carry out requests of Government as to whether the latter's policies are being carried out.

6.98 In Serbia, the current budget inspectorate is the basis upon which the internal audit function will be built. It is established as the Budget Inspection and Audit Service (BIAS) in Articles 63 through 67 of the LBS, initially solely within the Ministry of Finance as a government-wide unit. At a later stage, some larger Ministries may establish their own internal audit units, operating under standards set by the central BIAS. The BIAS will initially focus on traditional compliance auditing, though when capacity is further developed, it is expected the BIAS will also conduct performance auditing.

6.99 As established under the LBS, the BIAS will have audit responsibility over: (i) direct and indirect budget beneficiaries; (ii) organizations for compulsory social insurance; and, (iii) public enterprises founded by the Government, enterprises in which the Republic has direct or indirect control over capital or management, as well as over legal entities in which the public funds comprise more than 50 percent of the total revenue. Local governments are also required to establish Audit and Inspection Services. MOFE should establish and properly staff the BIAS, as soon to help insure the integrity of resource management.

6.100 Development of a treasury. Supporting cash flow management, accounting and reporting, and program financial management is a treasury system. An EU funded program has been initiated to develop the single treasury system. Given the likely time required for producing the system specification, inviting tenders, selecting successful tenderers and designing and implementing the system, consideration must be given to improvements resource management.

6.101 A number of functions already exist that can provide a basis for treasury development and improved budget execution. For example, The information already existing in the AMS, the MOFE and the EBFs should be brought together to provide a consolidated overview of budget execution. The AMS has hitherto been regarded solely as a support service to individual ministries. It can also provide the aggregate and
summary data on budget execution necessary for the central oversight and control of budget execution.

6.102 Given the substantial role already played by AMS it is sensible to develop interim accounting and financial processing arrangements based on the existing AMS system. The MOFE should consider the feasibility of transferring financial control and accounting function of AMS to form the core of Treasury Expenditure Control and Accounting sectors.

6.103 There are two major and several small direct spending units whose financial processes are not provided by the AMS. Since the single treasury will require a complete integration of all financial processes early steps should be taken to bring all remaining direct spending units into the AMS system.

6.104 The Clearing and Payments Service – ZOP. Even as the Government is committed to transitioning towards a stronger private banking sector and is making changes in ZOP operations, one of the largest threats to public finances in the near term is over-hasty abolishment of ZOP before other systems replace it. This is practically true in revenue collections and administration. Loss or fall in tax revenues as well as social insurance contributions would pose an unnecessary and avoidable burden on the public purse just as Serbia is addressing spending pressures from individual sectors. It is advisable to take a prudent approach to ZOP reform, as Slovenia has done over the past decade, avoiding the revenue shortfalls experienced by FYR Macedonia and Bosnia and Herzegovina in recent years.

D. SUMMARY OF RECOMMENDATIONS

6.105 In budget formulation, the major objective is to weave together policy, resources, laws and implementing organizations to reduce excess policy commitments and begin to focus on the objectives of government spending. To assure sustainable policy commitments, it is important to assure that policies developed outside the budget process are linked with resource framework, and are affordable before being adopted.

6.106 A second theme in budget formulation is adopting a comprehensive resource framework, and a multi-year perspective. Comprehensiveness is critical for managing all risks to the budget, assuring government priorities are met. The multi-year framework provides basis for assessing future consequences of current decisions, and improving the effectiveness of spending over time.

6.107 In budget execution, the issue of comprehensiveness also arises, for similar reasons. Absent a complete picture of evolving spending trends during the fiscal year, Government cannot take appropriate action in a timely manner to bring programs back on target.

6.108 Two more technical themes involve the mechanics of budget execution. A treasury system, including commitment controls, as well as internal audit offices are important tools of Government for managing resources, monitoring resource use,
supporting line managers in program delivery, and informing the public on the use and results of their funds.

6.109 With a treasury system and internal audit office, broad shifts in accountability and authority can be made from the center of government - which is not well equipped to efficiently manage service delivery from the center – to actual program managers. This shift can result in improved service delivery and economy and efficiency of resource use – without loss of information or management control by the center of government. The role of central agencies such as MOFE becomes much more steering the ship of state than rowing. However, to fully achieve the gains from this reform, budget formulation must be realistic, and integrate policy with laws. Normative requirements that force uniform service delivery may inhibit efficiency gains from “deconcentration” of authority to program managers.
1. This annex presents a method for estimating the long run sustainable fiscal deficit of Serbia. In this exercise, alternative estimates of sustainable deficit are compared with the current fiscal position to measure the magnitude of required expenditure adjustment. The estimated sustainable deficit is conditional on an indicative set of assumptions and projections. The assumptions concern the implementation of policy reforms and the resulting macroeconomic outcomes. Much of the discussion here focuses on a “middle-case”, or intermediate growth scenario. Cases of “high” growth and “low” growth are also presented.

