Report No. 23689-YU

Serbia and Montenegro
Public Expenditure and Institutional Review

(In Three Volumes) Volume III: Montenegro

February 2003

Poverty Reduction and Economic Management Unit
Europe and Central Asia Unit

Document of the World Bank

Currency and Equivalent Units

(Exchange Rate Effective as of February 15, 2003)
Currency Unit = EURO
US$1.00 = EUR 0.9311

Fiscal Year

January 1 to December 31

Weights and Measures

Metric System

ACRONYMS AND ABBREVIATIONS

CEEC	Central and Eastern European countries
DFID	Department for International Development (of the U.K. Government)
DM	Deutsche Mark
DSU	direct spending unit
EBF	extrabudgetary fund
EPCG	Elektroprivreda Crne Gure (power utility)
EU	European Union
EUR	Euro
FRY	FR Yugoslavia
FY	Fiscal Year
GDP	Gross Domestic Product
GFS	Government Financial Statistics
GOS	Government of Serbia
GOM	Government of Montenegro
HIF	Health Insurance Fund of the Republic of Montenegro
IMF	International Monetary Fund
KAP	Kombinat Aluminijuma Podgorica
LBS	Law on the Budget System
MOF	Ministry of Finance (GOM)
MOH	Ministry of Health (GOM)
OECD	Organization for Economic Cooperation and Development
PEM	Public Expenditure Management
PEIR	Public Expenditure and Institutional Review
PIO	Pension Fund of the Republic of Montenegro
SAI	Supreme Audit Institution
SFRY	Socialist Federate Republic of Yugoslavia
SPAI	Stability Pact Anti-Corruption Initiative
USAID	U.S. Agency for International Development
UST	U.S. Treasury
YUD	Yugoslav Dinar
ZOP	Clearing and Payments Agency

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Acknowledgements

This Public Expenditure and Institutional Review (PEIR) is based on findings of World Bank missions that visited the Republic of Montenegro in 2001-2002. This study would have been impossible without the very close involvement and support of the Government of Montenegro. Fruitful dialogue with many Government agencies, and in particular with the Ministry of Finance team led by Minister Miroslav Ivanišević and Assistant Minister Milan Dabović, which greatly improved the team's understanding of the reform strategy pursued by the Montenegrin Authorities.

The report was prepared by a team led by Sergei Shatalov, and composed of Juan Carlos Ginarte (fiscal sustainability), William Dorotinsky and Mallika Krishnamurthi (budget management), Mamta Murthi (pensions), Pierella Paci (health), Gary Stuggins (energy), Paulette Castel (consultant, pensions), Agnes Couffinhal (consultant, health), Aleksandar Kovaćević (consultant, energy), and Julie Lynn (DFID consultant, audit). Darinchuulun Bazarvaani competently prepared datasets and presentations for the report and ensured data consistency.

The PEIR team benefited from valuable comments and suggestions from peer reviewers - Stefan Koeberle and David Shand, as well as from our World Bank colleagues Nancy Cooke, Annette Dixon, Bernard Funck, Tim Gilbo, Ardo Hansson, Ali Hashim, John Hegarty, Erika Jorgensen, Alma Kanani, Pascale Kervyn de Lettenhove, Maureen Lewis, Shaun Moss, Michael Mertaugh, Helga Muller, Joao Oliveira, Kyle Peters, Gary Reid, Milan Ruzica, Mary Sheehan, James Stevens, Roberto Tarallo, Siew Chai Ting, Marina Wes and Debbie Wetzel. This report reflects valuable inputs from and discussions with Emmanuel Zervoudakis, Joshua Charap, Johannes Herderschee, Istvan Szekely and Janet Kong (IMF). Eileen Browne (US Treasury Advisor to the MOF) and Gary O'Callaghan (EU advisor to the Office of the Prime Minister) provided invaluable help in discussing the forward-looking agenda for public expenditure reform in Montenegro. The PEIR benefited from insights by other donor agencies, too numerous to list here.

Sincere words of appreciation go to Rory O'Sullivan and Elaine Patterson, who headed the Belgrade office of the World Bank at the time this review was prepared, and to the staff of the Belgrade office, in particular to Zana Ivanović, whose able logistics support was vital for the success of PEIR missions. Vesna Kostić (Belgrade office of the World Bank) and Predrag Vusurović (office of the US Treasury Adviser), expertly organized dissemination of this report.

This study was written under the general guidance of Christiaan Poortman (Country Director), Pradeep Mitra (Sector Director), and Helga Muller (Sector Manager).

Special thanks go to Maja Pejić Medić, who translated this volume; Nataša Obradovic, Predrag Vusurovic and Lazar Sestovic who have thoroughly reviewed this translation; to Emily Evershed and Karalee Rocker, who competently edited it; and to Alison Panton for her outstanding skills and dedication in processing it.

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PREFACE

1. The key themes for this volume of the Public Expenditure and Institutional Review (PEIR) are similar to the second volume, but stress features specific to Montenegro, whose public finance reform started earlier and moved at a faster pace. It was supported by significant donor assistance, but limited local institutional capacity to sustain these processes resulted in greater dependence on external resources, both financial and human. The fiscal system evolved over the past few years in a fashion largely autonomous from Serbia, leaving Montenegro with strengths and challenges which differ from those in Serbia, and calling for a volume dedicated to capturing Montenegro's distinctions.

2. This volume addresses three cross-cutting themes of **sustainability, strategic allocation**, and **accountability** in their practical application to the current context of Montenegro's public expenditure system. The authors aimed to formulate their analysis and recommendations to help the Government of Montenegro in defining and implementing sustainable fiscal policies and strong public institutions that would further market-oriented reforms and facilitate the integration of Montenegro into the European economic space.

3. The Government of Montenegro has taken strong ownership of the PEIR agenda and maintained an active dialogue with the PEIR team throughout its preparation, to refine the priorities and sequencing of PEM reforms.

4. The PEIR builds upon the more detailed fiduciary and public procurement evaluation undertaken by the World Bank's Country Financial Accountability Assessment (CFAA) and Country Procurement Assessment Report (CPAR) for FRY. The PEIR benefited from the PEM work in Montenegro carried out by other multilateral and bilateral agencies, such as the IMF, UNDP, European Agency for Reconstruction (EAR), US Treasury, and USAID.

5. In this volume, Chapter 1 provides an overview of the macro/fiscal context of the Government's public expenditure reform program, and documents these reforms until mid-2002. Chapter 2 discusses the outlook for fiscal sustainability, including quasi-fiscal issues in the enterprise and banking sectors, with particular focus on the energy sector. Chapter 3 analyzes allocative trends in Montenegro's general government expenditures. Chapter 4 examines two largest social expenditure programs: pensions and health care. Chapter 5 focuses on the budget management challenges.

1. INITIAL CONDITIONS AND EARLY REFORMS

A. BACKGROUND

1.1 Montenegro is confronted with many of the same policy challenges faced by Serbia. The legacy of poor economic policies during the SFRY period, together with a decade of sanctions have affected Montenegro as well, weakening its economy and undermining fiscal sustainability. Despite the fact that Montenegro started public sector reforms a couple of years earlier than Serbia, the size and scope of government intervention in economic affairs remains large and continues to weigh on the prospects for economic growth. Much of the socially owned industry is unprofitable, depends on direct and hidden state subsidies, and lacks financial discipline. This has resulted in large quasi-fiscal deficits. The banking system is weak and unable to perform financial intermediation. Recovery from the effects of the sanctions and the Kosovo crisis has been slow, and unemployment remains high.

1.2 The present level of expenditure commitments is unsustainable and inconsistent with growth and stabilization objectives. Spending is concentrated in wages and social programs, while revenues are derived from high, distortional taxes. Public service employees (comprising education, health care, and central administration) account for about 6 percent of the population and around 20 percent of the labor force - one of the highest levels of public employment in Europe. Spending overruns have been typical in these categories, and have been compensated with cuts in spending on goods and services, and capital spending. At over 23 percent of GDP, spending on social protection and health is one of the highest in the region.[1] At the same time, public investment is low and many public services are either of poor quality or inefficient.

1.3 While in the near-term fiscal gaps may be closed with continued foreign grant support, fiscal sustainability is a serious concern. At close to 37 percent of GDP before grants, revenues are high by international standards and are based on high tax rates. It may not be feasible to sustain such high tax rates, including contributions to social security funds, since they encourage tax evasion and distort incentives to invest and produce. In order to encourage tax compliance and stimulate savings and investment, the government needs to reduce the tax burden equitably. Social spending commitments are likely to grow in any event – both in the absence of reforms, driven by the demographic momentum of an aging population; but also under the active reform scenario – due to increased social assistance needs associated with enterprise restructuring. At the same time, the depletion of capital stock cannot proceed indefinitely; it must be reversed and public investment expanded in order to support growth. All of these competing demands will need to be reconciled to prevent further accumulation of expenditure arrears.

[1] GDP estimates used for this report equal 1.25 times the IMF estimates of net material product. NMP excludes services of the "non-material" sphere, including education, culture, public health, banking, insurance, government services, and defense. Montenegrin officials estimate that GDP is 25 percent larger than NMP.

B. Early Reforms

1.4 In recognition of the magnitude of the policy challenges confronting Montenegro, soon after the elections of 1999, the Government set out to reform Montenegro's economy and public sector. Early on, steps were taken to stabilize prices, and to eliminate trade distortions. In 2000 a simplification of the customs tariff structure was implemented, together with a cut in the average tariff rate to under 3 percent. The gradual introduction of the Deutsche Mark as legal tender completed in November 2000, helped to reduce inflation from over 100 percent per annum in 1999 to 12 percent in 2002.[2] On the fiscal front, the progress was less impressive, and 2000 finished with a substantial budget deficit of 6.7 percent of GDP. Still, the Republic Government had made several key steps towards fiscal sustainability. A significant increase in administered prices in the energy sector helped to reduce relative price distortions and to improve the still fragile position of the state-owned power company EPCG. In order to stabilize the banking system and to reduce risks to the budget coming from it, the government introduced in 1999 strict limits on lending, including a 100 percent reserve requirement against enterprise deposits, until it again becomes safe for the banks to lend.

1.5 In 2001, the reforms accelerated. Prices of basic foodstuffs, particularly bread and milk, were fully liberalized. New measures were instituted to enhance and better target the funding of social assistance and child allowances to the poorest households. Some effort has also been made to reduce civil service costs through the use of temporary employment. Many important reforms in financial management and control have focused on budget formulation, execution, and auditing, and on the process of public procurement. The Central Bank started to issue one-month Treasury bills in 2001 to bridge temporary financing gaps. A single-account Treasury system is currently being piloted and eventually will be implemented throughout the consolidated government, including local governments. This system will improve expenditure control and alleviate cash shortages.

1.6 On the revenue side, recent tax measures have focused on reining in tax evasion through improved tax administration and collection. Since July 2001, goods in transit through Montenegro have been required to pay all duties, taxes, and excises in advance. As a result, international trade taxes exceeded planned amounts by nearly 70 percent. At the end of 2001 another package of tax laws strengthened collection procedures, contributing to an expanded revenue base. In 2003, the government expects to further boost the collection of indirect taxes by introducing a value-added tax.

1.7 Significant steps have also been undertaken to restructure the enterprise sector. The Privatization Council was established in 2000 to oversee the privatization of nearly 300 state-owned and socially owned assets via "batch" sales, public tenders, auctions, bankruptcy procedures, and mass voucher methods. Full or majority stakes in some hotels and a coal mine have already been sold. The mass voucher privatization program has been completed, with around 70 percent of citizens receiving vouchers, making the purchase of around 250 companies possible.

[2] In early 2002, Montenegro replaced the Deutsche Mark with the Euro.

1.8 In the financial sector, important steps have been taken to develop the institutions needed to create a sound banking system. The Council of the Central Bank was appointed in 2001 to establish core central bank functions, including bank supervision. A comprehensive set of regulations is being set up to establish the licensing provisions, financial reporting, and performance requirements for commercial banks. All banks have been required to be re-licensed, and licensing is now conditional on financial soundness. In the case of Montenegro Banka, the Republic's largest institution, the Central Bank has appointed a temporary administrator and has prohibited any new lending until the bank is privatized. A bankruptcy and liquidation law was passed by the Parliament defining the triggers and procedures involved in actions against insolvent banks.

C. THE STABILITY OF THE BUDGETARY SYSTEM

1.9 Notwithstanding significant progress made in many areas, the agenda for reform is only at an early stage across all sectors, and far-reaching adjustment is required to ensure fiscal and macroeconomic stability. Imbalances in the enterprise, banking, and other sectors combined with budgetary failures and over-commitments threaten to destabilize fiscal accounts. The fiscal outturn in 2001 demonstrates that budgetary discipline is very fragile and that sustainability is highly dependent on donor support, calling for a permanent reduction in commitments across a wide range of expenditure categories.

1.10 Reported spending on wages and salaries exceeded the planned amount by DM 35 million, or close to 2 percentage points of GDP (see Table 1.1). In reality, wage commitments increased much more, since the government did not make the required employer contributions to the social security funds.[3] Spending on health care, which had been projected to remain stable in real terms, actually increased by 1 percentage point of GDP. While price liberalization allowed for a decrease in the subsidization of agriculture, the railways, and other sectors, subsidized lending to enterprises almost doubled in 2001 compared to the planned amount.

1.11 By contrast, capital expenditure equaled the budgeted amount, suggesting a decline in real spending of nearly 25 percent compared to 2000. Expenditures on goods and services exceeded the planned amount by DM 22 million. However, the increase was just sufficient to cover the increase in prices. As the overall deficit remained close to the targeted amount, the large increase in wages and salaries, health spending, and net lending was paid for with cuts by accumulating arrears to the pension funds and slower accumulation of reserves.

1.12 The budgets of the social funds have an unpredictable and weak link to their principal sources of funding, revenues from taxes. The GOM did not make all of its employer contributions to the social insurance funds in 2001. Instead, it provided larger subsidies to enterprises than were budgeted, which the enterprises used to increase somewhat their contributions to the Pension Fund. The latter's financial position did not deteriorate in 2001: it was able to pay 12.5 pensions, and to reduce its arrears to beneficiaries. However, the main

[3] The increase in wage costs seems to have been limited largely to the state administration. In the health sector, for example, the wage bill remained stable at around 2.3 percent of GDP.

reason for this was foreign grant assistance. Without foreign grants, the Pension Fund would have had a deficit of 2 percent of GDP.[4]

Table 1.1: Montenegro: Consolidated Central Government Operations

	2000	2001		2002	2000	2001		2002
	Outturn	Plan	Outturn	Plan	Outturn	Plan	Outturn	Plan
	(DM million)				*(percent of GDP)*			
Revenue	595.9	730.3	734.3	847.7	36.7	37.2	37.4	37.3
Current revenue	595.4	710.8	734.3	847.7	36.6	36.2	37.4	37.3
Tax revenue	560.7	672.7	657.0	726.9	34.5	34.3	33.5	32.0
Non-tax revenue	34.7	38.1	77 3	120.8	2.1	1.9	3 9	5.3
Capital revenue	0.5	19.5	0.0	0.0	0.0	1.0	0.0	0.0
Expenditure and net lending	731.6	825.4	830.6	962.1	45.0	42.1	42.3	42.4
Wages and salaries [1/]	135.4	203.1	237.7	279.7	8.3	10.3	12.1	12.3
Expenditure on other goods and services	112.6	91.7	113.7	121.6	6.9	4.7	5.8	5 4
Interest payments	1 4	0.9	1.2	46.1	0.1	0 0	0.1	2.0
Transfers and subsidies	407.5	438.0	400.3	436.3	25 1	22.3	20.4	19.2
o/w Subsidies to agric. and enterprises	50.3	22.3	22.7	40.4	3.1	1.1	1 2	1.8
Pension Fund	183.1	225.7	208.5	241.0	11.3	11.5	10.6	10.6
Health Fund	53.0	63.0	83.4	79.7	3 3	3.2	4 3	3.5
Employment Fund	5.8	7.7	7.0	5.0	0.4	0.4	0.4	0.2
Capital expenditure[2/]	43 1	37.7	37.7	32.8	2.7	1 9	1.9	1.4
Net lending to enterprises	15.4	14.4	27.3	22.5	0.9	0.7	1.4	1.0
Reserves	16 2	39.6	12.6	23.3	1.0	2.0	0.6	1.0
Balance	135.7	-95.1	-96.3	-114.4	-8.3	-4.8	-4.9	-5.0
Memorandum Items.								
Grants	139.0	90.0	63.0	57.0	8.6	4.6	3.2	2.5
Balance incl. Foreign grants	3.3	-5.1	-33.3	-57.4	0.2	-0.3	-1.7	-2.5
Health care wages	39.0	44.3	45.0	51.8	2.4	2.3	2 3	2.3
Privatization	0.0	0.0	0.0	47.0	0.0	0.0	0.0	2.1
GDP	1625	1963	1963	2271				
Inflation						6.5	24.0	12.0

Note. (1) Including health care wages. In 2002, the Republic Government did not make all of the required employer contributions to the social insurance funds (2) In addition, larger capital expenditure occurred off-budget (directly funded by the donors)
Source: World Bank and IMF staff estimates

1.13 To a certain extent, the Pension Fund increased its own spending by reducing transfers to the Health Insurance Fund (HIF). The latter's financial position was highly dependent on transfers from the Pension Fund for the care of pensioners.[5] In 2001, transfers from the Pension Fund were DM 10 million less than budgeted, and accounted for only 16 percent of total

[4] Chapter 4 discusses the financial situation of the pension fund in greater detail. In that section, the concept of the "primary" deficit is introduced, which refers to the difference between pension system's legal obligations and the contribution revenues. On this basis, the deficit of the Fund is 5.6 percent of GDP.
[5] Unlike the Pension Fund, the Health Fund did not receive foreign grants directly.

