



SIGMA

Support for Improvement in Governance and Management

A joint initiative of the OECD and the European Union, principally financed by the EU

**FORMER YUGOSLAV REPUBLIC
OF MACEDONIA**

**PUBLIC EXPENDITURE
MANAGEMENT SYSTEM**

ASSESSMENT MAY 2009

1. Summary

Main Developments since last year

The main developments in public expenditure management that have occurred in the former Yugoslav Republic of Macedonia¹ over the past year are as follows.

- The Law on Budgets has been updated and now includes provisions for a medium-term budget process with top-down elements, based on fiscal policy objectives and macroeconomic projections.
- New parliamentary rules of procedure, which have facilitated a far more active Budget and Finance Committee to examine the government's budget proposals, can be regarded as a positive development during 2008.
- On debt management, efforts have been made, supported by an ongoing technical assistance project:
 - to better integrate the cash management function with the debt management function; and
 - to strengthen the capacity for longer-term projections, which should result in a better trade-off in terms of liquidity requirements and the cost of raising funds.

The past year has seen the introduction of development programmes within the budget allocations for users, which is a step towards closer integration of capital investment within the budget allocation process.

Main Characteristics (strengths and weaknesses)

Macedonia continues to make significant progress towards complying with baseline standards for public expenditure management. The public expenditure management system in Macedonia now provides many of the essential preconditions for an effective and efficient administration characterised by a high level of fiscal discipline and control of public funds. Among the strengths are the following:

- Political commitment to fiscal sustainability;
- Sound legal framework that underpins and supports the annual process – although it is critical for the legal framework to be wholly embraced by management at all levels;
- Efficient treasury system that tightly controls expenditures and produces timely and informative reports on budget evolution and deviations;
- A well-operating Debt Management Department of the Ministry of Finance, which has a good record of ensuring liquidity.

Nevertheless, there are significant weaknesses that must be addressed in the short term:

- A lack of appropriately qualified staff to carry out specialist tasks and a difficulty in retaining staff that are qualified means that there is a lack of skills at all levels of the administration.
- The budget documentation lacks some of the basic information required by best practice. For example, comparative budgetary information is provided only for the previous budget year, and information is not provided on the impacts of current budget decisions on the budgets of future years.

¹ In this report the former Yugoslav Republic of Macedonia will hereafter be referred to as "Macedonia".

- There does not seem to be a consolidated set of accounts produced at year-end for parliamentary approval but only a summarised compilation of the results of each separate audit of budget-users.
- Failure to present a clearly defined overall budget and economic strategy framework to parliament in advance of, or along with, the detailed expenditure proposals is probably indicative of the assumptions underpinning the budget projections, which are not particularly robust.
- Very poor capital investment appraisal and management techniques are characterised by a failure to distinguish between current and capital expenditures in the development programmes.
- There is no real delegation of budget and control responsibilities at the budget-user level, with even senior managers often not knowing what the budget is for their area. This calls into question the reliability of annual and three-year strategic plans, which ministries prepare and submit along with their budget submissions.

A mistaken belief throughout the administration is that the budget is established on a programme classification basis. In reality, not all of the “programmes” are sets of related activities and projects aimed at the realisation of a common goal. The classification is still at an item level.

Recommendations for Reform

Parliament’s role in the budget process should be strengthened. A pre-budget statement, outlining some main parameters of the government’s fiscal and budget policies early in the budget process, should be introduced. While additional staff for the Budget and Finance Committee is desirable, it is essential that any new staff have the appropriate qualifications so that they can analyse and challenge budgetary projections and their underlying assumptions.

The budget preparation process should be developed to strengthen fiscal discipline, facilitate the process of prioritising between main policy areas, and improve expenditure and revenue projections. Top-down procedures could be strengthened through the introduction of medium-term fiscal targets and a reduction of the scope for the adjustment of ceilings for individual areas in the budget so as to relieve expenditure pressure. Fiscal risks should be analysed and presented in the budget documents. While economic models underpinning expenditure and revenue estimates also need to be improved, of equal importance is the need to enhance the skills of individuals within the relevant areas.

The preparation of investment expenditure should be better linked to the strategic planning process and co-ordinated with the planning of current expenditure. Capital projects require careful appraisal and management to ensure that they are cost-effective and are delivered on schedule and within budget. Efforts should be made to strengthen the capacity of the Budget Department to prepare the budget for investment purposes alongside the budget for current expenditure. Finally, the “30%” rule, according to which at least 30% of the annual capital budget must be spent in the first half of the year, incites budget-users to incur inefficient expenditures so as to avoid losing funds that have been budgeted; this rule should be scrapped.