2. The purpose of this analysis is not to lay down an optimal macroeconomic framework or to define a desirable set of monetary or fiscal targets for Serbia. The definition of such a framework requires further analysis and consultation, including with the International Monetary Fund. The objective is solely to introduce the reader to a useful framework for analyzing fiscal sustainability. The principal analytical tool presented here may be adapted to examine the fiscal implications of alternative macroeconomic conditions and policy decisions.

3. A basic assumption in this analysis is that reforms in public finance, along with structural measures in the enterprise and financial sectors could substantially improve macroeconomic performance in Serbia, yielding steady economic growth and stable prices. The weaker the commitment to reforms, the poorer the macroeconomic outlook and the lower the sustainable deficit. Given the degree of policy commitment, the sustainable fiscal deficit also depends on the projected availability of financing. This is determined in part by macroeconomic performance, as more resources would tend to be available to a strong economy. But it also depends on the ability and willingness of the international community to commit funds.

4. The framework that brings together the assumptions and projections regarding macroeconomic performance and financial resources is based on theoretical models that combine the general government fiscal accounts with the operations of the central bank. The consolidated public sector deficit is defined as the sum of the general government deficit and the change in net worth of the central bank. Since the principal liabilities of the central bank are non-interest bearing bank reserves and cash in circulation, defining the deficit in this manner makes it possible to include the inflation tax as a means of financing. This approach also makes it possible to link the notion of fiscal sustainability closely with overall macroeconomic sustainability and performance. The sustainable fiscal deficit is simply that which can be financed from both foreign and domestic

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89
resources and which is consistent with low inflation, steady economic growth, and sustainable current account balances.

5. More specifically, the analysis is based on the two following accounting relationships:

(1) Deficit of National Bank = change in net worth = change in reserve money − change in net foreign assets − change in credit to banks − change in credit to the government − change in credit to the rest of the economy.

(2) Deficit of the general government = change in credit from the National Bank + change in credit from the banks + foreign borrowing + foreign grants + privatization receipts.

Adding these two individual deficits together gives the consolidated public sector deficit. To simplify the analysis, the deficit of the NBY is assumed to be zero after 2001. The estimated sustainable deficit depends on how each of the variables making up the deficit evolve over time. How these variables change over time is, in turn, a factor of the set of specific financing and macroeconomic assumptions.

6. A key assumption underlying the middle-case scenario is that continued efforts to stabilize and restructure the economy will bear fruit. Price stability will be achieved through improved financial discipline. The pace of structural reforms would continue over the next several years, with further moves to ensure the soundness of the banking system and significantly increase the role of the private sector. Success in these areas would be expected to produce stable growth and development of the financial system (Annex 1 - Table 1). GDP could be expected to grow steadily at about 4 percent per annum, approximately the average rate of growth the advanced reforming countries in Central Europe following the transitional recession of the early 1990s. Private financial intermediation could be expected to improve markedly, and would be reflected in greater investment and increasing monetization of the economy.

### Annex 1-Table 1: Middle Case: Key Macroeconomic Projections

<table>
<thead>
<tr>
<th></th>
<th>Average 2001</th>
<th>Average 2002-2005</th>
<th>Average 2006-2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth (percent)</td>
<td>5.5</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Domestic savings (% GDP)</td>
<td>-5.7</td>
<td>1.4</td>
<td>8.8</td>
</tr>
<tr>
<td>Private investment (% GDP)</td>
<td>13.4</td>
<td>14.2</td>
<td>16.5</td>
</tr>
<tr>
<td>Inflation (percent)</td>
<td>89</td>
<td>11.3</td>
<td>5</td>
</tr>
<tr>
<td>M2 money supply (% GDP)</td>
<td>9.7</td>
<td>16</td>
<td>26.8</td>
</tr>
<tr>
<td>Non-interest CAB (% GDP)</td>
<td>-4.6</td>
<td>-3.3</td>
<td>-1</td>
</tr>
</tbody>
</table>

Source: World Bank staff estimates.

7. Like any other economy, Serbia has access to a variety of financing options. New obligations could be financed with higher real tax revenues, increased domestic borrowing, more foreign resources, seignorage or privatization receipts. Owing to the fragility of the economic situation, however, reliance on any of these means of finance would
must be managed very carefully. Annex 1-Table 2 presents a set of assumptions regarding resource constraints during this decade. In principle, tax revenues could be raised to accommodate much of the new burden on the budget. However, revenues are already quite high as a share of GDP, and raising taxes further could damage business incentives to invest and create jobs. Higher taxes could in fact reduce revenues in the near term through slower economic growth and increased tax evasion.