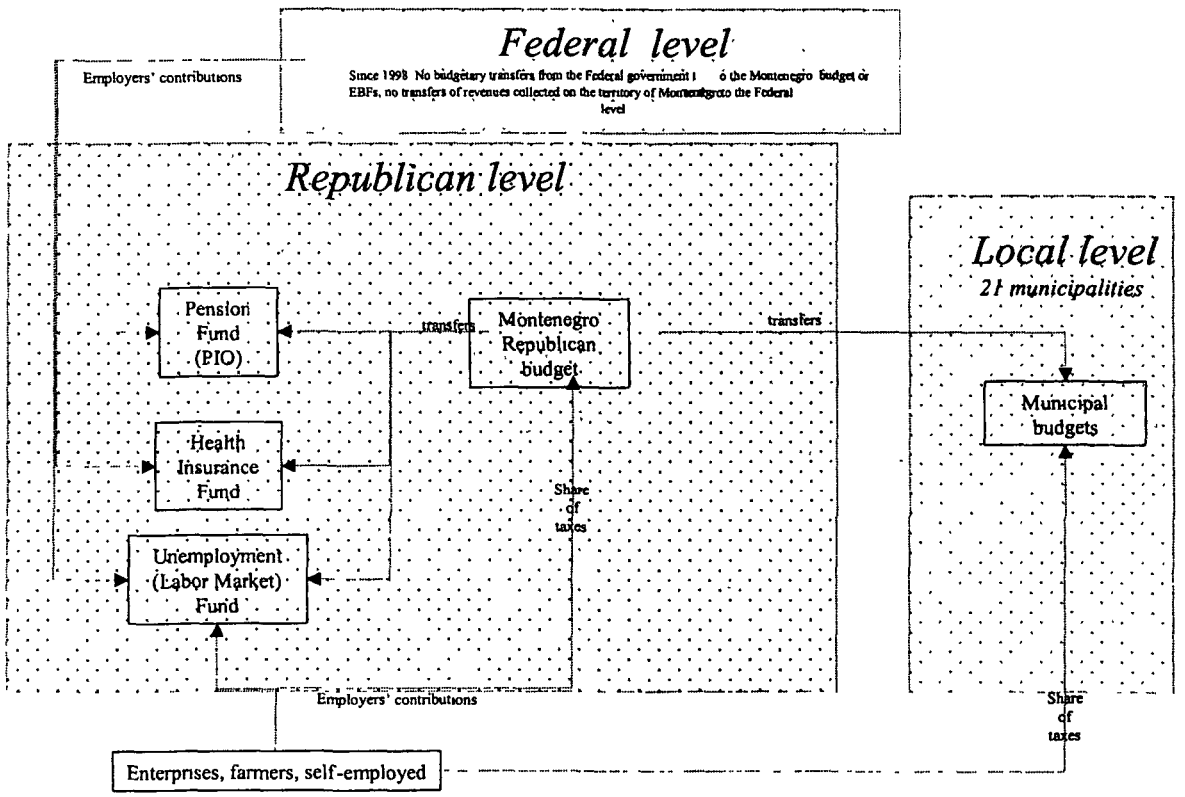
resources of the HIF. By contrast, the budgeted amount of these transfers was 24 percent of total HIF revenues. Unstable financing, combined with operational inefficiencies as well as a growing demand for health services, resulted in a system frequently unable to provide even the basic health services.

Box 1.1: Structure of Montenegro's General Government

The figure below presents an overview of Montenegro's general government. Fiscal flows between the Federal and Montenegrin Republic level of government have been minimal since 1998, when the Federal Budget stopped making transfers to the Montenegrin Pension Fund, and the Republic responded by redirecting into it the customs revenues it collects on its territory. Thus, Montenegro does not transfer any resources *to* the Federal level, while the only transfers to it *from* the Federal level are contributions from the Federal Budget to the Montenegro social funds for Federal government employees who come from Montenegro. This status will continue at least until the implementation of the March 2002 Constitutional Agreement.

The extrabudgetary sphere is more centralised than in Serbia, as there exists only three funds - Pension (PIO), Labour Market and Health Insurance. The financing mechanism for social finds in Montenegro is similar to that in Serbia.

Local governments in Montenegro are represented by 21 municipalities. Their share in public spending is modest (about 3 percent of total government spending). It is supplemented by modest transfers from the Republican Budget (less than 1 percent of total Budget spending in 2000-2002). Local governments are responsible for water supply, sanitary services, public transportation, and for a limited range of social services.



Note Status prior to the March 2002 constitutional agreementbeen Serbia and Montenegro

1.14 The general government deficit in 2001 was approximately DM 96 million excluding grants, or 4.7 percent of GDP. This was only slightly more than the planned level. Nearly two-thirds of this deficit is due to excess spending at the central government level, and the rest is due to the deficit of the Pension Fund (excluding foreign grants). About two-thirds of the general

government deficit was financed also with foreign grants, which totaled DM 63 million, or -1/3 less than the budgeted amount. As a result, the deficit after foreign grants was 1.6 percent of GDP instead of the planned 0.3 percent. Domestic borrowing, including the issuance of short-term securities, covered the gap. In the first half of 2001, part of the gap was financed with borrowing from the Republic's Payments and Clearing System (ZOP), in contravention of the Stand-By Arrangement with the IMF.

1.15 Projections for 2002 indicate that expenditure and net lending will grow only slightly faster than revenue in real terms. As a result, the general government deficit will remain at about 5 percent of GDP (excluding grants and contributions to the social funds). Total foreign grants are expected to decrease to EUR 57 million, and will account for 50 percent of the total financing. The rest of the gap is to be closed by foreign borrowing and privatization revenues. On a net basis, domestic credits will be negative, as previous loans will be repaid. As in previous years, the deficit will be split between the Republic Budget and the Pension Fund.[6]

1.16 The 2002 consolidated general government budget targets a stable aggregate level of expenditure, but with important shifts in some categories of spending. The real wage bill will increase only slightly as a share of GDP, reflecting a 15 percent increase in the nominal wage rate and the planned realization of contributions to the social funds. Interest payments will rise from DM 1 million to DM 46 million, as Montenegro starts to service its foreign debt. More alarming is the trend in subsidies and net subsidized lending to the enterprise sector. These are budgeted to increase by over 70 percent compared to the 2001 budgeted levels (to the total of over 2.8 percent of GDP). Real capital spending is expected to decline for the second consecutive year to 1.4 percent of GDP, or about one-half of the amount spent in 2000.

1.17 The 2002 budgets for the main social insurance funds will reflect an attempt to slow the pace of expenditure growth. Health Fund spending will increase in nominal terms, but less than inflation, so that its share in GDP will fall by 0.8 percentage points. Pension fund expenditure will remain stable as a share of GDP, and will reflect a greater effort to control outlays in comparison with 2001. In 2002, twelve pensions (one due per month) are expected to be paid, rather than the 12.5 that were paid in 2001. In Montenegro, pensions are linked directly to the average wage, making it difficult to control expenditure.

1.18 The Government of Montenegro has made significant efforts to combat corruption. Montenegro participates in the Stability Pact Anti-Corruption Initiative (SPAI), (see Box 1.2).

1.19 To summarize, Montenegro has undertaken a number of key reforms encompassing a broad range of policy areas. However, as the recent experience demonstrates, fiscal control and sustainability have not yet been achieved. The reform process is still in the early stages, despite the changes that have occurred so far. Incomplete reform across the economy feeds into the budget via enterprise subsidies and net lending. This reflects the financial imbalances in these sectors as much as a lack of budgetary discipline. Similarly, the financial imbalances of the social funds drain resources away from other priority areas of expenditure, and create a

[6] The split in the general government deficit (excluding grants) between the Republic Government and the Pension Fund will depend on the amount of grant support to the Pension Fund. It is understood that the republican government will make transfers to the Pension Fund to cover shortfalls in grant assistance.

dependence on foreign funding. As the imbalances tend to worsen over time, far-reaching and urgent reform is needed to ensure fiscal and macroeconomic stability.

Box 1.2: Anticorruption Program of the Government of Montenegro

The Republic of Montenegro has also made significant efforts to combat corruption. These include.

- In February 2000, Montenegro accepted the Stability Pact Anti-Corruption Initiative Compact and Action Plan;
- In February 2001, Montenegro established an Anti-Corruption Initiative Agency, responsible for preparing draft laws and regulations, adopting international standards and monitoring their implementation, defining an anti-corruption strategy, promoting transparency and integrity in business transactions and monitoring the privatization process, undertaking public awareness and prevention activities, and co-coordinating activities of both governmental and non-governmental sector aimed at curbing of corruption;
- In the summer of 2001, Montenegro passed the Public Procurement Act and the Law on Budget System;
- A Law on Illicit Enrichment Law has been passed, while a draft Code of Conduct for Civil Servants, a Conflict of Interest Law, A Law on the Financing of Political Parties, and a Freedom of Information Act are at different stages of readiness;
- A new Criminal Code included provisions against criminalized money laundering; in addition, a special anti-money laundering law is expected to be adopted in 2003, which will establish an Anti-Money-Laundering Commission;
- The Montenegrin Government and the NGO sector established a common cross-cutting Committee for Anti-Corruption to review the National Strategy for Anti-Corruption and to work on new legislation.

Source World Bank (2002). *Federal Republic of Yugoslavia Country Financial Accountability Assessment*

2. FISCAL SUSTAINABILITY

2.1 Fiscal imbalances that have emerged over the past decade in Montenegro have a structural character, and can only be eliminated by a decisive adjustment policy. This chapter examines the major factors that are likely to increase budgetary pressure in the medium term and presents estimates of the adjustment needed to regain fiscal sustainability.

A. THE NEED FOR FURTHER FISCAL REFORM

2.2 Pressure on the Republic Budget and the social funds is likely to increase significantly in the near future without expenditure reforms. This is likely to happen for three main reasons. *First*, the **tendency to increase spending** in relation to revenue is institutionalized by the laws and practices governing the system of entitlements, particularly the social insurance schemes. Spending on pensions is especially likely to increase without reforms owing to relatively early retirement clauses, high replacement rates, and generous indexation rules. In the health care system, large inefficiencies, distorted incentives, and a lack of accountability have resulted in substantial resource waste and poor service delivery. Without significant reform of the pension and health insurance systems, their finances will steadily deteriorate as the number of contributors diminishes and the demands of beneficiaries grow.

2.3 *Second*, **new commitments** will be brought onto the central Republic Budget. In 2002, Montenegro began to pay its share of FRY's external debt service. Interest payments will rise from 0.1 percent of total spending in 2001 to 4.7 percent in 2002. Over time, debt service will increase further as grace periods on restructured debt expire. The budget will also need to allocate more resources for social assistance in order to mitigate the social costs of future bank and enterprise restructuring. In 2002, this cost is budgeted at about 0.7 percent of GDP. Given the magnitude of financial problems in these sectors, social assistance and other social programs are likely to increase in the near future.

2.4 *Third*, **grant assistance** is not likely to continue at the current level. Both the Republic Budget and the social funds are now critically dependent on foreign financing.[7] In 2000, foreign grants totaled 9 percent of GDP. In 2001-02 they will average about 3 percent of GDP and will cover almost 60 percent of the fiscal gap. In 2001, over 50 percent of these funds went to the Pension Fund, up from 17 percent in 2000. Some of the grant money has also funded imports of electricity and foodstuffs. This level of support is unlikely to continue indefinitely, in part because foreign donors are wary of creating aid dependence, which is neither in their interest nor in the interest of Montenegro. Donors are also unlikely to be as generous with grant funding

[7] Such support has largely been on concessional terms, particularly grants from the EU and USAID. The funds have paid for technical assistance and for meeting direct budgetary needs.

because competition for such resources is growing internationally. In the future, financial assistance will be more closely tied to result-based policy performance.

2.5 Given that grant support is likely to decline and some categories of spending will tend to rise in the future, Montenegro is left with few policy options apart from expenditure cuts with which to ensure fiscal sustainability. Recent experience suggests that measures to increase revenue alone are not likely to close large fiscal gaps. In 2001 stepped up efforts to reduce tax evasion succeeded in raising revenues from international trade taxes, which increased 14 percent in real terms. In total, tax revenues increased just over 1 percent in real terms despite positive output growth of 3.5 percent. This suggests that the burden of taxation is very high, further motivating tax evasion. Attempts to boost revenue from taxation need to be adjusted to the realities of the Montenegrin economy, with a large percentage of growth still coming from the grey market. In these conditions, tax evasion could limit the efficacy of attempts to boost revenue.

2.6 Addressing the challenging economic and fiscal problems in Montenegro will require strong reform efforts and substantial financing. Furthermore, the fact that the financial imbalances are very large and are concentrated in a few areas creates the potential for high short-term costs of adjustment. Once reform is completed in these areas, however, the economic and financial benefits could accrue quickly. For example, much of quasi-fiscal deficits stem from the provision of households and industry with subsidized electricity[8]. Furthermore, bringing the finances of the social programs into balance would go a long way to ensuring macroeconomic stability.

B. Estimating a Sustainable Fiscal Deficit

2.7 Fiscal sustainability will require significant cuts in budgetary spending and also improved budget management. As it is often socially costly and politically difficult to reduce the role of government in the economy, there are risks that expenditure adjustment may be delayed or that many obligations will be converted to off-budget commitments. One way in which expenditure adjustment could be delayed would be to increase borrowing to meet new expenses and to offset the eventual loss of grant assistance. To some extent this is already happening. Whereas in 2000 foreign grants fully covered the deficit, in 2001 net borrowing was 2 percent of GDP in 2001. In 2002, net borrowing was estimated at about 1 percent of GDP. Foreign grants declined in 2001 and are expected to be lower in real terms in 2002. By contrast, there was effectively no borrowing in 2000 to finance the deficit. As relations with foreign creditors are normalized, Montenegro may gradually gain access to foreign lending on hard commercial terms. Tapping such resources prior to undertaking the amount of expenditure adjustment that is needed to ensure the stability of budgets could eventually lead to default and loss of creditworthiness or unnecessary large fiscal adjustment.

[8] In particular, these low tariffs benefit Kombinat Aluminijuma Podgorica (KAP), the state-owned aluminum producer, which accounts for over 40 percent of the electricity consumed. KAP also accounts for around 70 percent of merchandise exports, is the largest industrial employer, and is burdened with heavy labor redundancy. A financial restructuring of KAP could yield significant fiscal savings and could help to reduce power cuts, which reached up to four hours per day starting in late October 2001.

2.8 There is also the danger that too much will be borrowed from the domestic economy. In 2001 the Government began to issue Treasury bills to bridge short-term financing gaps. The experience of other countries suggests that if there were no substantial expenditure rationalization, the stock of such debt can increase rapidly. The associated interest costs will increase even more rapidly because of a growing perception of default risk among lenders. The GOM should avoid such debt financing, since it diverts scarce resources away from private sector projects. Given the need to stimulate investment and employment, significant domestic borrowing will be ill warranted.

2.9 The current fiscal stance suggests that deficits on the order of 4.5 percent to 5.0 percent will persist without substantial policy reform. Table 2.1 summarizes the results of an analysis undertaken to determine whether this level of the fiscal deficit is sustainable.[9] Assuming that private sector crowding out is minimized, and that the general government debt to GDP ratio eventually stabilizes at around 35 percent of GDP, the sustainable fiscal deficit will be on the order of 2.5 percent of GDP by the end of the decade.[10] In the short run, the deficit can be higher, but macroeconomic stability requires not exceeding its long-term sustainable level. This means that the primary balance will need to improve from -4.8 percent of GDP in 2001 to around -0.5 percent in 2010.

Table 2.1: Sustainable Fiscal Deficit Projections

(Percent of GDP)	2001	2002-05	2006-07	2008-10
Total Financing	**4.9**	**4.2**	**2.6**	**2.6**
o/w Foreign Financing	3.2	3.6	1.9	1.9
Change in Foreign Debt	0.0	1.9	1.5	1.5
Foreign Grants	3.2	2.0	0.5	0.5
Domestic Financing	1.7	0.6	0.6	0.6
Government Domestic Borrowing	1.7	-1.5	0.0	0.0
Privatization	0.0	2.1	0.6	0.6
Memorandum Items:				
GDP Growth	3.5	4.0	4.0	4.0
Public debt/GDP (%)	67.8	40.1	35.9	33.8

Source: World Bank staff estimates

2.10 The estimate of sustainable deficit depends on assumptions regarding macroeconomic performance and the projected availability of financing. In particular, under the assumption that the Government implements a comprehensive structural reform and stabilization program to support private sector development and growth, Montenegro can expect a steady growth of about 4 percent per annum, the average growth rate of advanced reforming countries in Central Europe during the 1990s. Given such performance, Montenegro can also expect continued donor support, albeit at lower levels than recently. Foreign grants could decline to around one-half

[9] This analysis is presented for illustrative purposes and in no way defines an optimal macroeconomic framework. The analysis does not establish monetary or fiscal targets, which would require further analysis and consultation, including with the International Monetary Fund.