A comprehensive strategy for developing government sector accounting and reporting should be elaborated. As a first step, a consolidated cash-based budget statement incorporating the state budget, local government budgets and the funds budgets should be published based on the Treasury’s higher level three-digit codes. While the introduction of full accruals-based accounting is a longer-term target, it is not an immediate priority, particularly as the cash-based accounts can be used as the basis for the ESA 95-based accounts that should be developed in the more immediate future.

Greater emphasis on ensuring that receipts from sales of land should not be used for day-to-day expenditures. In recent years, cash raised from a number of privatisations has been used for early redemption of the most unfavourable debt obligations, rather than being used to fund day-to-day expenditures. However, despite several regulations controlling borrowing by local government, it

seems that a similar restriction does not apply to municipalities with regard to their utilising receipts from sales of land by the central government in their area. There should be a clear restriction to prevent municipalities from using such proceeds to finance ongoing expenditure.

Longer-term objectives. Performance-oriented evaluation and full accruals-based accounting should be long-term goals. Of more immediate importance is ensuring that the cash-based system of accounting becomes more transparent so that controls can be enhanced.

2. Legal Framework

The baseline standard for a legal framework that underpins a sound public expenditure management system requires clearly defined principles to be set out in the Constitution, an Organic Budget Law and/or related laws. This requirement is generally satisfied in Macedonia, where public expenditure matters are regulated by the Constitution, the Law on Budgets, the (annual) Law on the Execution of the Budget, the Law on Accountancy, and related secondary legislation.

The Constitution explicitly recognises as a fundamental constitutional principle “the division of state powers into legislative, executive and judicial”. It also specifies that the government proposes the budget but that the Assembly adopts the budget and determines public taxes and fees and expenditures, i.e. it recognises the separate roles of the legislature and the executive regarding public finances.

The Law on Budgets regulates the procedures for preparation, adoption and execution as well as reporting and control of the state budget, the budget of local municipalities and the budgets of the extra-budgetary funds. This law complies almost entirely with the fundamental principles required under the baseline standards. The only principles with which it might be said to not comply fully are as follows:

- Limiting the creation of extra-budgetary funds to special cases authorised by special statute; and
- Ensuring the comprehensiveness of the budget.

Given that the number of extra-budgetary funds would appear to be limited to four in any event, the failure to comply fully with the first principle would be of no great concern if a consolidated set of budget accounts were being produced.

However, while a final report of the previous year’s budget is prepared for parliamentary approval each year, this report is not a consolidated set of accounts but rather a summarised compilation of the results of each separate audit of budget-users. The Law on Budgets should demand the publication of a consolidated budget statement incorporating the state budget, local government budgets and the funds budgets. While officials have mentioned the adoption of ESA-95 principles, it is difficult to see how this can be implemented unless the accounts of all parts of the government are fully consolidated and published.

3. Parliament/Executive Relationships

Parliament’s right to determine public revenue and expenditure is established by the Constitution, while the government’s right and obligation to propose a budget are determined by both the Constitution and the Law on Budgets. The Law on Budgets also sets out the timetable for the approval of the budget by parliament. The power of parliament to amend the budget is within the constraint of having to propose balancing savings elsewhere so as to remain within the government’s overall expenditure target. With regard to fiscal matters, therefore, the relationship between the legislature (the Assembly) and the executive (the government) is appropriately balanced, with a clear role for preparing, executing and monitoring the budget assigned to the government. The role of the Assembly is to scrutinise the government’s budget proposal and to decide on revenue and expenditure.

While the final budget is debated in the full chamber of parliament, parliamentary scrutiny of the budget proposals is given effect primarily through the Budget and Finance Committee, which has been very active since November 2008, having previously not met for three years. This activity has been facilitated by new parliamentary Rules of Procedure, which can be regarded as a positive development in 2008. Procedural rules allow for wide media coverage of about 10 days of actual debate with the Minister of Finance and/or his/her deputy (and with other ministers when required). However, the power of the Committee to scrutinise the budget is severely compromised by the following:

- Inadequate resources: One civil servant economist is assigned permanently to the Committee but cannot complete all of the required analysis in the time available. While six or seven support staff are borrowed from other committees, they lack the necessary economic and financial skills to do an effective job. The Committee relies heavily on information provided by the Minister of Finance.
- General lack of transparency in the government's budget proposals: There is no explanation of the assumptions that underpin the budgetary calculations. For example, there is no attempt to show the effects of agricultural subsidies on tax revenues. It has also been claimed that much of the debate focused on amendments which, it later transpired, the government had already decided to change from its original proposal – in other words, the Committee was debating issues that were already out of date.
- The government presenting its overall economic and budgetary strategy in the wrong order: The detailed budget expenditure proposals are presented at the beginning of December, with the overall macroeconomic and fiscal strategy being published at the end of that month. This is clearly inadequate, not just from a parliamentary scrutiny perspective but also in the context of the government's ability to plan its expenditure allocations over the course of the next year and in the medium term.