Annex 1-Table 2: Main Financing Assumptions

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>Average 2002-2005</th>
<th>Average 2006-2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net foreign borrowing</td>
<td>0.9</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Foreign grants</td>
<td>0.6</td>
<td>0.6</td>
<td>0.2</td>
</tr>
<tr>
<td>Privatization</td>
<td>0</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Domestic borrowing*</td>
<td>-0.1</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

*Excludes National Bank financing, which is netted out in consolidation

Source: World Bank staff estimates

8. As Serbia is highly indebted and needs to encourage development of its private sector, access to credit will also likely be quite limited. As in the case of higher taxes, reliance on domestic borrowing could divert significant amounts of resources away from private business, damaging prospects for increased business liquidity and investment. Government borrowing can also lead to higher domestic interest rates and raise the risk premium that investors require from investments in Serbia. The IMF Extended Arrangement approved on May 13, 2002 limits resort to domestic credit to bridging small liquidity gaps. For purposes of this analysis, this amount of financing is excluded, however, due to the consolidation of the central bank and general government accounts.

9. In the future, wider resort to domestic credit may be possible without significantly distorting private incentives. Indeed, such limited future borrowing through a treasury bill or treasury bond market may be desirable to support the development of a domestic capital market. This Review has not determined what level of credit from the private sector would be optimal. However, the fiscal risks associated with borrowing and the potential for private sector crowding out suggest quite low limits to domestic borrowing, at least for the near-term.

10. For illustrative purposes, the change in NBY credit is assumed to be negative and decreasing in importance. In the past, credits from the central bank to the banks and enterprises were quite large and substantially destabilizing from a macroeconomic perspective. However, it is natural to expect that the NBY will at times lend to individual banks, and perhaps even most of the banking system, to provide liquidity as needed.

11. It is likely that only moderate amounts of foreign lending will be available over the next decade. Initially, borrowing will be confined to official creditors, but could include greater private participation as Serbia's creditworthiness is restored. This will require that indebtedness, as measured by the stock of debt and debt service obligations, be reduced, and aligned with the country's capacity to service debt.

12. For simplicity, the change in net foreign assets is assumed to be driven by the desire to maintain reserve cover at about three months of imports. Therefore, this variable
is largely driven by the trade assumptions underlying the middle-case growth path.\textsuperscript{76} In the short run, both exports and imports are assumed to grow at relatively rapid rates. In the long run, however, the growth rates are assumed to come down to sustainable levels. Over the course of the decade, exports of goods and services are assumed to grow at about 10 percent on average. Imports are assumed to grow at an average of about 8 percent per year.

13. The foreign resources available to Serbia in the coming years will likely include substantial budgetary grants. In 2002, these are projected to reach US$ 100 million, or about 1 percent of GDP. This level of support could continue in the next few years, but it is unlikely to last long. Owing to the slowdown in the world economy, many of the major donors are themselves experiencing tighter fiscal situations at the same time that demand for assistance is increasing around the world. Moreover, donors are wary of creating a situation of aid dependency and prefer to limit the extent and duration of budgetary support. Serbia is unlikely to be able to secure the level of assistance it enjoys now throughout this decade.

14. Privatization could provide significant resources, also in the short run only. Total privatization revenues in 2002 could reach US$ 350 million, or about 3 percent of GDP, if plans to accelerate the sale of state assets succeed. In projecting privatization revenues into the future, however, it is important to bear in mind that state assets are rundown, due to the lack of investment and maintenance in the last decade. It is unlikely that a consistently strong flows of privatization receipts will be available over the medium term.

15. At 10 percent of GDP, monetization of the Serbian economy is low by regional standards. Years of high inflation and the threat of bank insolvencies have reduced the public’s demand for deposit and cash balances. Since the early 1990s, this has limited the Government’s ability to finance itself with seignorage revenues. This was one of the hard lessons of the hyperinflationary period. Accordingly, the Government of Serbia is keen to avoid monetary financing of its fiscal deficits. With reform of the banking system and increasing stabilization of prices, however, demand for real money will likely grow substantially over the next decade. For illustrative purposes, it is assumed that the money multiplier and ratio of broad money to GDP rise to the average level of countries in Central Europe (about 5 and 30 percent of GDP, respectively) Even with low inflation it would be possible to finance some of public expenditure with seignorage revenue.