[10] This is based on a preliminary World Bank staff debt stock estimate of about 70 percent of GDP. This amount, however, may very well be understated. More will be known when Montenegro reaches agreement with the Federal authorities on its debt to the creditors of the former Yugoslavia. The projected halving of the debt stock by the end of the decade partly reflects debt stock reduction under the terms of the Paris Club agreement reached in 2001.

percent of GDP from the current level of about 3 percent. Consistent with the goal of sustainable economic growth, indebtedness must be controlled. Current levels of about 70 percent of GDP could come down to about 35 percent by the end of the decade. The public debt to GDP ratio is assumed to be stabilized at this level in the long run. This implies average net borrowing rates of no more than 1.5 percent of GDP, including both domestic and foreign credits.

2.11 In the event of poor policy implementation or adverse external shocks, the growth rate of the economy would be lower. Slower growth implies growing indebtedness and pressure on the budget if borrowing is not reduced. Poor policy performance would also reduce the availability of credit and could damage the prospects for grant assistance. Hence, with slower growth the sustainable deficit would tend to be lower. At a 2 percent rate of GDP growth, the deficit would need to decline to about 1.5 percent of GDP. A similar impact on the sustainable deficit would result if world interest were to increase by 50 percent and affect half of the external debt, which is a distinct possibility given the current historically low world interest rates .

2.12 Given a GDP growth of 4 percent per annum, a sustainable deficit of 2.5 percent of GDP would require that the Montenegrin Government make expenditure cuts of 2.5 percent of GDP (assuming there is no further boost in revenue relative to GDP). The increase in interest payments and rise of capital expenditure to about 4 percent of GDP implies that the fiscal savings would have to come from a 7 percentage point of GDP cut in non-interest current spending by the end of the decade. With slower growth and an equal level of commitment to public investment, non-interest current spending would need to be cut a further 1 percentage point of GDP to ensure sustainability.

C. Quasi-Fiscal Activities

2.13 Like governments in many other countries, the Government of Montenegro resorted to quasi-fiscal activities (QFAs), in an attempt to protect vulnerable social groups and politically influential enterprises from the economic shocks. The much needed, but politically painful reforms of the social protection mechanism, enterprise and banking sector, were stalled. Instead, energy and utilities were used to provide off-budget subsidies. Like in other such cases, these off-budget operations disrupted fiscal stability and resulted in the accumulation of large stock of unmet obligations, which threaten the Republic's long-term growth prospects and its capacity to fight poverty.

2.14 The most prominent class of implicit contingent liabilities in Montenegro is related to **enterprise and bank restructuring**. The authorities need to ensure fiscal stability by reducing the build-up of contingent liabilities in the enterprise and financial sectors. The 2002 budget allocates 0.7 percent of GDP to reform-related expenditure. Given the size of the financial problems in the enterprises and banks, it is likely that significantly more will be spent for this purpose in the future. The lack of adjustment in these sectors only postpones and enlarges the negative impact on the budget. While in the near future both the social and financial costs associated with reform are likely to be significant, such measures should be seen as an investment in the future. Prospects for private sector development and growth will improve with the elimination of quasi-fiscal deficits and enhanced financial discipline. Much larger costs of adjustment can be averted through early action.

2.15 The risks of increased costs due to delays in implementing policy reforms, particularly in the financial and enterprise sectors can be avoided through privatization, forced liquidation, and other means of corporate restructuring. Even with these measures, weaknesses in the enterprise and financial sectors could pose severe risks to the public finances of the Republic. The GOM plans to privatize Montenegro Banka, the Republic's largest financial institution. Before the bank can be sold to a strategic investor, however, its balance sheet will need to be strengthened. Current plans call for the removal of foreign debts and frozen foreign currency accounts from the balance sheet, and the conversion of these liabilities into public debt. This is potentially a costly recapitalization that will need to be carefully managed by the government. The experience of Serbia suggests that the frozen foreign currency liabilities alone could have a significant impact on the budget. If such obligations are indeed assumed by the government, any repayment arrangement should attempt to minimize the annual cash outflows from the budget.

2.16 In addition, Montenegro needs to continue to strengthen the regulatory, supervisory, and judicial frameworks to ensure that proper financial standards are met. This is essential to prevent large-scale bank failure and to limit the size of contingent liabilities. While Montenegro is already establishing the proper statutory framework in the banking system, there may be inadequate capacity to supervise institutions and enforce prudential regulations and other rules. This capacity will become increasingly important as the Republic becomes creditworthy in the eyes of potential foreign creditors. International experience shows that without an adequate regulatory and supervisory framework banks are likely to take excessive risks, particularly when the amount of regulatory capital is low or depleted. Under these circumstances, many large borrowers are able to overstretch their balance sheets and ultimately transfer the costs of their risky behavior to the taxpayers.

2.17 The privatization strategy needs to be managed very carefully. Montenegro completed mass voucher privatization (MVP) at the end of 2001. The use of privatization funds to manage assets can be an efficient way of consolidating the diffuse ownership of vouchers and of diversifying risk. The funds could also help to drive enterprise restructuring through active corporate governance. Still, the experience of the Czech Republic and other transition countries suggests that such an approach can be fraught with fiscal risks if an adequate regulatory framework governing enterprises, investment funds, and banks, is not in place. In addition, a successful approach demands that investment fund managers have the resources and expertise to carry out their functions. Otherwise, the mass privatization now being carried in Montenegro could result in massive losses to investors and large contingent liabilities for its Government.

D. A Case Study of the Power Sector

2.18 The Montenegrin energy sector is characterized by severe financial imbalances that have important implications for fiscal sustainability. Unlike Serbia, Montenegro has been a net importer of electricity for more than twenty years, which has resulted in an inability to meet demand during the winter months. Low prices, along with up to four hours per day of electricity outages have had a considerable negative economic impact.

2.19 The Republic's power company, EPCG, operates with tariffs that do not cover its costs and is forced to postpone necessary maintenance expenditures and system upgrades. It must also contend with unstable supplies of coal due to financial, technical and organizational problems in

the mining companies. The low quality of electricity supply distorts business incentives and leads companies to prioritize the purchase of backup generators rather than to undertake energy-saving investments. Although less than their Serbian cohorts, Montenegrin households use subsidized electricity for heating and have little incentive to conserve energy. At the fiscal level, these distortions redirect scarce resources from urgent spending priorities towards subsidies and expose the Republic Budget to substantial fiscal risk.

High Costs of Production and Low Tariffs

2.20 The energy sector in Montenegro is dominated by several large and inefficient state-controlled enterprises. In addition to the vertically integrated electricity monopoly (EPCG), there are the Pljevlja coal mines, the largest coal suppliers to EPCG, and the vertically integrated oil and gas company, Jugopetrol Kotor (the latter has been privatized in 2002).[11] The coal mines are plagued by low productivity and high costs. While internationally the average cost of producing coal output is DM 30 per ton, in Montenegro the average cost is DM 45 per ton. The inefficiency of coal production stems from labor redundancy, excessive spending on capital equipment, and a lack of funds for removing the overburden.[12] Preliminary research indicates that under current levels of operating efficiency the mines are able to cover the full cost of production only with the current high selling price of DM 42 per ton of coal.

2.21 Inefficiencies throughout the system have important implications for electricity prices and, more generally, for the cost structure of the economy as a whole. Low productivity at the coalmines is passed on to EPCG. The current contract between EPCG and the coalmines sets a coal purchase price that is DM 12 per ton above the international average. On top of this, one must add the effect of inefficiencies in electricity generation.[13] Although capacity utilization is about 50 percent of the level for which the plants were designed, Montenegro must import 28 percent of the electricity consumed in the Republic due the lack of regular maintenance of generators. In the winter, the cost of producing and importing electricity can be especially high.

2.22 In principle, the operating cost of producing a megawatt-hour of power is covered by the average price of electricity. Operating costs are estimated to be US$27/MWh, while the average price of electricity is US$30/MWh. Full cost recovery, however, is not achieved because this excludes financing costs and non-cash operating expenses such as depreciation. It also excludes additional maintenance and investment that normally is required to prevent the interruption of power. The imbalance between revenues and expenses is made worse by the low collection rate, which averages around 75 percent. Since consumers do not pay the full cost of electricity, EPCG often lacks liquidity and is forced to engage in barter. In 2001 EPCG effectively made a loss of US$ 75 million or about 8 percent of GDP. In the end, these quasi-fiscal deficits result in the build-up of contingent public liabilities, since immediate savings on insurance, maintenance and other costs ultimately may force much larger cash outlays in the future.

[11] This chapter focuses only on the electricity/coal complex as the largest source of fiscal pressures.
[12] Overburden is the soil and its contents that must be dug out to get at the coal.
[13] The high cost of supply refers to the thermal power plant only. Hydro-electrical output, which accounts for 69 percent of all production, is generated efficiently.

2.23 Recognizing these dilemmas, the Government has developed and begun to implement a program of price adjustments. In November 2001, the average tariff was raised 50 percent in relation to the same period in 2000. In 2002, the Government decided not to implement the traditional shift to lower summer tariffs and kept the average price at around US$37 per MWh. By the winter of 2002/2003, the average tariff will be raised an additional 25 percent. It is expected that these increases will put EPCG on a sounder financial footing.

Subsidization of Industry and Households

2.24 The long-term solution to the financial imbalances in the energy sector will need to involve other measures besides adjustments to tariffs. Households and KAP,[14] the state-owned aluminum producer, are subsidized with cheap electricity at the expense of the rest of the economy, which pays significantly higher tariffs. An exclusive focus on energy price policies, therefore, would ignore the inefficiencies in the sector, and would further restrain economic growth. Accordingly, EPCG has announced a program for disconnecting non-payers and is committed to reducing the growth of account receivables and limit the use of barter. A new energy law is being developed, which will, among other goals, regulate the monopoly components in the sector and allow competition where it is feasible.

2.25 As KAP is EPCG's largest client, accounting for 43 percent of total electricity consumption, any attempt to significantly reduce quasi-fiscal deficits solely with a price increase could adversely affect aluminum production. Since KAP is a price taker in world commodity markets, it cannot simply pass on higher costs to its buyers. In general, the profitability of any aluminum producer is critically dependent on cheap electricity.[15] The changes in electricity tariffs described above, therefore, do not apply to KAP. Since KAP relies on equipment and services from other domestic sectors, its financial well-being is important to the broader economy. This includes EPCG, whose revenue and liquidity are closely tied to sales of electricity to KAP. When aluminum prices are low, it is more difficult for KAP to meet its obligations to suppliers and the government. Owing to liquidity problems, KAP ordinarily pays for electricity with a 60-day lag. These stubborn financial problems are shifted to EPCG, which is forced to finance the receivables from KAP, its most important customer, with short-term borrowing. Currently it rolls over debts totaling DM 100 million, split about evenly between public and commercial bank credits. The public component of the debt is subsidized, but interest on private credits is over 25 percent. Any plan to resolve the problems of the energy sector, therefore, must address the operating inefficiencies of KAP. Recognizing this, the Government is formulating a time-bound program which addresses ownership and all operating issues of KAP.

[14] KAP currently pays $20/MWh for electricity delivered at 110 kV. This high voltage results in less network loss and allows EPCG to supply power below the cost of output to other consumers. The plant was built based on utilization of Montenegrin hydroelectric power, the cost of which is well below the current price of electricity. The current electricity price to KAP is roughly in line with global electricity prices to aluminum smelters.

[15] In the future, a reorganized KAP may be able to absorb higher power costs. Currently, the company is overburdened with substantial surplus labor.

Fiscal Implications

2.26 The linkages between the financial imbalances of the energy sector and the Republic Budget are complex and extend beyond the diversion of resources to provide subsidized liquidity loans. As in Serbia, attempts to deal with the financial difficulties in the energy sector have lead instead to a buildup of inter-enterprise obligations and debts between the Government and enterprises, including supplier credits and tax debts. Periodically, these obligations are reduced, but not permanently eliminated, through offsets and barter arrangements between the various debtors. In the case of the power sector, these transactions account for about 30 percent of total revenue of EPCG, and include the offsetting of taxes and credits against the electricity bills of public institutions. Thus the problems in the energy sector ultimately spillover to both the revenue and expenditure sides of the budget through low revenue collection and excessive spending on subsidies. Poor financial outcomes in the sector also tend to weaken the broader economy and limit the tax revenues that potentially could be collected.

2.27 Moreover, the problems inherent in the structure of the energy sector create large risks for budgetary instability. The low level of maintenance at EPCG could lead to a prolonged failure of the power plants. A breakdown in the system could require massive, unplanned expenditures aimed at restoring electricity to industry and households. In 1995, the sudden breakdown and replacement of the turbines at the Pljevlja thermal power plant cost the budget US$ 45 million, or about 4.3 percent of 2001 GDP. Any such calamity would require an urgent shift in spending away from social programs, debt service, or other important priorities to restore electrical power.

2.28 Spot market purchases also create risks for the budget through imports of mazut for KAP. A sharp increase in price can reduce KAP's liquidity and affect the ability of the company to pay taxes and make transfers to various segments of the economy, including Podgorica's water supply company. These risks apply equally to the importation of electricity. The biggest risk comes from the portion of imports that is for KAP. According to a contract with the Government, the aluminum producer purchases this power at a price of US$20/MWh. By guaranteeing this price, the budget is exposed to the risk of fluctuating electricity import costs. In 2001, the difference between higher-priced electricity imports and the tariff charged to KAP cost the budget US$ 5 million.

E. Policy Recommendations

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

- Limit new debt issuance to contain debt service costs and to avoid the crowding out of private borrowers. This measure should be introduced soon, and maintained until significant improvement of the Republic's debt carrying capacity;
- By end-2002, establish a fiscal risk management function at the MOF to monitor and assess budgetary risks;

- By 2003, raise electricity tariffs to cover operating and debt service costs, improve financial management at EPCG to cut supply costs, implement a collection policy to reduce barter and offsets, and audit the accounts of EPCG;
- Promptly increase maintenance spending at EPCG (most urgent needs in 2002), and consider selected key investments for 2003;
- By 2003, reduce KAP's dependence on low tariffs and diminish the risks it poses to the public finances.

2.30 Beyond this prioritized list of necessary changes, additional measures will be needed to achieve financial balance in the energy sector and increase operating efficiency to optimal levels. It is estimated that Montenegro needs foreign financial assistance totaling US$ 35 million to cover the costs of implementing the recommendations above.

2.31 This chapter has examined the major sources of fiscal and quasi-fiscal imbalances and threats to sustainable economic growth in Montenegro. It presents estimates of the amount of expenditure reduction needed to promote sustainability and a set of key policy recommendations. A complete analysis of the impact of public expenditure on macroeconomic stability and growth, however, must also examine the allocation of spending. The next chapter examines the structure of spending in detail and makes recommendations on how to improve expenditure allocation.

3. ALLOCATION OF PUBLIC SPENDING

3.1 This chapter considers the allocation of public resources across key spending categories in Montenegro. It aims to identify both where the spending level appears excessive, poorly targeted, or inefficient, and where spending may need to be expanded. The chapter looks at the economic and functional composition of general government expenditures.

3.2 Analysis of allocative trends in public spending of Montenegro is complicated for several reasons. First, trends are difficult to establish, as data for 1999 and earlier years are not fully comparable with 2001-02, owing to the existence of multiple exchange rates prior to 2000. Second, data in the GFS breakdown are not available before 2001. Third, a substantial part of public spending takes place outside the Republic Budget, in three extrabudgetary funds.[16] Fourth, spending is recorded on a cash basis and is not a good indication of allocative patterns, as the budget has run up significant arrears in all recent years, and the budget outturns differ significantly from the legislated spending levels. Fifth, a large part of donor money is spent outside the budget, particularly on social needs. Sixth, as in Serbia, own funds of some direct spending units[17] are significant. While they have been included in the legislated budget since 2001, the newly-established Treasury system still does not cover them, so budget execution data for this flow of funds is very sparse. Finally, unreliable GDP data make cross-country comparisons of spending levels less meaningful.

3.3 Since 2000, the Government of Montenegro has taken progressive steps to increase the comprehensiveness of the budget (see Chapter 5). Apart from the three social funds (see Box 1.1), no public sector agencies are funded outside of the budget.[18] These steps have brought Montenegro's Republic Budget closer to good international practices.

A. ECONOMIC COMPOSITION OF GENERAL GOVERNMENT OPERATIONS

3.4 The key allocative patterns in Montenegro are as follows:

- **Overall levels of consolidated government expenditures** are large (over 40 percent of GDP), and the **extrabudgetary sphere** (social funds) is large compared to the

[16] Data on local governments are incomplete and thus cannot be consolidated with central government spending.
[17] Two terms are common to the budget systems of all former SFRY Republics: direct and indirect spending unit. Direct spending units (DSUs) are the line ministries and other organizations receiving funds directly from the Budget (e.g., Ministry of Education). Indirect spending units ISUs are second line users (e.g. public schools); they receive funds from DSUs.
[18] This volume follows Volume 2 in defining public sector agencies as excluding public enterprises.