If there is to be proper debate in the Assembly, it is important that a clearly defined overall budget and economic strategy framework be presented to parliament in advance of or at least along with the detailed expenditure proposals. It is clear that there should be more transparency in the process, with underlying assumptions being clearly articulated and explained. The availability of appropriately qualified staff is also desirable, but it is essential that any new staff have the appropriate qualifications so that they can analyse and challenge budgetary projections and their underlying assumptions.

4. Scope and Transparency of the Budget and Quality of Budget Documentation

Budgetary best practice requires a comprehensive budget process that promotes allocative efficiency and effectiveness by forcing the government to prioritise in its use of the financial resources available to it. Earmarked revenue is to be discouraged since it runs contrary to the principle of budget universality and the need for prioritisation. Any public expenditure that takes place outside the official budget process is in danger of not being subjected to the discipline of the resource allocation process.

The annual budget comprises budget-users and spending-units. The 2005 Law on Budgets and the amendments in 2007 defines budget-users as first-line users in legislative, executive and judicial authorities (central government), the funds (pension and disability insurance fund, health insurance fund, regional and national road fund, and employment agency) and municipalities. Spending-units are second-line budget-users that are financed by a budget-user. Since the funds are listed as first-line budget-users, they are subject to the same rules as the other first-line users. This should also make it possible for the funds to be incorporated fully into the state budget, but this does not seem to have happened so far. For instance, the Pensions and Disability Fund receives resources from employee contributions based on gross salaries, from the Employment Agency, and from the state budget when shortfalls arise in its annual budget. This fund could be easily incorporated into the state budget but, according to senior staff within the fund, its budget is published separately and is not even reconciled with the state budget until after year-end.

With the existence of separate budgets for the funds (and municipalities) in Macedonia, there is at least a strong risk that the budget is not comprehensive enough to ensure that all public funds are subject to the full rigours of the resource allocation process. However, the existence of extra-budgetary funds is not just a budgetary issue, but also a question of actual decision-making and policy implementation. Furthermore, changing the presentational structure of the annual budget may be less important than improving the decision-making process for planning the funds' budgets. In this regard, it seems that the funds are included fully in the budget formulation process, given the requirement to submit revenue and expenditure forecasts to the Ministry of Finance in accordance

with the annual budget circular. In addition, all transactions involving the funds and municipalities are effected through the Treasury.

Of more concern is the way in which the municipalities' budgets operate. While there are only four funds, there are 85 municipal budgets – all of which are published separately in the *Official Gazette* of Macedonia. Since 2005 municipalities have been responsible for paying many second-line users under a fiscal decentralisation process. For example, over 20,000 employees in schools are paid by the municipalities. While these payments are effected through the Treasury, there is no evidence to suggest that expenditure by the municipalities is subject to the same controls as expenditure under the state budget. While the Ministry of Finance contains a unit with responsibility for local government budgets, it has a staff of only three, thereby making it impossible to comprehensively monitor and control these expenditures from the ministry's perspective.

Finally, donor funds, with the exception of EU funds, are incorporated into the state budget.

The quality of the budget documentation submitted to parliament fails to meet the required standards in several respects:

- It does not include fiscal policy objectives, the macroeconomic framework, and the policy basis for the budget (or at least it does not include this information until such a late stage that it is too late to be of much use).
- It fails to take account of the macroeconomic or fiscal effects of significant revenue or expenditure changes.
- No risk or sensitivity analysis, showing the impact of changes in the underlying assumptions on the main budgetary estimates, is carried out.
- Virtually no presentation of fiscal risks, including contingent liabilities, is provided in the budget documents.

The low quality of budget documentation is indicative of a lack of awareness as to how important this information is, from the perspective of both informing the public and making robust, soundly-based projections throughout the Macedonian administration. While the budget documentation also includes background information on programmes, including a description of achievements in the outgoing year and indicators for the upcoming year, and the budget as published shows own revenues, foreign donations and inflows from loans as well as the use of these funds (according to administrative and economic classifications) on the expenditure side, the actual capacity to plan these revenues and their intended use is weak. For example, it is normal in Macedonia to produce a revised budget during the year – and on some occasions there have been two such revisions. While it is perfectly acceptable for the Minister of Finance to submit a review of the budget execution every July in accordance with the Law on Budgets, the fact that this review has become an annual supplementary budget is not. It suggests that budget forecasting / planning is weak and is never close enough to the actual budget. More importantly, it means that budget managers cannot plan with any certainty the amount of funds that will be available for service delivery.

In overall terms, the structure of the budget is excessively detailed, with too many expenditure items. While a certain level of flexibility is provided by allowing every budget item to change by up to 15% during the budgetary year, budget-users must obtain Ministry of Finance approval for these changes. If the number of budget items were decreased and the reallocation rules were made stricter, there could be both sufficient flexibility for budget-users and better control of the initially planned budget. This would also provide a better basis for budgetary discussions in parliament.