16. The projected amounts of financing can be summarized as the sum of net domestic financing, net foreign financing and the change in base money (Annex 1-Table 3). Over the medium term Serbia can expect net foreign financing, defined as the sum of net borrowing and grants less the accumulation of reserves, to rise to about 1.5 percent of GDP and then decline to about 0.5 percent of GDP. Foreign borrowing will form the largest part of this component, averaging close to 2.0 percent of GDP in the first half of the decade.\textsuperscript{77} Because debt service will consume a growing share of revenues during this

\textsuperscript{76} In principle, this variable could also be affected by exchange rate fluctuations, but revaluation effects have been assumed away in this exercise.

\textsuperscript{77} In reality, foreign financing includes adjustments to the public debt stock resulting from the Paris Club agreement. This analysis, however, focuses only on the actual cash flows that are financing the budget.
period, foreign borrowing will need to decline in the latter half of the decade to about 1 percent of GDP. This would allow external debt service to come down and the public debt to GDP ratio to decrease to around 60 percent. Foreign grants will be important initially, but will become relatively insignificant by 2010 as the Serbian economy strengthens and reconstruction projects are completed.

### Annex 1-Table 3: Financing of Serbian Public Sector Deficit 1/

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002-05</th>
<th>2006-07</th>
<th>2008-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total financing</td>
<td>1.4</td>
<td>4.6</td>
<td>1.4</td>
<td>0.8</td>
</tr>
<tr>
<td>Net foreign financing</td>
<td>-2</td>
<td>1.5</td>
<td>0.3</td>
<td>0.1</td>
</tr>
<tr>
<td>Change in foreign debt</td>
<td>0.9</td>
<td>2.4</td>
<td>1.2</td>
<td>0.8</td>
</tr>
<tr>
<td>Foreign grants</td>
<td>0.6</td>
<td>0.9</td>
<td>0.3</td>
<td>0.2</td>
</tr>
<tr>
<td>Change in net foreign assets</td>
<td>3.5</td>
<td>1.8</td>
<td>1.1</td>
<td>0.8</td>
</tr>
<tr>
<td>Net domestic financing</td>
<td>0</td>
<td>2.1</td>
<td>0.4</td>
<td>0.3</td>
</tr>
<tr>
<td>Change in NBY credit to economy</td>
<td>0</td>
<td>-0.9</td>
<td>-0.4</td>
<td>-0.3</td>
</tr>
<tr>
<td>Government domestic borrowing 2/</td>
<td>-0.1</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Privatization</td>
<td>0</td>
<td>1.2</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Change in reserve money</td>
<td>3.4</td>
<td>1.0</td>
<td>0.7</td>
<td>0.4</td>
</tr>
</tbody>
</table>

**Memoranda:**

- Primary balance
- Public sector debt
- Debt service/revenue (%)

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002-05</th>
<th>2006-07</th>
<th>2008-10</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Notes:**
1. The public sector is defined to include the Serbian general government and the NBY.
2. Access to NBY financing in the amount of 0.6% of GDP is excluded due to consolidation of the general government and central bank accounts.

**Source:** World Bank staff estimates

17. Under this illustrative scenario, net domestic financing of about 1.7 percent of GDP, equal to the sum of domestic borrowing and privatization receipts less NBY credit to the economy, could be available in 2001 to 2005. This would mainly be due to privatization proceeds. However, opportunities to privatize high-value assets could be exhausted by the latter half of the decade. Domestic borrowing would be constrained by the need to prevent crowding out of the private sector. Thus by the end of the decade, the Serbian Government is unlikely to depend significantly on domestic financing.

18. Financing constraints, together with a growth rate of around 4 percent, low inflation, and a public debt to GDP ratio of around 60 percent imply that towards the end of the decade sustainable public sector deficit will be about 1 percent of GDP. With projected interest payments of around 2.8 percent of GDP, fiscal sustainability will require that the Government run a primary surplus of almost 2 percent of GDP. The government could run a larger deficit but would have to accept greater inflation and less economic growth. If the deficit were financed with more foreign borrowing, the debt service burden would rise. With more money creation the deficit could increase, but at the cost of higher inflation. Increased domestic borrowing to fund higher commitments could crowd out private investors from the capital market as well as raise the debt service burden. One possibility is that more privatization revenues would be forthcoming than envisioned, which would increase the sustainable fiscal deficit in direct proportion.
ANNEX 2: FISCAL DECENTRALIZATION IN SERBIA

Current Administrative Structure

1. The two constituent Republics of the FRY enjoy considerable political, administrative, and fiscal autonomy. The Federal Constitution allows each republic to organize its government autonomously, and stipulates that “local self-government shall be guaranteed, in accordance with the Constitution of each member republic.” Municipalities are considered a basic self-governing unit.78