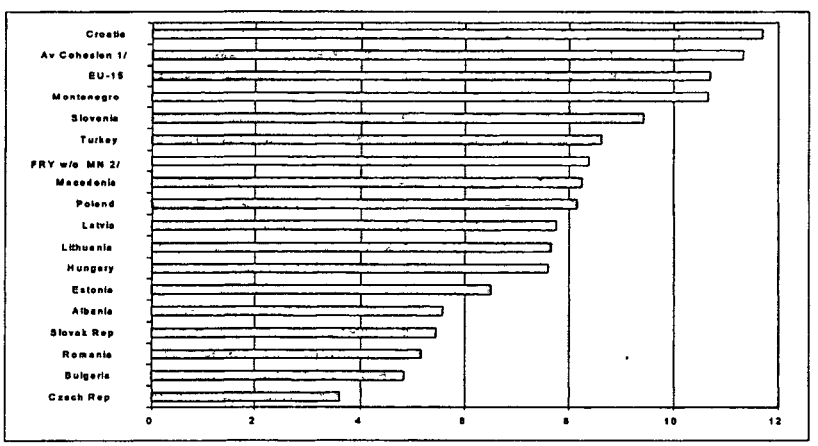
budgetary system, which is not good practice, as the transparency and accountability practices of the latter are weaker than those of the Republic Budget;

- **Spending on wages and salaries** is significant: both as a share of GDP and as a share of total spending, it is higher than in Serbia and the CEEC[19] average;
- **Spending on goods and services** is below regional levels;
- **Social transfers** are above the regional mean and are closer to wealthier countries, which (this raises sustainability concerns, discussed in Chapter 4);
- **Subsidies** are close to the region's average; however, the rising trend is worrisome;
- **Budgeted capital spending** is very low but, as in Serbia, much of capital spending is not captured by the consolidated government statistics, as it occurs with donors' support outside of the budget; and
- **Interest payments** have been very low but will be increasing steadily in the near future, constraining the fiscal space.

3.5 The non-discretionary component of public spending (wages, social entitlements, and foreign interest payments) is quite significant. The latest rises in the overall spending levels are mostly related to the expansion of such non-discretionary items. These increases would be acceptable if they were accompanied by real structural reforms, which would promise efficiency gains in the near future. However, the upward drift of expenditures may also indicate the continuation of the past unsustainable policies.

3.6 **Public Sector Wages and Salaries** make up the largest non-discretionary spending item. Spending on this item was above 12 percent of GDP in 2001, which is significantly higher than in Serbia and in most other CEEC (Figure 3.1). The real wage bill would be even higher if data on temporary workers are included. Like in Serbia, salaries of temporaries are funded from the goods and services budget. On the positive side, the GOM appears to have put a brake on the wage bill in the 2002 budget, after steep increases in 2000-2001.

Figure 3.1: Public Spending on Wages and Salaries, Percent of GDP



Note. Data for FRY and Montenegro are averages for 1997-2001, for EU and CEEC the data are averages for 1995-2000.
(1) Cohesion countries are Spain, Greece, Ireland and Portugal. (2) FRY w/o MN is FRY without Montenegro.
Source: World Bank and IMF staff estimates

[19] CEEC are Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, FYR Macedonia, Poland, Romania, the Slovak Republic, and Slovenia.

3.7 **Non-wage Goods and Services**. This category of spending is significantly higher in Montenegro than in Serbia, and is close to regional average. This reflects the classification of wages of temporary workers under this rubric. Indirectly, this is confirmed by the significant variability of this category: the steep decline in spending on it in 2001 reflects the layoffs of many temporary workers (including by the Ministry of the Interior). With spending on temporary workers taken out of this category, expenses on goods and services are low, and may be inadequate to properly maintain public assets.

3.8 **Interest on Debt**. Montenegro's interest payments have been low, primarily owing to the default situation in which FRY had remained for the past decade. Almost all interest payments were on very small domestic debt. In 2002, interest payments are budgeted at about 2.0 percent of GDP. Further increases in interest payments over the next three years will be slower, due to strict ceilings on domestic financing (as envisaged under the IMF program), and due to the highly concessional terms applied in rescheduling of SFRY-era debt, as well as for any new external financing. Nevertheless, the Government should not conclude that there is room to incur more debt: more borrowing would be undesirable, weakening investors' confidence. Budget execution results in 2001 indicate that the high borrowing path cannot be totally ruled out – as opposed to the previous years, three-quarters of the Republic Budget deficit was financed with domestic debt.

3.9 Budget **subsidies** in 2001 were modest at 1.2 percent of GDP, and targeted toward large public and socially owned enterprises such as EPCG. While existing budget subsidies to enterprises have declined over 2000-02, off-budget subsidies persist, and are in fact much higher than the on-budget ones. [20] If the latter cannot be phased out completely, a good fiscal practice would be to bring them on budget, making Montenegro's fiscal policy more comprehensive and transparent.

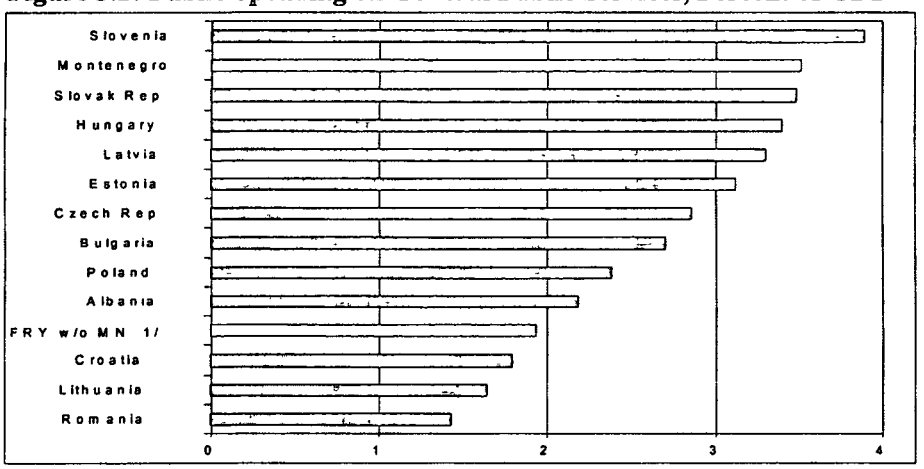
3.10 Montenegro's **budget lending** to enterprises is close to 1.4 percent of GDP, and in 2001 showed a large expansion compared to the budgeted level. Some of these loans are subsidized at interest rates below inflation, with the budget absorbing the loss (most of budget loans went to EPCG). The steep rise in budget lending is disturbing on the grounds of equity and efficiency, since budgetary loans have poor collection records, and the Republic MOF has a very limited capacity to manage this loan portfolio.

3.11 **Grants and Social Transfers.** Montenegro is facing a pressure to maintain or to increase spending on social protection. Unemployment and other social support payments are set to grow as loss-making enterprises are privatized and restructured. Yet the existing system of social transfers and grants is not affordable, and maintaining its level is not an option. The budget-funded social protection schemes, mainly child and maternity benefits, are relatively small. Most transfers for social support come from three extrabudgetary funds, which are in a difficult financial condition (see Chapter 4). Montenegro's level of social transfers as a share of total spending, as well as a share of GDP, puts it well above the regional average. Furthermore, the percentage of social spending in overall spending is growing, suggesting the Government may have difficulty in establishing discipline in these areas.

[20] Primarily in the form of tax expenditures, regulated utility tariffs and non-enforcement of tax and tariff collection.

3.12 **Capital Spending.** Capital spending is about half the regional average in terms of its share in total general government spending, and has been declining as a share of GDP since 1997. In 1999-2001, it averaged 2 percent of GDP. Unlike in Serbia, there was no rebound in this spending item in 2000, and further cuts are budgeted for 2002. Over the past decade, and possibly longer, Montenegro has been under-investing in public assets, in particular in infrastructure, compared with other countries of the region of similar income levels, and is now at the bottom of the regional league. Capital spending is also volatile, which confirm that it was used as a balancing item – a practice typical for countries under budget stress.

Figure 3.2: Public Spending on General Public Services, Percent of GDP



Note· Data for FRY and Montenegro are averages for 1997-2001, for CEEC are averages for 1995-2000
FRY w/o MN is FRY without Montenegro.
Source World Bank and IMF staff estimates

B. Functional Analysis of Public Expenditure

3.13 The problems faced in analyzing the functional distribution of Montenegro's general government include short time series, classification problems (related to the unfinished implementation of the new GFS-based budget classification), and inadequate coverage, as local governments are not included in the consolidation. From the data for 2000 and 2001, the following conclusions can be drawn:

- The two largest functions are **social security** (including pensions) and **health**, which together account for over 60 percent of general government spending;
- **General public services** are also oversized, even before the resumption of interest payments, which are included in this category;
- **Recorded public order and safety** spending is broadly in line with regional comparators;
- **Economic affairs** spending includes mostly subsidies to public enterprises and to agriculture; and
- **Education** spending is comparatively high, while its efficiency is low, with a distortion toward oversized tertiary education.

3.14 **General Public Services.** As a share of both GDP and total spending, Montenegro allocated to this function more than other transition economies (Figure 3.2). In the future, the

level will rise even further, as interest payments (which are classified under this heading), will rise progressively. Rationalization of non-interest spending in this category may be advisable.

3.15 **Public Order and Safety.** Defense is a federal responsibility, so the Budget of Montenegro does not include defense allocations. However, policing is a republic responsibility. Montenegro spends slightly more than the regional average on public order (about 2.5 percent of GDP in 2001) [21]. As the reasons for significant allocations to this function have ended with the toppling of the Milosevic regime, the GOM expects to reduce further the levels of spending on this function.

3.16 **Education** is the second largest function after social protection and welfare, and accounts for about 11 percent of total spending. The level of spending on education is over 4 percent of GDP, which is in line with the regional levels, though higher than in Serbia. The Montenegrin and Serbian education systems share the same quality issues, as outlined in the second volume, such as: (i) a bias in favor of wage bill, at the expense of spending on supplies and equipment; (ii) a bias toward tertiary (university) education at the expense of the primary education system; and (iii) a lack of performance-oriented criteria. The bias towards tertiary education is further exacerbated given its large own revenues, which are still not included in the Republic budget.

C. Policy Recommendations

3.17 Based on the preceding analysis, the following recommendations can be made for the near term:

- **Reverse the rise in public spending**, and prepare sector-specific strategies aimed at generating savings (for example, in general public services);
- **Stabilize the public wage bill** in real terms as a percent of GDP and begin formulating approaches to public service reform;
- **Phase out subsidies and budget loans** to enterprises not specifically linked to covering the costs of restructuring; and
- **Identify selective public investment activities** in vital sectors of the economy such as infrastructure, strengthen the capacity of the MOF to manage the risks of such projects, increase the transparency of donor funds by bringing them fully on budget, and
- **Bring quasi-fiscal subsidies on budget**, to reveal their true cost.

3.18 Most of the savings can be achieved, however, only over the medium term, via the following measures:

- **Strictly limit government borrowing**, to prevent new destabilization of the debt situation;
- **Restructure the social protection system**, to set it on the road towards sustainability; and
- **Phase out quasi-fiscal subsidies**, particularly in the energy sector.

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

4. SPENDING ON PENSION AND HEALTH CARE

A. THE PENSION SYSTEM

4.1 The Montenegrin pension system is unsustainable, with legal obligations towards pensioners and other beneficiaries well in excess of revenues coming from payroll contributions. The system deficit in 2001 was of the order of DM 109.7 million, or 5.6 percent of GDP. While the GOM is projecting the deficit to fall in 2002 to 4.3 percent of GDP, this is heavily dependent on improvements in contribution compliance. The Government itself did not meet its contribution obligations in 2001.

4.2 Public expenditure on pensions in Montenegro is very high. Cash spending in 2001 was estimated at 13.2 percent of GDP, which puts Montenegro at the high end by regional and OECD standards[22]. If the Pension Fund met its legal obligations in full, the figure would have been 14.9 percent of GDP (Table 4.1).

4.3 Not surprisingly, payroll contribution revenues covered only a fraction of obligations over the last three years. In 2001 they covered 55 percent of Pension Fund expenditures. The remaining balance was met out of additional tax revenues[23] and contributions from donors. This figure may be somewhat overstated, owing to the fact that contributions are in arrears, with the GOM itself being one of the largest debtors to the pension system. There is little doubt, however, that the system is seriously imbalanced.

4.4 The main factors underlying the pension system deficit are as follows: (i) a sharp decline in the ratio of contributors to beneficiaries to the current level of 1.4 contributors per beneficiary,[24] (ii) benefit provisions which are overly generous and essentially unaffordable,[25] and (iii) the historical factors which enable the structural imbalances to persist. Traditionally, system deficits were met through a system of Federal transfers. Owing to a breakdown in

[22] In the mid 1990s average spending on pensions as a share of GDP in Central and Eastern Europe was 8.5 percent, and ranged from 5.1 percent (Albania, 1995) to 14.4 percent (Poland, 1995). The OECD average was 10.0 percent. See Palacios and Pallares-Mirralles (2000).

[23] In addition to the payroll tax (24 percent of gross wages), pensions are funded out of redirected Federal revenues (arising from the Federal share of sales tax, excise tax and custom duties), and other special taxes. The Pension Fund also receives a (small) income from ZOP and PTT, and other sources (fines, interest, etc.). See Table 4.1 for shares in total revenue.

[24] There was a vast expansion in the number of both pension and non-pension beneficiaries during the 1990s, and a decline in the effective number of contributors. The incidence of take-up of disability pension in Montenegro is particularly high.

[25] Average replacement rates (ratio of net pensions to net wages) are around 90 percent. For old-age pensions, replacement rates are higher.

relations with the Federal Government, these transfers ceased in 1998, and the GOM redirected a share of customs revenue and surcharges notionally owed to the Federal Government to the Pension Fund.

4.5 The sections that follow are devoted to understanding the financial status of the Pension Fund (PIO) during 2000-2001, assessing the projected budget of the Pension Fund for 2002, and drawing conclusions. Table 4.1 shows the revenues and expenditures on a cash basis of the Pension Fund during 2000 and 2001, based on budget execution data for the Republic and the Pension Fund Budgets for 2000 and 2001, and PIO forecasts for 2002.

The Year 2000

4.6 In 2000, PIO spending amounted to 14.7 percent of GDP. Seventy percent of this (10.2 percent of GDP) was on pensions. Health contributions were another 16 percent (2.3 percent of GDP).[26] The remainder (a high 2.2 percent of GDP) was spent on non-pension benefits and on administrative expenditures (not including salaries and benefits of the PIO employees). On the revenue side, contribution revenues accounted for over 63 percent of revenues (9.3 percent of GDP), but redirected funds (federal tax revenues redirected to the Pension Fund) and donor funding were also important. Redirected funds were 21 percent of revenues (3.1 percent of GDP) and donor funding 9.6 percent of revenues (1.4 percent of GDP).

4.7 Pension systems have many functions, including providing income-smoothing over one's life, insurance against risk (especially disability, widowhood, and orphanhood), and redistribution of wealth. Though primary functions of a contributory pensions system include saving and insurance, it should, in general, operate on the same principles as the market, i.e. be self-financing. While some redistribution should be expected, best practice in this area suggests that the redistribution should be transparent, directed at the most needy, and provided out of general revenues. Whether a system is sustainable depends on whether it can meet the bulk of its obligations and administration costs with the payroll contributions received. A notional deficit or surplus can be calculated as the difference between benefits (including administration costs) and contribution revenue.

4.8 Computing the balance of the Montenegrin system requires information on actual payments of obligations, generation of new benefit arrears, and the level of contribution compliance. Twelve pensions were paid in 2000, and there was a 2-month lag in payment. This is likely to have resulted in some savings for the Pension Fund, as delayed pensions are typically not indexed. For ease of computation, this section ignores this factor and assumes that pensions were paid in full. Health contributions also appear to have been paid in full (particularly based on the higher MOF figure);[27] this presentation also ignores any new arrears in other non-pension benefits. On the revenue side, little information is available to assess contribution compliance, but available data indicates that it is low. The GOM, as mentioned above, does not typically

[26] There is a discrepancy between the Pension Fund's and the MOF's execution data. According to the Pension Fund DM 17.5 million was paid to the Health Fund in 2000, whereas the MOF puts health contributions at a higher figure of DM 37.7 million.

[27] The PIO has to pay 19 percent of pensions and two main invalidity benefits to the HIF.

make full payments on its social contributions. The data is not available to fully assess the extent of the Government's contribution compliance in 2000.

4.9 On the basis of these assumptions, the deficit of the Pension Fund for 2000 was DM 85.7 million or 5.3 percent of GDP,[28] and largely financed through additional tax revenues and donor assistance. In sum, there is little direct subvention from the Republic Budget to the Pension Fund (DM 1.9 million or 0.12 percent of GDP). If the pension system were largely self-financing, there would be an additional 5.3 percent of GDP to spend on other priority areas (including support for low-income pensioners if that was deemed a priority), or equivalent fiscal "space" to reduce taxes, or some combination of the two. In order to be largely self-financing, the system would need to impose the equivalent of an additional tax of 13.6 percent on the payroll, raising the effective contribution rate from 24 percent to 37.6 percent.

The Year 2001

4.10 On the expenditure side for 2001, two observations can be drawn from the second column of Table 4.1 presents execution data. First, there appears to have been a sharp increase (25 percent) in spending on pensions from DM 166.4 million in 2000 to DM 208.4 million in 2001. Some of this increase represents the clearing of arrears.[29] The payment of pensions however seems to have come at the cost of paying health contributions, which declined sharply during 2001.[30] On the revenue side, the noticeable changes are the sharp rise in redirected funds (19.8 percent) and donor assistance (47.8 percent). Other sources of income also rose substantially.[31] The only source of revenue that did not display marked buoyancy is revenues from payroll contributions, which declined by 4.3 percent. As a result, the deficit of the pension system rose from DM 85.7 million in 2000 (5.3 percent of GDP) to DM 109.7 million in 2001 (5.6 percent of GDP).