It is often claimed that the budget is now on a programme classification basis. However, in reality it seems that the basis is still at an item level. The programme classification in use provides very little added-value because not all of the programmes are actually sets of related activities and projects aimed at the realisation of a common goal (which is how the term “programme” is defined in the Law on Budgets). Not only does this make it impossible to set meaningful indicators, but the targets set are not in line with budget limitations.

Attempting to incorporate the information on programmes and their intended results into the budget documentation is a good step forward, but considerable efforts need to be made to make the programme classification and indicators meaningful and usable in the actual policy-planning process.

It also seems that the budget documentation still lacks some of the basic information required by good practice. For example, comparative budgetary information is provided only for the previous budget year, and information is not provided on the impacts of current budget decisions on the budgets of future years. While a medium-term fiscal framework is gradually being introduced, it has a long way to go before it becomes an important instrument for assessing future financial liabilities.

5. Monitoring the Deficit and Government Debt

While debt is a stock and strictly speaking does not fall within the public expenditure area, debt service is a cost on the public purse. As the size of the deficit has implications for expenditure, both the debt and the deficit comprise important elements of the budget process.

It is clear that the Debt Management Department of the Ministry of Finance operates well. As regards baseline standards, the level of debt:

- is calculated in accordance with the GFS;
- distinguishes between domestic and external debt; and
- is published.

The department meets weekly with the Treasury and Budget Funds Departments as well as with the Public Revenue Office to plan ongoing liquidity requirements. There has been little problem in liquidity to meet Treasury commitments in recent years and so this part seems to have been working well. By concentrating available liquidity in the Treasury Single Account, the Ministry of Finance has been able to benefit from the economies of scale of cash management in the government sector and to limit the need for cash and thus the costs of borrowing.

Moreover, work is ongoing to adopt the ESA methodology used in EU Member States. A software upgrade is in process that will enable the department to better monitor debt servicing costs and to improve its capacity to assess risk associated with raising debt and servicing it. A technical assistance project is ongoing, the goals of which are as follows:

- to better integrate the cash management function with the debt management function; and
- to strengthen the capacity for longer-term projections, which should result in a better trade-off in terms of liquidity requirements and the cost of raising funds.

As regards the deficit, this is also published on a GFS basis. Furthermore, in recent years revenue shortfalls that would have led to higher deficits have been addressed through supplementary budgets that cut back on expenditure. So it seems that the deficit and the effects that unplanned increases in its scale would have on fiscal sustainability are taken seriously in Macedonia. On the other hand, in years when revenues have been ahead of target, expenditure has increased, when it might have been more prudent to run down the stock of debt and only use the additional resources after having planned their best use in the context of the following year's budget.

However, two areas of concern could be the sale of government assets in recent years and the stock of local government debt. It seems that the debt has been reduced due to a number of privatisations, and the cash raised in this manner has been used for early redemption of the most unfavourable debt obligations. It is important that this principle continues to apply and that revenues raised from such sales not be used to fund day-to-day expenditures. While the Debt Management Department has significant responsibility for the approval of local government borrowing and monitors movements in local government debt in conjunction with colleagues in the unit that has responsibility for local government budgets, evidence from other countries would suggest that this is an area that should be

kept under close scrutiny within the Ministry of Finance. Furthermore, the freedom enjoyed by municipalities to utilise 80% of the receipts from sales of land in their area by the central government should be restricted so as to prevent municipalities from using such proceeds to finance ongoing expenditure.

While in general the deficit and government debt is well monitored by the Ministry of Finance, there is some concern as to the monitoring of local government debt and borrowing. Local governments appear to enjoy a significant degree of freedom from central government control, despite the regulations that do exist. A formal restriction should be in place to prevent municipalities from financing ongoing expenditure out of receipts from the sale of land in their area by the central government.

6. Medium-Term Expenditure Framework

The 2008 amendments to the Law on Budgets included provision for a medium-term budget process with top-down elements, based on fiscal policy objectives and macroeconomic projections. The formulation of the 2010 budget will include a medium-term fiscal strategy for the three-year period 2010-2012. It is intended to include in the strategy maximum expenditure ceilings for the three years, which indicates a clear ambition to move towards a medium-term expenditure framework in Macedonia. So too does the development of a new software package for improving budget management and expenditure forecasting, which was first used for the preparation of the 2008 budget.

The process starts with the definition of the government's strategic priorities, which must be completed by 15 April. By 31 May the government is required to adopt a medium-term fiscal strategy, in which revenue and appropriations for the next three-year period are projected. Investments are planned in a three-year rolling framework. A medium-term baseline projection of revenue and appropriations are also included in the government's budget proposal to parliament. The Ministry of Finance provides top-down expenditure ceilings to budget-users, with which they must comply. Furthermore, it seems that attempts have been made to strengthen the link between the overall policy-making process and the budget since all new expenditure proposals that are brought to the government for approval must contain cost-impact assessments on a three-year basis. While the fiscal impact of these proposals is summarised in the standardised Fiscal Impact Assessment (FIA) forms, it seems that in-depth analysis is not conducted in many cases. The three-year Public Investment Programme must also be consistent with the budgetary projections before it is finalised (although this cannot be ascertained from the published documentation).