2. The Republic of Serbia nominally has two levels of sub-Republic Governments: the provinces (Vojvodina and Kosovo) and the municipalities (191 unities). Notwithstanding this three level structure, the Serbian Republic Government has direct relations with the municipalities. The province of Vojvodina until 2002 has played mainly a coordinating role and had insignificant fiscal powers79

3. The government of the province of Vojvodina (45 municipalities) is formed by a Provincial Assembly of elected representatives and an Executive Board. Until 2001, the provincial budget was very small (only enough to pay the members of the Assembly, Executive Board, and other administrative expenditures), since the provincial government had played no role in the delivery of public services—which were functions performed by the municipal and the Republic Governments. The Republic of Serbia has maintained some budgetary expenditures in the province, of Kosovo including the payment of teachers’ salaries. The rest of the Republic of Serbia (118 municipalities) has no intermediate self-government, and these local governments relate to the central Republic Government directly.

4. The Republic of Serbia’s Constitution defines municipality as a territorial unit in which local self-government is exercised. Municipalities do not have residual powers to operate, but can only exercise those rights (on responsibilities and on resources) that are explicitly specified by the law. Laws also establish that more than one contiguous municipality may form a city. Municipalities’/cities’ administrative and political structures are also based on the Assembly of elected representatives, and an Executive Board, each with a President which is indirectly chosen among their respective members. Apparently the current system of Municipal Assembly and Executive Board has been considered ineffective because of their confusing deliberative vis-à-vis executive authorities—especially in relation to the authority of the Executive Board’s President.

78 The Republic of Montenegro is structured into 21 municipalities, without any intermediate level of self-government between them and the Republic Government.

79 The province of Kosovo is not covered by this report.
The new Law on Local Self-Government (LLSG)\textsuperscript{80}, passed in the Spring 2002, has introduced a commendable innovation with the elimination the Executive Board and making the Municipal President (and City Mayor) directly elected by the population and the only authority accountable for the executive functions in the jurisdiction.

**Intergovernmental Fiscal Relations and Decentralization Reforms**

5. Decentralization of fiscal responsibilities and powers to local self-governments is currently under discussion in the Republic of Serbia. The new Law on Local Self-governance redefines the administrative structure, responsibilities and rights of local governments, aiming at attuning the intergovernmental fiscal system to the Council of Europe’s Charter for Local Self-Governments. Also in the Spring 2002, a “Law on the Establishment of Competencies of the Autonomous Province of Vojvodina”\textsuperscript{81} was passed, which devolves to the province of Vojvodina a degree of fiscal autonomy and authority over most areas of the public expenditures (including on education, primary health care and sanitation, social assistance, culture, tourism, sports, housing, environment, urban planning, agriculture, mining and energy), as well as management of inflows and outlays of the regional social insurance funds (pension, health insurance, and unemployment).\textsuperscript{82} These recent changes in the legal framework are, however, still to be regulated.

6. International experience demonstrates that a sustainable fiscal decentralization process requires a proper overall design of viable reforms from the outset, with a clearly established strategic direction, and a well-sequenced agenda of policy implementation. The Government of the Republic of Serbia is aware that a consistent design of the decentralization reform will require a prior definition of: (a) the scope of decentralization and the degree of fiscal autonomy; (b) the sequencing and speed of reform implementation; (c) the assignment of responsibilities, access to resources (including adequate borrowing regulation), and property rights to local governments; and (d) an explicitly well-articulated strategic orientation for fiscal decentralization implementation, including a credible institutional and capacity building set up.

7. **Defining the scope of decentralization and fiscal autonomy is essential at the outset of reforms in order to set the right expectations.** Although the Republic of Serbia has started to increase local fiscal autonomy (by giving local governments the possibility of choosing the rate of wage tax surcharge between 1.0 and 3.5 percent), it still has a long way to go in this direction. Beyond the improvement of allocative efficiency by promoting better public expenditure prioritization at provincial and local levels, efficiency can be increased by improving quality and reducing costs of public service delivery. Technical efficiency tends to improve when decentralization reaches further down to the implementation units, such as schools, by providing managers with

\textsuperscript{80} Promulgated by the President’s Decree no. 4 on February 20, 2002.

\textsuperscript{81} Also known as the “Omnibus Bill”, promulgated by President’s Decree No.2 on February 6, 2002.