4.11 Budget execution data in Table 4.1 (Column 3) provide a preliminary estimate of the deficit of the pension system deficit on an accrual basis, which is different from Column 2, based on three assumptions: (i) under pension spending, it is assumed that in 2001 only the 12 pensions due were paid, while pension arrears from earlier years are assumed not to have been paid, and (ii) health contributions were paid in full, and (iii) the Government paid its contributions in full.[32] Column 3 suggests that the deficit for 2001 on an accrual basis was DM 125.3 million (6.4 percent of GDP). Thus, if the pension system were to meet all its obligations and receive its contributions in full (at least from the Government), the system would still run a deficit.

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[28] The deficit is defined as benefits minus contribution revenues. Benefits includes all benefits paid from the Pension Fund with the exception of special purpose funds and investments. The size of the deficit obviously depends on which benefits are included. Dropping some of the non-pension allowances and compensations would make the deficit of the pension system appear smaller. However, it would expand the deficit of the general government, unless the legal obligation to pay the benefits was to cease.

[29] According to the Pension Fund's execution data, 12.5 pensions were paid in 2001, reducing the outstanding stock of pension arrears by half a month.

[30] The decline in 2001 is relative to the budget execution data from the MOF. As indicated in footnote 26, there is a discrepancy between execution data from MOF and PIO for 2000.

[31] Income from special taxes rose by 44 percent, income from ZOP by 46 percent and other revenues by 512 percent.

[32] According to the MOF's budget execution data, if the Government were to pay its contribution in full it would have needed to pay an additional DM 20.2 million to the PIO during 2001.

Table 4.1: Revenues and Expenditures of the Pension Fund

(DM million)	2000	2001	2001 (accruals)	2002 (Proj.)
	1	2	3	
EXPENDITURES				
Pensions (old-age, invalidity, survivors')	166.4	208.4	214.6	241
Allowances for assistance and care	4.0	4.8	4.8	5.3
"Compensations" (physical disability, category II and III disability, funeral expenses)	13.6	10.8	10.8	12.0
Health contributions	37.7[33]	17.9	43 7	41.0
Special purpose funds· recuperation and recreation, housing support, support for pensioners associations etc.	0.6	4.8	4.8	4.8
Administrative costs[34]	11.8	8.6	8.6	8.8
Salaries and benefits[35]	2.6	3.2	3.2	4.1
Investment	1.7	1.4	1.4	1.6
TOTAL	*238.5*	*260.0*	*291.9*	*316.8*
As a share of GDP	*14.7*	*13.2*	*14.9*	*13 9*
REVENUES				
Payroll contributions	150.5	144.1	160.4	201.6
Redirected funds	50.3	75.8	75.8	0.0
Budget transfers	1.9	0.0	0.0	99
International donor assistance	23.0	34.0	34.0	0.0
Income from special taxes	7.2	10.4	10.4	10 2
Income from ZOP	4.8	7.0	7.0	7.0
Other revenues	0.8	4.9	4.9	1.8
TOTAL	238.5	276.3	296.5	320
DEFICIT				
BENEFITS[36] – PAYROLL CONTRIBUTIONS	85.7	109.7	125.3	108.8
GDP	1625	1963	1963	2271
Deficit as a share of GDP (percent)	5.3	5.6	6.4	4 8

Source: Staff estimates, based on MOF and PIO data.

The Year 2002

4.12 The final column of Table 4.1 reports the projected budget for 2002. Spending on pensions is expected to rise in line with nominal GDP, from DM 208.4 million to DM 241 million. Total spending from the Pension Fund is set to increase from DM 260 million (13.2 percent of GDP) to DM 316.8 million (13.9 percent of GDP). The deficit of the pension system is projected to decline to DM 108.8 million (4.8 percent of GDP), largely as a result of anticipated improved compliance with payroll contributions. If this target reduction is to be met, it will be important for the Government to fully pay its contributions in a timely manner.

[33] See footnote 26 on the discrepancy between the Pension Fund and the MOF's execution data. The Pension Fund has a lower figure for health contributions, and total spending is correspondingly lower (by around DM 22 million).
[34] This includes the cost of disbursement of pensions (PTT costs, costs to checks, ZOP fee, etc.) and the funds for the technical-administrative (computer department).
[35] This is understood to be staff salaries and benefits, but is not fully confirmed.
[36] Benefits include all PIO expenditure except Special Purpose Funds and Investment.

Policy Recommendations

4.13 The short-term "remedies" (notably, reliance on additional taxes and/or budgetary support and donor assistance) used to date do not offer a sustainable solution to the problem of an oversized pension system. Recent measures in the 2002 budget to make the subsidy to the pension system more transparent by replacing "redirected" funds with an earmarked subvention from the budget to the Pension Fund are a step in the right direction. The Government should build on this by:

- taking measures to replace all hidden subsidies with explicit ones; and
- implementing measures that would reduce the level of subsidies to the pension system over time.

This should include measures to (i) raise the retirement age; (ii) change the benefit formula to bring benefits from the system more in line with contributions; (iii) change indexation so as to move away from full wage indexation; and (iv) re-qualify disability pensioners (especially those with continued ability to work).

4.14 Over the medium-term, the Government may wish to encourage the diversification of sources of pensioner income through the introduction of privately managed mandatory and voluntary funded pensions. Implementation of such a system should be carefully planned, so as to be consistent with the macroeconomic and balance of payments position of the country, as well as be within institutional capacity for implementation and ability to finance transition costs.

B. THE HEALTH FINANCE SYSTEM

4.15 The health care sector in Montenegro suffers from a number of structural problems which seriously limit its ability to deliver effective and quality care and that impose large costs on the public finance. These problems include: (i) an inadequate incentive structure; (ii) provision of almost universal coverage, with increasingly weak links between contributions and entitlements to services; and (iii) the accumulation of large arrears owed to the Health Insurance Fund (HIF) by other social funds and by a number of large companies in financial difficulties. These problems, coupled with declining employment, stagnant wages and contributions - and a liberal package of services, have led to an accumulation of large debts on the part of the HIF, which seems to be on the brink of financial collapse. This is clearly an unsustainable situation. Sustainability requires that the gap between the HIF revenues and its expenditures be bridged.

4.16 This section discusses mainly the financial sustainability of the health care finance system in Montenegro. Issues in budget management in the HIF are outlined in Box 4.1.

4.17 **Health Care Financing** in Montenegro relies on a combination of public finance and private contributions. Public funding is primarily channeled through the HIF. In 2001, more than 95 percent of HIF income came from earmarked contributions and a similar figure is expected

for 2002.[37] In 2001, 80 percent came from payroll contributions, with the second largest source being the Pension Fund. Although over 25 percent of the contributions were supposed to come from the Pension Fund in 2001, actual contributions reached only 17 percent.[38] Three percent of the Fund's income came from self-employed workers (4 percent was expected) and 0.16 percent from farmers. The Labor Fund has not paid any contributions for the temporary unemployed in

Box 4.1: Financial Management in the Health Insurance Fund of Montenegro

The HIF of Montenegro is an independent legal entity operating a budget parallel to the Government process. The HIF maintains its own bank accounts, collects its own revenues, and executes its own financial plans. The HIF has branches in each municipality. All invoices or claims are received at the municipal branch, and transmitted daily to headquarters. All payments are initiated from headquarters.

Revenues. The payroll contribution rate for health insurance is set by the Government. The HIF can propose a level, the Ministry of Health can modify the recommendation, and ultimately the Ministry of Finance and Government decide the rate. ZOP has been the primary enforcement mechanism for revenue collections, and if ZOP is abolished, the HIF will either have to develop its own collection office or rely on the public revenue administration. Even with ZOP, some payment problems have emerged with the Republic not paying for employees, Pension Fund not paying for retirees, and some enterprises under financial stress not making their contributions to the HIF.

Expenses. Benefit levels are determined by the Health Insurance Law, and all citizens are insured. The HIF must contract with all health providers in the country. There is very little scope for controlling expenses. The HIF did initiate a commission to review and approve referrals for treatment outside of Montenegro, which reduced expenses. The HIF also has some ability to control pharmaceutical expenses through a commission that maintains the positive list of approved drugs. However, health policy, including capital construction, is the purview of the Ministry of Health, and new construction does entail added costs for the HIF (though it is not consulted).

Financing. The HIF has authority to take out loans from commercial banks, and has used this to finance cash flow problems. The loans are short-term loans, even though the cash flow problems are from more chronic revenue and expenditure imbalances. Moreover, the HIF does buy on credit from suppliers. The HIF did not know the current total outstanding liabilities.

Budget and financial planning. The HIF time horizon for financial planning is one year. The HIF begins preparing its budget receiving the guidelines and normative marks from the Ministry of Finance. After receiving the mark, the Fund draws up a needs-based budget (bottom up) based on the prior year's spending. The Fund does not do any analysis for setting policies and controlling costs. After the HIF develops its budget, the Fund's Board must approve the budget. Then the budget goes to the Ministry of Health. MoH could make changes, but traditionally does not. The MoH submits the Fund's budget to the Ministry of Finance, which also does not review or change the budget. The budget is transmitted to Parliament along with the Republic Budget. In 2001, the Fund was audited by the independent auditor, but is generally not audited by the budget inspector.

2000 or 2001, nor is it expected to contribute in 2002.[39] The HIF also receives transfers from the Republic MOF - via the Ministry of Health - for coverage of the long-term unemployed. In 2001, the MOF made a transfer in full, while no additional funding was provided for internally

[37] The contribution rates are higher than the Serbian ones across the board (7.5 percent for both employers and employees), because the taxable income does not include fringe benefits.

[38] See below arrears and debts.

[39] This is intended as the reflection of the low number of individuals who fall in that category and the small amount involved.

displaced persons (IDPs) and refugees (47,000 used the public system in 2000 according to the HIF) since the 1999 transfer from the EU.[40]

4.18 Public expenditure not channeled through HIF includes heath care spending by the MoH, and the Yugoslav National Army for personnel and their families based in Montenegro - and the net expenditure of health care facilities not covered by the Montenegro HIF or by foreign institutions. The breakdown of expenditure on health in Montenegro is presented in Table 4.2. The extent of private out-of-pocket payment is unknown, but findings of UNPD surveys conducted in 2000 and 2001 estimate it to be approximately 25 percent of the total expenditure on health (3 percent of the GDP). Only about 6 percent of this comes from official co-payments at the point of service. The rest allegedly covers predominantly the cost of "private services" and the purchase of drugs. As a consequence of its liquidity constraints, the HIF cannot meet its obligations towards the rest of the economy and records debts for nearly 30 million DM, of which about 15 percent is repayment of debts towards commercial banks, around half is represented by unpaid arrears for the import of drugs, 20 percent arrears of health workers salaries and 4 percent arrears of sick leave benefits.

Table 4.2: Total Health Expenditure in Montenegro

(DM Million)	2000	2001 Actual	2002 Plan
Public health expenditure	119.8	146.5	165.7
o/w HIF Expenditure	108.3	148.7	160.0
Contributions of MOH	1.5	2.1	3.0
Health expenditure of the Yugoslav Army	1.8	2.5	2.7
Net expenditure of facilities 1/	8.2	(6.8)	
Private health expenditure	39.5	47.7	55.2
o/w Out-of-pocket payment for facilities	2.1	2.8	
Other	37.4	44.9	
Total Health Expenditure	159.3	194.2	220. 9
GDP	1,625.0	1,962.5	2,272.1
Public health expenditure (percent of GDP)	6.7	7.6	7.0
Total health expenditure (percent of GDP)	9.8	9.9	9.7

Note (1) In 2001, health facilities reported a surplus shown in brackets, which is subtracted from the total expenditure.

Source World Bank Staff calculations.

4.19 **Health Care Provision.** The health care financed via the HIF is provided through an extensive network of public facilities owned by the Republic Government. The very small private sector is largely unregulated and the services are provided primarily by consultant physicians holding full-time contracts in public institutions, with clear potential conflicts of interest emerging. The health care delivery system has two main weaknesses: (i) there is a lack of the necessary incentives for an efficient utilization of resources; and (ii) it offers an extremely generous package of health services including coverage of treatments abroad and in military

[40] The consolidated revenues of health facilities show that they received 3 percent of their income in 2000 and 1 percent in 2001 for the coverage of refugees and IDPs, but the exact source and nature of these payments still needs to be determined.

hospitals. 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 on a salaried basis but staffing, salary levels and appointment decisions are made by the MOH, while 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 for pursuing efficiency in the system. Given the lack of efficiency and the limited resources available, the generous package currently offered is clearly not affordable. This is reinforced by the magnitude of the arrears and claims.

4.20 **Fiscal Sustainability.** The HIF is under tremendous financial pressure, but much of this problem is related to liquidity constraints. At the end of 2001, the debts to the HIF exceeded its unpaid liabilities by nearly DM 27 million (20 percent of the planned 2002 budget). In other words, if the HIF had been able to collect the sums due, it would have run a surplus rather than a DM 12.2 million deficit. Thus, looking at the structure of arrears gives important insights on the HIF future liquidity.

4.21 As Table 4.3 shows, 20 percent of the Fund's claims consists of arrears from contributions of firms (they doubled in 2002 to reach over 10 million DM), with the Pension Fund responsible for the bulk of the remaining sum. At the end of 2000, the MOF formally took over 19 million arrears incurred by the Pension Fund, but did not pay any installments on that

Table 4.3: Arrears to and of the HIF

(DM million)	12/31/2000	12/31/2001
Arrears to the HIF		
Pension Fund	2.8	23 7
Budget (on behalf of pension fund and for contributions)	21.1	22.5
Companies (contributions)	4.7	10.3
Total	**28.5**	**56.5**
Arrears of the HIF		
For treatment outside of Montenegro	0.4	1.1
Towards budget [1/]	1 6	0.1
Salaries and meal supplements		5.4
Sick leave of insured	0.7	1.2
Travel costs	0.2	0.5
Material costs of health institutions	5.0	0.9
Electricity	-	0.4
Investment	0.4	0 4
Imports of drugs	8.6	15.1
Insurance premium		0.7
Towards "Titeks" and "Hemomont"		0.2
Towards banks [2/]	0.3	4. 1
Total	**17.1**	**29.9**
Net Arrears	**11.4**	**26.6**

Notes. (1) End of 2000. for salaries in health sector plus "according to compensation with ICN" plus for currency (only item left at the end of 2001) (2) It is not clear whether these are arrears or regular debts.
Source· HIF

debt in 2001. At the same time, the Pension Fund paid only about 70 percent of what their planned liability for 2001, accumulating an additional 21 million DM arrears. Finally, nearly 5 million DM are due to the Fund by the Republic Government as payroll contribution for its employees in 2001. The total amount of the arrears to the HIF is more than 56 million DM.

4.22 **Increasing Revenue.** Given the extent of the arrears due to the HIF the first step to improve the sustainability of the system is the settlement of these debts. However, an issue arises on the feasibility of this recommendation in a context in which the Pension Fund and the Republic Government face serious financial constraints and the poor economic prospects limit the liquidity of private enterprises for years to come. It is important to distinguish between debts accumulated over a number of years and arrears related to the current fiscal year and the future ones. One could then conceive a situation in which the focus is on paying current arrears and preventing their further accumulation leaving the issue of accumulated debts for further discussion with the view of possibly offsetting them at a given date. Thus the emphasis should be on: (i) eliminating all forms of exemptions from contribution payments and no longer allowing rescheduling of debts; (ii) ensuring the social funds – especially the Pension Fund – pay their contributions regularly; and (iii) assuring that the Republic Government pays contributions for its employees.

4.23 Additional measures to increase revenue could include: (i) assuring regular transfers to the HIF to cover the health care of refugees and IDPs; (ii) increasing the proportion of self-employed and farmers who pay their contributions; and (iii) ensuring that the contributors pay an amount which reflects their ability to pay. The first point raises the issue of what the appropriate transfer for coverage of refugees and IDPs is and who is responsible for its payment. The Republic Government is likely to take on this responsibility but it is not easy in the context of limited budget and unmet payment of contributions, etc. The amount of the transfer should reflect the number of refugees and an appropriate contribution per capita, which could be related to the minimum wage. The second and third points refer to the wider issue of how to increase the tax base and obtain more accurate estimates of ability to pay.

4.24 Finally, an alternative way of increasing the resources going to the public health system is to formalize the extensive private payments which are already occurring. This can be done in a number of ways. The most obvious is to increase the nominal co-payments and introduce some form of exemptions to safeguard access of the poor to the system. Another way would involve allowing for the use of public facilities on a private basis.

4.25 **Improving the efficiency of the system.** The only other way of closing the current gap between revenues and expenditures is to reduce the costs of running the system. In addition to reducing the package of services offered, cost reductions may arise from improved efficiency of the system. According to our estimates - DM 146.5 million in 2001 - public expenditure on health in Montenegro amounted to 7.6 percent of GDP. If we add the UNDP-based estimate of private expenditure, total health expenditure in Montenegro amounts to 9.9 percent of the estimated GDP. This percentage is extremely high by international comparisons, accounting for one of the largest percentages of GDP in the region -- very close to the average for high income countries.

4.26 Using standard indicators of efficiency of the health care delivery system, no obvious inefficiencies emerge. The hospital occupancy rate (77 percent) is high by international comparison and the average caseload per hospital physician (142) is higher than in Serbia. The number of beds per 1,000 population is lower than in many transition and high-income economies (including Serbia) and the average length of stay (10.7 days) is relatively short. In addition, the Statistical Yearbook 2000 gives the number of physicians per thousand populations

at 1.8 (or even 1.6 if the IDPs and refugees who used the system in 2000 are taken into account), which is extremely low by international comparison. However, their workload -- expressed as number of visits per day[41] -- is low (just over 23 in general practice). Low is also the number of yearly visits per capita (5). All these elements suggest an underutilization of outpatient care compared with other countries. The causes of this underutilization are unknown but may include poor quality of the service, high out-of-pocket expenses, and extensive – and largely unreported -- use of a "quasi-private" system.