If the government is to have reliable medium-term fiscal projections, it must also have good quality macroeconomic forecasts over the same period. The Macroeconomic Policy Department in the Ministry of Finance is responsible for these forecasts. With about 20 staff allocated across four units, it would appear to have adequate numbers. It also communicates regularly with the Budget and Funds Department in the ministry, informing that department as soon as revisions to important macroeconomic aggregates are made. Early in the year, the department makes a forecast of all relevant macroeconomic parameters, which serves as the basis for the government's Fiscal Strategy. The macroeconomic framework is then updated on a quarterly basis to ensure that the budget proposal is based on the best available information.

While the forecasts for the past three years have been borne out to be relatively accurate, it is unclear how the department would perform in a less stable economic situation. Although steps have been taken in recent years to strengthen forecasting through the development of economic models with the aid of a technical assistance project, the appropriate skills were invested in one individual, who has since left the Ministry of Finance. Furthermore, economic modelling is only in the initial stage of development. In the less stable economic situation that now prevails, the need to further develop capabilities in individual staff will come to the fore. Having lost the individual who was best placed to deal with this challenge, it is clear that the department may struggle to produce reliable forecasts in the medium term.

While a medium-term fiscal strategy is a prerequisite for sound, sustainable fiscal management, its usefulness and benefits are dependent on the capacity within the Ministry of Finance to prepare macroeconomic, revenue and expenditure forecasts and on the quality of strategic planning throughout the administration as a whole.

Given the fact that the annual budget is revised in most years, it is clear that the quality of strategic planning and the capacity of the Ministry of Finance to make reliable medium-term forecasts are both weak at the current time. Furthermore, it would seem that many budget-users pay little heed to the medium-term expenditure projections, focusing solely on the forecasts for the upcoming year. Nevertheless, it is important to recognise that tentative steps in the right direction are being taken.

The intention of including medium-term expenditure and revenue projections in the budget preparation phase is a positive sign. It is necessary, however, to make the ministerial budget projections beyond the upcoming fiscal years as realistic as possible. If this is to happen, medium-term projections must be realistic and reliable, which will require enhanced capacity in both the Ministry of Finance and line ministries. While developing an economic model is important, of equal importance is the need to enhance the skills of staff within the department. Furthermore, a way needs to be found of retaining staff once skills have been developed and of ensuring that appropriate succession planning takes place in advance of staff departures.

7. Annual Budget Process

The budget process should be based on a well-defined sequence of steps, with sufficient time allowed for each step to be implemented effectively. Within the framework of the timetable, the roles of the government, the Ministry of Finance, line ministries and parliament should be clearly defined and understood. Of crucial importance is for the Ministry of Finance – and the budget and finance departments of line ministries – to have sufficient human resources, skills and IT support so as to ensure that the process runs efficiently and effectively.

The budget process in Macedonia is regulated by the Law on Budgets. The amendments to the law in 2008 made changes to the budget preparation calendar, but the main stages and characteristics of the process remained unchanged. In general, the process complies well with baseline standards in terms of the sequencing of steps and the definition of roles, although the time allotted to some of the steps may be too short. It also tries to comply with most of the essential points contained in the baseline standard. However, it is not at all clear whether the attempts to comply have always been successful.

The first step is the government's agreement on its main strategic priorities in mid-April. It agrees on its fiscal strategy by 31 May, using an assessment and forecast of central macroeconomic parameters provided by the Ministry of Finance. The fiscal strategy sets expenditure ceilings for about 30 budget-users and for each of the four funds, which correspond to a quasi-functional allocation structure. However, budget ceilings set early on are usually altered during the preparation process, which may undermine fiscal discipline. The procedures for setting overall expenditure restrictions are therefore not fully consistent with a top-down approach to budgeting, where available resources determine the scope for government policy.

Then by 15 June the Ministry of Finance issues the annual budget circular to the approximately 30 budget-users and the four funds. This circular is consistent with the government's strategic priorities, its overall fiscal strategy and the above-mentioned expenditure ceilings. The circular also includes macroeconomic forecasts and technical issues concerning the preparation of draft budget requests. An explicit attempt is made to take into account factors that affect expenditure, such as macroeconomic parameters, volumes of entitlement systems or recently agreed new policies. Policy changes not agreed by the government may not be included. A high degree of discretion is given to the heads of main budget-users in dividing the budget between subordinate budget-users and in deciding how to allocate available resources. It is unclear how this can be effective, however, given that many managers at senior level within line ministries do not know how much money is spent in their area. However, the Budget and Funds Department has primary responsibility for calculating salary expenditure provisions, using data from an employee register maintained by one of its units.