\textsuperscript{82} The extent to which the current funding is adequate is still an open question. The Law includes only the following vague reference (Art. 66): “Funds for implementation of certain competencies quoted in this Law, in the area where the Autonomous Province takes over the founding rights, will be covered by the Autonomous Province budget.”
discretion to make decisions on the input mix to deliver services, and providing adequate oversight for performance and accountability.

8. **Sequencing and speed of the reform implementation are crucial for the maintenance of macro-economic stability.** In 2001, the Republic of Serbia started assigning new revenues sources to lower level governments before the approval of a clear attribution of responsibilities. This represents a risky decentralization implementation strategy, since in general local/regional governments tend to commit new resources immediately, and when the new responsibilities are attributed to them, additional resource sources will have to be assigned. To guarantee macroeconomic stability, assignment of revenue sources to a given level of government should either follow or be simultaneous with the attribution of responsibilities.

9. **Assignment of responsibilities, resources and asset ownership to local governments are to be associated to the right incentives to increase allocative efficiency.** A sustainable implementation of decentralization in the Republic of Serbia requires that the basic incentive mechanisms and institutions be in place, beginning with balancing responsibilities with resources of local governments. This would require major adjustments both on revenue and expenditure assignments, and on transfers between the levels of government (see Annex 2-Tables 1 and 2 below). The exclusive responsibilities of local governments are mainly those related to public utilities and sanitation (e.g., water supply, sewerage, district heating, refuse collection and disposal, street cleaning, cemeteries). These services are delivered by off-budget companies, most of which are experiencing financial difficulties because of unrealistic tariff policies and low collection rates. This situation is leading to a waste in consumption, accumulation of arrears, and a “cannibalization” of the companies’ capital stock, which will negatively impinge on local and Republic budgets. The only sustainable long-term solution is a full cost recovery system of tariffs, and a more effective judicial system that helps with the implementation sanctions. In the interim, the governments’ accounts should be made more transparent by showing the respective subsidies that have been provided for the public utility system.

10. The new LLSG has substantially improved the definition and specification of many delegated responsibilities, and continues assigning them asymmetrically, allegedly according to local implementation capacity. Nevertheless, most of the regulating and decision powers remain with the Republic Government and areas of undefined and joint responsibilities still seem to be significant. The assignment of revenue in the Republic of Serbia is excessively complex and, together with a review of the tax system, needs to be streamlined. As simplicity, transparency, and predictability are essential properties of an efficient system of resource assignment, all the parameters of this system should be established in an organic law (instead of annual ordinary budget laws), including those of the formula based equalization transfer mechanism.

11. **Without a full restoration of property rights, the current decentralization policies could lead to increased inefficiencies.** Responsibilities for the maintenance of public assets should be at the same level of government where the property of the asset is, otherwise there will be no incentives for proper maintenance and the assets tend to
deteriorate faster. This is important and urgent for the normal functioning of a fiscally decentralized system and for the success of the decentralization reform.

12. Access to borrowing by local governments is free in the Republic of Serbia, only subject to a 25 percent debt-outstanding/annual revenue ratio, regardless of the nature of the debt. Because of the precarious financial situation of the majority of the utility (and other) companies, significant risks to the Republic Budget exist on account of explicit and implicit guarantees, including loans and arrears with suppliers and employees. The Government of Serbia may consider either building up an adequately regulated financial system for local governments, or preventing access to borrowing by lower level governments altogether.

13. **Successful fiscal decentralization hinges upon an overall well-articulated strategy, the institutional set up and the implementation capacity.** The current piecemeal, top-down decentralization approach misses two crucial elements: (a) the inputs from a full consultation with all stakeholders, and the possibility of reaching a sustainable political understanding; and (b) the definition of clear, explicitly established long-term objectives. Instead, the Serbian government could define and lead a consistent, well-articulated strategic orientation for the fiscal decentralization. Then the government may consider putting in motion this decentralization implementation strategy by establishing a deliberative Standing Committee at the Council of Ministers, a Technical Group of Advisors, and an Implementation Monitoring Agency for fiscal decentralization.