4.27 However, according to the Statistical Yearbook, large inefficiencies exist in the combination of skills used. Less than 13 percent of physicians are general practitioners and only 35 percent of physicians work in general practice facilities.[42] In addition some types of physicians clearly appear underused: e.g., physician in women's health appear to see only 12 patients per day. The available information is insufficient for an estimate of the potential savings that could be generated by a move to a more efficient skill mix. However, it is important to note that in 2001 gross salaries represented around 40 percent of the total HIF expenditure and 43 percent of the funds going to health facilities. These numbers compared very favorably with other countries – including Serbia - and this suggests that health workers in Montenegro are relatively underpaid for their skills level.[43]

4.28 Furthermore substantial savings can be generated by moving to a more competitive procurement system for pharmaceuticals and by reducing the current list of basic drugs.

Priorities for the Future

4.29 The main findings of this analysis emphasize the urgent need to increase the health care system's accountability and improve its financial sustainability. Priority action in this area is the setting up of an adequate mechanism to monitor the development of the system and the flow of funds between its different agents.

4.30 To improve the sustainability of the health care system, the PEIR recommends that the Republic Government:

- In the near-term, create a list of "vulnerable individuals" entitled to receiving health care financed out of the Republic budget and transfer at the beginning of each year a sum equivalent to the contributions these individuals would have paid had they received the minimum wage;
- From 2003 onward, stop the practice of granting exceptions from the payment of contributions to companies in financial difficulties and enforce the timely payment of contributions for all employers;
- From 2003 onward, formalize the extensive out-of-pocket payments into co-payments to be paid to the HIF or directly to the health care facilities – as from draft law currently under discussion;

[41] Including home visits and based on a 270 working days year.
[42] A training program is starting in collaboration with a Canadian university to retrain some physicians in family medicine.
[43] A specialists initial wage is EUR250, that of a nurse is EUR130.

- In preparation for the 2004 budget, transfer responsibilities for collection of health contribution for pensioners and the unemployed from the other social funds to the HIF; and
- In preparation for 2004, improve the accountability of the system by setting up an adequate health information system to monitor the financial status of all of its components.

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

- 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
- A more accurate estimate of private expenditure on health care and public expenditure on pharmaceuticals.

5. REFORMING BUDGETARY MANAGEMENT

5.1 Montenegro shares with the Federal Government and the Government of the Republic of Serbia a common public expenditure legacy and features, detailed in Volume 2, Chapter 6. Though coming from a common starting point, Montenegro differs in the degree of progress it has made in public expenditure reform, its relative size, and its heavy reliance on foreign consultants to support public expenditure reforms.

5.2 This chapter assesses the Republic of Montenegro's PEM system. The chapter begins with a brief comparison of the system's recent progress which highlights the differences between the Montenegrin and neighboring public expenditure systems, followed by a description of general budget issues, then an outline of the Montenegrin budget formulation and execution systems (recent and new). This is followed by an evaluation of the system's effectiveness, and recommendations. The purpose of this review is to provide Montenegro with the tools and systems necessary to enable the republic to manage its public expenditures in the short run, and to eventually make a successful transition to a market economy.

A. RECENT PROGRESS IN REFORMING BUDGET MANAGEMENT

5.3 The Government and the MOF have shown strong commitment to public expenditure reform, particularly in the face of very limited in-house capacity. As of December 2001, the MOF had a total of 42 staff, of which 3 were responsible for budget formulation and 2 for budget execution.[44] This commitment has borne fruit in the form of tangible progress toward a more comprehensive budget and the establishment of a modern public expenditure system. With this objective in view, Montenegro has taken the following steps:

- Transferred in November 2000 the central payments bureau (ZOP) to the Central Bank, thereby, providing a better organizational framework for reform;
- Adopted in August 2001 a new Law on the Budget System (LBS), and began its implementation;
- Implemented a new chart of accounts and budget classification system beginning with fiscal year 2001;
- Passed in August 2001 a new procurement law, and began its implementation;
- Established a Treasury Office within the MOF, appointed a Treasurer, began staffing and equipping the office, and developed guidance and operating manuals;
- Developed and operated a new Treasury financial management information system, covering over 50 percent of expenditures (including payroll); prepared an operating manual and trained spending ministry staff;

[44] With the creation of the Treasury, the MOF is recruiting additional staff for cash management (budget execution).

- Taken steps to improve cash management by developing priorities for cash allocations and establishing a formal payments council within the MOF;
- Implemented a Consolidated Treasury Fund;
- Improved budget comprehensiveness and cash management by incorporating most spending ministry own revenues into the budget and thus the Consolidated Treasury Fund;
- Developed some aspects of a multi-year fiscal policy framework, and began building permanent capacity in this regard;
- Stopped as of June 2001 issuance of guarantees; under the new LBS, all new guarantees must be approved by Parliament;
- Issued in 2001 its first short-term bond for improving cash flow;
- Commissioned a private, independent audit of government accounts for 2000 and 2001, and published the audit reports;
- Used a revised budget classification and improved information to developed annual budgets, and trained direct spending units (DSUs) in the new methodology;
- Enacted a new tax law to expand the revenue base and strengthen collections;
- Initiated an anti-corruption program (see Box 1.2); and
- Converted its monetary system from the Deutsche Mark to Euro.

5.4 In moving forward, it will be important for the Government and MOF to remain focused on implementing key reforms rather than starting numerous new PEM reforms. Fully implementing the new laws that have been passed, expanding capacity in key functions such as the Budget Office and Treasury, and managing the process well, are relatively more important at this stage than passing new laws.

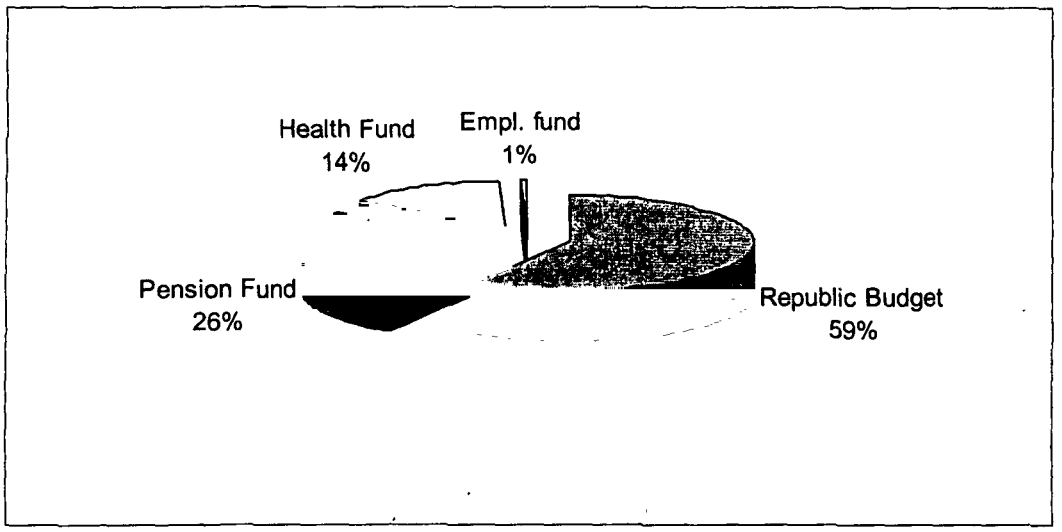
General Budget Issues

5.5 **Comprehensiveness.** Like the Republic of Serbia budget, the Republic of Montenegro budget document transmitted to Parliament contains four distinct parts: the Republic Budget; the Health Fund; the Pension Fund; and the Employment Fund. However, the MOF has budget formulation responsibility only for the Republic Budget. As indicated in Figure 5.1, the Republic Budget accounts for about 60 percent of total spending.[45]

5.6 The new LBS specifies that all revenues be considered Government revenues for budget purposes. In 2002, the consolidated central government incorporated own revenues of the DSUs into the Republic Budget. It is not clear, however, if the following revenues were included: the 2 to 4 percent turnover tax on goods and services for the Yugoslav National Army, various unspecified Ministry of Interior revenues, the 0.5 percent gross salary surcharge for the Chamber of Commerce and unions, car registration fees, tobacco tax, 50 percent of court fees for Ministry of Justice (reportedly still off-budget), veterinary service fees for the Ministry of Agriculture, or 10 percent of revenue penalty earnings for the Public Revenue Office.

[45] Includes DM 61 million in ministry own reserves and associated spending previously off budget.

Figure 5.1: Montenegro Consolidated Central Government Spending, 2002



Source Republic of Montenegro Ministry of Finance

5.7 The extent of foreign-financed expenditures remaining off budget is also unclear. For 2000, DM 72 million (46 percent of foreign financed expenditures, and 10 percent of consolidated central government expenditures in 2000) remained off budget. The new LBS requires all external grants and loans to be on budget.

5.8 The General Balance Table prepared by the Ministry of Finance (see Volume 2, Box 6.2) provides a way of tracking total public sector spending, including aggregate municipal revenues and spending.[46] Additionally, the Montenegrin Prime Minister's Office produced a consolidated **central** government table for 2002, showing net spending and transfers between the Republic and four extrabudgetary funds, within a multi-year context.

5.9 Earmarked revenues, though on budget, also fragment the budget system. These include one-half of a 4 percent goods turnover tax dedicated to railways, a petrol tax for road maintenance, an international truck transport tax for road repair, and a petrol tax dedicated to public works. The Maritime Ministry controls dedicated railway and sales taxes.

5.10 **New Law on the Budget System**. The budget laws for the Republic of Serbia and other former Yugoslav republics follow local civic law traditions and tend to be very detailed. Compliance with laws is considered higher than compliance with subordinate regulations or administrative rulings, and details in the budget law are more likely to be adhered to. In contrast, the Republic of Montenegro has adopted a more streamlined LBS, which provides a framework for the budgetary process, assigning significant responsibility to the MOF to issue subordinate regulations that detail the process and requirements. This approach is more flexible, since it is easier to modify subordinate legislation under the control of the MOF than to pass new legislation. The value of this flexibility is partially dependent on the degree to which subordinate legislation is adhered to and enforceable. The MOF needs to develop and issue the subordinate

[46] It is also unclear whether all municipal revenues are in the municipal budgets, such as the 2 or 3 percent salary surcharge for local public works, taxes on new construction for road and electricity operations, car registration fees, local administrative taxes, and local privatization or operating revenues.

regulations in order to make the budget process fully effective and to provide guidance to participants. Some progress has been made with the development of the Treasury Operating Manual.

Budget Formulation

5.11 The MOF is responsible for managing the budget formulation process and producing the budget documents. The formulation of Budget 2002 followed the traditional approach described in Volume 2, Chapter 6. The annual cycle began in September, when the MOF sent out instructions to budget users. The instructions generally consisted of special forms the users had to fill out with their requests. The MOF received and aggregated ministry requests.

5.12 Parallel with the budget user preparation of requests, the MOF worked with the Public Revenue Administration to estimate revenues. Combining ministry needs and estimated revenues, the MOF knew the rough balance for the central government. With the balance, the MOF calculated the amount by which Ministry spending requests had to be reduced to meet the available revenues. The MOF met with all budget users to discuss their requests and reconcile ministry needs with available resources. The quality and substance of these discussions was mixed. The Ministries of Education and of Social Welfare were reportedly the best prepared for the discussions. Based on the outcome of these discussions, the MOF prepared a draft budget for submission to the government commissions.

5.13 As with the Federal and Republic of Serbia processes, four GOM commissions reviewed and amended the draft budget:

- Budget Commission comprised of assistant ministers from all ministries;
- Financial System and Public Expenditure Commission comprised of all the ministers. This commission is the lead commission for budget review;
- Economic Policy Commission comprised of technical experts and some assistant ministers; and
- Security Commission for security policy and funding.

All four commissions independently reviewed the budget and returned their amended budgets to the MOF, which then consolidated the changes and submitted the revised version to the Government for approval. The Government adopted the budget and forwarded it to Parliament.

5.14 Parliament has three committees that consider the budget: a Legislative Committee, a Finance Committee, and an Education Committee. Once the budget has passed the committees, it proceeds to the full National Assembly, and is voted.

5.15 **Information for Decision-makers.** Consistent with the general structure of policymaking in the Federal and GOS systems discussed in Volume 2, sectoral policy used to be the responsibility of each ministry. In the budget process, this was reflected in budget requests from ministries being in table format, and the focal point of budget discussions being tables. The budget tables had four columns: (i) Current budget; (ii) Ministry request; (iii) Ministry of Finance proposed levels; and (iv) an empty fourth column for decisions. This tabular format was also supplied to the Cabinet and Parliament as the basis for decisions.

5.16 The MOF proposal was developed primarily to fit spending allocations for each ministry within the available resources, with little regard for sectoral policy (other than education) or operational efficiency. According to the MOF, each spending ministry must prove or justify its needs. The MOF usually cut investment requests, and did its best to leave the "large budget position requests" (e.g., salaries) untouched. Likewise, MOF avoided cutting the small budget positions (e.g., printing) as it produced few results.

5.17 **New Process.** The 2003 budget will be the first budget prepared under the new LBS. The budget process will begin in July, with the MOF preparing an updated report on the current year's budget execution and macroeconomy, including estimated public revenues and expenditures for the budget year. This document will be discussed in Cabinet.

5.18 Based on the Cabinet decisions, the MOF will prepare a budget circular for budget users. The budget circular will formally initiate the budget process for spending ministries, and will include the key parameters needed to prepare the budget, the budget preparation timetable, and indicative totals for each budget user. Spending ministries are expected to prepare their requests within these indicative totals.

5.19 The budget law requires budget users to provide explanations of requests in addition to the traditional tables and forms, and presumably these would form the basis for more policy-oriented discussions with each sector and the Cabinet. Budget user requests are also required to provide multi-year requests (budget year plus three additional years), to indicate personnel levels, and to identify multi-year commitments being requested (particularly investments).

5.20 The MOF is required to submit the budget to the Government in October, and it is expected that the four Government commissions will continue to review the draft budget before its submission to the Cabinet. Once reviewed and approved by the Cabinet, the Government is expected to submit the budget to Parliament in November.

Budget Execution

5.21 Differences between Montenegro's budget execution system and the budget execution norms that existed in the FRY primarily reflect capacity limitations in the Montenegro MOF, greater reliance on foreign technical assistance, more severe cash shortages, and greater progress to date.[47] Until 2001, the Montenegrin budget execution process was similar to the Federal Government and the current Republic of Serbia system. The Ministry of Finance involvement extended only to the republic budget and did not directly cover the extrabudgetary funds (EBFs) or extend beyond the transfer of funds to direct budget users. Each EBF was responsible for executing its own budget - until cash shortages necessitated MOF cash "credits." The EBFs do provide occasional reports to the MOF on spending.

5.22 Once Parliament passes the budget, it is published in the official Gazette, which informs budget users of budget allocations.

[47] Montenegro began reforming its PEM system two years earlier than Serbia or the Federal Government.

5.23 In the former system, for cash planning, budget users did not prepare monthly financial plans. However, the MOF knew in advance the yearly schedule of payroll payments, which accounted for almost 45 percent of the budget. Other payments, such as capital, subsidies, material costs, and transfers, occurred at irregular intervals, and the MOF acknowledged a need for financial plans from budget users for cash flow purposes.

5.24 The core of the old budget execution system was control of cash transfers to line ministries own accounts. Ministries made daily requests for payment to their accounts, and the MOF made daily decisions on transfers depending on the available resources. Ministries paid vendors directly, leaving the potential for idle cash balances on ministry accounts, as well as the risk of actual payments differing from budget priorities. Budget users could use funds in their accounts to pay any invoice, and misreport to the Treasury. While this appears to be rare, there was insufficient budget inspection (internal audit) capacity to detect errors.

5.25 There were no formal guidelines on the payment of invoices. The Minister of Finance was formally responsible for decisions on all payments, in cooperation with the government. The Budget Office did make recommendations, though anecdotal reports suggest that authorities higher than the Minister of Finance frequently intervene in the execution process. In practice, payment priority has been given to salaries and social payments.

5.26 If unusual payment requests came from budget users, the Budget Office informed the Minister and did not allow undocumented transfers. The Budget Office also took care that the budget was not violated, and alerted the minister and ministry involved. However, there were no penalties attached to adverse findings, and no examples could be cited where disciplinary action followed an adverse finding.

5.27 No commitment control system was in place, which increased the likelihood that arrears would be generated, particularly during periods of fiscal restraint or retrenchment. Arrears have been a particular problem for the Ministry of Interior.

5.28 **In-year monitoring and reporting.** For revenues, the MOF had direct, instant access to ZOP accounts and knew the daily account status, including the status of revenues by source. For expenditures, the MOF knew only how much was transferred from the main government account to ministry accounts.

5.29 The MOF did not actively monitor EBF budget execution, although the MOF received monthly reports from the Pension and Health Funds. However, there were too few staff in MOF budget execution to closely monitor spending trends. The EBFs had the authority to issue debt issuance, and the MOF did not know of new debt issuances.[48] At the end of the year, the Budget Office prepared the closing accounts bill for the Government and Parliament.