The draft budget requests must be submitted to the Ministry of Finance by 15 August. These budget requests include strategic plans of each institution, covering programmes and activities for the realisation of the government's strategic priorities as well as the goals of the budget-user over the next three years. However, as mentioned in the previous section, very little credence is attached to the projections beyond the upcoming fiscal year. This calls into question the value of the three-year Strategic Plans that ministries are required to submit along with their budget submissions. If budgetary planning is poor, it is difficult to see how the strategic plans can be robust in terms of service delivery.

The Ministry of Finance scrutinises the draft requests and prepares a draft budget proposal for submission to the government by 1 November. After adopting the draft budget, the government submits it to parliament by 15 November, where it is discussed for a minimum of 20 days before its adoption by 31 December. While it has been suggested that this element of the process would be enhanced by submitting the government's budget proposal to parliament at least three months prior to the start of the fiscal year (as recommended, for instance, in OECD's *Best Practices for Budget Transparency*), account should be taken of the challenges associated with fiscal forecasting in a small administration such as Macedonia's. Beginning the process at an earlier stage or attempting to telescope other parts of the budget formulation cycle could lead to even weaker projections, which could unravel before the new fiscal year begins. Therefore, while the earlier submission of the proposed budget should remain a goal for the future, it could be sufficient for the moment to facilitate better debate within the existing timeframe, along the lines recommended at the end of section 2 above.

The structure and sequencing of the budget preparation process largely follows international good practice. However, this process could be somewhat restructured to strengthen top-down elements. The expenditure ceilings set in the early stages of the budget process should follow a more purely functional division to facilitate the process of setting political priorities between areas and should not be negotiable at a later stage due to increased expenditure pressure. So that budget-users better assume responsibility for their budget proposals, the capacity for analysing and compiling financial aspects should be improved, with regard to both the next fiscal year and the medium term. Furthermore, reforms that will improve the capacity of parliament to analyse and debate the budget should be introduced. While the capacity for performance-oriented evaluation should be improved – both at the level of the budget-user and in the Ministry of Finance – this should be a much more long-term goal.

8. Budget Management of Public Investments

The key to complying with the required standards for managing public investments is the capacity to ensure that multi-annual development programmes are approved only after being subjected to sound technical and economic appraisal. This requires close co-ordination between partners at various levels of government and across ministries. It also demands the integration of procedures for preparing and approving budget proposals for capital expenditure with procedures for current expenditure.

Appropriations for investment purposes are presented in the state budget. As already stated, with the exception of salaries, the Budget Department does not take a lead role in dividing between items in the budget. In Macedonia, therefore, budget-users enjoy a high degree of autonomy with regard to investment proposals, where they are responsible for the current/capital allocation between investment projects and current expenditures. However, it is doubtful that line ministries have the capacities to subject investment proposals to the required appraisal. Therefore, it is almost certain that there is sub-optimal allocation between capital expenditure and current expenditure, with many capital projects being decided on the basis of spurious appraisal techniques. In addition, it is likely that the current costs directly associated with an investment project are regularly underestimated.

The Macedonian authorities see the introduction of the concept of development programmes within the budget allocations for users as being the main improvement in the past year. While the introduction of a development programme plan is a step towards closer integration of capital investment within the budget allocation process, this change has not resolved the previous problem

whereby the evaluation of capital investment projects were for the most part separated from the process of preparing the budget items. For example, the Law on Budgets requires the draft development plans submitted by budget-users to be harmonised with their strategic plans, but in view of the budget calendar this requirement would be impossible to fulfil. Furthermore, the development programmes do not distinguish between capital and current expenditures.

It had been intended to replace the Public Investment Programme (PIP) with a development programme plan, but this has not happened. The PIP has been published for 2009-2011 and there has been no mention of it being discontinued in the immediate future. It is also worth noting that the PIP states that, with a view to furthering economic growth, “fiscal policy would continue to be more relaxed in the area of capital investments”. This suggests an assumption that capital investment always has a return on that investment, which is not necessarily the case.

The record of capital investment projects being completed on budget and in the time envisaged has been poor. To improve this situation, funds for investments from the development programme plan may be carried forward and used during the first half of the next budget year. However, budget-users are required to spend at least 30% of the annual capital budget in the first half of the year, which will surely have the opposite effect on the carry-over regulation by inciting budget-users to incur inefficient expenditures in order not to lose the funds that have been budgeted.

Capital projects require careful appraisal and management to ensure that they are cost-effective and are delivered on schedule and within budget. While the requisite skills and expertise are frequently in short supply or not available within the public service in many administrations, it would be better to improve the patterns of management (including planning) of capital investment funds rather than trying to regulate them. Thus, there is a need to further develop staff capacity in running investment projects and in liaising with donors. Comprehensive guidelines for appraising and managing capital investments should be compiled and be complemented by a project management training programme.