14. A common constraint to successful fiscal decentralization has been the inadequacy of local technical and administrative capacities for fiscal policy implementation. The Republic Government may consider: (a) making the appropriate arrangements for an adequate financing and taking the lead of the capacity building process; and (b) pacing the implementation of the fiscal decentralization reform measures to the development of the absorption capacity of the local governments.
## nex 2-Table 1: Assignment of Responsibilities

<table>
<thead>
<tr>
<th>Responsibility</th>
<th>Federal Government</th>
<th>Tax Sharing in Republic of Serbia</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Republic</td>
</tr>
<tr>
<td>Monetary policy</td>
<td>Central Bank Financial system, monetary supply, interest and exchange rates.</td>
<td></td>
</tr>
<tr>
<td>Foreign relations</td>
<td>Diplomacy, foreign debt</td>
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</tr>
<tr>
<td>Trade and customs</td>
<td>Administration of customs duties and foreign trade.</td>
<td></td>
</tr>
<tr>
<td>Defence</td>
<td>Army and civil defense (police)</td>
<td></td>
</tr>
<tr>
<td>General State</td>
<td>Regulates, authorizes and finances administrative functions (justice, licenses, electoral register, etc.), fire brigade, consumer protection</td>
<td></td>
</tr>
<tr>
<td>Territorial administration</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Communications and</td>
<td>Regulates the Federal system</td>
<td>Republic</td>
</tr>
<tr>
<td>Public transport</td>
<td>Regulates and operates the Republic communal system, incl. highways and the traffic system.</td>
<td></td>
</tr>
<tr>
<td>Development</td>
<td>Regulates urban and regional/spatial planning, tourism</td>
<td></td>
</tr>
<tr>
<td>Iture, leisure and</td>
<td>Regulates and maintain theaters, museums, libraries, sports, leisure, incl. public buildings for cultural events.</td>
<td></td>
</tr>
<tr>
<td>Sports</td>
<td>Regulates operation, including on environment protection.</td>
<td></td>
</tr>
<tr>
<td>Environment and</td>
<td>Regulates operation on Gas and Electricity. Service delivery is made by off-budget Republic utility companies.</td>
<td></td>
</tr>
<tr>
<td>Public sanitation</td>
<td>Regulates and provide most of education (primary, secondary, and tertiary) except pre-school. Exclusive responsibility for teachers’ salaries at all levels.</td>
<td></td>
</tr>
<tr>
<td>Public utilities</td>
<td>Regulates and provide primary health care &amp; protection Hospitals, public health facilities. Responsible for doctors’ salaries. Financed by off-budget HIF</td>
<td></td>
</tr>
<tr>
<td>Education</td>
<td>Regulates and provide primary education (primary, secondary, and tertiary) except pre-school. Exclusive responsibility for teachers’ salaries at all levels.</td>
<td>Vojvodina Province responsibility. Expanded under the 2002 Omnibus Bill (see para 5 in this Annex)</td>
</tr>
<tr>
<td>Health Care</td>
<td>Regulates benefits for pension and disability, and for unemployment. Financing by the respective off-budget Funds.</td>
<td></td>
</tr>
<tr>
<td>Social Welfare</td>
<td>Regulates benefits for pension and disability, and for unemployment. Financing by the respective off-budget Funds.</td>
<td></td>
</tr>
</tbody>
</table>

\[
\text{major areas undefined or of joint responsibilities are reconstruction of infrastructure, immigration, refugees and asylum policies, and persons. at the end-1990 all capital assets belong to the State, local governments have no property rights. Municipalities are responsible for the maintenance, expansion and operation of local social facilities, public utility companies, and housing, and are authorized to appropriate rents of these assets in their jurisdiction.}
\]
<table>
<thead>
<tr>
<th>Tax Type</th>
<th>Type and Rate</th>
<th>Levied on</th>
<th>Collection Basis</th>
<th>Federal Government</th>
<th>Tax Sharing in Republic of Serbia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customs duties&lt;sup&gt;2&lt;/sup&gt;</td>
<td>Ad-valorem (many rates, which vary in a wide range)</td>
<td>Imports</td>
<td>Point of entry</td>
<td>Regulates, collects and Appropriates</td>
<td></td>
</tr>
<tr>
<td>Excise</td>
<td>Specific (legislated in absolute Dinar value)</td>
<td>Petrol &amp; derivatives, tobacco, beer and alcohol, table salt, and luxury goods</td>
<td>Derivation basis</td>
<td>6%</td>
<td>96% Regulates, Administers, (Law April 2001)</td>
</tr>
<tr>
<td>Personal Income Taxes—PIT&lt;sup&gt;3&lt;/sup&gt;</td>
<td>Wage tax = 14% on gross wage</td>
<td>Payroll</td>
<td>Derivation basis (withheld at the place of work)</td>
<td>90-95% Regulates, and Administers</td>
<td>5% Vojvodina 0% others</td>
</tr>
<tr>
<td></td>
<td>Local wage tax = up to 3.5%</td>
<td>Payroll</td>
<td>Derivation basis (withheld at the place of work)</td>
<td>Regulated by local govs., but Administered by Republic Govt.</td>
<td>100% Regulate rate (between 1-3.5%). Earmarked to housing construction.</td>
</tr>
<tr>
<td>Non-Incorporate Income Tax</td>
<td>Agricultural incomes tax = 20%</td>
<td>Agricultural incomes</td>
<td>Derivation basis (in general withheld where income is earned)</td>
<td>Regulates and administers</td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td>Other schedular PIT taxes = 20%</td>
<td>Royalties, rents, capital gains, gambling, dividends, interests, and other non-wage incomes</td>
<td>Derivation basis (in general withheld where income is earned)</td>
<td>100% Regulates and Administers</td>
<td></td>
</tr>
<tr>
<td>Corporate Income Taxes (CIT)</td>
<td>20%</td>
<td>Taxable profits of legal entities</td>
<td>Derivation basis</td>
<td>90-100%&lt;sup&gt;5&lt;/sup&gt; Regulates and administers</td>
<td>10%&lt;sup&gt;5&lt;/sup&gt; Vojvodina 0% Others</td>
</tr>
<tr>
<td>Sales Tax</td>
<td>17% Republic turnover tax on domestic goods &amp; services.</td>
<td>Cumulative on sales transactions of goods and services</td>
<td>Derivation basis</td>
<td>23%</td>
<td>77% (shared with municipalities)&lt;sup&gt;6&lt;/sup&gt; Regulates and Administers</td>
</tr>
<tr>
<td></td>
<td>3% Federation turnover tax on domestic goods &amp; services.</td>
<td>Cumulative on sales transactions of goods and services</td>
<td>Point of sale</td>
<td>100% Regulates</td>
<td>Municipalities shares &quot;on an annual regulating basis&quot;. Criteria not pre-determined. Shares depend on situation of municipality.&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td></td>
<td>20% Federation sales tax on imported goods</td>
<td>Cumulative on sales of imported goods and services</td>
<td>Point of sale</td>
<td>100% Regulates</td>
<td></td>
</tr>
</tbody>
</table>