5.30 Most budget users relied on the Montenegrin Administration for Mutual Services (AMS) for accounting support. The AMS did not report to the MOF, but to budget users, who were then responsible for quarterly reporting to the MOF. The MOF had limited capacity to monitor such reports in-year for deviations from the budget that would necessitate management intervention. (The AMS budget execution system was automated, including automated purchase orders). Each

[48] The new LBS requires MOF approval of all debt issuance of the EBFs and municipalities.

payment was recorded in bookkeeping, and this file was backed up every two days. AMS processed payroll without any certification from budget users of the employees, work status, or hours worked. In the AMS accounting register, the AMS entered the planned amount, the amount paid, and the computer automatically checked the two for appropriateness.[49] The Ministry of Development programmers developed the AMS software in-house. The Ministry of Interior had its own accounting service, and operated independently of the general public expenditure system.

5.31 Virements (formal in-year reallocation of spending authority) did not occur. The Government had complete discretion over transfers or reallocations to the extent that these were consciously addressed at all.

5.32 **Financing.** Illiquidity has been a problem and has been handled through short-term loans from banks or other domestic institutions (ZOP). These loan transactions have not been transparent nor have they been properly recorded. The 2000 Deloitte and Touche independent audit found a DM 20 million loan[50] improperly reported and expenditure of the funds improperly recorded. Cash flow shortages for the Republic budget institutions and EBFs have been exacerbated through debt exchange (enterprise tax liability to Government off-set against Government payments to enterprises) and Government acceptance of payment in-kind.

Budget Inspection (Internal Audit)

5.33 The MOF has a Budget Inspectorate that performs basic compliance auditing, checking to see whether actual budget user payments match the payment requests and whether funds were used for the approved purposes. The current Budget Inspectorate has only one staff. The MOF does have the authority and potential to occasionally reconcile actual payments with coding, but this is not a regular activity. While the control environment (respect for laws and controls) generally appears high, this can erode quickly in the absence of formal audit and monitoring processes.

5.34 **External audit.** Montenegro has no public external audit capacity. ZOP did provide some audit functions, but it is not clear whether these resources will be transferred to the MOF to form the core of an internal audit unit or a new external audit body. Montenegro has contracted with Deloitte and Touche for the annual external audit. This audit goes unedited to the Republic Assembly, and after review, is made public. The Assembly discusses, and either accepts or rejects the report. The Law on Budget System authorizes new external audit procedures, but these have not been implemented. For the 2000 audit, Deloitte and Touche examined 80 percent of the budget users and found accounting errors in 3 percent of records.

5.35 **Parliamentary oversight.** Parliament has several committees to review proposed budgets, as noted above, and also has an opportunity to exercise oversight responsibility through approval of the annual closing accounts bill as well as approval of the annual audit report. Parliamentary rejection of either the closing accounts bill or independent audit is not a vote of confidence (would not induce a change of government). The Parliamentary Finance Committee is usually

[49] However, AMS, a service agent of the DSUs, could be instructed to overspend budget positions.
[50] This loan was extended to an enterprise.

chaired by an Member of Parliament from the majority party, rather than from an opposition party as is the practice of many other countries.

New Budget Execution System

5.36 The U.S. Treasury, USAID, and EU have been providing support to the MOF to develop a Treasury system and a new budget execution process. USAID and US Treasury assisted with the development of an interim Treasury system using an Access database. The EU has also awarded a contract to provide a permanent SAP-based treasury IT system to Montenegro.

5.37 In 2001, the MOF (i) established a Treasury Office; (ii) closed most budget user own accounts and moved to a consolidated Treasury fund (also known as a single Treasury account); (iii) began operating a new Treasury financial management information system covering over 50 percent of expenditures (including payroll), drafted a Treasury operating manual, and trained spending ministry staff; (iv) took steps to improve cash management by developing published priorities for cash allocations and establishing a formal payments council within the MOF (consisting of the Minister of Finance, Assistant Minister for Budget, and Treasurer); and (v) began developing a timetable for extending the interim Treasury system to social funds and local governments.

5.38 The interim Treasury operating manual incorporates important features of modern PEM systems, including: (i) the designation of a chief financial officer in each spending ministry, who is accountable for the financial management of that organization; (ii) the introduction of a monthly or quarterly warrant system, including special warrants for donor-funded projects to safeguard resources; (iii) the establishment of internal control procedures for budget users and safeguards on receipt of revenues; (iv) introduction of commitment controls; (v) formal establishment of a general ledger system; (vi) specification of banking arrangements, borrowing and debt management processes; (vii) regular reconciliation of fiscal and banking information; and, (viii) monthly reporting to MOF.

5.39 The new Law on Budget System limits Government virement authority to 5 percent of budget, above which formal amendments to the enacted budget are required.

5.40 **Financing.** USAID helped to develop a formal short-term security instrument. In September 2001, the Ministry of Finance successfully issued a 28-day Treasury bill in denominations of DM 1,000 totaling DM 10 million. In addition, the Government continues to rely on transfers from ZOP (central bank) to finance cash shortages. ZOP is financed via a percentage of the value of each transaction processed. In 2001, the rate was increased and the surplus transferred to the Pension Fund. ZOP surpluses are also being transferred to the general budget.

5.41 **Internal audit.** The new Law on Budget System includes provisions for a modern internal audit operation, but there has been no progress to date implementing the provision and the current budget inspectorate remains unchanged.

5.42 **External Audit.** Article 53 of the Law on Budget System anticipates the creation of a Supreme Audit Institution (SAI), but this has not occurred to date. The Government is exploring different SAI models.

B. How Has the System Performed?

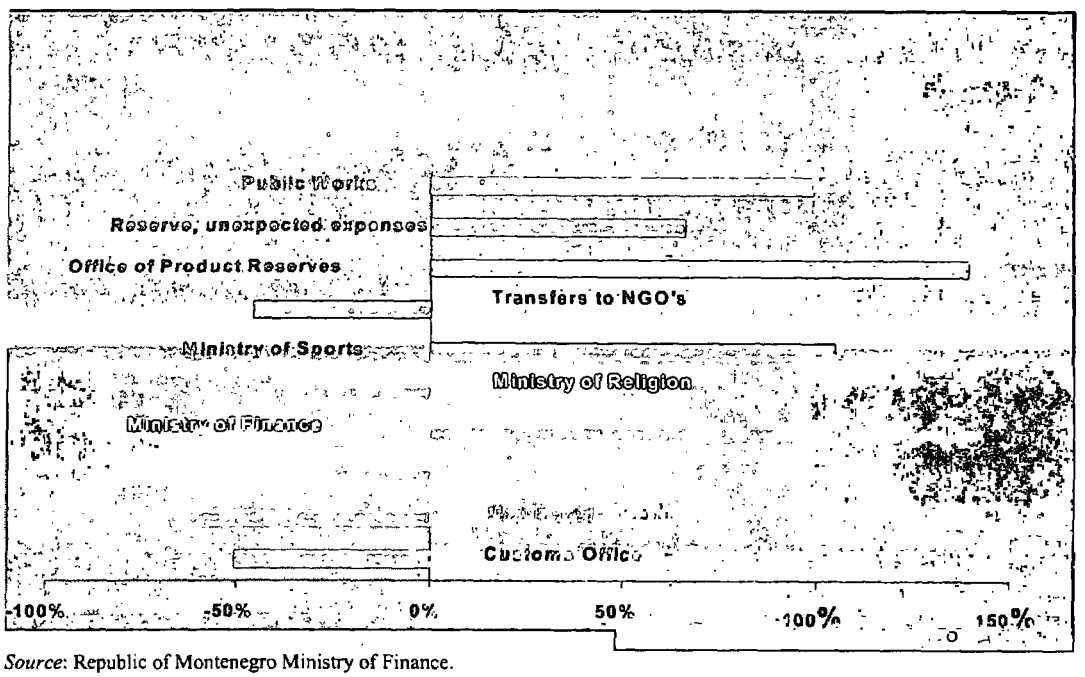
Macro Fiscal Discipline

5.43 Republic budget revenues have performed closely to budget estimates, owing in large part to good estimates by MOF, and efficiency of the Public Revenue Agency and ZOP in revenue collection and reporting. Between 1995 and 2001, actual budgetary revenues collected averaged 99 percent of planned levels.[51]

5.44 Republic expenditures have been less successfully contained. Between 1996 and 2001, actual republic expenditures averaged 106 percent of planned expenditures, with the variation growing to 119 percent for 2000 and 117 percent for 2001.

5.45 The Pension Fund ran a deficit in five of the seven years between 1995 and 2001. The Health Fund ran a deficit in three of the last seven years, broke even in three years, and had a surplus in support one year. The financing gaps of EBFs requiring from the Republic Budget or from sources other than social contributions support have been increasing.

Figure 5.2: Deviation between Actual and Approved Budget in Selected Agencies, 2001



Source: Republic of Montenegro Ministry of Finance.

[51] Excludes own revenues of DSUs and off-budget revenues. Social funds' revenue performance was significantly worse, with large arrears receivable accumulated.

Allocative Efficiency

5.46 At present, the Budget is a poor guide to government policy intentions and is not used as a tool for managing government or for implementing policies. The Budget Deviation Index provides a simple measure of budget predictability: whether the Budget provides an accurate estimate of final expenditures. The Budget Deviation Index expresses the average of absolute budget deviations by budget user as a percentage of the originally approved budget. For 2000, the Budget Deviation Index for the Republic Budget was 29 percent – significantly higher than Serbia's index of 18 percent for the same year. Table 5.1 and Figure 5.2 show the range of variation for different budget items.

Table 5.1: Average Variation, Approved Versus Executed Budgets by Position, 1996-2001

	Average
Personnel Expenses	7
Materials	-2
Investments	3
Special Purpose	-20
Economic Intervention	16
Grants and Social Benefits	-1
Other	319

Source: Ministry of Finance, Republic of Montenegro

Technical Efficiency

5.47 As with the Federal and Republic of Serbia systems reviewed in Volume 2, no detailed numbers on costs per unit of service delivered, or comparative procurement costs exist. A proxy measure is variation in aggregate budget position. For 2000, the wage bill variation from the approved budget by budget users was 15 percent, ranging from a high of 42 percent above budget for the Ministry of Justice to a low of 54 percent below budget for the Customs Service. This degree of volatility in funding levels undermines effective program implementation. Budget users cannot plan in advance, focus on program effectiveness, efficiency, or improved productivity, if they must spend most of their time battling arrears or for funds to operate their program.

General Assessment

5.48 Montenegro has made tangible progress in PEM reform, especially in passing new laws, but does not have fully operational the various institutions and tools to manage the fiscal situation. Key pieces missing include:

- a multi-year perspective;
- comprehensive commitment control and budget monitoring;
- stewardship and responsibility for public finances;
- internal audit; and
- communication strategy.

5.49 **Multi-Year Perspective.** While multi-year fiscal frameworks were produced for the recent donor conference, these assume a high degree of continued donor financing for several years. A multi-year perspective without donor financing would better illustrate the need for retrenchment, reveal how current policy commitments outstrip resources, and that, to avoid having to make the

same cuts every year, focus should be on spending reductions that yield savings every year. This is the only sound means to attain fiscal sustainability.

5.50 Maintaining a one-year perspective tends to lead to spending reductions that are less difficult politically, but are more fiscally damaging over time. For example, cutting capital investment, equipment and supplies, or deferring maintenance and repair are easy measures to achieve a one-year savings. But they are only appropriate if the fiscal imbalance is short-lived. If these same spending reductions were implemented for several years, would prevent needed capital spending, and reduce the efficiency and this effectiveness of social safety net programs and other important government spending (education, health).

5.51 Moreover, a multi-year framework for more accurately reflects the costs of quasi-fiscal activities. Issuing guarantees, for example, might make sense in a one-year time horizon, but over several years, the costs of guarantees would deepen the out-year deficits. Similarly, undertaking capital investments that would require recurrent spending in future years without considering whether there would be fiscal room for such spending or how such room would be created, could lead to sub-optimal utilization of the investment.

5.52 The elements necessary for success in this area include the following:

- Develop a realistic multi-year public revenue and expenditure envelope, including
  - conservative multi-year economic growth,
  - conservative multi-year and general government revenue estimates,
  - sound government spending estimates taking into account current legal and policy commitments, and
  - realistic financing expectations;
- Build the above analysis into a fiscal policy paper, including policy options for bringing fiscal balance to government accounts;[52]
- Use the fiscal policy paper to hold Cabinet-level dialogues on the multi-year situation, serving to educate the policy officials about the situation and choices, and to build consensus for the necessary measures;
- Develop a mechanism to produce multi-year cost estimates for new policy proposals or commitments, and assuring that these costs are presented with the proposals to Cabinet, including information on whether these costs are affordable in the multi-year spending envelope; and
- Hold a broader dialogue with the public on the multi-year situation to prepare them for any significant policy changes necessary to assure the future economic health of the country.

5.53 These needs can, in the short run, be partially filled with the support of technical assistance, think tanks, and donor advice. Efforts must be made, however, to develop domestic human capital to fill these roles.

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

5.54 **Comprehensive Budget, Commitment Control and Budget Monitoring System.** It is difficult for a Government to achieve planned spending targets without a comprehensive picture of planned and actual spending. While progress has been made, there are still important exceptions such as the revenues of the Ministry of Interior and Ministry of Justice. Montenegro needs to complete the integration of these budget users into the budget process, both for formulation and execution.

5.55 It is also difficult to manage spending if there are no means during the year of controlling the rate of spending by government programs at a level that will meet the annual budget target. Simply triaging payables to available cash is too late in the process, and allows arrears to accumulate. Implicit in this notion is the hard budget target. Progress has been made in this regard through the interim Treasury system, but the process should be completed and comprehensive spending must be limited to the approved budget levels rather than to the normative output level: this may entail changing some laws to clarify the normative as the target, with achievement constrained by available resources.

5.56 Underlying this system, however, is some means of monitoring the comprehensive government fiscal position during the year, especially for identifying spending trends that, if unchecked, would lead to arrears or budget problems. The MOF must monitor the government-wide fiscal position, not only the on-budget positions. Until a Treasury and commitment control system is in place, the MOF should be receiving monthly spending reports from second-line users, including all extrabudgetary funds. These reports should be in a standard format and should allow some identification of where, in each second-line user, spending problems may be occurring. Economic classification may be sufficient for the short-term, with a move to program classification in the medium-term.[53] Once these reports are produced, summary tables of fiscal position, with projections to year-end, should be produced monthly for the Minister of Finance and for the Cabinet. Problem areas should be identified, so that they can be addressed directly in Cabinet.

5.57 **Stewardship and Responsibility.** The foregoing discussion implies a broader role and set of responsibilities for the MOF, which must assume the role of steward of public resources, counterbalancing tendencies on the part of ministries to overspend. This is not a role that ministries of finance traditionally played in the socialist era, when they were responsible for finding ways of financing whatever decisions were taken elsewhere.

5.58 In a modern public finance system, ministries of finance generally have a seat at the decision-making table and press for lowering spending. At the budget development stage, the debate between the ministry of finance and sector ministries can be very basic, with each side mustering arguments for its case. Between the budget negotiations, however, the ministry of finance has a role in promoting more cost-effective means of achieving policy decisions from elected officials, and in assuring that policy advice to the government gives due weight to costs as well as benefits. Most important, the ministry of finance has a role in enforcing approved government decisions on spending, monitoring compliance with these decisions, and actively

[53] In addition to GFS-based reports on a functional and economic classification basis, Montenegro should continue to report on an administrative basis, which is the form in which organizations are held accountable.

managing the public finance system and its development. No other government entity is as well placed to fulfill the role of stewardship of the budget and public finance systems.

5.59 Good financial management is also the responsibility of all spending units. Under the previous system, finance was literally left to the MOF, and spending ministries did not feel responsible. Under modern public finance systems, each entity of government that spends resources is responsible and accountable for the resources it spends, with the MOF setting standards and monitoring performance. As Montenegro develops it public finance system, this message must be clearly communicated to all spending units. It is the principle underlying many of the other changes that are under way, including ex-post auditing (internal or external) and internal controls.

5.60 **Internal Audit.** It may well be some years before a functioning external audit body is in place in Montenegro. Use of a private independent audit does provide some measure of assurance. In the interim, there still remains an institutional need to have regular reviews of budget user records and accounting practices to ensure the integrity of the financial management system, to assure that funds are used as approved, and in compliance with new laws and procedures (e.g. procurement, Treasury system). Moreover, the internal audit does properly respond to the government in assuring that executive policies are being carried out. In Montenegro this function can be built upon the budget inspector function, but additional resources are required to make this effective and to assure adequate coverage of budget users. Options include hiring additional staff and training them for this office, or possibly transferring some staff with accounting skills from the AMS, or even transferring some of the former ZOP auditors to the new internal audit office.

5.61 Though often overlooked, an effective communication strategy is critical to the success of reforms, especially significant budget management and fiscal reforms like those proposed in Montenegro. By educating citizens, policy-officials, and politicians on the problems of the current system, presenting options for change and the reasons for actions chosen, the reform is more likely to gain the necessary support to be successful. It also assists government staff in implementing reforms if they understand why they are being asked to do something, as well as citizens, civil society, and businesses in adapting to change. Understanding reduces opposition and promotes working with new direction rather than against it. Box 5.1 presents some approaches that have been used in other countries to improve communications.

Budget Formulation Assessment[54]

5.62 **Comprehensiveness.** The use of the General Balance Table, including republic and extrabudgetary fund balances, as well as most direct budget user own revenues, for 2002, provides a relatively comprehensive picture of the public sector. Use of this table should be continued and can serve as part of a fiscal policy paper, mentioned above. Furthermore, the table should be on a net basis, showing the overall fiscal situation for the public sector.