Furthermore, much still remains to be done in terms of integrating investments into the budget process. Efforts should therefore be made to strengthen the capacity of the Budget Department to prepare the budget for investment purposes alongside the budget for current expenditure. Such an arrangement would have the potential of enhancing the effectiveness of capital investments at the same time as overall fiscal control increases. Finally, the “30%” rule, which can only encourage inefficient spending, should be scrapped.

9. Budget Execution and Monitoring

Budget execution is thoroughly regulated by the Law on Budgets, the annual Law on the Execution of the Budget, and the guidelines for Treasury operations. Furthermore, the system works quite well in practice and complies with the baseline standards in many respects.

The execution of the budget is based on the apportionment of the annual budget for each budget-user, which is reflected in a quarterly financial plan that each budget-user is required to submit to the competent line ministry or first-line budget-user. The budget-users are then obliged to consolidate these financial plans and submit them to the Ministry of Finance. These financial plans may be revised during the year. Budget-users also prepare a monthly financial plan (based on the quarterly financial plan) according to budget classification, which is submitted to the Treasury for approval before the beginning of the quarter. The quarterly financial plans may be changed within the limits approved for the respective quarter.

The general rules for reallocation during the budgetary year allow for the redistribution of a maximum of 15% of line-item appropriations, with Ministry of Finance approval (although salaries may not benefit from a reduction in other budget items). Parliamentary approval is required for any transfer above 15% or between central government budget-users and the funds. The Treasury indicated that reallocation is excessive due to poor planning capacity within budget-users and that it ties up a considerable amount of personnel resources in the Ministry of Finance. It had been expected that this situation would improve with the introduction of new budget and accounting software in 2008 that

would allow personnel to devote more time to analytical and planning activities. However, this does not seem to have happened and there has certainly been no mention of any improvements in this regard by Ministry of Finance personnel.

The budget execution process is heavily focused on expenditure control through a consolidated Treasury Single Account. In addition, a commitment ledger, in which budget-users are required to register financial commitments above 3000 EUR in advance, has been put in place.

When a payment is due, the respective budget-user issues a payment request and sends it, either electronically or in paper format, to one of the 17 regional offices of the Treasury. The Treasury verifies whether a requested payment is in line with the submitted payment plan, corresponds to what has been entered in the commitment ledger, and matches the purpose stated in the budget. It also verifies whether there is a sufficient balance in the appropriate account. If the request is approved, the Treasury sends a payment order to the Central Bank, which is responsible for the payment system. Executed payments are registered in the Treasury General Ledger.

All government entities, including the four funds and municipalities, are incorporated in the Treasury Single Account. Donor funds, apart from EU funds, have also been incorporated into the system. Through cash planning, based on the historical trends of payments and the information in the commitments ledger, the Treasury has a reasonably good picture of its cash position. Furthermore, while liquidity pressures have arisen occasionally in recent years, the close co-operation between the Treasury Department and the Debt Management Department minimises the danger of liquidity impeding expenditures. In recent years the government has built up reserves in the Central Bank, which could yield higher returns if managed more effectively. However, the objective of obtaining higher yields means higher risks, and it may be that a lower-yield but less risky approach is more appropriate when the objective is to maintain a sufficient balance in the Central Bank.

This system has fundamentally been designed for Treasury and budgetary control purposes. It is unclear as to how relevant the information made available by the system is to the needs of line management in the wide range of the various budget organisations. Moreover, the centralised control of individual payments reduces flexibility at the level of budget-users. Nonetheless, the existing system should remain, given the relatively weak internal financial control systems among budget-users. It is unclear whether arrangements exist to secure systematic reconciliation between the Treasury system and budget-users' own accounting systems. For instance, the Ministry of Finance has difficulty in reconciling returns from some municipalities with the information supplied by the Treasury. Before the existing treasury control mechanisms are reduced, it is vital to ensure the sufficient control of financial resources by alternative control systems.

The budget execution and monitoring elements of the process have remained unchanged over the past few years. To further minimise the possibility of cash shortages, liquidity management and the access to liquidity markets are being further developed. Centralised budget execution through the Treasury provides a solid control of payments and makes it possible to closely monitor adherence to the detailed line-item specification in the budget. Given the budget-users' mandate to make reallocations at the most detailed level of economic classification and the relatively smooth process of reallocating funds between line-items where the approval of the Ministry of Finance or the government is required, there is definitely scope for better operational efficiency. The overall objective should be to gradually decrease the number of lines in the budget and relax the tight, centralised payment control system. This can only be done, however, after the budgetary management and control process has been strengthened in budget-users.