---

<sup>1</sup> From: [World Bank](https://www.worldbank.org)
## Annex 2 - Table 2: Tax Structure and Assignment/Sharing System (continued)

<table>
<thead>
<tr>
<th>Financial Transaction</th>
<th>Tax</th>
<th>On the value of every financial transaction</th>
<th>Point of transaction</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property (Real Estate) Tax</td>
<td>0.4% on immovable</td>
<td>Land, buildings, structures</td>
<td>Derivation basis</td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td>0.25% on shares</td>
<td>Shareholders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property Transfers (Gifts and Inheritance)</td>
<td>5% on transfers</td>
<td>Real state, inheritance and gifts</td>
<td>Derivation basis</td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td>3-5% on gifts</td>
<td></td>
<td>Administrates and administers</td>
<td></td>
</tr>
<tr>
<td></td>
<td>and inheritance—progressive</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Road Taxes</td>
<td>Annual (specific)</td>
<td>Motor vehicle tax</td>
<td>Derivation basis</td>
<td>60%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Road tax</td>
<td></td>
<td>Regulates, administers</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Other fees on vehicles</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Levies, Fines, Rents, Utility user charges</td>
<td>Miscellaneous (in general specific fees)</td>
<td>Utilities, housing, natural resources, constructions, advertising, etc…</td>
<td>Derivation basis</td>
<td>Regulates administrative fees. Administers.</td>
</tr>
<tr>
<td></td>
<td>Right to use telecommunication on devises, etc…</td>
<td></td>
<td>100%</td>
<td>Regulates and administers</td>
</tr>
<tr>
<td>Social Security Contributions</td>
<td>19.6% to Retirement Pension &amp; Disability; 11.9% to Healthcare; 1.1% Unemployment</td>
<td>Employees and employers contribution 50-50%, on the wage-bill</td>
<td>Pension Fund Health Ins Fund Labor Market Fund.</td>
<td>100% to Funds Regulates, administere</td>
</tr>
<tr>
<td>Privatization proceeds</td>
<td></td>
<td></td>
<td></td>
<td>100%</td>
</tr>
</tbody>
</table>

Notes:

1. In the Republic of Serbia all public revenues are regulated by the Assembly of the Republic and administered by the Republic Government (through the Public Revenue Agency and ZOP). There are three exceptions: (a) "Custom Duties", which are regulated by the Federal Assembly and administered by the Federal Customs Office, and transferred for the appropriation by the Governments of Republics; and "Local Fees" (except administrative fees), which the municipalities fix the rates and, in some cases, collect directly.
2. Republic of Serbia has only schedular income taxes. Since there is no universal income tax, which would allow for deduction of the tax already paid (or withheld), PIT contributors (above the minimum threshold) end-up being double taxed.
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