5.63 The new LBS leaves Pension and Health and Employment Funds off-budget, although it does give the Minister of Finance the opportunity to review and recommend changes to the Fund

[54] For an overview of good budget formulation practices, see also Volume Two, pp. 80 ff.

budgets before their approval by respective Fund boards and their submission to the Government. This can work if progress is made in containing deficits and arrears of the EBFs.

Box 5.1: Communication Strategy

A communications strategy can entail many activities, for example:

Citizen's guide to the budget. Many countries are adapting "budgets-in-brief," outlining the budget process, explain the fiscal and macroeconomic situation, and providing a brief summary of key government policies. These reports have the objective of making the budget process and policy more accessible to citizens, raise awareness, and build consensus on general policies. This is an effort at direct communication with citizens.

Media training. The media will report on budget and fiscal issues, but public finances are often confusing to all but insiders. The result is media reports that are inaccurate or misleading, and which serve to confuse rather than educate the public. Providing a one-half day seminar on budgeting, terminology, and data sources to reporters can at least improve the probability of correct reporting.

Public Relations (PR). In order to improve transmission of the government message and policy, reduce confusion or misinformation, and promote orderly press relations, many MOF's establish standard operating procedures for media contact, and designate a PR office or officer to field questions. This can also assure a consistent government message, as well as keep the PR officer (and through them, policy officials) aware of emerging issues.

Policy promotion. Occasionally it will be necessary to prepare citizens for major changes in policy, especially where fiscal retrenchment is necessary. It may also be necessary to reduce spending on very popular programs which otherwise would never be touched ("sacred cows"). Such changes can be successfully pursued, but it requires an active public relations campaign well in advance of the proposed change, in order to prepare the ground and begin changing public opinion.

Process. Editorials by cabinet members, government white papers, think thank reports, blue ribbon panel reports, seminars, town-hall meetings, speeches to key interest groups, academic studies, international organization studies, and appearances on talk shows, can all serve as vehicles for getting the facts, and Government's message, into the public domain, and engender debate. These vehicles can be orchestrated to produce a continuous stream of information, raising public awareness of the problem, its causes and consequences, and exploring options for reform. Public debate can also provide valuable feedback on perhaps unseen complications of some proposals. Over several months, public opinion can change from opposition to support for reform. When public interest has been heightened and opinion has shifted, the government can release its proposal for change. The probability of success and sustainability has increased as a result of the preparatory work.

5.64 Municipal budgets appropriately remain independent, while the use of the General Balance Table provides a vehicle for monitoring trends in municipal finance and their effect on the Republic Budget.

5.65 The Ministry of Justice's own revenues remain off budget. Some international donations were off budget, primarily because of the loan agreement terms. Efforts should be made to fully incorporate these funds into the budget, to provide a comprehensive picture of the fiscal situation and resources devoted to each sector[55].

5.66 In 2001, shortfalls in expected foreign-financed general budget support produced cash shortages. This fact emphasizes the need for greater attention to donor coordination as well as conservative spending policies. For foreign project financing, expenditures should not be made until funds are received, to avoid unfunded expenditures (a common problem in many

[55] Since August 2002, line ministries began systematically reporting their own revenues.

countries).[56] For general budget support under structural deficit situations, the issue is more challenging, as spending is already occurring above own revenues.

5.67 As with other former Yugoslav republics, budget formulation has been viewed narrowly as the finance function, filling up as many pre-formed programs and policy commitments as possible. Policy commitments and programs were established outside the budget process, and with little reference to financial implications. Going forward, it will be important to bring the policy discussion into the budget formulation discussions between the MOF and budget users, as well as into the Cabinet discussion of the budget. As part of their budget requests, spending ministries should include the identification of normatives or other laws that may not be fulfilled under indicative funding levels. The policy discussions should include whether these normatives or other laws need to be amended to avoid incurring liabilities or to improve the linkage between resources and policy.

5.68 While the government budget document includes the Republic Government and EBFs, the three Funds (Pension, Health and Employment) are provided for information purposes only. The MOF deals only with the central government budget. Off-budget entities control their own budgets. While it is generally accepted practice that insurance-based programs such as health and pensions remain segregated from general budgets, the Funds should operate under reporting and accountability regimes similar to other public resources and should also have some means of controlling in-year spending other than non-payment of invoices. The risk to the republic budget of excessive fund spending must be managed, and the first line of defense is adequate authority and accountability on the part of Fund managers.

5.69 **Capital Budgeting**. Montenegro's Directorate for Public Works handles all capital spending. The Government decides on the projects, which are reflected in the budget with only one line per project. It is important to reflect capital projects in the sector or program to which they apply. This improves the transparency of the budget by allowing policy officials to see how much is being spent for each program or sector. Further, by providing the funds to the budget user, the budget user could conceivably choose whether to use the Directorate for Public Works or a private sector organization to manage the project or to directly construct the facility, introducing an element of competition into the process that might improve service delivery, reduce costs, and expedite project completion.

5.70 The current method of handling ministry budget requests and developing the budget proposal undermines accountability and efficiency. The MOF spending ceilings are often met by cutting investment spending, which can erode program effectiveness and efficiency, and harm overall economic development. Looking only at a one-year budget, and ignoring both policy and program objectives, contributes to short-sighted budget decisions. Leaving large positions untouched does not promote effectiveness and efficiency either.

5.71 Private sector organizations have natural pressures toward economy and efficiency (limitations in cash flow, sales, competition, etc). The public sector lacks such natural pressures, and it is important to establish some incentives. This does not mean recreating markets, but

[56] The Treasury will need to be able to monitor spending proposals that are to be financed from foreign grants or loans, both to limit spending to available resources and to prevent commitments until resources are received. The current Treasury manual does provide a warrant system to cover these issues.

rather employing such techniques as setting spending ceilings by sector early in the budget process, with which the spending ministries must comply and within which they must develop their programs and budgets. The spending ministry itself must question the mix of inputs (salaries, capital) to most effectively and efficiently achieve its objectives.

5.72 **Production function.** At a program level, it can be conceptually useful to think of the operations as a production function. That is, some mix of inputs is used to produce a good or service (intermediate or final). One might have as inputs very gross indicators, such as total funding, staff levels, equipment, and capital. A first point is whether the MOF has enough information to correctly judge this mix. In most countries, this is not the case. This suggests that in fact the exact mix should primarily be left to the spending ministry itself. However, the MOF does have a role insofar as it must set the aggregate spending targets (multi-year) including targets for different classes of spending (salaries), and must also serve to vet ministry requests or assure that ministry requests reflect some internal deliberation on the input mix. The MOF can use benchmarks for the program, or for comparable programs, and can employ various analyses to probe these issues. A second important point is that the MOF must look not only at the multi-year costs, but also at how daily decisions may affect out-year costs and performance of individual programs. Cutting investment today may balance the current year's budget and not show deterioration in outputs or outcomes, but it may prevent productivity gains in the later periods. For maintenance spending, cutting investment may reduce the useful life of buildings, resulting in reconstruction or new construction earlier than would have occurred with proper maintenance.

5.73 In addition to formal techniques, **how** the MOF interacts with spending ministries can influence outcomes. The MOF should seek to engage in a dialogue with ministries to assess whether they have in fact considered the questions of mix of inputs, whether there are benchmarks for assessing staffing patterns, whether there are alternate means or modes of achieving the objectives, and should use these issues to develop a budget. It is the dialogue that is important to build ownership for the decision-making process. These issues must regularly be raised, or they will go unaddressed: thus, current staffing and production patterns will remain fixed, with only incremental for new programs or activities possible. For example, the MOF may provide additional funds to spending ministries for official pay raises but may provide no funds for "promotions." Assuming there is a salary cap per ministry, this puts a slight but palpable pressure on spending ministries to economize on salaries, to examine where savings can be achieved within the wage bill, to fund some promotions. It also forces economical decisions on the number of promotions, which may differ from the established practice of automatic promotions based on seniority and tenure.

Budget Execution Assessment

5.74 Montenegro has made good progress in improving budget execution, as noted earlier. Aside from improved reporting and the establishment of an internal audit function, the key emphasis should be on completing the implementation of the interim Treasury system, extending it to all budget users and the EBFs, and making the commitment control system fully operational. Increased attention will also be necessary to improve public revenue administration, in anticipation of the ZOP transformation at some point.

5.75 The initiation of short-term Treasury bills is an improvement in transparent financing. However, there is a high risk that if spending controls are not operational and arrears and cash shortages continue, short-term securities will be rolled over indefinitely, becoming long-term debt at high interest rates. Short-term tax revenue anticipation should be used to smooth seasonal fluctuations in revenue flows rather than to plug financing gaps arising from overspending.

5.76 Some discussion has taken place in the Government over ring-fencing donor funds. Generally, ring-fencing means setting up separate accounts outside the Treasury at the central bank, with disbursement, accounting, and reporting procedures outside normal government channels, and often with separate implementing units. While some donors may insist on ring fencing to "protect" their funds, fungibility of resources means donor funds may simply offset existing resource flows, undermining any veneer of safeguards. Moreover, the parallel budget formulation and execution processes under ring-fencing place additional burdens on the limited Republic PEM capacity, and can even reduce such capacity by drawing-off highly qualified staff from the MOF to higher paying implementing units. A preferable approach might be to use the new budget classification and Treasury systems to "tag" items of expenditure or projects within the existing budget execution system and to monitor these items of expenditure closely, perhaps providing more frequent reports to the public and donors (as a prelude to making all in-year spending reports publicly available). Strengthening the internal audit capacity and creating some external audit capacity continue to be high priorities within this virtual ring-fencing approach.

General Budget Management Issues

5.77 Beyond the technical changes described above, the Government and the MOF must take pains to operate in a spirit of transparency and appropriate use of institutions, and to not succumb to temptations to do what is expedient to meet a momentary crisis. For example, good practices were not followed in adopting the recent tax law, as no estimates were available of the potentially significant revenue effects, costs of implementation, or the potential effects on economic activity of the proposed legislation. Such estimates should be available to the Government prior to its making a decision on major legislation, and should be made public when transmitted to Parliament.

5.78 Moreover, seeking expedient expenditure reductions does not remove the structural imbalances in spending or provide a permanent reduction in spending. These expedient choices can damage service delivery and program effectiveness over time. A multi-year perspective can help raise these issues, but it will take a strong commitment on the part of the Government and MOF. This commitment is necessary in order to make greater effort to review the imbalances in each sector and retrench policy commitments and spending, to choose what the government can no longer afford to undertake and to make the reductions.

5.79 Another example of expedient decisions was the way in which ZOP transaction fees were modified in 2001 in order to generate surpluses that the government could use to finance arrears or overspending in the republic budget or Pension Fund. Such stopgap measures could only delay the realignment of programs with the available resources.

5.80 A further case of note is the 2001 finding from the independent auditor of a DM 20 million unrecorded loan (see above, para.5.32). The Government must take a clear stance on the role of government and the private sector and must design explicit programs and procedures for supporting its decisions. Engaging in non-transparent financing arrangements for selected

companies undermines both the public expenditure system and government credibility. Some companies are not viable, and the government cannot postpone the inevitable restructuring of the private sector. Such behavior only prevents resources from being put to more productive use.

5.81 Similarly, making decisions outside the budget process without reference to financing consequences undermines confidence in the Government and the budget process, and can lower business and investor confidence. A case in point was the decision to raise the minimum wage rate in 2001, not knowing the cost implications but knowing that such a raise was not funded or affordable in the current economic and fiscal situation.

5.82 These expedient choices may seem to be the path of least resistance at the moment, but they delay the necessary adjustment of the public sector and private sector. To the extent that the MOF understands these issues, an important role for the Ministry is to educate and advise policy officials on the consequences and appropriateness of their actions - not to mention developing appropriate options for pursuing government objectives.

C. Policy Recommendations

5.83 Montenegro's key challenge now is to complete the implementation of the PEM reforms already initiated. The passage of legislation has been an important watershed in transforming the PEM system, but the real test will be in fully implementing the reforms. The limited number of staff in the Ministry of Finance who can manage the reform implementation further supports the need to shift the MOF emphasis from designing new ones to completing those reforms already initiated. To support government fiscal policy and the transition to a market economy, the following actions in 2002 are essential:

- Developing a comprehensive medium-term (three-year) macro/fiscal framework as a basis for public expenditure planning, comprising the central budget, social funds, and local governments, and reflecting fully all major policy commitments, such as the resumption of external debt servicing, bank and enterprise restructuring, and the reform of the social welfare system. This activity will simultaneously address the need for a more comprehensive budget and for a medium-term perspective in fiscal policy, and will help identify unaffordable policy commitments;
- Completing the implementation of the interim Treasury within the MOF, implementing commitment controls, and transferring the accounts of all direct budget users into the single Treasury account). All social funds should be included in the Treasury system as Treasury sub accounts, possibly with delegated authority for transaction processing, and a decision would be taken as to whether the 21 municipalities should be incorporated into the Treasury system; and
- Strengthening significantly the internal audit and inspection function within the MOF, establishing the new audit procedures, adequately staffing it, beginning specialized training and adopting the annual audit plan.

5.84 In the medium-term perspective (over 2003-2004), the MOF will need to maintain the pace of PEM reform; strengthen its capacity in budget formulation, macro/fiscal analysis and the budget execution area; gradually replace input-based budgeting with budgeting practices geared

to measurable outcomes; and expand the budget inspection and audit function to all public sectors. Other specific goals in the same time period are to:

- Support transparency, incorporate into the consolidated budget presentation the balance sheets of all public enterprises;
- Further strengthen resource management in the direct budget users (e.g. by designating CFOs);
- As part of the Treasury development, strengthen the public debt management arrangements; and
- Adopt a Law on Supreme Audit Institution and establish an SAI based on the Government's preferred model of external audit.

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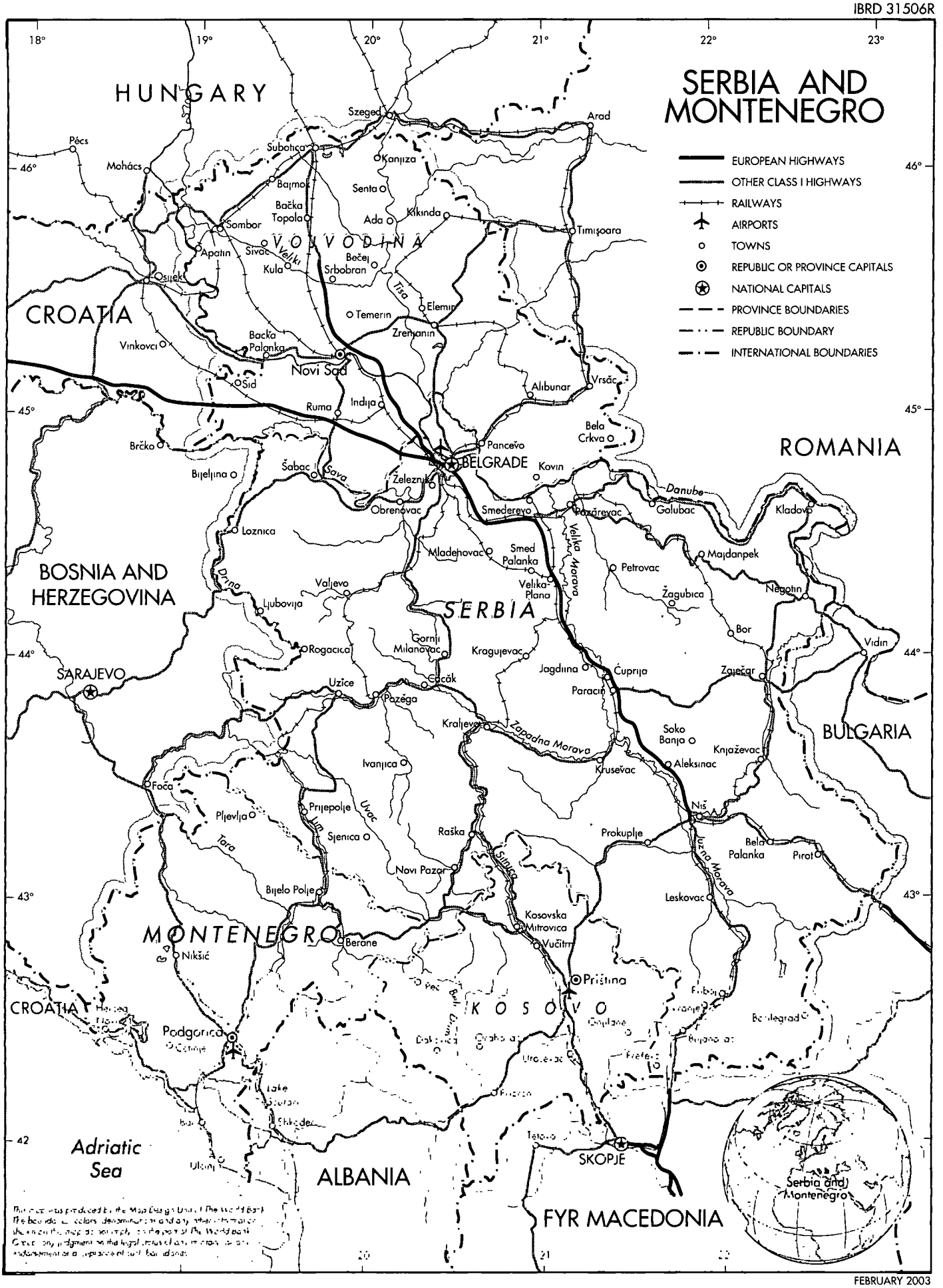
[57] Sources listed here are in addition to the ones included in Volume 2.

IBRD 31506R



FEBRUARY 2003

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Report No.: 23689 YU
Type: ER