10. Accounting and Reporting

Budget accounting and reporting is based on cash transactions registered in the Treasury General Ledger. Commitments are also entered into the system. Most of the reporting is produced by or through the Treasury Department, although budget-users are also required to keep their own accounts. The centralisation of budget accounting facilitates the production of budget execution reports, which

can be used to monitor the development of in-year revenue and expenditure. The Treasury produces reports on the cash execution of the budget with virtually no delay. Daily reports showing payments and the balance on sub-accounts in the Treasury Single Account are sent to the Minister of Finance and to the Prime Minister, as well as being made available to budget-users. Monthly reports, showing deviations from the planned budget, are produced and distributed to the government within 30 days after the end of the month. These reports are also published on the Ministry of Finance's website. A semi-annual report on budget execution is sent to the government and published no later than 31 July.

Since the chart of accounts is identical for all budget-users, it is simple to compile aggregated information on government finances. The chart of accounts is based on the IMF General Finance Statistics (GFS) 86, with a certain modification of the updated GFS 2001. In recent years, work has begun to move to GFS 2001 and to make the chart of accounts compatible with the European System of Accounts (ESA) 95. While producing ESA-compatible accounts should be a priority, it is not clear whether any significant progress has been made towards this objective.

According to the Law on Accountancy, the final accounts are to be submitted to the State Audit Office and the Central Registry by end-February. According to the Law on Budgets, the Minister of Finance is required to submit to the government by 31 May the final accounts of the previous year's budget, together with the audit report of the State Audit Office. After approval by the government, the final accounts are to be submitted to parliament no later than 30 June. As stated previously, however, since this is not a consolidated set of accounts its usefulness is limited. There is no formal parliamentary debate associated with the publication of the report. While it could be argued that structures need to be put in place to facilitate debate, it should be noted that the report is used in the monthly "question time" of the Minister of Finance.

There has been talk of the move to accrual accounting and of the need to develop performance reporting. While these are necessary steps in the longer term, it is considered that before they are introduced other areas should be given priority. If there is to be an increased emphasis on performance reporting, the focus should be on keeping it simple, with just a few overall performance measures. As in most OECD countries, performance information should be aimed at informing, rather than determining, the allocation of resources. As for accruals, given the complexities of managing such an accounting system, it should not be a priority for an administration at the stage where the Macedonian administration now stands. While the move to the mainly accrual-based ESA 95 is to be encouraged, this is not a full accruals system and, in any event, the basic building-blocks of these returns for several EU Member States are cash-based accounts.

For the purpose of monitoring budget execution, cash-based accounting is clearly appropriate. While the introduction of full accruals-based accounting is a longer-term target, it is not an immediate priority, particularly as the cash-based accounts can be used as the basis for the ESA 95-based accounts that should be developed in the more immediate future. The issue of the government's submission of the final accounts to parliament needs to be reviewed so that consolidated accounts may be compiled and published.

11. Capacity to Further Develop the System

The system for managing public expenditure is fundamentally adequate. However, greater efforts must be made to improve capacity and competence throughout the administration in order to comply with good international practice. There needs to be a greater delegation of authority and accountability throughout the administration. In this regard, it is important to enhance the appropriate qualifications of staff in ministries (including the Ministry of Finance) and in budget-users. While remuneration levels may make it difficult to recruit and keep the required competence, attempts must be made to ensure that staff who receive training, thereby increasing their skills and attractiveness to private sector employers, do not leave at short notice, without first having trained colleagues to succeed them. On the other hand, these restrictions cannot be so severe that they discouraged staff from undertaking training in the first place.

Another key challenge involves improving co-operation between policy departments and departments responsible for financial management – currently, developments in public expenditure management are carried forward without any real internal demand for these changes, and therefore the public expenditure management system does not support the actual decision-making process. The recommendation made in the context of public internal financial control in Macedonia² to upgrade the financial function in budget institutions may contribute to improving this situation.

Previous reforms have been ambitious and have produced results. The Macedonian authorities have assumed responsibility for modernising expenditure management and are clearly committed to a reform agenda. To continue such improvements, consideration should be given to elaborating strategic plans in some key areas, such as accounting, financial management systems and budgeting, management and control. Such initiatives would benefit from political commitment, the assignment of responsibility and a mandate to a task group in charge of the reform programme, sufficient and unambiguous financing for projects, and a structured sequence of reform steps. The role and scope of technical assistance should be clearly spelled out.

Reform in the area of fiscal management has benefited from the support of multilateral organisations, such as the World Bank, the International Monetary Fund and the European Commission, as well as from bilateral technical assistance programmes. To optimise the resources offered to the Macedonian administration, it is important to co-ordinate these projects and – in the worst cases – to avoid any conflicting advice.

² See Sigma's 2009 assessment report on Public Internal Financial Control (PIFC) in the former Yugoslav Republic of Macedonia.